THE STATE OF PAKISTAN's ECONOMY

Third Quarterly Report
For the year 2012-13 of the
Central Board of State Bank of Pakistan

STATE BANK OF PAKISTAN

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LETTER OF TRANSMITTAL

State Bank of Pakistan
Karachi.
June 12, 2013

Dear Mr. Chairman,

As required by Section 9 A(f) of the State Bank of Pakistan Act, 1956, I am pleased to submit herewith the Third Quarterly Report for the year 2012-13 of the Central Board of Directors of the State Bank of Pakistan on the State of the Economy.

With warm regards,

Yours sincerely,

(YASEEN ANWAR)
Governor

Syed Naveed Hussain Bukhari
Chairman
Senate
ISLAMABAD

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Sardar Ayaz Sadiq
Speaker
National Assembly
ISLAMABAD

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1 Overview*

As the economy entered the second half of the current fiscal year, the key challenges to macroeconomic management emanated from the fiscal side and also the external sector. After a surplus during the first half of FY13, the current account position deteriorated to a deficit in Q3-FY13, resulting in pressure on the country's foreign exchange reserves. On the domestic front, the growth in FBR tax revenues remained sluggish, while expenditures on power subsidies and debt servicing increased sharply. Finally, the government had to resort increasingly to borrowing from SBP to finance its fiscal deficit. On a positive note, however, inflation fell significantly in Q3-FY13, and large-scale manufacturing showed some signs of recovery.

Table 1.1: Selected Economic Indicators

		FY11	FY12	FY13
Growth rate (percent)				
Real GDP[1]	Jul-Jun	3.7	4.4	3.6
Agriculture	Jul-Jun	2.0	3.5	3.3
Industry	Jul-Jun	4.7	2.7	3.5
o/w LSM	Jul-Jun	1.7	1.2	2.8
Services	Jul-Jun	3.9	5.3	3.7
Exports (fob-PBS)	Jul-Mar	26.0	-3.6	5.4
Imports (cif-PBS)	Jul-Mar	15.6	14.7	-1.6
Tax revenue (FBR)	Jul-Mar	12.2	25.5	5.0
CPI (period average)	Jul-Mar	14.0	10.8	8.0
Private sector credit	Jul-Mar	7.6	6.4	4.1
Money supply (M2)	Jul-Mar	9.4	8.1	9.0
billion US dollars				
Total liquid reserves[2]	31st Mar	17.6	16.6	12.2
Home remittances	Jul-Mar	8.0	9.7	10.3
Net foreign investment	Jul-Mar	1.3	0.4	0.6
percent of GDP[3]				
Fiscal deficit	Jul-Mar	4.3	4.5[4]	4.6
Trade deficit	Jul-Mar	3.8	5.2	4.7
Current a/c deficit	Jul-Mar	0.0	1.3	0.4

1. As per new base of FY06.
2. With SBP & commercial banks
3. Full-year GDP (at new base) in denominator
4. Fiscal deficit rises to 6.4 percent of GDP in Jul-Mar FY12, after one-off circular debt settlement.

Sources: PBS, SBP, FBR

While the growth in industrial sector increased with the support of broad-based recovery in *large scale manufacturing, construction* and *mining & quarrying*, agriculture growth was adversely affected by heavy rains and localized floods during Kharif season.[1] Services sector also remained subdued due to decline in growth rates of transport, storage and communication

* The analysis in this report is confined to the period July-March FY13.
[1] See **Chapter 2** for further discussion.

(on the back of weakening profits in the telecom and transport), general government services and other private services. Consequently, growth in overall real GDP (at new base of FY06 released recently by Pakistan Bureau of Statistics) declined from 4.4 percent in FY12 to 3.6 percent in FY13 despite recovery in LSM (**Table 1.1**).

Revival in large scale manufacturing was also supported by increase in loan disbursement by banks to the private sector during Jul-Mar FY13 along with a number of other industry-specific factors as discussed in **Chapter 2**. Loans to private businesses have increased from Rs 42.9 billion in Jul-Mar FY12, to Rs 165.1 billion in the same period this year; within this, fixed investment loans to the industrial sector have increased considerably.[2]

A part of this increase is the result of SBP's monetary easing over the last two-and-a-half years. As receding inflationary pressures provided room to cut interest rates, SBP reduced its policy rate to stimulate investment and growth.[3] Encouragingly, inflation has continued its declining trend and registered a 45-month low of 6.6 percent (YoY) in March 2013. However, any deterioration on the external front, or an increase in administered prices to minimize subsidies and arrest the size of the circular debt (as necessary steps for fiscal consolidation), pose the greatest risks to inflation in the medium term. In the absence of these risks, inflation is likely to continue the declining trend in the short-term.

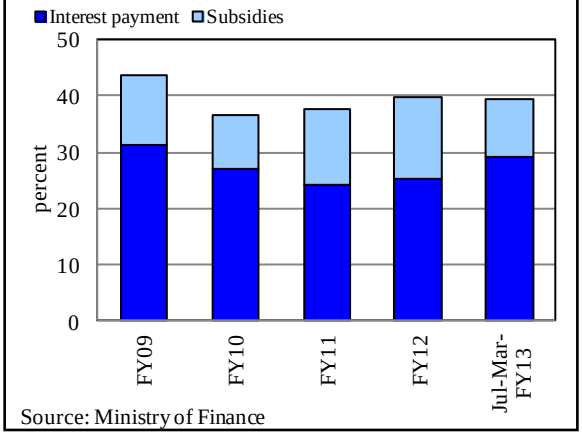
These subsidies, along with rising interest payments on domestic debt, have worsened the fiscal situation. The amount of subsidies paid during the first three quarters of FY13, exceeded the full year target by a distressing 29.4 percent; [4] while debt servicing payments have increased by 23.6 percent during this period, compared with the same period last year. Debt servicing during Jul-Mar FY13 has surpassed development expenditures, whereas, subsidies and debt servicing together constitute around 40 percent of total current expenditures (**Figure 1.1**).

On the revenue side, FBR taxes increased by only 5.0 percent in Jul-Mar FY13 – the lowest increase since FY02. While a part of this sluggishness may be the result of low level of economic activity and anemic investment due to energy

[2] While anecdotal evidence suggests increased demand for private sector credit; supply of loanable funds for private sector also increased during Jul-Mar FY13 with the government shifting its borrowing away from the commercial banks. However, from macroeconomic management point of view, it was not a desirable outcome as the government resorted to SBP borrowing instead of non-bank or external sources of financing.
[3] The policy rate has been lowered by a cumulative 250 basis points since August 2012.
[4] Almost the entire amount of subsidies was disbursed to the power sector during Jul-Mar 2013.

constraints and law and order issues; the lack of tax reforms; a range of tax exemptions; and leakages; remain the major factors behind this slowdown. However, the availability of US$ 1.8 billion of Coalition Support Funds (CSF) helped the government keep its deficit close to the last year's level during Jul-Mar FY13 – i.e., 4.6 percent of GDP, compared with 4.5 percent in same period last year. Moreover, provincial surpluses also supported the overall fiscal position during the first nine months of FY13. However, according to SBP projections, the continuing pressure of subsidies and interest payments, are likely to push the budget deficit to 7 – 7.5 percent of GDP (in FY13), compared to the target of 4.7 percent.

Figure 1.1: Subsidies and Interest Payments (% of Current Expenditure)



Source: Ministry of Finance

The government continued to rely on the domestic banking system to finance its deficit as external financing dried up completely. More worryingly, domestic borrowing remained skewed towards short-term financing, which raises concerns about the sustainability of Pakistan's public debt.[5,6] During the first nine months of the year, the public debt stock increased by Rs 940.6 billion – which is 44.6 percent higher than the increase in debt over the first nine months of FY12 (after adjusting for the one-off settlement of circular debt last year). More importantly, according to the FRDL Act (2005), the government must achieve a public debt-to-GDP ratio of 60 percent by end FY13. However, given the pace of the increase in the fiscal deficit (and resulting rise in public debt) during the first three quarters of FY13, there is a high likelihood that the government will not be able to achieve this target. In our earlier reports, we have repeatedly highlighted that the rise in the debt stock

[5] The short-term borrowing increased the stock of floating debt by Rs 910.3 billion during FY12, resulting in a hefty Rs 294.0 billion addition to debt servicing in Jul-Mar FY13. Similarly, the Rs 633.1 billion increase in floating debt during the first nine months of FY13 is likely to increase interest payments by Rs 179.9 billion during the next fiscal year.

[6] According to in-house estimations, the cumulative 250 bps reduction in the policy rate during H1-FY13, brought down interest payments on the auction of T-Bills by around Rs 21.8 billion for the full year FY13. This understates the savings to the Federal government, as we have limited the impact only to FY13.

accompanied by debt servicing, directly adds to subsequent fiscal deficits – this shows the increased risk of entering a debt-deficit spiral for the country.[7]

This situation underscores the need for initiating fiscal reforms on an urgent basis. Meaningful fiscal consolidation would require retrenchments in spending and efforts to increase tax revenues. We believe a significant reduction in spending can be achieved by rationalizing power tariffs and restructuring loss-making public sector enterprises (PSEs). As a strategy to reduce the domestic debt-servicing burden, the government should move away from bank borrowing, which is short-term and costly. The alternatives include domestic non-bank sources, which usually have a longer maturity, and external borrowing, which is usually cheaper. On the revenues side, the tax net needs to be widened along with removal of tax exemptions, and leakages in the tax collection need to be plugged. Moreover, provincial taxation authorities should be strengthened to mobilize revenues from both agriculture and services – in our view, the provincial governments have very promising sources of revenues in their hands.

In addition to the challenges on the fiscal front, Pakistan's external account also came under pressure after the first half of FY13. A current account surplus of US$ 187 million during H1-FY13, driven primarily by the inflows under the Coalition Support Fund (CSF), strong remittances, and a lower trade deficit; quickly turned in to a deficit of US$ 1.3 billion in Q3-FY13 because of the absence of CSF flows and a 5.1 percent YoY decline in remittances – the latter appears to be a one-off event.

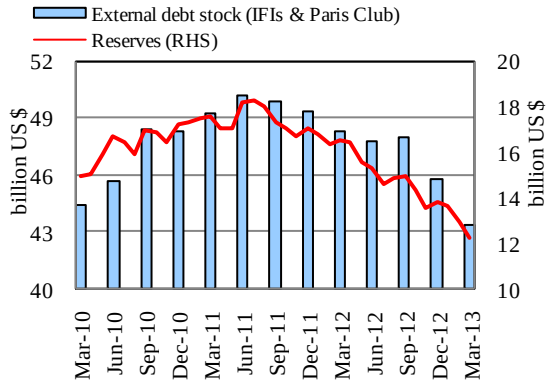
Although the cumulative current account deficit of US$ 1.1 billion for Jul-Mar FY13 was much lower than the same period last year, the external outlook remains challenging, with scheduled repayments to the IMF in the rest of FY13. As shown in **Figure 1.2**, on-going repayments of external debt (mostly to the IMF) caused Pakistan's liquid foreign exchange reserves to decline from US$15.3 billion (as of end-June 2012) to US$12.3 billion as of end-March 2013, which is the lowest level since July 2009.[8] Most of the decline was concentrated in Q3-FY13 (US$1.6 billion) and primarily impacted SBP's FX reserves. However, compared to the extent of pressures on reserves, Pak Rupee remained relatively stable in Q3-FY13.

Although the country's reserves are currently above international adequacy benchmarks (e.g., import and short-term debt coverage), they have been

[7] Our assessment is that the primary deficit and Rupee depreciation are two main drivers of the increase in government debt during the past five years (**Box 4.2**).
[8] The external debt owed to multilateral institutions, the IMF and Paris Club, constituted 71.2 percent of Pakistan's stock of total external debt & liabilities as of end-March 2013.

consistently falling since the beginning of FY13.[9] If this trend continues, the challenges in managing the FX market will persist.

Figure 1.2: Liquid Foreign Exchange Reserves and External Debt Stock



Source: State Bank of Pakistan

These underlying macroeconomic challenges should be addressed through decisive structural reforms, instead of just securing short-term financing.[10] It is important that all provinces should be taken on board in this process of economic reforms (from formulation to implementation), as their role in the economy has become significant after the introduction of fiscal devolution through the 18th amendment.[11] Particularly, success of *fiscal* reforms will hinge on the performance of the provincial governments, as their share in overall revenues (as well as in expenditures) has increased.[12] Moreover, provinces now have an exclusive role in the development of the social sector (health and education) and in broader economic development.

To summarize the immediate risks facing the country, we would list the following: (1) the size of the fiscal deficit and how it will be addressed; (2) providing comfort to the FX market for FY14; (3) institutional strengthening of tax authorities (federal as well as provincial) so they can increase the tax base and collection; (4) a balanced approach to energy reforms that supplements tariff rationalization with strict enforcement on theft, overdue bills, better management practices, and decisive steps to encourage the use of alternate fuel sources (e.g. coal); (5) a strictly commercial orientation towards PSE reforms (especially for Pakistan Railways; PIA; and Pakistan Steel Mills); (6) increasing the risk-appetite of

[9] Liquid foreign exchange reserves as of end-March 2013 were equivalent to 4 months of imports – higher than the rule-of-thumb of 3 months of imports. When the previous IMF SBA was signed, Pakistan's liquid FX reserves were US$9.0 billion which were equivalent to 12.2 weeks of imports.
[10] Given Pakistan's past history with multilateral lenders like the IMF (**Table 1.2**), a credible reform agenda is also essential to negotiate with the IFIs.
[11] One way to take provinces on board is to include provincial finance ministers in negotiations with IMF.
[12] During FY12, the first complete year after devolution, total expenditures of provinces were higher than federal expenditure excluding debt servicing and defense expenses.

commercial banks; and (7) immediate steps to increase power generation, which may require fresh liquidity to secure fuel supplies.

To achieve sustainable and equitable economic growth, the government will have to firmly commit to bold economic reforms.

Table 1.2: IMF Programs since 2000 *

IMF Program	Start Date and Changes	Amount (in millions)		Status
		Sanctioned	Drawn	
Emergency Natural Disaster Assistance (ENDA)[13] to help the country manage the aftermath of massive floods	September 15, 2010	SDR 296.98 (or US$ 451)	SDR 296.98 (or US$ 451)	Immediate disbursement of full amount.
Stand-by Arrangement (SBA)	November 2008 The program was originally for 23 months (to October 2010). It was extended to end December 2010 after the second review; and further to end-September 2011 to enable Pakistan to complete GST reform, consolidate fiscal policy, and amend the legislative framework for the financial sector.	SDR 7,235.9 (or US$ 11,327) Originally SDR 5,169 million (or US$ 7.6 billion) was approved. It was enhanced to SDR 7,236 million (or US$ 11.3 billion) after the second review in August 2009.	SDR 4,936.0 (or US$ 7,477)	**1st** tranche of US$3.1 billion in December 2008; **2nd** tranche of US$847 million in March 2009; **3rd** tranche of US$1.2 billion in August 2009; **4th** tranche of US$1.2 billion in December 2009; **5th** tranche of US$1.13 billion in May 2010. Remaining amount not released due to non-implementation of agreed measures.
Poverty Reduction and Growth Facility (PRGF)[14]	December 2001 (3 years)	SDR 1,034 (or US$ 1,322)	SDR 861.42 (or US$ 1,186)	**1st** tranche of US$ 109.6 million in December 2001; **2nd** tranche of US$ 107

[13] The ENDA, which provides rapid and flexible financial assistance for countries affected by natural disasters with an urgent balance of payments need, is not linked to any program-based conditionality or review. Pakistan's financing under the ENDA carried the IMF's basic rate of charge, had a three-year and three month grace period, and to be repaid in eight equal installments with a final maturity of 5 years.

[14] The IMF's concessional facility for low-income countries, the Enhanced Structural Adjustment Facility (ESAF), was renamed in November 1999 the Poverty Reduction and Growth Facility. PRGF loans carry an interest rate of 0.5 percent a year, and are repayable over 10 years with a 5½-year grace period on principal payments.

				million in March 2002; **3rd** tranche of US$ 114 million in July 2002; **4th** tranche of US$ 114 million in November 2002; **5th** tranche of US$ 118 million in February 2003; **6th** tranche of US$ 123 million in June 2003; **7th** tranche of US$ 247.54 million in October 2003; **8th** tranche of US$ 252.60 million in June 2004. The final tranche was approved in Dec 2004, but Pakistan did not draw this tranche.
Stand-by Arrangement (SBA)	November 2000 (10 months)	SDR465 (or US$ 596)	SDR465 (or US$ 591)	**1st** tranche of US$ 192 million in November 2000; **2nd** tranche of US$ 133 million in March 2001; **3rd** tranche of US$131 million in July 2001; Last tranche of US$135 million in September 2001. This program was completed successfully.

* See SBP Annual Report, 1999-00, Chapter 8 for IMF programs of 1980s and 1990s.
Source: Various documents available at IMF website.

2 Real Sector

2.1 Overview

The Pakistan Bureau of Statistics (PBS) has recently released the national income accounts for FY13. These estimates have been compiled on a new base of 2005-06 (previously the base year was 1999-2000). PBS has improved its compilation methods, and has captured economic activities that are increasingly prominent – this data set is also at par with international standards (**Box 2.1**).[1]

According to provisional estimates, GDP growth during FY13 fell to 3.6 percent from 4.4 percent in FY12.[2] As evident in **Table 2.1**, higher industrial growth, driven by more activity in large scale manufacturing, was insufficient to make up for the slowdown in services.

Table 2.1: Overall GDP (at Constant Basic Prices of 2005-06)

Growth in percent; contribution in percentage points

	Growth		Contribution to Growth	
	FY12	**FY13^P**	**FY12**	**FY13^P**
Agriculture	3.5	3.3	0.7	0.7
Industry	2.7	3.5	0.6	0.7
Services	5.3	3.7	3.0	2.1
GDP	**4.4**	**3.6**	**4.4**	**3.6**

P: Provisional

Source: Pakistan Bureau of Statistics

Table 2.2: Value Addition by Agriculture

Share and growth in percent; contribution in percentage points

	FY13 Share	Growth		Contribution to Growth	
		FY12	**FY13^P**	**FY12**	**FY13^P**
Crop	40.5	2.9	3.2	1.2	1.3
Major crops	25.2	7.4	2.3	1.8	0.6
Other crops	12.3	-7.7	6.7	-1.0	0.8
Cotton ginning	2.9	13.8	-2.9	0.4	-0.1
Livestock	55.4	3.9	3.7	2.2	2.0
Forestry	2.0	1.7	0.1	0.0	0.0
Fishing	2.0	3.8	0.7	0.1	0.0
Overall	**100.0**	**3.5**	**3.3**	**3.5**	**3.3**

P: Provisional

Source: Pakistan Bureau of Statistics

[1] The PBS has now implemented 2008 version of international System of National Accounts (SNA). Previous estimates of national accounts were based on 1993 version of SNA.

[2] In view of changes introduced for the computation of National Income Accounts, the actual GDP growth for FY13 is not directly comparable to the annual target of 4.3 percent for the current fiscal year. According to PBS, GDP growth for FY13 on *previous base* (which is also consistent with the target) is 3.2 percent. It may also be noted that the PBS has revised the GDP growth for FY12 from earlier provisional estimate of 3.7 percent to 4.2 percent.

2.2 Agriculture[3]

In overall terms, agricultural growth has remained largely unchanged during FY13. In particular, the livestock sub-sector (which has a 55.4 percent share in agriculture value addition), continued as the largest contributor to agriculture growth (**Table 2.2**). However, a significant change was witnessed within the crop sector, where considerable gains in wheat, sugarcane and other crops were almost neutralized by the losses in rice and cotton.

Crop sector

The *rabi* crop has done well as fertilizer prices remained relatively stable compared to last year; the government raised the support price for wheat; adequate irrigation water was available at the time of sowing (unlike the *kharif* season); the frequent rains and moderate temperatures throughout the season helped improve crop productivity; and finally, agri-credit disbursement were higher compared to last year (**Table 2.3**). The *kharif* crops of rice and cotton, on the other hand, were adversely affected due to heavy rains and localized flooding. Therefore, the overall growth in major crops during FY13 has remained significantly lower than last year.

Table 2.3: Agriculture Credit

	Disbursement	**Growth**
	billion Rupees	percent
FY08	211.6	25.4
FY09	233.0	10.1
FY10	248.1	6.5
FY11	263.0	6.0
FY12	293.8	11.7
Jul-Mar FY12	197.4	17.0
Jul-Mar FY13	231.0	17.0

Source: State Bank of Pakistan

Table 2.4: Rice Crop

	FY11	**FY12**	**FY13**
Area in 000 hectare			
Punjab	1767	1,714	1,711
Sindh	361	636	511
KPK	46	50	51
Balochistan	191	171	38
Pakistan	**2,365**	**2,571**	**2,311**
Production in 000 tons			
Punjab	3,384	3,277	3,4778
Sindh	1,230	2,260	1,844
KPK	78	95	99
Balochistan	131	529	120
Pakistan	**4,823**	**6,160**	**5,541**

Source: Pakistan Bureau of Statistics

Rice harvesting was completed in October 2012, and available information suggests an output of 5.5 million tons, which is much lower than the target of 6.9 million tons. Despite production gains in Punjab, the overall crop suffered mainly due to

[3] This section focuses on the major crops which account for 26 percent of the value addition by the agriculture sector. We did not cover the livestock subsector, the largest contributor to agriculture with 52 percent share, due to non-availability of sufficient information.

localized flooding in upper Sindh and adjoining areas of Balochistan during September 2012 (**Table 2.4**).

While heavy rains damaged the rice crop in Sindh, sugarcane growing areas remained largely unaffected. As a result, sugarcane production witnessed a sharp recovery in Sindh following the floods of FY12.[4] In addition, anticipating heavy rains and floods this year as well, farmers preferred to plant sugarcane, which is more resilient to rains and floods. In effect, overall sugarcane production reached 62.5 million tons, which is higher than the target of 59 million tons (**Table 2.5**).

