ANNUAL REPORT

2011 – 2012

THE STATE OF PAKISTAN'S ECONOMY

STATE BANK OF PAKISTAN

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CENTRAL BOARD OF DIRECTORS

Mr. Yaseen Anwar	Governor & Chairman
Mr. Abdul Wajid Rana	Member
Mirza Qamar Beg	Member
Ms. Sahar Z. Babar	Corporate Secretary

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LETTER OF TRANSMITTAL

State Bank of Pakistan
Karachi.
January 29, 2013

Dear Mr. Chairman,

As required by Section 9A(f) of the State Bank of Pakistan Act, 1956, I am pleased to submit the Annual Report of the Central Board of Directors of the State Bank of Pakistan on the State of the Economy for the year 2011-12.

Yours sincerely,

Sd/-

(YASEEN ANWAR)
Governor

Syed Nayyar Hussain Bukhari
Chairman
Senate
Islamabad

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Dr. Fehmida Mirza
Speaker
National Assembly
Islamabad

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of the Central Board of Directors
of the State Bank of Pakistan for
the year ended 30th June 2012.

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The efforts of Dr. Mushtaq A. Khan and officers of the Economic Policy Review Department of State Bank of Pakistan in preparing this report are highly appreciated.

Publication Managers:	Mahmood ul Hasan Khan and Asma Khalid
Analysis	Asma Khalid (LSM, and Aggregate Demand); Bilal Khan (Energy); Mahmood ul Hasan Khan (Monetary policy); Mohib Kamal Azmi (Balance of Payments); Muhammad Akmal (Trade Account); Muhammad Farooq Arby (Aggregate demand, and Fiscal); Mushtaq A. Khan (Economic Outlook); Sabina Khurram Jafri (Domestic and External Debt, and Services); Syed Ozair Ali (Energy, Inflation and Aggregate Demand); Syed Sajid Ali (Aggregate Supply); Syed Zulqernain Hussain (Current and Financial Accounts; Exchange rate and Reserves); Tamkinat Rauf (LSM, Special Section 2.1 and 2.2); and Waseem Fazal ur Rehman (Services).
Editing:	Bilal Khan and Syed Ozair Ali
Formatting:	Muhammad Akmal, Waseem Fazal ur Rehman

For feedback and queries: annual.report@sbp.org.pk

1 Economic Outlook

1.1 Introduction

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. Although the economy underperformed compared with the growth target of 4.2 percent, this outcome was expected given the energy shortages; security concerns; and floods in two consecutive years. Nevertheless, 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. Strong worker remittances, a vibrant informal economy and higher fiscal spending, supported consumption growth during the year. On the other hand, investment remained sluggish – a continuing trend over the past several years.

Although the increase in fiscal spending contributed to commercial activity, it did so at the cost of pushing Pakistan's budget deficit to 8.5 percent of GDP.[1] This outcome is not surprising with the settlement of accumulated circular debt, losses stemming from public sector enterprise, higher interest payments, and floods in the last years, which boosted public works and transfer payments. However, the size of the fiscal deficit is not sustainable as it is contributing to inflation; squeezing out private investment; impacting the balance sheet of commercial banks; and could push the country into a debt trap.

Table 1.1: Macroeconomic Indicators

growth in percent

	FY11	FY12 Target	FY12
Real GDP	3.0	4.2	3.7
Agriculture	2.4	3.4	3.1
Industry	0.7	3.1	3.4
Services	4.4	5.0	4.0
Consumption	3.9	-	11.1
Investment	-4.7	-	-8.6
CPI inflation	13.7	12.0	11.0
as percent of GDP			
Current account balance	0.1	-	-2.0
Fiscal balance	-6.6	-4.0	-8.5*
Public debt	61.0	60.0	62.6

*See foot note 1.

Source: State Bank of Pakistan and Provincial Bureau of Statistics

On a positive note, 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 (**Table 1.1**). 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.

Another positive was the external front, 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.

1.2 Assessment of the year FY12

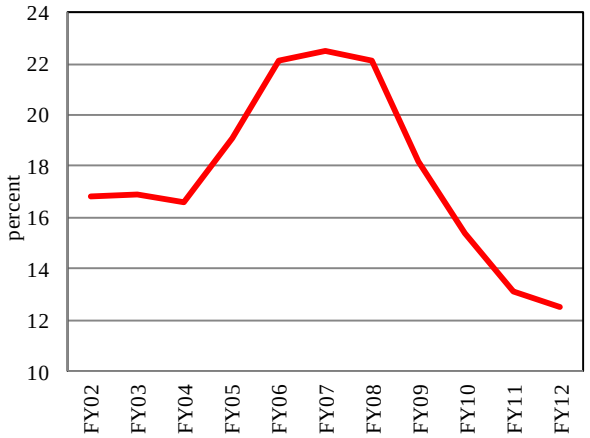
Looking at the supply side, Pakistan's economic growth in FY12 was broad-based. While services continued to support the economy, commodity producing sectors (agriculture and industry) posted an

[1] Without the one-off payment of the circular debt, the fiscal deficit was 6.6 percent of GDP. However, this difference was *financed* by the government, so the overall gap was 8.5 percent.

improvement over FY11. Growth in agriculture came from livestock and *kharif* crops, but minor crops witnessed a decline due to the floods in Q1-FY12.[2]

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).

Figure 1.1: Investment-to-GDP Ratio

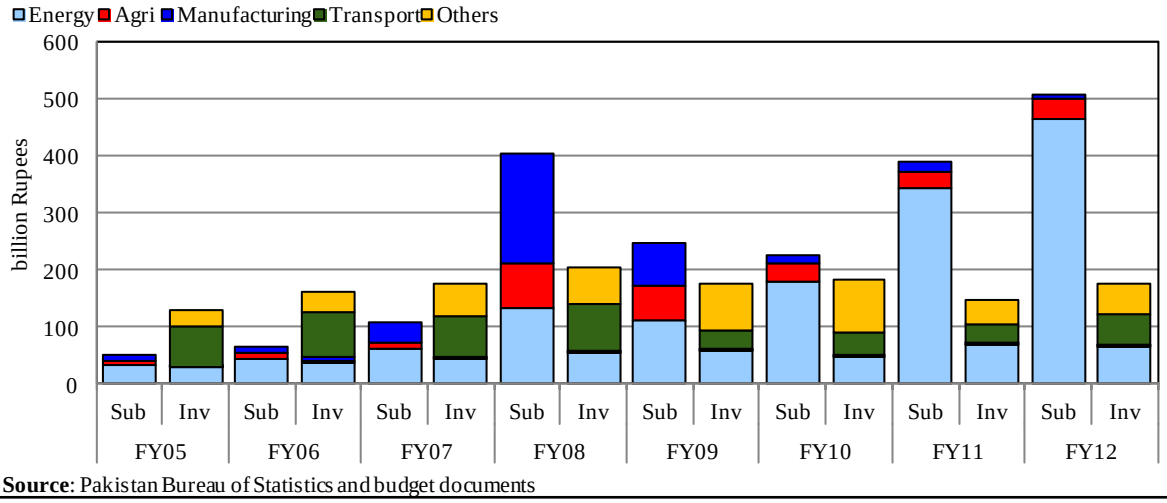


Source: Economic Survey 2011-12

On the demand side, real consumption grew by 11.1 percent during FY12. It is important to realize that over-dependence on consumption makes growth unsustainable, especially when the country's investment rate has been falling (**Figure 1.1**). During FY12, the investment-to-GDP ratio reached a low of 12.5 percent, due to security concerns; energy constraint; excess capacity with the manufacturing sector; the fiscal spillover on the balance sheet of commercial banks; and concerns about sector-specific policies. Public investment has also been overshadowed by subsidies (**Figure 1.2**).

Besides the low investment rate, the increase in the budget deficit has also emerged as a key challenge to the macroeconomic stability of the country. For FY12, the government had envisaged a significant fiscal consolidation, but the actual outcome was a sizeable expansion.

Figure 1.2: Government Subsidies Surpassing Nominal Public Investments



Source: Pakistan Bureau of Statistics and budget documents

Subsidies turned out to be more than three times the target, but this included Rs 391 billion that was spent to consolidate the PSE debt, especially in the power sector.[3] Excluding subsidies, the fiscal

[2] In our view, the constant 7.5 percent growth in small-scale manufacturing (SSM) does not adequately capture the impact of the energy shortage on these manufacturing units, which generally cannot afford alternative sources of energy generation.
[3] In fact, the shift from hydel to thermal power; the change in fuel mix from low-priced gas to high priced furnace oil; high line-losses from old infrastructure; theft; inadequate collection from billed units; inefficient generation units; uncertain fuel

deficit narrows to 6.0 percent of GDP. This reflects higher-than-target expenditures including debt servicing, and the fact that fiscal devolution has not been as smooth as anticipated. Furthermore, provinces were expected to run budget surpluses, but they ended up contributing Rs 39.1 billion to the overall deficit. FY12 was also the sixth consecutive year when the government ran a revenue deficit, against the requirement of a revenue surplus stipulated under the Fiscal Responsibility and Debt Limitation (FRDL) Act of 2005.[4]

Transfer payments were another heavy item on the fiscal side. With income support programs like the Watan Card and Benazir Income Support Program (BISP), direct outreach was deemed necessary to alleviate the suffering from the floods in FY11, which were far worse than what was experienced in FY12. Another fiscal drain is the weak financial position of public sector enterprises (PSEs). Direct support to Pakistan Railways, Pakistan Steel Mills, PIA and others PSEs, amounted to Rs 33.8 billion in FY12 (see **Chapter 2**).[5]

Financing the fiscal deficit in FY12 was also challenging, as net external financing (which was higher than FY11) did not even cover 8.0 percent of the total fiscal gap. With limited external finance and pending privatization receipts (Etisalaat), the government was able to realize a 12.3 percent increase in non-bank financing, which brought in Rs 529.4 billion.[6] Despite this increase in non-bank financing, the stream of on-going expenditures left the fiscal authorities with no other option but to rely on the banking system – first through commercial banks, then from SBP. The latter has breached the quarterly borrowing limits from the central bank during Q4-FY12.[7]

As a result, the country's domestic debt increased by Rs 1.6 trillion (YoY growth of 27.0 percent) during the year, and the public debt-to-GDP has reached 62.6 percent.[8] The shift of this debt towards the shorter-end has not only increased the debt servicing burden on the country, but has also intensified the roll-over and interest rate risks. These debt dynamics, together with persistence in primary and revenue deficits, indicate that Pakistan could move into a debt trap.

The current debt composition has also complicated monetary management, which was further compounded by the fact that the drawdown of FX reserves (during the year) continued to absorb domestic liquidity. With a price-insensitive dominant borrower, and SBP's aversion to deficit financing, the central bank had to inject short-term liquidity into the system (via OMOs) to smooth out market liquidity conditions.

Commercial banks were clearly not averse to lending to the government. As of June 2012, just the deficit financing by commercial banks (i.e., their holdings of government securities) accounted for 34.4 percent of their aggregate balance sheet, while total private sector lending was only 39 percent: in June 2008, the stock of government securities was only 16.4 percent, while lending to the private sector was 52.4 percent of their total assets. This significant shift in their balance sheet may provide

sources; and the inability to increase tariffs to cover generation costs, forced the fiscal authorities to earmark funds to subsidize these units – it also reduced capacity utilization in both private and public sector generating units.

[4] FRDL Act 2005 states that the government should generate revenue surplus from 2008 onwards.

[5] From company reports and public statements, it is clear that direct government funding is to pay salaries and pensions, and to ensure that minimal services are provided.

[6] However, even this number is deceptive. Rs 229 billion of this amount came from NBFIs (primarily mutual funds) that have shown limited primary mobilization: in effect, most of this "non-bank" financing came from commercial banks and was simply channeled via NBFIs. Net mobilization via National Saving Schemes (NSS), on the other hand, was only Rs 142 billion in FY12.

[7] According to the new Section 9C, in SBP Act 1956, the flow of federal government borrowing from SBP has been restricted by imposing a limit of zero quarterly borrowing on a net basis.

[8] The FRDL Act stipulates that public debt should be reduced to 60 percent of GDP by end-FY13, which means the government has till the end of this fiscal year to manage its public debt. SBP's public debt definition differs from the Ministry of Finance, as it includes military debt, short-term debt and external liabilities. According to the Ministry of Finance definition, the stock of public debt has reached Rs 12.7 billion at end-June 2012, which is 61.3 percent of GDP.

some comfort to banks (for the returns, and improvement in their risk-weighted assets), but also reveals their increasing risk aversion.

During FY12, net lending to private sector businesses was only Rs 18.3 billion, against Rs 692.3 billion that commercial banks lent (in net terms) to finance the budget deficit (and the circular debt settlement). Given the bank-dominated financial sector in Pakistan, SBP is concerned that banks are shifting away from their role as intermediaries between private savers and borrowers. This shift in lending strategy, is marginalizing the private sector.

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

Fixed investment loans have been falling for several years, and have now stagnated. What is more alarming is the sharp fall in working capital loans and trade finance during the year. We acknowledge that the fall in commodity prices (i.e., cotton and sugarcane), stricter regulation of loans under export finance scheme (EFS), and a fall in FX loans would reduce working capital needs. However, the low levels indicate that banks are more interested in lending to the public sector.

Like most other countries, there is no hard data to deconstruct private sector lending (the equilibrium) between the demand for loans, and what banks are actually willing to lend. As expected, there are opposing explanations for the sharp fall in private sector lending: banks complain about the lack of quality borrowers, and correctly highlight non-price impediments to invest (e.g., energy shortages; the law and order situation; forthcoming elections, etc.). Businessmen, on the other hand, always stress that banks are simply unwilling to lend and therefore charge high margins. In our view, commercial banks remain concerned about credit risks under the influence of a dominant borrower, and hence increase risk margins on the private sector. In effect, during a recession with a dominant borrower, banks become even more risk averse, which exacerbates the slump in private sector activity. The results change significantly when the dominant borrower is taken out of the picture.[9]

Finally, at the start of FY12, SBP's main concern was the external sector, as we did not expect the one-off current account surplus in FY11 to be repeated. With the expiry of the IMF Stand-by Agreement (SBA) in September 2011, the market was concerned about the accelerated IMF repayments that would begin in FY12. Our initial BoP projections were revised to show a larger external gap, after the trade deficit worsened in the first few months of the fiscal year, and remittances slipped below expectations. As a result, SBP projected the current account deficit at US$ 5.2 billion, and an overall BoP gap of US$ 3.4 billion.

The actual outcome for the year was better: a current account deficit of US$ 4.6 billion, and an overall gap of US$ 3.3 billion, which 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,

[9] To get a better handle, a framework was developed to understand this problem. By anchoring the framework to the concept of counter-cyclical bank margins (which simply refer to the fact that bank margins include a premium for credit risks, and these risks are lower during a boom, and are higher during a recession), we observe that in a near-recessionary environment with a dominant borrower (the government), an increase in the discount rate triggers an exaggerated increase in lending rates *offered* to non-prime borrowers. This sharply reduces private sector credit disbursements as the government becomes even more attractive. Furthermore, an increase in the benchmark rate only allows a partial pass-through in terms of the documented *average* lending rates, as non-prime borrowers are rationed out of the credit market. As banks only focus on prime borrowers, the increase in the *average* lending rate is smaller.

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 the backdrop of international developments.[10] In effect, the Rupee was impacted more by one-off events than the underlying economic fundamentals.

Looking at key tradeables, the fall in textile exports was primarily responsible for the negative growth in export receipts, and the realized trade deficit was slightly larger than projected. However, the price of oil ended up giving the country some comfort. Oil prices softened between July and October 2011, but edged up between November and March, and then fell sharply from April to June 2012; the latter period ensured that the actual BoP outcome was better than anticipated. Even the lumpy US$ 1.3 billion repayment to the IMF in H2-FY12, and a further US$ 1.3 billion owed to the other IFIs, did not unnerve the market (see Outlook for FY13).

The swing factor was worker remittances. Against a forecast of US$ 12.5 billion in FY12, Pakistan was able to realize US$ 13.2 billion. The 17.7 percent growth was realized despite continuing weaknesses in the global economy, as the number of Pakistani workers abroad increased by 6.4 percent during the year.[11] Putting this in perspective, the Rupee value of inward remittances surpassed the increase in domestic money supply during the year. As will be discussed in the outlook, SBP remains optimistic that remittances will continue to post strong growth in the remaining part of FY13.

In light of the above discussion, the solution to Pakistan's economic problems lies in initiating decisive reforms in the fiscal, PSEs and energy sector (see **Box 1.1**). These reforms are indispensible not only to manage scarce government resources that could otherwise be employed more productively, but also to create fiscal space to improve public services, infrastructure and revive investments.

Box 1.1: Reforms Required to Lift Pakistan's Economic Growth

In assessing Pakistan's economic performance, there are three key points:

Energy sector reforms

The growing losses of energy-related PSEs have been draining scarce fiscal resources in recent years. Specifically, the federal government has provided over Rs 1.0 trillion to the power sector during the last 4 years (FY09-12), an amount more than the cost of Diamer Bhasha Dam. Despite these efforts, the country faced a record shortfall of both electricity and natural gas in FY12, and the circular debt stood at Rs 382.5 billion as of 27th July 2012. With this backdrop, the following points would capture our assessment:

1. ***Short run fix***: capacity utilization in the power sector must be increased. At this stage, the goal should not be to invest in new capacity *per se*, but to work with the infrastructure Pakistan currently has, and ensure that cash-flows are not hampered and government guarantees are honored. More to the point, subsidies must be accurately budgeted, and public and quasi-public entities must be compelled to pay their bills on time.
2. Leakages in terms of theft and inefficiencies at the generation and transmission stage, must be seriously addressed. In this regard, the example of a privatized KESC is insightful: this utility has shed surplus staff (despite stiff union opposition); has cut power supply on account of unpaid bills (even for high profile government agencies); has invested in more efficient generation units; and has formulated a commercially-driven load-shedding schedule. As a result, the situation is quite different in Karachi compared to the rest of the country.
3. DISCOs must take necessary actions to increase collections, which are far below the desired level.
4. It is important to formulate a comprehensive medium-to-long-term strategy to develop hydel and coal-based generation units. This plan must be shared with the general public, so they have a handle on how the current supply problem is to be resolved in the next several years.

[10] May 2012 witnessed currency volatility in the region and beyond. During this month, while the Pak Rupee lost 2.2 percent of its value, the Indian Rupee depreciated by 5.1 percent; the Sri Lankan Rupee lost 1.5 percent; and the Bangladesh Takka depreciated by 0.3 percent. The British Sterling also lost 3.3 percent of its value during the month.

[11] Source: Bureau of Emigration & Overseas Employment, Islamabad.

5. The regulatory authorities that set tariff rates for power and gas, need to rethink their pricing for end users. Grossly underpriced household and industrial gas leads to wastage, and carries a high opportunity cost (see **Chapter 3**). Although the government's recently approved Petroleum Policy has increased well-head prices and standardized this across the country (which should bring more foreign investment for oil and gas exploration), more pressing concerns about security and contract enforcement need to be addressed first.

Cognizant of the above issues, the government has prepared a restructuring plan to resolve structural weakness in the energy sector. In addition to financial support as mentioned earlier, the following steps are worth noting:

1. Dissolution of PEPCO has been finalized. The administrative and financial intervention of PEPCO in the power sector has ceased.
2. Formation of new Board of Directors of CPPA, QESCO, SEPCO and the GENCO holding company (GHC). The CEOs for GHC, HESCO and PESCO have been appointed, while CEOs for 3 other DISCOs (LESCO, MEPCO and SEPCO) have been replaced.
3. The NEPRA Act has been amended to facilitate passing of Fuel Price Adjustment (FPA) on to the consumers. However, there have been delays by NEPRA in determination of FPA that contributed to liquidity crunch in the sector.
4. A new Electricity Act has been approved by the cabinet to strengthen the legal framework for curbing theft and other administrative losses.

In addition to these reforms, the government may work with the IFIs to formulate a sustainable, irreversible and credible energy policy for the country.

PSE reforms

Although energy has dominated public attention, one must realize the underlying problem in the energy sector is effectively the inability of PSEs to operate commercially. Other PSEs like Pakistan Railways; PIA and the Pakistan Steel Mills, also need to embark on difficult reforms to nudge them back to commercial viability. Comprehensive reform strategies have already been formulated; it just requires the will to take the first difficult steps to reduce staff and rationalize operations. In simple terms, these PSEs need to implement business plans that meet strict standards of commercial viability. In this regard, the government has taken some measures to change senior level management in PIA and Pakistan Steel Mills.[12]

Fiscal reforms

It is important to put things into perspective. Since FY07, Pakistan has been running a *revenue* deficit and also a *primary* deficit[13] – the only upside, is these imbalances slightly narrowed in FY12 compared to FY11. A *revenue* deficit implies the government is borrowing to meet current expenditures, which means the government is effectively borrowing without *creating* repayment capacity (assuming all development spending is used productively and creates repayment capacity).

The repercussions of this fiscal overstretch on the energy sector and the impact on the banking sector, are recurring themes in this report. The solution remains the same as put forward by the IFIs for many years. However, with Pakistan's investment rate already at record lows, the fiscal problem will have to be addressed while taking concurrent steps to revive private investment. As is the case in Europe, a customized reform program will have to be designed to achieve both fiscal austerity and private sector growth.

1.3 Global Economic Conditions and Implications for Pakistan

Throughout FY12, European policymakers struggled to manage conflicting goals: how to show tangible fiscal austerity to calm an increasingly skeptical global financial market; and how to mollify public sector employees who could lose their benefits (or livelihood) and vote accordingly. This uncomfortable trade-off is made worse by the fact that members of the Euro can broadly be placed into two categories: those that are fiscally responsible, and those that are not. Fortunately, the market has already shown where each country stands: Greece; Spain; Portugal; Ireland; Italy and Cyprus need help; Germany; Finland and Austria do not.

For a union, which is political as much as it is economic, such differences will determine the level of pain that individual countries would have to endure, if they are to win the market's trust. Not

[12] It is expected that with the current bailout package to PSM, it may attain capacity utilization of 55 percent from its current 20 percent. Likewise, the new management in PIA has prepared its draft Business Plan, which is in the process of being fine tuned.

[13] A primary deficit implies that revenues (tax and non-tax) cannot even cover non-interest expenses; this basically means the government must borrow to meet its debt servicing obligations.

surprisingly, the champions of austerity are those that will have to experience less pain, and those who want growth would like to defer the pain. Deferring fiscal reforms (and pushing for growth) raises the issue of the credibility of future austerity plans, which is not easy given the track record of the problem countries in the Euro.

A further complication is that some members of the Euro will have to bailout the others, which means one set of tax-payers will have to pay for the other. And it is not just about lending enough to keep problem countries current on their debt payments – these countries already have high debt-to-GDP ratios, which is an important metric the market uses in pricing sovereign bonds (**Table 7.4**). Hence, a credible solution would entail grants from the disciplined to the less disciplined, which will not be easy. By most accounts this issue will drag on, and the uncertainty it creates is likely to keep the Eurozone in a recession for the next several years.

Developments in the US, on the other hand, have been somewhat better. However, even in the US, the lead-up to the fiscal cliff in January 2013, created a good deal of uncertainty about what would happen.[14] The non-partisan Congressional Budget Office (CBO) had predicted the cliff could bring about a 2.9 percent contraction in US GDP, which would push US unemployment back above 9 percent. The total impact would be a fiscal contraction of US 560 billion, or 3.5 percent of GDP.

The resolution of the fiscal cliff in early 2013, has been a temporary compromise. Taxes on the very rich have automatically increased, but spending cuts have been postponed for two months. A more credible solution will require a Congressional decision regarding the debt ceiling, which is likely to be politically divisive.

What we do know, is the modest US growth in the past few years has been jobless. We also know that with bleak employment opportunities, households will continue to deleverage (i.e., pay off their debts), which implies that a consumer-led recovery is highly unlikely. This is a growing concern, as two-thirds of the US economy is driven by consumer spending. In response to this, the Fed has announced the third round of quantitative easing (QE3), which is an open-ended bond-purchasing program that seeks not just to revive economic growth, but more importantly, to create jobs. Analysts are not convinced that such injection of liquidity would necessarily create jobs, especially with the government's focus to revive the housing market.

Making matters worse, the Asia Giants are beginning to slow. Since China and India have been powering world economic growth over the past decade, this slowdown can be traced to falling export demand from the US and EU. In effect, these export-driven countries cannot avoid the contagion from the OECD.

Although a major concern for both China and India are weakening exports, domestic demand in India is beginning to taper off. In particular, declining corporate investment, low public investments and rising input costs, is troubling Indian policymakers. Furthermore, the heavy burden of government subsidies is creating fiscal pressures, which are difficult to contain politically. On the other hand, China is also beginning to slow, with concerns that easing demand for Chinese exports could increase unemployment and puncture the real estate boom.

As the near-term recovery in the global economy appears unlikely, the prospects for Pakistan's external sector are mixed. Although the global recession would hurt Pakistan's exports, the possible upside could come from international commodity prices – the most obvious being oil. It is clear that geo-political uncertainty about Syria and Iran is keeping oil prices high, but such levels are also

[14] The cliff refers to specific tax laws that will expire in December 2012, which will eliminate Bush-era tax cuts and halt certain unemployment benefits and tax holidays.

dragging down the global economy. In our view, this uncertainty will dissipate after the US elections, which means the remaining half of FY13 should see oil prices falling.

In this discussion, one must realize that in the past decade, global demand for oil has come primarily from Asia (i.e., China and India): if these economies were to slow, global demand for oil will be impacted. Add to this the strength of the US Dollar as investors adjust their currency holdings to the on-going Euro crisis, and realize that oil is priced in Dollars. So with easing global demand for oil and a strong Dollar, oil prices are likely to edge lower. As discussed in **Chapter 8**, easing oil prices could have a decisive impact on Pakistan's current account deficit, while rising food prices (wheat and rice) would help at the margin. In net terms, Pakistan's external sector is relatively insulated from developments in the global economy, with a possible upside on commodity prices.

1.4 Outlook for FY13

The target GDP growth of 4.3 percent for FY13 appears optimistic; we think Pakistan will grow at about the same rate as it did last year (**Table 1.2**). 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 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.

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. This decision was supported by an improved inflation outlook, and also seeks to signal that banks may re-examine the rapid accumulation of government securities on their balance sheets (directly or indirectly). 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.

In addition to the inclination of banks, the effectiveness of this interest rate signal will depend on the quantum of government borrowing, its borrowing mix and liquidity conditions in the market. 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. We are also optimistic that with the opening of NATO supply routes, Coalition Support Fund (CSF) will be realized in a timely manner.[15] SBP remains hopeful that inflows from privatization (Etisalaat) and the 3G licenses will also be realized in FY13.

Table 1.2: Major Macroeconomic Targets and Projections

	FY12[P]	FY13 Targets	FY13 SBP Projections
	percent growth		
Real GDP	3.7	4.3	3.0 – 4.0
CPI	11.0	9.5	8.0 – 9.0
M2	14.1		14.0 – 15.0
	billion US Dollars		
Remittances	13.2	14.1	14.0 – 15.0
Exports (fob)	24.6	25.8	25.0 – 25.5
Imports (fob)	40.0	42.9	41.0 – 42.0
	percent of GDP		
Fiscal deficit	6.6	4.7	6.0 – 7.0
Current account deficit	2.0	1.9	0.5 – 1.5

Note: Targets of fiscal and current account deficits to GDP ratios are based on the nominal GDP in the budget projections. [P]: provisional

The central bank shares the market's view that the Rupee-Dollar parity is a key indicator. Given the nature of this market, the Rupee parity is perhaps the most important market signal that policymakers have. In making our interest rate decisions, SBP looks closely at the likely

[15] Pakistan has already received US$ 1.8 billion under CSF as of December 2012.

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. However, in late November 2012, some pressure 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.

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. 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.

On a final note, we would stress 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.

2 Aggregate Supply[1]

2.1 Overview

FY12 was the first year for the Planning Commission's 'Economic Growth Framework'. This strategy envisages a greater role of the private sector in the development process, by promoting market-oriented policies, and replacing direct government intervention with more efficient regulation.[2] Accordingly, the Annual Plan for FY12 assumed some easing in energy constraints; an improvement in the business environment; observance of fiscal prudence; and a recovery in global demand.[3] With these assumptions, a GDP growth target of 4.2 percent was set for the year.

The actual GDP growth of 3.7 percent, however, fell short of the Annual Plan target. Though the commodity producing sector succeeded in achieving its target, the underperformance by the services sector held back overall GDP growth.[4]

Nonetheless, this growth seems reasonable as the economy continues to face multiple challenges. For example, on the domestic front, heavy rains in August 2011 caused significant flooding in lower Sindh. Apart from displacing people and livestock, and damaging infrastructure, the floods destroyed 2.2 million bales of cotton, and damaged minor crops. In lower Sindh, the impact of floods stretched to the *rabi* season, when stagnant floodwater led to a decline in area under wheat cultivation. However, on an encouraging note, the FY12 floods were less damaging than in FY11:[5] despite flood-related damages, the cotton crop of 13.6 million bales in FY12 surpassed the conservative target of 12.8 million bales.

Contrary to the assumption made in the Annual Plan, energy constraints intensified during FY12, forcing a number of industries to scale down production.[6] In the gas sector, mispricing led to a widening of the demand-supply gap (for a more detailed discussion, see **Chapter 3**).

Despite these setbacks, economic growth was not only higher, but also more broad-based compared to FY11. In FY11, the impetus to growth came mainly from the services sector, which contributed more than three-fourth of the overall increase in GDP. This year, the commodity producing sectors have made a larger contribution, as both agriculture and industry witnessed an improvement over FY11.

The improvement in agriculture mainly came from major *kharif* crops (particularly rice and cotton), where water availability has emerged as a key growth determinant. The improved and timely availability of water supported these crops, whereas wheat (a key *rabi* crop) suffered due to a fall in the area under cultivation. While the latter can be traced to a level of water scarcity, this issue is likely to become a very important factor in determining the fate of agriculture in the country.

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[1] Commonly represented by the Gross Domestic Production (GDP), the aggregate supply reflects the total value of final goods and services produced in the economy during a year.
[2] Source: http://www.pc.gov.pk/hot%20links/growth_document_english_version.pdf
[3] Source: Annual Plan 2012-13, Planning Commission, Pakistan.
[4] The less-than-target performance in *wholesale & retail trade* and *transport, storage and communication* constrained growth in the services sector.
[5] According to Economic Survey 2011-12, the floods of 2011 led to a loss of Rs 324.5 billion to the economy, which was on top of Rs 855 billion damages caused by 2010 floods.
[6] The power shortage became more acute as the rise in international oil prices inflated the volume of circular debt, which forced a number of power plants to remain idle due to the lack of funds to purchase fuel.

In the industrial sector, manufacturing and construction largely explain the growth in FY12 (**Table 2.1**). However, the constant 7.5 percent growth in small-scale manufacturing appears overstated, since such units are particularly vulnerable to prolonged energy shortages.

Table 2.1: Gross Domestic Product (at constant prices of 1999-2000)

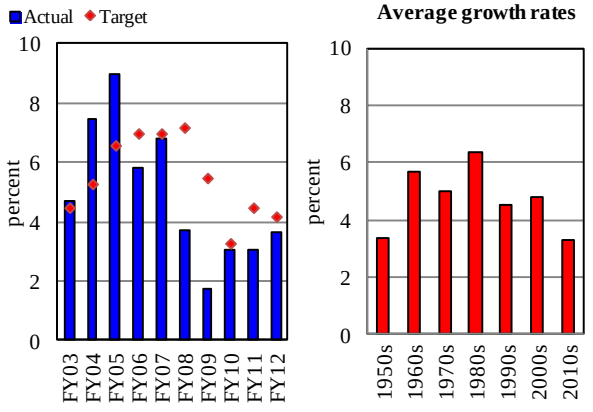
percent	Share in GDP		Growth			Contribution to growth	
	FY11	FY12	FY11	FY12[T]	FY12	FY11	FY12
1. Commodity producing sector	46.6	46.5	1.5	3.2	3.3	0.7	1.5
(a) Agriculture	21.2	21.1	2.4	3.4	3.1	0.5	0.7
Major crops	6.7	6.7	-0.2	3.0	3.2	0.0	0.2
Minor crops	2.2	2.1	2.7	2.0	-1.3	0.1	0.0
Livestock	11.6	11.6	4.0	4.0	4.0	0.5	0.5
Fishing	0.4	0.4	1.9	2.0	1.8	0.0	0.0
Forestry	0.2	0.2	-0.4	-1.0	0.9	0.0	0.0
(b) Industry	25.5	25.4	0.7	3.1	3.4	0.2	0.9
Mining & quarrying	2.4	2.4	-1.3	1.0	4.4	0.0	0.1
Manufacturing	18.7	18.6	3.1	3.7	3.6	0.6	0.7
Large scale	12.1	11.9	1.1	2.0	1.8	0.1	0.2
Small & household	5.1	5.3	7.5	7.5	7.5	0.4	0.4
Construction	2.1	2.2	-7.1	2.5	6.5	-0.2	0.1
Electricity and gas distribution	2.3	2.2	-7.2	1.0	-1.6	-0.2	0.0
2. Services	53.4	53.5	4.4	5.0	4.0	2.3	2.1
Transport, storage & communication	9.9	9.6	0.9	4.5	1.3	0.1	0.1
Wholesale & retail trade	17.1	17.1	3.5	5.0	3.6	0.6	0.6
Finance & insurance	4.7	4.8	-1.4	0.2	6.5	-0.1	0.3
Ownership of dwellings	2.7	2.7	1.8	3.5	3.5	0.0	0.1
Public admn. & defence	6.7	6.6	14.2	6.0	2.6	0.9	0.2
Social and community services	12.3	12.6	6.9	7.0	6.8	0.8	0.8
GDP (fc)	**100.0**	**100.0**	**3.0**	**4.2**	**3.7**	**3.0**	**3.7**

T: target
Source: Pakistan Economic Survey 2010-11, and Annual Plan 2011-12

The modest improvement in large-scale manufacturing was concentrated within a few sectors. Consumer goods performed well, mainly due to domestic consumption, but this growth decelerated during the course of the year due to an increased preference for imported goods.

The services sector, which has the largest share in GDP, recorded lower growth during FY12 compared to the previous year. Contrary to FY11, when a large increase in public salaries and flood-related social spending boosted services, the growth in FY12 was more broad-based. Increasing profitability of the banking sector led to a turn-around in *finance and insurance*. Similarly, *transport, storage and communication* posted higher growth in FY12 compared to FY11.[7] This mainly reflects the increased volume of imported petroleum products that were transported (via pipelines) to the northern parts of the country.

Figure 2.1: Real GDP Growth



Source: Economic Survey 2011-12

[7] This was despite the continued losses in PIA and Pakistan Railways.

Although the economy has shown some recovery in FY12, the growth still remains below the historical norms. In fact, persistently low GDP growth has become one of the major concerns for the economy, as average long-term growth is declining (**Figure 2.1** and **2.2**).

Pakistan's growth was also weaker compared to other emerging economies (e.g., Brazil, Philippines, Malaysia, Indonesia, Sri Lanka, India, Vietnam and China). As evident from **Figure 2.2**, despite some slowdown in these countries after the 2008 credit crunch, growth in most of these countries remained higher than Pakistan.

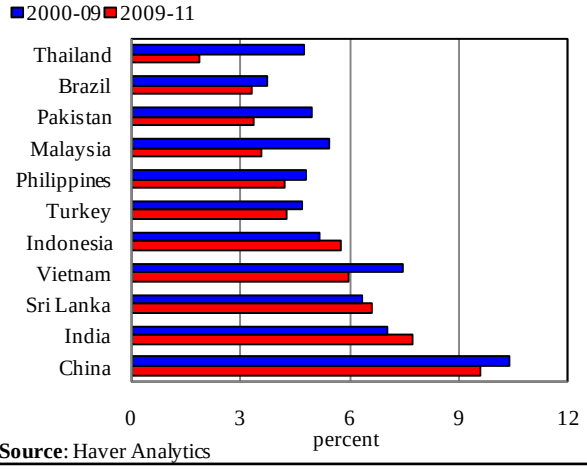
We associate the slower growth in Pakistan more with domestic constraints, than with the global economic conditions. In particular, the worsening energy shortages; falling investment; persistent macroeconomic imbalances; and the recurring floods, have held back economic activity. Hence, there is an urgent need to address these issues to revive economic growth, bring down poverty and absorb the growing labor force.[8]

2.2 Agriculture

Despite the floods of August 2011, the agriculture sector recorded a modest improvement, growing by 3.1 percent in FY12 compared to 2.4 percent in the previous year. However, farmers' margins came under pressures due to a sharp increase in input costs, and a fall in agri prices.

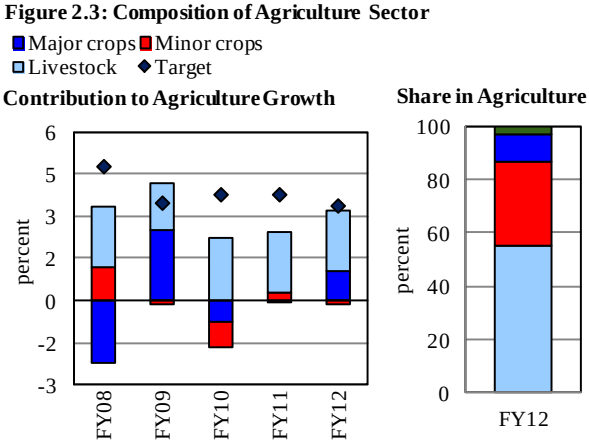
The livestock sub-sector (with a 55.1 percent share in agriculture) remained the main contributor to growth, followed by major crops. Minor crops, however, suffered due to the floods and extremely low temperatures in the winter season (**Figure 2.3**).

Figure 2.2: Pakistan's GDP Growth Rate vis-à-vis Other Countries



Source: Haver Analytics

Figure 2.3: Composition of Agriculture Sector



Source: Economic Survey 2011-12

Table 2.2: Major Crops

	FY10	FY11	FY12	Growth (%)	
				FY11	FY12
Area (000 hectare)					
Cotton	3,106	2,689	2,835	-13.4	5.4
Sugarcane	943	988	1,058	4.8	7.1
Rice	2,883	2,365	2,571	-18.0	8.7
Maize	935	974	1,083	4.2	11.2
Wheat	9,132	8,901	8,674	-2.5	-2.6
Production (000 tons, cotton is in 000 bales of 170 kg)					
Cotton	12,914	11,460	13,595	-11.3	18.6
Sugarcane	49,373	55,309	58,397	12.0	5.6
Rice	6,883	4,823	6,160	-29.9	27.7
Maize	3,261	3,707	4,271	13.7	15.2
Wheat	23,311	25,214	23,337	8.2	-7.4

Source: Pakistan Bureau of Statistics

[8] The Economic Growth Framework acknowledges that to absorb the young and growing population, the economy has to grow over 7 percent per annum on a sustained basis.

Major crops

The main contribution to value addition came from major *kharif* crops. The production of cotton, sugarcane and rice improved over the previous year, whereas wheat (the main *rabi* crop) declined during the year (**Table 2.2**). While improved soil moisture after the floods, and timely availability of water supported crop yields (**Table 2.3**),[9] the higher use of agri inputs (e.g., fertilizer) compared to the *kharif* crop of FY11, also enhanced production.

Table 2.3: Irrigation Water Situation

million acre feet

	Kharif			Rabi		
	FY11	**FY12**	**%△**	**FY11**	**FY12**	**%△**
Punjab	29.0	34.3	18.2	18.7	17.6	-6.0
Sindh	22.6	23.3	3.0	14.5	10.1	-30.2
Khyber Pakhtunkhwa	0.8	1.0	27.4	0.5	0.6	16.7
Balochistan	1.2	1.9	53.4	0.9	1.1	27.8
Total	**53.6**	**60.5**	**12.8**	**34.6**	**29.4**	**-14.96**

Source: Suparco

In the *rabi* season, the decline in wheat production can be traced to a decrease in area under cultivation and lower availability of water. Southern Sindh remained inundated at the time of sowing, while some farmers could not prepare their land for wheat sowing due to late harvesting of the sugarcane crop; others simply preferred to sow cotton earlier at the direct expense of wheat.

Water availability and other agri inputs

Water availability has become a major concern for the agriculture sector. In *rabi* FY12, lower winter precipitation and extended periods of low temperature (which reduced glacier melting) led to a decline in river flows. Unfortunately, water availability did not improve even for *kharif* FY13, due to delays in the monsoon rains.

The situation is likely to worsen in the future, as freshwater supplies continue to be overwhelmed by mounting demand pressures. In this context, building water storage capacity is crucial to buffer against dry seasons. At the same time, the price of irrigation water needs to be raised to reflect excess demand and the resource cost of water availability (see **Special Section 2.1** for more details).

