1 Overview

1.1 Overview

Provisional estimates put forward by the National Income Accounts Committee show GDP growth at 2.4 percent for FY11, lower than the growth of 3.8 percent in the previous year. In the context of the prevailing security concerns, the exogenous shock from rising oil prices and the impact of the unprecedented floods, this decline is broadly in line with SBP's expectations.

Table 1.1: Selected Economic Indicators

		FY09	FY10	FY11
Growth rate (percent)				
GDP (at factor cost)	Jul-Jun	1.7	3.8	2.4
Agriculture	Jul-Jun	4.0	0.6	1.2
Major crops	Jul-Jun	7.8	-2.4	-4.0
Minor crops	Jul-Jun	-1.2	-7.8	4.8
Livestock	Jul-Jun	3.1	4.3	3.7
Industry	Jul-Jun	-0.1	8.3	-0.1
LSM	Jul-Jun	-8.1	4.9	1.0
Services	Jul-Jun	1.7	2.9	4.1
Exports (fob)	Jul-Apr	-3.4	7.3	28.1
Imports (cif)	Jul-Apr	-9.8	-2.8	14.7
Tax revenue (FBR)	Jul-Apr	19.9	11.6	12.2
CPI (12 month ma)	May	21.5	11.8	13.9
Private sector credit	Jul-4th June	-0.1	2.8	3.3
Money supply (M2)	Jul-4th June	6.5	9.8	13.7
billion US dollars				
Total liquid reserves[1]	31st May	11.6	16.0	17.2
Home remittances	Jul-Apr	6.3	7.3	9.0
Net foreign investment	Jul-Apr	2.2	1.6	1.4
percent of GDP[2]				
Fiscal deficit	Jul-Mar	3.2	4.3	4.5
Trade deficit	Jul-Apr	8.7	6.9	5.8
Current a/c deficit	Jul-Apr	-5.5	-1.9	0.3

1. With SBP & commercial banks.
2. Based on full-year GDP in the denominator.

On a positive note, the post-flood recovery in wheat, sugarcane and minor crops helped agricultural growth surpass previous year's level. However, rural incomes may not rise proportionately due to lower market prices of wheat and rising input costs (e.g. diesel and fertilizer).

In the manufacturing sector, demand for products, particularly textiles, autos, fertilizer, cement, and POL remained strong. Nevertheless, despite this strong demand, supply constraints – particularly the shortfall in energy – created production bottlenecks, which led to a significant slowdown in industrial growth.

In our view, the growth outlook will be shaped by policy responses to several key domestic challenges: (1) energy shortages, which are restricting growth; (2) the high fiscal deficit whose financing has become difficult – partly owing to the backlog arising from the non-recognition of power sector subsidies of earlier years as reflected in the circular debt; (3) build-up of domestic debt, raising concerns for macro stability; and (4) inflationary pressures which are not receding readily. The subsequent discussion will elaborate these challenges.

1. The growing energy shortages:

In the energy sector, gas supply constraints have become more binding and this shortage is affecting broader economic growth. For example, textile units generally rely on natural gas not only for power generation but also for production. Fertilizer output and power generation have been affected by gas-load management in particular, and the resulting power shortages have created production constraints in several industries.

Going forward, the policy challenge is to distribute available gas supplies efficiently amongst competing users. Keeping this in view, the ECC recently decided to divert gas supply to the fertilizer sector,[1] recognizing the importance of stable agricultural input prices and saving foreign exchange on imported fertilizer.

In the context of a sustainable energy policy, we believe that feasible alternatives to furnace oil (for power generation) need to be developed urgently. Furthermore, the potential role of imported gas is unquestionable in the medium-term, and policy emphasis must be directed towards developing the necessary infrastructure to use imported gas. More importantly, a better policy option going forward is to rationalize tariffs for different users of this scarce resource and improve the gas pricing structure to incentivize further exploration and extraction.

2. A rising fiscal deficit:

The government is facing difficulties in containing the fiscal deficit. Information available upto March 2011 puts the budget deficit at 4.5 percent of GDP, slightly higher than the deficit of 4.3 percent in the corresponding period of the previous year. The sectors experiencing growth still remain either outside the tax net or are lightly taxed (e.g. agriculture and services).

Although revenue growth has been weak for most of the year, additional measures were introduced in the fourth quarter. The government has also managed to contain spending – showing its commitment to pursue prudent macroeconomic policies, although much of the burden has been borne by development

[1] According to the arrangement, gas supplies of 40 mmcfd will be diverted to the fertilizer sector at the expense of the power sector, which will run its plants on diesel instead. The fertilizer sector will compensate the federal government for two-thirds of the additional cost incurred by running the power plants on diesel instead of gas.

expenditures. In addition, a reduction in power sector subsidies has been pledged in an effort to resolve problems in the energy sector. Furthermore, FBR is making efforts to improve tax compliance.

However, implementation of fiscal reforms still poses political challenges. For instance, structural problems that require difficult policy decisions for fiscal consolidation (e.g. expanding the base of GST through the withdrawal of exemptions, tax on agri-income, and restructuring and privatization of PSEs[2]) are pending resolution and awaiting multi-partisan consensus.

As far as financing is concerned, the government has had little option but to rely on domestic sources to finance a growing fiscal gap. More specifically, while borrowing from SBP was largely contained at end-September 2010 levels, the abrupt change from April 2011 onwards (the government borrowed over Rs 350 billion from the central bank during 31st March – 3rd May 2011) merits some explanation:

> Firstly, a large part of this borrowing was meant to internalize the growing quasi-fiscal expense (e.g. the circular debt in energy) into the budget. In other words, this borrowing is actually financing the *carry-over* of quasi-fiscal deficits from previous years. This one-off adjustment is likely to add an additional burden of approximately 0.6 percent of GDP (in FY11) over the target deficit the government is working with. Hence, against the government target of 5.5 percent of GDP, the country is likely to end up with a fiscal gap of close to 6.0 percent of GDP in FY11 – after paying off Rs 120 billion for old dues reflected in the stock of the circular debt of the power sector. The final budget deficit will depend upon the realization of the targets of FBR revenues and provincial surpluses.
>
> Secondly, SBP is already shifting a portion of this borrowing to the market through outright OMOs, and we expect that government borrowing from SBP will converge to the end-September 2010 level by the end of the current fiscal year as committed by the government.

3. Implications for domestic debt:

The impact of the widening fiscal deficit is clearly visible in the sharply rising domestic debt. Outstanding government domestic debt reached Rs 5,594 billion

[2] Loss making PSEs (e.g. Railways, PIA and Pakistan Steel) continue to be a huge drag on the country's narrow resource base. Support to such PSEs was about 1.6 percent of government's total current spending during July-March FY11.

(31.8 percent of estimated GDP) which is more than double the stock at end-June 2007. This sharp growth in debt stock is fueling concerns about macro stability and monetary management.

In addition, the maturity profile of domestic debt reveals that the government has to rollover the entire stock of Rs 2,854 billion of short term debt at least once a year. Any surge in credit demand from other sectors of the economy could elevate rollover risk,[3] and could also expose the government to interest rate risk.[4]

4. Stubborn inflationary pressures:
Fiscal discipline and restrictions on government borrowing from SBP are necessary to contain inflationary expectations, which we believe have become ingrained in recent months. In overall terms, although the post-flood hike in CPI inflation has largely dissipated, inflation is stubborn, in excess of 13 percent. Possible reasons could include: (a) the lagged impact of government borrowings from SBP during Jul-Sep 2010; (b) frequent upward adjustments in utility and POL prices;[5] (c) increase in commodity prices; and (d) the rising trend in the house rent index (HRI).

On a positive note, despite these major challenges, the external sector showed significant improvement. Specifically, rising prices of value added textiles and strong growth in remittances pushed the current account into a surplus of US$ 748 million (Jul-Apr 2011) from a deficit of US$ 3.5 billion in the corresponding period of the preceding year. Textile exports managed to post strong growth despite efforts by competitor countries to hinder concessionary access of Pakistani products in developed markets. The steady growth in remittances is a welcome development – for the first time in Pakistan's history, monthly remittances crossed the US$1 billion mark for two consecutive months (March and April 2011).

This comfort from the external account together with broadly contained government borrowings from the central bank, allowed SBP to hold the policy rate at 14 percent in the last three policy announcements (January, March and May 2011). These decisions reveal a shift when compared to the cumulative increase of 150 bps implemented during H1-FY11. For effective monetary management,

[3] Countries generally face rollover risk when their debt is about to mature and needs to be converted into a new debt, but liquidity shortage makes this rollover very costly.
[4] A risk attached to movement in interest rate, i.e. changes in interest rates affect the debt servicing of the country.
[5] While tariff adjustments have direct impact on inflation, we should also realize that timely pass-through of tariff would help contain the borrowing requirement of the government.

maintaining government borrowings from SBP at end-September 2010 levels will be critical.

1.2 Outlook

For agriculture, we are optimistic about the next cotton crop for several reasons: (a) higher cotton prices during FY10 encouraged farmers to increase acreage for the next crop; (b) there is a shift towards more productive (and disease resistive) BT cotton seeds; and (c) water availability is expected to improve over last year. Rising fertilizer prices are the key downside risk at the moment.

The government has set the wheat procurement target at 6.57 million tones, which is lower than the target for the previous year. However, we feel the government may come under pressure to exceed this target since the market price of wheat is considerably lower than its support price while banks appear to be willing to finance the additional procurement. This could feed the circular debt problem and also crowd out the private sector at the margin.

While energy shortages continue to impact a number of industries, some sectors could face new challenges. For example, the disruption in the global supply of auto parts from Japan may impact some manufacturers in Pakistan. In addition, auto manufacturers will face stiff competition from imported cars as the government has increased the age limit for used imported vehicles from 3 to 5 years.

In terms of fiscal management, going forward, desirable revenue generating measures (e.g. broadening of the tax base, improving documentation of the economic system, gradual elimination of un-targeted subsidies and curtailment of quasi-fiscal operations) are necessary to contain the fiscal deficit to below 4.5 percent of GDP in FY12.[6] These efforts need to be accompanied with better debt management to increase the tenor of domestic debt and lower risks associated with debt re-pricing and rollover.

While ensuring fiscal sustainability, these initiatives will also protect the external account position and rebuild confidence of the private sector and the country's international development partners. More importantly, this will help in reducing inflation and the crowding out of private sector credit, thereby facilitating investment, growth and employment opportunities.

[6] For more details on the Federal Budget for FY12, see **Box 1.1**.

The inflation outlook however is not very encouraging. International crude oil prices have increased by around 40 percent since the beginning of FY11, following the unrest in the Middle East and a shift from nuclear to thermal power generation in Japan after the earthquake. Overall, no significant easing in oil prices can be expected at this point.

In addition, the increase in palm oil prices is likely to impact domestic prices of vegetable oil and ghee. However, following a good *rabi* season, wheat and sugar prices have come down, which should contain, and perhaps ease food inflation in the months ahead.

There are real risks of reversal in Pakistan's external sector performance. Remittances – US$ 1.7 billion higher during Jul-Apr FY11 compared to the corresponding period of FY10 – cannot be forecast with much reliability. Imports may come under pressure given the sharp increase in crude oil prices in recent days, while the recovery in global demand appears fragile, and could hit Pakistan's textile exports. Furthermore, the price gain in textiles, which helped create a surplus in the current account during FY11, may not be available going forward following a sharp drop in cotton prices even during the off-peak season. Some exporters have also pointed out that buyers are already insisting on re-pricing of export contracts.

Recent political events could have adverse implications for the business environment and the external sector, especially with respect to future IFI flows and bilateral assistance. However, there are two reasons for comfort: first, the relative stability in financial markets is an indication that Pakistan has the ability to handle exogenous shocks; and second, net IFI inflows in the past two years have been low, which means a further curtailment is not likely to change the overall position in the external sector.