Table 2.5: Sugarcane Crop

	FY11	FY12	FY13
Area in 000 hectare			
Punjab	672	761	768
Sindh	226	190	254
KPK	88	106	102
Balochistan	1	1	1
Pakistan	**988**	**1,058**	**1,124**
Production in 000 tons			
Punjab	37,481	42,893	42,982
Sindh	13,766	10,788	14,909
KPK	4,030	4,684	4,550
Balochistan	31	31	32
Pakistan	**55,309**	**58,397**	**62,472**

Source: Pakistan Bureau of Statistics

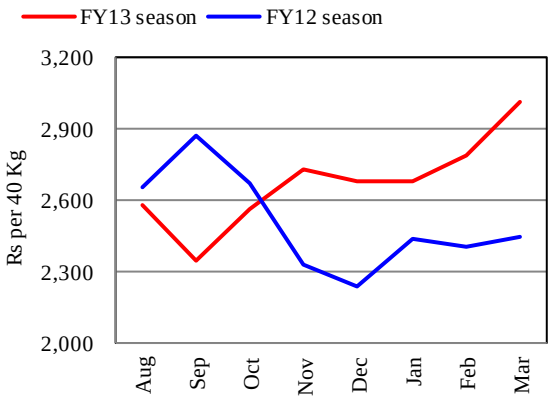
Meanwhile, the crop assessment committee has estimated 13.3 million bales of cotton for FY13, which is lower than the target of 14.5 million. However, the information provided by the Pakistan Cotton Ginners Association (PCGA), paints a more pessimistic picture. According to PCGA, the ginners have received 12.9 million bales of cotton by the end of April 2013 (i.e., close of cotton season). Generally, the cotton bales reported by PCGA are of lower weight, i.e., between 160-165 kg, compared to the standard weight of 170 kg. If we standardize the PCGA data, the likely harvest will be much lower.

While the area under cotton cultivation fell this year,[5] the crop also suffered due to two other shocks: (1) localized flooding in Southern Punjab (particularly, in DG Khan, Rajanpur, Muffargarh, Rahim Yar Khan, Bahawalpur and Bahawalnagar);[6] and (2) the impact of the Cotton Leaf Curl Virus (CLCV). The impact of the virus, which was more severe compared to last year, was concentrated in central

[4] It may be recalled that after the FY12 floods, key sugarcane growing districts of Sindh (e.g., Badin, Mirpurkhas, and Tando Allahyar) remained inundated for an extended period. These three districts, together, contribute more than 40 percent of the sugarcane production in Sindh.
[5] Area under cotton cultivation fell because of delays in the harvesting of FY12 wheat crop, water shortage at the sowing time, and lower cotton prices compared to the previous season.
[6] These six districts produced 4.9 million cotton bales in FY12 (36 percent of the total production).

Punjab (Khanewal, Multan, and Burewala).[7] Cotton varieties that are sown later in the season are more vulnerable in the early stage of growth, as they are exposed to humidity.[8] At the same time, the higher prices of pesticides constrained farmers' ability to take precautionary measures.[9] However, the impact of the damages to the cotton crop on farmers' income was partially offset by a rise in seed-cotton (*phutti*) prices in the domestic market (**Figure 2.1).**

Figure 2.1: Domestic Price of Seedcotton (Phutti)



Source: Pakistan Central Cotton Committee

Wheat, which is the main crop of the *rabi* season, reached its final stage by end-March 2013. Harvesting, which has already ended in Southern Sindh, will continue till late May in the central and upper parts of the country.

Table 2.6: Wheat Crop

	FY11	FY12	FY13
Area in 000 hectare			
Punjab	6,691	6,483	6,537
Sindh	1,144	1,049	1,058
KPK	725	729	734
Balochistan	341	388	363
Pakistan	**8,901**	**8,650**	**8,693**
Production in 000 tons			
Punjab	19,041	17,739	18,627
Sindh	4,288	3,762	3,731
KPK	1,156	1,130	1,105
Balochistan	729	843	768
Pakistan	**25,214**	**23,473**	**24,231**

Source: Pakistan Bureau of Statistics

The wheat crop benefited from better availability of irrigation water; timely rains; favorable temperatures; increased off-take of fertilizer; and higher support prices for wheat (from Rs 1,050 per 40 kg to Rs 1,200). Hence, initial estimates of the wheat crop are at

[7] These three districts produced over 1.5 million cotton bales in FY12.
[8] CLCV generally shows up in the months of August and September (which are relatively humid). Hence, to protect against the pest attack, farmers prefer to sow cotton early in February so that the plant grows strong enough to withstand the virus attack. Unfortunately, the cotton sowing for the current crop got delayed, first due to extended winter season last year, and then on account of water shortage before monsoon. This delay in planting made the crop susceptible to pest attack.
[9] The wholesale price index for pesticides posted a rise of 18 percent during Jul-Sep 2012 (this period coincides with CLCV virus attack).

24.2 million tons, which is higher than the 23.5 million tons last year, but this is still lower than the target of 25.5 million tons set for FY13 (**Table 2.6**).

Prospects of a good harvest, together with gradual declines in global prices,[10] are already pulling down wheat prices in the domestic market.[11] To protect farmers against a sharp fall in domestic prices, the government has set a procurement target of 7.9 million tons for the current season, which is significantly higher than the 6 million tons *procured* during FY12.

Finally, growers' income remained under pressure during Jul-Mar FY13, despite productivity gains in sugarcane production.[12] This loss in income can be traced to the cotton and rice crops. However, the impact of the increased production of wheat crop will mostly be realized after April 2013. On the input side, the price of pesticides increased sharply for the second year in a row, whereas the price of fertilizer remained relatively stable during Jul-Mar FY13 (**Table 2.7**).

Table 2.7 Agricultural Input Prices

YoY % Change in Wholesale Price Index (Jul-Mar)

	FY12	FY13
Tractor	23.3	-9.5
Fertilizer	58.7	2.3
Pesticides	26.6	18.9
Insecticides	2.4	-5.7
Diesel	0.7	0.3

Source: Pakistan Bureau of Statistics

Box 2.1: The Rebasing of National Income Accounts

The Pakistan Bureau of Statistics (PBS) has re-based the National Accounts from the fiscal year 1999-2000 to 2005-06. The rebasing has been accompanied by significant changes in the compilation methodology for national income accounts from System of National Accounts (SNA) 1993 to SNA 2008.[13] The major changes introduced in the compilation method are detailed below:

- GDP statistics are now reported at *basic* prices. Earlier, national accounts were being estimated on the basis of factor costs. The key difference between the factor cost and the basic price method

[10] The prices of CBOT wheat have fallen from around US$ 350 per ton in mid-July 2012 to US$ 250-260 in early April 2013.

[11] The weekly wheat prices compiled by Pakistan Bureau of Statistics posted a decline of around Rs 50 per 40 kg during the first fortnight of April 2013. Furthermore, there are reports that farmers are selling their produce at much lower prices (Rs 1,100 – 1,150 per 40 kg) compared to government support price of Rs 1,200. The price that farmers eventually get would be even lower once we adjust for the cost of transportation and *bardana* (i.e., jute bag).

[12] In November 2012, government increased the wheat support price to Rs 1,200 from Rs 1,050 per 40 kg. For sugarcane, the Punjab government raised the indicative prices to Rs 170 per 40 kg from Rs 150 in the previous season. The Sindh government also increased indicative prices from Rs 154 to 172 per 40 kg.

[13] System of National Accounts (SNA) is the international statistical standard for the national accounts, adopted by the United Nations Statistical Commission. SNA 2008 is the latest version.

is that the former excludes *all* indirect taxes on production and includes all subsidies, while only taxes and subsidies on *intermediate* commodities are treated in this manner in the latter method. Hence, basic price is what the producer actually gets.[14]

Table 2.1.1: Change in Economic Structure in 2005-06

	Share in GDP (%)	
	Old base (1999-00)	**New base (2005-06)**
Agriculture	22.5	23.0
Industry	25.9	20.9
Services	51.7	56.0

Source: Pakistan Bureau of Statistics

- With the change in international classification, cotton ginning is now a part of agriculture; in the previous system, it was included in large scale manufacturing. Similarly, meat and meat products have been excluded from manufacturing, and are now covered in slaughtering.

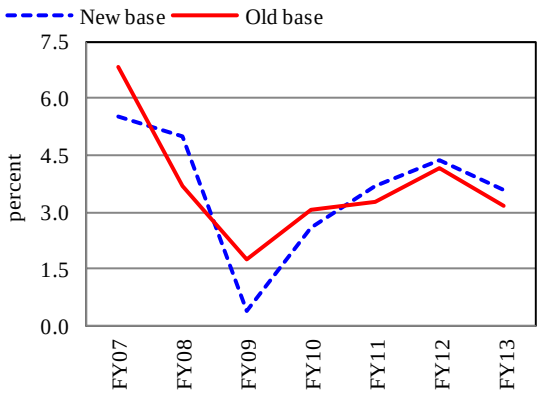
- The new base has expanded its coverage to include new economic activities such as flower production, animal husbandry and hunting, newspaper and periodicals etc.

- National accounts are now using more recent census, surveys, and studies for the computation of value addition for different sectors.

- The growth rate of small scale manufacturing has increased from 7.5 percent in the earlier base to 8.2 percent. This revision was made following results of the new survey of Small and Household Manufacturing Industries.

- The coverage of the transport, storage and communication sector has been expanded by including Railway-franchised booking, franchised post offices, Pakistan Railway Advisory and Consultancy Services (PRACS), shipping agents, goods forwarding and custom clearance agents, travel agents, and tour operators.

Figure 2.1.1: GDP Growth



Source: Pakistan Bureau of Statistics

- The finance and insurance subsector has been totally revamped on the basis of SNA 2008 after consultation with Security and Exchange Commission of Pakistan (SECP) and State Bank of Pakistan (SBP). Since this sector's output is neither visible nor directly measureable, SNA 2008 uses an indirect measurement method called 'Financial Intermediation Services Indirectly Measured (FISIM)'. Conceptually, FISIM is the sum of the service charge paid by the borrower and the service charge paid by the lender.

[14] This excludes any tax on the final produce, but includes subsidies.

Figure 2.1.1 compares GDP growth rates based on the old and new series and the similarity in their trends. The composition of real GDP has also changed. Specifically, the share of services has increased substantially, whereas the share of industry has declined (**Table 2.1.1**).

2.3 Industry

A stronger performance by *large scale manufacturing*, *mining & quarrying* and *construction* (with a combined share of 77 percent in industry index) helped the industrial sector to post a growth of 3.5 percent in FY13, compared to 2.7 percent last year (**Table 2.8**). More strikingly, this improved performance was despite continued energy constraints.

Table 2.8: Value-addition by Industry

Share and growth in percent; contribution in percentage points

	Share in FY13	Growth		Contribution to Growth	
		FY12	FY13^{p}	FY12	FY13^{p}
Mining & quarrying	14.7	4.6	7.6	0.6	1.1
Manufacturing	63.0	2.1	3.5	1.4	2.2
Large scale	50.9	1.2	2.8	0.6	1.5
Small scale	7.6	8.4	8.2	0.6	0.6
Slaughtering	4.5	3.6	3.5	0.2	0.2
Electricity gen & dist and gas dist	10.9	2.7	-3.2	0.3	-0.4
Construction	11.4	3.2	5.2	0.4	0.6
Overall	**100.0**	**2.7**	**3.5**	**2.7**	**3.5**

P: Provisional

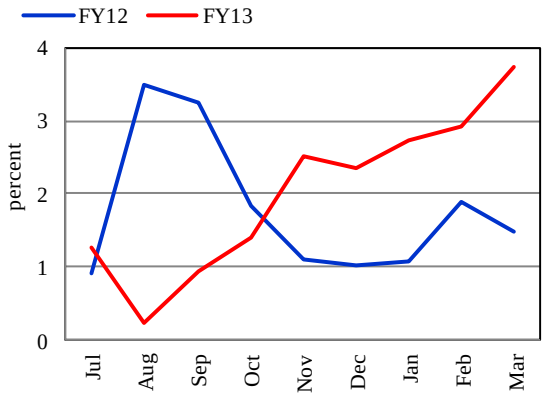
Source: Pakistan Bureau of Statistics

Large Scale Manufacturing (LSM)[15]

LSM growth gained further momentum during Q3-FY13, on the back of higher production of sugar, POL, cement, fertilizer, and cotton yarn. This is in contrast to the same period last year, when LSM growth was largely explained by sugar production (**Table 2.9**).

On a cumulative basis, LSM grew by 3.7 percent during Jul-Mar FY13, which is higher than 1.5 percent in Jul-Mar FY12 (**Figure 2.2**). More importantly, the recovery is broad-based and can be traced to: (a) improved producer margins on account of lower financing costs and falling raw material prices; (b) a better sugarcane crop; (c) capacity enhancements in iron & steel, and paper & paper board; (d) the continued

Figure 2.2: Cumulative Growth in LSM



Source: Pakistan Bureau of Statistics

[15] This discussion is based on data available for Jul-Mar FY13 period.

strength in construction activities; (e) higher external demand for cotton yarn; and (f) better gas availability for the fertilizer industry. Encouragingly, this higher growth was realized despite frequent interruption in economic activities due to the challenging law & order situation, and power shortages.

Table 2.9: Performance of Selected Industries

percent YoY growth

								Contribution to Growth	
		Jul-Mar		Jul-Dec		Jan-Mar		Jan-Mar	
	Wt	FY12	FY13	FY12	FY13	FY12	FY13	FY12	FY13
Overall LSM		1.5	3.7	1.0	2.4	2.3	6.0		
Consumer durable	4.9	4.9	-12.9	7.3	-14.1	0.4	-9.0	0.0	-0.6
Cars & jeeps	2.8	8.8	-23.0	8.7	-24.5	8.8	-20.6	0.3	-0.7
Electronics	2	-7.4	-6.7	-8.1	-11.7	-6.1	2.5	-0.10	0.04
Construction-led									
Cement	5.3	3.0	6.0	3.1	4.5	3.0	8.9	0.3	0.8
Steel coils & sheets	2.3	-34.2	45.5	-46	75.7	-7.0	4.8	-0.1	0.1
Paints	0.3	-23.4	-2.2	-27.1	-7.2	-13.4	9.4	-0.04	0.02
Export-led									
Cotton cloth	7.2	0.7	0.2	0.9	-0.1	0.1	0.9	0.1	0.5
Cotton yarn	13.0	1.1	1.3	1.4	0.3	0.6	3.2	0.1	0.6
Pharmaceutical	3.6	10.3	11.5	15.4	6.5	1.3	21.6	0.1	1.5
Leather	0.9	2.3	-5.1	8	-6.6	-7.5	-2.2	-0.1	0.0
Agriculture-led									
Fertilizer	4.4	-0.4	-5.0	-3.7	-10	8.1	6.6	0.3	0.3
Tractors	0.5	-48.1	34.5	-59	102.5	-29.3	-33.5	-0.2	-0.2
Food	12.4	7.4	6.7	7.2	4.1	7.6	9.2	2.2	2.7
Sugar	3.5	15.2	3.0	35.8	-25.3	10.5	11.0	1.8	2.1
Edible oil	2.2	1.7	11.2	-3.4	15.2	13.2	3.5	0.4	0.1
POL	5.5	-5.7	13.3	-1.8	10.4	-12.8	19.3	-0.7	0.9
Petroleum products	5.4	-4.5	13.5	-0.3	10.8	-12.4	19.1	-0.7	0.9
Paper & board	2.3	18.2	23.3	9.4	32.6	37.4	7.2	0.9	0.2

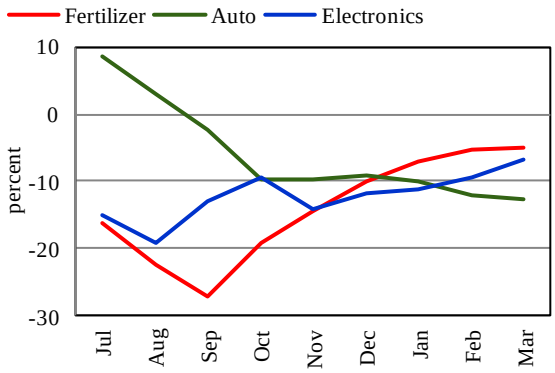
Source: Pakistan Bureau of Statistics

Following some improvement in gas supplies, fertilizer production has increased since October 2012.[16] However, the drag from the drop in production in the first quarter is still pulling down LSM growth for FY13 (**Figure 2.3**). The other two

[16] According to industry data, urea production during Oct 2012-Mar 2013 increased by 5.3 percent compared to a decline of 14.2 percent in the corresponding period of previous year.

sectors that have been holding back LSM growth are automobiles and consumer electronics. Adjusting for fertilizer, auto and electronics (which have a combined weight of 11.0 percent in LSM index), LSM growth is 5.6 percent during Jul-Mar FY13, compared to 2.0 percent in the corresponding period last year.

Figure 2.3: Key Industries Showing Negative Growth in FY13 (Cumulative Growth)



Source: Pakistan Bureau of Statistics

A number of factors, both domestic as well as external, explain the recovery in LSM growth.

Better sugarcane crop drives higher sugar production

The third quarter generally experiences a seasonal rise in sugar production. This quarter was particularly favorable due to a good sugarcane harvest; substantial support from the government; and the lower than normal crushing in the preceding quarter.[17] So far, total sugar production during Jan-Mar FY13 is 4.6 million tons, which is 3.0 percent higher than the corresponding period of FY12.

Higher external demand boosts textile production

In the textile sector, increased demand for cotton yarn and cloth from the Chinese and Hong Kong markets, translated into higher domestic production.[18] However, subdued growth in the ginning sector reveals that the industry is using imported cotton (and running down existing inventories) for the production of yarn and cloth.[19]

Enhanced capacity in iron & steel, and paper & paper board

The iron & steel, and paper & paper board industries (having a combined weight of 7.7 percent) witnessed capacity expansions that became operational during this year. Within iron & steel, the production of hot-rolled and cold-rolled steel rose to

[17] The sugar industry was facing a liquidity crunch because of large unsold stocks and unfavorable international prices. Government therefore intervened by: (1) purchasing surplus sugar through TCP; (2) permitting sugar exports; and (3) facilitating exporters through the freight subsidy.
[18] For details on increased demand in China and Hong Kong, see trade section in Chapter 5.
[19] According to cotton ginning association, the cotton arrival, cotton stocks and sold stocks remained lower in procurement season of FY13 relative to last year.

1.8 million tons during Jul-Mar FY13 from 1.3 million tons in the corresponding period last year. This is due to two new plants: one came online in October 2012, and is already working at full capacity; the other commenced production in January 2013, and is currently working at 70 percent of capacity.

Low input costs helps cement and edible oil

While persistent domestic demand helped the cement and the edible oil sectors, falling raw material prices also incentivized domestic producers to expand output. For instance, the fall in international coal prices during FY13 benefited cement producers running coal-based plants.[20] This industry expanded by 6.0 percent during Jul-Mar FY13, compared to 3.0 percent in Jul-Mar FY12. Similarly, the increase in growth in oil and ghee production was on account of lower international prices of palm oil.[21]

2.4 Services Sector

The growth in the services sector decelerated from 5.3 percent in the previous year to 3.7 percent in FY13. The slowdown in *transport, storage & communication* and *general government services* overshadowed the improved performance by *wholesale & retail trade* and *finance & insurance* (**Table 2.10**).

Table 2.10: Value Addition by Services

Share and growth in percent; contribution in percentage points

	Share in FY13	Growth		Contribution to Growth	
		FY12	FY13[p]	FY12	FY13[p]
Wholesale & retail trade	31.5	1.7	2.5	0.5	0.8
Transport, storage & communication	23.7	8.9	3.4	2.1	0.8
Finance & insurance	5.2	1.0	6.6	0.1	0.3
Housing services	11.7	4.0	4.0	0.5	0.5
General govt. services	11.7	11.1	5.6	1.2	0.6
Other private services	16.2	6.3	4.0	1.0	0.6
Overall	**100.0**	**5.3**	**3.7**	**5.3**	**3.7**

P: Provisional

Source: Pakistan Bureau of Statistics

Lower growth by the telecom sector and higher losses in Pakistan Railways, held back growth in *transport, storage & communication*. Unlike previous years, air transport saw an increase in its contribution to services growth. This probably reflects the impact of lower fuel costs as a result of which, PIA has been posting operating surpluses since October 2012.

[20] On average, international price of coal fell by 22.8 percent on YoY basis in Jul-Mar FY13 in contrast to a growth of 8.5 percent in the corresponding period of FY12.

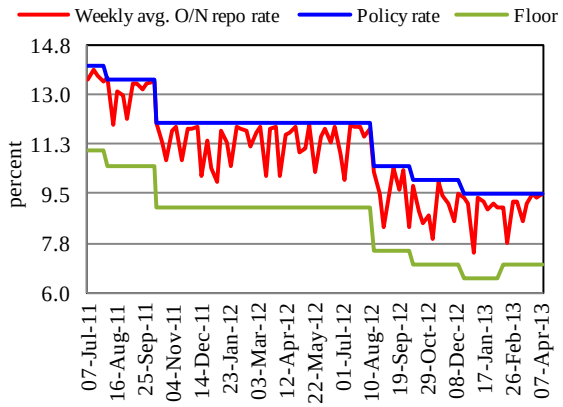
[21] The better production of palm oil during 2012-13 in Indonesia, the largest palm oil producing country, weakened the international prices of the commodity. Specifically, these prices fell from US$ 1,052 per ton in mid-September 2012 to US$ 756 by end-March 2013.

3 Monetary Policy and Inflation

3.1 Overview

Following the 250 bps cut in the policy rate during first half of the year,[1] SBP kept the rate unchanged at 9.5 percent in the last two monetary policy decisions in February and April 2013 (**Figure 3.1**). While inflationary concerns eased to a great extent, a weakening external account posed the real challenge to further monetary easing. Specifically, SBP's liquid foreign exchange reserves declined by US$ 3.7 billion during Jul-Mar FY13, and the Pak Rupee lost 3.9 percent of its value against the US$.[2]

Figure 3.1: Trends in Overnight Repo Rates



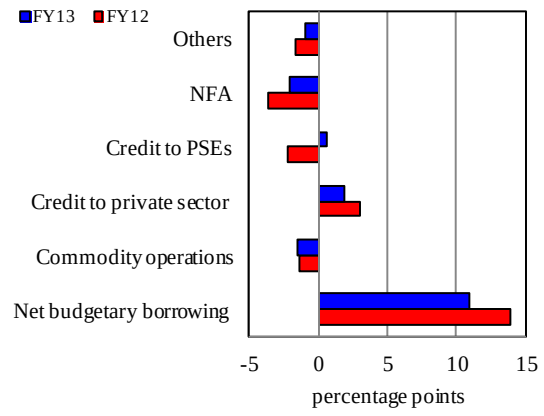
Source: State Bank of Pakistan

Given the *nature* of the weaknesses in the external account, the interest rate policy is less likely to yield the desirable results as: (a) the absolute size of current account deficit is small;[3] (b) increase in interest rates is less likely to attract external financial inflows in the presence of other country-specific risks; and (c) the high cost of borrowing could negatively impact the already low level of private sector investment. Cognizant of these issues, SBP kept the policy rate unchanged in order to keep the opportunity cost of investing in foreign assets high to avoid unnecessary pressure on the local currency. Moreover, the continuation of fiscal weaknesses (as evident from increasing government borrowing from the banking system) also weighted in favor of cautious monetary easing.

