THE STATE OF PAKISTAN'S ECONOMY

First Quarterly Report for the year 2014-15 of the Central Board of State Bank of Pakistan

State Bank of Pakistan

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Contents **Page No.**

1 Overview

Pakistan's economy faced several challenges in the initial months of FY15. The fourth review of the Extended Fund Facility (EFF) could not be finalized in the early-August meetings with the Fund. This caused uncertainty in the FX market, as the fourth tranche was delayed. In mid-August, political events in Islamabad impacted the economic activity in the country. In September, floods inundated a large part of the country's agriculture heartland (Punjab), which damaged standing crops. It was feared these losses may push the price of perishable food items up, which fueled inflation expectations.

Against this backdrop, key macroeconomic indicators could not follow up positive developments observed in the second half of FY14.[1] Q1-FY15 saw higher deficits in the current and fiscal accounts, which had to be financed via domestic resources (**Table 1.1**). SBP's FX reserves fell slightly, and the PKR depreciated by 3.7 percent during the quarter. Meanwhile, the prospect of achieving the FY15 GDP growth target was hindered by a slowdown in LSM, and a below-target performance of *kharif* crops. The only exception was headline CPI inflation, which continued to decline throughout the quarter.

Table 1.1: Selected Economic Indicators

	Q1-FY14[E]	FY15[T]	Q1-FY15[E]
Growth rate (percent)			
LSM[a]	6.8	7.0	2.0
CPI (period average)[1,a]	8.1	8.0	7.5
Private sector credit[b]	-0.5	NA	1.6
Money supply (M2)[b]	0.2	NA	-0.1
Exports (customs)[a]	9.0	5.8	-10.4
Imports (customs)[a]	3.0	6.2	11.6
Tax revenue -FBR (billion Rs)[c]	475.3	2,810	537.9
Exchange rate (+app/-dep%)[b]	-6.0	NA	-3.7
billion US dollars			
SBP's liq. reserves (end-period)[b]	4.7	NA	8.9
Worker remittances[b]	3.9	16.7	4.7
FDI in Pakistan[b]	0.2	4.3	0.2
Current account balance[b]	-1.3	-2.8	-1.6
percent of GDP[2]			
Fiscal balance[d]	-1.1	-4.9	-1.2

[E] Provisional estimate; [T] Targets set by the government in the Annual Plan for 2014-15;
[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 2014-15; NA: not applicable.

Source: [a] Pakistan Bureau of Statistics; [b] State Bank of Pakistan, [c] Federal Board of Revenue; and [d] Ministry of Finance

Having said that, there has been a marked improvement in the economy during the second quarter of FY15, which is likely to persist through rest of the year. Most importantly, global oil

[1]However, situation improved significantly during the second quarter of the year. For a more updated discussion, please see Section 1.2, and SBP's Monetary Policy Statement for January 2015.

prices have slumped to a five-year low, which is being passed on to domestic consumers (**Section 1.3**). The YoY November and December CPI inflation was only 4.0 and 4.3 percent respectively, which is the lowest in 13 years. Other than easing food inflation, lower oil prices would also help contain Pakistan's import bill and its trade deficit. Furthermore, discussions related to the fourth and fifth reviews of the IMF program, were concluded successfully in November, and the Board approval came through on 19th December 2014.

The IMF is broadly satisfied with the progress on economic reforms, and has released a combined 4th and 5th tranche of US$ 1.1 billion in December 2014. The government has already issued Sukuks in the international market worth US$ 1.0 billion, and is likely to get more external support via divestures, and additional funding from the World Bank, ADB, and coalition support fund. In this context, we expect less government demand from commercial banks in the remaining part of the year, which would then need to deploy their funds more productively with the private sector.

1.1 Economic Review

The government envisaged GDP growth of 5.1 percent for FY15. It is too early to conclude whether or not this target is achievable; however, preliminary estimates suggest some difficulties in the commodity producing sector. Farmers reduced the area used for sugarcane cultivation due to lower incomes last year, which caused a decline in its production. Although cotton was grown on a larger area this year, production is expected to remain below-target (**Chapter 2**).

The industrial sector is presenting a mixed picture. Higher cement dispatches, steel imports and strong PSDP spending, suggest a pick-up in construction activity in Q1-FY15 (**Section 2.2**). In contrast, LSM growth posted a decline in Q1-FY15, as local manufacturers faced gas shortages (especially in fertilizer, textiles, paper, glass and leather sectors). Furthermore, textiles also remain dull on account of lower demand for yarn and fabric from China and Bangladesh.

The fall-out of a weak commodity producing sector, can also be seen in *wholesale and retail trade* activity. However, the vibrancy in *finance and insurance*, and *telecommunications*, appears to have provided services a boost this year. While banks' profitability has been boosted by the volume of PIBs they carry in their portfolio, telecom benefited from the roll out of 3G/4G services in the country (see **Chapter 2**). Cellular firms have been spending heavily to upgrade their network, and as customers begin to use the wider set of services, this should have a strong positive impact on other services in the country (e.g., finance, advertising, entertainment, social networking, etc.).

Telecom based imports cost an *additional* US$ 188.3 million to Pakistan's import bill during Q1-FY15.[2] Steel imports added another US$ 233.3 million, whereas textiles (mainly synthetics) and fertilizer together chipped in US$ 166.6 million during the quarter. In overall terms, the country's imports grew by 11.6 percent during Q1-FY15, compared to only 3.0 percent in the same period last year.[3]

Commodity prices impacted Pakistan's exports, which declined by 10.4 percent during Q1-FY15, compared to an increase of 9.0 percent in the same period last year. The biggest decline was seen in naphtha, where prices are closely related to oil prices. Despite higher production, the export decline probably suggests that traders have been waiting for prices to stabilize (and recover) in the international market, before they offloaded their inventories. Furthermore, the decline in unit values of knitwear, ready-made garments and towels, eclipsed the quantum increase in export of these commodities. Furthermore, export of yarn and fabric remained low due to faltering Chinese demand, and declining exports of Bangladesh – countries that import textile raw-materials from Pakistan.

As a result, the overall trade deficit increased by US$ 1.6 billion in Q1-FY15, compared to the same period last year. This increase was partly compensated by US$ 765 million increase in home remittances during the quarter. A large part of this increase came from remittances from GCC countries, especially the UAE and Saudi Arabia. Construction-related Pakistani workers are benefiting from higher infrastructure spending in this region (especially Dubai). Additional support also came from the coalition support fund, which lowered the services deficit by US$ 401 million. In overall terms, this led to a US$ 332 million increase in the current account deficit in Q1-FY15 over last year, to reach US$ 1.6 billion. Financing this deficit remained a concern as foreign investments remained low, and official assistance was less than expected. Consequently, SBP's FX reserves declined by 1.7 percent, and the PKR depreciated by 3.7 percent during the quarter.

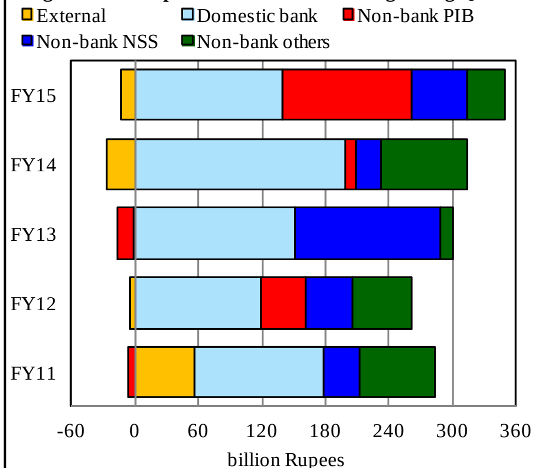
The rising current account deficit, coupled with the uncertainty in the FX market, was one of the key factors that guided SBP's decision to keep monetary policy tight during the quarter. The other important factor, CPI inflation, also raised some concerns initially – e.g., fears about flood-related crop losses, and a rise in electricity tariffs; but these gradually dissipated.

[2]Telecom imports increased by US$ 96.3 million in Q1-FY15, compared to Q1-FY14; whereas the import of data processing equipment were US$ 92.0 million higher than last year. This increase mainly reflects network up-gradation by telecom companies to provide their customers 3G/4G services.

[3] Source: Pakistan Bureau of Statistics

Nonetheless, SBP kept the discount rate unchanged, and also kept rupee liquidity tight in the interbank market. Overall money supply posted a net contraction of 0.1 percent during the quarter, against an expansion of 0.2 percent in the same quarter last year (these low values reflect the seasonal reduction in M2 during the first quarter of the fiscal year). In our view, tight liquidity was not the *major* factor behind this contraction; it was driven primarily by falling net foreign assets (NFA) of the banking system, and relatively contained government borrowing. Private sector credit posted an increase of 1.6 percent in Q1-FY15, compared to net retirement in the same period last year.

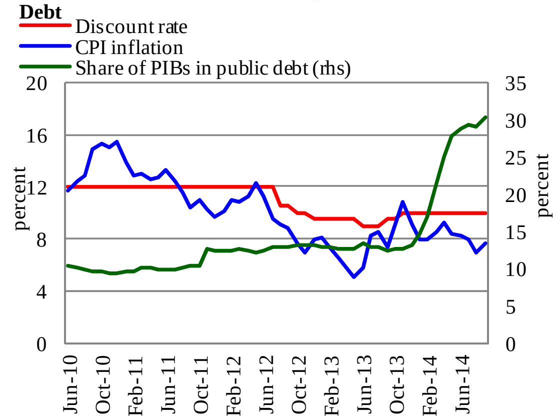
Figure 1.1: Composition of Deficit Financing during Q1



Source: Ministry of Finance

As far as government borrowing is concerned, it remained lower than last year because the government was able to borrow more from non-banks via PIBs and NSS (**Figure 1.1**). Within the banking system, instead of borrowing from the central bank, the government borrowed from commercial banks, which also remained lower than the same period last year. Banks' interest in PIBs persisted throughout the quarter, as the difference in rates between T-bills and PIBs, remained abnormally high. Furthermore, banks had been anticipating a cut in interest rates, which encouraged them to lock-in funds in PIBs (**Figure 1.2**).

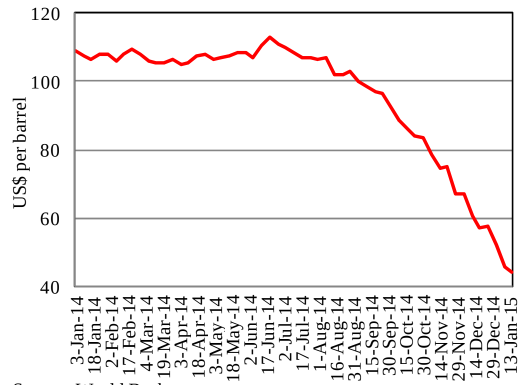
Figure 1.2: Inflation and the Composition of Domestic Debt



Source: State Bank of Pakistan

For the government, these placements helped improve the maturity profile of domestic debt, but would continue to increase its servicing burden. More specifically, the 31 percent YoY growth in interest payments during Q1-FY15, was the major factor responsible for a higher fiscal deficit during the quarter. On the other hand, the government was able to run a primary surplus, which reflects some expenditure restrain.

Figure 1.3: Weekly Global Crude Oil Prices (Saudi Arabian Light)



Source: World Bank

Revenue collection remained weaker than last year: the growth in total revenues came down from 19.9 percent in Q1-FY14, to only 1.2 percent in Q1-FY15. However, adjusting for the one-off factors that had inflated the non-tax collection last year, the total revenue growth increases to 8.4 percent for Q1-FY15.[4] The slowdown in tax revenues basically reflects a decline in collection under the gas development surcharge. Furthermore, the higher growth in Q1-FY14 had come primarily from a sharp rise in provincial tax revenues (especially by Punjab), that had started collection on services. This base effect was also not available in Q1-FY15.

1.2 Assessment and Outlook

It has now been more than a year since Pakistan entered into the extended fund facility with the IMF. Structural reforms have been *initiated* in the fiscal and power sectors, and efforts are being made to build the country's FX reserves by mobilizing resources from the international market, and IFIs.[5] Furthermore, the government is currently evaluating various options of importing natural gas into the country, to alleviate the growing gas shortage that is adversely impacting domestic industry. From this perspective, the deterioration in key macroeconomic variables in Q1-FY15, suggest that the reform process in important sectors will take some time to materialize. However, we believe the broader consequences would not be as severe in subsequent quarters, as they were in the first quarter. Without doubt, the most important development is the sharp fall in global oil prices since the start of this fiscal year (**Figure 1.3**). Crude oil

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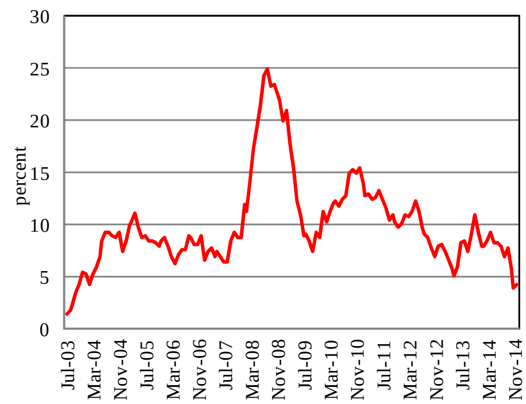
[4] The government had mobilized Rs 67.0 billion from the universal service fund and Rs 56.7 billion from PSEs, in Q1-FY14; these one-off resources were not available in Q1-FY15.

[5] For instance, in FY14, the government issued euro bonds and divested UBL; whereas in FY15, it has issued Sukuk in the international market, as well as have plans to sell its stake in other entities (like HBL).

prices (Saudi Arabian Light) slumped by 60.4 percent during end-June to 16th January. It was expected that OPEC would cut back production when it met in Vienna on November 27th, but OPEC decided not to change its production strategy for the next six months – implying that a price recovery is not in sight.[6] The market responded to this decision by pushing prices down by 10.6 percent in the following week.[7]

Figure 1.4: Headline CPI Inflation in 12 Years



Source: Pakistan Bureau of Statistics

Pakistan's external sector would benefit most from the decline in oil prices, as petroleum directly makes up nearly 35 percent of our import bill. Inflation is also likely to end up much lower than initial expectations, as the government has steadily been reducing retail POL prices in line with international prices.[8] Headline inflation has reached a 13-year low of 4.0 percent in November and 4.3 percent in December, pushing down the Jul-Dec inflation to only 6.1 percent, against the full-year target of 8.0 percent (**Figure 1.4**). In addition to fuel prices, low inflation was realized by deflation in some key food items like wheat, wheat flour, onions and tomatoes. Furthermore, as has been mentioned in previous reports, households anchor their inflation expectations on energy and fuel prices. Based on these factors, we expect the full-year inflation to stay within the range of 4.5 – 5.5 percent in FY15.

The external position is also likely to improve in subsequent quarters. In addition to fuel prices, the following factors would contribute:

(i) Discussions with the IMF over the fourth and fifth reviews of the EFF have successfully been concluded. The Fund showed its satisfaction over the

[6] OPEC was divided on this issue, with Venezuela and Iran on one hand – wanting a cutback in oil production; and the Gulf and Russia on the other, allowing the oil prices to fall.
[7] Some analysts call this a new price war between Gulf countries and the US, while others call it OPEC's tactic to price out US firms that extract oil from shale formation. Whatever is the case, the depressed oil prices bode well for oil importing countries like Pakistan.
[8] After reducing petrol prices by Rs 1.1 per liter in Q1-FY15, the government made further reductions of Rs 2.9 per liter for October; Rs 9.4 per liter for November; and Rs 9.7 per liter for December 2014.

progress made and output growth, and released US$ 1.1 billion tranche in December 2014;

(ii) Pakistan has successfully issued Sukuk in the international market in November 2014.[9] Initially the target was set at US$ 500 million, but like the Euro Bonds, the Sukuk was oversubscribed and the government was able to mobilize US$ 1.0 billion;

(iii) After the divesture from UBL in FY14, the government is now planning to sell its stakes in ABL and HBL in FY15. These divestures would not only provide budgetary financing to the government, but could provide FX support of over a billion dollar during the year; and

(iv) There has been a broad-based recovery in exports in Q2-FY15 (2.7 percent YoY), along with a significant increase in FDI into the country (telecom sector).

This positive outlook on the external sector, and low inflation in the second quarter, provided SBP the room to cut the policy rate by 50 basis points to 9.5 percent in November. The timing of this cut was important, as seasonal demand for credit generally picks up in November and December. SBP has further reduced the policy rate by 100 basis points to a multi-year low of 8.5 percent, in January 2015.

As far as the fiscal sector is concerned, it might be challenging to achieve the consolidation target of 0.6 percentage points during the year.[10] In terms of revenue mobilization, FBR had envisaged a growth of 24.0 percent in tax collection during the year, but achieved only 13.1 percent growth in Q1-FY15. This leaves much to be done in the next three quarters. FBR revenues must increase by 27 percent in Oct-Jun, if it is to achieve the full-year target.[11] In addition, the significant decline in oil prices during the second quarter, may reduce government revenues from this source. On the expenditure side, interest payments will remain strong, but this growth may weaken keeping in view the market

[9] With an offered amount of US$ 2.3 billion, Sukuk was 5 times oversubscribed (Source: http://www.finance.gov.pk/releases_nov_14.html).

[10] Government has set the target of reducing fiscal deficit from 5.5 percent of GDP in FY14, to 4.9 percent of GDP in FY15.

[11] During the period Oct-Jun, tax collection has grown by an average growth of 17 percent in last five years.

expectations that the declining interest rate trend will continue. The government has already reduced the returns on PIBs and NSS instruments.[12]

As mentioned before, financing the deficit is likely to be less of a concern in the remaining quarters of the year. Nonetheless, important reforms are needed to reduce the structural component of the fiscal deficit. The government has formulated a medium-term strategy to implement fiscal reforms, ranging from improving revenue generation to promoting private sector participation in loss-making PSEs (like PIA and Pakistan Steel). Plans are also underway to restructure Pakistan Railways, Gencos and Discos, so that these PSEs can contribute positively to Pakistan's economic development. However, these plans should be fast-tracked, with a specific focus on their managerial and operational inefficiencies, and their spill-overs on the fiscal sector and the rest of the economy.

[12] In the PIB auction held on 20th November, the cut-off rate on 3-year PIBs was reduced by 160 basis points, compared to the previous auction (23rd October – before the monetary policy decision). On 5-year and 10-year PIBs, the government reduced the cut-off rates by 190 and 150 bps, respectively. Similarly, on NSS instruments, rate of returns were reduced as follow: 215 bps on regular income certificates; 167 bps on defence saving certificates; 200 bps on special saving certificates; and 132 bps on pensioners' benefit accounts.

2 Real Sector

2.1 Overview

Performance of real sector in Q1-FY15 does not appear encouraging. While most *kharif* crops posted lower-than-target production, the growth in large-scale manufacturing also declined (**Section 2.3**). Services, on the other hand, showed mixed results, with upbeat financial and telecom sectors but a weak transport sector. Wholesale and retail trade activity may remain strong due to an increase in import volumes, but its overall performance would hinge on whether the commodity producing sector picks up in the remaining part of the year.

2.2 Agriculture

Preliminary estimates for the *kharif* crops are not encouraging. Cotton and sugarcane crops are expected to remain short-of-target, whereas sugarcane may not achieve last year's level. Production of rice and cotton is likely to post 1.5 percent and 5.7 percent growth over last year, respectively.

Table 2.1: Production Estimates of Kharif Crops

thousand tons

	FY14		FY15	
	Target	**Actual**	**Target**	**Estimates**
Rice	6,200	6,798	6,808	6,901
Sugarcane	65,000	67,460	65,472	64,740
Cotton (000 bales)	14,100	12,769	15,100	13,498

Source: Planning Commission; Ministry of National Food Security & Research; and Cotton Crop Assessment Committee

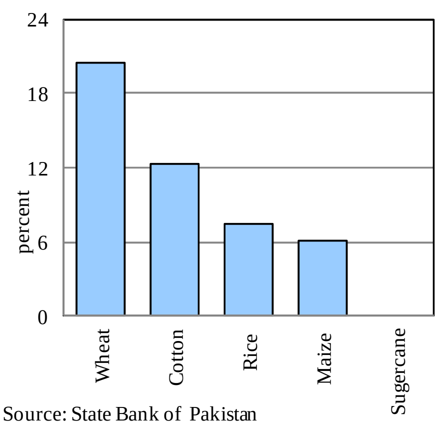
In terms of agri inputs, while water availability was better than last year, the use of fertilizer (both urea and DAP) posted a decline during Apr-Sep 2014. The use of bank credit witnessed significant improvement over last year.

Major crops

There appears to be a link between commodity prices and the area under cultivation during FY15. While the area under cotton and rice increased (benefiting from increase in crop prices in the previous season), sugarcane suffered from stagnant prices last year (**Figure 2.1**).[1] It must be noted here that the area under sugarcane cultivation posted a decline for the first time in last 6 years; in the previous five years, sugarcane was the only crop that showed resilience against floods, and adverse weather conditions. As a result, the crop size continued to increase, and by FY14, it touched the historic-high of 67.5 million MT.

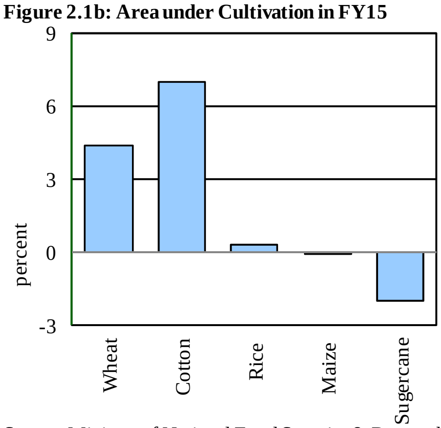
[1] Last year, the area under cotton had suffered because of water shortages at sowing time.

Figure 2.1a: Change in Price in FY14



Source: State Bank of Pakistan

Figure 2.1b: Area under Cultivation in FY15

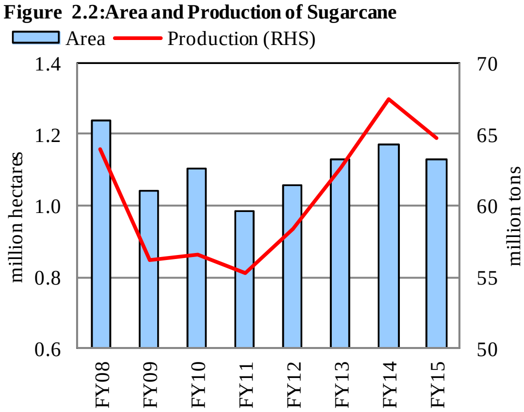


Source: Ministry of National Food Security & Research

Unfortunately, this increased production had a negative impact on farmers' income: sugarcane prices remained stagnant, as sugar mills were struggling with large inventories. Therefore, while input costs increased, sugarcane prices did not change.[2] In effect, FY15 is a repeat of FY09, when area under sugarcane declined due to price-related disputes between cane growers and sugar mills, amid a bumper crop in the previous season.

Having said this, we believe the damage in the sugarcane sector was more controlled in FY15 compared to FY09, due to better administrative handling of the issue. More specifically, sugar mills were able to offload a large volume of their stocks via exports in FY13 and FY14, which was allowed by the government. Hence, although area under cultivation declined in FY15 compared to FY14, it was more contained compared with

Figure 2.2: Area and Production of Sugarcane



Source: Ministry of National Food Security & Research

[2] In FY14, fertilizer prices were up by 5 percent, whereas, prices of pesticides and insecticides were higher by 28 and 12 percent YoY, respectively.

FY09 (**Figure 2.2**). Regional data shows that Punjab suffered more than other provinces, as the area was also reduced due to floods.[3] As far as Sindh is concerned, more area was brought under sugarcane, as farmers were still optimistic about their earnings, keeping in view the installation of new sugar mills in the vicinity.

News from the market is not encouraging: while the government has increased the sugarcane support price by Rs 10, to Rs180 per maund, it has not been able to satisfy either growers or millers.[4] Farmers claim that they cannot breakeven at any price below Rs 200 per maund, whereas sugar mills complain of high inventories and regulatory hurdles in passing on the higher procurement cost to end customers, and depress export market/prices. On 3rd December, Sindh government notified support price at Rs 155 per maund, however, upon protests from local farmers, it re-notified prices at Rs 182 per maund on 7th December.[5] Due to the stand-off between cane growers and sugar millers, the crushing has been delayed across the country.[6]

In case of cotton, the Cotton Crop Assessment Committee (CCAC) had initially estimated production at 13.5 million bales (170 kg each), which was 5.7 percent higher than the previous year. It is expected that due to low prices in the domestic market, farmers may not wait for the third and fourth picking. Nonetheless, it is expected that the final crop size for cotton would still remain larger than last year. In addition to area, the crop may gain from improved yields over the last year thanks to better water availability and certified seeds at the sowing time.[7]

As far as rice is concerned, there was an increase of 2.1 percent in the cultivated area over last year, and the production is estimated to have increased by 1.5 percent.[8] Most of the increase in rice production came from Punjab, which showed a 2.0 percent growth over last year. According to PBS, there has been some shift of sugarcane and maize crop area into the rice crop, especially in Faisalabad, Jhang, Chiniot, Kasur, Okara, Sahiwal and Bahawalnagar districts.

