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1 Overview

The analysis in this report is confined to the end of the first quarter, and mainly covers the period July-September 2013 and the outlook.

1.1 Economic Review

FY13 ended on a positive note for Pakistan's economy: political transition remained smooth in June 2013, and the new government spelled out its policy focus on energy issues, which had suppressed growth in the previous few years.[1] In addition, several other factors had positioned the economy to post a recovery in Q1-FY14, including: adoption of alternate fuel sources by industrial sector in past few years; initiation of talks for the new IMF program; single-digit headline inflation throughout FY13; and a 300 bps reduction in discount rate during FY13, which triggered some pick-up in manufacturing loans – in addition to reducing the government's debt servicing burden.[2,3] However, as FY14 proceeded, structural weaknesses in the economy started taking a toll, and concerns started to emerge about the sustainability of economic recovery.

Since macroeconomic indicators were favorable at the start of the year, the increase in real GDP growth in FY14 was discernible. Estimates for first quarter growth exceeded expectations: GDP grew by 5.0 percent during Q1-FY14, compared to only 2.9 percent in Q1-FY13, and a target of 4.4 percent for the full year (**Table 1.1**). As anticipated, industry and services were the major drivers of growth, as agriculture performed below-target.[4]

Agriculture under-performed due to water shortages at sowing time, and soft agri prices globally (mainly cotton), which reduced the area under cultivation. In addition, pest attacks and heavy rains before the harvest season, also damaged the standing crops (**Chapter 2**). While nothing significant can be inferred about

[1] This focus was manifested in a partial settlement of circular debt during June 2013, along with a commitment of full settlement within 60 days.
[2] Interest payments during Q4-FY13 were reduced to Rs 218.8 billion, compared to Rs 264.5 billion in Q4-FY12. The decline in interest rates was expected to mitigate some pressure on interest payments during FY14 arising from the sharp increase in public debt stock.
[3] Loans to manufacturing sector were increased by Rs 58.9 billion in FY13, compared to only Rs 4.5 billion in the preceding year.
[4] Pakistan Bureau of Statistics has released only the growth numbers of quarterly GDP so far, and the volumes of nominal and real GDP are not yet released.

the services, till the detailed information is available, improved energy supplies and higher capacity utilization were mainly responsible for a broad-based improvement in the industrial sector. The rebound in the fertilizer sector, which alone contributed 35 percent of LSM growth in Q1-FY14, can be traced to better gas availability; in the case of steel, higher capacities and alternate fuel arrangements weighed in (**Chapter 2**). Furthermore, lower palm oil prices in the international market helped the domestic edible oil sector.

Table 1.1: Selected Economic Indicators

	Q1-FY13[E]	FY14[T]	Q1-FY14[E]
Growth rate (percent)			
Real GDP	2.9	4.4	5.0
LSM	0.5	4.0	6.3
CPI (period average)[1]	9.1	8.0	8.1
Private sector credit	-2.5	NA	-0.5
Money supply (M2)	0.7	NA	0.2
billion US dollars			
Tax revenue (FBR)	411.0	2,475.0	481.0[3]
Total liquid reserves	14.9	NA	9.8
Worker remittances	3.6	15.1	3.9
Direct investment in Pakistan	0.1	2.1	0.2
Current account balance	0.4	-2.9	-1.2
percent of GDP[2]			
Fiscal balance	-1.2	-6.3	-1.1

[E] Estimate; [T] Targets set by the government in the Annual Plan for 2013-14;
[1] YoY growth in the average of CPI index for the quarter;
[2] Based on the full-year GDP estimates stated in the Annual Plan for 2013-14; NA: not applicable;
[3] This is the revised number, reported in the FBR's Quarterly Review for Jul-Sep 2013. The Ministry of Finance has reported provisional number (Rs 468.5 billion) for FBR tax collection, in its fiscal operations data for the period.
Source: State Bank of Pakistan, Federal Board of Revenue and Pakistan Bureau of Statistics

As the industrial sector revived, import pressures reappeared, especially for capital goods and raw materials. The import of petroleum, machinery, and metal, was particularly strong, which increased the trade deficit by US$ 0.6 billion during Q1-FY14 over Q1-FY13. Additional stress on the current account came from delayed inflows of coalition support fund (CSF) in Q1-FY14; in Q1-FY13, payments under CSF had turned a current account deficit into a surplus.[5] As a result, the current account posted a deficit of US$ 1.2 billion in Q1-FY14, against a surplus of US$ 0.4 billion in Q1-FY13. Putting this in perspective, this deficit used up to 10.9 percent of the country's liquid FX reserves, available at the start of the quarter (**Table 1.2**). Although worker remittances posted an impressive 9.1 percent growth, this was not enough to cover the FX gap in other heads (**Chapter 5**).

Financial flows did not help either. Repayments on external debt continued to exceed fresh disbursements; and foreign investments still remain shy. This caused a strain on the country's FX reserves, which posted a decline of US$ 1.2 billion during the quarter. Meanwhile, the government was already in negotiations with

[5] Current account had posted a surplus of US$ 0.4 billion in Q1-FY13, however, excluding coalition support fund, this account turned into a deficit of US$ 0.7 billion.

the IMF for an extended fund facility (EFF), which had become necessary in the face of lumpy IMF-SBA repayments; and almost non-existent FDI. As a prior action for this program, SBP purchased US$ 125 million from the interbank market during July and August 2013, to shore up its reserves. SBP's net international reserves (NIR) were US$ -3.2 billion at the end of the quarter, which was lower than the adjusted target of US$ -2.9 billion agreed with the IMF.[6,7]

Table 1.2: External Payments as % of Liquid FX Reserves*
percent

	Q1-FY12	Q1-FY13	Q1-FY14
Trade balance	-22.8	-23.7	-38.5
Current account balance	-7.3	2.9	-10.9
IMF debt servicing	0.6	3.1	7.9
Total external debt servicing	4.7	7.3	16.3

*calculated as imbalances during the quarter, as percent of total liquid FX reserves of the country at the start of the quarter.
Source: State Bank of Pakistan

The PKR depreciated by 6.0 percent against the US Dollar during Q1-FY14, compared to only 0.3 percent in the first quarter of the previous year. In addition to a larger external deficit and SBP's FX purchases from the interbank market, pressures on PKR also came from adverse market sentiments. More specifically, when the IMF released the detailed *letter of intent* in September 2013, the market focused on future FX purchases by SBP to meet subsequent NIR targets. This even caused the interbank rate to touch a record-high of 110.5 on 26th September 2013, before closing at 105.35 on the same day (**Chapter 5**). This unprecedented movement in a single day was triggered by the settlement of a large oil payment, which caused some misperception in the FX market. When this settlement was made later in the day, the interbank market returned to normal. The fact that the interbank rate settled so quickly, reflects how adverse market sentiments can trigger exaggerated movements in the PKR.

This level of PKR depreciation was partially responsible for the increase in inflationary pressures in the country (**Chapter 3**). More specifically, weaker Rupee not only triggered inflation expectations, but also pushed up prices of imported items like petroleum products. The impact on headline inflation was

[6] The IMF defines net international reserves (stock) of the (SBP) as the US Dollar value of the difference between usable gross international reserve assets and reserve-related liabilities, evaluated at the program exchange rates.
[7]Two factors explain this deviation in end-September 2013. First, the target was based on optimistic balance of payment projections; and second, the target and adjustor were derived using a definition that was inconsistent with reserve accounting practices. In Q1-FY14, the overall external balance was a deficit of US$ 1.2 billion against a deficit of US$ 0.2 billion projected by the IMF. In the first review of the EFF program in December 2013, the IMF significantly revised its balance of payment projections for the second and third quarters of FY14; rationalized the NIR target for end-December 2013; and rectified the definition of NIR and it adjustor.

exacerbated by liberal export of onions; lower wheat stocks;[8] and the collusive behavior of traders and distributors, which pushed food inflation into double-digits (**Chapter 3**).[9] Headline CPI inflation increased to 8.1 percent in Q1-FY14, compared to only 5.6 percent in the preceding quarter.[10] Under these circumstances, if nominal interest rates were left unchanged, it would have undermined SBP's efforts to rein in the second-round effect of food inflation and curb inflation expectations. The revision in monetary policy was also required to counter market sentiments following the volatile PKR.

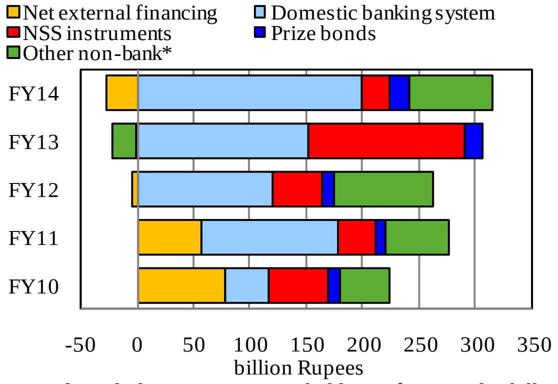
Therefore, SBP increased its policy rate by 50 bps to 9.5 percent in the monetary policy decision announced in September 2013 (**Chapter 3**). This policy tightening was required despite the fact that monetary growth was already subdued; the growth in broad money supply (M2) during Q1-FY14 was only 0.2 percent, compared to 0.7 percent in the corresponding quarter last year.[11] This trend can primarily be traced to a rise in the external deficit, which reduced the NFA of the banking system by 64.4 percent during the period.[12]

NDA, on the other hand, posted an increase of 2.3 percent during the quarter, mainly on the back of high budgetary borrowing from the banking system, and lower net retirement of private sector credit. The latter is partially explained by the re-emergence of circular debt in the energy sector from August 2013 onwards, which increased borrowings by petroleum refineries and IPPs. This, coupled with higher credit demand from fast moving consumer goods (FMCGs) and the textile sector, offset most of the seasonal retirement. A positive development was the higher credit off-take for fixed investment purposes; energy, food, cement and paper industries borrowed long-term loans from banks to finance capital expenditures. As far as budgetary borrowing from the banking system is concerned, this was higher than the previous year due to a decline in financing

[8] For instance, wheat stocks available with Punjab Food Department were only 491.5 thousand MT at end April 2013, compared to 3500 thousand MT available with the authority at end April 2012.
[9] Prices of fresh vegetables remained particularly strong in Q1-FY14. For instance, onions prices posted an inflation of 50.7 percent YoY in Q1-FY14. Its price increased from Rs 31.2 per kg on average in Q1-FY13, to Rs 47.0 per kg in Q1-FY14. Similarly, price of tomatoes increased from an average of Rs 46.0 per kg in Q1-FY13, to Rs 83.0 per kg in Q1-FY14. Potato was also expensive this year, as its price increased from an average of Rs 29.1 per kg in Q1-FY13, to Rs 32.8 per kg in Q1-FY14.
[10] After increasing to 10.9 percent in November 2013, CPI inflation tapered to 9.2 percent and 7.9 percent in December 2013 and January 2014, respectively.
[11] Since SBP monetary policy is forward looking, the decisions on interest rates are not based on the previous data, but on the forecast of key macroeconomic variables.
[12] In absolute terms, the NFA of the banking system declined by Rs 173.2 billion in Q1-FY14, compared to an increase of Rs 11.8 billion in Q1-FY13.

from domestic non-bank (especially NSS) and external sources – the size of the fiscal deficit during the quarter was fairly modest compared to the same period last year (**Figure 1.1**).

Figure 1.1: Composition of Budgetary Finance during Q1



* mainly includes corporate sector holdings of PIBs and T-bills
Source: Ministry of Finance

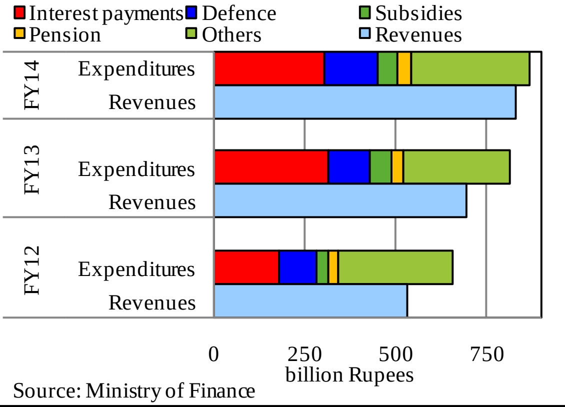
Within the banking system, government borrowing from the central bank was more pronounced, as commercial banks did not participate actively in T-bill auctions held during the quarter. This apparent disinterest was actually the outcome of prevailing uncertainty ahead of the new IMF program, regarding the future course of interest rates. 6-month and 12-month T-bills were perceived to be unattractive instruments, because expectations of a rise in interest rates (as part of the IMF program) were strong.[13,14] Therefore, banks offered much less in these auctions compared to the target volumes, and on-going maturities (**Chapter 3**). In effect, the roll-over risk and interest rate risk facing the government, which we have highlighted in our previous reports, were partially realized during the quarter. As banks were not willing to reinvest their maturing T-bills, the government had to rely on central bank financing through most of the quarter.

As a result, the government could not meet the limit of zero quarterly borrowing from SBP, though its borrowings were well below the limit agreed with the IMF.[15] However, as discussed later, this reliance on central bank fell after the increase in interest rates in mid-September 2013.

The fiscal deficit fell to 1.1 percent of GDP in Q1-FY14, from 1.2 percent in the corresponding quarter last year.[16] This improvement occurred on both the revenue and expenditure sides. Tax revenues grew by an impressive 19.0 percent YoY in

[13] In the auction held on 5th September, not a single bid was offered for 6-m and 12-m T-bills.
[14] Interbank market was anticipating an increase in interest rates also because of prevailing inflation expectations.
[15] The *stock* of budgetary borrowings from SBP at end-September 2013 was Rs 2,521 billion, against the ceiling of Rs 2,690 billion.
[16] In absolute terms, fiscal deficit posted a marginal increase from Rs 283.8 billion in Q1-FY13, to Rs 286.9 billion in Q1-FY14.

Figure 1.2: Improvement in Revenue Balance during Q1 (Revenues vis-a-vis Current Expenditures)



Source: Ministry of Finance

Q1-FY14, compared to only 10.3 percent in corresponding quarter last year. Non-tax revenues also posted healthy growth of 21.5 percent over the first quarter of the previous year, despite the absence of CSF inflows. On the expenditure side, interest expenses posted a *reduction* of 3.7 percent YoY, which was the single-most stressful item in the previous year. In overall terms, the primary balance posted a surplus of 0.1 percent of GDP, whereas the revenue deficit was brought down by 0.4 percentage points (**Figure 1.2**).

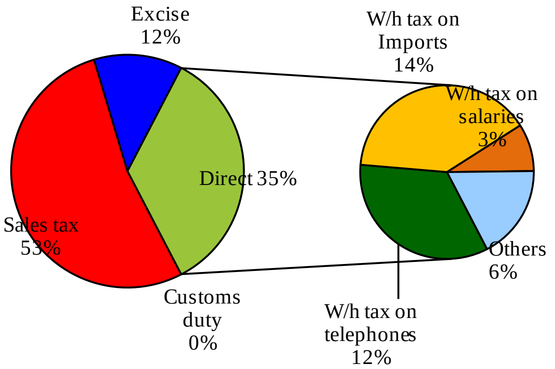
This improvement in the fiscal accounts primarily represents revenue measures announced in the 2013-14 Annual Budget (**Chapter 4**). In addition to these measures, the government has formulated a medium-term strategy for implementing fiscal reforms in the economy, ranging from improving tax administration, to privatizing loss-making PSEs. However, the policy mix which delivered the better fiscal outcome in Q1-FY14, may not be sustainable in the medium-to-long term; tougher decisions on energy prices and institutional reforms are yet to be taken, and legal complications related to higher prices, add to the challenges facing the government (e.g., the partial reversal of the August 2013 increase in power tariffs, and suspension of gas infrastructure development cess in July 2013 till December 2014).[17]

On the revenue side, it was the increase in tax rates and *not* the base, which is responsible for higher collections during the quarter. Specifically, more than half of the increase in tax revenues came from sales tax collection, which followed the 1 percentage point increase in the standard GST rate stated in the Annual Budget 2013-14 (**Figure 1.3**). The improvement in direct tax collection, can also be traced to higher withholding tax rates. For instance, the increase in collections from mobile phone subscribers, which contributed 34.0 percent to the *increase* in direct tax collections, came from a 5 percentage point rise in the withholding tax

[17] The cess was later revived in January 2014.

rates during the quarter.[18] Similarly, the contribution of tariff rationalization to the increase in withholding tax on imports, was fairly significant.[19] Furthermore, a rise in tax collection from salaries and corporate dividends *also* came from rate increases, and a revision in salary slabs (for details on revenue measures, see **Box 4.1**).[20]

Figure 1.3: Composition of YoY *Increase* in Tax Collection during Q1-FY14



Source: Federal Board of Revenue

A similar trend was also visible in non-tax revenues; the gas development surcharge increased from only Rs 3.9 billion in Q1-FY13, to Rs 20.8 billion in Q1-FY14 due to a rise in the surcharge rate. However, the swing factor in non-tax collections was the mobilization of certain one-off revenues, which turned the YoY decline in these collections into an increase (**Table 1.3**). These one-off revenues included the dividend/mark-up received while settling the circular debt; and a transfer of Rs 67.6 billion in Universal Service Fund (USF) and Research & Development Fund

Table 1.3: Impact of One-off Non-tax Revenues during Q1

billion Rupees

	FY13	FY14
I. Development surcharge on gas	3.9	20.8
II. Other collections from energy sector	31.2	29.9
III. SBP profit	50.0	80.0
IV. Interest and dividends	16.0	60.6
of which: circular debt related (a)	0.0	56.7
V. Defence	107.3	1.9
VI. Universal service fund (b)	0.0	67.6
VII. Others	32.4	31.8
Total non-tax revenues (I to VII)	**240.8**	**292.7**
of which: **one-off revenues** (a + b)	**0.0**	**124.3**
Non-tax revenues excluding one-offs	**240.8**	**168.4**

Source: Ministry of Finance

[18] Withholding tax rates on mobile phone subscribers both prepaid and postpaid have been increased from 10 percent to 15 percent in the 2013-14 Annual Budget.
[19] For details, please see FBR Quarterly Review for Jul-Sep 2013-14.
[20] The government relies heavily on withholding tax because these are easily collected at source. However, since withholding taxes must be refunded if the amount deducted is above the total tax liability of the individual and businesses, this is only possible if the tax payer files his/her income tax form. Since many tax payers in Pakistan do not file their income tax returns, this reduces the volume of withholding taxes that the government must refund.

(RDF), from the Ministry of Information Technology to the federal consolidated fund.[21]

The impact of USF and RDF alone was 0.3 percent of GDP; excluding these one-off inflows, budget deficit would have increased to 1.4 percent of GDP during Q1-FY14. It is important to mention here that USF and RDF were mobilized with an objective to finance expansion of the IT and cellular infrastructure in the country; utilization of these funds for other budgetary purposes may defeat this objective.

Similarly, on the expenditure side, a major positive was the reduction in interest payments, following the interest rate cuts in FY13. Since debt servicing has been driving current expenditures in last couple of years, this factor alone was able to deflect the momentum created by excessive government borrowing.[22] Having said this, the burden of interest payments would increase in the second half of FY14, when payments on 6 & 12-month T-bills, issued in Apr-Jun 2013, would fall due.[23] Half-yearly payments on PIBs issued in Apr-Jun 2013 (for circular debt settlement) would also add to the debt burden. This implies that concerns about the debt-trap situation that we highlighted in the Annual Report 2012-13, may materialize later in the year.

The reduction in interest expense during Q1-FY14 was partially offset by a large increase in defence related expenditures. While a part of this increase represents salary and pension increments for defence employees, the rest can be traced to the cost of logistics borne by our armed forces for supporting NATO’s engagements in Afghanistan. The other big item – subsidies, remained stubbornly at the previous year’s level, despite a partial increase in power tariffs in August 2013.

As far as public debt is concerned, it posted a record increase of Rs 1.0 trillion during the quarter. This increase, however, does not represent the fiscal imbalances alone, which recorded only a modest increase. Instead, this increase can primarily be traced to large revaluation losses associated with the external

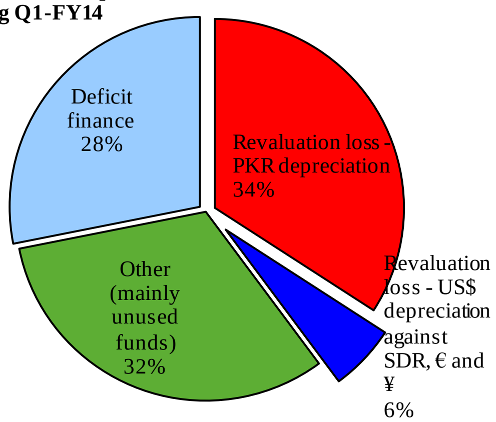
[21] Universal Service Fund was created in 2006, and became operational in 2007, as a public-private partnership. The major objective of the USF was to expand the telecom footprint to un-served and underserved areas of Pakistan. USF account, which is maintained by the Ministry of IT, gets funds from licensed telecom operators, who have been contributing 1.5 percent of their adjusted revenues to USF; and also from long-distance and international operators (LDIs), who have been contributing a part of their proceeds to the fund.

[22] Despite a sharp rise in outstanding debt stock last year, interest payments – that increased by 76.5 percent YoY in Q1-FY13, actually declined by 3.7 percent in Q1-FY14 (**Chapter 4**).

[23] More specifically, around 38 percent of the total increase in the government’s domestic debt during FY13, was mobilized in the fourth quarter (Rs 720.4 billion). Since banks were anticipating a fall in interest rates at that time, they were locking in their funds in 6 & 12-month T-bills.

debt stock due to adverse exchange rate movements during the period (**Figure 1.4**).[24] As far as the government's domestic debt is concerned, it increased by Rs 634.0 billion in Q1-FY14 – a large amount compared to the Rs 286.9 billion fiscal deficit during the quarter. The additional borrowing *over and above* the budgetary requirements, was kept unused in the government's deposits with SBP at end-September 2013 (**Chapter 4**).[25]

Figure 1.4: Composition of the *Increase* in Public Debt during Q1-FY14



Source: Ministry of Finance

Notwithstanding the contained spending by the government, we are still concerned about the increase in the public domestic debt. More specifically, the increase in domestic debt would have been significantly larger, if the government was not able to realize certain one-off revenues during the quarter. Furthermore, the government cannot increase tax rates *indefinitely*, to secure higher revenues, as such measures will start choking economic growth, which reduces the revenue generation capacity of the country. More worryingly, interest payments are likely to increase in the second half of the year. If the government is not able to mobilize funds from abroad, then pressures on domestic debt could increase significantly. Therefore, there should be no compromise on initiating broad-based fiscal reforms, to bring the public debt-to-GDP ratio on a declining trajectory.

In addition to fiscal reforms, there is a corresponding need to rebalance the maturity profile of Pakistan's domestic debt. The growing prominence of 3-month

[24] There were two adverse effects of exchange rate on external debt stock during Q1-FY14. First was the depreciation of US Dollar against Japanese Yen, Euro and SDRs, which increased the US Dollar value of external debt. And secondly, depreciation of PKR against the US Dollar, which increased the Rupee value of external debt.

[25] In fact, the government was able to mobilize these funds from active participation of commercial banks in T-bill auction held on 19th September – when uncertainty in the interbank market regarding interest rates, was finally over after the announcement of monetary policy, in which, SBP raised the policy rate by 50bps. On aggregate, Rs 515.9 billion was mobilized by the government in this auction, which is the highest ever amount raised in a single T-bill auction. Government deposited most of these funds with central bank, and later, retired SBP debt using these deposits.

instruments in the outstanding volume of T-bills requires attention.[26] As discussed in previous reports, this exposes the financial system to *interest rate* and *roll-over* risks. The latter is particularly challenging as Pakistan has agreed to quarterly performance targets that seek to limit government borrowing from SBP; if banks do not roll-over their debt in any one primary auction, the remaining amount is automatically borrowed from the central bank.[27] Hence, there is an urgent need to lengthen and spread out debt service payments by the government.

1.2 Assessment and Outlook

The EFF program with the IMF is on track, and Pakistan has been able to meet all the agreed targets, except SBP's NIR for end-September 2013, which was missed by a margin (**Table 1.4**).[28] Since the government is expecting significant volume of financial flows from abroad for the rest of the year, we expect an increase in the SBP NFA. However, this increase would largely substitute for the budgetary borrowings from SBP, which are already capped under the IMF program. As a result, we expect a moderate growth in reserve money, albeit with a significant change in its composition.