Finally, the use of credit and fertilizer also dropped during the *rabi* season, compared to the same season in the previous year (**Table 2.4**). Fertilizer demand declined mainly due to higher prices coupled with lower expected crop income as the prices of cotton, sugarcane and maize fell during the year. According to our estimate, the price decline more than offset the gains from quantum growth. On top of that, the cost of pesticides, diesel, and seeds also increased substantially, further squeezing growers' margins, especially in Sindh, where farmers were already grappling with the second floods in a row (**Figure 2.4**).[10]

Table 2.4: Fertilizer Sales and Prices

	Volume (000 tons)		Prices (Rs/bag)	
	Urea	**DAP**	**Urea**	**DAP**
Kharif				
FY11	2,777	471	852	2,625
FY12	3,014	486	1,461	4,049
%△	**8.5**	**3.2**	**71.5**	**54.2**
Rabi				
FY11	3,160	815	985	3,142
FY12	2,710	564	1,766	4,138
%△	**-14.2**	**-30.8**	**79.3**	**31.7**

Source: Suparco

To hedge against such production risks (water and cash availability; crop and input prices), farmers depended more on traditional means (e.g., *arhtis*, investing in livestock, and earning through non-farm

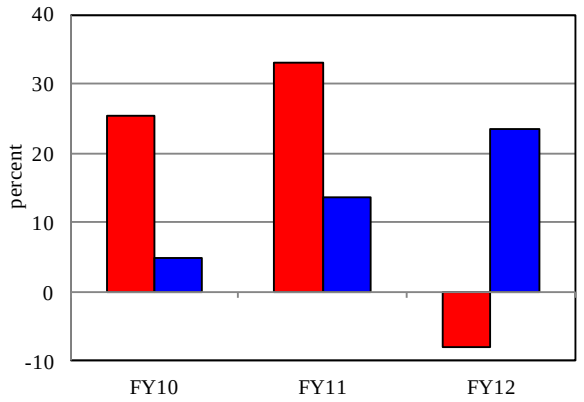
[9] In the case of cotton, exceptionally high prices of cotton lint during the previous crop season, increased use of BT cotton, and a better control over cotton leaf curl virus and sucking pest (particularly in Punjab), led to a higher production. In fact, gains in Punjab more than offset the flood-related losses in Sindh.

[10] Sugarcane growers faced an additional burden due to payment disputes with sugar mills. While some payments were delayed due to disagreements over prices, there were reports that sugar mills - facing liquidity problems owing to large inventories - held back payments to farmers. In this situation, the government intervened in the sugar market by purchasing 4.75 million tons of sugar through TCP. Thus the decline, as well as postponement, in revenue from *kharif* 2012 crops also added to the list of reasons for low wheat cultivation this year.

labor). In some cases, farmers also opted for crop diversification.[11] More recently, there has been a growing focus on developing market-based instruments (e.g., forward market in commodities, crop insurance) as risk management measures. To facilitate this, SBP has developed a comprehensive framework for a commercially viable warehouse receipt system, which will allow farmers to have a reliable storage facility, and the receipts against stored commodities could be used as collateral for bank financing.[12]

The government continues to subsidize key agri inputs (e.g., fertilizer, water, and electricity) and intervenes in the market by setting benchmark prices as well as directly procuring strategic crops.[13] While such interventions have ensured adequate supply of food staples, the resulting economic costs has become a growing concern. Specifically, even with substantial government support, this sector suffers from lack of innovation and productivity gains, as crop yields remain low (**Table 2.5**) and harvest losses are alarmingly high.[14] Going forward, as natural resources (primarily water) come under stress, agriculture production could suffer a great deal, having serious repercussions for the food security in the country.

Figure 2.4: Crop Output Prices vs. Input Prices (growth 12-m ma)



* WPI of wheat, rice, sugar crops and fiber crops (incl. cotton)
** WPI of tractors, fertilizers, insecticides and pesticides
Source: Pakistan Bureau of Statistcis

Table 2.5: Yield Gap of Major Crops
tons per hectare

	Progressive farmer's yield	National 3-year average yield	Gap (%)
Wheat	4.6	2.6	43.5
Cotton	2.6	1.8	30.8
Sugarcane			
Sindh	200.0	55.0	72.5
Punjab	130.0	50.0	61.5
Maize	6.9	2.9	58.0
Rice	3.8	2.1	44.7

Source: Final Report of the Task Force on Food Security, Planning Commission, 2009

For now, Pakistan's food supply is adequate for meeting the country's needs. Nevertheless, poor infrastructure and rising income inequality could threaten food security.[15] The country needs to revisit its policy priorities to ensure that efforts for ensuring food availability are stepped-up (see **Special Section 2.2** for more details).

Livestock

The output estimates for livestock – the largest contributor to agriculture and a major source of rural income after crops – are based on previous census growth rates.[16] Generally, these estimates are not

[11] To hedge against changing climate conditions or fluctuating prices, farmers generally adopt crops that are either more resilient to weather conditions or have more stable prices. Sometimes, farmers even experiment with crop cycle to protect their produce from pest attacks.
[12] The implementation of the project rests with Pakistan Mercantile Exchange (PMEX) and a Collateral Management Company is being formed under PMEX for the purpose.
[13] The wheat support price was enhanced to Rs 1,050 per 40 kg. Huge subsidy was provided on the imported fertilizers, and 25 percent of power sector subsidy is provided to the agriculture sector.
[14] The Planning Commission's report on food security suggests the supply-chain losses of over 10 percent for wheat and other grain; such losses swelled to 30-40 percent for horticulture products.
[15] Food security is a blanket concept that refers to the food supply chain from production to actual absorption of food by people.
[16] The current estimates use the growth rate in the last census of 2006 over the 1996 census. While the head count of livestock is based on inter-census growth, the quantity of livestock products is computed on the basis of some fixed ratio for

as rigorous as those computed from the census; hence they remain within a close range during the inter-census years. During FY12, the computed growth for livestock was 4.0 percent, which was unchanged from the previous year.

Being a major source of savings and investment for small farmers, livestock assumes a central role in economic development. Particularly, a number of developing countries have expanded their livestock production in response to higher global demand stemming from an expanding population, rising incomes and faster urbanization (**Table 2.6**).

Table 2.6: Livestock Production Growth in Selected Countries

annual average growth in percent

	2000-2005	2005-2010	2000-2010
Vietnam	8.1	6.3	7.2
Malaysia	4.9	6.5	5.7
Indonesia	5.1	4.6	4.8
Egypt	3.2	4.2	3.7
India	3.4	4.0	3.7
Pakistan	2.8	4.4	3.6
Brazil	5.4	0.8	3.1
China	3.5	2.7	3.1
Thailand	1.1	4.6	2.8
Turkey	1.7	3.5	2.6
Mexico	2.7	1.8	2.3
Argentina	1.7	-0.4	0.6
Australia	-0.4	-0.7	-0.6

Source: World Bank

In some of these countries, the technological advances and the increase in incomes have induced major structural changes in the livestock sector.[17] For example, China has increased its share in world meat production (beef and veal) from 0.6 percent in 1980 to around 10.0 percent in 2011.[18] Similarly, Brazil has doubled its share to 16.0 percent during the same period. In terms of swine meat, China increased its share from 23.0 percent in 1980 to 49.0 percent in 2011. Although poultry meat production is more evenly distributed between developed and developing countries, growth rates in China have been very high.

Compared to these developing countries, livestock production in Pakistan has not seen any significant change. Although Pakistan's performance appears reasonable, it is far below potential considering Pakistan's ranking in terms of livestock holding. According to the Food and Agriculture Organization of the United Nation, Pakistan ranks 2nd in the world in terms of number of buffaloes, 4th in terms of number of goats, 7th in terms of cattle, and 8th in terms of number of sheep. Despite this, the country has not been able to transform its stock advantage into higher value addition.

Table 2.7: Category-wise Industrial Growth

percent		Growth			Contribution to growth	
Category	**Share in industry**	**FY10**	**FY11**	**FY12**	**FY11**	**FY12**
Industry		6.1	0.7	3.4		
Electricity & gas	8.6	6.2	-7.2	-1.6	-0.7	-0.1
Construction	8.5	16.3	-7.1	6.5	-0.6	0.5
Mining	9.4	2.2	-1.3	4.4	-0.1	0.4
SSM	21.0	7.5	7.5	7.5	1.4	1.5
LSM	46.9	4.8	1.1	1.8	0.5	0.8
	Wt. in LSM	**FY10**	**FY11**	**FY12**	**FY11**	**FY12**
Consumer goods	41.1	3.0	7.0	4.9	3.0	2.2
Durables	7.0	31.8	8.2	5.8	0.5	0.4
Non-durables	34.2	-0.8	6.8	4.7	2.5	1.8
Intermediates	55.5	-2.4	-2.4	-1.3	-1.3	-0.7
Capital goods	3.3	13.2	-7.2	-13.0	-0.2	-0.3

SSM: Small Scale Manufacturing, LSM: Large Scale Manufacturing

Source: Pakistan Bureau of Statistics; SBP calculations

2.3 Industry

The industrial sector grew by 3.4 percent in FY12 – higher than 0.7 percent in the previous year. Despite this visible recovery, industrial performance during FY12 was far from satisfactory. To begin with, the growth in value addition by small scale manufacturing, which is assumed constant at

each product (e.g., average milk yield for a buffalo) and some additional information (e.g., production numbers of poultry and eggs).

[17] The new technology allowed large-scale animal-farms to operate with efficient systems for slaughtering, processing and distribution of meat. The industry is now offering a variety of fresh and processed items (such as cooked, refrigerated, and ready-to-eat) while meeting quality, nutritional and safety standards.

[18] The meat production generally rises with consumption. For example, the per capita meat consumption in China rose from 13.7 kg/year in 1980 to 59.5 kg/year in 2005.

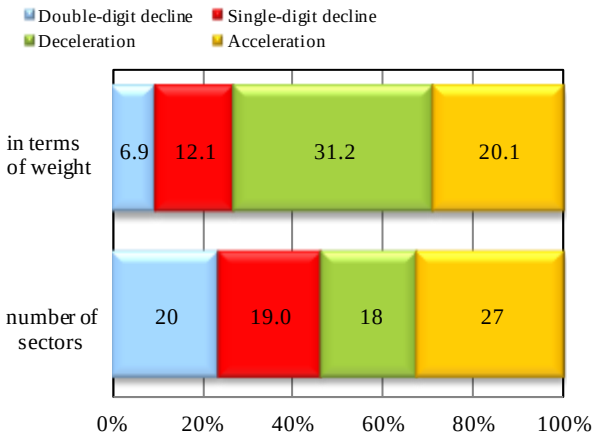
7.5 percent each year, contributed almost 45 percent of the increase in industrial activities (**Table 2.7**). In our view, this seems overstated given the large decline in SME exports during the year (e.g., garments, bed-wear, sports goods, and electric fans).

Secondly, the modest improvement in large-scale manufacturing was concentrated in a few sectors (**Figure 2.5**). Many industries suffered production declines due to supply-side constraints, necessitating higher imports (**Figure 2.6**). A modest slowdown was seen in sectors with relatively large weights in the LSM index due to bearish export sales (e.g., textiles and footwear), lower growth in agri-production (e.g., sugar and wheat milling), and increased consumers' preference for imported goods (e.g., cars and home appliances).

Only the construction sector displayed strong growth during the year, mainly on the back of post-flood reconstruction activities, increase in public works, project loan inflows, and a rebound in private sector demand. Resultantly, construction-based industries (including cement, glass, wood, etc.) also performed well during the year.[19]

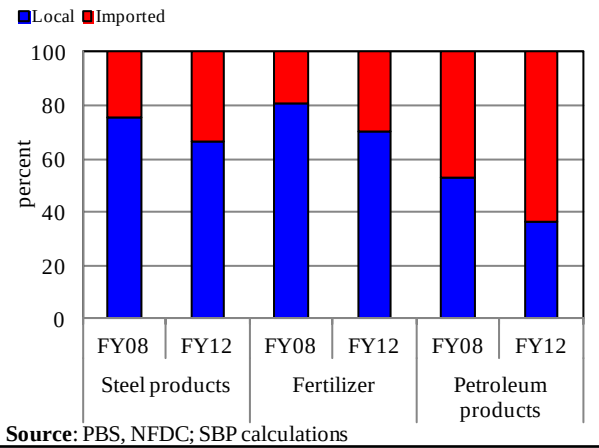
Within LSM, the decline in intermediate goods continued for the fourth year in a row. SBP reports have repeatedly mentioned issues faced by the steel, petroleum refining, and fertilizer sectors, which are operating well below capacity. This is an acute challenge in the energy sector (circular debt) and in fertilizer (gas shortages). Furthermore, ad-hoc decisions regarding fertilizer imports[20] and delays in the restructuring of Pakistan Steel Mills, have weakened the financial structure of these industries.[21]

Figure 2.5: Performance of LSM Sectors during FY12



Source : Pakistan Bureau of Statistics

Figure 2.6: Declining Share of Local Products in Key Intermediate Goods



Source: PBS, NFDC; SBP calculations

Table 2.8: Production and Import of Consumer Durables in FY12

percent growth

	Production	Imports
Cars	14.7	268.0
Rubber tyres and tubes	-23.2	12.0
Footwear	2.3	6.8
Refrigerators	7.7	79.6
A/Cs	-6.5	50.9
Pharmaceuticals	7.0	5.4
Electric fans	-4.3	17.8

Source: Pakistan Bureau of Statistics

In contrast, consumer goods posted yet another year of strong growth. While food processing continues to benefit from good harvests and rising demand from Afghanistan, the durable goods industry benefited from a favorable duty structure

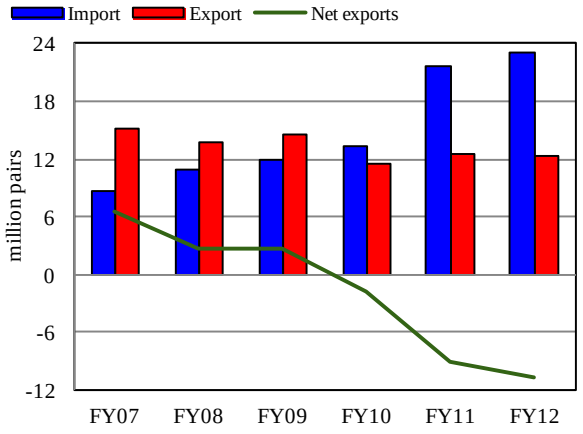
[19] Cement and glass sub-sectors grew by 2.7 percent and 1.8 percent during FY12, respectively.
[20] See Annexure 3 of the SBP Third Quarterly Report for FY12.
[21] For details on issues related with fertilizer import policies, please see section on Fertilizer in SBP Third Quarterly Report for FY12.

and growing domestic demand.[22] However, we believe durable goods have actually under-performed (during the year), as a large part of domestic demand was met through imports, despite available local capacity. For instance, although the production of cars, rubber tyres, footwear, refrigerators and pharmaceuticals increased during the year; the import of these goods has also increased (**Table 2.8**). For TV sets, the increased penetration of imported/smuggled items has caused a decline in local production. Indeed, this trend highlights serious competitiveness issues for the local industry, not to mention the use of the kerb market to secure foreign exchange.

In the case of household appliances and automobiles, high domestic prices remained an issue. These can be traced to high assembly costs and producer margins. In addition, there are certain products which are not being assembled locally. This is a major reason why consumers prefer reconditioned imported cars over brand-new locally manufactured units. They also prefer imported fans, bulbs and wooden furniture, over products manufactured locally.[23]

Similarly, the local footwear industry has been facing stiff competition from products imported from China, Thailand and Vietnam. In the past, Pakistan had been a net exporter of footwear, but in the previous 3 years, it has become a net importer (**Figure 2.7**). Anecdotal evidence suggests that imported products cater mainly to lower-to-middle income households. A similar trend is also seen in the clothing industry, where products from China and Thailand have flooded the low-end market. Furthermore, import of used clothing has increased sharply, suggesting that local manufacturers cannot compete.[24]

Figure 2.7: Pakistan's Trade in Footwear



Source: Pakistan Bureau of Statistics

These trends are discomforting. This is either due to high manufacturing margins for local producers, or simply because local manufacturers are not producing what consumers want. We are certain about one thing: to keep customers satisfied, manufacturers must not only step-up their marketing, but also need to tailor their products to changing tastes and styles.

In our view, quality of domestic investment (and entrepreneurship) in the consumer durable sector should be enhanced. Furthermore, in the previous 5 years, with the exception of intermediate goods like fertilizers, cement, steel, and petroleum refining, no sector has attracted much investment. For instance, despite strong demand, we find little or no local manufacturing of cellular phones and their accessories, rechargeable fans, energy saving bulbs, synthetic fabrics, moulds and dies for auto parts, processed/powdered milk, children-wear, low-tech electrical appliances, remote controls, and office equipment. Similarly, despite having a strong agriculture base, Pakistan spends millions of dollars every year to import food products like cereals, macaroni/pasta, juices, sauces/pastes, seasonings, etc.[25] Furthermore, in many consumer industries, local firms are losing market share by not investing in research and development, and continue to offer products with obsolete designs and inferior quality. We have also observed that imported products have been making strong in-roads in the

[22] Government reduced federal excise duty on automobiles and electronic items in FY12 budget.
[23] Rechargeable fans and energy saving bulbs are not manufactured locally despite huge demand.
[24] Import of used clothing has increased from around US $ 128.6 million in FY11 to US$ 148.0 million in FY12.
[25] Despite a strong agri-base and a large grain milling industry, Pakistan imported US$ 91.3 million on import of pastas, cereals and other prepared food of flour, starch and milk during FY12. Similarly, Pakistan spent some US$ 14.2 million on fruit juices; and another US$ 17.7 million on prepared stuff of vegetables and fruits during the year.

domestic market for apparel, footwear, articles of home décor like ceramic tiles, furniture, kitchen gadgets, tableware and sanitary fixtures.

With vibrant domestic demand and awareness of product offerings, local manufacturers of consumer products should upgrade not just their manufacturing units but also strategize about how to position themselves. In fact, reclaiming the domestic market should be a goal, especially when global market conditions appear unfavorable. This is easier said than done. The persistent energy and security issues have dented what would otherwise have been a lucrative environment and incentive for investment. These issues must be resolved to fill competitiveness gaps, and make this consumption-led growth more sustainable and welfare enhancing.

2.4 Services

The services sector contributed over 55 percent of GDP growth in FY12. Unlike FY11, when a large increase in government salaries and flood-related social spending led the growth in services, the performance in FY12 marks an improvement in almost all sub-sectors.[26] Nonetheless, the absence of the aforementioned factors has pulled down growth in services to 4.0 percent during FY12, from 4.4 percent in FY11 (**Table 2.9**).

Table 2.9: Contribution in Services Sector Growth

percent

	Growth			Contribution	
	FY11	**FY12[T]**	**FY12**	**FY11**	**FY12**
Growth in services	4.4	5.0	4.0	4.4	4.0
Wholesale & retail trade	3.5	5.0	3.6	1.1	1.1
Transport, storage & communication	0.9	4.5	1.3	0.2	0.2
Finance & insurance	-1.4	0.2	6.5	-0.1	0.6
Ownership of dwellings	1.8	3.5	3.5	0.1	0.2
Public admin. & defence	14.2	6.0	2.6	1.8	0.3
Community, social & personal services	6.9	7.0	6.8	1.6	1.6

T: Target

Source: Pakistan Bureau of Statistics

After declining for three consecutive years (FY09-FY11), the value addition in *finance and insurance* rebounded strongly in FY12 (**Table 2.10**). Besides commercial banks, insurance companies and pension funds also contributed to this resurgence. Specifically, substantial profits earned by heavily investing in risk-free government securities, propped up the value addition of this sub-sector.[27] Commercial banks also benefited from the slowdown in the incremental stock of non-performing loans, and some ease in provisioning requirements by SBP.[28] Finally, the strong growth in SBP profits also supported value addition in this sector (**Table 2.10)**.

Table 2.10: Contribution to Value Addition in Finance & Insurance

percent

	Growth		Contribution	
	FY11	**FY12**	**FY11**	**FY12**
Finance & insurance	**-1.4**	**6.5**	**-1.4**	**6.5**
SBP	-3.4	6.7	-1.1	2.1
Other depository corporations	-0.6	1.4	-0.3	0.7
Other financial intermediaries	0.1	6.4	0.0	0.5
Insurance and pension funds	-0.2	28.7	0.0	3.3

Source: Pakistan Bureau of Statistics

The growth in *wholesale and retail trade* remained almost unchanged from the previous year. The improvement in manufacturing, along with continued expansion in the hotel industry, supported growth in this sub-sector (**Table 2.11**).

[26] Within services, *public administration and defence* was the only sub-sector that recorded a sharp slowdown from a peak of 14.2 percent in FY11 to a mere 2.6 percent in FY12. This slowdown, mainly reflecting absence of government salary increase and flood-related social spending in FY12, is not alarming. The value addition by public administration & defence is mainly based on wages & salaries of government employees (i.e., for federal, provincial, and district and *tehsil* municipal administration) and expenditure on defence related activities.

[27] To put things into perspective, the investment-to-advances ratio for commercial banks, which was 77.4 in June 2011, was around 92 percent in June 2012. Since these risk-free assets do not attract capital requirement, the compositional shift in assets has significantly improved banks' profitability.

[28] In November 2009 and October 2011, the SBP eased provisioning requirements for banks by relaxing rules related to forced sale value of collaterals.

The steady increase in the number of hotels and restaurants over the past few years is in response to rising demand, which reflects higher disposable income and the growing informal economy (see **Chapter 4**). In fact, the emergence of a number of shopping malls and supermarkets in the large urban centers of the country, points toward a major shift in the trading business. These trends should help shore-up Pakistan's baseline commercial activities.

Despite the sustained losses in Pakistan Railways and PIA during FY12, value addition in *transport, storage & communication* witnessed a marginal increase due to oil transport (via pipeline) and the telecom sector (**Table 2.12**).[29] While plans to improve the financial conditions of these two public sector enterprises (PSEs) have been under discussion for some time, urgent and concrete steps are needed to limit the resource drain through these entities (**Box 2.2**).

The value addition in the telecom sector increased by 0.9 percent during FY12, compared to a 11.6 percent decline recorded in FY11. Available data shows an increase in telecom revenues during Jul-Mar 2012, particularly from cellular operation (**Table 2.13**). We understand that while intense competition among firms has constrained average revenues per user, a steady increase in the usage of telecom services is supporting revenues. Importantly, total tele-density in the country has more than doubled to 72.1 percent in May 2012 during the last six years.[30]

Table 2.11: Percentage Point Contribution to Real Growth in Wholesale and Retail Trade

percent

	FY11	FY12
Wholesale and retail trade	**3.5**	**3.6**
Crops	-0.1	-0.2
Other agriculture	0.4	0.4
Manufacturing	1.4	1.7
Imports	0.1	-0.2
Hotels and restaurants	1.8	1.9

Source: Pakistan Bureau of Statistics

Table 2.12: Contribution to Growth in Transport, Storage and Communication

percent

	Growth		Contribution	
	FY11	FY12	FY11	FY12
Transport storage & communication	**0.9**	**1.3**	**0.9**	**1.3**
Pakistan Railways	178.5	-73.3	-0.35	0.40
Water transport	-1.7	-3.1	-0.05	-0.09
Air transport	17.4	-27.9	0.85	-1.58
Pipeline transport	-2.7	34.6	-0.01	0.16
Communication	-11.6	0.9	-1.71	0.12
Road transport	2.8	2.9	2.09	2.18
Storage	2.1	2.1	0.06	0.06

Source: Pakistan Bureau of Statistics

Table 2.13: Telecom Sector Revenue Growth

percent

	Cellular	Other	Total
FY08	36.8	-5.9	18.2
FY09	16.6	26.0	19.9
FY10	11.1	-11.4	3.1
FY11	11.3	-6.9	5.4
FY12*	14.2	4.4	13.6

* Jul-Mar

Source: Pakistan Telecommunication Authority

[29] Pipeline transport registered a 34.6 percent increase in FY12, compared to a 2.7 percent *decline* recorded in FY11. Higher fuel imports largely explain this sharp reversal. The value addition came from transporting this imported petroleum (via pipelines) from Karachi to the northern parts of the country.

[30] The tele-density was just 26.3 percent at the end of FY06.

Box 2.1: Progress of Reforms in the Transport Sector PSEs

While efforts to introduce reforms in PSEs are still underway, the operational efficiency of these loss making entities showed no improvement during FY12. Specifically, in 2011, Pakistan Railways repeated the operational loss of the previous year. Likewise, the 2010 operational surplus for PIA turned into a large deficit in 2011. Hence, the financial distress of these entities continue to drain government's resources during FY12 as well (**Figure 2.1.1**).

The Cabinet Committee on Restructuring (CCOR), working since 2010, has already finalized various structural reforms. The key pillars of the restructuring plans are:

a) Improving governance structure;
b) Achieving financial sustainability;
c) Undertaking operational restructuring;
d) Promoting private sector participation; and
e) Introducing supportive legal framework, if needed

Though comprehensive, these reforms need to be implemented urgently, as any delay would only aggravate the financial losses of these entities and, hence, increase the fiscal burden for the government.

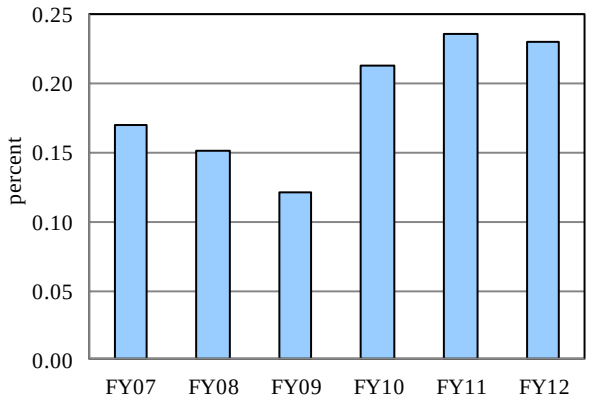
PIA

After achieving a nominal operating surplus during 2010, PIA recorded huge operating losses of Rs 17.9 billion during 2011. A sharp increase in international oil prices and faltering demand for air travel contributed to the lackluster performance of PIA during 2011.

In addition, poor governance and slower implementation of reforms added to financial distress of PIA. The resulting shortage of funds even delayed availability of spare parts. The operational tasks become more complicated as the average age of aircrafts is significantly higher compared to other airlines (**Table 2.1.1**).[31] Hence, not surprisingly, out of a scheduled fleet of 39 aircrafts for 2012, a large number of aircrafts are not operational.

To improve its operations and financial position, PIA is developing its Business Plan in consultation with the Ministry of Finance since 2010. At the same time, five Boeing-777 aircrafts are being acquired. However, the key reforms (for example, restructuring of PIA's Board of Directors, rationalization of human resource, etc.) are still pending. More importantly, the implementation of reforms becomes challenging due to frequent changes in the leadership.

Figure 2.1.1: Fiscal Burden of Transport Sector PSEs as percent of GDP



Source: Ministry of Finance

Table 2.1.1: PIA Active Fleet Details

Aircraft	Number of planes	Average age in years	Rank by Age	
			Pakistan	Among
Boeing 737	6	26	200	284
Boeing 747	5	25.9	71	92
Boeing 777	9	6.7	30	60
Airbus A310	12	19.7	7	33
ATR 42	7	5.8	41	157
Memorandum items				
PIA	39	16.2 years		
Emirates	178	6.4 years		
Air India	100	8.8 years		

Source: PIA and airfleets.net

Table 2.1.2: PR - Financial Summary

billion Rupees, growth in percent

	FY09	FY10	FY11	FY12
Revenues	**23.2**	**22.1**	**17.5**	**15.0**
growth	*14.6*	*-4.6*	*-20.8*	*-14.3*
Expenditure	**46.2**	**47.1**	**48.6**	**45.4**
growth	*71.2*	*1.9*	*3.2*	*-6.7*
Operating expense	14.5	15.5	14.6	14.0
Other expenses	31.7	31.6	34.0	31.4
Repair & maintenance	9.9	10.1	11.8	12.0
General admin	3.7	4.3	5.5	6.1
Profit /loss	**-23.0**	**-25.0**	**-31.1**	**-30.4**

Source: Ministry of Railways

Pakistan Railways

While revenues of Pakistan Railways (PR) continue to decline during FY12, a slight improvement in operating expenses led to a marginal decline in operating losses, which fell from Rs 31.1 billion in FY11 to Rs 30.4 in FY12 (**Table 2.1.2**).

As a part of the restructuring process, various reforms were initiated in PR during FY12. These included: (i) the formation of new Board of Directors (BoDs), which started working after the amendment of the Railway Order; (ii) financial assistance

[31] Average fleet age of PIA is 16.2 years, one of the highest in the region (e.g., Thai Airline, Emirate Airline and Air India)

from the banking system for the rehabilitation of locomotives;[32] (iii) the establishment of an asset management company for optimum utilization of PR's assets; (iv) the outsourcing of non-core functions (e.g., ticketing operation) is also in the pipeline, with an aim to improve efficiency of rail operations; and (v) private sector trains (after the start of Business Express operations, etc.) to enhance public-private partnership.

In addition, the government has allocated funds to procure locomotives, improve track and signal system. At the same time, National Logistics Cell (NLC) is also in the process of procuring reconditioned locomotives from Korea Rail for freight trains.

Despite these reforms, the dwindling strength of locomotives kept hampering revenue generation capacity during FY12 (**Table 2.1.3** & **Table 2.1.4**). The number of passengers plunged to 25.0 million in Jul-Feb 2012, from 64.9 million in FY11. Similarly, freight operations also witnessed a drastic reduction from 2.6 million tons of cargo during FY11 to a mere 0.9 million tons during Jul-Feb 2012 (**Table 2.1.4**).

Table 2.1.3: PR's Locomotives Strength

in numbers

	FY10	FY11	FY12
Total owned	536	521	510
Active on passenger	187	169	124*
Active on freight	95	40	10
Repairs	12	-	-
Purchases	-	-	-

* This number includes 34 locomotives involved in shunting and balancing operations[33]

Source: Pakistan Railways Headquarter

Table 2.1.4 : Pakistan Railway Operations

millions

	FY10	FY11	FY12 (Jul-Feb)
Number of passenger carried	74.9	64.9	25.0
Freight carried tons (Rs)	5.8	2.6	0.9
Freight tones km (Rs)	4,846.9	1,757.3	279.3

Source: Pakistan Economic Survey 2011-12

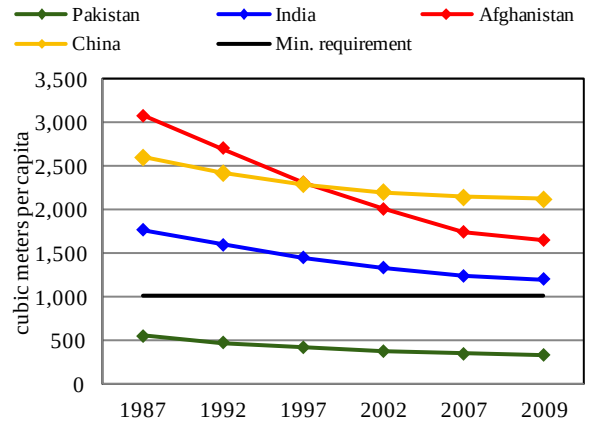
The fiscal cost of such operational setback is huge: the government provided Rs 30.5 billion as subsidy during FY12, against a targeted amount of Rs 25.0 billion.[34] This was in addition to Rs 9.9 billion provided as a PSDP grant to PR during FY12. To plug this continuing resource drain, the government must speed up the restructuring process.

[32] These funds have not been disbursed to PR yet.
[33] Shunting and balancing operations, involve the process of sorting items of rolling stock into complete train sets.
[34] Importantly, a large part of this amount was provided for the payment of salaries and pensions.

Special Section 2.1: Water Scarcity: Issues and Options in Irrigation Water Governance

With increasing scarcity, the irrigation water– which claims 94 percent of the total water supply in the country – is also coming under stress.[35] According to the World Bank, Pakistan is one of the most arid countries in the world, having the lowest per capita freshwater supplies in the region - less than half the global benchmark of 1000 cubic centimeters (**Figure S2.1.1**). On top of it, the declining water supply through canals has led to heedless rise in tube-wells,[36] which is fast depleting the underground water-table.

Figure S2.1.1: Per Capita Freshwater Supply

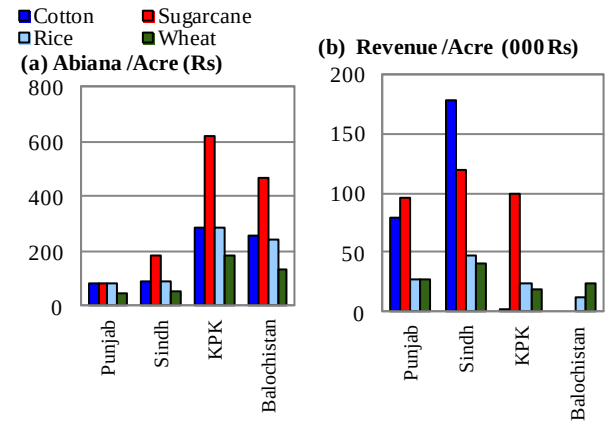


Source: World Bank

Several factors contribute to growing water shortages. The flows through Indus River – the primary source of freshwater supply – are shrinking as climatic changes, along with rapid population growth and increased water diversion to hitherto un-irrigated areas, are adding to demand pressures.[37]

The distinct cycles for water demand and supply also add to the difficulty. Specifically, while supply peaks during summer because of monsoon rains and glacier melting, demand is spread over the year; hence, without storage, excess water simply runs off into the sea. Hence ironically, over 40 percent of the water that flows through the Indus River in Pakistan is lost each year:[38] transpiration and seepage through the *kachchi* canals and tributaries (unlined with brick and concrete) account for part of this loss; the rest flows out to sea simply because we do not have enough dams.

Figure S2.1.2: Abiana and Revenue Comparison



Source: www.wfp.org/food-security

While any increase in water supply has physical limitation, a better management can always ease such shortages to some extent. The immediate focus can be on: (i) prudent supervision of existing water resources (i.e., recovering bills, controlling theft, building storage, controlling seepage, and encouraging water efficient irrigation technologies); (ii) financial sustainability of irrigation agencies in the government; this will enable them to bear regular repair and maintenance costs; and (iii) an increased awareness of the real cost of water.

Financially sustainable supply

To a large extent, problems in Pakistan's water supply have their roots in a public goods supply model – similar to that in the power sector. In a nutshell, the resource is under-priced (dis-incentivizing

[35] World Bank is the source for data on annual water withdrawal.
[36] Over the past decade, the number of tube-wells has grown by 52 percent, reflecting an addition of 0.4 million tube-wells.
[37] The first phase in the construction of three major canals (Rainee, Kachchi, and Greater Thal) will be completed by Q4-FY13.
[38] Hussain, et al., 2011.

conservation and efficient use); the transmission system is replete with line-losses; and low cost recovery and heavy subsidies have led to persistent losses, crumbling the finances of supplying agencies.[39] An obvious outcome is that there is an absolute dependence on the government and foreign financial institutions for funding new investments, while regular support is also sought to meet the running costs.[40] With low foreign funding and growing fiscal constraints, the irrigation water supply system suffers from massive underinvestment in Pakistan.[41]

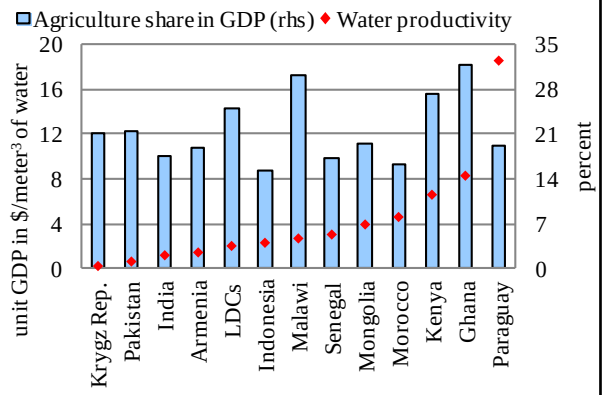
Hence, cost recovery becomes an important issue in irrigation water governance. The 'right' price of water fully recovers supply costs (operational and capital), and also places a value on the resource (the opportunity cost of supplying water to that user, and the economic and environmental externalities).[42] A price that is based on these principles ensures financial and environmental sustainability. While full cost recovery from irrigation may not be possible in a country with rural poverty as high as in Pakistan, at least the supply costs need to be completely recovered with a long-term vision to move towards full recovery.

Unfortunately in Pakistan, we are not even close to recovering supply costs. Irrigation water tariff (*abiana*) is extremely low, accounting for less than 0.5 percent of the crop revenue in Punjab and Sindh (**Figure S2.1.2**). Even with these low rates, average revenue collected is just 60 percent of the total receivables. Thus, the collected revenues cover merely one fourth of the annual operation and management (O&M) costs.[43]

To achieve financial sustainability, the system needs a massive overhaul, beginning with a large upward revision in tariffs. Encouragingly, the government is already working along this line. This year, the Planning Commission came up with an extensive study on Canal Water Pricing in Pakistan.[44] The study recommends full recovery of O&M costs, and suggests that tariffs should reflect water scarcity.

Secondly, volumetric use should be accounted for and the tariff rate should increase with consumption. Currently, a flat rate is charged per unit of area cropped, which means that small and large landholders are charged by the same proportion. Graduating the tariff structure with increasing consumption will put a tax on large landholders, and can also be used as a mechanism for cross-subsidizing supply costs for small farmers.

Figure S2.1.3: Water Productivity in Similar Income Countries with a Strong Agricultural Base



Source: World Bank database.

Tariffs and efficiency

Low tariffs result in high inefficiency in the use of water. Hence, flood irrigation, the most common irrigation method in Pakistan, is highly water inefficient. The sown field is completely inundated, with water being subject to continuous evaporation, while exposure to

[39] According to the Planning Commission (2012), receivables from irrigation water supply cover only 24 percent of the supply cost.
[40] Usually provincial governments provide financial support to irrigation departments; in FY12, Punjab, Sindh and Khyber Pakhtunkhwa together provided Rs 17.3 billion to cover deficits in irrigation system.
[41] In the federal budget of FY13, capital expenditure on water claimed 10 percent of the total PSDP outlay (Rs 44 billion). This was in addition to PSDP allocation of Rs 27.8 billion by four provinces.
[42] Rogers, P., Bhatia, R., and Huber, A. (1998), Global Water Partnership.
[43] Planning Commission, 2012.
[44] See reference number 5 to this article.

excess moisture can even reduce crop yield. Not surprisingly, Pakistan has one of the lowest rates of water productivity compared to similar income countries with a strong agriculture base (**Figure S2.1.3**).[45] More worryingly, farmers have no incentive to shift from this inefficient irrigation method.

The solution is to invest in micro-irrigation methods, such as drip and sprinklers. Although such methods require an expensive outlay of pipes and electricity to pump water, the costs are not entirely prohibitive: India and Nepal have successfully introduced low-cost drip technology on large-scale. The government of Pakistan also introduced a drip and sprinkler irrigation scheme through which the system could be installed at a low cost;[46] however, any tangible impact is not yet visible. With a bleak water situation in the medium-to-long run, technology adoption needs to be expedited.

Plugging water wastage

Although water conservation through tariff rationalization is important of its own accord, a tariff increase will only be acceptable if the government can put the water thus saved to a better use. Specifically, farmers may be willing to pay higher tariffs only if off-season water supply is guaranteed.

Dam construction has remained a priority area for all governments, but the construction of mega projects, e.g., Diamer Bhasha dam, has been delayed due to lack of funding. One point of view, propagated by a group of water experts, economists, and environmentalists, is that smaller dams might be a better solution in the backdrop of Pakistan's fiscal constraints.[47] In any case, we need to find a solution to this imbroglio before our water resources run dry.

Summing up

Both supply and demand management are interlinked. Traditionally, governments in Pakistan have responded to scarcity issues in the provision of public utilities by augmenting supplies, without placing a meaningful price on the good. As a result, expensive new projects do not break-even, adding to the fiscal burden. On the other hand, a tariff increase will only be acceptable when the government ensures better service delivery against it: augmenting storage to balance out off-season shortages, and controlling seepage.

Without simultaneously tackling the two issues, the vicious cycle of chronic losses, under-investment, and debt-build-up will go on unceasingly.

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[45] Water productivity, as defined by the World Bank, is the GDP produced per cubic centimeter of freshwater withdrawal.

[46] http://www.presidentofpakistan.gov.pk/index.php?lang=en&opc=5&sel=9

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Special Section 2.2: Inefficiency and Inequality, not Shortage, behind Food Insecurity in Pakistan

In the book "Poverty and Famines: An Essay on Entitlement and Deprivation", Nobel Laureate Amartya Sen gave a novel perspective on the Great Bengal Famine of 1943. Sen argued that it was not the shortage of food, but the lack of entitlement, or access to an adequate amount of food, that led to the large-scale starvation.

It is now a universally accepted idea that shortage is only one of the many facets of food security. In 1996, the World Food Program adopted the following definition of food security (FS): "People are considered food secure when they have an all-time access to sufficient, safe, nutritious food to maintain a healthy and active life".[48] Thus, along with availability of food, the concept of FS also entails physical and economic access, as well as enabling health and environment required for the proper utilization of food. **Table S2.2.1** gives a snapshot of these so-called 'three pillars' of FS.

Table S2.2.1: The Three Pillars of Food Security

Availability	Access	Utilization
Production and storage	Resources to buy food	Good health to ensure absorption
Ability to import	Physical access	Adequate water & sanitation

Based on the World Food Program's concept;
Source: www.wfp.org/food-security

However, economic policies in Pakistan have for a long time focused only on increasing food production. Input subsidies (fertilizer, water, and electricity), fertilizer import, subsidized credit, seed distribution, crop procurement, crop price setting, tractor schemes, among others, are all efforts geared towards encouraging crop production – wheat claiming most of the benefits.

