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LETTER OF TRANSMITTAL

State Bank of Pakistan
Karachi.
March 20, 2012

Dear Mr. Chairman,

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

With warmest regards,

Yours sincerely,

(YASEEN ANWAR)
Governor

Syed Nayyer Hussain Bokhari
Chairman
Senate
ISLAMABAD

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Dr. Fehmida Mirza
Speaker
National Assembly
ISLAMABAD

Acknowledgment

Publication Manager:	Mahmood ul Hasan Khan
Analysis:	Bilal Khan (automobile); Mahmood ul Hasan Khan (monetary sector); Mohib Kamal Azmi (external); Muhammad Akmal (trade); Muhammad Farooq Arby (fiscal); Muhammad Zeb (fiscal); Sabahat (monetary aggregates); Sabina Khurram Jafri (debt); Syed Ozair Ali (fertilizer & inflation); Syed Qamar Hussain (POL); Syed Sajid Ali (Agriculture); Syed Zulqernain Hussain (balance of payments); and Tamkinat Rauf (industry & special section 2.1).
Formatting:	Fatima Khaliq; Syed Zulqernain Hussain

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

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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

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[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.

2 Real Sector

2.1 Overview

While it is too early to make any definitive statement on aggregate demand, there are some signs of improvement in private consumption, investment, as well as government support. Specifically:

- Increase in consumption demand is evident from higher production of consumer goods and renewed interest in auto finance. This improvement in domestic demand is supported by growth in workers' remittances, stable corporate profits and lower taxes.[1] Farm income which had been one of the major drivers of rural demand in the past, however remained under pressure.[2,3]
- Recovery in investment demand is reflected in higher imports of capital goods and FDI inflow in selected industries as well as a modest revival in construction activities.
- The government's role has been largely positive in terms of tax cuts on consumer durables and the cement industry, which supported private demand. Moreover, some foreign-funded public sector construction projects are also supporting economic activity. Lastly, energy supply, particularly thermal electricity generation improved because the government took measures to improve the liquidity situation in the power sector.

An important feature of FY12 growth is that it is not being backed by credit from the banking sector. While low raw material prices for textile and sugar sectors explain the slack in private sector advances to some extent, there are other areas where the price explanation does not hold – such as construction and fixed investment. As for now, foreign aid and investment as well as retained corporate earnings, are driving growth.

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[1] Taxes and duties on automobiles, air conditioners, deep freezers, and beverages were reduced in Budget FY11.

[2] While the final outcome of agri-output would depend on wheat, initial indications are that this improved production is not sufficient to overcome loss of farmers' income due to a sharp fall in commodity prices and escalation in input costs.

[3] According to an ADB study, crop income accounts for 67 percent of the total income in cotton/wheat producing areas in Sindh and 64 percent of the total income in cotton/wheat producing areas in Punjab. Source: Malik, Sohail J. (2005), "Agricultural Growth and Rural Poverty: A Review of the Evidence", Asian Development Bank, Islamabad.

In terms of aggregate supply, major *kharif* crops have performed better than expectation, with estimates of highest ever production of rice and sugarcane, and strong cotton harvest. This has been led by favorable weather conditions, better water availability, and the incentive for increasing cultivated area because of last year's high crop prices. By December 2011, it appears that the major crops will have a strong contribution to GDP growth in FY12.

While production improved in real terms, farm incomes have taken a hit from lower crop prices and higher input costs after the imposition of sales tax. Prices of cotton and sugarcane crop declined this year as a supply glut took shape in both domestic and global markets. Moreover, revenues from the rice crop have also suffered on account of lower Basmati production this year.

The downward pressure on price of agri-based raw material has benefitted the sugar and cotton yarn industries. Furthermore, consumer goods production remained strong, mainly led by food, pharmaceuticals, home electronics, and consumer automobiles. However, overall large scale manufacturing showed decline in Q2-FY12 after posting 3.5 percent YoY growth in Q1-FY12, mainly due to supply-bottlenecks in intermediate and capital goods industries.

Shaped by real sector developments, the export and import baskets also underwent some changes. For instance, while manufactured goods exports declined (mainly led by textiles), agri-based food exports remained strong. Similarly, a decline in agriculture product imports was offset by higher demand for intermediate goods and machinery, particularly in Q2-FY12. Services trade balance also deteriorated in H1-FY12. Overall, net exports had a downward pull on aggregate demand in H1-FY12.

2.2 Agriculture Sector

Most of the major *kharif* crops (cotton, rice, sugarcane) have already been harvested and preliminary estimates show strong performance by these crops.[4] This improved performance is commendable given that farmers faced multiple challenges during the crop season, including floods in the summer, sharp fall in prices of agri produce and increase in input costs.

On a positive note, floods also improved soil moisture. This, together with the improved and timely availability of water, supported the crop yield for sugarcane, rice and cotton. In the case of cotton, the attractive crop prices in the previous

[4] The improved performance by rice and sugarcane is likely to reflect in higher production of fodder which is one of the key inputs for livestock.

season also encouraged farmers particularly in Punjab to increase area under the crop.

The demand of key agri inputs also increased during the *kharif* season (April-September). The total nutrient off-take was higher by 5.8 percent YoY in *kharif* 2011, despite sharp increase in prices during this period; banks' credit to agriculture sector also recovered from last year's dismal performance because of the floods in August 2010. The demand for tractors however remained lower, probably because of higher prices following the imposition of sales tax in March 2011. The fall in tractor sales was also expected as farmers re-prioritized their spending in response to higher prices of fertilizer.[5]

Performance of *kharif* crops

Cotton

According to the Cotton Crop Assessment Committee (CCAC), the estimated crop size is 12.6 million bales, against the target of 12.8 million bales, and last year's production of 11.6 million bales. As evident from **Table 2.1**, gains in the Punjab more than offset the flood-related losses in Sindh.

The key concern for farmers has been the sharp fall in domestic price of seed cotton. Following the global trend, cotton phutti prices fell from Rs 5,767/ 40 kg in March 2011(peak level) to Rs 2,050/40 kg in December 2011.[6,7] Moreover, given the persistent weakness in developed economies, it would be difficult for cotton prices to post an upward trend in the near future.[8]

Table 2.1 Cotton Crop Production
million bales of 170 kg

	2011	2010	Change
Sindh	2.3	3.5	-1.2
Punjab	10.1	7.9	2.3
Total	**12.6**	**11.4**	**1.2**

Source: Cotton Crop Assessment Committee

[5] The government reduced General Sales Tax (GST) on tractors from 16 percent to 5 percent in December 2011.
[6] Source: Agri-Business Field report by Zarai Taraqiati Bank Limited.
[7] In the international market, the Cotlook -A index, that averaged US cents 506.3/kg in March 2011, fell to US cents 210.1 in December 2011.
[8] According to US Department of Agriculture (USDA), 2011-12 global cotton production is expected to reach record level of 123.4 million bales, showing an increase of 7 percent over the last year. Cotton consumption on the other hand is estimated to fall by 3.4 percent to 111.3 million bales.

Rice

The production estimates for rice vary in the range of 6.2 – 7.2 million tons, surrounding this year's official target of 6.6 million MT and significantly above the 4.8 million tons produced last year. The information collected from the provinces suggests a crop size of 6.2 million tons, whereas US Department of Agriculture (USDA) projects Pakistan's rice production at 6.55 million tons. Estimates provided by Suparco are on the higher side at 7.2 million tons (**Table 2.2**).

It may be noted that the rice crop of 2010-11 was damaged due to the floods in August 2010. During the current season, though the area and production both declined marginally in the Punjab, the recovery in Sindh was impressive. Both the area under cultivation and the yield increased during this season despite some damages in Badin and Tando Muhammad Khan districts in June 2011. Major recovery was witnessed in Jacobabad, Shikarpure, Kashmore, Qambar and Ghotki districts.

Table 2.2: Rice Production

area in '000 hectare; production in 000 tons; yield in Kg/hectare

	2011	**2010**	**% growth**
Sindh			
Area	636	361	76.0
Production	2,350	1,230	91.0
Yield	3,695	3,406	8.5
Punjab			
Area	1,733	1,767	-1.9
Production	3,308	3,384	-2.3
Yield	1,908	1,915	-0.4
Balochistan			
Area	171	191	-10.5
Production	529	131	304.7
Yield	3,089	683	352.2
Pakistan[1]			
Area	2,540	2,319	9.5
Production	6,186	4,745	30.4
Yield	2,435	2,046	19.0
Pakistan[2]			
Area	3,095	2,365	
Production	7,182	4,823	

Source: [1] Provincial Crop Reporting Centers, [2] Suparco

Unfortunately, the recovery in rice production is concentrated in non-basmati varieties. The production of basmati rice, which fetches higher export value compared to other varieties, has actually declined compared to previous year. The international market for non-basmati varieties is already under pressure as world supplies outstripped demand, and India lifted its ban on non-basmati rice exports. More importantly, the downtrend in prices may continue due to comfortable global supplies.[9]

[9] According to USDA global production is expected to reach record level of 461.6 million tons – 2.0 percent higher than the previous year.

Sugarcane

The crop estimates for 2011-12 vary considerably, ranging from 56.2 – 69.9 million tons. This year's official crop target was 57.6 million tons. Estimate of 56.2 million tons provided by provincial crop reporting centers is closer to the projection of 58 million tons by the US Department of Agriculture. On the extreme side, the Suparco in its recent report has revised its estimate from 55.3 million tons to 69.9 million tons (**Table 2.3**).

While the sugarcane production suffered in Sindh due to floods, the crop in Punjab showed remarkable growth. Sugarcane growers are facing several problems. Not only that the price of their produce fell,[10] the crushing season also got delayed. It may be noted that farmers do not receive any compensation for this delay in their payments. In fact, they incur additional costs as their trolleys are stuck for extended period before offloading cane at the mills. To avoid these costs, growers prefer to sell their produce to middlemen at prices lower than the minimum support price set by provincial governments.

Table 2.3: Sugarcane Production

area in '000 hectare; production in million tons; yield in Kg/hector

	2011	2010	% growth
Sindh			
Area	189.7	226.5	-16.2
Production	9.1	13.8	-34.0
Yield	47,910	60,792	-21.2
Punjab			
Area	754.7	672.2	12.3
Production	42.8	37.5	14.1
Yield	56,711	55,761	1.6
KP			
Area	94.4	88.4	6.7
Production	4.3	4.0	7.3
Yield	45,835	45,589	0.5
Pakistan[1]			
Area	1,038.80	987	5.2
Production	56.2	55.3	1.6
Yield	54,091	56,004	-3.4
Pakistan[2]			
Area	1,278.70	987	29.6
Production	69.9	55.3	26.4

Source: [1] Provincial Crop Reporting Centers [2] Suparco

The government has already procured 378,000 tons of sugar from mills, so that the mills can make timely payment to growers. Since cane harvesting continues till March, it is expected that the government efforts would allow farmers to receive a fair price for their produce.

[10] The better production has resulted in lower price for sugarcane in the Punjab compared to that in Sindh.

Rabi crop: Wheat

The 2012 target for wheat is 25 million tons. For this crop, not only the sowing season stretched till December 2011 (in some areas of Sindh and Punjab) due to inordinate delays in sugarcane crushing, the sowing area came out marginally lower than the last year figure of 8.9 million hectares. This decline in area under cultivation (despite an increase in support price to Rs 1,050 from Rs 950 per 40 kg) was due to water availability issues and delayed rains in *barani* areas. At the same time, some of the agri land in Badin and Mirpurkhas still remains inundated following floods last year.

2.3 Industry

Half-way into FY12, the industrial sector has been showing some improvement over the previous year (**Table 2.4**). However, this performance must be qualified, as part of the growth in Q1-FY12 reflects the effect of a low base.[11] As this base effect faded out, large-scale manufacturing (with a share of 52.3 percent in overall industry) posted decline in October and November 2011, before finally picking up in December.

Table 2.4: Mid-year Industry Performance Review
percent YoY growth

	% share[1]		FY11		FY12	
	GDP	Ind.	H1	FY	H1	FY[t]
Industry	**24.8**	**100**	**..**	**-0.1**	**..**	**3.1**
LSM	13.0	52.3	-2.0	-0.02	0.8	2.0
Mining	2.7	10.9	-1.5	-1.6	2.3	1.0
Construction	2.4	9.8	..	0.8	..	2.5
Electricity, gas, & water distribution	2.0	8.1	..	-21.1	..	1.0
of which						
Electricity	..	..	-12.5	-9.9	22.5	..

FY= full year; t= target. [1]5-year avg. Growth in LSM & mining based on respective indices; GVA growth for overall industry & construction.
Source: Pakistan Bureau of Statistics.

Nevertheless, there are some reasons to be optimistic:

1. Private consumption demand has gained traction in H1-FY12, as reflected in higher production of consumer goods. Demand has improved on the back of growth in workers' remittances,[12] stability in corporate incomes, and renewed interest in auto financing by the banking sector.[13] Moreover, tax cuts on key consumer products were also pivotal in strengthening consumption demand.

[11] Floods of August 2010 particularly affected natural gas production, power generation, petroleum refining, construction, automobiles, and fertilizer demand.
[12] Workers' remittances during the past five years average around 6 percent of private consumption expenditure.
[13] Automobile loan disbursements of Rs 34.1 billion were made in H1-FY12 compared to Rs 24.3 billion in H1-FY11.

2. Pick up in construction activity, particularly initiation of public sector construction projects, further supported economic activity. Foreign assistance has played a key role in this regard.[14]
3. There are some indications that investment demand is recovering. For example, although overall foreign direct investment is showing a slowdown, investment in some industries – particularly construction, chemical and beverages – has increased in FY12. Similarly, imports of capital goods have also increased (**Chapter 5**).

It is important to note here that the growth in output is not being reflected in bank financing, which has remained fairly stagnant at last year's levels. This is partly explained by lower raw material prices – particularly in the textile and sugar sectors. In other areas, such as construction and fixed investment, where prices do not explain the low credit demand, foreign sources of funding (FDI and project loans), public spending, and stable corporate earnings are driving growth.

Energy recovery and reforms

Energy sector output improved in H1-FY12 led by growth in natural gas production and higher thermal power generation (which crossed the 6 Gwh mark for the first time in Q2-FY12 since August 2007 – **Table 2.5**). While a part of this increase is simply a recovery from last year's damages from floods, this progress should translate into a positive contribution to real GDP for FY12.[15]

Table 2.5: Energy Availability During H1

	Production in 000 tons of oil equivalent			YoY growth	
	FY10	**FY11**	**FY12**	**FY11**	**FY12**
Natural gas production	4,117	3,602	4,412	-12.5	22.5
Electricity generation	15,784	16,043	16,560	1.6	3.2
Coal mining	995	887	724	-10.9	-18.3
Crude oil processed	5,051	4,709	4,641	-6.8	-1.4
POL product imports	5,937	5,989	6,853	0.9	14.4
Total	**31,885**	**31,229**	**33,191**	**-2.1**	**6.3**

Source: Pakistan Bureau of Statistics, SBP calculations.

Nevertheless, this progress seemed insufficient in the backdrop of increasing demand. Specifically, it appears that with the pickup in manufacturing sector,

[14] Foreign project loans grew by 69.8 percent YoY in H1-FY12 compared to a decline of 14.5 percent YoY in H1-FY11. Major projects for which foreign assistance was received this year include: Chashma Nuclear Power Plant phase III and IV (US$111 million); Karakoram Highway realignment (US$100 million); flood emergency reconstruction funds of US$71 million; Islamabad safe city project (US$68.6 million); highway rehabilitation project (US$41.8 million); Sindh water sector project (US$34.9 million); Neelum-Jehlum hydropower project (US$33.5 million); and KPK road development (US$24.5 million).

[15] During FY11, electricity, gas and water distribution posted a decline of 21.1 percent in value addition.

energy demand grew at a faster pace than supply. As a result, despite higher energy availability, power and natural gas shortages continued, and even increased in some cases. For example, CNG and industrial gas holidays were increased compared to the same period in FY11.

The allocation of natural gas amongst competing users was a key point of contention due to growing demand. In this regard, the government took several decisions this year:

1. After a considerable delay, the government finally decided to discourage CNG usage by raising tariffs, increasing weekly fuel holidays, and banning new CNG vehicles.
2. For industrial and power sectors, an additional surcharge (Gas Infrastructure Development Cess) was levied.