[1] Policy rate was initially lowered by 150 bps to 10.5 percent in August 2012 and then by 50 bps each in October 2012 and December 2012 to reach 9.5 percent.
[2] For details on external accounts, please see **Chapter 5** on External Sector.
[3] Within the current account, imports recorded a YoY decline of 1.9 percent during Jul-Mar FY13.

Stepping back, one of the most notable developments over the period of analysis has been the deceleration in inflation. Headline YoY inflation reached a low of 6.6 percent in March 2013, pulling down the *period* average (Jul-Mar FY13) to 8.0 percent compared to 10.8 percent during the same period last year. This marked decline in inflation was largely attributed to the stability in fuel and food prices, and softening inflationary expectations.

Figure 3.2: Contribution to M2 Growth (Jul-Mar)



Source: State Bank of Pakistan

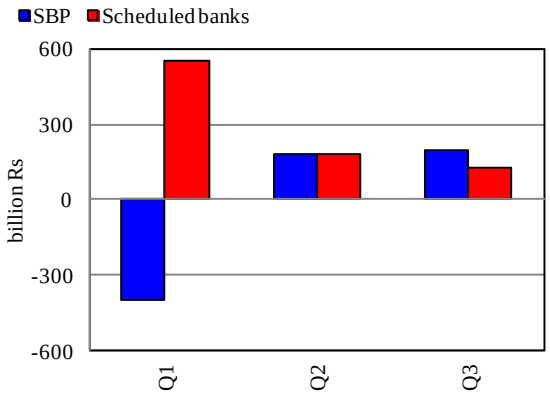
While there is no immediate upside risk to inflation at this point in time, adverse developments on the external front and the government's reliance on bank financing remains the major concerns to inflationary outlook. Currently, developments in both these sectors are complicating the monetary management.

At the aggregate level, broad money supply (M2) grew by 9.0 percent during Jul-Mar FY13, compared to 8.1 percent during the same period last year. However, major source of this monetary expansion has been high government budgetary borrowing from the banking sector (**Figure 3.2**). Specifically, the government borrowed Rs 836.4 billion from the banking sector during Jul-Mar FY13, compared to Rs 932.8 billion during the same period last year.

This small decline in government borrowing in FY13 must be seen in the context of two *one-off* events: lump sum payments (Rs 391.0 billion) on account of the circular debt consolidation in FY12; and the realization of CSF receipts (US$ 1.8 billion) in H1-FY13, the latter helped contain the government's borrowing needs this period.

Within the banking sector, cumulative flows indicate that the government relied mostly on borrowing from commercial banks, and retired some of its debt from SBP during Jul-Mar FY13. However, quarterly data indicate that the government's reliance on SBP funding increased as the year progressed (**Figure 3.3**).

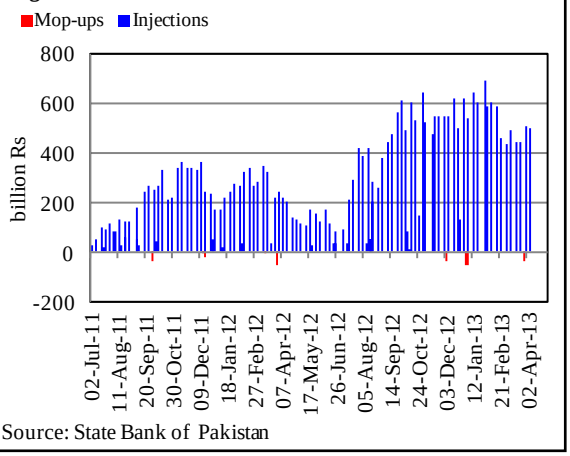
Figure 3.3: Quarterly Budgetary Borrowing (FY13)



Source: State Bank of Pakistan

In fact, commercial banks could not mobilize enough deposits to match the government's appetite for funding over the period of analysis.[4] This, combined with the servicing of external debt (other than IMF) and SBP's foreign exchange interventions, kept rupee liquidity in the market under pressure. Under these circumstances, SBP has been injecting liquidity through Open Market Operations (OMOs) to ensure that the market functions smoothly. As shown in **Figure 3.4,** the volume of OMOs has been hovering around Rs 500 billion since September 2012, which is substantially higher compared to the same period last year.

Figure 3.4: SBP Interventions

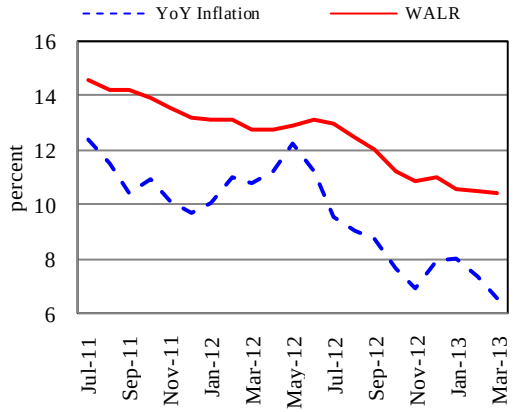


Source: State Bank of Pakistan

[4] Private sector deposits held with commercial banks saw an increase of Rs 482.5 billion during Jul-Mar FY13, while the commercial banks' lent Rs 860.2 billion for budgetary finance.

The provision of liquidity to the system was also necessary to ensure the pass-through of monetary policy decisions – i.e., to ensure that banks reduced the cost of private sector borrowing. Following the cuts in policy rate, the weighted average lending rate (on fresh loans) saw a reduction of 267 bps to 10.5 percent since June 2012. This seems to be one of the key factors contributing to the modest increase in loans to private sector businesses. However, it is pertinent to note here that the impact of the decline in lending rates was partially diluted, since the *real* cost of borrowing remained almost constant, i.e. inflation adjusted weighted average lending rates (**Figure 3.5**).

Figure 3.5: Inflation and Lending Rate



Source: PBS and SBP

In absolute terms, loans to private sector businesses increased by Rs 165.1 billion during Jul-Mar FY13, compared to Rs 42.9 billion in the same period last year.[5] The volume of all three segments of private sector borrowing (including working capital loans, fixed investment loans, and trade loans) expanded over the first three quarters of the year. Moreover, the distribution of loans across sectors indicates that the expansion was broad-based as well.

Finally, consumer financing also expanded by Rs 8.5 billion during Jul-Mar FY13; this was in contrast to the contractions that had been witnessed in this segment during the last four years (FY09 to FY12). The expansion was largely driven by personal loans, while volumes of other categories of consumer finance (mortgage loans, consumer durable and credit cards) are still declining.

3.2 Developments in Monetary Aggregates

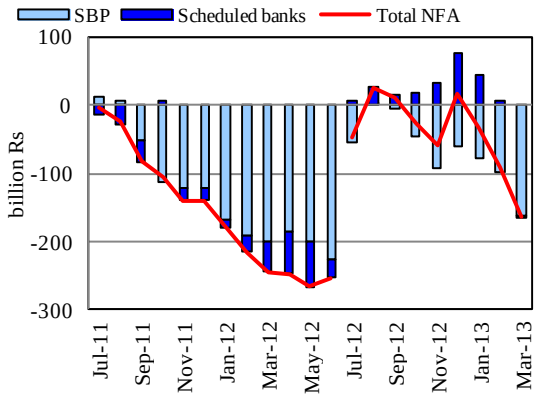
Similar to last year, monetary expansion during Jul-Mar FY13 was driven entirely by net domestic assets (NDA) of the banking sector, while changes in net foreign assets (NFA) partially offset this expansion. However, a net contraction in NFA of Rs 161.2 billion during Jul-Mar FY13 was lower as compared to a decline of Rs

[5] Compared to 3-year average of Rs 137.6 billion.

244.3 billion in the same period last year: this is a reflection of the relative improvement in the balance of payments position.[6]

The decline in NFA occurred mainly in the *third quarter* of this year (**Figure 3.6**). It is pertinent to mention that two tranches of CSF inflows in H1-FY13 had kept the current account positive during that period. However, the absence of CSF inflows, along with the fall in remittances and an unchanged trade deficit, resulted in the contraction in NFA during Q3-FY13.

Figure 3.6: NFA Cumulative Flows



Source: State Bank of Pakistan

Within the banking system, NFA of commercial banks expanded by Rs 1.8 billion during Jul-Mar FY13, which was totally overshadowed by a net contraction of Rs 163.0 billion in NFA of SBP. Although CSF inflows helped contain pressures on the external account, a number of other factors – including external debt obligations (other than IMF), weak financial inflows, and interventions in the FX market – were driving the net contraction in SBP's NFA. On the other hand, the minor expansion in NFA of commercial banks during Jul-Mar FY13 was attributed to a rise in the balances of banks held abroad, and the decline in non-resident foreign currency deposits.[7]

Net Domestic Assets (NDA)

NDA of the banking system grew by 11.9 percent during Jul-Mar FY13, compared to 13.4 percent during the same period last year. The expansion was largely driven by government borrowing, while credit to private sector and PSEs

[6] The overall external account balance recorded a deficit of US$ 1.8 billion during Jul-Mar FY13 compared with a deficit of US$ 2.7 billion during the same period last year. CSF inflow of US$ 1.8 billion during Jul-Mar FY13 was the prominent factor.

[7] Foreign loans for trade financing recorded a retirement of US$ 431.0 million during Jul-Mar FY13. The balances of banks held abroad also increased by US$ 224.0 million during this period. Non-resident foreign currency deposits, a foreign liability of the banks, recorded a decline of US$ 278.0 million during Jul-Mar FY13, which also contributed to an increase in the NFA of scheduled banks.

expanded slightly. Commodity operations, another important component of NDA, recorded net retirements during Jul-Mar FY13.

Government Borrowing for Budgetary Support [8]

Overall government borrowing for budgetary support was slightly lower during Jul-Mar FY13, compared to the same period last year (**Table 3.1**). As discussed earlier, this relative decline was largely because of *one-off* events as fiscal weakness continued to persist. Specifically, government borrowing last year included a one-time adjustment of Rs 391.0 billion on account of circular debt consolidation. Adjusting for this one-off payment indicates that government borrowing this year is much higher than last year. Another important factor is the realization of CSF money during H1-FY13, which helped contain the overall volume of government borrowing.

Table 3.1: Changes in Monetary Aggregates (Jul-Mar)

billion Rupees

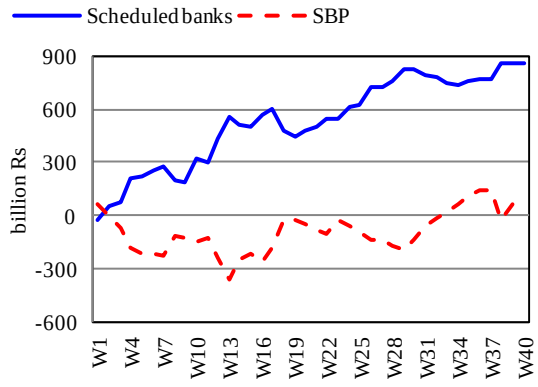
	FY12				FY13			
	Q1	**Q2**	**Q3**	**Jul-Mar**	**Q1**	**Q2**	**Q3**	**Jul-Mar**
Broad money (M2)	-21.0	400.4	166.0	545.4	54.0	558.4	74.0	686.4
NFA	-82.7	-57.2	-104.5	-244.3	11.8	5.4	-178.4	-161.2
SBP	-53.3	-69.3	-77.4	-200.0	-4.3	-55.6	-103.1	-163.0
Scheduled banks	-29.4	12.1	-27.0	-44.3	16.0	61.0	-75.3	1.8
NDA	61.7	457.6	270.5	789.8	42.2	553.0	252.3	847.6
SBP	120.8	116.9	143.6	381.2	101.7	170.6	114.7	387.0
Scheduled banks	-59.0	340.7	126.9	408.6	-59.4	382.4	137.6	460.6
Key components of NDA								
Government borrowing	179.6	512.3	148.7	840.6	159.0	319.2	247.0	725.3
For budgetary support	184.4	571.7	176.7	932.8	152.5	365.6	318.3	836.4
SBP	-101.9	219.2	81.8	199.1	-399.4	183.2	192.5	-23.7
Scheduled banks	286.3	352.4	95.0	733.7	551.9	182.4	125.9	860.2
Commodity operations	-2.8	-60.8	-29.4	-92.9	9.0	-47.8	-73.7	-112.5
Non government sector	-63.4	-23.9	144.2	56.8	-69.4	214.3	39.8	184.6
Credit to private sector	-88.7	282.2	7.0	200.5	-84.9	189.5	35.3	139.8
Credit to PSEs	25.2	-306.8	137.2	-144.3	15.5	24.8	4.6	44.9
Memorandum items: Government borrowing on cash basis								
Banking system	160.8	573.6	141.7	876.1	211.5	346.4	298.7	856.7
SBP	-103.5	227.9	70.8	195.2	-247.6	39.8	182.1	-25.7
Scheduled banks	264.3	345.7	70.9	680.9	459.2	306.6	116.6	882.4

Source: State Bank of Pakistan

[8] See Data Explanatory Note 4(b) at **Annexure A.**

Within the banking system, government borrowing from SBP fell by Rs 23.7 billion during Jul-Mar FY13, while borrowing from commercial banks increased by Rs 860.2 billion (a 41.1 percent increase over the stock of end-FY12) during the same period (**Figure 3.7**). This clearly implies that the government has relied heavily on commercial banks for budgetary financing this year.

Figure 3.7: Weekly Budgetary Borrowing -Cumulative Flows (FY13)



Source: State Bank of Pakistan

However, these numbers conceal true behavior of government borrowing during FY13. A quarterly analysis of government borrowing indicates that net retirement to SBP was concentrated in the first quarter of FY13, which offset the increase in government borrowing from SBP in subsequent quarters. On the other hand, heavy government borrowing from commercial banks during Q1-FY13, meant that *overall* borrowing from commercial banks during Jul-Mar FY13 remains high despite the substantial decrease in borrowing in subsequent quarters (**Table 3.1**).

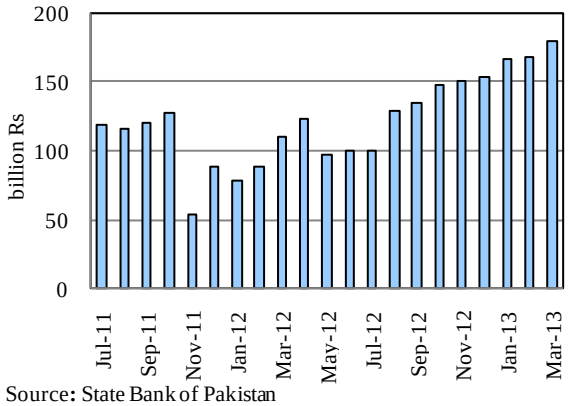
Commodity Financing

In addition to budgetary borrowing, the government also borrows from commercial banks for its commodity operations. These loans witnessed a net retirement of Rs 112.5 billion during Jul-Mar FY13, compared to Rs 92.9 billion last year. The retirement was largely driven by repayments of loans taken for wheat procurement last year, before the commencement of the new procurement season.[9] Specifically, the Punjab Food Department retired Rs 84.4 billion as it offloaded its wheat stocks aggressively after October – the Sindh Food Department also retired Rs 30.3 billion during Jul-Mar FY13. In addition to the usual release of stock, the export of wheat during this period also helped retirement of loans.

[9] Net retirement of Rs 145.4 billion was recorded by the wheat procurement agencies during the period of analysis.

However, the retirement on account of wheat was partially offset by fresh borrowing for the procurement of sugar and the import of fertilizer.[10] Despite an increase in sugar exports (which should allow for retirement), the outstanding loans for sugar procurement increased by Rs 14.5 billion during Jul-Mar FY13.

Figure 3.8: Stock of Outstanding Subsidies (receivables) for Commodity Financing



Source: State Bank of Pakistan

It is pertinent to mention here that outstanding subsidies (receivables) for commodity operations (especially for wheat and fertilizer) increased significantly during Jul-Mar FY13. Unlike previous years, when this rising trend of outstanding subsidies peaked in October 2011, the stock of subsidies is still increasing (**Figure 3.8**). This not only impairs the repayment capacity of procurement agencies, but also entails relatively higher financial costs for the government.[11]

Credit to PSEs

Credit to public sector enterprises (PSEs) increased by Rs 44.9 billion during Jul-Mar FY13 (**Table 3.2**), in sharp contrast to a net retirement of Rs 144.3 billion last year. While last year's net retirement was primarily driven by debt consolidation (especially of energy-related PSEs) [12], this year's borrowing reflects the continuation of the weakened financial position of PSEs.

Table 3.2: Changes in Credit to PSEs (FY13)

billion Rupees

	Q1	Q2	Q3	Jul-Mar
Credit to PSEs	15.5	24.8	4.6	44.9
PSM	3.3	4.9	3.8	12.0
PSO	13.3	-15.1	8.5	6.6
PIA	-0.2	12.8	1.9	14.5

Source: State Bank of Pakistan

[10] Fresh borrowing by fertilizer sectors increased by Rs 17.9 billion.

[11] The outstanding loans for commodity finance saw a YoY increase of 6.3 percent. Commodity finance loans are relatively expensive as compared to the cost of government borrowing from commercial banks for budgetary finance.

[12] The retirement last year was due to the shifting of PSEs' debt on to the government. Adjusting for *one-off* settlement of Rs 312.0 billion reveals that the loans to PSEs indicate an increase of Rs 168.0 billion during Jul-Mar FY12.

Within PSEs, Pakistan Steel Mills, Pakistan State Oil and Pakistan International Airlines were the major borrowers during the period of analysis:

- A bailout package for the revival of Pakistan Steel Mills Limited was approved by the ECC in July 2012;[13]
- Lending to a power sector holding company also recorded a rise during this period;[14] and
- Borrowing by the Pakistan International Airline Company increased to repay some of its external loans.

Credit to Private Sector

Overall credit to the private sector grew by 4.1 percent (Rs 139.8 billion) during Jul-Mar FY13, compared to 6.4 percent (Rs 200.5 billion) during the same period last year (**Table 3.3**).

Table 3.3: Change in Credit to Private Sector

billion Rupees

	FY12				FY13			
	Q1	**Q2**	**Q3**	**Jul-Mar**	**Q1**	**Q2**	**Q3**	**Jul-Mar**
Overall	-88.7	282.2	7.0	200.5	-84.9	189.5	35.3	139.8
of which								
Loans to private sector businesses	-95.3	181.3	-43.2	42.9	-39.6	186.1	18.6	165.1
Investments in shares & securities	2.9	9.0	-4.4	7.5	-1.1	12.3	4.4	15.6
Consumer financing	-4.5	-2.8	-1.2	-8.5	-1.8	8.4	1.9	8.5
Credit to NBFCs	6.6	18	41.7	65.9	-65.7	-12.6	2.0	-76.3

Source: State Bank of Pakistan

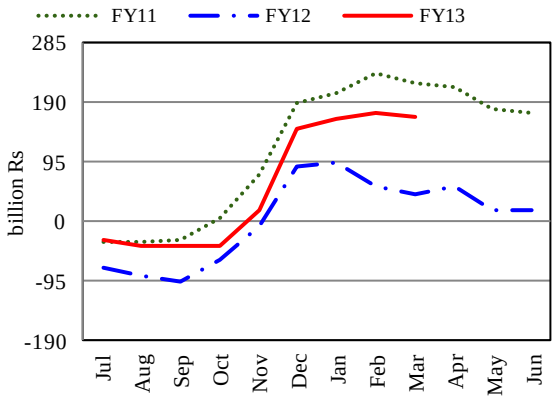
Given the monetary easing during the first half of the year, the fall in credit off-take is confusing at first sight. However, the deceleration stems largely from the decline in banks' investments in Non-Bank Finance Companies (NBFCs), which saw a reduction of Rs 76.3 billion during Jul-Mar FY13 in contrast to an increase of Rs 65.9 billion during the same period last year. This sharp reversal is attributed to the downward revision in tax incentives on investments in mutual

[13] It was a term loan secured to finance the LC opening for raw material import and to meet current expenditures of the company.

[14] The oil marketing company initially borrowed Rs 13.3 billion during Q1-FY13, of which Rs 12.0 billion was availed to meet the working capital needs. However, by the end of March 2013, total borrowing since June 2012 was Rs 6.6 billion.

funds;[15] and lower returns on government securities following the cut in the policy rate.

Figure 3.9: Loans to Private Sector (Cumulative Flows)

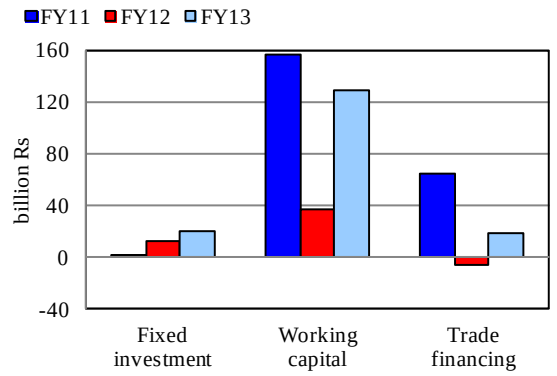


Source: State Bank of Pakistan

Within private sector credit, loans to *private sector businesses*, which account for over 70 percent of credit to the private sector, expanded by 6.7 percent during Jul-Mar FY13, compared to 1.8 percent during the same period last year (**Figure 3.9**).

Apart from the low base effect,[16] the lower cost of borrowing appears to be a contributory factor. A modest expansion is visible in all three segments of credit to private businesses: working capital loans; fixed investment loans; and trade finance. Among these categories, the disbursement of working capital loans was much higher than fixed investment loans and trade finance (**Figure 3.10**).

Figure 3.10: Trend in Types of Financing (Jul-Mar)



Source: State Bank of Pakistan

In absolute terms, *working capital loans* expanded by Rs 128.6 billion during Jul-Mar FY13, compared to only Rs 37.2 billion in Jul-Mar FY12. While the increase in working capital loans seems to be broad-based, some sector-specific developments should be highlighted.

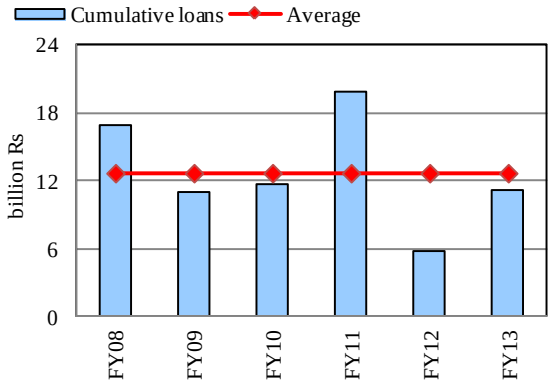
[15] Following revision in tax incentives, income (dividend) received from money market funds and income funds will be taxed at 25.0 percent in FY13 and 35.0 percent in FY14 (Finance Act 2012), compared to 10.0 percent up to FY12. Not to surprise, non-bank/corporate investments in government securities have seen a reduction of Rs 140.8 billion during Jul-Mar FY13.

