1 Overview

Policy makers were hopeful that the country would put up a better economic performance in FY12 after last year, which was a difficult one for the economy, not only due to the devastating floods that hit the country early in the fiscal year, but also due to the lack of external financing and energy shortages.

Table 1.1: Selected Economic Indicators

		FY10	FY11	FY12
Growth rate (percent)				
LSM	Jul-Oct	-1.7	-2.9	2.1
Exports (fob)	Jul-Nov	-8.3	15.8	7.6
Imports (cif)	Jul-Nov	-23.0	17.3	20.2
Tax revenue (FBR)	Jul-Sep	0.7	11.2	29.7
CPI (12 month ma)	Dec	13.9	12.9	12.0
Private sector credit	Jul-Nov	1.1	2.3	2.5
Money supply (M2)	Jul-Nov	3.8	5.3	2.3
billion US dollars				
Total liquid reserves[1]	29th Dec	15.0	17.1	16.9
Home remittances	Jul-Nov	3.8	4.4	5.2
Net foreign investment	Jul-Nov	1.0	0.7	0.3
percent of GDP[2]				
Fiscal deficit	Jul-Sep	1.5	1.5	1.2
Trade deficit	Jul-Nov	2.7	2.2	2.7
Current a/c deficit	Jul-Nov	1.0	0.3	0.9

1. With SBP & commercial banks

2. Based on full-year GDP in the denominator

Unfortunately, as in FY11, the country was hit once again by floods in the early months of FY12. This, coupled with adverse developments in the external account, has somewhat dented prospects for FY12.

On a positive note, the floods in FY12 were not as severe as those in FY11. While there was some damage to cotton and minor crops in lower Sindh, it was largely compensated for by the improvement in cotton production in Punjab. Latest estimate of Cotton Crop Assessment Committee put crop size at around 12.6 million bales against the Annual Plan target of 12.8 million bales.

Moreover, the agriculture sector could get a boost from improved wheat and rice production, but this may not translate into increase in farm incomes. Stronger global crop production has put downward pressure on crop prices: cotton prices are down by more than 50 percent from their peak in Mar 2011, while domestic sugarcane growers are struggling to secure fair returns due to the global slump in sugar prices. Though the support price for wheat has been increased to Rs 1,050 /40 kg, the government is yet to announce its procurement targets. The government's borrowing needs will stretch further if it sets too ambitious a target.

This, in turn, could create complications in terms of coverage, forcing some farmers to sell wheat to middlemen at lower than the support price.

A decline in aggregate farm income could have negative implications for the manufacturing sector, particularly for the consumer durable industry. Fortunately, manufacturing activity has been largely unaffected by floods this year. Large-Scale Manufacturing (LSM) registered a growth rate of 2.1 percent (as of Jul-Oct 2011), which is on track towards the full year target of 2.0 percent. The largest sub-sectors (textile, food, cement, POL, pharmaceuticals, etc.) have posted decent growth rates. Going forward, however, growth prospects are relatively uncertain. Textiles could suffer from falling demand and low international prices; the recent growth in cement is largely driven by the base-effect, as floods had kept cement demand subdued during Q1-FY11; fertilizer production that is already constrained by gas shortages can slowdown further ; and the POL sector could be undermined by the circular debt issue.

Consistent with the performance of LSM sector during Jul-Oct FY12, credit demand by the private sector has remained sluggish. Credit to the private sector as of end-Nov 2011 increased by 2.5 percent against 2.3 percent last year. Loans to private businesses (advances), which show a contraction of Rs 9.1 billion against an expansion of Rs 73.6 billion in the same period last year, are more worrying.[1] In terms of the distribution of loans to private sector businesses, sugar and telecommunication experienced the sharpest slowdowns because of a delayed crushing season (sugar) and possible saturation in the telecom business.[2] Cement and IPPs on the other hand, recorded significant increases. As in the past, most of the loans were availed to meet working capital requirements, while fixed investment loans remained depressed.

FY12 is the second consecutive year in which widespread floods adversely impacted economic growth, besides bringing distress and devastation to the country. Although the government was quick to respond with immediate relief early this fiscal year, the institutional and physical infrastructure needed to cope with such natural calamities needs improvement. The government, therefore, must adopt special safeguards to minimize the potential loss to life and property. This will be difficult, however, given that the government is already resource-strapped.

Recent fiscal figures, however, show that the government has been making some

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[1] Credit to private sector includes private sector advance, investment and bill discounted.
[2] See chapter 3, table 3.4.

headway towards improving its finances. The budget deficit for the first quarter of FY12 was 1.2 percent of GDP, compared with 1.5 percent during the same quarter last year. This reduction in the budget deficit was caused primarily by the 29.7 percent growth in FBR revenues, on the back of increased tax collection efforts and higher revenues from imports. Non-tax revenues also recorded impressive growth of 50.4 percent.[3] However, on the basis of seasonal trend in FBR revenues, the amount collected up to end-Dec 2011, falls short of the amount needed to meet the annual target of Rs 1,952.3 billion.[4] Meeting end-year revenue targets would also depend upon the realization of CSF and sale of 3G licences (around Rs 150.0 billion), in absence of which, it would be difficult for the government to contain the fiscal deficit within its annual target.[5]

Moreover, the federal government has budgeted a surplus of Rs 125.0 billion on part of provinces, however, due to 52.8 percent increase in their expenditures, provinces managed only Rs 11.6 billion surplus up to Q1-FY12, which was 85.7 percent lower than the corresponding period last year. Any short fall in the contribution by the provinces would make achievement of the fiscal deficit target more challenging.

Lack of external funding has put the burden of financing the deficit disproportionately on the banking system, which has led to crowding out of private sector and is acting as a disincentive for banks to perform their role of financial intermediation. Government borrowing from the banking system up to end-Nov 2011 was Rs 736.8 billion, against Rs 336.1 billion in the corresponding period last year. This amount includes Rs 391.0 billion borrowed from the banks to retire PSE debt, which has now been transferred on to the government's books. Unfortunately, PSEs continue to hemorrhage as a credible restructuring plan has not been put into action. As a result circular debt issue is likely to persist.

The government's efforts to keep its borrowing from SBP in check during the initial months of FY12, helped in keeping demand-driven inflationary pressures at bay, which was supplemented by the easing of food prices. As a result, YoY CPI inflation declined to single digits (9.7 percent) in Dec 2011 after remaining in

[3] During Q1-FY12, major increase in non-tax revenues was recorded on account of increase in transfer of SBP profits, dividend income on government investments and miscellaneous receipts (license fees, sale proceeds of assets etc.). Non-tax revenues are generally more volatile than tax revenues.
[4] As per FBR data, Rs 840.1 billion has been collected up to end-Dec 2011.
[5] In the budget 2012, government announced fiscal deficit target of 4.0 percent, which was later raised to 4.7 percent to incorporate the impact of flood-related expenditures and expected short fall in revenues.

double digits for the last two years. While the increase in energy prices, recent weakening of the Pak Rupee and the base effect may increase inflation in the coming months, the end-year average inflation is likely to fall close to 12.0 percent as projected earlier.

While SBP has shown its willingness to relax its policy to support the private sector as it did in Jul and Oct 2011, it cannot add to the stress on the economy arising from weaknesses in other sectors. The most recent policy decision to keep the policy rate unchanged was influenced among others, by the weakness in external accounts during Q1-FY12.

Pakistan was fortunate in FY11 that its current account ended up in a surplus and, despite the drying up of FDI and other foreign investments; there was a net increase in its FX reserves. Given the rigidities in the trade account and the vulnerability of the financial account, sustaining this performance in FY12 was always going to be difficult. Nevertheless, the pace at which the current account deteriorated during the first quarter of FY12 took many by surprise. Specifically, the current account deficit for Sep 2011 alone was over US$ 1.0 billion.

In the past, Pakistan has sustained larger current account deficits without losing its foreign reserves due to healthy inflows in the financial account. Unfortunately, owing to both domestic weaknesses and the international financial upheaval, financial flows have almost dried up, adding to the country's economic vulnerability. While some financial inflows are expected, a part of the current account deficit is likely to be financed through reserves as was the case during Jul-Oct FY12. This has important implications for monetary management and price stability.

The government is, however, optimistic that the 3G telecom license fee will be realized. In addition, due to recent developments, there is still optimism that parts of the CSF, bilateral assistance from the US, and the privatization proceeds of PTCL will be received. Furthermore, currency swap arrangements, which were recently formalized with the central banks of Turkey and China, will also facilitate bilateral trade and investment, easing the stress on the country's reserves.

Nevertheless, SBP remains vigilant that pressure on the Rupee is not translated into market speculation, which could become self-fulfilling. Striking a balance in managing a flexible exchange rate driven by economic fundamentals *and* by market speculation (within the context of sharp currency movements in the global economy) is challenging. SBP will continue to monitor the forex market closely to remove any excessive volatility in the Rupee.

2 Real Sector

2.1 Overview

The initial months of FY12 challenged the key assumptions on which this year's growth target rested: continuation of post-flood revival, firm global commodity prices, and back-up electricity supply arrangements by industries.[6] Firstly, 2010 flood recovery was interrupted by another flood in Q1-FY12, which caused considerable damage to cotton crop in Sindh. This was followed by an outbreak of dengue fever in Punjab which disrupted economic activity for about a month. Furthermore, global prices of agricultural commodities softened significantly to the disappointment of farmers. Moreover, industries found it difficult to run gas or furnace oil based captive power plants, in the wake of gas shortages and high oil prices. With this backdrop, realizing the 4.2 percent growth target for FY12 GDP looks difficult **(Table 2.1)**.

Table 2.1: GDP Growth Targets for FY12
percent

	FY11	FY12[T]
Agriculture	1.2	3.4
Major crops	-4.0	3.0
Industry	-0.1	3.1
LSM	1.0	2.0
Construction	0.8	2.5
Services	4.1	5.0
Wholesale, retail and trade	3.9	5.0
GDP	2.4	4.2

Source: Planning Commission, Annual Plan 2011-12

Agriculture is facing many challenges this year: flood damage to *kharif* crops; taxation on inputs (which has reduced margins); decline in global commodity prices; and low credit availability. Although the increase in support price is likely to help wheat production, we fear that low global prices may make it hard to offload stocks that are procured by PSEs and provincial governments. In this regard, there is a dire need to improve supply chains, build storage facilities for grains, and develop market-based solutions to hedge against price fluctuation.

Agriculture-related manufacturing also requires well thought out policies. For instance, the fertilizer sector needs to be monitored more carefully. High fertilizer prices coupled with low agri credit availability created liquidity constraints, which in turn led to a sharp decline in tractor sales. This liquidity impact could have

[6] In the Annual Plan FY12, one of the assumptions on which the Planning Commission has based manufacturing growth projection was that captive power plants (CPP) will make up for electricity load-shedding faced by industries. However, the CPPs are run on gas or furnace oil, neither of which seem to be viable alternate fuels in the current scenario.

been minimized had it been complemented by more liberal lending by commercial banks.

Manufacturing sector looks better placed with increase in demand for consumer and intermediate goods (food, fertilizers, POL, pharmaceuticals, consumer vehicles, and cement). However, growth may be hard to sustain. Fears of another global recession have already led to a fall in textile export demand. Furthermore, gas shortages will constrain output in many industries.

A revival in construction may also be difficult on account of sales tax on the already anemic sector in Sindh, and high building material prices. Due to irregular domestic production, steel and glass demand is largely being met via imports which are costlier. Cement prices remain inexplicably high.[7]

Investment growth is a key ingredient for economic revival. In our view, power and transport infrastructure should have top investment priority. Although there have been some encouraging developments on this front – construction plans for new dams, a gas pipeline from Iran, and some bridges and highways projects are now being more seriously considered – but in most cases, progress has been very limited. Moreover, the private sector must also upgrade their production facilities in order to become more energy efficient. In this regard, progress is being made in some manufacturing industries, for example cement manufacturers are constructing tyre-derived fuel facilities, while the country's major soda ash producer is setting-up coal fired boilers to reduce energy-related costs.

2.2 Agriculture Sector Performance[8]

The initial assessment indicates major losses to cotton due to floods in Central and Southern Sindh. However, improved water availability, introduction of better yielding variety of rice, and the increase in wheat support price, are likely to help agriculture sector achieve its target for FY12.

Cotton

The cotton crop target of 12.8 million bales was fairly conservative compared to initial estimates of around 15.0 million bales. Unfortunately, the expected gains

[7] Cement prices increased by 17.3 percent YoY during Jul-Nov FY12 despite a reduction on cement taxes and only 10.7 percent increase in local coal prices during the period.