Although the government is making efforts to augment gas supplies, plugging leakages and theft-related losses is equally important. Line losses amount to nearly 9 percent of total gas input, compared to the international benchmark of 1-2 percent.[16]

In the power sector, the government arranged debt swaps with commercial banks to address the circular debt involving power companies and procurement agencies. This arrangement has provided only temporary relief to power producers, as the needed tariff adjustments were not passed on to end-consumers throughout Jul-Dec FY12.[17]

Large-scale manufacturing

Large-scale manufacturing growth decelerated during the quarter, from 2.8 percent YoY in Q1-FY12 to negative 1.0 percent in Q2-FY12. It was anticipated that the drivers of Q1 growth – export demand and favorable post-flood base effect – would not help.[18] However, further deterioration occurred on account of continuing gas shortages during the peak winter months, which constrained production in fertilizer, cotton weaving, and steel re-rolling. As a result, only 46 percent of LSM subsectors showed positive YoY growth in Q2-FY12 compared to 57 percent in Q1. On a cumulative basis, H1-FY12 growth stands at 0.8 percent, which is below this year's growth target of 2.0 percent.

[16] World Bank, "Natural Gas Efficiency Project, Report No. AB6124", September 9, 2011.
[17] Thermal power constitutes around two-thirds of total electricity generation in the country. Thermal generation increased by 25 percent YoY in Jul-Nov-FY12, compared to 15.1 percent decline last year.
[18] See LSM section in the First Quarterly Report on The State of Pakistan's Economy FY12.

But a detailed look at LSM sectors shows the decline was limited to capital and intermediate industries, whereas consumer goods remained strong (**Table 2.6**). In fact, the latter had a positive contribution of 2.4 percentage points in Q2-FY12 growth; which was mainly led by food, pharmaceuticals, home electronics, and consumer automobiles. Growth has been driven by fiscal support, automobile financing, improved agriculture output, and higher workers' remittances.[19]

Table 2.6: Economic Category-wise LSM Production
percent YoY growth

Category	Wt	Q1		Q2	
		FY11	FY12	FY11	FY12
Consumer goods	31.9	2.8	6.7	2.5	5.0
Durables	5.2	14.1	4.8	5.8	4.6
Non-durables	26.7	0.8	7.1	1.9	5.1
Capital goods	2.4	4.2	-33.3	-5.7	-17.6
Intermediate goods	36.1	-9.5	1.3	-2.0	-5.8
Overall LSM	**70.3**	**-3.9**	**2.8**	**-0.1**	**-1.0**

Source: Pakistan Bureau of Statistics, SBP calculations

Interestingly, contrary to earlier expectations that growth in consumer durables would fade after the post-Budget buying rush, it seems that demand is holding on. In fact, in the case of cars, we believe production could have been even higher had it not been for supply side constraints.[20]

Moreover, strong performance of the agriculture sector is also benefitting resource-based industries. For example, cotton yarn production growth in Jul-Nov FY12 is the highest in four years, mainly driven by improved cotton availability, stable margins, and recent capacity enhancements.[21,22] Sugar production, on the other hand, is expected to surpass earlier projections on the back of upward revisions of crop estimates. Growth in sugar production in Nov-Dec 2011 stood at 35.8 percent YoY. Naturally, with growth in consumer products, some pick-up in intermediate and capital goods is also expected. This demand is being reflected in higher imports this year.

However, this is not translating into domestic production due to a number of reasons. In the case of capital goods, the presence of investment demand can be

[19] Taxes and duties on automobiles, air conditioners, and deep freezers were reduced in the Budget. For details, see First Quarterly Report on The State of Pakistan's Economy-FY12.
[20] Production was constrained by: (1) shortages of auto parts resulting from floods in Thailand strongly affected the production of one manufacturer, and (2) production of one car model was being phased out. This effect was offset to some extent by purchases made by the Punjab Government under the yellow cab employment scheme.
[21] Spinning machinery of approximately Rs 37 billion was imported during the period FY09-FY11.
[22] The spinning sector is relatively impervious to energy shortages. Most spinning firms are financially strong and can afford to run on back-up energy supplies.

gauged from the growing FDI inflows in selected industries as well as higher imports of capital goods. But domestic production is still low on a number of accounts: (1) most importantly, it is believed that a large proportion of imports do not have local substitutes – this is true for electrical apparatus and power generating machinery; (2) tractor production declined as demand fell after imposition of a 16 percent sales tax in Budget FY12; and (3) demand for local commercial vehicles is being met by cheaper imports (**Table 2.7**).

Table 2.7: Capital Goods Production and Imports in H1

Industry	Share in index	Production		Imports[1]	
		FY11	FY12	FY11	FY12
Electrical apparatus	41.8	0.2	-6.2	25.1	-11.8
Commercial vehicles	29.9	-0.7	-10.0	-18.7	101.6
Agricultural machinery	21.8	-3.5	-51.8	-33.4	42.6
Power gen. machinery	3.7	-18.7	-65.8	-32.5	12.4
Heavy machinery	2.8	24.4	26.6	..	..
Total	**100.0**	**-0.9**	**-24.6**	**1.7**	**3.8**

1. Value in US dollars.

Source: Pakistan Bureau of Statistics

Demand for intermediate goods is reflecting in higher imports of petroleum products, synthetic yarn, rubber products, and plastic material. However, production declined mainly due to supply-side issues: for example, circular debt in POL; and gas shortages to fertilizer, textile and steel, among other industries.[23] This is particularly problematic since the total energy supply in Pakistan actually increased in FY12. In this context, policy measures outlined in the National Industrial Policy of 2011 for reducing dependence on imported inputs and strengthening domestic supply chains, are significant and need to be enacted (**Box 2.1**).

Box 2.1: Rethinking Industrial Policy

The *National Industrial Policy 2011 Implementation Framework*[24] is mainly focused on four broad areas: (1) reducing dependence on imported inputs (specifically, chemical, steel, and mining); (2) promoting knowledge-intensive industries (electronics, machinery, pharmaceutical); (3) performance-based import protection (mainly automobiles and electronics) and value-addition based export subsidies; and (4) removing supply-side bottlenecks such as energy shortages and deficient transport infrastructure. Under these policies, the manufacturing sector's growth rate is projected at 8 percent per year for the next decade.

However, it might become very difficult to realize this growth target unless two major concerns are addressed: (1) indiscriminate energy availability, and (2) mining sector development.

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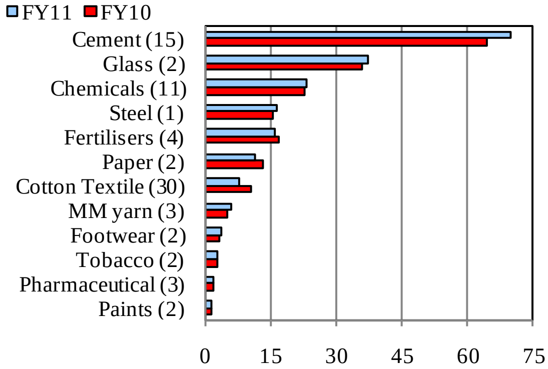
[23] Such as energy losses faced by glass and steel sector due to gas and electricity load shedding, high cement prices, high transport cost and law and order issues in timber rich areas, etc. For detailed information see Annual Report on The State of Pakistan's Economy FY11.

[24] Available online: http://www.moip.gov.pk/Industrial_Policy_Implementation_6%200_May18_2011.pdf

Figure 2.1.1: Energy to Manufacturing Cost Ratio (percent)



Source: Notes to financial accounts of listed companies. For companies following CY, reports for year 2010 or H1-2011 have been consulted, as per data availability.

1. Mining development. A major focus of the policy is on mining (mainly iron ore, copper, and chromites) in order to reduce import dependence of downstream manufacturers of steel, electronics, and chemicals. First a market for these raw materials will be created by establishing user industries, and it is expected that investment in mineral development will naturally follow.

Although this mechanism seems reasonable, it must also be noted that low demand is not the sole reason for lack of this sector's development. In fact, it is the incentive structure which needs to be revised. The last National Mineral Policy issued in 1995 does not offer a competitive tax and duty structure (compared to other resource rich countries) and as a result, did not attract meaningful investment.[25] Poor law and order in resource-rich areas also adds to the country risk.

Despite these drawbacks, the policy has not been revised to date. This is because under the Constitution, mining (other than petroleum and natural gas) is a provincial subject. Therefore, in order to align mining sector's development with manufacturing sector's needs, provincial polices and development budgets must also have similar priorities.

2. Energy availability. Another key policy outlined in the Framework is that industries will be given preference in terms of both energy supply and tariffs over domestic consumers.[26] This not only seems impractical, given the current energy supply constraints, but also at odds with the government's current energy policies (industrial power supply has been compromised to allocate more gas and electricity for domestic users).

A more practical approach would be to discriminate energy supply to industry based on the marginal economic benefit of an additional energy unit. This can be gauged by measuring the energy-intensity of different industries against its direct and indirect employment generation capacity, foreign exchange earnings (or savings), tax compliance, and linkages with the rest of the industry (**Figure 2.1.1**).

Moreover, concrete steps are also needed for improving energy efficiency and investment in renewable energy by the industry. In this regard, it is encouraging that the government is already taking some measures.[27]

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[25] Peter van der Veen (2003), World Bank, Mining Department, "Legal/Fiscal Framework to Attract Investments: Where does Pakistan stand?" Mineral Sector Development Workshop, Islamabad, December 15-16.

[26] Pages 6-7 of the National Industrial Policy 2011 Implementation Framework.

[27] In May 2011, renewable energy use was exempted from sales tax. The ADB has also extended a US$200 million Guarantee Facility for the Government of Pakistan for the period April 2011-March

Similarly, despite higher demand for building materials, steel, glass, wood, and paints continued to post declining production. High inflation in building material prices also persisted, which constrained the construction industry's growth. Encouragingly, the Competition Commission of Pakistan is looking into the reasons for the consistently high cement prices. The steel sector's chronic problems of raw material shortages and high production costs, also need to be addressed (**Special Section 2.1**).

Table 2.8: Construction Indicators in H1
percent YoY growth

	FY11	FY12
Construction machinery import[1]	-22.5	105.0
Cement sales	-8.3	12.3
Steel sale (PSM pig iron)-Jul-Nov	-38.2	-54.0
Building materials production	-8.3	-6.6
FDI in construction	-53.7	41.6
Credit to construction[2]	4.5	-4.4
Residential	8.1	-4.6
Infrastructure	10.2	-1.2
Housing finance	-6.2	-7.3
Building material prices	7.2	13.2

[1]SBP data; HS-codes: 8474.3120-90 (concrete mixers); 8701.2000-2090 (road tractors); and 8705.1000 (crane lorries). [2]Growth over June.
Source: State Bank of Pakistan, Pakistan Steel Mills, All Pakistan Cement Manufacturers' Association, and Pakistan Bureau of Statistics.

Modest revival in construction

Following a slowdown in FY11, the construction sector began reviving in FY12 (**Table 2.8**), as work on public projects accelerated and sentiments improved in the real estate sector.

Two main factors have led to improved expectations for real estate. Firstly, the law and order and administrative situation in major cities improved. Secondly, there was high growth in home remittances, of which a certain proportion is believed to be invested in property.

Not surprisingly, private construction is concentrated in the residential sector rather than commercial property, as the residential sector is apparently a safer bet at present. According to a number of real estate agents, majority of their clients have been looking for residential property, compared to shops or offices. This reflects a subdued commercial environment, but does not detract from the personal needs of individuals.

2012 to help mobilize commercial loans for project financing. Following that, a local company finalized a 49.5 MW wind-powered project in June 2011. In January 2012, a Chinese company announced that it will invest US$15 billion during the next five years for a 10,000 MW wind-powered project.

However, for builders, the excess demand for housing is challenging as a large majority of customers are seeking property for rent, rather than purchase.[28] Therefore, returns on investment are slower, which limits builders' liquidity to develop new projects. Unfortunately, bank financing for housing projects is hard to obtain because banks are not willing to take perceived commercial risks. Oddly, while the stock market could be an excellent source of this type of financing, only three of an estimated 600 real estate developers and builders, are listed on the stock exchange.[29]

[28] According to real estate agents, customer profiles have changed over the past few years. Most home-seekers are now younger and have small net worth. To put this in perspective, according to the Pakistan Social and Living Standards Measurement Survey of 2010-11, only 16.7 percent of urban households were living in rented homes in FY11.

[29] The three listed companies are AKD Securities Ltd., Pace (Pak) Ltd., and Javedan Construction. The total number of builders and developers is estimated from the number of members of All Pakistan Builders' Association (ABAD). ABAD has 575 members in April 2011.

Special Section 2.1: What Ails Pakistan's Steel Industry?

Over 96 percent of growth in world steel production during the last decade was contributed by Asia, with China and India virtually explaining the entire expansion.[30] In sharp contrast, Pakistan's crude steel production declined from 1.1 million MT in FY01 to 0.4 million MT in FY11.

Table 2.1.1: Production & Import of Finished Steel
million MT/annum

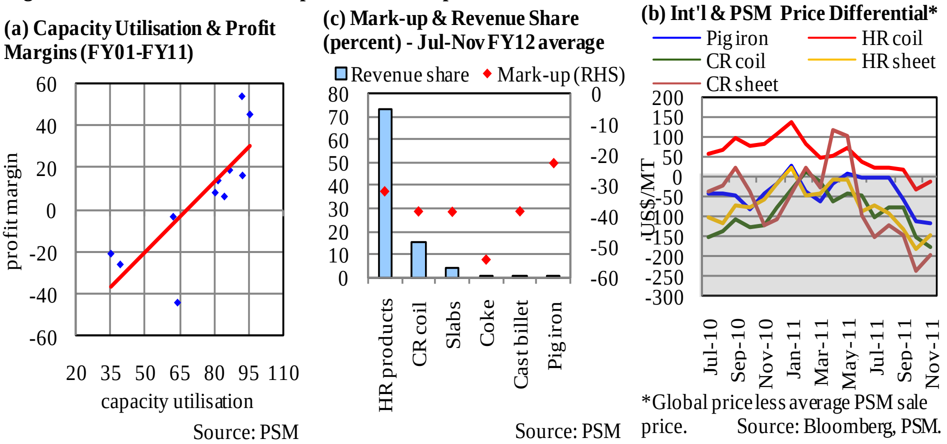
	PSM	Pvt. Sector	Imports	Total
Actual[1]	0.5	2.2	1.9	4.6
Full capacity	1.1	4.5[2]	0.5-1[3]	6-7

[1] Average of FY09-FY11.[2] Estimated. [3] Imports of products for which sufficient domestic capacity is not present will continue.
Source: Pakistan Steel Mills, State Bank of Pakistan estimates based on Pakistan Bureau of Statistics data.

As domestic consumption continues to grow, the demand-supply gap is widening. A conservative estimate puts demand for finished iron and steel products (hot-rolled (HR), cold-rolled (CR), and galvanized coils and sheets; and long rolled products, such as bars, rods, angles, and sections), at over 6 million MT/annum.[31] Pakistan imported 3.2 million MT of iron and steel in FY11 amounting close to US$2 billion; roughly 5 percent of the annual import bill.

Interestingly, finished steel imports are price competitive despite high import duties (from 10 to 35 percent), 16 percent sales tax, and 3 percent withholding tax. This is distressing given Pakistan's 1.4 billion MT unexploited proven iron ore

Figure 2.2.1: PSM Profits, Mark-up, and Price Competitiveness



[30] World steel production grew by 66.5 percent during the last decade. Asia's contribution was 64.5 percentage points, and China and India contributed 55.8 and 4.8 percentage points, respectively. Source: Steel Statistical Yearbook 2011, World Steel Association.
[31] The National Industrial Policy 2011 puts demand estimate at 7 million MT/annum.

reserves[32] as well as sufficient domestic capacity (roughly 4.5 million MT). With full capacity utilization, imports of finished goods can drop to as low as 0.1 million MT a year (**Table 2.1.1**). In dollar terms, the net saving could exceed US$1.0 billion per year.