Box 1.1: Highlights of the Federal Budget for FY12

- Revenue growth of 23 percent (an increase of Rs 364 billion) appears challenging, since there are no additional revenue measures;
- In fact, the impact of tax measures in FY12 shows a net reduction of Rs 27 billion, while "administrative efforts" may bring in an additional Rs 50 billion;
- The 15 percent salary increase for government employees may have to be extended to provincial governments and PSEs; if this were to happen, provincial cash balances would be under pressure and the overall financing gap may widen beyond Rs 851 billion;
- Debt servicing, defence, and current subsidies account for 70 percent of current expenditures in FY12; the 4.5 percent reduction relies on a very sharp reduction in subsidies (especially in the power sector);
- Sharp reduction in external financing means greater reliance on domestic sources; privatization proceeds of Rs 70.4 billion would test the resolve of the government in view of political consensus that would be required to right-size PSEs.

Rupees (billion)	Revised FY11	Budget FY12	YoY Growth
Gross revenues	**2,235.9**	**2,732.2**	**22.2**
Net revenues (excluding provincial shares)	**1,238.2**	**1,528.9**	**23.5**
Tax revenue	1,679.4	2,074.2	23.5
FBR taxes	1,587.7	1,952.3	22.9
Non-tax revenue	556.5	658.0	18.2
SBP profit	185.0	200.0	8.1
Defence receipts	115.3	118.7	-11.1
Total expenditure	**2,394.6**	**2,504.5**	**4.6**
Current expenditure	**2,168.5**	**2,071.7**	**-4.5**
Debt servicing	698.6	791.0	13.2
Defence	444.6	495.2	11.4
Subsidies	395.8	166.4	-58.0
Development expenditure	**241.5**	**397.1**	**64.4**
PSDP	196.0	300.0	53.1
Federal budgetary gap	**-1,156.4**	**-975.6**	**-15.6**
Provincial cash balances	*119.8*	*124.9*	*4.3*
Overall budget deficit	**-1,036.6**	**-850.7**	**-17.9**
as percent of GDP	-5.7	-4.0	
Financing			
External resources	121.8	64.1	-47.4
Domestic			
Bank	452.2	303.5	-32.9
Non-bank	462.6	413.0	-10.7
Privatization	--	70.4	--

2 Real Sector

2.1 Real GDP Growth

FY11 proved to be another difficult year for Pakistan's economy. Against the target of 4.5 percent, the country could post a growth of 2.4 percent – this was even weaker than the 3.9 percent achieved in FY10.

A slowdown in growth was anticipated since the country had suffered severe losses due to the devastation caused by the unprecedented floods in August 2010. In addition to major *kharif* crops, the allied industries, trading services, and export sectors were adversely affected. Furthermore, logistics, power infrastructure, and many industrial units were also damaged.

Growth was also hampered as the government had to re-allocate development funds to disaster management and rehabilitation. A reduction in several key expenditure heads was therefore required and many public construction projects were shelved. Although this strategy helped the government cope with an unexpected shock, it has had adverse consequences for investment and productive capacity in the country.

Another key factor constraining growth was the energy shortfall. Specifically, while gas supply constraints are directly reducing production in a number of industries, the curtailment of gas and rising furnace oil prices, have compelled power producers to run below capacity. The resulting power shortage has added to the energy deficit in the country.

Finally, the policy response to growing macroeconomic imbalances – particularly the fiscal deficit and persistent inflation – has also had a bearing on the real sector performance.

On the positive side, the only growth stimulus came from the external front. The recovery in developed economies helped boost Pakistan's exports (textile and leather) and led to a record inflow of remittances. Anecdotal evidence suggests that higher remittances strengthened private consumption, and also supported real estate investment and residential construction.

More worryingly, investment declined in FY11 for a third consecutive year. The most pressing concern is low investment in energy; more specifically, petroleum exploration and coal mining, infrastructure for LPG and natural gas import, and the construction of dams. Without a supportive energy infrastructure, future growth opportunities in the short-to-medium term are likely to face bottlenecks.

2.2 Agriculture Sector

The agriculture sector posted a strong recovery after the devastating impact of the floods in early FY11. This recovery was mainly led by the livestock sub-sector,[1] followed by minor crops and some major crops (sugarcane and wheat).

Notwithstanding the significant losses caused by the floods, growth in the livestock sub-sector was sufficient to provide much needed impetus to agriculture growth. In the case of minor crops, some recovery was expected after the flood as farmers focused more on minor crops (vegetable, pulses etc.) instead of established major crops.

Table 2.1:Performance of Major Crops

	FY09	FY10^{P}	FY11^{T}	FY11^{E}	YoY growth FY11
Area under cultivation ('000 hectares)					
Cotton	2,850	3,106	3,200	2,693	-13.3
Sugarcane	1,029	943	1,070	998	5.8
Rice	2,963	2,883	2,708	2,335	-19.0
Wheat	9,046	9,105	9,045	8895	-2.3
Production ('000 tons; cotton in '000 bales of 170.09 kg each)					
Cotton	12,060	12,914	14,010	11,700	-9.4
Sugarcane	50,045	49,373	53,665	53,738	8.8
Rice	6,954	6,883	6,048	4,713	-31.5
Wheat	24,032	23,917	25,000	24213.5	1.2
Yield (Kg/hectare)					
Cotton	720	707	745	739	4.5
Sugarcane	48,635	52,357	51,000	53856	2.9
Rice	2,347	2,387	2,228	2018	-15.5
Wheat	2,657	2,627	2,764	2722	3.6

P: Provisional, T: Target, E: Estimates
Source: Ministry of Food & Agriculture estimates released on May 09,2011

The floods and the favorable weather conditions helped enhance sugarcane production both in Punjab and Sindh. Not surprisingly, therefore, production estimates were revised upward to 53.7 million tons, from the earlier estimates of 49.4 million released in November 2010.

The record wheat crop of 24.2 million tons produced in FY11 was slightly lower than the target of 25 million tons. A surge in wheat output is attributed to: (a) improved water availability; (b) supportive weather conditions; (c) increased area under cultivation along with better yields in *barani* areas in Punjab and Sindh; and (d) provision of free-of-cost seeds in flood affected areas.

[1] The livestock sub-sector includes the value of livestock and its products (milk, meat, hides and skins, eggs, wool & hair). The output estimates of livestock and their products are based on inter-census growth rates of livestock censuses. The last census was conducted in 2006.

We should, however, acknowledge that despite strong performance in sugarcane and wheat, rural incomes may not rise proportionately due to lower market prices of wheat and rising input costs (e.g. diesel and fertilizer).[2]

Looking forward, agriculture growth may improve in FY12 because of expected recovery in rice and cotton,[3] and improved water availability. Rising urea prices and timely availability are, however, major concerns.

2.3 Large-Scale Manufacturing

The overall LSM posted a growth of only 1.6 percent during Jul-Mar 2011, substantially lower than 4.4 percent in the corresponding period of FY10. However, quarterly data reveals some signs of recovery as LSM growth improved to 2.4 percent on a YoY basis in Q3-FY11, after rising by 1.2 percent during H1-FY11 (see **Table 2.2**).

Table 2.2: Growth in Selected Industries

	Weight	FY10		FY11	
		H1	Q3	H1	Q3
Overall LSM	**75.1**	**1.7**	**9.7**	**1.2**	**2.4**
Export-led	27.9	1.8	3.6	2.9	4.3
Import-based	14.2	-4.0	-6.9	-0.6	0.8
Agri-based	8.5	0.4	0.2	-4.3	24.6
Construction-based	5.3	8.5	6.8	-9.2	-17.9
Consumer durables	4.26	11.6	87.4	7.7	3.6
Investment-led	1.4	-8.1	43.1	5.1	6.5
Other intermediate	11.3	-5.1	1.9	-3.5	-20.1

This gradual recovery can be traced to a number of factors. First, despite facing losses in August 2010 due to the floods, industries based on agri raw material thrived during the quarter due to better crops. Second, favorable movements in global commodity prices helped improve margins of domestic producers. Lastly, export demand remained strong.

The agri-based industries (sugar, ginning, and milling industries) together had a 3.2 percentage point contribution to Q3-FY11 LSM growth. Within agri-based industries, improved sugarcane yields and a good wheat harvest, led to growth in sugar manufacturing and wheat milling. Moreover, the government’s decision to allow wheat export also benefited grain millers. On the other hand, while cotton ginning contributed negatively to overall growth, the decline was not passed on to

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[2] Specifically, the current market price of wheat is in the range of Rs 800-840 per 40 kg, whereas urea prices are up by roughly Rs 400 per 50 kg during Nov 2010 – Apr 2011 period, and diesel prices reached Rs 94.1 per liter in June 2011 from Rs 75.7 per liter in June last year.

[3] In the case of cotton, higher cotton prices during FY10 encouraged farmers to increase acreage for the next crop. Furthermore, increased focus on more productive (and disease resistant) Bt cotton is likely to have positive impact on crop yields.

upstream yarn and cloth industries, since raw cotton imports were sufficient to meet domestic requirements.

Many industries, particularly POL, cotton yarn, cloth, cement, and fertilizers, registered an improvement in profit margins during the quarter, mainly due to rising global prices. However, while corporate profitability improved across the board, this was not reflected in production growth. In cotton cloth and fertilizer, for instance, effective capacities were truncated due to gas shortages. In contrast, cement production was cut down apparently due to low demand from construction sector and limited export opportunities.

Going forward, energy shortages will continue to be a binding constraint for manufacturing growth, particularly for textile, glass making and fertilizer units. While emphasizing alternative sources of energy, there is a need to rationalize tariffs for different users of natural gas and improve the gas pricing to incentivize further exploration and extraction.

Annexure 1: Textiles[4]

Healthy cotton arrivals and consolidation in export demand brought about a modest recovery in the textile sector during Q3-FY11. Production of cotton yarn posted a visible increase as spinners took advantage of widening margins. A parallel increase in fabric production was, however, precluded by severe energy shortages in the power-loom sector. Wastages, productivity losses and delays were widespread in weaving and processing, which not only led to production declines but also disrupted the supply chain in the value-added segment. However, since fabric inventories had been well-managed, the value-added sector managed to increase export quantities in response to higher demand.

A detailed assessment of the sector suggests that three trends will shape the short-term performance going forward.

I. Loss of credibility: the most serious manifestation of the energy crisis

The worst-ever energy crisis in the country has forced a large number of textile units to halt production. Industry officials have reported huge employment and productivity losses, along with the loss of credibility in the global market.

In addition to production declines in the power loom sector, gas curtailment led to output losses at the processing stage. Furthermore, energy shortages had an indirect impact on power looms in the form of repeated processing and wastages. The weaving sector also suffered from losses in labor productivity due to frequent power outages. Consequently, it has become difficult for the industry to repay financial liabilities as they become due.

To avoid building up financial charges and default on obligations, a number of power looms were shut down. According to the Power Loom Association, around 20 percent of locally made power looms were scrapped during FY11. Moreover, imported machinery is now being re-exported to Bangladesh, Sri Lanka and India.

More worryingly, exporters have been forced to cancel orders due to frequent unscheduled energy outages. Since global buyers put significant weight to timely delivery of orders while evaluating different export offers, the disruption in energy supplies is weakening exporters' ability to retain market shares. Some exporters are now even reluctant to book orders in anticipation of operational hitches.

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[4] Authored by Asma Khalid, Specialist on the Textile Sector.

II. Pakistan's exports to face tough conditions in Europe

The demand outlook for Pakistan's textile products is not optimistic in Europe unless WTO provides a go ahead to EU trade concessions for Pakistan.

Initially, Turkey increased import tariffs on various textile categories to safeguard local producers. Turkey – the largest exporter of garments in EU – imports fabric in large quantities from various Asian countries including Pakistan, Bangladesh and India.[5] These countries will face demand compression from July 2011 onwards when the increase in duties becomes effective.[6]

For other European countries, especially within the European Union, exporting conditions can improve if WTO approves the GSP+ status to Pakistan as approved by EU to support recovery in the economy from the devastating impact of floods. Pakistan was due to secure concessionary access to EU January 2011 onwards, but this was delayed due to heavy objections raised by regional competitors at WTO.