As a result, while the total food production in Pakistan is not a cause of food insecurity, wastage and lack of access has left a large part of the population food insecure. A recent global rating of country food security ranked Pakistan 75th out of 105 countries sampled, substantially below regional countries like India (ranked 66th), Sri Lanka (63), Vietnam (55), China (39), and Malaysia (33).[49,50]

Production is not the problem

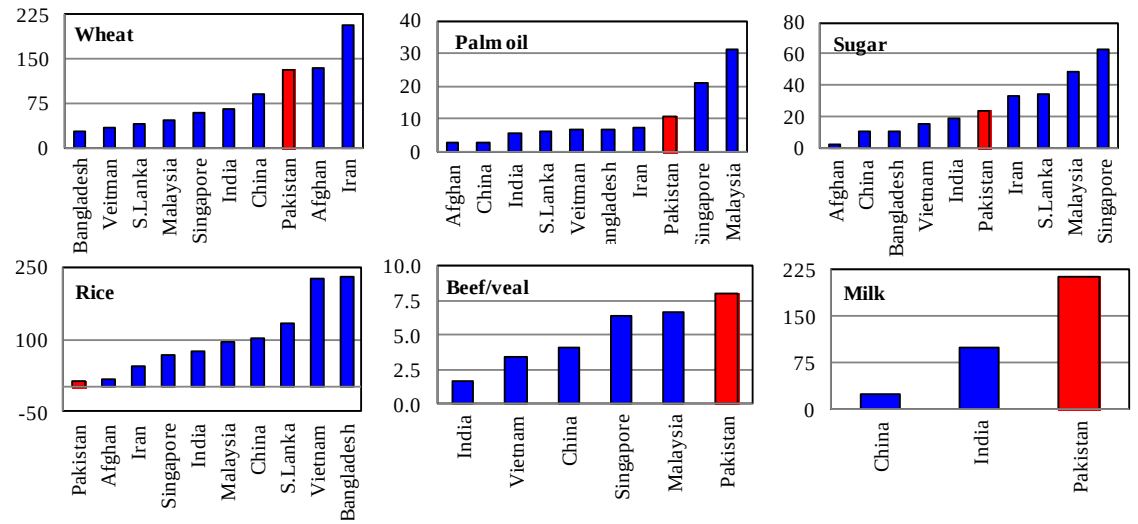
A glance at average per capita consumption of key food items in regional countries illustrates that lack of food is certainly not the problem in Pakistan (**Figure S2.2.1**). In terms of food available for consumption (domestic production adjusted for inward and outward trade), Pakistan ranks higher than many regional countries, even surpassing countries like India, China, and Sri Lanka, which rank higher on the overall food security index.

Two facts explain this anomaly:

(i) **Wastage:** The total "consumption" number measures food available at source (such as grain available at the farm gate and landed quantity of imports). It lacks information about food wasted due to improper storage, mishandling, and smuggling. The Competitiveness Support Fund (CSF) in 2008 estimated that Pakistan annually loses 15 percent of its wheat crop due to improper handling: 5 percent of the grain is lost immediately after harvest, while another 10 percent is destroyed by moisture and poor handling of flour.[51]

[48] Definition adopted at the World Food Summit. http://www.wfp.org/food-security
[49] The index developed by Economist Intelligence Unit (EIU), of the Economist magazine, was released in August 2012.
[50] On an absolute scale, Pakistan's FS index value is 6.6 percent below that of India, the lowest ranking country among the group cited.
[51] Bastin and Kazmi (2008).

Figure S2.2.1: Annual Per Capita Consumption of Major Food Commodities in 2011 (kgs/capita) - Regional Comparison

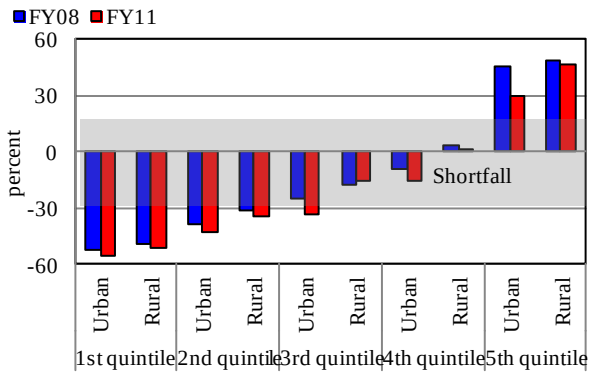


Source: Consumption data from US Department of Agriculture (World Agriculture Statistics), except milk production in Pakistan (Pakistan Agriculture Statistics) is used as consumption proxy. Consumption is adjusted for population (World Bank database).

Lack of proper storage is also a major cause of food wastage. Although hard numbers on national (public and private) storage capacity is not available, provincial storage capacity information is insightful. For example, Punjab and Khyber Pakhtunkhwa, which together produced around 19 million MT of wheat in 2011 (75 percent of national production), have a combined public storage capacity of only 2.5 million MT.[52] According to the CSF, 70 percent of the country's total capacity in 2008 comprised of temporary emergency stores[53] – these do not provide adequate shelter from rain or floods.

(ii) **Income inequality:** Not surprisingly, persistent income inequality is one of the key reasons for lack of access to food. Food is costly as it claims 57 percent of income of the lowest four quintiles. Even so, our estimates show that at least 60 percent of population is spending less on food than required for a healthy and active life.[54] The situation has changed little over the past three years. Moreover, data shows that for the lowest income quintiles, the situation is worse in cities than in the rural areas (**Figure S2.2.2**).

Figure S2.2.2: Percentage Difference in Per capita Food Spending over Minimum Requirement



Source: Analyst estimates; based on PSLM and Planning Commission data.

Encouragingly, the government is making efforts towards improving the situation. To address storage issues, the government has undertaken a project to construct 0.5 million MT of storage capacity in Sindh over the next few years. Direct cash

[52] Development Statistics of Khyber-Pakhtunkhwa 2011 and Development Statistics of Punjab 2011.
[53] Bastin and Kazmi (2008)
[54] The calculations were made as follows: (i) average household spending on food by income quintile (from Pakistan Social and Living Standards Measurement Survey, PSLM) was divided by quintile-wise household size (also from PSLM) to obtain per capita spending on food; (ii) minimum cost of (adequate) food basket was obtained from the Planning Commission's Annual Report on "Change in the Cost of Food Basket". This was taken as benchmark; (iii) percentage difference between benchmark spending and actual spending was computed using the standard formula.

subsidies are also being provided under the Benazir Income Support Program (BISP). Indeed, the BISP buffered a large part of the population against poverty in the aftermath of floods.

However, to be food secure in real terms, state efforts should be guided by a vision towards promoting self-reliance and financially sustainable governance. Both these objectives entail similar ideology: (i) that the role of state is not to dole out charity (whether in the form of food stamps or subsidies); (ii) that if subsidies must be given out, they need to be highly targeted and should help the poorest sections become self-reliant in a practical timeframe; and finally (iii) while market forces should not entirely dictate the supply of public goods (like transport lines, ports, and storage), proper investment in, and maintenance of, public facilities is only possible if the relevant government bodies gain some level of financial sustainability. This can be achieved by eliminating untargeted subsidies and promoting efficiencies in the working of the government.

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3 Energy

3.1 Overview

Energy availability in Pakistan has been declining over the last few years, as a result of low investment in the sector since FY03 (FY11 was an exception). The country faced a record shortfall of both power, and natural gas in FY12. Despite several measures taken by the government, prolonged and frequent power cuts not only affected production activities, but also disrupted daily life. Since a detailed analysis of the structure and issues in the energy sector was presented in the Annual Report for 2010-11, this chapter will look specifically at those factors that exacerbated the energy situation in FY12.

At its core, the energy crisis reflects the lack of a coherent policy.[1] Despite a significant increase in energy demand, supply remains a problem due to limited exploration of natural gas and oil; slow progress on Thar coal; meager investments in port infrastructure for energy imports; and insufficient fiscal resources to maintain Pakistan's generation capacity at optimal levels. On the demand side, subsidized energy has reduced incentives for conservation, and has actually encouraged inefficient consumption.

Although the government has undertaken several measures to encourage energy conservation over the last few years, these have focused primarily on electricity. In particular, energy audits were conducted in a few industries; a two-day weekend was introduced; daylight savings were implemented; and a media campaign was launched to conserve electricity. However, no efforts were made to encourage households to conserve natural gas; as a result, excessive consumption of gas by households continues unabated.

In the last couple of years, a continuous increase in international oil prices has seen power generation costs soar.[2] Meanwhile, delays in subsidy payments by the government, and inadequate recovery of electricity bills from consumers, have held the sector hostage to a growing *circular debt*. Despite a settlement of Rs 313 billion by the government in November 2011, net circular debt receivables reached Rs 382 billion by 27th July 2012. This forced power plants to remain idle due to lack of fuel supplies, and was the primary reason for the power cuts the country experienced. Inefficiencies of energy-related PSEs; mis-governance; theft; high transmission losses; and low recoveries (current as well as receivables), only added to the problem.

In the case of natural gas, a gross mispricing of the resource has led to excessive consumption and underproduction – resulting in the current shortage. Gas supplies to all sectors (industry, power plants and CNG stations) – with the exception of households – remained erratic throughout the year. This is largely because the current gas allocation framework, prioritizes households that consume almost double the amount of *energy* in the form of gas than electricity.[3] Most of this is simply wasted, and leaves behind little for other productive uses – notably power generation.

In our view, the current state of the energy sector is unsustainable. While years of suppressed tariffs and public sector control of the energy supply chain, have fostered a public expectation of *cheap* energy, the dominance of public sector firms and weak governance has undermined a transition to

[1] For instance, in the past few power policies, there has been a clear focus that the country must shift towards using indigenous resources such as hydel and natural gas. However, the subsequent pricing of these resources for alternate purposes (such as irrigation and household heating) does not appear to reflect this priority.
[2] Electricity tariffs were increased by an average of roughly 14.0 percent in FY12.
[3] Households consumed roughly 5.4 million tons of oil equivalents (TOE) of energy in FY11 in the form of gas, compared to only 3.0 million TOE in the form of electricity.

commercial viability. While the government must continue encouraging investments in alternative sources of power (e.g., wind, solar etc.), capacity expansion in conventional fuels is the only longer-term solution. In the meantime, energy conservation must be encouraged in order to manage the demand-supply gap. In our view, this would require rationalization of electricity *and* gas prices – particularly for households.

3.2 Electricity

While the power sector has been facing serious challenges over the past few years, FY12 proved to be particularly difficult. During the year, electricity supply was inadequate to meet rising demand: load-shedding worsened as the country experienced a record peak shortfall since the power crisis began.[4]

Table 3.1: PEPCO Electricity Generation

GWh

Fuel	FY10	FY11	FY12
Gas	19,368	22,998	23,421
HSD	827	422	1,473
Hydro	24,915	31,958	28,462
Nuclear	1,883	2,930	4,413
RFO	30,913	31,253	30,631
Others	1,081	922	1,097
Total	**78,987**	**90,482**	**89,688**

Source: CPPA; Analyst estimates

This situation was worsened by circular debt related cash-flow problems that forced generation capacity in Independent Power Producers (IPPs) to remain idle; furthermore, a decline in hydel generation because of lower water availability in key reservoirs, added to the seasonal gap that hydel would otherwise have filled. In response to the seasonal shortage, the government has been taking several steps to augment hydel power generation in the country (e.g., the 4th extension of Tarbela, Mangla Dam Raising Project, as well as construction of a number of smaller dams, such as Gomal Zam Dam).

3.2.1 Power Generation and Load Management

As *circular debt* continues to choke cash-flows across the power supply chain, liquidity constrained power plants were forced to remain idle (or produce below capacity) because of their inability to procure fuel (see *Circular Debt* below).[5] As discussed earlier, *peak load management* for the Pakistan Electric Power Company (PEPCO) system has risen sharply (**Table 3.1** & **3.2**).[6] According to NEPRA's annual report for FY12, at the height of the crisis, urban centers witnessed power outages of 9-10 hours in urban areas, and rural areas witnessed outages of 16-18 hours.

In Karachi, which is supplied by the privately-run KESC, generation was also lower in FY12 compared to last year; however, the situation was quite different from the rest of the country. KESC adopted the strategy of loss-segmented load-shedding, which means the duration of power outages in a particular area depends on the recovery of bills from that area. In effect, outages were minimized

Table 3.2: Trend in Peak Electricity Demand, Generation and Load Management for the PEPCO System

MW

	FY07	FY08	FY09	FY10	FY11	FY12
Peak demand load	15,838	17,398	17,852	18,467	18,521	18,940
Peak generation load	13,645	14,151	14,055	14,309	14,468	15,062
Peak load management	2,645	5,454	7,018	6,408	6,151	8,393
percent of peak demand	*16.7*	*31.3*	*39.3*	*34.7*	*33.2*	*44.3*

Source: NTDC; Analyst estimates

[4] The peak shortfall for the PEPCO system has risen from 2,645 MW in FY07 to 8,398 MW in FY12.

[5] Anecdotal evidence suggests that although the daily furnace oil requirement for power generation is in excess of 30,000 tons, at certain times during the year, oil companies were forced to ration less than a third of this amongst power producers; since circular debt had affected imports.

[6] Load management is the process of balancing the supply of electricity on a network with the demand by adjusting, or controlling, the *load* (demand) rather than output of the power station. Peak in this case, refers to the *maximum* adjustment made at a particular point in time.

for areas where bill collection was high. Furthermore, the fuel mix improved, as the share of generation from gas was increased (**Table 3.3**).

Table 3.3: KESC* Electricity Generation

GWh

Fuel	FY11	FY12
Gas	5,222	5,901
RFO	4,142	3,061
Total	**9,364**	**8,962**

* including IPPs
Source: KESC

KESC has also reduced transmission and distribution losses to 29.6 percent for Q3-FY12, compared with 31.2 percent last year. Going forward, capacity expansion projects, such as the recently commisioned 560 MW Bin Qasim (BQPS-II) Combined Cycle Plant, should improve the power situation in the city.

3.2.2 Circular Debt

As discussed, *circular debt* was the main cause of the lengthy power cuts the country experienced during the year. Essentially, the term refers to cash-flow problems in the power sector that arise due to the factors like non-payment of electricity bills by consumers (public and private), transmission losses, and delays in subsidy payments (see **Box 3.2** for details). This build-up of unpaid bills (or *receivables)* at the distribution stage, then cascades across the power supply chain and constrains the ability of power plants to make timely payments to fuel suppliers. Fuel shortages, in turn, result in idle power generation capacity, and exacerbate load-shedding in the country.

Table 3.4: Distribution of Circular Debt Receivables

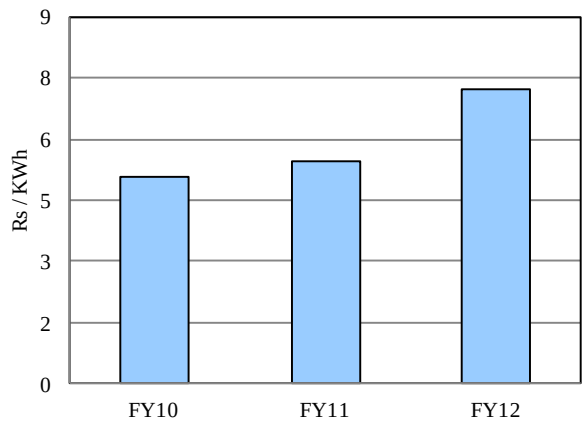
billion Rupees

Company	Receivables	Payables	Net Position		Change
			27-Jul-12	29-Jul-11	
PSO	189	51	138	57	81
SSGCL	74	47	27	8	19
SNGPL	36	11	25	7	18
PEPCO	383	478	-95	38	-133
OGDCL	174	0	174	101	73
PARCO	25	0	25	22	3
KESC	115	69	46	19	27
GHPL	12	0	12	9	3
PPL	32	0	32	16	16
KW&SB	7	8	-1	-1	0
Total	**1046**	**664**	**382**	**275**	**107**

Note: Figures may not sum due to rounding.
Source: Ministry of Finance

These problems worsened in FY12. By 27th July 2012, net outstanding receivables in the power sector had increased to Rs 382.5 billion from Rs 275.1 billion a year ago (**Table 3.4**).[7] Non-payment of their dues for the sale of electricity prompted some IPPs to invoke sovereign guarantees under their Power Purchase Agreements (PPAs), and approached the Supreme Court in June 2012 for a resolution of their overdue payments.[8] This was despite government efforts to ease liquidity constraints in the sector by swapping power sector debt held by commercial banks during the year (see *Management of Circular Debt* below).

Figure 3.1: Fuel Costs for Electricity Generation



Source: Central Power Purchase Agency; Analyst estimates

[7] The net outstanding position refers to the difference between total receivables and payables.
[8] These include eight IPPs set up under the 2002 Power Policy. Sovereign guarantees were provided by the government in order to promote private sector participation in the power sector. Essentially, these are undertakings by the guarantor (the government) to pay if the creditworthiness of the institution (e.g., PEPCO/NTDC) deteriorates.

In addition to the above factors, delays in the notification of monthly Fuel Price Adjustments (FPAs) added to financial pressures in the power sector (for details on FPAs, see **Box 3.1),** as average fuel costs of electricity generation rose by almost a third compared with last year (**Figure 3.1**).[9]

Box 3.1: How are Power Tariffs Determined?

Keeping in view the recent public reaction to tariff changes, we find it useful to provide an overview of the determination of tariffs in the power sector. In order to understand electricity tariffs, consider the three main stages in the power supply chain: (i) generation; (ii) transmission; and (iii) distribution. Electricity tariffs paid by consumers are essentially a sum of production costs incurred and a fixed rate of return (margin) for firms at each stage. These are approved by the power sector regulator, the National Electric Power Regulatory Authority (NEPRA). At the end of the supply-chain (distribution), the government provides a subsidy to ensure uniform tariffs across the country (PEPCO system), and notifies the final consumer tariff. The following provides a generalized overview of this process:

Generation

Power plants that produce electricity (e.g., IPPs, private; and GENCOs, Wapda Hydel, etc., public), have Power Purchase Agreements (PPAs) with a single purchaser, the National Transmission and Dispatch Company (NTDC). This PPA specifies a two-part tariff structure which includes (i) *Capacity Charge*: to cover the fixed costs of maintaining power plant capacity (e.g., operating and maintenance expenses (O&M), debt servicing, and return on equity, etc.) that are to be paid regardless of dispatch; and (ii) *Energy Charge*: to cover variable costs, mainly fuel (based on a benchmark for fuel prices by NEPRA), and variable O&M costs, that depend on the amount of electricity actually sold. Fuel costs above or below the NEPRA benchmark are passed onto consumers as *Fuel Prices Adjustments* (*FPAs*) (see *Distribution* below).

Transmission

NTDC acts as an intermediary: it purchases power from generation companies to sell it onwards to distribution companies (DISCOs). For providing this service, it receives a *Transfer Charge*. This too includes a fixed component (which depends on a particular DISCO's maximum power demand during a billing period); and a *variable charge* which is the average price of electricity procured from the generation companies (adjusted for NEPRA approved power losses incurred during transmission).

Distribution

Each DISCO has a separate tariff approved by NEPRA. This is because in addition to the cost of power procured from NTDC, it includes a *Distribution Margin*. This margin covers the costs associated with use of the DISCO's infrastructure (e.g., O&M expenses, depreciation, return on assets, etc.), and an adjustment for power losses incurred during distribution. Since these losses vary widely across DISCOs, this would mean that consumer tariffs too would vary across the country. However, in order to ensure uniform consumer tariffs across the PEPCO system, at this stage the government provides an *Inter-Disco Tariff Differential Subsidy (TDS).* Therefore, while DISCO tariffs are determined by NEPRA; the rates that consumers pay are notified by the government and were most recently revised in May 2012.

Fuel Price Adjustments (FPAs)

In addition, consumer tariffs are adjusted monthly by NEPRA for variation in generation fuel costs, against approved benchmarks through *Fuel Price Adjustments (FPAs).* These can be driven by variation in the *actual* fuel mix versus NEPRA's *reference* mix (e.g., gas shortages that force power plants to substitute gas with more costly High Speed Diesel); and/or changes in fuel prices on global markets (e.g., furnace oil). Either of these can automatically increase (or decrease) generation costs, and is passed on to consumers through FPAs. These charges appear on consumers' electricity bills separately based on units consumed in the previous month. It was the pass-through of these adjustments that experienced delays during FY12.

Source: NEPRA.

Management of Circular Debt

In order to incentivize banks to continue lending to power sector clients – and keep the supply chain running – the government struck two key deals with commercial banks in FY12. These deals reduced banks' *outstanding* power sector exposure by swapping it for government securities. Essentially an asset adjustment on banks' balance sheets, this entailed a significant cost: the first swap increased the

[9] This was mainly because of the rise in global oil prices (RFO-based generation accounts for around 35 percent of the fuel mix, and its cost rose from around Rs 12/kWh in FY11 to nearly Rs 16/kWh in FY12); a decline in hydel power generation (the cheapest fuel source) due to lower water availability in the dams; and gas shortages due to which some plants shifted to costly alternatives, e.g., HSD.

fiscal deficit by around 1.5 percent of GDP.[10] This swap alone accounts for nearly 45.0 percent of total government borrowings from commercial banks in FY12.

Deal 1: Banks had been lending to PEPCO under government guarantees to offset unpaid tariff differential subsidies. In 2009, the government set up the Pakistan Power Holding Company (PPHC) to acquire PEPCO's outstanding debts. By FY12, banks' exposure to PPHC had risen considerably. In order to encourage banks to continue lending to the power sector, these assets were swapped for sovereign debt. In effect, the government borrowed Rs 391.0 billion from commercial banks by issuing MTBs and PIBs in November 2011, and swapped Rs 313.0 billion (around 1.5 percent of GDP) worth of government securities for PPHC's liabilities. This cleared banks' balance sheets of exposure to the publicly owned power sector and converted it into direct lending to the government.

Deal 2: Even after this, banks still had significant exposure to the IPPs, which had been borrowing from banks for working capital requirements. However, as IPPs exhausted their assigned credit limits (due to delayed payments for the sale of electricity; see **Box 3.2**), banks were unwilling to extend additional loans. As a result, cash-strapped IPPs were finding it difficult to procure fuel to maintain power generation. To address banks' reluctance, in February 2012, PPHC-issued securities worth Rs 136.0 billion, were swapped for bank loans. By freeing used-up credit lines, this created room for fresh bank lending to IPPs. [11,12]

Notwithstanding these efforts, the power sector remains vulnerable to global oil prices given a heavily skewed fuel mix towards thermal generation – particularly imported furnace oil. This burden will have to be borne either by the government through subsidies, or consumers through higher tariffs. Since the government has already spent a total of Rs 464.3 billion (or 2.2 percent of GDP) on power sector subsidies and swap deals in FY12, further financial support in the form of subsidies, is unlikely.[13] Furthermore, as discussed earlier, the bulk of this spending was financed by borrowing from banks. Such borrowings, to keep the power sector running, have implications for commercial banks' operations – it has skewed their balance sheets towards sovereign debt.

As will be discussed later, a possible short-term solution would be to change the fuel mix by diverting some natural gas (as hydel capacities can only be increased in the medium-to-long-term) for power generation. More specifically, we believe there is significant potential for conserving natural gas from other sectors, especially households, and using it for power generation.

The long-run, however, will require a more structural fix, with better governance and management of the power production chain. A few steps have already been taken in this regard, particularly with the formation of new boards of directors in the Central Power Purchasing Authority (CPPA), Quetta Electric Supply Company (QESCO), Sukkur Electric Power Company (SEPCO) and the GENCO holding company. The dissolution of PEPCO was also finalized during the year, and there were management changes in the DISCOs.

Box 3.2: What is Circular Debt and Why Does it Remain Unresolved?

Circular debt in the power sector has emerged as a serious issue in recent years. Despite policymakers' efforts, it continues to pose financial challenges for entities across the power supply chain. It is therefore important to understand what exactly it is; who the key players are; how it affects power generation and load-shedding; and finally, why it appears insurmountable.

[10] See Deal 1.

[11] This section is based largely on discussions with commercial banks. The total amount of the swap was set at Rs 160.0 billion, of which Rs 136.0 billion had been arranged thus far, according to a statement by the Minister for Water and Power, during the 40th Session of the National Assembly held on 14th March 2012.

[12] However, these measures only served to ease liquidity constraints in the power sector temporarily. By March 2012, the situation worsened to the point where IPPs served legal notices to the government for non-payment of their dues.

[13] This includes the Rs 313.0 billion swap in November 2011 as part of Deal 1 mentioned earlier.

Circular Debt is a manifestation of operational inefficiencies and mis-governance.[14] It stems from: (i) higher transmission losses than allowed by NEPRA; (ii) low recoveries from billed amount; (iii) non-payment by public sector entities; (iv) high differential between generation cost and notified tariff; (v) delays and lag in determination of Fuel Price Adjustment by NEPRA, and recovery by DISCOs; (vi) payment of GST upfront on the billed amount; (vii) theft and distribution parked against TESCO and other DISCOs; (viii) delay in release of Tariff Differential Subsidy; (ix) non-recovery of receivables; and (x) abrupt disruptions in gas supply, which increases the cost of generation. Put simply, circular debt refers to a situation where one entity in the power supply chain – having inadequate cash-flows – is unable to discharge its obligations to its suppliers, and withholds payments. This results in cash-flow problems for other players in the sector, none of whom are then able to function at full capacity, causing unnecessary load shedding.

As discussed in **Box 3.1**, payments received by CPPA for the sale of electricity by DISCOs comprise of two parts: (i) consumer bill payments; and (ii) Tariff Differential Subsidies (TDS) by the government. Therefore, if DISCOs do not receive *full* payment for the sale of electricity (due to non-payment of bills by power consumers and/or delays in government subsidy payments) this leads to a buildup of *receivables* at the distribution stage. These receivables then cascade as *circular debt* across the power supply chain (since one firm's payables are its supplier's receivables), constraining electricity generation. To see how, consider a DISCO that is unable to pay NTDC for the electricity it had purchased. This means that NTDC, in turn, is unable to keep up payments to power producers (e.g., IPPs), from whom it purchased the electricity. Consequently, IPPs are forced to delay or withhold payments to Pakistan State Oil (PSO), the fuel supplier.

Faced with persistent delays in payments for the sale of electricity, IPPs become heavily reliant on bank borrowings to maintain plant availability (as required under their Power Purchase Agreements (PPA) with NTDC). However, banks are reluctant to increase their exposure to power sector clients beyond assigned credit limits. This leaves IPPs faced with severe liquidity constraints (as was the case in FY12), and ultimately means that PSO is unable to procure sufficient furnace oil to meet the requirements of the power sector. These fuel shortages, as a result, force power plants to remain idle or produce below capacity. Unsurprisingly, this situation translates into lower power generation, and adds to load-shedding in the country.

During the last 4 years, the government has paid over Rs 1 trillion, and the Ministry of Finance is now current in discharging its obligations towards Tariff Differential Subsidy upto end-August 2012. However, the challenge of circular debt continues because of the structural issues highlighted above. This explains why, even though one-off settlements as seen during FY12 did ease liquidity constraints in the power sector temporarily, the circular debt issue continues to persist.

3.3 Natural Gas

The problems in the power sector can be traced, to a large extent, to issues in the natural gas sector. Predictably, the shortfall of natural gas worsened in FY12, crossing the one billion cubic feet per day (bcfd) mark. At its peak during the winters, gas supply to industry in Punjab had been completely shut off;[15] power plants were receiving less than half of their allocated supply; CNG stations in Punjab remained closed for longer than they were open; and residents complained of frequent gas outages and low pipeline pressures (according to our discussions with gas distribution companies). This year was also the first time that gas supply to CNG stations in Sindh was interrupted due to shortages.

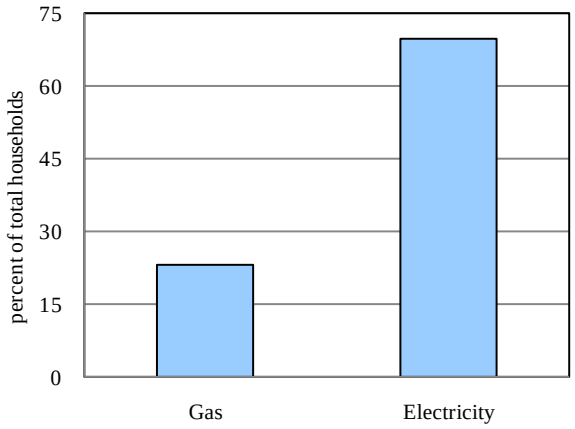
As expected, various industry groups and firms lobbied for natural gas supplies. The current gas allocation framework prioritizes consumers in the following order: (i) households; (ii) fertilizer manufacturers; (iii) power plants with gas supply agreements; (iv) the industrial and CNG sectors; (v) power plants without firm supply commitments (including captive power plants); and lastly, (vi) the cement sector.[16] Gas supplies to all these sectors, except for households, remained uncertain throughout the year as the government attempted to balance demand with existing supply.

[14] According to the Ministry of Finance, the cost of DISCOs inefficiencies is approximately Rs 200 billion, and the value of transmission and distribution losses is around Rs 220-240 billion annually.
[15] This is based on the load management schedules provided by SNGPL on its website. While the decline in industrial production is an obvious consequence, the inability of the government to ensure the stability of contract provisions, especially those backed by sovereign guarantees, has negative implications for attracting investment into the industrial sector.
[16] Natural Gas Allocation and Management Policy, 2005.

3.3.1 The short-term fix: increase households' gas tariffs

In our opinion, the very reason a formal allocation policy exists *is* because of the shortage of natural gas. Like any other shortage, this is, *fundamentally*, due to mispricing. Natural gas has been too cheap for too long, and this has led to overconsumption and underproduction. The most wasteful of natural gas consumers appear to be households.

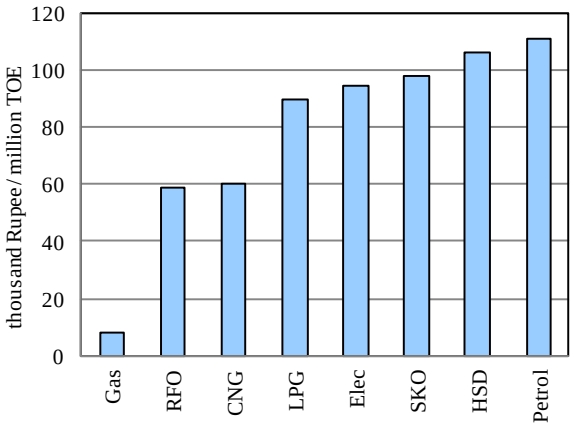
Figure 3.2: Connections in FY11



Source: Energy Yearbook FY11; HIES FY11

In FY11, households consumed 5.4 million tons of oil equivalents (TOE) of energy in the form of natural gas. This is 72 percent *higher* than the amount of energy that households consumed in the form of electricity during the same period.[17] The amount of energy consumed by households in the form of natural gas is equal to roughly 63.2 thousand gigawatt hours (GWh); putting this in perspective, the *total* amount of electricity generated in the country during FY11 was 99.8 thousand GWh. Natural gas consumers also represent a minority in Pakistan: only 23 percent of households have a natural gas connection (**Figure 3.2**).

Figure 3.3: Prices of Various Fuels (July 2012)



Source: NEPRA; OGRA; Analyst calculations

The reason that households use so much gas is straightforward: natural gas is grossly underpriced when compared to other fuels that households consume (**Figure 3.3**). Most consumers do not switch off their geysers after using hot water because the disutility incurred from switching off the geyser is actually greater than the marginal cost of keeping it on (**Box 3.3**).

Box 3.3: Household Heating and Profligate Geysers

Any heating process requires a significant amount of energy. While natural gas heats water directly using a flame, electric geysers work on the same principle as an iron does. Solar heaters simply use the sun's energy to warm water. Electric heaters are the most efficient since all electric energy is transferred to the water, while there are heat losses in solar and gas geysers.

According to industry experts, a 35 gallon gas geyser uses 29,000 BTU/hour. A 1.5 ton air conditioner uses 18,000 BTU/hr. Both appliances, however, have a thermostat, that switches the appliance off when the water/room has reached a certain temperature. A faulty thermostat can result in excess usage of energy. Consumers invest a considerable amount of money to buy energy-efficient air conditioners, but there are no such concerns when it comes to the geyser. In the absence of any quality standards, the informal sector has captured a significant share of the geyser market. Such geysers have insensitive thermostats and are scarcely ever serviced.

The energy wastage here is immense. Once again, consumers do not invest in energy-efficient geysers and are indifferent to quality due to the price of gas. The price of gas must be raised to encourage conservation, and quality standards for appliances must be formulated and strictly enforced.

[17] While electricity is used to power almost all household appliances, natural gas is only used for heating purposes.

In effect, the gas bill for households receiving piped gas is effectively irrelevant – the cost of gas does not impact consumption behavior in a significant manner. This arbitrage has encouraged the use of gas generators in households to the point where it is actually cheaper to power a house using a gas-fuelled generator, than keeping it on the grid. In effect, households take a rational decision by exploiting the differential between gas and electricity tariffs. In the absence of a proper price incentive, efforts to conserve gas by households will simply not happen.

Therefore, from a purely economic point of view, the price of gas to households needs to be increased sharply. Currently, households can reduce their natural gas consumption substantially, without a measurable impact on welfare, just by switching off heating appliances when not in use. The argument is made even stronger by the fact that natural gas is used only by urban households with above average incomes – *not* the common man.[18] Such households are also more likely to be able to afford investments in conservation. In fact, household budgets can actually improve in areas that have the most potential for conservation.[19] Each unit of gas saved by this measure can be diverted to power plants to alleviate the power shortage, decrease the cost of generation and power tariffs, and in turn, improve household budgets.

In our view, a rise in gas prices is not only needed, but also inevitable. As indigenous supplies dwindle, Pakistan will be forced to either import gas or shift away from this energy source altogether. Imported natural gas (through either the pipelines, or LNG) is significantly more expensive than indigenous gas.[20] As the average cost of piped gas increases, the government will have to pass that increase on to consumers – if it does not, it risks the formation of another circular debt scenario in the natural gas supply chain.

3.3.2 The long-run fix: restructure incentives along the value chain

While rationalizing the price of natural gas may re-allocate this resource more efficiently in the short-term, a more sustainable solution will require structural changes. Incentives across the value chain have to be aligned in such a way that encourages exploration and production (E&P), discourages wastage, allocates the resource amongst competing consumers most efficiently, and improves access to the resource.

Incentives for exploration and production

The single most important incentive for E&P companies is the well-head price of natural gas. One of the reasons for the current level of underproduction is the low price that E&P companies realize for their commercial activities.[21] The recently introduced Petroleum Policy 2012 has addressed the issue by raising prices to roughly US $6/mmbtu, but the risk-reward tradeoff may still not be attractive enough to secure meaningful foreign investment. The risks that E&P companies cite as deterrents include security; policy uncertainty;[22] and contract enforcement.[23] Finally, there is no authentic third-

[18] The choice of heating fuel for poorer households is either LPG or firewood. Both are more expensive per unit of energy than natural gas.

[19] Sindh, for instance, accounted for 34 percent of gas connections in FY11 and presents the greatest potential for conservation, given its relatively milder and shorter winters.

[20] The pricing of the pipelines is linked to basket of crude oil. Iran-Pakistan (IP) is priced at 80 percent of a basket of crude oil, while Turkmenistan-Afghanistan-Pakistan-India (TAPI) is priced at 70 percent of a basket of crude oil. To put this in perspective, furnace oil usually trades at a 20 percent discount to crude oil. Thus, the price of imported piped natural gas will be subject to the volatility of oil prices. LNG prices, meanwhile, are trading at an all-time high right now: current prices are slightly below US $20/mmbtu, as compared to tariffs for households, which are currently at US $1-3/mmbtu.

[21] E&P costs in Pakistan are relatively high given that the country's natural gas reserves are found at a greater than average depth, and given problems of terrain and infrastructure.

[22] Petroleum policies have been revised in 1994, 1997, 2001, 2007, 2009 and in 2012.

[23] The last point is particularly relevant for E&P companies, which have to operate on a much longer investment horizon than most other investors.

party estimate of Pakistan's natural gas reserves, which keeps Pakistan under the radar for foreign investors.

Transmission and distribution companies
The incentives for transmission and distribution companies must also be aligned with the long-run needs of the country. Currently, the two gas utility companies, SSGC and SNGPL, are compensated on a return-on-asset basis, after adjusting for gas losses and theft. Thus, these companies have an incentive to expand their network beyond what may be economically feasible. Under the current incentive structure, the utility companies will find it more profitable to serve multiple households than just one bulk consumer, e.g., a power plant. This skewed incentive has worsened the gas crisis as utility companies have increased the number of connections without a commensurate increase in the amount of gas in their pipelines. Therefore, the country needs to move towards a more market-based mechanism for the allocation of natural gas.

While transmission companies may be considered natural monopolies, distribution companies are not, and should be made to compete with each other. Companies along the value chain should be allowed to transact directly with each other, and the government's role in setting prices and quantities needs to be reduced. In fact, given the need for greater energy security, the government should prioritize natural gas conservation, impose efficiency standards for heating appliances, enforce production standards in industries, and facilitate investment by strengthening regulatory institutions.

3.4 The final word: Pakistan's energy mix and the government's role

The current energy situation is not sustainable. Years of suppressed tariffs and public sector control over E&P companies, power producers and utilities, have inculcated the mindset that the government *must* provide access to cheap energy. Unfortunately, energy is anything but cheap in the modern age, and the country is, and should be, transitioning towards less government control in the energy sector.

However, the government's role in guiding the evolution of the energy sector remains paramount. On the supply side, the country's energy mix needs to be based upon an indigenous fuel source (e.g., coal, natural gas or hydel) or, a robust and secure source of imports. However, with our dwindling natural gas supplies and the uncertain feasibility of Thar coal, incentives for exploration and production must be formulated and regulators need to be empowered. Similarly, the government must continue to play a facilitating role in encouraging investments in alternative and renewable energy – particularly in hydel-generation using both large and small dams.

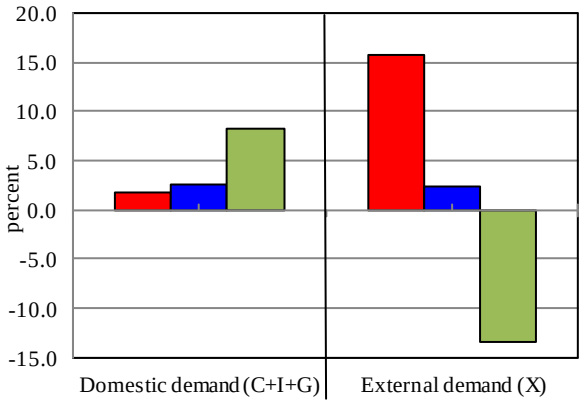
While supply initiatives are a critical part of a long-term solution, energy conservation must be encouraged to manage the demand-supply gap in the short-run. Both natural gas and electricity tariffs for households need to be rationalized to encourage households to invest in more efficient appliances and decrease wastage. Ultimately, sustainable economic development will depend on replacing the mindset of a *right* to cheap energy, with a culture that encourages conservation.

4 Aggregate Demand

4.1 Overview

Aggregate demand showed a moderate increase of 3.7 percent during FY12. The domestic market was responsible for the increase, as external demand faltered substantially during the year (**Figure 4.1**).[1] Factors including higher remittance inflows (so far immune to the global crisis), a vibrant informal economy, and a surge in fiscal spending, appear to have underpinned domestic demand.

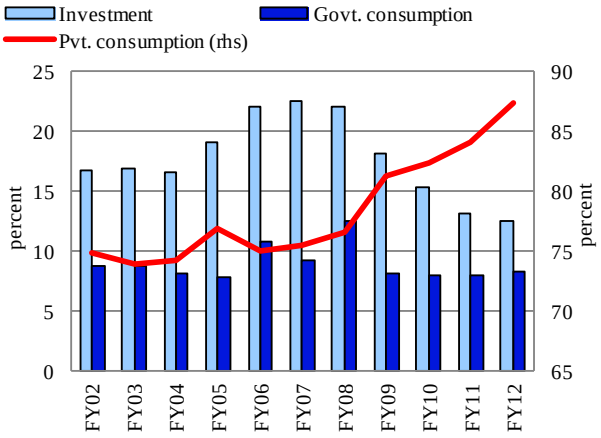
Figure 4.1: Growth in Aggregate Demand



Source: National Income Accounts, PBS.
Domestic demand includes consumption (both public and private) and investments. External demand is gross export of goods and services.

Indeed, given the bearish outlook of the global economy, domestic demand is indispensible for Pakistan's economic growth. However, the current demand structure is not conducive for sustaining the growth momentum: while consumption – especially private consumption – continues to remain strong, investments fell for the fourth consecutive year. The investment-to-GDP ratio has reached a low of 12.5 percent (**Figure 4.2**). Behind this trend were investor apprehensions regarding the current state of law and order, and the issue of energy availability (see **Section 4.2.2** for details).

Figure 4.2: Demand as Percent of GDP



Source: National Income Accounts. PBS

In our opinion, this composition of domestic demand was also an outcome of the government's fiscal strategy over the previous few years: while public investment has declined since FY09, pro-consumption fiscal measures have increased that include higher spending on untargeted subsidies, income support programs, increase in pensions and public salaries, and duty cuts on consumer items (see **Chapter 6**). In addition, we also know that worker remittances are typically channeled into household consumption and construction.[2]

[1] We consider continuous weakening in the global economy and domestic competitiveness issues as the major reasons for the decline in external demand for our goods and services. Here, it is important to mention that the exports, shown in the national income accounts, also reflect some impact of supply-side constraints (including energy shortages).

[2] For example, Nishat and Bilgrami (1991). This study has concluded that in Pakistan, remittances have the largest impact on consumption, and smallest on private investment. (Complete citation: 'The Impact of Migrant Workers' Remittances on Pakistan Economy', Mohammed Nishat and Nighat Bilgrami, Pakistan Economic and Social Review , Vol. 29, No. 1 (Summer 1991), pp. 21-41). Similarly, using the data for 84 countries for the period 1970-2004, the IMF Working Paper No. WP/09/153 'Do Workers' Remittances Promote Economic Growth?' (2009) by Adolfo Barajas, Ralph Chami, Connel Fullenkamp, Michael Grapen and Peter Montiel has concluded that the remittances are not intended to serve as investments, but rather as social insurance to help family members finance the purchase of life's necessities. Therefore, although remittances lift people out of poverty, but they do not typically turn their recipients into entrepreneurs.