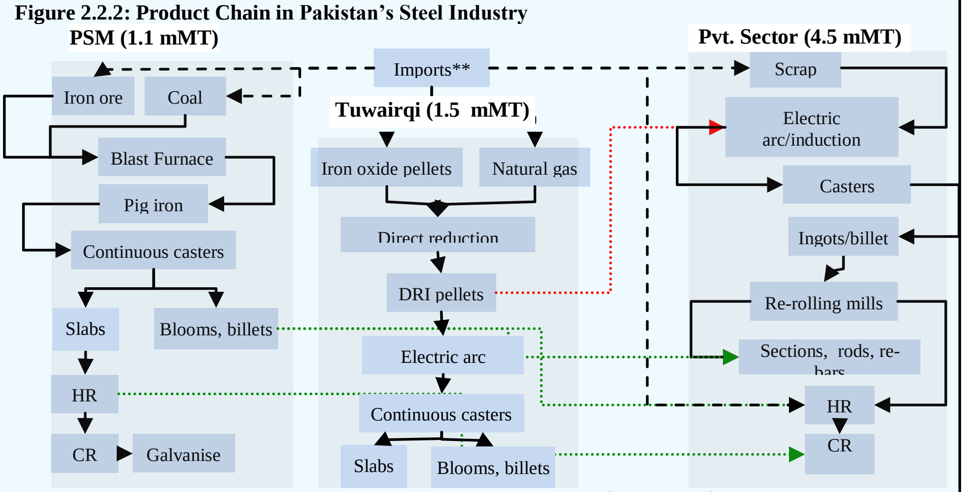
A number of factors are responsible for the present state of affairs: (1) the ailing Pakistan Steel Mills; (2) insufficient investment; and (3) loopholes in the tax system.

1. Low capacity utilization ailing Pakistan Steel Mills

Pakistan Steel Mills is the sole processor of iron ore in Pakistan and constitutes a little less than 20 percent of the country's capacity for finished steel. In better times, the mills supplied raw material (billets and HR sheets) to the private sector as well. But since FY09 (when PSM reported huge loss), crude steel production has been going downhill, dropping from 80 percent of installed capacity in FY08 to only 23.8 percent in Jul-Nov FY12. The PSM has since been strapped for liquidity, unable to consistently fund raw material imports. Low crude production has affected production of finished steel by the PSM and the numerous downstream private mills relying on PSM, which now have to import raw material.

To date, the PSM has been unable to emerge out of the low funds-low capacity

Figure 2.2.2: Product Chain in Pakistan's Steel Industry



*Values in parentheses show raw steel capacity; pig iron in the case of PSM, DRI for Tuwairqi, and the melting capacity of private sector.

[32] Engineering Development Board, Online: http://www.engineeringpakistan.com/Steel/workshop/ironoredeposts.htm

cycle. Low capacity utilization lowered scale economies because the PSM is a complex of interconnected mills which feed raw material and energy into each other. When functioning at a reasonable capacity, the excess heat generated during coke burning (for making raw steel) is used to generate electricity. This electricity, being low in voltage, is then swapped with the Karachi Electric Supply Company (KESC) for high-voltage current to runs the rolling mills. Since the steel is already molten while entering rolling mills, energy costs are conserved. (**Figure 2.2.2, panel 1**). Below efficient capacity, there is insufficient coking heat to run the captive power plant (CPP), and the mill becomes an electricity buyer, another burden on its weak finances. Due to this, PSM currently has hugely negative margins on all its products (**Figure 2.2.1, panel 2**).[33]

In order to circumvent the issue of low scale economies and lack of funds to finance imports, PSM has begun captive mining of local ore, which is 30 percent cheaper than the global price. However, domestic mining entails its own problems: supply is intermittent due to poor law and order in mining areas; the absence of a functional railway lines means that transportation has to be made via trucks, which are much costlier; lastly, because of nonexistence of beneficiation plants (to purify iron ore), transport cost has to be borne for heavy ore rocks, with less than 45 percent iron content.

But more importantly, the current local iron ore supply is sufficient to produce only 0.2 million MT steel a year. This means that at full capacity, PSM must import at least 1.5 million MT of iron ore, which amounts to import burden of approximately US$0.2 billion annually (at FY11 price).[34] The PSM also imports coal for coking. Coking needs superior quality coal and is therefore this component is not substitutable locally. At full capacity, the PSM requires 0.85 million MT of coal per year (US$ 0.1 billion at FY11 prices).

In short, in order to break even, the PSM must have sufficient funds to be able to run at efficient capacity. Otherwise, producing at low capacity will only lead to snowballing losses.

2. Low scale economies

One of the reasons why domestic steel prices are high compared to imports is the small scale of production and lack of integration. Large and integrated units have low units costs because they are more energy efficient. Pakistan's steel industry is

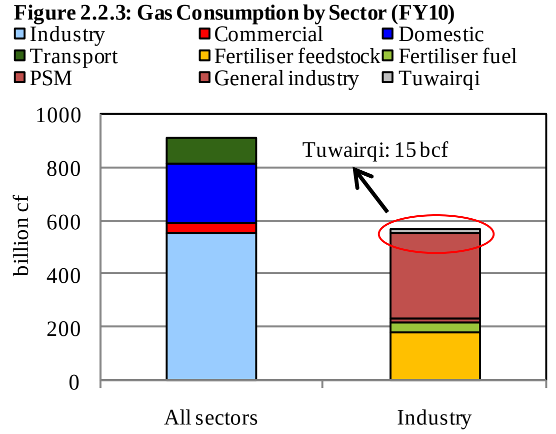
[33] PSM prices are slightly higher than the post-tariff landed prices of imports.
[34] Pakistani iron ore has an Fe (for Ferrous, i.e. iron) content of maximum 45 percent. The global standard is 62 percent. The estimate is based on FY11 ore mining number adjusted for Fe content.

highly fragmented, comprising of around 100 melting furnaces and 300 rolling mills. The average melting unit has an annual capacity ranging from 10,000 to 70,000 MT. Rolling mills are even smaller. PSM is the only truly integrated mill, but even its capacity is believed to be deficient scale economies.[35]

Over the past half decade, some consolidation took place between the private furnaces and re-rolling factories, which improved energy efficiency to some extent. Nevertheless, the capacity of even the largest private mills still remains below 0.5 million MT.

After PSM, there has been only one truly large-scale investment in Pakistan's steel industry: a 1.5 million MT steel complex of Tuwairqi Steel Mill (TSM). Once operational, TSM will reduce the country's dependence on imported raw material to a great extent by supplying raw material to the rolling industry. Secondly, it will utilize indigenous iron ore to a greater extent. The mill is expected to come online this year.

Figure 2.2.3: Gas Consumption by Sector (FY10)



Source: Pakistan Energy Yearbook 2010, Tuwairqi Steel Mills

The TSM was initially planned to start functioning in 2010, but commissioning was repeatedly delayed due to uncertainty over utility supplies. Specifically, the TSM will be a natural gas-based facility, a resource which is already in short supply. However, there is a case for making room for TSM gas: (1) TSM will be energy efficient – for example, to produce the same quantity of steel, it will consume lesser quantity of natural gas. (2) While other industries can use alternate fuels, TSM will be using natural gas a feedstock, which is not substitutable (**Figure 2.2.3**).

[35] At the time of commissioning, PSM's capacity was planned to be expanded to 3.0 million MT. Source: "Pre-feasibility Study for Steel and Related Products", May 2006. Employment and Research Section, Planning and Development Division, Government of Pakistan.

3. Tax machinery loopholes

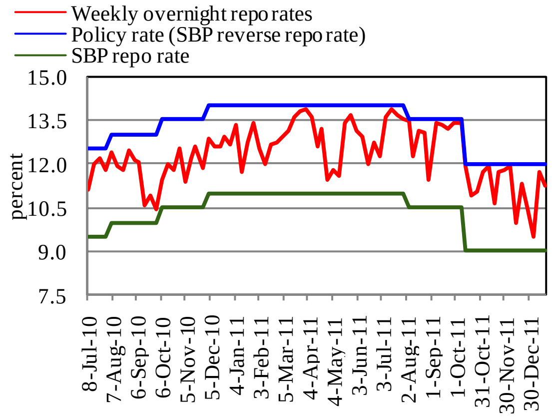
Allegedly, there is large scale tax evasion in this sector which deprives documented players, such as the PSM,[36] of a level playing field. These are the key issues: (1) Local scrap sales are undocumented and therefore cannot be taxed. Because of this limitation, private melters and re-rollers pay sales tax under a fixed formula based on electricity consumption – for furnaces, 800 electricity units are estimated to produce 1.0 MT steel; for re-rollers, the electricity consumption is taken at one unit per MT. However, a large number of re-rolling mills in the country are running on natural gas, for which there is no accounting for either production or tax payment. (2) Private importers allegedly under-invoice on a large scale, and also mis-state product quality to take advantage of the highly graded import tariffs.

[36] 16 percent sales tax is paid on both locally mined and imported iron ore; local mining also entails 3.5 percent withholding tax, while the same is 3.0 percent for imported ore. The sales tax on coal is 17 percent at import stage, in addition to 3.0 percent withholding tax. Final products are taxed as per value addition. In Jul-Nov FY12 alone, working at a monthly average capacity of 22 percent only, PSM paid Rs 1.2 billion to the exchequer.

3 Inflation and Monetary Policy

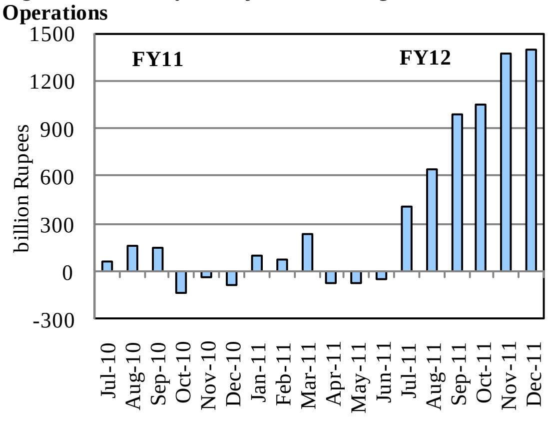
The government announcement of *zero* quarterly limits on its borrowing from SBP, projections of a relatively small current account deficit and the likelihood of average CPI inflation to remain close to the 12 percent target for FY12 at the beginning of the year, allowed the central bank to adopt an accommodative monetary policy during H1-FY12. Accordingly, the policy rate was reduced by a cumulative 200 bps to 12.0 percent following the two consecutive monetary policy announcements of July and October 2011. However, SBP kept its policy rate unchanged in November 2011, as comfort on the external accounts' position waned at a much faster pace than earlier expected, and the financing of the fiscal deficit became more challenging due to the lack of external funding.

Figure 3.1: Trends in Overnight Repo Rates



Source: State Bank of Pakistan

Figure 3.2: Monthly Net Injections Through OMOs Operations



Source: State Bank of Pakistan

Data indicates that inflation has decelerated to single digits (9.7 percent) in December 2011 and period average (H1-FY12) stood at 10.9 percent. In spite of this, underlying inflationary pressures remained strong as more than half of the commodities in CPI basket are still exhibiting double-digit inflation.

Weaknesses in the external account and government borrowing from the banking system complicated market liquidity management, especially during the second quarter of the year. The weighted average overnight money market repo rate remained close to the upper limit of the interest rate corridor, despite substantial liquidity injections through open market operations from September 2011 onwards (**Figure 3.1 & 3.2**).

The impact of these developments is clearly visible from changes in monetary aggregates. Broad money supply saw an expansion of only 5.7 percent during H1-FY12 compared to 9.0 percent during the same period last year. The deceleration in M2 growth is an outcome of the fall in net foreign assets (NFA) of the banking system. In fact, a sizeable portion of the current account deficit during H1-FY12 was financed by drawing down SBP foreign exchange reserves, as capital and financial account inflows declined significantly in Q2-FY12. Resultantly, SBP's NFA contracted by Rs 69.3 billion during the same period. However, overall NFA got some support from commercial banks, which recorded an expansion of Rs 12.1 billion (see **Chapter 5** on **External Sector**).

The drying up of external financing for the fiscal deficit left the government with no choice but to borrow from domestic sources, especially from the banking system. Monetization of the deficit (borrowing from the central bank) reemerged, and reached Rs 219.2 billion in Q2-FY12. In addition to this, the government also relied heavily on commercial banks, which reduced the flow of loan-able funds for the private sector.

3.1 Developments in Monetary Aggregates

Changes in broad money supply and its major components during H1-FY12 were driven primarily by the developments in the external accounts, government borrowing, and a one-off settlement of circular debt. Moreover, quarterly data indicates that the monetary expansion witnessed during H1-FY12 is entirely concentrated in the second quarter of the year due to seasonal credit off-take and a revival in government borrowing from the SBP. In terms of numbers, money supply (M2) saw an expansion of 6.0 percent during Q2-FY12 compared to a fall of 0.3 percent in Q1-FY12. Changes in major components and their causative factors are analyzed in the following discussion.

Net Foreign Assets (NFA)

The NFA of the banking system witnessed a net contraction of Rs 139.9 billion during H1-FY12, in sharp contrast to an expansion of Rs 126.8 billion during the same period last year (**Table 3.1**). This was driven by the developments in external accounts. Specifically, the overall external account recorded a deficit of

US$ 1.8 billion during H1-FY12 compared to surplus of US$ 1.0 billion in H1-FY11.[1]

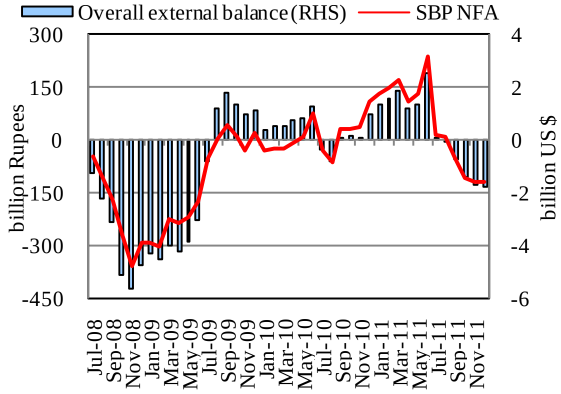
Table 3.1: Monetary Aggregates
flows in billion Rupees

	Flows					
	FY11			FY12		
	Q1	Q2	H1	Q1	Q2	H1
Broad money (M2)	35.5	482.9	518.4	-21.0	400.4	379.4
NFA	41.5	85.2	126.8	-82.7	-57.2	-139.9
SBP	30.5	73.7	104.2	-53.3	-69.3	-122.6
Scheduled banks	11.0	11.6	22.5	-29.4	12.1	-17.3
NDA	-6.0	397.7	391.7	61.7	457.6	519.3
SBP	85.5	45.0	130.5	120.8	116.9	237.6
Scheduled banks	-91.5	352.7	261.2	-59.0	340.7	281.7
of which						
Government borrowing	93.9	167.3	261.2	179.6	512.3	691.9
For budgetary support	120.5	188.0	308.5	184.4	571.7	756.0
SBP	120.5	-28.1	92.4	-101.9	219.2	117.3
Scheduled banks	0.1	216.0	216.1	286.3	352.4	638.7
Commodity operations	-26.0	-23.9	-49.9	-2.8	-60.8	-63.5
Non government sector	-63.3	243.2	179.9	-63.4	-23.9	-87.3
Credit to private sector	-47.7	211.0	163.4	-88.7	282.2	193.5
Credit to PSEs	-15.9	31.6	15.7	25.2	-306.8	-281.5
Other items net	-36.6	-12.8	-49.4	-54.4	-30.8	-85.3

Source: State Bank of Pakistan

Within the banking sector, the major contribution towards the net contraction in NFA came from SBP, which accounted for 87.6 percent of the total contraction, while its share in NFA was 78.7 percent as of end-FY11. This reflects a reduction in SBP's foreign exchange reserves stemming from the widening current account deficit and dwindling capital and financial account surpluses (**Figure 3.3**).

