1 Overview

The analysis in this report is confined to the end of the first quarter, and mainly covers the period July-September FY13.

Overview

Expecting an improvement in economic growth, Pakistan's policymakers set a GDP growth target of 4.3 percent for FY13, which is higher than the 3.7 percent realized in the previous year.[1] At the same time, they envisaged a more stable macroeconomic environment with lower inflation, fiscal consolidation, and a sustainable external account for the year.

Table 1.1: Selected Economic Indicators (Jul-Sep)

	FY11	FY12	FY13
Growth rate (percent)			
LSM	-2.5	3.2	1.0
Exports (fob)	14	17.4	3.9
Imports (cif)	19	23.1	-2.4
Tax revenue	6.2	28.9	10.3
CPI (period average)[1]	13.4	11.5	9.1
Private sector credit	-1.6	-2.8	-2.5
Money supply (M2)	0.6	-0.3	0.7
billion US dollars			
Total liquid reserves[2]	17	17.3	14.9
Workers' remittances	2.6	3.3	3.6
Net foreign investment	0.5	0.2	0.2
percent of GDP[3]			
Fiscal balance	-1.5	-1.2	-1.2
Trade balance	-1.4	-1.8	-1.5
Current account balance	-0.3	-0.6	0.1

1. Base year FY08
2. This represents end-period reserves of SBP & commercial banks.
3. Based on full-year GDP in the denominator.

By the end of the first quarter of FY13, most of the country's macro indicators did show some improvement: headline CPI inflation had fallen; the current account had posted a surplus; and the fiscal deficit remained at par with the corresponding quarter of FY12.

As in FY12, strong remittances and fiscal spending supported domestic demand, with some faint signs of investment activity beginning to take hold. The latter can be seen in higher machinery imports, increased production of capital goods, and a slight increase in fixed investment loans during the quarter.

[1] The Annual Plan identified agriculture and a revival in large scale manufacturing, as key drivers of growth in FY13.

As highlighted in the *Annual Report FY12*, persistent structural problems continue to burden Pakistan's economy. Specific reforms are still needed in the energy sector; to improve the functioning of public sector enterprises (PSEs); and enhance revenue generation.

With domestic debt increasing by Rs 482 billion in Q1-FY13 (compared to Rs 208 billion in Q1-FY12); our concerns about the impending debt trap remain.[2] Furthermore, despite a clear signal from SBP to support private investment (the benchmark rate was reduced by 150 bps during the quarter), net credit expansion remains anemic. We believe commercial banks are still risk averse about lending, while private borrowers could be delaying their investment plans because of domestic uncertainty.

Looking at the real sector, supply disruptions have dampened growth prospects for FY13. Specifically, lower cultivated areas for the cotton crop and monsoon rains in September 2012, reduced the rice and cotton crops.[3] Furthermore, persistent energy shortages continued to hold back industrial growth.

By contrast, the sugarcane crop performed well with a harvest of 62.6 million tons, which is higher than the 59 million target.[4] Although we do not have hard numbers for minor crops, the relative stability in the price of perishable foods, suggests that supply was not adversely impacted and adequate for domestic consumption.[5]

Supply-side disruptions also impacted large-scale manufacturing in the country. As an example, reduced availability of natural gas impacted the fertilizer sector, while domestic car production suffered due to the import of second-hand automobiles and the phasing out of certain models to comply with international standards. These factors weighed down LSM growth during the quarter to 1.0 percent, from 3.2 percent last year. Excluding these two sectors, manufacturing growth was higher and more broad-based.[6]

[2] This increase in domestic debt does not tally with the quarter's fiscal deficit, because government deposits in the banking system have increased by Rs 170.5 billion during the quarter.

[3] Although the rains in FY13 were less severe compared to the previous two years, they caused local flooding in districts of Southern Punjab, Upper Sindh and Eastern Balochistan, damaging the cotton and rice crops specifically. Pakistan's rice crop is expected to miss the target by 1.5 million tons (or 78 percent of the target), while initial estimates for cotton put the crop size at 13.3 million bales (of 170 kg), which is lower than the target of 14.5 million bales.

[4] Fearing heavy rains this year, farmers preferred sugarcane as it is more resilient to floods.

[5] Minor crops suffered last year due to floods and extreme winter, which pushed up food inflation.