[8] FY12 is the first performance year of this sector following the devolution of the Ministry of Food and Agriculture to provinces under the 18th Amendment. The absence of centralized planning and monitoring body has widened the information gap particularly on estimates of major crops.

from the bumper crop were lost due to the floods.[9] According to the Cotton Crop Assessment Committee, cotton production in the current season would be 12.6 million bales.[10]

Rice

The harvesting of *irri* rice in Sindh and Punjab is generally completed by mid-Oct, whereas harvesting of basmati rice continues till mid-Nov. Flood-related damage to rice is likely to be limited as most of the rice (around 70 percent of the rice in Sindh) is produced in the upper region which remained unaffected by the floods. According to the report by Suparco, the rice crop has benefitted from substitution of *irri* rice with better yielding hybrid varieties,[11] improved water availability and rich soil moisture. The expected rice production is over 7.0 million tons compared to 4.8 million tons produced last year.

Table 2.2: Growth in Agriculture
percent

	Share in agri VA	Growth in FY11	Target for FY12
Agriculture		**1.2**	**3.4**
Major crops	31.0	-4.0	3.0
Minor crops	11.0	4.8	2.0
Livestock	55.0	3.7	4.0
Fishing		1.9	2.0
Forestry		-0.4	-1.0

Source: Planning Commission, Annual Plan 2011-12

Sugarcane

Flood-related losses to sugarcane are expected to remain low, as the crop is relatively resilient to flooding. According to Suparco, the expected sugarcane production is 53.9 million tones.[12]

Table 2.3: Major crops
production (million tons; cotton in million bales of 170.0 kg each)

	Share in major crops VA	FY11^{P}	FY12^{T}	Estimates[1]
Rice	42.3%	4.8	6.6	7.2
Cotton	22.3%	11.6	12.8	12.2[2]
Sugarcane	11.7%	55.3	57.6	53.9
Wheat	14.2%	24.2	25.0	--

1. Estimates by Suparco
2. Estimates of Cotton Crop Assessment Committee are 12.6 mln bales
T. Planning Commission, Annual Plan 2011-12

However, sugarcane growers are facing problems as mills again delayed sugarcane crushing till mid-Nov 2011. Under the Sugarcane Factory Act 1950,

[9] Estimated production losses due to floods are 2.2 million bales (see SBP's Annual Report for 2010-11 for more details).

[10] The numbers on cotton arrival released by Pakistan Cotton Ginner Association show a YoY increase of 17.5 percent in cotton arrival up to 1st Jan 2012. If this trend continues, the expected cotton crop size may reach 13 million bales.

[11] The productivity of these hybrids is around 7,000-8,000 kg per ha against 3,000-4,000 kg per ha in conventional irri variety.

[12] This estimate is significantly lower than 60 million tones production estimates provided by the Pakistan Sugar Mills Association.

the crushing of sugarcane is supposed to start in Oct each year. This delay is costly for farmers as: (a) prolonged exposure of sugarcane to flood water in Sindh, deteriorates the crop quality; (b) farmers remain cash-strapped for a longer period; and (c) in some areas, farmers were unable to switch to wheat as their fields were not available.

In this context, government has allowed Trading Corporation of Pakistan (TCP) to procure 200,000 tons sugar from mills. This decision would considerably ease liquidity constraints of sugar mills.

Wheat

The most important development is the increase in the wheat support price to Rs 1,050 from Rs 950 per 40 kg. The wheat crop is currently in its sowing stage, and we expect the higher support price to encourage growers to increase yields and also bring more area under cultivation.[13] The crop outlook also benefits from better availability of water.

However, this rise in support prices only partially compensates farmers against the steep rise in the cost of inputs (including seeds, fertilizers, pesticides and electricity) during the past three years **(Table 2.4)**. Hence it will be safe to assume that this increase may not re-ignite rural demand on a scale that was observed following the price adjustment in Oct 2008.[14]

Table 2.4: Estimated Cost of Wheat Production

Rs per 40 Kg

Average cost of FY09 crop	667.6[1]
Support price for FY09 crop	950.0
Margin (percent)	42.3
Average cost of FY12 crop	950.0[2]
Support price for FY12 crop	1,050.0
Margin (percent)	10.4

1. Agriculture Policy Institute
2. Assumes 13 percent increase over cost of FY11 crop

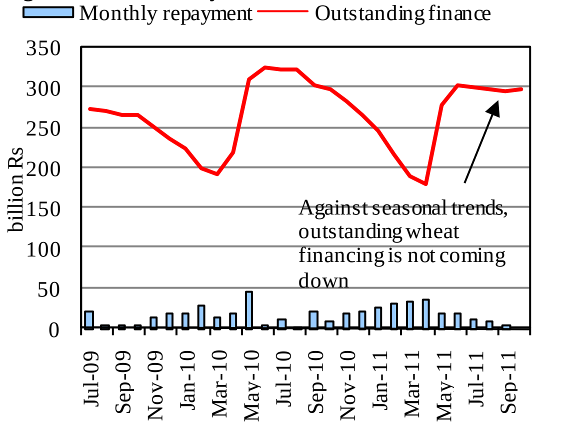
Having said this, the revised wheat support price is much higher than prevailing prices in the international market.[15] On top of this, the outlook is that global

[13] A case in point is the 2008 wheat crop when delays in the announcement of support price till end-Mar 2008 contributed to a sharp decline in the wheat production. In the next crop however, a steep rise in support prices before the sowing provided a boost to wheat production which crossed the 24 million tones mark for the first time in country’s history.
[14] The size of price increase in 2008 was exorbitant (i.e., 52 percent increase from Rs 625 to Rs 950/40 kg). This not only led to a windfall gains to farmers as their profit margins rose substantially, but also provided a considerable boost to consumer demand in rural areas (as reflected in swelled demand for automobiles, motorcycles and other consumer items).
[15] After conversion in Pak-Rupee, the spot price of wheat in Chicago Board of Trade (CBOT) is around Rs 760 per 40 kg as on 8th Dec 2011.

wheat prices would remain depressed during the 2012 crop season, as global production is likely to be higher than initially thought.

In view of this, setting the procurement target for the upcoming crop would be quite challenging. Not only will the government be pressured to set a higher procurement target, on-selling the surplus wheat (either in the domestic or international markets) would not be possible without incurring fiscal losses.[16] It may be noted that the government is already struggling to settle the outstanding obligations from previous years **(Figure 2.1)**.[17,18]

Figure 2.1: Commodity Finance for Wheat



Source: State Bank of Pakistan

2.3 Large-Scale Manufacturing

*The computation methodology for the large-scale manufacturing index has been revised this year. The index has been rebased, new industries have been added, and industry weights have been revised **(Box 2.1.)***

The LSM recorded a growth of 2.1 percent during Jul-Oct FY12 in contrast to 2.9 percent decline recorded in the corresponding period last year.

Box 2.1: The Rebased Index in Perspective

The Federal Bureau of Statistics (FBS) revises the computation methodology of quantum index of manufacturing – the index that measures movement in LSM – roughly after every decade to integrate changes in industrial trends. The changes made in the index this year include: (i) rebasing from FY00 to FY06, (ii) inclusion of nine new industries, (iii) exclusion of one redundant industry (cotton ginning), (iv) re-classification of industry sectors, and (v) reallocation of weights **(Table 2.1.1)**.

[16] Since the expected crop will be higher than domestic consumption of around 22 million tons, farmers will insist on the government to procure surplus wheat to prevent a fall in the price.

[17] Though borrowings for commodity operations are self-liquidating, the outstanding level of wheat financing is persistently high. Furthermore, against the norm when repayment of commodity loans picks up in Sept every year, the pace of repayment this year is very low.

[18] We feel that banks would be willing to fund the additional borrowing demand for wheat procurement as long as they can charge higher spreads over Kibor.

For analysts such changes sometimes create difficulties. For instance, rebasing has marginally deteriorated growth numbers for the past two years **(Figure 2.1.1)**. Major downward revisions in Q1-FY11 growth rates of some key industries – fertilizer, leather, chemicals, electronics, pharmaceuticals, and automobiles – also creates doubts about our assessment about these sectors at that time. In short, perception and reality are hard to delineate.

If last year was actually worse than earlier deemed, it implies that in absolute terms the industry is still *behind* FY10 production levels. This is corroborated by the fact that the QIM index value in Jul-Oct-FY12 is 3.1 percent lower than the value recorded in Jul-Oct-FY10. It is much further behind the pre-recession levels of FY09 and FY08.

To conclude, we believe that it would not be judicious to compare LSM performance based on the new index against the official growth target of 2.0 percent. In simple terms, target is the number obtained by setting desired production levels and computing the growth against previous year's actual production. Now, this year's target was based on the old FY11 growth number of 1.1 percent. According to the new methodology, FY11 growth was actually 0.01 percent. In our view, plugging in the earlier desired production levels in the new LSM setup may yield a higher target. In this regard, the Planning Commission may be expected to update the benchmark growth.

Table 2.1.1: Revision of LSM Weights

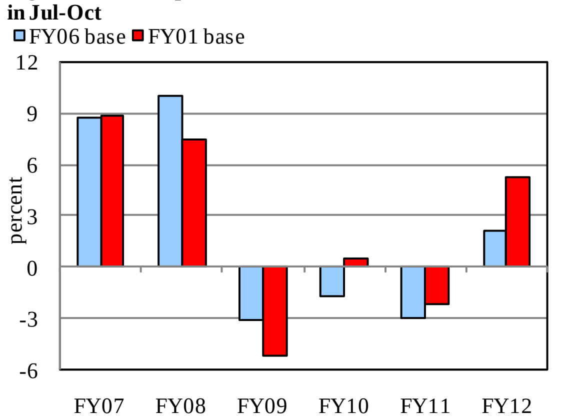
percent

Industry	Revised	Old
Textile	29.7	35.1
Food, beverages, & tobacco	17.5	19.1
Petroleum	7.8	6.9
Steel	7.6	4.6
Non-metallic minerals	7.6	5.5
Automobiles	6.5	5.2
Fertilizers	6.3	4.5
Pharmaceuticals	5.1	6.7
Paper	3.2	0.8
Electronics	2.7	3.3
Chemicals	2.3	3.8
Leather products	1.2	3.0
Wood	0.8	0.0
Engineering	0.5	0.5
Rubber products	0.3	0.4
Overall LSM	100	100

*Adjusted to 100.

Source: Pakistan Bureau of Statistics

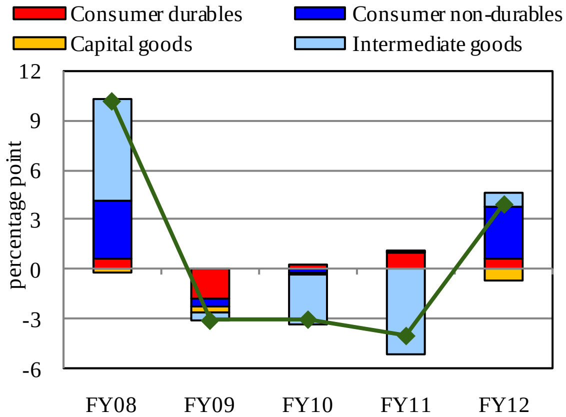
Figure 2.1.1: Comparison of Old and Rebased QIM Growth in Jul-Oct



Source: Pakistan Bureau of Statistics

Growth was mainly led by consumer goods, with food and pharmaceuticals showing the strongest contribution. Intermediate goods – building materials, fertilizers, industrial chemicals, petroleum products, and other raw material – posted a welcome recovery. However, revival is not yet seen in capital goods, which continued to post declining production for the fourth consecutive quarter **(Figure 2.2)**. In overall terms, the following factors helped LSM:

Figure 2.2: Contribution to LSM Growth in Q1



Source:Pakistan Bureau of Statistics

1. Fiscal policy was supportive. Reduction in duties on beverages, automobiles, cement, and air conditioners as well as across-the-board reduction in the sales tax, helped manufacturers absorb fluctuations in input prices.[19] The yellow cab employment scheme of the Punjab government, also contributed to vehicle sales.
2. Gross margins improved for some industries. For instance, the global refining margins for POL sector improved; textile benefitted from lower prices of raw cotton in the wake of higher arrivals this season as well as lower global prices; and a decline in global coal prices led to better profits for the cement industry. A similar trend was observed in the pharmaceutical and wheat milling.
3. It appears that vegetable oil & ghee, cigarette, tea, and tyre manufacturers may have compromised profit margins to compete with the informal sector and smuggled substitutes.
4. Rural demand fared well despite the 16 percent sales tax on agricultural inputs. Demand for fertilizers and small farm implements remained intact.[20] Anecdotal evidence however suggests resource reallocation away from investment in tractors in response to high fertilizer prices. This drift was

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[19] FED on beverages was reduced from 12 percent to 6 percent; cement FED brought down from Rs 700/Mt to Rs 500/MT; 10 percent FED on deep freezers and air conditioners was slashed; 2.5 percent SED (Special Excise Duty) on automobiles was eliminated. Overall sales tax was brought down from 17 percent to 16 percent.