III. Lawn Revolution: what good this would do

A paradigm shift appears to be emerging in textile designing and branding. Large textile firms are entering fabric processing in collaboration with fashion designers – textile firms are providing fabric whereas designers are providing brand recognition.

Though this phenomenon began some four years back, the fervor it touched this year is unprecedented. One of the key reasons is their aggressive marketing strategy; they selected leading celebrities from the fashion industry as their brand ambassadors. Hence, well reputed textile firms, with strong brand recognition, strategized so as not to go out of competition. While some firms chose to rely only on revamping marketing campaigns; others decided to run parallel product lines – one with the firm's name, and a second with the designer label.

Some critics are of the opinion that large-scale branding and marketing of casual wear has only propped up unbridled consumerism in the country. They feel Pakistan is already struggling with lavish spending habits and mass media campaigns are only nurturing these habits. They also believe that collaboration between textile firms and designers is small-scale, and limited only to the big cities, which will not impact sector's long-run growth.

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[5] Pakistan exported around US $ 343 million worth of textile products to Turkey in FY10 – of which, 70 percent was the export of cotton fabrics.

[6] With the imposition of safeguard measures, import duty on cotton fabrics will increase from 6.4 percent to 24.5 percent.

In our view, such critics have missed the key point.

Over the years, analysts characterized the local textile sector as one with stagnant products and markets. Textile manufacturers were not investing in product innovation, or marketing to diversify business portfolios. Today, however they are taking strides in both directions.

In our view, the collaboration between textile manufacturers and the fashion industry, is the first step towards a paradigm shift in apparel exports. Specifically, we expect this collaboration will not remain limited to lawn production and marketing, but could penetrate other categories like garments and knitwear. It is a well known fact that one of the reasons why the majority of Pakistan's apparel manufacturers could not compete in the global markets is their designs were not sensitive to changing global trends. Furthermore, Pakistan's presence in the world market is largely focused on men's clothing, women clothing is more fashion-oriented and demands continuous market research. Now with professional and contemporary designers on-board, there is an opportunity for local apparel manufacturers to penetrate this profitable market segment.

Second, domestic textile firms are realizing the value of branding and thus the need to invest in it. Progressively, they are reading the mood of local consumers to gauge how much more they are willing to pay for specific brand, and are formulating business strategies accordingly.

Thirdly, textile firms are taking leaps in marketing. Besides deploying traditional advertisement campaigns in the mainstream media, they are using the web and promotional magazines to enhance the appeal of their products.

Finally, and as an outcome of branding and marketing, the potential for exports of processed fabric is much enhanced. Due to cultural similarities, Pakistan's processed fabric has a large market in India and Bangladesh. It is a stylized fact that, Pakistani fabric is well-liked, especially in India, where local retailers order fabrics in bulk from Pakistan. A couple of Pakistani textile firms have even opened their retail outlets in India. Some firms have also started selling online for the same reasons. Meanwhile, Pakistan also has a huge market in the UAE and some western countries, thanks to Indian, Pakistani and Bangladeshi diaspora in these countries.

Annexure 2: Automobiles[7]

Automobile production during Jul-Mar 2011 was 14.6 percent higher compared with the same period last year.[8] Strong rural incomes continued to fuel demand, supported by rising commodity prices; the bulk of sales were transacted on cash basis as bank financing remained marginal.

Robust demand - for both cars and motorcycles- provided a boost to the sector. In the case of cars, the recent launch of a new model for a popular sedan and the government's decision to allow the import of CNG kits provided a boost to the two largest car manufacturers.[9]

Despite favorable demand conditions, the performance of the sector in Q4-FY11 faces headwinds from the ensuing disruption to the global supply chain of auto parts.[10] Anecdotal evidence suggests that a large manufacturer (Toyota) had temporarily suspended new bookings for its products. Even as bookings resume, Japanese Original Equipment Manufacturers (OEMs) operating in Pakistan, who are reliant on imports of key parts will be forced to produce below capacity in the remaining months of the fiscal year.

Another concern for the sector has been the government's recent decision to relax rules on the import of used vehicles.[11] Not surprisingly, market participants remain divided over these measures. Local manufacturers claim such policy changes create uncertainty and undermine their operations as they are already operating below capacity, while importers argue the measures have not gone far enough to ensure that there is greater competition in the local market.[12]

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[7] Authored by Bilal Khan, Specialist on the Auto Sector.

[8] Sales growth for the same period last year was 31.6 percent; however, this reflects a recovery from low base of the crisis in FY09.

[9] Due to some safety concerns, the government was not clearing shipments of CNG kits. This had created some backlog of orders. Therefore, as soon as the government granted its approval, car sales picked up for the month of March 2011.

[10] While auto manufacturers in Japan were not directly affected, auto part makers have been severely hit by the tsunami and related devastation in Japan. This has resulted in disruption to the supply of parts to factories globally and cutbacks in production.

[11] Initially the relaxation was provided for cars, and later for buses and trucks.

[12] Importers argue that the government has not yet allowed the commercial import of used cars; the policy amendments have centered on gift, baggage and residence transfer schemes.

The industry is also in the process of finalizing a subsequent policy to the Auto Industry Development Plan (AIDP) that is due to expire in 2012.[13] Discussions include revisions to tariff structures on imports of localized vs. non-localized auto parts, as the government appears keen to offer incentives to encourage new entrants in the local auto market.

[13] The Auto Industry Development Program (AIDP) was a plan formulated by the government in consultation with industry stakeholders as part of the move towards Tariff Based Systems (TBS) upon elimination of deletion programs in 2006.

Annexure 3: Cement[14]

I. Cement financials improved despite lower sales volume.
In Q3-FY11, financials of 14 (out of 19) companies – having 83 percent of the country's total installed capacity – showed profit-after-tax of Rs 674 million, compared to a loss-after-tax of Rs 1.4 billion in Q3-FY10.[15] The higher profits largely reflect price effect, as quantum of sales was down by 5.9 percent YoY in Q3-FY11. [16]

Cement prices were raised by Rs 35-40 per 50 kg bag when global coal prices began increasing Q2-FY11 onwards.[17] For most cement manufacturers, this was a windfall gain as the pass-through of global prices is different across companies. This is because, firstly, local coal is used in varying proportions by firms and costs vary likewise; firms using greater quantities of local coal are protected from fluctuations in global commodity prices and the exchange rate, and from the additional burden of import financing. Moreover, costs are buffered while inventories last, creating variation even among companies using entirely imported coal. Lastly, there are wide variations in plant efficiency and depreciation costs.

II. Local market was more profitable in FY11.
Higher profitability was also partly attributed to lower exports, which entail distribution costs and fetch lower prices compared to the local market. In the domestic market, most firms sell at ex-factory prices to dealers, although some units based in the north of the country bear domestic freight charges in order to capture southern markets and to export via Karachi. However, rising diesel prices and consequent increase in the transportation cost of the cement is now discouraging even this movement.

III. Exports expected to increase going forward as India lifts non-price barriers.
Cement exports remained sluggish this year as: (1) non-price barriers in exporting to India; (2) higher import duty imposed by Afghanistan, and (3) increased production capacities in the Middle East and India.

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[14] Authored by Tamkinat Rauf, Specialist on the Cement Sector.
[15] Selection was based on availability of data.
[16] In overall terms, the industry's sales declined by 7.1 percent YoY in Q3-FY11, and 8.7 percent YoY in Jul-May 2011.
[17] An increase in special excise duty (SED) from 1 percent to 2.5 percent in mid-March also added to the price. However, in the FY12 Budget, a complete withdrawal of SED and reduction in FED has been proposed.

The export to India may increase following the renewal of export licenses in April 2011.[18] Pakistan reciprocated by opening up railway passage – a relief for north-based producers.[19] However, there is a quantity constraint in railway-based trading because of limited number of freight wagons as well as an implicit understanding that freight wagons must not return empty from India.[20] Interestingly, privately-run trucks do not entail such implicit conditions, but truck-based cement trade is not allowed via the Wagah border at present.

The most positive development for exporters in FY12 will be the installation of scanners at the Wagah border, after which truck-based export will be allowed. This will be a win-win for both trade partners; the rapidly expanding Indian economy has a growing appetite for cement, but its lime and gypsum reserves are drying up fast, which means it will either need to import raw material from Pakistan, or the final commodity itself. Low-priced Pakistani cement is apparently the better alternative. Secondly, trucks will reduce handling of cement, which mars quality. For Pakistan, although exporters will have to bear higher trucking costs, they will be able to export more and even charge higher for better quality.

IV. Plants are growing more cost efficient.

Outdated production facilities are going out of business; around three million MT cement capacity running on the relatively inefficient wet process went offline during the past two years. New capacities are also coming online; a 2.6 million MT/annum cement plant was commissioned in May 2011 while another one million MT/ annum plant is scheduled to be commissioned in the next two years. New plants are more energy efficient, which implies lower production costs. Moreover, existing plants have invested in energy efficient technologies, such as waste heat recovery, which reduces electricity consumption by up to 30 percent, and refused dried fuel (RDF) plants, which reduce dependence on coal. These measures are expected to lower cement production costs in the long run.

[18] Beyond immediate borders, cement's cost competitiveness quickly erodes as freight charges rapidly escalate on the bulky commodity. Over 50 percent of Pakistan's cement exports are directed to Afghanistan while around 7 percent are routed to India.

[19] Inland freight charges double after wheat harvest in April due to increased movement of the grain. Current freight is $20/MT for North to South movement.

[20] The latter raises concerns for import-competing sectors, such as auto parts and vegetable and pulse farming.

Annexure 4: Fertilizer[21]

Fertilizer production for the first three quarters of FY11 has been 5.1 million tons, a slight increase of 3 percent over the same period last year. However, data for the month of March and estimates for the month of April, present a cause for concern. Gas curtailment to the fertilizer sector continued beyond the winter season and has stunted production.[22] With fertilizer demand expected to stabilize, a demand-supply mismatch is likely.

The situation is particularly dire in the case of urea. Although the country now possesses enough capacity to meet domestic urea demand, insufficient gas supplies will force the country to import urea in the foreseeable future.[23]

I. Urea – Gas shortages to stymie production

Urea production for the first three months of 2011, registered a decline of 8 percent as compared to the same period last year, despite the addition of 1.3 million tons of capacity this fiscal year. The curtailment of natural gas supply to the fertilizer sector is primarily responsible for this decline in production.

While production remains below capacity, urea off-take has started recovering after the impact of last year's floods, and is due to rebound in the upcoming *kharif* season. Estimates indicate that urea off-take for the *kharif* season will be 3.0-3.1 million tons. This implies that the country will need to import 200-300 thousand tons of urea if gas curtailment to the fertilizer industry remains at 20 percent on the SNGPL network, and at 12 percent on the Mari Gas network.

An ECC decision in May 2011 allowed fertilizer companies on the SNGPL network to receive around 40 mmcfd of gas (maintaining the level of gas curtailment at 20 percent) at the expense of four private power producers which will run their plants on diesel instead. Fertilizer companies have agreed to bear two-thirds of the diesel-gas cost differential. The agreement, which is in place till the end of this fiscal year, is yet to be implemented.

Concerns about this transient tourniquet are pertinent since the expected import of 200-300 thousand tons of urea will present an import bill of US$ 90-150 million, contingent upon the international urea price, and reduce fiscal space by Rs7-8 billion, if the government agrees to subsidize the imported urea. Currently, local urea sells at a 40 percent discount to fob international prices.

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[21] Authored by Syed Ozair Ali, Specialist on the Fertilizer Sector.
[22] The fertilizer industry uses natural gas for feedstock.
[23] The government provides a subsidy on imported urea since local urea sells at a discount to international urea.

If gas curtailment increases beyond current levels, fertilizer companies are likely to raise urea prices. The primary concern, however, should be the timely supply of fertilizer so that farmers recoup their initial investment in the commodity.