Figure 3.3: SBP NFA and Overall External Balance (Cumulative Flows)

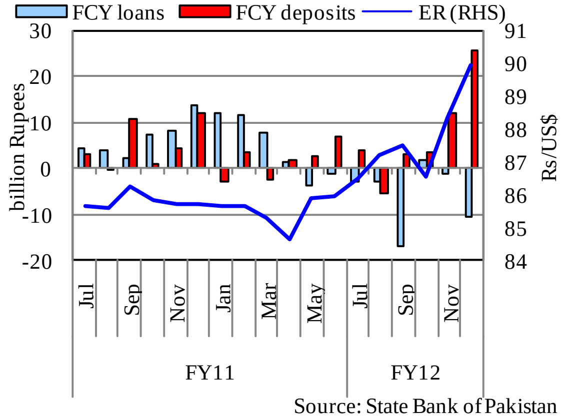


Source: State Bank of Pakistan

[1] For detail discussion on external accounts, see Chapter 5 on External Sector.

Quarterly data shows that changes in NFA of commercial banks followed different patterns during first and second quarters of the year (**Table 3.1**). Specifically, it expanded by Rs 12.1 billion during Q2-FY12 compared to a net contraction of Rs 29.4 billion in the first quarter. This turnaround was largely attributed to depreciation of Pak rupee against major foreign currencies, which led to an increase in FE-25 deposits and a quickening in the retirement of foreign currency loans[2] (**Figure 3.4**). Balances in NOSTRO accounts also expanded sharply by US$ 304.1 million in Q2-FY12 relative to US$ 138.8 million in Q1-FY12.

Figure 3.4: Impact of Exchange Rate Depreciation on FCY Loans and Deposits

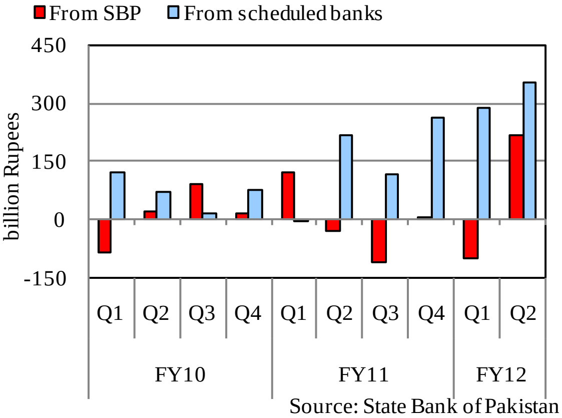


Source: State Bank of Pakistan

Net Domestic Assets (NDA)

The seasonal increase in private sector credit off-take coupled with a sharp rise in government borrowing for budgetary finance led to an acceleration in NDA growth. Specifically, NDA of the banking system experienced a rise of 8.8 percent during H1-FY12 compared to 7.5 percent in same period last year.

Figure 3.5: Budgetary Borrowing from Banking System (Quarterly Flows)



Source: State Bank of Pakistan

Government Borrowing for Budgetary Support

Overall government borrowing for budgetary support more than doubled in H1-FY12 relative to the same period last year (**Table 3.1**). Apart from the shifting of

[2] FE-25 deposits rose by US$327.0 million during Q2-FY12 relative to net withdrawal of US$ 68.0 million in Q1-FY12.

Rs 391.0 billion worth of PSEs' and procurement agencies' loans to the government's account, deficit financing from the banking system alone accounted for Rs 365.0 billion, which was higher than government borrowing of Rs 308.5 billion during first half of FY11. More importantly, the government also resorted to inflationary borrowing from SBP, especially in Q2-FY12. The government breached its quarterly limit of *zero* net budgetary borrowing from the SBP in the second quarter of FY12. This level of borrowing from SBP is the highest in a single quarter during the last 2 years (**Figure 3.5**).[3] This heavy dependence on central bank borrowing was partly attributed to the government's inability to roll-over maturing T-bills in the month of December 2011;[4] a risk regularly highlighted in SBP Annual and Quarterly Reports.

Besides deficit monetization, the government also borrowed Rs 638.7 billion from scheduled banks compared to Rs 216.1 billion last year. However, the monetary impact of this borrowing was limited to Rs 247.7 billion, as the remaining amount was an accounting adjustment due to partial settlement of circular debt. Further details revealed that the government also utilized non-conventional sources of deficit financing, i.e., it borrowed Rs 70.3 billion through Sukuk bonds issued on 20th December 2011. In sum, the burden of financing the deficit during H1-FY12 remained on the banking system, which has strong implications for crowding out the private sector.

Table 3.2: Banks' Exposure in Different Groups of PSEs (Outstanding Stocks)

billion Rupees

	Jun-10	Dec-10	Jun-11	Dec-11
Transport	31.6	33.2	41.4	46.2
Electricity generation	273.1	291.4	292.1	25.9
Oil & gas	51.5	44.8	41.5	39.5
Engineering sector	19.3	18.9	23.7	23.5
Services sector	0.1	0.1	0.4	0.4
Total exposure in selected sector	375.6	388.4	399.1	135.5

Source: State Bank of Pakistan

Credit to PSEs

Following the government's decision to deleverage the balance sheets of PSEs and procurement agencies, credit to public sector enterprises recorded a net retirement of Rs 281.5 billion during H1-FY12. A disaggregated analysis revealed that credit to PSEs was largely concentrated in electricity generation companies, which

[3] The government borrowed Rs 219.2 billion from SBP during Q2-FY12.

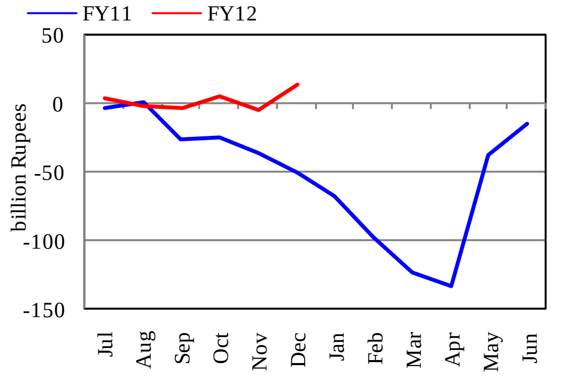
[4] Commercial banks offered Rs 65.7 billion relative to target of Rs 165 billion in last two T-bill auctions of H1-FY12 held on 15th December 2011 and 29th December 2011. This is not surprising as commercial banks tinker with their balance sheet before year end (closing).

accounted for 73.2 percent of PSEs' credit as of end FY11. However, after the settlement of energy related circular debt, banks' exposure to PSEs is more balanced now (**Table 3.2**).

Commodity Finance

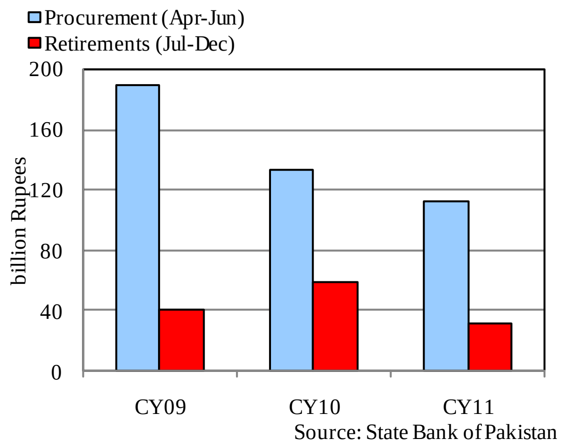
Loans for commodity operations experienced a net retirement of Rs 63.5 billion during H1-FY12 compared to a retirement of Rs 49.9 billion last year. Quartely data indicates that the retirment was primarily concentrated in Q2-FY12 as the government released Rs 78 billion to procurement agencies for the settlement of accumulated subsidies. Adjusting for this one-off payment, the extent of retirement in commodity loans remained low in H1-FY12 (**Figure 3.6**). In fact, TCP borrowing for fertilizer import and lower repayments under wheat advances, were mainly responsible for the slow pace of retirement during the period under review.

Figure 3.6: Cumulative Flow of Commodity Advances (Adjusting for Debt Shifted to Government Accounts)



Source: State Bank of Pakistan

Figure 3.7: The Dynamics of Wheat Advances



Source: State Bank of Pakistan

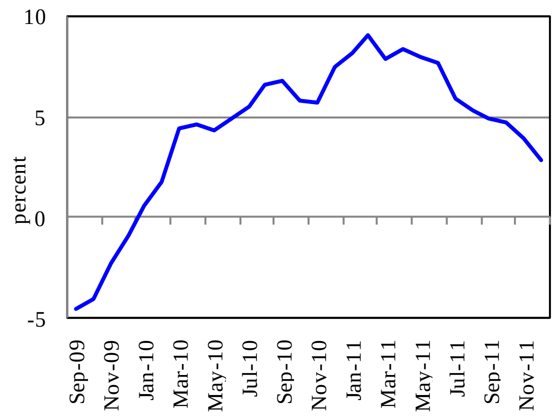
It is pertinent to mention here that speedy retirement of wheat advances in FY11 was largely attributed to the export of surplus wheat. However, export prospects are not very bright this year, which may undermine the repayment capacity of procurement agencies (**Figure 3.7**).

Loans to Private Sector

After reaching a recent peak in February 2011, YoY growth in private sector loans has been continuously declining; it dropped to 2.8 percent in December 2011 from

7.5 percent in December 2010 (**Figure 3.8**). This deceleration is broad-based and visible in all three categories of advances, i.e., working capital, fixed investment and trade financing. Having said this, the composition of advances is shifting from fixed investment loans towards working capital. During the last three years, most of industrial credit demand has been for working capital loans. The hike in raw material prices in global and domestic markets has raised the demand for short-term financing in FY11. In addition, liquidity shortages in POL and energy generation sector have also driven demand for working capital loans.

Figure 3.8: YoY Growth in Private Sector Loans



Source: State Bank of Pakistan

Table 3.3 a: Number of Private Industrial Sub Sectors Availing Bank's Loans (Jul-Dec)

	Loan Expansion			Loan Retirement		
	Working Capital	Fixed Investment	Trade Financing	Working Capital	Fixed Investment	Trade Financing
FY09	33	42	11	24	7	15
FY10	23	19	16	19	15	10
FY11	36	17	22	15	19	5
FY12	35	15	14	18	20	10

*All industries recording the credit flow of Rs 0.5 million or more in Jul–Dec period are included

Table 3.3 b: Expansion and Retirements of Loans taken by Private Sector (Jul-Dec)
billion Rupees

	Loan Expansion			Loan Retirement		
	Working Capital	Fixed Investment	Trade Financing	Working Capital	Fixed Investment	Trade Financing
FY09	126.5	122.0	15.9	-55.0	-7.9	-22.4
FY10	91.5	70.5	25.4	-41.6	-23.4	-10.5
FY11	164.3	39.7	59.0	-42.1	-29.0	-8.2
FY12	147.8	22.2	18.6	-65.5	-35.2	-20.9

*All industries recording the credit flow of Rs 0.5 million or more in Jul–Dec period are included
Source: State Bank of Pakistan

In contrast, industries have reduced their demand for fixed investment loans; only 15 industrial sub-sectors availed fixed investment loans during H1-FY12 compared to 42 in H1-FY09 (**Table 3.3.a & b**). This situation reflects a significant slowdown of investment activities in the economy. A number of factors explain this slowdown. For instance, structural issues (poor law and order situation and energy shortages) hampered overall industrial activity, resultantly reducing fresh demand for fixed investment loans. Simultaneously, long- term projects in fertilizer, cement and telecom sectors have been completed and these sectors are now retiring loans.

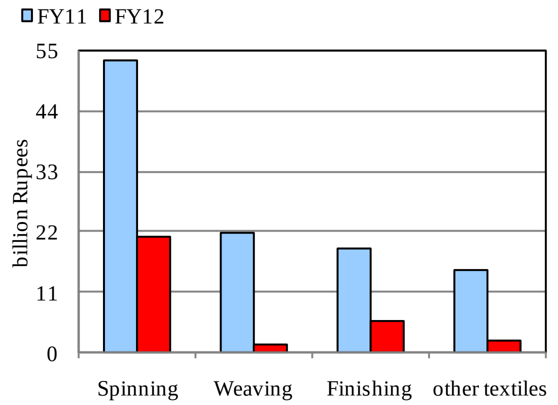
Table 3.4: Loans to Private Sector Businesses

billion Rupees

	Jul-Sep		Oct-Dec		Jul-Dec	
	FY11	**FY12**	**FY11**	**FY12**	**FY11**	**FY12**
Business Sector Advance	-30.4	-95.3	220.6	181.3	190.2	86.1
Working Capital	-32.7	-46.2	164.0	145.7	131.3	99.5
Seasonal Financing	-35.0	-71.0	108.0	70.0	73.0	1.0
Rice	-4.5	-10.7	26.4	22.8	21.9	12.1
Sugar	-27.4	-35.4	11.5	-4.8	-15.9	-40.2
Cotton	-2.7	-24.7	69.6	52.1	67.0	27.3
Fixed Investment	-4.8	-22.4	12.9	14.0	8.1	-8.5
Trade Financing	7.1	-26.8	43.7	21.7	50.8	-5.1
Consumer Financing	-8.8	-4.7	-8.6	-3.2	-17.4	-7.9

Source: State Bank of Pakistan

Figure 3.9: Loans to Textile Sector (Jul-Dec)

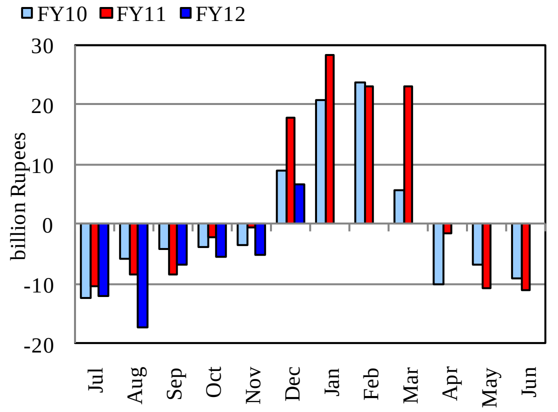


Source: State Bank of Pakistan

A recent marked retirement under trade financing, coupled with a deceleration in working capital loans, account for the lower credit off-take in H1-FY12 (**Table 3.4**). Deceleration in working capital loans is attributed to low demand for seasonal financing: fresh disbursements under rice, cotton and sugar sector remained low relative to last year. The slowdown in seasonal working capital loans for the textile sector was attributed to lower raw material prices and reduced global demand. It may be further noted that this slowdown in credit demand was visible in all important segments of textile sector (**Figure 3.9**).

Like textile, loans to the sugar sector did not accelerate at the pace shown in the last two years (**Figure 3.10**). In fact, sugar mills could not off-load their inventories before the start of the crushing season, due to the lower domestic price of sugar. This situation constricted sugar mills' ability to borrow from the banking system. Resultantly, the government intervened in the market and purchased 378,000 tons of sugar through TCP, to alleviate the problems faced by sugar mills. This intervention is expected to not only stabilize the market price but also help sugar mills clear their dues to farmers and to banks.

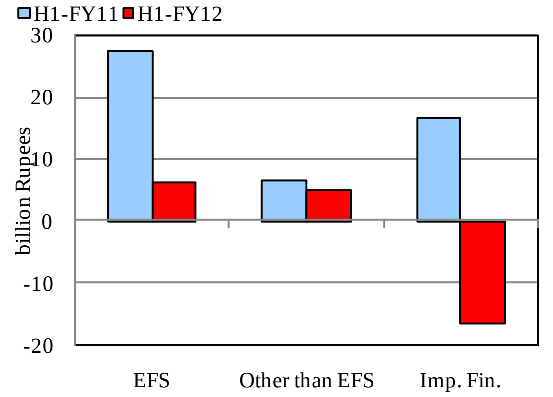
Figure 3.10: Activity in Sugar Loans (Monthly Flows)



Source: State Bank of Pakistan

Demand for working capital loans also came from other sectors including agriculture, refineries, fertilizer, basic metal, electricity equipments, retail trade and power generation. These sectors saw an expansion of Rs 66.0 billion during the first half of the year compared to Rs 26.5 billion in the same period last year. Most of the demand came from the cash- strapped power generation sector, which alone received Rs 35.4 billion in H1-FY12, which is almost twice that of the Rs 17.4 billion availed by the sector in same period last year.

Figure 3.11: Flows of Advances under Trade Financing



Source: State Bank of Pakistan

Meanwhile, the retirement of trade financing came mainly from importers, whereas EFS loans also decelerated sharply during H1-FY12. Within import financing, the retirement was concentrated mainly in foreign currency loans as the depreciation of the local currency during Q2-FY12 increased the cost of borrowing (in foreign currency) for traders. Accordingly, traders retired Rs 28.9 billion of FCY loans during H1-FY12 compared to a net borrowing of Rs 20.8

billion in H1-FY11. On the other hand, the deceleration in EFS loans is largely due to the slowdown in textile exports in H1-FY12 (**Figure 3.11**).