4.2 Consumption

Real consumption grew by 11.1 percent during FY12, compared to 3.9 percent a year earlier.[3] Although sales data is not available for most consumer items, there are indications of buoyancy in consumer spending:[4] for example, revival in construction and ancillary industries; higher production and import of consumer goods (**Table 4.1**); increase in sales tax collection by 15 percent despite a 100 bps reduction in tax rate;[5] strong public interest in retail exhibitions; new shopping malls and growing sales volumes; restaurants; increase in overseas travelling; and leading global brands opening their outlets in the country. Furthermore, the impressive performance of fast moving consumer goods (FMCGs) also supports this trend. [6]

Table 4.1: Import of Selected Consumer Durable Goods

import quantity in units given; growth rate (of import quantity) in percent; import value in million US$

	Units	Import quantity				Growth rate	Import value
Items		FY09	FY10	FY11	FY12	*FY12 over FY11*	FY12
Grinders/mixers/juicers	No.	605,326	782,332	397,089	439,481	10.7	6.5
Ovens/grillers/roasters	No.	7,436	10,681	16,994	23,234	36.7	0.5
Coffee/tea makers	No.	42,246	31,871	53,369	56,621	6.1	0.8
Complete dinner sets	dozens	92,946	2,872,98	440,873	577,598	31.0	8.3
Plates/dishes/teacups	dozens	234,112	173,080	226,938	330,099	45.5	1.4
Other table/kitchenware	No.	44,310	69,085	138,585	191,067	37.9	2.8
Electric iron	No.	177,850	294,780	282,081	290,377	2.9	1.1
Laptop	No.	40,385	83,462	82,565	282,559	242.2	72.1
LCDs	No.	11,480	6,294	1,912	4,934	158.1	1.3
Cellular phones	million nos.	3.8	11.0	12.3	29.2	137.0	688.4
Earphones	million nos.	1.0	0.9	1.3	2.2	77.6	5.6
Footwear	million pairs	11.8	13.2	21.6	23.0	6.8	77.6
Worn clothing	million kg	263.4	252.9	353.8	403.1	13.9	148.0
Handbags	No.	550,983	590,305	1,245,948	1,519,344	21.9	5.4
Remote controls	million nos.	2.0	4.8	8.8	11.3	28.2	4.5
Digital cameras and recorders	No.	17,296	27,385	28,072	36,903	31.5	1.0
Air-conditioners	No.	74,952	56,885	38,474	58,042	50.9	15.4
Refrigerators	No.	20,390	23,832	14,571	26,172	79.6	7.3
Electric fans	No.	283,701	526,378	607,193	715,185	17.8	8.6
Ceramic tiles and bricks	million kg	17.8	13.1	5.3	10.4	96.1	16.9
Sanitary fixtures	No.	260,605	251,983	274,618	336,373	22.5	3.4
Energy saving bulbs	million gram	1.4	1.8	1.1	4.7	316.5	72.7
Rubber tyres and tubes	million nos.	4.0	3.7	5.4	6.0	12.0	229.5

Source: Pakistan Bureau of Statistics

Within a high-inflation-low-growth environment, floods in last 2 years, and sluggish employment conditions in the country, the trend in consumer spending appears anomalous.[7] In our view, it was the income generated mainly from *outside* the domestic formal economy, i.e., remittances and the

[3] Consumption is calculated by Pakistan Bureau of Statistics as a residual in the national accounts identity: C = Y – I – NX; where C is consumption, Y is GDP, I is investment and NX is net exports. Conceptually, this method allows errors in the measurement of GDP, or other components, to creep into the consumption estimates.

[4] Sales data is available only for domestically produced cars and cement, which shows a growth of 18 percent and 8.8 percent in FY12, respectively. Although POL sales information is also available, but it is not meaningful given the prevailing gas shortages, and forced substitution of petrol/furnace oil over gas.

[5] This includes sales tax collected only on domestic goods.

[6] The net profits of FMCGs listed on the Karachi Stock Exchange grew by over 20 percent in FY12. Here it is important to mention that the FMCGs' bottom-line has been growing this rapidly since last 5 years, and the sector has outperformed the KSE-100 index with a wider margin.

[7] This was unlike the consumption boom in 2003-08, when the economy was on a high growth trajectory and the inflationary pressures were low. This boom was driven mainly by monetary activism that led to an unprecedented growth in private credit, especially to the consumer sector.

informal sector, which has helped support economic growth.[8] At the same time, we also believe that fiscal measures to support household incomes and expenditures over the previous years, proved effective.

We consider remittance growth as the prime stimulant for consumer spending in the country. This additional income has lifted household demand for various necessities and luxuries, and has also triggered private construction activity. In this context, it is not surprising to see a number of residential projects initiated across the country for overseas Pakistanis alone. In fact, Pakistan is not the only country where consumption growth is associated with inward remittance flows, there is sufficient empirical evidence that in most developing economies, remittance income is used for consumption and financing real estate activities.[9]

Similarly, we believe that a vibrant parallel economy is also seeping into consumption demand in the formal sector. Findings of the Household Integrated Economic Survey (HIES) 2011, show that the incomes derived from business activities (including services industry in the informal sector) posted the highest real increase amongst all the income sources during FY08-11 (**Box 4.1**).[10]

In addition to these factors, fiscal spending has also buoyed consumer sentiments: (i) subsidized energy and food has contained household expenditures on these items, which has encouraged other spending; (ii) cut in federal excise duty on electronics, and elimination of special excise duty on automobiles, have propped-up sales; and (iii) increased government spending on pensions, income support programs (e.g., Benazir Income Support Program) and other transfers, have shored up household incomes and consumption.

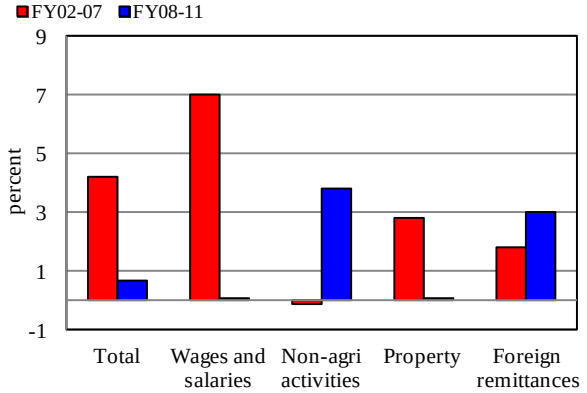
Box 4.1: Key Insights from the Household Integrated Economic Survey 2008 and 2011

HIES data provides useful insights about real consumption patterns of urban households, especially regarding the disparity in consumption trends across various income groups during FY08-FY11.[11]

At first, the survey results show that the increase in real incomes and real consumption of households was smaller in FY08-11, compared with FY02-07.

During FY02-07, household sector had enjoyed significant increase in wages and salaries, as well as house rents. In contrast, the highest increase during FY08-11 was seen in incomes derived from business activities (including, services and small-scale manufacturing in the informal sector), which have risen by 4 percent annually in real terms (**Figure 4.1.1**).[12] Given their record increase in recent years, foreign remittances are a close second. Real incomes from other sources have remained, more or less, unchanged during this period.

Figure 4.1.1: Change in Real Incomes of Urban Households by Source (CAGR)



Source: HIES, Pakistan Bureau of Statistics

[8] We believe that the informal economy in Pakistan is growing much faster than the formal economy. Therefore, GDP growth understates the actual economic growth in the country.

[9] See for example, IMF Working Paper No. WP/03/189 'Are Immigrant Remittance Flows a Source of Capital for Development' (2003) by Ralph Chami, Connel Fullenkamp and Samir Jahjah.

[10] HIES survey is conducted after every four years. Therefore, survey results for 2007 and 2011 are compared.

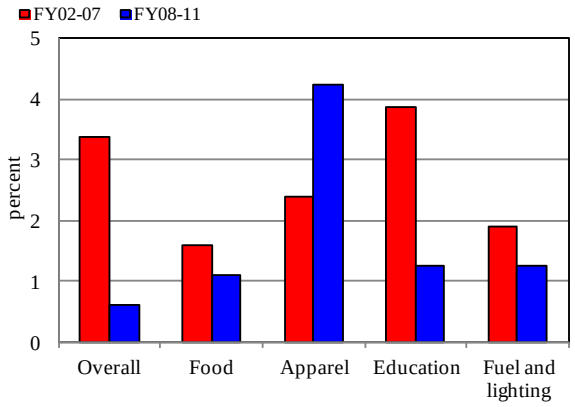
[11] Real consumption is calculated after adjusting for change in prices using changes in the CPI. Since the CPI (like other available price indices) is a survey of prices in urban centers, and, due to the prevalence of barter trade and sustenance farming in the rural sector, there is no appropriate price benchmark for calculating real incomes and consumption in the rural or aggregate economy.

[12] This is classified as "other non-agri activities" in the survey.

It is important to mention here that the increase in real incomes and consumption of urban households is concentrated only in the upper-class and upper-middle class (i.e., the top 40 percent of households by income). Other income groups have actually witnessed a fall in both their real incomes, and in their real consumption.

Household consumption patterns are even more revealing. As **Figure 4.1.2** illustrates, the urban population is spending *more* on food and clothes in real terms than it was four years ago. Interestingly, food's share in household consumption basket is not just the largest, but has also increased from 44.2 percent in FY08 to 48.9 percent in FY11. Anecdotal evidence also suggests an increase in demand for processed food, dairy products and beverages; in fact, investors have been positioning themselves to take advantage of this opportunity.[13]

Figure 4.1.2: Change in Real Consumption of Urban Households for Selected Commodity Groups (CAGR)



Source: HIES, Pakistan Bureau of Statistics

Compared to FY02-FY07, a period often associated with the consumption boom, spending on apparel in real terms has actually been rising faster in FY08-11. SBP's 3rd Quarterly Report for 2010-11 elaborated on the paradigm shift in domestic textile and textile-related industries, towards branding and designing, which is supported by mass-media campaigns and changing consumer preferences. Almost all the income groups have increased their expenditures on apparel; however, once again, it has been the upper and upper-middle income brackets that have led this increase.

4.3 Investment

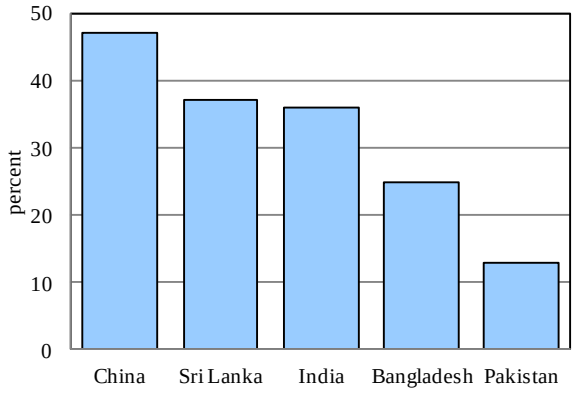
Investments continued to taper for the fourth consecutive year after the crisis of 2008. In FY12, the investment-to-GDP ratio reached 12.5 percent, which is the lowest amongst major Asian countries (**Figure 4.3**). Presently, both domestic as well as foreign investment is weak due to an unfavorable investment climate, characterized by idle capacities; security concerns; energy shortages; low public investments; unfocused trade policies; and governance issues (**Figure 4.4**).

FY12 was also the fourth consecutive year that saw a decline in FDI. Here it is important to mention that FDI has bounced back in a number of emerging and transition economies to surpass the pre-crisis average;[14] but in Pakistan, it is still waning (see **Chapter 8**).

Low capacity utilization

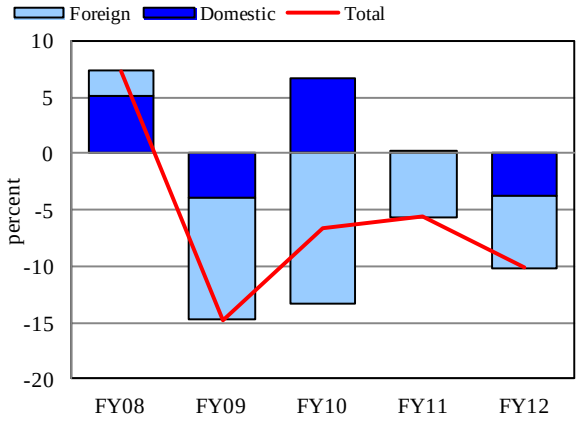
During FY12, most large-scale manufacturing units utilized less than 50 percent of capacity (**Table 4.2**). Energy constraints and law and order conditions, are the most frequently cited factors in explaining this trend, especially in fertilizer, steel and glass. However, there are other explanations as well.

Figure 4.3: Investment-to-GDP Ratio in Regional Countries (2011)



Source: World Bank databank.

Figure 4.4: Composition of Investment Growth



Source: Pakistan Bureau of Statistics, SBP

[13] The increase in fixed investment loans for animal farming and feeding, grains milling products, processing of food & vegetables, manufacturing of beverage, and dairy products, etc., during FY12, supports this view.
[14] 3-year average level for 2005-2007. Source: UNCTAD World Investment Report 2012.

In our view, the macroeconomic environment has become challenging for the investors. We must recall that investments in Pakistan peaked in FY07, when the macroeconomic environment was easier: interest rates were lower; energy prices were stable as demand-supply gap was benign; and the global economy was booming. However, just a year later, the situation changed significantly. The global economy entered a recession, and Pakistan (which was facing large macroeconomic imbalances) had to adopt demand compression policies that necessitated an increase in interest rates and partial withdrawal of energy subsidies. From our discussion with key manufacturing sectors, a number of newly established businesses became unfeasible within 2 years – most business projections were off-target due to the global recession, and a substantial increase in domestic fuel and financial costs. Cement manufacturers had increased capacities, expecting a continuation in the real estate boom in the GCC. The outcome was different than expected.

Business uncertainties

In addition to the challenging macroeconomic environment, investors are also mindful of changes in the sector-specific policies (e.g., fertilizer and CNG) and about the direction of Pakistan's trade policies. In terms of the latter, many investors remain skeptical about the current drive for trade liberalization with India, and are reluctant to take any firm position. Furthermore, certain business groups are apprehensive that they may be priced out of the market by Indian products, especially those who are enjoying a near-captive market. In addition, there is a possibility that Pakistan will get the generalized system of preference-plus (GSP+) from the European Union.[15] If this happens, Pakistani firms will be able to export at zero duty to the EU, which can boost investment in the exporting sectors.

Table 4.2: Capacity Utilization in Selected Industries

percent

Industry	weight	FY10	FY11	FY12	Industry	weight	FY10	FY11	FY12
Sugar	5.0	46.1	36.3	40.4	Fertilizer	6.3	99.7	93.6	72.5
Cigarettes	3.0	67.9	68.0	64.4	Bicycles	0.1	63.9	48.5	37.4
Vegetable oil & ghee*	4.8	31.1	31.7	32.6	Diesel engine	0.1	85.0	37.3	11.9
Wheat milling	1.4	16.6	18.1	18.9	Caustic soda	0.6	41.9	39.5	40.8
POL	7.7	74.6	73.9	69.6	Soda ash	0.2	80.6	74.4	72.3
Coke	0.1	35.3	31.1	19.9	Refrigerator	0.3	35.6	33.2	35.4
Cars & jeeps	4.0	44.7	49.0	56.3	Deep freezer	0.2	24.4	10.9	7.0
LCVs	0.5	38.9	47.9	52.3	Air conditioner	0.1	34.6	25.5	24.0
Trucks and buses	0.2	16.2	13.2	12.7	TV	0.2	13.7	17.6	10.8
Tractors	0.7	95.6	94.5	64.2	Paper & products	3.3	47.5	48.6	57.6
2-3/wheelers	0.9	76.8	55.8	56.1	Chip board	0.8	5.1	4.3	5.2
Pig iron	2.3	39.3	35.2	20.3	Glass sheet	0.1	23.3	18.8	19.9
Billets/ingots	2.2	39.1	38.2	37.9	Cement	7.5	69.6	69.6	66.6
Re-rolled products	3.2	55.6	47.0	36.3					

Sources: Economic Survey, Punjab Bureau of Statistics, PSMA, PVMA, PEMA, OCAC, NFDC, and APCMA (please see list of abbreviations at the end of the report).

[15] GSP is a facility given by the developed countries under which, imports from developing countries are allowed at lower duties. In addition to this, there is a facility called 'Everything but Arms' (EBA) only for least developed countries (LDC), which allows LDCs to export their products to the EU duty-free and quota-free. The objective of this facility is to support LDCs to increase exports and promote growth. Being a developing country, Pakistan is presently not eligible to avail benefits under the EBA. Therefore, LDCs (e.g., Bangladesh and Cambodia) get a competitive edge in the EU market over other countries. However, effective from 1st January 2014, EU is introducing a revised GSP plus scheme, under which, some developing countries will be eligible to export to EU duty-free and quota-free, depending upon whether they fulfill 'vulnerability criterion'. Pakistan is most likely to get through. For details, see 'GSP and EPAs key issues' by Isabelle and Ramdoo, European Center for Development Policy Management; and also visit European Commission website.

Low public investments

Sluggish public sector investment also explains the low investment rate in the country. As discussed earlier, the government is spending more on current expenditures than investment. Instead of crowding-in private investment, the government appears to be crowding-out private investment, as it borrowed excessively from commercial banks to finance its fiscal deficit (for details, see **Chapter 5**).

Governance indicators

Among other factors, Pakistan's inability to attract FDI can also be traced to governance issues in the country. The World Bank's *Governance Indicators* show that Pakistan has not performed well compared to regional peers including India, Sri Lanka and Indonesia. For instance, in terms of 'political stability/absence of violence' indicator, Pakistan has not fared well. In our view, Pakistan's poor global image could be one of the reasons that the country has not been able to share the rising FDI into our peer countries.

Sector-wise investment

The decline in investment has been broad-based, and is evident in almost all the sectors. For instance, investment in the agriculture sector declined by 7.6 percent in FY12, compared to slightly positive growth in FY11. This is despite the growth potential in areas such as corporate farming, dairy products, storage, food processing, supply chain, etc.

International investors and local business groups have shown keen interest in investing, and exploiting the potential in our agriculture sector. The increase in fixed investment loans for a number of agro-based industries, also substantiates this observation. Specifically, fixed investment loans (for these activities) jumped from Rs 3.1 billion in FY11 to Rs 10.5 billion in FY12. Supportive public policies for necessary infrastructure in rural areas, would go further in attracting private investors.

Within industrial groups, only the construction sector displayed positive investment (12.3 percent) growth in FY12, primarily on the back of developmental work in the public sector and worker remittances. Other sectors, including large-scale manufacturing, mining & quarrying, and electricity & gas distribution, experienced a decline in investments in FY12. In fact, real investment in the industrial sector has been declining for the last five years, and, as a result, the investment-to-GDP ratio in this sector has come down from 19.9 percent in FY07 to 9.3 percent in FY12.

Table 4.3: FDI Inflows in Pakistan – Sector-wise

million US$

	FY08	FY09	FY10	FY11	FY12
Food	66.5	195.3	108.2	68.1	40.7
Textile	30.1	36.6	27.8	25.0	30.3
Chemical	105.4	99.2	121.0	30.7	112.8
Petroleum refining	74.5	132.1	104.5	-18.4	14.7
Oil & gas exploration	634.8	775.1	740.6	512.2	612.8
Cement	102.5	32.6	-1.2	65.2	-11.0
Machinery	24.2	18.2	15.9	6.2	3.1
Electronics	27.6	22.6	23.5	15.9	22.8
Automobile	184.5	175.6	33.2	113.4	31.6
Power	70.3	119.8	-120.6	155.8	-84.9
Construction	88.5	92.5	101.6	60.8	71.8
Trade	175.5	165.7	117.0	53.0	25.3
Communication	1625.3	879.1	291.4	-34.1	-315.3
Finance	1607.6	707.4	163.0	246.9	56.4
Miscellaneous	335.5	269.9	424.9	272.9	201.5
Total	5152.8	3721.8	2150.8	1573.6	812.6

Source: State Bank of Pakistan

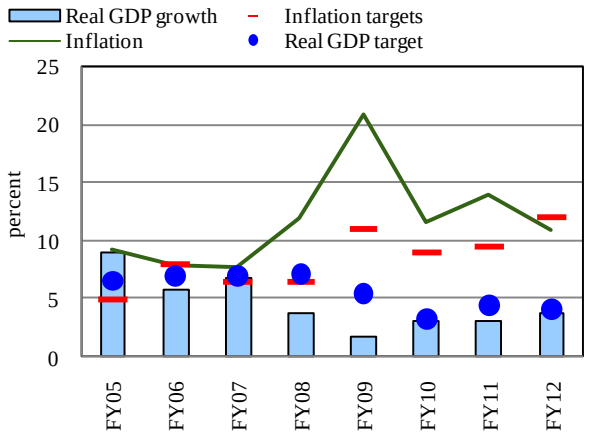
The most worrying development is the net outflow of FDI from the power and communication sub-sectors (**Table 4.3**). In particular, telecommunication had been a promising avenue to attract foreign direct investment; however, with market saturation, and the delay in the auction of 3G licenses, there is now a net outflow on account of repatriation of profits and retiring external loans.

5 Inflation and Monetary Policy

5.1 Overview

For the first time in five years, actual inflation for FY12 turned out to be lower than the annual target **(Figure 5.1)**. This, along with a modest improvement in economic activities, is amongst the key positives for the year. In spite of these developments, the economy was unable to move away from a low-growth, high-inflation environment. This situation is challenging for the central bank, as policy measures to contain inflationary pressures carry the risk of choking nascent improvement in economic activity. Cognizant of these tradeoffs, SBP utilized any room available to support economic growth.

Figure 5.1: Inflationary Trend and Real GDP Growth

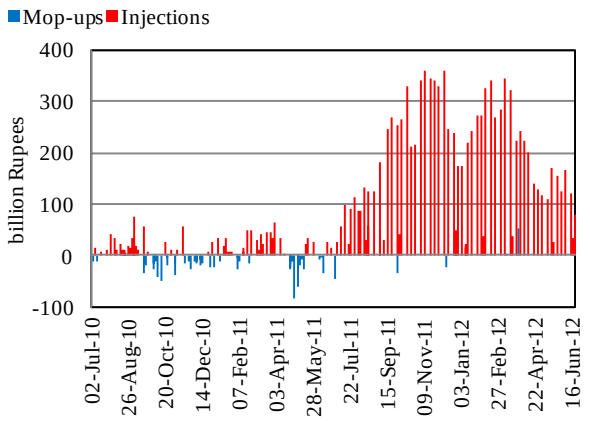


Source: SBP, Pakistan Bureau of Statistics

Broadly speaking, SBP adopted an accommodative monetary policy in FY12. The policy rate saw a cumulative reduction of 200 bps in the first two monetary policy announcements in the fiscal year.[1] However, the risks emanating from the external sector intensified during the initial months of the year, which forced SBP to put further easing on hold. Monetary management also became more challenging, with increasing government reliance on SBP funding as the year proceeded.

Despite the reduction in interest rates, overall monetary expansion decelerated in FY12.[2] This was largely due to the deterioration in the external account. The resulting depletion of FX reserves absorbed Rupee liquidity from the money market. This, along with increasing government borrowing from commercial banks, underlines the need for liquidity injections into the system to ensure that money market conditions remained calm. Not surprisingly, the volume of SBP's open market operations (OMOs) witnessed a sharp (one-sided) increase during the year (**Figure 5.2**).[3]

Figure 5.2: Volume of Open Market Operations



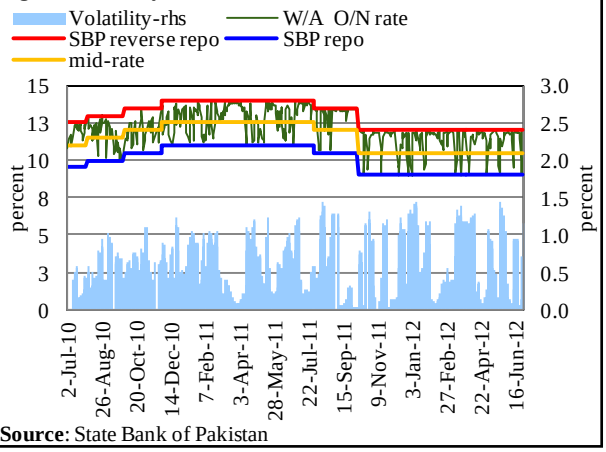
Source: State Bank of Pakistan

However, it is worth noting that the weighted average overnight rate remained near the upper bound of the interest rate corridor despite continuous liquidity injections through OMOs (**Figure 5.3**). This downward rigidity in interest rates on the very short-end of the yield curve, was also visible in other market rates, including lending rates of commercial banks. Specifically, following the 200 bps

[1] Policy rate was reduced by 50 bps to 13.5 percent in the first monetary policy statement issued on 31st July 2011. A more aggressive cut of 150 bps was announced in the second monetary policy statement issued on 7th October 2011.
[2] Theoretically, changes in interest rate and monetary expansion should be inversely correlated.
[3] It is important to realize that extended temporary liquidity support from SBP is equivalent to inflationary financing.

cut in the policy rate, weighted average lending rates of commercial banks saw a reduction of 112 bps to 13.1 percent by June 2012, against 14.2 percent in June 2011.

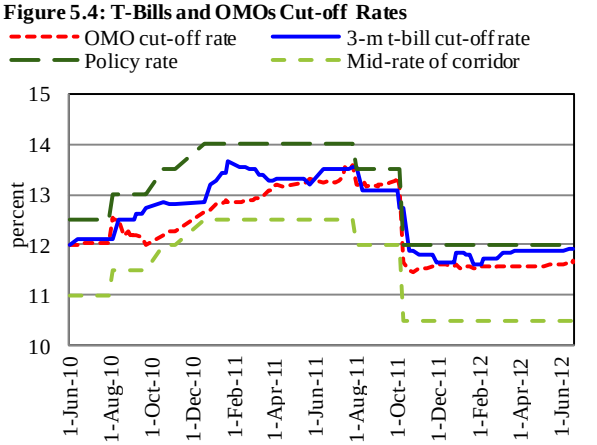
Figure 5.3: Policy Rate Movements



Source: State Bank of Pakistan

In fact, given the government's large borrowing requirements, commercial banks had little incentive to reduce lending rates in line with the cut in the discount rate, and channel funds towards the private sector. It also seems that banks were using liquidity from SBP for onward lending to the government. In practice, it makes sense for commercial banks to do so, as long as liquidity in the market is available at a rate lower than the T-bill cut-off rate. A positive spread between cut-off rates of 3-month T-bills and of OMOs, allowed commercial banks to do this for most of the year (**Figure 5.4**).

Figure 5.4: T-Bills and OMOs Cut-off Rates



Source: State Bank of Pakistan

The extent of government borrowing in FY12 can be judged from the fact that the stock of budgetary finance from the banking system grew by 46.1 percent to Rs 3.8 trillion.[4] Within the banking system, commercial banks' lending for budgetary finance has substantially increased in recent years, including FY12. Not too long ago (in FY07, in fact), the stock of budgetary finance was 18.8 percent of private sector credit; as of end FY12, this ratio has increased to 62.0 percent.

In addition to budgetary financing, government borrowing for commodity operations and bank lending to PSEs (usually against government guarantees), have also led to a rise in banks' exposure to the public sector. Although understandable from the banks' point of view, the changing composition of their balance sheets is discomforting, as banks are moving away from intermediating between private savers and investors.

The private sector appears to have been marginalized due to the shift in banks' lending strategy and the government's appetite for funding. Credit expansion to the private sector remained subdued for yet another year. A slight improvement in *overall* credit to the private sector, compared with FY11, is primarily driven by bank lending to (and investments in) non-banks finance institutions (especially mutual funds), which then invested these funds largely in government T-bills. As a result, loans to private sector businesses grew by less than one percent during the year – the lowest growth rate since FY08.

Looking ahead, SBP's decision to cut its policy rate by 250 bps to 9.5 percent in the initial months of FY13, is partially aimed at reviving private investment in the economy. It is expected to help consolidate the modest improvement in underlying economic activity seen in FY12. In addition to this, the government has also amended the SBP Act 1956 to limit the flow – as well as the stock – of

[4] In terms of GDP, government borrowing for budgetary finance reached 18.4 percent by end FY12, compared to 14.4 percent for the previous year.

government borrowing from the central bank. Specifically, a limit of zero quarterly borrowing from SBP was explicitly included in the Act. The government is also mandated to retire its outstanding borrowing from SBP within eight years from April 2011. While it is too early to gauge the medium-to-long term impact of these changes in the Act (as the amendments were passed in March 2012), the limit of zero quarterly borrowing for the last quarter of FY12 was not met. A strong commitment from the fiscal authority to limit its borrowing from SBP would not only help its credibility, but also facilitate SBP in managing inflationary expectations. In this context, meeting the stipulated limit on government borrowing from SBP during first quarter of FY13, is a positive development.

5.2 Monetary Aggregates

Growth in broad money supply decelerated slightly in FY12, for the first time since FY09. This was attributed *entirely* to the depletion of net foreign assets (NFA) of the banking system. On the other hand, net domestic assets (NDA) saw an expansion of 20.3 percent in FY12, compared to a relatively lower growth of 13.1 percent in FY11. The drivers of monetary expansion in FY12 are shown in **Table 5.1**.

Table 5.1: Changes in Monetary Aggregates

change in billion Rupees, growth in percent

	Absolute change during Jul-June			*YoY growth in stocks*	
	FY10	**FY11**	**FY12**	**FY11**	**FY12**
Broad money (M2)	640.0	918.0	946.6	15.9	14.1
NFA	49.4	235.0	-253.6	43.1	-32.5
SBP	75.9	235.3	-225.4	62.1	-36.7
Scheduled banks	-26.4	-0.3	-28.2	-0.2	-17.0
NDA	590.6	683.0	1200.2	13.1	20.3
SBP	86.4	48.7	474.9	4.9	45.8
Scheduled banks	504.2	634.3	725.3	14.9	14.9
of which					
Government borrowing	406.6	579.6	1237.4	23.7	41.0
For budgetary support	330.4	590.2	1198.3	29.3	46.1
SBP	44.0	-8.0	505.3	-0.7	42.1
Scheduled banks	286.4	598.2	692.9	74.5	49.5
Commodity operations	77.0	-15.7	38.6	-3.8	9.7
Non government sector	198.8	158.5	105.4	4.7	3.0
Credit to private sector	112.9	121.3	235.2	4.0	7.5
Credit to PSEs	85.0	36.3	-130.5	10.3	-33.7
Other items net	-14.9	-55.1	-142.6	9.2	21.8

Source: State Bank of Pakistan

5.2.1 Net Foreign Assets

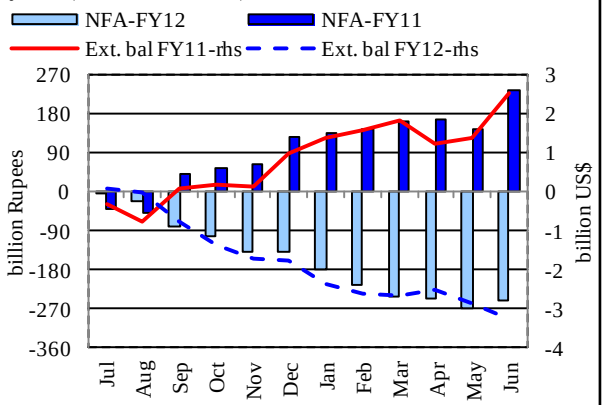
The challenge to monetary management during the year, is amply shown from the overall external account deficit of US$ 3.3 billion in FY12, compared to the surplus of US$ 2.5 billion in FY11 (**Figure 5.5**).

Within the banking system, NFA contraction was primarily driven by the depleting foreign exchange reserve of SBP. The main reasons for the decline were the drying up of external financial inflows; the repayments of IMF loans; and market support by SBP.[5]

[5] It is important to note that SBP's FX market interventions are aimed at reducing excessive volatility in the exchange rate, and not at managing the exchange rate at a specific level. The 9.1 percent depreciation of the Pak Rupee, against the US Dollar during FY12, also supports this argument. For further details, please see **Chapter 8.**

Commercial banks also contributed to the net contraction in overall NFA. Specifically, NFA of commercial banks saw a net contraction of Rs 28.2 billion during the year. This is surprising, at least on the face of it, since net liquid foreign exchange reserves of commercial banks recorded a healthy increase of US$ 1.0 billion during FY12. The confusion arises because of definitional issues. While the NFA of commercial banks reflect their net claims on foreign residents, net foreign exchange reserves are their liquid assets denominated in foreign currency.[6] This implies that the ownership and the utilization of foreign currency accounts (popularly known as FE-25 deposits), impact commercial bank NFA differently from their holding of net liquid foreign exchange reserves.[7]

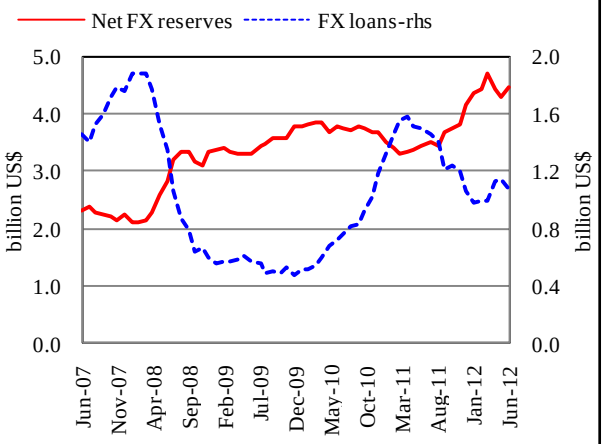
Figure 5.5: Overall External Balance and NFA of the Banking System (Cumulative Flows)



Source: State Bank of Pakistan

Data on the ownership of foreign currency deposits indicate that more than half of the increase in FCAs came from non-residents. This has increased commercial banks' liabilities to non-residents. At the same time, a decline in banks' placements outside Pakistan has reduced their claims on non-residents, which led to a net contraction in the NFA of commercial banks.

Figure 5.6: Net FX Reserves of Commercial Banks



Source: State Bank of Pakistan

5.2.2 Net Domestic Assets

Monetary expansion in FY12 was entirely driven by a rise in net domestic assets of the banking sector. Within NDA, the driving force was government borrowing, as credit expansion to the private sector remained subdued as shown in **Figure 5.7**.

Government Sector Borrowing

Changes in NDA of the banking system were almost entirely attributed to government borrowing. It saw an increase of Rs 1.2 trillion in FY12, compared to Rs 579.6 billion in the previous year. Within government borrowing, budgetary finance accounted for 89.2 percent of the increase, while the rest of the borrowing was for commodity operations. In terms of stocks, the outstanding amount of government sector borrowing from the banking system has overtaken the credit to non-government sector (**Figure 5.7**).[8] Although demand for private sector credit is low due to a host of factors (more on this issue later), crowding-out due to public borrowing cannot be ruled out.[9]

[6] It may be noted that net liquid foreign exchange reserves with commercial banks do not include trade financing against FE-25 deposits.

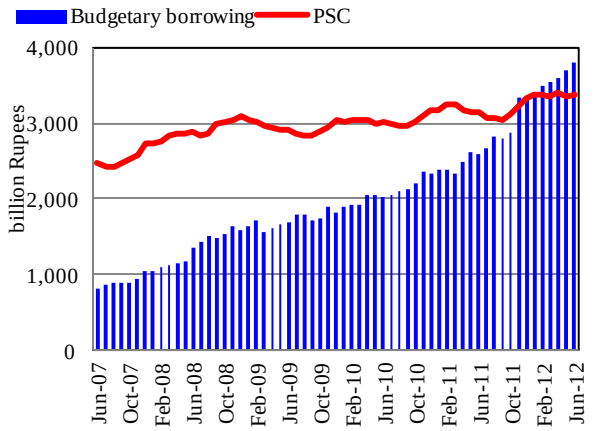
[7] For example, the utilization of foreign currency deposits revealed that foreign currency loans for trade financing saw a net retirement of US$ 423 million in FY12, compared to a net expansion of US$ 778 million in FY11. This led to an increase in commercial banks' balances held outside Pakistan, which helped them accumulate foreign exchange reserves (**Figure 5.6).**

[8] Credit to non-government sector includes loans (including investments) to private sector, PSEs and financial institutions.

[9] To make it clearer, let us take the government out from the credit market and leave liquidity with the banking system. This will put downward pressures on interest rates, which will help in supporting private sector business activities.

Budgetary Finance: one-offs and more: Overall budgetary borrowing from the banking system doubled in FY12 compared to the year before – the government borrowed Rs 1198.3 billion during FY12, compared to Rs 590.2 billion during FY11. A part of this increase includes a one-off adjustment of Rs 391 billion, which was used to settle accumulated subsidies/arrears of PSEs and commodity procurement agencies. Even after adjusting for this one-off, budgetary borrowings stood at Rs 807.3 billion for FY12, which was still substantially higher compared to the previous year (**Figure 5.8**).[10]

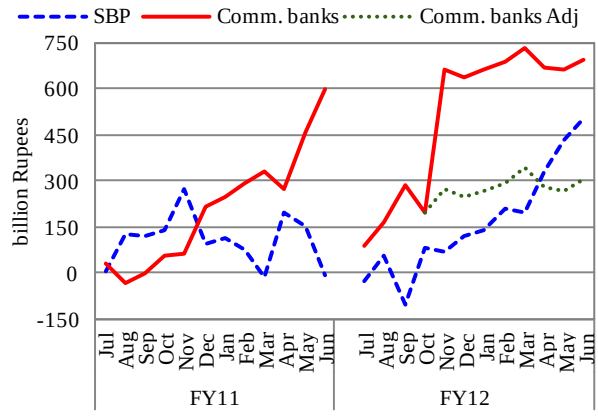
Figure 5.7: Govt. Budgetary Borrowing Vs. Private Sector Credit



Source: State Bank of Pakistan

Sources of budgetary borrowing indicate revival of monetization. As the year proceeded, government reliance on SBP funding increased. Specifically, there was a major shift towards SBP, and away from commercial banks, in the fourth quarter of FY12. For the entire fiscal year, the authorities borrowed Rs 505.3 billion from SBP, compared to a net retirement of Rs 8.0 billion in FY11. On the other hand, government borrowing from commercial banks (excluding the one-off adjustment) stood at Rs 301.9 billion in FY12, compared to Rs 598.2 billion in the year before. This allowed commercial banks to lend to PSEs and commodity financing (more on this issue later).

Figure 5.8: Source of Govt. Budgetary Borrowing (Net)



Source: State Bank of Pakistan

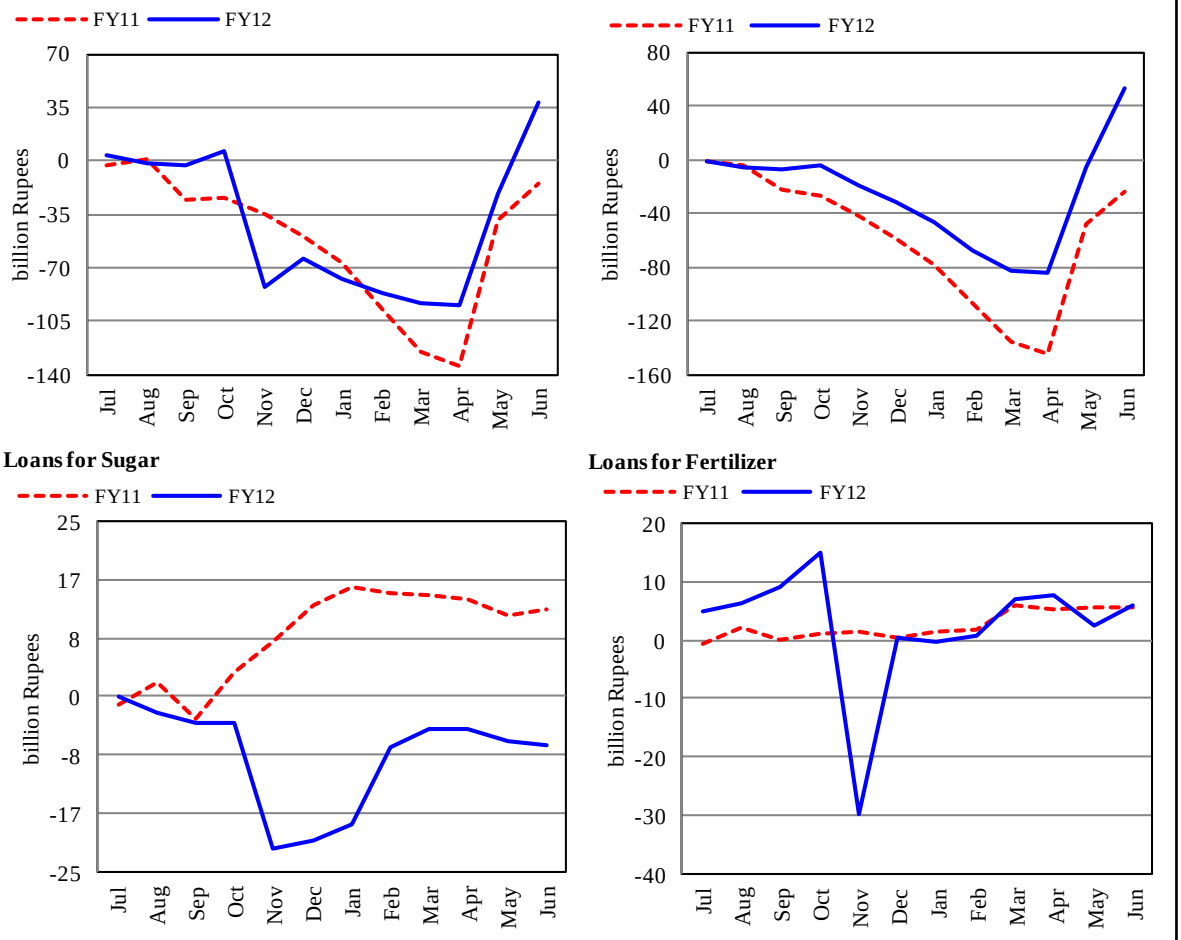
The limits on quarterly borrowing from SBP: The new Section 9C, in SBP Act 1956, limits federal government borrowing from SBP.[11] The Act prescribes two types of limits. Firstly, the flow of federal government borrowing from SBP has been restricted by imposing a limit of zero quarterly borrowing on a net basis. Hence, the federal government is now required to retire its borrowing from SBP to zero at the end of each quarter.[12] The second restriction is related to the stock of government borrowing from SBP. The Act states "the debt of the Federal Government owed to the Bank [SBP] as on the 30th April, 2011, shall be retired not later than eight years from that date". While the second limit on government borrowing is open to interpretation in terms of how it will be staggered, the limit on quarterly borrowing is straightforward. Budgetary borrowing of Rs 306.3 billion from SBP in Q4-FY12, is a breach of the quarterly borrowing limit.[13]

[10] For a detailed discussion on fiscal operations, please see **Chapter 6**.
[11] Act No. IX of 2012, dated March 13, 2012.
[12] In this context, the only exception is limited borrowing through ways and means.
[13] In the event of a breach, the government is required to provide a justification before the Parliament.