II. DAP - Prices to ease in the summer; and boost consumption in *Rabi* season

Di-ammonium phosphate (DAP) consumption remained stagnant for this year's *rabi* season (October-March) at 802 thousand tons, as compared to 800 thousand tons for last year's *rabi* season. Going forward, DAP consumption for the upcoming *kharif* season (April-September) is expected to be better than last year given an expected fall in international prices.

Unlike urea, DAP consumption is price elastic since farmers tend to view urea as a necessity and DAP as relatively less essential. DAP consumption has fluctuated significantly as a consequence of its volatile price.

Local prices for DAP follow international prices and are notoriously volatile. Going forward, DAP prices are expected to stabilize as China may allow DAP exports in the summer and a large DAP plant is expected to come online in Saudi Arabia by the end of this year.

Annexure 5: Construction[24]

After strong growth of 28.4 percent in FY10 (the highest since FY61), construction growth is projected to slow to 0.8 percent in FY11. A major reason for the slowdown was a sharp increase in construction costs. Some costs were expected to go up in FY11 following a raise in official minimum wages in May 2010. Not only is construction labor intensive, but the allied industries of brick, tile, etc, also employ a lot of manual work. In addition, cement prices, which are largely unaffected by the higher wages, rose sharply when global coal prices started increasing in Q2-FY11.

The rise in cost necessitated revision in budgets of all ongoing public and private projects. As fiscal space was already tight (PSDP budget was cut down), a number of planned and ongoing public projects had to be put on hold. In the private sector, this resulted in payment defaults to builders and contractors, which in turn led to a freeze in construction at several sites, as most builders' running costs depend on timely payments.

More financial intermediation could have helped to loosen up the cash flows of both buyers and builders and make construction growth more sustainable. Although real (inflation adjusted) house loan disbursements were marginally higher during FY11, it is not much of a stimulant since the financial outreach is limited. Moreover, commercial banks have no products for financing large-scale builders – the most common type of residential construction business model in Pakistan. Taking note of these issues, SBP is facilitating development of products for *large scale developer finance* as well as the Pakistan Mortgage Refinance Company (PMRC). Both these initiatives are set to be launched in FY12.

Some fiscal initiatives are also expected to benefit the construction industry going forward. For example: (1) FED on cement is proposed to be reduced from Rs 700/MT to Rs 500/MT and special excise duty has been withdrawn in the FY12 Budget – these measures are likely to bring down cement prices by around four percent; (2) construction work on a number of dams is expected to begin in Q4-FY11, including Mirani Dam, Jabban hydropower rehabilitation project, Daimer-Bhasha Dam, along with 12 small dams which are to be jointly financed by the Government of Pakistan and Exim Bank of China; and (3) anecdotal evidence shows that post-flood construction of vocational training centers, schools, hospitals, clinics, water tanks, and roads, as well as progress on Prime Minister's one million houses scheme is also gathering pace across the country.

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[24] Authored by Tamkinat Rauf, Specialist on the Construction Sector.

Lastly, even though construction began picking up in Q4-FY11, an across-the-board increase in real estate prices is not expected in the near future. This is because: (1) buying activity is mainly concentrated in smaller houses; (2) people are more risk-averse, so there are fewer speculators in the market; (3) government housing schemes are more popular; and (4) most of the construction activity is taking place in low-priced suburbs.[25] Hence, at least for some time to come, real estate prices are expected to remain steady.[26]

[25] An aggressive land-grab has started in low-priced suburbs. Furthermore, as cities grow over-crowded, the government has started buying undeveloped land on the outskirts of major cities. Once utility lines are laid out, private builders jump in to buy low-priced surrounding land.
[26] Interestingly, low real estate prices coupled with depreciating rupee over the last two years attracted remittance sending workers, especially in the Middle East. However, currency appreciation in Q3-FY11 eroded these effective earnings to some extent.

3 Prices

3.1 Overview

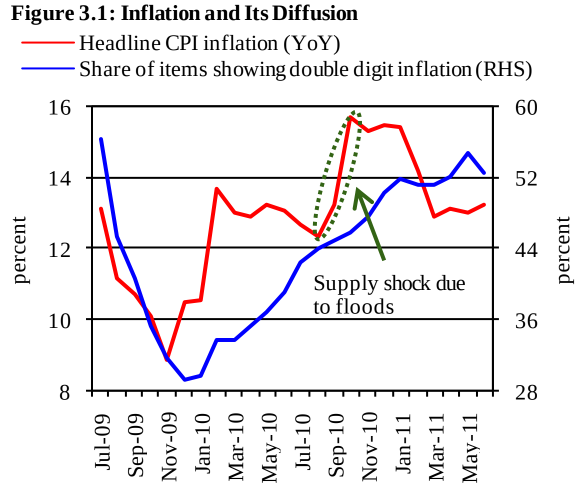
Recent trends in CPI inflation suggest that the impact of floods on prices has clearly worn-off, but in overall terms, inflationary pressures remain quite strong: Jul-May FY11 CPI inflation of 14.0 percent is considerably higher than 11.7 percent in the corresponding period of FY10. Nevertheless, we expect CPI inflation for FY11 to remain close to 14.0 percent – an improvement over SBP's earlier projections.[1]

Although high inflation is always a major source of concern for the central bank, some recent trends are disconcerting. Firstly, inflation remains stubborn. Secondly, inflationary pressures are broad-based, suggesting that inflation has permeated to most sectors and will therefore be difficult to curtail in the short run. Finally, although food inflation may decline in the coming months, overall inflation may not subside in the near future.

3.2 Inflation Trends

Year-on-year CPI inflation came down from a peak of around 15.5 percent in December 2010 to 13.23 percent in May 2011. Notably, this level of inflation was very close to its pre-flood level, indicating that the impact of the August 2010 floods on inflation has played out (see **Figure 3.1**). As the effects of the floods wore off, shortages of perishable food items were contained. The consequent decline in prices of perishable food items was the main reason behind deceleration in food inflation (see **Figure 3.2**). This, in turn, helped overall inflation ease till February 2011.

Figure 3.1: Inflation and Its Diffusion



[1] SBP projected FY11 inflation in the range of 14.5-15.5 percent (see **Second Quarterly Report on *State of Pakistan's Economy* for FY11**).

Disappointingly, this downtrend could not be sustained beyond February due to increases in the prices of non-perishable food items (e.g. cooking oil; dairy products; tea; and gram whole). Furthermore, rising prices of the apparel & textile and cleaning & laundry subgroups, as well as the increase in house rent index added to inflationary pressures. Hence, CPI inflation continued to hover around 13 percent February 2011 onwards – a reflection of inflation persistence.

Figure 3.2: Food Inflation (YoY)

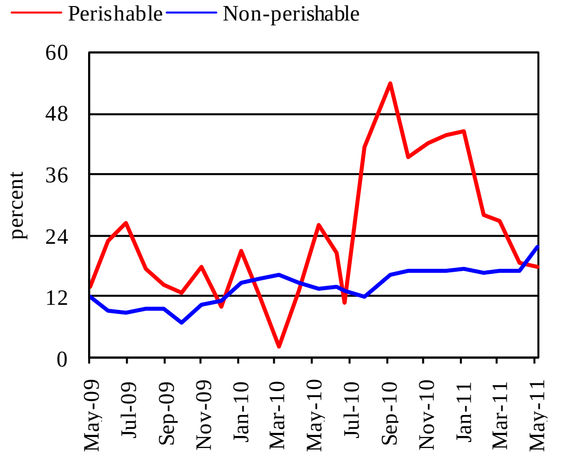
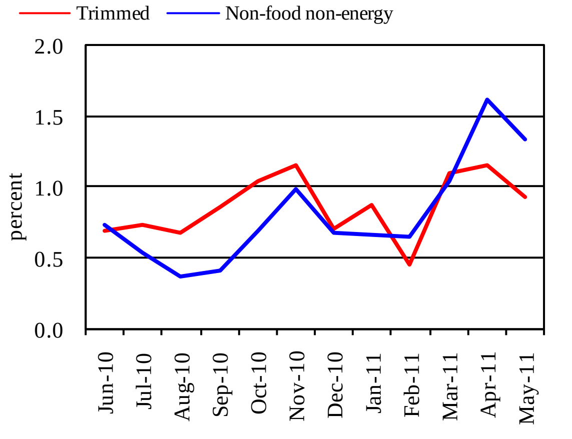


Figure 3.3: Core Inflation (MoM)



A key concern for SBP is the extent to which inflationary pressures have spread across the economy. Specifically, the share of items in the CPI basket displaying double digit inflation has remained over 50 percent in May 2011. To put this in perspective, in May 2010, only around 39 percent of commodities in the CPI basket were showing double digit inflation (see **Figure 3.1**). Paradoxically, this has not had a substantial effect on overall inflation. The reason is the items displaying double digit inflation have increased, but since they do not have significant weights in the CPI index, the overall inflation has not followed suit.

However, measures of core inflation do reflect the broad-based nature of inflationary pressures (see **Figure 3.3**). Month-on-month changes in core inflation (trimmed as well as non-food non-energy – NFNE) have been more pronounced lately due to the pass through of higher commodity prices in international markets. This implies that inflation has spread across a plethora of goods. The pressure on

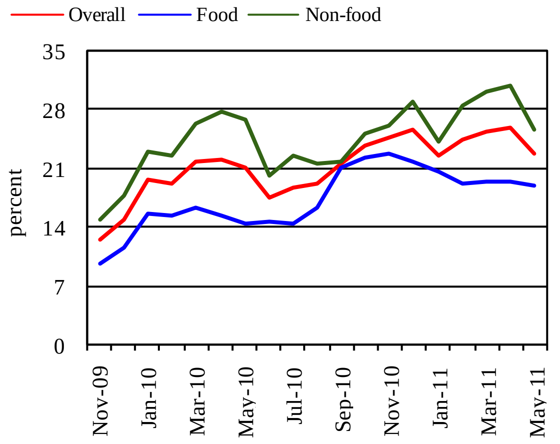
NFNE in particular implies that the economy will be much more vulnerable to food and energy shocks, which means that inflation cannot be mitigated entirely by orthodox policy measures such as monetary tightening.

3.3 Inflation Outlook

Following a good *rabi* season, wheat and sugar prices have come down which should contain, and perhaps ease, food inflation in the coming months.

Wholesale prices increased sharply, reaching 25.9 percent in April – the highest level in 30 months – before slowing down to 22.9 percent in May (see **Figure 3.4**). Non-food items (e.g., POL products and cotton) have largely accounted for the uptrend in wholesale prices.

Figure 3.4: WPI Inflation (YoY)



While cotton prices have dropped after March 2011, POL prices have not. Since POL prices pressure tend to spill-over to other items in the CPI basket, overall inflation seems unlikely to recede too sharply in the coming months. More generally, expectations of a global recovery, an earthquake in Japan and political unrest in MENA were the major factors responsible for the upward movement in global commodity prices in early 2011. However, commodity prices decreased sharply in the first week of May after a disappointing outlook on the US recovery. This drove the WPI inflation down in the month of May. Commodity prices have since rebounded and wholesale price inflation is expected to follow suit.

Unfortunately, the rebound in global commodity prices may fuel expectations that inflation in the country will remain stubbornly high in the near future. The perception that SBP monetizes the government's deficits adds to such expectations. Moreover, the general public has also come to expect increases in fuel prices, electricity tariffs and the imposition of the general sales tax, thus reinforcing inflationary expectations. Finally, the expected removal of various subsidies under the auspices of the IMF could also add to the problem.

Thus, the outlook for overall inflation, even in the absence of food or energy shocks, is not very encouraging. Although we expect food prices to provide some room for comfort, self-fulfilling inflationary expectations have ingrained themselves in the economy and consequently, inflation is not expected to ease substantially in the near future. On the external front, oil prices are expected to increase in the summer with increased demand from China, US and a recovering Japan. Higher, persistent core inflation has left the economy more vulnerable to such external pressures.