[20] Combined fertilizer off-take of urea and DAP grew by 13.4 percent YoY during Jul-Oct FY12, compared to 19.1 percent decline in Jul-Oct FY11, despite 62.1 percent average hike in fertilizer prices YoY during the period.

further reinforced by higher after-tax tractor prices and lower credit availability.

5. A marginal improvement in export demand for value-added textiles and leather helped these industries.

However, this growth may not be sustained as the LSM sector is expected to face many challenges in the coming months. Some of this growth is driven by a base effect, following the floods of FY11; specifically, POL, cement and leather.[21]

This phenomenon also affected other industries as rural demand fell and supply chains were damaged. In Q2-FY12, these industries will be compared to more 'normalized' production levels of last year, which is already reflecting in Oct FY12 growth.

The growth impact following the Federal Budget for FY12 must also be carefully evaluated, especially in the case of durable goods. Consumers generally hold off purchases in expectation of favorable tax adjustments, and rush to buy immediately after the budget. Therefore, Q1-FY12 sales include some carry-forward demand from last year.

Furthermore, global demand has declined amid fears of another recession, which could affect textiles. Apparently, manufacturers did not expect prices to fall by this proportion. Specifically, some textile processing mills purchased large quantities of grey cloth when prices were high in Q4-FY11 and early FY12, expecting demand for their output to remain stable. But now that cotton prices have fallen sharply, they are finding it difficult to offload inventories – this has adversely impacted the demand for upstream commodities. Reportedly, ginners are asking the government to intervene in the cotton market in order to keep prices from falling further. Fluctuations in cotton and yarn prices, coupled with rampant energy outages and uncertain global demand has made textile manufacturing an extremely challenging business lately. Therefore, investors are shying away from it; and are instead focusing on textile retailing **(Box 2.2)**.

On the supply side, the winter quarter will prove difficult for a number of industries running on natural gas, as household demand for gas will increase. Textile, fertilizer, vegetable oil & ghee, soda ash, glass, and steel will be hardest hit. Encouragingly, the soda ash industry is setting up coal-fired boilers to replace gas which will prove to be cheaper and more reliable in the long run – other

[21] The heavy monsoon in Q1-FY11 led to flooding of a major petroleum refinery, virtually complete freeze in construction, and livestock losses which affected hides and skins supply to leather industry.

industries facing gas shortages could take a cue from this sector. Lastly, automobile sector could face shortages of parts due to flooding in Thailand, which is the hub of auto parts trade in the region.

Box. 2.2: New Investments in Textile: a Shift from Manufacturing to Services
Despite adverse business conditions, investment appeal of textile sector is sustained in recent years; however, the dynamics of new investments have changed noticeably.[22] At a time when manufacturing appears an inauspicious business due to severe energy shortages and unfavorable export prospects, retailing has emerged as a promising avenue.

A small survey of a sample of textile firms registered with SECP during 2007-2011 shows that most of the new investments are self funded, smaller in size and largely concentrated in the retailing business.[23] The attractive margins in the retail business are in fact pulling in other businessmen besides manufacturers[24]

One obvious reason for the greater interest in retail business, besides low capital expenditures, is the disincentive that the textile manufacturers face due to persistent energy shortages and lackluster global demand.[25] In addition, a growing population with increasing awareness and brand consciousness is a major incentive for a thriving retail business in recent years

We must however not overlook the critical role of supply side responsiveness. In previous few years, the sector has taken major strides in the fields of product development and marketing; new products have entered market as per changing consumer preferences, new brands have flown in; and consumers got acquainted with the concept of complete textile stores.

Interestingly, the market for used textile products has also grown in recent years. Growth of clothing import increased tremendously during the period 2006-2010 – CAGR of 21.1 percent during the period compared with CAGR of 10.9 percent in 2003-2006. As a result, Pakistan has become 2nd largest importer of used/worn clothing by Dec 2010; up five notches since 2003.[26]

The higher demand for used clothing was expected from low-income segment of the society as they are burdened more due to rising inflation and escalating cost of fabrics. Surprisingly, middle to high income groups are also buying used clothing. Anecdotal evidence suggests that good quality products (mainly branded clothing and accessories) are sold in exclusive *Sunday bazaars* and other up markets.

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[22] During 2007-11, 484 firms were registered with SECP. Though the number is low compared with preceding five years; we still consider it decent given tough business conditions during most of this period (we understand that of these, many firms were already existed and operating in 1990s but got registered only recently).
[23] The survey conducted by SBP is based on randomly selected 70 textile-related firms (22 in Karachi, 20 each in Lahore and Faisalabad; 4 in Multan and 2 in Sialkot) registered with SECP during 2007-2011.
[24] Around one-third of the surveyed firms were in business of retailing – importing branded clothes and selling in local market.
[25] Around 15 percent of respondents also informed us that after having registered in those years, machinery has not started production yet due to different reasons; prominent being non-availability of gas and power.
[26] Russia is the world's largest importer of this category.

With increasing penetration of textiles, complementary industries (ranging from basic textile services to local advertisers and event managers) are also flourishing.

1. We observe growth in basic textile services including dyeing and printing followed by embroidery and tailoring services. For instance, tailoring charges alone have inflated by 30 percent in previous 3 years as per FBS data that signifies strong demand. Similarly, new firms focusing exclusively on embroidery are opening up. We could identify at least 3 of such firms that got registered with SECP only in FY11.

2. Anecdotal evidence suggests that a large number of women in every segment of society have taken up dress designing as their key business, employing a large number of dyers, printers, tailors, etc. These designers supply not only in domestic market but have also found niche overseas.

3. On a more macro level, the growing liaison of textile and domestic fashion industry has added tremendous business for domestic advertising and event management industry.

Conclusions

Domestic textile industry has been reshaped in recent years with growing scope and depth in terms of products, business strategies and penetration in services industry. Given a larger employment intensity of services sector, we believe that the sector's contribution in domestic economy and employment has further increased. But no matter how obvious the growth is, we unfortunately cannot measure it since the large part of the sector is undocumented.

More disturbing is investors' disinterest in textile manufacturing which calls for drastic steps to encourage them. Certainly pessimism regarding global demand is a major issue hurting investment prospects in textiles; we believe that energy supplies is the most dominant factor in discouraging additional investments in the sector, as well as disinvestments.

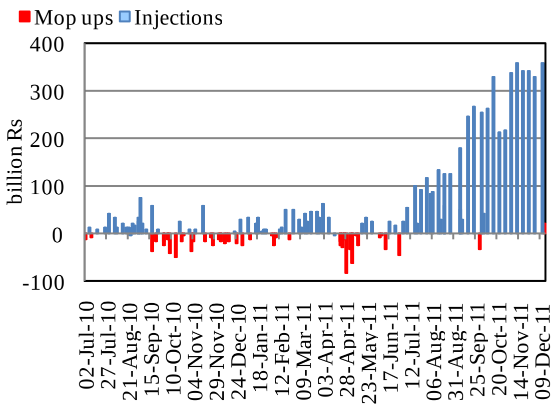
3 Inflation and Monetary Policy

3.1 Monetary Policy

SBP's decision to ease its monetary policy stance in Jul and Oct 2011 was influenced by a combination of gradual decline in headline inflation, comfort in the current account balance, and the government's efforts to contain its inflationary borrowing. SBP's policy rate was reduced by a cumulative 200 bps to 12.0 percent. While this monetary easing was expected to help stimulate economic activities in the economy, risks emerging from external sector were acknowledged; resultantly policy rate was kept on hold in Nov 2011.

A reflection of external sector deterioration is clearly visible from US$ 1.9 billion reduction in SBP's liquid foreign exchange reserves from Jul to Nov 2011. Accordingly, net foreign assets (NFA) of the banking system saw a contraction of Rs 140.5 billion over the same period, against an expansion of Rs 60.8 billion in the previous year **(Table 3.1)**. This, along with heavy reliance of the government on domestic sources for its budgetary finance, has complicated liquidity management. Since the depletion of FX reserves drains domestic liquidity, SBP was forced to inject liquidity through its open market operations, which had reached over Rs 300 billion in recent weeks **(Figure 3.1)**.

Figure 3.1: Open Market Operations of SBP



Source: State Bank of Pakistan

Stepping back, the massive rise of Rs 736.8 billion in net budgetary borrowing over the period of analysis, merits explanation **(Table 3.1)**. Details indicate that 53.1 percent (Rs 391 billion) of the increase in net budgetary borrowing is attributed to the issuance of government securities to settle the circular debt originating in the energy sector and commodity operations. Adjusting for this one-off shift in PSEs' borrowing to the government account, reveals that net budgetary borrowing for this year stood at Rs 345.8 billion, which was slightly higher than the previous year.

Within the banking system, the government relied heavily on borrowing from commercial banks. While this is a welcome development from the inflationary perspective, it may crowd out the private sector. Monthly data up to Nov 2011 indicates that overall credit to private sector witnessed an expansion of 2.5 percent during Jul-Nov FY12 compared to 2.3 percent over the same period previous year. This expansion is primarily driven by increase in banks' investments as loans to private sector businesses saw a contraction of Rs 9.1 billion (during Jul- Nov FY12), in contrast to an expansion of Rs 73.6 billion during the same period last year.[27] Having said this, it is important to note that demand for private sector credit is understandably low due to number of factors including: (a) massive decline in cotton prices compared to previous year; (b) delayed crushing season by sugar mills; and (c) little demand for fixed investment loans as there is excess capacity in the industrial sector.[28] However, provisional weekly data shows that credit to private sector is picking up in recent weeks.

Table 3.1:Monetary Aggregates (Jul-Nov)
flows in billion Rupees, growth in percent

	Flows		Growth rates	
	FY11	**FY12**	**FY11**	**FY12**
Broad money (M2)	305.9	154.4	5.3	2.3
NFA	60.8	-140.5	11.2	-18.0
SBP	31.9	-122.5	8.4	-19.9
Scheduled banks	28.9	-18.1	17.4	-10.9
NDA	245.1	295.0	4.7	5.0
SBP	221.6	267.9	22.4	25.8
Scheduled banks	23.5	27.0	0.6	0.6
of which				
Government borrowing	302.4	652.3	12.4	21.6
For budgetary support	336.1	736.8	16.7	28.3
SBP	274.7	71.8	22.7	6.0
Scheduled banks	61.3	665.0	7.6	47.5
Commodity operations	-35.2	-82.6	-8.5	-20.8
Non government sector	42.2	-198.3	1.2	-5.6
Credit to private sector	68.8	78.1	2.3	2.5
Credit to PSEs	-27.3	-276.7	-7.8	-71.4
Other items net	-99.6	-159.1	16.7	24.4

Source: State Bank of Pakistan

Besides lending to the government, the volume of loanable funds with the banking system is also constrained by slow growth in bank deposits. This is evident from the change in monetary aggregates, as growth in broad money was only 2.3 percent during Jul-Nov FY12, decelerated from 5.3 percent during the same period last year. These developments helped contain inflationary pressures. Year-on year inflation has declined to 9.7 percent in Dec 2011 compared to 13.3 percent in Jun 2011.

[27] One of the largest bank invested Rs 25 billion in non-bank financial institutions.
[28] Moreover, banks are hesitant to lend to the private sector (especially SMEs sector) due to heightened credit risk. This further reduces the supply of credit to the private sector.

Therefore, the end-year average inflation is likely to fall close to 12.0 percent as projected earlier.

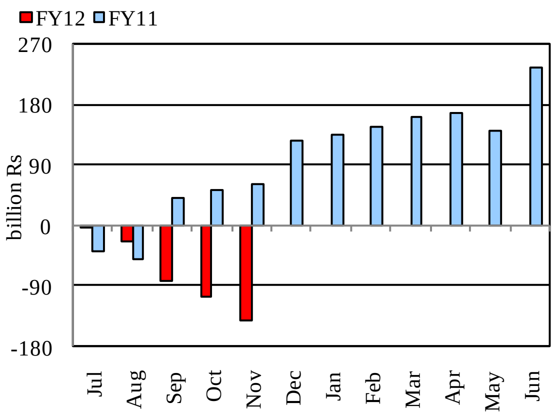
3.2 Developments in Monetary Aggregates

Changes in monetary aggregates during Jul-Nov FY12 are primarily driven by the deteriorating external accounts. Specifically, Net Foreign Assets (NFA) witnessed a contraction of 18.0 percent so far this year, against an expansion of 11.2 percent in the previous year **(Table 3.1)**. This sharp reversal led to deceleration in broad money (M2) growth as the expansion in net demotic assets (NDA) remained almost the same as in the last year.