Tale 1.4: Pakistan: Quantitative Performance Criteria and Indicative Targets for FY14

	Q1		Targets	
Performance criteria	**Target**	**Actual**	**Q2***	**Q3**
Floor on net international reserves of SBP (million US$)	-2,850	-3,154	-4,130	-2,750
Ceiling on NDA of SBP (stock, billion Rupees)	2,877	2,595	2,901	2,627
Ceiling on overall budget deficit (excl grants, billions Rs)	419	297	882	1,209
Ceiling on SBP's stock of net foreign currency swaps/forward position (millions US$)	2,255	1,775	2,255	2,255
Ceiling on net government borrowing from SBP (including provincial governments, stock, billions Rupees)	2,690	2,521	2,560	2,390

*Second quarter targets and actual will be discussed in detail in the Second Quarterly Report for FY14.
Source: IMF

A more balanced composition of reserve money should help contain inflation expectations in the economy, which may also get some support from the relative stability in the PKR parity in Q2-FY14. Unchanged petrol prices during the last 3 months, and the recent decline in prices of perishable food items has brought back headline inflation to a single-digit. Nonetheless, some upside pressures still persist from the external deficit; a further increase in energy tariffs that are also

[26] The share of 3-m T-bills in total outstanding T-bills held by commercial banks has increased from only 5.9 percent at end-June 2013, to 40.0 percent at end-September 2013; and further to 64.2 percent at end-December 2013. Furthermore, the share of floating debt in the total domestic debt has increased from 54.6 percent at end-June 2013, to 57.2 percent at end-September 2013.
[27] As mentioned before, the roll-over risk was partially realized in Q1-FY14, as banks offered much less than on-going maturities in T-bill auctions, through most of the quarter.
[28] The SBP's NIR target for December 2013 was duly met.

required as part of the IMF program; and the recent surge in global commodity prices. Having said this, after the December CPI data was published, SBP has reduced its forecast for headline inflation to a range of 10.0 – 11.0 percent for the year, which is still higher than the target of 8.0 percent set by the government (**Table 1.5**).

Table 1.5: Projections for Major Economic Indicators

	Annual Target	IMF Forecast	SBP Forecast
percent growth			
GDP	4.4	2.8	3.0 – 4.0
CPI inflation	8.0	7.9	10.0 – 11.0
Money supply (M2)	NA	13.8	13.0 – 14.0
billion US$			
Worker remittances	15.1	14.7	14.0 – 15.0
Exports (fob-BoP)	26.6	26.9	26.0 – 26.5
Imports (fob-BoP)	43.3	43.4	43.0 – 44.0
Current account deficit	2.9	2.3	2.5 – 4.5
percent of GDP			
Fiscal deficit	6.3	5.5	6.0 – 7.0

NA: not applicable
Source: SBP, Planning Commission, and the IMF

In the external sector, the receipt of CSF inflows in October 2013, February 2014, and expected inflows of US$ 1.2 billion for the full-year, should ease some of the pressures on FX reserves. Moreover, proceeds from the 3G auction are also likely to add US$ 1.2 billion in the country's FX reserves in H2-FY14. Worker remittances have gathered pace in the second quarter, and may even meet the government's target of US$ 15.1 billion by end-FY14. In overall terms, the current account deficit is likely to remain in the range of 1.0 to 1.8 percent of GDP.

Pressures from inadequate financial flows are likely to ease going forward, as Pakistan has already made bulky repayments to the IMF, and scheduled repayments in the second half of FY14 will largely be compensated by disbursements under EFF (**Chapter 5**). More specifically, a net inflow of US$ 4.0 million is expected from the IMF in Q3-FY14, whereas in Q4-FY14, net repayment to the Fund will be limited to only US$ 75.0 million.[29] In addition, the government is expecting financing of around US$ 3.3 billion in the second half of FY14, through various sources including a new Euro Bond; disinvestments through the stock market; privatization proceeds from Etisalat; and structured transactions.

In the fiscal sector, while the uptrend in tax collection is expected to continue in the second half, a major positive would be the inflows under CSF and 3G auction, as mentioned above. On the expenditure side, however, interest payments are

[29] In the first and second quarter of FY14, net repayments to the IMF were US$ 311.0 and US$ 585.9 million, respectively.

likely to increase in the second half of this fiscal year. In overall terms, SBP's forecast for the full-year fiscal deficit is in the range of 6 – 7 percent of GDP.

In our view, economic growth is likely to remain in the range of 3 – 4 percent, despite optimistic estimates for Q1-FY14. In fact, the IMF is even more skeptical, and envisages a growth of only 2.8 percent. We believe the industrial sector will continue its impressive performance for the rest of the year, but agriculture would remain subdued due to a decline in cotton production, and below-target sugarcane production.[30] Within the services sector, some improvement is visible in *telecommunications* due to the better financial position of PTCL this year; and some increase in value-addition by *wholesale and retail trade*, following the rise in industrial production. As far as *finance and insurance* is concerned, commercial bank profitability has declined in Q1-FY14, but the full-year performance will become clear once the banks finalize their year-end audited accounts, and provide conclusive figures for provisioning and recoveries.

In order to maintain the current growth momentum, and to take the economy to a higher growth trajectory, the government should speed up structural reforms in the fiscal and energy sectors. By focusing on these sectors, the government has signaled that its priorities are correct; however, the policies should aim to *sustainably* manage long-standing issues, instead of implementing makeshift arrangements. In the external sector, the government is making all efforts to mobilize financial inflows by engaging with the IFIs, and the international market. Although these inflows will be important to shore-up the country's FX reserves, more substantive measures are required in the real sector, to narrow the imbalance in the current account.

The IMF staff mission has recently concluded its meetings with Pakistan's fiscal and monetary authorities. Broadly speaking, the mission has found the macro stabilization process in the energy and fiscal sectors to be on track. Furthermore, the government is following through with Budget measures to increase tax rates and withdraw some tax exemptions. Similarly, the government is also implementing the National Energy Policy, which entails reducing end-user subsidies and improving bill collections. Although it is too early to make any impact analysis on these efforts, we believe the continuation of this reform process is critical for the long-term success of fiscal consolidation efforts.

[30] Here, it is important to highlight that since PBS has not made public the methodology of quarterly national accounts, it is not possible to clearly identify seasonal factors for growth estimation. In our view, for instance, the impact of lower cotton production, and below-target sugarcane growth, will be evident in growth numbers from second quarter onwards, as the harvest for these crops come in full swing during Oct-Dec.

2 Real Sector

2.1 Overview

FY14 is the first year when quarterly national accounts were disseminated publicly. [1] It is encouraging to have these timely macroeconomic indicators for intra-year policy decisions, as these deepen and update the analysis upon which such decisions are based. Just as encouraging are the growth estimates for the first quarter: real GDP recorded an increase of 5.0 percent during Q1-FY14, compared to only 2.9 percent in Q1-FY13 (**Table 2.1**). This growth is heartening considering the target of 4.4 percent set for the year.

Table 2.1: Estimates of Economic Growth
percent

	FY13^{P}	FY14^{T}	Q1-FY13^{P}	Q1-FY14^{E}
Real GDP	3.6	4.4	2.9	5.0
Agriculture	3.3	3.8	2.7	2.5
Industry	3.5	4.5	3.1	5.2
Services	3.7	4.5	2.9	5.7

^{P} Provisional; ^{T} Target; ^{E} Estimates
Source: Pakistan Bureau of Statistics

The impetus to Q1-FY14 growth came from industry and services, as agriculture is below the annual target. While a number of factors can be identified that supported local industry this year (e.g., low palm oil prices; steady demand in advanced economies; higher capacities; and modest construction activity), we believe the deciding factor was the settlement of circular debt right on the eve of FY14, which improved energy supplies and enabled the industrial sector to capitalize on available opportunities (**Section 2.3**). Equally important was an increase in gas allocation to fertilizer sector, which rebounded strongly during the quarter.

Given this pick-up by local industry, and the rise in trade volumes that directly impacts *wholesale and retail trade*, services appears to have recovered from the previous year's weak performance. Value addition by *telecommunication* has also posted a recovery during the quarter on the back of impressive growth in broadband and international businesses.

[1] So far, the Pakistan Bureau of Statistics has released only the growth numbers of quarterly GDP. Actual GDP volumes are not yet released, and the methodology for computing the Quarterly National Accounts has still not been made public. We believe that quarterly GDP data will be more insightful, when these numbers are reconciled with the Annual National Accounts.

As far as agriculture was concerned, initial estimates suggest the growth in FY14 will remain lower than the previous year. Cotton crop has shown a production decline due to reduced area under cultivation, and lower yields, whereas sugarcane has remained below target. Water shortage during the sowing period, and excessive rainfalls before the harvest, has become a norm in the previous few years, which has kept agriculture growth below potential (**Section 2.2**).

2.2 Agriculture

Initial estimates suggest a decline in cotton, which more than offset the increase in sugarcane and rice production (**Table 2.2**). A detailed crop-specific assessment is presented below:

Table 2.2: Production Estimates of Kharif Crops

million tons, except for cotton which is in million bales

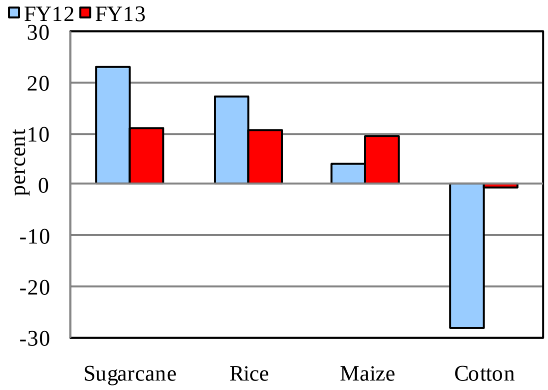
	FY13		FY14	
	Target	**Actual**	**Target**	**Estimates**
Rice	6.9	5.5	6.2	6.4
Sugarcane	59.0	62.7	65.0	63.0
Cotton	14.5	13.1	14.1	12.3

Source: Planning Commission, and Ministry of Food Security & Research

Cotton

The Cotton Crop Assessment Committee has estimated the size of FY14 crop at 12.3 million bales (170 kg each), which is well below the target for the year, and also FY13 crop (**Table 2.2**).[2] This decline can be traced to a fall in area under cultivation, particularly in Punjab,[3] as water remained short at sowing time,[4] while the crop did not earn enough in the previous season to make up for rising costs in this season.[5] Farmers were therefore more interested in growing maize, sugarcane and rice over

Figure 2.1: Trend in Prices of Major Crops (YoY growth of 12m average)



Source: Pakistan Bureau of Statistics

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[2] Pakistan Cotton Ginners' Association (PCGA) reports cotton arrivals at 13.1 million bales by 1st February 2014. We analyze cotton production as per the estimates provided by CCAC because size of bales quoted by PCGA is not standardized across time. Moreover, crop estimates provided by CCAC are used to prepare national income accounts.

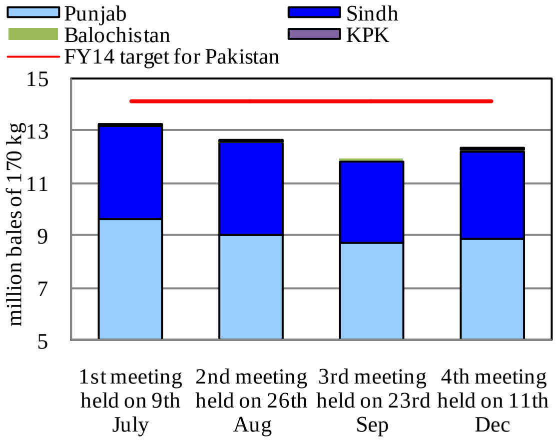
[3] In Punjab, cotton crop was planted on an area of 2.1 million hectare, showing an 11 percent decrease from the target, and 7.3 percent less from the last year's area sown.

[4] Water shortages at sowing time: irrigation water releases in Kharif 2013 season stood at 57.7 million acre feet, representing a shortage of 14 percent in this period compared to the average usage.

[5] While price of fertilizer and pesticides has respectively increased by 3.3 percent and 12.1 percent in Q1-FY14, cotton prices had declined by 0.8 percent in FY13.

cotton (**Figure 2.1**). In the post sowing period, conditions were not ideal: germination suffered due to poor quality seeds, and later, standing crop struggled with pest attacks, rains and high temperatures. Therefore CCAC, which had already estimated a lower-than-target crop size, further revised down its annual targets in subsequent meetings (**Figure 2.2**).[6] Fortunately, due to available inventory, demand for cotton from the textile industry was met, and the country was even able to export 36.9 thousand MT of cotton during the quarter (**Chapter 5**).[7]

Figure 2.2: Cotton Estimates by CCAC



Source: Cotton Crop Assessment Committee

Rice

Latest estimates show rice production of 6.4 million tons during FY14, which exceeds the target of 6.2 million tons. A strong recovery in Sindh and Balochistan over the previous year, more than offset the lower production in the Punjab.

Table 2.3: Rice Crop

	2012-13			2013-14		
	Basmati	Other	Total	Basmati	Other	Total
Area in 000 hectare						
Punjab	995	716	1,711	1,173	586	1,759
Sindh	0	511	511	0	741	741
KPK	0	49	49	0	48	48
Balochistan	0	38	38	0	179	179
Pakistan	995	1,314	2,309	1,173	1,554	2,726
Production in 000 tons						
Punjab	1,758	1,720	3,478	2,036	1,351	3,387
Sindh	0	1,844	1,844	0	2,366	2,366
KPK	0	94	94	0	91	91
Balochistan	0	120	120	0	577	577
Pakistan	1,758	3,778	5,536	2,036	4,385	6,421

Source: Ministry of Food Security and Research

Encouragingly, basmati rice which is mainly grown in Northern Punjab, recorded 15.8 percent increase over FY13, mainly reflecting a larger area under cultivation in Gujranwala. Being a mainstay of Pakistan's rice exports, a recovery in basmati production is a good sign for the country's external sector. As

[6] Production decline was more notable in Vehari, Multan, Sahiwal, Jhang and Okara districts of Punjab; and Ghotki and Shaheed Benazirabad districts of Sindh.

[7] The real short fall in the cotton crop depends on the requirement of local spinners. If they meet their requirement through imports, then local production is not hurt, but it impacts the balance of payments.

far as non-basmati varieties are concerned, despite a lower production in Punjab, the overall output rose by 16.1 percent in FY14, which was led by a sharp recovery in Sindh (particularly in Jacobabad, Kashmore, Shikarpur, Badin and Ghotki) and Balochistan. Export of these lower value varieties has increased recently, due to rising demand in China and Indonesia (**Chapter 5)**.

Sugarcane

Sugarcane continued to benefit from heavier rains, and the crop is expected to record an increase for the fourth consecutive year (**Table 2.4**).[8] Similar to FY13, the crop benefited from a larger area under cultivation, as well as higher yields.[9] Furthermore, farmers in some areas preferred sugarcane over cotton, which also enhanced the crop size. While the increased area can be traced to a sharp rise in procurement price in the preceding two years, yields also improved because of heavy rains and minor flooding.

Table 2.4: Sugarcane Crop

	2010-11	2011-12	2012-13	2013-14
Area in 000 hectare				
Punjab	672	761	760	724
Sindh	226	190	254	298
KPK	88	106	107	107
Balochistan	1	1	1	1
Pakistan	987	1,058	1,121	1,129
Production in 000 Tons				
Punjab	37,481	42,893	43,014	40,846
Sindh	13,766	10,788	14,909	17,371
KPK	4,030	4,684	4,770	4,772
Balochistan	31	31	32	32
Pakistan	55,309	58,397	62,724	63,022

Source: Ministry of Food Security and Research

Nonetheless, despite the rise in sugarcane production, sugar prices have surged in FY14. This increase was mainly due to delays in cane crushing, as the government's procurement prices came quite late in the season. A late arrival of fresh sugar, coupled with liberal exports of the commodity in H2-FY13, has put significant upward pressure on its domestic price (**Chapter 3**).[10]

[8] The data for FY13 in this table has been taken from Working Paper for Meeting of Federal Committee on Agriculture for Rabi Season 2013-14, prepared by Ministry of National Food Security and Research (MNFSR) in November 2013. The data for FY13 provided in this report differs from the one provided by PBS on its website: while MNFSR reports sugarcane production at 62.7 million tons in FY13, PBS estimates the same at 63.7 million tons.

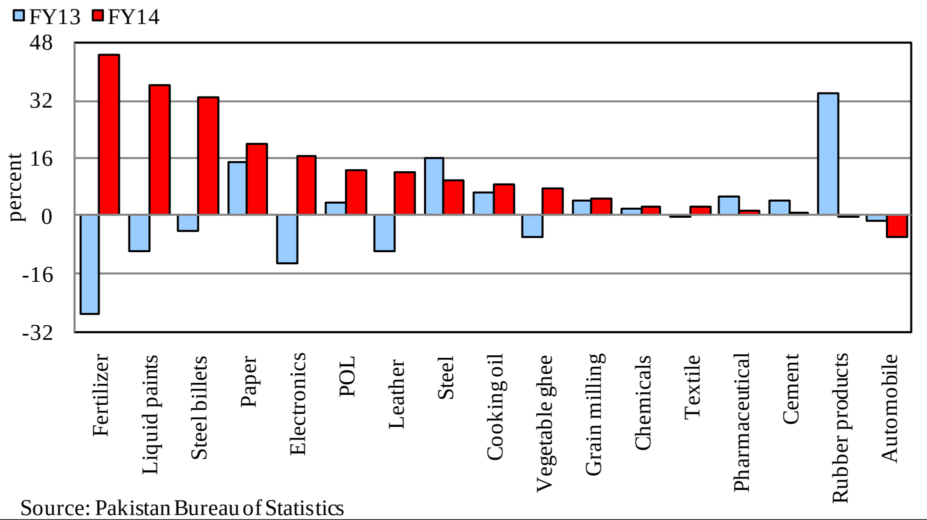
[9] The increased area under sugarcane crop in Sindh mainly reflects the impact of new sugar mills in Ghotki district.

[10] By end-November 2013, sugar prices have reached Rs 60.4 per kg, compared to 54.5 and 54.7 at end-June 2013 and November 2012, respectively.

2.3 Large-scale manufacturing (LSM)

LSM recorded an increase of 6.3 percent in Q1-FY14, compared to only 0.5 percent in the corresponding period of FY13. This strong growth came primarily from a rebound in domestic fertilizer production, as gas supply improved considerably (**Figure 2.3**).

Figure 2.3: Growth in LSM during Q1 (YoY)



Source: Pakistan Bureau of Statistics

In addition, the resolution of circular debt at end-June 2013, not only improved petroleum refining, but also benefited other industries by improving power supplies. Further support to LSM came from capacity enhancement; steady construction; increase in exports;[11] favorable palm oil prices during the period; and use of alternate energy sources by various industries (**Table 2.5**).

Favorable gas allocation benefited fertilizer

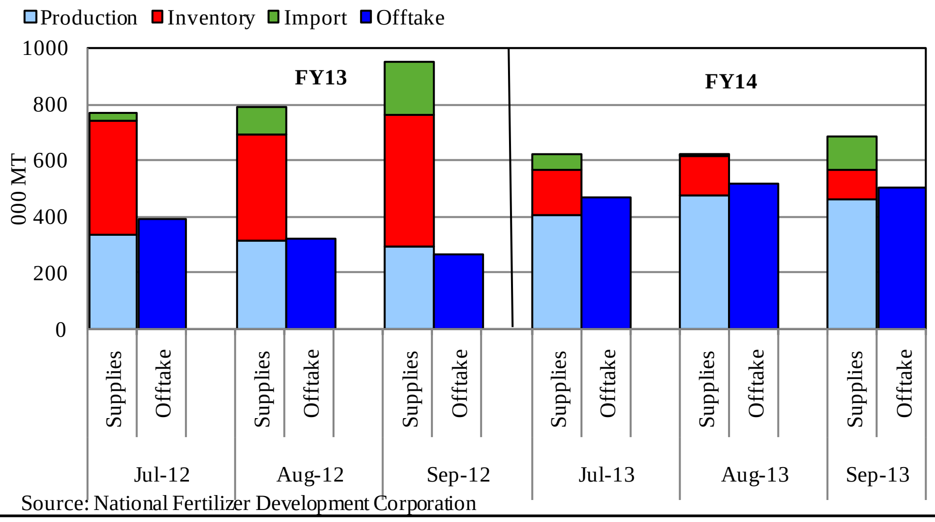
After a poor performance in the previous year, the fertilizer sector rebounded in Q1-FY14 as gas supplies to manufacturing plants improved, especially the Enven plant of Engro Chemicals (the largest in South Asia). This plant was earlier connected to the SNGPL network that was unable to provide the contracted volume of gas from Qadirpur fields. In April 2013, supply of Mari gas from Engro's base (old) plant was diverted to the Enven plant to enhance efficiency. Later in July 2013, the government decided to allocate an additional 60 mmcfd to Enven, as Guddu power plant – the key gas recipient from Mari fields – shut down for maintenance till March 2014. However, this additional gas is just a temporary

[11] Although textile and leather exports increased during Q1-FY14 (**Chapter 5**), these had a marginal impact on LSM growth.

arrangement, and as soon as Guddu power plant resumes operation, gas supplies to Engro are likely to revert to previous level. If this were to happen, Engro's old plant is likely to face production declines in Q4-FY14. Fatima Fertilizer also posted a sharp increase in production during Q1-FY14, as its plant successfully completed the Annual Turn Around (ATA) back in April 2013.

Higher capacity utilization in the fertilizer sector enabled the country to meet increased domestic demand for urea and other nutrients. However, production volumes remained lower than off-take throughout the quarter, causing a degree of inventory depletion (**Figure 2.4**).[12] Therefore, a rise in import was observed from September 2013 onwards, which is higher than the imports seen last year.[13]

Figure 2.4: Supply and Off-take of Urea Fertilizer



Source: National Fertilizer Development Corporation

Paper industry benefited from booming FMCGs and use of alternate fuels
Consolidating on its impressive performance last year, the paper industry posted strong growth of 19.6 percent during Q1-FY14. This growth can be traced to rising demand for packaging from fast moving consumer goods (FMCGs) – especially, processed food products that are thriving due to growing public awareness and popularity. Furthermore, similar to steel and cement, the paper industry has also shifted to alternate fuels to run smoothly, which has improved production (**Table 2.5** and **Special Section 2.1**). Specifically, one of the largest

[12] By end-September 2013, the country had stock of only 106 thousand MT of fertilizer, compared to 416 thousand MT at end-September 2012.
[13] In September and October 2013, the country imported 307 thousand MT of fertilizer; whereas last year, this amount totaled 250 thousand MT.

paper manufacturing plants, has recently installed coal/biomass fired boilers, with a capacity of 30 tons per hour of steam. This has reduced the company's dependence on natural gas, and had a positive impact on Q1-FY14 production.

Table 2.5: Use of Alternate Energy Sources by Various Industries in Pakistan

Industry	Conventional Energy Resource	Alternate Energy Resource
Steel melting	Electricity	Diesel-run generators
Steel re-rolling	Natural Gas: SNGPL,SSGC	Coal gasification plants
Textile composite	Natural Gas: SNGPL,SSGC	Combined-cycle power plants; waste heat recovery boilers
Textile spinning	Electricity	Diesel-run generators
Textile weaving	Electricity	Diesel-run generators
Textile dyeing/bleaching	Natural Gas: SNGPL,SSGC	Biomass/coal run boilers
Paper	Electricity, Natural Gas: SNGPL,SSGC	Coal/biomass run boilers
Ceramics	Natural Gas and LPG	Coal gasification
Leather	Electricity, Natural Gas: SNGPL,SSGC	Solar thermal boilers/diesel-run generators
Edible oil/ghee	Natural Gas: SNGPL,SSGC	Diesel run generators
Plastic	Electricity	Diesel run generators
Cement	Electricity	Coal/biomass/waste heat recovery
Caustic soda	Natural Gas: SNGPL,SSGC	Coal fired boilers
Soda ash	Natural Gas: SNGPL,SSGC	Coal /waste heat boilers
Polyester fiber	Natural Gas: SNGPL,SSGC	Combined cycle gas-run power plant
Pharmaceutical	Electricity	Diesel-run generators
Paints	Electricity	Diesel-run generators
Dairy	Electricity	Solar thermal boiler
Glass	Natural Gas: SNGPL,SSGC	LPG; initiated the arrangements for coal gasifiers
Sugar	Electricity	Bagasse/cogeneration

Source: Companies' websites; Financial Reports; Telephonic conversation

Improved liquidity helped petroleum refining

Settlement of the circular debt during June and July 2013, eased the liquidity constraints of petroleum refineries that enabled them to increase capacity utilization. As a result, production of petroleum products improved in Q1-FY14, after seeing a modest recovery a year earlier. Furthermore, demand for major petroleum products remained strong – while petrol sales were boosted by the continued shortage of CNG in the country, furnace oil sales recovered with the improving financial position of thermal power plants.