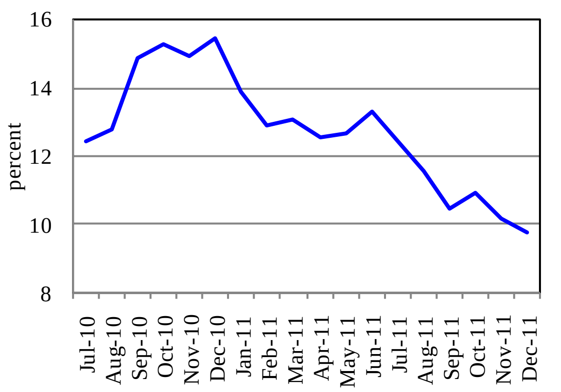
Finally, consumer financing showed some signs of improvement during H1-FY12. Loan disbursements under consumer financing reached Rs 75.8 billion in H1-FY12 compared to Rs 64.6 billion last year. Details indicate that auto financing accounted for 45.0 percent of consumer loans disbursed during the period.

3.2 Inflation

Headline inflation fell to single digits in Dec-11 after almost two years (**Figure 3.12**). This was undoubtedly positive news for the economy. However, our analysis indicates that inflation fundamentals have not changed much.

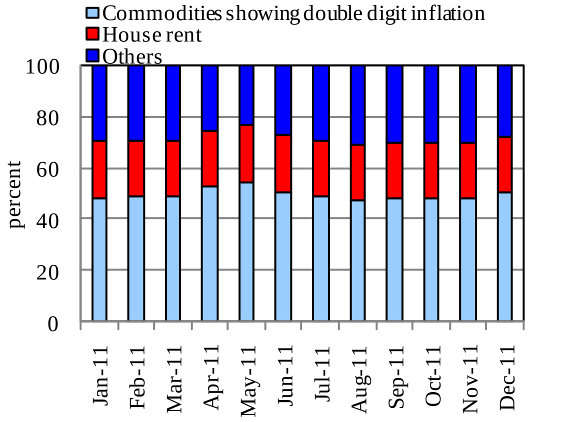
In our previous report, we indicated that more than half of the commodities in the CPI basket are posting double-digit inflation. Significantly, the weight of commodities that are displaying greater-than-10-percent inflation has also hovered around 50 percent for the past year (see **Figure 3.13**). However, inflation in house rents – which constitutes almost 22 percent in the CPI index – has been below 10 percent for the past year. In effect, this implies that the commodities displaying single-digit inflation are a small part of

Figure 3.12: CPI Inflation (Seasonally Adjusted)



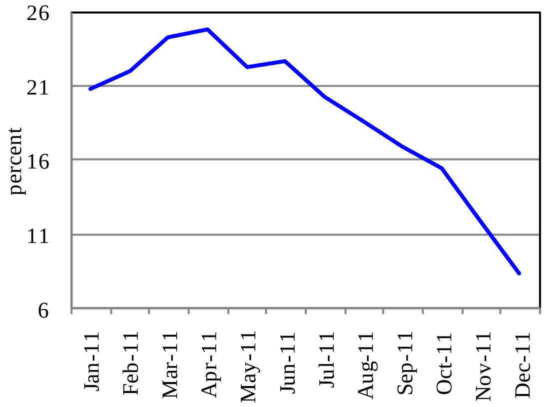
Source: Pakistan Bureau of Statistics, SBP

Figure 3.13: Distribution of CPI by Weight



Source: Pakistan Bureau of Statistics, SBP the consumption basket, with the exception of house rents. This, in turn, strongly suggests that inflationary pressures are broad-based and have not receded noticeably – despite the decline in headline CPI.

Figure 3.14: WPI Inflation



Source: Pakistan Bureau of Statistics, SBP

The December decline itself was led by a very sharp decrease in the prices of a few items within the food group. The most notable of these were sugar, onions and potatoes. If these three sub-groups are excluded from the basketYoY inflation comes out to be 11.0 percent, instead of 9.7 percent. The prices of onions and potatoes, like other vegetables, are notoriously volatile, while the price of sugar has declined considerably recently following a good sugarcane harvest. While the price of sugar is expected to stabilize at its current level, the prices of onions and potatoes are tough to predict, and may increase just as sharply as they decreased.

Since only three food items have essentially accounted for the decline in CPI inflation, it is unlikely that the prices of other commodities will experience any substantial slowdown in the near future. However, the price of these three food items – and especially the price of sugar, which is not expected to increase – may continue to help headline inflation in the short run.

In the medium term, given the significant seepage of inflation across commodities, we do not expect a slowdown in overall inflation. The easing of global commodity prices – as reflected by slowdown in WPI inflation – may be offset by the expected effect of the recent depreciation of the Rupee (**Figure 3.14**). POL prices, however, are also expected to increase following this depreciation, the rise in crude oil prices and the standoff between the US and Iran. Gas tariffs were also revised upwards in January 2012 with the imposition of the Gas Infrastructure Development Cess (GIDC). This increase in fuel and energy costs is expected to stoke inflation in the months ahead, both due to their direct impact on price indices and their impact on the overall cost of production.

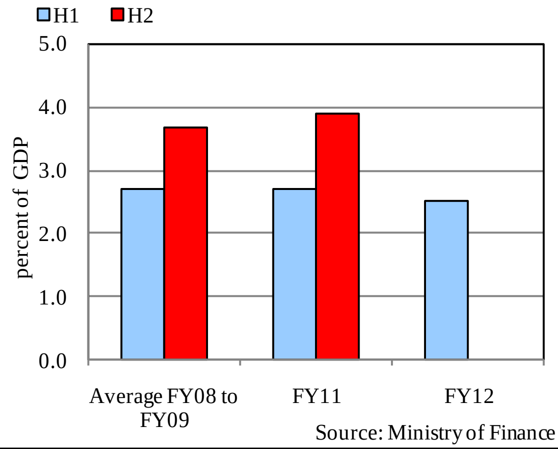
The deciding factor regarding long-term inflation, however, will be the level of government borrowing from SBP, which is linked to inflationary expectations in the economy. Therefore, the government's inability to retire its stock of borrowing from SBP at the end of this quarter is a matter of concern for SBP.

4 Fiscal Policy and Public Debt

4.1 Fiscal Policy

Although some degree of fiscal restraint was observed in the first half of the current fiscal year with a budget deficit of 2.5 percent of GDP – lower than that in H1-FY11, tougher fiscal discipline will still be needed in the second half to achieve the full year target.

Figure 4.1: Half Yearly Fiscal Deficit



Source: Ministry of Finance

The target for FY12 budget deficit has been revised upward to 4.7 percent; however, it will be challenging to achieve because:

(a) An analysis of the trend in the deficit within a year shows that it is relatively higher in the second half of the year than the first (**Figure 4.1**); and

(b) During the last two years the government managed expenditure growth through cuts in PSDP. Since containing development expenditure for a longer period hurts long-term economic growth, the government may not choose to exercise this option for the ongoing year. In fact, on the back of robust inflows for project-based external loans, the government has indicated that it may spend more than the budgeted PSDP amount to compensate for the loss in economic growth during the last two years.

Moreover, the government had to takeover PSEs' debt of Rs 391.0 billion in November, 2011. Although this amount will not appear in current year's budget, it has adverse implications for long-run fiscal sustainability.[1]

[1] During FY11, the fiscal deficit rose to 6.6 percent against the budget target of 4.0 percent. This was due to higher than budgeted subsidies including arrears of electricity subsidies on expenditure side, and less than target FBR revenue and lower inflows into Coalition Support Fund on the reveue side.

Table 4.1: Summary of Public Finance
billion Rupees

		H1		
	BE FY12	**FY11**	**FY12**	**Growth (%)**
Total revenue	**2,870.5**	**989.6**	**1135.3**	**14.7**
Tax revenue	2,151.2	721.6	904.6	25.4
Non tax receipts	719.3	268.0	230.6	-14.0
o/w SBP profit	200.0	80.0	104.0	30.0
Defense	118.7	66.9	4.6	-93.1
Total expenditure	**3,721.2**	**1,480.0**	**1,667.8**	**12.7**
Current	2,976.3	1,226.8	1,399.2	14.1
Dev and net lending	744.9	207.8	231.0	11.1
Unidentified		45.4	37.6	-17.1
Overall deficit	**850.6**	**490.4**	**532.5**	**8.6**
Financing through				
External resources	134.5	47.0	34.0	-27.7
Internal resources	716.1	443.4	498.5	12.4
Banking system	303.5	286.0	302.0	5.6
Non-bank	412.6	157.4	196.5	24.8
As % of GDP				
Overall fiscal deficit	4.0	2.7	2.5	
Revenue deficit		1.3	1.3	
Primary deficit		1.1	1.9	

On the revenue side, FBR collected Rs 840.7 billion during H1-FY12 showing a healthy growth of 27.1 percent over the same period last year. While it indicates increased tax efforts by the FBR when compared with its earlier performance, the amount still falls short of the seasonal projections for H1-FY12 by Rs 40.0 billion.

Within non-tax revenues, uncertainty still prevails over Coalition Support Fund CSF proceeds. On the positive side, SBP profit, which was expected to decline due to the reduction in policy rate, is likely to reach the budget target of Rs 200 billion owing to the exchange rate depreciation and increased borrowing requirements of the government from SBP.

Although 12.7 percent growth in total expenditure during H1-FY12 was the same as in the previous year, a more than 50 percent increase in the development expenditure is indeed encouraging as the country needs investment to stimulate and support economic growth.
In fact, the government increased its reliance on borrowing from the central bank during Q2-FY12, on account of liquidity shortages in the market, which impeded

commercial banks' ability to invest in government paper. During the second quarter of the fiscal year, the government borrowed Rs 227.9 billion from SBP while retiring Rs 45.0 billion to the commercial banks in the same period. This is exactly opposite of what occurred in the first quarter when there was a net retirement of Rs 103.5 billion to SBP while borrowing from commercial banks was recorded at Rs 223.0 billion.

Furthermore, although the government envisaged a net amount of Rs 134.5 billion in terms of net external borrowing during FY12, it has received only Rs 34.0 billion so far. The dearth of external financing is likely to further aggravate the burden of borrowing on domestic sources.

Stepping back, the ability of the provinces to show surpluses as envisaged in the budget, seems unlikely. In view of these pitfalls, even the revised budget deficit target is likely to be missed. This will be the fourth consecutive year of high budget deficit, which has adverse implications for growth and macroeconomic stability. In our reports, we have emphasized the importance of fiscal consolidation which requires an effective tax system and restraining unproductive expenses, particularly those related to PSEs and subsidies.

FBR taxes

Comparing FBR's performance with last year, collection during the first half of FY12 is encouraging. The 27.1 percent YoY growth in the total collection was mainly supported by direct taxes and the import component of sales tax.

The rise in direct taxes came mainly from its *collection on demand* component. The improved collection under this head suggests that FBR has accelerated its efforts in terms of audit and assessment of the tax returns filed. However, a sustainable increase in collection from direct taxes requires widening the tax base and FBR needs to increase efforts in this direction.

Sales tax collection was helped by a robust growth in the import component owing to an increase in the rupee value of imports. Also, the withdrawal of a number of sales tax exemptions and limiting the applications of zero-rating regime to a few sectors helped sales tax collection.[2]

[2] Sales tax exemptions were withdrawn on a number of items including, fertilizers, CNG kits and cylinders, machinery and equipments, canola seed and some organic chemicals. Regarding the main items to which zero rating no longer apply includes poultry products, some vehicles and bicycles.

However, the withdrawal of special excise duty and reducing the overall scope of the federal excise duty (introduced as relief measures in the FY12 budget) translated into a negative growth for the federal excise duty (FED) collection.

Table 4.2: FBR Tax Collection During Jul-Dec

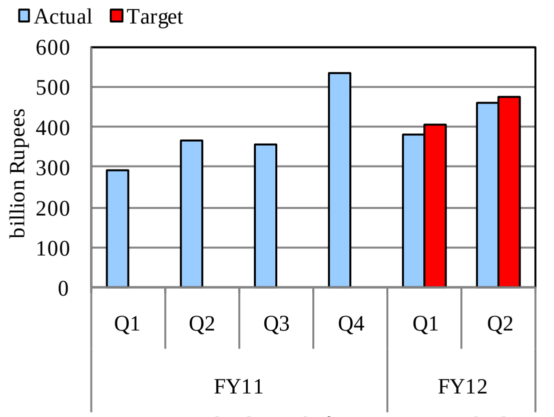
billion Rupees

	Net Collection		Growth		% of Annual Target	
	FY11	FY12	FY11	FY12	FY11R	FY12
Direct taxes	240.9	312.6	13.9	29.8	38.4	42.0
Indirect taxes	420.8	528.2	13.5	25.5	43.8	43.7
Sales tax	282.6	381.0	16.4	34.8	43.2	45.5
Federal excise duty	58.1	53.5	2.6	-8.1	43.8	32.3
Custom duty	80.0	93.7	12.3	17.1	46.2	45.4
Total	**661.7**	**840.7**	**13.7**	**27.1**	**41.7**	**43.1**

Source: Federal Board of Revenue

Custom duty collection, in general, follows the trend in the rupee value of imports. Specifically, receipts from custom duty grew by 17.1 percent in response to the 21.1 percent growth in the rupee value of imports during H1-FY12.

Figure 4.2: Quarterly FBR Tax Collection



Source:Federal Board of Revenue,SBP calculations

Relative to the estimate (based on seasonal projections) of Rs 883.9 billion in the first half, overall collection was only Rs 840.7 billion (**Figure 4.2**). This shortfall does not augur well for meeting the annual tax collection target which is already facing various risks. In fact, at the time of setting the target, the federal government had planned to collect sales tax on services. However, benefiting from the 18th amendment, Sindh has started collecting sales tax on services independently, which has dented the basic assumptions behind FBR target.[3] The FBR is,

[3] Although the provinces were allowed to collect GST on services on their own in the constitution even before the 18th amendment, this right was further endorsed with this amendment. Despite this fact, except Sindh, the other provinces have surrendered their right of collecting sales tax on services

however, determined to meet its target of Rs 1952.3 billion and has not revised as yet.

Provincial fiscal operations
Compared to same period of the previous year, the overall surplus of the provincial governments during H1-FY12, amounting to Rs 20.6 billion, does not portray a healthy picture. Last year, the provincial surplus stood at Rs 100.0 billion after the provinces started to receive a greater share of the federal revenue due to the 7th NFC award.

In terms of the budget target of Rs 125.0 billion for FY12, the overall balance of the first half means that only 16.5 percent has been achieved so far. Factors related to both the expenditure side as well as revenues account for this poor performance.

Table 4.3: Provincial Finances for H1
billion Rupees

	Punjab		Sindh		KP		Balochistan		Consolidated	
	FY11	**FY12**	**FY11**	**FY12**	**FY11**	**FY12**	**FY11**	**FY12**	**FY11**	**FY12**
Total revenue	**210.9**	**248.6**	**135.3**	**158.8**	**107.1**	**97.6**	**64.1**	**64.1**	**517.4**	**569.0**
Share in federal revenues	186.4	214.6	118.6	124.2	64.0	74.6	49.6	52.7	418.6	466.0
Taxes	14.3	17.2	11.6	18.1	1.5	1.6	0.4	0.5	27.8	37.3
Non-tax revenues	10.2	13.6	2.7	2.9	10.5	6.7	1.9	0.6	25.3	23.8
Federal loans & transfers	0.0	3.2	2.4	13.6	31.1	14.7	12.1	10.4	45.6	41.9
Total expenditure	**194.2**	**256.8**	**121.6**	**154.6**	**67.3**	**87.4**	**34.2**	**49.5**	**417.3**	**548.4**
Current	172.5	207.7	103.3	144.0	54.6	66.0	28.8	41.3	359.2	458.9
Development	21.8	49.1	18.4	10.6	12.7	21.5	5.4	8.3	58.2	89.4
Overall balance	**16.7**	**-8.2**	**13.6**	**4.1**	**39.8**	**10.1**	**29.9**	**14.5**	**100.0**	**20.6**
As % of GDP	*0.09*	*-0.04*	*0.08*	*0.02*	*0.22*	*0.05*	*0.17*	*0.07*	*0.55*	*0.10*

Although the increase in expenditure of all provincial governments was expected after the 18th amendment, the actual increase is quite skewed. Of the total increase of Rs 99.8 billion in current expenditure, Sindh alone witnessed an increase of Rs 40.7 billion followed by Punjab with an increase of Rs 35.2 billion. In terms of development expenditures, Punjab is well ahead of the three provinces, while Sindh experienced a decline under this head.

