1 Overview

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

Some of the positive developments in Q1-FY13 could not be sustained during the second quarter. Although the current account still posted a surplus in the first half of FY13, the second quarter posted a deficit; the downward trend in inflation in the first five months of FY13 appears to have halted in December; and the federal government sharply increased its reliance on SBP financing to fund its fiscal deficit.

Table 1.1: Selected Economic Indicators

		FY11	FY12	FY13
Growth rate (percent)				
LSM	H1	-2.0	1.0	2.1
Exports (fob-PBS)	H1	18.9	3.6	7.5
Imports (cif-PBS)	H1	19.4	18.7	-3.3
Tax revenue (FBR)	H1	13.7	27.1	5.7
CPI (period average)[1]	H1	14.3	10.9	8.3
Private sector credit	H1	5.4	6.2	3.1
Money supply (M2)	H1	9.0	5.7	8.0
billion US dollars				
Total liquid reserves[2]	31st Dec	17.2	17.0	13.9
Home remittances	H1	5.3	6.3	7.1
Net foreign investment	H1	1.0	0.3	0.7
percent of GDP[3]				
Fiscal deficit	H1	2.7	2.6	2.6
Trade deficit	H1	2.7	3.4	3.0
Current a/c balance	H1	0.0	-1.0	0.1

[1] Base year-FY08

[2.] With SBP & commercial banks

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

Source: State Bank of Pakistan

Seasonal rains have been less disruptive than the previous years, but localized flooding has hit the cotton and rice crops. Although sugarcane is comfortably above target (which should also help the manufacturing sector), in overall terms, agriculture growth is likely to be below the 4.0 percent that was targeted at the start of the year. However, with LSM growth expected to be above target (specifically steel and POL), SBP projects real GDP growth will remain in the range of 3.5 to 4.0 percent for the full year.

Having said this, concerns have been raised about the consistent fall in the country's FX reserves, which is primarily driven by lumpy repayments to the IMF. In fact, for the first time since H1-FY05, the country's *Financial Account* posted a deficit, which reflects on-going repayments with little fresh money coming into the country.[1] Foreign investment has increased but levels are low, which is understandable given global conditions and the uncertain domestic environment.

The real sector is showing a mixed picture. As one of the key drivers in Pakistan's economy, the cotton crop is expected to be 8.0 percent below target (at 13.3 million bales), while rice is 22.0 percent below target (see **Chapter 2**). Although the impact of sugar on the manufacturing sector is not yet visible, the 5.0 percent above-target production has created an exportable surplus, and should boost the LSM sector in the second half of FY13.[2] The critical wheat crop (given its weight in major crops and its impact on food inflation) is likely to be below target despite the increase in wheat support prices in November 2012.[3]

With the agriculture sector below target, Pakistan's manufacturing sector has posted an improvement, and is likely to continue with this trend. Heavyweights like fertilizer, POL and steel manufacturing, have shown strong growth, but with some qualifications. The fertilizer sector did not pull down LSM growth as it did in the first quarter, since it was able to use its imported inventories and then gear-up domestic production to meet seasonal demand – the sector also fared well because of better availability of natural gas. Production capacity in steel, on the other hand, increased with the commissioning of new energy-efficient plants, while glass and paper products gained as they shifted towards alternate energy sources.

Looking at other areas of the manufacturing sector, allied sub-sectors that support construction activities, have shown consistent growth. This supports our view that residential construction remains strong since FY12, while PSDP spending on construction is also appreciably up this year. Ambitious housing projects sponsored by local investors, appear to be responding to the demand for housing across the country. We also believe remittances are feeding the construction drive.

Lacking hard data on services, wholesale/retail trade may have dipped because of lower import volumes and below-target agriculture. Furthermore, falling interest

[1] Inflows and outflows to the IMF are not in the Financial Account, as they are treated below the line in the BoP.

[2] Against an initial export target of 700 thousand tons, this limit was increased to 1,200 in November 2012, when the authorities were sure that domestic production would be high enough to satisfy the domestic market and to export.

[3] In fact, a detailed look at inflation reveals that wheat support prices could be the swing factor for the recent up-tick in headline inflation (see **Chapter 3**). Other than being a staple food item, domestic wheat prices strongly influence food inflation and expectations of future inflation.

rates and the one-off loss incurred by Pakistan Telecommunication Company Ltd (PTCL) in H1-FY13, could put downward pressure on *finance & insurance* and *telecommunications*.

In overall terms, aggregate demand appears to be the same as in the previous quarter, shored up by remittances and fiscal spending. We would like to state that the reduction in the trade deficit in H1-FY13 is not necessarily a reflection of weak domestic demand. As will be discussed later, Pakistan's imports have been contained by exogenous factors and one-off domestic developments. In fact, the strong inflow of worker remittances that has helped the current account post a surplus, is directly driving household spending (see **Chapter 5**). We expect remittances to remain strong and may exceed the full year target of US$ 14 billion.