As far as high speed diesel is concerned, demand increased by 6.5 percent in Q1-FY14. However, increase in domestic production by 18.4 percent not only met the higher domestic demand, but also substituted import of diesel that declined by 17.5 percent during Q1-FY14. This switch in diesel supply can be traced to two reasons: first, in Q1-FY13, liquidity constraints did not allow local refineries to produce sufficient HSD that necessitated higher imports; and secondly, PSO imported extra diesel during Q1-FY13, anticipating lower domestic production and strong demand.[14]

Steady construction strengthened allied industries

Iron & steel industries were the major beneficiaries of steady construction activity in the country, these sectors operated at higher capacities in Q1-FY14. In particular, three new plants have started commercial operations in recent years; these plants have grabbed the market share of imported cold-rolled coil steel, by charging lower margins.[15] Importantly, the steel industry now seems largely immune to power shortages, since most of the newly established plants are running on captive power. In addition, anecdotal evidence suggests that some Punjab based steel plants switch to old tyres as alternate fuel when power shortages intensify.

In addition to steel, other construction allied industries also performed well (e.g., glass, and paints). In the case of cement, however, production was affected by a sharp decline in exports (**Chapter 5**). Local sales, on the other hand, posted a modest growth of 2.2 percent YoY in Q1-FY14, mainly due to Ramadan effect. In subsequent months, sales recovered especially in November and December 2013.[16]

Decent performance of exporting industries

The steady consumer spending in the US and Europe, supported exports in some of Pakistan's key industries like textile, leather and grain milling. For instance, as noted in some detail in **Chapter 5**, while the increase in production of cotton yarn can be traced to higher demand from China, cotton fabric benefited from rising demand in the EU. In case of leather, higher production was required to meet rising demand from European countries, including the UK, Italy, Germany and the Netherlands. Similarly, export demand for processed coarse rice increased

[14] OCAC data shows a growth of 25 percent in HSD imports during Q1-FY13. In subsequent quarters, imports declined sharply.

[15] Aisha Steel, which started its commercial production from October 2012, has a manufacturing capacity of 220,000 MT per year of cold-rolled steel. Similarly, International Steel started its commercial operations from January 2011. It has a capacity of producing 250,000 tons of steel and 150,000 MT of hot dip galvanized steel per annum. Finally, Tuwairqi Steel started its commercial operations in January 2013; this plant has a capacity to produce 1.28 million tons per annum of pellets of direct reduced iron.

[16] In November and December 2013, local sales posted a YoY increase of 8.6 percent and 3.8 percent, respectively.

production in the grain milling industry. This sector posted a growth of 4.8 percent in Q1-FY14, compared to 4.0 percent in the previous year.

Automobile production continues to decline

Production of automobiles (mainly cars) declined for the fourth consecutive year. In Q1-FY14, although car sales posted a marginal increase over the corresponding period last year, production continued to slide. This decline can be traced to the phasing out of an old model of Toyota, which is to be replaced by a new model in mid-2014. Excluding this one make, all other cars posted a rise in production, following a stricter import policy for used cars. Specifically, the import of used cars declined by a factor of three in Q1-FY14, as the government reduced the age limit on imported used vehicles from five to three years (**Table 2.6**).

Table 2.6 Production and Sales in Car Segment
in numbers

	Q1-FY12	Q1-FY13	Q1-FY14
Production	30,069	26,398	24,398
Sales	33,976	24,193	25,372
Import	9,225	14,223	4,965

Source: Pakistan Automotive Manufacturers Association

Services[17]

As mentioned before, we cannot analyze the PBS estimates for services sector growth during Q1-FY14 till the detailed information is available.[18] Although these estimates show a strong YoY recovery – increasing from 2.9 percent in Q1-FY13 to 5.9 percent in Q1-FY14, leading indicators in the sector showed a mixed performance. While *transport* and *finance* are likely to exhibit lower growth during FY14 compared to the preceding year, *communication* and *wholesale & retail trade* are expected to post a recovery.

The *wholesale & retail trade* sector clearly got some support from the broad-based recovery in manufacturing, along with a modest rise in import volumes during Q1-FY14. However, a part of these gains could be offset by underperformance of agriculture sector.

In contrast to FY13, the *finance & insurance* sub-sector appears to have weakened during Q1-FY14, mainly due to shrinking interest margins. The aggregate after tax profits of banks stood at Rs 82 billion in Q1-FY14, which shows a decline of 11.2 percent over Q1-FY13. This trend is likely to continue going forward, however, profitability position will become clearer after banks finalize their year-

[17] The break-up of services sector growth during Q1-FY14 is not yet available. Therefore, this section is based on the leading indicators for services sector's performance during the year.
[18] The detailed information on services sector is available only on an annual basis.

end audited accounts, and incorporate conclusive provisioning and recovery figures.

Within the *transportation sector*, private air transport performed better in FY13, but PIA could not overcome its operating losses.[19] In addition to its long standing operational inefficiencies, PIA suffered multiple setbacks during FY14: (i) Saudi government reduced the quota of Pakistanis by 30 percent for the Hajj season, which significantly reduced the available seat kilometer (ASK) during Q1-FY14;[20] (ii) a sharp depreciation of PKR has increased FX liabilities, and the airline's operating losses; and (iii) number of serviceable aircrafts has been reduced from 29 available last year, to only 23 in Q1-FY14.

The *communication sector* is likely to recover as in FY14, PTCL earned Rs 4.6 billion profit before tax in Q1- FY14, against a loss of Rs 9.2 billion in the same quarter last year. Most of the improvement has come from its international business and broadband services; the voice segment of PTCL's business could not perform well due to stiff competition from cellular companies. A sharp rise in the import of telecom machinery also reflects a recovery in this sector.

[19] PIA suffered by a loss of Rs 31.6 billion during Jan-Sep 2013, compared to Rs 22.2 billion in the same period last year.

[20] Available seat kilometer is the number of seats on an airplane, multiplied by the number of kilometers flown (empty or full). ASK is a key indicator of revenue of the airline industry. PIA's ASK declined from 14.7 billion in Q1-FY13, to 13.04 billion in Q1-FY14.

Special Section 2.1 Alternate Energy Resources[21]

2.1.1 Introduction

Energy availability in Pakistan has been declining over the past few years due to: a lack of investment; stagnant supply of domestic gas; persistent inefficiencies in energy-related PSEs; and inadequate infrastructure for gas import. While all economic sectors have been affected by the energy shortages, the industrial sector has been hurt the most. Due to technical differences in how the energy is used (fuel types), the impact on Pakistan's industry has varied across sectors.

More specifically, when power and gas outages began in FY09, a number of industries suffered production declines, except those that run primarily on coal (e.g., cement). However, as these outages persisted, firms in the large-scale manufacturing sector started arranging for substitutes. While power-intensive units like steel melting, edible oil/ghee, and textile spinning, opted for generators that run on high speed diesel and/or furnace oil [22],gas intensive units like paper, glass, and chemicals shifted to boilers that can run on coal, waste heat and biomass. A summary of the alternative arrangements is presented in **Table 2.5**.[23]

2.1.2 Industry's Response to Energy Shortages in Pakistan

In this section, we will explore the alternative arrangements that various industries have made to ensure smoother production.

<u>Steel</u>

The steel sector in Pakistan comprises of melting and re-rolling units. In the steel melting process, scrap is melted by using arc furnaces to form billets. This process is 100 percent electricity intensive and cannot be substituted by any other energy source. Facing power shortages, smaller firms located in Punjab, switched to diesel-run generators, which not only increased production cost, but also reduced productivity, as uninterrupted power supply is required to melt steel scrap.[24] In contrast, larger units in Karachi switched to captive power, which

[21] This section is based on discussion with a number of companies in each of the listed sub-sectors. Since we do not have hard data on energy consumption by Pakistan's industrial sector, the findings reported in this section are based on our conversation with various manufacturing firms and associations. Firm-level information is already in the public domain; via companies' websites and financial reports.
[22] Although this switch entails huge financial and productivity costs on producers, production declines *can* be avoided.
[23] Only in FY13, Pakistan imported 55,920 waste heat (hybrid) boilers.
[24] Otherwise, the process has to start from beginning.

required higher fixed costs, but guaranteed smooth production without interruptions.[25]

In contrast, the re-rolling process that requires the preheating of billets to shape final products, is a gas-intensive process. It is estimated that around 12 – 13 re-rolling units in Punjab have installed coal gasification plants in the previous two years. These plants have been imported from China, and their costs vary from Rs 4 million to Rs 30 million, depending upon size and specification. In addition to this, some smaller units in Punjab are also using used tyres for heating purposes.[26]

<u>Paper</u>

The production of paper is a very energy-intensive process, and requires a combination of electricity and steam. Energy is required to compress air, process pulp, and dry paper. Most of this energy is consumed in the drying process, which requires a steady flow of steam. In Pakistan, natural gas was the main fuel source for generating steam; its shortage has forced many manufacturers to shift to alternative sources recently. For instance, a large number of pulp manufacturers (e.g. Premiere Paper Mills), are using bio-mass run boilers (mainly wheat straw, kai grass and bagasse) to drain extra moisture from the paper[27], while Century Papers – one of the largest paper manufacturers in the country, has recently installed a coal/bio-mass run boiler.[28]

<u>Textiles</u>

Within textiles, spinning and weaving of fiber are electricity-intensive, whereas dyeing and finishing are gas-intensive processes as these require a steady supply of steam. In Pakistan, most spinning units are large-scale units, which can afford to run on back-up diesel generators. In the weaving sector, a large number of units located in Faisalabad, use power looms for fabric manufacturing. These power looms are small-scale units, and are forced to shut down in case of power outages as alternative energy sources are too expensive for their modest operations. Some medium-sized power looms have installed diesel generators, but as is the case in the steel sector, this has increased production costs.[29]

[25] For instance, International Steel Limited has a gas-fired power plant that can produce 18 MW of electricity. Similarly, Tuwairqi Steel has installed a 38 MW combined cycle power plant

[26] It is important to mention here that the use burnt tyres for generating steam is illegal in Pakistan due to environmental hazards.

[27] The Wheat Straw Pulp is blended with imported bleached soft wood Kraft Pulp to achieve the required strength

[28] This boiler runs 99 percent on coal, and only 1 percent on bio mass.

[29] If a power loom shuts down all of a sudden, then the portion of fabric stuck in the loom gets wasted.

In contrast, a number of *textile processing* units have installed boilers that can run on bio-fuels like cotton waste, rice husk, and other waste (**Section 2.1.3**). As far as big textile groups are concerned, most of them have captive power plants of their own; Nishat, Gul Ahmed, Sitara, and Saphhire are a few examples. More importantly, these companies use gas fired combined-cycle power plants, which generate power from gas; and the waste produced is automatically used to generate steam. For gas-intensive processes, companies like Yunus Textile, Kohinoor, Chenab, and Fazal have installed waste heat recovery boilers.

Chemical

In the chemical sector, caustic soda and soda ash are highly gas-intensive products.[30] When gas shortages began, chemical producers in Punjab suffered the most. Recently, the two largest players in Pubjab – Ittehad and Sitara Chemicals, have shifted part of their production to coal-fired boilers. The other two large producers in Karachi, have also reduced their dependence on natural gas. For instance, ICI Chemicals has installed a coal-fired boiler for its soda ash plant, while it has arranged solar thermal boilers for its polymer plant. Engro Polymers, on the other hand, is using excess energy from normal operations to generate steam using waste boilers, for the production of polymers. In the polyester business, the largest manufacturer (Ibrahim Fiber), has installed a gas run power plant, which produces steam as a by-product that is sufficient for the production of polyester staple fiber.

Leather

The leather industry requires both electricity and steam for its production process. As per our conversation with the industry, Punjab-based firms are using diesel-run generators as a back-up for electricity. For the gas-intensive process of drying of leather, a few companies have installed solar thermal boilers to generate steam. In Karachi, where gas outages are not as common as in Punjab, manufacturers only rely on diesel generators.

Sugar

Sugar mills in Pakistan are using captive power generated from bagasse.[31] This obvious synergy in the production process was initiated only four years back when the energy crisis was at its high. Presently, most of the large mills are generating power from by-products that is not only sufficient for their own needs, but could

[30] This sector is comprised of four major players: Ittehad Chemicals, Sitara Chemicals; ICI Chemicals; and Engro Polymers.

[31] Bagasse, termed as a captive biomass, is fibrous in nature. It has a calorific value of 2,300 kcal/kg. Bagasse is an excellent raw material for power generation. It already provides a stable and reliable source of electricity and steam to power the sugar mills.

add (by some estimates) as much as 3,000 MW of power into the national grid. Realizing this potential, the ECC approved a Framework for Power Co-generation in March 2013, which sets the modalities related to co-generation, tariff determination, and sales to DISCOs. This process would be overseen by the Alternative Energy Development Board.

Cement

Cement production is the most energy-intensive within LSM. The process of clinkering, in which the blend of different raw materials (including clay and limestone) is partially melted to form a granular material requires a great deal of energy.[32] This requires heating the rotary kiln using various fuels including pulverized coal or coke, natural gas, lignite, and fuel oil. In Pakistan, almost all cement manufacturers shifted from natural gas to coal in the early 2000s, which means this sector was largely immune to the worsening energy shortages in the country. [33]

However, as a cost cutting measure, a number of cement manufacturers(e.g. DG Khan Cement, Lucky Cement, Fauji Cement) have started using bio-fuels, especially refused and tyre derived fuels (**Section 2.1.3**).[34] In addition, Bestway, Cherat, Fecto, Lucky and DG Khan, have also installed *heat recovery plants* to generate their own electricity.[35]

Fertilizer

The fertilizer sector has no alternative, but to use natural gas as the principal raw material (feedstock) in the production process. Due to inadequate availability of gas, fertilizer production has declined in the previous 2 years, and the demand-supply gap in the country had to be met via imports. [36][37]

[32] As per Census of Manufacturing Industries (2005), fuel cost per manufacturing unit was highest in the cement sector compared to other industries. Since we do not have the data available on quantity of energy consumed by each sector, we are estimating it through comparing fuel costs. Here it is important to mention that since prices are not the same for different energy sources, the difference across industries would also reflect the kind of fuel they are using.

[33] Cement production has increased by 2.9 percent and 6.1 percent in FY12 and FY13, respectively.

[34] This is the major reason why import of coal did not increase in recent years. More specifically, although coal consumption in other industries has increased (to run boilers, or coal gasification plants), coal consumption by cement industry has declined.

[35] Electricity constitutes 11 percent of the energy usage in cement industry; and around 60 percent of the total production cost.

[36] Fertilizer sector is the second largest consumer of gas in Pakistan, after the power sector. In FY13, gas curtailment to the fertilizer industry was estimated at 20 percent on Sui Network plants, and 12 percent on Mari Network. During the winter season, gas load shedding has been increased from normal 45 days to 60 days on all networks (Source: Economic Survey 2012-13).

Edible oil/ghee

In Pakistan, edible oil manufacturing includes the refining, bleaching and deodorization of imported palm oil. These processes are highly energy-intensive as they require heating and cooling at different stages. Steam is a primary heating source, for which these units have installed boilers that run on furnace oil and high-speed diesel. Due to high costs and space limitations, manufacturing units cannot afford large boilers that run on bio-fuels, and hence are forced to operate on relatively expensive imported fuels.

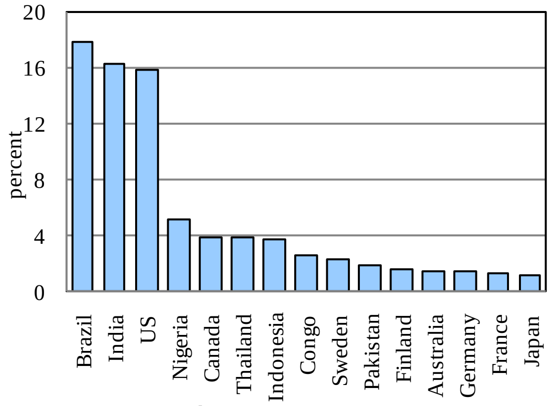
Glass

Glass manufacturing is also an energy-intensive process. Most of the energy consumed comes from natural gas combustion, which is used to heat furnaces that melt the raw material to form glass. In Pakistan, these furnaces are typically fired on natural gas. The share of natural gas in total fuel cost is estimated at 62 percent.[38] Most of the large players in this sector are planning to install coal gasifiers within 2 years.

1.1.3 Use of Biofuels and Wastes in Pakistan

Presently, Pakistan is among the top10 countries in terms of the use of biomass for energy (**Figure 2.1.1**). Although, most users of biomass are rural household, the share of industrial use is growing sharply. We will now discuss different types of biofuels and waste derived fuel alternatives, which are presently being used in the industrial sector (**Table 2.1.2**).

Figure 2.1.1: Share of Top-15 Countries in Global Use of Biomass



Source: EIA, September 2013

Waste Derived Fuels

Waste derived fuel include residue from industrial or commercial operations, such as rubber, used tires, battery cases, plastic residue, municipal waste, etc.

[37] For instance, urea production in the country declined by 8.6 percent in FY13; 1.8 percent in FY12; and 10.1 percent in FY11.
[38] Census of manufacturing industries 2005.

Refuse Derived Fuel (RDF): This technology was primarily designed to reduce the amount of solid waste in the country, but is now being used to meet the energy demand of various sectors. RDF plants utilize municipal solid waste after screening for clay, dust particles, debris and metal, etc. The cement industry is the prime beneficiary of this alternate energy resource in Pakistan, as almost a quarter of the entire cement industry has started using RDF.[39]

Tire Derived Fuel (TDF): TDF refers to using old shredded tires to produce fuel. The government does not allow the use of TDF in industries other than cement, as burnt tires emanate hazardous elements into the atmosphere. Surprisingly, import of rubber scrap is the main source of shredded tires, as no viable domestic avenue exists for recycling of used tires in Pakistan.[40] The cement sector, which is presently using coal as the base fuel, has started to operate on TDF, not only because of its high energy content, but also because it is cheaper than coal. Moreover, anecdotal evidence suggests that small steel firms are also using this resource illegally for power generation, as the process of steel melting requires uninterrupted power supply.

Poultry Waste: Chicken litter[41] can also be used for energy generation by combustion, using purpose-built incinerators.[42] The cement sector and brick kilns are currently utilizing poultry waste for energy generation in Pakistan. Going forward, poultry waste biogas plants are being set-up to provide electricity to large poultry and dairy farms.

Biofuels

Biofuels include plant tissue such as wood and farm waste – the latter include rice husk, rice straw, coffee husk, wheat husk, corn cob, sugarcane bagasse, cotton sticks, cane trash, etc.

Rice Husk: Rice husk and straw is the most productive agricultural by-product in rice producing countries. It can be used for power generation via steam or gasification, and is being utilized by the cement, paper and board, brick kilns and

[39] Cement industry is fulfilling around 20 to 30 percent of its energy need from RDF resources.
[40] Imports data on rubber waste and scrap in form of plates stood USD 806.4 thousand in Jul-Sep FY14 compared to USD 25.1 thousand and nil imports same period in FY13 and FY12 respectively.
[41] Poultry excreta, spilled feed, feathers, etc
[42] Incineration is a waste treatment process that involves the combustion of organic substances contained in waste materials.

steel industries.[43] Rice husks are also being used in textile sector via boilers to generate power for dying and bleaching purposes.

Bagasse: Bagasse of crushed sugar cane is considered to be an important source for generating power. Currently almost all sugar mills in Pakistan have in-house bagasse- based power generation capability, though many are using inefficient boilers and primitive pressure turbines.[44] Going forward, co-generation of power on commercial basis is in the pipeline, for which sugar mills will install steam economization equipment and infrastructure for more efficient use of bagasse for power generation. This will be done by replacing existing low-pressure boilers with new high-pressure technology to increase efficiency.

Cotton Sticks: Cotton stick is a major residue of the cotton crop, which, by weight, constitutes as much as 3 times the cotton produced. Energy derived from cotton sticks are currently being used by brick kiln operators and cooking fuel by farmers.

Table 2.1.2: Alternate Fuel Options for Different Industries in Pakistan

Category	Type	K.Cal against Imported Coal*	Beneficiary Industries
Agricultural waste	Rice husk	1.94	Fabric dyeing, bleaching, cement, paper ,steel, brick kilns
	Corn cob	1.59	Paper, cement
	Corn husk	2.09	Paper, cement
	Wheat straw	1.66	Textile processing, cement, brick kiln
	Cotton sticks	1.9	Cement, brick kiln
	Rice straw	1.94	Textile processing, cement, paper ,steel, brick kilns
Industrial waste	Wood saw dust	1.85	Cement
	Baggasse	1.82	Sugar, textile cement,
	Dropping	2.27	Cement
	Tyre waste	0.78	Steel, cement
	RDF	2.46	Cement
Waste & biomass	Cow dung	2.03	Cement
	Chicken	2.15	Cement, brick kiln

*Imported Coal= 1, Local Coal=1.19

Source: Industry Estimates

[43] Rice straw can either be used alone or mixed with other biomass material. In this technology, combustion boilers are used in combination with steam turbines to produce energy.

[44] Sugar industry is fulfilling major part of its energy requirement through this method. Moreover, three small textile firms in Jhang, have recently utilized bagasse cogeneration power facility.

Other Sources: Wheat husk, corn cob, corn husk, maize stem, are other sources of power generation currently being used in the cement, paper and brick kiln industries.

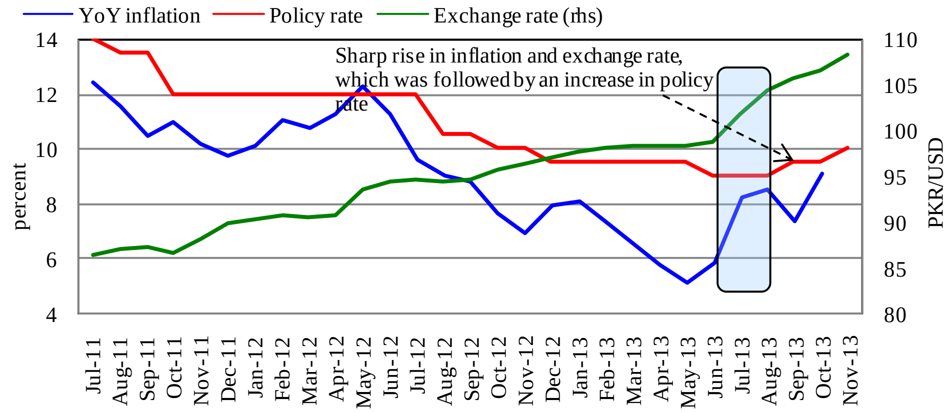
In overall terms, such usage of agricultural and industrial by-products is a very positive step, as long as the resulting pollution is strictly regulated. Given the fact that user dependence on such renewable sources of energy is more common in the rural sector, this reduces the need to expand an already stretched national energy grid (be it power or gas). The AEDB must focus on this issue to reduce rural household dependence (or expectations) on piped gas.

3 Inflation and Monetary Policy

3.1 Overview

Q1-FY14 saw an end to the accommodative monetary policy pursued over the previous two years: SBP increased the policy rate by 50 bps to 9.5 percent in September 2013, after reducing it by a cumulative 500 bps in FY12 and FY13 (**Figure 3.1**).[1,2] This policy shift was needed to: (i) support the PKR, which depreciated more in Q1-FY14 than any quarter in the past 5 years;[3,4] (ii) respond to the increase in inflation, along with the revival of inflationary expectations; and (iii) shift government borrowing away from SBP. In overall terms, SBP's monetary policy reflected the need to support the IMF stabilization program that Pakistan entered in September 2013.

Figure 3.1: Policy Rate and YoY Inflation



Source: State Bank of Pakistan

The depreciation in the PKR was particularly unsettling, as it not only increased the repayment burden of the country's external debt and liabilities, but was partially responsible for reversing the inflation trend and stoking inflationary

[1] After keeping the policy rate unchanged at 14.0 percent during November 2010-July 2012, SBP reduced it by 50 basis points on 31st July 2012. Since then, policy rates had declined by a cumulative 500 basis points, to only 9.0 percent by end August 2013.

[2] This was followed by another 50 bps increase in the policy rate in November 2013, taking the cumulative rise in policy rate to 100 bps during first half of the year.