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[3] According to SUPARCO's estimates, heavy rains and floods also damaged sugarcane crop area of around 12.8 thousand hectares. Major sugar producing district impacted were Multan, Muzaffargarh, and Chiniot.

[4] The government announced Sugarcane support price of Rs 180 per 40 kg for *Kharif* 2014.

[5] This increase came along with assurances to millers for necessary support in import restrictions and export quotas.

[6] Sugarcane crushing usually begins in the first week of November. However, this year the crushing was delayed especially in the areas of Hyderabad, Badin, Nawabshah, and Tharparkar. Some delays were also reported in Punjab, in the districts of Faisalabad, Sargodha, Sahiwal and Lahore.

[7] Source: Minutes of the first meeting of Cotton Crop Advisory Committee for *kharif* 2014.

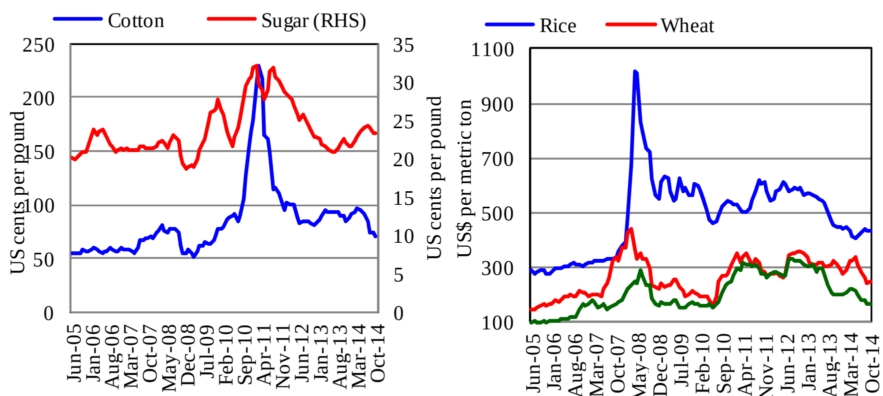
[8] Source: Pakistan Bureau of Statistics

Furthermore, basmati yields have also showed some improvement over last year. In Sindh rice production has posted an increase of 1.1 percent over last year. It is important to recall that most non-basmati rice varieties are grown in Sindh, and their exports have experienced a consistent increase in the previous few years.[9]

Global prices: Impact and Policy Response

Agri prices have been falling in the international market since Q3-FY14 (**Figure 2.3**). This trend was driven primarily by negative sentiments regarding the global economic recovery; depressed energy prices; improved supplies; and lower-than-expected consumption.[10] The decline in prices of cotton, rice and soybean, was more pronounced than other commodities. In case of cotton, bumper crops were recorded in the US, India and China, which together constitute 64 percent of global production.

Figure 2.3: International Prices



Source: IMF

In addition, a shift in cotton import policy was also responsible for depressed prices. More specifically, China has been importing cotton quite aggressively in recent years – around 15 million bales annually – not only to meet requirements of its textile industry, but also to build strategic reserves. Recently however, the government of China has significantly reduced cotton imports (in view of available stocks in the country), and has encouraged local manufacturers to

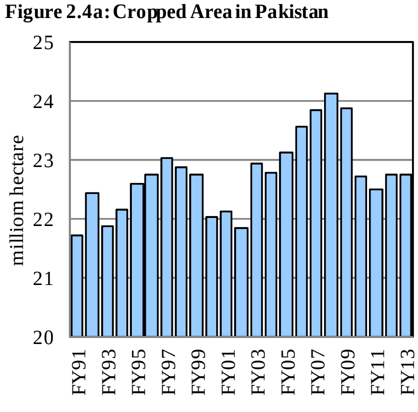
[9] Share of non-basmati has gradually reached up to 82 percent of Pakistan's total rice exports. Major destinations have been Kenya, Bangladesh, UAE, Afghanistan, and Somalia.
[10] One example was lower than projected growth of biofuels because of relatively higher costs.

purchase cotton from the government's reserves, instead of importing.[11] Analysts think this policy has created a surplus of around 11 million bales in the international market, which has put downward pressure on prices.[12]

As for rice, prices continued to slide throughout FY14 because of rising stocks. Prices have recovered in Jul-Sep 2014 to some extent, but still are quite low compared to the same period last year. 2014 harvests have not been promising so far (especially in India, Indonesia, Philippines and Sri Lanka); and the future trend would depend on how the respective governments in these countries will offload in the global market. The World Bank has estimated that commodity prices would remain weak through most of 2015.[13]

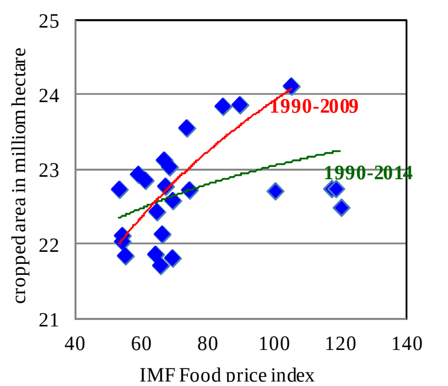
<u>How the fall in agriculture prices could shape agriculture trends?</u>
0There appears to be a strong correlation between what farmers get for their produce in one season, and their decision regarding area under cultivation in the next season (**Figure 2.4**). For instance, during FY04-FY09, prospects of food prices remained optimistic in the international markets, which improved agriculture incomes, and encouraged farmers to bring more area under cultivation.

Figure 2.4a: Cropped Area in Pakistan



Source: Pakistan Bureau of Statistics

Figure 2.4b: Foood Price Index Vs Cropped Area



Source: Economic Survey 2013-14; and Haver Analytics

[11] China has started restricting its local buyers to purchase from international sources with a policy restriction that 75 percent of the purchase must be made from domestic reserves while, rest of 25 percent can be imported.
[12] As soon as cotton prices in the international market started to fall, domestic spinners adopted wait & see policy, and postponed their purchases. Since farmers could not hold their produce for long, they were forced to sell at low price. As a result, cotton prices in the country hovered around Rs 2,200 - Rs 2,300/40 kg during Q1-FY15, compared to Rs 2,700 - Rs 2,800 in Q1-FY14.
[13] Commodity Markets Outlook, October 2014 by World Bank.

However, this trend seems to have changed since 2010: the country has experienced a steep fall in total cultivated area, despite rising food prices. This deviation/anomaly can be traced to recent climate changes, which created extreme weather conditions like floods and droughts that have increased crop vulnerability.

More specifically, when the 2010 floods hit the agriculture heartland in Punjab and Sindh, losses were reported in the crop and livestock sectors. Small farmers were displaced and incurred huge financial losses; their savings (crops, livestock, gold) were effectively wiped out with the single event.[14] As evident from **Figure 2.4a**, the area under cultivation has not yet recovered to pre-flood levels, showing that farmers have become increasingly cautious in their farm-related investments decisions.[15] And now with the decline in crop prices, we expect a strong response from subsistence farmers.

What should be the policy response?

Typically, governments respond to depressed commodity prices by intervening in the market. To some extent, such interventions are effective in rationalizing the demand-supply gaps and minimizing farmers' losses. However, these entail fiscal costs in the form of subsidies.

To mitigate farmers' losses, the government has directed TCP to revive its cotton purchase centers in Sindh and Punjab for procurement.[16] Accordingly, TCP has started buying one million bales of cotton from farmers, and is expected to achieve this target by end-December 2014. The procurement price has been set at Rs 3,000/40 kg (higher than last year's market price), to ensure reasonable returns to farmers.

Furthermore, the government has announced a support price of wheat at Rs 1,300/40 kg. The government has also increased the procurement price of sugarcane during the year, but as mentioned before, this increase was not sufficient to stabilize sugarcane prices in the country due to the ongoing stand-off between cane growers and millers. To mitigate this, the government has recently allowed the export of sugar to the tune of 0.65 million tons during FY15, and has also imposed a 20 percent regulatory duty on sugar imports, to avoid a sharp fall in domestic prices.

[14] Even when flood water receded, their poor financial condition did not allow them to reinvest in their land, in the form of spending on key inputs such as fertilizer, quality seeds and energy usage.
[15] Land quality also suffered due to floods, as farmers have to put in more efforts, and allocate additional money to make it cultivable. Furthermore, it is reported that in some parts, flood water has not receded yet and has caused excess moisture in the soil, making it uncultivable for most crops.
[16] Earlier TCP procured one million cotton bales in 2012 to stabilize market prices.

While market interventions would stabilize farmers' incomes to some extent, it has been observed that government procurement is not far-reaching, and only big farmers are able to sell their produce to procurement agencies. Small farmers face the brunt of low prices, as they are forced to sell their crops to *arhtis* at low rates. Furthermore, public-sector procurement agencies do not have proper storage facilities for agriculture produce, which often results in wastages. In the long-run, there is a need to make more transparent and inclusive mechanism of public procurement, benefiting all segments and regions of the country.

But government procurement is not the only solution; there are other *market-based* mechanisms to protect farmers' returns. For instance, the warehouse receipt system (WRS) is an institutional mechanism to mitigate some sources of price instability in the market.[17] With WRS in place, farmers can take their surplus to a designated warehouse, and get a receipt indicating the value of the stock, which can either be deposited in a bank as collateral, or sold to a broker for cash. Brazil, South Africa, the USA, and Bulgaria are a few countries that use warehouse receipts as collateral. In 2014, SBP issued a detailed framework for warehouse receipt financing, developed a working group with representatives from International Finance Corporation, ACE Controls and Expertise Global[18], and selected commercial banks for the implementation of this framework.

Commodity exchanges and futures markets also hedge farmers against price volatility. These markets basically ensure farmers get a reasonably stable price for their crop, against a certain quantity at a given period in time. Even subsistence farmers can grow more, if they know in advance what their returns would be. India, China and Brazil have managed to reduce the impact of price volatility by introducing commodity exchanges.[19]

Finally, crop insurance also protects farmers against unfavorable price movements. For instance, crop revenue coverage products are available in the US, which insures total *revenue* from the crop, thereby eliminating risk from both yield and price variability. However, such financial products require well-functioning commodity markets/exchanges and reliable set of information about the quantity and price of the produce.

[17] More specifically, small farmers are forced to sell their crop even when prices are depressed in the market, mainly because they need cash to pay for laborers, and make other post-harvest expenses. Therefore, they cannot afford to store their produce and wait for prices to recover.
[18] ACE global provides technical assistance in setting up warehouses and commodity standards.
[19] http://unctad.org/en/docs/ditccom20089_en.pdf

Agriculture Credit

Agriculture credit surged by 38.5 percent YoY during Q1-FY15; with this increase, commercial banks achieved 20 percent of their annual target of Rs 500 billion. This trend is heartening, as typically banks gear up their agri lending in last couple of quarters to achieve their annual target. Agri credit by all banks has posted a promising growth during the year, the improvement in domestic private banks and Islamic banks is more pronounced.

Table 2.2: Purpose-wise Disbursement of Agri Credit

billion rupees

	Q1-FY14	Q1-FY15
1. Production loans (A+B+C+D+E+F)	**66.5**	**86.1**
A- Crops	24.7	30.1
B- Horticulture	1.6	2.0
i- Vegetables	0.6	0.8
ii- Fruits	1.0	1.2
C-Livestock & dairy	12.2	19.4
D- Poultry	19.7	16.8
E- Corporate farming	0.2	0.5
F- Others	8.1	17.3
2. Development loans (A+B+C+D+E)	**4.3**	**12.0**
A- Crops	**1.9**	**3.6**
i-Tractors	0.9	1.7
ii-Farm machinery	0.1	0.1
iii-Tube wells	0.1	0.1
iv-Others	0.8	1.7
B-Livestock & dairy	2.2	5.8
C- Poultry	0.2	0.5
D-Corporate farming	0	2.0
E- Others	0.01	0.1
Grand total (1+2)	**70.8**	**98.1**

Source: State Bank of Pakistan

As expected, production loans in the crop sector constituted the bulk disbursements during the quarter, accounting for more than three-fourth of the total disbursements. However, development loans also posted strong growth during Q1-FY15, though their quantum remained insignificant (**Table 2.2**). Livestock has been the major recipient of development loans during the quarter, which reflects banks' growing interest in this high-potential sector. In addition, almost half of bank credit went to subsistence farmers[20], while economic[21] and above-economic[22] segments received around 25 percent share each.

Agri Credit: Analyzing Demand and Supply Side Constraints

The sustainable growth of Pakistan's agriculture sector requires its transformation from traditional to modern farming practices, which entails greater use of certified seeds; efficient utilization of water; balanced use of fertilizer; and farm

[20] Subsistence farmers have land holding of upto 12.5 acres in Punjab and KPK; while upto 16 acres in Sindh and upto 32 acres in Balochistan.

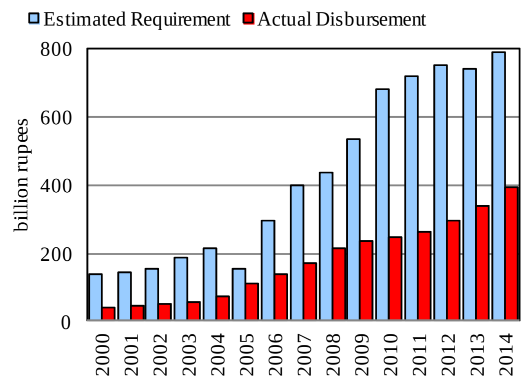
[21] Economic farmers have land size of above 12.5 acres upto 50 acres in Punjab and KPK; while in Sindh above 16 upto 64 acres and in Balochistan above 2 upto 64 acres

[22] Above Economic farmers have land holding of above 50 acres in Punjab and KPK; and above 64 acres in Balochistan and Sindh.

mechanization. Adequate supply of agri credit from the formal sector, is key for this transition, as lack of funds leave farmers with no choice, but to farm on traditional lines which are largely responsible for lower crop yields over the years.

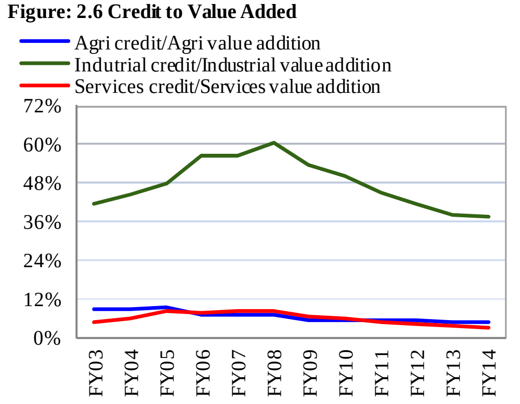
According to SBP estimates, almost half of farm credit needs remain unmet, and farmers are forced to rely on costlier options like *arhtis* and other informal sources that results in possible exploitation of farmers (**Figure 2.5**).[23] Similarly, the ratio of credit to agriculture sector to its value addition over the years has remained visibly low, especially compared to the industrial sector (**Figure 2.6**). The shift for balanced credit allocation amongst various sectors, particularly for agriculture, require better skill set and understanding of the business on the part of the banks, especially the large commercial banks.

Figure: 2.5 Agri Credit Demand & Supply



Source: Agricultural Credit & Microinance Department , SBP

Figure: 2.6 Credit to Value Added



Source: State Bank of Pakistan

We believe that constraints to agri credit can be found mostly on the supply side. For instance, farmers – especially small and subsistence, are reluctant to deal with banks because of perception issues that are reinforced by unfriendly and cumbersome procedures. These constraints can be sorted out, if banks are willing to invest in their

[23] The credit requirement is estimated by provincial planning departments on the basis of per unit cost of production; total area under cultivation; and its cash requirements. Moreover, production and development cost of subsectors of livestock, poultry and fishery are also accounted for, to arrive at the overall credit demand in the country. The state of financial exclusion is even grimmer; according to Agricultural Census 2010, there are 8.3 million farm households in the country, out of which, only 2.3 million are served by formal sources.

infrastructure; hire and train specialized human resource for agri finance; and further simplify their lending procedures.

More specifically, the following points needs to be addressed: (i) availability of other low-risk avenues to place funds, like investing in T-bills/PIBs; (ii) poor land documentation and ineffective foreclosure laws, which aggravates the problem of adequate collateral; (iii) limited (traditional) product offerings that cater only to large (urbanized) farmers and do not cover area like fishery, livestock, and horticulture; (iv) perceived high credit risk[24]; and (v) limited outreach. In addition to these factors, agri finance entails inconvenient field visits, which urban bankers may see as unwarranted, especially when they can make easy money by lending to large corporate, and most importantly, the government.

The situation demands systematic efforts for credit risk management. These efforts include pre-emptive measures of risk management, as well as post-emergency measures of providing relief to the affected borrowers. SBP is mindful of supplementing banks efforts through market-led policy interventions for risk mitigation, and sustainable development of the sector. Therefore, it has been issuing business guidelines for agri-finance from time-to-time (**Box 2.1**).

Box 2.1: Schemes Announced by SBP/GoP to Facilitate Agri Finance

Credit Guarantee Schemes

Credit Guarantee Scheme for Small and Rural Enterprises was introduced in 2010 to encourage finance to low income farmers. The scheme allows partial guarantee of up to 40 percent of a principal amount to banks, in case of defaults. It covers loan of up to Rs 2 million for a period of up to 5 years.

Microfinance Credit Guarantee Facility has helped in mobilization of funds from commercial banks, as well as capital markets to Microfinance Providers. These funds are being used for onward lending to microfinance borrowers. The scheme offered 40 percent partial coverage (or 25 percent of the first loss) of principal amount in case of default.

Crop Loan Insurance Scheme

Crop loan insurance scheme launched with the government support have helped a great deal in reducing vulnerabilities of farming community against different shocks. For the year 2014-15, the government has extended budgetary allocation of Rs 2.5 billion for crop loan insurance of 5 major crops. The government will pay insurance premium of 2 percent per season, on behalf of farmers having land size of up to 25 acres.

[24] The non performing loans (NPLs) of agri credit stood at 13.8 percent as compared to industry average of 12.8 percent during 2014 which are relatively higher but a gradual decline in Agri. NPLs is underway.

Livestock loan insurance scheme
Similarly, Livestock loan insurance scheme has been announced in 2013 for death coverage of farm animals at a premium price of up to 4 percent. In order to cover risk of small and marginalized farmers availing bank loan the government has allocated budgetary support of Rs 300 million. The scheme will cover premium subsidy by the government for the purchase of up to 10 farm animals. Some of banks have also included theft and partial disability coverage in the scheme.

Contract farmer/value chain financing
As small farmers lack acceptable collateral by banks therefore, guidelines on value chain finance have been initiated. Value Chain Finance works on a mutually benefitting tripartite agreement with different value chain actors i.e. farmers, input suppliers, processors, traders and the financing bank. A farmer or group of farmers interested to avail loan will enter into arrangement to supply certain quantity of his produce to a firm against which he will be able to avail credit.

In addition to above, product guidelines are likely to facilitate banks in designing products to diversify their agricultural portfolio that will help in reducing credit risk in activities such as fisheries, poultry, horticulture and water management financing. Similarly, Islamic banks have immense untapped potential to serve financial needs of rural and agricultural markets.

Going forward, the real challenge lies in access to finance by small and marginalized farmers, who are primarily unbanked. In order to mainstream them, banks need to package credit services (along with technical support), to help them manage their businesses efficiently. Success stories like the Bank Rakyat Indonesia, Land Bank of the Philippines, Bank for Agriculture and Agricultural Cooperatives, Thailand and Grameen Bank of Bangladesh, suggest that banks can work in close co-ordination with farming communities, and help them in storage and marketing by providing collateral-free lending.

Furthermore, banks can support farmers expand their productive capacity by investing in farm equipments. To achieve this, there is a need to introduce a mechanism that develops a link between farmers; financial institutions; extension services; and provincial agricultural departments, for an efficient flow of information, and service delivery to the farming community. In this context, the SBP's pioneering project on trader-agent intermediated lending (TRAIL), shows that developing such a link can help improve banks' lending to small and medium-sized growers (**Box 2.2**).

Box 2.2: Agent intermediated lending: A Matiari Case
Collateral is a major hurdle for gaining access to bank credit for small- and medium-sized growers. Therefore, adopting innovative means to exempt collateral can be a game changer. With this idea in mind, the State Bank of Pakistan carried out a pilot project by replacing collateral-based lending to finance small and medium sized farmers, with trader-agent-intermediated-lending (TRAIL). In this method, a third-party guarantor (Matiari Sugar Mills Limited in the pilot), helped facilitate agriculture bank-lending to small and medium size farmers against the supply of sugarcane. The project has been well received by all stakeholders, with hundred percent recovery rates and relatively lower market interest charges.

The State Bank of Pakistan brought all stakeholders on the same table; implemented the product design; monitored borrowing growers; and solved conflicting issues. A leading commercial bank was selected to provide loans to small and medium sugarcane growers, under the corporate guarantee of Matiari Sugar Mills (MSM). The sugar mill, at a nominal fee, screened for worthy growers from a pool interested in getting credit, MSM monitored the selected growers, the bank extended loans to selected growers, who sold their harvest at the market rate to the MSM. The bank charged a relatively low market interest rate, since the loan was backed by MSM's corporate guarantee. The loan contract was enforced by the farmer selling his/her produce to the sugar mill, which after settling the bank-loan credited the remaining amount into farmer's account.

In the first year (2013), a small amount of PKR 3.6 million was disbursed to 44 sugarcane growers. As mentioned before, loan recovery was 100 percent. In the second year (2014), PKR 21.7 million were disbursed. By the end of the first and a half month of MSM's crushing season 2014-15, 59 percent had already been recovered. We expect a full recovery by the end of MSM's crushing season in March 2015.

We appreciate the efforts and progressive thinking of our partners - the bank and MSM - which allowed the experiment to complete. The results of the project are available in Baluch K. A., and Choudhary, M. A., (2014), Agent Intermediated Lending: The Matiari Case Study, State Bank of Pakistan, Research Department, Occasional Research Papers.

2.3 Large-scale manufacturing (LSM)

LSM growth dipped to 2.0 percent in Q1-FY15, compared to 6.7 percent increase posted in the same period last year. This was led by a broad-based slowdown in a number of industries – production of 9 out of 15 sub-sectors tapered during Q1-FY15 (**Table 2.3**).

While a part of the decline can be traced to a base effect in fertilizer from last year, LSM growth was constrained by a broad range of issues that include: (i) continued weakening of export demand for cotton yarn; (ii) gas shortages in a number of industries (e.g., Punjab based textile industry, paper, glass, leather, some fertilizer plants, etc.); and (iii) sector-specific factors, including the closure of a large chip-board plant because of increasing wood prices and power shortages; and substitution of domestic production of edible oil with imports.

These factors not only overshadowed the impressive increase posted in automobiles and steel in the first three months of FY15, but also masked the impact of softening international commodity prices.

Base effect and reduced gas supply hampered fertilizer production

Fertilizer production fell by 4.1 percent in Q1-FY15, compared to a hefty 44.6 percent increase posted in Q1-FY14. This decline was caused by the government's decision to curtail gas supplies to a few fertilizer manufacturers.

Excluding these firms, fertilizer production during the quarter was slightly higher than the last year's level. This was because the additional gas supplied to Engro from Mari gas field, that had boosted last year's production, remains in place. Furthermore, the capacity utilization of these companies attached to Mari gas, also remained almost at last year's level (**Table 2.4**).

Table 2.3: Growth Trends in Large Scale Manufacturing – Q1

	Weight	Growth			Percentage Contribution		
	70.3	FY13	FY14	FY15	FY13	FY14	FY15
Increase in growth							
1. Steel	5.4	16.1	9.4	13.9	86.3	4.7	24.1
2. Automobile	4.6	-1.2	-4.8	13.3	-13.3	-4.1	33.7
3. Pharmaceutical	3.6	5.2	2.3	3.2	81.5	3.0	13.5
4. Rubber products	0.3	33.6	-0.4	6.5	23.2	0.0	1.5
5. Engineering industries	0.4	-12.9	-23.8	1.3	-11.7	-1.5	0.2
6. Chemicals	1.7	1.6	4.2	7.3	7.3	1.6	9.0
Fall in growth							
7. Textile	21.0	-0.5	2.4	1.0	-30.0	11.4	15.6
Cotton yarn	13.0	-0.6	3.0	1.2	-22.9	9.1	12.1
Cotton cloth	7.2	-0.3	0.9	0.1	-6.7	1.5	0.5
8. Food*	12.4	6.5	8.7	1.6	172.2	19.6	12.3
Cooking oil	2.2	6.4	8.7	7.5	44.3	5.2	-15.3
Tea	0.4	18.2	7.1	21.8	20.2	0.7	7.7
9. POL	5.5	3.4	12.7	4.9	39.9	12.3	17.0
10. Electronics	2.0	-11.2	15.9	8.5	-37.7	3.8	7.5
11. Paper & board	2.3	14.5	19.7	1.0	98.6	12.3	2.5
12. Non-metallic minerals	5.4	3.9	1.0	0.9	77.4	1.7	4.6
Cement	5.3	4.0	0.8	1.0	79.9	1.3	5.1
Fall in Production							
13. Fertilizer	4.4	-27.0	44.6	-4.1	-334.6	32.4	-13.5
14. Leather products	0.9	-10.0	13.0	0.1	-37.1	3.5	0.1
15. Wood	0.6	-13.1	-6.1	-81.2	-22.0	-0.7	-28.2
Overall LSM	**70.3**	**0.5**	**6.7**	**2.0**	**100.0**	**100.0**	**100.0**

*Estimate for sugar production has not been presented in this table, as cane crushing begins in the second quarter of the fiscal year.
Source: Pakistan Bureau of Statistics

Meanwhile, urea consumption posted a 3.5 percent YoY increase during Q1-FY15, compared to the same period last year. However, the country did not import urea this year because of improved supplies from higher inventories.