As in the first quarter, bank lending to the private sector does not appear to have picked-up much. However, headline numbers can be misleading: compared to H1-FY12 when credit to the private sector increased by Rs 194 billion, the first half of this fiscal year only posted a net expansion of Rs 105 billion. This fall is driven by commercial bank lending to non-bank financial institutions (NBFIs), which saw a net retirement of Rs 78 billion in the first half of FY13, probably on account of recent changes in the tax rules.[4]

Within private sector credit, loans to private businesses that account for the bulk of private sector credit, showed an expansion of Rs 146.5 billion, compared to Rs 86.1 billion in the corresponding period last year. This lends some support to our view that banks have started shifting their attention to the private sector.

This assessment gets further support from how the pattern of federal government borrowing from the banking system has changed in Q2-FY13. As shown in **Table 3.1**, while aggregated numbers show the government has borrowed less from the banking system this fiscal year, there has been a sharp shift away from commercial banks to SBP in Q2-FY13. As a result, the government has breached the zero quarterly borrowing limit from SBP during the second quarter of FY13.[5]

The fiscal picture explains the federal government's compulsion to borrow. Although the consolidated fiscal deficit in H1-FY13 is likely to be 2.6 percent of

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[4] As per section 15 (61) of Finance Act 2012, dividend received from Money Market Funds and Income Funds shall be taxed at the rate of 25% for tax year 2013 and at the rate of 35% for tax years 2014 and onwards. Up to 2012 this rate was just 10 percent.

[5] As per the SBP Act, the Federal government's debt to State Bank as on 30th April 2011 has to be retired in eight years (i.e. 2019). Since April 2011, however, the Federal government's outstanding debt to SBP (up to end-December 2013) actually increased from Rs 1,445 billion to Rs 1,575 billion.

GDP (which is the same as in H1-FY12), the US$ 1.8 billion inflow on account of Coalition Support Fund (CSF) made all the difference.[6,7] In terms of revenue collection by FBR, the first half of FY13 witnessed an increase of only 5.7 percent, against a 27.1 percent increase in the same period last year.[8] The lack of new tax measures in the FY13 Budget; a slew of tax exemptions; leakages; and a sluggish formal economy, could explain the poor growth of tax revenues. Furthermore, current expenditures of the federal government grew by 30.9 percent in H1-FY13, compared to 6.6 percent last year; the main drivers behind this year were interest payments and energy-related subsidies.

On a positive note, the provincial governments were able to do better in the first half of FY13. Against a full-year target to generate a surplus of Rs 80.0 billion, the combined provincial accounts posted a surplus of Rs 96.5 billion in the first six months of FY13 (against Rs 11.8 billion in the first half of FY12). There are two underlying factors: one, provincial governments were able to increase their revenues due to the collection of sales tax on services; and two, the provinces only received their share (from the *divisible pool*) late in the second quarter of FY13, not leaving them enough time to execute their spending plans.[9]

It remains to be seen if the provincial governments are able to post surpluses for the remaining part of FY13. If they are unable to do so, there will be growing pressure on the federal government to narrow the on-going consolidated fiscal deficit, or simply borrow more from banking system.

In terms of the underlying financing, taking out the one-off energy payments in FY12, the federal government actually increased its borrowing from the banking system from Rs 302 billion in H1-FY12, to Rs 558 billion in the same period this year.[10] In overall terms, Pakistan's domestic debt increased by Rs 691 billion in the first half of FY13 (an increase of 9 percent over June 2012) compared to Rs 854 billion in the first half of FY12.

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[6] CSF funds came in two installments: the first was US$ 1.12 billion in August 1, 2012 (Rupee equivalent was Rs 106 billion); the second was US$ 688 million in December 28, 2012, which translated into Rs 66 billion.

[7] The final nominal GDP number for FY13 is likely to be different from the beginning-of-the-year projection put out by the Federal government

[8] Part of this sharp fall is due to the fact that sales taxes (on services) collected by the Federal government has been shifted to provincial governments.

[9] Both Sind and Punjab received almost 30 percent of their Q2-FY13 transfers from the federal government on 31st December 2012 (see **Table 4.5**).

[10] Taking out the positive impact of the CSF inflows this year, the government may have required Rs 730 billion in H1-FY13.

Having said this, Pakistan's external public debt actually fell by US$ 1.9 billion during the half year (of which US$ 1.3 billion was owed to the IMF). Repayments without fresh inflows did put pressure on the country's BoP and exchange rate, which ideally should be countered by running a much larger current account surplus.[11]

In terms of trade flows, the picture in H1-FY13 was quite benign. Falling import quantums and softer commodity prices, meant that Pakistan's import bill actually fell by 3.3 percent in H1-FY13, compared to a 18.7 percent *increase* in the same period last year (PBS data).

Domestic production of rubber tyres reduced the country's import needs quite sharply (a quantum fall of 33 percent), while the additional production capacity in steel, kept import requirements about the same as last year. The real saving in the first half of FY13 was the 57 percent fall in imported fertilizer, which reduced the country's import bill by US$ 451 million (the savings from palm oil during this period was US$ 239 million|). Lastly, supporting our view that construction activities remain robust, *construction & mining machinery* imports increased by 40 percent in the first half of the year.