Government Borrowing for Commodity Finance

In addition to budgetary finance, the government also borrowed from commercial banks for its commodity operations. These loans have seen a substantial increase in outstanding amount in the recent past, despite their self-liquidating nature. The stock of commodity finance grew by 9.7 percent (Rs 38.6 billion) in FY12 to Rs 438.1 billion, despite the release of Rs 78.0 billion to procurement agencies by the government, for the settlement of accumulated subsidies. Moreover, this net expansion during FY12 is in sharp contrast to a net retirement of Rs 14.7 billion in the previous year (**Figure 5.9**). Details reveal that the expansion is primarily attributed to increased borrowing for wheat procurement.

Figure 5.9: Commodity Finance Loans - cumulative flows



Source: State Bank of Pakistan

In FY12, the government not only increased the wheat support price from Rs 950 to Rs 1050 per 40 kg, but also announced a higher procurement target of 7.7 million tons, compared to the actual procurement of 6.2 million tons last year. However, due to wheat stocks carried over from the previous season, the actual volume of wheat procured during FY12 stood at 6.0 million tons, which was substantially lower than the target. Despite this, the government borrowed Rs 153.5 billion from commercial banks in FY12 for wheat procurement, compared to Rs 138.8 billion in FY11. As shown in **Figure 5.9**, FY12 witnessed an increase in net wheat financing, while FY11 saw retirement.[14]

[14] It is pertinent to mention here that a slight decline in the *repayment* of wheat financing loans in FY12 was expected, since last year's repayments benefited from the government's decision to allow wheat exports in FY11.

Besides wheat, the government also intervened in the sugar and fertilizer sectors during the year, but their volumes were smaller than wheat's. In the case of sugar, mills held back their stocks in the hope that domestic sugar prices would recover before the crushing season. However, prices remained subdued, and sugar mills were not willing to offload their stocks. This led to a delay in the crushing season. In view of this, the government intervened by purchasing 4.75 million tons of sugar, which stabilized sugar prices in the market, and jumpstarted the crushing season by improving cash-flows for sugar mills.

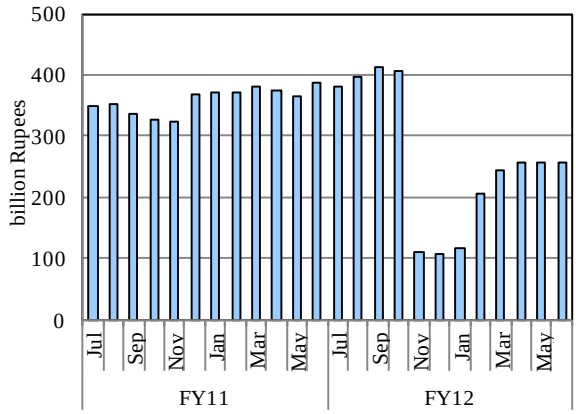
In the case of fertilizer, persistent gas shortages continued to limit domestic production. To meet the demand for fertilizer, especially during the sowing season, the government imported 1.45 million tons of urea in FY12. This increased the requirement for commodity financing since PSEs use bank financing for importing urea.

To summarize, the space created by settling accumulated subsidies for fertilizer and sugar, was almost entirely used up by fresh borrowing (**Figure 5.9**). This is evident from the amount of outstanding loans, which stood at Rs 82.2 billion by end-FY12, against Rs 83.3 billion in FY11.

Net Retirement in Credit to PSEs

Credit to PSEs witnessed a net retirement of Rs 130.5 billion in FY12, compared to a rise of Rs 36.3 billion in FY11. This turnaround was largely due to the *one-off* payment by the government, which was used to reduce the circular debt in energy-related PSEs, and the receivables of procurement agencies.[15] Consequently, banks' exposure to PSEs saw a reduction of Rs 296.5 billion in November 2011 as the PSEs' debt liabilities were taken over by the federal government (**Figure 5.10**).[16] While this adjustment had no immediate monetary impact, it had notable implications for the banking and energy sectors:

Figure 5.10: Outstanding Credit to PSEs



Source: State Bank of Pakistan

(i) Both commercial banks and the government benefited from the settlement of PSE debt. The commercial banks were able to transform their illiquid assets (lending to PSEs) into liquid assets (government securities). The cost of this substitution for commercial banks was the loss in interest income due to a positive gap between lending rates to PSEs, and the yield on government securities. However, this loss was largely compensated by the improvement in risk-weighted capital requirements, as investments in government securities are assigned zero weight for the calculation of credit risk. The government, on the other hand, was able to replace costly PSEs borrowing with relatively low-cost government securities.

(ii) The *one-off* adjustment also created room for further borrowing by PSEs from commercial banks, which appears to have been the intent. This enabled the government to shift the receivables of independent power projects (IPPs) to the Power Holding Company. As a result, the borrowing of

[15] PSEs' borrowings from the banking system have increased many folds in recent past. It jumped from Rs 81 billion as of end FY07 to Rs 388 billion by end FY11: a rise of 4.8 times in just four years. Prior to the intervention in November 2011, outstanding stock of credit to PSEs had reached Rs 412.9 billion by end Q1-FY12.

[16] In November 2011, government budgetary borrowing increased to Rs 460.8 billion.

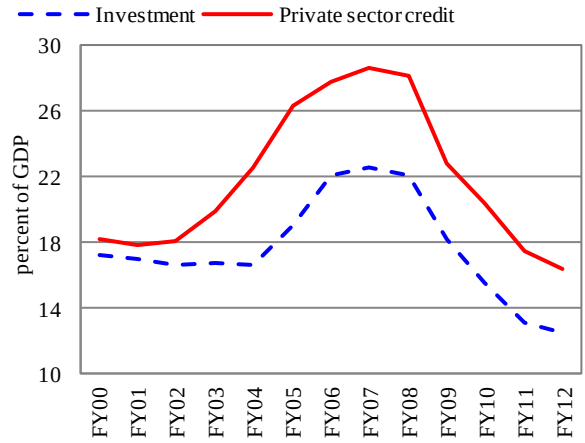
Power Holding Company saw a rise of Rs 141.8 billion in H2-FY12 (for details, please see **Chapter 3** on **Energy**).

5.3 Credit to Private Sector

On the face of it, overall credit to the private sector (CPS) grew by 7.5 percent in FY12 – the highest YoY growth since FY08. However, this provides little comfort to economic managers, since it was driven primarily by credit to non-bank finance companies (NBFCs), which predominantly lent to the government.[17] Loans to private sector businesses (PSB), on the other hand, grew by only 0.8 percent during FY12.

Given the double-digit rate of inflation in recent years, CPS in general, and loans to PSB in particular, have been shrinking in real terms. Not surprisingly, private sector credit-to-GDP has been on a continuous decline since FY07 (**Figure 5.11**). A similar decline in the investment-to-GDP ratio is a clear reflection of a continuous slowdown in investment. The factors responsible for this deterioration are quite familiar: excess capacity in the manufacturing sector due to persistent energy shortages; heightened security concerns that have pushed up the cost of doing business; issues and costs related to governance; and the government's appetite for credit. In addition to these factors, several sector-specific issues were also at play.

Figure 5.11: Credit to Private Sector and Investment Activities



Source: State Bank of Pakistan

Sharp Deceleration in Loans to Manufacturing Sector: Loans to the manufacturing sector grew by only 0.3 percent in FY12, compared to 9.6 percent last year. The deceleration was broad-based, as a large number of industries, either paid off existing loans, and/or reduced their fresh credit demand (**Table 5.2**). In this context, following points are worth noting:

(i) The textile sector, one of the biggest users of bank credit with a 20 percent share in loans to private sector businesses, saw a net contraction of Rs 23.7 billion in FY12, compared to an expansion of Rs 44.5 billion last year. This sharp turnaround can be traced to a significant decline in cotton prices during the year. Specifically, domestic cotton (lint) prices in FY12 averaged Rs 4,067 for 40 kg, against Rs 7,867 last year – a YoY decline of 48.3 percent. This not only reduced credit demand from the spinning and weaving sectors, but also eased the credit requirements of upstream industries like garments and knit-wears.

(ii) Loans to the cement sector also witnessed a net contraction for the second year in a row, but the pace has accelerated. A steady rise in domestic cement prices and healthy exports contributed to strong corporate earnings.[18,19] In our view, this availability of internal funding allowed the cement sector to retire its outstanding loans.

[17] Non-bank holdings of government securities saw a rise of Rs 360 billion during FY12.

[18] Average retail price of 50 kg cement bag jumped from Rs 350 in FY11 to Rs 420 in FY12: indicating YoY increase of 20 percent. Revival in construction activities facilitated cement sector to sustain this healthy growth in retail prices. Construction grew by 6.5 percent in FY12 compared to only 2.5 percent last year. However, it is interesting to note that loans to construction sector witnessed a net retirement of Rs 14.2 billion in FY12 against a small expansion of Rs 0.6 billion last year. In fact, revival in construction activities is primarily driven by the reconstruction in flood affected areas and housing demand by individuals. None of these activities are financed through bank loans.

Table 5.2: Net Flows in Manufacturing Loans
billion Rupees

	FY09	FY10	FY11	FY12
Overall manufacturing	27.28	31.83	121.86	4.49
Food products and beverages	11.36	10.83	61.04	15.09
Edible oil and ghee	-1.38	-5.41	6.05	11.09
Dairy products	-2.32	1.89	7.41	4.79
Rice processing	1.75	0.92	5.99	-4.84
Sugar	8.79	3.43	38.65	-1.19
Textiles	-33.43	-12.83	44.48	-23.68
Spinning	-10.82	-15.27	18.77	-10.72
Weaving	-10.56	1.00	11.76	-7.14
Finishing	-6.34	-3.68	5.98	0.61
Made-up textile articles	-2.56	9.38	-5.34	-4.49
Coke, refined petroleum products	3.18	5.38	4.53	1.58
Fertilizers and nitrogen compounds	19.28	18.07	2.36	8.87
Cement	9.04	1.01	-6.45	-20.74
Basic metals	2.87	1.36	3.04	12.32
Motor vehicles, trailers and semi-trailers	5.31	-2.56	-0.37	2.37

Source: State Bank of Pakistan

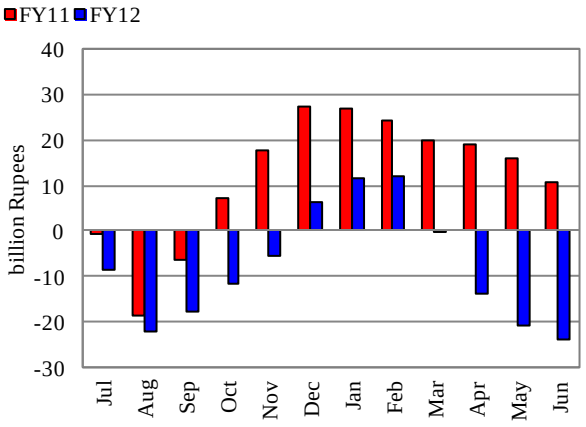
(iii) Similar to textiles and cement, the sugar sector also witnessed a net retirement in outstanding loans in FY12, which is in sharp contrast to credit expansion in the previous year (**Table 5.2**). This reversal is largely attributed to: (i) a sharp decline in the price of sugarcane that reduced overall demand for credit; and (ii) the government intervention, which improved cash-flows for sugar mills.

Some support for loans to the manufacturing sector came from the fertilizer sector, which saw credit expansion of Rs 8.9 billion during FY12 compared to Rs 2.3 billion last year. As discussed earlier, fertilizer producers were unable to offload their stocks due to the availability of imported urea at subsidized rates. This increased the working capital needs of fertilizer companies.

***Net Contraction in Trade Financing**:*
Despite increased trade volumes and modest growth in wholesale & retail services, trade loans saw a net contraction of 6.9 percent in FY12 compared to an expansion of 16.5 percent in the previous year.[20,21] This merits an explanation.

Within trade financing, both concessional loans under the export finance scheme (EFS), and foreign currency loans, registered sharp reductions in FY12. Specifically, EFS loans outstanding fell by 11.4 percent, on a YoY basis, to Rs 185.7 billion by the end of FY12 (**Figure 5.12**). This strong contraction is largely because of a decline in textile exports,

Figure 5.12: EFS Loans - Cumulative Flows



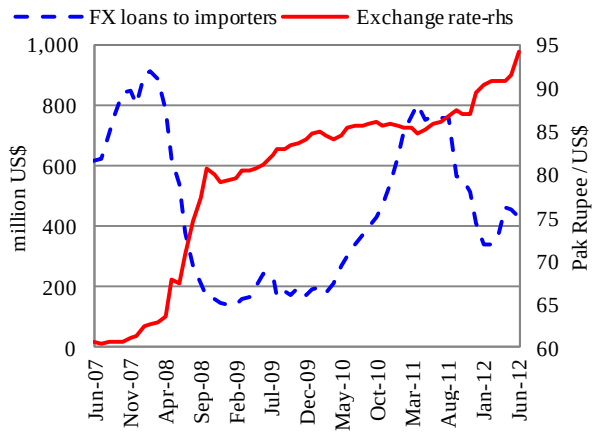
Source: State Bank of Pakistan

[19] Cement sector earned US$ 456 million from exports in FY12 compared to US$ 446 million last year.
[20] Trade volumes (sum of exports and imports) grew by 5.7 percent in FY12 to US$ 64.7 billion.
[21] Wholesale & retail services saw a real growth of 3.6 percent in FY12 compared to 3.5 percent last year.

and stricter eligibility criteria for EFS loans.[22]

To ensure the smooth repatriation of export proceeds, SBP revised the mechanism for EFS by imposing a maximum limit on overdue export proceeds. Specifically, overdue proceeds were not allowed to exceed 5 percent of last year's exports, if the borrower intended to continue availing EFS.[23] Exporters, who could not meet the revised criteria, were barred from availing EFS loans from 1st October 2011, up to the point that their overdue exports proceeds were within the prescribed limit.

Figure 5.13: FX loans for Import Financing

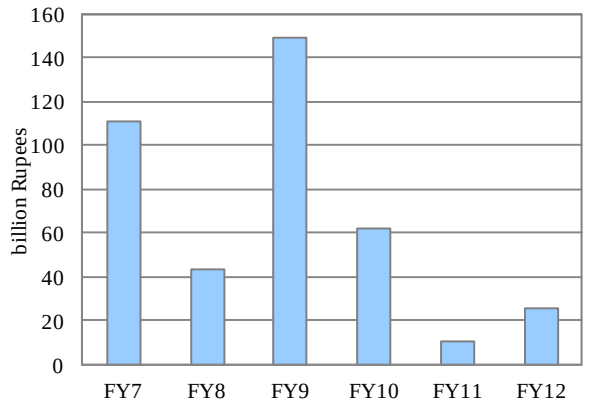


Source: State Bank of Pakistan

In addition to EFS, foreign currency (FC) loans for trade financing also witnessed a net retirement of US$ 423.3 million in FY12, compared to a net expansion of US$ 778.4 million in FY11. This reversal was primarily driven by exchange rate movements during FY12, as the interest rate on these loans remained largely unchanged at historically low levels. In fact, the depreciation of the domestic currency increased the effective cost of borrowing for importers, while exporters enjoyed a natural hedge against exchange rate volatility (**Figure 5.13**).[24] The composition of FC loans also supports this argument, as the retirement of FC loans was concentrated mainly in import-related loans, which accounted for 80.0 percent of total retirement in FY12.

Modest Recovery in Fixed Investment Loans: The demand for fixed investment loans has been low due to a number of factors, including the ones mentioned earlier. In this backdrop, a small increase in fixed investment loans during FY12 is a positive sign (**Figure 5.14**). The sectors responsible for this increase include consumer items, such as dairy products; beverages; road transport; and consumer durables**.** Fixed investment loans to the iron and steel industries also witnessed an increase, because of rising construction activity.

Figure 5.14: Fixed Investment Loans- Yearly Flows



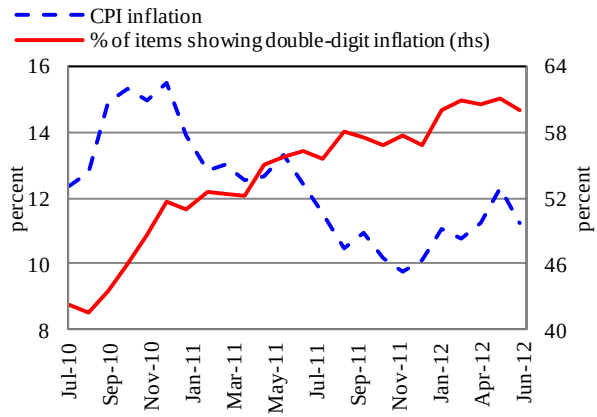
Source: State Bank of Pakistan

[22] Textile exports decreased by 2.8 percent in FY12, against a strong growth of 28.9 percent last year. Massive fall in cotton prices, both at international and domestic levels, also contributed to exports decline.
[23] Exporters were allowed to meet the revised criteria by end-September 2011.
[24] Pak Rupee depreciated against US$ by 9.1 percent in FY12 compared to less than one percent in the previous year.

5.4 Inflation

Average CPI inflation for FY12 was 11.0 percent, which is lower than the 13.7 percent posted in FY11 (**Figure 5.15**). The number is also lower than the government's target of 12 percent and at the lower end of SBP's forecast of 11-12 percent. Better domestic crop production, a gradual decline in global commodity prices during FY12, and the base-effect, contributed to this decline.

Figure 5.15: Overall Inflation and Diffusion

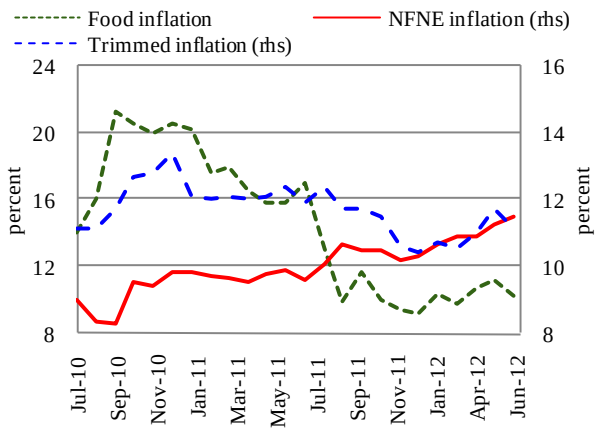


Source: Pakistan Bureau of Statistics

This meant that food prices stabilized to a large extent in FY12.[25] However, core inflation, as measured by non-food non-energy (NFNE) inflation, gradually increased over the year (**Figure 5.16**). Simultaneously, the number of items showing double-digit increases also increased.

The persistence in core inflation reflects the extent to which inflationary expectations have become ingrained in the economy. Such expectations may be a function of government borrowing, but may also be linked with changes in retail fuel prices. In our view, the direct impact of the exchange rate on inflation is substantial. The Rupee depreciated by 9.1 percent this year against the US Dollar, and we believe this has also contributed to the pickup in core inflation.

Figure 5.16: Food and NFNE inflation



Source: SBP & Pakistan Bureau of Statistics

The role of expectations

The problem with expectations is they are self-fulfilling. If households expect a certain rate of inflation in the future, they will negotiate a higher wage from firms, which in turn, will face an increase in their costs of production that is likely to be passed on to consumers in the form of higher prices. Firms may also anticipate an increase in costs and overall prices, and preemptively raise their own prices. Prices are revised very frequently – almost every quarter – in the Pakistani economy.[26] This means that the impact of any adjustments in inflationary expectations is very swift.

SBP's Research Department has, in collaboration with the Institute of Business Administration, launched a bi-monthly consumer confidence survey that uses a stratified random sample of over 1,600 households. The survey measures inflation expectations both qualitatively (i.e., whether inflation is expected to remain the same, increase or decrease) and quantitatively. It also measures households' perceptions about the current state of the economy relative to the past, and their expectations about the future state of the economy. Finally, it gathers information about households' expected future behavior and will provide a sound proxy for consumer demand. These results are then translated into a consumer confidence index.

[25] Volatility has been measured by using the 12-month standard deviation of month-on-month changes in food prices.
[26] Choudhary, Ali, Saima Naeem, Abdul Faheem, Nadeem Hanif, Farooq Pasha (2011). "Formal Sector Price Discoveries: Preliminary Results from a Developing Country." *SBP Working Paper Series* No. 42.

With the first survey conducted in January 2012, the indices developed need to stabilize before any concrete conclusion may be drawn from them. Nevertheless, very preliminary results in May 2012 suggested that slightly more than half of households – 58.3 percent to be exact – expect prices to rise significantly over the next six months. That proportion has not changed significantly since the survey first started and reflects the extent to which inflation expectations are ingrained in the economy. Households' expectations regarding the quantum of the increase in prices is less meaningful at this moment, since the survey panel will compare its own responses to actual inflation, and calibrate its future expectations accordingly.

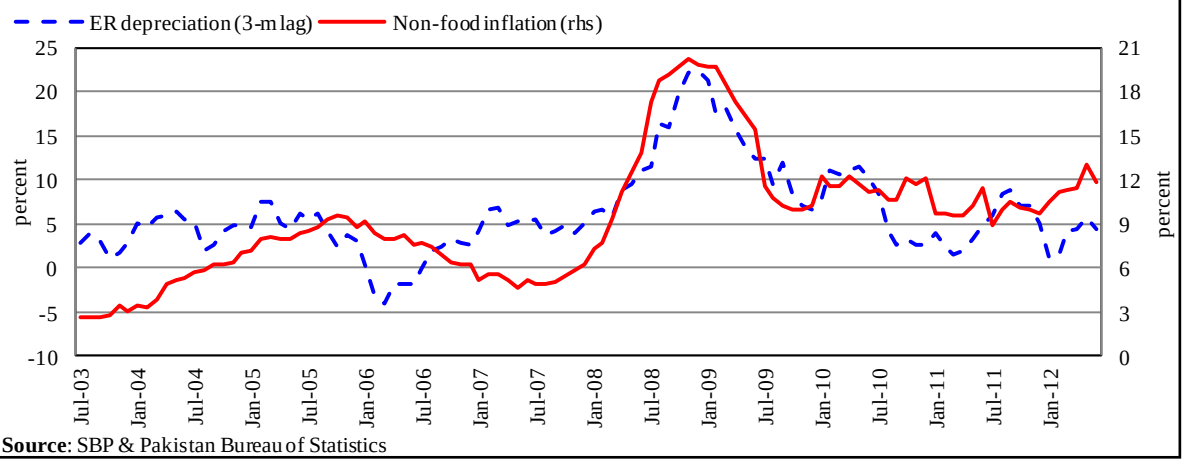
The surveys also indicate that households were less optimistic about future economic conditions in May, as compared to January, but considered their current economic state better off than it was in January. We would like to stress once more that these results are preliminary and tentative, and we expect the index to stabilize after several iterations. Nevertheless, the consumer confidence surveys are vital in conducting forward-looking monetary policy, and have started to serve as a vital rudder in our decisions and overall analysis of the economy.

The role of the exchange rate

The depreciation of the Rupee has implications for core inflation. Specifically, correlation between the depreciation in the exchange rate and the movements in non-food inflation, has strengthened since the balance of payments problem in 2008 (**Figure 5.17**).

While it may be tempting to conclude that a large part of domestic price pressures comes from imported inflation, the precise link between exchange rate depreciation and inflation is likely to be more nuanced. It remains a fact though, that the depreciation of the Rupee does *directly* impact the domestic price of oil & POL products, major crops and other inputs in agri-based industries. Second-round effects of the depreciation, as producers pass on the increases in cost, are likely to be significant. According to a survey, manufacturers listed raw material, energy and the exchange rate as three of the four most important factors in their price determination.[27] Combine this with the fact that prices are revised roughly every quarter, and it is unsurprising to note that there has been a strong correlation between non-food inflation and lagged exchange rate depreciation since 2008.

Figure 5.17: The Link Between Inflation and the Exchange Rate



Source: SBP & Pakistan Bureau of Statistics

International food prices and persistence are the greatest risks to inflation in FY13

Global grain prices surged in July 2012 due to droughts in the US and parts of Europe, and lower than average rainfall in India. While corn production has been primarily affected, wheat prices have risen

[27] The other factor is their competitors' price level.

as well since it is a substitute for corn in the production of animal feed. Domestic retail prices of wheat have started inching up following the Rs 150 per 40 kg increase in support price, announced in November 2012. Fortunately, global rice prices are expected to remain suppressed on the back of a large rice crop from Thailand.

On the energy front, keeping in line with our measured view on the global recovery, we expect oil prices to remain stable, if not recede. This should dampen headline inflation directly, and, more importantly, ease pressures on the balance of payments, the exchange rate, and consequently, core inflation.

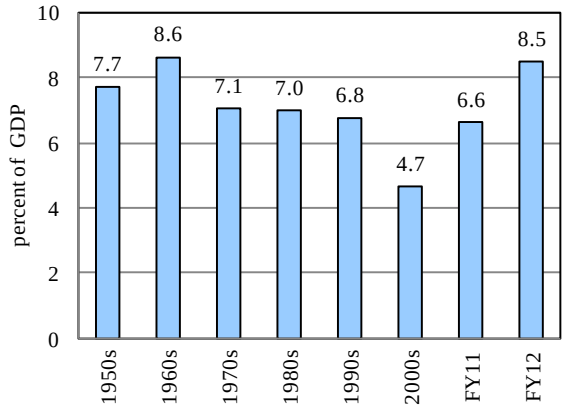
A greater concern, however, is the *persistence* in core inflation and expectations, which has yet to subside. Food and energy prices are extremely volatile and any unexpected increases in either may only serve to reinforce such expectations. Therefore, the consumer confidence and inflation expectations survey is expected to play an important role in our policy decisions and calibrating our future projections. Given our current conditions, however, SBP's inflation projections for FY12 are in the 8-9 percent range.

6 Fiscal Policy

6.1 Overview

The impact of fiscal policy continued to be expansionary in FY12. Strong growth in expenditures, primarily driven by the increase in debt servicing, subsidies and development spending, played a major role in pushing up the budget deficit to 8.5 percent of GDP (**Figure 6.1**).[1] The revenue side also contributed to this deficit, as the non-realization of envisaged receipts from the auction of 3G licenses and Coalition Support Fund overshadowed the healthy growth in tax collections. With the drying up of external sources of funding, the burden of financing the deficit fell on domestic sources. This heavy reliance on costly domestic borrowing, in the face of a high budget deficit, has unfavorable implications for the sustainability of Pakistan's public debt.[2]

Figure 6.1: Budget Deficit



Source: Ministry of Finance

Fiscal deficit against the target: The budget deficit for the year was targeted at 4.0 percent of GDP. To achieve this target, the government envisaged: (i) a containment in expenditure growth to only 7.9 percent, against 14.6 percent last year; (ii) a significant increase of 27.4 percent in total revenues, on the back of a high target for FBR tax collection; (iii) receipts from the auction of 3G licenses and Coalition Support Funds; and (iv) a surplus of Rs 125 billion by the provinces. However, the actual outcome was substantially different (**Table 6.1**). The provinces posted a deficit of Rs 39.1 billion;[3] non-tax revenues (specifically 3G licenses and CSF) showed significant shortfalls constraining growth in overall revenues to only 13.9 percent; and expenditures – including payment of Rs 391 billion for PSEs debt consolidation – increased by 25.5 percent.[4] Even after excluding one-off payments, expenditure growth turns out to be 14.2 percent, which is almost double the target growth.

Table 6.1: Deviations from Budget Targets FY12

billion Rupees

	Target	Actual	Shortfall (-) or Excess (+)
Budget Deficit	**851.0**	**1,760.7**	**909.7**
Key revenue items:			
FBR taxes	1,951.7	1,881.5	-70.2
PDL	120.0	60.4	-59.6
3G license & CSF	193.7	9.8	-183.9
Key expenditure items:			
Subsidies	166.4	556.2	389.8
Debt servicing	791.0	889.0	98.1
Provinces deficit	-125.0	39.1	164.1
Remaining budgetary items			-56.0

Source: Ministry of Finance

Although FBR tax collection grew by 20.8 percent during FY12, overall revenues were off target due to: (i) less than expected collection of PDL, which was adjusted downward to accommodate the

[1] This deficit in FY12 includes the one-off payment of Rs 391 billion (1.9 percent of GDP) for PSEs' debt settlement. Excluding the one-off, the budget deficit narrows to 6.6 percent of GDP.

[2] For detail discussion on public debt, please see **Chapter 7** on **Domestic and External Debt**.

[3] In fact, it was clear at the start of the year that provinces will not have the required surplus, and thus the targeted budget deficit was increased to 4.6 percent of GDP.

[4] The PSEs debt, taken over by the federal government, was the result of fiscal slippages in recent years, which had remained unaccounted for.

impact of rising oil prices (urged by the Parliamentary Committees); (ii) non-realization of receipts from 3G auctions; and (iii) sudden stop in CSF receipts. Expenditures, on the other hand, continued to increase because of debt servicing and the surge in subsidies and transfer payments. Specifically, subsidies (including one-off payments) ended up three times higher than the target of Rs 166.4 billion. Development expenditures, on the other hand, were on target with a significant growth of over 44 percent, which is good for long-term real growth.

An unfavorable change in financing mix: Although the country had been facing high budget deficits in the past, the key challenge in recent years has been financing the deficit. In the past, cheaper external financing had been available, which generally covered more than half the total financing requirements. However, receipts from this source have been declining for the past several years and its share has dropped to only 7.3 percent in FY12. The share of non-bank borrowing has also declined in FY12, despite a growth of 12.3 percent compared with 8.3 percent in the previous year. Moreover, a significant contribution to non-bank borrowing came from NBFIs' investments in T-bills, instead of savings mobilized through National Savings Schemes.[5] Thus the domestic banking system has become the major source of deficit financing, which is not only costly, but also carries a high opportunity cost, in terms of crowding-out the private sector. Within the banking system, financing from the central bank increased sharply during the year, which does not bode well for Pakistan's macroeconomic stability. A high budget deficit with such an unfavorable financing mix, is difficult to sustain, particularly given the debt burden the country already carries. The significance of this issue is amply visible from the debt servicing obligations of the federal government, which have surpassed its tax revenues (net of provinces' share) for the first time.

6.2 Key Fiscal Indicators

Despite the widening overall fiscal deficit in FY12, both *revenues* and *primary* deficits narrowed

Table 6.2: Summary of Consolidated Public Finance
billion Rupees

					FY12		FY13
	FY08	FY09	FY10	FY11	Budget	Actual	Budget*
Total revenue	1,499.4	1,850.9	2,078.2	2,252.9	2,870.0	2,566.5	3,376.0
Tax revenue	1,050.7	1204.7	1,472.8	1,699.3	2,151.0	2,052.9	2,626.0
Non-tax receipts	448.7	646.2	605.3	553.5	719.0	513.6	750.0
Total expenditure	2,276.6	2,531.3	3,007.2	3,447.3	3,721.0	4,327.2	4,480.0
Current	1,857.6	2,041.6	2,386.0	2,900.8	2,976.0	3,122.5	3,430.0
Development and net lending	423.4	455.7	652.8	514.0	745.0	743.9	1050.0
PSEs debt consolidation						391.0	
Unidentified	-4.4	34.0	-31.6	32.5	0.0	69.8	
Overall deficit	777.2	680.4	929.0	1,194.4	851.0	1,760.7	1,105.0
Financing through:							
External resources	151.3	149.7	188.9	107.7	135.0	128.7	135.0
Internal resources	625.9	530.8	740.2	1,086.7	716.0	1,632.1	971.0
Bank	519.9	305.6	304.6	615.1	304.0	711.7	484.0
Non-bank	106.0	223.8	435.6	471.6	413.0	529.4	487.0
PIB issues for PSEs debt						391.0	
Privatization proceeds	1.7	1.3					
Percent of GDP							
Overall budget deficit	7.6	5.3	6.3	6.6	4.0	8.5	4.7
Revenue deficit	3.5	1.5	2.1	3.6		2.7	
Primary deficit	2.8	0.3	1.9	2.8		2.3	

Source: Ministry of Finance

* Worked out on the basis of information given in Budget in Brief FY13 (page 46)

[5] Change in government policy barred institutional investment in National Savings Schemes from April 2011 onwards.

slightly during the year (**Table 6.2**). However, the revenue deficit of 2.7 percent of GDP in FY12 indicates that the country has to go a long way to achieve the revenue surplus required under the FRDL Act of 2005.[6] Furthermore, a deficit in the revenue balance implies that the government could not mobilize enough resources to finance even its current expenditure. In other words, part of government borrowing is being used to finance current expenses, which cannot contribute to the repayment capacity of the country.

The primary balance (the gap between revenues and non-interest expenditures) has also been negative for the last consecutive eight years.[7] It means that the government is not only borrowing for its debt servicing (non-discretionary spending based on past obligations), but also to finance a portion of its non-interest expenditures. The persistence of these deficits is gradually pushing the country into debt trap.[8]

Cognizant of these issues, the government has been striving to reduce its budgetary deficit to manageable levels. Specifically, the initial budget target has been set at around 4.0 percent of GDP in recent years, reflecting the government intent to pursue fiscal consolidation. However, the actual outcome has been substantially different, indicating challenges in tackling structural imbalances.

6.2.1 Revenues

The revenue receipts (tax and non-tax) for FY12 stood at Rs 2,566.6 billion, which were 89.4 percent of the target for the year. While chronic issues (including the undocumented economy, the provinces' inability to tax the agriculture and services sectors, and the prevalent culture of tax evasion) played their role in this shortfall, the specific factors in FY12 were the non-realization of receipts from CSF and 3G auctions, and below target revenues from the petroleum development levy (PDL). Specifically, the revenue collection target from PDL was Rs 120 billion, but only half of this was

Table 6.3: Composition of Tax and Non-Tax Revenue

billion Rupees

		FY12				
	FY11	**Q1**	**Q2**	**Q3**	**Q4**	**Overall**
Tax revenue	**1,699.3**	**409.0**	**495.7**	**467.0**	**681.3**	**2,052.9**
Direct taxes	594.7	127.6	185.3	156.7	262.3	731.9
Taxes on property	3.8	2.7	0.8	2.0	2.3	7.8
Taxes on goods and services	774.4	204.3	235.0	218.4	277.8	935.5
Taxes on international trade	185.4	42.4	51.8	54.1	69.9	218.2
Petroleum levy	82.7	15.6	4.7	17.9	22.2	60.4
Other taxes	58.2	16.2	18.2	17.9	46.7	99.0
Non-tax revenue	**553.5**	**124.7**	**106.0**	**137.2**	**145.8**	**513.6**
Interest	11.3	1.4	4.7	1.1	5.3	12.5
Dividend	50.6	13.0	4.8	15.2	16.6	49.7
Transfer of SBP profit	181.0	54.0	50.0	50.0	50.0	204.0
Defense	70.7	1.8	2.8	2.7	2.5	9.8
Development surcharge on gas	30.4	5.7	3.2	5.7	8.3	23.0
Discount retained on crude oil	35.9	4.3	6.9	4.6	4.3	20.0
Royalties on gas and oil	59.1	15.0	11.4	18.9	17.6	62.8
Miscellaneous	114.4	29.4	22.1	39.1	41.2	131.8
Total revenue	**2,252.9**	**533.6**	**601.6**	**604.2**	**827.1**	**2,566.5**

Source: Ministry of Finance

[6] FRDL Act 2005 states that the government should generate revenue surplus from 2008 onwards. FY12 is the 6th year in a row that the government has been running the revenue deficit.

[7] The primary deficit is an indicator of increase in the government's debt burden.

[8] It is important to note that the country's ability to sustain these fiscal imbalances has deteriorated in FY12 (for details, please see **Chapter 7**).

collected in FY12. The expected revenues from defense services (including CSF) were Rs 118.7 billion, but due to the absence of any inflows from CSF, actual revenues were Rs 9.8 billion. Similarly, 3G auctions were expected to fetch Rs 75 billion in revenue, but auctions did not take place. Although SBP's profit was Rs 4 billion more than target of Rs 200 billion, and receipts from oil and gas royalties were also higher than the target, these were not enough to compensate for the shortfall in CSF and 3G auctions (**Table 6.3**).

FBR taxes

FBR tax collections (net) recorded a healthy growth of 20.8 percent during FY12. With this growth, FBR's tax-to-GDP ratio has increased from 8.6 percent in FY11 to 9.1 percent in FY12.[9] However, this increase was not enough to achieve the annual target. The actual tax collected during the year stood at 96.4 percent of the target (**Table 6.4**). If the Rs 25 billion collected by the Sindh Revenue Board (through sales tax on services) is also added, target achievement is 97.7 percent, which is still lower than the previous year.

Further details of tax collections reveal that FBR has been tackling the misuse of refunds and rebates during the year. It not only tried to minimize malpractices in sales tax rebates, but also facilitated genuine cases by speedy liquidation of pending refunds. Specifically, it cleared rebate claims of Rs 91.6 billion in case of direct taxes during FY12, compared with Rs 46.7 billion in FY11. In case of sales tax, the volume of rebates declined from Rs 50.8 billion in FY11 to Rs 45.3 billion in FY12. As a result, the ratio of overall rebates and refunds (on all taxes) to total FBR tax collection slightly increased to 7.2 percent by end FY12, compared to 6.4 percent in FY11.

Table 6.4: FBR Tax Collection (Net)

billion Rupees

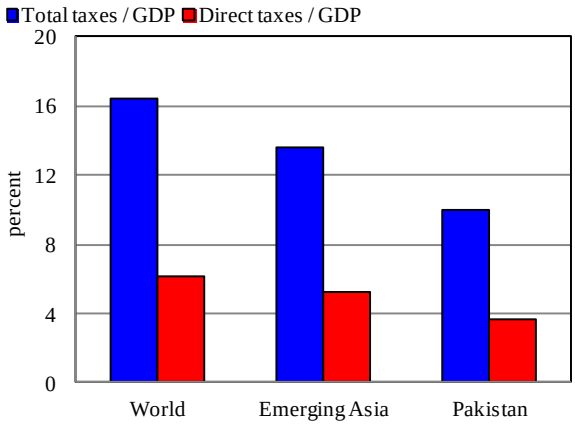
	Annual target		Net collection		% of annual target		% change YoY	
	FY11	FY12	FY11	FY12	FY11	FY12	FY11	FY12
Direct taxes	626.9	743.6	602.5	731.9	96.1	98.4	14.0	21.5
Indirect taxes	960.8	1208.1	955.6	1149.5	99.5	95.2	19.4	20.3
Sales tax	654.6	836.7	633.4	809.3	96.8	96.7	22.4	27.8
FED	132.9	165.0	137.4	122.0	103.4	73.9	13.3	-11.2
Customs	173.3	206.4	184.9	218.2	106.7	105.7	14.5	18.0
Total collection	1,587.7	1,951.7	1,558.0	1,881.5	98.1	96.4	17.3	20.8

Source: Federal Board of Revenue

Direct tax collection

Direct tax collection improved considerably during FY12, with a growth of 21.5 percent, compared with 14.0 percent in the previous year.[10] As a result, its contribution to growth in *total* taxes increased from 32.2 percent in FY11 to 40.0 percent in FY12. This is a favorable outcome towards developing a progressive taxation system. However, Pakistan has to go a long ways as its share of direct taxes in total taxes, is lower compared with many other countries (**Figure 6.2**).

Figure 6.2: Comparative Tax Structure



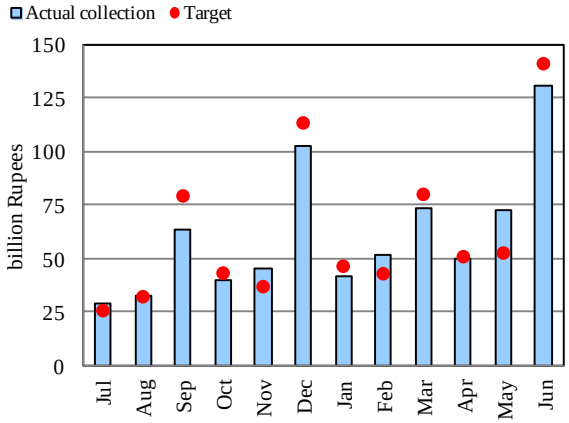
Source: Government Finance Statistics, IMF

[9] Overall tax-to-GDP ratio is 9.9 percent, which includes all federal and provincial taxes.
[10] This was impressive given that inflation was lower in FY12 compared to FY11.

