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Macroeconomic indicators improve: SBP's Quarterly Report

The State Bank of Pakistan released its Second Quarterly Report for FY14 on the State of Economy, today. According to the report, by the end of first half of FY14, there was a perceptible improvement in the country's macroeconomic indicators. Inflationary pressures have softened (post November); pressure on FX reserves and the PKR parity has eased in December 2013; LSM is showing improvement, which is supported by an increase in credit to the private sector; and as reported by the Ministry of Finance, the fiscal deficit as a percent of GDP declined in first half of FY14.

The report says that improvement in the fiscal *and* external accounts in the second half of FY14 depends on the expected proceeds from the auction of 3G licenses and Coalition Support Fund inflows. However, if expected official external inflows are realized in second half of FY14, SBP's FX reserves are likely to exceed our initial projection for the full year.

The report traced the recent comfort on the external side to an unanticipated US$ 1.5 billion inflow into SBP's reserves, which may have triggered market expectations that Pakistan may receive a facility to defer oil payments in Q4-FY14. "Along with dampening inflationary expectations for the remaining part of FY14, this has changed the market's interest rate outlook. SBP projects average inflation in FY14 to be in the range of 8.5 to 9.5 percent."

The report says that due to a decline in cotton production, the prospects of achieving the GDP growth target in FY14 could be undermined. However, LSM continues to post strong growth, which bodes well for the country's overall economic growth. The rebound in LSM is supported by investments in alternate energy sources; improved power supply (after the resolution of the circular debt); capacity enhancement (in steel, paper, fertilizer, beverages, and rubber) in past few years; and increased lending to private sector businesses, especially in fixed investment loans.

According to the report, government borrowing from commercial banks also increased in the second quarter. It mobilized Rs 188.1 billion from commercial banks during the quarter, against a net retirement of Rs 179.1 billion in the first quarter of the year. Government was not able to contain its borrowing from SBP within the limit agreed with the IMF. "However, with the bilateral inflows in February and March 2014, and other external inflows expected in second half of FY14, these targets should be easier going forward."

The report says that because of a slowdown in spending and an increase in revenues, the fiscal deficit during first half of FY14 narrowed to 2.1 percent of GDP, compared to 2.7 percent in the same period last year, as reported by the Ministry of Finance.

According to the report, the incidence of fiscal austerity fell on development spending both at the federal and the provincial level. This may be attributed to lack of external funding. "In our view, there is a need to rethink this avenue of fiscal consolidation within context of the long-term growth prospects of the economy."

The reduction in the budget deficit eased the pace of domestic debt accumulation during second quarter. This, along with the lumpy US$ 1.2 billion repayment to the IMF and favourable exchange rate movement during Q2-FY14, allowed for a marginal decline in the public debt stock during this period. The report expressed concern about Pakistan's debt profile, as its composition has witnessed a sharp shift towards the shortest tenor. This exposes the government to increasing roll-over and interest-rate risks. While SBP retains its view to rebalance Pakistan's domestic debt towards long-term paper, there was an improving trend in Q2-FY14, which has been maintained in Q3. The government mobilized Rs 105.6 billion through PIBs during the quarter, which was the highest amount raised after four quarters. This change in market sentiments can be traced to falling projected inflation, which means that the market does not expect further interest rate hikes.

The report says that headline inflation reached an average of 8.9 percent in first half of FY14, from 8.3 percent in first half of FY13. CPI inflation fell to 9.2 percent in December 2013, after entering double digits in November 2013; this downward trend is likely to persist. FX reserves remained under pressure till end-November 2013, due to the absence of financial inflows and large repayments to the IMF. However, the situation improved in December 2013, after receipt of the second installment of US$ 554 million Extended Fund Facility (EFF) from the IMF, and a current account surplus in this month. In fact, the PKR witnessed a 3.0 percent appreciation during December 2013, after shedding 8.2 percent of its value against US Dollar during Jul-Nov 2013.

Pressure on SBP's reserves has eased significantly in March 2014; not only has Pakistan met lumpy IMF repayments and expects substantial inflows from the IFIs before end-June 2014, the market has responded very positively to the unanticipated inflow of US$ 1.5 billion from a GCC country. As a result, after remaining stable throughout January and February 2014, the PKR appreciated significantly in March, following a shift in sentiments in the FX market.

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