[16] Credit expansion to private sector was unusually low in FY12 on account of shifting loans of private sector to the government sector, and government's intervention in sugar and fertilizer sectors.

- Working capital loans to the *rice processing* industry increased by Rs 11.1 billion during Jul-Mar FY13 as compared to Rs 5.7 billion during the same period last year (**Figure 3.11**). This increase is largely attributed to the unusually low credit off-take last year (base effect),[17] and some increase in rice exports this year.[18]

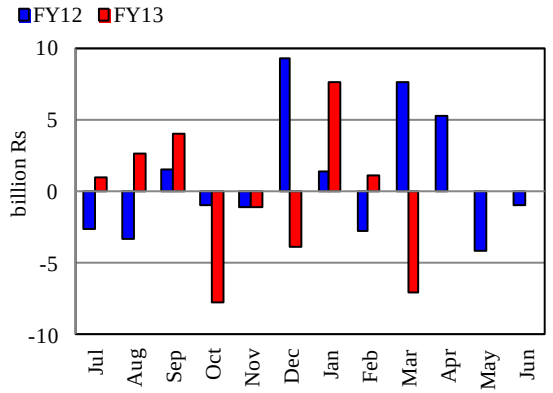
- Working capital loans to the *sugar industry* increased sharply this year. Increased sugar production in FY13;[19] delays in payments by TCP to sugar mills; the export of sugar;[20] and a low base effect[21] are the major reasons for the increase in working capital loans.

Figure 3.11: Working Capital Loans to Rice Sector (Jul-Mar)



Source: State Bank of Pakistan

Figure 3.12: Loans to Fertilizer Sector (Monthly Flows)



Source: State Bank of Pakistan

[17] Last year's low credit disbursements to rice sector was exceptional as overall credit demand was low due to high interest rates, and banks were reluctant for lending to private sector due to credit quality concerns.
[18] Rice exports reached Rs 135.3 billion during Jul-Mar FY13 compared to Rs 133.7 billion during same period last year.
[19] A sugarcane production in FY12 was 58.0 million tons whereas it is reported to be 62.5 million tons this year.
[20] Sugar mills exported 575.4 thousand MT of sugar in Jul-Mar FY13 compared to 4.24 thousand MT for the same period last year.
[21] The government actively intervened in the sugar sector in FY12. Specifically, the government purchased 4.8 million tons of sugar, which not only stabilized falling sugar prices in the market, but also helped in improving cash flows of the industry.

- There was also a significant rise in working capital loans to the textile sector. This can be explained by the increase in textile exports;[22] and seasonal rise, associated with the sale of lawn prints.

- Working capital for the manufacturing of soft drinks and other beverages, also increased significantly. More specifically, one of the leading beverage companies borrowed substantially for the construction of three new bottling plants as a part of its plans to increase capacity.

- Working capital loans to the fertilizer sector decelerated during Jul-Mar FY13, compared to the same period last year. This was largely because of decline in production due to persisting gas shortages (**Figure 3.12**).[23, 24]

- Electricity and gas companies utilized working capital loans of Rs 11.6 billion during Jul-Mar FY13 compared to a net retirement of Rs 7.8 billion last year (**Table 3.4**). This turnaround can be traced to the partial settlement of circular debt last year, which led to a reduction in the outstanding borrowing of power sector companies.[25]

Fixed investment loans (loans of more than 1-year maturity) increased modestly during Jul-Mar FY13. This is encouraging as a number of industries are adjusting their business processes to take advantage of growing opportunities. Specifically, manufacturers of dairy products are investing to increase capacity, while one large food producing company has availed financing for increasing its dry milk production. Similarly, some sugar mills availed financing to achieve self sufficiency in power generation, using bagass and biomass for fuel.

In addition to the food sector, there are signs of capacity expansion in a number of industries, including plastic products, paper and board, and electrical machinery. A prominent firm in rubber/plastic sector has invested in a new polyester film

[22] Textile exports reached US$ 9.6 billion during Jul-Mar FY13 compared to US$ 9.0 billion for the same period last year.
[23] However, there was a major increase in running finance in the month of January FY13. The most likely reason for this was the rise in the NP (nitro-phosphate) fertilizer stocks during that month, which tied up liquidity. NP is a substitute for urea and NP off-take usually rises if there is a shortage of urea. However, urea stocks have been more than adequate this Rabi season.
[24] However, following some improvement in gas supplies, fertilizer production has posted some growth since October 2012.
[25] Debt liabilities of Rs 93.4 billion were shifted from cash strapped private sector energy entities to PSEs (power holding company) in February FY12.

Table 3.4: Credit Flows (Jul-Mar)
billion Rupees

	Overall Loans		Trade Financing		Working Capital		Fixed Investment	
	FY12	FY13	FY12	FY13	FY12	FY13	FY12	FY13
Business sector loans	42.9	165.2	-6.4	17.3	37.2	128.6	12.2	19.3
Manufacturing	65.0	145.5	-0.9	17.5	52.5	112.5	13.4	15.5
Food and beverages	22.8	60.4	8.0	10.5	10.5	40.1	4.3	9.8
Dairy products	0.4	4.9	0.8	0.5	-2.0	0.8	1.6	3.6
Sugar	8.8	39.9	3.2	2.9	4.8	30.6	0.8	6.5
Rice processing	7.5	15.1	1.7	3.5	5.7	11.1	0.2	0.5
Beverages	-1.4	1.8	-1.6	0.7	0.4	3.7	-0.2	-2.6
Soft drinks & other beverages	-0.5	1.6	-0.9	0.7	0.5	3.8	-0.2	-2.8
Textiles	16.4	74.9	-9.1	10.1	19.6	56.8	6.0	8.1
Spinning	15.8	34.0	-4.0	-2.9	17.5	35.4	2.3	1.5
Weaving	-0.3	10.7	2.1	3.5	-5.0	6.3	2.6	0.9
Finishing	0.9	11.8	-0.5	-0.8	1.1	7.5	0.2	5.1
Made-up textiles	-1.9	6.9	-4.8	2.8	1.9	4.3	1.0	-0.2
Fertilizers	8.8	-3.3	0.1	-2.8	6.2	3.5	2.5	-4.0
Rubber and plastic products	2.6	6.4	0.7	1.6	2.1	3.7	-0.3	1.1
Plastic products	2.8	6.2	0.7	1.7	2.1	3.6	-0.1	0.9
Electrical machinery & apparatus	-0.2	5.6	0.4	1.2	0.1	1.3	-0.7	3.0
Commerce and trade	-4.3	1.8	-2.8	-2.0	-3.5	-4.4	2.0	8.2
Other private business	-1.4	8.7	0.9	-0.2	-2.6	3.6	0.2	5.3

Source: State Bank of Pakistan

plant,[26] while the paper and board industry has invested heavily in alternate energy arrangements and capacity enhancement projects;[27] and one of the leading companies in electrical machinery is expanding its production capacity. Lastly, a number of textile (especially spinning) firms are enhancing production capacities to take advantage of the growing demand for yarn from China.

Table 3.5: Trade Financing during Jul-Mar (Cumulative Flows)
billion Rupees

	FY11	FY12	FY13
EFS	19.8	-0.1	13.8
Other than EFS	14.9	8.9	5.2
Imp. financing	30.2	-15.2	-1.7
Total	64.9	-6.4	17.3

Source: State Bank of Pakistan

[26] PET film is used for food packaging and in LCD/LED TV panels, solar panels and other industrial applications.
[27] Such as coal and furnace oil fueled plants.

Trade financing saw an expansion of Rs 17.3 billion during Jul-Mar FY13, in sharp contrast to a net retirement of Rs 6.4 billion during the same period last year. Within trade financing, EFS loans (concessional financing for exporters) increased by 13.8 billion, whereas *loans other than EFS* increased by 5.2 billion (**Table 3.5**).

Table 3.6: Consumer Financing during Jul-Mar (Cumulative Flows)
billion Rupees

	FY11	FY12	FY13
Consumer financing	**-19.0**	**-9.7**	**8.1**
For house building	-5.4	-5.2	-2.4
For transport	-10.6	-5.6	2.3
Credit cards	-3.4	-1.7	-1.9
Consumers durable	0.0	0.1	-0.1
Personal loans	0.4	2.7	10.2

Source: State Bank of Pakistan

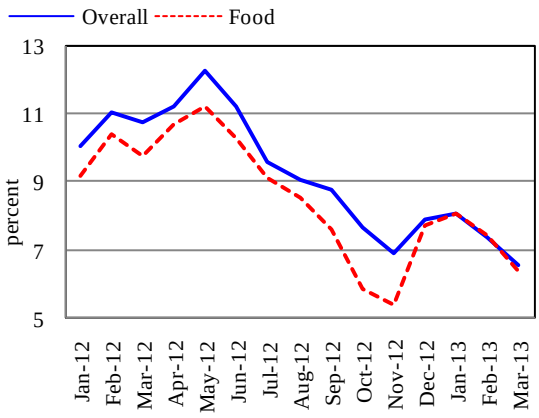
The rice, sugar and textile sectors remained the major beneficiary of concessional lending (EFS) during Jul-Mar FY13. The cuts in the EFS rate by 250 bps, during the first half of the year, made EFS loans more attractive during the period under review.

Finally, *consumer financing* showed some signs of improvement during Jul-Mar FY13 (**Table 3.6**). Details indicate that the expansion is largely because of personal loans, since November 2012, due to the upward revision in the loan limit for employees of a large public sector bank.

3.3 Inflation

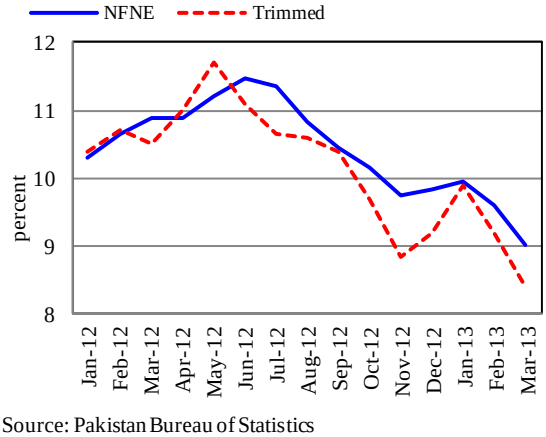
Headline inflation fell to 6.6 percent in March 2013 – the lowest in 45 months, since the new index was first computed (**Figure 3.13**).[28] With all measures of inflation, including core inflation (**Figure 3.14**), continuing their downward trend, the short-term outlook for inflation remains subdued. Furthermore, the decline in inflation has been broad-based, with disinflation across the commodities of the CPI basket (**Figure 3.15**).

Figure 3.13: CPI Inflation



Source: Pakistan Bureau of Statistics

Figure 3.14: Core Inflation



Source: Pakistan Bureau of Statistics

The reasons for the decline in inflation over the past two years were covered in the Second Quarterly Report for FY13; this report will focus on the factors that have recently impacted inflation, and the risks going forward.

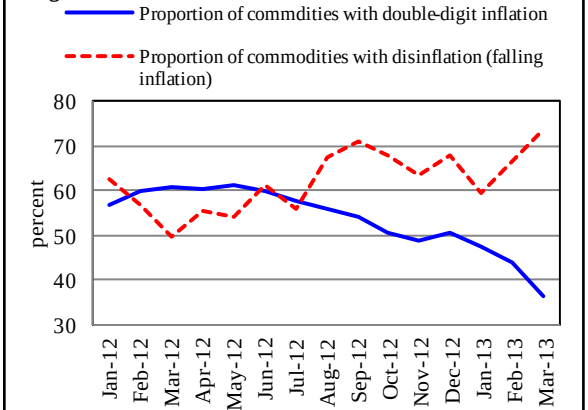
Food prices

An important reason for the decline in inflation has been the stability in food prices over the last twelve months (**Figure 3.16**).[29] The two exceptions to this trend have been the prices of wheat and rice. Although the rise in international wheat prices in Q1-FY13, and the upward revision in wheat support prices in Q2-FY13 did lead to an increase in retail prices of wheat and its products up to the end of the third quarter, retail prices seem to have stabilized since. In fact, there has even been a slight reduction in wheat prices over the course of the third quarter.

[28] The new index is calculated using 2007-08 as its base.
[29] Food and its associated subgroups constitute 37.5 percent of the CPI.

The increase in rice prices, on the other hand, has been largely because of higher prices in the international market, and the decline in domestic production. The price of other important food items have either remained stable or declined.

Figure 3.15: Broad-Based Decline in YoY Inflation



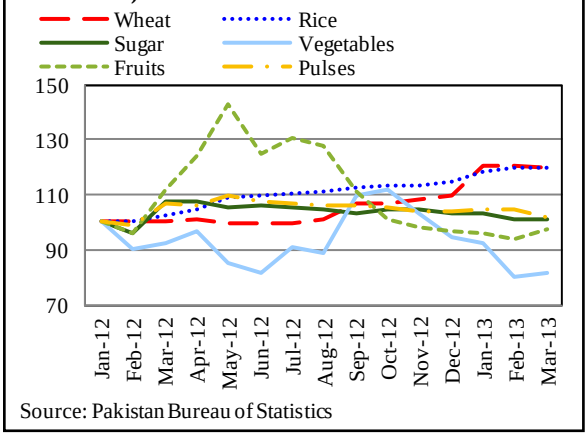
Source: Pakistan Bureau of Statistics

Since we expect the wheat harvest to more than satisfy domestic demand this year (adding to the current surplus of wheat in the country), wheat prices are expected to either decline or remain stable.[30] The only upside risk to food inflation, therefore, remains the price of rice. Overall, however, the outlook for food inflation, in the absence of any adverse supply shocks, is quite stable.

Energy prices

Within the broader domain of administered prices, energy prices have contributed most to the decline in inflation. Electricity tariffs were last revised in May 2012 and have been constant since then (**Figure 3.17**).[31] Natural gas tariffs for households were halved in July 2012 and have not been revised upwards thereafter.[32] Similarly, while fuel prices have fluctuated, they have hovered within a

Figure 3.16: Price Indices of Selected Food Items (January 2012 = 100)



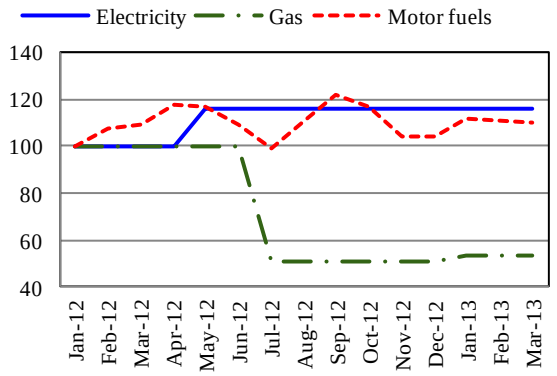
Source: Pakistan Bureau of Statistics

[30] Wheat stocks in the country totaled 2.5 million tons as of March 2013.
[31] Tariffs were increased by 16 percent in May 2012 for households.
[32] The price of piped gas to households was slashed by an average of 49 percent in July 2012

certain band in FY13.[33] These factors have capped inflationary pressures, and, in our opinion, also suppressed inflation expectations.

However, an upward revision in electricity tariffs is overdue. Gas prices will also cease to drag down inflation from July 2013 onwards, with a rise in tariffs of roughly 10 percent appearing likely. Fuel prices may also increase if the government chooses to increase the collection of the petroleum development levy – a surcharge imposed on transport fuels – in order to manage its deficit. While energy prices have played a large part in subduing inflation so far in FY13 (and will do so for the remainder of the year), they are unlikely to continue to dampen inflation going forward.

Figure 3.17: Indices of Selected Energy Prices (January 2012=100)



Source: Pakistan Bureau of Statistics

The external front

The absence of any external shocks in FY13 so far (e.g. a sharp depreciation of the Rupee or a sudden increase in the international price of oil) has also helped contain inflation. The depreciation of the rupee has been gradual so far and global commodity prices have remained stable. The only two commodities, whose prices have been inching upward in the global market in Q3-FY13, have been cotton and rice. The impact of these increases has been transmitted to domestic wholesale and retail prices, but is unlikely to spill over into the rest of the CPI. Given the subdued global economic climate, the outlook for most commodities prices is either stable or pessimistic. Therefore, the risks from any sudden movements in international prices are modest at best. The greater risk to inflation stems from any deterioration in the balance of payments position and the resultant depreciation, and can substantially affect the outlook for inflation.

Outlook

An adverse external shock seems unlikely at this point, and, therefore, the upside risks to inflation for the remainder of FY13 are minimal. Average inflation for the

[33] Petrol and diesel constitute roughly three-fourths of this index, while CNG makes up for almost another quarter.

year will fall comfortably below the government's target of 9.5 percent. However, the revision of energy tariffs is inevitable and poses the greatest risk to inflation beyond FY13. The risk of acceleration in reserve money growth (as a result of greater central banking financing for the fiscal deficit) is another concern for medium-term inflation. However, a return to double-digit headline inflation is also unlikely without a sharp deterioration on the external front, or a sudden disruption in food supplies.

Special Section 3.1: Macroeconomic Dynamics with a Dominant Borrower (Government).[34]

The State Bank of Pakistan has been grappling with a difficult trade-off in the past several years. With an insatiable government appetite for credit, how does the central bank contain the *quantum* of inflationary finance and yet ensure the private sector is able to secure *adequate* credit from commercial banks?[35] This is all the more important as the domestic banking system is the last avenue for government borrowing, and Pakistan has been in this position for the past couple of years.

The policy outcome so far is not heartening: (1) despite a 450 bps cut in the Discount Rate over the past 20 months, net private sector lending remains anemic; (2) spreads in the banking system remain high; (3) SBP financing of the fiscal deficit has increased sharply since Q3-FY13; and (4) the balance sheets of commercial banks continue to skew in favor of government paper.

Choudhary, Pasha, et., al. [2013] have customized a general equilibrium framework (using a Dynamic Stochastic General Equilibrium, DSGE model) that tries to capture the unique set of circumstances that currently exist in Pakistan. The main features they sought to incorporate in their model are:

1. A dominant borrower (government) whose appetite for credit is growing as it has limited avenues for raising taxes, which means it would become interest rate insensitive;
2. A central bank that is constrained in how much credit (*money creation*) it can provide to the government;
3. The fact that countries with under-developed financial systems, give the government few alternatives but to borrow from domestic banks (and the central bank); and
4. How endogenously determined banking spreads would behave in such a system.

[34] This is an assessment by Dr Mushtaq Khan, of an unpublished manuscript by Choudhary, A., Pasha, F., Khan, etc. [2013] titled: *Dominant Borrower and Endogenous Spreads: The Need to Avoid Corner Solutions*.

[35] We dismiss the suggestion that an independent central bank can (and should) impose a hard ceiling on government borrowing to be implemented by bouncing Federal Government cheques (if required). In our view, no central bank may want to take such a course of action, as this would not only seize up the money and FX markets, but could easily trigger a full-blown banking crisis.

Some of these features were empirically tested on various developed and developing countries, using the IMF as the primary source of data. The Financial Development Rankings developed by the World Economic Forum [2012] were also used.[36]

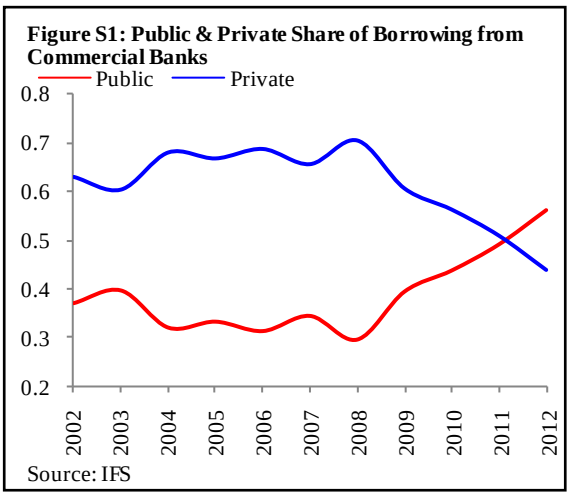


Figure S1 shows commercial banks increasingly lending to the government (the Dominant Borrower)[37], with the *public share* (the fraction of government borrowing in total *commercial bank* lending) in Pakistan rising consistently since 2008.[38]

The correlation between interest rates spreads and the level of financial development is shown in **Figure S2**.[39] This positive correlation is to be expected, as a more developed financial system (a lower ranking) has more players than

[36] There are several refinements to this model that are being developed. The most promising is modeling a fiscal shock that necessitates further government borrowing, which creates a fiscal feed-through to subsequent debt servicing, and the stock of domestic debt. This will increase subsequent borrowing by the government, which is made easier as commercial banks become increasingly risk averse in a recessionary environment. In a dynamic setting, the expected equilibrium is likely to be *suboptimal*, in that the system approaches an extreme outcome. In other words, if left alone, this dynamic model (shocked by a fiscal event) shows that banks would eventually only lend to the government and economic growth would fall to levels where private investment is only self-funded. A policy response can also be modeled, whereby the central bank responds to the fiscal shock by increasing interest rates (say in response to the increase in the fiscal deficit or likely inflation). If this happens, the model shows that the adverse outcome would be realized much earlier, while an effort to reduce interest rates would buy the country more time.

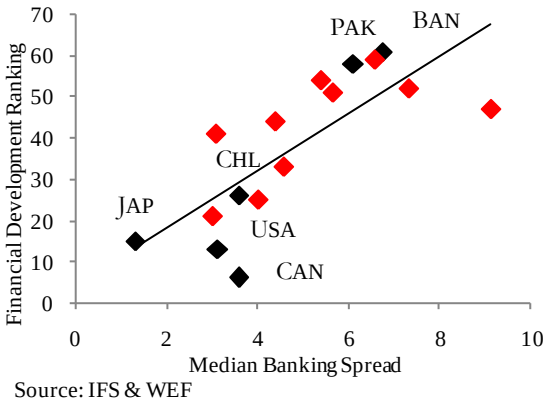
[37] Public borrowing from commercial banks in **Figure S1,** consists of claims of commercial banks on central, provincial and local governments; public sector enterprises and other FIs. Private borrowing from commercial banks consists of commercial bank claims on the private sector.

[38] However, Pakistan's banking system is not the largest financier to the government: countries like Mexico, Brazil, Japan and even the US have a higher public share compared to Pakistan. This is not just because these governments borrow too much (which they do), but also the fact that commercial banks are not the main source of private sector investment credit and government borrowing.

[39] The authors use the universal definition of interest rate spreads, meaning the difference between average lending and deposit rates. The financial development rankings put forward by the World Economic Forum can be found in the following website: http://www3.weforum.org/docs/WEF_FinancialDevelopmentReport_2012.pdf

commercial banks, which creates a degree of financial competition that keeps spreads low.

