Acknowledgment

The Team:

Publication Manager:	Sabina Khurram Jafri
Editorial:	Dr. Mushtaq A. Khan
Analysis:	Asma Khalid (balance of payments); Dr. Nadeem Hanif (inflation); Fatima Khaliq (private sector credit); Mahmood ul Hasan Khan (monetary sector); Mohib Kamal Azmi (fiscal); Muhammad Akmal (trade); Muhammad Farooq Arby (external); Sabahat (LSM); Sabina Khurram Jafri (fiscal, debt and inflation); Syed Sajid Ali (real sector); Syed Zulqernain Hussain (monetary aggregates); Waseem Fazal ur Rahman (revenues and services)
Formatting:	Sabahat

Review Panel:

Internal Publication Review Committee	Riaz Riazuddin; Qasim Nawaz; Muhammad Ashraf Khan; and Muhammad Ali Malik
Publication Review Committee of the Central Board of Directors	Zafar Masud (Chairman); Mirza Qamar Beg (Member); and Muhammad Hidayatullah (Member)

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

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1 Overview

The analysis in this report is largely restricted to the first half of FY14 (July-December 2013), but will include an Outlook.

By the end of H1-FY14, there was a perceptible improvement in the country's macroeconomic indicators. Inflationary pressures have softened (post November); pressure on FX reserves and the PKR parity has eased in December 2013; LSM is showing improvement, which is supported by an increase in credit to the private sector; and as reported by the Ministry of Finance, the fiscal deficit as a percent of GDP declined in H1-FY14 (**Table 1.1**).

Table 1.1: Selected Economic Indicators during H1

	FY12	FY13	FY14	FY14[T]
Growth rate (percent)				
LSM	1.0	2.3	6.8	4.0
Tax revenue (FBR)	27.1	5.7	16.8	27.2
CPI (period average)	10.9	8.3	8.9	8.0
Private sector credit	6.2	3.1	9.6	NA
Money supply (M2)	5.7	8	6	NA
billion US dollars				
Total liquid reserves [1]	17	13.9	8.3	NA
Home remittances	6.3	7.1	7.8	15.1
Direct investment in Pakistan	0.5	0.6	0.4	NA
Current a/c balance	-2.4	-0.1	-1.6	-2.9
percent of GDP				
Fiscal deficit	2.7	2.7	2.1	6.3

[T] Target
[1] As of 31st December.
Source: State Bank of Pakistan, Ministry of Finance and Pakistan Bureau of Statistics

Improvement in the fiscal *and* external accounts in the second half of FY14 depends on the expected proceeds from the auction of 3G licenses and Coalition Support Fund (CSF) inflows.[1] However, if expected official external inflows (e.g., PTCL privatization proceeds, the OGDCL GDR, a new Euro Bond, and fresh inflows from multilateral creditors) are realized in H2-FY14, SBP's FX reserves are likely to exceed our initial projection for the full year. In a related development, there has been a significant change in sentiments in the FX market in March 2014; the PKR has appreciated significantly and SBP's FX reserves have exceeded in-house projections for Q3-FY14. This comfort on the external side can be traced to an unanticipated US$ 1.5 billion inflow into SBP's reserves, which may have triggered market expectations that Pakistan may receive a facility to defer oil payments in Q4-FY14. Along with

[1] The country expects to receive US$ 702 million CSF inflows during H2-FY14, out of which US$ 352 million have been realized in February 2014.

dampening inflationary expectations for the remaining part of FY14, this has changed the market's interest rate outlook. SBP projects average inflation in FY14 to be in the range of 8.5 to 9.5 percent.

1.1 Economic Review

The prospects of achieving the GDP growth target in FY14 could be undermined by less than expected performance of agriculture. This is due to a YoY decline in cotton production, which is likely to offset the gains in rice, sugarcane and wheat production.[2] On a positive note, LSM continues to post strong growth in H1-FY14, which bodes well for the country's overall economic growth; this is because LSM accounts for 10.2 percent of overall GDP, and has spill-over effects on services, particularly *wholesale and retail trade* and *transport* (**Chapter 2**). The rebound in LSM is supported by investments in alternate energy sources; improved power supply (after the resolution of the circular debt); capacity enhancement (in steel, paper, fertilizer, beverages, and rubber) in past few years; and increased lending to private sector businesses, especially in fixed investment loans.[3]

Lending to private sector businesses witnessed an increase of Rs 271.8 billion in H1-FY14, compared to Rs 146.5 billion in H1-FY13. This increase was channeled into the manufacturing sector (**Chapter 3**). More importantly, 18.9 percent of the entire increase in loans to private businesses, was fixed investment loans.

In addition to an increase in lending to the private sector, government borrowing from commercial banks also increased in Q2-FY14. In the first quarter, in anticipation of a rise in interest rates, commercial banks shied away from investing in long-term government paper. However, this pattern changed with the 50 bps increase in the policy rate announced in September 2013. As a result, the fiscal authority mobilized Rs 188.1 billion from commercial banks during Q2-FY14, against a net retirement of Rs 179.1 billion in the first quarter of the year. However, the government was not able to contain its borrowing from SBP within the limit agreed with the IMF; furthermore, as was the case in the first quarter, the zero quarterly borrowing limit as

[2] According to latest estimates, rice production is likely to be 6.4 million tons during FY14, compared to a target of 6.2 million tons. In contrast, sugarcane production of 63 million tons for FY14, fell short of the production target of 65 million tons.
[3] Fixed investment loans recorded 6.8 percent increase in H1-FY14 compared to 2.8 percent in the same period last year.

prescribed in the SBP Act, was also not met in this quarter.[4] Having said this, with the bilateral inflows in February and March 2014, and other external inflows expected in H2-FY14, these targets should be easier going forward.

Encouragingly, the narrowing fiscal deficit during H1-FY14, reduced the financing requirements of the government.[5] More specifically, the fiscal deficit during H1-FY14, narrowed to 2.1 percent of GDP, compared to 2.7 percent in the same period last year, as reported by the Ministry of Finance. The reduction in the fiscal deficit came from a slowdown in spending and an increase in revenues.[6]

As has happened in the past, the incidence of fiscal austerity fell on development spending both at the federal and the provincial level. This may be attributed to the lack of external funding. In our view, there is a need to rethink this avenue of fiscal consolidation within context of the long-term growth prospects of the economy. However the growth in current spending also fell during H1-FY14, due to lower subsidies in this period (excluding subsidies and interest payment, current expenditures recorded a 15.0 percent YoY increase - see **Chapter 4**). In an attempt to minimize the fiscal burden of the power sector, electricity tariffs for residential consumers were raised in October 2013. While the impact of this measure on collections has yet to materialize, payables of the power sector have once again accumulated in H1-FY14.[7] This raises some questions about sustainability of the improvement witnessed in the fiscal account in H1-FY14.

On the revenue side, FBR tax receipts grew strongly in H1-FY14, but the half-yearly target was missed by Rs 80 billion. This implies that tax collections need to grow by

[4] The outstanding stock of net budgetary borrowing from the central bank stood at Rs 2,611.1 billion as of end-December 2013, compared to the IMF ceiling of Rs 2,560 billion.
[5] In absolute terms, fiscal deficit stood at Rs 540.1 billion in H1-FY14, compared to Rs 624.7 billion in H1-FY13.
[6] Fiscal spending recorded 6.6 percent YoY increase in H1-FY14, compared to 25.5 percent increase witnessed in the same period last year. Tax revenues posted 15.7 percent YoY increase in H1-FY14, compared to 12.0 percent increase in the same period last year.
[7] In response to a question in the National Assembly on March 7, 2014, the Minister of Water and Power informed the National Assembly that payables of the power sector stood at Rs 246.2 billion as of end-December 2013. A part of this amount may decline going forward, if the government decides to deduct the outstanding payables of the provinces to power sector at source.

36.6 percent in the second half of FY14 to meet the full year target,[8] which appears difficult, given the pattern of tax collection in the past several years and the actual impact of tax reforms undertaken so far.[9] Furthermore, non-tax revenues also witnessed a slowdown, due to lower CSF disbursements in H1-FY14, compared to the same period last year.[10]

The reduction in the budget deficit eased the pace of domestic debt accumulation during Q2-FY14. This, along with the lumpy US$ 1.2 billion repayment to the IMF and favourable exchange rate movement during Q2-FY14, allowed for a marginal decline in the public debt stock during this period.[11]

Notwithstanding this decline in public debt stock, we are concerned about Pakistan's debt profile, as its composition has witnessed a sharp shift towards the shortest tenor (i.e., 3m T-bills). To put things into perspective, on end-December 2013, the share of 3m T-bills rose to 19.5 percent of the domestic debt stock, compared to a mere 1.8 percent on end-June 2013.[12] As highlighted before, this exposes the government to increasing roll-over and interest-rate risks. In fact, the over-reliance on short-term debt has the potential to neutralize the government's fiscal consolidation efforts, if there is an adverse movement in interest rates.[13]

[8] According to SBP's internal estimates, the FBR tax collections stood at 92.8 percent of the half-yearly target in H1-FY14.
[9] During the past five years, on average, FBR revenues recorded 13.4 percent YoY growth in the second half.
[10] CSF inflows stood at Rs 34 billion in H1-FY14, compared to Rs 172 billion in the same period last year. Overall non-tax revenues could experience a one-off boost in H2-FY14, on account of the bilateral inflow in February-March 2014.
[11] Specifically, 6.8 percent depreciation of Japanese Yen against US Dollar during Q2-FY14, resulted in Rs 78.9 billion reduction in the Rupee value of the stock of public external debt in this period. Furthermore, an appreciation in PKR during Q2-FY14 (based on end-period exchange rate) resulted in a further Rs 16.2 billion decline in Rupee value of public external debt stock during this period.
[12] The share of short-term debt in domestic debt rose to 57.4 percent on end-December 2013 from 54.6 percent as of end-Jun 2013.
[13] One of the objectives of the ongoing fiscal consolidation is to put country's public debt on a declining path, to reach a sustainable level. However, the presence of a large share of short-term debt increases the vulnerability of debt stock to adverse movements in interest rate. This may in turn increase the servicing burden of domestic debt, leading to a further expansion of fiscal deficit, causing an increase in debt stock. For details, see IMF Country Report No. 14/1, January 2014.