Net Foreign Assets (NFA)

Composition of NFA reveals that the depletion in foreign assets primarily came from the central bank **(Figure 3.2).** In the absence of external inflows from the IFIs and official grants, SBP had to finance a portion of the current account deficit from its reserves.

Figure 3.2: Cumulative Flows of Overall NFA



Source: State Bank of Pakistan

NFA of scheduled banks also remained under pressure during Jul-Nov FY12. Specifically, in contrast to the expansion of Rs 28.9 billion in the previous year, it saw a contraction of Rs 18.1 billion so far this year. This is largely because of the widening trade deficit coupled with declining private inflows.

Net Domestic Assets (NDA)

NDA of the banking system grew by 5.0 percent during Jul- Nov FY12 compared with 4.7 percent in the corresponding period last year. Two developments in NDA growth remained prominent: (1) shifting of PSEs circular debt to the government account; and (2) continued government reliance on commercial banks for its budgetary financing.

Government Borrowing for Budgetary Support

Realizing the inflationary implications of central bank financing, the government contained its borrowing from SBP. Specifically, the government borrowed only

Rs 71.8 billion from SBP during Jul-Nov FY12, against Rs 274.7 billion in FY11 **(Figure 3.3a)**.

Figure 3.3a: Budgetary Borrowing from the Banking System (Cumulative flows)

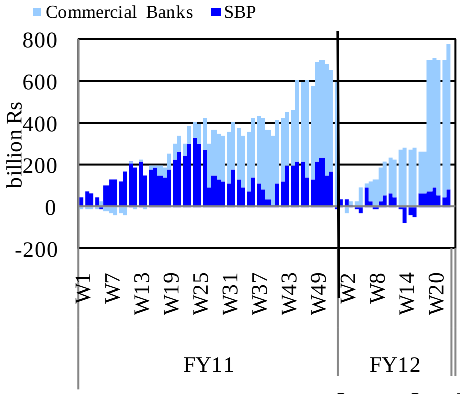
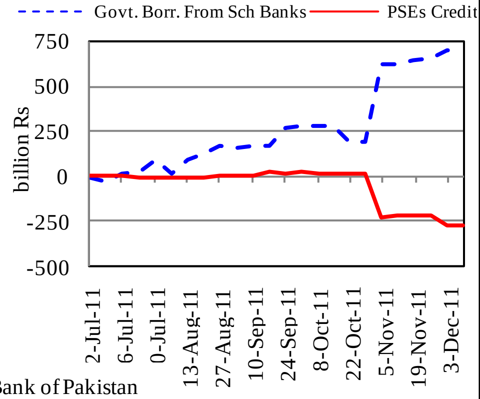


Figure 3.3b: Credit Adjustments in Different Accounts (Cumulative flows)



Source: State Bank of Pakistan

Meanwhile, most of the budgetary needs were met from the commercial banks. The most important development came in the week ended on 4th Nov 2011, when the government borrowed Rs 431.6 billion in one week. As stated earlier, this huge borrowing was made to clean the balance sheet of cash strapped PSEs and public procurement agencies (like TCP, PASSCO); resultantly PSEs retired Rs 251.2 billion and procurement agencies retired Rs 78.7 billion to commercial banks **(Figure 3.3b)**.[29] In other words, this adjustment has little immediate monetary impact. However, now the PSEs have more room to borrow from the commercial banks, which may pick up in coming months.

Table 3.2: Commodity Dues Accrued by the Government (Outstanding Stocks)
billion Rupees

	TCP		PASSCO
	Fertilizer	Sugar	Paddy
As on 31st Oct 2011	52.4	32.5	10.5
As on 25th Nov 2011	7.3	15.0	0.0
Settled amount	-45.1	-17.5	-10.5

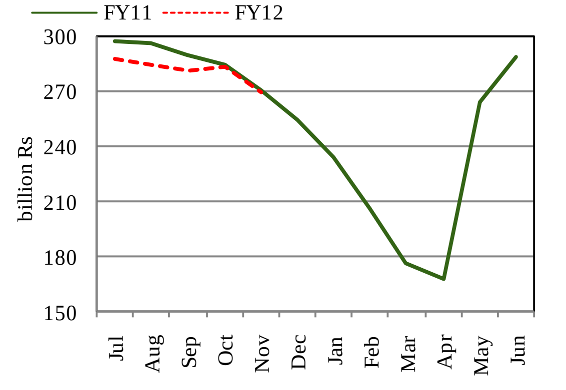
Source: State Bank of Pakistan

Beside these accounting treatments, commercial banks were able to finance the budgetary requirements of Rs 274.0 billion during Jul-Nov FY12. From the non-bank domestic source (NSS), the government borrowed Rs 77.1 billion till Nov 2011 compared to Rs 66.5

[29] The government transferred the debt of state owned energy entities mainly included Power holding company, WAPDA and NTDC.

billion during the same period last year; whereas it faced constraints in securing any significant funding from external sources.

Figure 3.4: Outstanding Stock of Wheat Advances (Excluding TCP- stocks)



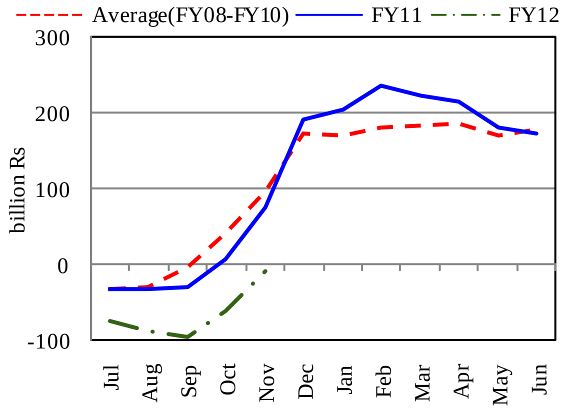
Source: State Bank of Pakistan

Prior to debt settlement, public sector enterprises borrowed Rs 19.4 billion during Jul-Oct FY12, in contrast to a retirement of Rs 26.0 billion in the corresponding period last year. Most of this increase came for working capital loans availed by cash strapped public sector oil and electricity distribution companies.

Commodity Finance

Commodity financing experienced net retirment of Rs 82.6 billion during Jul-Nov FY12, compared to Rs 35.2 billion over the same period last year. The strong retirement in FY12 was largely driven by the release of price differential subsidies to the procurement agencies by the government. Within procurementment agencies, Trading Corporation of Pakistan (TCP) alone retired Rs 62.6 billion to commercial banks as its receivable on account of subsidies were settled by the government. TCP now owes Rs 45.6 billion to commercial banks compared to its outstanding loans of Rs 97.1 billion as on 30th Jun 2011. The government also settled subsidy of Rs 10.5 billion to PASSCO, accrued earlier for the procurement of the paddy **(Table 3.2)**. Retiring commodity loans facilitates the procurement agencies by creating the financing room for the import of fertilizer and procurement for upcomg wheat season.

Figure 3.5: Private Sector Advances (Cumulative Flows)



Source: State Bank of Pakistan

This shift will also help reduce the financial cost of borrowing, as the government switched over to low cost budgetary financing from more expensive commodity loans.

Table 3.3: The Dynamics of Wheat Advances

billion Rupees

	Stocks (end of Nov)		**Advances Flows (Jul-Nov)**		**Subsidy (Receivable)**		**Amount of Sale Proceed**	
	FY11	FY12	FY11	FY12	Nov-10	Nov-11	Nov-10	Nov-11
PASSCO	53.8	73.4	-4.8	-1.7	1.6	0.0	8.9	12.0
Punjab	179.0	155.0	-12.1	-11.6	39.2	35.5	0.0	0.0
Sindh	34.1	34.3	-7.1	-8.7	0.0	9.6	1.5	2.3
Khyber Pakhtunkhwa	3.8	6.3	-2.8	1.8	0.0	0.0	0.4	0.5
Baluchistan	0.2	0.0	-0.8	0.0	0.0	0.0	0.0	0.3
TCP	12.6	13.6	-14.1	0.9	2.7	0.0	8.7	13.6
Total	283.4	282.7	-41.7	-19.4	43.5	45.1	19.4	28.7

Source: State Bank of Pakistan

A disaggregated analysis however suggests that before this payment of subsidy dues, procurement agencies availed advances of Rs 6.8 billion during Jul-28th Oct 2011, in contrast to the retirement of Rs 24.1 billion in FY11. This was mainly on account of lower repayments under wheat advances, as well as fresh borrowing for the import of fertilizer.

Under wheat advances, the deceleration in retirement is concentrated in TCP on account of borrowing for the import of wheat during FY08-FY09 **(Figure 3.4)**. The retirement pace of other major procurement agencies, such as the food Departments of Punjab and Sindh, is largely on track and they are expected to repay the major portion of their loans before the upcoming wheat procurement season of FY12 **(Table 3.3)**. It is pertinent to note that the government has already raised the support price of wheat by Rs 100/40 Kg, i.e. from Rs 950 to Rs 1050. This elevated support price would result in higher financing requirement if the government decides to procure the same quantity of wheat as targeted in the last year.

Private Sector Loans

Unlike the previous year, growth in loans to private sector businesses remained subdued during Jul-Nov FY12. Specifically, it experienced a net retirement of Rs 9.1 billion in Jul-Nov FY12 compared to an expansion of Rs 73.6 billion in Jul-Nov FY11 **(Figure 3.5)**.

Table 3.4: Advances to Private Sector Businesses during Jul-Nov

billion Rupees

	Trade Finance		Working Capital		Fixed Investment		Total Advances	
	FY11	FY12	FY11	FY12	FY11	FY12	FY11	FY12
Private sector advances	33.2	-15.1	45	27.7	-4.7	-21.9	73.6	-9.1
Manufacturing	30.6	1.2	20	-9.2	-1.4	-7.3	49.2	-15.3
Rice processing	0.3	2.5	8.2	3.5	-1.6	0.1	7.0	6.0
Sugar	-1.3	1.0	-30.5	-46.8	1.3	-1.4	-30.5	-47.2
Textiles	15.6	-10.2	47.5	21.5	3.9	-2.3	66.9	8.9
Spinning	5.1	-2.7	36.7	14.6	-1.3	-4.1	40.5	7.8
Weaving	4.9	-1.2	7.0	-2.6	4.6	2.3	16.6	-1.6
Coke & petroleum products	-0.1	1.1	2.9	3.2	-3.6	-2.7	-0.9	1.6
Fertilizers	0.6	-0.5	-9.9	-5.1	3.5	-1.1	-5.8	-6.6
Cement	6.6	3.9	-1.7	-1.7	-1.7	-1.5	3.2	0.7
Other manufacturing	8.9	3.5	3.6	16.2	-3.1	1.6	9.3	21.3
Production of electricity	-0.8	-2.9	2.9	27.1	4.3	0.7	6.4	24.9
Construction	-0.2	0.2	2.4	-1.4	0.8	-1.1	3.0	-2.3
Commerce and trade	2.9	-4.8	13.2	-2.1	-4.8	-1.2	11.6	-8.1
Exports of finished products	-0.1	-1.0	0.0	-2.6	0.9	0.4	0.9	-3.2
Telecommunications	-0.1	-0.1	-1.9	0.9	0.6	-11.1	-1.4	-10.3
Other sectors	0.8	-8.7	8.4	12.4	-4.2	-1.9	4.8	2.1

Source: State Bank of Pakistan

The contraction in credit was broad based and visible in all three types of loans i.e., working capital, trade financing and fixed investments. Sectoral distribution also reveals that most of the retirement came from sugar, telecom and fertilizer **(Table 3.4)**.

Retirement of Seasonal Financing

It is important to note that Jul-Sep is the retirement season of the credit cycle; credit generally starts picking up from Nov onwards. Sectoral distribution of data shows that sugar, rice and textile sectors availed record working capital credit in the procurement season of FY11. Hence, repayments are more pronounced this year. For example, the textile sector retired Rs 94.6 billion during Mar-Sep 2011, whereas it availed credit of Rs 97.1 billion during Aug-10 to Feb-11.

The sugar sector also retired Rs 68.7 billion of loans during Apr-Nov 2011. However, it still owes commercial banks Rs 14.7 billion from the last crushing season. The lower repayments relative to credit-off take, may hamper fresh loaning in the crushing season of FY12, which has already commenced in the specific regions of Punjab, Sindh and Khyber Pakhtunkhwa (KP). Anecdotal evidence suggests sugar mills were unable to offload their stocks due to depressed sugar price. This affected the repayment capacity of the sugar sector.