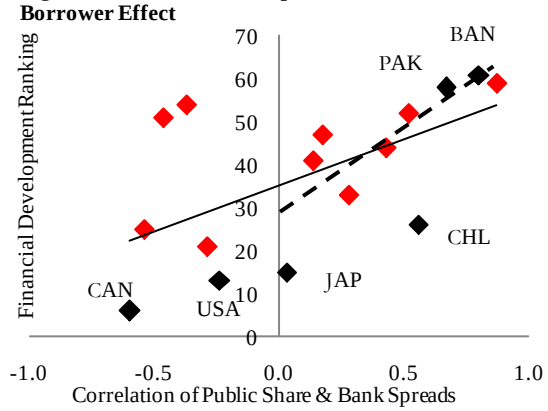
Figure S2: Median Banking Spreads & Financial Development



Source: IFS & WEF

In trying to determine whether there is a link between the share of government borrowing and interest rate spreads, Choudhary et. al., computed the correlation between the *public share* and *banking spreads* (**Figure S3**). The first thing to realize is there is no *causality* or universal correlation between the share of government borrowing and spreads: most developed countries show no correlation, while most developing countries post a positive relationship. The authors interpret this as implying that in developed countries, the efficiency of financial markets is such that spreads are low, and even if their respective governments are large borrowers, they are able to secure financing from *other* sources without putting upward pressure on domestic banking spreads.

Figure S3: Financial Development and Dominent Borrower Effect



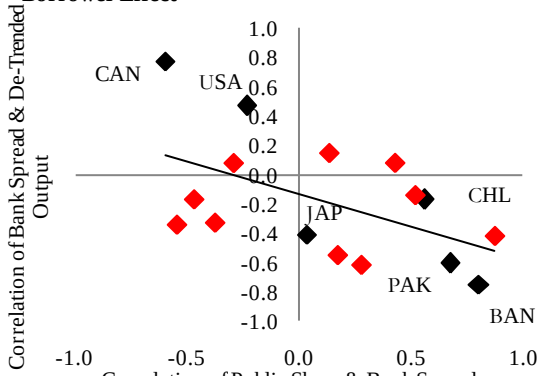
Source: IFS & WEF

For developing countries, on the other hand, if the government is a big borrower, and the options for alternate financing are severely limited, not only is the correlation between the public share and spreads positive, but the positive slope (**Figure S3**) suggests correlation becomes stronger when the financial system is under-developed. In

simple terms, the association of a Dominant Borrower and high spreads, is stronger when the financial system is relatively under-developed (this assumes no policy intervention).[40]

Taking this a step further, as interest rate spreads increase (with an increasingly dominant borrower), not only is the government crowding-out the private sector, but by pulling growth below its potential, it increases credit risk in private sector lending, which incentivizes commercial banks to place *even more* credit with the government, creating a vicious spiral. This crowding-out has implications for unemployment; tax collection; documentation; policy effectiveness; private investment; per-capita GDP; and many social welfare indicators.

Figure S4: Counter-cyclical Spreads and Dominant Borrower Effect



Source: IFS

Figure S4 reveals another insightful dimension of their analysis. The negative slope basically means that in countries with a Dominant Borrower and high banking spreads, the adverse counter-cyclical impact on economic activity is *more* severe. In other words, large banking spreads are more damaging – in terms of keeping GDP growth well below the country's potential – in those countries with an under-developed financing system and a Dominant Borrower.

Conclusion

As in all academic research that seeks cross-country validation, there are many country-specific details that have not been addressed. Furthermore, it is very important to stress that this analysis highlights *correlation* and not *causation*. One must also realize that interest rate spreads are determined by a host of factors; not just the demand for credit from an interest rate insensitive government.

[40] It is critical to realize that model dynamics do not reflect reality because of policy interventions. In a country like Pakistan, policy intervention cannot be ruled out, which means the dynamics shown by the model are not reflected in reality. For example, even though GoP has been borrowing quite a lot in the past 18 months, SBP was able to bring down interest rates (during this period) by injecting substantial volumes of liquidity into the system to support its monetary policy stance.

However, the analysis does provide a powerful counterpoint to orthodox economic thinking. It shows that customized analysis is better able to explain why traditional tools of economic management have failed – not just in Pakistan, but also in the OECD. It flags the need to be cautious when dealing with a large borrower, who is increasingly dominating the balance sheet of commercial banks. It also forces us to revisit the twin-mandate of most central banks (price stability and sustainable growth), which could explain why the US Fed; The Bank of England; and the Bank of Japan, have undertaken such an abrupt change in strategy to focus on growth and employment, even at the cost of higher inflation.

Looking specifically at Pakistan, the paper suggests that in an environment where private banks face a Dominant Borrower (who is increasingly attractive), the situation will require some policy intervention to avoid an adverse outcome.[41] This is not just for the overall health of the country's economy, but also to ensure the balance sheets of commercial banks are healthy enough to withstand unanticipated shocks.

[41] Price signals often fail in structurally distorted economies. One must realize that a desperate borrower does not respond to price signals; this is especially the case with addictive goods/services. In other words, while increasing interest rates is sufficient to deter an individual from borrowing more, in the case of a government with a short-term horizon, the rising cost of credit will not deter fresh borrowing, but only increase the government's indebtedness and squeeze the fiscal accounts further (Debt Trap). In this situation, the most effective way to exit the Debt Trap is to impose binding ceiling on the size of the fiscal deficit, and ensure that interest rates are not allowed to increase further.

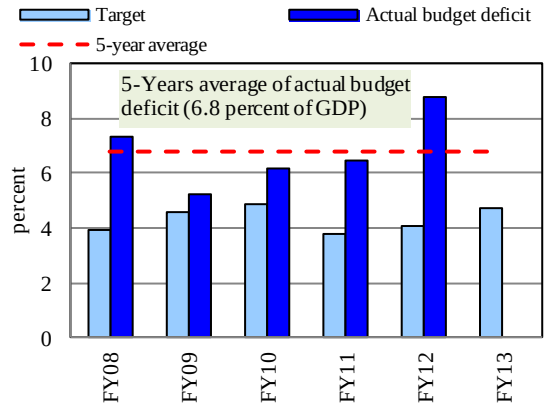
4 Fiscal Policy and Public Debt

4.1 Fiscal Policy

The target for FY13 fiscal deficit was set at 4.7 percent of GDP by the Ministry of Finance (MoF), which included Rs 80 billion consolidated provincial surplus. Given that actual fiscal deficit for the previous five years averaged 6.8 percent (and for FY12 it was 8.5 percent), the target for FY13 was ambitious (**Figure 4.1**). A large part of the improvement needed was to be achieved by increasing the FBR tax collection, which was targeted to grow by 26.4 percent during FY13. On the expenditure side, the government planned to reduce subsidies by Rs 300 billion compared to the previous year.

Unfortunately, many of the tax proposals to increase revenue could not be implemented. In addition to a slowdown in formal economic activity, the frequent changes in FBR management during Jul-Mar FY13 also hampered the efficiency of this tax collecting authority. As a result, growth in tax collection during the first three quarters of FY13 was lower than the average of the

Figure 4.1: Actual vs. Target Budget Deficit



Source: Ministry of Finance

Table 4.1: Summary of Public Finance
billion Rupees

	FY13 BE	Jul-Mar FY12	Jul-Mar FY13	Growth
Total revenue	**3,3876**	**1,739.4**	**2,124.9**	**22.2**
Tax revenue	2,626	1,371.6	1,527.8	11.4
Non-tax receipts	750	367.9	597.0	62.3
Total expenditure	**4,480**	**2,634.3**	**3,171.1**	**20.4**
Current	3,430	2,154.1	2,642.0	22.7
Development & net lending	1,050	428.0	445.8	4.2
Unidentified	-	52.2	83.3	59.4
Overall deficit	**1,105**	**894.9**	**1,046.2**	**16.9**
Financing through:				
External resources	135	47.4	-4.1	-108.7
Internal resources	971	847.5	1,050.3	23.9
Banking system	484	443.8	856.7	93.0
Non-bank	487	403.7	193.7	-52.0
As % of GDP				
Overall fiscal deficit	4.7	4.5	4.6	
Primary deficit	0.8	1.3	1.2	

Source: Ministry of Finance

last ten years, registering a mere 11.4 percent YoY increase. On the other hand, subsides paid as of end Mar FY13, were also well over what had been budgeted for the full year. As a result, the reported fiscal deficit for the first three quarters of FY13 again touched the last year level (which was 4.5 percent of GDP). In fact the availability of Rs 172 billion on account of Coalition Support Fund has contained the deficit to some extent.

However, as no further CSF flows are expected in remaining part of FY13, and both revenue and expenditure are deviating significantly from their targets, the budget deficit target for the full year is likely to be missed by a large margin.

Data on government expenditures for Q3-FY13 show an increase of 20.4 over the same period last year (**Table 4.2**).[1] The pattern of government expenditures is similar to the previous year – power subsidies and debt servicing account for more than half of Federal Government expenditures.

Table 4.2: Break-up of Expenditures

billion Rupees

	Jul-Mar		% growth
	FY12	**FY13**	**FY13**
Current (a+b)	**2,154.1**	**2,642.0**	**22.6**
a. Federal	1,478.7	1,887.1	27.6
Interest payments	624.5	772.0	23.6
Subsidies	103*	270.0	162.1
Non-interest, non-subsidy	751.2	844.9	12.5
o/w defense	348.0	405.8	16.6
b. Provincial	675.4	754.9	11.8
Development	**428.0**	**445.8**	**4.2**
PSDP	375.6	407.4	8.5
Federal	200.6	187.5	-6.5
Provincial	175.0	219.9	25.7
Others dev & net lending	52.3	38.4	-26.6
Unidentified	**52.2**	**83.3**	**59.6**
Total expenditure*	**2,634.3**	**3,171.1**	**20.4**

*Excluding Rs 391 billion debt consolidation in FY12

Source: Ministry of Finance

Development spending by the provinces posted a sharp increase during Jul-Mar FY13. The highest increase of 75.0 percent was recorded by Sindh, followed by Punjab with a 12.2 percent increase. Compared to the provinces, development expenditures by the Federal Government posted a decline.

[1] Adjusting for one off debt consolidation of Rs 391 billion in FY12, growth in expenditures, however, falls to 4.8 percent.

Financing

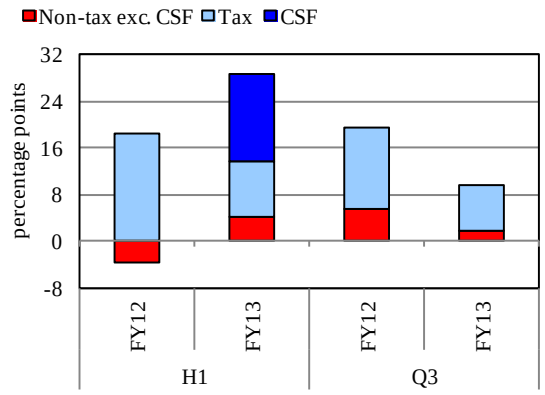
Lack of external financing shifted the entire burden of funding the fiscal deficit on domestic sources during Jul-Mar FY13.[2] Thus, in order to meet its budgetary requirements, the government had to borrow Rs 856.7 billion from the banking system during this period – more than double the same period last year.[3,4]

In addition to the banking system, government also borrowed Rs 193.7 billion from non-bank sources, mainly NSS during Jul-Mar FY13, compared to Rs 403.7 billion in the corresponding period last year.

4.2 Revenues

Due to the absence of coalition support funds (CSF) in Q3-FY13, revenue growth slowed substantially to 9.7 percent against 28.8 percent in H1-FY13 (**Figure 4.2)**. With FBR facing difficulties in achieving its collection target, the combined share of non-FBR duties and levies on energy grew to 10.1 percent of total revenues, up from 6.7 percent last year.[5] The government increased duties and charges (on various heads) and imposed a levy on LPG in Q3-FY13.[6]

Figure 4.2: Contribution to Revenue Growth



Source: Ministry of Finance

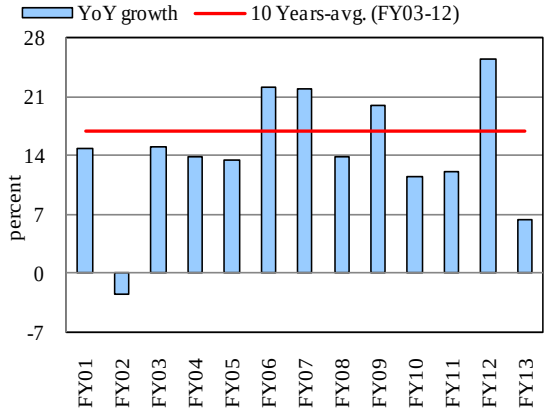
FBR Revenues

Although authorities set an ambitious growth target of 26.4 percent in tax revenues for FY13, realized growth of 5.0 percent in net tax collection during Jul-

[2] Net external financing for Jul-Mar FY13 was Rs -4.1 billion.
[3] Including Rs 391.0 billion of one time debt consolidation government borrowed Rs 932.8 billion from the banking system during Jul-Mar FY12.
[4] Government borrowing numbers may differ from those given in **Chapter 3**; see **Annexure A** for explanation.
[5] These revenue sources include: Gas Infrastructure Development Cess; Petroleum Development Levy (PDL), discount retained on crude price, development surcharge on gas, royalties on oil and gas, windfall levy against crude oil, and petroleum levy on LPG.
[6] The rates of GIDC were increased in September 2012. The rate on PDL were doubled in September 2012 (PDL was reduced in March 2013, but was again increased by an average 25 percent in May 2013). PDL on LPG was imposed in February 2013.

Mar FY13 was the lowest since FY02 (**Figure 4.3**). Specifically against the revised target of Rs 2,043.4 billion, FBR could collect only Rs 1,335.2 billion up to end March 2013, i.e., 65.6 percent of the revised target.

Figure 4.3: YoY Growth in FBR Tax Collection (Jul-Mar)



Source: Federal Board of Revenue

In disaggregated terms while FED collection registered a nominal decline, growth in all other categories declined, with the slowdown in sales tax having a prominent contribution (**Table 4.3)**. This shortfall in FBR collection contributed significantly to the overall fiscal deficit in FY13, making revenue collection one of the most pressing fiscal issues.

In spirit, FY13 was a year of positive tax reforms, targeting four broad issues:

Table 4.3: Summary of FBR Revenue Collection (billion Rupees)

billion Rupees

	Jul-Mar Collection			Annual Target			% of Target Reached		
					FY13			FY13	
Type of tax	FY11	FY12	FY13	FY12	Budget	Revised	FY12	Budget	Revised
Direct	374.2	469.6	491.3	744	932	758	63.1	52.7	64.8
Sales	426.6	570.2	594.7	837	1,077	904	68.1	55.2	65.8
FED	89.5	84.8	78.8	166	125	131	51.1	63.1	60.2
Custom duty	128.6	148.3	170.5	206	248	250	72.0	68.7	68.2
Total	**1,017**	**1,272**	**1,335.2**	**1,952**	**2,381**	**2,043**	**65.2**	**56.1**	**65.4**

Source: Ministry of Finance

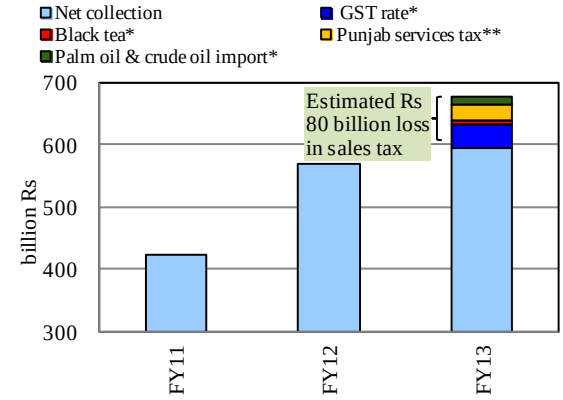
1) The income tax rate was made more progressive and the turnover tax rate was reduced from 1 percent to 0.5 percent. The resulting revenue deficit was expected to be offset by increase in the tax base. The proposed Amnesty Bill was a key measure in this regard.[7]

[7] The Bill guaranteed no further investigation or legal action to tax evaders who wished to register with FBR. It envisaged bringing 3.1 million more taxpayers into the tax net and generating additional revenue of Rs 150 billion. The Bill was tabled in the National Assembly in December 2012, but was not passed.

2) The rate of sales tax was brought down from 17 to 16 percent. The resulting loss was expected to be compensated by bringing more commercial agents into the tax net.
3) Sales tax on black tea – a major commodity smuggled via the Afghan Transit Trade (ATT) route – was lowered from 16 to 5 percent. Tax rebates on palm oil and petroleum exports via the ATT were disallowed in Q3-FY12, to discourage sales tax evasion.[8]
4) In pursuance of having a uniform tax rate by reduction/elimination of FEDs; it was proposed to remove zero-rating on some products; and where fixed value estimates were used for sales tax calculation (fertilizer and steel), these were made variable.[9]

However, when it came to execution, these reforms failed to deliver. In the case of direct taxes, the biggest set back was the non-passage of the Amnesty Bill which aimed to bring more taxpayers in the net. On the other hand, withholding taxes, which comprise 60 percent of total direct tax collection, were lowered in response to pressure from industrial lobbies. Furthermore, the 0.5 percent withholding tax on the manufacturing sector was exempted in December 2012, while in February 2013, withholding tax on raw material imports (ranging from 1-3 percent) was eliminated.

Figure 4.4: Analysis of FBR Sales Tax Collection in Jul-Mar



Source: Federal Board of Revenue; Punjab Revenue Authority (**); analyst estimates (*).

The slowdown in sales tax can be traced to both policy and external factors (**Figure 4.4**). This included: (i) lowering of GST rate by 1 percentage point; (ii) tax concession on black tea;[10] (iii) shifting of tax collection on 17 services (including telecom) to Punjab Revenue Authority (PRA), leading to a federal revenue loss of Rs. 28.3 billion in

[8] Vide SROs 136(1)/2012 and 137(1)/2012. Technically, these SROs were issued in February FY12. However, the impact was greater in FY13 due to base effect.
[9] Vide SROs 594(1)/2012 and 596(1)/2012.
[10] Full 16 percent general sales tax was resumed on black tea in end-Feb 2013.

the first nine months of this fiscal year;[11] and (iv) a failed tax registration drive (instead of increasing registration of taxpayers, it resulted in protests against the stricter tax rules). As a result of lobbying, the requirement of CNIC for allowing rebates was withdrawn in Q1-FY13,[12] while in March 2013, zero-rating on textile exports (which was limited to registered taxpayers), was extended to include unregistered persons as well.[13]

Import-related sales taxes were driven down by a series of factors.[14] One, remeltable steel scrap and wastepaper (input for paper and board industry) were given sales tax exemption on imports. Two, petroleum import mix shifted towards crude oil, which is zero-rated. Although both locally manufactured and imported POL products are equally taxed, rebates are allowed on local products, which eat into net revenue collection. And three, revenue from palm oil imports declined, during Jul-Mar FY13, due to a drop in (rupee) import prices.

Table 4.4: Revenue Generated by Income Tax Amnesty Schemes in Pakistan

Revenues are in billion Rupees, share in percent

Year	Revenue generated	Share in total revenue
FY58	0.0013	0.1
FY69	0.92	12
FY76	1.5	7.8
FY00	10	2.0
FY09	2.5	0.1
FY13*	150	4.4

*Proposed scheme.
Source: Ministry of Finance (revenues); Pakistan Economist, Feb 21-27, 2000 (FY58-FY76 schemes); Dawn newspaper, Dec 24, 2012 (FY00 and FY09 schemes)

Nevertheless, some positive efforts from the revenue authorities (particularly in the third quarter), brought some relief. These include: resumption of full sales tax on black tea;[15] imposition of sales tax on textile sector from the spinning stage onwards;[16] a rise in sales tax on tractors from 5 percent to 10 percent;[17] and an amnesty schemes for sales tax defaulters on smuggled vehicles.[18] According to media reports, the two amnesty schemes had a marginal revenue impact: only Rs 2

[11] The FBR tax collection target for FY13 had already been adjusted for sales tax on services in Sindh. In overall terms however, shifting of tax collection to provinces will have no impact on total government revenues.
[12] Vide SRO 880(1)/2012.
[13] Vide SRO 221(1)/2013.
[14] Import-related sales tax – 50 percent of the total sales tax collection – grew by 0.6 percent YoY during Jul-Mar FY13, compared to 47.6 percent growth in the same period last year.
[15] Vide SRO 153(1)/2013.
[16] Vide SRO 154(1)/2013.
[17] Vide SRO 70(1)/2012.
[18] Vide SRO 179(1)/2013 and SRO 172(1)/2013.

billion revenues were generated by the textile amnesty scheme, while custom duty on over 50,000 vehicles was collected as opposed to expected 100,000 to 150,000.

Amnesties are not uncommon in Pakistan. In the past, the government has granted several amnesties in the form of exemption from penalties and prosecution to sales and income tax evaders. However, arguably, Income Tax Amnesty Bill of 2012 (unsuccessfully tabled in the National Assembly in December 2012), was the most significant legislative effort in this regard. The scheme could have reportedly generated Rs. 150 billion revenue with the addition of 3.1 million tax filers; in these terms, this would have been the most significant amnesty scheme the state has ever offered (**Table 4.4**). However, regardless of their revenue potential, amnesty schemes are not robust solutions to the persistent problem of non-compliance (**Box 4.1**).

Table 4.5: Provincial Fiscal Operations – Jul-Mar

billion Rupees

	All provinces	Punjab	Sindh	KPK	Balochistan
FY13					
Total revenue	1,125.0	506.0	326.0	181.0	111.8
Share in federal revenue	893.0	417.0	236.0	146.0	94.2
Taxes	110.0	56.0	50.0	3.0	0.8
Non-taxes	49.0	22.0	17.0	6.0	3.7
Federal loans and transfers	74.0	11.0	23.0	26.0	13.1
Total expenditure	986.0	474.0	272.0	149.0	90.9
Current	766.0	374.0	213.0	110.0	69.1
Development	220.0	100.0	59.0	39.0	21.8
Overall balance	139.0	32.0	54.0	32.0	20.9
Financing *	-103.0	-42.0	-20.0	-19.0	-21.9
FY12					
Total revenue	932.0	411.5	263.8	159.0	97.8
Share in federal revenue	762.2	355.1	205.3	123.3	78.5
Taxes	57.6	27.8	26.7	2.4	0.8
Non-taxes	36.0	19.0	10.8	2.8	3.3
Federal loans and transfers	76.2	9.6	21.0	30.4	15.2
Total expenditure	862.1	406.7	235.8	137.7	81.9
Current	687.1	317.8	202.0	101.9	65.3
Development	175.0	88.8	33.8	35.8	16.5
Overall balance	69.9	4.8	27.9	21.2	16.0
Financing *	-65.4	-22.5	-6.9	-17.9	-18.1

* Numbers of overall balance and financing do not match due to statistical discrepancies.