While SBP retains its view to rebalance Pakistan's domestic debt towards long-term paper, there was an improving trend in Q2-FY14, which has been maintained in Q3. The government mobilized Rs 105.6 billion through PIBs during the quarter, which was the highest amount raised after four quarters. Furthermore, the auction held on 26th February 2014 was even more encouraging: in just one auction, the government raised Rs 240.7 billion of long-term funding. This change in market sentiments can be traced to falling projected inflation, which means that the market does not expect further interest rate hikes. The recent comfort on the external sector adds to this change in sentiments.

Headline inflation reached an average of 8.9 percent in H1-FY14, from 8.3 percent in H1-FY13.[14] The quarterly analysis indicates that the impact of the rise in wheat flour prices, the increase in GST rate and volatility in the prices of perishable food in Q1-FY14, was compounded by a rise in power tariffs during Q2-FY14. The latter is a one-off development, which is needed to resolve the structural problems in the energy sector. As a result, the combined share of inflation contributed by wheat flour, perishable food items, electricity prices and transport, rose to 39.3 percent in the second quarter, compared to 27.2 percent in Q1-FY14. This said, the situation improved in December 2013, with enhanced supply of perishable food items and PKR stability against the US Dollar. As a result, CPI inflation fell to 9.2 percent in December 2013, after entering double digits in November 2013; this downward trend is likely to persist.

On the external front, current account deficit deteriorated to US$ 1.6 billion in H1-FY14, compared to US$ 0.1 billion in H1-FY13. However, the entire increase was witnessed in Q1-FY14, whereas Q2-FY14 witnessed a YoY decline in the deficit. The improvement during Q2-FY14, was led by home remittances and a reduction in the trade deficit during the quarter, compared to the same period last year.[15] Nevertheless, the country's FX reserves remained under pressure till end-November 2013, due to the absence of financial inflows and lumpy repayments to the IMF. In fact by end-November 2013, SBP's liquid reserves reached US$ 3.0 billion, while the PKR posted a 1.5 percent depreciation in the month (**Chapter 5**). However, the situation improved in December 2013, after receipt of the second installment of US$

[14] Headline inflation continued to increase in Q2-FY14, reaching an average of 9.7 percent in the quarter, from 8.1 percent in Q1-FY14.
[15] The current account posted a deficit of US$ 385 million in Q2-FY14, compared to US$ 522 million in the corresponding quarter of FY13.

554 million Extended Fund Facility (EFF) from the IMF, and a current account surplus in this month. In fact, the PKR witnessed a 3.0 percent appreciation during December 2013, after shedding 8.2 percent of its value against US Dollar during Jul-Nov 2013. More importantly, SBP's adjusted Net International Reserves (NIR) target for end-December 2013 agreed with the IMF, was met.

Table 1.2: Projections for Major Economic Indicators

	Annual Target	IMF Forecast	SBP Forecast
Growth rate (percent)			
GDP	4.4	3.1	3.5 – 4.5
CPI inflation	8.0	7.9	8.5 – 9.5
Money supply (M2)	NA	13.8	13.0 – 14.0
billion US dollars			
Home remittances	15.1	14.7	14.5 – 15.5
Exports (fob-BoP)	26.6	26.9	26.0 – 26.5
Imports (fob-BoP)	43.3	43.4	42.0 – 43.0
Current account deficit	2.9	2.3	< 3.5
percent of GDP			
Fiscal deficit	6.3	5.5	6.0 – 7.0

NA: not applicable
Source: SBP, Planning Commission, and the IMF

1.2 Outlook

The outlook of the economy will be influenced by uncertainties in the fiscal account during the second half. On the external front however, the pressure on SBP's reserves has eased significantly in March 2014; not only has Pakistan met lumpy IMF repayments and expects substantial inflows from the IFIs before end-June 2014, the market has responded very positively to the unanticipated inflow of US$ 1.5 billion from a GCC country. Furthermore, the disbursement of CSF is on track; remittances are posting strong growth; and global commodity prices are likely to remain stable. If the government is able to realize the budgeted CSF and 3G inflows, the current account deficit is likely to be less than US$ 3.5 billion for the full year (**Table 1.2**).

As regards the fiscal account, higher development spending and an anticipated increase in the debt servicing will push up overall spending in the second half. Even accounting for the expected CSF and the proceeds from 3G licenses before July 2014,[16] the overall fiscal deficit is likely to remain in the range of 6.0 to 7.0 percent of GDP. The full year fiscal situation will depend on year-end subsidy payments; the possible need to pay off the circular debt in the power sector; the terms of payments for the 3G licenses opted by the cellular companies; and the performance of FBR. If

[16] Even if the 3G license auctions are held on time, the cellular companies have been given the option to spread the payment of 50 percent of the license fee over 5 years, which may impact Pakistan's fiscal account for FY14 (Source: Information Memorandum: The Award of 2100 Mhz, 800 Mhz, and 850 Mhz Spectrum: The Next Generation Mobile Services Award, PTA. http://www.pta.gov.pk/media/im_250214.pdf).

the February-March 2014 inflow is channeled into PSDP, this should ease the financing constraint.

In the real sector, GDP growth is likely to remain in the range of 3.5 to 4.5 percent. The main concern is a weaker than expected performance of agriculture. However, LSM is well positioned to achieve the growth target set in the Annual Plan for FY14, even if value addition by fertilizer and sugar are to subside in the remaining part of FY14. Furthermore, while hard data on services is not available, mixed signals are emerging from the performance of various sub-heads: *wholesale & retail trade* and *telecom* are likely to post an improvement over the previous year, whereas the performance of *finance & insurance* is likely to remain subdued during FY14.

Inflationary pressures have tapered since December 2013; headline CPI growth declined to 7.9 percent in Jan-Feb 2014, compared to 9.2 percent in December 2013. This can be traced to the stability in food inflation, the recent reduction in retail POL prices, and the stability and recent appreciation of the PKR parity. Furthermore, the latest 'SBP-IBA Consumer Confidence and Inflation Expectations Survey' of January 2014, suggests that inflationary expectations are easing. Based on these factors, we project inflation to remain in the range of 8.5 to 9.5 percent, unless the government announces an increase in household gas tariffs, which was due in January 2014.

While the macroeconomic picture is more encouraging, a sustainable improvement still requires deep-seated structural reforms. A tangible reduction in the fiscal deficit is crucial to alleviate financing pressure from the banking system, which is all the more important to support the recent increase in private sector credit off-take; this in turn is an important factor for the current improvement in LSM. More importantly, a sustained improvement in LSM can help achieve the long-run growth objectives of the country in terms of employment generation; economies of scale; technological progress; and spill-over effects to other sectors of the economy.

Having said this, measures to increase tax revenues have been guided by expediency rather than a focus on the structural problems in the fiscal system. There is also a need to ensure that fiscal consolidation has minimal fallout on the prospects for economic growth. In particular, taxation reforms should address the following issues: (i) widening the tax base by eliminating a broad range of tax exemptions; (ii) improvement in FBR's image and clamping down on leakages to minimize tax avoidance and evasion; and (iii) enhancing compliance and strengthening the tax administrative capacity. Similarly, broad based reforms in the energy sector and restructuring of loss-making PSEs, is required to contain the fiscal burden and to create space for undertaking development spending. In our view, the needed revival in public investment is likely to *crowd-in* the private sector by expanding opportunities for it. In addition to all these issues, internal security concerns continue to disrupt domestic economic activities. Without a solution to these challenges, it will be very difficult to revive domestic investment, which is required to put the country on a high growth path.

2 Real Sector

2.1 Overview

The most encouraging development in the real sector, is the 6.8 percent growth of the large scale manufacturing (LSM) in H1-FY14, compared to 2.3 percent in the same period last year. While the factors underpinning LSM growth include the improved energy supplies; capacity enhancement in some of the sectors (in steel, paper, fertilizer, and beverages) in the past few years; construction activity; and availability of credit; a significant impetus came from the rise in sugar production during Q2-FY14 due to early start of crushing compared to last year.[1] As discussed later, the full year LSM growth will be lower than what was posted in H1-FY14.

As regards the performance of agriculture, wheat is likely to post a recovery due to the prospects of a better harvest, compared to the last year. Specifically, growth conditions have been favorable for wheat in all regions, except for Potohar, where the crop is under water stress.[2] However, the overall improvement in wheat may not be sufficient to offset the drag from the kharif season.[3] We therefore expect agriculture to record below target growth in FY14.