4 Money and Credit

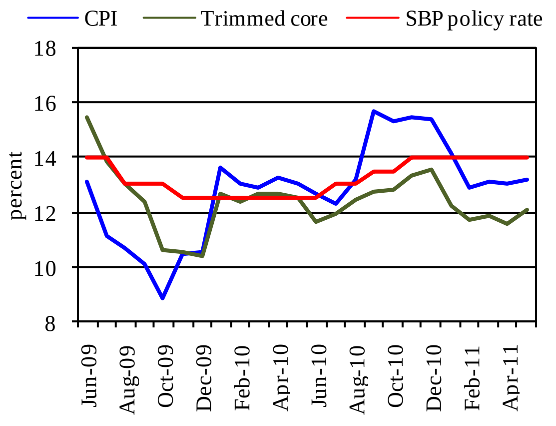
4.1 Overview

The improvement in the external account, and some let-up in government borrowing from SBP, allowed SBP to keep its policy rate unchanged at 14.0 percent in the last three policy announcements (January, March and May 2011). These decisions reveal a shift in monetary policy when compared to a cumulative increase of 150 bps in the policy rate during H1-FY11.

The key challenges for monetary policy included weak domestic economic activity, double-digit inflation, risks of reversal in the external account and a large fiscal deficit that requires on-going domestic financing. Although the impact of the floods on domestic prices has clearly dissipated, inflationary pressures remain (see **Figure 4.1**). More disturbingly, as discussed in the previous chapter, the outlook for inflation is not encouraging.

Another key concern for monetary policy could stem from the possible reversal in the external account. Specifically, any pressure on the external sector would impact Rupee liquidity in the interbank money market, thereby complicating the implementation of monetary policy.

Figure 4.1: Policy Rate & Inflation



On the fiscal side, the government is currently working with a revised deficit target of 5.5 percent of GDP. However, since the budget deficit during Jul-Mar 2011 has already reached 4.5 percent of GDP, meeting the annual target will be challenging.

Despite these fiscal pressures, the government has kept its commitment to SBP, and broadly contained borrowings from the central bank at end-September 2010 levels. In fact, during Q3-FY11, the government retired Rs 107.3 billion to SBP. This containment, along with significant improvement in external account, is the key reason for an unchanged policy rate during H2-FY11.

However, the recent increase in government borrowing from SBP to pay-off the quasi-fiscal expense in the energy sector (the circular debt), appears to be a departure from its commitment. In our view, this surge in government borrowing is temporary, and we hope this will converge to the end-September 2010 level by the end of the current fiscal year as committed by the government.

4.2 Monetary Aggregates

According to available information, both the net foreign assets (NFA) and net domestic assets (NDA) of the banking system contributed to monetary expansion during Jul 1st - May 28th 2011 (see **Table 4.1**). While NFA of the banking system showed an expansion of Rs 170.8 billion (mirroring the comfort in the external account[1]) during this period, NDA increased sharply by Rs 507.1 billion.

Table 4.1: Monetary Aggregates (Jul 1st - May 28th, 2011)
flows in billion Rs, growth in percent

	Flows		Growth rates	
	FY10	**FY11**	**FY10**	**FY11**
Broad money (M2)	463.6	677.8	9.0	11.7
NFA	-22.3	170.8	-4.5	31.3
SBP	2.9	147.4	0.9	38.9
Scheduled banks	-25.2	23.3	-13.1	14.0
NDA	485.9	507.1	10.5	9.7
SBP	155.4	113.4	17.2	11.5
Scheduled banks	330.5	393.6	8.8	9.3

Major components affecting NDA of the banking sector are briefly reviewed in the following discussion.

Government borrowing for budgetary support

Fiscal slippages and inadequate external funding led to over 30 percent increase in government borrowing for budgetary support during Jul 1st - May 28th 2011 (see **Table 4.2**). This accounts for 89.7 percent of the expansion in broad money.

Table 4.2: Major Components of NDA (Jul 1st -May 28th, 2011)
flows in billion Rs, growth in percent

	Flows		Growth rates	
	FY10	**FY11**	**FY10**	**FY11**
Government borrowing	422.2	563.5	20.8	23.1
For budgetary support	371.1	608.3	22.1	30.2
SBP	142.6	129.5	12.2	10.7
Scheduled banks	228.5	478.8	44.3	59.6
Commodity operations	52.0	-49.0	15.5	-11.9
Non government sector	173.3	121.1	5.4	3.6
Credit to private sector	103.5	102.5	3.6	3.4
Credit to PSEs	68.9	18.1	25.9	5.1

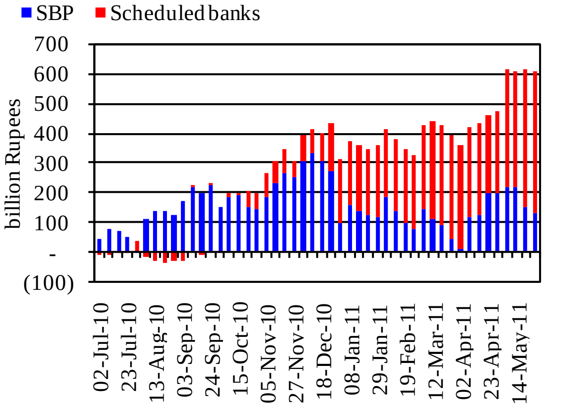
Government borrowing for budgetary support can be viewed in three distinct phases. In the first phase that runs till mid-December 2010, the government relied

[1] The external accounts indicate a current account *surplus* of US$ 748 million during Jul-Apr 2011 against a current account *deficit* of US$ 3,456 million over the same period last year (for details, please see Chapter 6 on **External Sector**).

primarily on SBP borrowings. Thus, from July to mid-December 2010, the government borrowed Rs 413.5 billion from the banking system; of which Rs 328.6 billion was from SBP.

The second phase starts from mid-December 2010 till end-March 2011. During this period, the government was able to contain its borrowings from the banking system. More importantly, the government even replaced some SBP debt by borrowings from commercial banks. This helped the government contain its borrowings from SBP at end-September 2010 levels. Hence, in net terms, the government retired Rs 286.1 billion to SBP (see **Figure 4.2**). The containment of government borrowings from SBP was facilitated by two developments:

Figure 4.2: Cumulative Government Borrowing



1. The National Saving Scheme (NSS) witnessed net inflows of Rs 87.2 billion in Q3-FY11, which was substantially higher compared to the first two quarters.

2. Increase in bank deposits, seasonally low demand for private sector credit, retirement of commodity finance loans, and the rupee liquidity stemming from a buildup in FX reserves, helped banks to finance the government without putting pressure on interest rates. Cut-off rates in T-bill auctions witnessed a slight decrease over the same period.

The third phase starts from April 2011 onwards. From April 2nd till mid-May 2011, the government borrowed Rs 207.9 billion from SBP. A large part of this borrowing was meant to pay-off the growing circular debt in the energy sector. In other words, this borrowing is actually financing the *carry-over* of quasi-fiscal deficits from previous years. More importantly, SBP expects government borrowings will soon converge to end-September 2010 levels. In fact, a portion of this borrowing has already been shifted to commercial banks through an outright sale of government securities into open market.

Credit to PSEs

Net credit to public sector enterprises declined to Rs 18.1 billion during Jul 1st – May 28th 2011 compared to Rs 68.9 billion over the same period a year ago. This slowdown primarily reflects improvement in the cash flow of PSEs as the government decided to gradually increase electricity tariffs and pass on changes in international oil prices to domestic consumers. However, the outstanding loans to PSEs are still hovering around Rs 350 billion.

Government borrowing for Commodity Operations

The much awaited government decision to export surplus wheat in Q3-FY11, is an important step towards dealing with the growing problems in commodity operations. This measure accelerated the retirement of wheat financing loans by the government and created much needed room for wheat procurement before arrival of the fresh crop (in the last week of March 2011).

Nonetheless, outstanding commodity operations loans as of May 28th 2011 stood at Rs 364.2 billion. Of this, Rs 205.1 billion is on account of borrowings for commodity operations in previous years.[2] This includes subsidy 'receivable' from the federal and provincial governments, which amounts to Rs 118.5 billion as of May 28th 2011. In a sense, this is another example of a quasi-fiscal operation that the government needs to internalize in the forthcoming year.[3]

Credit to Private Sector[4]

While private sector business continued to utilize bank credit, there is hardly any credit demand for new investment activities in the economy. Specifically, the growth of credit to private sector was slightly lower at 3.4 percent during Jul-May 28th 2011 compared to 3.6 percent over the same period in FY10.

Working capital loans during Jul-Apr 2011 jumped to Rs 144.7 billion against Rs 47.4 billion in the corresponding period of FY10 (see **Figure 4.3**). This three-fold increase in demand for working capital loans is due to the rise in raw material prices, especially of cotton, sugarcane and edible oil. Both textile and sugar

[2] It also shows that the government commodity operations are not self liquidating as they are generally envisaged.

[3] Any decision to settle these subsidies will have no monetary implications since the government agencies have already borrowed from the banking system. Furthermore, the government stands to gain from recognizing quasi-fiscal expenses because: (a) it will render fiscal accounts more transparent; and (b) the government will be able to substitute expensive commodity operations loans with relatively less expensive market based borrowing.

[4] While the overall credit numbers are based on monetary survey data, the detailed discussion in this section relies on loans to private sector businesses.

sectors accounted for 68.5 percent of the rise in working capital loans over the period of analysis.

The surge in exports increased the demand for trade loans. These loans increased by Rs 68.0 billion during Jul-Apr 2011 compared to Rs 21.0 billion in the previous year. The sectoral distribution of trade loans reflects the dominance of the textile sector, which accounts for 71.6 percent of the rise.[5]

Figure 4.3: Changes in Working Capital Loans

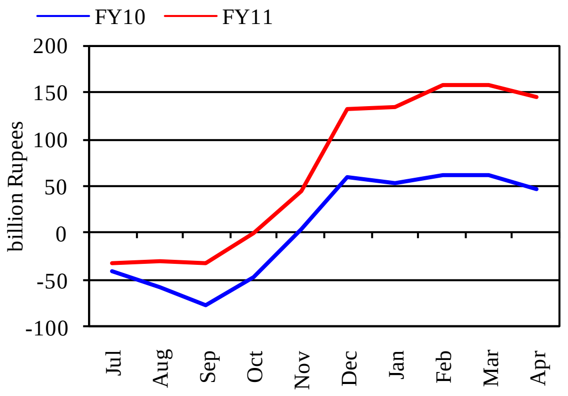
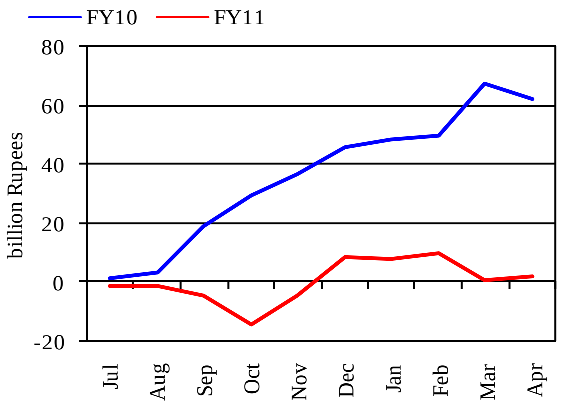


Figure 4.4: Changes in Fixed Investment Loans



Compared to the significant increase in working capital and trade loans, the fixed investment component saw a nominal increase of only Rs 1.7 billion against an expansion of Rs 62.0 billion over the same period last year (see **Figure 4.4**). Monthly data indicate net retirement of investment loans in 6 out of 10 months of this fiscal year. This does not bode well for the economy.

Compared to slow growth in credit for businesses, consumer loans witnessed net retirement for a third year in succession. The share of consumer financing in private sector loans has declined to 7.7 percent in April 2011, as compared to 9.1 percent as of end-June 2010. In absolute terms, these loans witnessed net retirement of Rs 21.8 billion in Jul-Apr 2011 against Rs 44.4 billion in the previous year. This slowdown in net retirement is largely because banks are reluctant to provide fresh loans, while outstanding loans continue to be paid-off.