Slack demand and intermittent gas undermines cotton yarn

Cotton yarn production witnessed both demand and supply issues. Export demand for cotton yarn has remained low since last year, especially after a change in China's import policy. On the supply side, gas shortages for Punjab-based textile mills continued to be another drag for yarn manufacturing. The situation has still not changed. In fact, given the acute nature of gas shortages, the government has implemented a gas load shedding plan ahead of schedule in November 2014, and discontinued supplies to Punjab-based textile units. However, this decision has been reversed temporarily, on the plea of textile industry.[25]

Table 2.4: Urea Production (000 tons)

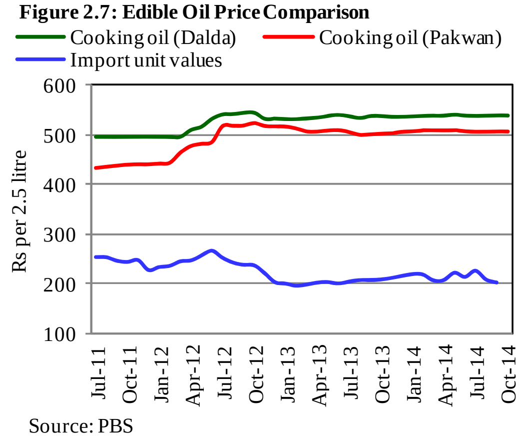
		Production		Capacity Utilization (%)	
Company	**Gas field**	**FY14**	**FY15**	**FY14**	**FY15**
EFERT	MGCL	**445.3**	**485.5**	**78.3**	**85.4**
FFC		**601.7**	**593.4**	**117.5**	**115.9**
Pak-Saudi	MGCL	208.1	174.0	116.0	96.9
G. Machi	MGCL	393.6	419.4	118.4	126.1
FFBL	SSGC	66.9	55.4	48.6	40.2
Fatima		**100.2**	**109.5**	**67.7**	**74.0**
FATIMA	MGCL	100.2	109.5	80.2	87.6
Pak-Arab	SNGPL	0.0	0.0	0.2	0.0
DHCL	SNGPL	24.4	8.3	21.9	7.4
AGRITECH	SNGPL	91.8	34.9	84.8	32.3
Total		**1,330.5**	**1,287.0**	**83.9**	**81.1**
Opening Inventory (Q1)		162.0	486.5		

Source: Various reports of NFDC

Paper & board also hit by gas shortages

Gas shortages in Punjab hampered growth in the production of paper & allied industries in Q1-FY15. Two of the largest paper plants, having a market share of around 60 percent, are located in this region. In the absence of gas, the paper industry had to rely on furnace oil, which increased the cost of production. Hence, one of the largest manufacturers had to reduce its production in Q1-FY15.

Figure 2.7: Edible Oil Price Comparison



Source: PBS

Import of edible oil substituting domestic production

The production of cooking oil posted a 3.2 percent decline in Q1-FY15, compared to a 8.7 percent increase in the same

[25] http://www.finance.gov.pk/press_releases.html

period last year. Pakistan's edible oil production largely depends on palm oil imports, which are further processed and packaged into various varieties. However, there has been a change in this trend lately. With joint collaboration between Pakistani and Malaysian firms, Malaysian cooking oil has been introduced to Pakistan in FY14.[26] The Malaysian Palm Oil Board is actively engaged in this collaboration. Under these arrangements, packaged refined, bleached and deodorized (RBD) palm oil is imported, which is directly marketed to commercial and household consumers. This shift is also supported by lower prices of imported palm oil compared to the prices offered by domestic brands (**Figure 2.7**).

Demand for automobiles

The growth in automobiles production touched a four-year peak of 14.0 percent in Q1-FY15 (**Table 2.5**), compared to a 4.8 percent decline in the same period last year. Encouragingly, the production of cars, trucks and tractors witnessed a significant increase in Q1-FY15.

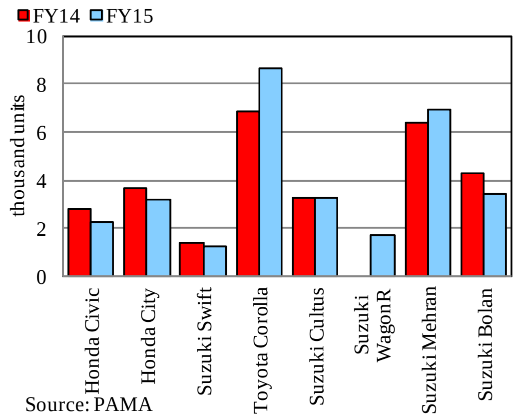
Table 2.5: Growth in Automobiles Production –Q1

percent

	FY11	FY12	FY13	FY14	FY15
Jeeps / Cars	23.0	4.2	-11.9	-5.3	11.5
Trucks	8.0	-33.9	-16.3	2.0	125.7
Tractors	-5.1	-69.1	156.4	-43.8	85.2
L.C.V.s	24.5	10.8	-11.3	3.3	3.2
Motor Cycles	14.6	18.0	-4.5	5.8	2.5
Overall	14.1	-3.4	-1.2	-4.8	14.0

Source: PBS

Figure 2.8: Production of Cars



Source: PAMA

The increase in car demand was already anticipated with the launch of a new model by Indus Motors in July 2014.[27,28] Category-wise analysis shows that with the exception of Toyota Corolla, Suzuki Mehran and Suzuki Wagon R, production of almost all

[26] Century cooking and MinYak cooking oil are the two recent examples of joint ventures (of Malaysian and Pakistani firms) opening in Karachi in FY14.

[27] The production of Indus Motors posted 14.5 percent decline in FY14, because of the phasing out of its old model.

[28]Given the demand prospects, there is increasing interest reported in the sector by the international player – Chinese and European large car manufacturers.

categories declined in Q1-FY15 (**Figure 2.8**).[29]

Production of tractors also increased significantly after a cut in general sales tax (GST) from 16 percent in FY14, to 10 percent in the Federal Budget for FY15. The agricultural community has been demanding this reduction since last year, after the GST rate was increased to 16 percent in FY14 from 10 percent in FY13.

Table 2.6: Production of Trucks during Q1

No. of units

	FY13	FY14	FY15
Trucks	**443**	**452**	**1,020**
Hino	226	196	342
Nissan (GHNL)	46	66	194
Master	64	94	218
Isuzu	107	96	266

Source: PAMA

Production of trucks increased substantially during Q1-FY15, compared to the same period last year (**Table 2.6**). All manufacturers increased production levels indicating an across the board increase in demand. Specifically, one of the leading manufacturers, GHNL has established its assembling plant in Pakistan, under the name of Ghandara DF Pvt Ltd in H2-FY14. Initially, GHNL was importing CBUs and selling them in the local market, but after getting a positive response from the local market, this company decided to set-up its plant in Pakistan.[30] The higher domestic production of trucks subsequently led to a decline in import.[31]

Going forward, production of LCVs is also likely to improve after the launch of *Apna Rozgar Scheme* by the government of Punjab in November 2014. Under this scheme, the Punjab government intends to provide 50,000 vehicles (Suzuki Bolan and Suzuki Ravi) to prospective candidates, at below market rates.[32]

Construction led growth in steel and cement

Strong demand from a number of mega construction projects, (e,g.: the Rawalpindi-Islamabad Metro; the Multan-Faisalabad Motorway and the

[29] The decline in the production of Honda Civic and Honda Citi can be attributed to substitution by the new model of Indus Motors.

[30] The truck manufacturing facility is located at Port Qasim Karachi. The plant is capable of producing 2,500 units annually. The company started its production operations from the second half of FY14. http://ghandharanissan.com.pk/24EAD16B-164F-4AE7-8E93-E804D59821DF/FinalDownload/DownloadId-930D403C77E13859A39B4072F087F928/24EAD16B-164F-4AE7-8E93-E804D59821DF/sep2013.pdf

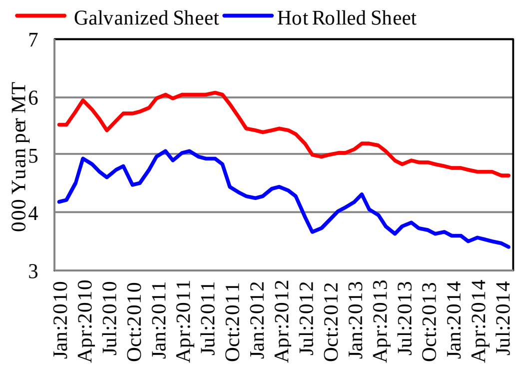
[31] The import of trucks fell from 219 units in Jul-Aug 2013, to only 171 units in Jul-Aug 2014.

[32] Suzuki Bolan is considered a car, and Suzuki Ravi is categorized as LCV.

construction at KPT and Port Qasim[33], and large infrastructure projects in energy sector) – led to a substantial increase in the demand for steel and cement in Q1-FY15. In the case of steel, a sharp increase in auto production provided a further boost to demand.

In addition to strong demand, steel production also benefitted from certain supply side factors: Pakistan Steel Mills resumed operations after receiving another bail-out package from the government;[34,35] and softening global steel prices (particularly in China), helped the local industry by reducing the cost of imported raw material. More specifically, steel prices in China have fallen consistently since mid- 2013 (**Figure 2.9**), because of a slowdown in construction sector.[36] In Pakistan, around one-third of the raw material (non-alloy and alloy steel) is sourced from China, and the continuous decline in the prices resulted in on average 11.1 percent drop in steel import unit values in Q1-FY15.

Figure 2.9: Steel Product Prices in China



Source: Haver Analytics

A part of this gain was, however, offset by an increase in the rate of taxation on different segments of the steel industry in the FY15 Budget.[37] Although, steel producers have passed on the tax increase to consumers,[38] the margins of some manufacturers have been squeezed.

Growth in cement production in Q1-FY15 remained at last year's level, despite high base effect. Most of the demand came from local markets, as cement exports

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33 The construction of Pakistan International Bulk terminal by Port Qasim Authority started in 2010, but was halted later due to an internal dispute. This project has started again in May 2014

34 The government approved a restructuring plan for PSM amounting to Rs18.5 billion in May 2014.

35 Pakistan Steel had 6.4 percent share in total steel manufacturing in Q1-FY15, compared to only 5.1 percent in the same period last year.

36 http://www.ft.com/intl/cms/s/0/cd91ea1e-5381-11e4-8285-00144feab7de.html

37 For example: (i) the rate of duty on silicon steel, pipe mills and perforated steel has been increased from 0 percent and 5 percent to 10 percent; (ii) the sales tax on steel melters, re-rollers & composite units has been increased from Rs 3 per unit of electricity, to Rs 7 per unit of electricity, etc.

38 The prices of an indicative category of iron bars posted 6.3 percent increase in Q1-FY15, compared to the same period last year.

declined by 8.1 percent mainly due to sluggish demand from Afghanistan (**Table 2.7**).[39] However, exports to India improved substantially with the relaxation of Non-Tariff Barriers (NTBs). As per our discussion with cement manufacturers, quicker clearance at the Wagah border has facilitated exports to the northern part of India.

Table 2.7: Trend in Cement Dispatches- Q1

In 000 MT

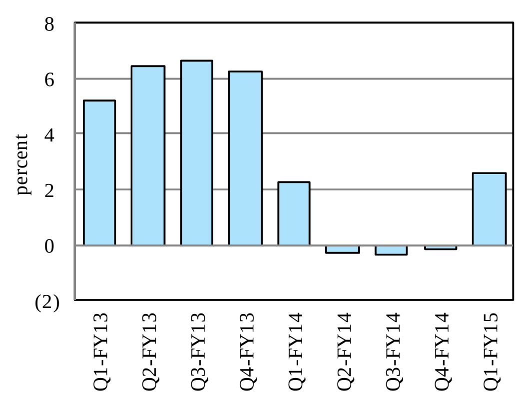
	Local dispatches		Export dispatches		
	North	**South**	**Afghanistan**	**India**	**Other Destinations**
FY08	4,911	804	744	11	681
FY09	4,005	881	751	191	1,213
FY10	4,699	797	921	195	1,705
FY11	3,861	757	1,009	106	1,130
FY12	4,216	945	1,315	163	857
FY13	4,389	1,048	1,224	138	911
FY14	4,569	987	1,171	105	967
FY15	5,063	1,040	835	190	1,035

Source: APCMA

Pharmaceuticals helped by a stable PKR

Production of pharmaceuticals posted a 2.6 percent increase during Q1-FY15, after a consistent decline in the preceding three quarters (see **Figure 2.10**). This was mainly helped by the strengthening and relative stability of the PKR since March 2014. The pharmaceutical industry was hit by the sharp depreciation of Pak Rupee during Jul-Feb 2014, due to its significant import dependence. Furthermore, the increase in prices of various drugs announced by the Drug Regulatory Authority of Pakistan (DRAP) in November 2013, was another important factor supporting pharmaceuticals.[40] This said, the announcement of a formal drug policy, which is required to eliminate uncertainty about drug pricing in the country, is still awaited.

Figure 2.10 :Pharmaceutical Production - YoY Change



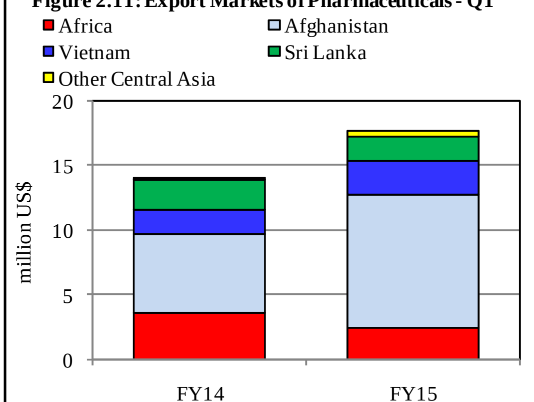
Source: Pakistan Bureau of Statistics

[39] Exports to Afghanistan fell by 28.6 percent during Q1-FY15, as compared to a fall of 4.4 percent in Q1-FY14.
[40] S.R.O.1002 (1)/2013 dated November 27, 2013. Although, the GoP withdrew this price increase, Sindh High Court restituted the old decision on the plea of the association of pharmaceutical companies.

Drug manufacturing in Pakistan is heavily dependent on imported raw materials due to non-availability of domestic inputs. Only a few companies are manufacturing basic ingredients in the country. Specifically, Pakistan is a net importer of pharmaceuticals, with pharma products constituting 1.7 percent of the entire import bill during Q1-FY15. Pakistan also imports finished medicines mainly because of: (i) slow registration process for the domestic production of medicines; (ii) influx of cheap alternatives through smuggling; and (iii) non-availability of raw materials needed for patent-protected medicines in the international market.

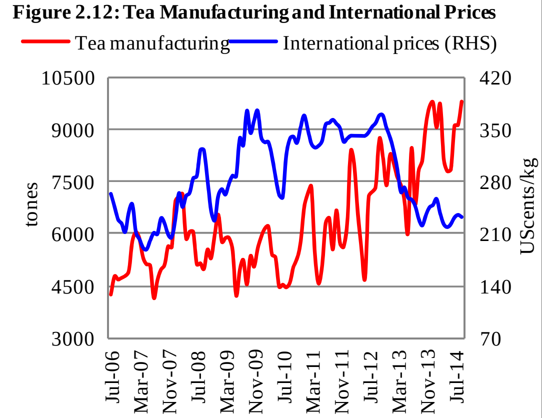
On the other hand, country's pharma exports posted a 15.6 percent increase in Q1-FY15, mainly on the back of an increase in unit prices. Our major export markets include Afghanistan, Vietnam, Sri Lanka and Africa (**Figure 2.11**). However, the share of African countries is being lost to India due to stringent quality requirements by these countries. Specifically, no Pakistani pharmaceutical company has an FDA approved manufacturing plant, which is a prerequisite for pharmaceutical exports to most of the countries.[41]

Figure 2.11: Export Markets of Pharmaceuticals - Q1



Source: PBS

Figure 2.12: Tea Manufacturing and International Prices



Source: IMF, Pakistan Bureau of Statistics (PBS)

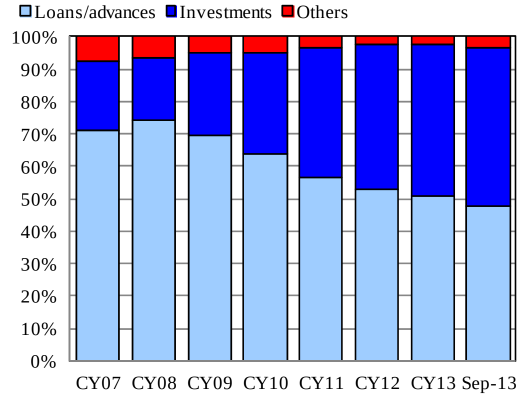
Tea production boosted by falling international prices

Tea manufacturing posted a sharp 21.1 percent increase in Q1-FY15, compared to 7.1 percent growth in the same period last year. Tea production is witnessing growth over the past few

[41] United States Federal Drug Authority (FDA).

years, because of the growing focus of manufacturers on marketing, branding and expanding distribution networks. Tea manufacturing in Pakistan entails blending and packaging of imported tea. Kenya is one of the largest suppliers of black tea, with around 64 percent share in the country's overall black tea imports in Q1-FY15. The fall in global tea prices since last year, gave another boost to this industry, as international prices of this commodity touched a 7-year low in 2014, and have not bottomed out as yet. This encouraged import and production of tea in the domestic market (**Figure 2.12**).[42]

Figure 2.13: Break-up of Mark-up Earned



Source: State Bank of Pakistan

2.3 Services

The performance of overall services sector in Q1-FY15, appears mixed. While *finance and insurance* and *telecommunications* have shown improvement over last year, the weakening in commodity producing sector would drag down *wholesale and retail trade.*

Finance and insurance

The operating performance of the banking sector observed a marked improvement in Q1-FY15. Profit before tax for the first 9 months of 2014 increased to PKR 176 billion, almost 44 percent higher than the corresponding period of last year. Key profitability indicators, like return on assets (ROA) and return on equity (ROE), improved over last year (**Table 2.8**).

Table 2.8: Financial Soundness Indicators

	Sep-13	CY13	Mar-14	Jun-14	Sep-14
Capital adequacy	15.5	14.9	14.8	15.1	15.5
Capital to total assets	9.3	9.0	8.9	8.8	9.0
NPLs to loans (gross)	14.3	13.3	13.4	12.8	13.0
NPLs to loans (net)	3.8	3.4	3.3	2.9	3.2
ROA (before tax)	1.7	1.6	1.9	2.1	2.2
ROE (before tax)	21.0	21.0	24.7	27.2	28.0
Advances to deposit	48.7	49.5	49.2	47.7	48.2

Source: State Bank of Pakistan

[42] Tea imports posted 35.7 percent quantum increase during Q1-FY15, compared to the same period last year.

2.1 This growth in earnings was achieved due to higher interest income, mainly from an increase in return on long-term government bonds. As shown in **Figure 2.13**, mark-up earned on investments now constitute the bulk of banks' total interest income. Banks have been aggressively placing funds in government securities in the past five years – T-bills and more recently in PIBs, to finance the fiscal deficit. In effect, higher profitability in the banking sector can be traced directly to a large fiscal deficit.

Another factor explaining banks' profitability has been the improvement in their asset quality, as lower provisioning charges have improved the bottom line. As shown in **Table 2.9**, banks' NPLs to loan ratio was only 13.0 percent in Q1-FY15, compared to 14.3 percent last year. This improvement was broad-based, as nearly all the economic segments posted a decline in infected loans.

Table 2.9: Segment-wise NPLs to Loan Ratio
percent

	Sep-13	Dec-13	Jun-14	Sep-14
Corporate sector	15.1	13.4	13.6	13.6
SMEs	38.7	32.3	33.9	35.7
Agriculture	17.6	14.0	14.8	16.0
Consumer sector	14.8	13.6	12.4	12.3
Commodity financing	1.0	1.1	0.8	1.0
Staff loans	1.4	1.5	1.5	1.5
Others	10.4	8.9	8.0	7.6
Total	14.3	13.0	12.8	13.0

Source: State Bank of Pakistan

<u>Telecommunications</u>
Q1-FY15 was the first quarter after the auction of 3G/4G to cellular companies. While U-fone, Mobilink and Telenor acquired 3G licenses, Zong was the only firm that was able to get both 3G and 4G licenses. With this, a new era has begun in Pakistan's telecommunication industry, in which cellular firms are able to provide high-speed mobile internet access to customers, along with improved voice quality. Telecom operators have been aggressively marketing new data packages at competitive prices. Customers can now use their mobile phones for video conferencing, advanced car navigation, video streaming, online shopping, and many other services. Every firm is operating with its own strategy: some are providing data services with unlimited speed, while others have it bundled with social media services like Facebook, Twitter, etc.

For cellular firms, revenue generation from value-added services is a major advantage, especially as stiff price competition among firms, does not allow them to increase cellular revenues from basic services. Operating performance of these firms in Q1-FY15, tells this story. For instance, average revenue per user (ARPU) of Telenor continued to decline during the quarter, which caused a reduction in its total cellular revenues by 0.5 percent YoY.[43] ARPU posted a reduction from Rs 206.5 per month in Q1-FY14, to Rs 177 in Q1-FY15.[44] However, this was more than offset by non-cellular revenues, which grew by 45.3 percent during the quarter. As a result, the firm was able to book an operating profit that was 27.7 percent higher than last year. Similarly, Mobilink's ARPU also declined from Rs 229 per month during Q1-FY14, to Rs 195 per month in Q1-FY15.[45] Like Telenor, Mobilink's data revenue also increased significantly during Q1-FY15 – posting 40 percent growth YoY, on the back of 3G and mobile financial services.

This sector offers immense potential for growth. Most firms have been investing for network modernization. This can be seen in the sharp rise in import of telecom machinery and data processing units in recent years. In Q1-FY15, capital expenditures by Mobilink and Telenor increased by 87 percent and 67 percent YoY, respectively. Development of Pakistan's telecom sector also has positive spill-overs on the banking system. Over the past five years, mobile banking has increased at a rapid pace, as customers increasingly using their mobile phones to pay utility bills; for inter-bank fund transfers; and inter-city remittances. In FY14 alone, Rs 1.6 million mobile banking transactions were made, with a turnover of Rs 67.2 billion. However, market analysts claim that a major constraint to further expansion of this sector is the high level of taxation. Pakistan is among the top-three global markets for telecom, where taxes weigh heavily on mobile phone usages (taxes are levied on purchase of mobile set; subscription; and air-time).[46] The global representative body of mobile operators – GSMA, opines that high mobile taxes reduce the digital inclusion, operator investment, GDP growth, and eventually, tax revenue growth.

As far as PTCL is concerned, its financials during Q1-FY15 show a dismal performance: the company's net revenues posted a 3.9 percent decline over last year. This, coupled with a sharp increase in overall costs, led to a substantial fall in its profitability. This sudden downturn can be explained by a combination of factors including, a sharp increase in marketing and service delivery cost; curtailment of LDI operations; and most importantly, the fire incident at one of PTC's major exchanges in Lahore, which reportedly disrupted its broadband and landline services. The fire damage alone cost Rs 776 million to the corporation.

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[43] Financial results of Telenor Pakistan are posted at the website of its parent company. These results can be accessed at: http://www.telenor.com/investors/

[44] ARPU has declined from 12 Norwegian Krone in Q1-FY14, to 11 NOK in Q1-FY15.

[45] Financial results are posted at the website of Mobilink's parent company, VimpleCom. These results can accessed at: http://www.vimpelcom.com/#Investor-relations/Reports--results/Results/

[46] Source: *www.gsma.com/.../GSMA_Digital-Inclusion-Report_Web_Singles_2.pdf*

However, amidst these unfavorable events, the company has managed to contain its administrative and financing costs.

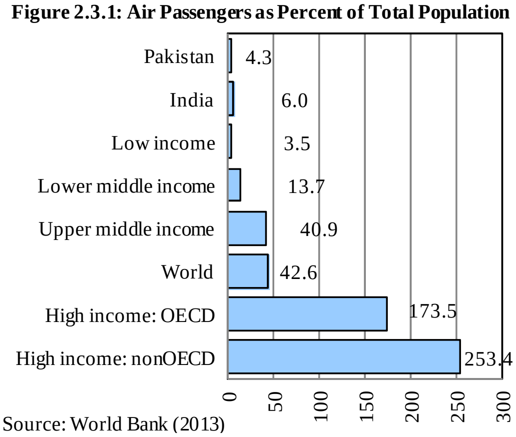
Transport

The increase in trade volumes during Q1-FY15 should have improved cargo handling at ports; however, public entities like PIA and Pakistan Railways are expected to end up with losses in FY15. The government has budgeted Rs 37 billion losses by Pakistan Railways in 2014-15. On the other hand, PIA has already booked losses of Rs 10.7 billion during the first quarter of the year. However, it must be noted that PIA's losses in Q1-FY15, are smaller compared to Q1-FY14 (Rs 13.6 billion). This improvement can be traced to lower fuel cost in the wake of falling international prices of jet fuel. Furthermore, the corporation has recently acquired fuel-efficient aircrafts on lease, which may have also reduced its expenses. PIA needs serious organizational reforms, ranging from reducing ground staff to cutting loss-making routes; or else the corporation will continue to suffer shrinkage in business and loss in market share (**Box 2.3**).