Source: Ministry of Finance

Provincial fiscal operations

While provincial revenues continued to grow throughout FY13, their expenditures did not increase much. As a result, all provinces put together witnessed a surplus of Rs 103.0 billion in Jul-Mar FY13, which is higher than their full year target (**Table 4.5**). Although 80 percent of provincial revenues come from the federal divisible pool, their own mobilization has been impressive: Punjab increased revenues by 101.8 percent (YoY), while Sind managed a YoY increase of 87.1 percent – these numbers are mainly due to sales tax on services.

Box 4.1: Tax Amnesty as Public Policy

A tax amnesty is any change in the law which grants lenience to tax evaders on the condition that they pay (in part or full) their outstanding liabilities to the state. Amnesties give evaders a chance to review their past decisions. And by availing this offer, non-tax-compliant citizens can avoid prosecution.

For governments, the most common motive for offering tax amnesty is to quickly generate additional revenue in times of fiscal stress.[19] Indeed, recent papers by Luitel and Tosun (2013) and Le Borgne (2006) have found that tax amnesty decisions are strongly linked with weak fiscal indicators.

What is wrong with amnesty?

In favor of amnesty, it can be argued that it brings Pareto improvements: although the evaders benefit, tax compliant citizens do not lose in pecuniary terms, and the additional revenue generated can be utilized for providing more public goods (the debate is summed up by Luitel and Tosun, 2013).

But three strong arguments can be made against amnesties: Firstly, the fact that the need for amnesties arose (and taxes were successfully being evaded) points to problems with the tax collection system. In the worst cases, the situation may even have arisen from the connivance of tax authorities and the offenders. Secondly, amnesties defy basic principles of equity and fairness by rewarding dishonest behavior.

A corollary fact is that the 'unfairness' of amnesty programs increases with poor governance. Countries with weak governments have more lenient amnesty schemes (offering reduced penalties and outstanding liabilities), as opposed to countries with strong state controls like Australia or USA. This relationship between the quality of governance and leniency of amnesty schemes is illustrated in **Figure 4.1.1**. We have ranked 26 amnesty schemes in 19 countries on a 'leniency scale': an ordinal measure calibrating a scheme on four parameters: protection from criminal charges, concession in penalty, concession in principal liability and interest, and backing of a credible threat. The first three parameters are assigned a value of 1 for yes and 0 for no. The last parameter (of strictness) is assigned a value of -1 for yes and 0 for no. The y-axis plots the sum of these, termed here as 'leniency measure'. The scale ranges from 3 (most lenient) to 0 (most stringent). This leniency measure is plotted against three measures of good governance taken from World Bank's Worldwide Governance Indicators. The three governance criteria are rated on an index ranging from

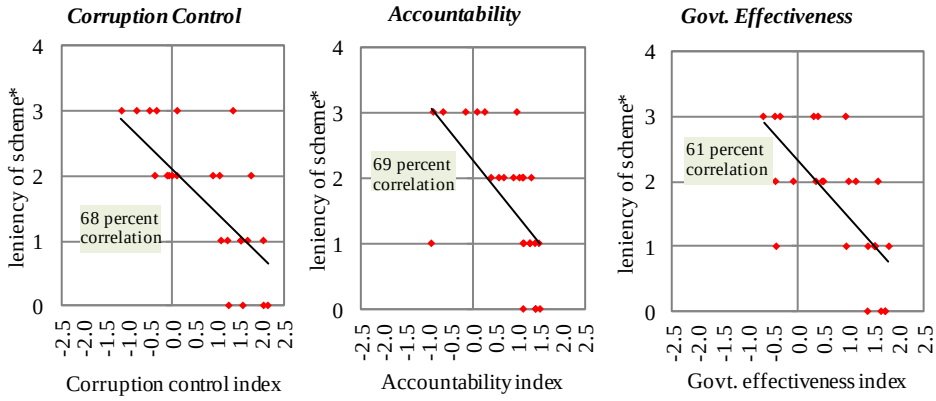
[19] Another objective of an amnesty scheme may be to give tax evaders a 'second chance' to change their behavior before stringent tax reforms are implemented. More recently, countries like USA and the Netherlands introduced tax amnesties to attract repatriated savings.

-2.5 (very poor) to 2.5 (very good). We found our leniency measure highly correlated (above 60 percent correlation) with all three governance indicators.

Naturally, tax amnesty is an unpopular policy tool. In fact, Le Borgne (2006) found that due to their unpopular nature, amnesty programs were mostly introduced in the first year of a government's coming to power; and if introduced in the last year, these schemes do not help in re-election.

However, the most important *economic* argument against amnesty is lack of evidence of higher post-amnesty revenue growth in either the short or long run (Baer and Le Borgne, 2008). One obvious reason is that amnesty is a short-sighted measure, treating only the symptom (revenue shortage) but not the cause (large-scale non-compliance). In worst cases, it can create a moral hazard as citizens may decide to evade current taxes in the hopes of a future amnesty scheme,[20] which can even *decrease* compliance in long-run.

Figure 4.1.1: Governance and the Nature of Tax Amnesty Schemes - Cross-Country Analysis



Source: Worldwide Governance Indicators, World Bank, analyst research.

Lessons for Pakistan

Revenue-increasing measures that can worsen future compliance are ill-advised in any country, but perhaps particularly so in a country like Pakistan where tax evasion is a problem of significant magnitude.[21]

However, since tax enforcement is costly and time consuming any sound tax reform plan will necessarily involve a 'cut-off date': older liabilities will have to be either completely written-off, or can be partly recovered through a 'voluntary payment' scheme. Thus, some kind of tax amnesty is inevitable.

A good amnesty scheme will be part of a reform agenda to clear past liabilities as much as possible, and move ahead with a stronger taxation system. It would offer minimum perks, and instead be made

[20] The benefit would be greater if interest is not charged on outstanding tax liability, as is the case in Pakistan.

[21] There are only 3 million income tax payers in Pakistan. Source: Budget Speech 2012.

'attractive' by increasing the cost of non-payment (setting examples by prosecuting non-filers, media campaigns portraying tax evasion as unethical, and by publicly 'naming and shaming' evaders). Finally, a successful reform program would facilitate non-compliers when they do come clean: helpful measures could include a fair payment installment plan (adjusted for interest) to ease the cash flow burden,[22] and assuring against harassment by tax officials.[23]

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4.3 Total Debt & Liabilities

Pakistan's public debt stock increased by Rs 297 billion during the third quarter, reaching Rs 13.9 trillion as of end-March 2013 (**Table 4.6**).[24] The entire increase in public debt was on account of domestic debt, as Pakistan's external debt continued to decline. Moreover, the pace of debt accumulation increased in Q3-FY13, after a slowdown in the second quarter. More importantly, public debt is subject to the limit imposed in the FRDL Act (2005), which states that public debt should not exceed 60 percent of GDP on end-June 2013. Our internal estimates, however, indicate the risk of missing the FRDL target this year (**Box 4.2**).

On the face of it, the absolute increase in domestic debt during Jul-Mar FY13 is lower than the rise in same period last year. However, adjusting for the one-off settlement of circular debt last year, the increase in domestic debt this year is 44.6 percent higher.[25]

The worsening debt dynamics in the country can be seen in the heavy interest payments on domestic debt, which is squeezing out development spending. In

[22] Brazil and Singapore governments made successful tax recoveries through payment installment agreements with their citizens.
[23] For example, assurance against harassment was an important feature of the 2007 Russian income tax amnesty scheme.
[24] This analysis is based on SBP's definition of public debt, which differs from MoF. For details, see Data Explanatory Notes. 5(b), **Annexure A**.
[25] Q3-FY13 again witnessed a dependence on short tenor (3m) securities, as banks were reluctant to lock funds in longer term paper, consequently borrowing from central bank continued unabated.

fact, Pakistan's debt repayment capacity for both domestic and external debt, deteriorated during Q3-FY13.[26]

Table 4.6: Debt Burden

billion Rupees

	Stocks		Absolute Δ				
			Jul-Mar		FY13		
	Jun-2012	Mar-2013	FY12	FY13	Q1	Q2	Q3
Total debt & liabilities	14,553	15,446	1,204	892	595	87	211
Total public debt	12,924	13,865	1,299	941	535	109	297
Total debt	13,888	14,885	1,289	997	583	129	286
A. Domestic - government	7,638	8,801	1,195	1,162	482	209	472
B. Domestic - PSEs	281	326	-144	45	16	25	5
C. External	5,969	5,759	238	-210	85	-105	-190
Total liabilities	665	560	-85	-105	12	-42	-75
D. Domestic	438	325	-93	-113	9	-47	-75
E. External	227	235	8	8	3	5	-0.3
Memorandum items:							
Total public debt adjusted for one-off settlement (of Rs 391 billion) in FY12	12,533	13,878	908	941			
Domestic-government debt adjusted for one-off settlement of circular debt	7,247	8,801	804	1,162			

Source: State Bank of Pakistan

Composition of domestic debt

Banks' reluctance in investing in long term securities (PIBs), the absence of *Ijara Sukuk* auctions, and falling institutional investment in NSS, meant that floating debt was the only option available for the government to finance its deficit during Q3-FY13.[27] As a result, 80 percent of the entire increase in domestic debt, in Q3-FY13 was due to these short term securities.[28]

[26] To put things in perspective, as opposed to a 26.5 percent YoY surge in the interest payments on domestic debt during Jul-Mar FY13, FBR tax revenue recorded a meager 5.0 percent YoY increase during this period. Similarly, the ratio of external debt servicing to foreign exchange earnings continued to deteriorate during the third quarter of FY13 also.

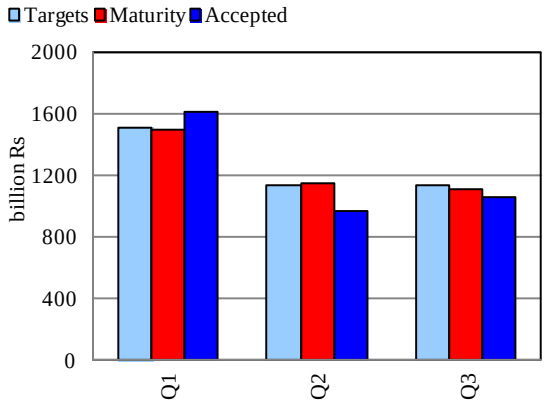
[27] During Q1-FY13 last *Ijara sukuk* auction was held against M3 highway. M3 was identified as an asset in December 2011. Government raised Rs 233.8 billion against this asset compared to the target of Rs 195 billion.

[28] In overall terms, floating debt had 54.5 percent share in the government domestic debt increase during Jul-Mar FY13.

Floating Debt

As in the first half of FY13, T-bills auction targets in Q3-FY13, aimed at merely rolling over the maturing T-bills stock (**Figure 4.5**). Thus the acceptance of T-bills remained closed to the target level during most of the third quarter of FY13. However, banks anticipating a rise in the discount rate shifted their interest almost entirely to 3-m T-bills.

Figure 4.5: T-Bills Auction Profile (FY13)

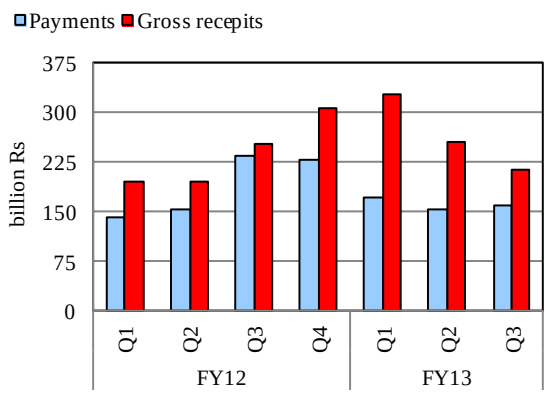


Source: State Bank of Pakistan

Unfunded debt

Net NSS flows declined during Q3-FY13, compared to the first half of FY13. This was expected, as the impact of allowing institutional investment in April 2012, had already started to taper off in Q2- FY13 (**Figure 4.6**). In overall terms, however, net inflows in NSS during Jul-Mar FY13, were significantly (Rs 200 billion) above the level observed during the same period last year.[29]

Figure 4.6: NSS Flows



Source: State Bank of Pakistan

More importantly, the gross inflows to these schemes proved resilient to the rate reductions announced during FY13, showing that NSS instruments still dominate other channels of savings for households. [30]

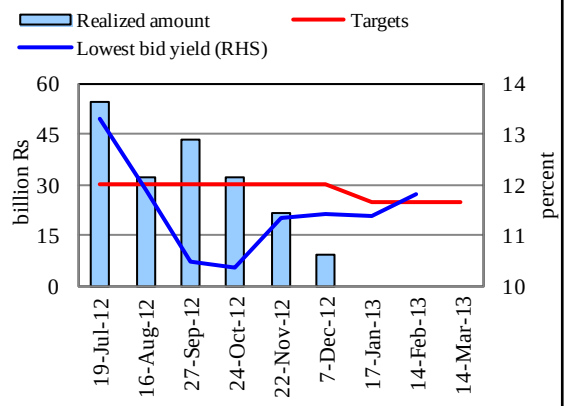
[29] The net inflows in NSS during FY12 were compressed because of huge payments, after the ECC decision in April 2011 that barred institutional investors from investing in NSS.

[30] NSS rates have been revised downwards on three occasions in FY13 i.e., August 27, 2012; October, 12 2012: and Jan 1, 2013.

Permanent debt

Government had planned to raise Rs 75.0 billion from PIBs during the third quarter of FY13, but no funds could be raised in the auctions. Given the already significant exposure to PIBs (Rs 1.1 trillion), banks appeared reluctant to lock funds into long term paper. More to the point, banks viewed that the phase of interest rate cuts was over, as BoP compulsions would begin to dominate in the remainder of FY13. In fact, the increasing yields demanded by banks show up quite clearly in the bid patterns. However, this effort by the banks to bid up medium and long term rates was not acceptable to the government, which simply opted to reject the PIB offers (**Figure 4.7**).[31]

Figure 4.7: PIB Auction Profile

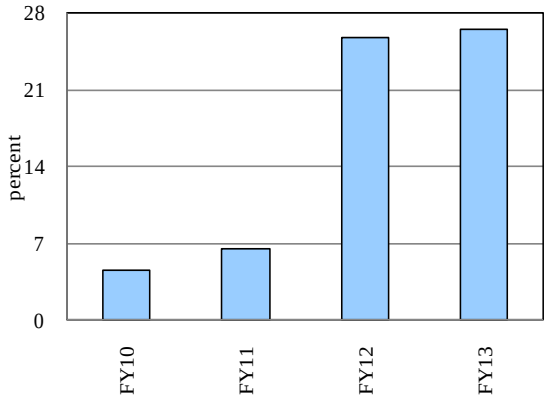


Source: State Bank of Pakistan

Interest Payments on Domestic debt[32]

In tandem with the rising stock of domestic debt, interest payments swelled by 26.5 percent during Jul-Mar FY13, compared to the same period last year (**Figure 4.8**). Around 84.6 percent of this rise came from the increase in payments on floating debt. Due to the government's reluctance to accept more expensive longer term debt, shorter maturity T-bills have become the main driver of

Figure 4.8: Growth in Interest Payments (Jul-Mar)



Source: State Bank of Pakistan

[31] The lowest bid yield in Figure 4.6 pertains to 10-year PIBs.

[32] This analysis is based on SBP's numbers for interest payments on domestic debt, which do not match with the information provided by MOF. For details, see Data Explanatory Notes 5(c), **Annexure A**.

Pakistan's domestic debt servicing.[33]

Specifically, short-term borrowing increased the stock of floating debt by Rs 910.3 billion during FY12, resulting in a hefty Rs 294.0 billion addition to debt servicing in Jul-Mar FY13. Similarly, the Rs 633.1 billion increase in floating debt during the first nine months of FY13 is likely to increase interest payments by Rs 179.9 billion during the next fiscal year. This mechanical increase in debt servicing compounded by the short term nature of this debt, has pushed the country into a debt trap.

The increase in interest payments is a part of the domino effect, of the growing needs of the government, which is increasing the debt burden of the country. This has been highlighted repeatedly in past SBP reports: increasing debt servicing burden in the absence of a corresponding increase in tax revenues, reveal the increased risk of a debt-deficit spiral for the country.

External Debt

More specifically, Pakistan paid US$ 2.0 billion to the IMF during first nine months of FY13. This impact was reinforced by the 15.5 percent depreciation in the value of the Yen vs. US Dollar, which resulted in US$ 2.1 billion fall in the country's external debt as of end-Mar 2013, compared to end-Jun 2012.

Table 4.7: External Debt & Liabilities Stock

billion US$

	Jun-12	Mar-13	Δ
Total external debt & liabilities	**65.5**	**60.9**	**-4.6**
Government external debt	46.1	43.7	-2.4
Debt from IMF	7.3	5.3	-2.0
External liabilities	2.4	2.4	0.0
Private sector external debt	5.4	5.1	-0.4
PSEs external debt	1.5	1.8	0.3
Intercompany debt	2.7	2.5	-0.1
Memorandum items:			
Public external debt	55.9	51.4	-4.4
External debt servicing/foreign exchange earnings (percent)	9.5	12.4	

Source: State Bank of Pakistan

Pakistan's external debt & liabilities (EDL) posted a US$ 4.6 billion decline during Jul-Mar FY13 (**Table 4.7**). Both, scheduled repayments to the IMF and some gains from appreciation of US$ contributed to this decline.

External inflows, on the other hand, recorded a 25.2 percent YoY increase during Jul-Mar FY13, compared to the same period last year. A large share of this

[33] Floating debt constituted more than one-half share in the total additions to domestic debt stock during past five years.

increase can be traced to credit disbursements by IDB (US$ 256 million). However, project and program loan inflows also recorded increases (**Table 4.8**).

Table 4.8: External Loan Disbursement (Jul-Mar)

million US$

	FY12	FY13	Absolute Δ
Total	**1,337.8**	**1,674.5**	**336.7**
of which			
Project	1,255.5	1,359.5	104.0
Program loans	30.7	36.4	5.7
IDB	--	256.0	256.0

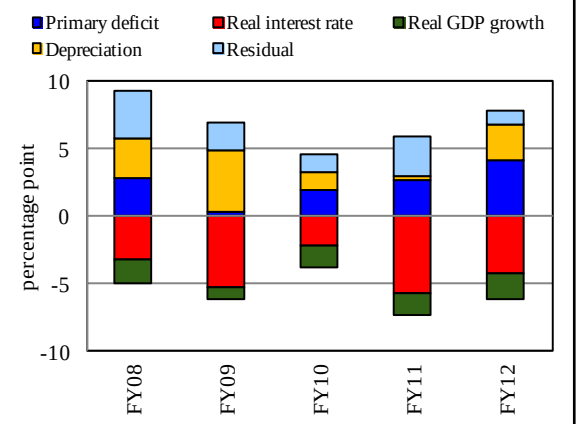
Source: Economic Affairs Division, Islamabad

Notwithstanding the decline in external debt stock, Pakistan's external debt repayment capacity weakened during Q3-FY13, compared to end-June 2012. External debt servicing to foreign exchange earnings, deteriorated from 9.5 percent in Jun 2012 to 12.4 percent in Mar 2013.

Box 4.2: What Caused Public Debt to Rise In Pakistan during Last Five Years (FY08-FY12)?

Government debt in Pakistan is subject to limits prescribed in the FRDL Act (2005), which stipulates a ceiling of 60 percent on the public debt-to-GDP ratio, which is to be reached by end-FY13.[34] However, Pakistan's public debt stock has been rising consistently since FY07 (with the exception of FY11) and reached 62.6 percent of GDP as of end-June 2012 from 56.4 percent in FY07. Given the continued increase in the fiscal deficit and, hence, the public debt during the first three quarters of the current fiscal year, there is a risk that the country is likely to miss the FRDL target this year. In this context, this note attempts to understand the underlying dynamics of the persistent increase in the public debt burden of Pakistan.

Figure 4.2.1: Contribution to the Change in Public Debt Stock



Source: Analyst estimates

The evolution of a country's public debt is based on the following identity:[35]

[34] The Act also envisages an annual 2.5 percentage point reduction in this ratio after achieving the 60 percent benchmark by end FY13.

[35] (IMF 2008), "Staff Guidance Note on Debt Sustainability Analysis for Market Access Countries", Prepared by the Policy Development and Review Department.

$$d_t - d_{t-1} = \left(\frac{r - \Pi(1+g) - g + \varepsilon\alpha(1+r)}{(1+g+\Pi+\Pi g)} \right) d_{t-1} + pb_t + z_t \qquad (1)$$

where d is country's public debt-to-GDP ratio, pb is the primary balance, r is the average nominal interest rate paid on government debt, g is real GDP growth, Π_t is the change in the domestic GDP deflator, α is the share of foreign-currency denominated public debt and changes in the exchange rate are denoted by ε, whereas z_t is other debt creating or debt reducing flows, such as cross country movements, recognition of contingent liabilities, errors and omissions, etc.

Based on (1), and the behavior of the determinants of public debt during past five years, our estimates identify the primary deficit and the Rupee depreciation as the chief contributors to the persistent increase in the country's debt burden during FY08-FY12 (**Figure 4.2.1**). These findings correspond with the general perception about the sources of increase in Pakistan's public debt – a deficit in the primary balance directly translates into increased financing requirements, and hence the level of debt, whereas exchange rate depreciation inflates the Rupee value of external debt of the country. Our results indicate that both these important factors had contributed almost equally to the additions in the country's debt stock over the past five years. In addition to these two factors, however, exchange rate movements of US Dollar against other major currencies (as captured by a *residual*) also had a sizeable contribution to the annual increments in government debt stock during this period.

The impact of these factors was partially offset by the negative average real interest rates on debt (which was led by strong double digit inflation in this entire period), as well as the rate of economic growth in the country.

What level of primary deficit could have achieved the FRDL public debt target in FY13? We have used (1) to determine the level of primary deficit which would have been required to achieve the desired reduction in the public-debt-to-GDP ratio this year. For this estimation, our assumptions about the determinants of public debt in FY13 are given in **Table 4.1.1**. Our estimates indicate that a primary surplus of roughly 1.6 percent of GDP could have resulted in obtaining the required i.e., 60 percent of GDP, public debt ratio by the end of this fiscal year. Compared with the actual primary deficit (4.2 percent of GDP, including the one-off payment of circular debt) last year (FY12), the required surplus this year indicates the need for substantial fiscal consolidation. As opposed to this requirement, however, the primary balance recorded a deficit equal to 1.2 percent of GDP during Jul-Mar FY13. The result indicates that delays in undertaking fiscal consolidation measures, will result in aggravating the government's debt burden, which implies a significant cost associated with the increase in debt servicing and a subsequent squeeze on development spending, which further shrinks the chances of a decent real economic growth.

