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Pakistan's economy grows by 3.7% in FY12: SBP Annual Report

Pakistan's economy witnessed a modest improvement in FY12 – real GDP grew by 3.7 percent during the year, compared with 3.0 percent in FY11, says the State Bank's Annual Report on the State of the Economy for the year 2011-12 released today. It said the growth was more broad-based compared to FY11, as it was evenly distributed across agriculture, industry and the services sector.

The demand side was more insightful, as the growth in FY12 was primarily driven by private consumption, it said, adding that strong worker remittances, a vibrant informal economy and higher fiscal spending, supported consumption growth during the year.

SBP Report said that food prices have remained relatively stable during FY12, which helped bring down overall inflation to 11.1 percent – better than the 12.0 percent projected earlier. 'It was this easing that allowed the central bank to reduce the policy rate by 200 bps during the year; this was done to partially revive private sector borrowing, and encourage banks to improve their intermediation between private savers and borrowers,' the Report added.

According to the Report, the external front was positive as remittances posted yet another year of strong growth, which not only helped narrow the current account deficit, but also contributed to economic activity. 'In overall terms, the external sector has been less worrying than anticipated at the beginning of the year; however, as financial inflows dried up, the burden of financing the current account deficit and external debt, has fallen on the country's FX reserves,' the Report added.

While services continued to support the economy, commodity producing sectors (agriculture and industry) posted an improvement over FY11, the Report said, adding that the growth in agriculture came from livestock and *kharif* crops, but minor crops witnessed a decline due to the floods in Q1-FY12.

It said the positive spillovers from agriculture, coupled with strong remittances and income support schemes, boosted construction activities and household consumption – both of which helped the manufacturing sector. 'In terms of services, there was a sharp improvement in financial sector earnings, driven primarily by the volume of commercial bank financing of the fiscal deficit, and deceleration in fresh non-performing loans (NPLs),' the Report added.

Among other factors, SBP's decision to cut its policy rate by a cumulative 200 bps in H1-FY12 was partially motivated by its concern over commercial banks' reluctance to extend credit to the private sector. However, in the presence of a risk-free dominant borrower, average bank lending rates fell by only 112 bps, which suggest that banks remain apprehensive about (or uninterested in lending to) the private sector, and were willing to accept lower earnings on government securities, according to the Report.

It said the actual outcome in the external sector in FY12 was better: a current account deficit of US$ 4.6 billion, and an overall gap of US$ 3.3 billion, meant that Pakistan's FX reserves fell by US$ 4.0 billion, against an initial projection of US$ 4.4 billion. 'Nevertheless, this contributed to a 9.1 percent depreciation of the Rupee during the course of the year. The Rupee depreciated from November to late December 2011, and sharply so in the last week of May 2012. The first event may have been triggered by the closure of NATO supply routes to Afghanistan, and sustained by rising oil prices; the second adjustment was a brief market panic in response to international developments. In effect, the Rupee was impacted more by one-off events than the underlying economic fundamentals,' the Report added.

According to the Report, the Pakistan economy will grow at about the same rate in FY13 as it did last year (FY12). 'We are confident that milder flooding this year and the underlying factors that allowed for 3.7 percent growth in FY12 will largely remain in play,' the Report added.

The Report observed that the structural problems in the energy sector, PSEs and the fiscal side, may not be tackled in the near-term. However, since the government paid-off the accumulated subsidies in FY12, we do not expect the same level of fiscal pressure this year. 'While the government hopes to achieve a fiscal deficit target of 4.7 percent of GDP, we think a range of 6 – 7 percent is more realistic,' the Report added.

According to the Report, a key concern for the central bank is the on-going decline in domestic investment. Although the investment environment in Pakistan is likely to remain challenging, we believe the recent 250 bps cut in the benchmark interest rate, could revive private investment and provide some relief to commercial enterprises, 'In our view, with interest rates at current levels, commercial banks may be incentivized to book high-return private assets, rather than just place money with the government. Although SBP does not tell banks what to do, commercial banks should be cautious about how their balance sheets are evolving, and look to diversify their asset portfolio with a long-term view,' the Report added.

Since the size of the fiscal deficit last year was mainly due to one-off factors, we are hoping things will be better this year, the Report said, adding: 'We are also optimistic that with the opening of NATO supply routes, Coalition Support Fund (CSF) will be realized in a timely manner. SBP remains hopeful that inflows from privatization (Etisalaat) and the 3G licenses will also be realized in FY13'.

In making our interest rate decisions, SBP looks closely at the likely impact on the FX market. One must note that the FX market's reaction to the discount rate cuts in August and October 2012 was quite muted, the Report said, adding that in late November 2012, some pressure, however, appeared, even though the current account posted a surplus in the first four months of FY13. 'In our view, this pressure can be traced to net outflows to the IFIs (around US$ 1.5 billion during Jul-Nov FY13). Although these payments do not impact the FX market directly, the drawdown of SBP's forex reserves has impacted market sentiments,' the Report added.

In terms of tradeables, our export projections assume that cotton prices have bottomed-out, while Pakistan's low value-added textiles may be insulated from the demand contraction in the OECD, the Report said, adding that we do not expect any spike in imports given the sluggishness in domestic investment, and our view on global commodity prices. 'We also remain optimistic that inward remittances will continue to post strong growth,' the Report said.

The State Bank Report stressed upon the *urgent* need to embark on structural reforms in the energy sector, PSEs and public finances. 'This, together with a more balanced deficit financing mix in FY13, would ease a great deal of pressure from domestic sources of financing – especially the commercial banks,' the Report added.

The detailed Report is available at SBP website www.sbp.org.pk

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