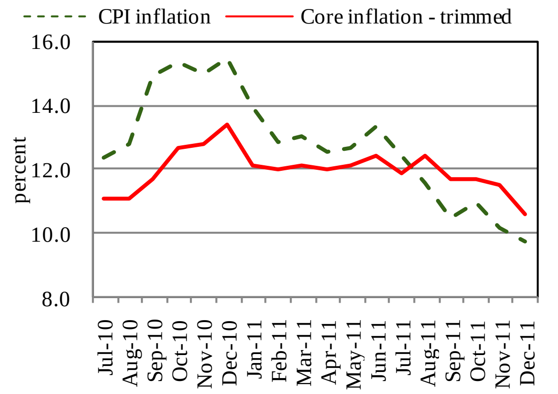
Fall in Cotton Prices Reduced Demand for Textile Credit in FY12
Following the massive decline in cotton price in international markets, domestic cotton price in FY12 are hovering around Rs 5500/40 Kg compared to Rs 8700 in the same period last year. This has substantially reduced the credit requirements of the textile sector. This sector is also reluctant to borrow due to the slowdown in global economic activities (i.e. EU and US) and intensifying electricity and gas shortages. Accordingly, the textile sector has availed only Rs 8.9 billion from the banking sector in FY12, against net borrowing of Rs 66.9 billion in FY11.

Demand for Credit in the Energy Sector
Despite broad based retirement, the power sector borrowed Rs 24.9 billion from the banking sector during Jul-Nov FY12. Hemorrhaging continues to create interagency receivables in the energy sector, which remained a primary reason for the additional borrowing requirements.

Retirement of Consumer Loans Eased
During Jul-Nov FY12, retirement in consumer loans was lower than the previous year. All categories of consumer loans, other than housing and personal loans, witnessed a slowdown in retirements - notably in auto loans.

Loan disbursements indicate that fresh consumer loans comprise of auto and personal loans. In fact, demand for auto loans revived following the change in government policy for the auto sector. Auto sales of both locally manufactured cars and motorcycles, as well as imported one, has witnessed healthy growth in FY12.

Figure 3.6: YoY CPI and Core Inflation

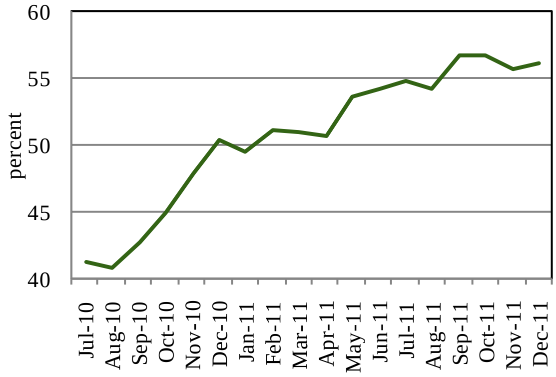


Source: Pakistan Bureau of Statistics

3.3 Inflation
Headline inflation number has been edging down consistently and core inflation, encouragingly, is following suit **(Figure 3.6)**. Food inflation has receded considerably recently and been the major contributor towards the slowdown in

inflation. However, commodities displaying double digit inflation have been above 50 percent since Feb 2011– an indication of the broad-based nature of inflation in the country (**Figure 3.7**).

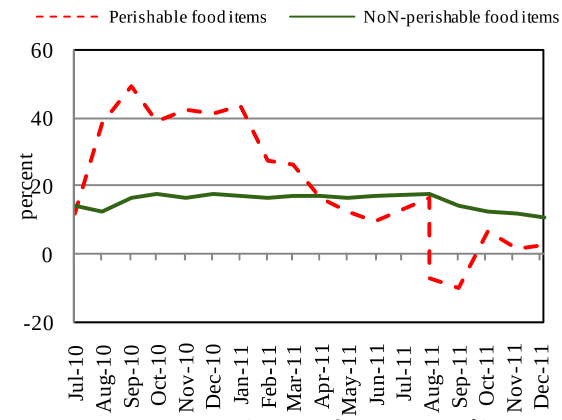
Figure 3.7: Percentage of Items Showing Double Digit Inflation



Source: SBP calculations

Core inflation is likely to recede gradually if there are no supply shocks that reinforce inflationary expectations. The key risk here is the recent deterioration of the external account and the resulting pressures on Rupee, which will increase input costs across the board.[30] Although the prices of most agricultural commodities are expected to decline in the international market, we expect the prices of crude oil and POL products to remain largely stable.

Figure 3.8: A Break up of Food Inflation (YoY)



Source: Pakistan Bureau of Statistics

Therefore, while we expect declining global prices to contribute to slower inflation, the external account position and firm POL prices may put upward pressure on prices. In such a scenario, higher energy prices, which, combined with shortages of natural gas, will lead to a steady rise in overall costs. Consequently, we believe that supply-side pressures on retail prices are unlikely to recede in the short-run.

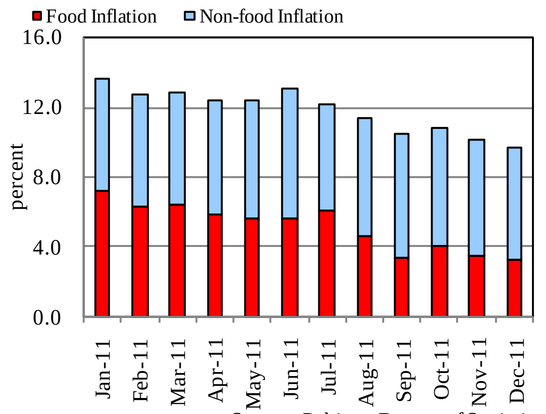
Domestic food prices, however, are expected to remain stable with: (i) a bumper crop of wheat in the offing that will suppress grain prices – despite the increase in the support price – (ii) a surplus of sugar in the market and; (iii) suppressed

[30] Inputs to industry account for roughly 70.0 percent of the country's imports.

international agriculture prices that will reduce exports and smuggling, thus shoring up domestic supply.

Within the food group, prices of perishable food items fell considerably as supply lines were restored following the floods in Sindh **(Figure 3.8)**.[31] The impact of food prices on overall inflation has been falling consistently since Jan 2011 as well **(Figure 3.9)**. Going forward, we expect food prices to remain stable on a monthly basis.

Figure 3.9: Contribution to Overall CPI Inflation



Source: Pakistan Bureau of Statistics

The prices of non-perishable and manufactured food items have been on a steady rise since Jul 2010 due to increases in the cost of production throughout the economy.[32] However, keeping in line with the decrease in the prices of perishable food commodities – which act as inputs for manufactured food items – the pace of price increases has slowed.

Ultimately, given that average CPI inflation for Jul-Dec of this year has been 10.9 percent and with the slowdown in food prices being offset by supply-side pressures and the risks emanating from the external account position, we do not expect either a significant quickening or a rapid slowdown in CPI inflation.

[31] Perishable food commodities account for 4.9 percent of the CPI basket.
[32] Prices of non-perishable food items have increased at an average of 14.1 percent for the first half of FY12 on a yearly basis.

4 Fiscal Policy and Public Debt

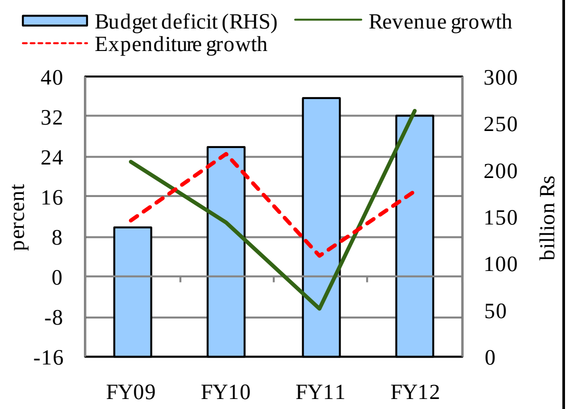
4.1 Fiscal Situation

The budget deficit in the first quarter of FY12 was 1.2 percent of GDP, compared with 1.5 percent during the same quarter of the last year **(Figure 4.1)**. The reduction in the budget deficit was caused primarily by sharp rise in tax collection on the back of increased tax collection efforts as well as high growth in taxes on imports. While expenditures also showed higher growth than the last year, the upside is that some of this growth was tilted towards development expenditures **(Table 4.1)**.

Financing of the deficit, however, remained an issue. The government could not mobilize external resources to finance the budget deficit. During the quarter, repayments of external loans were higher than receipts of new loans, resulting in net external financing of negative Rs 4.4 billion in Q1-FY12. As a result all the burden of financing fell on domestic sources.

Going forward, it will be challenging for the government to achieve its fiscal deficit

Figure 4.1: Fiscal Developments



Source: Ministry of Finance

Table 4.1: Summary of Public Finance
billion Rupees

	BE FY12	First quarter FY11	First quarter FY12	Growth (%)
Total revenue	**2870.5**	**400.1**	**533.6**	**33.4**
Tax revenue	2151.2	317.3	409.0	28.9
Non-tax receipts	719.3	82.9	124.7	50.4
Total expenditure	**3721.2**	**676.3**	**790.9**	**16.9**
Current	2976.3	566.7	656.6	15.9
Development & net lending	744.9	62.8	87.7	39.6
Unidentified	0	46.8	46.6	-0.4
Overall deficit	**850.6**	**276.2**	**257.2**	**-6.9**
Financing through:				
External resources	134.5	56.9	-4.4	
Internal resources	716.1	219.3	261.6	
Banking system	303.5	120.9	119.5	
Non-bank	412.6	98.4	142.1	
As % of GDP				
Overall fiscal deficit	4.0	1.5	1.2	
Revenue deficit	-	0.9	0.6	
Primary deficit	-	0.6	0.4	

Source: Ministry of Finance

target of 4.7 percent of GDP mainly because; (1) the strong growth in tax revenue was largely due to import related sales tax, which was supported by higher unit value of crude oil and fertilizers during the quarter; however, this gain in taxes could be offset by subsidies both on fertilizer and POL in the months ahead; (2) heavy dependence (Rs 150 billion) on the realization of CSF and 3G licences; and (3) the expected surplus of Rs 125 billion in the provincial balances. While issuances of 3G licences are scheduled for Mar 2012, the CSF and provincial surpluses are already lagging.

Revenue

The growth in overall revenue was 33.4 percent during Q1-FY12, compared with a negative growth during Q1-FY11. While the non-tax component also contributed to this growth (particularly Rs 54.0 billion transferred as SBP profit), the main contributing factor is high growth in sales tax **(Table 4.2)**. [33]

Table 4.2: Tax and Non-tax Revenues – during Q1
billion Rupees

	FY11	FY12	Abs Δ
Tax revenue	**317.3**	**409.0**	**91.7**
Direct taxes	94.4	127.6	33.2
Taxes on goods and services	156.9	204.3	47.4
Excise duty	24.4	28.8	4.4
Sales tax	132.5	175.5	43.0
Taxes on international trade	36.5	42.4	5.9
Other taxes	14.1	19.0	4.9
Petroleum levy	15.3	15.6	0.3
Nontax revenue	**82.9**	**124.7**	**41.8**
Interest and dividends	0.9	14.5	13.6
SBP profits	40.0	54.0	14.0
Defense	1.4	1.8	0.4
Development surcharge on Gas	5.0	5.7	0.7
Royalties	19.6	15.0	-4.6
Miscellaneous	15.9	33.7	17.8
Total revenue	**400.1**	**533.6**	**133.5**

Source: Ministry of Finance

Although FBR could not carry forward tax reform agenda during FY11 (except some ad hoc measures in the latter part of the year), removal of exemptions in the FY12 budget, and the tax authority's resolve to improve enforcement, helped shore up federal tax revenues.

Collections under direct tax and sales tax – which together make 81.4 percent of the total FBR revenue – grew by 30.1 and 38.6 percent, respectively. As mentioned earlier, healthy sales tax collection has been supported by higher import prices. Although detailed commodity-wise data for sales tax collection is

[33] Within non-tax revenues, the biggest increase was in SBP profit followed by interest and dividend (on government investments). There are other numerous small heads including different kinds of fees, licenses, etc. showing a combined increase of Rs 17.8 billion during Q1-FY12; the sustainability of such receipts is a question.

yet not available, we can attribute this growth to the import of two commodities – fertilizer and petroleum products.

The import of both these commodities grew by more than 50.0 percent during the first quarter. Moreover, the value of total imports also increased by 24.3 percent during Q1-FY12, compared with 10.3 percent in the same quarter last year, which also led to growth in import related taxes **(Table 4.3)**.