The available indicators on the services sector, present a mixed picture. We expect an uptick in value addition by *wholesale & retail trade,* as suggested by higher credit off-take by this sub-sector, and the increase in LSM growth – this will also have a positive spillover on road transport. Moreover, the decline in profitability of commercial banks is likely to contain growth in value addition by *finance & insurance* in FY14.[4]

Table 2.1: Production Estimates of Kharif Crops
million tons, except for cotton which is in million bales

	FY13		FY14	
	Target	**Actual**	**Target**	**Estimates**
Rice	6.9	5.5	6.2	6.4
Sugarcane	59.0	62.5	65.0	63.0
Cotton	14.5	13.0	14.1	12.3

Source: Planning Commission, and Ministry of National Food Security and Research

In overall terms, while a strong rebound in LSM and an expected increase in wheat production are key positives;

[1] Sugar production more than doubled during Nov-Dec 2013, compared to the same period last year.
[2] Source: Crop situation reports by Suparco.
[3] During kharif, the decline in the production of cotton compared to last year is likely to offset the improvement in rice and sugarcane production.
[4] The lower profits during H1-FY14, compared to corresponding period of last year, were mainly led by one large bank, and do not reflect the overall performance of the banking system.

the full-year GDP growth will depend on the performance of services.

2.2 Agriculture

The *kharif* season (April 2013-September 2013) suffered a setback due to a fall in the production of cotton, which was led by lower area under cultivation compared to the target (this reflects water shortages at the sowing period).[5] In addition, pest attacks and heavy rains before the harvest led to significant crop losses (**Table 2.1**).[6, 7] Although the sugarcane and rice crops were better compared to the previous year, this may not be sufficient to compensate for the damage to the cotton crop.[8]

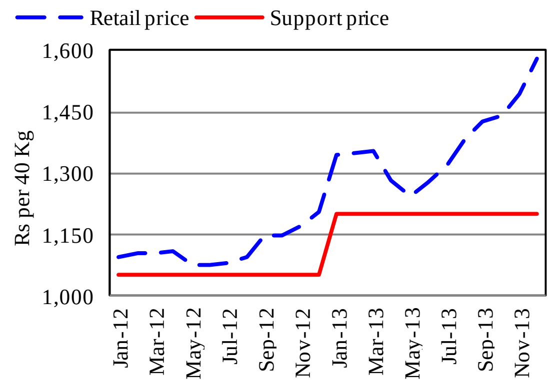
Table 2.2: Area under Wheat Crop
000 hectare

	2011-12	2012-13	2013-14	
			Target	Actual
Punjab	6,483	6,511	6,693	6,778
Sindh	1,049	1,058	1,100	1,118
KPK	729	727	750	749
Balochistan	388	363	400	398
Pakistan	8,650	8,660	8,943	9,044

Source: Ministry of National Food Security and Research

On a positive note, the *rabi* season that began in November 2013, has been showing encouraging signs. The area under wheat cultivation, registered an increase of 4.4 percent over last year (**Table 2.2**). Although, the government decided to keep wheat support prices unchanged at Rs 1,200 per 40 kg, market prices proved attractive for growers (**Figure 2.1**). More importantly, farmers were able to complete the sowing

Figure 2.1: Wheat Prices in Domestic Market

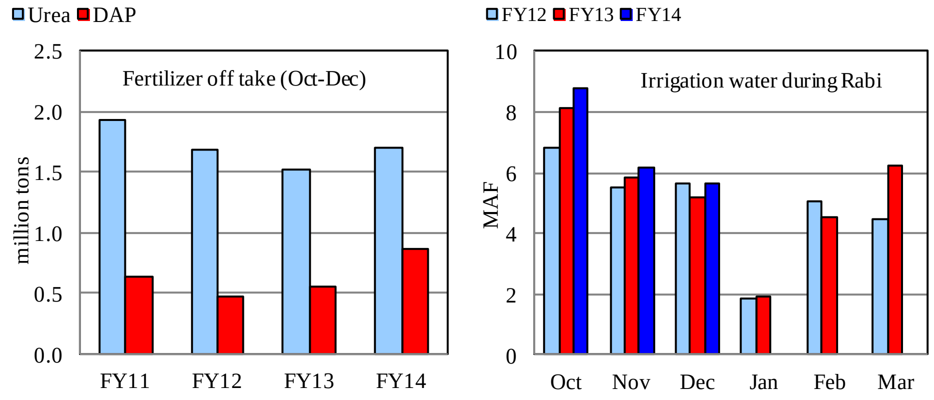


Source: Pakistan Bureau of Statistics and Pakistan's Economic Survey

[5] The area under cotton crop in FY14 was 2.7 million hectare, which was lower than the target of 3.1 million hectare.
[6] For details, see **Chapter 2** of SBP's 1st *Quarterly Report for FY14.*
[7] The cotton crop yield remained at 772 kg per hectare in FY14, which was almost unchanged from 774 kg per hectare in the previous year.
[8] Cotton contributes 27.9 percent of the value addition by major crops. This is greater than the combined share of 23.4 percent, from rice and sugarcane.

stage well in time owing to improved water availability (**Figure 2.2**) and the early harvest of the cotton crop which allowed for timely sowing of wheat.[9]

Figure 2.2: Availability of Key Agri Inputs



Source: NFDC

Source: Suparco

Furthermore, growing conditions for wheat have remained favorable. For example, the cold wave in mid-December that swept across the plains of Punjab was good for the crop yield, while fertilizer off-take during the *rabi* season remained higher than the corresponding period last year (**Figure 2.2**).[10]

Despite these positives, realizing the wheat production target of 25.0 million tons appears challenging, as this would require substantial improvement in the crop yield.[11] There are already reports that lower rainfall in Potohar has suppressed the crop growth in this region.[12]

[9] Around 30 percent of the wheat is sown under cotton-wheat cropping system. The wheat crop under this system is generally vulnerable to late sowing due to delays in cotton picking. This year, early maturing of cotton due to warmer conditions allowed sowing of wheat as early as in November, which is beneficial for seed germination and plant growth.

[10] The urea off-take increased to 1,702 million tons in Oct-Dec 2013, compared to 1,514 million tons in Oct-Dec 2012. Similarly, the demand for DAP rose from 559 million tons last year to 868 million tons in Oct-Dec 2013.

[11] The Annual Plan had set the wheat target of 25.5 million tons. This target was later revised downward to 25.0 million tons by the Federal Committee on Agriculture. The government aimed to achieve this target through the use of quality seeds; timely availability of fertilizer and promotion of its balanced use; and increase in loan facilities.

[12] Potohar region (that includes districts of Attock, Rawalpindi, Islamabad, Jhelum and Chakwal) produces on average around 650 thousand tons of wheat annually.

As mentioned earlier, the government has kept wheat support price unchanged at Rs 1,200 per 40 kg, which is significantly lower than the current market price of around Rs 1,600 per 40 kg. Going forward, if the existing gap between domestic market prices and the support price remains high even at the time of harvest, farmers will be reluctant to sell to the government. However, it is important to emphasize here that the country has been maintaining its strategic reserves of wheat to ensure domestic food security.

2.3 Large Scale Manufacturing

Growth in LSM rebounded to 6.8 percent during H1-FY14, compared to 2.3 percent in the same period last year. As mentioned earlier, a number of factors helped in this recovery, e.g., improved supply of power to industry; availability of private sector credit; and higher export demand. Furthermore, fertilizer sector benefited from diversion of gas to one of the urea manufacturers. In addition,

Table 2.3: Growth in Key Sectors of LSM (H1)
percent

		YoY Growth		Percentage Contribution to Growth	
	Weights	**FY13**	**FY14**	**FY13**	**FY14**
Textile	21.0	0.2	1.7	3.0	8.0
Cotton yarn	*13.0*	*0.3*	*2.2*	*3.0*	*6.3*
Cotton cloth	*7.2*	*-0.1*	*0.8*	*-0.5*	*1.2*
Food	12.4	3.4	18.3	26.2	44.5
Sugar	*3.5*	*-25.3*	*78.0*	*-37.4*	*26.2*
Beverage	*1.1*	*23.0*	*29.8*	*21.6*	*10.5*
Petroleum products and coke	5.5	10.4	8.3	29.2	7.8
Steel	5.4	19.3	2.3	24.7	1.1
Pig iron	*1.6*	*-37.0*	*-41.5*	*-13.3*	*-2.9*
Billets	*1.5*	*1.9*	*26.7*	*0.8*	*3.6*
Automobile	4.6	-8.2	-2.3	-22.4	-1.8
Tractors	*0.5*	*102.5*	*-34.5*	*16.4*	*-3.4*
Jeeps and cars	*2.8*	*-24.5*	*2.3*	*-36.6*	*0.8*
Fertilizer	4.4	-10.0	28.8	-27.7	21.9
Urea	*4.0*	*-11.8*	*31.8*	*-28.7*	*20.8*
Paper	2.3	26.6	17.5	41.8	10.6
Leather products	0.9	-6.6	9.6	-5.7	2.4
Overall LSM growth		2.3	6.8		
Memorandum items					
Excluding fertilizer	4.4	2.9	5.7		
Excluding sugar	3.5	3.0	5.2		
Excluding fertilizer and sugar	7.9	3.9	3.9		

Source: Pakistan Bureau of Statistics

early sugarcane crushing this season compared to last year provided a further stimulus to growth. However, if we adjust for fertilizer and sugar (as their impact is likely to dissipate over the course of the year), LSM grew by 3.9 percent (YoY) during H1-FY14, which is unchanged from H1-FY13 (**Table 2.3**). Having said this, the overall LSM growth for the full year is likely to exceed the target of 4.0 percent set by the government.