[5] Unsurprisingly, textile related exports accounts for 55.3 percent of total exports over the period of analysis.

5 Fiscal Developments

5.1 Overview

The overall fiscal position continued to be under stress during the first three quarters of FY11. The consolidated deficit during Jul-Mar 2011 reached 4.5 percent of GDP, slightly higher than the 4.3 percent for the same period last year. Given that the budgetary gap usually peaks in the last quarter, meeting the revised annual target of 5.5 percent of GDP will be challenging.[1]

Table 5.1: Key Fiscal Aggregates (Rs in billion) and Performance Indicators (percent)

	Jul-Mar		YoY Growth	
	FY10	**FY11**	**Q3FY11**	**3-year average**
Revenue	**1,401.8**	**1,495.3**	**6.7**	**17.1**
Tax	1,014.6	1,117.6	10.1	18.3
Non-tax	387.2	377.7	-2.5	15.9
Expenditure	**2027.8**	**2278.5**	**12.4**	**22.0**
Current	1,659.9	1,909.8	15.1	20.6
Development	364.0	352.7	-3.1	16.9
Budget deficit	**626.0**	**783.3**	**25.1**	**43.3**
Financing				
External	92.6	83.1	-10.3	0.3
Domestic				
Non-bank	322.5	383.8	19.0	5.7
Banks	210.8	316.4	50.1	-12.6
As % of GDP				
Budget deficit	4.3	4.5		
Revenue deficit	1.8	2.4		
Primary deficit	1.0	1.6		

On a positive note, the government has managed to control its spending. Expenditures grew by 12.4 percent in Jul-Mar 2011, considerably lower than the average growth of over 20 percent of the past three years (see **Table 5.1**). More importantly, growth in non-interest, non-defence spending remained at 12 percent compared to the average growth of 25 percent, despite unexpected outlays – both by the Federal and provincial governments – on flood related activities. However, as in past years, the brunt of this curtailment in spending was borne by development expenditure, which will hurt the long-run growth potential of the economy.

Despite this restraint, the budget deficit could not be contained due to weak revenue collection and outlays on subsidies to the power sector. Total revenues showed a growth of just 6.7 percent during Jul-Mar 2011 which was considerably

[1] Overall fiscal deficit target announced in the federal budget was 4 percent of GDP. However, this number rose to 5.3 percent of GDP as per announced consolidated Federal and provincial budgets. In March 2011, government projected the fiscal deficit for FY11 at 5.5 percent of GDP.

lower than the nominal GDP growth of 21.8 percent. As a result, the *revenue deficit* rose sharply, i.e., revenues are not enough to finance even current expenditures. In other words, the government is shifting the burden of current expenditure to future generations. It may be noted that the Fiscal Responsibility and the Debt Limitation Act of 2005 required the government to reduce revenue deficit to zero in FY08. This is being breached since then.

Furthermore, the financing of the budget gap has also become complicated with waning external resources. The government only received Rs 83.1 billion during the first nine months of FY11, which represents less than half of the full year target of Rs 185.8 billion. Hence, domestic bank and non-bank sectors largely financed the budget deficit. So far, the weak demand for private sector credit and the rupee liquidity stemming from a buildup in FX reserves, helped reduce the pressure on interest rates, while banks financed the government.

As an upside, the government was able to contain its borrowing from SBP. However, one major departure occurred in April 2011, when the government paid-off quasi-fiscal expenses in the energy sector (i.e., circular debt) by increasing its borrowing from the central bank. This one-off adjustment of Rs 120 billion – a carryover of the deficit from previous years – will add approximately 0.6 percent of GDP over the target deficit.

While the government has initiated steps to resolve the long-standing issue of circular debt in the energy sector, other key structural reforms that are critical for fiscal consolidation (e.g. expanding the base of GST through the withdrawal of exemptions, tax on agri-income, and restructuring and privatization of PSEs) are pending and await multi-partisan consensus. Unless significant steps are taken to address these structural issues, containing the fiscal deficit below 4.5 percent in FY12 will be difficult.

5.2 Expenditures

As mentioned earlier, the government was able to contain overall expenditures during Jul-Mar 2011. While this is indeed a positive development, there are some disconcerting observations:

1. Though the government has pledged to reduce power sector subsidies, subsidies reached Rs 136.5 billion as of March 2011, against a full year target of Rs 126.7 billion.[2]

2. Development spending of Rs 353 billion during the first nine months of FY11 was not only below target, but also less than the expenditure during the corresponding period of last year (see **Table 5.2**). It may be noted that the original budget for development was Rs 740.1 billion. However, when the floods hit in August 2010, the government decided to re-allocate development funds to disaster management and rehabilitation activities. Although this strategy helped the government cope with the unexpected shock, it has adverse implications for investment in productive capacity of the country.[3]

Table 5.2: Break-up of Expenditure
billion Rupees

	Jul-Mar		% Growth
	FY10	**FY11**	
Total expenditure	**2,023.9**	**2,262.6**	**11.8**
Current expenditure	**1,659.9**	**1,909.8**	**15.1**
Federal	1,222.6	1,345.7	10.1
Interest payments	473.5	507.4	7.2
Defense	269.8	335.1	24.2
Public orders and safety	32.1	43.3	35.0
Economic affairs	43.2	63.7	47.6
Health and education	25.6	34.1	33.2
Social protection	3.9	19.0	388.9
Provincial	437.3	564.1	29.0
Development expenditure & net lending	**364.0**	**352.7**	**-3.1**
PSDP	286.5	246.5	-13.9
Federal	169.3	130.4	-23.0
Provincial	117.2	116.1	-0.9
Other than PSDP	61.0	35.7	-41.5
Net lending	16.5	70.5	
As % of GDP			
Total expenditure	13.8	13.1	
Current	11.3	11.0	
Development	2.5	2.0	

3. Loss-making public sector enterprises continue to be a significant drag on fiscal resources. For example, the poor financial health of Pakistan Railways resulted in injection of Rs 25.1 billion during Jul-Mar 2011 which is higher than the budget allocation of Rs 21.9 billion for the entire

[2] It may be noted that the government has recently decided to divert gas supplies from the power sector to fertilizer producers. The expected increase in domestic urea production would reduce government expenses on imports and potential subsidy on imported fertilizer.
[3] While the share of development expenditure in total expenditure declined from a 5-year average of 25 percent to 12 percent in FY11, it is not surprising to note that investment to GDP ratio also declined from over 20 percent to 12 percent during the same period.

year.[4] Likewise, the government is paying a mark-up on commercial loans acquired by Pakistan Steel Mills and PIA.[5] In overall terms, provision of grants to Pakistan Railways and mark-up to PIA and Pakistan Steel Mills, constitutes 1.6 percent of current expenditure (or 0.2 percent of GDP) during Jul-Mar 2011. It is therefore critical to push the re-structuring of these PSEs to stop hemorrhage.

One key development is the transfer of resources from the Federal Government to provinces following the NFC award. This shift is clearly reflected in the rising share of provinces in total expenditure from 28 percent in Q3-FY10 to 32 percent in Q3-FY11.

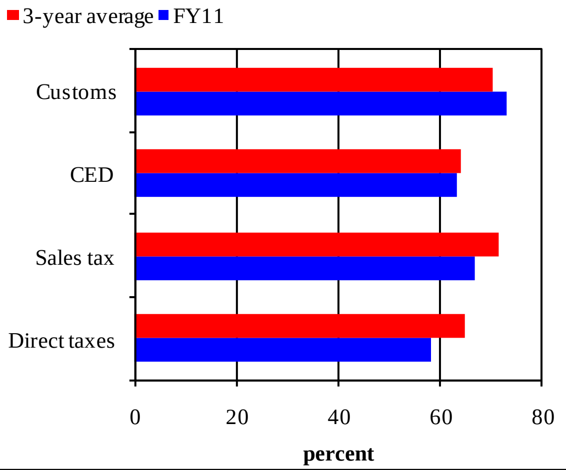
Table 5.3: FBR Tax Collection (Jul-Mar)
billion Rupees

	FY10	FY11	FY11 (year target)	% Growth	% of target
Direct taxes	342.3	381.6	626.9	11.5	60.9
Indirect taxes	567.3	638.5	960.8	12.6	66.5
Sales tax	371.2	422.7	654.6	13.9	64.6
FED	84.4	89.1	132.9	5.6	67.0
Customs	111.7	126.8	173.3	13.5	73.2
Total collection	**909.6**	**1,020.1**	**1,588**	**12.2**	**64.3**

5.3 Revenues[6]

Revenue collection remained weak throughout most of the year, and FBR was only able to collect Rs 1,020 billion during Jul-Mar 2011, which represent 64 percent of the annual tax collection target (see **Table 5.3**).[7]

Figure 5.1: FBR Target Achievement upto March



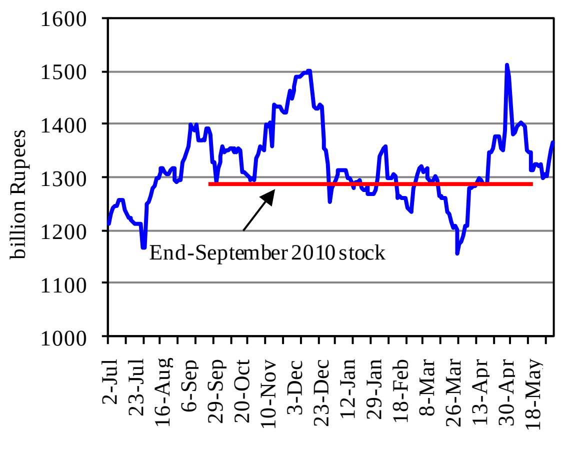
More importantly, tax collection did not show any growth in real terms, as it remained lower than the current inflation of 14 percent. Furthermore, the sectors experiencing growth still remain outside the tax net or are lightly taxed (e.g. agriculture and services).

[4] In addition to this grant, the government has provided Rs 2.3 billion to railways as PSDP funding during this period.
[5] This amount is afterwards treated as government equity in these entities.
[6] FBR collects about 90 percent of total taxes (federal plus provincial).
[7] FBR collection during Jul-Mar has averaged 68 percent during the last three years.

The underperformance is more evident for direct tax collection. During Jul-Mar 2011, FBR was able to collect only 58 percent of the annual target set for direct taxes. This is very low compared to the past average of 65 percent target achievement in nine months (see **Figure 5.1**). Frequent postponement of deadlines for income tax returns, poor tracking of withholding taxes[8] and institutional inefficiencies in raising 'collection-on-demand' through audits and inspections are key factors underlying the shortfall in direct taxes.[9]

In the prevailing scenario, even achieving the revised target of Rs 1,588 billion will be challenging. Specifically, this would require FBR to collect Rs 189 billion per month during the last quarter; in April 2011, FBR was able to collect only Rs 127 billion.

Figure 5.2: GoP Borrowing from SBP (Daily stock)



The revenue shortfall is not peculiar to the current year; for the last several years growth in tax has lagged nominal GDP growth. As a result, the tax/GDP ratio has fallen to below 10 percent, which is considerably lower than the average tax/GDP ratio in comparable countries like India, Indonesia, and Sri Lanka.[10]

5.4 Budgetary Financing

Since external financing remained below expectations, the burden of financing the budget deficit fell on domestic sources (bank and non-bank). Specifically, the government borrowed Rs 700 billion from domestic sources during Jul-Mar 2011 – showing a growth of 31.3 percent over Rs 533.3 billion during the same period last year. Total domestic financing of the deficit during the three quarters, is 4 percent of GDP.

[8] According to a performance audit report by Auditor General of Pakistan, a number of public listed companies, banks and national saving centers do not deposit the full amount of tax withheld on profits and dividends to government accounts.
[9] Tax collection-on-demand was only Rs 34.3 billion in Jul-Mar FY11 compared with Rs 60.1 billion in the same period last year.
[10] IMF Policy Paper on "Revenue Mobilization in Developing Countries", March 8, 2011.