Break-up of direct taxes reveals that more than 80 percent come from voluntary payments and withholding tax, with the latter being mechanical.[11] However, efforts of FBR officials is visible through 'collection on demand' which jumped from Rs 72.2 billion in FY11 to Rs 130 billion in FY12.

The seasonal pattern of direct tax collection in FY12 shows shortfalls at quarter ends; however, FBR attempted to make up for this in subsequent months (**Figure 6.3**). As a result, it was able to achieve 98.4 percent of the target by the end of the year, which was higher than the previous year.

Figure 6.3: Month-wise Direct Tax Targets and Actual Collection



Source: Ministry of Finance and FBR

In Pakistan, income and corporate taxes are the only form of direct taxes; other forms like social contributions and wealth tax are non-existent. In order to upgrade the tax structure in Pakistan, there is a need to expand the base of direct taxes and improve the tax collection machinery to reduce leakages. In our view, the major reasons for low tax compliance are procedural difficulties, tax exemptions and the incentives of tax officials. Currently, only 1 percent of Pakistan's population pays income tax, compared to 3 percent in India and 40 percent in the US.[12]

Indirect tax collection

The collection of indirect taxes continued to follow its growth momentum, and registered a YoY increase of 20.3 percent in FY12; however, it did not meet the target (**Table 6.4**). The major shortfall was in federal excise duties, which was largely due to the removal of special excise duties on manufactured and imported goods, and the withdrawal of federal excise duties on some consumer durables. Moreover, about 50 percent of the collection under this head, comes from cigarettes, beverages and petroleum products; the production of all these items declined during FY12.

Unlike federal excise duties, sales tax collection showed significant growth of 27.8 percent in FY12, compared with 22.4 percent in FY11. This was despite a 100 bps reduction in the sales tax rate, and the transition of the sales tax collection on services from the federal to provincial governments.

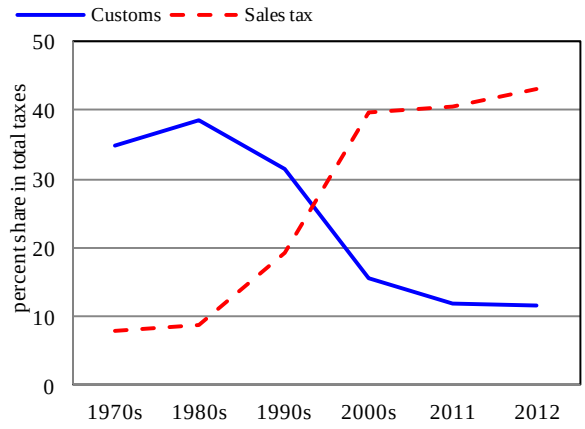
A commodity-wise break-up of sales tax collection suggests that the major contribution to its growth came from domestic sales tax on cement, sugar, natural gas, and fertilizers. While domestic sales tax collection grew by 15.3 percent, sales tax on imports increased by 39.4 percent, primarily due to the removal of exemptions and higher imports of POL products, edible oil, automobile and machinery. Another factor that contributed to the high growth in sales tax was the increased vigilance by FBR over rebates and refunds. Having said this, the bulk of sales tax comes from specific items, which means there is significant potential from documentation and computerization of businesses.

[11] There are three major components of direct taxes in Pakistan: (i) voluntary payments, which include tax payments with returns and advances; (ii) withholding tax, which is amount of tax deducted at source when payments are made in case of salary, contracts, cash withdrawal from banks, interest and dividend payments, telephone bills, etc.; and (iii) collection on demand, which shows the amount of tax recovered by tax officials through audits of tax payers.

[12] See for example www.irs.gov/pub/irs-soi/11infallbulincome.pdf for number of tax returns filed in US and Business Standard, Jan 19, 2011 issue at http://business-standard.com/india/ for a number of Indian tax payers.

Custom duties also grew strongly and contributed Rs 218.2 billion, which was 5.7 percent higher than target. Although custom duties have given way to sales tax as a major contributor to the national exchequer (**Figure 6.4)**, it is still an important policy instrument, both as a source of revenue and as regulator of international trade.

Figure 6.4: Changing Position of Sales Tax and Customs



Source: Federal Board of Revenue

6.2.2 Expenditures

Total expenditures (including one-off payments for PSEs debt settlement) witnessed 25.5 percent growth during FY12. However, if we exclude one-off payments, the total expenditures increased by 14.2 percent, mainly due to sharp rise in debt servicing and public sector development spending. It was the first time in last five years that actual development spending exceeded the target in FY12.[13] Particularly, the provinces prioritized development projects and their development outlays grew by 52.9 percent during the year (**Table 6.5**).

Table 6.5: Break-up of Expenditure

billion Rupees

	FY11	FY12		% Change over	
		Actual	Budget	FY11	FY12 Budget
Total expenditure	**3,447.3**	**3,936.2**	**3,721**	**14.2**	**5.8**
Current expenditure	**2900.8**	**3122.5**	**2976.0**	**7.6**	**4.9**
General public service	1434.0	1472.4	1361.1	2.7	8.2
Interest payments[1]	698.1	889.0	791.0	27.4	12.4
Domestic debt	629.7	821.1	714.7	30.4	14.9
Foreign debt	68.4	67.9	76.3	-0.7	-11.0
Pension	106.6	140.4	96.1	31.7	46.1
Grants	232.1	224.3	295.0	-3.4	-24.0
Others	397.1	218.6	179.0	-44.9	22.2
Defence	450.6	507.2	495.2	12.5	2.4
Others	203.5	175.2	159.7	-13.9	9.7
Provincial	812.7	967.8	960.0	19.1	0.8
Development and net lending	**546.2**	**813.7**	**745.1**	**49.0**	**9.2**
PSDP	461.5	664.8	640.0	44.0	3.9
Federal	215.6	289.3	300.0	34.2	-3.6
Provincial	245.6	375.4	340.0	52.9	10.4
Others[2]	85.0	148.9	105.1	75.3	41.7

[1] These numbers do not match with the amount of interest payments reported in Table 7.1 as: (i) MoF takes actual interest paid on T-bills during the year, while SBP calculates interest payment on accrual basis; and (ii) variation in interest payments on foreign debt is attributed to differences in MoF and SBP definitions of external debt (see Box 7.1 for details).

[2] Includes other development expenditures, net lending, and unidentified expenditure; and excludes one-off payment for debt consolidation.

Source: Ministry of Finance

Current expenditures, on the other hand, showed a subdued growth of 7.6 percent in FY12, compared with 21.6 percent in FY11. However, within current expenditure, domestic debt servicing and pensions increased significantly – by more than 30 percent in the year. While the increase in debt

[13] The government often cuts development expenditure in order to consolidate its overall fiscal balance.

servicing is the result of excessive borrowing from banks, pension increases of 15 to 20 percent, was announced in the FY12 budget to give relief to retired civil and military employees.[14]

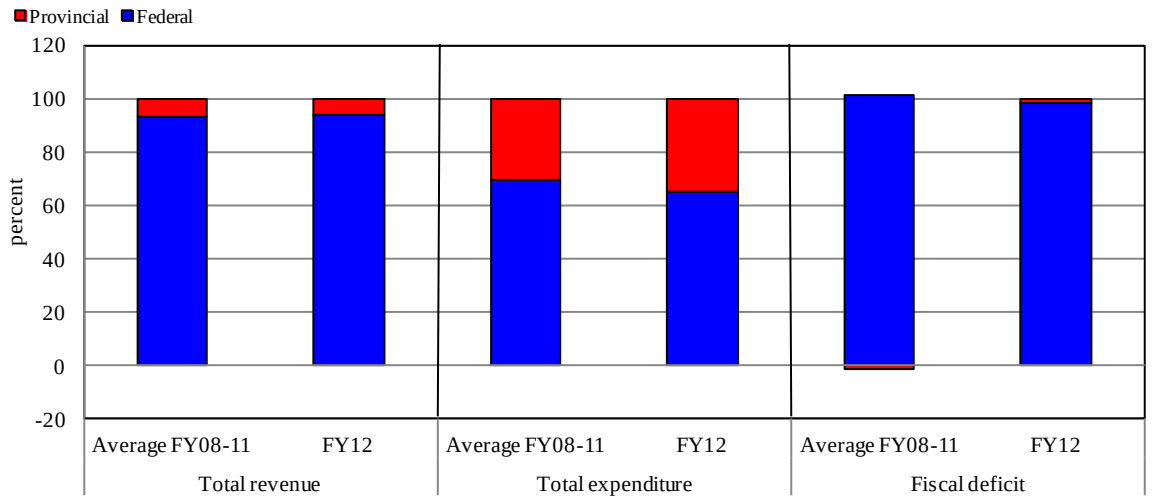
Total interest payments (domestic plus foreign), having a share of 28.5 percent in current expenditure, increased by 27.4 percent in FY12, compared to 8.7 percent in the previous year. The rise in interest payment was entirely driven by a surge in interest paid on the country's domestic debt – interest payments on foreign debt, remained at the same level as in FY11. On the other hand, defence expenditure – another major head of current expenditure with a share of 16.2 percent – increased by 12.5 percent during the year, which is lower than 20.2 percent in FY11.

As discussed earlier, subsidies have become the second largest item in current expenditures after debt servicing; the total volume of subsidies in FY12 actually surpassed the defence budget. During FY12, total subsidies were Rs 556.2 billion, of which 83.2 percent went to power sector and the rest to fertilizer and agriculture commodities.

6.3 Provincial Fiscal Operations

Fiscal operations in Pakistan are traditionally dominated by the federal government. Efforts have been made through the 7th NFC Award and the 18th Amendment, to enhance the role of provincial governments. As shown in **Figure 6.5**, although FY12 was the first full year following the completion of the fiscal devolution process, the share of provinces in revenues and expenditures has not changed much, compared to the period when the federal government dominated Pakistan's fiscal operations.

Figure 6.5: Relative Fiscal Position of Federal and Provincial Governments



Source: Ministry of Finance

Although provincial expenditures have been growing at a CAGR of 21.0 percent during the last four years, their tax effort has not been in line with the understanding reached during the NFC Award. Despite transferring the functions of 17 ministries to provinces, federal expenditure did not fall as: (a) most of the employees of the devolved ministries preferred to stay on the federal payroll rather than opting for the provinces; (b) some new ministries were created in the federal government; and (c) some divisions were upgraded to ministries. Additionally, the federal government agreed to finance the vertical programs over the NFC period.[15]

[14] Of the total pension bill, more than 75 percent goes to retired servants of armed forces.
[15] Vertical programs include projects related to health and population welfare in the provinces, whereby service delivery is the responsibility of the respective province, but finances are provided by the federal government.

As a result, the federal government continued to face pressure on its fiscal balance. The provinces, on the other hand, were unable to support the federal government as had been envisaged in the fiscal devolution process. More specifically, the provinces' share in total expenditure increased from 31.1 percent in FY11 to 34.9 percent in FY12, whereas their share in revenue generation remained almost the same at 6 percent of the total (federal plus provincial) revenues.

Unlike the previous year, when the combined fiscal balance (of all provinces) was in surplus, the provinces showed a deficit in FY12. While the surplus of Rs 134.5 billion in FY11 was due to upward revision in the share of provincial governments to 56 percent in divisible pool (a welcome consequence of 7th NFC Award), the deficit in FY12 was driven by sharp rise in provincial expenditures. However, putting aside what has happened in the last two years, both the 7th NFC Award and 18th Amendments are considered right steps towards greater accountability and efficient decision making in the provision of local services and financing thereof. There is a large theoretical literature, and some empirical evidence, which suggests that decentralization increases economic growth.[16] However, risks associated with decentralized fiscal operations like coordination failure and non-compliance of international agreements – already identified in SBP Annual Report for 2010-11 – still remain.

Of the four provinces, Punjab has a share of 44.5 percent, both in total provincial revenues and in total provincial expenditures. It is followed by Sindh, with a 28.8 percent share in total provincial revenues and a 30.4 percent share in total expenditures. These two provinces drive the whole outcome of provincial fiscal operations. This is why, despite a budget surplus of Rs 19.1 billion in Balochistan, the overall provincial balance was in deficit due to Sindh and Punjab (**Table 6.6**).

Although both Sindh and Punjab displayed efforts to increase revenue, they could not control expenditures. Sindh had to face extra outlays to rehabilitate flood affectees in a large part of the province, while Punjab spent on infrastructure, health, education and food subsidies.

Khyber Pakhtunkhwa (KPK) witnessed a budget deficit of Rs 3.7 billon during FY12, despite being the largest recipient of federal loans and grants (Rs 34.5 billion). The province's own resources (other than grants and transfers from the divisible pool) shrank (-69.7 percent), while its expenditure growth was 30.2 percent during the year. The performance of Balochistan, did not differ from KPK in revenue mobilization; however, its expenditures were well contained. While all other provinces spent on development programs, Balochistan could not keep pace, and therefore witnessed a budget surplus of Rs 19.1 billion.

[16] Some debate on fiscal decentralization can be seen in (i) Darby, J., A. Muscatelli, and G. Roy (2003) Fiscal Decentralization in Europe: A Review of Recent Experience. European Research in Regional Science, 13, 1-32; and (ii) Thiessen V. (2001) Fiscal Decentralization and Economic Growth in High-income OECD Countries; Working Paper 1, European network of Economic Policy Research Institute.

Table 6.6: Summary of Provincial Fiscal Operation

billion Rupees

	Punjab	Sindh	KPK	Balochistan	All
2011-12					
Total revenue	**593.9**	**383.8**	**222.1**	**134.2**	**1334.0**
Share in federal revenue	518.3	285.2	178.9	107.4	1089.9
Provincial taxes	42.1	60.4	3.7	1.0	107.2
Provincial nontax	25.8	12.2	5.0	5.0	48.0
Federal loans/grants	7.6	26.0	34.5	20.8	88.9
Total expenditure	**602.9**	**412.3**	**225.8**	**115.1**	**1356.1**
Current expenditure	445.1	298.1	151.2	86.3	980.6
Development expenditure	157.8	114.2	74.6	28.8	375.4
Overall balance	**-9.0**	**-28.5**	**-3.7**	**19.1**	**-22.1**
*Total financing of deficit **	*-3.1*	*56.1*	*-6.0*	*-7.8*	*39.1*
2010-11					
Total Revenue	**531.0**	**330.7**	**223.8**	**125.9**	**1211.3**
Share in federal revenue	460.8	279.9	157.9	100.7	999.3
Provincial taxes	32.6	27.5	3.5	1.0	64.6
Provincial nontax	24.0	11.5	25.1	1.7	62.3
Federal loans/grants	13.6	11.9	37.2	22.5	85.1
Total expenditure	**482.9**	**310.2**	**173.4**	**110.3**	**1076.8**
Current expenditure	375.5	248.0	121.7	85.9	831.2
Development expenditure	107.4	62.2	51.7	24.3	245.6
Overall balance	**48.1**	**20.5**	**50.3**	**15.6**	**134.5**
*Total financing of deficit **	*-66.1*	*-10.4*	*-35.0*	*-22.4*	*-133.9*

Source: Ministry of Finance

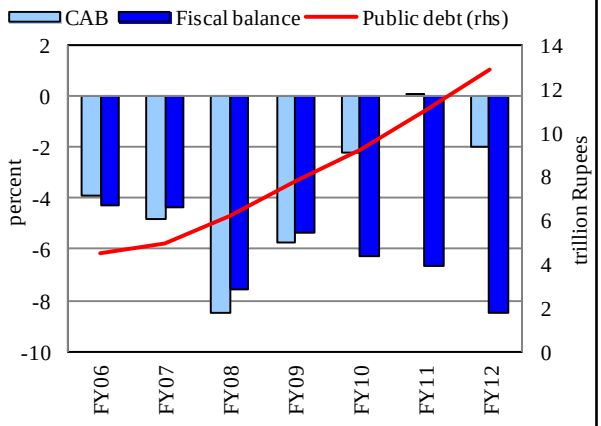
***** The numbers of total financing are different than overall balance due to statistical discrepancies.

7 Domestic and External Debt

7.1 Overview[1]

The improvement in the government's debt burden last year proved short lived: public debt-to-GDP has increased to 62.6 percent in FY12, after falling in FY11.[2] With an increase of Rs 1.9 trillion during the year, Pakistan's total public debt now stands at Rs 12.9 trillion (**Figure 7.1**).[3] This sharp rise was due to a large fiscal deficit (including one-off payment for the settlement of PSE debt); and exchange losses stemming from the depreciation of the Pak Rupee.

Figure 7.1: Deficits and Public Debt Stock



Source: Ministry of Finance and SBP

Most of the increase in public debt was contributed by domestic debt:[4] its share has increased from 54.7 percent in FY11, to 59.1 percent in FY12 (**Table 7.1**). On the other hand, the stock of public external debt has declined by US$ 2 billion due to repayments to the IMF and currency revaluation impact. However, in Rupee terms, this stock has increased due to the depreciation of Pak Rupee against US Dollar in FY12.[5]

Since the persistently large fiscal deficits in the past few years have been financed primarily by costlier domestic sources, this has raised concerns regarding debt sustainability. In this context, two points are worth noting: firstly, within domestic sources, a heavy reliance on expensive short-term debt has increased the debt servicing burden of the country, and has also intensified roll-over and interest rate risks;[6] and secondly, Pakistan has been running a revenue deficit for the past six years, implying that a large part of public borrowings (that financed its current expenditures) did not add to the repayment capacity of the economy (**Figure 7.2**).[7] These debt dynamics indicate that Pakistan could move into a debt trap.[8]

Table 7.1: Public Debt Vulnerability Indicators

percent

	FY08	FY09	FY10	FY11	FY12
Public debt/GDP	60.7	61.6	62.4	60.9	62.6
Public debt/revenues	414.6	423.3	444.1	486.2	503.6
Domestic debt/total public debt	52.7	49.3	50.4	54.7	59.1
Floating debt/domestic debt	50.0	49.3	51.5	53.8	54.2

Source: State Bank of Pakistan

[1] This analysis is based on the SBP's definition of public debt, which is different from Ministry of Finance coverage of public debt. For details, see **Box 7.1**.
[2] In FY11, public debt-to-GDP had declined to 60.9 percent from 62.4 percent a year ago (see **Table 7.2**).
[3] According to Ministry of Finance, public debt has reached Rs 12.7 trillion by end June 2012.
[4] Around 84 percent of the entire increase in the public debt stock during FY12 was contributed by domestic debt, whereas the residual increase was caused by increase in Rupee value of external debt on account of depreciation of Pak Rupee.
[5] Countries normally contract debt in various currencies, which is converted into US Dollar at a particular point in time, for reporting purposes. The exchange rate movements of US Dollar against these currencies cause significant changes in the external debt stock of these countries, which is referred as currency revaluation impact.
[6] Debt servicing payments have surpassed government's tax revenue receipts (after adjusting for provincial share) since last year.
[7] Revenue balance is the gap between total revenue and current expenditures of the government. In FY12, the revenue deficit stood at 62.5 percent of the country's interest payments.
[8] Debt trap refers to a situation, when a country incurs a large amount of debt in comparison to its income. As a result, high interest payments prevent repayment of the principal. According to ADB (2002), the classic symptoms of debt trap include: falling investment rates, declining development and social spending by the government, and progressively lower rates of

Table 7.2: Profile of Pakistan's Debt and Liabilities

	FY10	FY11	FY12	FY10	FY11	FY12
	billion Rupees			percent of GDP		
Total debt & liabilities	10,702.2	12,530.0	14,587.0	72.3	69.5	70.6
Public debt[1]	9,229.1	10,990.7	12,924.3	62.4	60.9	62.6
Total debt	10,069.9	11,908.4	13,921.6	68.0	66.0	67.4
Govt. domestic debt[2]	4,650.8	6,012.2	7,638.3	31.4	33.3	37.0
PSEs domestic debt	375.0	411.5	281.1	2.5	2.3	1.4
External debt	5,040.8	5,484.7	6,002.3	34.1	30.4	29.1
Govt. external debt	3,667.1	3,987.7	4,364.5	24.8	22.1	21.1
IMF loans	690.3	768.7	694.3	4.7	4.3	3.4
PSEs external debt	131.2	116.6	144.2	0.9	0.6	0.7
Private sector external debt	386.2	470.4	600.6	2.6	2.6	2.9
Intercompany debt	166.1	141.2	198.7	1.1	0.8	1.0
Total liabilities	635.5	621.6	665.4	4.3	3.4	3.2
Domestic liabilities	414.6	399.5	438.1	2.8	2.2	2.1
External liabilities	220.9	222.1	227.3	1.5	1.2	1.1
Total debt servicing	978.4	1,017.4	1,260.2	6.6	5.6	6.1
Interest payment	715.0	807.1	966.3	4.8	4.5	4.7
Domestic debt	577.7	650.3	811.2	3.9	3.6	3.9
External debt[3]	82.9	90.6	89.8	0.6	0.5	0.4
Domestic liabilities	52.1	65.0	64.2	0.4	0.4	0.3
External liabilities	2.3	1.3	1.1	0.0	0.0	0.0
Repayment of principal (foreign)	263.4	210.3	294.0	1.8	1.2	1.4

[1.] Public debt include govt. domestic debt, govt. external debt, IMF loans & external liabilities

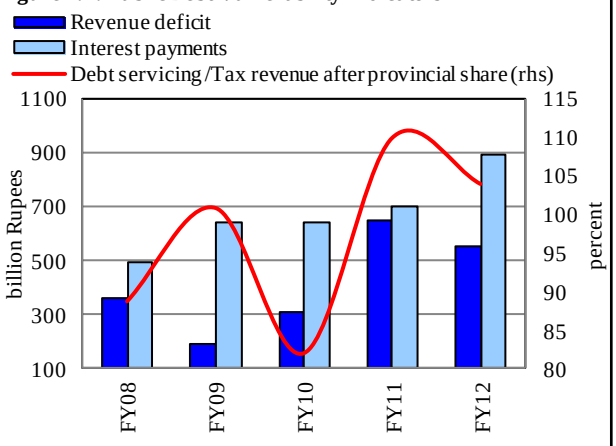
[2.] Domestic debt also includes Rupee value of FEBCs, FCBCs, DBCs and Special US Dollar Bonds held by the residents

[3.] Principal repayment of scheduled bank is excluded from the analysis.

Source: State Bank of Pakistan

In this context, it is not surprising to see the current level of Pakistan's debt stock *above* domestic and international standards. Specifically, public debt in Pakistan is subject to limits prescribed in the FRDL Act (2005), which places a ceiling on the public debt-to-GDP ratio of 60 percent by end FY13, which is to be achieved by running a positive revenue balance after 2008.[9] A public debt-to-GDP ratio of 62.6 percent in FY12, along with persistent revenue deficits, reflects the need for a significant fiscal adjustment in FY13.[10] Similarly, this ratio is also higher than the threshold level identified by the IMF.[11] In addition, an international comparison shows

Figure 7.2: Public Debt Vulnerability Indicators



Source: Ministry of Finance

GDP growth. These factors further weaken macroeconomic performance of the country, making the servicing of debt even more difficult.

[9] The Act also envisages an annual 2.5 percentage point reduction in this ratio after achieving the 60 percent benchmark by end FY13.

[10] Although the condition for 60 percent of debt-to-GDP ratio was met ahead of schedule in FY06, this achievement could not be sustained.

[11] IMF (2011), "Modernizing the Framework for Fiscal Policy and Public Debt Sustainability Analysis", Fiscal Affairs Department and the Strategy Policy and Review Department. According to IMF, at a public debt level of 60 percent of GDP, detailed analysis of risks to sustainability arising from high debt levels should be conducted.

that Pakistan's gross debt is higher than the average for both emerging, as well as low-income economies (**Table 7.3**). However, Pakistan fares better than many European countries. In our view, the on-going Euro crisis is likely to persist as most European countries are still struggling to contain their massive debt-to-GDP ratios (**Table 7.4**).

Stepping back, Pakistan's external vulnerability has also increased during FY12; as in the absence of sufficient external inflows, the repayment burden of external debt (along with the financing of current account deficit) fell on the country's FX reserves.[12] This resulted in downgrading of Pakistan's sovereign credit rating to its lowest level, Caa1, by Moody's in July 2012.[13]

These challenges to the macroeconomic stability of the country, emphasize the need for fiscal consolidation. It is important to realize that a country cannot continue increasing its debt stock without a commensurate increase in its repayment capacity. Global experience shows that failing to adhere to this simple principle, has led to several episodes of defaults, on both external and domestic debts (**Box 7.3**).[14]

Box 7.1: Public Debt – Differences in SBP & MoF Definition

According to SBP data, public debt reached Rs 12.9 trillion by end June 2012, while the Ministry of Finance has reported public debt at Rs 12.7 trillion for the same period (**Table 7.1.1 & 7.1.2**). This disparity in debt numbers is due to differences in coverage of public debt reported by the two organizations.

The SBP follows IMF guidelines for compiling public debt, which state, "public sector includes the general government, monetary authorities, and those entities in the banking and other sectors that are public corporations."[15]

Thus, public debt reported by SBP, is composed of four broad categories: (i) government domestic debt; (ii) government external debt; (iii) IMF loans; and (iv) external liabilities. It may be noted, however, that due to the unavailability of detailed information, SBP public debt numbers do not include PSE's debt.

Table 7.3: International Comparison - Gross Debt/GDP

percent

	2008	2009	2010	2011	2012
Low income countries	39.1	41.3	38.6	38.2	39.5
Advanced economies	81.5	93.0	99.3	103.5	106.5
Emerging economies	34.7	36.7	41.0	37.6	35.7
China	17.0	17.7	33.5	25.8	22.0
India	74.7	75.0	69.4	68.1	67.6
Pakistan*	60.7	61.6	62.4	60.9	62.6

*Data for Pakistan pertains to fiscal year.

Source: Fiscal Monitor, Balancing Fiscal Policy Risks, April 2012, IMF & State Bank of Pakistan

Table 7.4: Government Debt-to-GDP Ratio in European Countries

percent

	2011	2012
United Kingdom	82.5	88.4
Austria	72.2	73.9
Belgium	98.5	99.1
France	86.1	88.2
Germany	81.2	82.2
Greece	165.4	162.6
Ireland	108.2	117.6
Italy	120.1	125.8
Netherlands	66.2	70.1
Portugal	107.8	114.4
Spain	68.5	90.3

Source: IMF and Bloomberg

Table 7.1.1: Public Debt -Ministry of Finance

billion Rupees

	FY09	FY10	FY11	FY12
Public debt (I+II)	**7,595**	**8,938**	**10,709**	**12,661**
I. External debt	3,736	4,284	4,694	5,023
II. Government domestic debt	3859	4,654	6,015	7,638
Public debt/GDP	**59.7**	**60.4**	**59.4**	**61.3**

Source: Pakistan Economic Survey 2011-12 and Ministry of Finance

Table 7.1.2: Public Debt - SBP

billion Rupees

	FY09	FY10	FY11	FY12
I. Government external debt (i+ii+iii)	3,452.0	3,667.1	3,987.7	4,364.5
i. Medium & long-term	3,382.7	3,580.1	3,921.0	4,318.7
ii. Military	16.2	14.3	11.6	9.7
iii. Short-term debt	53.1	72.7	55.0	36.1
II. From IMF	419.0	690.3	768.7	694.3
III. External liabilities	103.7	220.9	222.1	227.3
IV. Government domestic debt	3,860.7	4,650.8	6,012.2	7,638.3
Public debt (I+II+III+IV)	**7,835.3**	**9,229.1**	**10,990.7**	**12,924.3**
Public debt/GDP	**61.6**	**62.4**	**60.9**	**62.6**

Source: State Bank of Pakistan

[12] Country's FX reserves fell from the level of 27.8 weeks of imports in FY11, to 19.9 weeks of imports in FY12.
[13] This is the lowest rating assigned to Pakistan since 1999, by Moody's.
[14] (IMF 2008), "Staff Guidance Note on Debt Sustainability Analysis for Market Access Countries", Prepared by the Policy Development and Review Department
[15] Source: IMF (2003), "External Debt Statistics, Guide for Compilers and Users."

While both MoF and SBP follow the same definition of government domestic debt, the coverage of government 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 the government external debt. As a result, overall public debt numbers from these two organizations do not match.

7.2 Domestic Debt

As discussed earlier, a large fiscal deficit has resulted in Rs 1.6 trillion increase in the country's domestic debt during FY12 (**Table 7.5**). More than half of this increase came from short-term debt, as the government borrowed heavily from the domestic banking system (**Table 7.6**).

Table 7.6: Government Primary Auction Details for FY12

billion Rupees

	Target	Offered	Accepted
T-bills	3,345.0	4,773.6	2,854.6
PIBs	185.0	325.0	221.0
Ijara	150.0	248.3	186.8
Total	**3,680.0**	**5,346.9**	**3,262.4**

Source: State Bank of Pakistan

Table 7.5: Position of Domestic Debt

billion Rupees

Debt Instrument	Outstanding Stock			Interest Payments		
	FY11	FY12	Change	FY11	FY12	Change
A. Permanent debt	1,122.4	1,695.9	573.5	91.8	136.0	44.2
Of which						
GOP ijara sukuk 3yrs	224.6	383.5	158.9	11.2	26.9	15.6
Pakistan investment bonds (PIBs)	616.4	974.7	358.3	57.3	81.7	24.5
Prize bonds	277.1	333.4	56.3	22.8	27.3	4.5
B. Floating debt	3,232.6	4,142.9	910.3	361.4	377.1	15.7
Market treasury bills	1,814.8	2,383.2	568.4	191.9	202.8	10.8
Market related treasury bills (MRTBs)	1,417.8	1,759.7	341.9	169.5	174.4	4.9
C. Unfunded debt	1,655.8	1,798.0	142.2	197.0	298.0	101.0
Of which						
Defense saving certificates	234.5	241.8	7.3	55.9	70.8	14.9
Special savings certificates (registered)	394.6	341.8	-52.8	24.3	86.7	62.4
Regular income certificates	182.6	226.6	44.0	19.3	25.5	6.2
Behbood savings certificates	428.5	480.8	52.3	61.0	69.8	8.8
Pensioners' benefit account	146.0	162.3	16.4	21.4	23.9	2.6
D. Foreign currency instruments *	1.4	1.4	0.0	0.1	0.0	-0.1
Total domestic debt (A+B+C+D)	6,012.2	7,638.3	1,626.1	650.3	811.2	160.9

* It includes FEBCs, FCBCs, DBCs and Special US Dollar Bonds held by the residents.
Source: State Bank of Pakistan

7.2.1 Floating Debt

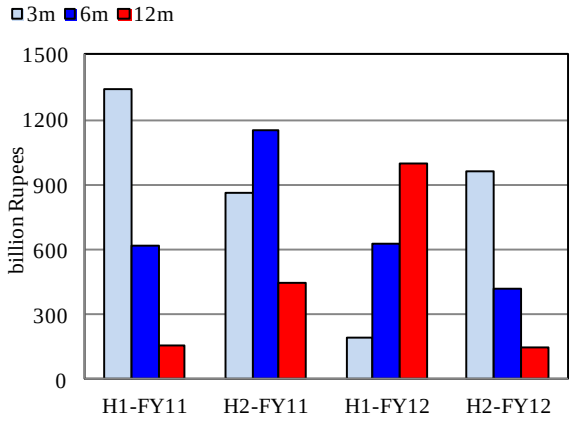
The share of floating debt in domestic debt has reached to 54.2 percent by end FY12; the increase of Rs 910.3 billion includes Rs 195 billion for the settlement of circular debt discussed earlier.[16]

Bank investment in T-bills saw two distinct patterns during FY12. In the first half of the year, following a cut in the policy rate, banks shifted their investment towards 12-month T-bills, to lock-in longer-term assets in anticipation of a further decline in interest rates. However, in the second half of the year, concerns over a weak external position and persistence in inflation, raised expectations of status quo in the policy rate, which prompted banks to shift towards 3-month T-bills (**Figure 7.3**)[17].

[16] Of the total settlement of Rs 391 billion, Rs 195 billion were raised by issuing 12-month T-bills.
[17] By end-June 2012, the share of 3-month securities in the outstanding T-bills stock stood at 25 percent, compared to a mere 8.4 percent in the same period last year.

As shown in **Table 7.5**, even though banks *offered* above-target amounts in the T-bill auctions, the government did not adhere to these targets, and borrowed much less. This was due to higher rates demanded by the banks, which the government was not comfortable with. As a result, the government's reliance on borrowing from the central bank increased during FY12: after retiring Rs 103 billion to SBP during Q1-FY12, the government breached its commitment of zero quarterly borrowing from SBP in the fourth quarter after the amendment in the SBP Act.

Figure 7.3: Realized Amount in T-bill Auctions



Source: State Bank of Pakistan

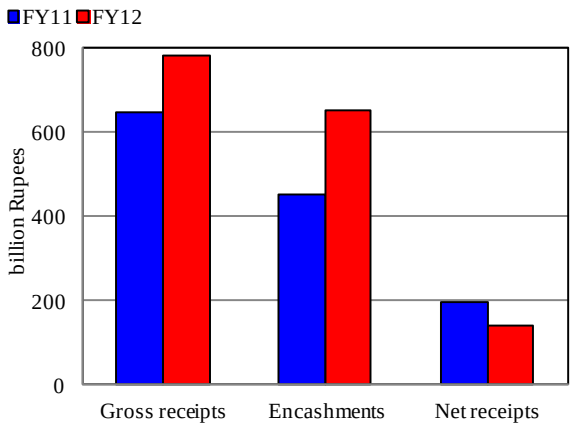
7.2.2 Permanent Debt

Permanent debt increased by Rs 573.5 billion during FY12 that includes Rs 195 billion worth of 5-year PIBs for the settlement of circular debt (**Table 7.4**). Furthermore, the stock of prize bonds also increased by Rs 56.3 billion due to strong public interest in the newly introduced Rs 25,000 denominated bond during the year. While some of this increase could be attributed to substitution from other securities, we believe that fresh mobilization has taken place as this denomination appears to meet investors' needs.

7.2.3 Unfunded debt

Pakistan's unfunded debt increased by Rs 142.2 billion during FY12, which was smaller than FY11, despite higher gross NSS inflows during FY12. This was primarily due to higher encashments by institutional investors, who were barred from participating in these schemes from April 2011 (**Figure 7.4**).

Figure 7.4: NSS Flows



Source: Central Directorate of National Savings

Gross receipts in NSS were higher despite two downward revisions in the rates in October 2011 and January 2012. This probably reflects the fact that even lower rates were attractive to investors compared with alternative bank deposits (**Table 7.7**).[18]

Furthermore, to boost private savings in the country and reduce government dependence on the bank borrowing, the Central Directorate of National Savings (CDNS) has launched certificates of shorter maturities, i.e., 3-month, 6-month and 12-month, from 1st July, 2012. While this initiative will help in mobilizing funds, it carries the risk of reducing the average maturity of borrowing through NSS.

Table 7.7: Rates of Return on Major NSS Instruments

percent

	RICs	PBAs	BSCs	SAs
Jul-11	13.44	15.36	15.36	9.00
Oct-11	12.60	14.40	14.40	8.50
Jan-12	11.76	13.86	13.86	8.25
Apr-12	12.12	14.28	14.28	8.40
Jul-12	12.36	14.64	14.64	8.65

Source: Central Directorate of National Savings

[18] The rates on NSS were, however, revised upward during April 2012 and July 2012.

7.3 Interest Payments on Domestic Debt

Interest payments on domestic debt rose by 24.7 percent during FY12. However, nearly one-third of the total increase (Rs 811.2 billion) was due to encashment by institutional investors from NSS, specifically SSCs (**Table 7.5**). Previously, institutional investors were reinvesting interest payments on these certificates, but due to the ban on their participation, large withdrawals were seen during the year. Furthermore, concentrated payments on PIBs due in Q4-FY12, increased interest payments on permanent debt in FY12.

Table 7.8: Pakistan's External Debt and Liabilities

billion US$

	FY11	FY12	Abs Δ
Public debt (1+2+3)	**57.9**	**55.9**	**-2.0**
1. Government debt	46.4	46.1	-0.3
i) Long term(>1 year)	45.7	45.7	0.0
of which			
Paris club	15.5	15.0	-0.4
Multilateral	25.8	25.4	-0.4
Bilateral	1.9	2.5	0.5
Euro/Sukuk global bonds	1.6	1.6	0.0
ii) Short term (<1 year)	0.6	0.4	-0.3
2. From IMF	8.9	7.3	-1.6
i) Federal government	2.0	1.9	-0.1
ii) Central bank	6.9	5.4	-1.5
3. Foreign exchange liabilities	2.6	2.4	-0.2
4. Public sector enterprises (PSEs)	1.4	1.5	0.2
i) Guaranteed debt	0.1	0.2	0.1
ii) Non guaranteed debt	1.3	1.3	0.0
5.Banks	1.1	1.8	0.7
i) Borrowing	0.4	0.9	0.5
ii) Nonresident deposits (LCY & FCY)	0.7	1.0	0.3
6. Private sector	4.4	4.5	0.1
i) Non guaranteed debt	4.4	4.5	0.1
Loans	2.4	2.2	-0.1
Non-guaranteed bonds	0.1	0.1	0.0
Trade credits	1.6	1.6	0.0
Other debt liabilities	0.3	0.3	0.0
7. Debt liabilities to direct investors	1.6	2.1	0.5
Total external debt (1+2+3+4+5+6+7)	**66.4**	**65.8**	**(0.6)**

Source: For serial no. 1 & 2, with the exception of 2.i & 4.i Economic Affairs Division, rest from State Bank of Pakistan.

7.4 External Debt & Liabilities

The stock of external debt & liabilities (EDL) fell by US$ 569 million to reach US$ 65.8 billion by end-June 2012 (**Table 7.8**).[19] Currency revaluation, and a sizeable increase in debt repayment, explains this fall.[20]

7.4.1 Sustainability of External Debt & Liabilities

The evaluation of a country's external debt sustainability includes an assessment of its debt carrying capacity as indicated by solvency indicators, as well as the ability to meet immediate external liabilities (as measured by liquidity indicators). On a positive note, following the decline in EDL stock, Pakistan's external debt burden fell from 31.5 percent of GDP in FY11, to 28.5 percent in FY12 (**Table 7.9**). However, this improvement was not reflected in a reduction in debt servicing burden, since debt servicing ratios to foreign exchange earnings (FEE) and export earnings (XE) deteriorated this year. While the debt repayment to IMF led to a 21.2 percent increase in debt servicing, FEE grew by only 0.6 percent during the year (largely on account of declining export earnings).

Furthermore, the country's foreign exchange reserves also came under pressure in FY12, as *reserve adequacy* in relation to the short-term debt and current account deficit – as shown by the ratio (STD+CAB)/RES – deteriorated (**Table 7.9**).[21]

[19] SBP has enhanced the coverage of external debt statistics, according to the IMF external debt guide (2003). The additional data includes: (i) short term local currency securities held by the government (ii) over draft balances of PSEs (iii) local and foreign currency deposits held by non-residents (iv) private sector trade credits (e) liabilities of pension funds & life insurance companies to non-residents, claims on non-life companies; capital subscriptions to international non-monetary organizations, etc., and (v) debt liabilities to direct investors.

[20] Exchange rate revaluation resulted in US$ 1.3 billion transactional gain for Pakistan during FY12. Currency composition of external debt revealed that 11 percent of public external debt stock is denominated in Euros. Therefore, a large 13.1 depreciation in the value of Euro vs. US Dollar resulted in US$ 767 million fall in the external debt stock during FY12. In addition, the appreciation of US Dollar against SDRs resulted in a further US$ 662 million transactional gain during this year.

[21] The dip in this ratio during FY11 was mainly due to a surplus in current account.

Non-interest current account deficit is an important determinant of a country's external debt burden. In the absence of a commensurate increase in non-debt creating capital inflows, the rise in the current account deficit translates into an increase in debt stock of a country (or depletion of foreign exchange reserves). In FY12, as external loan inflows were not forthcoming, the current account deficit along with payments of external debt, led to a fall in the country's FX reserve from 27.8 weeks at end-June 2011, to 19.9 weeks by end-June 2012 (**Table 7.9**). Thus, despite a fall in external indebtedness, Pakistan's external vulnerability increased during FY12.

Table 7.9: Indicators of External Debt Sustainability

	FY08	FY09	FY10	FY11	FY12
Solvency indicators					
TED/GDP*	--	--	33.4	30.3	27.4
EDL/GDP*	--	--	34.9	31.5	28.5
IP/FEE	3.4	3.3	2.7	2.3	2.2
EDS/FEE	8.7	13.5	12.2	7.5	9.0
IP/XE	6.1	6.1	5.2	4.2	5.5
EDS/XE	15.6	24.8	23.3	13.9	23.3
Liquidity indicators					
STD/TED*	--	--	3.3	2.6	2.0
RES/STD*	--	--	8.7	11.7	12.0
(STD+CAB)/RES*	--	--	34.9	7.5	38.8
WoM (number)	17	21.1	28.2	27.8	19.9

TED: Total External Debt; EDL: External Debt and Liabilities; IP: Interest Payments; EDS- External Debt Servicing; IP- Interest Payments; STD; Short Term Debt; CAB- Current Account Balance; WoM- Weeks of Imports; FEE- Foreign Exchange Earnings; XE- Exports Earnings; RES- Overall Reserves

*Debt data according to new coverage, not available before FY10.

Source: State Bank of Pakistan calculations

Furthermore, a regional comparison of Pakistan's external debt also highlights some concerns. According to the Global Development Finance (2012), Pakistan's external debt (while declining) is higher than the average South Asian and developing economies. Similarly, debt servicing claims a larger share of export earnings in the case of Pakistan, compared to developing and South Asian countries, whereas FX reserves-to-external debt, is also below the comparison countries (**Figure 7.5**).