Sugar production

Sugar production recovered strongly in December 2013, recording an increase of 78.0 percent (YoY), compared to a fall of 25.3 percent in December 2012. To put this in perspective, higher sugar production explains 26.2 percent of the LSM growth in H1-FY14. This can be traced to early start of sugarcane crushing this year, which means subsequent production in the remaining part of FY14 is likely to be lower compared to the first half.

Urea continued to drive LSM

As mentioned in the 1st *Quarterly Report for FY14*, the availability of gas on temporary basis from Mari led to a sharp recovery in urea production during Q1-FY14 – this continued in the second quarter.[13] In fact, most of the fertilizer plants operating on Mari gas functioned at their full capacity during H1-FY14 (**Table 2.4**). However, these manufacturers are likely to face production declines if the gas supply reverts back to previous levels.[14]

Table 2.4: Urea Production – Gas Allocation vs. Capacity Utilization

	Gas field	Production as % of installed capacities during H1	
		FY13	**FY14**
EFERT		40.3	77.8
EFL	MGCL	NA	NA
Enven	SNGPL & MGCL	NA	NA
FFC		87.0	102.3
Fauji (G. Machi)	MGCL	100.5	120.9
Fauji (Pak-Saudi)	MGCL	98.7	115.6
FFBL	SSGC	38.9	40.1
FATIMA		36.7	71.5
Fatima	MGCL	43.4	83.8
Pak-Arab	SNGPL	0.0	4.9
AZGARD (Pak- Amer)	SNGPL	14.2	57.2
DHCL	SNGPL	5.0	11.0

Source: NFDC and Companies' reports

At the same time, urea off-take remained strong in anticipation of an increase in Gas Infrastructure Development

[13] In April 2013, supply of Mari gas from Engro's base (old) plant was diverted to the Enven plant The Enven plant of Engro Chemicals (the largest in South Asia), was earlier connected to the SNGPL network that was unable to provide the contracted volume of gas from Qadirpur fields. For details, see SBP's 1st *Quarterly Report* for FY14.

[14] The temporary shutdown of Guddu power plant allowed more gas to fertilizer plants on the Mari network. This means production of urea may likely to suffer declines as soon as Guddu power plant resumes its operation.

Cess (GIDC) and gas tariffs from January 2014 onwards. As a result, urea production posted strong YoY growth of 31.8 percent in H1-FY14, compared to 11.8 percent fall in H1-FY13. It may be noted that the production of urea contributed 20.8 percent of the growth in LSM during H1-FY14.

Improved demand for exports

Cotton yarn, cloth and leather continued to post strong growth led by increased demand. Specifically, leather exports to European countries increased as our major competitor – China – has moved into high value-added products. The production of cotton yarn and cloth appears to have benefited from increased demand from both domestic and external markets (particularly, bed-wear and readymade garment). It may be noted that not only the credit growth for the procurement of cotton remained strong, the weaving sector has utilized fixed investment loans for BMR (balancing, modernization and replacement) to take advantage from GSP plus.

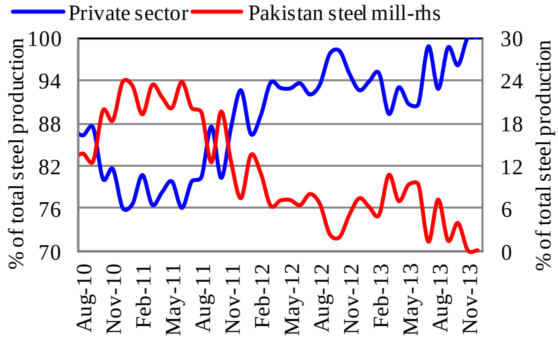
Strong growth in beverages

Beverages that include juices, squashes and soft drinks, have been growing in double digits since FY12. In fact, 10.5 percent of the entire increase in LSM growth in H1-FY14 was contributed by beverages alone. This can be attributed to capacity enhancements by one of the leading beverage manufacturers last year, and FDI inflows in the past three years.[15] In addition, credit demand from the food sector remained higher in H1-FY14, compared to corresponding period last year.

Capacity enhancement boosted steel production

The steel sector consists of private manufacturers and the state owned Pakistan Steel Mill (PSM) (**Figure 2.3**). This sector saw a major change in mid-2012, when

Figure 2.3: Market Share of PSM & Private Sector in Steel Production*



*Include hot rolled and cold rolled strips and galvanized sheets
Source : Pakistan Bureau of Statistics

[15] Beverages witnessed US$ 25 million FDI inflows in H1-FY14, compared to US$ 5.1 million outflows in the same period last year. In overall terms, FDI inflows in beverages stood at US$ 9 million in FY11, US$28 million in FY12, and US$ 20 million in FY13.

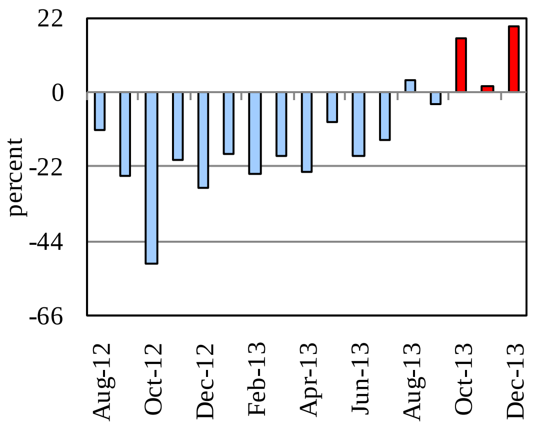
most of the new capacities in the private sector came online.[16] Thus, steel production posted a YoY growth of 19.3 percent in H1-FY13. However, this pace is now tapering off as the base-effect comes into play. Nonetheless, we expect some recovery in H2-FY14, given the increased focus of the government on infrastructure projects which may further boost steel production.

However, the prospects for Pakistan Steel Mill (PSM) are not encouraging. PSM shows a negative equity, and is unable to repay its existing loans, or secure new working capital lines. Hence, its production came to a complete standstill in October 2013. As a result, the share of PSM in total steel production dropped to *zero* in October 2013 (**Figure 2.3**).

Revival in car production

After its poor performance in FY13, car manufacturing (having more than 60 percent share in auto industry) is showing signs of recovery in H1-FY14 (**Figure 2.4**). This may be explained by a reduction in the age limit of imported reconditioned vehicles from five to three years in December 2012,[17] and the introduction of a new model of passenger car.

Figure 2.4: Production of Jeeps & Cars (YoY Growth)



Source : Pakistan Bureau of Statistics

2.4 Services

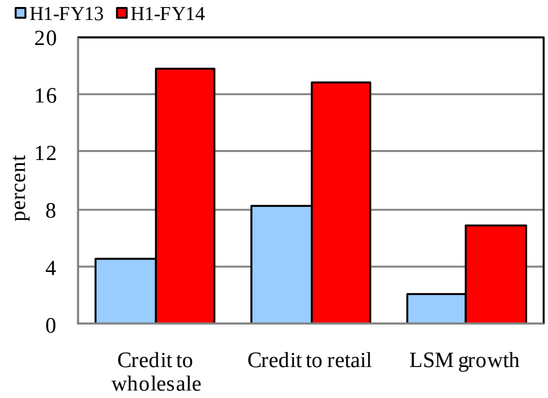
Hard data on value addition by services is not yet available; however key indicators present a mixed picture in H1-FY14. Our analysis suggests an uptick in value addition by *wholesale & retail trade*, and *telecom*, whereas *finance & insurance* is likely to post lower growth in FY14, compared to the previous year.

[16] Three new steel plants commissioned in Karachi during 2012 (one in H2-FY12, and two in H1-FY13).

[17] The imports of cars reduced to 10,776 units during H1-FY14, compared to 29,153 units in corresponding period of FY13.

Wholesale and retail trade, which was 31.5 percent of overall value addition by services in the previous year, is likely to post a decent increase in FY14. This can be seen from LSM growth and an increase in credit off-take by wholesale and retail trade during H1-FY14, which shows an increase in trade activity in the country (**Figure 2.5**). The lackluster performance of agriculture, however, creates a downside risk to this outlook.

Figure 2.5: Wholesale & Retail Trade Indicators



Source: State Bank of Pakistan & Pakistan Bureau of Statistics

The *telecom sector* posted encouraging performance in H1-FY14. Strong telecom imports, an increase in the subscriber base, and an improvement in telecom revenues, helped this sector (**Table 2.5**).