Table 4.3: FBR Tax Collection during Q1

	Rs billion		% Growth	
	FY11	**FY12**	**FY11**	**FY12**
Taxes on imports	**105.0**	**148.8**	**19.4**	**41.7**
Sales tax	64.0	104.1	22.7	62.8
FED	3.9	2.2	41.2	-44.0
Custom duty	37.2	42.5	12.4	14.4
Domestic taxes	**92.7**	**107.4**	**2.4**	**15.8**
Sales tax	69.7	81.2	7.4	16.4
FED	23.0	26.2	-10.2	14.1
Total indirect taxes	**197.8**	**256.3**	**10.8**	**29.6**
Direct taxes	**95.718**	**124.5**	**12.2**	**30.1**
Total tax collection	**293.5**	**380.8**	**11.2**	**29.7**

Source: Federal Board of Revenue

FBR's annual tax collection target for FY12 is Rs 1,952.3 billion, which means an additional Rs 394.3 billion over the last year tax collection. On the basis of seasonal trend in tax collection, the FBR should have collected Rs 406.4 billion in Q1-FY12 – implying a shortfall of Rs 25.6 billion. Similarly, FBR data shows tax collection of Rs 840.1 billion as of end-Dec 2011, which indicates that FBR would have to make considerable efforts to achieve the end-year target.

Table 4.4: Break-up of Expenditures during Q1

	Rs billion		% Growth	
	FY11	**FY12**	**FY11**	**FY12**
Current	**566.7**	**656.6**	**8.8**	**15.9**
Federal	**419.1**	**436.4**	**9.9**	**4.1**
General public service	274.5	292.8	3.5	6.7
Interest payments	161.6	177.3	14.2	9.7
Pension	14.3	27.9	-12.3	94.7
Grants.	44.7	47.8	-25.5	6.9
Other services	53.9	39.8	13.9	-26.1
Defense	93.1	107.2	8.1	15.1
Public orders& safety	11.9	14.5	21.6	22.2
Provincial	**147.7**	**220.2**	**5.8**	**49.1**
Development	**59.4**	**88.9**	**-65.4**	**49.7**
PSDP	43.1	78.9	-67.4	82.9
Federal	27.2	47.3	-68.3	73.7
Provincial	15.9	31.6	-65.7	98.7
Others	16.3	10.0	-58.7	-38.4

Source: Ministry of Finance

Expenditure

The devolution of a number of public services from federal to provincial governments has clearly changed the pattern of current expenditures. While the federal current expenditure grew by only 4.1 percent, provincial expenditures increased by 49.1 percent in Q1-FY12 **(Table 4.4)**. The provinces have also doubled their development spending during the quarter.

In fact, both federal and provincial governments are expected to increase outlays substantially to satisfy local constituents. Although we expect pressure on both the current and development expenditures, development spending will be welcomed as long as it adds to key physical infrastructure that support the long term growth.

Provincial fiscal operations

A glimpse of provincial finances shows that with the exception of Baluchistan, the other three provinces have posted a sharp growth in expenditure in the first quarter. As a result, the provincial surplus declined from Rs 81.3 billion in Q1-FY11 to Rs 11.6 billion in Q1-FY12.[34] While the other provinces managed a surplus, Sindh witnessed a deficit during the quarter primarily due to unexpected outlays for rehabilitation in flood-affected areas. Expenditure in other provinces also increased substantially, but those were mostly development related **(Table 4.5)**.

On the revenue side, the growth in the provincial share in federal revenue has fallen sharply. This shows the dilution of the one-off increase in provincial revenues due to the 7th NFC award last year. In terms of provinces' own resource mobilization, only Sindh presented a strong growth in tax revenue during Q1-FY12, while the tax growth in other three provinces was less than the previous year.

Table 4.5: Provincial Fiscal Operations during Q1
billion Rupees

	Punjab		Sindh		KPK		Balochistan		All provinces	
	FY11	**FY12**	**FY11**	**FY12**	**FY11**	**FY12**	**FY11**	**FY12**	**FY11**	**FY12**
Total revenue	**96.4**	**120.3**	**60.2**	**68.5**	**59.5**	**45.5**	**33.0**	**33.1**	249.1	267.4
Share in federal revenue	82.5	94.3	52.8	55.2	28.8	33.1	26.0	27.9	190.1	210.5
Taxes	8.0	9.2	5.3	8.9	0.9	0.9	0.2	0.2	14.4	19.2
Non-taxes	3.4	10.4	0.8	0.3	3.5	7.9	1.0	0.3	8.7	18.8
Federal loans and transfers	2.5	6.5	1.3	4.1	26.3	3.6	5.7	4.7	35.8	18.9
Total expenditure	**73.1**	**117.0**	**49.4**	**77.5**	**29.4**	**42.5**	**15.9**	**18.7**	**167.7**	**255.8**
Current	64.8	100.4	46.0	73.8	26.5	32.5	14.5	17.5	151.8	224.1
Development	8.3	16.6	3.4	3.8	2.9	10.1	1.4	1.2	15.9	31.6
Overall balance	**23.3**	**3.3**	**10.9**	**-9.0**	**30.1**	**3.0**	**17.1**	**14.3**	**81.3**	**11.6**

Source: Ministry of Finance

[34] The budget FY12 envisaged a surplus of Rs 125 billion on the part of provinces.

4.2 Total Debt & Liabilities

The settlement of circular debt of power sector PSEs and public procurement agencies resulted in a substantial Rs 572.2 billion increase in the stock of total debt & liabilities (TDL), during the first five months of FY12, that reached Rs 12.7 trillion **(Table 4.6)**. However, after adjusting for this one-off factor, the increment in TDL stock shows a lesser magnitude during Jul-Nov FY12 as compared to the same period last year.

Table 4.6: Debt Burden
billion Rupees

	Jun-11	Nov-11^{p}	Change
Total debt & liabilities	**12,146.1**	**12,673.3**	**527.2**
Total public debt	**10,995.5**	**11,826.4**	**830.9**
Total debt	**11,524.5**	**12,132.6**	**608.1**
Domestic - government	6,017.0	6,778.7	761.7
Domestic - PSEs	411.5	134.8	-276.7
External	5,096.0	5,219.1	123.1
Total liabilities	**621.5**	**540.7**	**-80.8**
Domestic	399.5	316.8	-82.7
External	222.0	223.9	1.9
Memorandum item:			
After adjusting for circular debt	6017.0	6387.7	370.7

P: Provisional
Source: State Bank of Pakistan

Furthermore, as external inflows tapered, the pressure of financing the fiscal deficit has fallen on domestic banking and nonbanking sources.[35] While this trend may bode well in terms of external indebtedness, it has adverse implications for the private sector. Moreover, declining foreign inflows is also putting pressure on Pakistan's FX reserves to finance current account deficit.[36]

Table 4.7: Absolute Change in Government Domestic Debt during Jul-Nov
billion Rupees

	FY11	FY12
Government domestic debt	**477.1**	**761.7**
Instrument-wise		
Permanent debt	60.0	274.9
Floating debt	363.6	421.0
of which		
MTB	114.8	566.3
MRTBs	295.6	-45.0
Unfunded Debt	54.8	65.8
Institution wise		
Through banking system	337.9	500.7
Scheduled banks	42.3	545.7
SBP	295.6	-45.0
Through non-bank debt	140.5	261.0
Foreign currency instruments	-1.3	0.0

Source: State Bank of Pakistan

Government domestic debt

The rising borrowing needs of the government were largely met from the banking system

[35] The share of the domestic component was 76.3 percent of total expansion in debt and liabilities during Jul-Nov FY12 compared with 69.1 percent during the same period last year.

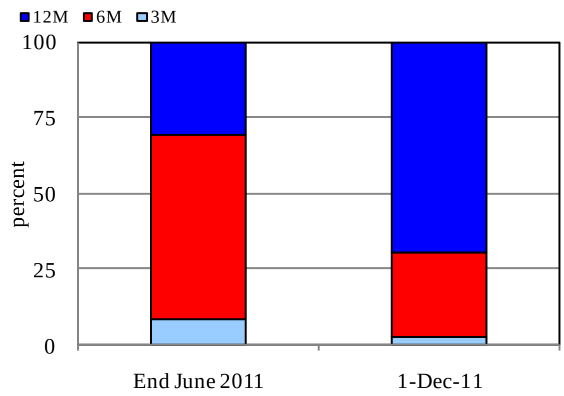
[36] Pakistan's FX reserves fell from the level of 27.9 weeks of imports on end-Jun 2011 to 23.6 weeks of imports on end-Nov 2011.

through short term floating debt instruments **(Table 4.7)**. This resulted in further amplification of scheduled banks holding of domestic debt to 37.7 percent on end-Nov 2011 from 33.4 percent on end-Jun 2011.

Floating debt*:* MTBs held by scheduled banks were one of the chief sources of financing the circular debt settlement in Nov 2011. Specifically, government raised around Rs 200.0 billion from 12-M MTBs in the auction held on Nov 4, 2011.

On the upside, the maturity profile of floating debt has seen an improvement, after the monetary policy loosening by SBP in Jul and Oct 2011. This is, due to a shift in commercial banks investment towards 12M T-bills instead of the shorter tenor bills (**Figure 4.2**). This shift towards longer tenor securities will reduce the roll-over and interest rate risk faced by the government. Furthermore, as a result of the SBPs efforts to diversify investors, the amount raised though the non-bank sector in MTBs auctions has also increased sharply.[37]

Figure 4.2: Composition of Outstanding MTBs Stock



Source: State Bank of Pakistan

Encouragingly, the stock of government debt held by SBP registered Rs 45.0 billion reduction during Jul-Nov FY12 over the end Jun 2011 position. As the government is trying to keep additional budgetary borrowing from SBP at zero level, Rs 103.5 billion were retired to SBP during Q1-FY12. However, it had to resume borrowing from SBP in Oct 2011 as the cut in policy rate and the resultant fall in MTB yields has dented scheduled banks incentives for investing in government paper.[38] Resultantly, government had to borrow from SBP to settle the maturing amount.

[37] During Jul-Nov FY12, government raised Rs 59.1 billion through MTBs from non-bank sector, as compared to the retirement of Rs 208 billion to non-bank sector during the same period last year.
[38] The net of maturity acceptance of MTBs was negative in the auctions held on Oct 20, 2011 and Dec 14, 2011.

***Permanent Debt*:** The inflows through permanent debt continued the rising trend witnessed since Q2-FY11. Specifically, in the auctions held during Q1-FY12, Rs 52.2 billion were raised through PIBs, against a target of Rs 50.0 billion. However, permanent debt stock recorded a surge in Nov 2011, as the government raised a hefty amount of Rs 195.0 billion for the circular debt settlement through 5-year PIBs.

Unfunded Debt: The inflows into NSS instruments recorded a healthy 20.1 percent increase in Jul-Nov FY12 over the same period last year. An analysis of monthly inflows shows that the downward revision in NSS rates (in Oct 2011) has not, so far, discouraged investment in these instruments.

External debt

Pakistan's external debt stock fell by US$ 255.0 million on end-Nov 2011, from its Jun 2011 position, as compared to the hefty increase witnessed during the same period last year (**Table 4.8**).[39] However, after the suspension of the IMF program in FY11, the weakening of external loan inflows was anticipated. The early suspension of the IMF program sent negative signals about country's macro-economy to other IFIs, which has halted their pipeline assistance.

Table 4.8: Absolute Change in External Debt Stock during Jul-Nov
million US Dollar

	FY11	FY12^P
Public debt	1832.0	-780.0
Government debt	1230.0	-352.0
From IMF	578.0	-380.0
Foreign exchange liabilities	24.0	-48.0
PSEs external debt	-42.0	54.0
Private sector external debt	165.0	471.0
Total external debt	**1955.0**	**-255.0**

P: Provisional

Source: State Bank of Pakistan

Going forward

With the risks mentioned to fiscal outlook above and weakening of external inflows, the stock of domestic debt is likely to continue the rising trend. As regards the servicing of debt, although the cut in policy rate has reduced the cost of borrowing, these gains are likely to be partially offset by the adverse movement in the Pak Rupee with rise in Rupee cost of external debt servicing **(Box 4.1)**. Thus, in overall terms, debt servicing as a share of government's revenues, which already stood at 43.3 percent in FY11, is likely to increase further going forward.

[39] Pakistan's external debt increased in Rupee terms due to depreciation of Pak Rupee during Jul-Nov FY12 as shown in Table 4.6 of this chapter.