Table 4.1.1:Assumptions Regarding the Behavior of Economy

in percent

	Avg. real interest rate	Real GDP growth	Inflation
FY13	1.4	3.2	7.4

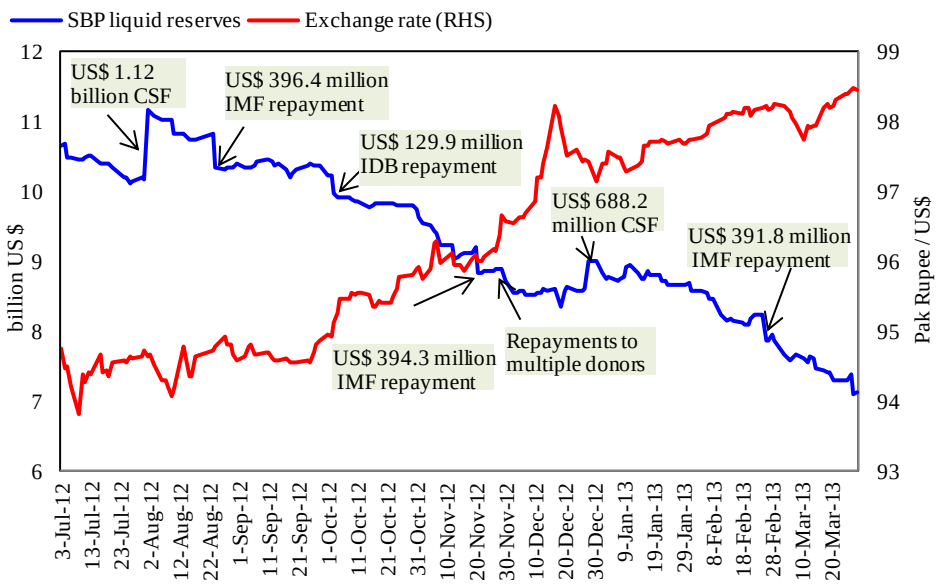
Source: SBP Calculations

5 External Sector

5.1 Overview

Pakistan's overall external deficit was US$ 1.8 billion in Jul-Mar FY13 – an improvement of US$ 0.9 billion over the same period last year. However, SBP's foreign exchange (FX) reserves have been declining throughout FY13 (**Figure 5.1**). During Q3-FY13, IMF payments accounted for US$ 743.7 million decline in the level of reserves;[1] exports and foreign investments failed to recover; and worker remittances posted a 5.1 percent YoY decline, which appears to be one-off. Consequently, the current account deficit increased to US$ 1.3 billion in Q3-

Figure 5.1: Daily Position of SBP Liquid FX Reserves & Exchange Rate



Source: State Bank of Pakistan

FY13, and the exchange rate remained under pressure throughout FY13.

Presently, Pakistan's liquid FX reserves meet the international adequacy standards, in terms of import and short-term debt coverage (**Section 5.4**). However, lumpy IMF payments scheduled for the next few months will put

[1] The total principal repayments to IMF, after including budgetary support amount to US$ 720.1 million in Q3-FY13.

pressure on the country's reserves. Market sentiments have occasionally been unhinged as evident in erratic spikes in the kerb premiums (**Section 5.5**).

Any policy actions to stabilize the external account must realize that the problem stems from the financial account, not the current account. More specifically, in a scenario where the imbalances are emanating primarily from debt repayments and almost non-existent investment flows, orthodox stabilization policies may not work. Demand compression, especially when imports are already falling and exports are affected by a weak global economy, can undermine the already low level of economic growth, and increase the debt repayment burden on the country.

While external assistance may be required in the short run, long-term capital inflows (and robust current account surplus) will only be possible with structural adjustments to create the fiscal space needed to improve the provision of public services and infrastructure; promote competition, transparency and efficiency; and minimize the unproductive use of financial resources. SBP has been emphasizing the need for such decisive structural reforms to contain both fiscal and external imbalances.

5.2 Current Account – *Deficit soars as remittances weaken*

The current account, which had recorded a surplus in Q1-FY13 and a nominal deficit in Q2-FY13, swelled to a US$ 1.3 billion deficit during Q3-FY13 (**Table 5.1**). However, the cumulative current account deficit for Jul-Mar FY13 was US$ 1.1 billion, which is still less than half the deficit recorded last year. This improvement is mainly due to the CSF flows in H1-FY13.

The relatively large current account deficit in Q3-FY13 was caused by the decline in remittances. This was the first YoY decline in remittances in any quarter since Q2-FY05 (**Figure 5.2**), and can be attributed primarily to prolong delays in reimbursement of telegraphic transfer (TT) charges by the government to institutions on inward home remittances.[2]

[2] To encourage overseas Pakistanis to remit through official channels, the government of Pakistan partially reimburses the TT cost that banks have to bear in transferring money to Pakistan. For every inward remittance of over US$ 100, the government pays Saudi Riyal 25 to the bank, which partially covers their related expenses. For last 13 months, the government was unable to reimburse banks operating overseas.

Table 5.1: Summary of Balance of Payments
billion US$

	Q1		Q2		Q3		Jul-Mar		Abs. Δ
	FY12	FY13	FY12	FY13	FY12	FY13	FY12	FY13	
I. Current account balance	**-1.4**	**0.3**	**-1.0**	**-0.2**	**-0.6**	**-1.3**	**-3.0**	**-1.1**	**2.0**
A. Trade balance	**-4.2**	**-3.7**	**-3.8**	**-4.1**	**-3.8**	**-3.6**	**-11.8**	**-11.3**	**0.5**
Export	6.1	6.0	5.9	6.1	6.3	6.3	18.3	18.3	0.0
Imports	10.4	9.7	9.7	10.1	10.1	9.8	30.2	29.6	-0.6
B. Services	**-0.7**	**0.2**	**-0.6**	**0.0**	**-0.7**	**-0.6**	**-2.1**	**-0.4**	**1.7**
of which: Logistic support	0.0	1.1	0.0	0.7	0.0	0.0	0.0	1.8	1.8
C. Income account	**-0.7**	**-0.7**	**-0.9**	**-1.1**	**-0.7**	**-0.9**	**-2.3**	**-2.7**	**-0.4**
Payments include:									
Repatriation of profit by oil companies	0.3	0.4	0.4	0.4	0.4	0.5	1.1	1.3	0.2
Interest on off external debt, incl.IMF	0.2	0.1	0.3	0.2	0.1	0.1	0.5	0.5	0.0
D. Current transfers	**4.3**	**4.5**	**4.3**	**5.0**	**4.6**	**3.8**	**13.2**	**13.3**	**0.1**
of which: Worker remittance	3.3	3.6	3.0	3.5	3.4	3.2	9.7	10.4	0.6
II. Capital account	**0.0**	**0.0**	**0.1**	**0.1**	**0.1**	**0.1**	**0.1**	**0.2**	**0.0**
III. Financial account	**0.6**	**0.0**	**-0.3**	**-0.6**	**0.1**	**0.0**	**0.4**	**-0.6**	**-1.0**
(i) Net foreign investment	0.2	0.2	0.1	0.4	0.1	-0.1	0.4	0.6	0.2
FDI (net)	0.2	0.1	0.3	0.4	0.1	-0.1	0.5	0.4	-0.1
Portfolio	0.0	0.1	-0.1	0.0	0.0	0.0	-0.1	0.2	0.3
(ii) Net debt flows	0.0	0.0	0.4	-0.1	-0.1	-0.2	0.3	-0.3	-0.6
Disbursement	0.5	0.4	0.8	0.6	0.4	0.4	1.7	1.4	-0.3
Amortization	0.5	0.5	0.4	0.6	0.5	0.6	1.4	1.7	0.3
(iii) Official assistance	-0.1	0.0	0.0	0.0	0.0	-0.1	-0.1	-0.1	0.0
(iv) Others	0.5	-0.2	-0.8	-1.0	0.1	0.4	-0.2	-0.8	-0.6
IV. Errors and omissions	**0.0**	**-0.4**	**0.3**	**0.1**	**-0.4**	**0.1**	**-0.2**	**-0.3**	**-0.1**
V. Overall balance	**-0.8**	**0.0**	**-1.0**	**-0.6**	**-0.9**	**-1.2**	**-2.7**	**-1.8**	**0.9**

Source: State Bank of Pakistan

5.3 Financial and Capital Account

The financial and capital accounts remained under stress in FY13. Pakistan was unable to attract foreign investment due to the uncertainty associated with the elections, as well as the perceived macro-economic risks. The net FDI *outflow* in Q3-FY13 basically reflects disinvestment from one of the largest chemical manufacturers in Pakistan, and a lumpy loan repayment by a cellular firm (**Figure 5.3**).

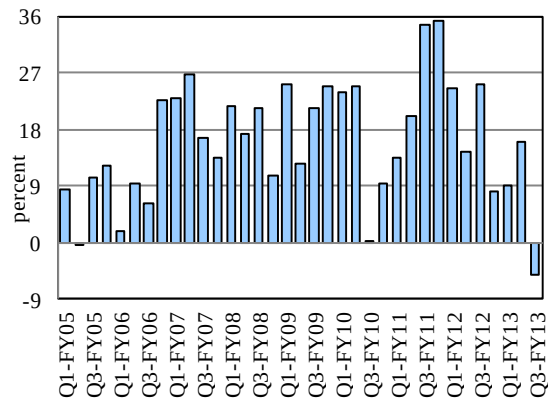
Portfolio investment also declined despite the boom in the equity market. A multinational FMCG – Unilever – has recently revealed plans regarding the buyback of its shares (worth over US$ 500 million), listed on the KSE during the

rest of the fiscal year. This is expected to support direct investment in the fourth quarter, but a part of this inflow is likely to be repatriated.

5.4 Reserves

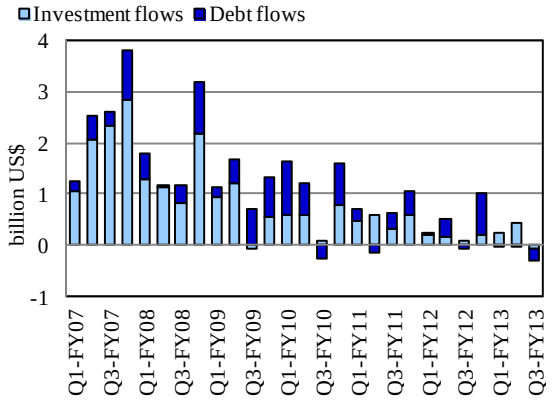
The decrease in the country's liquid foreign exchange reserves gathered pace in Q3-FY13. The country's reserves declined by US$ 3.04 billion during Jul-Mar FY13, out of which, a US$ 1.6 billion decline was observed in Q3-FY13 alone. The decline was concentrated in SBP reserves, as commercial banks' FX (liquid) holdings increased during the period (**Table 5.2**).

Figure 5.2: YoY Growth in Remittances



Source: State Bank of Pakistan

Figure 5.3: Quarterly Financial Flows



Source: State Bank of Pakistan

Most of the decline in SBP reserves can be traced to IMF repayments, which totaled to US$ 2.1 billion between Jul-Mar FY13 (**Figure 5.4**). The magnitude of the support that was required to calm market expectations, and for smooth functioning of markets, was also significant. However, it must be noted that despite the decline in foreign reserves, the measures of foreign reserve adequacy remain above international standards:

i) *Sufficient import cover*: According to international standards, a country's liquid FX reserves should be sufficient to cover three months of imports – Pakistan's liquid FX reserves seem adequate according to this criterion (**Table 5.3**). In fact, even after adjusting for IMF repayments for the next quarter, Pakistan will have adequate import cover.

Table 5.2: Reserves Composition
million US$

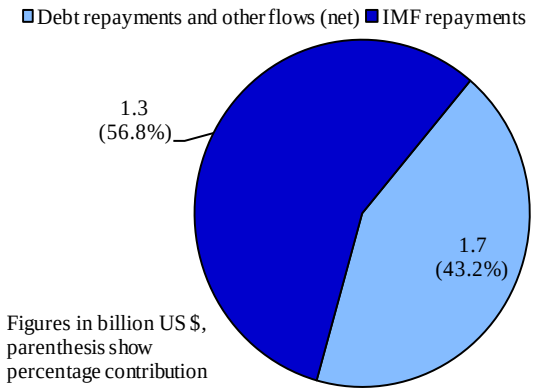
	FY12		FY13		
	Mar	**Jun**	**Sep**	**Dec**	**Mar**
A. Gold	3,442	3,311	3,679	3,433	3,311
B. SBP forex holding	12,075	10,856	10,410	9,028	7,147
B-i) SDRs	1023	966	953	924	875
B-ii) Cash forex holding	241	53	52	41	21
B-iii) Nostro (excl. CRR)	10,812	9,837	9,406	8,064	6,251
C. Commercial banks' forex holding	5,561	5,175	5,408	5,376	5,139
C-i) FE-25	5,707	5,557	5,618	5,608	5,764
C-ii) Trade nostros	-231	-456	-256	-264	-655
C-iii) Placement abroad (other than FE-25)	85	74	46	32	30
D. Commercial banks' forex utilizations	3,133	2,849	2,848	2,445	2,601
D-i) Trade finance	991	1072	1053	736	641
D-ii) FE-25 placements in Pakistan	78	81	90	88	107
D-iii) Others	2,064	1,696	1,705	1,621	1,853
E. SBP liquid reserves (Bi + Biii)	**11,835**	**10,803**	**10,359**	**8,988**	**7,126**
F. SBP liquid reserves and cash holdings	12,075	10,856	10,410	9,028	7,147
G. Commercial banks' liquid reserves (Ci - Di)	**4,716**	**4,485**	**4,564**	**4,872**	**5,124**
H. Commercial banks' total reserves (C - D)	2,428	2,326	2,559	2,931	2,538
I. Total liquid reserves (E + G)	**16,551**	**15,288**	**14,924**	**13,860**	**12,250**
J. Total reserves (A + F + H)	17,946	16,493	16,649	15,392	12,996

Source: Statistical Bulletin, SBP

Short-term debt is also covered: Pakistan's liquid FX reserves are 10 times the stock of short-term debt (both public and private). According to international standards, a country's reserves should be at least equal to the volume of short-term debt.

ii) *Hybrid coverage:* The IMF has recently proposed a metric to incorporate different potential FX outflows

Figure 5.4: Sources of Decline in SBP Reserves (Jul-Jan FY13)



Source: State Bank of Pakistan

(e.g., the risk of a decline in exports, short-term debt and other portfolio liabilities) to estimate reserves adequacy (**Box 5.1**). Pakistan's reserves lie within the recommended range of 100-150 percent of the proposed metric.

Table 5.3: Reserves Adequacy Indicators

	FY12		FY13		
	Mar	**Jun**	**Sep**	**Dec**	**Mar**
Import based adequacy					
Liquid forex reserves (LFR) as weeks of import	21.6	19.7	19.6	18.0	16.0
LFR as percent of **next 3-month projected imports***	160.8	158.3	147.2	141.4	109.9
After adjusting next 3-month IMF repayments	155.3	153.7	142.0	131.6	101.5
SBP LFR as percent of next 3-m projected imports	115.0	111.9	102.2	91.7	63.9
Commercial banks' LFR as % of next 3-m projected imports	45.8	46.4	45.0	49.7	46.0
Debt-based adequacy					
Short-term (ST) debt as percent of LFR	8.6	10.6	11.3	10.0	11.8
ST debt as percent of SBP LFR	12.1	14.9	16.3	15.4	20.3
IMF repayments next quarter as percent of SBP LFR	4.8	4.1	7.0	7.0	13.1
ST debt + IMF repayments as percent of SBP LFR	16.9	19.0	23.3	22.5	33.4
Hybrid indicators					
ST debt + current account deficit / LFR (percent)	12.5	21.1	9.0	11.1	21.8
ST debt + current account deficit / SBP LFR (percent)	17.5	29.9	13.0	17.2	37.4
LFR as percent of composite index (flexible)**	268.6	246.3	238.0	216.6	NA
SBP LFR as percent of composite index (flexible)**	192.0	174.0	165.2	140.4	NA
LFR as percent of composite index (fixed)**	141.8	130.6	126.5	114.2	NA

*Based on SBP projections; **See **Box 5.1**
Source: State Bank of Pakistan

Box 5.1: New Hybrid Indicators of Reserves Adequacy

A large number of countries are using traditional metrics to gauge their reserves adequacy. These measures include simple rules of thumb like three-month of import cover, or full coverage of short-term debt. Although these metrics are relevant and simple to follow, they focus on a particular source of external sector vulnerability. However, pressures on external account can stem from multiple sources, including imports, unanticipated decline in exports, capital flight and debt repayments. Therefore, there was a need to devise a metric that account for most vulnerabilities that countries are facing, and suggest a certain level of reserves against that metric.

Developing such metric was a two step process: first, the relative risk levels of different sources of balance of payments pressures were identified. And second, evidence was observed to assess how much reserves might be needed to cover this risk-weighted measure. Certainly, every country has different risk factors facing their balance of payments – depending upon the level of financial integration, trade openness, etc – and it may be arbitrary to assign a common weight to a particular risk for all countries.

To resolve this issue, separate metrics were developed for emerging economies, and low income countries. For identifying risk factors and assigning an appropriate weight, IMF followed a lengthy process: previous crisis episodes were reviewed, reserves managers were interviewed/surveyed, and evidence was considered from reserves demand regressions and range of metrics already in use by different countries. After going through this process, four key variables were identified to include in the risk metrics: export income (XE), short-term debt (STD), other portfolio liabilities (OPL), and liquid domestic assets, proxied by broad money (M2).

While short-term debt and other portfolio liabilities represent the potential drain from country's reserves, the decline in export earnings basically reflect the *source* of the crisis. Although imports are typically used in gauging reserves adequacy, technically this can be considered as a *symptom* of balance of payments crisis. Finally, M2 is used to represent the stock of domestic assets that can be sold and transferred during a crisis.

Finally, to assign weights, the approach uses tail event outflows (10^{th} percentile) observed during the periods of exchange market pressures, in the variables discussed above. Distributions are estimated separately for fixed and floating exchange rate regimes, based on which, following metrics were formed for the emerging economies:

Floating = 30%STD + 15%OPL + 10%XE + 10%M2
Fixed = 30%STD + 10% OPL +5% XE + 5%M2

It is recommended that country's reserves should lie within 100-150 percent range of the above metrics.

Source:
"Assessing Reserves Adequacy", Prepared by Monetary and Capital Markets, Research, and Strategy, Policy, and Review Departments, International Monetary Fund. Approved by Reza Moghadam, Jonathan D. Ostry and Robert Sheehy, February 14, 2011.

5.5 Exchange Rate

Stable Q3 but expectations remain pessimistic

The foreign exchange market remained calmer in Q3-FY13, compared to the previous quarter. Not only did the pace of Rupee depreciation slow, volatility also declined considerably (**Table 5.4).** On a cumulative basis, the Pak Rupee depreciated by 3.9 percent during Jul-Mar FY13, which is lower than the 5.2 percent depreciation in the same period last year.

Table 5.4: Rupee-Dollar Parity during FY13

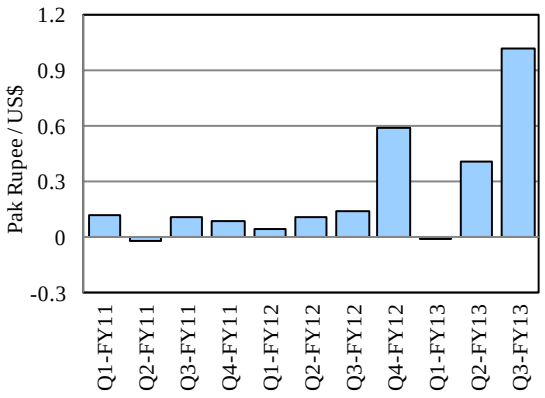
	Q1	Q2	Q3
Exchange rate (end-period)	94.87	97.14	98.47
Dep/App during the quarter (percent)	-0.25	-2.34	-1.36
Co-efficient of variation (percent)	0.22	0.87	0.33
Cumulative dep/app (percent)	-0.25	-2.58	-3.91
Increase/decrease in total liquid reserves (billion US$)	-0.37	-1.06	-1.61

Source: State Bank of Pakistan

We are, however, concerned with the resurgence of the kerb premium during the quarter (**Figure 5.5**). In our view, the disproportionate increase in demand for FX

reflects the expectation of further depreciation in the Pak Rupee that encourages people to hold US Dollars *outside* the banking system.

Figure 5.5: Average Kerb Premium



Source: State Bank of Pakistan

5.6 Trade Account[3]

Pakistan's trade deficit contracted by 8.9 percent YoY during Jul-Mar FY13, in contrast to an expansion of 43.6 percent during the same period last year. This improvement was due to a 5.4 percent YoY rise in exports and 1.6 percent decline in imports (**Table 5.5**).

However, after YoY decline in the first two quarters of FY13, the trade deficit recorded a 2.8 percent YoY increase during Q3-FY13. This deterioration was mainly caused by a slowdown in exports.

5.6.1 Exports

The growth in textile and food exports led to a modest 5.4 percent rise in overall exports during Jul-Mar FY13; the exceptional jewelry exports during July-Oct 2012, also contributed to this overall growth (**Figure5.6**). Although the rise in textile exports is a result of improved external demand and higher price of yarn and fabric, the growth in food exports was largely due to better prices in the international market.

Table 5.5: Foreign Trade

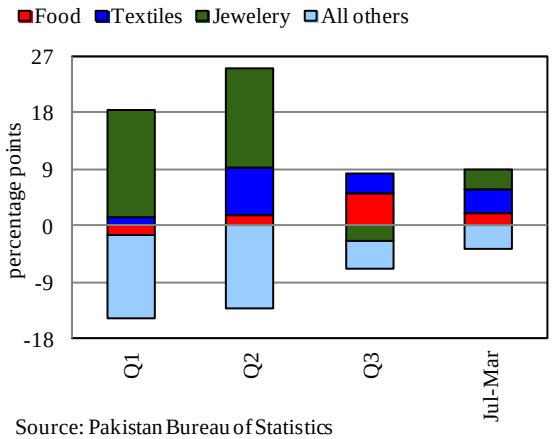
	Exports	Imports	Trade deficit
		Value in billion US$	
Q1-FY13	6.1	10.9	4.7
Q2-FY13	5.9	11.1	5.2
Q3-FY13	6.0	10.8	4.8
Jul-Mar FY12	17.1	33.3	16.2
Jul-Mar FY13	18.0	32.8	14.7
		YoY growth in %	
Q1-FY13	3.5	-2.4	-9.2
Q2-FY13	11.6	-4.2	-17.5
Q3-FY13	1.6	2.1	2.8
Jul-Mar FY12	-3.7	14.7	43.6
Jul-Mar FY13	5.4	-1.6	-8.9

Source: Pakistan Bureau of Statistics

[3] The analysis in this section is based on the data from the Pakistan Bureau of Statistics (PBS), which differs from the exchange record data prepared by the SBP. For details, see Data Explanatory Note. 5(d), **Annexure A**.