Transport sector showed a mixed performance. The operating losses of PIA increased to Rs 13.6 billion in Q1-FY14, compared to Rs 4.4 billion in the same period last year. However, the anecdotal evidence suggests an improvement in PIA's financials during Oct-Dec 2013, on account of an expansion in its fleet size.[18] Furthermore, the government also plans to disinvest 26 percent of PIA's shares by end-December 2014, which bodes well for the financial performance of this airline.[19] Pakistan Railways (PR) witnessed a marginal improvement by posting smaller losses, compared to the same period last year (**Table 2.5**). Going forward, the

Table 2.5: Indicators for Value addition in Transport & Communication during H1

	Units	FY13	FY14
Telecom			
Tele density (Jul-Nov)	% population	72.1	77.1
Telecom imports	million US$	429.3	662.1
Telecom investments (Jul-Sep)	million US$	108.2	120.9
Telecom revenues	billion Rupees	105.6	109.9
Transport			
Pakistan Railway losses ^{P}	billion Rupees	-15.0	-13.8
PIA losses (Jul-Sep)	billion Rupees	-4.4	-13.6

Source: PTA, SBP, PR, PIA website, P: provisional

[18] Reportedly, PIA has added four aircrafts in its fleet during Oct-Dec 2013, which led to an improvement in its flight operations.
[19] IMF Country Report No. 14/1, January 2014.

operations of PR are likely to improve due to an expansion of its fleet size.[20] Although this entity is not included in the list of PSEs which are to be disinvested by the government, the authorities have hired new board members for PR, who are in the process of preparing a medium-term restructuring plan.

The value addition by *finance & insurance* is likely to remain subdued. This is due to a decline in the profitability of commercial banks, which as stated earlier, can be attributed to one large bank.

[20] A total of 22 locomotives have been made available for freight operations during the last six months, while another 10-15 locomotives are added for passenger operations.

3 Inflation and Monetary Policy

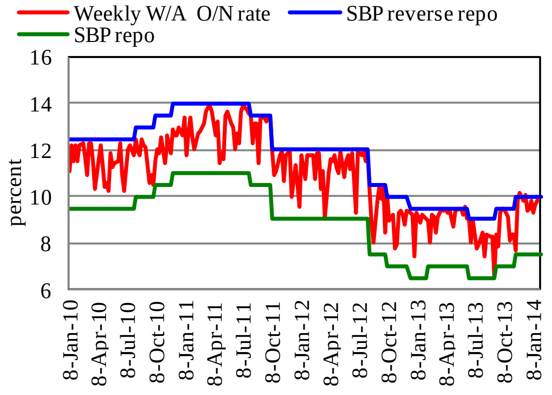
3.1 Overview

One of the most notable developments during the first half of the year, was the shift in SBP's monetary policy stance from accommodative to gradual tightening. SBP increased the policy rate by 50 bps each in its monetary policy decisions announced in September and November 2013 (**Figure 3.1**).[1] This change in the policy stance was primarily driven by: (i) growing inflationary expectations; and (ii) to calm the FX market against the backdrop of a widening external deficit.

There was some improvement as the economy moved towards the end of H1-FY14. Pressure from Pakistan's external sector eased in December 2013, and is likely to remain benign in the second half of the year, as the large repayments to the IMF have been met during H1-FY14. This, along with the improvement in the inflation outlook and stability (and recent appreciation) in the exchange rate allowed the central bank to keep the policy rate unchanged at 10.0 percent in its monetary policy decisions announced in January and March 2014.

Headline YoY inflation, which had been increasing since early FY14, entered double digits in November 2013, before softening to 9.2 percent in December 2013. This increase in the inflationary pressures during H1-FY14 can be traced to: (i) excessive volatility in perishable food prices due to supply constraints; (ii) a sharp increase in the price of wheat and its related products; (iii) increase in GST rate; and (iv) the reduction in subsidies on fuel and electricity, which pushed up administered prices of energy. Inflation expectations also gathered pace as the households and

Figure 3.1: SBP Policy Rate



Source: State Bank of Pakistan

[1] It is pertinent to note that the policy rate saw a cumulative reduction of 500 bps during FY12 and FY13.

businesses *anchor* their expectations on the prices of wheat and petroleum products, and movements of exchange rate.

However, inflationary pressures have weakened since December 2013, as the prices of perishable food items retreated after an ease in supply constraints.[2] Furthermore, the pressures on PKR parity have also eased since December 2013, and the government is trying to reduce its inflationary borrowing from SBP. Hence, average inflation for the year is likely to fall in the range of 8.5 to 9.5 percent.

In addition to inflation, continuation of government borrowing from the banking sector and the on-going external sector weakness significantly impacted the monetary sector during H1-FY14. These two factors were pushing money supply in opposite directions, i.e. government borrowing was contributing to monetary expansion, while deterioration in external accounts had a contractionary impact. In net terms, broad money supply (M2) grew by only 6.0 percent during H1-FY14, compared with 8.0 percent during the same period last year.

Government borrowing target was missed in the second quarter

Causative factors of monetary expansion showed that government borrowing for budgetary finance decreased from Rs 518.1 billion in H1-FY13, to Rs 471.7 billion during H1-FY14 (**Table 3.1**). Nonetheless, the government was unable to meet the end-December 2013 target on its borrowing from SBP, as agreed with the IMF.[3] Furthermore, the government could not limit its borrowing from SBP to zero by end of both quarters, as prescribed in the SBP Act.[4] In net terms, the government borrowed Rs 83.7 billion from SBP in the second quarter of the year, in addition to the Rs 379.2 billion borrowed in Q1-FY14.

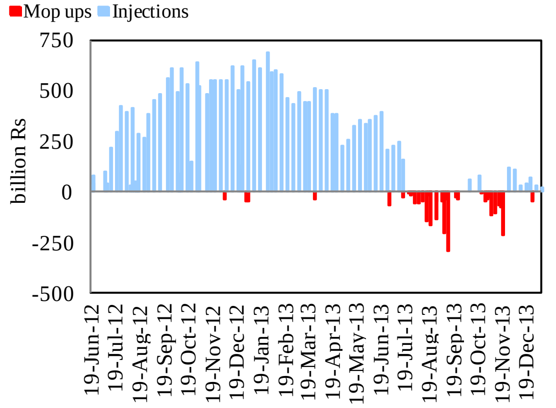
SBP begins to mop-up liquidity after a prolonged phase of monetary injections

SBP's purchases from the FX market to support falling FX reserves in Q1; the government's increasing reliance on SBP funding till September 2013; and commercial banks' reluctance to invest in short-term government securities, created excess liquidity in the interbank market.[5] These developments not only

[2] With the arrival of fresh crops, month-on-month prices of perishable food items declined by 25.6 percent in December 2013.
[3] Outstanding stock of net budgetary borrowing from the central bank (on cash basis) stood at Rs 2,611.1 billion as on end-December 2013, compared to the IMF target of Rs 2,560 billion.
[4] With the bilateral external inflows in February and March 2014, and other external inflows expected in H2-FY14, it will be easier to meet these targets going forward.
[5] It may be noted that banks were reluctant to re-invest their maturing T-bills at prevailing rates in anticipation of an increase in interest rates. Specifically, before the announcement of monetary

ended the prolonged period of SBP's injections seen in FY12 & FY13, but also forced SBP to mop-up liquidity to maintain money market rates within the interest rate corridor (**Figure 3.2**).

Figure 3.2: Open Market Operations



Source: State Bank of Pakistan

The increase in SBP's policy rate in September 2013, facilitated the government to shift some of its borrowing from SBP towards commercial banks. Resultantly, net budgetary borrowing from commercial banks during Q2-FY14 reached Rs 188.1 billion, against a net retirement of Rs 179.1 billion in the first quarter of the year.

In addition to the government borrowing, credit to the private sector also picked up during H1-FY14. The private sector borrowed Rs 321.3 billion during H1-FY14, which was three times the credit expansion seen in H1-FY13. Major contributions to this increase came from healthy growth in large scale manufacturing sector, seasonal credit off-take, and the demand for trade financing. Finally, consumer financing also grew by 8.3 percent during H1-FY14, compared to 3.2 percent in H1-FY13.

3.2 Monetary Aggregates

Broad money supply (M2) expanded by Rs 527.9 billion during H1-FY14, compared to 612.4 billion in H1-FY13. This deceleration in M2 was primarily driven by the net contraction of the NFA of the banking system, which partially offset the expansionary impact of net domestic assets (**Table 3.1**).

3.2.1 Net foreign assets (NFA)

In absolute terms, the NFA of the banking system recorded a sharp contraction of Rs 215.2 billion during H1-FY14, in contrast to a rise of Rs 17.2 billion during the same period last year. Within the banking system, the contraction was entirely

policy decision in September 2013, commercial banks offered only Rs 812.3 billion in five T-bills auctions held during Q1-FY14, against the maturity of Rs 1,384.34 billion and the target of Rs 1,350 billion.

stemming from SBP's NFA, as the onus of financing the external deficit fell largely on the central bank. In fact, the drying up of financial inflows in recent

Table 3.1: Monetary Aggregates during H1
flows in billion Rupees, growth in percent

	Cumulative Flows		Quarterly Flows (FY14)		Growth during H1	
	FY13	FY14	Q1	Q2	FY13	FY14
Broad money (M2)	**612.4**	**527.9**	**21.5**	**506.4**	**8.0**	**6.0**
NFA	17.2	-215.2	-173.2	-42.0	3.2	-80.0
SBP	-59.9	-229.8	-146.1	-83.7	-15.2	-172.9
Scheduled banks	77.1	14.6	-27.1	41.7	55.8	10.8
NDA	595.3	743.0	194.6	548.4	8.4	8.7
SBP	272.3	335.5	174.2	161.2	18.1	17.2
Scheduled banks	323.0	407.6	20.4	387.2	5.8	6.1
Major components of NDA						
Government sector borrowing	478.3	380.5	176.7	203.7	11.2	6.6
For budgetary support*	518.1	471.7	200.0	271.7	13.6	9.0
SBP	-216.2	462.8	379.2	83.7	-12.7	20.9
Scheduled banks	734.3	8.9	-179.1	188.1	35.1	0.3
Commodity operations	-38.8	-89.4	-22.0	-67.4	-8.9	-19.1
Non government sector	144.8	375.4	17.6	357.9	4.0	10.2
Credit to private sector	104.5	321.3	-17.4	338.7	3.1	9.6
Credit to PSEs	40.3	54.3	35.1	19.3	15.7	18.9
Other items net	-27.9	-12.9	0.3	-13.2	3.5	1.6

*These numbers will not match with the financing numbers provided by MoF on its website. This is because MoF reports government borrowing on *cash basis*, while SBP's monetary survey is compiled in *accrual basis*.
Source: State Bank of Pakistan

years has finally pushed the stock of SBP's NFA into negative territory for the first time since October 2001.[6] Temporal changes in the NFA indicate that a major contraction took place in the first quarter of the year, whereas CSF inflows worth US$ 322.0 million in the second quarter helped contain the overall deterioration in the NFA of the banking system (**Table 3.2**).