[6] Excluding cars and fertilizer, LSM growth improves to 3.5 percent in Q1-FY13, compared to 2.9 percent in Q1-FY12.

In particular, food processing, capital goods and building materials recovered strongly over the corresponding quarter of FY12. This trend was supported by a marginal increase in fixed investment loans; higher imports of machinery; and fresh investments in textile; paper; glass; steel; and food-processing. Although a vibrant construction sector (driven by the private sector) appears to be underpinning Pakistan's manufacturing growth[7], this is somewhat surprising as the above-mentioned sectors are quite energy intensive.[8] In overall terms however, a more meaningful industrial revival will require urgent solutions to overcome the on-going energy shortage.

As we have flagged before, the solution to the energy shortfall lies in decisive structural reforms. In the case of natural gas, the under-pricing of gas for household users is contributing to the shortages, while power generation fell much below capacity due to the continuing circular debt problem. Reforms in the energy sector are necessary not only for Pakistan's industrial revival, but also to cap fiscal spending.[9]

Table 1.2: Fiscal Developments
billion Rs

	Q1-FY12	Q1-FY13
Major receipts		
Tax collection	409.0	451.3
CSF inflow	1.8	107.3
Provincial surplus	3.9	85.4
Major payment		
Servicing of domestic debt	164.8	299.4

Given the sharp rise in domestic debt last year, and the corresponding increase in interest payments, fiscal pressures in FY13 are likely to remain. This pressure to borrow was brought about because of a slowdown in tax collection (**Chapter 4**). However, the realization of US$ 1.12 billion under the Coalition Support Fund (CSF) in August 2012, and a surplus of Rs 85.4 billion posted by provincial governments (against the *full-year*

[7] A steady growth in construction is evident from a consistent rise in cement dispatches; increased production of building materials; and higher imports of iron and construction machinery. The decline in PSDP during the quarter, suggests that the private sector is driving this growth. Within the private sector, construction loans for *commercial* projects continue to decline (for the second consecutive year), but advances for residential projects are picking up. One must also acknowledge that residential construction is often financed from undocumented sources. Except for ancillary inputs (in construction) that come from formal companies, most construction activities fall in the informal sector.

[8] In our discussions with representative firms, we have learnt that in the paper, steel and glass sectors, businesses have shifted to self-generated power to maintain their manufacturing activity.

[9] It may be noted that energy-related subsidies have risen sharply in recent years, i.e., from 7.5 percent of the current spending in FY10, to 14.9 percent in FY12.

target of Rs 80 billion) kept the fiscal deficit for the quarter at 1.2 percent of GDP, unchanged compared to Q1-FY12 (**Table 1.2**).

As these appear to be exceptional developments, it is important to gauge what could have happened if they had not taken place. Without CSF, the fiscal deficit in the quarter would have been Rs 389.5 billion, against a realized gap of Rs 283.8 billion. Although the aggregate provincial surplus has exceeded the full year target, we do not expect this level of support for the remaining three quarters of the year.[10] This raises concerns about the federal government's borrowing needs for the remaining part of FY13.

Looking at tax collection, the annual target of 27.9 percent growth for FY13, was contingent on improving the efficiency of the tax machinery, rather than introducing any new taxes.[11] So far, efforts to improve tax compliance have not yielded results, as FBR tax collection during Q1-FY13 grew by only 7.9 percent, compared to 29.7 percent last year.

Furthermore, fiscal spending was higher compared to the same period of last year, mainly due to a steep rise in interest payments. Interest payments alone now make up over 38 percent of overall current spending, compared to 27.0 percent in Q1-FY12. The resulting lack of fiscal space is undermining the government's ability to revive economic growth.

As in FY12, the burden of financing the fiscal deficit has fallen primarily on domestic sources, as external financing was not forthcoming (**Table 1.3**). Within domestic sources, the reliance on non-bank fell during the quarter, despite greater revenue mobilization through NSS. Interestingly, higher returns on NSS and a larger investor base, allowed

Table 1.3: Financing of Fiscal Deficit

Billion Rs

	FY13(BE)	Q1 FY12	Q1 FY13
Overall deficit	**1,105**	**257.2**	**283.8**
Financing:			
External resources	135	-4.4	-1.6
Internal resources	970	261.6	285.4
Banking system	484	119.5	151.5
Non-bank	487	142.1	133.9