However, most of these gains were realized during the first half of the year, and exports decelerated in subsequent months; as a result, the YoY growth in exports was only 1.6 percent in Q3-FY13.

Figure 5.6: Contribution to Export Growth (FY13)



Source: Pakistan Bureau of Statistics

Textiles

Textile exports grew by 7.2 percent during Jul-Mar FY13, in contrast to a *fall* of 9.7 percent in the same period last year. The expansion was quite broad-based with visible increases in yarn, fabric, hosiery, towel and readymade garments (**Table 5.6**). Moreover, while the recovery in textile exports was largely because of low value-added items in H1-FY13, the growth in the third quarter was driven by high-value added segment (**Figure 5.7**).[4] The increase in low-value exports was due to both higher quantum and prices, with higher demand for yarn and fabrics coming from China.[5] The growth in high-value textile exports was largely due to higher quantum, after the announcement of duty-free access for 75 categories by the EU from November 15,

Table 5.6: Textile Exports (Jul-Mar FY13)

	% Growth (YoY)	million US$		
		Absolute Δ	Quantum Impact	Price Impact
Textiles	**7.2**			
Raw cotton	-65.1	-236.0	-222.8	-13.2
Cotton yarn	29.7	379.9	457.0	-77.1
Cotton fabrics	11.7	208.4	-65.8	274.2
Hosiery	2.9	42.6	62.8	-20.2
Bed wear	0.5	7.0	95.0	-88.0
Towels	17.5	85.4	114.8	-29.5
Readymade garments	10.2	121.5	131.5	-9.9
Low value-added	10.0	352.3	168.4	184.0
High value-added	6.0	256.4	404.1	-147.7

Source: Pakistan Bureau of Statistics

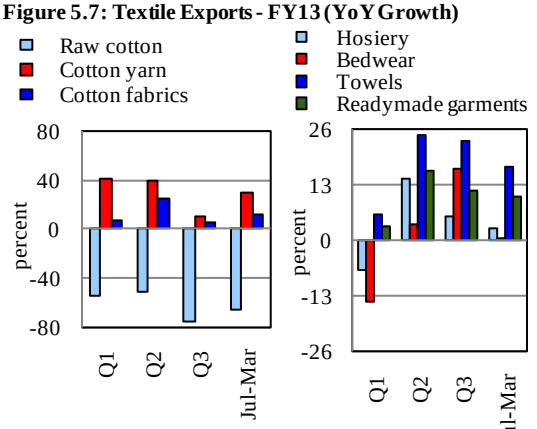
[4] About 60 percent of total textile export consist of high value added goods, while remaining is low value added.

[5] This transformation is due to the continuously rising labor wages in China that have increased production cost there. Pakistan could benefit substantially from this opportunity, as it possesses an abundance of low-cost labor and a large cotton production base, backed by some level of vertical integration in the weaving, ginning and spinning sectors.

2012 onwards;[6] and a slight improvement in the US economy during the second half of 2012 (**Table 5.7**).

Anecdotal evidence suggests that textile exporters are installing their own power generating units to overcome power shortages. Having said this, issues like liquidity constraints and the shortage of raw material have adversely impacted production numbers.

Figure 5.7: Textile Exports - FY13 (YoY Growth)



Source: Pakistan Bureau of Statistics

Non-textile sector

Non-textile exports increased by 3.4 percent on a YoY basis during Jul-Mar FY13 (**Figure 5.8**). This increase is largely because of higher prices as the quantum for most non-textile exports declined during this period.

While growth in the non-textile sector was largely due to jewelry exports during the first half of FY13, food exports led the way in Q3-FY13. After declining in Q1-FY13, food exports rebounded strongly, growing by 28.7 percent during Q3- FY13. On the other hand, jewelry exports declined by 54.0 percent during Q3-FY13. The surge in exports during the first half of FY13 was attributed to a higher price differential between domestic and international prices, and the deprecation of Pak Rupee.[7]

Table 5.7: US Textile and Apparel Imports (Jul-Feb FY13)

YoY change in percent

	Quantity	Value
Bangladesh	26.0	14.0
China	17.3	12.8
India	17.5	10.2
Pakistan	15.2	7.8
Vietnam	22.6	21.5

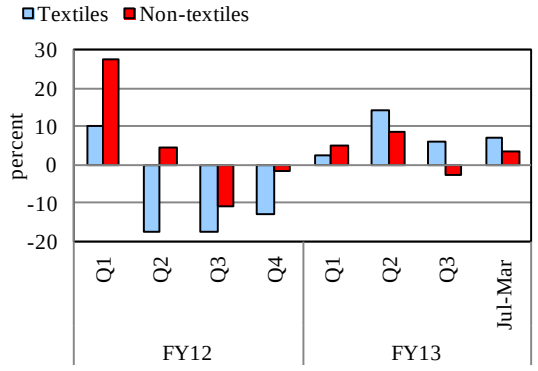
Source: US Department of Commerce

[6] Pakistan is expected to gain US$ 350 to US$ 500 million from the duty free access to exports of 75 categories during FY13. Pakistan has the price advantage over its competitors (mainly India and Bangladesh) in 19 categories.

[7] Specifically, price differential with respect to UAE gold market has remained on higher side during the past few months. Pakistan exports more than 90 percent of jewelry to UAE.

Rice exports declined by 7.0 percent (YoY) due to fall in domestic production and delay in harvesting due to late monsoon rains (**Figure 5.9)**. The export of basmati rice recorded a significant 22.4 percent decline due to a lower quantum of exports,[8] whereas non-basmati rice exports rose by 2.8 percent, entirely due to higher unit values. Rice exports did, however, rebound strongly in Q3-FY13 and grew by 11.8 percent during the quarter.

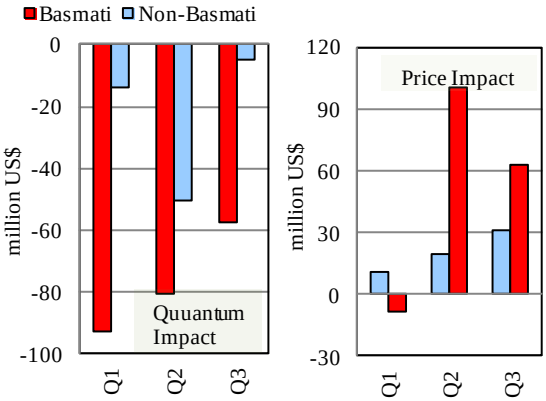
Figure 5.8: Textile and Non-Textile Exports (YoY change)



Source: Pakistan Bureau of Statistics

In ***other manufactures***, the export of jewelry, cement, electric fans and onyx products recorded a rise; however, this was partially offset by a decline in the export of sports goods, chemicals and pharmaceuticals, and leather. The rise in cement exports was led by strong demand from African markets and relatively better export prices. The export of molasses remained subdued due to its increased use domestically to produce energy in some industries.

Figure 5.9: Rice Exports (FY13)



Source: Pakistan Bureau of Statistics

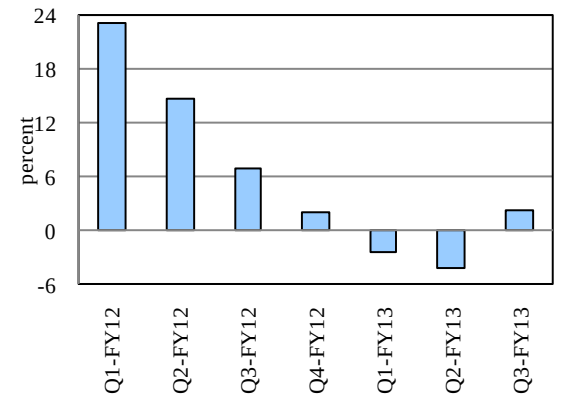
5.6.2 Imports

After declining during Q1 and Q2-FY13, imports increased in Q3 (**Figure 5.10**). Imports picked up during Q3-FY13 with the rise

[8] The introduction of a new high-yield basmati rice variety in India last year captured a substantial portion of the international rice market. Iran was the second-largest market for rice exports two years ago for Pakistan, but, according to the rice exporters association of Pakistan (REAP), the loss of Iranian market was due to the absence of currency swap arrangements from Pakistan, which India had in place, along with the India-Iran 'food-for-oil' swap agreement.

in machinery, raw cotton and metal imports outpacing the significant decline in food, transport and agricultural imports (**Table 5.8**).

Figure 5.10: Imports FY13 (YoY change)



Source: Pakistan Bureau of Statistics

Textile imports grew by 8.0 percent during Jul-Mar FY13, with Pakistan importing a significantly higher quantity of raw cotton in order to meet its demand for cotton yarn and fabric in the wake of a sharp fall in domestic production.[9] Pakistan's cotton import bill would have been much higher, had the international price of cotton not declined.[10]

Table 5.8: Import Performance (Jul-Mar FY13)

	YoY Growth (%)		% Contribution to Growth	
	H1	**Q3**	**H1**	**Q3**
Total	**-3.3**	**2.1**		
of which				
Food	-17.3	-3.6	59.9	-19.2
Transport	9.7	-3.9	-18.8	125.3
Petroleum	1.3	-4.4	-13.2	-68.2
Textile	-9.4	45.4	15.4	115.0
Agri. & chem.	-13.9	-13.7	69.7	-100.4
Metals	11.8	20.3	-21.5	59.1

Source: Pakistan Bureau of Statistics

Similarly, the import of *metals* – (gold, iron and steel) – also rose during Jul-Mar FY13 (**Figure 5.11**). The rise in gold is linked to higher exports of jewelry, while iron and steel imports increased due to an increase in steel production capacity.[11]

In contrast, a decline in food imports in Jul-Mar FY13 was led by decreasing *palm oil* imports. However, *palm oil* imports picked up in Q3-FY13 and increased by US$ 64.4 million, with an increase in palm oil demand due to lower prices compared to other edible oils.[12]

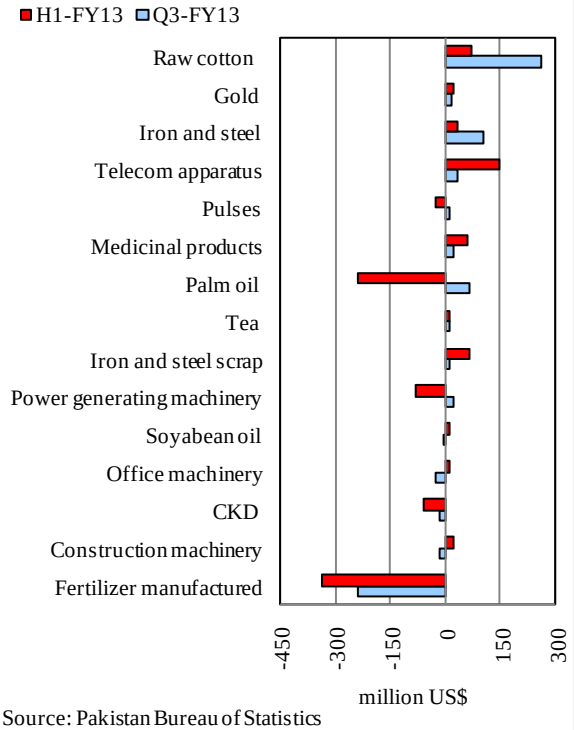
[9] Estimates indicate that cotton production will not only fall short of target, but will also be less than the last year level.
[10] Cotton prices in global market are down by 23 percent YoY in Jul-Mar FY13 compared to last year;
[11] According to reports, three new steel plants were commissioned in Karachi during 2012 (one in H2-FY12, and two in H1-FY13).
[12] Malaysia – the largest producer and exporter of palm oil in the world – has reduced tax on palm oil exports that brought down price in international market.

In transport group, imports of CKD kits group fell by 14.5 percent during Jul-Mar FY13. Car production has also suffered, as the production of various models (i.e., Suzuki Alto and Daihatsu Cuore), was discontinued in the country after July 2012. Total production of cars during Jul-Mar FY13 stood at 84,489 units, compared to 110,059 units last year.[13] The import of cars also declined as a result of change in import policy, which reduced the age limit for used cars.[14]

With Pakistan processing a higher quantity of crude oil, (especially during Q2 and Q3 of FY13), and lower international prices of crude oil, Pakistan's import bill for *petroleum* declined during Jul-Mar FY13.[15]

Fertilizer imports recorded a 53.6 percent fall in Jul-Mar FY13. This was due to increased domestic production and carryover stocks from last year.

Figure 5.11: Import Performance (YoY change)



Source: Pakistan Bureau of Statistics

[13] Last year 20,000 units were produced under the Yellow Cab Scheme of the Punjab government.
[14] The Commerce Ministry issued statutory regulatory order (SRO) for reduction in the age limit from five to three years for used cars import in December 2012.
[15] Pakistan's average monthly crude oil processing is 880 thousand MT during Oct-Mar FY13 compared to 800 thousand MT for the last three years. Average crude oil price during Jul-Mar FY13 remained at US$ 103.3 per barrel as compared with average price of US$ 106.2 per barrel during FY12.

Acronyms

ATT	Afghan Transit Trade
BE	Budget Estimate
BOP	Balance of Payment
CBOT	Chicago Board of Trade
CKD	Completely Knocked Down
CLCV	Cotton Leaf Curl Virus
CNIC	Computerized National Identity Card
CNG	Compressed Natural Gas
CPI	Consumer Price Index
CRR	Cash Reserve Requirement
CSF	Coalition Support Fund
DEGE	Dynamic Stochastic General Equilibrium
ECC	Economic Coordination Committee
EDL	External Debt and Liabilities
ENDA	Emergency National Disaster Assistance
EFS	Export Finance Scheme
ESAF	Enhanced Structural Adjustment Facility
EU	European Union
FBR	Federal Board of Revenue
FDI	Foreign Direct Investment
FED	Federal Excise Duty
FIs	Financial Institutions
FISIM	Financial Intermediation Services Indirectly Measured
FMCG	Fast Moving consumer Goods
FPI	Foreign Portfolio Investment
FRDL	Fiscal Responsibility and Debt Limitation
FX/FE	Foreign Exchange
FY	Fiscal Year
GDP	Gross Domestic Product
GIDC	Gas Infrastructure Development Cess
GOP	Government of Pakistan
GST	General Sales Tax
IDB	Islamic Development Bank

IFIs	International Financial Institutions
IFS	International Financial Statistics
IMF	International Monetary Fund
KIBOR	Karachi Interbank Offer Rate
Kg	Kilograms
KP/KPK	Khyber Pukhtunkhwa
KSE	Karachi Stock Exchange
LC	Letter of Credit
LCD	Liquid Crystal Display
LED	Light Emitting Diode
LFR	Liquid Forex Reserves
LPG	Liquefied Petroleum Gas
LSM	Large Scale Manufacturing
M2	Broad Money Supply
MT	Metric Ton
MOF	Ministry of Finance
NBFC	Non-Bank Finance Companies
NDA	Net Domestic Assets
NFA	Net Foreign Assets
NFNE	Non-Food Non-Energy
NP	Nitro-phosphate
NSS	National Savings Scheme
OECD	Organization for Economic Co-operation and Development
OMOs	Open Market Operations
OPL	Other Portfolio Liabilities
PBS	Pakistan Bureau of Statistics
PCGA	Pakistan Cotton Ginners Association
PDL	Petroleum Development Levy
PET	Polyethylene Terephthalate
PIA	Pakistan International Airline
PIB	Pakistan Investment Bond
POL	Petroleum, Oil and Lubricants
PRA	Punjab Revenue Authority
PRACS	Pakistan Railway Advisory and Consultancy Services

PRGF	Poverty Reduction and Growth Facility
PSDP	Public Sector Development Program
PSEs	Public Sector Enterprises
PSM	Pakistan Steel Mills
PSO	Pakistan State Oil
Q	Quarter
REAP	Rice Exporters Association of Pakistan
RHS	Right Hand Side
Rs	Rupees
SBA	Stand-by Arrangement
SBP	State Bank of Pakistan
SDR	Special Drawing Rights
SECP	Security and Exchange Commission of Pakistan
SNA	System of National Accounts
SRO	Statutory Revenue Order
ST	Short Term
STD	Short Term Debt
T-bills	Treasury Bills
TCP	Trading Corporation of Pakistan
TT	Telegraphic Transfer
TV	Television
UAE	United Arab Emirates
US/USA	United States of America
WALR	Weighted Average Lending Rate
XE	Export Income
WEF	World Economic Forum
YoY	Year on Year

Annexure A: Data Explanatory Notes

1) **GDP:** In the absence of actual GDP data, SBP uses the GDP target given in the Annual Plan by the Planning Commission in order to calculate the ratios of different variables with GDP, e.g., fiscal deficit, public debt, current account balance, trade balance, etc. SBP does not use its own projections of GDP to calculate these ratios in order to ensure consistency, as these projections may vary across different quarters of the year, with changing economic conditions. Moreover, different analysts may have their own projections; if everyone uses a unique projected GDP as the denominator, the debate on economic issues would become very confusing. Hence, the use of a common number helps in meaningful debate on economic issues, and the number given by the Planning Commission better serves this purpose.

2) **Inflation:** There are three numbers that are usually used for measuring inflation: (i) period average inflation; (ii) YoY or *yearly* inflation; and (iii) MoM or *monthly* inflation. Period average inflation refers to the percent change of the *average* CPI from July to a given month of the year over the corresponding period last year. YoY inflation is percent change in the CPI of a given month over the same month last year; and monthly inflation is percent change of CPI of a given month over the previous month. The formulae for these definitions of inflation are given below:

$$\text{Period average inflation } (\pi_{Ht}) = \left(\frac{\sum_{i=0}^{t-1} I_{t-i}}{\sum_{i=0}^{t-1} I_{t-12-i}} - 1 \right) \times 100$$

$$\text{YoY inflation } (\pi_{YoYt}) = \left(\frac{I_t}{I_{t-12}} - 1 \right) \times 100$$

$$\text{Monthly inflation } (\pi_{MoMt}) = \left(\frac{I_t}{I_{t-1}} - 1 \right) \times 100$$

Where I_t is consumer price index in t^{th} month of a year.

3) **Change in debt stock vs. financing of fiscal deficit:** The change in the stock of public debt does not correspond with the fiscal financing data provided by the Ministry of Finance. This is because of multiple factors, including: (i) The stock of debt takes into account the gross value of government borrowing,

whereas borrowing is adjusted for government deposits with the banking system, when calculating the financing data; (ii) changes in the stock of debt also occur due to changes in the exchange rate, which affects the rupee value of external debt, and (iii) the movement of various other cross-country exchange rates also affect the US Dollar rate and, hence, the rupee value of external debt.

4) Government borrowing: Government borrowing from the banking system has different forms and every form has its own features and implications, as discussed here:

(a) Government borrowing for budgetary support:

Borrowing from State Bank: The federal government may borrow directly from SBP either through the "Ways and Means Advance" channel or through the purchase (by SBP) of Market Related Treasury Bills (MRTBs). The Ways and Means Advance is extended for the government borrowings up to Rs 100 million in a year at an interest rate of 4 percent per annum; higher amounts are realized through the purchase of 6-month MTBs by SBP at the weighted average yield determined in the most recent fortnightly auction of treasury bills.

Provincial governments and the Government of Azad Jammu & Kashmir may also borrow directly from SBP by raising their debtor balances (overdrafts) within limits defined for them. The interest rate charged on the borrowings is the three month average yield of 6-month MTBs. If the overdraft limits are breached, the provinces are penalized by charging an incremental rate of 4 percent per annum.

Borrowing from scheduled banks: This is mainly through the fortnightly auction of 3, 6 and 12-month Market Treasury Bills (MTBs). The Government of Pakistan also borrows by a quarterly auction of 3, 5, 10, 15, 20 and 30 year Pakistan Investment Bonds (PIBs). However, provincial governments are not allowed to borrow from scheduled banks.

(b) Commodity finance:

Both federal and provincial governments borrow from scheduled banks to finance their purchases of commodities e.g., wheat, sugar, etc. The

proceeds from the sale of these commodities are subsequently used to retire commodity borrowing.

5) Differences in different data sources: SBP data for a number of variables, such as government borrowing, public debt, debt servicing, foreign trade, etc – often do not match with the information provided by MoF and PBS. This is because of differences in data definitions, coverage, etc. Some of the typical cases have been given below.

(a) **Financing of budget deficit (numbers reported by MoF vs. SBP):** There is often a discrepancy in the financing numbers provided by MoF in its quarterly tables of fiscal operations and those reported by SBP in its monetary survey. This is because MoF reports government bank borrowing on a cash basis, while SBP's monetary survey is compiled on an accrual basis, i.e., by taking into account accrued interest payments on T-bills.

(b) **Public debt (MoF vs. SBP):** SBP follows IMF guidelines for compiling public debt, which state that the "public sector includes the general government, monetary authorities, and those entities in the banking and other sectors that are public corporations."[1] Thus, public debt reported by SBP, is composed of: (i) government domestic debt; (ii) government external debt; (iii) IMF loans; and (iv) external liabilities.[2]

While both MoF and SBP follow the same definition of domestic public debt, the coverage of external debt compiled by MoF differs from that of SBP. Specifically, MoF does not include short-term debt, military debt and external liabilities in its compilation of external public debt. As a result, the overall public debt numbers from these two organizations do not match.

(c) **Interest payments on domestic debt (SBP vs MoF):** SBP calculates interest payments on an accrual basis, whereas MoF reports the actual interest paid on T-bills during the year.

(d) **Foreign trade (SBP vs PBS):** The trade figures reported by SBP in the *balance of payments* do not match with the information provided by the

[1] Source: IMF (2003), "External Debt Statistics, Guide for Compilers and Users."
[2] It may be noted, however, that due to the unavailability of detailed information, SBP public debt numbers do not include PSE's debt.

Pakistan Bureau of Statistics. This is because the trade statistics compiled by SBP are based on exchange record data, which depend on the actual receipt and payment of foreign exchange, whereas the PBS records data on the physical movement of goods (customs record). Furthermore, SBP reports both exports and imports as free on board (fob), while PBS records exports as free on board (fob) and imports include the cost of freight and insurance (cif).

In addition, the variation in import data also arise due to differences in data coverage, e.g., SBP import data does not include Non-Repatriable Investments (NRI) by non-resident Pakistanis,[3] imports under foreign assistance, land-borne imports with Afghanistan, etc. In export data, these differences emerge as PBS statistics do not take into account short shipments and cancellations, while SBP data does not take into account land borne exports to Afghanistan, export samples given to prospective buyers by exporters, exports by EPZs, etc.

[3] The non-repatriable investment (NRI) consists of small investments made by expatriate Pakistanis transporting machinery into the country that has been bought and paid for abroad and the purchases made from the *duty-free shops*.