Box 2.3: Aviation Sector

The significance of aviation sector for the process of economic development and growth is well documented. Efficient means of air transport contribute to the economic development via: (i) connecting far-flung areas; (ii) minimizing time and cost for freight and passenger movement, and (iii) increasing market accessibility for producers and consumers. Unfortunately, Pakistan could not reap the benefits of global connectivity *via* air services. Current statistics shows that the level of air transport penetration is very low in Pakistan: the country is standing far behind the regional peers as well as most countries of the same income group (**Figure 2.3.1**).

Figure 2.3.1: Air Passengers as Percent of Total Population



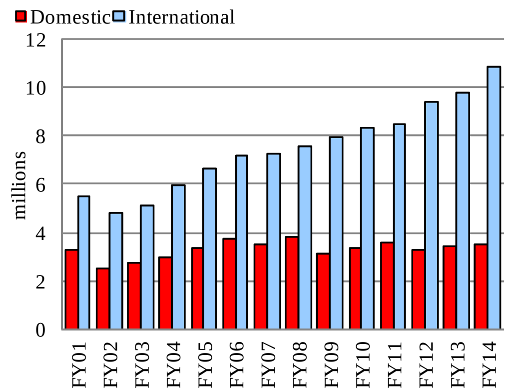
Source: World Bank (2013)

Over the years, the bulk of air transport in Pakistan has been to serve the passengers traveling on international routes (**Figure 2.3.2**); local passenger movement has remained fairly stagnant.[47] Presently, four airlines are operating on domestic routes including the state-owned PIA, and three private airlines, including Airblue, Shaheen Air International (SAI), and Indus Air. Having the

[47] The ratio of local passengers to total population declined from 2.2 percent in FY01 to 1.87 percent in FY14. The reason why local passengers travel less via air is the availability of alternate transportation for traveling within the country, including railway and road network.

largest fleet size, PIA has had the largest share in passengers and cargo over the years; however, more recently, the airline has lost some of its share to the private-owned airlines, especially the Shaheen Air (**Figure 2.3.3**).[48]

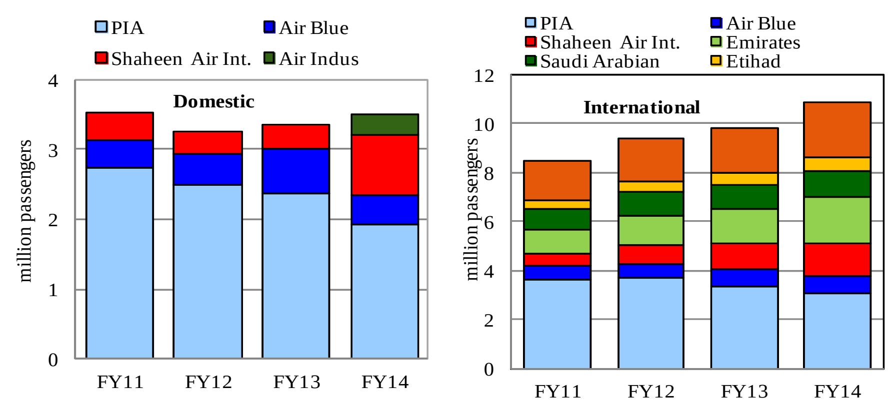
Figure 2.3.2: Passenger Movement via Air



Source: Civil Aviation Authority

Operating inefficiencies, limited flight operations, and impaired revenues are responsible for the declining share of the national carrier. Despite the continuous government support in the form of financial guarantees for credit, and direct funding, the corporation has continued to suffer losses. However, more recently, some cost cutting strategies have been adopted by the PIA (like the acquisition of fuel efficient aircrafts), which have reduced its losses. More specifically, during the first 9 months of 2014, it posted a net loss of Rs 20.9 billion, compared to Rs 32 billion in the corresponding period of CY13.[49]

Figure 2.3.3: Passenger Movement Through Different Airlines



Source: Civil Aviation Authority

As far as international routes are concerned, there has been a significant growth in passengers' movement in recent years. It appears that Pakistanis visit foreign countries more than before, for both business and leisure purposes. For instance, a large number of Pakistanis have been going abroad for work in recent years – mainly to the GCC countries. Unfortunately, however, due to

48 Share of Shaheen Air rose from 5.2 percent in FY07 to 24.2 percent in FY14.

49 In the ECC meeting held on February 2013, government decided to provide financial support to the PIA. Not only it approved the extension in government-back guarantees, it also allocated funding of Rs 12 billion for fiscal space, and US$ 46 million for the acquisition of narrow-body aircrafts on dry lease.

growing security concerns (e.g., attacks on international airports), a number of foreign airlines suspended their operations in Pakistan - Singapore Airlines, Cathay Pacific, Air India, Swiss Air, are some examples. Therefore, despite the increase in international traveling, fewer airlines operate in Pakistan than before: in 2007, 23 foreign airlines had flight operations in Pakistan, whereas in 2014, this number has declined to only 16. Among these, 11 are from GCC countries. The airlines, which chose to stay, have to bear high insurance costs due to security concerns.

Apart from passenger segment, air cargo segment failed to show any significant growth; in the presence of cost efficient alternative, for instance shipping and road transports, it seems very difficult for the air cargo to grab any sizable share. Currently most of the international movement of cargo is handled through shipping industry whereas local transport is mainly carried through road transport via trucks.

Source: Civil Aviation Authority, Shaheen Air and PIA websites.

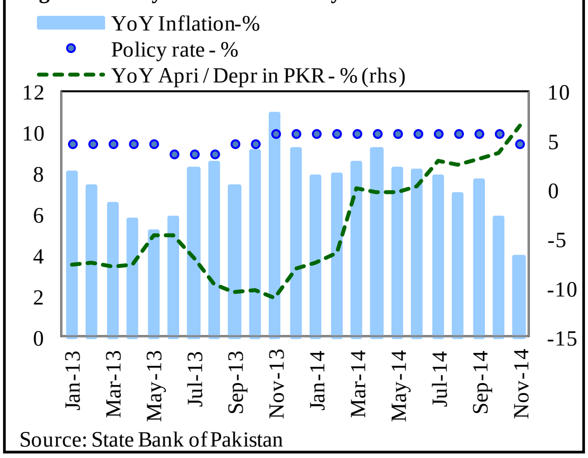
3 Monetary Policy and Inflation

3.1 Overview

SBP kept its monetary policy stance unchanged during the first quarter of the year (**Figure 3.1**). In effect, SBP had to weigh the comfort from declining inflation; lower government borrowing from the banking system; and stability in the FX market, against the potential impact of the August 2014 floods on food inflation in subsequent months, and the activity on the political front. In addition, the widening trade deficit, coupled with the delay in 4th Review of the IMF program, contributed to uncertainty about the outlook for FX inflows. Keeping a watchful eye on these developments, SBP maintained its policy rate at 10 percent in its policy decisions of July and September 2014. Furthermore, liquidity in the money market was cautiously kept tight to avoid any unnecessary pressure on the exchange rate, and to ensure sustainability.

However, risks to inflationary outlook dissipated as the economy entered the second quarter of the year. Not only was the impact of floods on perishable food items limited, but softening global commodity prices, and the lagged impact of monetary tightening, helped improve the inflation outlook. YoY inflation in November 2014 has already declined to 13-year low of 4.0 percent.

Figure 3.1: Key Indicators of Policy Environment



Source: State Bank of Pakistan

Concerns about the external sector also eased with the successful completion of discussions for the 5th Review of the IMF program, which subsequently paved the way for the combined release of the 4th and 5th tranches (amounting to US$ 1.1 billion) in December 2014. Moreover, the government was able to issue Sukuks worth US$ 1.0 billion in the international market[1], which will reduce government reliance on domestic sources of funding, and help improve the external position.

[1] Against the target of US$ 500 million, total bids worth US$ 2.3 billion were received.

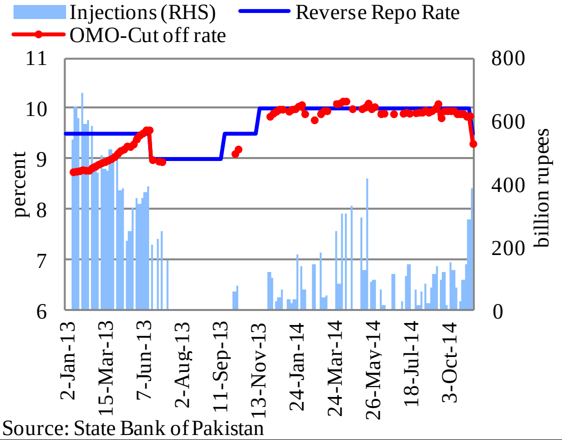
This positive outlook on the external sector, along with the government efforts to contain the budget deficit, created some room to support weak economic activity. Hence, SBP decided to reduce the policy rate by 50 bps to 9.5 percent in its monetary policy decision of November 2014, and by 100 bps to 8.5 percent in monetary policy decision of January 2015. This reduction will help the private sector, as the month of November marks the period of seasonal credit offtake. The first quarter, which is a period of seasonal retirement in the credit cycle, saw a net expansion of Rs 59.6 billion YoY (1.6 percent) in Q1-FY15, against a net contraction of Rs 17.4 billion in Q1-FY14. This unexpected increase was primarily driven by a healthy growth in trade volumes, and a pick-up in consumer financing.[2]

The expansionary impact of the increase in credit to the private sector and the government, on money supply, was more than offset by the undesirable but contractionary impact of a fall in foreign exchange reserve and SBP's money market intervention for liquidity management. As a result, the M2 witnessed a small contraction of Rs 6.0 billion in Q1-FY15, against an expansion of Rs 21.5 billion during the same period last year.

3.2 Money Market Developments

Cognizant of the developments taking place in the FX market, and the decline in government borrowing from the banking sector, SBP had to be careful in managing liquidity in the money market. The hard earned stability in the FX market faced some challenges in August 2014, following political events in Islamabad. The situation was further complicated by the sharp increase in current account deficit, and the potential delay in the official FX inflows (**Chapter 5**).[3] As a result, the PKR depreciated by 2.8 percent and SBP's FX reserves fell by US$ 558.4 million in

Figure 3.2: SBP Liquidity Support: OMOs



Source: State Bank of Pakistan

[2] Loans for import financing saw a net expansion of Rs 49.5 billion during Q1-FY15, which were 2.7 times of the increase in Q1-FY14. Similarly, consumer financing benefited from a healthy demand for auto loans (for details, see **Section 3.4**).
[3] Balance of payment data for July was released in the third week of August 2014.

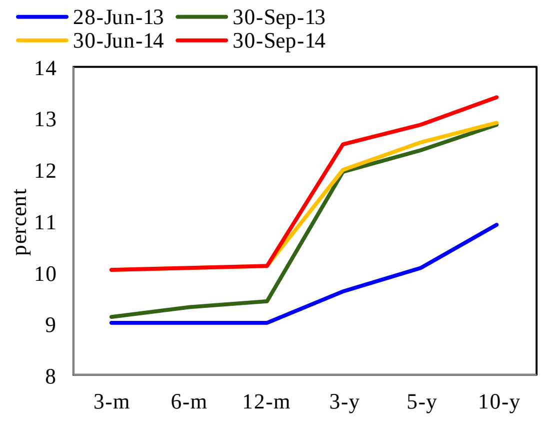
the month of August 2014 (**Figure 3.1**).[4]

In this situation, SBP kept rupee liquidity tight in the money market, to avoid pressure on the exchange rate, and to further contain depletion in its FX reserves. The weighted average overnight rate was maintained very close to the upper limit of the interest rate corridor (IRC), by providing limited liquidity through open market operations (**Figure 3.2**). Not only were OMO cut-off rates very close to the upper limit of the IRC, but the acceptance-to-bid ratio (84.9 percent for the quarter), was lower than the preceding quarter (Q4-FY14). Moreover, the utilization of SBP's window for liquidity management, indicates that commercial banks visited the window 98 times during the quarter to borrow a total of Rs 693.3 billion, compared with only 17 visits to place funds amounting to Rs 163.4 billion.

While proactive liquidity management helped maintain stability in the FX market, it impacted bank participation in government securities, and increased the demand for foreign currency loans. Specifically, trade financing (loans for both imports and exports) against foreign currency deposits, increased by US$ 439.1 million during the quarter, to reach all time high of US$ 2.1 billion by end-September 2014. In our view, the impetus came from importers who borrowed heavily to benefit from the prevailing interest rate differential. In addition to this, exchange rate movements also played an important role in determining the effective cost of borrowing in foreign currency.

Elevated domestic interest rates rendered the short-end of the yield curve (up to one year) almost flat (**Figure 3.3**). Specifically, the term premium between the 3-month and 12-month T-bills, was only 8 to 15 bps during the quarter. During the same period, term premium between the 12-month T-bills and 3-year PIBs was huge ranging between 216 to 245 bps. This disconnect in the yield curve, stoked the

Figure 3.3: Secondary Market Yields



Source: State Bank of Pakistan

[4] Although SBP's FX reserves saw an increase of US$ 224.3 million in September 2014, the end-September target of Net International Reserves under the IMF program was missed on account of non realization of OGDCL privatization inflow.

market appetite for PIBs. As a result, the government was able to mobilize Rs 303.7 billion from three PIB auctions held during the quarter against a combined target of Rs 300.0 billion. However, SBP had to inject liquidity into the market to facilitate the settlement of these auctions, as a number of banks were over-bidding. This is a common practice, as investing banks can fund their lucrative investments by borrowing from the money market or from SBP.

3.3 Monetary Aggregates

Money supply posted a small contraction of 0.1 percent during Q1-FY15, compared to a net expansion of 0.2 percent in the corresponding period last year. However, it is encouraging to note this reduction did not come from credit to private sector, which expanded by 1.6 percent during the quarter. In effect, major contributions came from lower government borrowing, and an undesirably higher external deficit that reduced NFA of the banking system.

Table 3.1: Monetary Aggregates
billion Rupees

	Stock as of		Absolute changes	
	Jun-14	**Sep-14**	**FY14**	**FY15**
Money Supply (M2)	9,968.0	9,962.0	21.5	-6.0
NDA	9,367.0	9,392.1	194.6	25.0
SBP	1,871.6	1,804.5	174.2	-67.1
Comm. Banks	7,495.5	7,587.6	20.4	92.1
NFA	601.0	570.0	-173.2	-31.0
SBP	489.6	481.6	-146.1	-8.0
Comm. Banks	111.4	88.3	-27.1	-23.0

Source: State Bank of Pakistan

Net Foreign Assets (NFA) of the Banking System

Contraction in NFA of the banking system reflects the pressure on the external account: sharp increase in the current account deficit, and a decline in both debt and non-debt inflows.[5] However, this contraction was much lower compared to Q1-FY14, when the country had to make lumpy repayments to the IMF (**Table 3.1**).

Within the banking system, the decline in commercial banks' NFA was more pronounced. In effect, SBP's FX support in the interbank market remained fairly limited, because of quarterly targets on its net international reserves (NIR) under the IMF program. As a result, the burden of financing lumpy import payments fell on commercial banks, which is visible from both the contraction in their NFA, and an all-time high volume of import financing against FE-25 deposits.[6] Since net

[5] For details, please see **Chapter 5** on External Sector.
[6] Specifically, import financing (loans for imports only) against FE-25 deposits surged by US$ 615.5 million during the quarter, to all time high level of US$ 1,266.6 million.

mobilization of FE-25 deposits was quite low compared to the demand for FX loans, commercial banks had to draw down their FX investments/placements abroad. This shift in commercial banks' claims (assets) from foreign to domestic residents, led to a contraction in their NFA.

Net Domestic Assets (NDA) of the Banking System

The *growth* in NDA of the banking system, declined from 2.3 percent in Q1-FY14, to only 0.3 percent in Q1-FY15. As mentioned before, this deceleration was entirely driven by lower government borrowing, as credit to non-government sector grew at a higher pace during the quarter. Within the banking system, SBP's NDA saw a net contraction of Rs 67.1 billion during the quarter. Despite this, SBP's NDA target for end-September 2014, agreed with the IMF, was not met primarily on account of non-realization of OGDCL privatization inflows.

Government Borrowing for Budgetary finance[7]

The availability of higher NSS funding during the quarter, reduced the government's reliance on bank financing for budgetary support. Government borrowing from the banking system during Q1-FY15, was around 70 percent of the amount borrowed during the corresponding period last year. Moreover, lower borrowings came with a favorable change in the source of funding within the banking system: unlike heavy reliance on SBP in the previous year, the government actually retired Rs 39.0 billion to the SBP during Q1-FY15 (**Table 3.2**). While this retirement helped the government meet its quarterly limit of zero budgetary borrowing from SBP (as prescribed in SBP Act 1956), it was not enough to meet the end-September target under the IMF program. Delay in issuance of Sukuk and non-realization of OGDCL privatizations proceeds explains this breach of the target. Specifically, the stock of government borrowing from SBP stood at Rs 2,288.7 billion at end-September 2014, against the IMF target of Rs 2,070 billion.

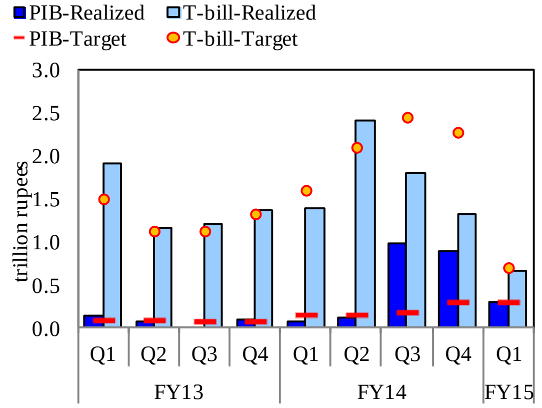
Table 3.2: Net Budgetary Borrowing during the First Quarter

cash basis, billion rupees

	FY13	FY14	FY15
Banking System	151.5	198.0	139.9
SBP	-412.1	352.8	-39.0
Scheduled banks	563.6	-154.8	178.9

Source: State Bank of Pakistan

[7] Numbers discussed in this section are on cash basis, which will differ from that of Monetary Survey.

Table 3.4: Auction Profile


Source: State Bank of Pakistan

The pattern of government borrowing from commercial banks in Q1-FY15, is exactly the opposite to what was realized in Q1-FY14. The government borrowed Rs 178.9 billion from commercial banks in Q1-FY15, compared to net retirement of Rs 154.8 billion seen in Q1-FY14 (**Table 3.2**). This turnaround is primarily because of a change in market expectations of future interest rates, and subsequent banks interest in government papers.

Unlike Q1-FY14, when banks were anticipating an increase in interest rates and refrained from actively participating in T-bills auctions, they were expecting a policy status quo throughout Q1-FY15, with some probability of a rate cut. In this scenario, commercial banks were eager to lock-in funds in risk-free government securities at prevailing interest rates.[8] This facilitated government's efforts to meet its funding requirements from the market largely as planned. Specifically, the government realized Rs 303.7 billion in primary auctions of PIBs, against the pre-auction (accumulated) target of Rs 300.0 billion for the quarter. In case of T-bills, the government mobilized Rs 658.0 billion, against the quarterly target of Rs 700.0 billion (**Figure 3.4**).

This pattern of government borrowing helped improve the maturity profile of its domestic debt, and also mitigated re-pricing and roll-over risks.[9] Commercial banks were also happy to place their funds in PIBs, as the disconnect between T-bills and PIBs yields (which emerged during Q1-FY14), remained in place throughout Q1-FY15 (**Figure 3.3)**.

[8] Market expectations of interest rate cut materialized during second quarter of the year, when the SBP cut the policy rate by 50 bps to 9.5 percent in its monetary policy decision of November 2014.
[9] For details, please section on **Domestic Debt.**

Commodity Operations

In addition to budgetary support, the government also borrows from the banking sector to finance its commodity operations. Loans for commodity operations saw a net reduction of Rs 23.7 billion during the quarter, to reach Rs 468.7 billion at end-September 2014. Moreover, commodity-wise distribution shows three major commodities saw a net retirement during the quarter, with a dominating role of wheat financing (**Table 3.3**).[10]

Table 3.3: Commodity Operations
billion rupees

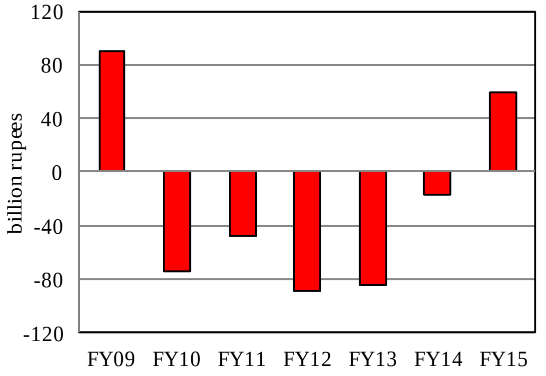
	Stock as of		Absolute change	
	Jun-14	**Sep-14**	**Q1-FY14**	**Q1-FY15**
Wheat	386.2	371.2	-20.2	-15.0
Sugar	46.8	44.7	-5.7	-2.1
Fertilizer	58.4	51.8	3.9	-6.7
Rice	1.0	1.0	0.0	0.0
Total	492.4	468.7	-22.0	-23.7

Source: State Bank of Pakistan

3.4 Credit to Private Sector

Credit to private sector recorded a YoY growth of 1.6 percent during Q1-FY15 – positive growth after a gap of five years (**Figure 3.5**). However, detailed data suggests that the increase came primarily from a rise in import financing during the period (**Table 3.4**).

Figure 3.5: Credit (net flows) to the Private Sector in the First Quarter



Source: State Bank of Pakistan

Working capital and fixed investment loans posted net retirements during the quarter (**Table 3.1**). It must be noted that seasonal retirements of working capital loans from sugar and textile industries, remained stronger than last year. However, this was more than offset by higher credit offtake by petroleum refineries and cement manufacturers. As a result, overall working capital loans show lower retirements than last year.

[10] Following the end of wheat procumbent season (March-June), procurement agencies generally start retiring their loans against wheat from July onwards.

Similar to the trend in previous years, heavy bank investments in government papers reduced the supply of loanable funds for the private sector. Since the start of 2014, banks have been actively placing funds in PIBs, which carry much higher returns than the WALR banks get from the manufacturing sector (**Table 3.5**). Given market expectations that the policy rate is unlikely to be increased in the near future, the incentive to invest in government securities is likely to continue. In addition, anecdotal evidence suggests that banks are presently lending only to blue-chip customers, whereas other borrowers have largely been priced out from the market.

Table 3.4: Changes in credit to private sector
billion rupee

	FY14	FY15
Credit to private sector (MS)	-17.4	59.6
of which		
A) Credit to NBFIs	-16.2	-14.0
B) Private sector business	-3.0	13.6
of which		
Working Capital	-31.3	-16.9
Fixed Investment	19.4	-27.4
Export Financing	-9.5	8.4
Import Financing	18.4	49.5
C) Consumer financing	13.4	5.1
of which		
Personal Loans	10.0	1.9
Auto Loans	3.1	3.6

Source: State Bank of Pakistan; MS: Monetary Survey

Borrowing by type of financing

Import financing increased by Rs 49.5 billion in Q1-FY15, compared with an increase of Rs 18.3 billion in Q1-FY14. This expansion was driven by higher imports of fertilizer, basic metals, petroleum products and edible oil. Import financing for *edible oil & ghee* doubled compared to last year amid higher quantum. As mentioned earlier, it was also beneficial for importers to borrow in US$ to avail the wedge between PKR and US$ loans, especially given a stable outlook for the PKR (**Chapter 5**).

Table 3.5: Rate of return on credit to manufacturing sector; T-Bills; and PIBs
percent

	WALR manufacturing	PIBs*	T-bills*	KIBOR
Dec-11	12.18	12.45	11.83	11.94
Jun-12	11.93	12.75	11.92	11.97
Dec-12	10.90	10.40	9.28	9.40
Jun-13	10.66	9.70	9.09	9.41
Dec-13	10.29	12.10	9.93	10.06
Jun-14	10.50	12.10	9.96	10.17
Sep-14	N.A	12.59	9.95	10.18

* Monthly average cut-off rates of 3-M T-bills & 3 year PIBs
Source: State Bank of Pakistan

Fixed investment loans recorded net retirement of Rs 27.4 billion during Q1-FY15, in contrast with an expansion of Rs 19.4 billion during the same period last year. Sector-wise information indicates that major retirements were made by the energy and textile sectors (Rs 16.3 and Rs 6.5 billion, respectively) (**Table 3.6**). Both sectors availed fixed investment loans last year for capacity expansion and

BMR, respectively.