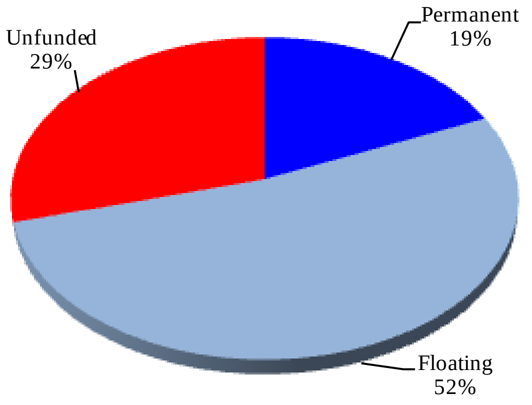
Such a large volume of domestic financing has obvious implications for availability of financing private investment through its crowding out.[11]

On a positive note, the government was able to broadly contain its borrowings from SBP within end-September 2010 level (see **Figure 5.2**).

5.5 Domestic Debt

The impact of a widening fiscal deficit and the government's heavy reliance on domestic sources for its financing, is clearly visible in terms of the sharp increase in domestic debt. Outstanding domestic debt reached Rs 5,463 billion (30.2 percent of estimated GDP for FY11) by end-Mar 2011, which is Rs 809 billion higher than at the end of FY10.[12] Back-of-the-envelope calculations indicate a monthly rise of Rs 90 billion in domestic debt in the first three quarters of the year. This growing stock is fueling concerns about government debt management and macroeconomic stability. Some of the key issues related to domestic debt management are summarized in the following discussion.

Figure 5.3: Composition of Domestic Debt



Rollover Risk:[13]

An analysis of the composition of domestic debt reveals that the share of debt maturing within a year (known as floating debt) in total outstanding domestic debt reached 52.2 percent by end-Mar 2011 (see **Figure 5.3**). This implies that the government must rollover the entire floating debt stock of Rs 2,854 billion at least once a year. A surge in credit demand from other sectors of the economy, or reduction in liquidity in the banking system can play a role in intensifying the rollover risk.

[11] It may be noted that subdued credit demand from the private sector and sufficient rupee liquidity stemming from a build-up in reserves allowed government to easily meet even large financing needs.
[12] Numbers do not include provincial governments' borrowings from banks for commodity operations. Commodity operations of the government are discussed in "Money and Credit".
[13] Countries face rollover risk when their debt is about to mature and needs to be converted into a new debt, but liquidity shortage makes this rollover very costly.

Interest Rate Risk[14]:
In addition to rollover risk, the government is also exposed to significant interest rate risk. Specifically, the entire stock of floating debt will be re-priced at least once a year. Hypothetically, a 100 bps increase in the average interest rate on T-bills will push up interest payments by Rs 28.5 billion. Although it can be argued that interest earned on T-bill holdings of SBP is transferred back to the government as 'profits' of the SBP, one should not overlook the domestic debt held by commercial banks.

Maturity Profile of Unfunded Debt
While the government is increasing its exposure to short term debt, it continues to borrow through the National Savings Scheme (categorized as unfunded debt), which had risen to Rs 1.6 trillion by end-Mar 2011 (see **Table 5.4**). Unfunded debt witnessed a net inflow of Rs 142 billion during Jul-Mar 2011. It is important to note that unfunded debt is difficult to manage; early encashment of unfunded debt instruments allows investors to re-price their investments at any point in time. This not only complicates debt management for the government, but also creates unnecessary volatility in the money market.

Table 5.4: Government Domestic Debt
billion Rupees

	June 2010	March 2011	Change
Permanent debt	794.3	1,007.6	213.3
Floating debt	2,399.1	2,853.9	454.8
Unfunded debt	1,457.5	1,599.5	142.0
Foreign currency instruments	3.1	1.5	-1.6
Total	**4,654.0**	**5,462.6**	**808.6**

[14] A risk attached to movement in interest rate, i.e. changes in interest rates affect the debt servicing of the country.

6 External Sector

6.1 Overview

After remaining in deficit for six consecutive years, Pakistan's current account posted a surplus of US$ 0.7 billion in Jul-Apr 2011. This improvement overshadowed the deterioration in the financial account during this period, resulting in an overall surplus of US$ 1.2 billion during Jul-Apr 2011, compared to US$ 0.7 billion in corresponding period of the previous year (see **Table 6.1**).

The current account surplus is primarily a result of strong export growth, and an increase in worker remittances. We expect the improvement in the current account to be sustained through the remaining two months of FY11.

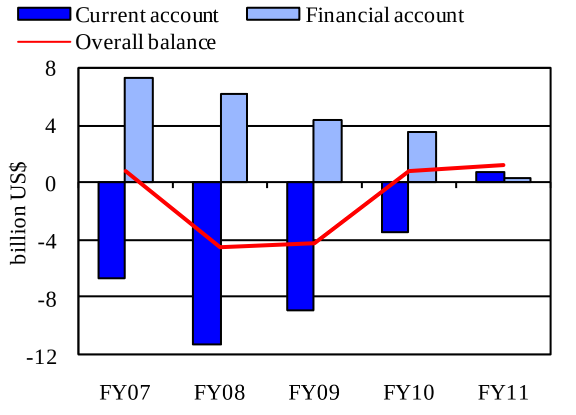
A key concern, however, is the sharp and continuous deterioration of the financial account. Specifically, the surplus under this head declined for the fifth consecutive year during Jul-Apr 2011(see **Figure 6.1**): the financial account posted a meager surplus of US$ 0.5 billion during Jul-Apr 2011 against US$ 3.7 billion last

Table 6.1: Summary of External Accounts (Jul-Apr)

billion US$

	FY10	FY11	Abs. Change	Percent Change
C/A balance	**-3.5**	**0.7**	**4.2**	**120.0**
Trade balance	-9.3	-8.3	1.0	10.8
Exports	16.2	20.5	4.4	27.0
Imports	25.5	28.8	3.4	13.2
Invisible balance	5.8	9.0	3.2	54.2
Remittances	7.3	9.0	1.7	23.8
Financial/Capital balance	**3.7**	**0.5**	**-3.2**	**-86.5**
FDI	1.7	1.2	-0.5	-29.4
FPI	0.0	0.3	0.3	500.0
Other investment	1.9	-1.2	-3.1	-163.1
Errors & omissions	0.5	0.0	-0.5	-100
Overall balance	**0.7**	**1.2**	**0.5**	**71.4**

Figure 6.1: External Sector



year since both investment and loan inflows experienced a decline during the period under review.

Another concern is that Pakistan's textile exports may not be able to repeat the performance shown in FY11 as (a) recovery in global demand appears fragile; (b) the price gain in textiles, which helped create a surplus in FY11, may not be available going forward following a sharp drop in cotton prices; and (c) domestic constraints such as energy and a deteriorating law & order situation, have only got worsened. Hence, with imports showing no sign of contracting, there is a likelihood of the trade deficit widening in FY12.

Net financial inflows in the past few years have remained low, but the situation could deteriorate as Pakistan has to make substantially large debt repayments to the IMF in FY12. Since the global financial environment remains uncertain, mobilizing financial resources from international markets would be challenging.

6.2 Current Account Balance

Record export earnings, strong growth in worker remittances and increase in receipts on account of the coalition support fund and flood related grants, helped transform the current account balance into a surplus for the first time in 6 years (see **Table 6.2**).

Table 6.2: Current Account (Jul-Apr)

billion US$

	FY10	FY11
Major inflows		
Exports	16.2	20.5
Remittances	7.3	9.0
Services exports	3.7	4.7
Major outflows		
Imports	25.5	28.8
Services imports	5.7	6.1
Overall C/A	**-3.5**	**0.7**

The trade deficit– the largest component of the current account – contracted significantly, as the sharp growth in exports outpaced imports.

Although the rising unit prices of textile items account for majority of the improvement in export performance, higher demand particularly in the US and the EU also contributed.[1,2] On the other hand, imports posted a growth of 13.2 percent during Jul-Apr 2011 due to a rise in international commodity prices (e.g., food and oil).

[1] Textile exports increased by US2.0 billion, of which US$ 1.6 billion was due to rising export unit prices.
[2] This is the highest level of export proceeds during the first 10 months of a fiscal year.

The deficit in the *services* also showed a contraction of 28.1 percent during Jul-Apr 2011, primarily driven by inflows under the coalition support fund (US$ 743 million) and flood-related grants (roughly US$ 500 million).

The *income account*, however, did not show any major change, but did experience higher payments on account of IMF charges, interest on official and private external debt, and repatriation of profits and dividends (particularly in oil & gas and financial businesses). However, payment pressures eased somewhat due to lower outflows of income on equity.

The most significant development in the external account is the sharp increase of 23.8 percent in workers' remittances during Jul-Apr 2011. This growth represents a continuing improvement over and above last year's increase of 14.9 percent. At its current pace, workers' remittances would surpass US$ 10.5 billion by end of FY11. The ongoing global economic recovery, SBP and government efforts to channelize remittances into the banking system,[3]coupled with support from expatriates to the flood affected households, largely explain this strong performance.

Interestingly, more than 60 percent of remittances originated from the Gulf region (particularly UAE). More importantly, remittances from Dubai which declined substantially last year following the financial crisis in the country, staged a sharp recovery this year.

6.3 Financial Account Balance

As mentioned earlier, the financial account surplus declined for the fifth consecutive year in FY11, to US$ 0.5 billion in Jul-Apr 2011 compared with US$ 3.5 billion in the corresponding period last year. Unlike the previous year, when only *investment* inflows declined, this year *loan* inflows fell sharply (see **Figure 6.2**).

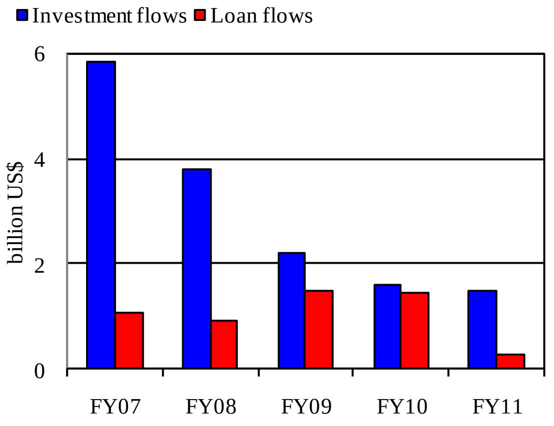
Net foreign private investment fell by 8.6 percent, primarily due to a decline of US$ 500 million in foreign direct investment during Jul-Apr 2011. On the other hand, foreign portfolio investment recorded a net inflow of US$ 298 million during this period, which was in sharp contrast to an *outflow* of US$ 48.0 million during Jul-Apr 2010. The outflow during 2010 was mainly on account of the

[3] Initiatives under PRI such as Xpress money, incentives in the form of interbank fund transfer facility and Easy-paisa by Telenor Pakistan has helped in increasing the remittances through formal channels.

repayment on Sukuk bonds worth US$ 600 million. This means the absence of any large repayment this year, is responsible for the improvement in net terms.

A detailed analysis of FDI reveals that major declines were recorded in telecommunication (US$233.8 million) and oil & gas exploration (US$191.8 million) sectors. The decline in Telecom is understandable as this sector has already reached a saturation point in the country. In case of the oil & gas exploration, a growing circular debt and the deteriorating law & order situation seem to be major hurdles in attracting fresh FDI. [4]

Figure 6.2: Financial Account (Jul-Apr)



On the other hand, FDI inflows in power [5] and financial sector, recorded increases. In the financial sector, one-off injection (US$ 74.0 million) in one particular bank, explains the rise in FDI.[6]

In case of loan inflows, suspension of the IMF Stand-by Arrangement is impacting inflows from other IFIs. It is therefore not surprising that the ratio of realized to pledged loans has declined considerably since the suspension of the IMF program.[7]

6.4 Exchange Rate and Reserves

The improvement in the external account also lent stability to the exchange rate; during Jul-May 2011, the Rupee showed a marginal depreciation of 0.2 percent against a depreciation of 4.5 percent during the corresponding period of the

[4] It may be worth noting that the country's overall ranking in terms of World Bank's *Doing Business* report has dropped to 83 in 2011 from 75 in 2010.
[5] KESC inaugurated a water purification plant in April 2011. FDI inflow is most likely on account of import of plant equipment.
[6] Injection of US$ 74.0 million in NIB by Bugis Investments – a wholly-owned subsidiary of Fullerton Financial Holdings of Singapore.
[7] The World Bank and the ADB pledged US$ 1.0 billion each, however only US$0.55 and US$0.40 have been realized so far.

previous year. However, the Rupee appreciated by 3.0 percent in real terms against Pakistan's trading partners due to higher domestic inflation in the country.