[3] This large depreciation was driven by an increase in external deficit; SBP's FX purchases from the interbank; and speculative market sentiments, ahead of the new IMF program (**Chapter 5**).

[4] The rising external deficit caused a decline in country's foreign exchange reserves by US$ 1.2 billion during the quarter.

expectations during the quarter. Overall CPI inflation increased to 8.1 percent in Q1-FY14, compared to only 5.6 percent a quarter earlier. In addition to the PKR weakness, the increase in inflation was driven by a modest rise in global commodity prices; an increase in power tariffs; supply constraints in essential food items; and, the increase in GST rate. The increase in retail prices of petrol and wheat not only trigger cost-push inflation and higher wages, but also *anchor* household and business inflation expectations (**Section 3.4**).

Although the recent surge in inflation appears to be a cost-push phenomenon, it requires a policy response from SBP to avoid its second-round impact. More specifically, while monetary policy cannot contain supply-driven food inflation, it can avoid its spread across commodities by managing inflation expectations. Furthermore, constant nominal interest rates in an environment of increasing inflation could trigger pressures if borrowings by the private sector begin to heat up.

The trend in monetary aggregates during Q1-FY14 was not helpful either. Government borrowing from SBP increased by 17.1 percent during Q1-FY14, compared to net retirements in Q1-FY13.[5] This increased reliance on SBP can be traced to a number of factors like the net loan retirements to external creditors; a decline in investment in NSS instruments following the reduction in profit rates; and banks' cautious participation in primary auctions in anticipation of a tighter monetary policy (**Section 3.2**).

While the government was able to contain its borrowing from SBP within the limit set in IMF program for the quarter, it could not avoid the breach of the zero quarterly limit on central bank borrowings by the federal government, prescribed in the SBP Act 1956. Nonetheless, the expansionary impact of this surge in budgetary borrowings on broad money supply (M2), was largely offset by a contraction in the NFA of the banking sector. In effect, broad money supply increased by only Rs 21.5 billion (0.2 percent) during Q1-FY14, which is less than half the increase seen in Q1-FY13 (**Table 3.1**).

As far as private sector credit is concerned, the first quarter typically records net retirement of working capital loans. However, during Q1-FY14, net retirements were visibly lower than the previous year, as disbursements were relatively strong.[6]

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[5] More specifically, the government borrowed Rs 379.2 billion from SBP, whereas budgetary borrowings from scheduled banks declined by Rs 179.1 billion during the quarter.
[6] Net retirements in private sector credit were only Rs 17.4 billion, compared to Rs 84.9 billion in the same quarter last year.

Table 3.1: Monetary Aggregates – Q1
stocks and flows in billion Rupees, growth in percent

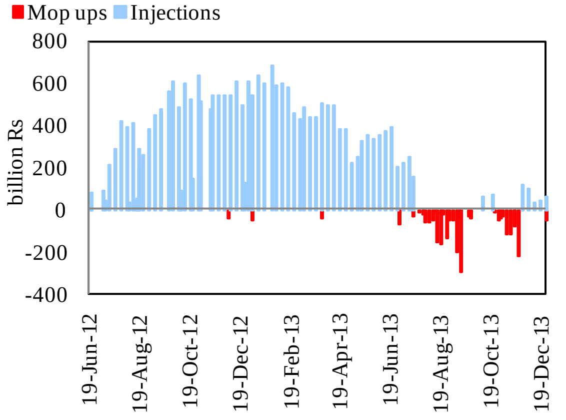
	Stock as on		Absolute change in stocks		Percent growth in stocks	
	Jun-13	Sep-13	FY13	FY14	FY13	FY14
Broad money (M2)	8857.8	8879.3	54.0	21.5	0.7	0.2
NFA	268.8	95.7	11.8	-173.2	2.2	-64.4
SBP	132.9	-13.1	-4.3	-146.1	-1.1	-109.9
Scheduled banks	135.9	108.8	16.0	-27.1	11.6	-19.9
NDA	8589.0	8783.6	42.2	194.6	0.6	2.3
SBP	1954.0	2128.2	101.7	174.2	6.8	8.9
Scheduled banks	6635.0	6655.4	-59.4	20.4	-1.1	0.3
of which						
(i) Government borrowing	5737.1	5913.8	159.0	176.7	3.7	3.1
For budgetary support	5246.4	5446.4	152.5	200.0*	4.0	3.8
SBP	2212.9	2592.1	-399.4	379.2	-23.4	17.1
Scheduled banks	3033.5	2854.3	551.9	-179.1	26.4	-5.9
Commodity operations	467.7	445.7	9.0	-22	2.1	-4.7
(ii) Non government sector	3664.0	3681.6	-69.4	17.6	-1.9	0.5
Credit to private sector	3357.4	3340.0	-84.9	-17.4	-2.5	-0.5
Credit to PSEs	288.1	323.1	15.5	35.1	6.0	12.2
(iii) Other items net	-812.1	-811.8	-47.4	0.3	5.9	0.0

*Budgetary borrowing from the banking system reported in monetary survey is slightly different than the financing numbers provided by the Ministry of Finance (reported in **Table 4.1**). Please see Data Explanatory note No. 5 for details.

Source: State Bank of Pakistan

The higher off-take of fresh loans can be traced to excess liquidity in the interbank market, as well as a recovery in local manufacturing. Specifically, the banks' reluctance to reinvest in maturing T-bills, coupled with SBP's net FX purchases from the interbank,[7] created excess Rupee liquidity in the market. This quantum of liquidity even caused a direction reversal in SBP's open market operations;

Figure 3.2: Open Market Operations



Source: State Bank of Pakistan

[7] One of the prior actions for IMF program was to purchase US$ 125 million from the interbank market during Jul-Aug 2013, to contain reduction in country's foreign exchange reserves.

compared to net OMO *injections* of Rs 208 billion by end-June 2013, SBP's net *mop-ups* stood at Rs 40 billion by end-September 2013 (**Figure 3.2**). Going forward, it is important to note that monetary expansion is capped by the quantitative ceilings on the NDA of SBP; limits on net government borrowing from SBP; and, a floor on SBP's net FX reserves. This contained monetary expansion, coupled with a partial reversal in PKR parity in Q2-FY14, may be helpful in curbing inflation expectations. The sharp deflation in perishable food items has already eased YoY inflation pressure in December 2013 and January 2014.[8] For the full FY14, SBP's inflation forecast would be in the range of 10.0 – 11.0 percent (**Section 3.4**).

3.2 Monetary Aggregates

Broad money supply (M2) during Q1-FY14 increased by only 0.2 percent in Q1-FY14, compared to a rise of 0.7 percent in the corresponding quarter last year (**Table 3.1**). This slowdown in M2 growth can be traced to a decline of 64.4 percent in the NFA of the banking system, which more than offset a 2.3 percent growth in the NDA during the quarter.

Net Foreign Assets (NFA)

Net foreign assets (NFA) of the banking system declined by Rs 173.2 billion during Q1-FY14, compared to an increase of Rs 11.8 billion in Q1-FY13. A rise in the external deficit during Q1-FY14 – led by debt servicing, was responsible for this decline, which caused a US$ 1.2 billion reduction in the country's liquid FX reserves (**Chapter 5**).[9] Most of the decline was evident in SBP's NFA, as external debt servicing is financed directly by SBP. However, NFA of the scheduled banks also fell during the quarter, as current account related payments were large, and SBP FX support was not available. Furthermore, commercial banks increased their borrowings from financial institutions abroad (usually in the form of overdraft on their trade nostros) during the quarter, to bridge the gap between FX payments and receipts, which further pulled down their NFA.[10]

Net Domestic Assets

The NDA of the banking system posted a growth of 2.3 percent in Q1-FY14, compared to a modest rise of 0.6 percent in Q1-FY13. This increase was driven

[8] After increasing to 10.9 percent YoY in November 2013, CPI inflation has come down to 9.2 percent YoY in December 2013, and further to 7.9 percent YoY in January 2014. This decline was driven mainly by a sharp fall in food inflation from 13.0 percent YoY in November 2013 to only 8.9 percent and 6.7 percent YoY in December 2013 and January 2014, respectively.

[9] External debt servicing (including short-term loans) totaled US$ 1.8 billion during Q1-FY14.

[10] While calculating NFA, liabilities from external sources are netted out from foreign assets.

by a rise in budgetary borrowings from the banking system, higher credit off take by PSEs, and lower retirements from the private sector.

Budgetary borrowings from the banking system increased by Rs 200.0 billion in Q1-FY14, compared to Rs 152.5 billion in Q1-FY13. This increase can be traced to a decline in financing from external sector and NSS instruments. More specifically, external debt repayments continued to surpass fresh disbursements during Q1-FY14. This increased the actual financing requirements from Rs 286.9 billion, to Rs 314.1 billion.[11] On the other hand, net mobilization via NSS instruments during Q1-FY14 were less than the previous year, due to a reduction in profit rates on January and July 2013 (**Chapter 4**). Consequently, government had little choice but to resort to the banking system to finance the budget deficit.

Within the banking system, there was a shift in government borrowings from commercial banks, to SBP: the government borrowed Rs 379.2 billion from the SBP during Q1-FY14, whereas it retired Rs 179.1 billion to the scheduled banks (**Table 3.1**). This shift to SBP was due to increased market uncertainty regarding the future course of interest rates, and the delay in monetary policy announcement in September, which kept commercial banks away from actively participating in the T-bill auctions.

Table 3.2: Summary of T-bill Auctions in Q1-FY14
billion Rupees

	Pre- auction target	Maturity	Offered (competitive)	Accepted (all)	Accepted (competitive)	Accepted net of maturity
11-Jul-13	300.0	345.2	229.3	240.3	226.4	-104.9
25-Jul-13	300.0	457.7	279.2	275.5	264.7	-182.2
8-Aug-13	300.0	332.6	184.7	195.7	182.6	-136.9
22-Aug-13	200.0	34.4	31.1	33.1	25.5	-1.3
5-Sep-13	250.0	214.4	87.9	88.3	82.1	-126.1
19-Sep-13	250.0	210.3	634.3	515.9	495.4	305.6
Q1-FY14	**1600.0**	**1594.6**	**1446.6**	**1348.9**	**1276.7**	**-245.7**

Source: State Bank of Pakistan

Data on the T-bill auctions reveal that the amount realized by the government was substantially lower than auction targets, and also much below maturing T-bills, during the period (**Table 3.2**). Outcomes of auctions held on 22nd August and 5th September were particularly insightful: against a cumulative target of Rs 450 billion and maturing amount of Rs 248.8 billion, the market offered only Rs 119.0

[11] Fiscal deficit during Q1-FY14 was Rs 286.9 billion; however, if we add back net decline in external financing of Rs 27.2 billion, the effective financing requirement increases to Rs 314.1 billion.

billion. As expected, most of this amount was offered in 3-month T-bills – not a single bid was offered in 6-month and 12-month T-bills in the auction held on 5th September.[12] Clearly, the market did not want to lock-in funds in longer term instruments when they expected interest rates to rise.

PIB auctions during the quarter also met a similar fate – the government could realize only 43.1 percent of the targeted amount (Rs 150 billion). Facing this situation, the government had no other option but to borrow from SBP. Despite this, borrowings from SBP remained within the quantitative target agreed with the IMF: against the target of Rs 2,690 agreed with the IMF, net government borrowings from SBP was Rs 2,521 billion by end-September 2013. However, the government was unable to meet the limit of zero quarterly borrowing (on net terms) prescribed in the SBP Act.[13]

Commodity Operations

The outstanding volume of loans for commodity operations declined by Rs 22.0 billion during Q1-FY14, compared to an increase of Rs 9.0 billion during Q1-FY13. The data on commodity-wise loans indicate that net retirement during the quarter was primarily driven by repayment on wheat and sugar loans. In fact, PASSCO and the Food Department of Punjab offloaded their wheat stocks at a rapid pace during the quarter, to meet domestic demand for wheat and stabilize flour prices.[14] This helped these procurement agencies to retire their borrowings during the quarter (**Table 3.3**).

Table 3.3: Change in Outstanding Loans and Stock of Wheat (end-Q1)

	PASSCO		Punjab Food Department	
	FY13	FY14	FY13	FY14
Quantity (stocks in 000 MT)	163.2	-264.3	-78.8	-454.4
Outstanding loans (billion Rupees)	-1.0	-5.8	-1.0	-15.6

Source: State Bank of Pakistan

Further details reveal that the receivables of both PASSCO and the Food Department of Punjab on account of wheat, stood at Rs 294.8 billion as of end-

[12] However, the situation substantially changed following the Monetary Policy announcement on 13th September 2013. The market offered Rs 634.3 billion against the target of Rs 250 billion in T-bill auction held on 19th September 2013. The government realized Rs 515.9 billion from this auction, which helped contain government borrowing from SBP to an extent.

[13] Besides statuary requirements, rise in government borrowing has strong implications for the debt and monetary management. Specifically, the government's increasing reliance on T-bills has increased the re-pricing and rollover risks for the government. In an increasing interest rate scenario, the re-pricing risk could undermine the government efforts to consolidate the fiscal deficit.

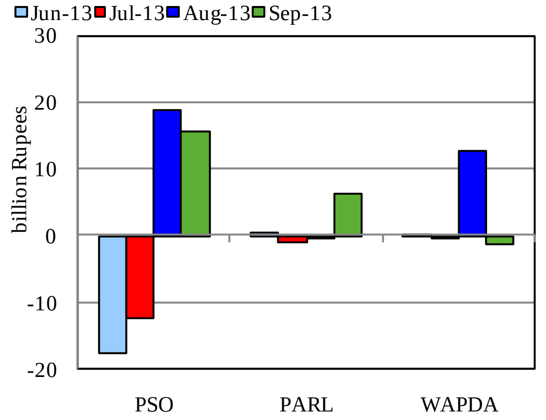
[14] However, this proved insufficient, as wheat and flour prices continued to increase throughout the quarter (**Section 3.4**).

September 2013, of which Rs 65.6 billion was on account of receivable subsidies. Moreover, total receivables of procurement agencies stood at Rs 486.4 billion as of end Q1-FY14, including Rs 155.3 billion of receivable subsidies. The payment of these subsidies by the respective governments, would allow the procurement agencies to retire 34.8 percent of their costly borrowing from commercial banks.

Credit to PSEs

Credit to PSEs recorded a YoY growth of 12.2 percent during Q1-FY14, compared to a growth of 6.0 percent during the same period last year. The demand for credit originated from energy-related PSEs, which can be traced to their cash flow problems.

Figure 3.3: Monthly Changes in Credit to PSEs



Source: State Bank of Pakistan

Specifically, most of the PSEs retired their loans in June and July 2013, following the settlement of the circular debt by the government. However, as structural issues continued to persist in the energy sector, the circular debt started to build up in subsequent months, causing a rise in PSE's demand for bank loans (**Figure 3.3**).

3.3 Credit to Private Sector

Net retirement of private sector credit remained significantly lower in Q1-FY14, compared to the previous year (**Table 3.4**). Private businesses and non-bank finance companies (NBFCs) were mainly responsible for lower retirements this year, as consumer financing posted an increase of Rs 13.4 billion.

Table 3.4: Change in Credit to Private Sector during Q1

billion Rupees

	FY12	FY13	FY14
Overall	-88.7	-84.9	-17.4
of which			
Loans to private business	-95.3	-39.6	-3.0
Investments in private stocks	2.9	-1.1	1.4
Consumer financing	-4.5	-1.8	13.4
Credit to NBFCs	6.3	-65.7	-16.2

Source: State Bank of Pakistan

Credit to NBFCs continued to show net retirements during Q1-FY14. This was mainly because the government had reduced tax incentives on investments in mutual funds from July 2012 onwards.[15,16] Therefore commercial banks, who were routing some of their investments in government securities through NBFCs, are now gradually disinvesting from these institutions. With a reduction of Rs 16.2 billion in Q1-FY14, the credit to NBFCs has largely reverted to its trend prevailed before June 2011.

Table 3.5: Net Change in Loans to Private Sector Businesses during Q1
billion Rupees

	% share	Overall loans		Trade financing		Working capital		Fixed investment	
	in stock	**FY13**	**FY14**	**FY13**	**FY14**	**FY13**	**FY14**	**FY13**	**FY14**
Private sector business		-39.7	-3.0	-2.2	8.9	-43.2	-31.3	5.6	19.4
Of which									
a) Elec.& gas distribution	10.3	-0.5	25.6	0.0	3.2	-1.8	15.4	1.2	6.9
b) Petroleum refining	1.8	0.2	14.0	0.0	0.6	-2.2	2.6	2.3	10.8
c) Other manufacturing	55.9	-47.6	-40.7	-1.7	-3.8	-43.9	-40.4	-1.8	3.4
Textiles	20.9	-25.0	0.3	-2.6	-8.5	-16.2	9.7	-6.1	-0.9
Food & beverages	11.0	-42.1	-46.3	-3.9	-4.5	-42.6	-40.9	4.5	-0.9
Sugar	3.9	-24.7	-31.0	0.8	-4.1	-28.5	-28.3	2.9	1.4
Bakery	0.6	-1.2	1.6	0.3	0.0	-0.8	2.3	-0.6	-0.7
Beverages	0.9	-0.1	5.5	0.4	1.2	-2.3	4.5	1.7	-0.2
Paper & paper board	1.2	1.1	0.3	0.2	0.3	1.9	-1.8	-1.0	1.8
Fertilizers	3.9	7.7	-1.2	-1.0	0.0	10.1	1.6	-1.3	-2.8
Rubber & plastics	1.0	4.8	-0.4	2.0	1.0	0.3	-0.6	2.5	-0.8
Electrical machinery	2.1	2.0	3.7	1.2	1.0	-0.9	0.8	-0.1	2.0
Cement	2.1	-3.2	-1.3	-1.9	-0.8	-0.7	-4.9	-0.5	4.3

*Category of *Government self employment schemes*, which constitutes around 0.01-0.03 percent of total outstanding loans, is excluded from private sector business's total loans.
Source: State Bank of Pakistan

Loans to private businesses posted net retirement of only Rs 3.0 billion in Q1-FY14, compared to Rs 39.7 billion in Q1-FY13 (**Table 3.5**). Export-led buying of cotton and yarn, and the re-accumulation of circular debt in the energy sector (which increased bank borrowings by refineries and IPPs), were mainly

[15] The Gazette of Pakistan dated June 27th, 2012 noted that " ….dividend income from Money Market Mutual Funds and Income Funds shall be taxed at the rate of 25 percent for tax year 2013 and at the rate of 35 percent for tax years 2014 onwards". It is pertinent to mention here that standard income tax rate for the corporate sector is 35 percent.

[16] Banks' investment in NBFIs substantially increased due to tax incentive on the investments of NBFCs, especially of mutual funds. The scheduled bank took advantage of this opportunity by routing some of their investments in government securities through NBFIs. As a result, banks' investment in NBFCs saw a 2.4 time increase in just one year (i.e., FY12), and reached historic high of Rs 231.0 billion by end November 2012. However, the government announced the withdrawal of tax incentive in a phased manner in June 2012. Consequently, the banks are containing their investments in NBFCs.

responsible for the increase in fresh loans. Moreover, fixed investment loans also posted a modest increase especially in the energy sector, including power distribution and petroleum refining. This increase largely offset seasonal retirements, as well as bulky repayments by the cement and fertilizer sectors.

Loans to the energy sector – including refineries and electricity and gas distribution companies, increased by Rs 39.6 billion during Q1-FY14, compared to a decline of only Rs 0.3 billion in the corresponding quarter of FY13. This increase took place despite a retirement of Rs 58.1 billion (related to the circular debt settlement) during the month of June 2013. However, as mentioned before, the circular debt piled up again in August and September, which caused a rise in bank borrowings by refineries, OMCs and IPPs. In addition to this, anecdotal evidence suggests that a few private power plants, which were closed in the previous year due to financial constraints, had started operating in Q1-FY14 – this generated additional demand for working capital loans to purchase furnace oil.

Loans to the *textile sector,* which is one of the biggest users of bank loans, recorded an increase of Rs 0.3 billion in Q1-FY14, compared to a net reduction of Rs 25.0 billion in Q1-FY13 (**Table 3.5**). A rise in procurement of raw cotton, and cotton yarn by the exporters, increased credit demand of the textile sector**.**[17]

Loans to *food and beverages* saw a net contraction of Rs 46.3 billion in Q1-FY14, due to seasonal retirements from the sugar sector.[18] Among other food industries, working capital loans to the FMCG sector increased by Rs 2.3 billion during Q1-FY14, due to higher grain prices.[19] In contrast, the rise in loans to *beverages* can be traced to the construction of three new greenfield bottling plants in the country.

As far as cement and fertilizer are concerned, these sectors continued to retire loans in Q1-FY14. While cement benefited from strong profitability and improved cash flows,[20] fertilizer continued to retire long-term loans that were taken to finance capacity expansion a few years back. Encouragingly, there has also been some increase in the fixed investment activity in the cement sector, in the form of new local plants, and a joint-venture to set-up a plant in Africa.

[17] According to PBS, total cotton yarn exports stood 193.7 thousand MT during Q1-FY14 compared to 181.5 thousand MT during Q1-FY13, raw cotton exports stood 36.9 thousand MT during Q1-FY14 compared to 14.5 thousand MT during Q1-FY13.
[18] First quarter of the year is a retirement period for the sugar sector.
[19] Price of wheat and corn surged by 25.0 percent each in Q1-FY14, over the previous year.
[20] Profits of cement manufacturers remained strong due to declining international coal prices, and better margins.

However, investment in fertilizer is at standstill due to uncertainties related with gas availability and contract enforcement.[21]

Finally, *consumer financing* is finally showing some signs of improvement after a long period of net retirements**.** Details indicate that expansion in consumer financing is largely stemming from personal loans, which have picked up since November 2012, as the National Bank of Pakistan revised the limit on its salary loan scheme for government employees (**Table 3.6**).[22] Moreover, *Cash and Gold Scheme* (ready cash against gold) of NBP is also contributing to the personal loans. There is also some increase in consumer financing by other commercial banks as well during Q1-FY14, mainly in the car loan segment.

Table 3.6: Loans to Consumer Sector during Q1

billion Rupees

	FY12	FY13	FY14
Consumer financing	**-4.7**	**-1.7**	**13.6**
of which			
House building	-1.9	-1.1	-0.1
Auto loans	-2.3	-0.2	3.1
Credit cards	-1.0	1.3	0.6
Personal loans	0.6	-1.7	10.1

Source: State Bank of Pakistan

3.4 Inflation

After receding throughout FY13, inflationary concerns resurfaced with the start of FY14: headline inflation increased to 8.1 percent YoY in Q1-FY14, compared to only 5.6 percent in the preceding quarter (**Table 3.7**). This increase in inflation was driven by multiple factors, including: (i) a modest rise in global commodity prices; (ii) a sharp depreciation in PKR; (iii) trend reversal in administered prices; (iv) supply constraints in essential food items; and (v) a rise in standard GST rate by one percentage point.

Table 3.7: Quarterly Averages of YoY Inflation

percent

		CPI	Food	NFNE	Trimmed
FY13	Jul-Sep	9.1	8.4	10.9	10.6
	Oct-Dec	7.5	6.3	9.9	9.2
	Jan-Mar	7.3	7.3	9.5	9.2
	Apr-Jun	5.6	6.6	8.2	7.0
FY14	Jul-Sep	8.1	9.1	8.5	7.8

Source: Pakistan Bureau of Statistics

While all these factors indicate supply-side forces at work – and food inflation taking the lead, both the measures of core inflation (i.e., NFNE and trimmed) have also edged up (**Table 3.7**). However, this increase does not necessarily imply demand pressures in the economy; it can be seen as a second-round impact of

[21] As mentioned in **Chapter 2**, the increase in gas supplies to fertilizer sector in Q1-FY14 was a temporary arrangement.

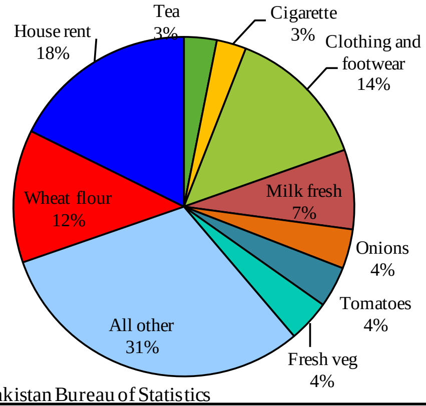
[22] Personal loans account for around 50 percent of consumer financing.

price increases in key items like petrol and wheat, which not only trigger cost-push inflation and higher wages, but also *anchor* inflation expectations of households. In addition, movements in the Dollar-PKR parity directly influence price setting by private sector businesses. Therefore, to arrest the spread of inflation across commodities, and to stabilize real interest rates, supply-side inflationary pressures required a timely policy response (**Section 3.1**).[23]

Composition of inflation

A commodity-wise break up of CPI inflation shows that wheat and house-rent alone added 2.4 percentage points to Q1-FY14 inflation (**Figure 3.4**). Contributions from clothing & footwear, fresh milk, tea, cigarettes and vegetables were also large. The remaining items contributed nearly 30 percent of Q1-FY14 inflation. Although the number of items showing double-digit inflation is still low, a large number of items in the CPI basket are posting price increases during the quarter (**Table 3.8**).