Table 3.6: Credit to private sector businesses
changes in billion rupees

	Abs. Change		Working capital		Fixed		Trade financing	
	FY14	**FY15**	**FY14**	**FY15**	**FY14**	**FY15**	**FY14**	**FY15**
Private sector	-3.0	13.6	-31.3	-16.9	19.4	-27.4	8.8	57.9
1) Agriculture	7.7	9.5	8.0	6.1	-0.7	3.4	0.4	0.1
2) Manufacturing	-26.7	-14.7	-37.8	-46.6	14.2	-9.4	-3.2	41.2
Food & beverages	-46.3	-24.8	-40.9	-39.6	-0.9	0.4	-4.5	14.5
Rice	-8.3	-11.5	-6.9	-12.3	0.0	0.1	-1.4	0.7
Sugar	-31.0	-27.2	-28.3	-35.1	1.4	6.6	-4.1	1.3
Beverages	5.5	-3.3	4.5	-4.1	-0.2	-0.1	1.2	0.9
Edible oil & Ghee	4.4	9.4	-0.2	2.2	0.0	-1.9	4.6	9.1
Feeding stuff animals	-0.2	7.9	1.7	3.9	-0.3	0.2	-1.6	3.9
Textile	0.3	-14.8	9.7	-9.6	-0.9	-6.5	-8.5	1.3
Cement	-1.3	2.8	-4.9	2.8	4.3	-1.2	-0.8	1.3
Petroleum Products	14.0	18.9	2.6	10.0	10.8	1.4	0.6	7.5
Basic Metals	9.0	6.6	3.2	1.3	1.0	-3.0	4.8	8.3
3) Electricity	25.6	-2.1	15.4	15.1	6.9	-16.3	3.2	-0.8
4) Telecom	-7.1	-0.6	-2.9	0.5	-5.1	-1.0	1.0	-0.2
5) Commerce & Trade	-4.8	1.3	-8.3	-2.6	1.1	0.1	2.3	3.8
6) Construction	-3.2	-2.5	-4.2	-2.7	1.1	0.0	0.0	0.2
7) Mining & Quarrying	1.5	2.2	0.6	0.4	2.2	-0.3	-1.3	2.0
8) Ship breaking	3.4	8.0	0.4	-0.1	-0.6	0.1	3.7	7.9
9) Real estate	0.4	8.8	-2.1	5.0	0.1	1.5	2.3	2.2
10) Others*	0.2	3.8	-0.4	7.9	0.2	-5.6	0.4	1.4

*Fishing, hotel, transport, education, health, etc.
Source: State Bank of Pakistan

Working capital loans that mature within a year, generally reflect procurement of raw material by manufacturing firms and seasonality in cash flows. These recorded a contraction of Rs 16.9 billion during Q1-FY15, compared to a decline of Rs 31.3 billion during the same period last year. Retirement by sugar, textile and rice processing industries were particularly strong. In view of the trend in global commodity prices, it appears the working capital requirement for manufacturing during FY15, will remain lower than last year (**Chapter 2**).

As far as working capital loans are concern, sugar firms retired Rs 6.8 billion *more* in Q1-FY15, than in Q1-FY14. As discussed in Chapter 2, sugar manufacturers were facing liquidity problems last year, due to excessive carry-over stocks and strong production, which forced them to borrow heavily from banks. As usual, the bulk of retirement took place in the first quarter.

Textile sector, with a share of 20 percent of loans to private businesses, retired Rs 14.8 billion during Q1-FY15, in contrast with a negligible expansion of Rs 0.3 billion during Q1-FY14. This contraction was expected, as textile manufacturers had to borrow more last year, keeping in view a sharp rise in cotton prices (**Chapter 2**). Furthermore, after gaining GSP plus status in FY14, many large exporting firms expanded and revamped their operations using fixed investment loans. These loans were scheduled to be retired in the first quarter.

Consumer Financing

Consumer financing recorded a YoY growth of 2.3 percent during Q1-FY15, compared with a growth of 6.5 percent during the same period last year. Within consumer financing, relatively low-risk auto financing increased by 5.6 percent, against 6.2 percent growth recorded last year. This consistent growth in auto financing was further boosted in FY15, due to an amendment in car financing regulations; banks can now finance cars up to 9 years old.[11] In addition, the launch of the long awaited new model of Toyota Corolla, also seems to have played a part in higher demand for auto loans in FY15.

3.5 Inflation

Headline YoY inflation remained in single-digits during the first quarter of FY15 – a trend witnessed since July 2012.[12] During Q1-FY15, the average CPI inflation came down to 7.5 percent, compared to 8.1 percent in the corresponding quarter last year (**Table 3.7**). Furthermore, year-on-year inflation remained low in Q1-FY15, and continued to edge lower.

Table 3.7: Quarterly Averages of YoY Inflation
percent

		CPI	Food	NFNE	Trimmed
FY14	Jul-Sep	8.1	9.1	8.5	7.8
	Oct-Dec	9.7	10.7	8.4	9.0
	Jan-Mar	8.1	8.0	7.8	8.2
	Apr-Jun	8.6	8.2	8.6	8.4
FY15	Jul-Sep	7.5	6.6	8.0	7.3

Source: Pakistan Bureau of Statistics

The ease in inflationary pressures was realized despite significant upside risks to inflation. Specifically, while it was feared that floods might impact the availability of perishable food throughout the country, seasonal price hikes on

[11] BPRD Circular No. 07 of 2014, dated July 23, 2014. According to which, banks/DFIs desirous of financing the purchase of used cars shall prepare uniform guidelines for determining the value of the used vehicles. In no case the bank/DFI shall finance the cars older than nine years.
[12] The only exception was the month of November 2013, when the YoY inflation touched 10.9 percent.

account of Ramadan and Eid were expected to make things worse.[13] In addition to this, an increase in power tariffs was widely anticipated, which would have pushed inflation further up.

As things played out, the floods in 2014, did not impact food prices to the same extent as in the past, mainly because floods were not as severe it was expected (**Chapter 5**). As far as the Ramadan effect was concerned, it must be noted that inflation for common use items like fresh fruits, onions, tomatoes, potatoes and fresh vegetables, *did* increase on a quarter-on-quarter basis, but this was more than offset by *deflation* in heavier items like wheat, edible oil and ghee.[14] Finally, the government did increase power tariff during the quarter, but the increase was less than expected.

Compared to Q1-FY14, decline in inflation this fiscal year was driven by: (i) improved grain supplies; (ii) soft oil prices; (iii) reported delays in the increase in power tariffs; and (iv) the cut in retail POL prices. The disinflation in food was more pronounced, due to favorable supply-side factors, mentioned above. Both measures of core inflation have also softened (**Table 3.7**).

Improved food supplies

If we look at the 20 heaviest items in the CPI basket, most of the disinflation in Q1-FY15 was evident in wheat flour, rice and fresh vegetables (**Figure 3.6**). This improvement was driven primarily by improved stocks in the country, thanks to better production, and timely imports in August and September 2014.[15] Similarly, more rice was available in the domestic market this year, as traders preferred to hold back exports due to depressed international prices (**Chapter 5**). As far as fresh vegetables are concerned, their supply remained smooth due to timely imports. Furthermore, prices of onions and tomatoes were lower than last year, due to better demand-supply management.[16]

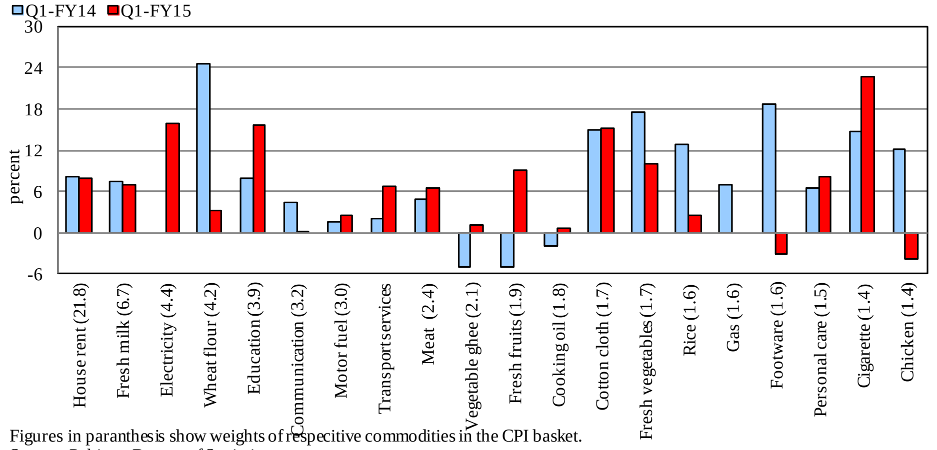
[13] Increase in prices, especially of perishable food items, during the month of Ramadan is a common phenomenon, and is observed almost every year.

[14] Wheat prices had started to decline with the arrival of new crop. During Apr-Jun, the price of wheat remained 11.7 percent lower on average, than the preceding quarter. This trend continued into Jul-Sep, when price of wheat posted a further quarter-on-quarter decline of 0.5 percent. As far as edible oil and ghee is concerned, their prices are directly linked with global prices. In the international market, palm oil prices started to decline from April 2014 onwards: the commodity was being traded at US$ 850 per MT in March 2014, which declined to US$ 758.5 in June, and further to only US$ 657 during September.

[15] Wheat production in Rabi 2014 had increased by 4.4 percent YoY. Furthermore, the country imported 275,000 MT of wheat during August and September 2014.

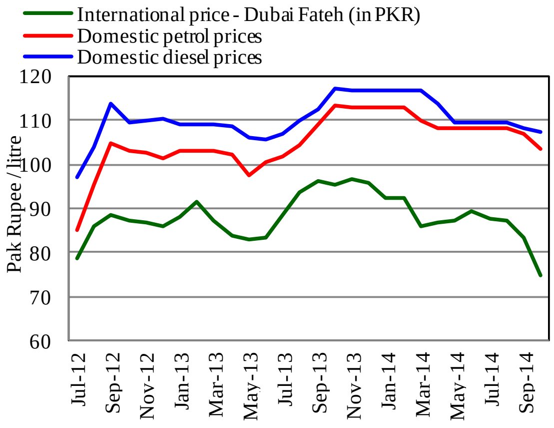
[16] In Q1-FY14, Pakistan had doubled its onion exports, mainly to compensate for the damage to Indian crop. This had caused a demand-supply gap in local market, which put upward pressures on

Figure 3.6: Inflation Trends in 20 Heaviest Items in the CPI Basket



Figures in paranthesis show weights of respecitive commodities in the CPI basket.
Source: Pakistan Bureau of Statistics

Figure 3.7: Comparison of International Oil Prices and Domestic Fuel Prices



Source: Pakistan Bureau of Statistics; IMF and SBP (for exchange rate data)

Administered prices continue to influence headline inflation

The government increased electricity tariffs on various consumption slabs, by an average of 16 percent in October 2013. This increase alone contributed 0.7 percentage points to inflation during Q1-FY15. This contribution would have been more pronounced, if the government had increased the tariffs further, as committed.

In case of motor fuel, despite a significant easing in the international prices of crude oil, there was only a nominal reduction in the domestic fuel prices during Q1-FY15 (**Figure 3.7**). However, in October, the government further reduced oil prices (by Rs 3.3 per litre), and a much more significant reduction at end-November 2014.

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its price. In case of tomatoes, local crop had suffered damages in Q1-FY14. Although the government increased its imports from India, but quantities were not sufficient to fill the demand-supply gap.

It is interesting to note that some consumer items like kerosene oil, cigarettes, soft drinks etc. are selling at above their retail prices either fixed by the government or manufacturers. Provincial Supply and Prices Departments as well as their 'Bureau of Supplies and Prices' are entrusted by the federal government to check this practice under the relevant laws[17].

Increases in cigarette prices
The 2014-15 Budget did not specifically increase federal excise duties on cigarettes, but its imposition at the wholesale and retail level was simplified and re-structured. More specifically, from three-slabs based on a composite formula, the duty is now levied on two-slabs based on a specific rate. This simplification resulted in higher retail prices of cigarettes (an increase of 13.5 - 27.6 percent for different brands). Cigarettes alone contributed 0.4 percentage points to overall CPI inflation during Q1-FY15.

Going forward
In November 2014, the CPI inflation has come down to a 13-year low of 4.0 percent, reflecting the impact of downward revision in domestic fuel prices announced at end-October, 2014, and ease in food supplies. This softening has been more broad-based, as it was contributed by food items, as well as housing, water, electricity, gas group.[18] Various factors that feed into our assessment on inflation through rest of the year are listed below: [19]

- Another large downward revision in POL prices announced at end-November 2014, is expected to reduce the motor fuel inflation through its direct effect on CPI inflation as well as through cost-push inflation in other items;

- With falling international oil prices, the government has now the comfort to defer the decision to increase power tariffs further;

- According to IBA-SBP consumer confidence survey of November 2014, inflation expectations remain soft for the next six months. The major fall

[17] Price Control and Prevention of Profiteering and Hoarding Act, 1977.
[18] The contribution of these items in overall CPI inflation declined to 2.2 percentage points and 1.4 percentage points as compared to contribution of 2.8 and 2.2 percentage points respectively in average quarterly inflation Q1-FY15.
[19] Through two separate notifications, the federal government had imposed 52 paisa per unit and Rs1.50 per unit equalization surcharges on electricity consumers.

is expected in energy inflation (an outcome of lower oil prices), followed by the food inflation;

- Since fuel prices are correlated with inflation expectations of households, falling domestic POL prices are expected to positively influence their inflation expectations; and

- The stable PKR against the US dollar will further agument the positive impact of falling international commodity prices, especially crude oil and food, on domestic inflation.[20]

- However, the likely imposition of gas infrastructure development cess (GIDC) in January 2015, could positively impact inflation.

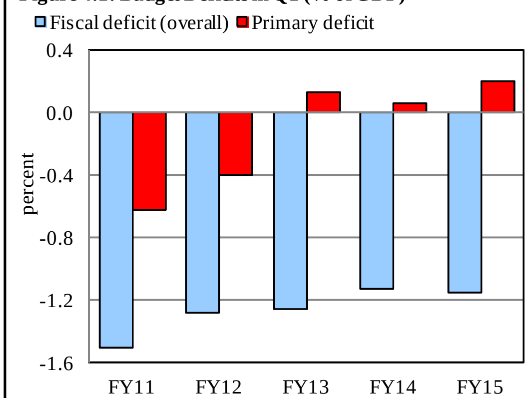
[20] The inflow of US$ 2.1 billion in December 2014 on account of International Sukuk, and 4th & 5th tranche of EFF from the IMF, has brought stability to the PKR.

4 Fiscal Policy and Public Debt

4.1 Overview

The fiscal deficit increased slightly to 1.2 percent of GDP in Q1-FY15, from 1.1 percent in the same period last year. This increase came primarily from a rise in interest payments, reflecting a higher volume of PIBs in the government's resource mobilization during the last three quarters.[1] Otherwise, the primary balance has shown a surplus in Q1-FY15, which was even larger than that in Q1-FY14 (**Figure 4.1**).

Figure 4.1: Budget Deficits in Q1 (% of GDP)



Source: Ministry of Finance

The growth in non-interest expenditures was contained to 5.2 percent in the first quarter of FY15, compared with 28.4 percent in Q1-FY14. On the revenue side, the growth in total revenues declined to 1.2 percent, as some one-off factors that increased non-tax collection last year, were not available this year (**Table 4.1**).[2] Excluding these inflows, the growth in total revenues increases to 8.4 percent in Q1-FY15 (see **Section 4.2** for further detail).

Thus, in view of high interest payments to balance the maturity profile of the government's local currency debt, achieving the fiscal consolidation, as announced in the Budget FY15, may be challenging.[3] Furthermore, how the government decides to account for and settle the outstanding circular debt, may have

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[1] With the increase in the share of PIBs (having higher interest rates than T-bills) in government's debt, a rise in debt servicing cost was expected in FY15. The increase in interest payments of PIBs in Q1-FY15 was more than the decline in interest payments on T-bills during the quarter, when compared to the same period last year (**Figure 4.2**).

[2] The one-off non-tax receipts during the first quarter of FY14 include mark-up from PSEs and utilization of Universal Service Fund (USF).

[3] The FY15 budget estimated a reduction of the fiscal deficit from 5.5 percent of GDP in FY14, to 4.9 percent in FY15.

repercussions for the fiscal outcome. Finally, provincial surpluses do not seem in line with the targets set for the year, and has fallen significantly from Rs 121.6 billion in Q1-FY14, to only Rs 57.7 billion in Q1-FY15.[4]

Table 4.1: Summary of Fiscal Operations
billion rupees

	Budget	Actual		% Growth	
	FY15	**Q1-FY14**	**Q1-FY15**	**Q1-FY14**	**Q1-FY15**
A. Total revenue	4,218	829.7	839.7	19.9	1.2
Tax revenue	3,344	560.9	626.9	23.2	11.7
Non-tax revenue	874	268.8	212.9	13.4	-20.8
B. Total expenditure	5,640	1,038.50	1,170.20	17.1	12.7
Current[1]	4,420	868.4	1,050.10	6.9	20.9
Of which					
Interest payments	1,325	301.1	394.5	-3.7	31
Development	1,220	87.1	115.3	17.6	32.3
PSDP	1,175	79.5	93	16.4	16.9
Others		7.6	22.3	31.7	193.3
Net lending		83	4.8		
C. Statistical discrepancy		78.1	6.4		
Fiscal balance (A-B-C)	-1,422	-286.9	-336.8		
Financing	*1,422*	*286.9*	*336.8*		
External sources	508	-27.2	-13.5		
Domestic sources	914	314.1	350.3		
Banks	228	198	139.9		
SBP	0	352.8	-39		
Commercial banks	228	-154.8	178.9		
Non-bank	686	116.1	210.4		
% of GDP					
Overall fiscal balance	-4.9	-1.1	-1.2		
Revenue balance	-0.7	-0.2	-0.7		
Primary balance	-0.3	0.1	0.2		

[1]: Includes pensions, grants, subsidies, and general government expenses.
Source: Ministry of Finance

On the financing side, the government made external repayments of Rs 13.5 billion in Q1-FY15, against the target of net external *inflows* of Rs 507.6 billion

[4] The FY15 target for provincial fiscal surplus is Rs 289.0 billion, which is almost twice the surplus of Rs 149.5 billion realized in FY14.

for the full year.[5] Within domestic financing, non-bank borrowings increased sharply from Rs 116.1 billion in Q1-FY14, to Rs 210.4 billion in Q1-FY15, which was primarily due to increased holding of PIBs.[6] Encouragingly, the government retired Rs 39.0 billion to SBP (in net terms) during Q1-FY15, compared to the borrowing of Rs 352.8 billion in the same period last year.

Pakistan's public debt reached Rs 16.6 trillion as of end-September 2014, showing an increase of Rs 246.7 billion during Q1-FY15, which was almost a quarter of the rise recorded in Q1-FY14. More importantly, the government mobilized more through medium to long-term PIBs, which improved the maturity profile of the country's debt (see **Section 4.5** for detail).

4.2 Revenues

Total revenues posted an increase of only 1.2 percent, compared with 19.9 percent during the same period last year.[7] The slowdown was visible in both tax and non-tax revenues. While a decline in non-tax revenues was anticipated (as it benefitted from a number of one-off inflows during FY14), the growth of tax revenues was not in line with budget targets.[8] Tax collection showed a growth of 11.7 percent in Q1-FY15, against the full year target of 26.9 percent for FY15. More importantly, this growth was only half the growth in Q1-FY14. This was mainly due to the base effect in case of provincial, and other taxes.[9]

Tax revenues

FBR taxes, which constitute more than 85 percent of total (federal and provincial) tax collection, did not pick up as targeted. FBR had envisaged 24.0 percent growth in its tax collection during the year. However, tax collection showed a growth of 13.1 percent in Q1-FY15, on the higher base number, compared with 15.6 percent in Q1-FY14 (**Table 4.2**). This creates a tougher challenge for FBR, requiring a growth of 26.4 percent in the remaining three quarters to meet the full

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[5] It must be noted that external financing showed some improvement in Q2-FY15, with the issuance of Sukuk worth US$ 1.0 billion, in the international market. The government is also planning to divest ABL, HBL and National Power Construction Corporation during the current fiscal year.

[6] With a rise in the spread between interest rates on PIBs and T-bills, both banks and non-bank financial institutions increased their PIBs holdings Q3-FY14 onwards.

[7] If the effect of one-off inflows in non-tax revenues is adjusted, growth in total revenues becomes 8.4 percent, instead of 1.2 percent.

[8] Budget target of non-tax revenues was Rs 874 billion for FY15, compared with actual receipts of Rs 1,002.4 billion last year.

[9] Other taxes also include GIDC and Gas Development Surcharge, which were earlier categorized as non-tax revenues by MoF.

year target.[10] Putting this in perspective, the required growth is nearly 10 percentage points *higher* than the average of the past five years for the same period.[11]

Table 4.2: FBR Tax Collection
billion rupees

	Budget FY15	Actual		% Growth	
		Q1-FY14	Q1-FY15	Q1-FY14	Q1-FY15
Direct	1,149	161.7	189.7	16.5	17.3
Indirect	1,661	313.6	348.1	15.2	11
Customs	284	52.4	64.5	0.2	23.1
Sales tax	1,206	235.8	258.2	19.5	9.5
Federal excise	171	25.4	25.4	12.9	0
Total taxes	**2,810**	**475.3**	**537.8**	**15.6**	**13.1**

Source: Federal Board of Revenue

Although FBR has taken a number of measures to increase tax collection (see **Box 4.1**), these focused more on deductions at source, and/or increasing the tax rates. It must be realized from the past, that such measures have had met limited success in increasing the tax-to-GDP ratio of the country. In our view, the taxation system in Pakistan needs improvement through enhanced documentation of the economy, simplification of tax procedures, and effective enforcement.

Box 4.1: Taxation Measures in Budget FY15

In order to widen the tax net, a distinction was made between filers of income tax returns and the non-filers; and high withholding tax rates were suggested for the latter. Some of the specific measures are the following:

Direct taxes:

1. Capital gain tax (CGT): a CGT @ 12.5 percent for securities held up to 12 months, and 10 percent for securities held for a period between 12 to 24 months; whereas the securities held for more than 24 months shall be exempted from CGT.
2. Advance income tax: A number of transactions/businesses were brought under advance tax like: (i) 3 percent tax on first and business class airline tickets if the passenger is income tax filer and 6 percent in the case of non-filer; (ii) a 1 percent tax on the purchase of immovable property (with value more than Rs 2 million) for filer, and 2 percent for non-filer persons; (iii) an adjustable tax at a rate of 7.5 percent on electricity bills over Rs 100,000 per month for domestic electricity consumers; and (iv) an adjustable tax on interest income and dividends was imposed on persons who are non-filer with a rate of 5 percent .
3. Removal of tax loopholes: Tax on certain classes of income was being avoided because of loopholes. Taxation of bonus shares by companies and bonus units of mutual funds and modarbas was different than that of dividend. This anomaly has been corrected.

[10] Declining petroleum prices may pose another challenge to FBR in realizing the targets for sales tax and customs duties collection.
[11] In the past five years, the average YoY growth in tax collection was 17 percent for the period October to June.

4. Tax rates for services: the budget FY15 enhanced tax rate on services to 8 percent in corporate cases and 10 percent in other cases.
5. Reduction of tax rates: The budget FY15 also proposed reduction of tax rates for some cases, like: (i) for telecommunication services, FED was withdrawn from those provinces which have imposed GST on telecom services. In areas where FED shall continue to be collected, the rate was reduced from 19.5 percent to 18.5 percent. Furthermore, it was also decided to reduce the rate of withholding tax on telephone services from 15 percent to 14 percent; (ii) withholding tax on marriages and functions was reduced from 10 percent to 5 percent; (iii) in order to attract Foreign Direct Investment in manufacturing, construction and housing sectors, corporate tax rate was reduced to 20 percent in case of new investment; (iv) on the demand of business community, corporate tax was reduced by one percentage point to 33 percent; and (v) Income Support Levy, which was imposed during the last year budget was withdrawn.
6. In order to broaden the tax net, obtaining of NTN was made a compulsory condition for seeking commercial and industrial electricity and gas connections.

Sales Tax and FED:

1. At retail stage, the businesses were categorized into two tiers for the purpose of sale tax: the first tier comprises those retailers who operate as part of national and international chain stores; operate in air-conditioned shopping plazas; have machines for credit or debit cards; or have monthly electricity bills in excess of Rs 50,000; and all remaining retailers fall under the second tier. The first tier retailers would be required to pay sales tax in the normal regime and to keep electronic cash register. For the second types of retailers, a simple mechanism of payment of sales tax was introduced through their electricity bills with the rate of 5 percent for those having electricity bills less than Rs 20,000 in a month; and 7.5 percent for those having higher bills.
2. Increasing sales tax on steel sector from fixed rate of Rs 4 per unit of electricity to Rs7 per unit.
3. FED has been increased on locally produced cigarettes.

Customs Duty:

1. Maximum rate was reduced from 30 percent to 25 percent; and number of tax slabs reduced to six.
2. At present, 40 percent of imports are totally exempted for customs duty. For addressing the structural flaw in tariff and improving assessment and documentation, 0 percent slab in tariff was substituted by 1 percent. However, socially sensitive items like petroleum products, fertilizers, and all food items etc. were kept at 0 percent rate, through inclusion thereof in a new schedule to the Customs Act.
3. To promote agricultural sector and encouraging tunnel farming, the budget FY15 removed customs duty on import of plastic coverings and mulch film, anti-insect net and shade net.