The 18th amendment encouraged the provinces to enhance their own revenues. However, the provinces appeared to be lagging behind in this regard. Sindh has

to the federal government. If the federal government collects this tax, it would distribute the revenue according to the NFC award. Sindh, however, expects greater revenue compared to its share based on the NFC award if it collects the sales tax on services by itself due to considerable business activities in the province.

showed some increase in provincial taxes, after starting to collect revenue under the head of sales tax on services. Concerted efforts by other provinces to mobilize their own resources have not borne fruits yet.

Table 4.4: Changes in Debt Profile
billion Rupees

		FY11		FY12	
	Dec-11	**Q1**	**Q2**	**Q1**	**Q2**
Total debt & liabilities	12832.2	556.4	282.7	322.7	363.4
Total debt	12269.8	577.1	308.4	324.9	420.4
Domestic government	6866.3	304.7	335.9	207.6	641.7
Domestic PSEs	130	-15.9	31.6	25.2	-306.8
External	5273.6	288.3	-59.1	92.9	85.5
Total liabilities	562.4	-20.7	-25.8	-2.2	-57
Domestic	335.9	-27.5	-22.9	-2.8	-60.9
External	226.5	6.8	-2.9	0.6	3.9
Memorandum items;					
Public debt[1]	11992.8	587.2	288.8	267.9	729.3
Adjusted public debt[2]	11601.8	587.2	288.8	269.5	336.7

[1]Public debt includes government domestic and external debt, debt from IMF and external liabilities

[2] Adjusted public debt excludes the impact of one-off increase in November 2011.

Source: State Bank of Pakistan

4.2 Domestic & external debt

After registering a modest increase during the first quarter, Pakistan's public debt stock recorded a sharp increase in Q2-FY12, reaching Rs 12.0 trillion by end December 2011 (**Table 4.4**). The surge in debt burden, during the second quarter, was the outcome of a one-off settlement of circular debt of power sector PSEs and public procurement agencies by the government. After removing this factor, the pace of public debt accumulation during H1-FY12 shows a slowdown.

Though this one-off factor has raised the public debt burden to 61.1 percent of GDP at end December 2011, this measure entails some savings to the government, resulting from lower interest rate on government securities compared to the TFCs issued by PSEs (**Box 4.1**). Having said this, power sector losses are a huge drag on country's meager fiscal resources. According to the budget documents the tariff differential subsidy paid to WAPDA and KESC, along with the interest payments on TFCs, created with the Power Holding (Private) Limited company (PHPL) for the resolution of circular debt, alone amounted to 1.8 percent of GDP during FY11, having 27.2 percent contribution in the fiscal deficit of the preceding year.

Box 4.1: Circular Debt Settlement –Fiscal Relief to the Government
In November 2011, the government borrowed Rs 391 billion from the commercial banks to partially settle circular debt through 12-m T-bills and 5-year PIBs. This one-off settlement is a fiscal reform measure that will help government in making substantial savings on interest payments.

Table 4.1.1 : Partial Savings Resulting From Circular Debt Settlement of Power Sector in FY13

billion Rupees

	Interest Payments		
	Pre-reform	**Post reform**	**Savings**
TFCs	55.7		
T-bills		22.0	
PIBs		22.8	
Total	**55.7***	**44.8**	**10.9**

*For the calculation of government savings we have assumed the interest payments on TFCs in FY13, to stay at the level projected during FY12

Source: Budget documents & SBP calculations

According to details, out of the total amount Rs 312.8 billion were raised for settling power sector claims – mainly the power holding company created by the government in mid 2009, for resolving the circular debt problem through the issuance of TFCs. These TFCs carried government guarantees and the liability of their interest payments also rested with the government. The investment in these TFCs, however, raised bank's exposure in power sector and acted as a disincentive for further bank lending to this sector. In addition, since these TFCs were issued at a market rate of around 200 bps above Kibor, they entailed huge liability of interest payments for the government. The budget estimates for interest payments on TFCs during FY12 stood at Rs 55.7 billion. To address this issue, the government decided to take these loans on its books by transforming them into sovereign debt. With this objective, a hefty amount of Rs. 391 billion was raised through 12-m T-bills and 5-year PIBs. The 12-m T-bills raised on November 4, 2011 entail interest payments of Rs 22 billion in the second quarter of FY13. Similarly for PIBs, the government will have to pay Rs 11.4 billion in interest payments biannually for the next five years. In overall terms, the interest payment for both of these instruments in FY13 will amount to around Rs 44.5 billion, which is less than the payments projected only for the power sector circular debt in FY12. Assuming the interest payments on TFCs to stay at the level projected for FY12, if there had been no settlement of circular debt in FY13, this arrangement implies more than Rs 10 billion saving in interest payments for the government in the upcoming year (**Table 4.1.1**).

In the absence of external financing, excessive reliance on costlier domestic resources for financing these fiscal imbalances is increasing the country's debt servicing burden, and hence complicating debt management.[4] In the presence of persistent revenue and primary deficits incurred by the country during the past several years, such an increase in debt servicing implies further increase in borrowing requirements – a situation which may push the country into a debt trap.

To add to these concerns, Q2-FY12 also witnessed a significant increase in deficit monetization by the government. In the face of tight liquidity conditions in the

[4] The interest payments on domestic debt saw a sharp 21.7 percent YoY increase during H1-FY12.

market, commercial banks investment in government securities fell short of the government's requirements. Resultantly, during Q2-FY12 the government could not meet the self imposed limit of 'zero' net quarterly borrowing from central bank.[5]

On the upside, however, the roll-over of external debt payment, worth 420 million Euros, owed to IDB during Q2-FY12, provided a breather to the government.

Table 4.5: Government Domestic Debt
billion Rupees

	End Period Stock		Change in FY12	
	Jun-11	**Dec-11**	**Q1**	**Q2**
Domestic debt	**6,017.0**	**6,866.3**	**207.6**	**641.7**
Permanent debt	1,124.4	1,462.6	56.2	281.9
Floating debt	3,235.4	3,667.8	106.5	325.9
Unfunded debt	1,655.8	1,734.5	44.8	33.9
FC instruments	1.4	1.4	0.0	0.0

FC: Foreign Currency
Source: State Bank of Pakistan

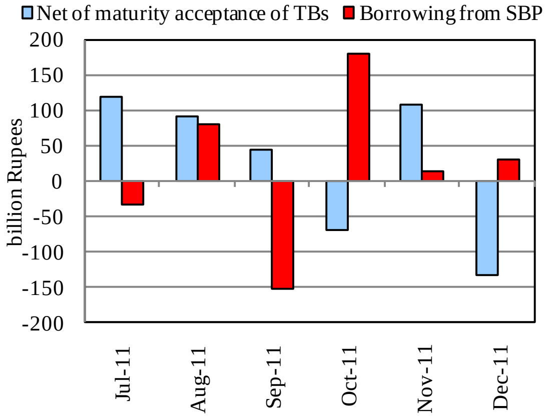
Government domestic debt

Deficit financing requirements, along with the circular debt settlement by the government, resulted in a hefty Rs 849.2 billion increase in the domestic debt stock during H1-FY12. Some of the key features are discussed below.

Floating debt

50.9 percent of the total increase in domestic debt stock during H1-FY12 was contributed by short term debt instruments (**Table 4.5**). Specifically, the government raised around Rs 195 billion, through 12-m T-bills, for circular debt settlement in the auction held on November 4, 2011. However, with this increase in the stock of 12-m T-bills, the maturity profile of domestic debt has slightly improved – the share of less-than-one-year maturity T-bills in government domestic debt has declined from 21.4 percent at end-June 2011, to 9.2 percent at end-December 2011.

Figure 4.3: Bank Borrowing



Source: State Bank of Pakistan

Another important issue is

[5] Government borrowed Rs 227.9 billion from SBP in the second quarter of FY12.

the resumption of deficit monetization on account of liquidity shortages in the market. Commercial banks' investment in T-bills witnessed a decline during Q2-FY12 and the net of maturity acceptance of T-bills stood at negative Rs 96.5 billion during this period (**Figure 4.3**). This forced the government to turn to central bank borrowing for financing. Resultantly, the net quarterly government borrowing from SBP stood at Rs 227.9 billion in the quarter ending on end-December 2011, after remaining negative during the last four quarters.

Permanent debt

The stock of permanent debt recorded a significant increase of Rs 338.2 billion during H1-FY12. As mentioned above, a greater share of this increase was because of Rs 195 billion raised through five-year PIBs for the settlement of the circular debt. However, similar to what happened with T-bills, commercial banks' investment in PIBs also lost fervor in December 2011, as the government could raise only 41.7 percent of the targeted amount in the PIB auction held in this month (**Table 4.6**).

Table 4.6: PIB Auctions

billion Rupees

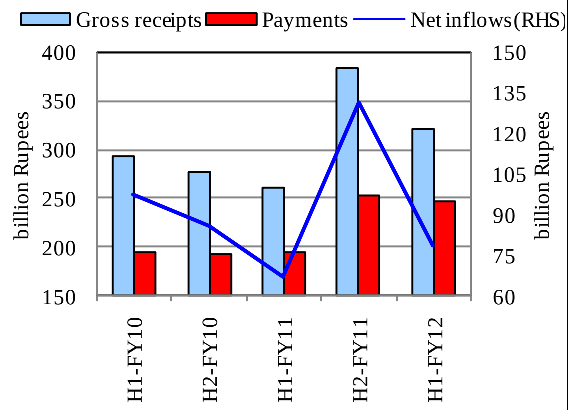
	Aug-11	Sep-11	Oct-11	Nov-11*	Dec-11
Targets	30.0	20.0	15.0	15.0	15.0
Acceptance	40.5	25.9	18.9	11.2	6.3

*During November 2011 government also raised Rs 195.3 billion for circular debt settlement through PIBs.

Source: State Bank of Pakistan

Furthermore, the government also raised Rs 70.3 billion through 3-year Ijara Sukuk, during the auction held in December 2011, against a targeted amount of Rs 50 billion. Greater than target acceptance in this issue reflects investment demand from Islamic debt instruments and bodes well for the diversification of debt market.

Figure 4.4: NSS Flows



Source: State Bank of Pakistan

Unfunded debt

The downward revision in NSS rates in October 2011, have apparently not discouraged gross investment in NSS instruments, which recorded a substantial increase of Rs 59.5 billion during the first half of FY12 as compared to the same period last year (**Figure 4.4**). Healthy inflows in these schemes helped curtail a drop in net investment after large payments to institutional investors, following the ECC's decision that barred institutional investment in these schemes in April 2011.[6] Nonetheless, NSS rates have been revised downwards further in January 2012. While heavy payments are likely to continue going forward, the impact of further cut in NSS rates on investment in unfunded debt is yet uncertain.

Table 4.7: Interest Payments on Domestic Debt During Jul-Dec
billion Rupees

	FY10	FY11	FY12	Change
Permanent debt	40.9	42.9	60.1	17.2
Floating debt	86.2	154.5	176.6	22.1
3-months	1.5	15.6	7.1	-8.6
6-months	12.2	17.8	76.5	58.7
12-months	3.0	39.2	10.1	-29.1
MRTBs	69.4	81.9	83.0	1.1
Unfunded debt	141.2	91.2	114.4	23.3
Total domestic debt	268.2	288.6	351.2	62.6

Source: State Bank of Pakistan

Interest payments on domestic debt

In tandem with the rising borrowing needs of the government and partly due to the higher cost of debt during the preceding year, interest payments on domestic debt recorded a sharp 21.7 percent YoY increase during H1 FY12 – 6-m T-bills had the highest share in these payments (**Table 4.7**). Due to the recent improvement in maturity profile of domestic debt, the pace of debt servicing may register a slowdown during Q3-FY12. However, this respite is likely to be short-lived as the interest payments on the PIBs, raised for settling circular debt, will start in the final quarter of FY12. In fact, interest payments on domestic debt are likely to post substantial growth from Q4-FY12 onwards, as around one-quarter of the entire debt stock has a maturity of one year, with payments scheduled in the upcoming year.

Table 4.8: Change in External Debt Stock in Jul-Dec[P]
million US Dollar

	FY11	FY12
Public debt	2,590.0	-915.0
Government debt	1,893.0	-355.0
From IMF	659.0	-496.0
Foreign exchange liabilities	38.0	-64.0
PSEs external debt	-136.0	51.6
Private sector external debt	98.0	152.6
Total external debt	2,552.0	-710.8

P: Provisional
Source: State Bank of Pakistan

External debt & liabilities

External loan inflows declined for yet another year, with EDL stock recording a fall of US$ 710.8 million during H1-FY12 over the end June 2011 position (**Table 4.8**). Out of the budget estimates of inflows of US$ 3.7 billion for

[6] Net investment in unfunded debt recorded Rs 11.9 billion increase during H1-FY12, despite a sharp Rs 49.9 billion YoY increase in payments of these instruments.

loans and grants during FY12, only 30.4 percent could be realized during H1-FY12.

On a positive note however, the government was able to rollover a significant debt payment worth 420 million Euros to IDB, which was due in December 2011, for a period ranging between 6 to 18 months. In addition to this, the roll-over of China deposits, worth US$ 500 million, which were due in January 2012, is also in process. This arrangement will ease pressure on the country's foreign exchange reserves, which have declined from 27.9 weeks of imports in end-June 2011 to 23.6 weeks of imports as of end-December 2011.

5 External Sector

5.1 Overview

Q2-FY12 data indicates further deterioration in external accounts with overall deficit widening to US$ 1.0 billion compared to US$ 0.8 billion in Q1-FY12. It may be recalled that against the deficit of US$ 1.8 billion in H1-FY12, the country had posted a surplus of almost US$ 1.0 billion in H1-FY11.

The worsening in external account was caused by both the current account and the financial account relative to the previous year.

In the current account, the problem arose because of the widening of the trade deficit as exports growth during H1-FY12 decelerated to 9.1 percent from 19.3 percent last year.

Imports growth on the other hand accelerated to 17.8 percent compared to11.2 percent last year. More than 60 percent of this increase was due to rise in the imports of the petroleum products and fertilizer, which showed 37.2 and 18.7 percent increase in their unit values.

Table 5.1: Summary of External Accounts
billion US Dollar

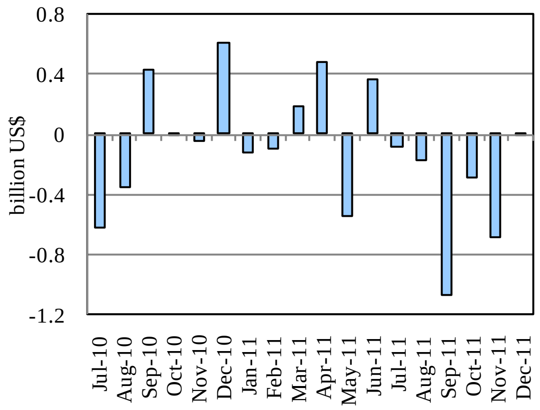
		FY12		
	H1-FY11	**H1**	**Q1**	**Q2**
A-C/A balance	**0.0**	**-2.3**	**-1.3**	**-1.0**
i) Trade balance	-5.8	-7.8	-4.2	-3.6
Exports	11.1	12.1	6.1	6.0
Imports	16.9	19.9	10.3	9.6
ii) Services account balance	-0.3	-1.3	-0.7	-0.6
iii) Income account balance	-1.5	-1.6	-0.6	-1.0
iv) Current transfers	7.6	8.4	4.2	4.2
Remittances	5.3	6.3	3.3	3.0
B-Financial/Capital balance	**1.0**	**0.4**	**0.6**	**-0.2**
i) FDI	0.8	0.5	0.2	0.3
ii) FPI	0.2	-0.1	0.0	-0.1
iii) Others	0.0	0.0	0.4	-0.4
C-Errors & omissions	**0.0**	**0.1**	**0.0**	**0.1**
Overall balance (A+B+C)	**1.0**	**-1.8**	**-0.8**	**-1.0**
Foreign reserves (31st Dec)	17.2	16.9		
Exchange rate (31st Dec)	85.7	89.9		

P: Provisional
Source: State Bank of Pakistan

While the rise in imports was attributable to increase in the unit values, the fall in export was largely due to decline in quantum, particularly textiles. Though textile exports may also have suffered from slowdown in demand in its main markets (EU and US); across the board increase in unit values of value added textiles indicates that domestic issues, particularly energy shortages, may have been the main reason for slowdown in the country's exports.[1]

A point of consolation was the slowdown in the pace of deterioration of the current account in Q2-FY12 relative to the first quarter (**Figure 5.1**). Specifically, compared to a deficit of US$ 1.3 billion in Q1-FY12, the current account deficit was US$ 1.0 billion in Q2-FY12 (**Table 5.1**). This was primarily due to lower trade deficit in Q2-FY12, as the country's service deficit and current transfers were more or less the same in both the quarters.