3.2.2. Net Domestic Assets (NDA)

In sharp contrast to the net contraction in NFA, net domestic assets (NDA) of the banking system expanded by Rs 743.0 billion during H1-FY14, compared to a rise of Rs

Table 3.2: NFA and CSF
billion Rupees

	NFA	CSF	NFA excl. CSF
Q1-FY13	11.8	104.1	-92.3
Q2-FY13	5.4	66.1	-60.7
Q3-FY13	-178.3	0.0	-178.3
Q4-FY13	-102.1	0.0	-102.1
Q1-FY14	-173.2	0.0	-173.2
Q2-FY14	-42.0	31.9	-73.9

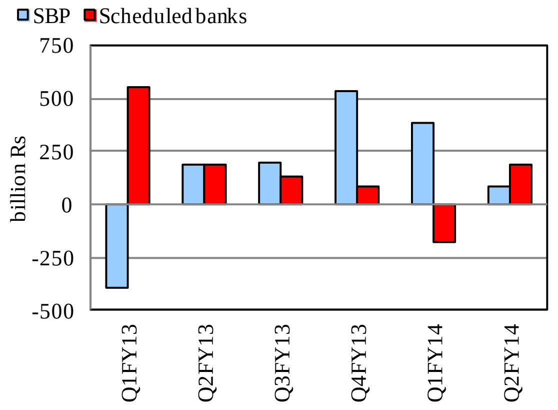
Source: State Bank of Pakistan

[6] It implies that SBP's foreign liabilities have exceeded its holding of foreign assets.

595.3 billion during H1-FY13 (**Table 3.1**). The rise in NDA during H1-FY14 can be traced to government borrowing for budgetary finance, and pickup in credit to the private sector, with the impact of the former being the greater.

The government borrowed Rs 271.7 billion from the banking system in Q2-FY14, in addition to Rs 200.0 billion borrowing in the first quarter of the year. Within banking system, the government heavily relied on SBP funding. Specifically, it borrowed Rs 462.8 billion from SBP, which was 98.1 percent of the total government borrowing from the banking sector in H1-FY14.

Figure 3.3: Government Borrowing for Budgetary Support



Source: State Bank of Pakistan

Within the banking system, there was a change in the source of deficit financing in the second quarter of the year. While the fiscal authorities extensively relied on the central bank in Q1-FY14 and retired some of the borrowing from commercial banks, this trend reversed in Q2-FY14 (**Figure 3.3**). This was primarily facilitated by the shift in SBP's monetary policy stance. Specifically, the 50 bps increase in the policy rate in September 2013 revived commercial bank interest in government securities, which helped fiscal authority to contain its borrowing from the central bank.[7] However, the government could not limit its quarterly borrowing to zero as prescribed in the SBP Act. As stated earlier, the government was also unable to contain its borrowing from SBP within the limit agreed with IMF.

Commodity Operations[8]

With a net retirement of Rs 89.4 billion during first half of the year, the outstanding stock of loans for commodity operations reached Rs 378.3 billion by end-December 2013. This is encouraging to note that the net retirement in H1-FY14 was more than double the amount retired in the same period last year.

[7] Commercial banks offered Rs 3,225.6 billion in T-bill auctions held after the change in monetary stance from 13th September 2013 to 31st December 2013, against the cumulative target of Rs 2,350.0 billion. Please, see foot note 4 also.

[8] Discussion in this section is based on domestic public sector commodity operations.

Moreover, unlike the previous year when retirement was entirely driven by the repayment of wheat loans, the net retirement in H1-FY14 was broad based (**Table 3.3**).

Loans for wheat procurement, which accounted for 72.8 percent of commodity financing as of end-December 2013, saw a net retirement of Rs 86.2 billion during H1-FY14, compared to Rs 66.3 billion in H1-FY13 (**Table 3.3**). This was largely attributed to aggressive off loading of wheat stocks by the provincial food departments to stabilize wheat price in Q2-FY14.[9] This, along with the lower carry forward stocks from the previous year, has pushed down the country's wheat stocks as of end-December 2013, to the levels observed by end-February, i.e., before the arrival of the new crop.[10] However, it is important to emphasize here that the country still has comfortable level of wheat stocks to meet domestic requirements.

Table 3.3: Loans for Commodity Operations
billion Rupees

	As of end Dec-2013	Share (%)	Cumulative Flows H1 FY13	FY14
Wheat	275.3	72.8	-66.3	-86.2
Sugar	42.4	11.2	5.2	-3.0
Fertilizer	59.7	15.8	22.3	-0.3
Rice	1.0	0.3	-0.1	0.0
Total	378.3	100.0	-38.8	-89.4

Source: State Bank of Pakistan

In the case of fertilizer, lower imports due to an increase in domestic production reduced the borrowing requirements of TCP.[11] Similarly, loans for sugar procurement also witnessed net retirement during H1-FY14, as TCP aggressively off loaded its sugar stock.

Despite these favorable developments, the ability of procurement agencies to retire costly borrowing from the commercial banks is undermined by accumulated receivables. As of end December 2013, total receivables stood at Rs 267.7 billion, of which Rs 173.4 billion was on account of subsidy payments due from the government. In overall terms, these receivables account for 70.7 percent of outstanding commodity financing as of end H1-FY14. It implies that speedy realization of receivables would help retire outstanding loans for commodity operations. However, given the fiscal pressures, this seems unlikely. It implies

[9] Wheat prices increased by 27.8 percent YoY during Q2-FY14 compared to 24.5 percent in the first quarter of the year.
[10] See **Figure 3.9**.
[11] Fertilizer imports during H1-FY14 stood at US$ 427.6 million, compared to US$ 478.3 million in H1- FY13. Within fertilizer, the share of DAP imports was 61.5 percent in H1-FY14, compared to 43.0 percent in H1-FY13.

Table 3.4: Credit to PSEs in FY14
billion Rupees

	Q1	Q2	H1
PARCO	5.2	12.2	17.3
PSO	22.1	31.7	53.7
WAPDA	11.1	2.1	13.2

Source: State Bank of Pakistan

that procurement agencies may struggle to retire their debt. As repeatedly highlighted in SBP's Annual and Quarterly Reports, timely payment of subsidies will not only help improve fiscal transparency, but also be cost effective for the government.

Credit to PSEs

The net lending to PSEs increased by Rs 54.3 billion during H1-FY14, compared to Rs 40.3 billion during the same period last year. The institutional breakup shows that energy sector PSEs borrowed from the banking sector due to re-accumulation of receivables (**Table 3.4**).

3.3 Credit to Private Sector

Credit to the private sector expanded by Rs 321.3 billion in H1-FY14, compared to only Rs 104.5 billion in H1-FY13 (**Table 3.5**). This significant increase can be traced to: (i) lower cost of borrowing in real terms;[12] (ii) some improvement in power and gas availability, which supported credit demand by the LSM sector; and (iii) higher business confidence due to the government's focus on industrial activity. In addition to these macro factors, sector specific developments like expansions in production capacities, product diversification, investment in alternate energy sources, etc., also contributed to the healthy growth in credit to the private sector.

Table 3.5: Change in Credit to Private Sector
billion Rupees

	FY13			FY14		
	Q1	Q2	H1	Q1	Q2	H1
Overall	-84.9	189.5	104.5	-17.4	338.7	321.3
of which						
Loans to private business	-39.6	186.1	146.5	-3.0	274.8	271.8
Investments in private stocks	-1.1	12.3	11.2	1.4	5.2	6.5
Consumer financing	-1.8	8.4	6.6	13.4	4.7	18.1
Credit to NBFCs.	-65.7	-12.6	-78.3	-16.2	2.9	-13.3

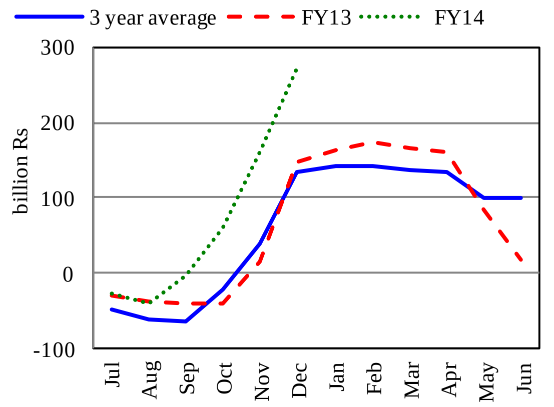
Source: State Bank of Pakistan

Within private sector credit, loans to private sector businesses during H1-FY14, increased by Rs 271.8 billion compared to Rs 146.5 billion in H1-FY13 (**Figure**

[12] YoY inflation adjusted lending rates on fresh loans for H1-FY14 averaged at 1.2 percent, compared with 3.5 percent for the same period of the previous year.