[10] Having said this, we take some comfort from the provincial surpluses, and hope this is an indication of the capacity of provincial governments and the potential from fiscal devolution.
[11] In contrast, the high growth in tax collection during FY12, was mainly due to the removal of sales tax exemptions in March 2011.

the government to realize Rs 154.4 billion (in net terms) through NSS during Q1-FY13[12] – much higher than the Rs 54.3 billion mobilized in Q1-FY12. This mobilization through NSS was partially offset by a net retirement under NBFIs' investment in government securities – so in overall terms, non-bank sources did not finance a larger share of the government's borrowing needs.[13]

As a result, financing from the banking system increased in Q1-FY13 compared to the corresponding quarter last year. But this figure conceals a change in its composition, since the government borrowed Rs 564 billion from commercial banks (the highest in a single quarter) and retired Rs 412 billion of its debt with the central bank. Although the growing reliance on commercial banks is disturbing (as it could crowd out the private sector), this shift had some positive implications for the government:

a) It improved the maturity profile of T-bill holdings, as commercial banks reduced their holding of 3-month T-bills from 26.4 percent (of their total holding) at end-June 2012, to just 7.1 percent as of end-September 2012;[14]

b) The retirement of central bank borrowing also enabled the government to meet the limit of zero borrowing during the quarter, as set under the amended SBP Act of 1956; and

c) The fiscal authorities were able to retire expensive debt with slightly cheaper debt.

In fact, the shift in government borrowing from commercial banks (to retire SBP debt), absorbed Rupee liquidity from the system, which was already under pressure because of weak deposit growth and the fall in SBP's NFA. To counter this, the central bank continued to provide liquidity through open market operations (OMOs) to ensure the smooth functioning of the money market.

As a result, the market did not show any signs of pressure on interest rates. We are mindful of the fact that while the first quarter is typically characterized with

---

[12] In April 2012, the government allowed institutional investment in NSS as long as the funds were pensions, gratuity, superannuation, contributory provident funds and trusts.
[13] In our view, to make NSS more efficient in primary mobilization of household savings, the authorities should streamline and rationalize its product offerings, so that they do not undermine other investment options that already exists (e.g., investment in T-bills and PIBs).
[14] Commercial banks that already favored risk-free lending to the government over private sector placement, have become more aggressive (or risk averse) as expectations of further cuts in the policy rate took hold. Predictably, they invested more in 6 - 12 month T-bills, Sukuk and PIBs.

seasonal retirement of private sector credit,[15] loan off-take in the subsequent quarters is usually high. Although we expect credit off-take to increase in response to the policy rate cuts, this will only be possible if the government scales down its borrowing from commercial banks.

We realize the demand for financing by the federal government has perhaps allowed commercial banks to become complacent, which means they are not intermediating between private savers and borrowers. This repeated concern of the central bank remains one of several factors that incentivized SBP to reduce its policy rate by 150 bps in August 2012, and then cut it twice by 50 bps each, in October and December 2012.

Although the external sector gained from a smaller trade deficit and higher remittances, it was the inflow of US$ 1.12 billion under CSF (in August 2012) that turned the current account into a surplus. Though small, the current account surplus of US$ 0.34 billion in Q1-FY13, follows a deficit of US$ 1.34 billion in the corresponding quarter of FY12.[16] This enabled the economy to withstand the weakness in the financial account due to nominal inflows under foreign direct investment and foreign loans.

The trade deficit (based on SBP data) contracted during the quarter due to a larger decline in imports compared to the fall in exports. The fall in import costs is driven by lower prices and lower quantums. Falling international prices of palm oil, raw cotton and crude oil, contained overall imports; however, the most significant quantum decline was witnessed in urea because of greater domestic availability after last year's excessive imports. On the other hand, the import of machinery and the quantum of petroleum imports increased during the quarter.

Due to the relative comfort in the external account, the Rupee remained fairly stable during Q1-FY13 – it depreciated by just 0.25 percent against the US Dollar during Q1-FY13, compared to 1.7 percent in the corresponding quarter of FY12. However, SBP's FX reserves fell by US$ 445 million (in net terms) during the

[15] Loans to private sector businesses saw a net retirement of Rs 39.6 billion in Q1-FY13 against a net retirement of Rs 95.3 billion during the corresponding period last year. Moreover, fixed investment loans (i.e. loans of more than one-year maturity) increased by Rs 5.6 billion during the quarter, compared to a net contraction of Rs 22.4 in Q1-FY12.
[16] If CSF money is taken out of the equation, the current account would have posted a deficit of $ 774 million in Q1-FY13.

quarter, largely due to repayments of US$ 479 million to the IMF.[17] As a result, SBP's FX reserves fell to US$ 10.4 billion by end-September 2012.