Box 4.1: Debt Servicing - Interest Rate and Exchange Rate Impact in FY12

The fall in policy rate is likely to result in reduction of debt servicing to the extent of around 0.1 percent of GDP in FY12. However, these gains can be partially offset by rise in Rupee cost of external debt servicing with an adverse movement in Pak Rupee vs. US Dollar exchange rate.

Interest Rate Impact: According to our estimates, maximum impact of Monetary Policy easing, on interest payments of domestic debt will be witnessed in floating debt instruments which have slightly greater than 50 percent share in total domestic debt stock. However, the impact is likely to be modest in FY12, because of the nature of debt instruments.

Table 4.1.1: Savings in Auctions of Floating Debt Instruments (billion Rupees)

	3M	6M	MRTBs
Weighted average yields*			
Scenario1	13.2	13.4	13.6
Scenario2	11.8	11.8	11.9
Interest payments			
Scenario1	2.29	23.7	58.3
Scenario2	1.6	17.7	51.2
Savings	**0.7**	**6.0**	**7.1**

*Scenario 1: Before 150bps cut in policy rate

*Scenario 2: After 150bps cut in policy rate

Analyst estimates based on State Bank of Pakistan data

A detailed analysis shows that the fall in MTB rates will not affect the interest payments for 12M T-bills in FY12, as they are derived from MTB holdings of FY11. Similarly, the impact on interest payments for 6M T-Bills as well as MRTBs is likely to be realized only from Q4-FY12 onwards, as the payments from Jul-Mar 2012 correspond to the TBs raised during Jan-Sep 2011 i.e., mostly Monetary Policy tightening phase. The fall in policy rate could have stronger impact on interest payments for 3M T-Bills, if banks had been willing to invest in shorter tenor securities, which is not the case.[40] Therefore, government savings, in interest payments during FY12, are likely to originate mostly from 3 & 6M T Bills and MRTBs created during Q2-FY12.

After the 150 bps reduction in policy rate announced in Monetary Policy, on Oct 8, 2011, the weighted average yields of MTBs recorded a significant 140-160 bps fall in Q2-FY12 as compared to that in Q1-FY12. This is likely to translate in a saving of Rs 13.8 billion in interest payments during FY12, which implies a 0.1 percent of GDP reduction in fiscal deficit in this period **(Table 4.1.1)**.

Table 4.1.2: Exchange Rate Depreciation & Debt Servicing Burden in FY12 (amount in billions)

	Principal	Interest	Total
Debt servicing (US$)	**3.0**	**0.5**	**3.5**
Debt servicing in (Pak Rupee*)			
Scenario 1	258.0	42.4	300.4
Scenario 2	261.6	43.0	304.7
Scenario 3	262.4	43.2	305.6

*Scenario 1: Average exchange rate in FY11 @ 85.5

*Scenario 2: Average exchange rate in Q1-FY12 @86.7

*Scenario 3: Average exchange rate in Oct-Nov 2011 @ 87.0

Analyst estimates based on Economic Affairs Division data

Exchange Rate Impact: According to the Debt Office Islamabad, government's estimated external debt servicing payments for FY12 stand at US$ 4.1 billion. In terms of currency composition 85 percent of these obligations are denominated in US Dollar, while the rest of the payments are due in currencies as Euro, yen, etc. The huge share of US Dollar makes country's debt servicing burden, in Rupee terms, highly vulnerable to adverse movements in Pak Rupee/ US Dollar exchange rate.

[40] The outstanding 3M TBs holding fell from the level of Rs 168.0 billion in End Jun 2011 to Rs 64.7 billion On Dec 1, 2011.

The Rupee-dollar exchange rate after remaining relatively stable in FY11,[41] has come under increasing pressure in FY12, with the current account turning into deficit in FY12 from a surplus position in FY11 – Pak Rupee shed 1.4 percent value against US dollar during Q1-FY11 and a further 1.7 percent during Oct & Nov 2011. The depreciation of Pak Rupee is inflating the Rupee cost of external debt servicing payments of the country. According to calculations, a 1.4 percent depreciation in Pak Rupee/US$ average exchange rate as compared to that in FY11 is likely to result in around Rs 4.2 billion increase in country's Rupee debt servicing burden during FY12, while a larger 1.7 percent depreciation will expand the debt servicing burden by Rs 5.1 billion **(Table 4.1.2)**.[42]

[41] The Pak Rupee depreciated nominally by 0.6 percent during FY11 against 4.7 percent in FY10.
[42] These calculations incorporate external debt servicing obligations denominated in US Dollar.

5 External Sector

5.1 Overview

The first five months of FY12 saw a sharp deterioration in the external account position compared to the previous year. Specifically, external account posted a deficit of US$ 1.7 billion during Jul-Nov FY12 compared to a surplus of US$100.0 million in the corresponding period of the previous year. The deficit in overall external account is attributed to the deteriorations recorded in both, the current and financial accounts during the period under review **(Table 5.1)**.

Table 5.1: Summary of External Accounts (Jul-Nov)
billion US Dollar

	FY11	FY12P
A-C/A balance	**-0.6**	**-2.1**
i) Trade balance	-4.7	-6.4
Exports	9.0	10.0
Imports	13.7	16.5
ii) Services account balance	-1.0	-1.1
iii) Income account balance	-1.2	-1.3
iv) Current transfers	6.3	6.8
Remittances	4.4	5.2
B-Financial/Capital balance	**0.6**	**0.2**
i) FDI	0.6	0.4
ii) FPI	0.2	-0.1
iii) Others	-0.2	-0.1
C-Errors & omissions	0.1	0.2
D-Overall balance	**0.1**	**-1.7**
Foreign reserves (21st Dec)	16.3	16.6
Exchange rate (21st Dec)	85.7	89.9

P: Provisional

Source: State Bank of Pakistan

Current Account Deterioration

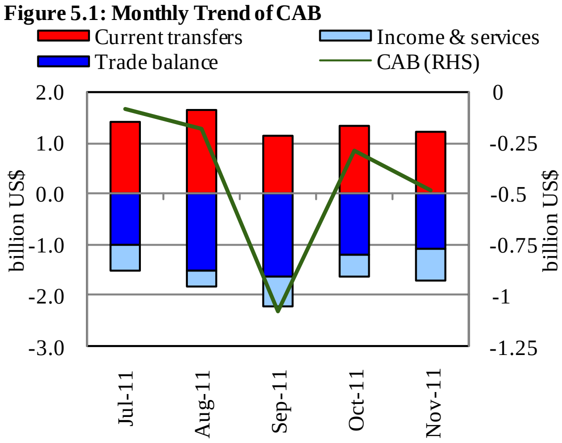
Although deterioration in current account was on the cards, the timing and magnitude was unexpected. This larger than expected worsening was mainly concentrated in the month of Sep 2011 when simultaneous surge in trade deficit and fall in current transfers led to over a billion dollar deficit in the current account during this month alone **(Figure 5.1).**

Trade deficit widened due to the surge in POL and fertilizer imports, and deceleration in exports, particularly textiles. Current transfers, on the hand declined, due to a 29.1 percent MoM decline in remittances.

The fall in remittances was driven by a seasonal slowdown; delays in the payment of commission to banks bringing in funds and speculative pressures in the forex market. Fortunately, remittances picked up pace Oct 2011 onwards; consequently despite the MoM decline in Sep 2011, remittances recorded a healthy growth of 18.3 percent for Jul-Nov FY12 over the year before.

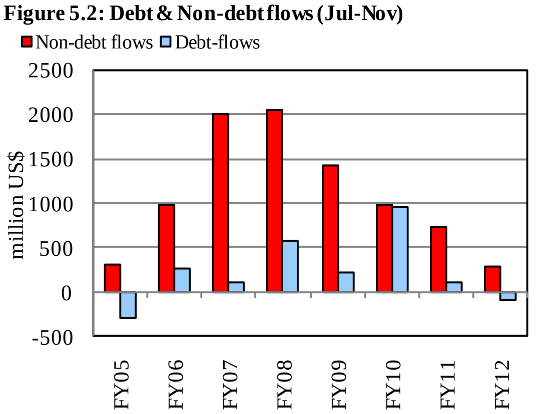
As against the current transfers, deterioration in the trade account is likely to get worse in the coming months due to adverse development in international commodity prices. In FY11, price movements favored Pakistan, but are now against it. Specifically, while the prices of commodities that Pakistan imports (POL, fertilizer etc) have increased, prices of its main exports (textiles) have collapsed. To make matters worse, demand in Pakistani major export markets is also sagging, which suggests that the decline in export revenues could be prolonged, while the import bill could continue to rise, primarily driven by the prices and quantum of POL imports.

Figure 5.1: Monthly Trend of CAB



Source: State Bank of Pakistan

Figure 5.2: Debt & Non-debt flows (Jul-Nov)



Source: State Bank of Pakistan

Unfortunately, unlike the past, when the deficit in the current account was financed by surpluses in capital & financial accounts; during Jul-Nov FY12, capital & financial accounts recorded only a modest surplus of US$ 200.0 million. As such, most of the deficit in the current account had to be financed through reserves, which brought some pressures on the exchange rate.

Capital & Financial Account and External Sector's Vulnerability

Jul-Nov FY12 developments have revealed the vulnerability of Pakistan's external account. Pakistan's financial account has been in surplus since FY05; a conducive domestic and international climate coupled with generous IFI support, helped Pakistan post over US$ 10.0 billion financial account surplus in FY07 alone. This surplus not only financed a widening current account deficit, but also helped build up reserves.

The global and domestic environment, however, changed in FY08. First the global financial crisis tapered FDI inflows and later lack of support from the IFIs saw both the Pak Rupee lose value and depletion in FX reserves. As such, financial account surplus steadily declined FY08 onwards **(Figure 5.2)**.

The serious consequences of a declining financial account surplus were overlooked in FY11 due to the comfort in the current account. Nevertheless it was evident that Pakistan will be challenged even by a small current account deficit without support from the financial account.

Pakistan must make all efforts to ensure the resumption of financial inflows. In case, resumption of IFIs funding is to be delayed, Pakistan must focus on non-traditional bilateral funding.

An encouraging development in this regard is the Currency Swap Arrangements (CSA) that Pakistan has entered into with Peoples Republic of China and Turkey. The objective of these swaps is to promote the use of regional currencies for trade settlement purposes and specifically in the case of China; to enhance the role of the Chinese Yuan in international trade and investment.[43]

Depleting Foreign Exchange Reserves & Volatility in Exchange Rate

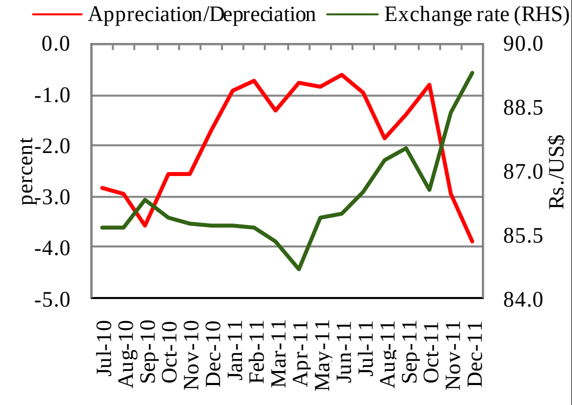
After peaking at US$ 18.2 billion in end- Jun 2011, Pakistan's foreign exchange reserves dropped to US$ 16.6 billion by 21 Dec 2011. This decline, as explained earlier, is driven by the widening current account deficit, and SBP's effort to calm the forex market.

The US$ 1.6 billion decline in liquid foreign exchange reserves since end Jun FY11, is entirely on account of a fall in SBP reserves, which have declined by over US$ 2.0 billion during the Jul-Dec period. The reserves of the scheduled banks actually increased by US$ 0.4 billion during this period. The decline in SBP reserves reflects lower inflows and higher payments compared with last year. In particular, inflows from donor agencies remained much lower than projected, while debt servicing to ADB increased compared to last year.

[43] In case of China, CSA has been executed for a tenor of 3 years in respective local currencies, Pakistan Rupee 140 billion and Chinese Yuan 10 billion, while in case of Turkey the CSA arrangement is for equivalent US$ 1.0 billion in respective currencies.