Figure 3.4: Composition of YoY CPI Inflation - Q1-FY14



Source: Pakistan Bureau of Statistics

Table 3.8: Distribution of CPI Items as per Inflation Outcome

number of items

	Q1-FY13	Q2-FY13	Q3-FY13	Q4-FY13	Q1-FY14
Deflation	41	45	48	60	44
No change	26	30	28	40	48
1 - 5 % inflation	60	69	71	107	86
5 - 10 % inflation	95	111	129	139	156
Above 10% inflation	255	224	194	132	143

Source: Pakistan Bureau of Statistics

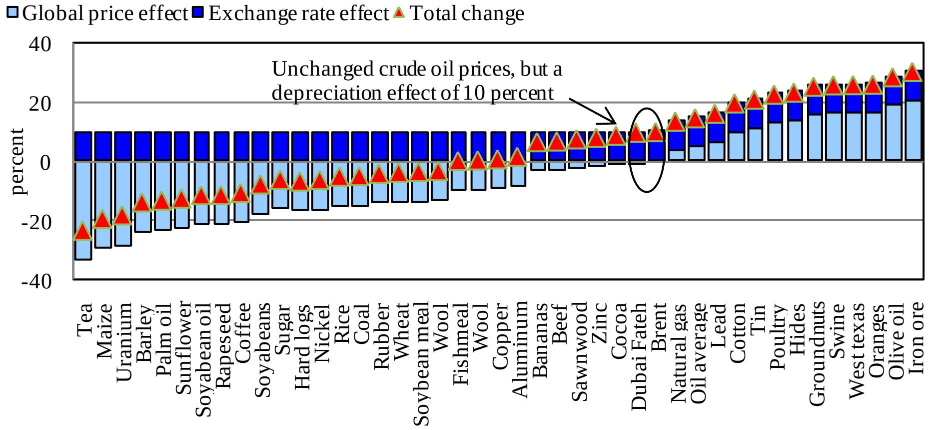
[23] It is important to mention here that monetary measures are not taken to reduce food inflation, but to contain inflationary expectations, and preventing the diffusion of food inflation into a wider range of commodities. In reducing food inflation, administrative actions are more effective, which include correcting market structure by addressing collusive behavior of producers and distributors; and also managing strategic reserves of key commodities. To achieve this, the government should aim to assess accurate estimates of production and available stocks, before taking important decisions of exporting essential commodities. Time and again, food inflation surges due to ineffective management, and central bank has to respond to avoid its second-round impact.

Disentangling the trend in global prices and PKR depreciation

Compared to a decline of 4.8 percent in Q1-FY13, global commodity prices showed a modest rise of 0.7 percent during Q1-FY14. Most of the increase was seen in the month of July 2013, when crude oil prices soared in response to escalating tensions in Iraq, Syria and Libya. However, as the global economy continued to weaken, and oil production was completely restored in Libya, prices have receded. Furthermore, prices of a number of commodities have declined in Q1-FY14, e.g., palm and soybean oil, wheat, rice, coal, and nickel.

The effect of global prices on domestic inflation was intensified by the PKR depreciation during the quarter. As shown in **Figure 3.5**, while the increase in dollar prices of key commodities was marginal, the real concern was the trend in PKR prices. For instance, if we look at the price of crude oil (both Dubai Fateh and Brent), its dollar price has remained more or less unchanged, but its PKR price shows a 9.9 percent increase during the period. This increase was translated into higher domestic petrol prices, which in turn, forced up prices of fresh milk, and other food items where transportation costs are significant.[24]

Figure 3.5: Composition of Change in Global PKR Prices of Primary Commodities



Source: IMF

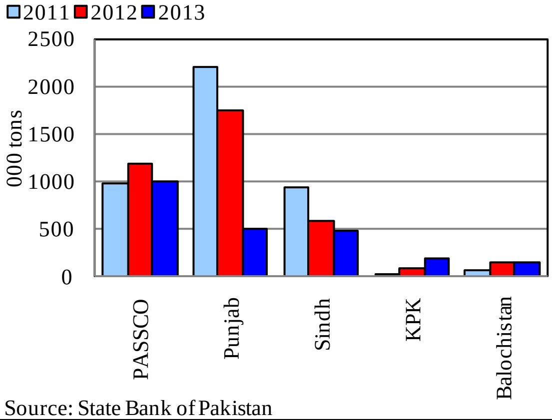
Increase in energy tariffs

During Q1-FY13, the government had significantly reduced the price of piped gas, which pulled down headline inflation. This deflationary effect had held back inflation numbers throughout FY13, but this has been reversed, as FY14 began. In fact, the government increased gas tariffs in January 2013 by 6.1 percent, and later in June 2013 by 1.0 percent.

[24] Domestic price of petrol super increased by 10.6 percent YoY in Q1-FY14.

Similar to gas, electricity tariffs also show no respite: the government has already increased these tariffs on various consumption slabs by an average of 16 percent in October 2013. The increase in these tariffs will push CPI inflation both through its direct contribution to the index, as well as through cost-push inflation in other items.

Figure 3.6: Carry-over Stock of Wheat at the Start of Harvest



Source: State Bank of Pakistan

Lower stocks drove wheat flour prices

Despite a 3.5 percent fall in global wheat prices, domestic wheat prices increased by 25.0 percent in Q1-FY14. This increase is largely driven by the lower-than-target crop in the previous season, and export of wheat flour, which has reduced the carry-over stock (**Figure 3.6**).[25] In fact, the country imported 143.9 thousand MT of wheat during Q1-FY14, but this was not enough to make up for the prevailing demand-supply gap.

Budgetary measures increases cigarette and tea prices

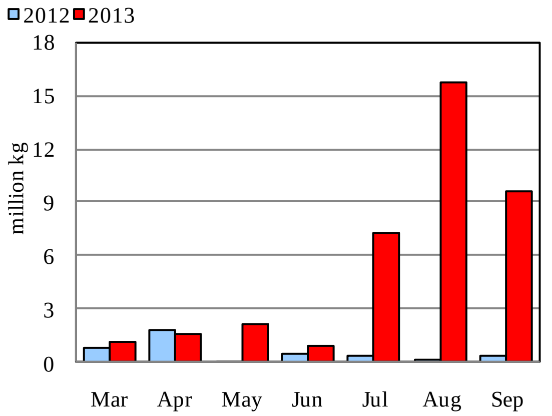
While the increase in GST in Federal Budget 2013-14, has added to inflation across commodities, the impact of certain budgetary measures on cigarettes and tea was more pronounced. More specifically, the government had reduced sales tax on tea from 16 percent to only 5 percent back in April 2012, to contain smuggling. However, in the 2013-14 Budget, this relaxation was withdrawn, and the sales tax on tea was increased to 17 percent in one go. In case of cigarettes, the government increased federal excise duty from 2.0 percent last year, to 3.0 percent in the 2013-14 Budget.

Onion and tomatoes: trade didn't help

Pakistan almost doubled onion export during Q1-FY14 compared to the previous year, primarily to compensate for the damage to Indian crop (**Figure 3.7**). However, this increase was at the direct cost of higher domestic prices, which increased by 50.7 percent YoY during the quarter.

[25] Pakistan exported 185.7 thousand MT of wheat flour during Q1-FY14.

Figure 3.7: Onion Exports by Pakistan



Source: Pakistan Bureau of Statistics

As far as tomatoes are concerned, its price posted an increase of 80.3 percent during the quarter, as bad weather damaged the crop in Balochistan and parts of Sindh. In response, Pakistan increased the import of tomatoes from India to 98.0 million kg in Jul-Sep 2013, from only 57.1 million kg in the previous year.[26] However, this quantum of import was not sufficient, as domestic prices rose consistently throughout the quarter. Inflation in tomato prices has increased further in the second quarter to 101.6 percent YoY, as supplies from India suffered a setback due to unseasonal rainfall in tomato growing areas.

Going forward

The CPI Inflation in Q1-FY14 was driven mainly by PKR depreciation; higher petrol prices; increase in GST; and an increase in energy tariffs. These factors were also manifested in consumer confidence surveys, which showed increase in inflation expectations of households and businesses. However, some of the factors that drove inflation in Q1-FY14, have eased – or reversed in recent months. More specifically, unexpected appreciation of PKR in December is containing price pressures; domestic petrol prices, in particular, have not changed for months. This relative price stability may soften inflationary expectations going forward. However, some upside pressures still persist in the form of a large external gap; recent trend in commodity prices;[27] and the need to further reduce energy subsidies as part of the IMF program.[28] On balance, SBP's inflation forecast for FY14 is in the range of 10.0 – 11.0 percent.

[26] Source: Pakistan Bureau of Statistics

[27] Price of Brent crude oil increased from US$ 108.1 per barrel in November 2013, to US$ 110.6 per barrel in December 2013, showing a growth of 2.4 percent.

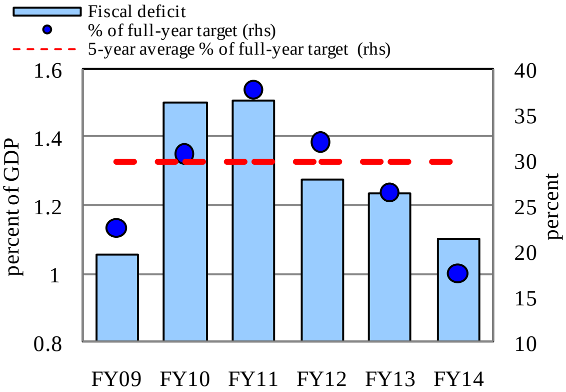
[28] The recent increase in gas infrastructure development cess (GIDC) on industrial and power sectors, may also trigger cost push inflation (**Chapter 4**).

4 Fiscal Policy and Public Debt

4.1 Fiscal Operations

The budget estimates for FY14 envisage fiscal consolidation of 1.7 percent of GDP, which would reduce the budget deficit to 6.3 percent.[1] This is to be achieved through a number of measures, including: (i) an increase in power tariffs to phase out subsidies;[2] (ii) increase in various direct and indirect tax rates; (iii) agreement with the provinces that they post fiscal surpluses in FY14; and (iv) the auction of 3G licenses and divesture of public shares.[3]

Figure 4.1: Analysis of Fiscal Deficit in Q1



Source: Ministry of Finance

In Q1-FY14, the budget deficit narrowed to 1.1 percent of GDP, showing a 0.1 percentage point reduction over Q1-FY13. Furthermore, this deficit is well below the ceiling put in place as part of the IMF program, for end-September 2013.[4] More importantly, the deficit for the first quarter was 17.5 percent of the full-year target, which is significantly lower than the average in the previous 5 years (**Figure 4.1**).

The improvement in the fiscal accounts was a combination of a slowdown in spending, and an improvement in revenue collection (**Table 4.1**). While the increase in revenues was mainly an outcome of the increase in tax *rates* (e.g., GST) and certain one-off non-tax revenues, the retrenchment in spending came from the cumulative 300 bps reduction in the discount rate in FY13, which contributed to lower debt servicing during Q1-FY14 (**Section 4.3**). Furthermore,

[1] In FY13, fiscal deficit reached 8.0 percent of GDP.
[2] The government aims to eliminate power subsidies in the next three years.
[3] Budget estimates also included inflows under coalition support fund.
[4] Compared to the ceiling of Rs 419 billion set by the IMF, the actual budget deficit (excluding grants) was only Rs 297 billion in Q1-FY14. Including grants, the actual budget deficit was Rs 286.9 billion during the quarter.

provincial fiscal accounts also posted a notable improvement, as the provincial surplus was 12.1 percent higher in Q1-FY14 over the same period last year.

Notwithstanding the improved fiscal performance during Q1-FY14, a record Rs 1.0 trillion was added to the public debt during this period. While a part of the incremental debt was needed to finance the fiscal gap during the quarter, around 40 percent of the additional debt came from adverse exchange rate movements (**Section 4.4**).

Although the overall fiscal position during the first quarter of FY14 was encouraging, in our view, the full-year performance will depend on three factors: (i) level of subsidies and the possible need to again pay off the circular debt in the power sector; (ii) the performance of FBR; and (iii) the quantum of CSF and the inflow of 3G license auction proceeds.

Table 4.1: Summary of Fiscal Operations - Q1
billion Rupees

	Actual		Growth (%)	
	FY13	**FY14**	**FY13**	**FY14**
Total revenue	692.1	829.7	29.7	19.9
Tax revenue	451.3	537.1	10.3	19.0
Non-tax receipts	240.8	292.7	93.2	21.5
CSF	107.3	0.0		
Total expenditure	975.9	1,116.6	23.4	14.4
Current	812.4	868.4	23.7	6.9
Development & net lending	74.9	170.1	-14.6	127.3
Unidentified	88.7	78.1	90.6	-12.0
Overall Fiscal balance	**-283.8**	**-286.9**	**10.4**	**1.1**
Financing through:				
External resources	-1.6	-27.2		
Internal resources	285.4	314.1		
Banking system	151.5	198.0*		
Non-bank	133.9	116.1		
As % of GDP				
Overall fiscal balance	-1.2	-1.1		
Revenue balance	-0.5	-0.1		
Primary balance	0.1	0.1		

*The data on financing from domestic banking system reported by the Ministry of Finance is slightly different than what is reported in monetary survey (**Table 3.1**). Please see Data Explanatory Note No. 5 for details.
Source: Ministry of Finance

As far as subsidies are concerned, the targeted reduction of 34.6 percent during the year, does not seem likely. We take this view because the level of subsidies in Q1-FY14 is almost at the previous year's level, despite the selective increase in power tariffs during the quarter.[5,6] Legal complications related to decisions on power tariffs, may continue to challenge the government's ability to reduce the subsidy burden.[7]

[5] Power tariffs for industrial users were raised in August 2013, whereas for the domestic consumers increase was made effective from November 2013.
[6] The increase in power tariffs is indeed welcome, but more concerted efforts are needed to be made in terms of bill collections, and minimizing transmission and distribution losses.
[7] The government first announced an increase in power tariffs in August 2013; however, this decision was partially rolled back for some large consumers (residential, commercial and bulk

In the case of tax revenues, while the collection performance has been encouraging so far, tax receipts still need to grow by 30.3 percent in the remaining part of the year, to meet the full-year target. This appears difficult, given FBR's performance in recent years.[8] The primary concern is that the increase in tax revenues was largely an outcome of tax rate increases in the 2013-14 Budget: in our view, a more sustainable solution would be improving the taxation system; eliminating loopholes in the tax machinery; and above all, widening the tax base. The IMF has also flagged the need to avoid a further rise in GST or income tax *rates* to achieve lower deficits, and to focus more on expanding the tax base by documenting the economy.[9]

The swing factor in the FY14 fiscal outcome, is the disbursement of CSF during the second quarter,[10] and the ground work required to realize the 3G auctions.[11] Another positive for the government is the resolution of legal issues related to the gas infrastructure development cess (GIDC),[12,13]and an increase in GIDC on gas consumers, as agreed with the IMF.[14] It is estimated that instead of Rs 38.0 billion envisaged in the 2013-14 Budget, the government may be able to collect as much as Rs 125.0 billion under this head. The downside risks to the full-year fiscal outcome include: below-target tax collections; re-emergence of the circular debt in the energy sector; and higher interest payments in the second half of the year. On balance, therefore, the SBP expects the fiscal deficit to lie in the range of 6 – 7 percent of GDP during FY14.

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consumers) due to legal issues. In October 2013, government was able to increase the power tariffs again.

[8] During the previous five years, average growth in FBR revenues during Oct-Jun has been 14.1 percent.

[9] IMF Country Report No. 14/1, dated January 2014, "First Review under the Extended Arrangement under the Extended Fund Facility, Request for Waiver of Nonobservance of a Performance Criterion and Modification of Performance Criteria".

[10] Pakistan received US$ 322.2 million under CSF in October 2013.

[11] The government of Pakistan has hired the international consultant in Q2-FY14, to conduct the 3G auction.

[12] GIDC was first introduced in 2011 through "Gas Infrastructure Development Cess Act 2011", primarily to finance the infrastructure development for the import of natural gas. It was estimated that around Rs 34 billion will be collected by the government annually under this head, which will finance the on-going infrastructure projects including Pakistan-Iran gas pipeline, and Turkmenistan-Afghanistan-Pakistan-India (TAPI) pipeline.

[13] In July 2013, Peshawar High Court suspended the collection of GIDC by the government. This suspension was challenged by the government in the Supreme Court, which set aside the High Court decision, resulting in the resumption of GIDC.

[14] The government has increased the Gas Infrastructure Development Cess (GIDC) at end-December 2013 via SRO 1091(I) of 2013, of 31st December 2013. The government has increased the GIDC on fertilizer feedstock from Rs 197 / mmbtu to Rs 300 / mmbtu. Similarly, on power and industrial sector, the GIDC has been doubled from Rs 50 / mmbtu to Rs 100 / mmbtu.

4.2 Revenue

Total revenues posted an increase of 19.9 percent during Q1-FY14, compared to a 29.0 percent increase in Q1-FY13 (**Table 4.2**). This increase came from both tax and non-tax revenues.

Table 4.2: Tax and Non-tax Revenues –Q1
billion Rupees

	Actual		Change	
	FY13	**FY14**	**Abs.**	**%**
Tax revenue	**451.3**	**537.1**	**85.8**	**19.9**
Direct taxes	136.5	160.8	24.2	17.8
Taxes on goods & services	212.4	255.9	42.6	20.1
Excise duty	22.0	24.7	1.7	7.6
Sales tax	190.3	231.2	40.9	21.5
Taxes on international trade	50.8	52.8	2.0	3.9
Other taxes	28.7	42.8	14.0	48.9
Petroleum levy	22.8	25.8	2.9	12.9
Non-tax revenue	**240.8**	**292.7**	**51.8**	**21.5**
Interest and dividends	16.0	60.6	44.6	283.5
SBP profits	50.0	80.0	30.0	60.0
Defence (incl. CSF)	107.3	1.9	-105.3	-98.2
Dev. surcharge on gas	3.9	20.8	16.9	434.2
Royalties	14.8	19.2	4.3	29.3
Miscellaneous	49.1	110.3	61.2	124.7
of which				
Universal service fund	0	67.6	67.6	
Total revenue	**692.1**	**829.7**	**137.6**	**19.9**

Source: Ministry of Finance

FBR Taxes[15]

Given the stubbornly low tax-to-GDP ratio in Pakistan, the government's fiscal consolidation efforts are primarily focused on increasing tax revenues. The thrust of these efforts so far, has been on increasing the rate of various direct and indirect taxes (**Box 4.1**).

As a result, FBR taxes posted an increase of 17.0 percent during Q1-FY14, compared to a 7.9 percent increase in the same period last year. Most of this improvement came from indirect taxes, specifically from GST on domestic sales; just petroleum products and fertilizer contributed more than half of the increase in this segment. Revenues from GST on imports and custom duties however, remained sluggish during Q1-FY14, mainly due to a decline in the import of high-speed diesel (HSD) and automobiles (**Chapter 5**).

Direct tax collection also witnessed a 17.5 percent increase in the first quarter, mainly due to an increase in withholding tax collected on imports, telephone bills and salaries. In overall terms, FBR tax collections were 95 percent of the quarterly target in Q1-FY14, compared to 82.8 percent in the same period last year.

[15] The information used in this section is based on the revised FBR data, which was reported in the FBR Quarterly Review, Vol. 13, No.1 for Jul-Sep 2013.

Non-tax revenues

Despite the absence of CSF inflows during Q1-FY14, non-tax revenues recorded a 21.5 percent increase over the previous year. As mentioned before, this improvement came from a number of one-offs, including: Rs 56.7 billion mark-up received by the government from PSEs; [16] and a transfer of Rs 67.6 billion in Universal Service Fund (USF) and Research & Development Fund (RDF), from the Ministry of Information Technology to the federal consolidated fund (**Chapter 1**). Without these one-offs, non-tax revenues in Q1-FY14 would have been lower than in Q1-FY13.

Box 4.1: Tax Reforms Introduced in FY14[17]

In the federal budget 2013-14, various measures were announced to increase tax collection. These can broadly be classified into four categories; (i) increase in tax rate, (ii) broadening of the tax base, (iii) removing anomalies in the taxation system, (iv) improving tax compliance. In this regard, following changes have been introduced by FBR in the taxation system during the first quarter:

Revenue measures

Income\ Withholding tax

1. Withholding tax rate on mobile phone subscribers both prepaid and postpaid have been increased from 10 percent to 15 percent;
2. The rate of adjustable withholding tax on cash withdrawal increased from 0.2% to 0.3% on amount exceeding Rs.50,000 in a day;
3. Introduction of a 10 percent withholding tax (not adjustable) on dividends received by a corporate taxpayer;
4. Income tax on Builders @ Rs.25 per square feet of the constructed area sold and Land Developers @ Rs.50 per square yard of the area sold respectively have been levied;
5. The existing six slabs of tax on salary income are increased to twelve. The maximum rate of tax on salary income is progressively increased from an existing 20% to 30%;
6. The maximum tax rate on business income of non-corporate taxpayers is increased progressively to 35% on income exceeding Rs. 6 million from an existing maximum of 25%.

Sales tax

7. Standard tax rate is increased from 16 % to 17 %.
8. Further tax @ 1 % is levied where taxable supplies are made to unregistered persons.
9. An additional sales tax of 5% is levied through electricity and gas bills of those having commercial or industrial connections but remain unregistered.

FED

10. FED rate on cigarettes is simplified and re-structured, from three slabs based on a composite formula, to two slabs based on a specific rate;
11. The rate of federal excise duty on aerated beverages increased from 6% to 9% and introduction of capacity based taxation on aerated beverages to stop evasion and malpractices in the sector;

[16] 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.

[17] Sources: Finance Act 2013, FBR Quarterly Review, Vol. 13, No.1 for Jul-Sep 2013, Budget Speech 2013-14, FBR's Notes on clauses of Finance Bill 2013 and Grant Thornton Tax Memorandum 2013.

12. Federal Excise Duty @ 40 paisa per kg on imported seeds, Rs. 1/ per kg on locally produced oil purchased by a manufacturer of vegetable ghee and cooking oil in lieu of FED payable at production or manufacturing stage of vegetable ghee or cooking oil; [18]
13. Exemption of FED on cement, and services provided or rendered by Asset Management Companies is withdrawn;
14. The scope of chargeability of FED on financial services is expanded by making all kinds of financial services including banks, insurance companies, modarabas, musharikas, leasing companies, forex dealers, NBFIs, AMCs etc. falling under levy of 16% Federal Excise Duty.

Custom Duty

15. In FY14 budget custom duty has been reduced on several items including hybrid cars and energy savers but nothing new has been introduced whereas duty is increased on betel nuts by 5% and betel leaves from Rs.200/kg to Rs. 300/kg.

Measures to improve compliance

1. Each banking company shall provide the FBR a list containing particulars of deposits of one million or more on monthly basis;
2. FBR is empowered to levy and collect sales tax on production capacity or on fixed basis;
3. In order to improve compliance and discourage corruption a reward incentive for officers of the FBR has been introduced;
4. Regulatory control on exempt/concessionary import of agricultural machinery, tourism sector, packaging industry and pharmaceutical sector is being strengthened to ensure the benefit to bonafide importers only;
5. Introduction of WeBoc a new monitoring system for imported items. It is an automated and transparent system which will minimizes interaction between taxpayers and tax collectors, thereby minimizing malpractices;
6. FBR empowered to monitor production, sales, clearance, stocks or any other activity through electronic monitoring;
7. The obligation to file tax return made compulsory in the case of an industrial and commercial electricity consumer where annual electricity bill exceeds Rs. 500,000 as against Rs. 1,000,000 per annum presently.