Source: Budget Speech of Minister of Finance, FY15

Non-tax revenues

Non-tax revenues were abnormally high in Q1-FY14 due to one-off inflows (e.g., the universal service fund and the mark-up received from PSEs against the circular debt settlement **-Table 4.3**). In the absence of such inflows in Q1-FY15, non-tax revenues posted a decline. Some support came from the Coalition Support Fund during the quarter, which is basically reimbursement for logistic support provided by Pakistan to NATO troops in Afghanistan.[12]

Table 4.3: Non-tax Revenues

billion rupees

	Budget FY15	Actual		Absolute change	
	(full-year)	Q1-FY14	Q1-FY15	Q1-FY14	Q1-FY15
Mark-up (PSEs & others)[1]	26	56.8	0.9	55.9	-56
Dividend	82	3.7	10.9	-11.3	7.1
SBP profits	270	80	67.5	30	-12.5
Defence (incl. CSF)	140	2	77.3	-105.3	75.4
Royalties on gas & oil	81	19.2	20	4.3	0.8
Passport & other fees	20	4	2.7	0.8	-1.3
Discount retained on crude oil	20	3.9	2.3	0.7	-1.6
Windfall levy against crude oil	17	3.8	5.3	-0.7	1.6
Foreign grants	35	10.1	8	10.1	-2.1
Other federal [2]	125	74.6	5.5	69.6	-69
Of which USF	--	67.6	--		
Provincial	58	10.7	12.4	-13.7	1.7
Total nontax revenue	**874**	**268.8**	**212.9**	**40.5**	**-55.9**
Memorandum [3]					
One-off inflows		124.3	75.4		
Nontax revenue (excl. one-offs)		144.5	137.5	21.9	-7

[1]: Markup for Q1-FY14 includes Rs 56 billion as a recovery of payables from PSEs (NTDC, Atomic Energy Commission and Wapda) to the federal government. This inflow was a part of the non-cash component of the circular debt settlement, which took place in July 2013.

[2]: Budget FY15 includes Rs 56 billion from the auction of the remaining licenses for 3G/4G spectrum.

[3]: We have excluded inflows on account of mark-up on PSEs and USF from Q1-FY14; and CSF inflows from Q1-FY15, to make the numbers comparable.

Source: Ministry of Finance

4.3 Expenditure

Federal expenditure remained under pressure due to a sharp increase in interest payments in Q1-FY15, as said earlier. While total non-interest expenditures increased by only 5.2 percent YoY basis; interest expenses grew by 31.0 percent in Q1-FY15 (**Table 4.4**).

[12] The government received US$ 371.4 million under CSF on August 27, 2014, and US$ 363.8 million on September 30, 2014.

Nearly 70 percent of the increase in total expenditures came from domestic interest payments alone. This increase was expected, as the maturity profile of domestic debt has been shifting towards costlier long-term government bonds, for the last three quarters. As a consequence, interest payments on account of PIBs increased sharply in July 2014, when the 6-monthly coupon payments fell due. In fact, the increase in servicing PIBs more than offset the decline in interest payments on T-bills during Q1-FY15 (**Figure 4.2**).

Defence is the second largest expenditure of the federal government and increased by 12.4 percent in Q1-FY15. This was broadly in line with the Federal Budget for the current year that envisaged 11.2 percent growth under this head.[13]

Table 4.4: Analysis of (Consolidated) Fiscal Spending – Q1
billion rupees

			% growth	
	FY14	**FY15**	**FY14**	**FY15**
Total expenditure	**1,038.5**	**1,170.2**	**17.1**	**12.7**
Current	868.4	1,050.1	6.9	20.9
Federal	639.5	772.1	4.9	20.7
Interest payments	301.1	394.5	-3.7	31
Domestic	286.3	375.9	-4.4	31.3
External	14.9	18.6	11.1	24.8
Pension	36.4	39.7	6.3	8.8
Grants	41.8	52.8	7.2	26.3
Defence	146.5	164.6	24.7	12.4
Public orders & safety	18.3	21.3	19.4	16.3
Health & education	14	12.7	19.7	-9.6
Others	81.4	86.7	2.8	6.5
Provincial	228.8	278	12.9	21.5
Development	87.1	115.3	17.6	32.3
PSDP	79.5	93	16.4	16.9
Federal	44.9	39.6	48.2	-11.9
Provincial	34.6	53.4	-9	54.4
Other dev. expenditure	7.6	22.3	31.7	193.3
Net lending	83	4.8	--	-94.2
Memorandum				
Non-interest expenditures:				
Total - consolidated	737.4	775.7	28.4	5.2
Total – federal	486.9	468.6	36.6	-3.8
Current - federal	350.6	385	12.9	9.8

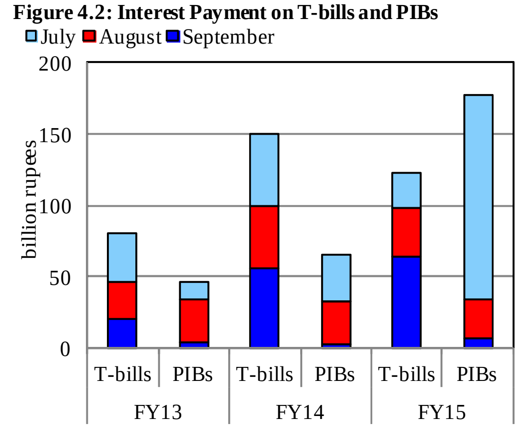
Source: Ministry of Finance

Federal government's expenditure on health and education, on the other hand, declined from Rs 14.0 billion in Q1-FY14 to Rs. 12.7 billion in Q1-FY15. Most of the health and education related activities have been transferred to provincial governments, except for some services that are still in the federal domain, like higher education, national vocational & technical training, and a number of big hospitals.

[13] By mid-September 2014, Finance Ministry released Rs 33 billion for the Operation Zarb-e-Azb, which also includes the requirement of funds for Internally Displaced Persons (IDPs).

Development expenditures increased sharply on the back of higher PSDP spending by provinces, and other expenditure (including the Benazir Income Support Program) by the federal government.

Figure 4.2: Interest Payment on T-bills and PIBs



Source: State Bank of Pakistan

4.4 Provincial fiscal operations

As mentioned above, provinces are required to show a combined surplus of Rs 289.0 billion during FY15, which is almost double the surplus in FY14. However, the actual surplus posted by the provinces in Q1-FY15 is Rs 57.7 billion, i.e., less than half the surplus in Q1-FY14. This decline was driven by current expenditures, which showed considerably higher growth during the quarter, compared to the corresponding period of last year (**Table 4.5**). In addition, all provinces also increased their PSDP spending. On the revenue side, transfers from the divisible pool were lower compared to last year, whereas provincial government efforts only posted a marginal increase in tax collection.

In Punjab, while the damages from the floods of September 2014 partly explain higher current spending during the quarter,[14] development expenditures also doubled due to infrastructure and social sector development. Infrastructure developments projects mainly include construction of road, energy and urban development, whereas health and education account for the bulk of total social sector development spending.

In Sindh, spending on Thar coal has the largest share in total development outlays. In addition to this, health related spending, and the expense on special initiatives like the construction of drinking water hubs, pushed the increase in development expenditures.

[14] According to Punjab government, Rs 15.1 billion is estimated as initial damage cost by recent floods. [Source: Post Flood Restoration & Rehabilitation of Public Infrastructure; http://www.pndpunjab.gov.pk/downloads].

The KPK government launched a pro-poor initiative to provide subsidies on basic food items, which explains very high growth in its current expenditures.

Table 4.5: Provincial Fiscal Operations
billion rupees

	All	Punjab	Sindh	KPK	Balochistan
Q1-FY15					
Total revenue	392.7	183.5	104.9	63.6	40.7
Share in federal revenue	311.3	145.3	79.2	52.3	34.5
Taxes	44.7	23.9	17.5	3.0	0.3
Non-taxes	12.4	5.4	1.7	4.7	0.6
Federal loans and transfers	24.3	8.9	6.5	3.6	5.3
Total expenditure	335.0	150.9	95.0	59.9	29.1
Current	281.5	120.3	81.9	52.7	26.8
Development	53.4	30.6	13.2	7.3	2.3
Overall balance	57.7	32.6	9.8	3.6	11.6
Q1-FY14					
Total revenue	388.4	164.6	113.8	62.7	47.3
Share in federal revenue	322.7	136.4	93.0	51.5	41.8
Taxes	42.1	22.5	17.0	2.3	0.3
Non-taxes	10.7	5.5	0.9	3.2	1.2
Federal loans and transfers	12.9	0.1	3.0	5.8	4.0
Total expenditure	266.8	117.3	80.7	44.9	23.9
Current	232.2	102.1	69.3	38.3	22.5
Development	34.6	15.1	11.5	6.6	1.4
Overall balance	121.6	47.3	33.1	17.8	23.4

Source: Ministry of Finance

4.5 Public debt[15]

With an addition of Rs 246.7 billion during Q1-FY15, Pakistan's public debt reached Rs 16.6 trillion as of end-September 2014 (**Table 4.6**). Encouragingly, the addition to public debt was almost quarter of the increase seen in Q1-FY14. Furthermore, this increase was primarily driven by government borrowing from domestic sources. Finally, the maturity profile of Pakistan's debt improved compared to Q1-FY14, as the government was able to mobilize more through medium to long-term PIBs.

Table 4.6: Debt Burden
billion rupees

	Stock		Absolute change				
	Jun-14	**Sep-14**	**Q1-FY14**	**Q2-FY14**	**Q3-FY14**	**Q4-FY14**	**Q1-FY15**
Public debt	**16,321.0**	**16,567.8**	**1,052.7**	**-23.1**	**277.9**	**438.9**	**246.7**
Public domestic debt	10,907.0	11,096.4	634.0	72.7	592.3	87.1	189.4
Public external debt	5,414.0	5,471.3	418.7	-95.8	-314.5	351.8	57.3
Govt external debt	4,791.3	4,839.8	361.1	-34.3	-264.4	417.9	48.4
Debt from the IMF	298.4	300.1	6.5	-61.9	-22.7	-58.2	1.7
External liabilities	324.2	331.5	51.1	0.4	-27.3	-7.9	7.2

Source: State Bank of Pakistan

Despite an increase in the fiscal deficit during Q1-FY15, the net addition to domestic debt stock was lower than budgetary borrowings from domestic sources.[16] This apparent disconnect is explained by the huge withdrawals of government deposits kept with the central bank (**Table 4.7**).

Domestic Debt

Following the net addition of Rs 189.4 billion, the outstanding stock of domestic debt reached Rs 11.1 trillion by end-September 2014. This increase was

[15] Public debt-to-GDP ratio is based on SBP data, which is slightly different from numbers reported by the Ministry of Finance. The disparity in debt numbers is due to differences in coverage of public debt reported by the two sources. Public debt reported by SBP is composed of: (i) government domestic debt; (ii) government external debt; (iii) IMF loans; and (iv) external liabilities. 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 (see Data Explanatory Notes at the end of the Report).

[16] Although the change in debt should be equal to the size of budget deficit during a given period, this is not the case in practice, because: (i) exchange rate movement exerts a significant impact of the PKR value of external debt, without having strong implications for financing of the deficit; and (ii) changes in government deposits directly impact government borrowing from the domestic sources, without affecting the domestic debt.

concentrated in long term instruments, mainly 3-year PIBs. Anticipating a decline in interest rates, banks were actively participating in PIBs auctions throughout Q1-FY15, enabling the government to retire its debt to the central bank. As a result, the government was able to meet the limit of zero quarterly borrowings from SBP for Q1-FY15.

Table 4.7: Absolute Change in Government Domestic Debt
billion rupees

	Q1-FY14	Q1-FY15
1. Government domestic debt	**634.0**	**189.4**
Permanent debt	**-3.0**	**248.0**
of which		
PIBs	-21.2	234.0
Floating debt	611.1	-112.9
of which		
MTBs	-138.6	37.2
MRTBs	749.7	-216.7
Unfunded debt	25.6	54.1
Foreign currency loans	0.3	0.2
2.Change in govt. deposits with SBP	345.5	-161.5
Domestic financing of fiscal deficit	314.1	350.9

Source: State Bank of Pakistan

In terms of ownership, though a considerable portion of PIBs has been shifted to non-bank financial institutions through secondary market trading, around two-third of outstanding PIBs are still held by commercial banks (**Table 4.8**). This is not the mandate of the primary dealers, who are required to offload PIBs to non-banks, instead of carrying them on their balance sheets. However, in terms of quantum, the holding of non-bank has doubled in the last year, which is indeed a welcome development.

Table 4.8: Bank & Non-banks holding of PIBs - End September Stock
billion rupees

	FY13		FY14		FY15	
	Volume	**Share**	**Volume**	**Share**	**Volume**	**Share**
Scheduled Banks	562.9	52.4	681.6	52.4	2,290.3	66.2
Non-Banks/ Corporates	512.1	47.6	620.2	47.6	1,167.3	33.8
of which						
Insurance companies	240.6	22.4	280.7	21.6	448.2	13.0
Funds	182.0	16.9	152.9	11.7	382.5	11.1
Corporates/Other	89.5	8.3	186.5	14.3	336.6	9.7
Total	**1,075**	**100.0**	**1,301.8**	**100.0**	**3,457.6**	**100.0**

Source: State Bank of Pakistan

On the other hand, short-term debt (mainly T-bills) declined by Rs 112.9 billion during Q1-FY15. More specifically, banks offered Rs 619.6 billion in T-bill auctions during the quarter, against a target of Rs 700 billion, and maturities of Rs 630.1 billion (**Table 4.9**). The expectations of a fall in interest rates, and the record high term premium between T-bills and PIBs, largely explain why banks were not interested in T-bills.[17] In this environment, the government rightly decided to finance a portion of the budget deficit by drawing down its deposits with the central bank.

As for financing through National Saving Schemes (NSS), net mobilization more than doubled in Q1-FY15 compared to same period last year (**Table 4.10**), mainly due to attractive return on underlying instruments (**Figure 4.3**).[18]

Table 4.9: T-bills Auction Profile (competitive bids only)
billion rupees

	Target	Offer	Acceptance	Maturity
Jul-14	225.0	254.6	253.6	190.1
Aug-14	225.0	163.4	163.1	180.4
Sep-14	250.0	201.6	200.6	259.6
Oct-14	550.0	351.7	349.3	482.7
Nov-14	520.0	504.5	498.8	399.0

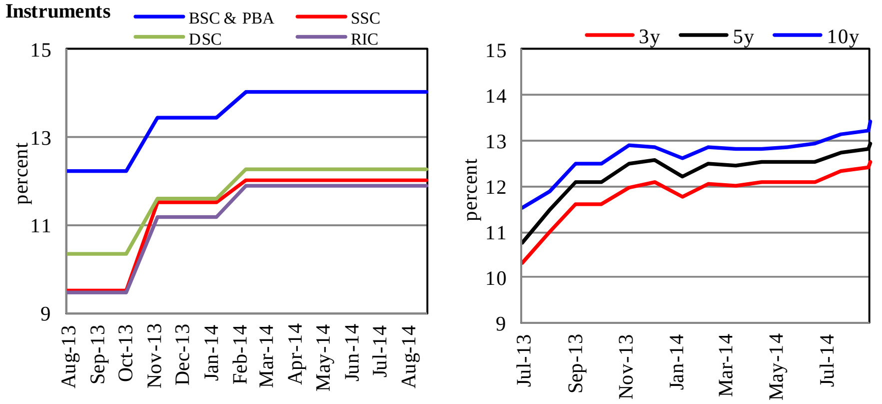
Source: State Bank of Pakistan

Table 4.10: Receipts under NSS Instruments during Q1
billion rupees

	FY14		FY15	
	Gross	Net	Gross	Net
DSCs	9.1	1.7	10.5	3.2
SSCs	23.5	3.7	56.6	17.1
RICs	18.3	5.0	37.2	14.6
BSCs	28.5	11.0	35.8	15.2
Others	73.1	4.2	70.9	2.1
Total	**152.5**	**25.6**	**211.0**	**52.2**

Source: Central Directorate of National Savings (CDNS)

Figure 4.3: Rate of Returns on Major NSS Instruments



Source: SBP and CDNS

An instrument-wise breakup shows Special Saving Certificates (SSC) as the most popular scheme, recording a net inflow of 17.1 billion during the quarter.

[17] See SBP's Annual Report for FY14.
[18] The tenor of DSC, BSC and PBA is ten year, while that of SSC is three year. Traditionally, NSS rates are linked with PIBs of same tenor.

Furthermore, in case of SSC and Defence Saving Certificates (DSC), the absence of any direct penalty on early encashment, may have encouraged some investors to re-invest their original certificates, so that mobilization in net terms did not increase much, though gross investment showed a significant increase.[19]

Public external debt & liabilities

Pakistan's public external debt & liabilities, posted a decline of US$ 1.5 billion during Q1-FY15 (**Table 4.11**). This happened despite an increase in loan disbursements, and a fall in debt repayments during the quarter. In fact, this reduction in external debt was the outcome of a hefty US$ 1.8 billion revaluation gain from the appreciating US Dollar against other hard currencies during Q1-FY15.

Table 4.11: Pakistan's Public External Debt & Liabilities
million dollars

	Jun-14	Sep-14	Change
Public external debt & liabilities	**54,793**	**53,301**	**-1,492**
Government debt	48,491	47,148	-1,343
IMF	3,020	2,923	-97
External liabilities	3,281	3,229	-52

Source: State Bank of Pakistan

Disbursements

External loan disbursements saw an increase of 16.4 percent in Q1-FY15, over the same period last year, mainly from China and ADB. Gross inflows from almost all other creditors declined in Q1-FY15 (**Figure 4.4**):

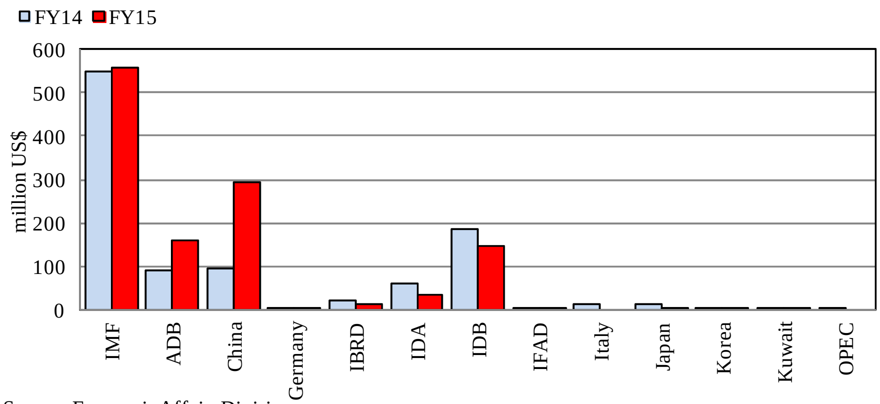
(i) China disbursed a tranche of US$ 242.8 million in Q1-FY15, for setting up nuclear power plants (K2 & K3) in Karachi;

(ii) Inflows from ADB included US$ 50 million under the *Social Protection Development Project*, which seeks to enhance the coverage of the Benzair Income Support Program. ADB has so far committed a total of US$ 430 million for this purpose.[20] ADB also disbursed US$ 43.3 million for *Flood Emergency Reconstruction Project* (signed in April 2011) to restore infrastructure after the 2010 flooding;

(iii) Pakistan also received US$ 556 million from the IMF in July 2014, after the completion of 3rd Review in June 2014. Importantly, net inflows from

[19] For example, the increase in NSS rates in January 2014 encouraged investors to re-price their certificates whenever their subsequent coupon payment falls due.
[20] http://adb.org/projects/details?proj_id=45233-001&page=overview

Figure 4.4: External Loan Disbursements - Q1



Source: Economic Affairs Division

IMF stood at US$ 36 million in Q1-FY15, compared to negative US$ 308 million in Q1-FY14.

In overall terms, GoP expects substantial inflows from external creditors during FY15, which include: US$ 1.1 billion from ADB; US$ 1.5 billion from China and US$ 1.6 billion from IDA.[21] Furthermore, the government successfully raised US$ 1 billion from the issuance of a 5-year Sukuk in the international market, in November 2014. Like the Eurobonds issued in April 2014, this bond was also oversubscribed (against an initial offering of US$ 500 million, the market offered US$ 2.3 billion). Encouragingly, the government was able to get a lower rate compared to the Eurobond (6.75 percent for this 5-year paper, compared to 7.25 percent rate on the same tenor Eurobond issued in April 2014).

Debt servicing

Servicing of public external debt fell by US$ 448.5 million in Q1-FY15, compared to the same period last year (**Table 4.12**). This also eased servicing pressure on Pakistan's foreign exchange earnings (FEE) – the ratio of external debt servicing (EDS)-to-FEE, fell from 14.3 percent in Q1-FY14 to 9.7 percent in Q1-FY15.

The largest decline was seen in repayments to the IMF. As discussed in SBP's *Annual Report FY14*, external debt servicing is likely to ease in FY15, as the

[21] Source: Economic Affairs Division

country has already made bulk repayments to IMF during FY14. Specifically, debt servicing to the Fund is projected at US$ 1.3 billion in FY15, compared to US$ 3.2 billion in FY14.

Table 4.12: Public External Debt Servicing - Q1
million dollars

	FY14	FY15	Change FY15 over FY14
Public debt (a+b+c)	**1,620.1**	**1,171.6**	**-448.5**
Principal	1,451.8	958.7	-493.1
Interest	168.3	212.9	44.6
a. Government debt	743.4	619.7	-123.7
Principal	596.8	438.9	-157.9
Interest	146.6	180.8	34.2
b. IMF	873.4	533.1	-340.4
Principal	854.9	519.8	-335.1
Interest	18.5	13.3	-5.2
c. Foreign exchange liabilities	3.3	18.9	15.6
Principal	0.0	0.0	0.0
Interest	3.3	18.9	15.6
Memorandum item: Debt servicing/Foreign exchange earnings	14.3	9.7	

Source: State Bank of Pakistan

5 External Sector

5.1 Overview

The concerns on Pakistan's external sector, which remained muted throughout the second half of FY14, re-emerged with the start of FY15. The sharp increase in the country's current account deficit compared to preceding quarters, and the absence of financial inflows, put strain on Pakistan's balance of payments in Q1-FY15 (**Table 5.1**). Although the country received the 3rd tranche from the IMF in early July, delays in the 4th review of the program caused uncertainty in the FX market. That said, neither this uncertainty, nor the overall external pressures, was as severe in Q1-FY15, as it was in the same period last year.[1]

Table 5.1: Summary of Pakistan's External Sector
million US$; PKR trend in percent

	Q1-FY14	Q2-FY14	Q3-FY14	Q4-FY14	Q1-FY15
SBP liquid reserves (change)	-1,315	-1,214	1,885	3,731	-154
Total FX reserves (change)	-1,203	-1,504	1,761	4,065	-630
PKR depreciation(-)/appreciation(+)	-6.0	0.7	6.9	-0.3	-3.7
Current account balance	-1,268	-647	-678	-378	-1,647
Trade balance	-4,301	-4,213	-3,883	-4,130	-6,022
Exports	6,275	6,257	6,282	6,348	5,960
Imports	10,576	10,470	10,165	10,478	11,982
Services balance	-894	-603	-619	-521	-505
CSF	0	322	353	375	735
Worker remittances	3,927	3,863	3,793	4,249	4,695
FDI in Pakistan	231	189	255	956	169
Portfolio investment in Pakistan	108	-23	19	2,642	141
External loans (net flows)	-289	-210	77	1,450	218
External debt servicing (gross)	1,809	2,325	1,250	1,612	1,459

Source: State Bank of Pakistan

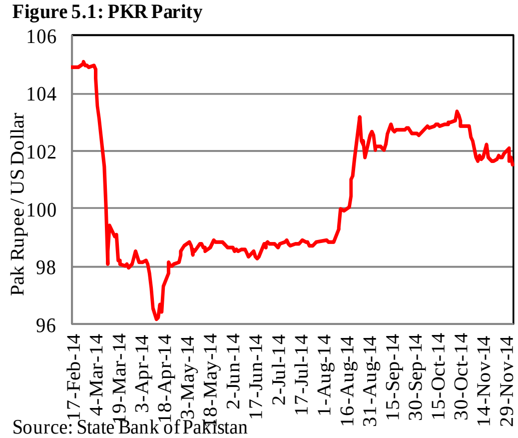
The fall in global commodity prices, was felt heavily on the country's exports; its impact on imports was diluted by a rise in the demand for imported steel and fertilizer; higher import of vegetables due to flood-related losses; and outlays on network up-gradation of telecom and data processing sectors (**Section 5.4**). As a result, trade deficit widened sharply during the period. Home remittances grew strongly, but these could finance only 80 percent of the trade deficit during the quarter. Therefore, the current account deficit increased by 11.4 percent YoY; in

[1] The first quarter of FY14 was quite challenging, mainly due to lumpy debt servicing to the IMF (which remained in place till end-November 2014).

the absence of financial flows, this had to be financed by drawing down the country's FX reserves.

