1 Overview

The analysis in this report is confined to the end of the second quarter, and covers the period July-December FY12.

Half way into FY12, the economy is showing signs of a modest improvement. Preliminary data indicates that the commodity producing sector, especially agriculture, is doing better than expected. Services also seem well-placed to gain from robust retail trade activities; transportation; and increased profitability of the banking sector. The ample availability of key staple crops and less than anticipated supply disruptions due to floods, played a key role in containing inflationary pressures during the period under review.

Despite these positive developments, risks to macro-economic stability have, nevertheless, increased. Specifically, the position of the external sector weakened at a rate faster than expected; and the fall in financial and capital inflows exerted pressure both on SBP's foreign exchange reserves and on the Pak Rupee. This, along with the pickup in government borrowing from SBP, complicated liquidity management. Finally, energy shortages continued to plague production activities, especially in the industrial sector.

Table 1.1: Selected Economic Indicators

		FY10	FY11	FY12
Growth rate (percent)				
LSM	Jul-Dec	-0.8	-2.0	0.8
Exports (fob-FBS)	Jul-Dec	-4.0	18.9	3.9
Imports (cif-FBS)	Jul-Dec	-16.3	19.4	18.9
Tax revenue (FBR)	Jul-Dec	5.1	13.7	27.1
CPI (period average)[1]	Jul-Dec	8.7	14.3	10.9
Private sector credit	Jul-Dec	4.3	5.4	6.2
Money supply (M2)	Jul-Dec	6.6	9.0	5.7
billion US dollars				
Total liquid reserves[2]	31st Dec	15.0	17.2	17.0
Home remittances	Jul-Dec	4.5	5.3	6.3
Net foreign investment	Jul-Dec	1.1	1.0	0.4
percent of GDP[3]				
Fiscal deficit	Jul-Dec	2.7	2.7	2.5
Trade deficit	Jul-Dec	3.3	2.7	3.3
Current a/c deficit	Jul-Dec	1.4	0.0	0.9

[1] Base year-FY08

[2.] With SBP & commercial banks

[3.] Based on full-year GDP in the denominator

Source: State Bank of Pakistan

Within the commodity producing sectors, major *kharif* crops are likely to achieve their target growth for FY12.[1]

[1] However, initial estimates suggest that area under wheat cultivation (Rabi crop) is slightly lower than 8.9 million hector last year.

Fortunately, flood-related damages to the cotton crop in Sindh have been more than offset by gains in Punjab. The use of high quality cotton seeds; improved availability of water; and the increase in area under cultivation due to higher crop prices last year were the main reasons here.

However, the benefits of productivity gains to farmers are being eroded by the dwindling price of their produce.[2] This, along with the increased cost of inputs (especially that of fertilizer), has squeezed margins for farmers. Accordingly, farm income is expected to be lower than last year.

The improvement in the production of minor crops and the ample availability of key staple crops has eased inflationary pressures in the food group during H1-FY12.[3] This was primarily responsible for bringing YoY CPI inflation down to single digits (9.7 percent) in December 2011 – at that level for the first time since October 2009. However, the declining trend in headline inflation may not persist. Core inflation (non-food, non-energy) has shown no signs of receding, and more than half of the commodities in the CPI basket are still posting double-digit inflation.[4] This stubbornness is attributed to a host of factors including: (1) the periodic upward revision in administered prices, especially that of petroleum products; (2) depreciation of the domestic currency, particularly during the second quarter of the year; and (3) the revival of inflationary expectations with the government borrowing from SBP since November 2011.

Within aggregate demand, there has been almost no improvement in the investment component, despite the reduction in the cost of borrowing, following the cut in SBP's policy rate.[5] Loans to private sector businesses saw an expansion of only 3.5 percent in H1-FY12, compared with 8.4 percent during the first half of FY11. More importantly, fixed investment loans during H1-FY12 saw a net retirement of Rs 8.5 billion, against an expansion of Rs 8.1 billion last year. The low demand for fixed investment loans is largely due to persistent energy

---

[2] Domestic prices of *Phutti* (cotton with seeds) fell from its peak level of Rs 5767 per 40 Kg in March 2011 to Rs 2050 in December 2011: a decline of 64.5 percent. Growers are also struggling to secure better price of sugarcane, which is under pressure due to good sugarcane harvest and delayed start of crushing season. In case of rice, while domestic prices are slightly higher than the previous year, relatively high share of non-basmati varieties in overall rice production and gradual decline in price of rice in international market, limit the opportunity of strong earnings from rice exports.