Figure 5.1: Monthly Trend of Current Account Balance



Source: State Bank of Pakistan

As against the current account, the pace of deterioration in the financial and capital account accelerated in Q2-FY12. Financial and capital account, which posted a surplus of US$ 0.6 billion during Q1-FY12, posted a deficit of US$ 0.2 billion in Q2-FY12. While fresh inflows remained constrained, a large retirement of trade financing loans by importers fearing depreciation of rupee caused the financial account to post a deficit in Q2. Accordingly, the financial and capital account surplus declined to US$ 0.4 billion in H1-FY12 against a surplus of US$ 1.0 billion in the corresponding period of FY11 (**Table 5.1**).

Although the government remains optimistic regarding PTCL privatization proceeds, inflows on account of 3G license fees and a Euro bond issue, these inflows have not materialized so far.

The combined deterioration of current and financial accounts during H1-FY12 brought pressures on SBP reserves and exchange rate. During H1-FY12, Pakistan's liquid foreign exchange reserves declined by US$ 1.4 billion, while the exchange rate depreciated by 4.4 percent. The pressure on the country's reserves and exchange rate could increase in H2-FY12 with a further widening of the trade

[1] EU and US textile imports from the world as of end-October and end-November 2011 declined by 18.0 and 8.1 percent respectively.

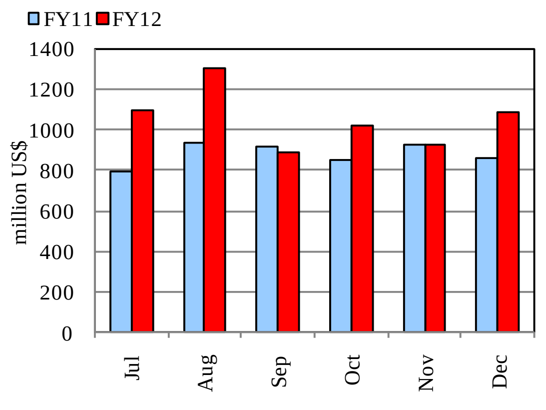
deficit and external debt servicing. In this scenario, it is important for the government to have a clear and credible strategy for shoring up the external position to avoid undue speculative pressures.

5.2 Current Account

While the bulk of the increase in the current account deficit was due to widening of the trade deficit; increase in the services account deficit also contributed to the widening of deficit in the current account during H1-FY12.

Services account deficit increased to US$ 1.3 billion during H1-FY12 compared to US$ 0.3 billion during the same period last year. This increase in the deficit was due to: (1) the absence of inflows under the coalition support fund (CSF); and (2) increase in outflows for travel services. It is pertinent to mention that against US$ 743.0 million in H1-FY11 Pakistan has not received any inflow under CSF in the current fiscal year.

Figure 5.2: Monthly Workers' Remittances



Source: State Bank of Pakistan

Current transfers continued to be the only source of comfort for the external sector, posting YoY growth of 9.7 percent during Jul-Dec FY12. Within current transfers, workers' remittances recorded a healthy growth of 19.5 percent on top of 16.8 percent growth recorded during the same period of the previous year. Monthly data reveals that workers' remittances dropped sharply in September 2011, before recovering in the following months (**Figure 5.2**).[2]

Channel-wise data indicates that remittances through banks increased by 24.9 percent while remittances through exchange companies declined by 4.7 percent during the period under review. Since the start of Pakistan Remittance Initiative in August 2009, remittances through the banking channel have increased

[2] The remittance dropped sharply by 32.0 percent MoM in September 2011, contributing to the widening of the current account deficit. The fall in remittances owed to seasonal slowdown, delays in payment of commission to authorized money changers and due to speculative pressures in the forex market.

significantly. During H1-FY12, share of remittances received through banking channel was 89.0 percent compared with 84.0 and 76.0 percent in FY11 and FY10 respectively.

5.3 Financial Account

Financial account surplus declined to US$ 309 million during H1-FY12 against US$ 990.0 million last year. Decline in both debt (loans) and non-debt creating (investment) inflows contributed to reduction in surplus.

Foreign direct investment recorded inflow of US$ 532.0 million during H1-FY12 against US$ 840.0 million received last year. Sectoral distribution of FDI shows that major contributor to this decline was the telecom sector, recording a fall of US$ 232.0 million. Disinvestment by one of the cellular company largely explains the fall in the telecom sector during this period.

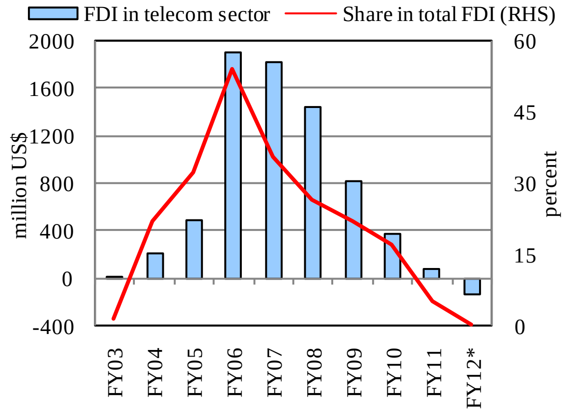
FDI in the telecom sector, which in the past was a major attraction for foreign investors, has been falling since last few year; factors responsible for this fall have been analyzed in (**Box 5.1**).

Box 5.1: FDI Trend in the Telecom Sector

The telecom was one of the most attractive sectors for foreign investors from FY05 to FY08 **(Figure 5.1.1)**. The share of telecom in total FDI started to rise gradually and reached 45.0 percent in FY06. Privatization of PTCL and investment of foreign cellular companies, initially Telenor and Warid and later China Mobile were dominant factors behind the sharp rise in FDI during FY05-FY08.

One obvious reason for the sharp jump in FDI in the telecom sector was the privatization of PTCL. However, even after excluding the privatization proceeds of PTCL, the FDI in the telecom sector was encouraging. Within the telecom sector, FDI flows were concentrated in five companies (PTCL, Telenor, Warid, Pakcom and China Mobile). Foreign investment in these companies stood at 95 percent of FDI (on average) in telecom sector during FY04-FY10. However, the share of these five companies declined sharply in FY11 **(Figure 5.1.2**). The share of companies providing broad-band internet services such as Qubee (subsidiary of Augere), Wateen and Wi-tribe increased in FY11.

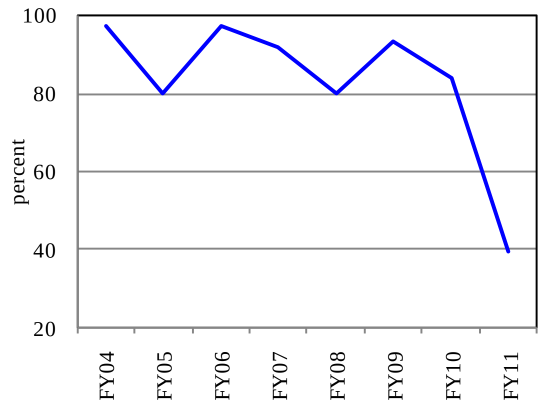
Figure 5.1.1: Trend of FDI in the Telecom Sector



* Jul-Dec Source: State Bank of Pakistan

Following are the prominent factors that led to a drop in share of these companies.

Figure 5.1.2: Share of Top 5 Companies in Telecom Sector



Source: State Bank of Pakistan

Pakistan Telecommunication Ltd (PTCL)'s 26 percent stake along with management control was sold to Etisalat for US$ 2.8 billion in FY05. These proceeds helped in increasing the financial account surplus at that point of time; however, US$ 800 million payment was held back by Etisalat due to a dispute with the government of Pakistan over legal transfer of land and property titles. If this issue is resolved then the inflow of US$ 800 million would definitely provide support to the financial account.

Another factor that led to disinvestment was the cancellation of license of Pakcom (Instaphone) by Pakistan Telecommunication Authority because of Pakcom's failure to pay outstanding dues on account of license fee of US$ 291.0 million for the next 15 years. After an unsuccessful legal battle, Pakcom started to disinvest FY10 onwards.[3] Recently, the government has decided to auction the license of Instaphone, which could generate US$ 291.0 million in the upcoming months.

The problem of falling average revenue per user (ARPU) is also a challenge for all the cellular operators.[4] With growing competition and entrance of three foreign cellular companies during FY04-09; profits started to squeeze and ARPU/month declined from US$ 3.2 in FY07 to US$ 2.4 in FY09 onwards. Even the latest data of December 2010 shows that APRU/month is US$ 2.5 only.[5] Due to falling average revenues, the existing cellular companies are not only reluctant to bring new investment but one of the cellular company is continuously disinvesting from Pakistan.

Cellular teledensity reached 65 percent by the end FY11, starting from only 3.0 percent in FY04; this reflects that the telecom sector is at the verge of saturation. This factor is also impeding fresh FDI in this sector. Furthermore, we believe that all the existing cellular companies suffered losses following the cancellation of 16 millions unregistered SIMs by PTA.

These are the factors which are hampering FDI flows to telecom sector in Pakistan. However, upcoming auction of 3G licenses, and expected release of PTCL privatization proceeds by Estilate may lead to some rebound in FDI.

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[3] M/s Pakcom (Instaphone) challenged the Authority's decision in Islamabad High Court which was dismissed by the honorable Court. The operator appealed against the decision of the Islamabad High Court in the Supreme Court of Pakistan. The honorable Supreme Court also disposed off the appeal on 27th May 2010 in favor of PTA. On receipt of the detailed judgment, PTA issued final cancellation letter on 24th January 2011.

[4] ARPU is one of the key indicators to gauge the financial status of telecom market in any country.

[5] Pakistan Telecom Authority, Telecom Quarterly Report, December 2010.

Portfolio investment recorded an outflow (net) of US$ 140.0 million during H1-FY12, in contrast to net inflows of US$ 219.0 million in the corresponding period last year. Details indicate that US$ 375.0 million fall was recorded in equity securities, a reflection of bearish stock market during the period under review. At the same time, FPI inflows in fixed income instruments remained unchanged over the previous year even after the tax incentive given in the Federal Budget of FY12.[6] This shows that non-economic factors are impeding foreign inflows. Global Competitiveness Index 2011-12 indicates that Pakistan is ranked at 118th number out of 142 countries in terms of competitiveness. The most problematic factors are political instability, corruption and policy inconsistency. The index further indicates that the law & order situation and the costs of terrorism in Pakistan is the second worst in the world after Somalia.[7]

Other investment which primarily comprises of foreign loans and credits also recorded a fall during the period under review. Disbursement of loans declined by US$ 7.0 million with a major fall in program loan receipts (decline of US$ 389.0 million). However, project loan receipts increased by US$ 438.0 million during the period under review.[8] *Going forward*, potential external flows , includes project loans from World Bank and ADB in the range of US$ 1.0 to 1.2 billion.

Trade financing recorded a decline of US$ 412.0 million during H1-FY12 in contrast to a rise of US$ 328.0 million in the corresponding period last year.[9] This decline was attributed to the retirement of forex loans, which accelerated due to depreciation of Pak Rupee.[10]

Exchange Rate and Foreign Exchange Reserves

The impact of worsening in the current and financial accounts during H1-FY12 is reflected in the depletion of foreign exchange reserves and pressures on Pak Rupee. Specifically, liquid foreign exchange reserves declined to US$ 16.9 billion by end- December 2011, compared with US$ 18.3 billion as of end June 2011.

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[6] For encouraging investments made by non-residents in government securities, the withholding tax on profit on debt deductible @ 10 percent is proposed to be a final tax. This measure will relieve the non-residents from the statutory requirement of filing of return of income, and will boost national economy.

[7] The Global Competitiveness report 2011-12, *World Economic Forum.*

[8] A project loan is strictly for a specific project and it cannot be used for other purposes. A program loan on the other hand can be utilized for a specific project as well as for overall economic development.

[9] Trade financing is basically the financing provided by the banks to exporters/importers for manufacturing, processing, distributing, clearing and other trade related activities.

[10] The decline in trade financing was mainly due to retirement of loans by importers.

While SBP reserves declined by US$ 2.0 billion, those of scheduled banks increased by US$ 0.6 billion during H1-FY12 (**Table 5.2**).[11]

Table 5.2: Sources of Foreign Exchange Inflows During H1

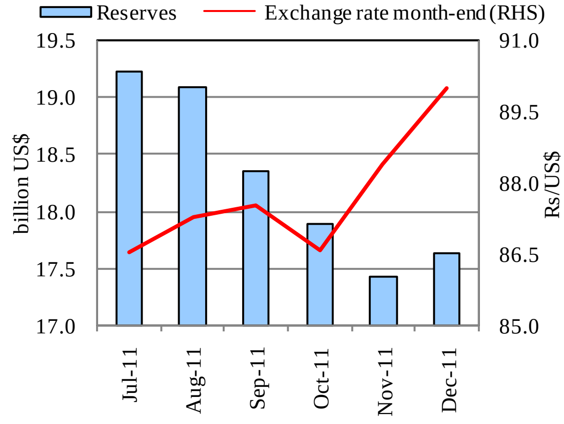
million US Dollar

	FY11	FY12
SBP purchases	1,540.0	850.0
Swaps	3,251.1	2,194.0
Donor agencies & others	2,843.8	1,555.5
IMF	454.5	2.6
IBRD	19.9	87.1
IDA	78.7	161.2
ADB	133.7	206.9
UN troops	109.8	138.9
US/UK/EU COMM/SAMA Grants	202.2	66.9
Logistic support	743.3	0.0
Total	7,634.9	4,599.5

Source: State Bank of Pakistan

Owing to the weakening of overall external accounts and the subsequent depletion of foreign reserves, Pakistan's currency vis-à-vis US dollar depreciated by 4.4 percent during Jul-Dec FY12 (**Figure 5.3**). Data indicates that fall in reserves generated negative sentiments in the forex market causing exaggerated loss in the value of rupee.

Figure 5.3: Foreign Exchange Reserves and Exchange Rate



Source: State Bank of Pakistan

In terms of Nominal Effective Exchange Rate (NEER) Pak rupee depreciated by 0.7 percent during Jul-Dec FY12. This was due to the fact that compared to 4.4 percent depreciation against the US dollar, Pak rupee depreciated by 8.5, 6.5 and 0.2 percent against Yen, Euro and Pound. Higher nominal depreciation against these currencies is attributable to weakness of the dollar against these major currencies in the international market.

The real effective exchange rate (REER) takes into account the exchange rates of trading partners as well as their CPI inflation. REER is mostly indicative of the

[11] SBP was also a net seller of US$ 403.0 million during Jul-Dec FY12.

competitiveness of a country, and therefore has assumed greater importance as an external sector indicator.

During H1- FY12, the depreciation in the NEER was offset by higher inflation in Pakistan compared to its trading partners. Relative price index increased by 3.7 percent in H1-FY12. Therefore, the net result was the *appreciation* of the Pak rupee in real terms by 3.0 percent during period under review (**Table 5.3**).