3.4). Apart from the usual seasonal demand for the procurement of rice and cotton, loans to other sectors also gathered pace during H1-FY14.[13]

Figure 3.4: Loans to Private Sector - Cumulative Flows



Source: State Bank of Pakistan

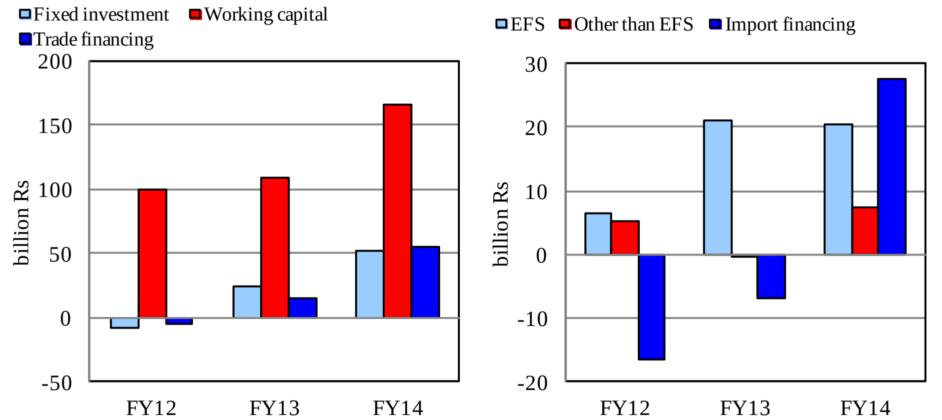
The sectoral distribution of loans clearly indicates that credit expansion is broad based as a large number of sectors and sub-sectors recorded an increase in credit off-take. Moreover, distribution of loans to private businesses by type also indicates that all three categories (namely trade financing, fixed investment and working capital) witnessed an increase during H1-FY14 (**Figure 3.5a**).

Seasonal credit off-take explained part of the rise in working capital

- The rice processing units availed Rs 30 billion of working capital during H1-FY14, compared to Rs 17.6 billion during H1-FY13. This significant rise in credit was primarily attributed to increased rice production and healthy growth

Figure 3.5a: Trend in Type of Financing (H1)

Figure 3.5b: Flows in Trade Finance (H1)



Source: State Bank of Pakistan

[13] Following the seasonal pattern of credit to the private sector, credit expansion was concentrated in the second quarter of the year, while the Q1-FY14 saw a net retirement of Rs 17.4 billion.

in rice exports.[14]

- Credit demand for *cotton* procurement from spinning, weaving and finishing industries, remained strong due to: (i) early cotton arrival in the market;[15] (ii) increased cotton buying by the textile mills to meet the anticipated demand from the European market after attaining GSP plus; and (iii) rise in demand by cotton exporters.

Table 3.6: Net Change in Loans to Private Sector Businesses during H1[1]

billion Rupees

	Share-End	Overall Loans		Trade Financing		Working Capital		Fixed Investment	
	H1-FY14	**FY13**	**FY14**	**FY13**	**FY14**	**FY13**	**FY14**	**FY13**	**FY14**
Private. business	100.0	146.5	271.8	14.1	55.1	108.7	165.4	23.7	51.4
a) Manufacturing	58.9	94.0	165.0	11.0	30.5	70.8	96.0	12.1	38.5
Of which									
Food & beverages	12.3	3.7	20.9	6.4	7.8	-11.7	2.3	9.0	10.8
Of which									
Edible oil	1.5	-9.7	7.5	-4.3	6.2	-5.6	1.2	0.1	0.1
Rice	3.0	23.7	40.8	6.0	9.8	17.6	30.0	0.1	0.9
Sugar	3.8	-16.8	-23.9	2.9	-2.4	-23.8	-28.0	4.1	6.5
Bakery	0.6	1.1	3.9	0.3	-0.3	0.8	4.1	0.0	0.1
Beverages	0.8	0.6	3.9	0.7	-0.2	-0.3	4.5	0.2	-0.4
Textiles	22.5	65.2	100.0	5.7	13.9	55.6	80.5	3.9	5.6
Of which									
Spinning	9.6	39.4	49.2	5.0	0.0	35.7	51.9	-1.2	-2.8
Weaving	4.0	6.2	21.0	1.2	2.0	3.9	13.2	1.1	5.7
Finishing	3.8	10.9	19.3	-1.6	5.3	8.3	10.3	4.2	3.7
Cement	2.0	-7.8	0.4	-3.0	-0.9	-2.1	-5.2	-2.7	6.4
b) Power	9.5	9.6	31.5	0.6	2.4	5.4	22.3	3.6	6.8
c) Commerce	8.8	12.4	34.1	-0.4	12.2	9.3	22.5	3.5	-0.6
d) Others*	22.8	30.5	41.3	2.9	10.0	23.2	24.6	4.5	6.7

[1]Numbers may not add up exactly due to separate rounding off.
*Agriculture, Fishing, Mining, Ship Breaking, Construction, Hotel, Transport, Real Estate, Education, Health, Community, Others.
Source: State Bank of Pakistan

- Higher working capital requirements by the *fast moving consumer goods* (FMCGs) sector also contributed to the rise in credit demand;[16]

[14] Rice production reached 6.4 million tons during FY14, which not only exceeded the target of 6.2 million tons for the year, but was also significantly higher than the last year's production of 5.5 million tons. Moreover, rice exports sharply increased to US$ 966.6 million during H1-FY14, compared to US$ 749.3 million in H1-FY13 (Source: PBS).

[15]Early arrival of cotton due to changing seasonal pattern, especially in Punjab, caused improved cotton arrivals in the market.

[16] Manufacturers of *soft drinks* and *other beverages* showed significant rise in working capital requirement on account of increased demand from a leading beverages company which availed bank

- Working capital loans to the *power sector* increased by Rs 22.3 billion in H1-FY14, compared to Rs 5.4 billion in H1-FY13 (**Table 3.6**). This significant increase was largely attributed to higher capacity utilization by the power sector following the settlement of circular debt by end FY13, which opened up space to lend to the power sector.[17] Interestingly enough, the re-accumulation of receivables in subsequent months, again created appetite to borrow from banks.
- Working capital loans to c*ommerce and trade* also increased during H1-FY14, due to an increase in trading activities, and growing business of retailing outlets.[18]

Broad based expansion in trade financing: Within trade financing, the expansion was largely driven by loans for import financing (**Figure 3.5b**). Increased demand for various imported goods, and depreciation of PKR, were the major contributory factors. Specifically, the private sector heavily borrowed to import *electrical machinery* and for *commerce & trade* during Q2-FY14.[19] The import of petroleum products picked up for power generation, and to meet the acute CNG shortage during the winter season.[20]

In addition to imports, loans for export financing also increased by Rs 27.6 billion during H1-FY14, compared to Rs 21.1 billion in H1-FY13. Major contribution came from concessional EFS loans, which saw an expansion of Rs 20.3 billion during the period under review. Further details indicate that exporters borrowed under EFS for rice, cotton and textile made-ups. As stated earlier, this was driven by better rice production and cotton demand from China.

Improvement in fixed investment loans: Within credit to the private sector, increase in the fixed investment loans (loans for more than one year maturity),

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finance to expand its operations. Moreover, increasing demand for bakery products and rise in corn prices, also contributed to credit expansion during H1-FY14.

[17] It is important to note the credit expansion was concentrated during the first quarter of the year; in Q2-FY14, loans to the energy sector declined, as a number of power plants could not sustain their operations due to gas shortages during the winter season.

[18] With the opening of mega retailing stores in big cities, there is a visible change in retail trading. Moreover, these outlets are well integrated with the banking sector due to increasing use of debit and credit cards as a means of payments. This increased interaction with the banking system, help retailing stores utilize bank financing for expanding their business.

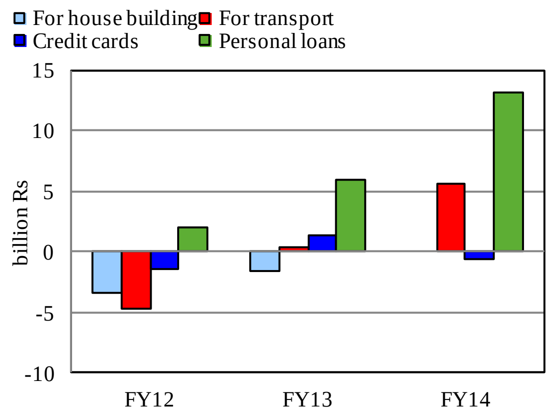
[19] Imports of electrical machinery (refrigerators, freezers, generators, washing machines etc) reached US$ 535.4 million during H1-FY14, compared to US$ 403.1 million in the same period last year (Source: PBS).