Q1-FY13 also witnessed a consistent fall in headline inflation. After remaining in double-digits for more than two years, annualized CPI inflation fell to 9.15 percent in Q1-FY13, compared to 11.48 percent in Q1-FY12. At the same time, SBP's survey of consumer confidence suggests some softening in inflation expectations.

A more detailed analysis shows that supply-side factors are largely responsible for the fall in inflation. Most of the decline can be attributed to better availability of food items (e.g., perishable commodities, refined sugar, pulses) and lower *administered* prices (e.g., lower tariff on piped-gas and CNG).[18] However, the change in price of other household items is rather mixed. For example, while categories like *footwear & clothing* and *restaurants & hotels* have posted consistently high inflation, *furnished household equipment* has shown a significant decline in inflation. This suggests consumer demand is easing, or at best remains stable. The dominant impact of supply-side factors in falling inflation is understandable, as market agents generally adjust their prices more quickly to supply shocks, than to changes in demand conditions.

Outlook

With a below-target harvest of rice and cotton already realized, the projection for agricultural growth depends on the upcoming wheat crop. The government has increased the wheat support price from Rs 1,050 to Rs 1,200 per 40 kg, to ensure ample sowing. Although wheat sowing was delayed in some areas due to the late harvesting of sugarcane, timely rains and relative stability in input prices are expected to help the crop. Nonetheless, the drag from rice and cotton is large enough, so as to pull down overall growth in agriculture to 3.5 percent, which is below the target of 4.0 percent.

In the industrial sector, LSM growth is expected to pick-up as the strong growth in sugarcane is likely to translate into higher sugar production, while a more stringent policy on used car imports will benefit the domestic auto sector. The expected commissioning of a cold-rolling steel mill, and a new motorcycle tyre plant later this year, should further support LSM growth. In overall terms, we see real GDP growth for FY13 to fall within a range of 3.5 – 4.0 percent. However,

[17] Since IMF loans are the liability of the central bank, their repayments do not *directly* impact the FX market. However, a persistent decline in SBP's FX reserves does impact market sentiments.
[18] Food and energy together account for 47 percent of the CPI basket.

the key economic challenges remain: the continuing energy shortages; and frequent interruption of commercial activity because of law and order conditions.

As far as inflation is concerned, upside risks stem from the recent increase in wheat support price (which has pressured wholesale and retail markets), and the pass-through of recent PKR weakness. However, SBP takes some comfort from quarterly data, which shows that inflation has also been falling quite broadly in the CPI basket; one must also note that retail energy prices have remained stable during the quarter under review. The impact of lower gas tariffs and the stability in house rents and food prices, are expected to keep FY13 inflation below the annual target of 9.5 percent, despite the expected increase in food inflation. We therefore project average inflation to be in the range of 8-9 percent in FY13.

In the fiscal sector, the annual target for tax collection has become more challenging because of a sluggish formal economy and a reduction in imports. At the same time, uncertainty about the receipts from 3G licenses and Etisalat still prevails, which has been offset somewhat due to substantial inflows under CSF.[19] On the expenditure side, we expect subsidies to exceed the budgetary allocation, with the result that the overall budget deficit may fall in the range of 6.5 – 7.5 percent of GDP for FY13.

The external sector has so far been manageable, as the current account got considerable support from CSF inflows. For the remaining part of the year, while additional CSF inflows appear unlikely, a smaller trade deficit and strong remittances should keep the current account deficit in check. We project the current account deficit to remain modest at less than 1 percent of GDP. The financial account, on the other hand, is likely to remain weak as chances of a revival of external inflows remain slim.

In closing, structural problems in Pakistan's economy persist and manifestations like the debt trap; loss-making PSEs; and a narrow tax base, will continue to challenge policymakers. Without concrete steps to address the energy shortage, the losses of PSEs and generate additional tax revenues; the private sector will remain reluctant to take up the challenge of driving the country's economic growth.

---

[19] The federal government realized US$ 1.8 billion through CSF during Jul-Dec FY13. In contrast, there was no inflow under this head during the entire FY12.