Disbursements

Disbursements by external creditors recorded a welcome 19.0 percent YoY increase in FY12. According to the donor-wise composition, while bilateral loan inflows recorded a sharp 59.3 percent increase during FY12, inflows from the multilateral creditors, particularly IDA & ADB declined (**Table 7.10**). The increase from bilateral creditors, largely owes to the provision of a medium-term (2-years) BoP support from China in June 2012. Excluding this, inflows of external loans fell by 0.6 percent, compared to last year.

Table 7.10: Net External Flows from Major IFIs

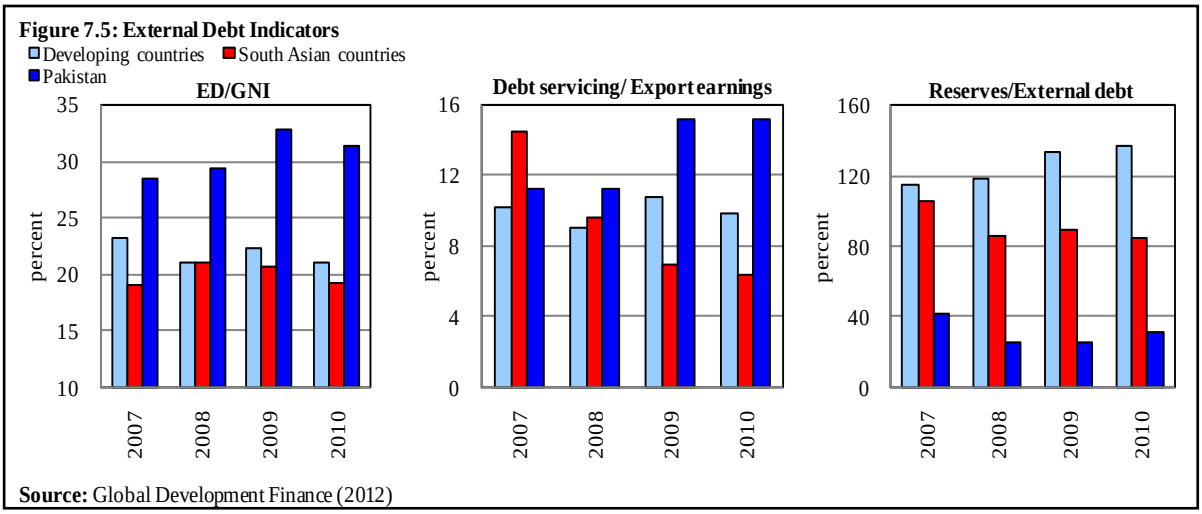
million US$

	FY09	FY10	FY11	FY12
ADB	1,019.4	323.3	-231.6	-400.0
IDA	622.9	453.4	540.8	290.4
IDB (LT)*	62.6	126.6	40.2	138.4
IDB(ST)**	-280.0	201.1	-353.7	-23.0
IMF	3639.0	2054.0	-440.0	-1,319.0

*Long-term, **Short-term

Source: State Bank of Pakistan and Economic Affairs Division

Figure 7.5: External Debt Indicators



Source: Global Development Finance (2012)

In overall terms, against the total commitments of US$ 4.0 billion, actual inflows stood at US$ 3.0 billion during this year (**Figure 7.11**). In particular, program loans recorded a sharp decline during FY12. It is important to mention here, that the suspension of IMF's SBA is a key factor in the declining program loan inflows. These inflows are long-term in nature, involve strict scrutiny at the time of disbursement, and are generally linked to the IMF's endorsement. The suspension of the IMF program in FY11, and slow progress of fiscal reforms are responsible for dwindling inflows.

Table 7.11: Loan Disbursements

million US$

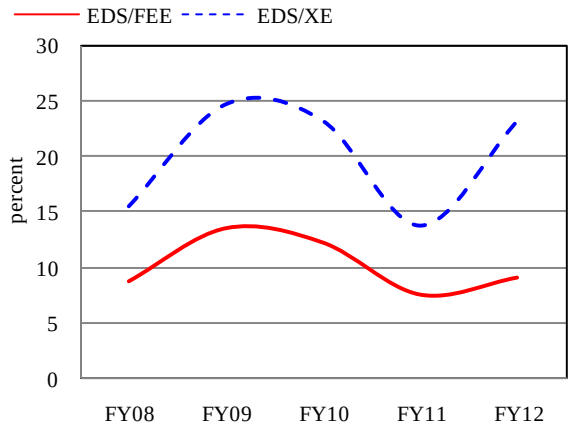
	FY11	FY12	Abs Δ
Bilateral	**1,096.8**	**1,747.5**	**650.8**
of which			
China	314.1	1,047.6	733.6
Japan	167.2	227.3	60.0
UK	117.6	171.8	54.2
Multilateral	**1,451.2**	**1,284.5**	**-166.6**
of which			
ADB	497.4	417.8	-79.5
IDA	791.5	575.4	-216.2
IDB	55.0	149.6	94.6
Total	2,548.0	3,032.1	484.1

Source: Economic Affairs Division

7.4.2 External Debt Servicing

As expected, Pakistan's external debt servicing recorded a significant US$ 784.5 million increase during FY12 (**Table 7.12**). Within that, while the interest payments on external loans witnessed a YoY decline, repayments of *principal* surged due to the repayment to the IMF.[22] This increase in debt servicing, in the presence of negligible growth in foreign exchange earnings, reduced the country's debt servicing capacity during the year (**Figure 7.6**).

Figure 7.6: Detrioration in Pakistan's Debt Servicing Capacity



Source: State Bank od Pakistan

On the upside, Pakistan was able to roll-over central bank deposits worth US$ 1.0 billion, as well as US$ 543 million owed to IDB during FY12. In the absence of these arrangements, the debt servicing burden would have been even higher.

[22] Importantly, the amortization of IMF loans is likely to keep debt servicing high till FY15.

Table 7.12: External Debt Servicing
million US$

	FY07	FY08	FY09	FY10	FY11	FY12
i. Public debt (a+b+c)	**2,031.3**	**2,377.1**	**3,130.7**	**3,321.9**	**2,826.6**	**3,657.0**
Principal	1,120.8	1,372.7	2,162.9	2,445.1	1,881.7	2,800.0
Interest	910.5	1,004.4	967.9	876.9	944.9	892.6
a. Govt. debt	1,833.3	2,128.1	2,822.7	2,784.1	2,247.9	2,263.0
Principal	978.8	1,177.7	1,930.9	2,053.4	1,491.5	1,546.3
Interest	854.5	950.4	891.9	730.7	756.5	716.7
b. IMF loans	143.0	191.0	264.0	359.4	441.8	1317.8
Principal	120.0	173.0	210.0	239.8	268.2	1153.7
Interest	23.0	18.0	54.0	119.6	173.6	164.1
c. FX Liabilities	55.0	58.0	44.0	178.4	136.9	111.8
Principal	22.0	22.0	22.0	151.9	122.0	100
Interest	33.0	36.0	22.0	26.5	14.9	11.8
ii. PSEs debt	**270.1**	**252.7**	**236.9**	**351.9**	**358.9**	**248.9**
Principal	200.7	171.0	176.8	290.4	310.1	211.0
Interest	69.3	81.7	60.1	61.4	48.7	38.0
iii. Private sector debt	**382.7**	**484.8**	**628.6**	**457.0**	**321.0**	**349.5**
Principal	271.6	323	497.8	388.2	247.2	265.3
Interest	111.1	161.8	130.8	68.8	73.8	84.1
External debt (i+ii+iii)	**2,684.0**	**3,114.6**	**3,996.2**	**4,130.8**	**3,506.5**	**4,291.0**
Principal	1,593.1	1,866.7	2,837.4	3,123.6	2,439.0	3,276.3
Interest	1,090.9	1,247.8	1,158.8	1,007.1	1,067.5	1,014.7

Source: State Bank of Pakistan

Box 7.2: Domestic Debt Burden: Early Warning Signs for Pakistan

International Experience: Difficulties in raising external financing have led to large increases in domestic debt burden in a number of countries. According to Reinhart & Rogoff (2008), domestic debt accounted for almost two-third of total public debt for a sample of 64 emerging and advanced countries, during the period 1914-2007. Contrary to the popular belief, that governments *always* honor their domestic liabilities, an excessive reliance on expensive domestic borrowing has led to a large number of sovereign defaults on domestic debt.[24]

Table 7.2.1: Early Warning Signs[23]
percent

Indicators	Threshold
Fiscal deficit/GDP	3
Public debt servicing/government revenues	15
Public domestic debt/government revenues	200

Given the risks to macroeconomic stability from excessive reliance of the government on domestic borrowing, this is pertinent to assess the sustainability of a country's domestic debt burden also. A detailed survey of literature provides a set of indicators for assessment of fiscal and debt sustainability in member countries (**Table 7.2.1**). Furthermore, the literature also highlights the growth supporting effects of a moderate level of domestic debt, through the channels of improved monetary policy; broader financial market development; strengthened domestic institutions and enhanced private savings and financial intermediation. In this regard, Abbas and Christensen (2007) finds that the domestic debt above 35 percent of bank deposits can hurt economic growth.[25] These benchmarks can be used as early warning signals for the assessment of Pakistan's fiscal and domestic debt sustainability.

Pakistan's Scenario: Pakistan's case is not an exception to international experience. A sharp increase in the fiscal deficit, coupled with unavailability of external financing, has led to a rising domestic debt burden over the past few years. In particular, the share of domestic debt in total public debt has risen from 49.3 percent in FY09 to 59.1 percent in FY12.

[23] Sources: (i) Buti Marco and Noord Paul van den (2004), "Fiscal policy in EMU: Rules, discretion and political incentives", European commission, Directorate-General for Economic and Financial affairs. Economic papers; (ii) Heavily Indebted Poor Countries Capacity Building Programme (2009), "Debt Sustainability Indicators", www.development-finance.org/.../83-debt-sustainability-indicators-2009-02.html; (iii) A study on "domestic debt sustainability" by Macroeconomic and Finance Management Institute of Eastern and Southern Africa –MEFMI (2002).

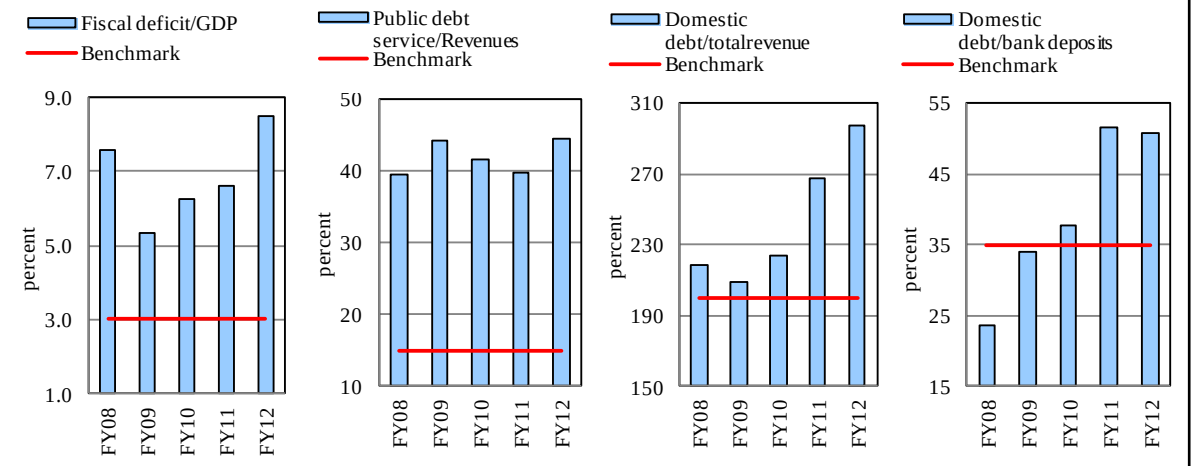
[24] According to Reinhart & Rogoff (2008), during the period of 1914-2007, there have been 68 cases of defaults on domestic debt. These defaults took place through a number of mechanisms ranging from forcible conversions to suspension of payments.

[25] For obtaining consistent data series on domestic debt across the sample countries, Abbas and Christensen (2007) defined domestic debt as banks' and other banking institutions' claims on central government.

A comparison of Pakistan's fiscal and debt indicators with the earlier identified benchmarks presents a gloomy picture. The country's fiscal deficit is above the threshold level by a wide margin, and the servicing of public debt takes away a growing share of revenues as compared to the benchmark level. Similarly, due to a sharp increase in country's domestic debt, the ratio of domestic debt-to-total revenues has witnessed significant deterioration since FY10 (**Figure 7.2.1**). Finally, domestic debt, calculated as banks' and other depository institution's claims on the government is also above the benchmark. This shows that excessive reliance on the banking system for budgetary borrowing has reached the level where the growth distorting effects of domestic debt in the form of crowding-out of private sector, debt sustainability issues, inflation, etc., start to emerge.

This situation indicates the need for introducing stringent fiscal discipline. In this regard, Pakistan has adopted a 'rule based fiscal policy stance' since 2005. The fiscal policy rules/targets were incorporated in the 'Fiscal Responsibility and Debt Limitation (FRDL) Act, which was passed by the Parliament in 2005. This act laid down specific targets for fiscal and debt indicators, along with clearly mentioned timelines. In addition, the recent amendment in the SBP Act in March 2012 – that places limits on government borrowing from the central bank – is also an attempt in this direction.

Figure 7.2.1: Domestic Debt Sustainability - Early Warning Signs



Source: Analyst estimates

Therefore, the early warning indicators identified in this section are an addition to the existing stock of fiscal rules for the government. International experience suggests that a failure to introduce reforms can lead the country to a serious macroeconomic crisis.

References:

- Reinhart Carmen M. and Rogoff Kenneth S. (2008), "The forgotten history of domestic debt", NBERWorking Paper 13946.
- Abbas S. M. Ali and Christensen Jakob E (2007), "The role of domestic debt markets in economic growth: An empirical investigation for low-income countries and emerging markets", IMF Working Paper, WP/07/127
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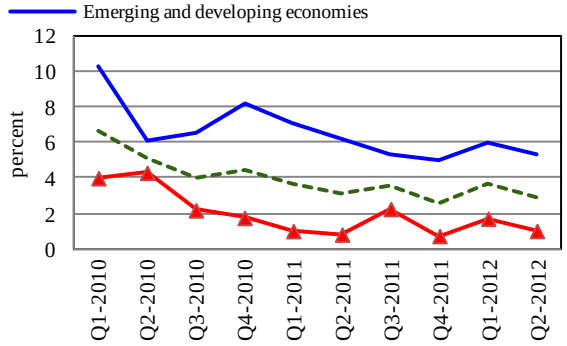
8 Balance of Payments

Since Balance of Payments is a record of all transactions made between one country and all other countries during a specified period of time, a review of global economic developments provides a useful perspective to discuss Pakistan's balance of payments. As such, first part of the chapter gives a brief overview of the global economic environment during FY12, while the rest of the chapter focuses on Pakistan's specific balance of payment developments.

Figure 8.1: Global Trends in GDP Growth
(quarter over quarter annualized)

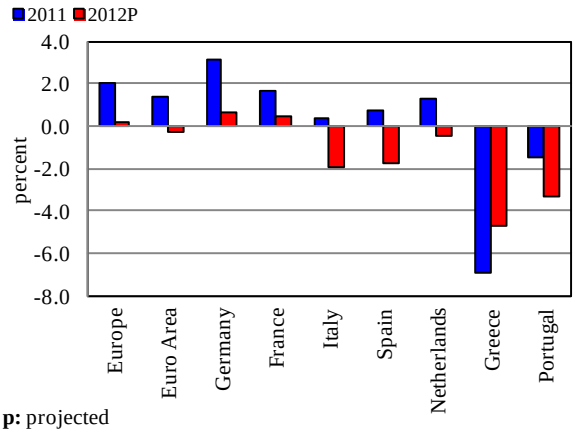


Source: World Economic Outlook

8.1 International Developments[1]

Prospects for the world economy in 2012 were not very promising to begin with (**Figure 8.1**). As the year progressed, downside risks to the anticipated recovery escalated due to the deepening Eurozone debt crisis, cuts in fiscal spending, and continued deleveraging by firms and households in the US and other advanced economies.

Figure 8.2: GDP Growth



p: projected
Source: World Economic Outlook

The epicenter of the current recession gripping the OECD, is the Eurozone. Lack of consensus among policymakers over Greece, and rumors regarding its possible exit from the currency union, has seen the crisis spillover to other larger Eurozone economies. In addition, banking sector problems in Spain have emerged as an additional threat to the economic recovery. As a result, borrowing costs in Italy and Spain are on the rise, and private credit growth is declining. Overall, the outlook for Europe remains bleak: most countries are expected to experience a contraction in GDP this year (**Figure 8.2**). Even Germany, which has so far shown resilience to the crisis, is showing signs of a slowdown as the demand for its exports declines.

The European Union has taken several measures in response, especially to ensure adequate funds to make repayments, and keep market borrowing rates affordable. Notwithstanding these efforts, the crisis continues. Perhaps this is because the solution is neither simple nor cheap. European banks are the largest holders of EU government debt. In case a problem country defaults on its debt, their balance sheets will be impacted. Given the contagion in a financial crisis, the failure of a single bank could spread across the global financial system.[2]

[1] This section is based on the data and information from IMF World Economic Outlook July 2012.
[2] IMF Working Paper No. 10/236 October 1, 2010: CFS Working Paper, No. 1999, 17th November 1999.

As far as the US is concerned, the economy is likely to grow at 2.0 percent during 2012, slightly better than last year. However, this projected recovery could stall due to a slowdown in the Eurozone, and the expected expiry of fiscal incentives in December 2012, the so-called "fiscal cliff".

In fact, even the economies of Brazil, China and particularly India, which have so far been the drivers of global growth, are also slowing. In particular, India's quarterly GDP growth declined for the eighth consecutive quarter in January-March (Q4-FY12), hitting a nine-year low of 5.3 percent.[3] Moreover, foreign capital inflows have declined, the Indian Rupee has depreciated sharply during FY12, and the government's failure to implement reforms have hurt business confidence. Growth prospects in Brazil and China are also softening, as risk aversion by global investors takes hold.

The IMF has revised downward its projections for world economic growth for 2012 and 2013. Growth rates for both advanced and emerging economies have been revised downwards since the April projections. The global economy is now expected to grow by 3.5 percent in 2012, 10 bps lower than the projection in April 2012 (**Table 8.1**).

8.2 Pakistan's External Account

Pakistan's external account posted a deficit of US$ 3.3 billion in FY12, against a surplus of US$ 2.5 billion in FY11. Given the one-off nature of developments that led to the surplus last year, it was expected that the external position would not be as comfortable in FY12.[4]

Table 8.1: Major Indicators of World Economies

percent	GDP growth			Inflation rate		
	2010	**2011**	**2012^{P}**	**2010**	**2011**	**2012^{P}**
World	5.3	3.9	3.5	3.7	4.8	4.0
Advanced economies	3.2	1.6	1.4	1.5	2.7	1.9
US	3.0	1.7	2.0	1.6	3.1	2.1
Eurozone	1.9	1.5	-0.3	1.6	2.7	2.0
Japan	4.4	-0.7	2.4	-0.7	-0.3	0.0
UK	2.1	0.7	0.2	3.3	4.5	2.4
Emerging and developing economies	7.5	6.2	5.6	6.0	7.1	6.2
China	10.4	9.2	8.2	3.3	5.4	3.3
India	10.6	7.2	6.9	12.0	8.6	8.2
Pakistan	3.8	2.4	3.4	10.1	13.7	12.0
Bangladesh	6.4	6.1	5.9	8.1	10.7	10.4
Indonesia	6.2	6.5	6.1	5.1	5.4	6.2
Philippines	7.6	3.7	4.2	3.8	4.8	3.4
Russia	4.3	4.3	4.0	6.9	8.4	4.8

P: Projected

Source: World Economic Outlook Database

However, the widening of the trade deficit, and fall in workers' remittances during the initial few months of FY12, led to apprehensions of a far worse external position.[5] Consequently, SBP revised upwards its projections of the current account deficit in November 2011 to US$ 5.2 billion, and an overall deficit of US$ 3.4 billion – significantly higher than the initial forecast of US$ 3.7 billion and US$ 2 billion, respectively. As such, the actual FY12 external position was relatively better than what was being anticipated after the first quarter of the year (**Table 8.2**).

[3] Data from Reserve Bank of India Bulletin: Macroeconomic and Monetary Developments Review, Q2-FY13.
[4] In FY11, large part of the increase in exports was due to one-off increase in the cotton and cotton yarn prices that increased by 106.9 and 78.4 percent, respectively.
[5] The current account deficit for Q1-FY12 alone was US$ 1.3 billion.

As in the past, the trade account was the main source of deterioration: the deficit increased by almost 50 percent compared to the previous year. This was because, prices of Pakistan's main exports fell sharply, and the price of its major imports increased.[6] In fact, the entire increase in Pakistan's import bill was due to higher prices, as the quantum of imports actually declined.

A rise in workers' remittances provided much needed support to the current account. Remittances crossed US$ 13.0 billion for the first time in the county's history, while all other heads of the current account deteriorated compared to FY11 (**Table 8.2**).

Financing of the current account deficit was very challenging as the capital & financial account surplus contracted by US$ 0.6 billion in FY12. This fall was due to a decline in both, non-debt (investment) and debt (loans) inflows. Not only did foreign direct investment decline to US$ 812 million from US$1.6 billion last year, disbursements of fresh loans were also lower than the previous year.

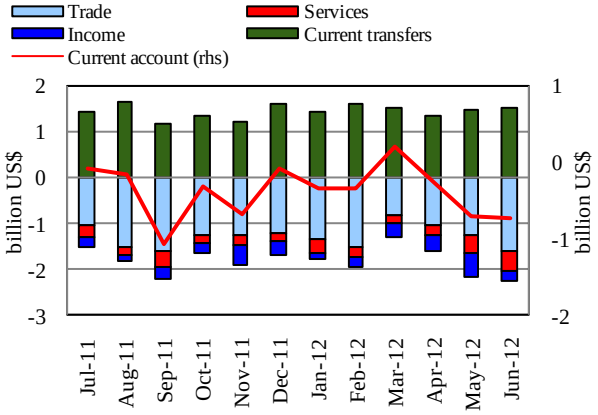
This meant that the overall deficit in the external account had to be financed from the country's foreign exchange reserves, which declined by US$ 3.8 billion during FY12 **(**see section on **Reserves and Exchange Rate)**. The depletion in reserves, and appreciation of the US Dollar against the world's major currencies, caused the Pak Rupee to depreciate by 9.1 percent against the Dollar during FY12, compared to a nominal depreciation of 0.6 percent in FY11.

Table 8.2: Balance of Payments: Key Indicators
billion US$

	FY09	FY10	FY11	FY12
Current account balance	**-9.3**	**-3.5**	**0.2**	**-4.6**
Trade balance	-12.6	-11.5	-10.5	-15.5
Exports	19.1	19.7	25.4	24.7
Imports	31.7	31.2	35.9	40.1
Services balance	-3.4	-1.7	-1.9	-3.0
Income account balance	-4.4	-3.3	-3.0	-3.4
Workers' remittances	7.8	8.9	11.2	13.2
Financial account balance	**5.6**	**5.1**	**2.1**	**1.5**
Foreign direct investment	3.7	2.2	1.6	0.8
Portfolio investment	-1.1	-0.1	0.3	-0.2
Disbursement of loans	4.0	4.1	2.8	2.5
Amortization of loans	1.9	1.9	2.0	1.9
Overall balance	**-3.1**	**1.3**	**2.5**	**-3.3**
as percent of GDP				
Current account balance	**-5.7**	**-2.0**	**0.1**	**-2.0**
Trade balance	-7.8	-6.5	-5.0	-6.7
Exports	11.8	11.1	12.0	10.7
Imports	19.6	17.7	17.0	17.3
Services balance	-2.1	-1.0	-0.9	-1.3
Income account balance	-2.7	-1.9	-1.4	-1.5
Workers' remittances	4.8	5.0	5.3	5.7
Financial account balance	**3.5**	**2.9**	**1.0**	**0.6**
Foreign direct investment	2.3	1.2	0.8	0.4
Portfolio investment	-0.7	0.0	0.2	-0.1
Disbursement of loans	2.5	2.3	1.4	1.0
Amortization of loans	1.1	1.1	0.9	0.8
Overall balance	**-1.9**	**0.7**	**1.2**	**-1.4**

Source: State Bank of Pakistan

Figure 8.3: Components of Current Account Balance



Source: State Bank of Pakistan

8.3 Current Account

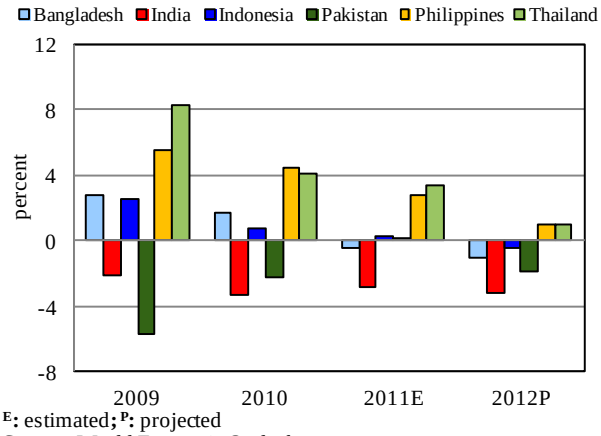
As discussed earlier, the current account reverted to a deficit after the unexpected surplus seen in FY11. Although current transfers (remittances in particular) grew by 10.2 percent, these could not offset the deficits in the trade and services account (**Figure 8.3**). As against a US$ 22.0 million surplus in H1-FY11, the current account recorded a deficit of US$ 2.4 billion in H1-FY12. This was due to a sharp increase in oil imports, and a temporary slowdown in

[6] Unit prices of cotton and cotton yarn declined by 28.8 and 23.2 percent, respectively; while that of petroleum products and crude oil increased by 19.7 and 29.6 percent.

remittances that led to a billion Dollar deficit in the month of September alone.[7] While some weakening in the current account was expected, its pace in the initial few months was indeed unsettling for policymakers. Fortunately, however, in the second half of FY12, the increase in the trade deficit was smaller, and remittances also picked up.

With exports continuing to perform poorly, the easing trade deficit during H2-FY12 was entirely on account of international oil prices. Had they continued to rise at the same pace as in H1-FY12, the FY12 current account deficit would have been much higher. The fact that Pakistan's external position is heavily dependent on two commodities – oil imports and cotton related exports – highlights its vulnerability to adverse movements in the prices of these commodities.

Figure 8.4: CAB as Percent of GDP



E: estimated; P: projected
Source: World Economic Outlook

On a positive note, however, Pakistan was not the only country to experience a worsening external position. In the backdrop of the global recession, a number of emerging economies have experienced a deteriorating external position (**Figure 8.4**).

In fact, Pakistan may be relatively less affected compared to some of the other emerging market economies due to its relative isolation from global financial markets, and the basic nature of its exports (**Box 8.1**).

Box 8.1: International Financial Recession and Its Likely Impact on Pakistan

There are two possible channels through which the global financial crisis can impact Pakistan:

1. The banking channel
2. External accounts

Pakistani **banks** are relatively safe due to limited exposure:

- Only 101 Pakistani banks branches, out of a total of 9,528, are based overseas;
- The share of overseas operations of Pakistani banks accounts for less than 10 percent of assets of the banking system;
- Investments account for less than 20 percent of overseas operations;
- Within the banking system, only three big banks dominate the overseas operations; and
- The share of foreign currency deposits in total deposits is capped at 20 percent, and the actual share is around 13.5 percent.

On the **external side,** the global financial crisis could have a possible impact on:

- Trade account
- Remittances
- Capital and financial inflows

Trade account

- Further impact of global economic slowdown on Pakistan's trade account is likely to be neutral or positive. This is because:
  - Pakistan exports are mainly low value added cotton products (e.g., gray cloth, bed sheets, towels and knitted garments etc.); intermediate cotton products (e.g., carded cotton, cotton yarn etc.); and primary commodities. Demand for these products is relatively income inelastic, making a sharp fall in exports unlikely.

[7] Dubai crude oil prices averaged US$ 106.6/bbl in H1-FY12 against US$ 79.2/bbl in H1-FY11.

  - Pakistan has one of the lowest unit cost of comparable products in the region.
- Pakistan's exports to Asian countries – such as China, Afghanistan, Middle East and India – are increasing. Demand in these markets is relatively less affected by financial crisis.
- Pakistan's trade account can benefit from the fall in international commodity prices, especially crude oil, which could decline in response to falling global demand in the event of a further slowdown.
- Sixty percent of Pakistan's imports comprise of raw materials or intermediate goods. A fall in international commodity prices could substantially reduce the country's import bill
- Thus, if exports stay at the current level and import bill falls, Pakistan's external account stands to benefit.

Overseas workers' remittances

- A financial crisis may result in an increase in inward remittances. This is because:
  - Job losses for overseas Pakistani workers may force them to move back with their savings;
  - Remittances could increase as overseas Pakistanis benefit from depreciation of domestic currency
  - Some overseas Pakistanis might consider this a good time to invest in their home country.

Pakistan's financial account

Pakistan's financial account is the most vulnerable to a global financial crisis. However, since the surplus is already small, any further decline is likely to be very small. Nevertheless:

- Inflows on privatization proceeds or bond floatation on global capital markets are unlikely during a financial crisis;[1]
- Private and bilateral loans could decline as donor countries face fiscal constraints;
- However, given that financial inflows are already negligible, further deterioration is likely to be marginal, though IMF repayments would keep reserves under pressure.

Overall impact on the external sector

Trade account	Neutral/positive
Remittances	Positive
Financial account	Neutral/negative
Net overall impact	Positive

The deficit in the *trade account* increased by US$ 5 billion during FY12, compared to a decline of US$ 1 billion last year. A slowdown in external demand, and domestic supply-side constraints contributed to a decline in the country's exports. The increase in imports, as mentioned earlier, was mainly a function of higher oil prices. In addition, fertilizer imports also contributed to the increase in the import bill (see **Section 8.7** for details).

The *services account* mirrored the performance of the trade account. Imports of services increased by 3.3 percent, while exports declined by 14.1 percent during FY12. The rise in trade related services (e.g., insurance, transportation and travel) was the main reason for the increase in services, whereas the non-realization of coalition support fund (CSF) explains the contraction in inflows from services.

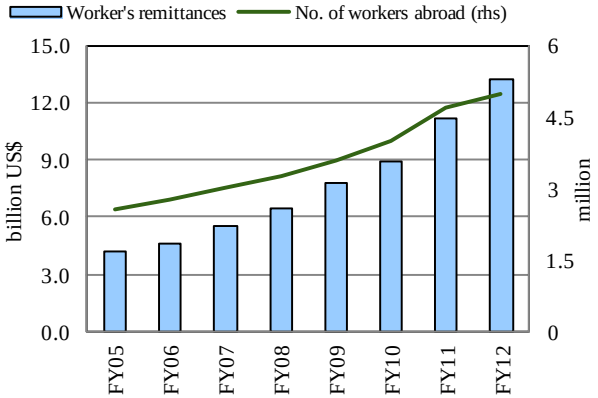
The *income account* balance deteriorated marginally during FY12, with a higher deficit of US$ 3.4 billion compared to US$ 3.1 billion last year. This was because an improvement in profitability of the domestic banking sector led to higher profit repatriation by the foreign banks. In addition, interest payments on IMF loans also widened the income account deficit.

Current transfers increased by 10.2 percent during FY12, against a 24.9 percent rise in FY11. As discussed, record remittances provided the biggest boost, and more than offset the decline seen in FE-25 deposits and cash grants. Two factors explain this consistent increase in remittances over the last few years: (i) the increase in number of Pakistanis working abroad; and (ii) efforts by the government and SBP to channel remittances via the banking system. In our view, former appears to have a larger role. Limited job opportunities within the country appear to have incentivized more skilled workers to seek employment elsewhere (**Figure 8.5**).[8]

[8] Remittances per worker per year increased from US$1,600 in FY05 to US$ 2,600 in FY12.

Other than the rise in the number of migrants, the Pakistan Remittances Initiative (PRI) – a scheme launched jointly by the government of Pakistan and SBP to channel remittances through banks – has also played an important role. For instance, after the introduction of PRI in FY09, the share of official remittances routed through banks increased from 70 percent to almost 90 percent in FY12.

Figure 8.5: Workers' Remittances



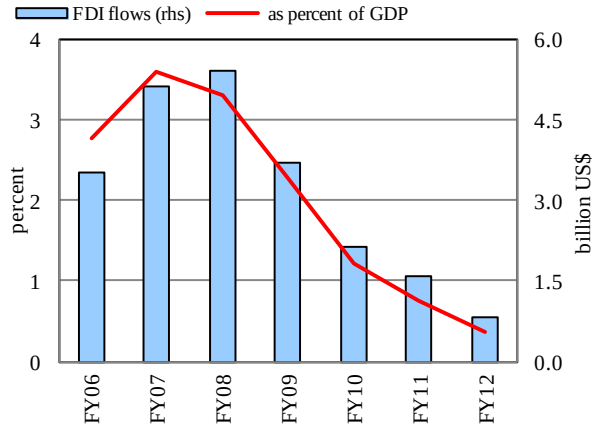
Source: State Bank of Pakistan, Bureau of Emigration and Overseas Employment

Net inflows under foreign currency accounts *RFCAs* fell to US$ 289 million in FY12 from US$ 367 million last year. A large part of this decline was the withdrawal of US Dollar deposits held with commercial banks to realize capital gains from the depreciation of Pak Rupee.

8.4 Capital and Financial Account

The capital and financial account surplus contracted for the fifth consecutive year, as both non-debt flows (investment) and debt flows (loans) continued to decline.[9] This declining trend, and not the size of current account deficit, is increasingly troubling policymakers.

Figure 8.6: Trend in FDI



Source: State Bank of Pakistan

Foreign direct investment (FDI), which supported the external sector during the past few years, fell below US$ 1 billion, and reached 0.35 percent of GDP (**Figure 8.6**).[10] Disinvestment (foreign loan repayments) by two large cellular companies was the major reason for this decline in FDI. Pakistan in recent years has struggled to attract foreign investment as shown in (**Box 8.2**).

[9] The amount of loans disbursement in the *Balance of Payments* may not tally with the numbers stated in **Chapter 7** due to definitional differences.
[10] This is in comparison with 0.8 percent of GDP last year and 3.5 percent in FY07.

Box 8.2: Regional Trend in FDI; Pakistan vis-a-vis Peers

FDI is a non-debt creating source of financing the current account deficit. The global financial turmoil of 2008-09 had an adverse impact on foreign direct investment in the emerging economies. However, with a subsequent improvement in investor confidence, FDI flows have recovered to some extent in the recent years. In the case of Pakistan, however, FDI has not yet picked up **(Figure 8.2.1)**.

The *Inward FDI Performance Index* – measures the amount of FDI that countries receive relative to the size of their economy (GDP). The index can be specified as:

$$IND_i = \frac{FDI_i / FDI_w}{GDP_i / GDP_w}$$

Where,

INDi = Inward FDI Performance Index of the ith country

FDIi = FDI inflows in the ith country

FDIw = World FDI inflows

GDPi = GDP in the ith country

GDPw = World GDP

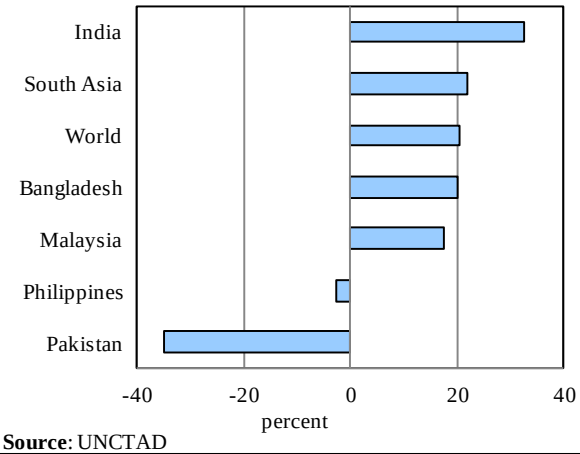
A value greater than one suggests that the economy has received more FDI relative to its economic size, while a value below 1 suggests that it received less FDI. The inward FDI performance index suggests that over the years, Pakistan has lost momentum in attracting FDI. In contrast, some of the other countries in the group have either stabilized or improved **(Table 8.2.1)**.

Table 8.2.1: Inward Performance Index of FDI

	2006	2007	2008	2009	2010	2011
Bangladesh	0.36	0.25	0.42	0.37	0.44	0.45
India	0.76	0.62	1.22	1.38	0.77	0.89
Indonesia	0.46	0.45	0.64	0.44	0.99	1.00
Pakistan	1.13	1.10	1.16	0.70	0.58	0.29
Philippines	0.81	0.55	0.31	0.57	0.33	0.27
South Asia	**0.79**	**0.64**	**1.19**	**1.23**	**0.79**	**0.80**

Source: IMF, Haver Analytics

Figure 8.2.1: FDI Inflows during 2011 (YoY Growth)

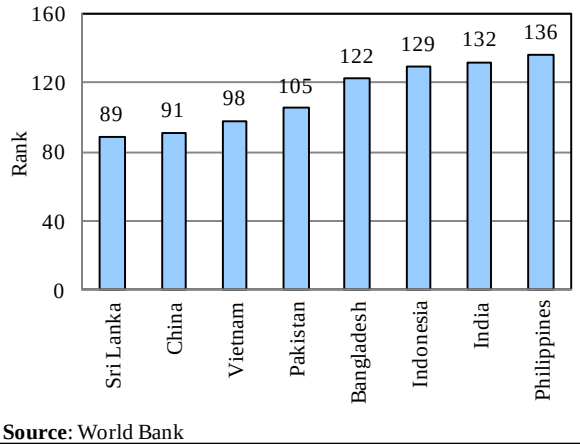


Source: UNCTAD

Initially, the fall in FDI flows to Pakistan was considered to be in line with global trend as most of the countries in the region were facing similar declines. However, while the FDI flows to number of regional countries have resumed recently, they are yet to recover in case of Pakistan. This suggests that country needs to make more efforts to attract foreign direct investment, especially when debt inflows are also low.

Interestingly, Pakistan has a better standing in terms of "*Ease of Doing Business Ranking"* compiled by the World Bank. The ranking shows that Pakistan is better placed than Bangladesh, India, Indonesia and Philippines **(Figure 8.2.2)**. The Cost of Doing Business Report assesses regulations affecting domestic firms in 183 economies and ranks the economies in 10 areas of business regulation, such as starting a business, resolving insolvency and trading across borders. [11]

Figure 8.2.2: Ease of Doing Business Ranking



Source: World Bank

On the other hand, Pakistan's standing is not as encouraging when it comes to the macroeconomic environment, quality of institutions, infrastructure facilities, human development indicators and political risk, which are considered important determinants of foreign direct investment. According to Global Competitiveness Report of 2011-12 Pakistan lags behind its peers in most of these indicators. Moreover, while, other countries have either made improvement or (remained stagnant), Pakistan has slid further down. Pakistan now ranks above 100 in all the competitiveness indicators **(Table 8.2.2).**

[11] http://www.doingbusiness.org/reports/global-reports/doing-business-2012.

Table 8.2.2: Global Competitiveness Ranking 2011-12

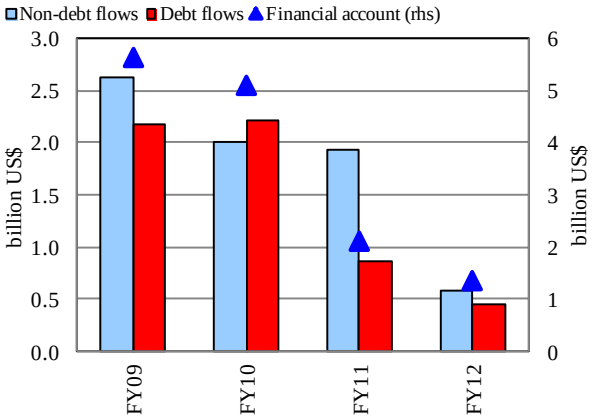
	Overall ranking	Institutions	Infrastructure	Macroeconomic environment	Health and primary education	Efficiency
China	26	48	44	10	32	26
Indonesia	46	71	76	23	64	56
Sri Lanka	52	50	60	116	45	69
India	56	69	89	105	101	37
Vietnam	65	87	90	65	73	66
Philippines	75	117	105	54	92	70
Bangladesh	108	112	134	75	108	99
Pakistan	118	107	115	138	121	100

The rankings are given out of 142 countries

Source: Global Competitiveness Report 2011-12, World Economic Forum

Portfolio investment posted net outflows of US$ 0.2 billion in FY12 in contrast to net inflows of US$ 0.3 billion last year. Both equity and debt observed outflows in FY12. As in the previous year, the fall in non-debt flows was accompanied by a contraction in debt flows*:* total loan receipts declined from US$ 2.8 billion last year to US$ 2.5 billion in FY12 (**Figure 8.7**).

Figure 8.7: Debt & Non-debt Flows (net)



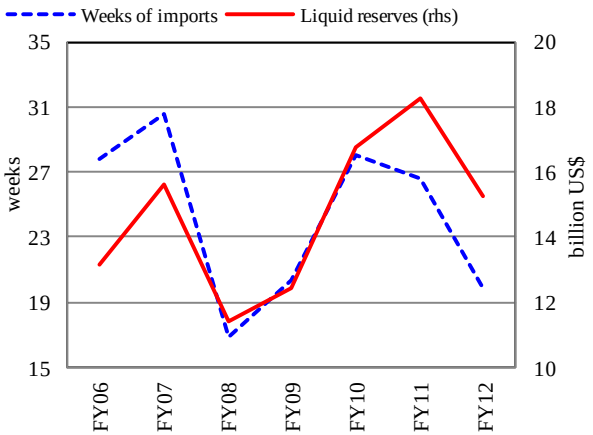
Source: State Bank of Pakistan

Compared with last year, the disbursement of program loans fell from US$ 1,440 to only US$ 80 million in FY12, while project loans increased from US$ 933 to US$ 2,049 million. Since program loans were effectively halted during FY12, the government focused on realizing as much of the pipeline *project* loans during the year. Project loans are mainly provided by ADB and the World Bank.