Looking at exports, textiles increased by 8.6 percent as manufacturers were able to draw down inventories from last year – in the first half of FY12, textile exports fell by 4.9 percent. Part of this improvement can also be traced to the duty free access granted to Pakistan by EU in November 2012. Jewelry exports spiked in September 2012, but this is largely because of a sharp increase in the price differential between the domestic and Dubai market.

Remittances continued to shore-up the domestic economy, posting inflows of US$ 7.1 billion in H1-FY13, compared to US$ 6.3 billion last year. While the full-year remittances last fiscal was US$ 13.2 billion, we are confident that remittances will exceed US$ 14 billion for this fiscal year. If so, this should sustain the pattern of domestic demand the country has witnessed in the past several years.

Despite a current account surplus of US$ 218 million in the first half of FY13 (against a deficit of US$ 2.4 billion in H1-FY12), scheduled repayments to the IMF pulled down SBP's FX reserves by US$ 1.8 billion. The fall in reserves has

[11] This simply reflects the micro underpinnings of balancing a household budget. Excessive borrowing that increased debt servicing, eventually squeezes disposable income and requires austerity measures to balance cash-flows.

occasionally exerted pressure on the Rupee-Dollar parity, coinciding with monetary policy decisions and IMF repayments.

Outlook

The outlook for the economy is strongly influenced by the perceived vulnerabilities in the external sector. Clearly, it is not the size of the current account imbalance, but the fall in FX reserves that is dampening sentiments. We however feel that even with scheduled repayments to the IFIs, SBP's FX reserves would be adequate to meet all forex obligations.

Table 1.2: SBP Projections of Major Economic Indicators

	FY12	FY13	
	Actual	Annual Plan Targets[1]	SBP Projections
Percent growth			
GDP	3.7	4.3	3.5-4.0
CPI inflation	11.0	9.5	8.0-9.0
Monetary assets	14.1		15.5-16.5
Billion US$			
Workers' remittances	13.2	14.0	14.0-15.0
Exports (fob-BoP)	24.7	25.8	25.0-25.5
Imports (fob-BoP)	40.1	42.9	40.0-40.5
Percent of GDP			
Fiscal deficit	8.5[3]	4.7	6.5-7.5[2]
Current account deficit	2.0	1.9	0.0-1.0[2]

[1] Targets on fiscal and current account deficit to GDP are based on nominal GDP projections from the government's budget document for FY13.
[2] SBP's projected ratios are based on our own projections for nominal and real GDP in FY13.
[3] The fiscal deficit in FY12 includes the one-off accumulated power subsidy that was paid in November 2011.
Source: State Bank of Pakistan

On the inflation front, the downward trend in YoY headline CPI stopped in November 2012, and has reversed since. Although SBP still feels the average inflation rate for the year will remain in the range of 8 to 9 percent, we believe the impetus for this change can be traced to wheat support prices announced in November 2012, while the recent weakening of the Rupee could add to inflationary expectations. Supplementing this change in sentiments is the growth of reserve money, which posted an increase of 11.0 percent in H1-FY13, against 5.8 percent in the corresponding period last year. The increase this year was driven almost entirely by government borrowing.

With provincial surpluses above the full-year target, we see growing fiscal pressures for the remaining part of FY13. Although spending patterns may ease somewhat during the next caretaker government, non-discretionary spending could push the fiscal gap to within 6.5 to 7.5 percent of GDP for FY13.

With growing resource needs to finance the government's day-to-day operations (e.g. debt servicing), we are less optimistic that much-needed structural reforms of PSEs and the energy sector, will take place in FY13.

Non-economic factors like the poor law-and-order situation continue to hamper commercial activity. The frequency of nationwide strikes and law & order incidents in the main cities of the country, have reduced the number of working days in the first half of FY13 compared to previous years.[12]

Despite these negatives, the resilience of the informal sector appears to be pushing the formal economy forward. Construction activities remain strong, and there are indications of foreign interest in joint-projects in Pakistan's real estate sector.[13] This is helping large-scale manufacturing, which could counter the weather-driven losses in the agricultural sector. We also see the increase in lending to private businesses as positive, which is likely to gain momentum during the rest of the year.

In the remaining part of FY13, we do not see pressure from Pakistan's trade account. Soft commodity prices and strong remittances, should keep the current account contained within 1 percent of GDP deficit. If key commodity prices remain soft in the second half of FY13, even a current account surplus is possible.

However, intangibles appear to be dominating Pakistan's economic outlook. With a caretaker government paving the way for general elections in May 2013, domestic investors are understandably reluctant to take a long-term view. So while this uncertainty cannot be denied, the government must prioritize addressing stubborn structural problems in public sector enterprises and the energy sector; similarly, concrete steps are required to enhance revenue collection in an equitable manner.

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[12] Proxy indicators such as bomb blasts, suicide attacks and number of bomb related fatalities, which may have led to disruption in economic activity, show significant increase from the previous year. Detailed information in this regard is available at the South Asia Terrorism Portal or at www.satp.org .

[13] Some large local entities have embarked on ambitious residential projects across the country, which are beginning to attract overseas interest.