The political environment was not helpful either. Since mid-August, protests in Islamabad made importers cautious about the PKR, and they opted to close their positions at a faster rate. This uncertainty created pressure in the FX market, and the PKR touched Rs 102.8 per US Dollar on 25th September – the first time after 7th March, and stabilized at 100.6 by the end of December (**Figure 5.1**).

Figure 5.1: PKR Parity



Source: State Bank of Pakistan

Going forward, we expect the external position to improve much more than initially projected. First, discussions with the IMF over the fourth and fifth reviews of the EFF program have successfully been concluded. According to the press release, the Fund "was encouraged by the overall progress in strengthening the macroeconomic stability and output growth.[2]" Pakistan has already received a combined tranche of US$ 1.1 billion in December 2014. Furthermore, the government has been able to mobilize US$ 1.0 billion from the international market, via Sukuk issuance in November. In addition to these, the government is expecting inflows from other sources, including: (i) around US$ 1 billion from the divestment of ABL and HBL; (ii) US$ 1.9 billion from the World Bank (budgeted); and (iii) US$ 1 billion from the ADB (budgeted).

However, a more comforting development from the sustainability perspective, is the recovery in exports in October 2014, along with healthy FDI inflows.[3] Imports have also shown higher growth, as local manufacturers benefited from currently low international prices of raw-materials. Moving ahead, the trend in commodity prices (especially oil) would determine where the current account balance would close at the year-end. Oil prices (Saudi Arabian Light) has already come down to only US$ 67.1/ barrel (4-year low) by end-November, and the expectations are

[2] Source: http://www.imf.org/external/np/sec/pr/2014/pr14505.htm

[3] During the month of October, exports have increased by 0.9 percent, as per the payments records; and by 5.0 percent, as per the customs records. FDI inflows increased from US$ 57 million in October 2013, to US$ 254 million in October 2014.

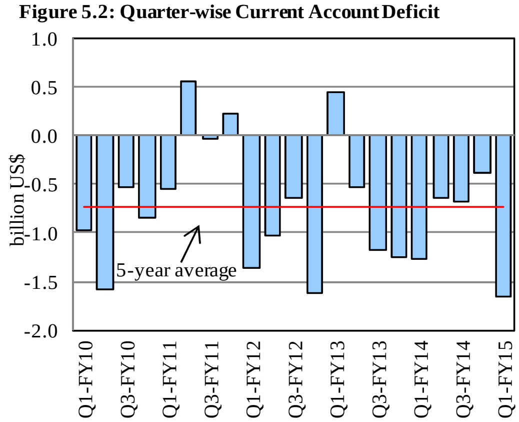
that these may not see a significant recovery throughout 2015.[4] Therefore, the biggest chunk in our import bill has become less of a concern, for this year.

In addition, food supplies in the domestic market seem to have improved, which should reduce their imports.[5] As far as other imports are concerned, most of the growth so far has come from machinery, chemicals and other inputs – items that directly support industrial activity.[6] Even if imports of these items continue to grow, it will be good for future growth. Our major concern remains the need to increase exports, and have the remaining trade deficit (or most of it) financed via FDI inflows and remittances. Until or unless we are able to finance the country's *strategic* import requirements via a sustainable increase in these inflows, our dependence on erratic external funding would remain high. This dependence alone is sufficient to make our growth vulnerable.

5.2 Current Account

The current account deficit stood at US$ 1.4 billion in Q1-FY15, which is 11.4 percent higher than Q1-FY14, and represents 50 percent of the full-year target set by the government.[7] Compared to the preceding three quarters, and the average in the past 5 years, the size of this deficit is a major concern (**Figure 5.2**).

Figure 5.2: Quarter-wise Current Account Deficit



Source: State Bank of Pakistan

[4] Key investment banks have slashed their forecasts for oil prices. Morgan Stanely has reduced its baseline prices to US$ 70 and US$ 88 for 2015 and 2016, respectively. Similarly, Goldman Sachs has also cut oil forecast for Brent and WTI crude to US$ 85 and US$ 75 per barrel during the first quarter of 2015 (Source: http://www.reuters.com/article/2014/12/08/us-markets-oil-idUSKBN0JM03P20141208 and http://www.bloomberg.com/news/2014-10-27/goldman-cuts-brent-wti-forecast-as-production-to-outpace-demand.html

[5] This view gets some support from a decline in food inflation to only 4.4 percent and 1.1 percent YoY, in the months of October and November, respectively, from 5.8 percent YoY in Jul-Sep 2014.

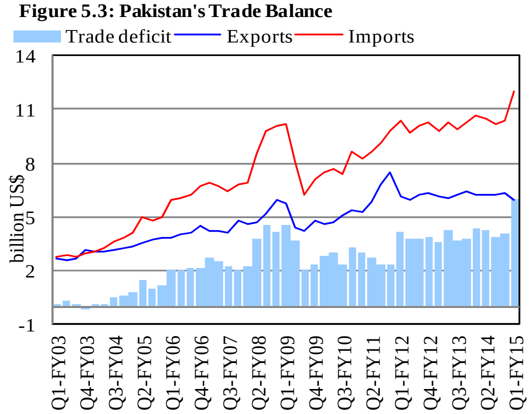
[6] 85 percent of Pakistan's imports are comprised of raw-materials and capital goods (Source: http://pbs.gov.pk/sites/default/files/tables/14.5.pdf).

[7] The government has set the target for current account deficit at US$ 2.8 billion in the Annual Plan for 2014-15.

Record high trade deficit amidst depressed oil prices

Pakistan's trade deficit reached an unprecedented level of US$ 6.0 billion during Q1-FY15. Imports were even higher than the peak seen in Jul-Sep 2008, when global commodity prices were at record highs (**Figure 5.3**). On the other hand, export receipts declined by 4.7 percent YoY, mainly because Pakistan fetched lower prices for its value-added products. Furthermore, saturation of the textile input market in China, and weaker activity in Bangladesh's garment industry, were also responsible for low exports of textile raw-materials like yarn and grey fabric from Pakistan (**Section 5.4**).

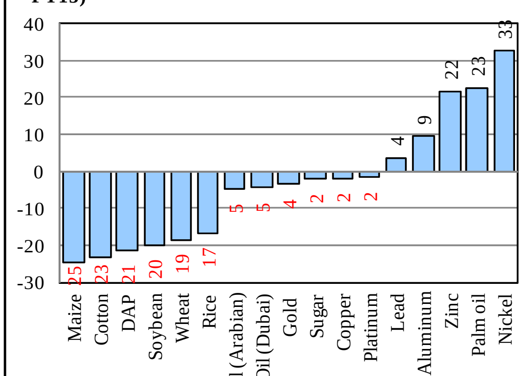
Figure 5.3: Pakistan's Trade Balance



Source: State Bank of Pakistan

A part of the divergence in export and import trends, can also be traced to developments in the global commodity market: prices of Pakistan's major exports (cotton and rice) declined *more* than the price of major imports (crude oil and some industrial metals) (**Figure 5.4**). Prices of other key import items like palm oil increased in the international market. Furthermore, the PKR's appreciation in Q4-FY14 also appears to have played a role in explaining the trade deficit (**Section 5.4**). Exporters, in particular, attribute declining orders to higher dollar prices they quoted to international buyers.

Figure 5.4: Global Commodity Prices (YoY growth in Q1-FY15)



Source: Bloomberg

The rise in trade deficit was largely offset by strong growth in home remittances, and an inflow of US$ 735 million under the coalition support fund (CSF), which helped reduce the services deficit. It is important to recall here that in Q1-FY14, inflows under the CSF were delayed, which added to the pressures in the FX market.

Home remittances

Home remittances grew by 19.5 percent YoY during Q1-FY15. In our view, the strong growth reflects the *combined* seasonal impact of both Eid(s) during the quarter.[8] July and September witnessed strong remittance growth of 17.4 percent and 33.8 percent, respectively. However, it must be noted that during August and October, when there were no seasonal inflows, remittances still grew quite modestly.[9] Furthermore, flood-affected areas are likely to have received more remittances this year.

Most of the increase came from the GCC countries, especially the UAE and Saudi Arabia. In addition to seasonal inflows, remittances remained strong because of the vibrant non-oil sector in this region. According to the IMF, the GCC is expected to post 4.4 percent growth during the year 2014, on the back of non-oil sector – mainly infrastructure.[10]

Efforts continue to promote the use of formal channels in remittance transfer. Besides banks, microfinance institutions (MFIs) are now also being tied up with global money transfer organizations. Since MFIs are more agile and responsive to the need of customers, their inclusion would improve the remittance delivery mechanism. Bangladeshi experience highlights the importance of these institutions in efficient remittance delivery.

An important measure taken under the Pakistan Remittance Initiative (PRI) has been the mandatory opening of bank accounts by departing workers via simplified procedure. These accounts are treated separately from conventional bank accounts, and inward and outward funds movement is being monitored, which should help the authorities identify *problem* regions, from where the remittances originate.[11] Having a bank account would also address the negative perception of migrants and their families about the financial sector, which is one of the major reasons behind the use of informal avenues to send money (**Box 5.1**).

[8] Eid-ul-Fitr was celebrated during the 3rd week of July, whereas, Eid-ul-Azha was celebrated during the first week of October. Expatriates send money to their families few days before the festival, therefore, the seasonal impact of Eid-ul-Azha on remittances was also felt during the first quarter.
[9] In August and October, remittances grew by only 7.1 percent and 2.6 percent, respectively
[10] Source: http://www.imf.org/external/pubs/ft/reo/2014/mcd/eng/pdf/c1c2.pdf
[11] For instance, if fund inflows from a particular region are consistently low, this might be taken as an indication that an alternative arrangement is available there for sending money. The PRI would then be able to highlight this issue with the concerned authorities in those regions.

Box 2.1: Why Household prefers Informal Sources for Remittances

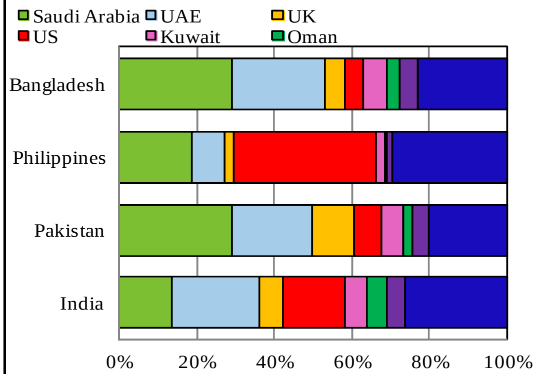
Amjad et al (2013) analyzed the reasons behind workers sending remittances via informal channels, using micro-data from two household surveys. First was the Household Survey of Overseas Migrants and Remittances (2009), which comprised a small sample of 548 households from randomly selected nine districts of the country; each household had a member employed in Saudi Arabia. The second data set comprised of a panel survey conducted by Pakistan Institute of Development Economics (2010), which was conducted in 16 districts covering 4,000 households. Although dated, but the insights provided in these surveys are valuable:

- The use of banking channel is quite low: 43 percent in case of urban families, and only 33 percent in the case of rural families. Thus, more than half of the households even in the urban centers also receive money via non-bank channels. Survey suggested that migrants and their families appear *hesitant* to use the banking channel, compared to informal channels where money is delivered at the doorstep;
- Nearly one-fourth of the rural sample complained of longer time required to collect money from the nearest bank; whereas, urban households cited high transaction cost as major reason for not using banking channels;
- In the GCC countries, workers usually live in groups and have an informal group leader, who manages the transfer of money through informal sources; or through a mutual friend visiting Pakistan;
- There is no linear relationship between migrants' level of education, and their use of banking channels to transfer money;
- Longer stays abroad appear to enable workers to find informal channels to send money to Pakistan.

Source: Rashid Amjad, G.M. Arif, and M. Irfan, "How to Increase Formal Inflows of Remittances: An Analysis of the Remittance Market in Pakistan" February 2013, Joint publication of the Graduate Institute of Development Studies (Lahore School of Economics), International Growth Center (IGC) and the Pakistan Institute of Development Economics (PIDE).

PRI is carefully monitoring FX inflows into remittance-rich areas of Pakistan, and is working closely with law enforcement agencies to curb illegal FX handling. However, there is a need to strengthen controls over cross-border smuggling of hard currency, in order to break the ultimate operating cycle of informal remittances. Border forces as well as law enforcement agencies in the country, should make sure that SBP's FX regulations are strictly complied with.

Figure 5.6: Composition of Diaspora of Most Populous Asian Countries

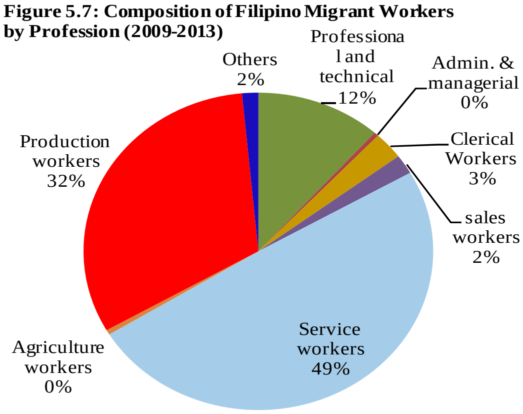


Source: UN Population Division

<u>Why Pakistanis send less than other Asians Countries:</u> In SBP's *Annual Report FY14*, we analyzed the performance of Pakistan viz-a-viz the other large remittance recipient countries, and observed that on average, Pakistani migrants send less than others (**Figure 5.5**).

This section will attempt to explain the reasons behind this trend. At first, there could be multiple factors contributing to this trend including: (i) difference in geographical concentration of their migrants; (ii) the skill-set of migrating workers, and nature of jobs; (iii) status of migrant workers (legal/illegal, temporary/permanent, etc.); and (iv) quality of financial regulations in source countries, where most migrants are concentrated. As shown in **Figure 5.6**, most workers from Pakistan, India, Bangladesh and Philippines, find jobs in the US, UK and GCC countries – especially, Saudi Arabia. While most Pakistani and Bangladeshi labor work in the Gulf, Filipino workers prefer the US. Indian workers appear evenly distributed across these destinations.

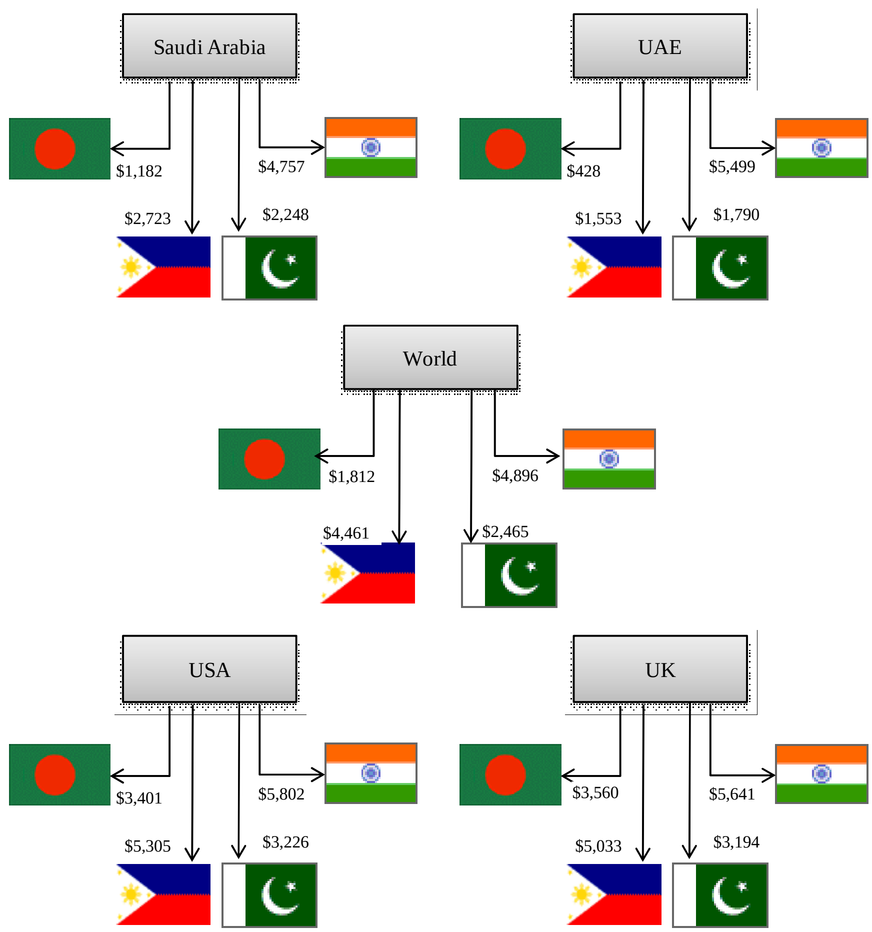
Figure 5.7: Composition of Filipino Migrant Workers by Profession (2009-2013)



Source: Philippine Overseas Employment Administration

It should be noted here that compared to the Philippines, there exists a huge difference with Pakistan in terms of the nature of migrant workers. Nearly half of the overseas Filipino workers are females, who work in services– mainly household help in the US, European and Asian countries (**Figure 5.7**). Certainly, this is not comparable to Pakistan, as our working migrant population predominantly comprises men, working mostly in construction, manufacturing and other professional sectors. However, in the case of Saudi Arabia, where Pakistanis

Figure 5.5: What Did an Average Asian Worker Send Home from Major Source Countries during 2013



Source: UN and World Bank

and Filipinos have a similar work profile, we do not observe much of a difference in remittance per migrant.

From the US and UK, an average Pakistani sends less than Indians and Filipinos, probably due to lower income. More specifically, the median annual income of a Pakistani household in the US was about $ 60,000, versus $89,000 for an Indian household, and $74,000 for a Filipino household (**Table 5.2**).[12] This difference is primarily due to higher level of education in Indian and Filipino diasporas, compared to Pakistanis. As a result, nearly 32 percent of Pakistani migrants work in managerial or professional occupation in the US, against 50 percent and 35 percent of Indians and Filipinos. In the UK also, the Indian diaspora is known to be the highest earning group, and is involved in a wide range of businesses like steel, engineering, finance, retail, IT, hotels, pharmaceuticals, and media.[13]

Table 5.2: Characteristics of the Asian Diaspora in the United States, 2009-13

	Total US population	Pakistani diaspora	Indian diaspora	Bangladeshi diaspora	Filipino diaspora
Household (hh) Income					
Median household income	$50,000	$60,000	$89,000	$54,000	$74,000
Share of hh with high incomes ($90,000+)	25%	33%	50%	32%	40%
Share of hh with very high incomes ($140,000+)	10%	18%	27%	15%	18%
Employment (total population age 16 and older)					
that was employed	91%	90%	94%	93%	92%
that was in a professional occupation	31%	32%	50%	31%	35%
Educational attainment (for population age 25 and older)					
with high school and some college education	57%	34%	16%	35%	43%
with a bachelor's degree	20%	33%	35%	28%	43%
with an advanced degree	11%	23%	44%	25%	9%

Source: Migration Policy Institute, US

As far as Bangladeshis are concerned, although estimates suggest they earn less compared to Pakistanis in the US, they send back more remittances. While there could exist a difference between living standards of these two communities, it also appears that Pakistanis send more via informal channels. The starkest difference between Bangladesh and Pakistan lies at the remittance delivery stage – the presence of microfinance institutions (MFIs). In Bangladesh, MFIs enjoy an extensive outreach, both in terms of geographical presence as well as membership base, which enables the country to provide money transfer services to clients in the remotest areas. Since 2004, key MFIs like BRAC, BURO Bangladesh and TMSS, have been providing remittance delivery services in Bangladesh.[14]

[12] Migration Policy Institute is an independent think tank in Washington DC, which is dedicated to analysis of movement of the people worldwide.
[13] Nearly two-third of software professionals entering in the UK, are from India.
[14] Currently about 50,000 transfer transactions are made per month by BRAC Bank alone (source: http://www.bwtp.org/MF_Industry_Report_Bangladesh_ELECTRONIC.pdf).

Although MFIs in Pakistan are gaining ground in rural areas, their network and size is quite limited as compared to that in Bangladesh.

In the case of GCC, average remittance from Pakistanis is more or less similar to what Filipinos and Bangladeshis send home. However, a huge difference exists between Pakistanis and Indians. From Saudi Arabia, this difference is more surprising, since labor dynamics are quite similar: the share of professionals in both the Indian and Pakistani diasporas is quite small compared to labor and technicians. Secondly, if many Pakistanis do not have a legal status in the Kingdom, then many Indians are also working without legal sponsors, or have overstayed. In our view, the major difference lies in the incentives provided by governments in these two countries to use official channels to remit money.[15] It must be noted that non-resident Indians (NRIs) send nearly 44 percent of remittances via special rupee accounts, including, non-resident (external) rupee accounts (NRER), and non-resident ordinary rupee account (NRO).[16] These deposits (over the years) have provided an arbitrage opportunity for NRIs: the offered interest rates were generally higher than the foreign currency rates prevailing in the source countries, which in the presence of a stable (Indian) rupee, incentivized NRIs to even borrow from abroad, and invest in non-resident deposits in India.[17] In fact, when India and other Asian countries suffered massive capital outflows in mid-2013, the Reserve Bank of India (RBI) used this window to attract more FX inflows into the country.

Compared to Saudi Arabia, NRIs in the UAE have a better economic profile: nearly a quarter of NRIs working in the UAE are professionals, and are well-paid for their expertise and competence.[18] According to the Ministry of External Affairs, in addition to a large number of professionals like doctors, engineers, architects, bankers and chartered accountants, Indian white collar workers are now

[15] For instance, according to the Ministry of External Affairs, NRIs in Saudi Arabia were the major contributors in Resurgent India Bonds and India Millennium Deposits, which were issued by the RBI back in 1998 and 2000, respectively to attract FX inflows.
[16] Only NRIs can invest in NRERs, whereas non-resident from any other country can invest in NROs.
[17] The Reserve Bank of India has acknowledged the presence of arbitrage opportunity in these deposits. In its Report of the Internal Group on External Liabilities of Scheduled Commercial Banks, released in May 2014, the RBI mentioned that "….the positive interest rate differential coupled with appreciating currency prompted large NRI inflows into Rupee accounts till the cap on interest rate was placed after which such inflows slowed down due to the reduced arbitrage opportunity". The complete report is available at:
http://www.rbi.org.in/Scripts/PublicationReportDetails.aspx?ID=383#5
[18] http://indiandiaspora.nic.in/diasporapdf/part1-ord.pdf;

also working in government offices and public sector enterprises in the GCC.[19] As far as Pakistanis are concerned, although there has been an improvement in the skill-set of Pakistani workers lately, unskilled labor finds work more easily in the Emirates.

5.3 Capital and Financial Account

Activity in Pakistan's capital and financial accounts remained dull during Q1-FY15, after bulky transactions in the preceding quarter.

Foreign investments

Low FDI continues to remain a major concern, as inflows declined further in Q1-FY15. Pakistan received only US$ 153.5 million FDI during Q1-FY15, compared to US$ 239.5 million in the same period last year. This decline was broad-based: except for metals, automobiles, power and a few services industries, nearly all the remaining sectors of the economy attracted less FDI so far this year.

Pakistan needs foreign investment in the energy and infrastructure sectors, but the response from foreign investors has not been that encouraging. The energy sector, in particular, offers tremendous investment opportunities to foreign investors. Not only well-head prices are above the global standards, exploration success rate is also attractive, compared to international standards.[20] However, it is the adverse law and order situation in the country, especially in the oil and gas-rich areas (of Balochistan, especially) that deters foreign investors. In case of power generation, existing idle capacities dilute the potential for foreign investment. However, as mentioned in the SBP Annual Report for FY14, there is a dire need to upgrade, and add capacity in power transmission network: this sector has been opened for foreign investment via the recently announced Power Policy. Petroleum refining is another sector, which requires heavy capital investment in the downstream industry (vertical integration).[21]

Similarly, in the manufacturing sector, Pakistan has the potential to become a hub for low-cost manufacturing. Pakistan enjoys freight advantages over East Asian countries for exporting to Middle-East and African countries. Furthermore, there are a large number of products in demand locally, which are imported from other countries. It is quite unfortunate that many low-technology products (for instance,

[19] Many others are in the business of gold, electronics, motor spare parts and hotel/restaurants. Together, these workers now constitute nearly 30 percent of Indian diaspora in the UAE.

[20] For details, see SBP Annual Report for 2013-14.

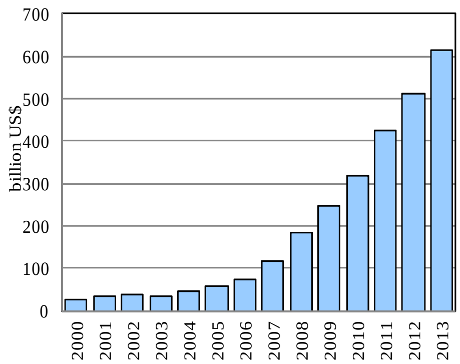
[21] For instance, to establish a fully integrated chemical industry in Pakistan, it is important to install a naphtha cracking plant in the country, which requires huge amount of capital and technology. Presently, India is the only south Asian country to have such facilities.

mobile batteries, basic cell phones, toys, and plastic items) are not being manufactured in Pakistan. Investment in these areas should be tapped from China, from where we import most of these products. It must be noted that Pakistan signed an FTA with China effective from 2007; since then, although Pak-China trade volumes have expanded significantly, investment flows have not picked up. Meanwhile, Chinese investment in other countries has grown very rapidly during this period (**Figure 5.8**).