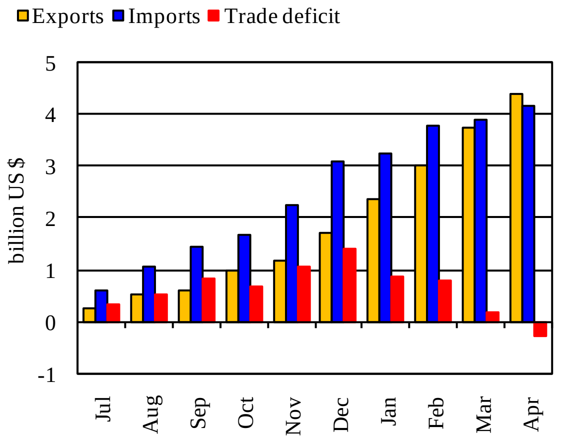
Comfort on the external sector allowed SBP to make substantial purchases from the inter-bank market during the year. As a result, FX reserves increased sharply and reached US$ 17.1 billion by end-May 2011. However, reserve adequacy, measured in terms of weeks of imports, declined slightly from 26.4 weeks of imports to 25.7 weeks, reflecting a pick-up in import growth.

6.5 Trade Account[8]

Pakistan's trade deficit continued to narrow for the third consecutive year, declining by 2.1 percent YoY during Jul-Apr 2011.

Unlike the previous two years, however, this decline was not due to contraction in the import bill, but due to the stellar performance of exports. Despite a challenging economic environment, a YoY growth of 27.9 percent during Jul-Apr 2011 is indeed commendable.

Figure 6.3: Trade Account YoY Change - Monthly Cumulative



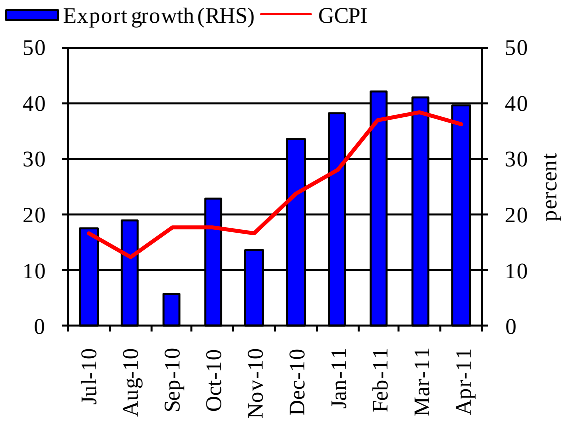
Imports also posted a significant rise of 14.7 percent during Jul-Apr 2011 after declining during the previous two consecutive years. In fact, the import bill initially increased the YoY trade deficit and it was only in Q3-FY11 that a surge in exports resulted in the contraction of the trade deficit (see **Figure 6.3**).

The surge in exports was driven by both rising demand owing to global economic recovery and rising trend in international commodity prices. Pakistan benefited particularly from the increase in cotton prices during Jul-Apr 2011. As a result, exports were driven by both increase in quantum and prices (see **Figure 6.4**). More encouragingly, not only did textile exports record a substantial improvement, but non-textile exports also made a sizeable contribution.

[8]The analysis is based on provisional data provided by the Federal Bureau of Statistics, which is subject to revisions. This data may not tally with the exchange record numbers posted in the section of *Balance of Payments.*

Although the rise in the global demand and favorable commodity prices benefited Pakistan's exports, they also led to a rise in imports which have remained dormant during the previous two years. Not surprisingly, therefore, the major contributors to import growth were food, petroleum and textile groups.

Figure 6.4: Global Commodity Price Index & Export Growth

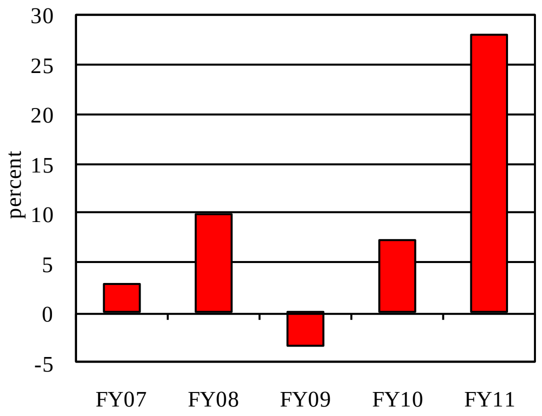


Both exports and imports are expected to witness a seasonal increase in the fourth quarter. However, the performance of exports suggests that the rise in imports would be more than offset and as a result, the country's trade deficit could narrow further in Q4-FY11.

Exports

A combination of both external and domestic factors caused exports to record a healthy YoY growth of 27.9 percent during Jul-Apr 2011 compared to a rise of 7.3 percent during the corresponding period of last year (see **Figure 6.5**). The analysis of the monthly export performance reveals acceleration in export growth from December 2010 onwards, which was broadly in line with the rising trend in international commodity prices. The recovery in exports has been broad-based, led by better performance of food group, textiles and jewelry exports

Figure 6.5: Eport Growth (Jul-Apr)



Textile group

Textile exports increased by 32.1 percent YoY during Jul-Apr 2011 compared to a 6.8 percent rise in the corresponding period last year. This improvement largely emanated from strong demand for textile and clothing in the EU and the US.

In overall terms, 25.6 percent of the total increase in textile exports was contributed by low value-added categories, i.e., cotton yarn, raw cotton and synthetic textiles. The rise in these categories of exports was due to better prices since export quantum declined compared to last year (see **Table 6.3**).

Table 6.3: Major Textile Exports Price & Quantum Impact (Jul-Apr)
million US$

	FY10			FY11		
	Absolute change	Qty	Price	Absolute change	Qty	Price
Textile Group	**385.1**			**2,333.8**		
Of which						
Raw cotton	113.0	99.7	13.3	43.0	-85.7	128.7
Cotton yarn	269.8	298.3	-28.5	392.2	-253.4	645.6
Cotton fabrics	-180.0	-144.1	-35.9	354.5	-5.6	360.2
Knitwear	-15.2	-49.0	33.8	422.3	349.2	73.1
Bed wear	-2.6	12.5	-15.1	273.0	47.6	225.4
Towels	21.9	69.9	-48.0	87.8	99.6	-11.8
Readymade garments	12.2	-66.1	78.4	365.6	242.3	123.3
Art silk and synthetic textiles	101.2	66.2	35.0	196.0	161.9	34.1

Although Pakistan's cotton crop was partially damaged due to floods earlier this year, this coincided with global supply shortages in key textile inputs. As a result, Pakistan was able to get better prices for both raw cotton and yarn. This advantage is, however, diminishing with the arrival of the new crop; cotton prices have started to recede from March 2011 onwards. Going forward, cotton prices are expected to decline further, which will reduce the price impact in these categories in the coming months of FY11.

Unlike the low value-added group, growth in high value-added textile was driven by a strong increase in quantum supplemented by higher prices (see **Table 6.3**). This reflects gradual improvement in global demand for textiles as exports of major textile and apparel producing countries, including Pakistan, increased during the third quarter of FY11.

Non-Textile Sector
The analysis of non-textile exports shows that most major groups posted positive growth, although with a declining quantum.

The export under the 'food group' however witnessed an increase in quantum mainly driven by *wheat, raw tobacco & vegetable*. Improvement in export quantum of *wheat* was supported by higher carryover stocks of FY10 and expectations of a bumper FY11 wheat crop. Furthermore, the rise in international wheat prices (due to bad weather conditions in Russia, USA and Canada) and a decent domestic output helped in exporting of wheat during the period under review.

In the *other* manufactures' group, exports of leather, chemicals and sports goods recorded an increase; however, this rise was partially offset by negative growth in exports of cement and the jewelry. The increase in leather, chemicals and engineering goods was a function of improved external demand in traditional markets and relatively better export prices. On the other hand, Pakistan's cement exports continued to decline during Jul-Apr 2011, as overall cement exports decreased by 11.0 percent YoY. The decline in the both – export value and volume – is due to (a) qualitative barriers in exporting to India; (b) higher import duty in Afghanistan[9], and (c) increased production capacities in the Middle East and India. Going forward, cement exports to India may pick-up following the renewal of export license in April 2011 by them. Furthermore, the expected installation of scanners at Wagah border in FY12 would make truck-based export to India possible.[10]

Imports
After recording YoY contraction during the previous two years, the country's imports surged by 14.7 percent YoY during Jul-Apr 2011. A large part of this increase in the import bill was recorded in Dec-Apr 2011, mainly due to higher *petroleum, food and textile group* imports. As with exports, a significant part of this rise was caused by a surge in the international prices of *oil, raw cotton* and *palm oil*. Rising international oil prices alone contributed 36.5 percent to the total increase in the import bill during Jul-Apr 2011.

[9] Beyond immediate borders, cement's cost competitiveness quickly erodes as freight charges rapidly escalate on the bulky commodity. Over 50 percent of Pakistan's cement exports are directed to Afghanistan while around 7 percent are routed to India.
[10] Since reserves for lime and gypsum (input for cement) in India are drying up fast, it will either need to import raw material from Pakistan, or the final commodity itself. Low-priced Pakistani cement is apparently the better alternative.

Disaggregation of the *food group* reveals that palm oil and sugar imports accounted for almost 70 percent of the total increase in group imports. A large part of the rise in palm oil imports was due to higher prices and a reduction in import duty on this commodity. Imports of sugar, on the other hand, increased on account of domestic supply shortages (see **Table 6.4**). As such, with the arrival of new sugar stocks in the market, imports of sugar have all but stopped since Jan 2011.

Table 6.4: Major Food Imports (Jul- Apr)
value: million US$, growth: percent

		Value		Δ in	% Δ FY11 over FY10		
		FY10	**FY11**	**Value**	**Quantity**	**Value**	**Unit Value**
Food group		**2,784.7**	**4,314.1**	**1,529.5**			
Of which							
Palm oil	MT	1,040.9	1,599.5	558.6	16.1	53.7	32.3
Pulses	MT	209.5	342.6	133.1	48.9	63.6	9.9
Tea	MT	227.8	288.4	60.6	31.7	26.6	-3.9
Sugar	MT	187.8	681.8	494.0	206.9	263.1	18.3
Wheat un-milled	MT	35.4	5.2	-30.3	-89.4	-85.4	37.7

As expected rising international oil prices inflated petroleum group imports, which increased by 8.4 percent YoY during Jul-Apr 2011. This rise, however, was partially compensated by the decline in quantum (see **Table 6.5**).

Table 6.5: Price and Quantum Impact of Petroleum Group Imports (Jul-Apr)
million US$

	FY10			FY11		
		Change in Value due to			Change in Value due to	
	Abs Δ	**Quantity**	**Price**	**Abs Δ**	**Quantity**	**Price**
Petroleum group	71.3	912.8	-841.5	703.8	-806.6	1,510.4
Petroleum products	662.7	1,233.4	-570.7	-330.6	-1,096.9	766.3
Petroleum crude	-591.4	-320.6	-270.8	1,034.3	290.3	744.0

The import of raw cotton increased sharply by 71.6 percent YoY during Jul-Apr 2011. Majority of this increase was recorded in Q3-FY11. The jump in raw cotton imports is attributable to the damage caused to the domestic cotton crop by floods earlier in FY11. Higher international prices for cotton further inflated the import bill during the period under review.