[3] Food inflation has sharply decelerated from 15.9 percent in June 2011 to only 9.5 percent in December 2011.

[4] If we exclude three food items namely potatoes, onion and sugar from the CPI basket, YoY inflation for December 2011 turns out to be 11.0 percent.

[5] Weighted average lending rates on fresh loans declined to 13.2 percent in December 2011 against 14.6 percent in July 2011 (before the cut in SBP's policy rate).

shortages, the unfavorable law and order situation, and excess capacity in the industrial sector.

Demand for working capital loans has also been low; these loans saw an expansion of Rs 99.5 billion during H1-FY12 compared to Rs 131.3 in H1-FY11. This was primarily driven by: (1) the textile sector, which required less working capital as cotton prices fell, and these units still carried forward healthy profits from FY11; and (2) the inability of sugar mills to offload their stocks from last year, which constricted seasonal demand for fresh loans. It is pertinent to note that the government had to intervene in the sugar market by purchasing 378,000 tons of sugar through TCP. This helped sugar mills retire some of their bank borrowings.

While demand for credit was understandably low, significant government borrowing from commercial banks also ate into the supply of loan-able funds for the private sector. H1-FY12 data indicates that government borrowing for budgetary support more than doubled, compared to the same period last year. Although the bulk of this borrowing (Rs 391.0 billion) was needed to partially settle the inter-agency receivables of PSEs in the energy sector, and the payment of subsidies to procurement agencies (popularly known as circular debt), direct borrowing for deficit financing was Rs 365.0 billion, which was higher than last year's borrowing of Rs 308.5 billion.

Of greater concern is the composition of government borrowing, which has tilted towards inflationary financing. Q2-FY12 data indicates that the government was unable to meet its self-imposed quarterly limit of *zero* net budgetary borrowing from SBP. High frequency data shows that government borrowing from SBP picked up from November onwards, and reached Rs 219.2 billion during Q2-FY12. This dependence on SBP financing was because of the difficulties encountered in rolling over maturing T-bills in the month of December 2011 – a risk highlighted in SBP's Monetary Policy Statements and Annual and Quarterly Reports.

Data for consolidated fiscal operations indicates a deficit of 2.5 percent of GDP for H1-FY12 (**Table 1.1**). This deficit was slightly lower compared to the first half of FY11. The good news is that this came primarily from the revenue side; FBR tax collections reached Rs 840.1 billion during H1-FY12, showing a YoY growth of 27.1 percent. Moreover, SBP profits of Rs 104.0 billion contributed significantly non-tax revenues. Nevertheless, it is important to note that financing this contained fiscal deficit in H1-FY12 was challenging as compared to H1-FY11. As mentioned earlier, the burden of financing fell squarely on domestic

sources, since the expected external inflows did not materialize. Specifically, uncertainty about inflows from the Coalition Support Fund (CSF) and the Eurobond issuances still prevails.

The slowdown in foreign exchange inflows has also raised concerns about country's balance of payments. Specifically, Q2-FY12 data shows that the overall external account deficit has increased to US$ 1.0 billion compared to US$ 0.8 billion in the first quarter of the year; this takes the H1-FY12 external deficit to US$ 1.8 billion (**Table 1.1**). The composition of the BoP reveals that the current account deficit has widened to US$ 2.2 billion, against an almost nil balance during H1-FY11.

Within the current account, a positive was the growth in worker remittances, which reached US$ 6.3 billion during the first half of the year. Excluding remittances, all other components of the current account deteriorated during the period under review. The import bill increased on account of higher international oil prices and the import of fertilizer. These two items alone accounted for 60 percent of the increase in imports during H1-FY12. On the other hand, export growth has slowed to 3.9 percent compared to 18.9 percent during the first half of the previous year.[6] The deceleration was largely concentrated in Q2-FY12, as exports actually fell on a YoY basis for all three months of that quarter. The fall was driven primarily by a decline in quantum; this is an indication of domestic structural weaknesses, as unit values (prices) actually increased for most of the textile items.