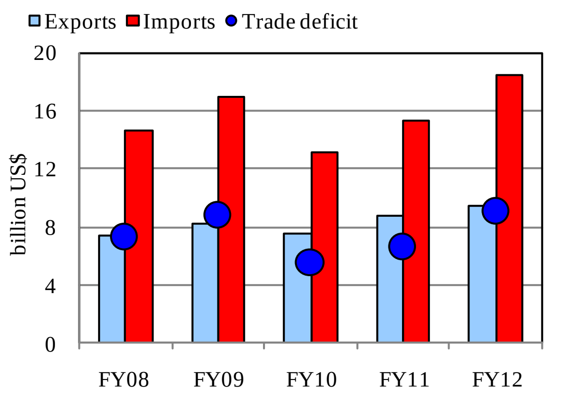
This deterioration in external flows was reflected in the weakness of Pak Rupee especially from Oct onwards. In absolute terms, the mid weighted rate in inter-bank market reached Rs 89.96 on 21st Dec 2011 **(Figure 5.3)**. The pressure on the exchange rate was initially brought about by a genuine shortage of hard currency due to large deficit in the current account; however, this was subsequently supplemented by speculative pressures in the FX market. Pakistan's exit from the IMF program in end Sep 2011 and growing tensions with the US, created an opportunity to speculate for short-term gain. SBP interventions consequently increased during Sep and Oct 2011 compared to last year.

Figure 5.3: Pak Rupee Volatility



Source: State Bank of Pakistan

Figure 5.4: Trade Account (Jul-Nov)



Source: Pakistan Bureau of Statistics

5.2 Trade Account[44]

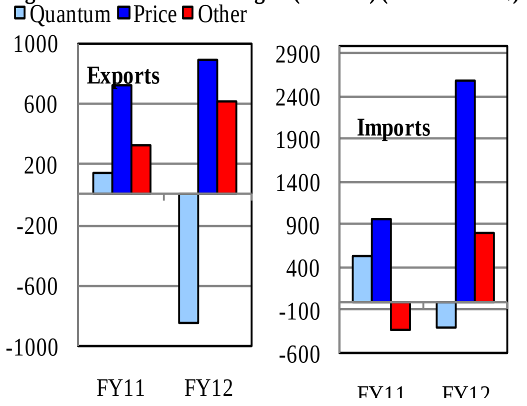
Trade account deteriorated for the second consecutive year, and the deficit widened by 36.7 percent to US$ 9.1 billion during Jul-Nov FY12, compared to 6.6 billion during the same period last year **(Figure 5.4)**. This deterioration in trade account was the result of an increase in commodity prices, the impact of which was more pronounced on the imports than exports **(Figure 5.5)**; and the slowdown in export demand in Pakistan's major export destinations.

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

Exports

Exports posted growth of 7.6 percent during Jul-Nov FY12, compared to 15.8 percent during the same period last year. The lower export is mostly the result of a decline in textile exports. Other items that recorded a decline include: rice, fish, carpets, sports goods and leather.

Figure 5.5: Sources of Changes -(Jul-Nov) (in million US$)



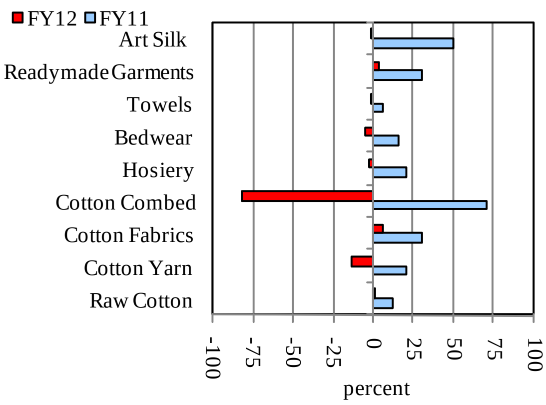
Source: Pakistan Bureau of Statistics

On the other hand, exports of fruits & vegetables, raw cotton, footwear, medical & surgical instruments, chemicals & pharmaceuticals, registered a significant rise over the previous year.

Textiles

Textile exports declined by 1.3 percent during Jul-Nov FY12 in contrast to YoY rise of 21.9 percent last year. The decline in textile exports is mainly due to the fall in quantity. Almost all textiles posted a decline during the period under review. The exports of cotton yarn, cotton cloth, knitwear, bed wear, towels and readymade garments, have shown lower growth rates or have declined compared to last year **(Figure 5.6)**.

Figure 5.6: Performance of Textile Exports (Jul-Nov)



Source: Pakistan Bureau of Statistics

The fall in textile exports in Oct and Nov is particularly alarming, as both, unit value and quantity registered a fall. It is feared that if this trend continues, textile exports could end up lower than last year. The prospects are indeed not very bright given worsening energy shortages and likely recession in Euro Zone and its contagion on rest of the world. The slowdown in demand is already visible from the fall in textile and apparel exports to US and EU during the recent months **(Table 5.2)**.

Non-Textiles

Non-textile exports recorded a YoY rise of 20.2 percent with all sub groups posting higher growth during Jul-Nov FY12 compared to the same period last year. Food exports recorded a growth of 22.7 percent, petroleum 13.7 percent, and the other manufactures 13.6 percent **(Figure 5.7)**.

Table 5.2: Textile & Apparel Demand (Jul-Sep)
growth in percent

	US		EU*	
	FY11	FY12	FY11	FY12
Bangladesh	11.4	-21.3	9.4	4.4
China	22.2	-5.6	14.6	3.3
India	4.0	12.4	13.2	-7.2
Pakistan	2.4	-4.7	15.1	-11.4
World	16.7	-5.4		

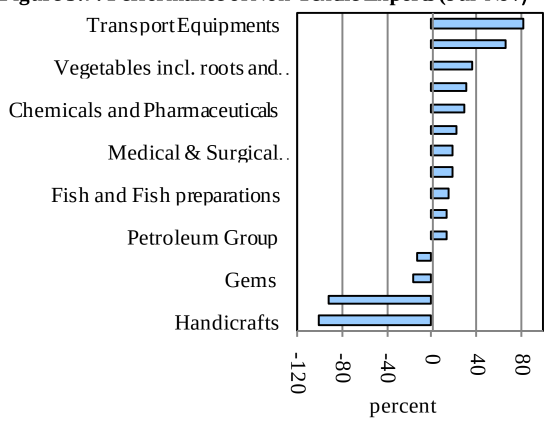
*Jul-Aug

Source: OTEXA and Eurostat

Rice exports: From the five months of FY12, rice exports were US$ 701.1 million, which suggests that Pakistan would probably miss US$2.5 billion rice export target for FY12. Exports of both basmati and irri rice declined by 15.9 and 8.1 percent during Jul-Nov FY12 entirely due to a quantum effect. However, Pakistan's rice exports could benefit from additional demand in the international market due to a possible shortage because of the floods in Thailand. Also Pakistan's rice crop is expected to be higher than initial target.

In *other manufactures*, export of sports goods, medical instruments, pharmaceuticals, and engineering goods, recorded a rise; however this rise was partially offset by negative growth in leather manufactures, cement, and handicrafts.

Figure 5.7: Performance of Non-Textile Exports (Jul-Nov)



Source: Pakistan Bureau of Statistics

Imports

Imports continued a rising trend for the second consecutive year registering 18.5 percent growth during Jul-Nov FY12. This increase in the import bill is a function of an increase in import prices of almost all products, whereas the quantum of most imports declined during the period. The highest increase (48.6 percent) was recorded in petroleum imports, followed by agricultural & other chemicals (22.8 percent) and textile group (9.6 percent). On the other hand, food, machinery and transport registered YoY decline **(Table 5.3)**.

Petroleum group imports during Jul-Nov FY12 increased by a significant US$2.1 billion over last year. Of the total increase around 87.8 percent was due to higher prices and remaining 12.2 percent due to increase in quantity **(Figure 5.8).**

Food group imports recorded a YoY fall of 1.1 percent during Jul-Nov FY12 in contrast to an increase of 58.8 percent during the same period last year. During FY11, substantial imports of Sugar had inflated the food import bill. However, the rise in domestic sugar production in FY12 does not require imports which explain the 96.9 percent decline in sugar imports this year. As against sugar, soybean oil, palm oil, tea and spices registered increases during Jul-Nov FY12.

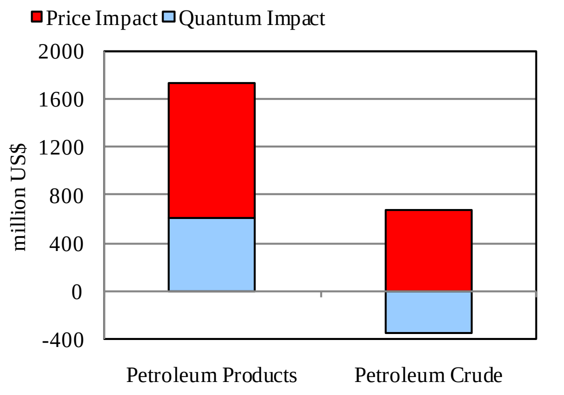
Machinery imports posted a decline of 12.4 percent in contrast to a small rise of 2.5 percent during the same period last year. Category-wise analysis reveals that imports of textile, construction, electrical and power generating machinery declined, which outstripped the positive growth in office, telecom and agricultural machinery **(Table 5.4)**.

Table 5.3: Import Performance (Jul-Nov)

	billion US$		YoY growth	Contribution in growth (%)	
	FY11	**FY12**	**FY12**	**FY11**	**FY12**
Food	2.2	2.1	-1.1	37.9	-0.8
Machinery	2.2	2.0	-8.5	3.4	-6.2
Transport	0.8	0.8	-7.7	10.4	-2.1
Petroleum	4.2	6.3	48.6	20.3	67.9
Textile	1.0	1.1	9.6	18.6	3.1
Agri. & Chemical	2.4	2.9	22.8	-4.1	17.9
Metal	1.1	1.1	5.5	5.8	1.9
Misc.	0.3	0.3	0.7	2.8	0.1
Total	**15.4**	**18.5**	**20.2**	**100**	**100**

Source: Pakistan Bureau of Statistics

Figure 5.8: Source of Changes in Petroluem Group (Jul-Nov)



Source: Pakistan Bureau of Statistics

In the case of *telecom* imports, out of the US$ 137.8 million increase, US$101.5 million was due to imports of cellular phones while US$36.3 million increase was due to import of infrastructure equipment. The demand for cellular phone has been on the rise since the government allowed for the import of cheaper Chinese mobile phone brands.

Table 5.4: Imports of Machinery (Jul-Nov)
million US$

	FY11	FY12	Abs. change
Textile	193.2	141.1	-52.1
Telecom	378.7	516.4	137.8
Electrical machinery and apparatus	344.3	275.4	-68.9
Agricultural	38.9	63.9	25.0
Power generating	469.8	347.2	-122.6
Construction and mining	52.4	47.3	-5.1
Other machinery	644.5	524.6	-119.9
Total	**2214.5**	**2025.6**	**-188.9**

Source: Pakistan Bureau of Statistics

Imports of *textile* increased by 8.4 percent mainly due to synthetic fiber, artificial silk yarn and second-hand clothing. However, import of raw cotton that increased during FY11 (owing to quantity as well as price impact), declined during Jul-Nov FY12 because of better availability of the product in domestic markets. Fertilizer imports, on the other hand, increased by 34.4 percent principally due to higher import price. A decline in domestic production due to gas shortages, also led to higher imports.

Acronyms

ADB	Asian Development Bank
CAB	Current Account Balance
c.i.f.	Cost, Insurance and Freight
CPP	Captive Power Plants
CPI	Consumer Price Index
CSF	Coalition Support Fund
EU	European Union
FBR	Federal Board of Revenue
FBS	Federal Bureau of Statistics
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
IDB	Islamic Development Bank
IEDs	Improvised Explosive Devices
IFI	International Financial Institutions
IMF	International Monetary Fund
Kg	Kilograms
KPK	Khyber Pukhtunkhwa
LSM	Large Scale Manufacturing
MoM	Month on Month
MRTBs	Market Treasury Bills for Replenishment for Cash
MTBs	Market Treasury Bills
NATO	North Atlantic Treaty Organization
NBFIs	Non-Bank Financial Institutions
NDA	Net Domestic Asset
NFA	Net Foreign Asset
NFC	National Finance Commission
NSS	National Savings Scheme
NTDC	National Transmission and Dispatch Company Limited

OMOs	Open Market Operations
PASSCO	Pakistan Agricultural Storage and Services Corporation Ltd.
PIB	Pakistan Investment Bond
PKR	Pak Rupee
POL	Petroleum, Oil and Lubricants
PSEs	Public Sector Enterprises
Q	Quarter
QIM	Quantum Index of Manufacturing
Rs	Rupees
SBA	Stand-By Agreement
SBP	State Bank of Pakistan
SECP	Securities and Exchange Commission of Pakistan
SED	Special Excise Duty
SME	Small and Medium Enterprises
SUPARCO	Space and Upper Atmosphere Research Commission
TCP	Trading Corporation of Pakistan
US	United States of America
WAPDA	Water and Power Development Authority
YoY	Year on Year