4.3 Expenditure

Along with enhancing revenues, the government needed to cut down expenditures as part of the fiscal consolidation strategy. On the face of it, the fiscal authorities appear to have made some headway in achieving this objective, as the growth in current expenditures declined to almost one-fourth of what was observed in Q1-FY13.[19] This was made possible due to a significant reduction in interest rates, which lowered interest payments during Q1-FY14. Other than this, subsidies were almost at the same level as last year, while non-interest non-subsidy current expenditures[20] recorded a 16.9 percent growth against 5.2 percent during the same period last year (**Table 4.3**). The increase in non-interest, non-subsidy expenses

[18] Earlier imported seeds were exempt from any tax or duty while locally produced seed oil was subject to 16 percent tax which was hurting the local farmers.
[19] Current spending posted 6.9 percent increase in Q1-FY14, compared to the 23.7 percent raise witnessed in the same period last year.
[20] Non-interest non-subsidy current spending is the current spending excluding interest payments and subsidies.

in the first quarter was on account of an increment in the ad hoc relief to government employees, and pensions of government and defense employees. Within development expenditures, net lending to PSEs showed an abnormal increase in Q1-FY14, due to a lumpy adjustment of circular debt during this period.[21] Furthermore, federal PSDP also posted healthy growth during the quarter.

As discussed earlier, the government's ability to contain its expenditures hinges on the level of subsidies and payments to settle the circular debt in the power sector. To resolve this recurring problem, the government raised power tariffs for industrial users.[22] The impact of this is not yet apparent, as the volume of subsidies in the power sector during Q1-FY14, remains almost at the same level as last year. Furthermore, as mentioned earlier a circular debt has re-appeared after a large adjustment in June 2013 (**Chapter 1**).

Table 4.3: Analysis of Fiscal Spending - Q1
billion Rupees

	Absolute		% of BE*	
	FY13	**FY14**	**FY13**	**FY14**
Current expenditures	**812.4**	**868.4**	**33.9**	**30.7**
of which				
Interest payment	312.8	301.1	33.8	26.1
Subsidies	58.0	59.0	27.8	24.5
Non-interest non-subsidy	441.5	508.2	35.0	35.4
Development expenditures	**74.9**	**170.1**	**12.7**	**21.6**
PSDP	30.3	44.9	8.4	8.3
Grants to provinces & other exp. incl.net lending	44.6	125.2	4.2	13.2
Unidentified	89.7	78.1	--	--
Total	**975.9**	**1,116.6**	**32.7**	**30.9**
Total expenditures, adjusting for circular debt settlement	975.9	978.6	32.6	27.0

*BE: Budget estimates
Source: Ministry of Finance

In overall terms, despite the year-on-year slowdown, fiscal expenditures during the first quarter were around 30.9 percent of the budget estimate for the entire year. Given the progressive increase in spending during the course of the year, the fiscal authorities may find it difficult to contain spending within the annual target.

Provincial fiscal operations

Provincial fiscal position improved further during Q1-FY14, with a 12.1 percent improvement in the surplus over Q1-FY13 (**Table 4.4**). This improvement was brought about by a 50.0 percent increase in revenues during Q1-FY14, over the same period last year. Major share of this increase came from Punjab, on the back of a rise in sales tax collection on services.[23] Moreover, KPK – following on the

[21] The government made a Rs 138 billion circular debt adjustment in Q1-FY14. This was the non-cash segment of the settlement, which was made in June 2013.
[22] Power tariffs for domestic consumers were also raised in November 2013.
[23] Punjab started collection of sales tax on services since last year.

footsteps of Sindh and Punjab, also established its revenue authority in August 2013. This is likely to further improve provincial revenues going forward.[24]

Table 4.4: Provincial Fiscal Operations – Q1
billion Rupees

	Punjab		Sindh		KPK		Balochistan		All provinces	
	FY13	FY14	FY13	FY14	FY13	FY14	FY13	FY14	FY13	FY14
Total revenue	**159.3**	**164.6**	**103.5**	**113.8**	**51.3**	**62.7**	**38.9**	**47.3**	**353.0**	**388.4**
Share in federal revenue	128.7	136.4	73.0	93.0	43.3	51.5	32.8	41.8	277.8	322.7
Taxes	10.8	22.5	16.3	17.0	0.9	2.3	0.2	0.3	28.2	42.1
Non-taxes	12.3	5.5	9.2	0.9	1.3	3.2	1.6	1.2	24.4	10.7
Federal loans & transfers	7.6	0.1	5.0	3.0	5.8	5.8	4.3	4.0	22.7	12.9
Total expenditure	**105.8**	**117.3**	**66.1**	**80.7**	**49.9**	**44.9**	**22.7**	**23.9**	**244.5**	**266.8**
Current	87.6	102.1	61.7	69.3	37.9	38.3	19.2	22.5	206.5	232.2
Development	18.2	15.1	4.4	11.5	12.0	6.6	3.4	1.4	38.0	34.6
Overall balance	**53.6**	**47.3**	**37.4**	**33.1**	**1.4**	**17.8**	**16.2**	**23.4**	**108.5**	**121.6**
Financing *	-30.5	-27.1	-29.6	-28.9	-10.4	-11.7	-15.0	-24.7	-85.4	-92.4

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

Source: Ministry of Finance

On the spending side, a rise in salaries and pensions of government employees, increased provincial current expenditures. A part of this increase, however, was offset by a drop in the development spending in all provinces, with the exception of Sindh.

4.4 Public Debt

With the addition of Rs 1.0 trillion during Q1-FY14, Pakistan's public debt stock rose to Rs 15.5 trillion at end-September 2013 (**Table 4.5**). This was the highest ever increase in any single quarter of a year, and was driven by both domestic and external debt. Given the risk of debt trap facing the economy, the need for immediate implementation of broad-based fiscal reforms can hardly be over emphasized. It is only through a concerted fiscal reform agenda that the country's public debt-to-GDP ratio can be brought on a firmly declining path.

Table 4.5: Pakistan's Public Debt Profile
billion Rupees

	Jun-13	Sep-13	Change
Public Debt	14,494.0	15,514.5	1,020.4
Public domestic debt	9,520.9	10,154.9	634.0
Public external debt	4,973.1	5,359.5	386.4
Government external debt	4,311.1	4,672.2	361.1
Debt from the IMF	434.8	441.3	6.5
External liabilities	227.2	246.1	18.9

Source: State Bank of Pakistan

[24] With the transfer of sales tax collection on services to provinces under the 18th amendment, Sindh and Punjab have already started collections since FY12 and FY13, whereas KPK also established its Revenue Authority in August 2013.

This said, around 40 percent of the addition in public debt originated from PKR depreciation, which inflated the external debt during Q1-FY14. More specifically, Rupee depreciation against US Dollar resulted in Rs 348.3 billion increase in the Rupee value of external debt, whereas depreciation of US Dollar against Japanese Yen further added Rs 58 billion to the public debt stock in this period. As regards the domestic debt, the increase came primarily from budgetary borrowings from SBP to finance the fiscal gap. However, it should be noted that the *increase* in domestic debt far exceeded actual budgetary requirements during the quarter; financing of the government from domestic sources was Rs 314.1 billion,[25] but domestic debt shows an increase of Rs 634.0 billion during the quarter. This difference arose mainly because the government borrowed *more* funds than it actually required, and placed the additional funds in its deposits held by SBP.[26] Therefore, the increase in debt stock represents *gross* budgetary borrowings, whereas the deficit financing is based on *net* budgetary borrowings – excluding government deposits.[27]

Over-reliance on domestic short-term financing resources remains a challenge for policy makers. Unlike the case of other emerging economies where the bulk of the domestic debt is held by non-bank institutions and foreign residents, two-thirds of Pakistan's domestic debt stock is held by domestic commercial banks alone. This is despite various initiatives to encourage non-bank investment in floating & permanent debt securities.[28]

As far as foreign investment in domestic debt is concerned, uncertainty about final tax liabilities and various country-specific risks have kept foreign ownership of Rupee debt securities at a very lower level (**Box 4.2**). As has been mentioned in previous SBP reports, this increases the vulnerability of Pakistan's public debt, as it gives rise to roll-over and interest-rate risk. This risk realized to some extent during the first quarter of FY14.

Materialization of roll-over risk in short-term floating debt

Anticipating a hike in the policy rate, banks were largely shy from participating in T-bill auctions throughout Q1-FY14 (**Chapter 3**). Resultantly, the government

[25]We get this number by adding net decline of Rs 27.2 billion in external financing, to Rs 286.9 billion budget deficit during the quarter.

[26] Government's deposits with SBP increased by Rs 384.6 billion during Q1-FY14.

[27]The domestic debt stock as on end-October 2014 shows a Rs 264 billion decline, compared to the end-September 2013 position. This is mainly due to the retirement of government debt owed to the central bank.

[28] To diversify the debt market, SBP allowed participation of individuals and small institutional investors in both MTBs and PIB auctions by non-competitive bids, through its circulars FSCD Circular No.07 &18, dated June 06, 2009, and December 04, 2010.

had to depend on the central bank to finance its debt payments to commercial banks, at the cost of breaching the limit of zero quarterly borrowings. However, the government also had to observe the limit placed by IMF on its net quarterly borrowings from SBP. In this regard, the increase in the discount rate on September 13, 2013, helped the government in reviving commercial bank's interest in T-bill auctions. In the last T-bill auction in the first quarter of FY14, the government was able to mobilize Rs 515.9 billion – the highest ever amount raised in a single auction. This helped the fiscal authorities meet the IMF's end-September limit on net government borrowing from SBP, retiring a part of central bank debt, and by increasing government deposits with the central bank.

PIBs were not attractive in Q1-FY14

The stock of PIBs recorded a slight decline during Q1-FY14, compared to the end-June position. This was due to a fall in PIB holdings by commercial banks, as they shifted a part of their holdings to insurance companies and other NBFIs.[29]

Changing sentiments about the discount rate, and banks' already high exposure in the PIBs, discouraged further investments during Q1-FY14. Even the 50 bps increase in the policy rate, during the first quarter, was not enough to revive interest in PIBs; the offered amounts remained well below target in all the auctions held during the quarter (**Chapter 3**).[30] On the other hand, the government was not inclined towards long-term borrowing, and did not accept the full amount offered in these auctions.[31] It must be noted that this trend was reversed from Q2-FY14 onwards: a total of Rs 105.6 billion was raised in three PIB auctions held during the quarter. Result of the auction held on 30th January 2014 was even more encouraging, in which, the government raised Rs 195.8 billion.

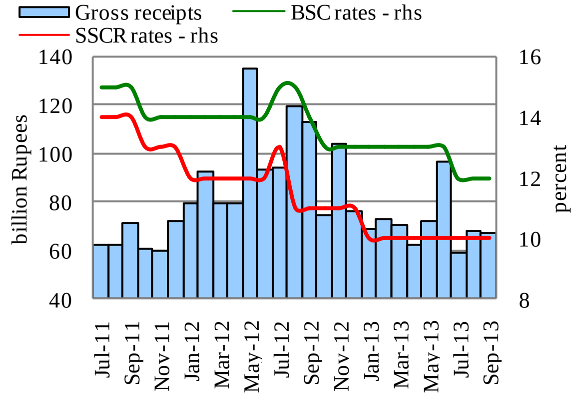
Falling returns, discouraged investment in NSS

Following the selective resumption of institutional investment in April 2012, gross inflows remained buoyant for a few months in FY13. However, with the reduction in profit rates on January 1, 2013, this temporary spurt appears to have stalled (**Figure 4.2**). In fact, with the next reduction in rates in July 2013, returns on NSS were at their lowest level in the past nine years. With ongoing maturities, net mobilization fell during Q1-FY14.

[29] Unlike T-bills stock that has around 90 percent holding by commercial banks, PIBs have almost equal ownership of bank and non-bank institutions.
[30] The offer-to-target ratio stood at 0.57 during Q1-FY14.
[31] Against the offer of Rs 85.5 billion, the government raised Rs 65.9 billion in the PIB auctions during Q1-FY14.

External Debt & Liabilities
Despite repaying US$ 1.3 billion, Pakistan's public external debt & liabilities increased in Q1-FY14 (**Table 4.6**). The depreciation of US Dollar against major currencies, created a significant exchange loss for Pakistan, which resulted in a US$ 548.5 million addition in the debt stock during the quarter.[32]

Figure 4.2: Gross NSS Inflows and Major Profit Rates



Source:State Bank of Pakistan, CDNS

The phase of declining external debt, which was observed during the past few years, ended with the Extended Fund Facility (EFF) from the IMF. Inflows from the IMF, and other multilateral creditors, are likely to add to Pakistan's external debt going forward. This said, a rise in the external debt and depletion in FX reserves, reduced the external debt servicing capacity of the economy in the first three months of FY14 (**Table 4.7**).

Table 4.6: Pakistan's Public External Debt & Liabilities
million US$

	Jun-13	Sep-13	Change
Public external debt & liabilities	50,176	50,560	385
Government debt	43,496	44,076	580
IMF	4,387	4,163	-224
External Liabilities	2,292	2,321	29
Debt servicing/FX earnings	12.0	12.9	

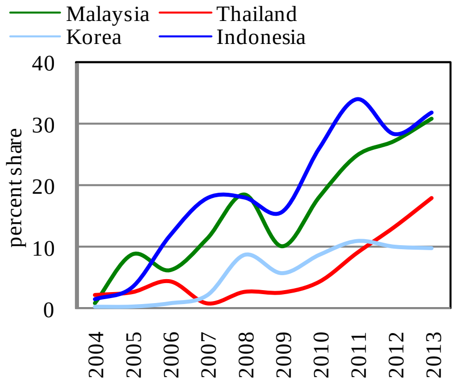
Source: State Bank of Pakistan

Box 4.2: Interest Rate Movements and Capital Inflows to Pakistan
Capital inflows to a country can be categorized as FDI, portfolio investment; external loans, remittances and external investment in debt securities. Typically, a rise in interest rates in the host country, is said to attract a higher stream of foreign capital inflows, however, this relationship does not always hold: FDI and portfolio investment display a negative relationship, whereas remittances and external debt are not sensitive to the interest rate movements. This leaves foreign investment in local debt securities (bond market) as the only category that merits consideration, while analyzing the impact of interest rate movements.

Pakistan's Case: Unlike the experience of other emerging economies that have a noticeable share of international investment in local currency bond markets, Pakistan receives only sparse external inflows into its domestic debt securities (**Figure 4.1.1**). To put things into perspective, FY11 witnessed highest foreign inflows in T-bills amounting to US$ 212 million, which constituted a mere 0.9 percent of the T-bills stock on end-June 2011. On the other hand foreign investment in PIBs has never crossed even US$ 100 million benchmark in a year (**Figure 4.1.2**). The data on international

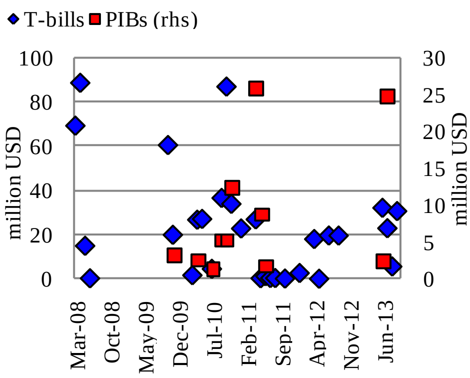
[32] US Dollar depreciated against Euro, Japanese Yen and SDRs during this period.

Figure 4.1.1: Foreign Holdings in Local Currency Government Bonds



Source: http://asianbondsonline.adb.org

Figure 4.1.2: Foreign Inflows in Pakistan Local Currency Debt Securities



Source: State Bank of Pakistan

investment in NSS is not available, but anecdotal evidence indicates only nominal foreign participation in these schemes.[33]

This sluggishness can be traced to a number of issues. In the literature, in addition to interest rate differential, strong economic fundamentals -stable exchange rate and inflation[34] - and extent of bond market development[35] are cited as important factors underpinning foreign inflows into local debt markets Burger and Warnock (2004).[36] The performance of Pakistan's economy on these counts, however, has remained unsatisfactory. In the period of last ten years, exchange rate has experienced various bouts of volatility, whereas inflation has mostly remained in double digits (**Figure 4.1.3**). As regards the development of the bond market, while the size of the domestic debt market has increased with government's growing dependence on internal resources for financing the fiscal deficit, the composition of domestic debt has shifted towards short-term floating debt. This not only hampers the liquidity of the long-term debt market, but also restricts development of bench-mark bonds. This is in sharp contrast to the situation in other

Table 4.1.1: Sovereign Ratings by Moody's (2013)

	Outlook
Pakistan	Negative
Malaysia	Stable
Thailand	Stable
Indonesia	Stable
Korea	Stable

Source: Bloomberg

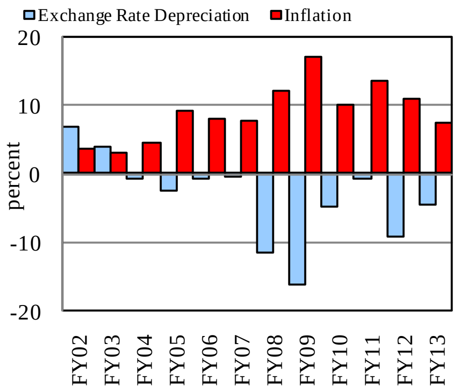
[33] To attract inflows from non-resident Pakistanis, CDNS has so far made formal arrangements with only two countries, namely Bahrain and UAE.

[34] Sharp fluctuations in exchange rate induce volatility in returns on local currency bonds, and hence discourage foreign investors. Similarly, high inflation undermines the purchasing power of funds invested in host country, and discourages foreign investment (Source: Kaur and Dhillon, 2010).

[35] The extent of bond market development can be gauged from the size of the market, composition of bonds in terms of maturities, type of instrument, investor base diversity; and market liquidity (source: Mehrotra, Miyajima & Villar, "Developments of domestic government bond markets in EMEs and their implications", BIS Paper No 67, 2012.

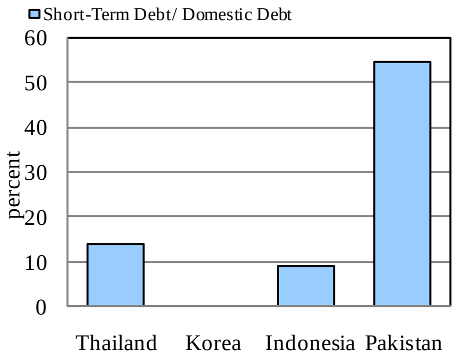
[36] Burger and Warnock (2004), "Foreign participation in local currency bond markets", http://faculty.darden.virginia.edu/

Figure 4.1.3: Trends in Inflation and Exchange Rate Depreciation



Source: SBP

Figure 4.1.4: Extent of Domestic Bond Market Development



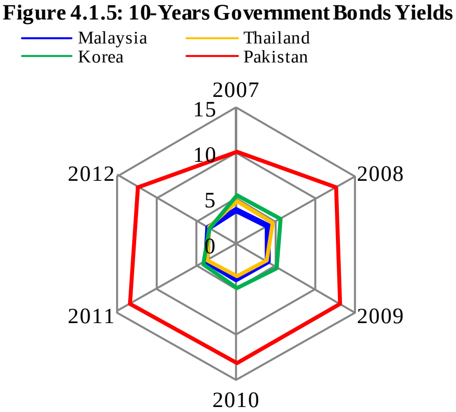
Mehrota, Miyajima and Agustin Villar (2012), BIS Paper No. 67

emerging markets, which largely depend on long-term fix rate bonds for the financing of fiscal deficits (**Figure 4.1.4**).

In addition to these factors, security concerns and political uncertainty are some other important deterrents to foreign inflows in Pakistan's debt market. This can also be seen from the lower sovereign ratings assigned to Pakistan by the international rating agencies e.g., Moody's vis-a vis other countries (**Table 4.1.1**). Resultantly, despite much attractive yields on Pakistan's long term bonds compared to other emerging economies, the country is not able to attract external inflows (**Figure 4.1.5**). In fact, our in-house estimates indicate that despite the large depreciation of Rupee against US$, investment in Pakistan's long term bonds is a profitable option for international investors (**Figure 4.1.6**); however, the numerous issues discussed above have stymied this avenue of foreign inflows for the country.

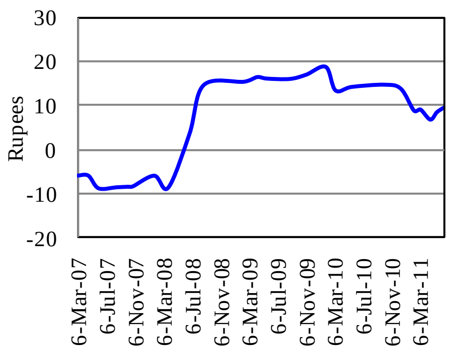
In this scenario this can be safely concluded that a rise in the domestic interest rates is not likely to boost capital inflows to the domestic bond market. On the other hand, this can discourage the

Figure 4.1.5: 10-Years Government Bonds Yields



Source: Haver Analytics, SBP

Figure 4.1.6: Hypothetical Returns on US$ 1 Investment in 3-year PIBs



Source: SBP in-house estimates

external inflows to the equity market, by negatively impacting the performance of domestic stock market.

5 External Sector[1]

5.1 Overview

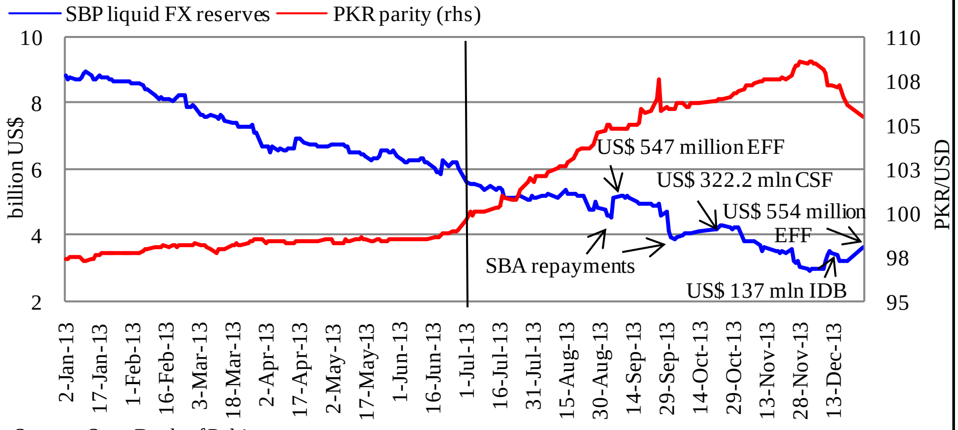
FY14 started with some concern on the external front: although Pakistan entered a new IMF program in Q1-FY14, the FX market remained volatile and PKR depreciated by 6.0 percent – the highest quarterly depreciation in five years (**Table 5.1**). This can be traced to: (i) a sharp rise in the current account deficit; (ii) FX purchases by SBP and the related speculative sentiments in the market; and (iii) US$ 1.8 billion external debt servicing.

Table 5.1: Key External Sector Indicators
billion US$

	FY13	Q1-FY13	Q1-FY14
SBP liquid FX reserves	6.0	10.4	4.7
Current account balance	-2.5	0.4	-1.2
Trade balance	-15.4	-3.6	-4.2
Worker remittances	13.9	3.6	3.9
Direct investment in Pakistan	1.3	0.1	0.2
Disbursement of external debt	2.9	1.2	0.6
External debt servicing*	6.5	1.1	1.8

*Including short-term debt servicing, and servicing to the IMF
Source: SBP

Figure 5.1: Comparison of SBP Reserves and PKR Parity in H2-FY13 and H1-FY14



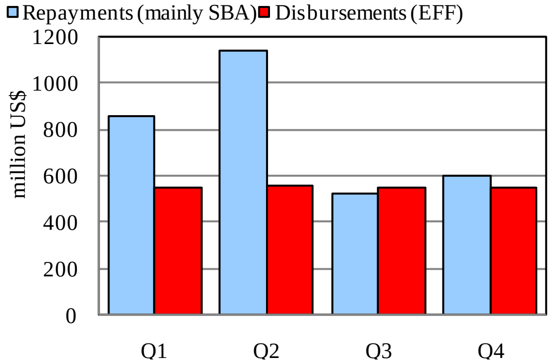
Source: State Bank of Pakistan

While debt repayments were known in advance, and the absence of coalition support fund (CSF) was already priced in, the FX market was unnerved by expectations of FX purchases by SBP to achieve quarter-end targets for net international reserves (NIR), as stipulated in the letter of intent. This even caused

[1] This section is based on 6th edition of the Balance of Payments Manual (BPM-6). State Bank of Pakistan has started compiling BoP statistics as per BPM-6 since July 2013, and has also transformed FY13 accounts according to these standards, for comparability. Please see **Box 5.1**, for a discussion on major heads of BoP under this edition, and interpretation of important indicators.

the interbank PKR parity to touch an all-time high of 110.5 on 26th September 2013, before closing at 105.35 on the same day (**Figure 5.1** and **Section 5.4**).