Despite these weaknesses, the size of the current account deficit should not be a major source of concern, given Pakistan's history. The real challenge is financing the current account deficit, as both debt and non-debt inflows have declined. Quarterly numbers indicate that financial/capital accounts posted a deficit of US$ 0.4 billion during Q2-FY12, which implies that the *overall* external deficit had to be financed by drawing down foreign exchange reserves. Hence, SBP's foreign exchange reserves saw a reduction of US$ 1.9 billion during H1-FY12 to US$ 12.9 billion. This decline in reserves was accompanied by a depreciating Pak Rupee, which lost 4.4 percent of its value during the first half of the year.

Looking Forward

Developments during H1-FY12 indicate that risks to macroeconomic stability are stemming from the external sector and the continued weaknesses on the fiscal side. In terms of the real sector, there has been some improvement since the

[6] Trade numbers are based on FBS data.

publication of SBP's *Annual Report* in December 2011. The economy is still expected to grow in the range of 3 to 4 percent (**Table 1.2**). Inflationary outlook has improved slightly on account of supply side factors (food). It is expected that FY12 inflation will fall within the range of 11.0 to 12.0 percent, with a bias towards the lower boundary.

In spite the lower fiscal deficit during H1-FY12, containing the overall fiscal deficit to its revised target of 4.7 percent of GDP seems to be challenging. Quarterly data for previous years has shown that the deficit remains relatively higher in the second half of the year. The achievement of the revised fiscal deficit is dependant on the realization of: (1) the envisaged surpluses from provincial governments, which are likely to be lower than expected;[7] (2) the non-tax revenues, which depends on inflows into the Coalition Support Fund, and the auction of 3G licenses;[8] and (3) strict control over expenditures.

Table 1.2: SBP Projections of Major Economic Indicators

	FY11	FY12	
	Actual	Annual Plan Targets	SBP Projections
Percent growth			
GDP	2.4	4.2	3.0-4.0
CPI inflation	13.7	12.0	11.0-12.0
Monetary assets	15.9		12.0-13.0
Billion US$			
Workers' remittances	11.2	12.0	12.0-13.0
Exports (fob-BoP)	25.4	25.8	24.1-24.6
Imports (fob-BoP)	35.8	38.0	40.3-41.0
Percent of GDP			
Fiscal deficit	6.6	4.7*	5.5-6.5^
Current account deficit	-0.1	0.6	1.5-2.5

Note: Targets of fiscal and current account deficit to GDP ratios are based on Nominal GDP in the budget document for FY12, while their projections are based on projected nominal GDP for the year.
*Revised fiscal deficit target for FY12, original target was 4.0 percent of GDP.
^ Pessimistic scenario assumes slippages in FBR tax revenues, zero receipts from 3G licenses, shortfall in Collation Support Fund, balance budget of provincial governments, and overrun in expenditures.

The burden of financing this deficit will fall on the banking system, specifically on commercial banks. Other than growing concerns about the supply of loan-able funds for the private sector, renewed government borrowing from SBP entails rising inflationary expectations in the economy.
On external front, although the current account deficit is expected to be in the range of 1.5 to 2.5 percent of GDP, there is an upward bias to this prediction. Given the fall in financial and capital inflows, funding this modest current account deficit could be challenging. Market players are increasingly concerned about

[7] H1-FY12 data indicate that the provincial government jointly recorded budget surplus of Rs 20.6 billion against the full year target of Rs 125.0 billion.
[8] An important development is that Pakistan Telecommunication Authority (PTA) has invited expression of interest for the auction of 3G/4G licenses. The resulting inflows will help in containing the fiscal deficit and supporting BoP.

whether the envisaged foreign inflows will materialize in time. This, together with the scheduled repayment of IMF loans (US$ 1.1 billion) during H2-FY12, may draw down SBP's foreign exchange reserves.