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Economy showing mixed picture halfway into FY13

State Bank of Pakistan released its first and second quarterly reports for FY13 on the State of Economy, today. According to the two reports that jointly cover developments in Pakistan's economy for July – December FY 13, some of the positive developments experienced by the economy in Q1-FY13 could not be sustained during the second quarter. Although the current account still posted a surplus in the first half of FY13, the second quarter posted a deficit; the downward trend in inflation in the first five months of FY13 was interrupted in December; and the federal government sharply increased its reliance on SBP financing in the second quarter. The reports further mentioned that persistent structural problems continue to burden the economy.

The real sector is showing a mixed picture. Within agriculture, both cotton and rice crops remained below target, whereas sugarcane performed well. The wheat crop is likely to be below target despite the increase in support prices in November 2012.

Pakistan's manufacturing sector on the other hand has posted an improvement, and is likely to continue with this trend. Heavyweights like POL and steel manufacturing have shown strong growth. In addition, allied sub-sectors that support construction activities have shown consistent growth, reflecting strong construction since FY12.

The reports point out that the loans to private businesses showed an expansion of Rs 146.5 billion, compared to Rs 86.1 billion in the corresponding period last year, which indicates that banks have started shifting their attention to the private sector.

In terms of federal government borrowing, the aggregated numbers show the government has borrowed less from the banking system this fiscal year, but there has been a sharp shift away from commercial banks to SBP during Q2-FY13.

The fiscal picture explains the federal government's compulsion to borrow. Although the consolidated fiscal deficit in H1-FY13 is likely to be 2.6 percent of GDP (which is the same as in H1-FY12), the US$ 1.8 billion inflow on account of Coalition Support Fund (CSF) made all the difference. The FBR revenue collection witnessed an increase of only 5.7 percent, against a 27.1 percent increase in the same period last year. Furthermore, current expenditures of the federal government grew by 30.9 percent in H1-FY13, compared to 6.6 percent last year.

The reports pointed out that Pakistan's domestic debt has increased by Rs 691 billion in the first half of FY13 compared to Rs 854 billion in the first half of FY12. However, Pakistan's external public debt actually fell by US$ 1.9 billion during the half year (of which US$ 1.3 billion was owed to the IMF). Repayments, without fresh inflows, did put pressure on the country's BoP and exchange rate, which ideally should be countered by running a much larger current account surplus.

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

Looking at exports, textiles increased by 8.6 percent as manufacturers were able to draw down inventories from last year – in the first half of FY12, textile exports fell by 4.9 percent. Part of this improvement can also be traced to the duty free access granted to Pakistan by EU in November 2012.

Remittances continued to shore-up the domestic economy, posting inflows of US$ 7.1 billion in H1-FY13, compared to US$ 6.3 billion last year. While the full-year remittances last fiscal was US$ 13.2 billion, SBP is confident that remittances will exceed US$ 14 billion for this fiscal year.

The outlook for the economy is strongly influenced by the perceived vulnerabilities in the external sector. Clearly, it is not the size of the current account imbalance, but the fall in FX reserves that is dampening sentiments. Despite a current account surplus of US$ 218 million in the first half of FY13 (against a deficit of US$ 2.4 billion in H1-FY12), scheduled payments to the IMF pulled down SBP's FX reserves by US$ 1.8 billion. The fall in reserves has occasionally exerted pressure on the Rupee-Dollar parity, coinciding with monetary policy decisions and payments to IMF. SBP however feels that even with scheduled payments to the IFIs, SBP's FX reserves would be adequate to meet all forex obligations.

On the inflation front, although downward trend in YoY headline CPI was interrupted in December 2012, SBP still feels the average inflation rate for the year will remain within target.

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

In the remaining part of FY13, SBP does not see pressure from Pakistan's trade account. Soft commodity prices and strong remittances, should keep the current account contained within 1 percent of GDP deficit.

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

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