Figure 5.2: Measuring Net Inflows from the IMF during FY14

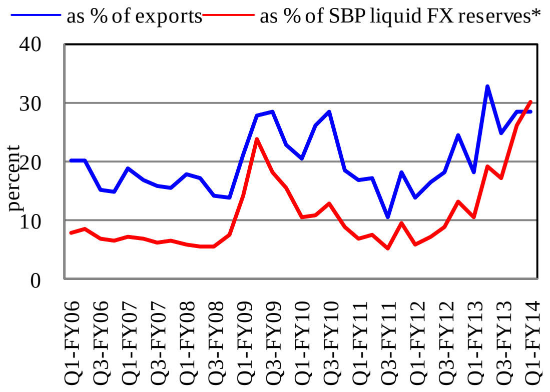


Source: IMF

In this context, while the new IMF program provided much needed FX support to Pakistan, the fact that fresh disbursements have been tagged with quarterly targets of SBP's NIR, it could not calm the FX market. More specifically, the EFF program was not frontloaded, and the burden of net repayments to the IMF, did not help market sentiments during the first two quarters of FY14 (**Figure 5.2**).

In addition to the IMF, debt servicing to other foreign creditors was also challenging during Q1-FY14, totaling US$ 927.4 million.[2] Total external debt servicing during the quarter used 30 percent of liquid FX reserves available with SBP at the start of the quarter. Its use of quarterly export revenues was also of the same magnitude (**Figure 5.3**).

Figure 5.3: Burden of External Debt Servicing



*debt servicing during the quarter as % of SBP's FX reserves at the start of the quarter
Source: State Bank of Pakistan

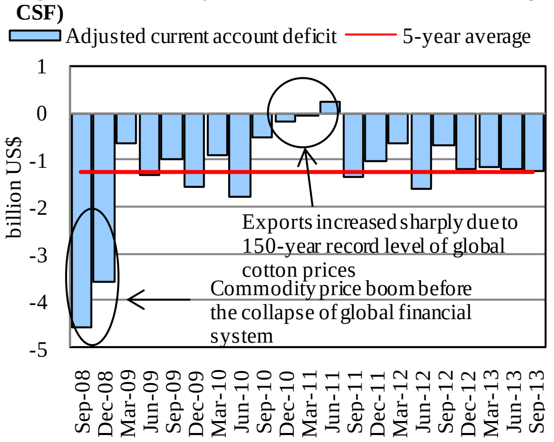
Pakistan's import bill was of growing concern, as it increased by 7.6 percent during Q1-FY14. This increase reflected rising demand for petroleum, to fill the demand-supply gap created by gas shortages in the country. The demand for crude oil was particularly strong, which can also be traced to the improved financial position of local refineries in Q1-FY14, compared

[2] In Q1-FY13, external debt servicing excluding the IMF was only US$ 645.2 million.

to the previous year, as the government settled a significant portion of circular debt at end-June 2013 (**Section 5.5**).[3]

Export growth, on the other hand, remained modest, though there was a visible improvement in the export of some of the major items like textiles, rice and leather. In overall terms, trade deficit widened to reach US$ 4.2 billion; unlike Q1-FY13, this gap could not be *completely* filled by worker remittances, even though, increased by an impressive 9.1 percent during the quarter (**Table 5.1**). The absence of CSF inflows during Q1-FY14 widened the current account deficit to reach US$ 1.2 billion, which is about the same size, as it was in the past 5 years (after adjusting for CSF inflows) (**Figure 5.4**).

Figure 5.4: Quarterly Current Account Deficit (Excluding CSF)



Source: State Bank of Pakistan

In contrast to the current account, the financial account performed relatively better in Q1-FY14, compared to the corresponding quarter of FY13. Foreign investments increased, and despite higher government debt repayments, net debt outflows were smaller due to FX borrowings by SBP and commercial banks (**Section 5.3**).[4] Nonetheless, the overall financial account continued to show a net outflow, and the country's FX reserves bore the entire burden of financing the external deficit.

[3] The quantum import of crude petroleum increased by 10.5 percent YoY in Q1-FY14. Moreover, quantum import of motor spirit (petrol) and furnace oil increased by 11.1 percent and 0.8 percent, respectively. In contrast, quantum import of high-speed diesel declined sharply by 17.5 percent YoY (**Chapter 2**). Since BoP data records imports at the time of actual payment, a *part* of the increase in petroleum bill was also on account of difference in timing of payments for furnace oil between the two periods: in Q1-FY13, most import payments were deferred to subsequent months, as PSO was facing severe liquidity constraints. Due to settlement of circular debt at end-June 2013, PSO's liquidity condition improved, and it was able to make import payments on time.

[4] SBP borrowed in the form of drawings from the currency swap arrangement with Bank of China. IMF loan for BoP support is not included in the financial account.

5.2 Current Account

Current account posted a deficit of US$ 1.2 billion in Q1-FY14, compared to a modest surplus of US$ 0.4 billion in the previous year. As mentioned before, this difference was explained mainly by an absence of coalition support fund this year, which had turned the deficit in the current account into a surplus last year (**Table 5.2**). Adjusting for CSF, the difference in current account deficits between two quarters, reduces significantly. The remaining difference was explained by higher import payments in Q1-FY14 (**Section 5.5**).

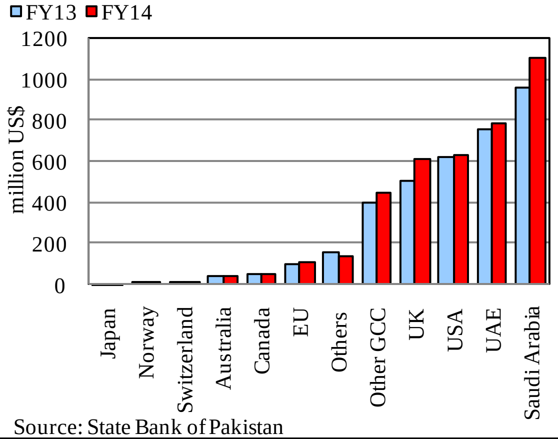
Table 5.2: Details of Current Account in Q1 as per BPM-6
million US$

	FY13	FY14
Current account balance	**439**	**-1,206**
Excl. CSF	***-679***	***-1,206***
A. Balance on trade in goods	-3,625	-4,243
Export of goods FOB	6,151	6,275
Import of goods FOB	9,776	10,518
B. Balance on trade in services	108	-890
Of which: CSF	1,118	0
C. Balance on primary income*	-692	-809
D. Balance on secondary income**	4,648	4,736
Of which: Worker remittances	3,599	3,927

*previously, income account; **previously, current transfers
Source: State Bank of Pakistan

As mentioned before, worker remittances grew by 9.1 percent during the quarter. Most of the increase came from Saudi Arabia and UK (**Figure 5.5**). Interestingly, it was earlier feared that due to ongoing drive against illegal immigrants in Saudi Arabia, there could be some repatriation of Pakistanis from the Kingdom, and subsequently, a reduction in remittances. Fortunately, this did not happen: while it is reported that over 50,000 Pakistani immigrants were sent back, around 800,000 documented and regularized, as per the new requirements, during the grace period of 7 months.[5] Therefore, the increase in remittances may reflect a shift from

Figure 5.5: Country-wise Remittances -Q1



Source: State Bank of Pakistan

[5] Saudi Gazette. Initially, Saudi government gave an amnesty for three months, i.e., April 2013 to June 2013, to illegal foreign workers to either regularize their status, or leave the country without prosecution. At the end of this period, it extended the time limit of this amnesty till the end of October 2013.

informal to formal avenues to remit funds, by those who were legalized; but we cannot rule out the possibility of reverse capital flight by those who returned.

As far as the UK was concerned, the increase in remittances mainly reflects the initiation of direct-to-bank (D2B) project of a domestic commercial bank with Western Union during Q1-FY14, which has made remitting through Western Union cost-free.[6] While this project is meant for Western Union outlets all across the world, early success in UK can be traced to aggressive marketing there.

Box 5.1: Major Heads of Balance of Payments as per BPM-6, and their Interpretation
The overall framework of the methodology of BPM-5 and BPM-6 is conceptually the same. However, BPM6 deepens the harmonization of recommendations given by the IMF's external sector statistics, with the update of the System of National Accounts (SNA), and the international standards in the area of direct investment statistics and other macroeconomic statistics. We are presenting below the major heads of BoP in the BPM-6, along with their interpretations. The difference between BPM-5 and BPM-6 in various components is summarized in **Table 5.1.1**:

1. Current account
The current account shows flows of goods, services, primary income and secondary income between resident and non-residents.

The ***primary income account*** shows primary income flows between resident and non-resident institutional units. Primary income captures returns for the provision of labour and financial assets, and renting of natural resources. The international accounts show following types of primary income: compensation of employees;[7] dividend incomes; reinvested earnings; interest; investment income attributable to policy holders in insurance, standardized guarantees, and pension funds; rent; and, taxes and subsidies on products and production.

The ***secondary income account*** shows current transfers[8] between residents and non-residents. The international accounts classify the secondary current transfers in following broad categories: personal transfers; and other current transfers. Personal transfers consist of all current transfers in cash, or in kind, made or received by resident households to or from non-resident households, e.g., workers' remittances. Other current transfers include social contributions; social benefits; current taxes on income or wealth; non-life insurance premiums and claims; current international co-operations; and miscellaneous current transfers.

2. Capital account
The capital account shows debit and credit entries for non-produced non-financial assets, between residents and non-residents. This account also includes capital transfers, in which the ownership of

[6] In addition to direct-to-bank, Western Union also offered various promotion offers for cash over the counter during Jul-Oct 2013.
[7] Compensation of employees has three main components: wages and salaries in cash; wages and salaries in kind; and employer's social contribution.
[8] A transfer is an entry that corresponds to the provision of good, service, financial asset, or other non-produced asset by an institutional unit to another institutional unit, when there is no corresponding return of an item of an economic value.

an asset changes from one party to another; or which obliges one or both parties to acquire or dispose of an asset; or where a liability is forgiven by the debtor.

3. Financial Account

The financial account records transactions that involve financial assets and liabilities and that take place between residents and non-residents. The overall balance on the financial account is called net lending (+)/ net borrowing (-). Net lending (when financial account balance is a positive number)

Table 5.1.1: Comparison of Balance of Payments as per BPM-5 and BPM-6

billion US$	BPM-5	BPM-6	Remarks
Current account balance	**-1,206**	**-1,206**	
Trade balance	-4,267	-4,243	Repairs of goods and goods for processing are now shifted from trade account to services account; whereas, merchanting of exports shifted from services to trade
Services balance	-868	-890	
Primary income balance	-807	-809	Financial intermediation services indirectly measured is now included in services account, and excluded from primary income account.
Secondary income balance	4,736	4,736	Renamed from 'current transfer'
Capital Account,	**46**	**46**	
Financial Account	**382**	**-382**	In the BPM-5, increase in assets was reported with a negative sign; therefore, the balance used to be calculated as assets + liabilities. In the BPM-6, increase in assets is reported with a positive sign; and now the balance is calculated as assets – liabilities
Direct investment	172	-172	
Direct investment abroad	-59	59	
Direct investment in Pakistan	231	231	
Portfolio investment	107	-107	
Portfolio investment abroad	-1	1	
Portfolio investment in Pakistan	108	108	
Financial derivatives (asset-liability)	0	0	
Other investment assets	195	-195	
Other investment liabilities	-92	-92	
Monetary authorities	245	245	
General Government	-258	-258	
Disbursements	525	525	
Amortization	783	783	
Banks	-5	-5	
Other sectors	**-74**	**-74**	
Net errors and omissions	**-415**	**-415**	
Overall balance	**-1193**	**1,193**	

means that in net terms, the economy supplies funds to the rest of the world, taking into account acquisitions and disposal of financial assets; and incurrence and repayment of liabilities. Net borrowing (when financial account is a negative number) means that in net terms, the economy is receiving/borrowing funds from the rest of the world

Financial account has 5 components:

1. ***Direct investment***, which is a category of cross-border investment associated with a resident in one economy having control or a significant degree of influence on the management of an enterprise that is resident in another economy. Direct investment has two components: net direct investment in rest of the world; and net direct investment in the reporting country. In case of

Pakistan, the balance in direct investment will be calculated as direct investment abroad (by Pakistanis) minus direct investment in Pakistan by the rest of the world. A positive balance in direct investment implies that in net terms, Pakistan invested in rest of the world (asset acquisition). Similarly, a negative balance in direct investment implies that in net terms, rest of the world invested in Pakistan (liability incurrence).

2. ***Portfolio investment*** is defined as cross-border transactions and positions involving debt or equity securities, other than those included in direct investment or reserve assets. The interpretation of a positive and negative balance for portfolio investment is the same as it is for direct investment. Therefore, there will be a negative balance in portfolio investment if portfolio investment in Pakistan by rest of the world exceeds portfolio investment by Pakistanis abroad. Similarly, there will be a positive balance in portfolio investment, if portfolio investment by Pakistanis abroad exceeds portfolio investment in Pakistan by rest of the world.

3. ***Financial derivatives*** and employee stock options: A financial derivative contract is a financial instrument that is linked to another specific financial instrument or indicator or commodity and through which specific financial risks can be traded in their own right in financial markets.

4. ***Other investment*** is a residual category, which includes positions and transactions other than those included in direct investment, portfolio investment, derivatives, and reserve assets. This category is comprised of currency and deposits; loans; trade credit and advances; SDR allocations; other accounts receivable/payable; non-life insurance technical reserves; and other equity. These items are classified under net acquisition of assets and net incurrence of liabilities for all the sectors of the economy. For instance, loans received by Pakistan are categorized under net incurrence of liabilities. For each sector, disbursements during the period are reported, along with the amortization of loans; net incurrence of liabilities will then be calculated as disbursements minus amortization during the period. If disbursements exceed amortization, the net incurrence of liabilities will be a positive number (an increase in liabilities), whereas, if amortization exceeds disbursements, then net incurrence of liabilities will be a negative number (a decline in liabilities).

5. ***Reserve assets*** are those external assets that are readily available to and controlled by monetary authorities for meeting BOP financing needs, for intervention in exchange markets to affect the currency exchange rates, and for other related purposes (e.g., maintaining confidence in the currency and the economy).

5.3 Financial Account

Before analyzing the financial account, it is important to revisit the data interpretation under the BPM-6. The US$ 0.4 billion deficit shown during Q1-FY14, does not imply net FX outflows from the country; in fact, this only shows the difference between net acquisition of financial assets, and net incurrence of financial liabilities during the period (**Table 5.3** and **Box 5.1**). For a more meaningful interpretation of the financial flows, it is important to discuss this account component-by-component.

Foreign investment

Foreign investment is the difference between net direct investment abroad and net direct investment in Pakistan. Net direct investment in Pakistan showed a strong recovery: it grew by 85.0 percent YoY during Q1-FY14, compared to a decline in Q1-FY13.[9]

Table 5.3: Details of Financial Account during Q1 as per BPM-6
million US$

	FY13	FY14
Financial account	**406**	**-382**
I. Direct investment (asset – liability; minus sign reflects net borrowing)	**-102**	**-172**
Direct investment abroad (asset)	23	59
Direct investment in Pakistan (liability)	125	231
II. Portfolio investment (asset – liability; minus sign reflects net borrowing)	**-109**	**-107**
Portfolio investment abroad (asset)	5	1
Portfolio investment in Pakistan (liability)	114	108
III. Other investment (A - B) (minus sign reflects net borrowing)	**617**	**-103**
A. Net acquisition of financial assets	420	-195
(i) Central bank	0	0
(ii) Deposit-taking corporations	285	-190
(iii) General government	-4	-2
(iv) Other sector	139	-3
B. Net incurrence of liabilities	-197	-92
(i) Central bank	0	245
(ii) Deposit-taking corporations	-310	-5
(iii) General government	17	-258
Disbursements	398	525
Amortization	381	783
(iv) Other sector	96	-74

Source: State Bank of Pakistan

This increase was driven by an 8.2 percent growth in gross FDI in the country, and a 20.0 percent decline in outflows (disinvestments from Pakistan) (**Table 5.4**). Despite this improvement, FDI inflows remain far from satisfactory:

Table 5.4: Direct Investment in Pakistan
million US$

	Inflow	Outflow	Net
Q1-FY13	464	339	125
Q1-FY14	502	271	231
percent growth	*8.2*	*-20.0*	*85.0*

Source: State Bank of Pakistan

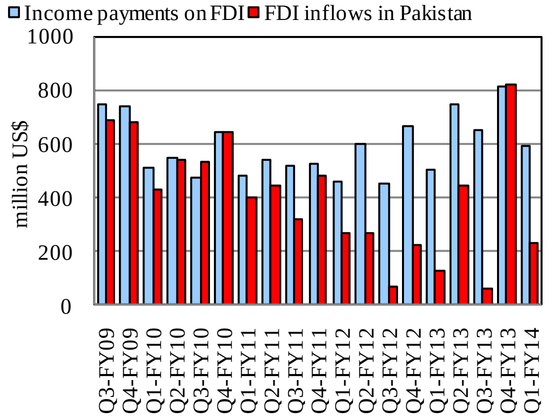
At first, component-wise FDI shows that the entire increase was explained by an increase in reinvested earnings (mainly reflecting better corporate profitability this year), and a sharp decline in corporate loan

[9] Net direct investment in Pakistan had declined from US$ 263 million in Q1-FY12, to US$ 125 million in Q1-FY13.

repayments.[10] In contrast, investments in the form of cash equity and capital equipments, which are considered more productive form of FDI, remained lackluster.

Secondly, the level of FDI is still too low to have much of an impact. Putting this in perspective, income repatriation from outstanding FDI continues to exceed FDI inflows in the country (**Figure 5.6**). Therefore, in net terms, foreign investments are causing a net FX outflow from the country.

Figure 5.6: FDI Income Payments vis-a-vis FDI Inflows



Source: State Bank of Pakistan

<u>Other investments</u>

Other investments mainly represent the difference between net acquisition of financial assets and liabilities during a certain period. While assets mainly include holding of FX denominated asset including currency, deposits, and outstanding export bills; liabilities comprise borrowings from foreign sources by different sectors of the economy. A negative balance in other investments during Q1-FY14 mainly represents a sharp decline in financial assets, which more than offset the decline in financial liabilities.

The decline in financial assets during Q1-FY14 can be traced to depletion in commercial banks' total reserves: during Q1-FY14, banks' trade nostros declined by US$ 414 million compared to an increase of US$ 200 million in Q1-FY13.[11] While a part of this decline can be attributed to an increasing current account deficit, absence of FX support from SBP through most of the period, appears to be the major swing factor (**Section 5.4**).

As far as net liabilities were concerned, these continued to show a decline in Q1-FY14. Most notably, debt retirements by the government exceeded fresh

[10] Gross FDI inflows in the country represents: (i) cash equity; (ii) capital equipments; (iii) reinvested earnings; and (iv) loans from investing company. Outflows include disinvestments and loan repayments to investing company.
[11] Total FX reserves of commercial banks include their liquid FX reserves and trade nostros.

disbursements, which caused a net decline in its liabilities by US$ 258 million during Q1-FY14.[12] A large part of this decline, however, was offset by a rise in FX liabilities of the central bank, which was in the form of drawings from the currency swap arrangement with Bank of China. As a result, the overall decline in net liabilities was much smaller in Q1-FY14 compared with the corresponding quarter of FY13.

5.4 Reserves and Exchange Rate

The decline in SBP liquid FX reserves continued into FY14: there was a drawdown of US$ 1.3 billion in Q1-FY14 from SBP reserves, which was 3 times larger than the decline seen in Q1-FY13. This decline can be traced to: (i) unwinding of the swap/forward contracts by US$ 480 million; (ii) net repayment of US$ 311 million to the IMF; and (iii) debt repayment of US$ 258 million by the government (**Table 5.3**). In contrast, commercial banks' liquid FX reserves showed a modest increase during the quarter, reflecting a rise in foreign currency deposits.[13] On aggregate, the country's liquid FX reserves reached US$ 9.8 billion at end September 2013, which can just cover 3-month (or 12.5 weeks) of the import bill. Furthermore, the quarterly target set by the IMF for SBP's NIR was also missed: against an adjusted target of US$ -2.9 billion, SBP's NIR was US$ -3.2 billion at end-September 2014.[14]

This pressure on FX reserves was also reflected in the PKR parity: compared to the modest depreciation in the previous year, PKR depreciated by a 20-quarter high of 6.0 percent during Q1-FY14 (**Figure 5.7**). While a large current account deficit, and a decline in FX reserves, explains the depreciating *trend*, it does not fully explain the *magnitude* therein. The magnitude, we believe, can be traced to lack of SBP FX support, as well as self-fulfilling market expectations during the quarter. SBP refrained from intervening in the FX market throughout the quarter, due to insufficient FX reserves; in fact, it purchased over US$ 125 million in July

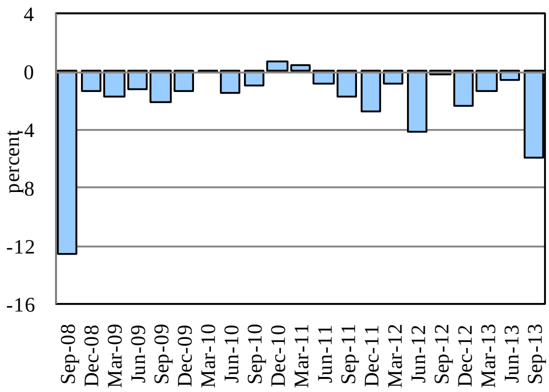
[12] Here, it is important to mention that the stock of external debt as reported in **Chapter 4** shows net increase, whereas, BoP accounts show net retirement of external loans. This difference stems mainly from revaluation of debt stock incurred in currencies other than US dollar (for details, see **Chapter 4**). The IMF loan for BoP support is another source of difference in these two data sets; while disbursement and retirement of IMF loans are included in the external debt data, these are not included in the balance of payments, and are reported below the line.

[13] Banks' liquid FX reserves are calculated as their holding of FE-25 deposits, minus trade financing. These do not include banks' trade nostros.

[14] IMF Country Report No. 14/1, dated January 2014, "First Review under the Extended Arrangement under the Extended Fund Facility, Request for Waiver of Nonobservance of a Performance Criterion and Modification of Performance Criteria".

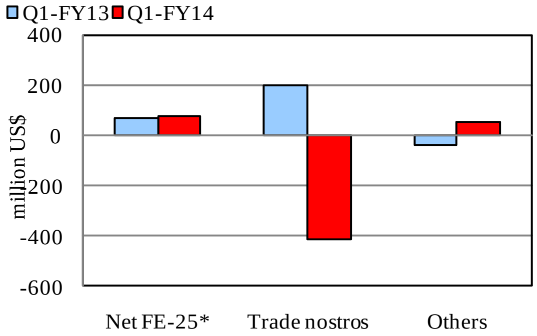
and August 2013 from the interbank as a prior action for the EFF program.[15] As such, the entire pressure of current account payments during the period was borne by commercial banks, which is evident in their depleting trade nostros (**Figure 5.8**).[16] In September 2013, the IMF released a detailed staff report for Article IV consultation, which emphasized the need for FX purchases from the interbank to shore up SBP's net reserves (NIR). This generated market speculations about future FX purchases by SBP to meet quarterly NIR targets, which pushed the interbank exchange rate to a record-high of 110.5 per USD on 26th September 2013.