Table 5.3: Appreciation/Depreciation during H1
percent

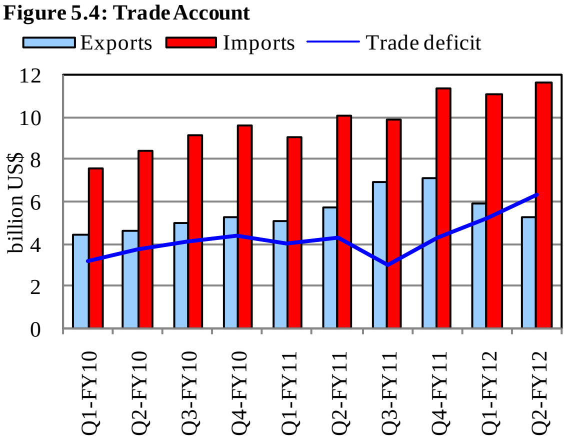
	NEER	RPI	REER
FY08	-4.8	4.3	-0.7
FY09	-7.4	5.4	-2.4
FY10	-6.2	3.6	-2.7
FY11	-5.1	6.4	0.9
FY12	-0.7	3.7	3.0

Source: State Bank of Pakistan

5.4 Trade Account[12]

A combination of sustained growth in imports and deceleration in exports cause the trade deficit to increase by 38.4 percent YoY during H1-FY12 (**Figure 5.4**). The increase in the imports was largely driven by rise in petroleum and fertilizer imports as both quantum and prices rose. Exports on the other hand, decelerated principally due to declining quantum of textiles.

Figure 5.4: Trade Account



Source: Pakistan Bureau of Statistics

Exports

Exports posted a nominal YoY growth of 3.6 percent during Jul-Dec FY12 compared to an impressive growth of 18.7 percent in the corresponding period last year. Given the falling cotton prices, persistence in the energy shortages and poor law and order situation, the deceleration in the exports is likely to continue in the remaining months of FY12 (**Figure 5.5**). As such, SBP expects the exports to contract by around 3.0 percent during the current fiscal year.

[12] The Analysis of trade account is based on PBS data, which differs from the SBP exchange record data.

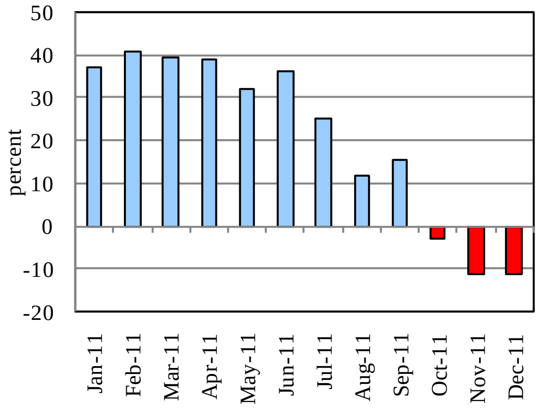
The decline in export growth is largely attributed to fall in textile exports. Textiles that contributed more than 73 percent to last year's export growth had a negative contribution this year, though this was largely offset by positive contributions made by overall food and other manufactures groups (**Table 5.4**).

Within the food and other manufactures groups; fish, fruits & vegetables, footwear, medical & surgical instruments, chemicals & pharmaceuticals, registered a significant rise over the previous year. Exports of rice, carpets and petroleum products, however, declined.

Textiles

Textile exports contracted by 4.8 percent during H1-FY12 against an increase of 25.2 percent last year. This contraction was mainly due to decline in the quantum of exports during Q2-FY12. Textiles in Q1-FY12 had registered a YoY growth of 9.9 percent (**Figure 5.6)**. Both demand and supply side factors were at play in the decline of textile exports with later being more significant. On the supply side, worsening energy situation (especially of gas) remained

Figure 5.5: Export Growth (YoY)



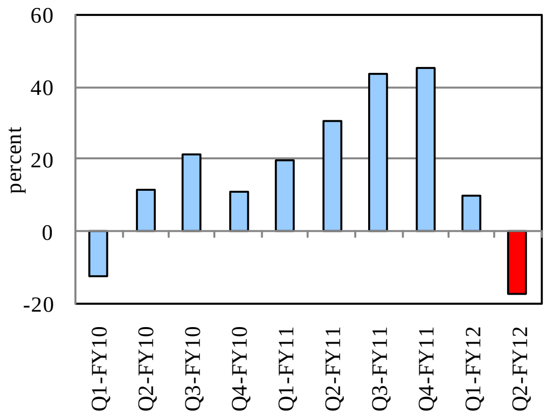
Source: Pakistan Bureau of Statistics

Table 5.4 Exports Performance (Jul-Dec)

	Value in billion US$		Cont. in Growth (%)	
	FY11	**FY12**	**FY11**	**FY12**
Food	1.6	1.9	9.0	66.2
Textile	6.3	6.0	73.4	-68.7
Petroleum	0.6	0.6	11.3	-9.4
Other manufactures	1.9	2.1	4.4	58.9
Others	0.5	0.7	1.8	53.0
Total exports	10.8	11.2	100	100

Source: Pakistan Bureau of Statistics

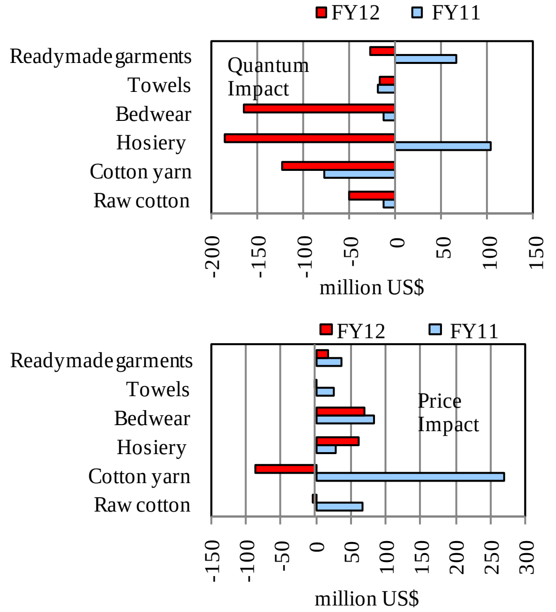
Figure 5.6: Textile Exports Growth (YoY)



Source: Pakistan Bureau of Statistics

a major drag on production activities of textile sector. The situation was particularly bad for the textile industry in Faisalabad, which contributes substantially to textiles related exports. In addition to electricity load shedding, the city faced increased shortages of natural gas.

Figure 5.7: Textile Exports During Second Quarter



Source: Pakistan Bureau of Statistics

With Euro Zone economies struggling and recovery in the US likely to be slow, the IFIs have revised downward their forecast for world growth.[13] The decline in demand in these two important economies would have adverse consequences for small emerging economies like Pakistan. Already decline in demand is clearly discernable from the fall in textile imports in both the EU and the US. This was more apparent in the Q2-FY12 as along with quantum, price impact also became negative (**Figure 5.7**).

To counter the impact of decline in the demand, it is high time that the government address long standing structural issues of this sector, the government should chalk out medium to long-term strategy including technology up gradation, development of standards, projects for skill development

Table 5.5 Non-Textile Exports During H1-FY12

million US Dollar

	Quantum Impact	Price Impact
Rice	-333.4	224.3
Petroleum products	-172.6	74.3
Leather garments	-29.9	6.8
Cement	-46.8	34.4
Pharmaceutical products	-68.8	63.1
Gloves	-12.4	8.4
Fruits	-32.2	44.0
Leather gloves	33.3	-7.9
Plastic material	-1.8	45.2
Solid fuel	-25.6	83.6

Source: Pakistan Bureau of Statistics

[13] World Economic Outlook Jan 2012

and infrastructure development with the effective involvement of private sector.

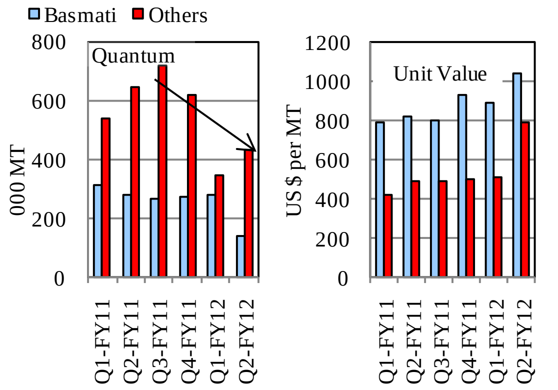
Non-Textiles

Non-textile exports recorded a YoY rise of 15.2 percent during Jul-Dec FY12 over the same period last year. Food exports recorded a growth of 17.6 percent, and the other manufactures 13.4 percent. This was largely attributed to higher prices as the quantum for most of the non-textile items declined during the period under review (**Table 5.5**).

Within the non-textile, one of the otherwise strong performers, *rice exports* declined by 10.7 percent during H1-FY12 compared to the same period last year due to the decline in quantum (**Figure 5.8**). The decline in rice exports is attributable to a number of factors including:

- Fall in the demand in Euro area;
- India's decision to allow export of non-basmati rice after four years that has augmented the world supply. India is offering non-basmati rice at much lower price due to both large carryover stocks and recent depreciation of the Indian currency;
- A part of this slowdown may be attributed to problems faced by rice mills due to frequent power shortages.

Figure 5.8: Rice Exports



Source: Pakistan Bureau of Statistics

The situation may, however, ease March 2012 onwards on account of an increase in rice procurement by the Indian government ahead of elections, which would constrain world supply and benefit Pakistani exporters. Nevertheless, despite exportable surplus, the country may not be able to meet its full year rice export target of US$2.5 billion due to shortfall in exports up to H1-FY12.

The exports of *petroleum products* also declined despite higher prices; circular debt problem appears to have constrained refineries capacity to import.

Imports

Imports continued to rise during Q2-FY12 registering a YoY growth of 14.8 percent. This rise in import bill was a function of increase in import prices of almost all products, whereas quantum of imports fell during the period.

Highest contribution in this growth came from the petroleum group followed by agricultural, other chemical group and machinery group (**Table 5.6**).

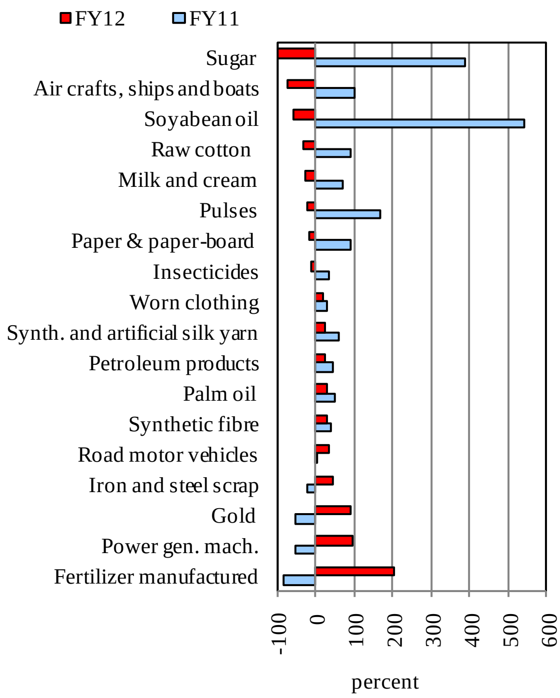
Table 5.6: Import Performance (FY12)
percent

	YoY Growth		Contribution in Growth	
	Q1	**Q2**	**Q1**	**Q2**
Food	7.2	-12.4	4.0	-12.5
Machinery	-12.9	18.7	-8.5	15.9
Transport	5.2	-16.1	1.2	-6.0
Petroleum	62.6	22.3	70.6	45.1
Textile	-0.9	4.8	-0.3	2.0
Agri. & chemical	24.0	18.2	17.3	16.4
Metal	6.3	9.0	1.9	3.6
Misc.	-9.7	-6.1	-0.9	-1.0
Total	**23.1**	**15.1**	**100**	**100**

Source: Pakistan Bureau of Statistics

Commodity wise data shows that import of fertilizer witnessed the highest YoY growth in Q2-FY12 (**Figure 5.9**). Specifically, fertilizer imports increased by 286.3 percent (to US$ 202.0 million) due to both higher prices and increased quantity. Decline in domestic production of fertilizer due to gas shortages, led to increase in fertilizer imports.

Figure 5.9: Import Performance During Second Quarter

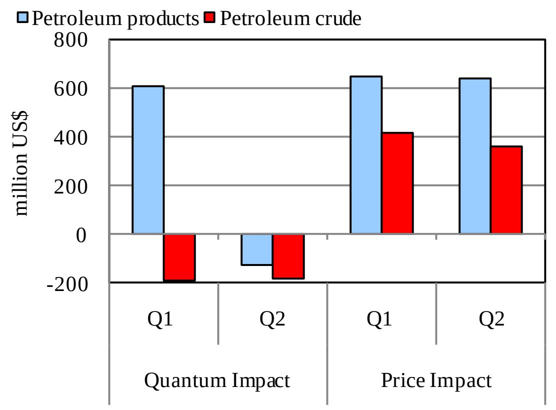


Source: Pakistan Bureau of Statistics

Petroleum products imports increased by 24.1 percent during Q2-FY12 over the same period last year. In absolute terms, POL imports increased by US$ 2.1 billion, out of which US$ 2.0 billion was due to price impact. In terms of quantum, petroleum imports recorded a decline during Q2-FY12 after registering a rise in Q1-FY12 (**Figure 5.10**). The slowdown in POL group import quantum can be attributed to the circular debt issue that limited the ability of refineries to import.

Machinery imports posted a rise of 19.0 percent during Q2-FY12 in contrast to a decline of 12.9 percent during Q1-FY12. Category-wise data reveals that imports of construction, electrical and power generating machinery increased, which outstripped the negative growth in textile and agricultural machinery. *Raw cotton* import recorded a YoY decline on account of good domestic cotton crop.

Figure 5.10: Petroleum Imports During First Half of FY12



Source: Pakistan Bureau of Statistics

Similarly, *Sugar* imports also declined sharply by 97.3 percent during Q2-FY12 on account of better production of this commodity in the country.

Acronyms

ABAD	Association of Builders and Developers
ADB	Asian Development Bank
ARPU	Average Revenue Per User
CAB	Current Account Balance
CCAC	Cotton Crop Assessment Committee
c.i.f.	Cost, Insurance and Freight
CNG	Compressed natural gas
CPI	Consumer Price Index
CR	Cold rolled
CSF	Coalition Support Fund
DRI	Directly reduced iron
ECC	Economic Coordination Committee
EDL	External Debt and Liabilities
EFS	Export Financing Scheme
EU	European Union
FBR	Federal Board of Revenue
FBS	Federal Bureau of Statistics
FCY	Foreign Currency
FDI	Foreign Direct Investment
FED	Federal Excise Duty
f.o.b	Free on Board
FPI	Foreign Portfolio Investment
FX	Foreign Exchange
FY	Fiscal Year
GDP	Gross Domestic Product
GIDC	Gas Infrastructure Development Cess
GST	General sales tax
Gwh	Giga watt hours
HR	Hot rolled
HS-code	Harmonized-system code
IDB	Islamic Development Bank
IMF	International Monetary Fund
Kg	Kilograms

KP/KPK	Khyber Pukhtunkhwa
LSM	Large Scale Manufacturing
M2	Broad Money Supply
MoM	Month on Month
MRTBs	Market Treasury Bills for Replenishment for Cash
MTBs	Market Treasury Bills
NDA	Net Domestic Asset
NFA	Net Foreign Asset
NFC	National Finance Commission
NSS	National Savings Scheme
OMOs	Open Market Operations
PBS	Pakistan Bureau of Statistics
PIB	Pakistan Investment Bond
PKR	Pak Rupee
POL	Petroleum, Oil and Lubricants
PSDP	Public Sector Development Program
PSEs	Public Sector Enterprises
PSM	Pakistan Steel Mills
PTA	Pakistan Telecommunication Authority
PTCL	Pakistan Telecommunication Ltd
Q	Quarter
QIM	Quantum Index of Manufacturing
Rs	Rupees
SBP	State Bank of Pakistan
SED	Special Excise Duty
SUPARCO	Space and Upper Atmosphere Research Commission
T-bills	Treasury Bills
TCP	Trading Corporation of Pakistan
TDL	Total Debt and Libilities
TSM	Tuwairqi Steel Mills
US	United States of America
USDA	United States Department of Agriculture
WPI	Wholesale Price Index
YoY	Year on Year