8.5 Foreign Exchange Reserves

Pakistan's liquid foreign exchange reserves declined to US$ 15.3 billion by the end of FY12, compared with US$ 18.2 billion a year ago. This was a consequence of the overall deficit in the external account during the year (**Flow Chart 8.1**).

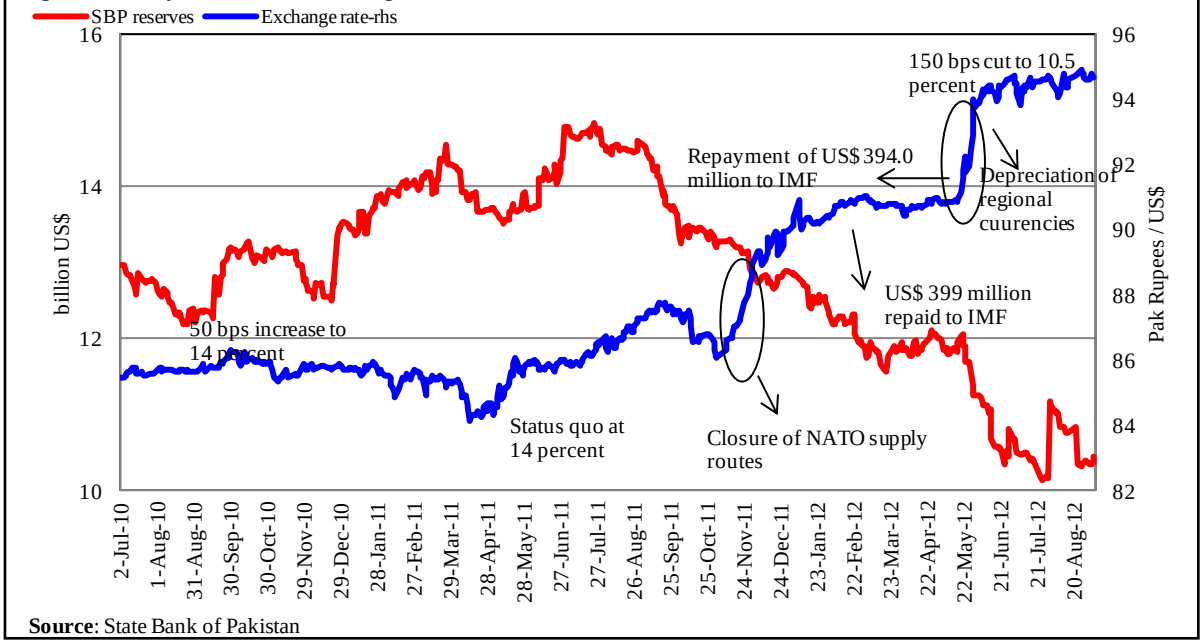
Figure 8.8: Import Coverage Ratio and Reserves



Source: State Bank of Pakistan

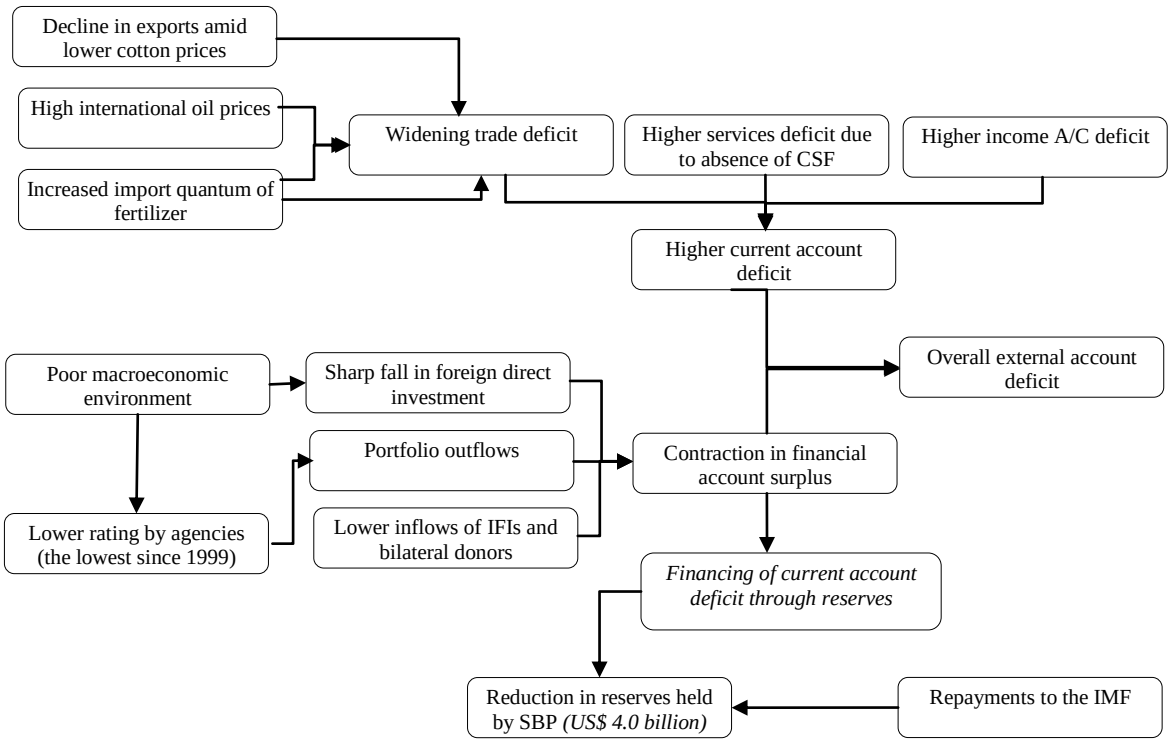
A disaggregation of FX reserves shows that the entire decline was on account of depletion in SBP's reserves, as the FX held by commercial banks increased by US$ 1 billion. Three factors explain this depletion: (i) market support by SBP, which remained a net seller during FY12; (ii) fall in multilateral inflows from US$ 5.3 to US$ 3.7 billion; and (iii) external debt servicing – Pakistan repaid US$ 5.8 billion to its lenders during FY12. It may be noted that the placement of US$ 500 million by China provided some relief to the forex reserves position.

Figure 8.9: Daily Movements in Exchange Rate and FX



Source: State Bank of Pakistan

Flow Chart 8.1: Factors leading to depletion in SBP reserves- A panoramic view



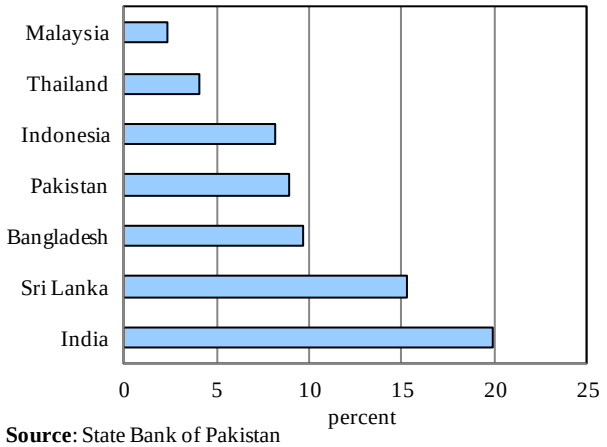
Increase in FX reserves held by commercial banks on the other hand, was mainly due to sustained growth in worker's remittances. The record level of remittances during FY12, along with market support from SBP, enabled commercial banks to cope with oil import payments without compromising their reserves. In addition, the retirement of FE-25 loans by importers also supported commercial bank holding of FX.[12]

The depletion in the country's reserves during FY12 led to a worsening of reserve adequacy indicators. In particular the import coverage ratio, which measures the ability of a country to meet its import requirements through its total reserves (in terms of weeks of imports), declined from 27.8 weeks in FY11, to 19.9 weeks by the end of FY12 (**Figure 8.8**). Unfortunately, this import coverage continues to fall in FY13.

8.6 Exchange Rate

The Pak Rupee depreciated by 9.1 percent against the US Dollar in FY12, compared to a marginal depreciation of 0.6 percent in FY11. Despite lumpy oil payments and servicing of IMF loans, the depreciation in Pak Rupee was relatively gradual through most of the year. Instead, the value of Pak Rupee seemed more sensitive to geo-political and adverse market sentiments. For instance, Pak Rupee depreciated more sharply in response to non-economic factors in November 2011 and May 2012 than at any other time during the year. **Figure 8.9** shows the movement of Pak Rupee in the context of the country's reserve performance.

Figure 8.10: Depreciation against the US Dollar during FY12



Source: State Bank of Pakistan

A part of this depreciation was also due to global economic developments: the US Dollar appreciated against most of the regional currencies throughout FY12, and Pakistan was no exception. However, when compared with some other South Asian countries, the depreciation in the Pak Rupee was relatively small (**Figure 8.10**).

NEER, RPI and REER

Pakistan's nominal effective exchange rate (NEER) depreciated by 3.9 percent in FY12 as compared to 6.7 percent depreciation recorded during FY11. The lower nominal depreciation was primarily the result of a 4.6 appreciation of the Pak Rupee against the Euro. This is to be expected given the economic weakness in the Eurozone. Nevertheless, Pak Rupee depreciated against all other major currencies (US Dollar, Japanese Yen and British Pound), which led to an overall depreciation of the Pak Rupee in nominal terms.

On the other hand, the relative price index (RPI) increased by 8.8 percent during FY12 compared with a rise of 9.3 percent in FY11, caused mainly by relatively high domestic inflationary pressures compared to Pakistan's trading partners.[13] In fact, the nominal depreciation of Pak Rupee was more than offset by a rise in RPI, which caused the real effective exchange rate (REER) to *appreciate* by 3.8 percent in FY12, in contrast to a small depreciation in FY11.

[12] Commercial banks' reserves increase when the traders retire foreign currency loans.
[13] Relative price index is a ratio of domestic prices to the prices in major trading partners.

8.7 Trade Account[14]

Pakistan's trade deficit increased by 36.2 percent YoY to US$ 21.2 billion in FY12 (**Figure 8.11**). The widening trade deficit is attributed to both a rise in imports and a decline in exports.

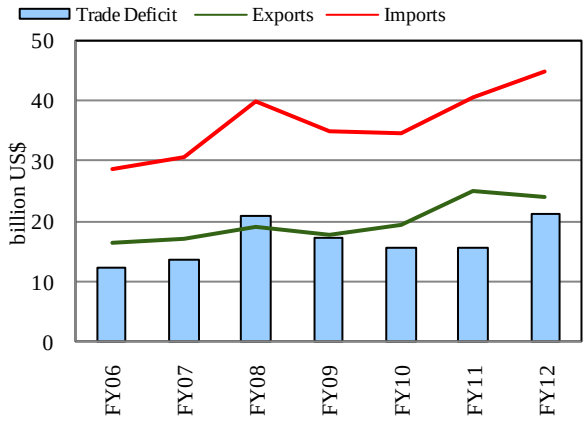
At the start of the year, weaker prospects of a global economic recovery, and trend reversal in international cotton prices when they peaked in April 2011, had already indicated a possible squeeze in export earnings in FY12. However, the supply-driven increase in international oil prices inflated the import bill beyond expectations.[15] Furthermore, gas shortages in the country had necessitated higher imports of certain petroleum products and fertilizer. Excluding these items, Pakistan's imports show a much smaller increase (**Figure 8.12**).

Detailed data shows that the imports of consumer goods are gradually building up (see **Chapter 4** and **Figure 8.13**). As a result, the share of consumer related items in total imports has increased from 56 percent in FY05, to 70 percent in FY12. This shift is consistent with the composition of aggregate demand, a large part of which is now consumption, as investment is continuously falling.

8.7.1 Exports

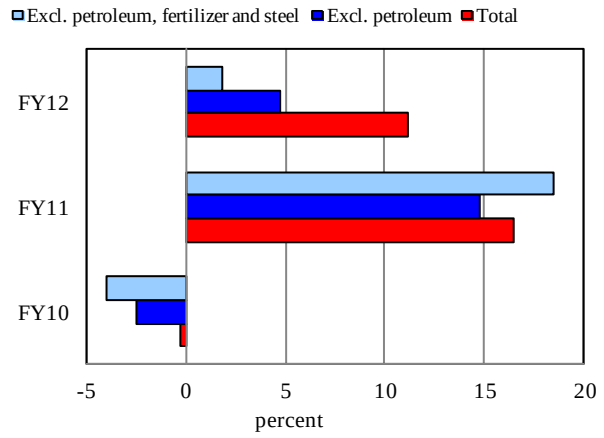
Exports declined by 4.7 percent during FY12 in sharp contrast to 28.9 percent growth last year. In terms of composition, exports of *food*, *textile*, *petroleum* and *leather & leather manufactures* recorded declines, whereas, *chemicals & pharmaceuticals*, *engineering goods* and *gems & jewelry* recorded increases during FY12 (**Table 8.3)**.

Figure 8.11: Trade Account



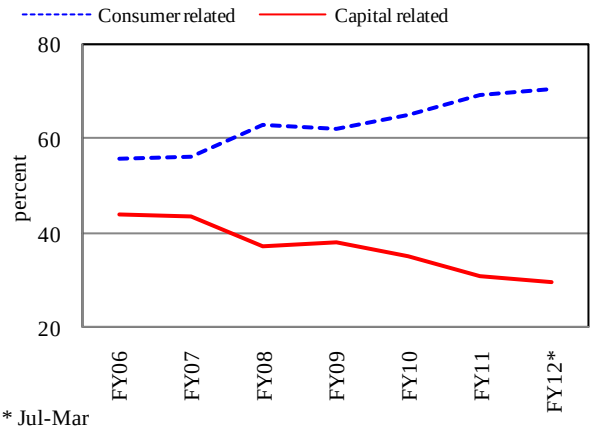
Source: Pakistan Bureau of Statistics

Figure 8.12: Import Growth



Source: Pakistan Bureau of Statistics

Figure 8.13: Imports Classification (share in total)



* Jul-Mar

Source: Pakistan Bureau of Statistics

[14] The analysis in this section is based on data from the Pakistan Bureau of Statistics (PBS), which differs from the exchange record data prepared by the SBP.

[15] The 'Arab Spring' affected oil and gas supplies—most notably the complete, albeit temporary, loss of Libyan supply—while the tragic Fukushima accident in Japan had knock-on effects for nuclear and other energy sources around the world. These shocks pushed energy prices higher in much of the world, with oil prices reaching a record average of over $100 per barrel (bbl). Source: The BP Statistical Review of World Energy, 2012 – 61st Annual Report.

Category-wise exports indicate that textile and leather exports are facing pressure from an unfavorable external and domestic environment: both declined by 10 percent (YoY) during FY12. Within the food group, while exports of rice, wheat and vegetables declined compared with the previous year, this was partially offset by growth in fish, meat, and fruits exports (**Table 8.4**).

Table 8.3: Exports Composition (YoY growth in percent)

	FY11	FY12
Food	34.6	-4.2
Petroleum	25.4	-28.0
Leather	25.3	-4.0
Chemicals & pharmaceuticals	22.6	18.1
Engineering	10.1	11.9
Gems & jewelry	-36.5	119.6
Total	**28.6**	**-4.7**

Source: Pakistan Bureau of Statistics

Rice exports, both basmati and non-basmati, declined for the second consecutive year. The fall in quantum was largely on account of the loss of Iranian market to India, which undercut Pakistani prices. According to reports, international prices of (par boil) rice rose, following Thailand's decision to introduce a support price, in a bid to ensure post-flood availability of the commodity. Against an international price in the range of US$ 200-300/MT, the Thai government was offering US$ 500/MT. This resulted in a 44 percent fall in rice exports from Thailand, which India and Vietnam capitalized on to increase their market share of rice exports. Pakistan was unable to do so as its prices were higher than those offered by both India and Vietnam.

Table 8.4: Food Exports

million US$	Abs. Δ	Quantum Impact	Price Impact
Rice	-85.8	-212.5	126.7
a) Basmati	-121.2	-188.7	67.5
b) Others	35.3	-64.6	99.9
Fish and fish preparations	19.3	-17.3	36.6
Fruits	87.7	28.0	59.7
Vegetables	-66.5	-97.9	31.4
Tobacco raw	2.2	7.8	-5.6
Wheat	-457.1	-445.7	-11.5
Spices	-0.4	-7.5	7.1
Oil seeds & nuts etc.	10.1	10.5	-0.4
Sugar	27.9	0.0	0.0
Meat and meat preparations	22.6	10.0	12.6
Food group	**-184.3**		

Source: Pakistan Bureau of Statistics

In case of ***wheat*** exports, Pakistan was unable to benefit from its record production last year (and carryover stocks), due to a fall in international prices, and the increase in domestic support price.[16] Exports of wheat in FY12 stood at 409,000 tons against 1.75 million tons last year.[17]

Exports of ***meat & meat preparation*** continued to grow for the sixth consecutive year, and reached US$ 168.3 million in FY12 compared to US$ 152.4 million in FY11. This rise is on account of higher demand from the Middle East, following an improvement in Pakistan's quality standards. Both the Punjab and Sindh governments have facilitated this trend by setting up branded *halal* units in their provinces. The sector seems to have considerable potential, as Pakistan currently holds a very small share in the global market for *halal* meat, which is estimated to be over US$ 600 billion.[18,19]

The export of ***fish and fish preparations*** grew by 6.5 percent in FY12, on account of higher unit values. This share in food exports had been stagnant at around 7.0 percent for the last five years,

[16] Pakistani wheat is priced at US$ 315 per MT compared to Indian and Russian wheat, which are priced at $280 and $250 per MT, respectively.
[17] To avoid such a situation in future, the government should set support prices after taking into account global production and price trends.
[18] Source: www.halalpakistan.com.
[19] The largest *halal* meat exporters in the world are Brazil, France, Thailand and Malaysia; whereas the Middle East and USA are the biggest importers.

which can be attributed to non-compliance with international standards.[20] This has also resulted in a shift of exports from more lucrative European markets, to the Middle Eastern market. In order to increase export earnings from this source, an improvement in quality standards at different stages (from fishing to packaging) is essential. In this regard, several EU missions have visited Pakistan and tried to set up pilot projects. In our view, the biggest hurdle seems to be lack of education, as fishermen are unable to follow complicated procedures for tracking and storing the fish.

Table 8.5: Textile Exports - FY12

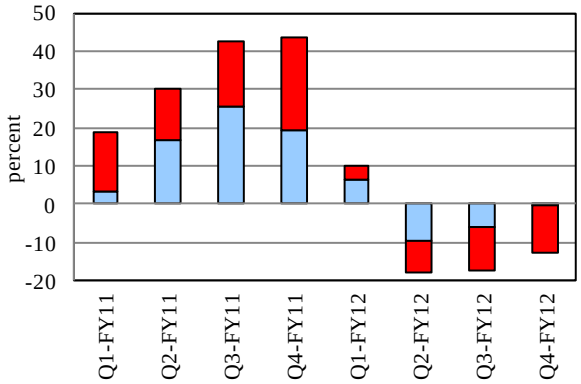
million US$	Growth (%)	Abs. Δ	Quantum impact	Price impact
Raw cotton	28.4	102.3	288.8	-186.5
Cotton yarn	-17.8	-388.2	155.6	-543.8
Cotton fabrics	-4.2	-108	-0.4	0.2
Cotton carded	-61.4	-18.7	-20.4	1.7
Hosiery	-13.9	-319.3	-560.8	241.5
Bed-wear	-16.2	-337	-394.9	57.8
Towels	-10	-75.9	-134.8	58.9
Readymade garments	-8.6	-153.6	-494	340.5

Source: Pakistan Bureau of Statistics

Textiles

Textile exports declined by US$ 1.4 billion during FY12, due to lower consumer spending in the US and EU. Other textile producers like China, India, Bangladesh and Indonesia, also faced contraction in their exports to these markets. In fact, the decline in Pakistan's exports was smaller than other countries. This may be attributed to the fact that its unit values are the lowest among peers, with buyer deciding to switch to low-price products.[21]

Figure 8.14: Contribution in Textile Export Growth



Source: Pakistan Bureau of Statistics

Furthermore, the decline in unit prices of cotton and cotton yarn in FY12, also hit our export earnings: quantity gains were completely offset by the negative price impact in yarn, and to a lesser extent in raw cotton (**Table 8.5**).[22] In addition to unfavorable global conditions, Pakistan's textile exports were also hit by domestic energy shortages, as local manufacturers could not meet delivery deadlines. This has also dented their reputation in export markets as credible suppliers.

Leather exports registered a decline of 3.6 percent during FY12, in sharp contrast to a 25.4 percent increase last year. Leather exports, including garments and footwear, declined by 15.7 and 5.8 percent, respectively. Leather products, being relatively expensive, are more sensitive to global economic conditions. Pakistani exporters are facing stiff competition from China and India, who not only benefit from economies of scale but also have much better designing and manufacturing facilities. Moreover, availability of cheaper substitutes in the global market, and rising domestic cost of production have also hurt the competitiveness of Pakistani exports. We also believe that Pakistan's branding in this sector lags behind its competitors.

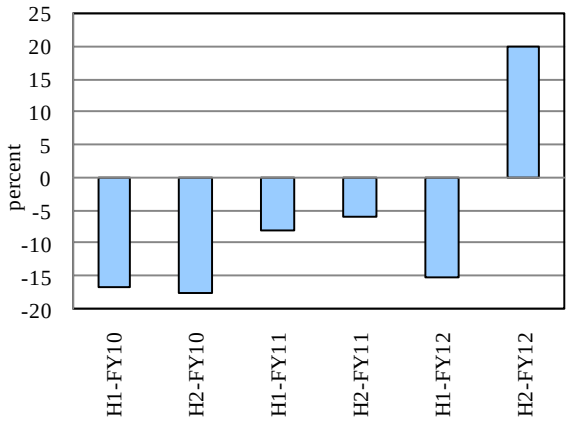
[20] Application of Sanitary and Phyto-sanitary Measures (the 'SPS Agreement') entered into force with the establishment of the World Trade Organization on 1st January 1995. It concerns the application of food safety and animal and plant health regulations.

[21] For details, please see **Annexure 1** in SBP Third Quarterly Report for 2011-12.

[22] New York average cotton prices in FY12 were 105.2 cents/lb compared to 157.9 cents/lb in FY11.

Cement exports increased by 2.1 percent in FY12, largely due to an improvement in the export of Ordinary Portland Cement (OPC).[23] In addition to higher demand from Afghanistan, OPC exports to India and Sri Lanka benefitted from improved relations with the two countries that saw a relaxation in import restrictions imposed earlier. As a result, cement exports improved in H2-FY12 (**Figure 8.15**). In contrast to OPC however, SRC exports to its main market, Iraq, declined. This was mainly due to competition from Iran and the UAE, which benefitted from closer geographical proximity to the country.[24]

Figure 8.15: Cement Exports (YoY growth)



Source: Pakistan Bureau of Statistics

Direction of Exports

The US remained the top destination for Pakistani exports, followed by UAE, Afghanistan and China (**Table 8.6**).[25] Bangladesh is also a top export destination for Pakistan, with 2.7 percent share in total exports. Exports to UAE and China increased compared with last year, whereas those to the US and Europe declined. In the case of the US and Europe, the decline was the result of financial and economic strains facing these economies. On the other hand, a 46.3 percent fall in exports to Bangladesh compared with last year, was mainly the result of high base-effect. Last year, Bangladesh imported a large quantity of raw cotton from Pakistan due to a shortage in the international market.

Table 8.6: Top 10 Export Destinations

million US$

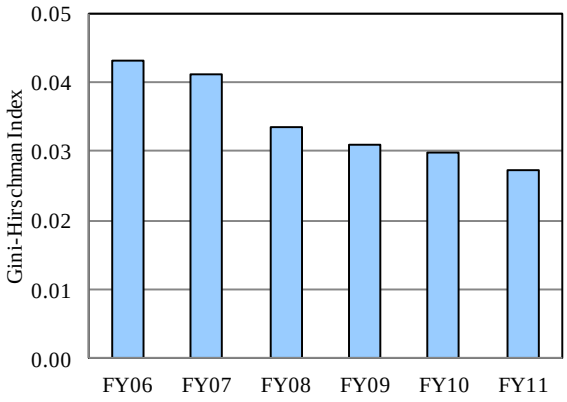
	FY11	FY12	YoY growth	% share in
USA	3,956.9	3,533.0	-10.7	15.0
UAE	1,808.1	2,303.1	27.4	9.7
Afghanista	2,335.0	2,247.6	-3.7	9.5
China	1,634.3	2,195.5	34.3	9.3
UK	1,206.1	1,184.2	-1.8	5.0
Germany	1,271.9	1,052.9	-17.2	4.5
Bangladesh	1,015.0	634.8	-37.5	2.7
Italy	790.1	580.0	-26.6	2.5
Belgium	658.9	521.8	-20.8	2.2
Spain	571.4	490.1	-14.2	2.1
Total	**2,4810.4**	**2,3631.9**	**-4.8**	**62.3**

Source: Pakistan Bureau of Statistics

Market Diversification

On a positive note, there was some improvement in market diversification. Traditionally, Pakistan's exports have been concentrated towards the US and EU markets, which makes them vulnerable to these economies. However, since FY03, Pakistan has gradually diversified its export markets; the share of exports to North America and EU has declined from around 55 percent in FY03, to 43 percent in FY11, whereas the share of Asia has increased from 39 percent to 50 percent. This is

Figure 8.16: Geographical Concentration of Exports



Source: Pakistan Bureau of Statistics; Analyst calculations

[23] Ordinary Portland Cement (OPC) accounts for 90 percent of the country's production capacity, and recovered from last year's decline growing by 3.8 percent in FY12.

[24] OPC exports to India and Sri Lanka grew by 11 percent and 41 percent respectively during Jul-May FY12, following the relaxation in export licenses and quality standards imposed by the two countries on Pakistan's cement exports.

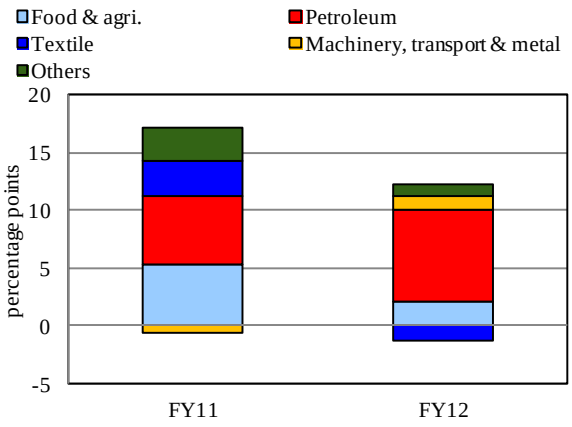
[25] The share of Afghanistan in Pakistan's exports has surprisingly increased in recent years. However, this is mainly because the informal trade between the two countries is now being documented.

a heartening trend, as Asia is increasingly driving global economic growth. The Gini-Hirschman Index also confirms this diversification (**Figure 8.16**). [26]

8.7.2 Imports

Imports grew by 11.1 percent YoY during FY12, to US$ 44.9 billion. The increase was due to a significant increase in international commodity prices, particularly oil. Other than prices, the increased quantum imports for power, construction, transport, and agriculture, also contributed to rise in the import bill during FY12 (**Figure 8.17**).

Figure 8.17: Contribution in Import Growth



Source: Pakistan Bureau of Statistics

The increase of ***petroleum products*** during FY12 was caused by both a rise in prices, and higher demand. Gas load shedding, rising sales of automobiles, and narrowing price differential between CNG and petrol, have increased the demand for petroleum products. On the other hand, a fall in crude oil imports was the result of refineries' inability to purchase oil due to the growing circular debt problem (see **Chapter 3).**

Palm oil imports increased for the second consecutive year, growing by 20.7 percent during FY12. The increase in quantum can be attributed to a preferential trade agreement with Indonesia that was approved in September 2011, and became effective from January 1, 2012. As a result of this agreement, Pakistan lowered import duty on palm oil by 15 percent from the world's top producer.[27]

Fertilizer imports also remained strong. As gas supply to the fertilizer industry remained sporadic during the year, urea production declined, and imports became necessary. However, the government overestimated the import requirement for the *kharif* season, which led to a urea glut in the latter half of FY12. While domestic prices remained suppressed because of this excess supply, manufacturers' profitability also suffered due to the increase in operating costs, fall in output, and depressed prices. Since imports are subsidized – as domestic prices are lower than international prices – the government's subsidy bill also increased. New arrangements regarding supply of gas to fertilizer industry, and carryover stock may, however, reduce the need for imports next year.[28]

Road motor vehicles recorded a 20.6 percent increase during FY12, on account of increased imports of completely built units (CBUs) of motor cars, buses and motor bikes.

In the backdrop of rising domestic prices, locally assembled cars faced stiff competition from imports of used Japanese cars, which have increased five-fold over the last year.[29] Despite being 5 years old, anecdotal evidence suggests these cars compete quite well against their locally assembled counterparts on price dependability, as well as interior features.

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[26] The Gini-Hirschman geographical concentration Index is defined as $G = [\sum(xi/X)^2]^{1/2}$., where the annual value of exports to country *i* is represented by *xi* , while the annual value of total exports is X. Higher the value of the index, more concentrated are the country's exports. For instance, if the value is 1, it means that the country exports to a single country.

[27] Indonesia is the largest palm oil producing country in the world, followed by Malaysia. On the other hand, Pakistan is the third largest buyer of palm oil in the world.

[28] For details, see **Annexure 3 Fertilizer** in SBP's 3rd Quarterly Report for 2011-12.

[29] According to Pakistan Motor Dealers' Association, Pakistan imported around 55,700 units of used cars in FY12, compared to 11,300 units in FY11.

Interestingly, as per customs record, imports of CBUs amounted to US$ 523.0 million whereas, as per the exchange record data, this was just US$ 70.6 million (**Figure 8.18**). This clearly indicates that payments for bulk of imported used cars, are being made from outside the country.[30]

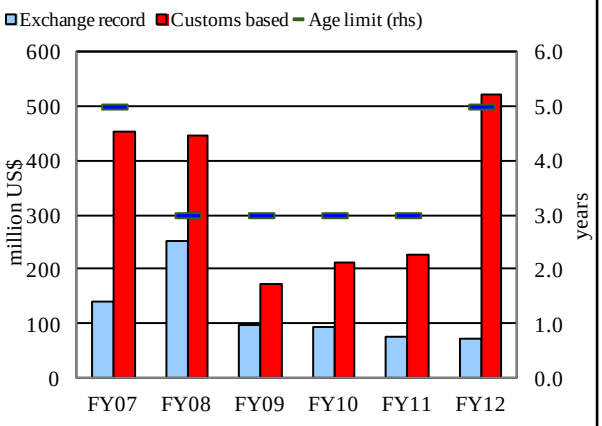
Going forward, as production of some locally assembled models is phased out to comply with Euro-II emissions standards, we believe imported used cars will continue to benefit – particularly in the under-1500cc segments.[31] However, the government's recent decision to limit the depreciation allowance, which can be claimed for duty purposes (effectively increasing customs duty), is likely to slow down the pace of imports as prices rise.[32]

Machinery imports increased by 6.9 percent during FY12 in contrast to a 1.7 percent fall last year (**Table 8.7**). The major driver of this growth was telecom machinery, mostly cellular phones. The share of other machinery groups was relatively small, with textile machinery posting negative growth.

Sugar imports fell by 98.0 percent compared to last year, mainly due to sufficient availability as a result of better domestic production and carryover stocks from last year (**Table 8.8**).[33] In fact, Pakistan is now in a position to export sugar, and there is an opportunity to enter into barter trade with Iran, as it is planning to buy about 1.6 million tons of sugar from the international market. Pakistan can offer at least 200,000 tons of sugar to Iran in exchange for fertilizer.[34]

Raw cotton imports fell compared to the previous year due to a good cotton crop. This was in contrast to FY11 when Pakistan had to import significant quantity of raw cotton to fulfill needs of the domestic textile industry. It may be recalled that Pakistan faced a shortage of cotton in FY11, after it exported this commodity to China and Bangladesh.

Figure 8.18: CBU Imports



Source: Pakistan Bureau of Statistics

Table 8.7: Contribution in Machinery Import Growth

percentage points

	FY11	FY12
Power generating	-7.8	0.4
Office machinery	0.3	0.8
Textile	3.0	-0.2
Construction and mining	-0.9	0.6
Electrical and apparatus	2.2	0.4
Telecom	4.9	4.6
A. Mobile phone	3.9	3.1
B. Other apparatus	1.0	1.5
Agricultural machinery	-1.8	0.5
Other machinery	-1.6	-0.2
Total machinery	**-1.7**	**6.9**

Source: Pakistan Bureau of Statistics

Table 8.8: Major Items Recorded YoY Decline in Imports

	Abs. Δ (million US$)	YoY Growth (%)	
	FY12	FY11	FY12
Sugar	-671.6	132.2	-98.0
Air crafts, ships, etc.	-456.4	5.9	-55.4
Raw cotton	-489.9	62.0	-50.0
Jute	-19.6	12.1	-27.4
Soybean oil	-15.5	142.2	-23.2
Aluminum	-15.3	-1.3	-10.9
Insecticides	-16.7	-4.1	-10.9

Source: Pakistan Bureau of Statistics

[30] Importers of used cars usually have agents in the host country who collect money from the expatriates. The importers in Pakistan make the payment in Rupees to the relatives of expatriates, and the car is imported as either gift, or transfer residence scheme.
[31] These accounted for around 90 percent of used car imports during FY12.
[32] Vide Federal Bureau of Revenue's CGO 13/2012.
[33] Pakistan imported 1.65 million MT of sugar from Brazil, Thailand, India, UAE, and Saudi Arabia during last three years.
[34] Source: Pakistan Sugar Manufacturing Association

List of Acronyms

A		
	ADB	Asian Development Bank
	APCMA	All Pakistan Cement Manufacturers Association
B		
	BOP	Balance of Payment
	BoDs	Board of Directors
	BISP	Benazir Income Support Program
	BQPS	Bin Qasim Power Station
	Bt	Bacillus thuringiensis
	BTU	British Thermal Units
C		
	CAB	Current Account Balance
	CAGR	Compound Annual Growth Rate
	CBO	Congressional Budget Office
	CBU	Completely Built Unit
	CCOR	Cabinet Committee on Restructuring
	CDNS	Central Directorate of National Savings
	CEO	Chief Executive Officer
	CGO	Customs General Order
	CNG	Compressed Natural Gas
	CPI	Consumer Price Index
	CPS	Credit to Private Sector
	CPPA	Central Power Purchase Agency
	CSF	Coalition Support Fund, Cash Settled Futures
	CY	Calendar Year
D		
	DAP	Di-ammonium Phosphate
	DBC	Dollar Bearer Certificate
	DISCOs	Distribution Companies
E		
	EBA	Everything but Arms
	ED	External Debt
	EDL	External Debt and Liability
	EDS	External Debt Servicing
	EFS	Export Finance Scheme
	EIU	Economic Intelligence Unit
	EPA	Economic Partnership Agreements
	ER	Exchange Rate

E&P	Exploration and Production
EU	European Union

F

FBR	Federal Bureau of Revenue
FBS	Federal Bureau of Statistics
FCAs	Fuel Charges Adjustments
FCA	Foreign Currency Account
FCBCs	Foreign Currency Bearer Certificates
FCY	Foreign Currency
FDI	Foreign Direct Investment
FE/FX	Foreign Exchange
FED	Federal Excise Duty
FE-25	Foreign Exchange Circular No. 25 dated 20th June 1998
FEBC	Foreign Exchange Bearer Certificate
FEE	Foreign Exchange Earnings
FESCO	Faisalabad Electric Supply Company
FMCG	Fast Moving Consumer Goods
FS	Food Security
FOB	Free on Board
FPA	Fuel Price Adjustment
FRDL	Fiscal Responsibility and Debt Limitation Act, 2005
FY	Financial/Fiscal Year

G

GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GENCOs	Generation Companies
GHC	GENCO Holding Company
GHI	Gini Hirschman Index
GHPL	Government Holding Private Ltd
GNI	Gross National Income
GoP	Government of Pakistan
GSP	Generalized System of Preference
GWh	Giga Watt Hour

H

H1	First Half of the Fiscal Year
HESCO	Hyderabad Electric Supply Company
HIES	Household Integrated Economic Survey
HSD	High Speed Diesel

I

IDA	International Development Association
IDB	Islamic Development Bank
IDPs	Internally Displaced Persons
IFIs	International Financial Institutions

IMF	International Monetary Fund
IP	Interest Payment/Iran Pakistan
IPP	Independent Power Producers

K

KESC	Karachi Electric Supply Corporation
KIBOR	Karachi Inter Bank Offer Rate
KPK	Khyber Pakhtoonkhawa
KWh	Kilowatt Hour
KW&SB	Karachi Water & Sewerage Board

L

LCD	Liquid Crystal Display
LCVs	Light Commercial Vehicles
LDC	Least Developed Countries
LESCO	Lahore Electric Supply Company
LL	Local Loop
LCY	Local Currency
LNG	Liquefied Natural Gas
LPG	Liquid Petroleum Gas
LSM	Large Scale Manufacturing

M

M2	Money Supply
MEFMI	Macroeconomic & Finance Management Institute of Eastern and Southern Africa
MEPCO	Multan Electric Power Company
MOF	Ministry of Finance
MRTBs	Market Related Treasury Bills
MT	Metric Tonnes
MTB	Market Treasury Bills
MW	Mega Watts

N

NATO	North Atlantic Treaty Organization
NBER	National Bureau of Economic Research
NBFIs	Non Bank Financial Institution
NDA	Net Domestic Asset
NEER	Nominal Effective Exchange Rate
NEPRA	National Electric Power Regulatory Authority
NFA	Net Foreign Asset
NFC	National Finance Commission, National Fertilizer
NFDC	National Fertilizer Development Centre
NFNE	Non Food Non Energy
NFI	Net Foreign Investment
NLC	National Logistic Cell
NPLs	Non Performing Loans

	NSS	National Savings Scheme
	NTDC	National Transmission and Dispatch Company
O		
	OCAC	Oil Companies Advisory Committee
	OECD	Organization for Economic Cooperation and Development
	OGDCL	Oil and Gas Development Company Ltd
	OGRA	Oil & Gas Regulatory Authority
	OICCI	Overseas Investor Chamber of Commerce and Industry
	OMO	Open Market Operation
	OPC	Ordinary Portland Cement
	O&M	Operation and Management
P		
	PARCO	Pak Arab Refinery Ltd.
	PBS	Pakistan Bureau of Statistics
	PDL	Petroleum Development Levy
	PEMA	Pakistan Electronics Manufacturers Association
	PEPCO	Pakistan Electric Power Company
	PESCO	Peshawar Electric Supply Company
	PIA	Pakistan International Airline
	PIB	Pakistan Investment Bond
	PKR	Pakistani Rupee
	PMEX	Pakistan Mercantile Exchange Limited
	POL	Petroleum, Oil and Lubricants
	PPA	Power Purchase Agreement
	PPHC	Pakistan Power Holding Company
	PPL	Pakistan Petroleum Limited
	PR	Pakistan Railway
	PRI	Pakistan Remittance Initiative
	PSB	Private Sector Business
	PSC	Private Sector Credit
	PSDP	Public Sector Development Program
	PSEs	Public Sector Enterprises
	PSM	Pakistan Steel Mills
	PSLM	Pakistan Social and Living Standards Measurement Survey
	PSMA	Pakistan Sugar Mills Association
	PSO	Pakistan State Oil
	PTA	Pakistan Telecommunication Authority, Pure Terepthalic
	PVMA	Pakistan Vanaspati Manufacturers Association
Q		
	Q2	Second Quarter
	Q4	Fourth Quarter
	QE	Quantitative Easing
	QESCO	Quetta Electric Supply Company
R		
	RES	Foreign Exchange Reserves

REER	Real Effective Exchange Rate
RFCA	Resident Foreign Currency Account
RFO	Residual Fuel Oil
RHS	Right Hand Side
RPI	Relative Price Index
R&D	Research and Development

S

SBA	Stand-By Arrangement
SBI	Sindh Board of Investment
SBP	State Bank of Pakistan
SDRs	Special Drawing Rights
SEPCO	Sukkur Electric Power Company
SMEs	Small and Medium Enterprises
SNGPL	Sui Northern Gas Pipelines Limited
SPS	Sanitary and Phytosanitary
SRC	Sulphate Resistant Cement
SSC	Special Saving Certificate
SSGCL	Sui Southern Gas Company Limited
SSM	small-Scale Manufacturing
STD	Short Term Debt
SUPARCO	Space and Upper Atmosphere Research Commission

T

TAPI	Turkmenistan-Afghanistan-Pakistan-India
T-Bill	Treasury Bills
TCP	Trading Corporation of Pakistan
TDS	Tariff Differential Subsidy
TED	Total External Debt
TESCO	Tribal Electric Supply Company
TFC	Term Finance Certificate
T&D	Transmission and Distribution
TOE	Tons of Oil Equivalent
TV	Television

U

UAE	United Arab Emirates
UK	United Kingdom
UN	United Nation
UNCTAD	United Nations Conference on Trade and Development
USA	United States of America
USA/US	United States of America

W

WAPDA	Water and Power Development Authority
WEO	World Economic Outlook
WOM	Weeks of Imports

X		
	XE	Export Earning
Y		
	YoY	Year on Year