Figure 5.7: Quarterly Depreciation of PKR



Source: State Bank of Pakistan

Figure 5.8: Change in Commercial Banks' Total Reserves



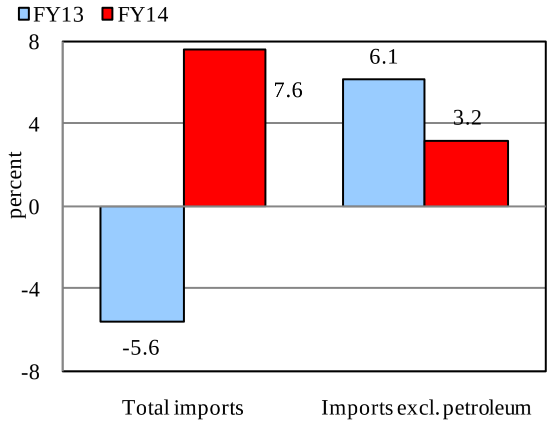
*These are calculated as commercial banks' holding of FE-25 deposits minus loans extended for trade finance, and other placements of these deposits inside Pakistan.
Source: State Bank of Pakistan

The FX market returned to calm, especially after the first IMF tranche of US$ 574 million was received at end-September 2013, and CSF inflow of US$ 322.2 million in October 2013. In mid-December 2013, Pakistan also received the second IMF tranche of US$ 554 million. Another important reason for the calm, is that Pakistan has already met the lumpy repayments from the old SBA; repayments in the second half of FY14 are relatively smaller, and will be compensated by scheduled disbursements of the EFF in that period (**Figure 5.2**). In addition to this, the market is expecting additional FX receipts

[15] IMF had suggested SBP to purchase US$ 125 million from the interbank to build up its NIR, as mentioned in the detailed letter of intent.
[16] Banks' trade nostros are not included in their liquid FX reserves.

under CSF; disbursements of IFI loans; 3G auction; and to a lesser extent, privatization proceeds from Etisalat.[17]

Figure 5.9: YoY Growth in Import Payments -Q1



Source: State Bank of Pakistan

5.5 Trade Account

Trade deficit widened during Q1-FY14, to reach US$ 4.2 billion. This increase can be traced to a sharp rise in imports, which outpaced the modest growth in exports. This outcome was driven primarily by the petroleum sector – excluding which, import growth showed a slight decline compared to Q1-FY13 (**Figure 5.9**). Two factors mainly explain the strong growth in petroleum payments.

First, the settlement of circular debt right before the first quarter, improved the liquidity situation across the energy sector value chain.[18] Refineries, in particular, were able to import crude oil to increase domestic production of key petroleum products (**Chapter 2**).[19] And second, reduced availability of CNG throughout the country has increased the demand for petrol: total sales of petrol countrywide increased by 11.6 percent YoY during Q1-FY14.

Non-petroleum imports

As mentioned before, non-petroleum imports tapered in Q1-FY14 compared to the previous year. This can be attributed to a number of items (**Figure 5.10**):

(i) Decline in international price of palm oil reduced its import bill by 19.2 percent, even though customs record shows a rise in import quantum.[20,21]

(ii) Better availability of gas to the fertilizer sector improved domestic production, and a corresponding decline in fertilizer imports (**Chapter 2**).

[17] The issue between Etisalat and Government of Pakistan still remains unresolved, regarding the transfer of all the agreed properties of PTCL to the UAE Company.

[18] The government paid Rs 322 billion to settle the circular debt in June 2013.

[19] Quantity import of crude oil has increased by 10.5 percent YoY in Q1-FY14 (Source: OCAC).

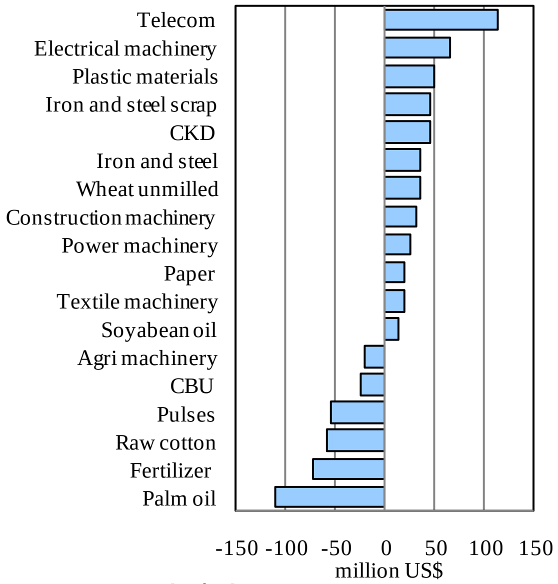
[20] Customs data shows an increase in quantum import of palm oil by 1.5 percent YoY in Q1-FY14, and a decline in its unit value by 10.9 percent YoY in the same period (source: Pakistan Bureau of Statistics).

[21] Higher domestic production of edible oil and ghee during Q1-FY14 also suggests a rise in import of palm oil. As noted in **Chapter 2,** production of edible oil and ghee has increased by 9.8 and 7.6 percent respectively in Q1-FY14.

(iii) Domestic production of pulses was strong in Q1-FY14 compared to the previous year, which reduced dependence on imports.

(iv) Till October 2012, import of CBUs was allowed for cars up to five years old. In November 2012, however, the government restricted this age limit to only three years, which caused a decline in import of CBU cars from 14,223 in Q1-FY13 to only 4,965 units in Q1-FY14.

Figure 5.10: YoY Change in NOn-petroleum Imports (Q1-FY14)



Source: State Bank of Pakistan

Encouragingly, machinery imports improved considerably, which bodes well for the economy. This increase was broad-based, including telecom, electrical, construction, power generating, and textile. A sharp increase in telecom imports was evident mainly in reception and transmission apparatus, as the country gears up to enter into 3G era that requires more innovative broadband services. While the increase in textile machinery may have been to capitalize on the GSP+ status January 2014 onwards, the increase in electrical machinery was primarily driven by the import of medical equipment. Finally, robust construction activity in the country continued to attract investment in the sector – the increase in import of construction machinery in Q1-FY14, was even larger than the full-year imports during FY13.

Table 5.5: Exports during Q1

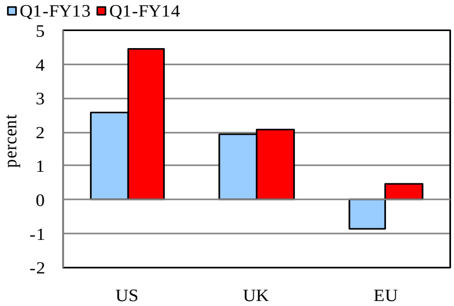
	Value in million US$		YoY growth (%)	
	FY13	**FY14**	**FY13**	**FY14**
Total exports	**6,151**	**6,275**	**0.0**	**2.0**
Textiles	3,220.8	3,462.9	-7.6	7.5
Food	886.6	867.2	-3.7	-2.2
Rice	339.7	402.8	-21.8	18.6
Basmati	189.2	209.2	-27.4	10.5
Non-basmati	150.5	193.6	-13.4	28.7
Fish	63.3	76.0	4.0	20.1
Jewelry	73.4	45.9	360.0	-37.5
Cement	147.3	142.3	15.7	-3.4
Leather	234.7	255.9	-4.2	9.0
Sports goods	128.3	132.4	-2.1	3.2

Source: State Bank of Pakistan

Exports After remaining constant in FY13, export receipts increased by 2.0 percent during Q1-FY14

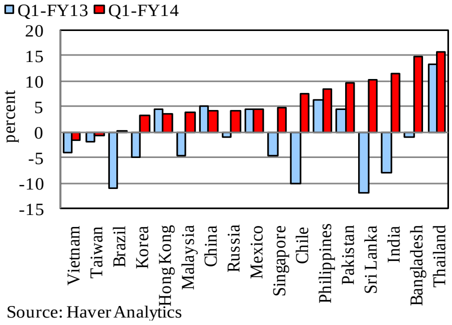
(**Table 5.5**). This improved performance can be traced to both domestic and external factors. While domestic factors include a relatively smooth energy supply, and a larger inventory of exportables (e.g., cotton and rice) (**Chapter 2**); external factors include the steady consumer demand in our export markets.

Figure 5.11a: YoY Growth in Retail Sales



Source: United States Census Bureau; Eurostat; and UK National Statistcis

Figure 5.11b: Recovery in Exports of Major Emerging Economies



Source: Haver Analytics

Figure 5.9c: Performance of Currencies of Emerging Economies

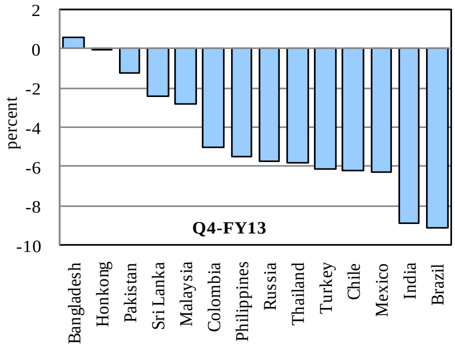
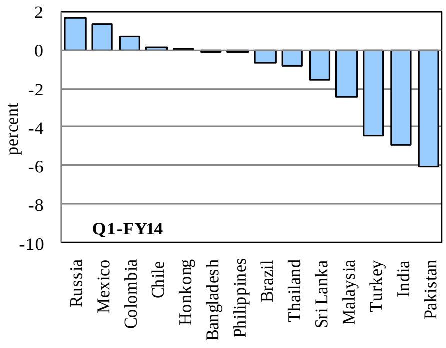


Figure 5.9d: Performance of Currencies of Emerging Economies



Source: Haver Analytics

Specifically, despite some uncertainty in key policy decisions, consumer demand in the US and European countries grew modestly during Q1-FY14 (**Figure 5.11a**). At the same time, there was a sharp depreciation of emerging market currencies soon after the Fed first flagged the need to begin tapering quantitative easing in June 2013. Together,

Table 5.6: Textile Exports during Q1

	Export value			YoY growth	
	FY12	FY13	FY14	FY13	FY14
Textile	**3485.9**	**3220.8**	**3462.9**	**-7.6**	**7.5**
Raw cotton	48.7	24.6	50.6	-49.5	105.5
Cotton yarn	432.1	510.4	561.3	18.1	10.0
Cotton cloth	673.6	644.0	726.4	-4.4	12.8
Knitwear	704.4	541.7	553.4	-23.1	2.2
Bed wear	538.0	459.5	501.7	-14.6	9.2
Towels	165.1	178.3	183.3	8.0	2.8
Garments	362.2	411.5	438.6	13.6	6.6

Source: State Bank of Pakistan

these factors helped the recovery of exports of most emerging economies, and Pakistan was no exception. However, South Asian competitors performed much better than Pakistan (**Figure 5.11a - c**).

<u>Textile exports:</u> The improvement in textile exports can be traced to three factors: (i) a rise in demand for cotton yarn in China; (ii) anticipation of Pakistan getting GSP + status from the EU January 2014 onwards; and (iii) PKR depreciation.

For the last couple of years, the Chinese government has been running a cotton stockpiling program through imports. However in FY14, there has been a shift in its policy; the government now promotes the import of cotton yarn instead of raw cotton, as China is now sitting on more than half of the world's cotton reserves. Pakistani yarn manufacturers capitalized on this opportunity, and were able to increase yarn exports by 10 percent during the quarter. While China scaled back its import of raw cotton, India, Indonesia and Vietnam have significantly increased their demand in Q1-FY14. As a result, Pakistan was able to double its export of raw cotton compared to the previous year (**Table 5.6**).

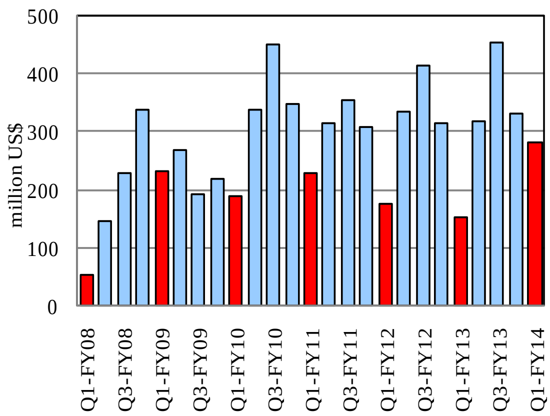
As far as value-added items are concerned, Pakistan's apparel exports to the EU have increased sharply in anticipation of duty-free access in 2014. Pakistani exporters have been strengthening their working relations with EU importers for the last few months, so they can fully utilize the opportunity of exporting certain items duty-free and quota-free from January 2014 onwards.

<u>Food group</u>

Major food exports performed well during Q1-FY14. ***Rice exports***, in particular, bounced back after declining in two consecutive years, principally due to carryover stocks of coarse rice from the previous season, and projections of higher production this year. As shown in **Figure 5.12**, exports remain typically low in Q1 before rice production comes in full swing October onwards. This year, however, exports have picked up in the first quarter due to available inventories. Furthermore, anecdotal evidence suggests that production of coarse rice will probably return to pre-flood levels in FY14. Major incentive to grow coarse rice includes lower water requirement; higher demand in China and Far-East Asia; and steady increase in domestic prices due to export-led buying.

Fish exports increased by 20.1 percent during Q1- FY14 compared to last year. This increase – evident mainly in frozen, fillet and crustacean categories – was

Figure 5.12: Seasonality in Export of Non-basmati Rice

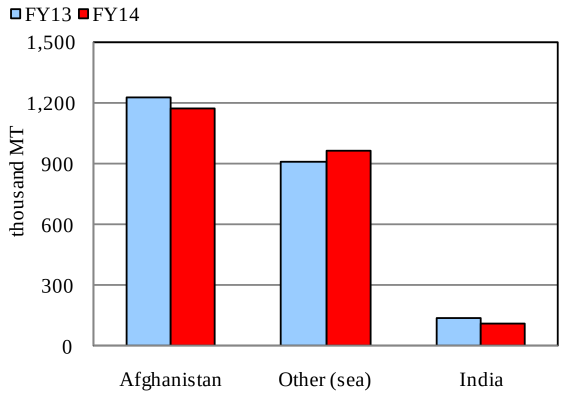


Source: State Bank of Pakistan

primarily a result of Sindh government's decision to lift a ban on catching fish in July this year.[22] In addition, higher demand from Vietnam, Thailand and the Middle-East, has also supported export growth. In fact, ever since the EU imposed a ban on seafood import from Pakistan, local exporters have strived to capture lucrative export markets in the Middle-East and East Asia. Going forward, it is expected that Pakistan's exports will grow further as EU has lifted the ban it imposed on seafood from Pakistan six years back. However, local exporters need to remain cautious regarding the quality standards to retain this, and other hard-earned markets. In particular, the country cannot afford rejection and subsequently cancellation, of import orders by Kuwait and Saudi Arabia on quality grounds.

<u>Cement</u>

Figure 5.13: Quantum of Cement Exports - Q1



Source: APCMA

Cement exports weakened further in Q1-FY14, mainly as new capacity in India came in to use. Furthermore, Pakistan's exports to Afghanistan continued to suffer, due to the strengthening foothold of Iranian cement in the country. Excluding these two countries, export of cement showed an impressive growth of 12 percent during Q1-FY14 (**Figure 5.13**). In particular,

[22] Government bans catching of fish for June and July every year due to the breeding season. Technically, this was not a good move to lift this ban during the breeding season. Although fish exports have improved in Q1-FY14, this will negatively affect breeding, and availability of fish next year.

exports to Mozambique, South Africa, Tanzania, Djibouti, Kenya and Iraq have improved considerably during Q1-FY14. Due to prevailing demand and an optimistic outlook for construction in most African countries, a leading Pakistani cement manufacturer has invested in production facilities in the Republic of Congo. In addition, its cement grinding facility in Iraq, is also expected to commence commercial operation in January 2014. Moreover, three local manufacturers are seriously considering setting up manufacturing units in Sri Lanka.

Going Forward

A peek into the most recent data suggests tapering of both exports and imports. The country has recorded a YoY decline in the trade deficit in both October and November 2013, mainly as the growth in import of petroleum (both crude and products) declined substantially. On the other hand, a modest decline in exports is mainly evident in textiles, naphtha, leather and cement. As Pakistan's GSP+ status in the EU has become effective from January 2014 onwards, we expect a recovery in exports as this allows Pakistan to export key textile and leather goods to the region duty-free and quota-free.[23] We forecast the trade deficit to remain within the range of US$ 16.5 – 17.8 billion by end FY14.

[23] To gain maximum advantage of this facility, Pakistani exporters should develop new product lines (e.g., technical textiles) and increase the use of man-made fibers to produce garments and home textile products.

Acronyms

AMC	Asset Management Companies
ASK	Available Seat Kilometer
ATA	Annual Turn Around
BE	Budget Estimate
BIS	Bank for International Settlement
BISP	Benazir Income Support Programme
BoP	Balance of Payment
bps	Basis Points
BSC	Bahbood Saving Certificate
CCAC	Cotton Crop Assessment Committee
CDNS	Central Directorate of National Savings
CKD	Completely Knocked Down
CNG	Compressed Natural Gas
CPI	Consumer Price Index
CSF	Coalition Support Fund
EFF	Extended Fund Facility
EME	Emerging Market Economy
EU	European Union
FBR	Federal Board of Revenue
FDI	Foreign Direct Investment
FED	Federal Excise Duty
FMCG	Fast Moving consumer Goods
FOB	Free on Board
FSCD	Financial Markets Strategy and Conduct Department
FX/FE	Foreign Exchange
FY	Fiscal Year
GDP	Gross Domestic Product
GIDC	Gas Infrastructure Development Cess
GST	General Sales Tax
HSD	High Speed Diesel
IFIs	International Financial Institutions
IMF	International Monetary Fund
IPPs	Independent Power Plants

IT	Information Technology
Kg	Kilograms
KP/KPK	Khyber Pukhtunkhwa
LDI	Long Distance and International
LSM	Large Scale Manufacturing
M2	Broad Money Supply
Mmbtu	Million Metric British Thermal Units
MT	Metric Tons
MTB	Marketable Treasury Bill
NBFC	Non-Bank Finance Companies
NBFI	Non-Banking Financial Institutions
NDA	Net Domestic Assets
NFA	Net Foreign Assets
NFNE	Non-Food Non-Energy
NIR	Net International Reserves
NSS	National Savings Scheme
OCAC	Oil Companies Advisory Committee
OMCs	Oil Marketing Companies
OMOs	Open Market Operations
PASSCO	Pakistan Agricultural Storage and Services Corporation Ltd.
PBS	Pakistan Bureau of Statistics
PIA	Pakistan International Airline
PIB	Pakistan Investment Bond
PKR	Pakistani Rupee
PSDP	Public Sector Development Program
PSEs	Public Sector Enterprises
PSO	Pakistan State Oil
PTCL	Pakistan Telecommunication Ltd.
Q	Quarter
RDF	Research and Development Fund
RHS	Right Hand Side
Rs	Rupees
SBA	Stand-by Arrangement
SBP	State Bank of Pakistan

SDR	Special Drawing Rights
SNGPL	Sui Northern Gas Pipelines Ltd.
SRO	Statutory Revenue Order
SSCR	Special Saving Certificates Registered
TAPI	Turkmenistan-Afghanistan-Pakistan-India
T-bills	Treasury Bills
UAE	United Arab Emirates
UK	United Kingdom
US/USA	United States of America
USF	Universal Service Fund
W/h Tax	Withholding Tax
YoY	Year on Year
3G	3^{RD} Generation

Annexure A: Data Explanatory Notes

1) **GDP:** In the absence of actual GDP data, SBP uses the GDP target given in the Annual Plan by the Planning Commission in order to calculate the ratios of different variables with GDP, e.g., fiscal deficit, public debt, current account balance, trade balance, etc. SBP does not use its own projections of GDP to calculate these ratios in order to ensure consistency, as these projections may vary across different quarters of the year, with changing economic conditions. Moreover, different analysts may have their own projections; if everyone uses a unique projected GDP as the denominator, the debate on economic issues would become very confusing. Hence, the use of a common number helps in meaningful debate on economic issues, and the number given by the Planning Commission better serves this purpose.

2) **Inflation:** There are three numbers that are usually used for measuring inflation: (i) period average inflation; (ii) YoY or *yearly* inflation; and (iii) MoM or *monthly* inflation. Period average inflation refers to the percent change of the *average* CPI from July to a given month of the year over the corresponding period last year. YoY inflation is percent change in the CPI of a given month over the same month last year; and monthly inflation is percent change of CPI of a given month over the previous month. The formulae for these definitions of inflation are given below:

   Period average inflation (π_{Ht}) = $\left(\dfrac{\sum_{i=0}^{t-1} I_{t-i}}{\sum_{i=0}^{t-1} I_{t-12-i}} - 1 \right) \times 100$

   YoY inflation (π_{YoYt}) = $\left(\dfrac{I_t}{I_{t-12}} - 1 \right) \times 100$

   Monthly inflation (π_{MoMt}) = $\left(\dfrac{I_t}{I_{t-1}} - 1 \right) \times 100$

   Where I_t is consumer price index in t^{th} month of a year.

3) **Change in debt stock vs. financing of fiscal deficit:** The change in the stock of public debt does not correspond with the fiscal financing data provided by the Ministry of Finance. This is because of multiple factors, including: (i) The stock of debt takes into account the gross value of government borrowing,

whereas borrowing is adjusted for government deposits with the banking system, when calculating the financing data; (ii) changes in the stock of debt also occur due to changes in the exchange rate, which affects the rupee value of external debt, and (iii) the movement of various other cross-country exchange rates also affect the US Dollar rate and, hence, the rupee value of external debt.

4) **Government borrowing:** Government borrowing from the banking system has different forms and every form has its own features and implications, as discussed here:

(a) Government borrowing for budgetary support:

Borrowing from State Bank: The federal government may borrow directly from SBP either through the "Ways and Means Advance" channel or through the purchase (by SBP) of Market Related Treasury Bills (MRTBs). The Ways and Means Advance is extended for the government borrowings up to Rs 100 million in a year at an interest rate of 4 percent per annum; higher amounts are realized through the purchase of 6-month MTBs by SBP at the weighted average yield determined in the most recent fortnightly auction of treasury bills.

Provincial governments and the Government of Azad Jammu & Kashmir may also borrow directly from SBP by raising their debtor balances (overdrafts) within limits defined for them. The interest rate charged on the borrowings is the three month average yield of 6-month MTBs. If the overdraft limits are breached, the provinces are penalized by charging an incremental rate of 4 percent per annum.

Borrowing from scheduled banks: This is mainly through the fortnightly auction of 3, 6 and 12-month Market Treasury Bills (MTBs). The Government of Pakistan also borrows by a quarterly auction of 3, 5, 10, 15, 20 and 30 year Pakistan Investment Bonds (PIBs). However, provincial governments are not allowed to borrow from scheduled banks.

(b) Commodity finance:

Both federal and provincial governments borrow from scheduled banks to finance their purchases of commodities e.g., wheat, sugar, etc. The proceeds from the sale of these commodities are subsequently used to retire commodity borrowing.

5) **Differences in different data sources:** SBP data for a number of variables, such as government borrowing, public debt, debt servicing, foreign trade, etc – often do not match with the information provided by MoF and PBS. This is because of differences in data definitions, coverage, etc. Some of the typical cases have been given below.

    (a) **Financing of budget deficit (numbers reported by MoF vs. SBP):** There is often a discrepancy in the financing numbers provided by MoF in its quarterly tables of fiscal operations and those reported by SBP in its monetary survey. This is because MoF reports government bank borrowing on a cash basis, while SBP's monetary survey is compiled on an accrual basis, i.e., by taking into account accrued interest payments on T-bills.

    (b) **Public debt (MoF vs. SBP):** SBP follows IMF guidelines for compiling public debt, which state that the "public sector includes the general government, monetary authorities, and those entities in the banking and other sectors that are public corporations."[1] Thus, public debt reported by SBP, is composed of: (i) government domestic debt; (ii) government external debt; (iii) IMF loans; and (iv) external liabilities.[2]

    While both MoF and SBP follow the same definition of domestic public debt, the coverage of external debt compiled by MoF differs from that of SBP. Specifically, MoF does not include short-term debt, military debt and external liabilities in its compilation of external public debt. As a result, the overall public debt numbers from these two organizations do not match.

    (c) **Interest payments on domestic debt (SBP vs MoF):** SBP calculates interest payments on an accrual basis, whereas MoF reports the actual interest paid on T-bills during the year.

    (d) **Foreign trade (SBP vs PBS):** The trade figures reported by SBP in the *balance of payments* do not match with the information provided by the

[1] Source: IMF (2003), "External Debt Statistics, Guide for Compilers and Users."
[2] It may be noted, however, that due to the unavailability of detailed information, SBP public debt numbers do not include PSE's debt.

Pakistan Bureau of Statistics. This is because the trade statistics compiled by SBP are based on exchange record data, which depend on the actual receipt and payment of foreign exchange, whereas the PBS records data on the physical movement of goods (customs record). Furthermore, SBP reports both exports and imports as free on board (fob), while PBS records exports as free on board (fob) and imports include the cost of freight and insurance (cif).

In addition, the variation in import data also arise due to differences in data coverage, e.g., SBP import data does not include Non-Repatriable Investments (NRI) by non-resident Pakistanis,[3] imports under foreign assistance, land-borne imports with Afghanistan, etc. In export data, these differences emerge as PBS statistics do not take into account short shipments and cancellations, while SBP data does not take into account land borne exports to Afghanistan, export samples given to prospective buyers by exporters, exports by EPZs, etc.

[3] The non-repatriable investment (NRI) consists of small investments made by expatriate Pakistanis transporting machinery into the country that has been bought and paid for abroad and the purchases made from the *duty-free shops.*