Figure 5.8a: Pakistan's Dependence on Imports from China

Source: *SBP **PBS

Figure 5.8b: Stock of Outbound Investments by China World-wide



Source: UNCTAD

Unfortunately, Pakistan's manufacturing sector has not been on the radar of foreign investors, while emerging exporters in Asia have benefited primarily from foreign investment. For instance, around 60 percent of Indonesian apparel exports are based on foreign investments (mainly from Malaysia and Singapore); Cambodia's apparel industry is almost entirely driven by FDI from China, Taiwan and Korea; the automotive parts sector of Thailand by Japanese firms; and Vietnam's high-tech boom (with the entry of Intel, Samsung, LG and Nokia) is also FDI-led. Similarly, in the case of Bangladesh, it was the Korean investments in ready-made garment sectors that enabled the country to become a leading exporter in the world.

One common element in all these success stories has been the strong regional integration, which generated a win-win situation for both investors as well as the host countries. The intra-regional investments among East Asian countries have been supported by the agreement of ASEAN free trade area. This integration was deepened further with the FTA of ASEAN with India, China and Korea in 2010. This bloc is also enjoying a comprehensive economic partnership agreement with Japan since 2008. Unfortunately, Pakistan has remained distant from these countries, and besides a couple of FTAs with Malaysia and Indonesia, we have not initiated any economic partnership program that focuses on investments. As a result, other than Japan (which is primarily interested in Pakistan's domestic demand for automobiles), no other Asian country has invested in our manufacturing sector (despite the fact that Japanese investments in Pakistan are earning one of the most lucrative returns in the world).[22] In our view, Pakistan should deepen its trade and investment ties with East Asian economies, to benefit from the dynamism that exists in this region.

External Loans

There was some improvement in the net loan inflows during Q1-FY15, over the same period last year (**Table 5.3**). Although the government retired more to the IMF this year (primarily the Emergency Natural Disaster Assistance loans), these were more than offset by healthy disbursements from other creditors (**Section 4.5**). The private sector showed net outflow of US$ 124 million during the quarter, as PIA paid-off some of its FX loans.

5.4 Exchange rate and reserves

FX market remained under pressure during Q1-FY15: the country's FX reserves declined by US$ 630 million, and the PKR posted a depreciation of 3.7 percent during the period. This pressure came from a sharp rise in the current account deficit; delays in the 4th review of the IMF program; and political uncertainty in the country since mid-August. Nonetheless, compared to Q1-FY14 – when the PKR had registered an unprecedented depreciation of 6.0 percent, Q1-FY15 was less of a concern.

Table 5.3: External Loans
million US$

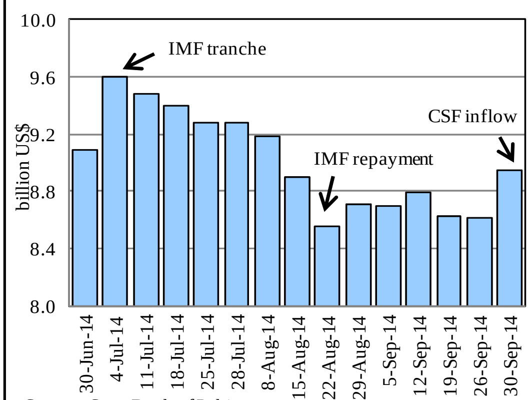
	Q1-FY14	Q1-FY15
External loans	-289	218
1. Central bank	0	0
2. Deposit-taking corporations	-20	-4
3. General government	-258	51
Disbursements	592	1,161
Long-term	459	711
Short-term	133	450
Amortization	776	682
Loans with the IMF	180	237
Other long-term	596	445
Short-term	0	133
4. Other sectors	-85	-124

Source: State Bank of Pakistan

[22] For instance, in 2013, Japan External Trade Organization (JETRO) survey ranked Pakistan as the second in the world, in terms of business growth. Pakistan's data was generated from 27 Japanese firms doing business here. The results found that 74.1 percent of the Japanese companies estimated operating profit in 2013, allotting second rank to Pakistan, only after Taiwan (81.8 percent).

The 3rd review of the IMF was successfully concluded in the last week of June 2014, after which, the Fund released the US$ 550 million tranche of the EFF loan. This took SBP reserves to US$ 9.6 billion during the first week of July (**Figure 5.9**). However since then, SBP reserves have been falling on account of payments for external debt (more specifically, the country retired US$ 1.5 billion). Some respite came from a US$ 735 million inflow under the CSF during the quarter.

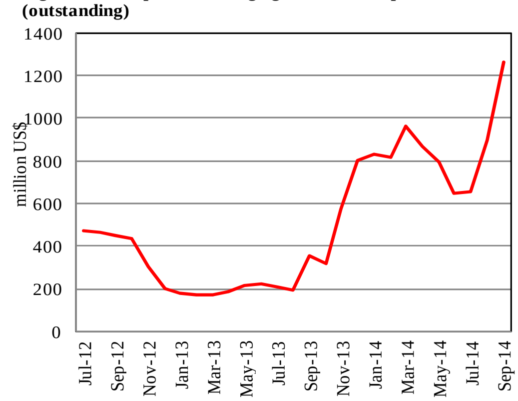
Figure 5.9: Weekly SBP Reserves



Source: State Bank of Pakistan

The decline in commercial banks' FX reserves was more pronounced. On the one hand, customers withdrew more from their foreign currency accounts than they deposited, and on the other hand, importers borrowed heavily to make FX payments.[23] More specifically, the outstanding stock of import loans against FE-25 deposits, increased by US$ 615.5 million during Q1-FY15, to reach an unprecedented US$ 1.3 billion by end-September 2014 (**Figure 5.10**). FX borrowings suited local importers, since these carried lower interest rates compared to PKR loans; and secondly, this also helped defer pressure on the exchange rate.

Figure 5.10: Import Financing against FE-25 Deposits (outstanding)



Source: State Bank of Pakistan

[23] Liquid FX reserves of commercial banks are calculated as foreign currency deposits, minus FX loans extended to importers and exporters.

5.5 Trade account[24]

During Q1-FY15, the trade deficit posted a ten-quarter high growth rate of 44.4 percent. This significant increase is an outcome of both strong growth in imports, and a fall in exports **(Table 5.4).** The rise in imports can be traced to: (i) increase in investment by domestic cellular companies to make their networks compatible with 3G/4G requirements; (ii) higher off take of phosphatic and NPK nutrients during the quarter; (iii) some recovery in public-sector construction activity; and (iv) the increased use of man-made fibers by local textile manufacturers to benefit from the GSP plus. Not surprisingly therefore, most of the increase in imports was seen in steel, telecom machinery, fertilizer and textile.

Table 5.4: Trade Balance (Jul-Sep)

billion US$				Growth rate YoY(%)	
	FY13	**FY14**	**FY15**	**FY14**	**FY15**
Export	6.1	6.7	6.0	9.0	-10.4
Import	10.9	11.2	12.4	3.0	11.6
Trade balance	-4.7	-4.5	-6.5	-4.8	44.4

These numbers are based on customs records, and will not tally with data provided in **Table 5.1,** which is based on payments records.
Source: Pakistan Bureau of Statistics

Exports

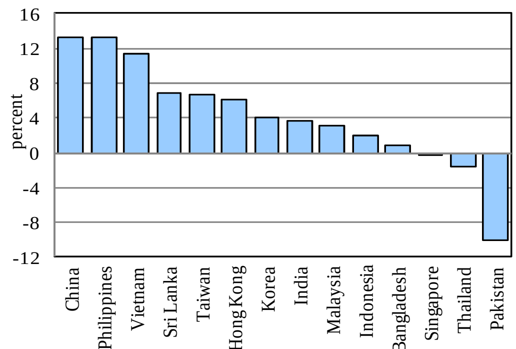
Before discussing the trend in Pakistan's exports, it is important to look at economic conditions in our major partner countries, and export trends in the rest of Asia.

Since the beginning of 2014, growth in advanced economies has been patchy. While Jan-Mar was marked by a sharp contraction in the US; an upbeat UK; and a modest EU: the Apr-Jun period showed strong growth in the US and UK, but zero economic growth in the EU. As far as Jul-Sep is concerned, survey data suggests a positive outlook in consumer and business sentiments in the US and UK, but in the EU, private consumption appears to have slowed down. With the oil surplus likely to shrink significantly in 2015, UK growth is vulnerable, and US growth may ease.

[24] This section is based on customs data reported by the PBS. We use this information because it reports the value of exports and imports, when the physical movement of goods takes place. This data set also has the advantage over payments record data for analysis purpose, since this carries information on quantums and unit values. The information in this section does not tally with the payments record data, which is reported in the balance of payments. To understand the difference between two data series in detail, please see Annexure on data explanatory notes.

Looking at exports data, most Asian economies posted strong growth during Q1-FY15 (**Figure 5.11**); Pakistan, Russia and Thailand were the only exception.[25] China, Philippines, Vietnam and Sri Lanka, showed more impressive performances than others. While China's exports have been helped by strong sales in the US, Philippines and Vietnam continued to benefit from the shift of low-cost manufacturing from China to these countries.[26]

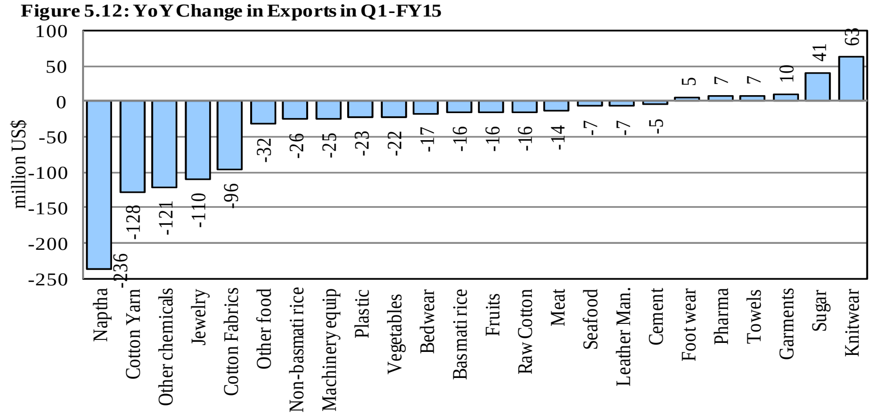
Figure 5.11: Asian Economies: YoY Growth in Exports in Q1-FY15



Source: Haver Analytics, except for Bangladesh whose data has been taken from Export Promotion Bureau, Bangladesh

In the case of Pakistan, exports declined by 10.4 percent in Q1-FY15, compared to a 9.0 percent rise in the same period last year. The decline was broad-based, but most prominent in five sectors: naphtha, yarn, fabric, chemicals and food (**Figure 5.12**). In addition to these, export of rice, fruits & vegetables, meat, leather goods, cement and jewelry, also declined. Value-added textiles like knitwear,

Figure 5.12: YoY Change in Exports in Q1-FY15



Source: Pakistan Bureau of Statistics

[25] Exports of Russia have suffered due to sanctions from the US, EU and international organizations, in response to Crimean crisis.
[26] Countries such as Indonesia, Vietnam, the Philippines, Cambodia and Myanmar are giving China a tough competition due to lower wages.

ready-made garments and towels, posted a YoY increase during the quarter. In fact, if international prices had remained stable, Pakistan's export growth in these categories would have been much stronger (**Table 5.5**).

Table 5.5: Causative Factors of Change in Export Values (Price and Quantity)
million US$

	Jul-Sep FY14			Jul-SepFY15		
	Quantity	Price	Value	Quantity	Price	Value
Basmati	-27.0	17.0	-10.0	-24.8	8.8	-16.0
Non-basmati rice	82.5	14.3	96.8	-21.7	-4.2	-25.9
Fish	15.2	6.6	21.8	-8.7	2.0	-6.7
Fruits	8.2	16.1	24.3	-13.6	-2.4	-16.0
Wheat	-29.2	0.5	-28.7	-4.0	0.0	-4.0
Sugar	-19.2	-4.3	-23.5	40.2	0.4	40.6
Meat	15.0	-10.2	4.8	-16.1	1.8	-14.3
Raw cotton	38.3	2.5	40.8	-12.1	-3.6	-15.7
Cotton yarn	40.0	10.9	50.9	-98.9	-28.7	-127.5
Cotton fabrics	0.2	-165.2	-165.0	-227.3	131.0	-96.3
Knitwear	6.1	-12.5	-6.4	81.1	-18.5	62.6
Bed-wear	133.1	-9.7	123.4	-10.6	-6.3	-16.9
Towels	-15.8	1.9	-13.9	25.0	-17.5	7.5
Readymade garments	19.1	31.8	50.8	32.2	-21.9	10.3
Petroleum products	26.0	7.8	33.7	-7.1	-0.2	-7.2
Leather garments	34.3	-23.6	10.8	-21.3	15.0	-6.3

Source: Pakistan Bureau of Statistics

In our view, the decline in exports was mainly due to supply-side issues. While the decline in naphtha exports appears to be linked with lower prices in the international market[27], floods eliminated the exportable surplus in the food sector. In the case of cotton yarn and fabric, higher domestic consumption was *one of* the reasons behind lower exports;[28] other reasons were mostly demand-driven, which are discussed below:

[27] Naphtha exports are linked directly with the domestic production of petroleum products. During Q1-FY15, local refineries faced liquidity shortages due to re-emergence of circular debt, and therefore, processed less amount of crude oil than Q1-FY14. It is important to recall here that due to the settlement of circular debt in June 2013, refineries had performed reasonably well, posting a growth of 6.8 percent in Q1-FY14. However in Q1-FY15, refining activity posted a decline of 4.5 percent; naptha production remained subdued; and its exports declined.

[28] Domestic consumption of cotton yarn and fabric has increased lately, mainly due to the increase in production of woven garments and knitwear for exports to the EU.

Pakistan exports cotton yarn and fabric to China, Bangladesh, and Turkey, who then export higher value added products like knitwear and woven garments to other countries. In Jul-Sep 2014, although China's apparel exports increased significantly, the country used its domestic inventories of yarn and fabric, instead of buying from resource countries like Pakistan. In contrast, the garment industry of Bangladesh is facing some challenges: ever since the US suspended its GSP privileges following the fire incident in one of Bangladesh's garment factory in 2012, its exports have remained subdued.[29] As a result, Bangladesh has reduced its import of yarn and fabric from resource countries like Pakistan. Finally, Turkey – the third largest buyer of Pakistani yarn and fabric, has imposed safeguard duties on fabric import from other countries. In addition to these demand related issues, Pakistani textile exporters complain that they are unable to deliver orders due to energy constraints and stuck-up refund claims with FBR.

Rice exports faced multiple setbacks. First, production remained lower than last year, however, it was the sharp decline in international prices, that kept growers/millers from exporting. As noted in **Chapter 2**, although global rice production in 2014 has been affected by adverse weather conditions in India, Pakistan, Thailand, Indonesia, Philippines and Sri Lanka, global prices are expected to remain depressed due to abundant inventories. Prices have declined by nearly 24.7 percent since the peak seen in early April 2014, and it appears that traders/middle-men are waiting for prices to recover before they offload their stocks in the international market.

A major concern for Pakistan (and also for India and Vietnam) is the return of Thai rice into the already over-supplied rice market. With the end of the subsidy program in February 2014, which had priced-out Thai rice from the international market, it is expected that global competition would stiffen again.[30] According to estimates, Thailand is now sitting on nearly 18 million MT of rice, which is half the global rice trade.[31,32] It is important to realize that Pakistan was one of the beneficiaries of this subsidy program, as it was able to increase its export of coarse rice since then.

[29] Vietnam and India have benefited the most from declining US orders to Bangladesh. Their export of textile and apparel to the US has increased by 15.7 and 8.5 percent YoY in Jul-Sep 2014, respectively. In contrast, exports from Bangladesh to the US have declined by 3.4 percent during the same period.

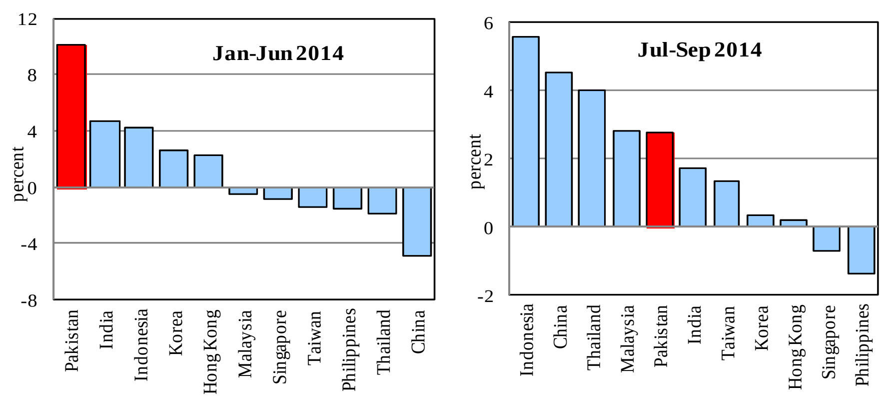
[30] The Thai government had initiated a populist rice purchase program in 2011. According to this program, the government purchased rice from its farmers at about 40 to 50 percent above the market price.

[31] Global rice trade stood at nearly 37.9 million MT on average during 2010-11 to 2013-14 (source: http://www.fao.org/worldfoodsituation/csdb/en/)

[32] Source: http://uk.reuters.com/article/2014/08/15/uk-thailand-rice-idUKKBN0GF19320140815

Notwithstanding the impact from sector-specific obstacles, the role of PKR appreciation in March 2014 in subsiding export growth, cannot be ignored – Pakistan's currency appreciated in both nominal and real terms during March 2014. Although the strong PKR was viewed positively by most, it raised concerns about the competitiveness of Pakistani products in the international market. Some of the *nominal* gains in the PKR were reversed during Jul-Sep, but in *real* terms, the PKR continued to appreciate in Q1-FY15 (**Figure 5.13**).

Figure 5.13: JP Morgan Broad Real Effective Exchange Rate



Source: Haver Analytics

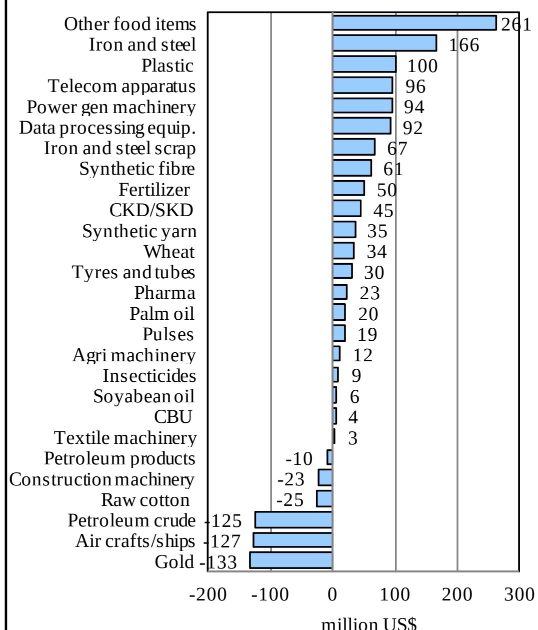
Imports

Imports posted 11.6 percent growth during Q1-FY15, compared to only 3.0 percent in the same period last year. As mentioned before, this increase was driven by higher imports of metals, machinery, fertilizer, and synthetic textile (**Figure 5.14**). Together, the import of these items more than offset the price-driven decline in Pakistan's oil import bill in Q1-FY15.[33]

Import of food items, which are not classified elsewhere, contributed most to the increase in imports during Q1-FY15. Although detailed data is not available for this category (nor is the production data of minor crops), it appears that the country has imported key food items like lentils and vegetables due to flood-related losses. The similar trend can be seen in SBP's payment record data, which shows higher import of potatoes from India; corns from the US; onions from China; and rapeseeds from Canada.

[33] The *quantity* import of petroleum (crude and products combined) increased by 5.2 percent YoY during Q1-FY15.

Figure 5.14: YoY Change in Imports in Q1-FY15



Source: PBS

Import of metals has also remained strong: scrap quantity increased by 33.9 percent, whereas import quantity of iron and steel more than doubled. As noted in **Chapter 2**, domestic construction activity is gaining pace with higher PSDP spending, and private housing activity. In addition, steel consumption in the auto industry also seems to have increased.

Fertilizer imports present a mixed picture. The country did not import urea altogether during Q1-FY15, due to available inventories (**Chapter 2**). However, DAP imports nearly doubled in Q1 (compared to the same period last year) – anecdotal evidence suggests that Engro Fertilizer, the largest importer, made early purchase of nutrients, to take advantage of low international prices. In addition, local importers also seem to have taken advantage of China's low tax window.[34]

Pakistan's import of DAP was intended for the Rabi sowing, which started in October. In overall terms, the import of fertilizer grew by 33.0 percent during Q1-FY15, as compared to a 37.8 percent decline in Q1-FY14.

In overall terms, the real problem in Pakistan's trade account is stagnant exports. Import substitution can also be considered in some areas, like palm oil, and by establishing in-house manufacturing facilities for low-end consumer items. However, a large part of the import growth has come from machinery and other industrial inputs, which directly adds to Pakistan's production capacity. Furthermore, Pakistan is not self-sufficient in producing what it presently imports. Hence, there is a need to boost the country's exports by taking necessary structural

[34] Announced in May 2014, this window allowed Chinese traders to export phosphate fertilizer *only* to India and Pakistan, at a reduced tariff of 15 percent.

reforms; diversifying the export base; and promoting the local manufacturing of low-technology goods. Furthermore, the government should create an effective mechanism of rebates and refunds for exporting industries.

Keeping in view a sharp decline in global oil prices, and an unchanged oil output in the next six months, Pakistan's trade deficit is likely to stay soft in the remaining part of the year. Meanwhile, price of palm oil has also weakened in the international market since end-September, which should reduce the import bill.[35] As far as exports are concerned, these showed a recovery in October, after declining consistently in the first quarter.[36] The impetus to export growth has come from textiles, rice, footwear and petroleum products. In overall terms, the performance of trade sector for the full-year is likely to be better than Q1-FY15.

[35] Palm oil prices have reduced by 0.2 percent in the international market during October to 28th November 2014 (source: World Bank).
[36] Exports posted a growth of 5.0 percent YoY in October 2014.

Acronyms

ABL	Allied Bank Limited
ADB	Asian Development Bank
ASEAN	Association of South East Asian Nations
BMR	Balancing, Modernization and Replacement
BoP	Balance of Payment
bps	Basis Points
CNG	Compressed Natural Gas
CPI	Consumer Price Index
CSF	Coalition Support Fund
DAP	Di-ammonium Phosphate
DISCO	Distribution Companies
EFF	Extended Fund Facility
EU	European Union
FBR	Federal Board of Revenue
FDI	Foreign Direct Investment
FX/FE	Foreign Exchange
FTA	Free Trade Agreement
FY	Fiscal Year
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GIDC	Gas Infrastructure Development Cess
GSP	Generalized System of Preferences
GST	General Sales Tax
HBL	Habib Bank Limited
IBA	Institute of Business Administration
IGC	International Growth Center
IMF	International Monetary Fund
IRC	Interest Rate Corridor
Kg	Kilograms
KPK	Khyber Pukhtunkhwa
LIBOR	London Interbank Offered Rate
LPG	Liquefied Petroleum Gas
LSM	Large Scale Manufacturing

M2	Broad Money Supply
MFI	Micro Finance Institution
Mof	Ministry of Finance
MRTBs	Market related Treasury Bills
MT	Metric Tons
NBFC	Non-Bank Finance Companies
NDA	Net Domestic Assets
NFA	Net Foreign Assets
NFNE	Non-Food Non-Energy
NPK	Nitrogen-Phosphorus-Potassium (fertilizer)
NRER	Non-resident (External) Rupee Account
NRI	Non-resident Indians
NRO	Non-resident Ordinary Rupee Account
NSS	National Savings Scheme
OECD	Organization for Economic Co-operation and Development
OGDCL	Oil & Gas Development Company Limited
OMOs	Open Market Operations
OPEC	Oil Producing and Exporting Countries
PASSCO	Pakistan Agricultural Storage & Services Corporation Ltd.
PBS	Pakistan Bureau of Statistics
PDF	Pakistan Development Fund
PIA	Pakistan International Airline
PIB	Pakistan Investment Bond
PIDE	Pakistan Institute of Development Economics
PKR	Pakistani Rupee
PPL	Pakistan Petroleum Limited
PRI	Pakistan Remittance Initiative
PSDP	Public Sector Development Program
PSEs	Public Sector Enterprises
PSO	Pakistan State Oil
RBI	Reserve Bank of India
rhs	Right Hand Side
Rs	Rupees
SBA	Stand-by Arrangement

SBP	State Bank of Pakistan
SRO	Statutory Regulatory Order
T-bills	Treasury Bills
TMSS	Thengamara Mohila Sabuj Sangha
TCP	Trading Corporation of Pakistan
UAE	United Arab Emirates
UBL	United Bank Limited
UK	United Kingdom
UNCTAD	United Nations Conference on Trade and Development
US/USA	United States of America
WAPDA	Water and Power Development Authority
YoY	Year on Year
3G	3^{rd} Generation
4G	4^{th} Generation

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) **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 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

[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.

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.*