[20] Imports of petroleum products rose to 6.7 million MT during H1-FY14, compared to 6.2 million MT during the same period last year (Source: PBS).

during the first half of the year, is a welcome development. More importantly, this increase in fixed investment loans is broad based:[21]

- Major players in the dairy sector borrowed in Q2-FY14, for product diversification, investment in alternate energy sources, and for enhancing their existing production capacity;[22]
- The cement sector availed fixed investment loans as some of the leading cement companies are expanding their production capacity;[23]
- Loans to the *paper and board* industry increased during Q2-FY14, as this sector is investing in alternate fuel plants/boilers to cope with the persistent energy crisis.[24]
- A number of sugar mills availed fixed investment loans for power generation from sugarcane bagasse during H1-FY14.
- Textile weaving utilized fixed investment loans for BMR (balancing, modernization and replacement) to benefit from preferential access to EU market (GSP plus status).
- Power sector utilized fixed investment loans for setting up new power projects, and for the up gradation of old units.

Figure 3.6: Consumer Financing-H1



Source: State Bank of Pakistan

Following a prolonged period of net retirement, ***consumer financing*** has picked up since November 2012; this trend continued during H1-FY14 (**Figure 3.6**). Composition of consumer finance indicates that the recovery was largely driven by personal loans, which saw an expansion of Rs 13.0 billion during H1-FY14. Further

[21] Dairy, Paper and Board, cement, Iron and steel, weaving and finishing of textiles and electrical equipment posted modest rise in fixed investment loans compared to the same period last year.

[22] Engro food entered in the loose milk market in Karachi with the launch of its brand, "Mubrook". It also opened few retail outlets in the city. Nestle, on the other hand, is on its way to increase production capacity.

[23] For instance, Askari Cement and Lucky Cement.

[24] Century papers and Packages have installed coal based boilers for drying purposes in paper production. It is interesting to note that import of boilers reached US$ 34.7 million during H1-FY14, compared to US$ 9.2 million during the same period last year.

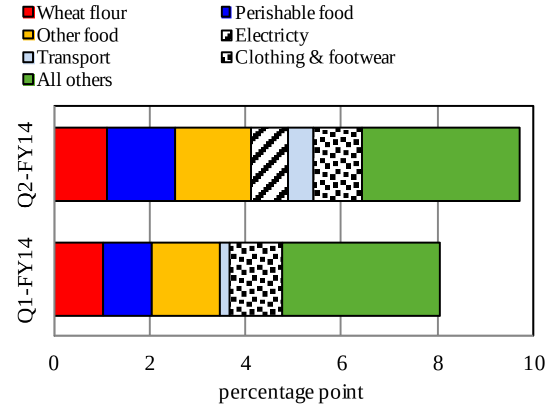
details indicate that the one of the public sector commercial banks marketed its *Salary Loan* scheme and *Cash and Gold* scheme, which was the swing factor in personal loans. In addition to personal loans, auto financing also picked up in recent months, as one of the private sector banks actively marketed its auto finance facility. More specifically, the bank followed a segmented marketing approach, which turned out to be quite a success.[25]

3.4 Inflation

Headline inflation continued to increase in Q2-FY14, reaching an average of 9.7 percent in the quarter, from 8.1 percent in Q1-FY14. In overall terms it rose to 8.9 percent during H1-FY14 compared to 8.3 percent in H1-FY13. The quarterly analysis indicates that as witnessed during Q1-FY14, the rise in wheat flour prices, and the increase in GST rate, continued to fuel headline inflation in the second quarter. Pressures were compounded in Q2-FY14 due to the increase in power tariffs and fuel prices, and worsening supplies of perishable food items. In fact, the combined share of inflation contributed by perishable food items, electricity prices and transport group, rose to 28.3 percent in the second quarter from 15.1 percent in Q1-FY14 (**Figure 3.7**). The role of perishable foods in H1-FY14 can be seen in **Table 3.7**.

Both the measures of core inflation (trimmed as well as NFNE) showed stability in 'underlying inflation' around 8.4 percent during H1-FY14. It is significantly lower than the core inflation observed during H1-FY13. However, trimmed core inflation increased to 9.0 percent in Q2-FY14, compared to 7.8 percent in Q1-FY14 (**Table 3.7**). This is due to the fact that trimmed inflation for Q2-FY14 included electricity prices, which were absent in the trimmed CPI basket during Q1-FY14 (**Table**

Figure 3.7: Composition of Inflation



Source: Pakistan Bureau of Statistics

[25] Bank-wise loans for auto financing indicate that 30.0 percent of increase in auto financing during H1-FY14 came from that bank.

3.7).[26] However, core inflation measured by NFNE remained almost stable during Q2-FY14, compared to the preceding quarter.

Table 3.7: CPI Inflation (YoY)
percent

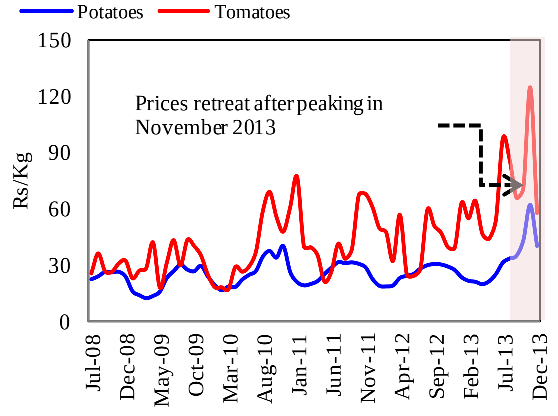
		CPI				
			Food Inflation		Core Inflation	
		CPI	Overall	Perishable	NFNE	Trimmed
FY13	Q1	9.1	8.4	9.7	10.9	10.6
	Q2	7.5	6.3	-7.3	9.9	9.2
	H1	8.3	7.3	1.2	10.4	9.9
	Q3	7.3	7.3	-4.6	9.5	9.2
	Q4	5.6	6.6	9.6	8.2	7.0
	H2	6.5	6.9	2.5	8.9	8.1
FY14	Q1	8.1	9.1	15.2	8.5	7.8
	Q2	9.7	10.7	25.4	8.4	9.0
	H1	8.9	9.9	20.3	8.4	8.4

Source: Pakistan Bureau of Statistics

Inflation in perishable food items

Inflationary pressures from perishable food items (specifically onions, tomatoes and fresh vegetables) intensified further in the second quarter, when prices of potatoes recorded a sharp increase.[27] In fact, the retail price of potatoes and tomatoes hit an all-time high in November 2013 (**Figure 3.8**).[28] The sharp rise in the prices of

Figure 3.8: CPI Prices



Source: Pakistan Bureau of Statistics

[26] Trimmed mean core inflation is computed by excluding items from the CPI basket, showing highest and lowest inflation with cumulative weight of 10 percent. This means, the trimmed CPI basket changes every month.
[27] The increase in the consumer prices of onions, tomatoes, fresh vegetables and potatoes had a 14.7 percent contribution in the headline YoY inflation during Q2-FY14, compared to 12.6 percent in the preceding quarter.
[28] The consumer prices of potatoes reached Rs 62.3 per kg in November 2013.

potatoes was because of harvest delays, particularly in Punjab.[29] Similarly, the supply of tomatoes worsened in the second quarter due to a slowdown in imports from India.[30]

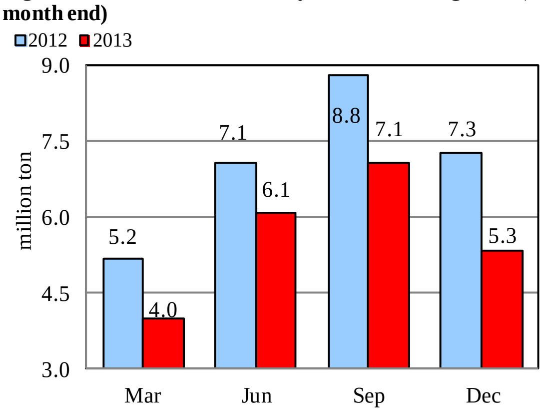
However, this situation eased in December 2013, following the arrival of fresh crops, which pulled down headline YoY inflation to 9.2 percent in December 2013, after touching double digits in November 2013.[31]

Increase in wheat and wheat flour prices

The wheat flour inflation recorded a sharp increase of 25.3 percent in H1-FY14, compared to 8.3 percent in the corresponding period last year. Wheat flour alone contributed 1.1 percentage points to headline inflation in Q2-FY14, which is 11.6 percent of the total increase. This was despite a falling trend in global wheat prices.[32]

The increase in the price of wheat, wheat flour and allied products during H1-FY14, can be traced to below target wheat production last year, and the resulting decline in stocks held by the government (**Figure 3.9**). Furthermore, there are fears the government may not be able to achieve the wheat procurement target this season (to build its stocks) as support prices are deemed unattractive for farmers.[33] In

Figure 3.9: Wheat Stocks Held by Procurement Agencies (at month end)



Source: State Bank of Pakistan

[29] Due to unfavorable weather this year, the cultivation of potatoes could not start on time. This led to delays in its harvesting, and in turn, caused supply shortages in the market.
[30] A sharp increase in the prices of tomatoes in India following the unseasonal rainfalls discouraged its exports to Pakistan.
[31] The arrival of fresh crops resulted in 25.6 percent decline in the prices of perishable food items during December 2013, compared to the preceding month. Had the prices of perishable food items not declined in December 2013, the Q2-FY14 average YoY headline inflation would have increased to 10.4 percent, rather than the actual 9.7 percent.
[32] Global wheat prices reached their four-year low of US $207 per metric ton in mid-January 2014.
[33] The federal governments have maintained the Wheat Support Price (WSP) at last year's level of Rs 1,200 per 40 kg, whereas its current market price is around Rs 1,600 per 40 kg. This gives little

this regard, the empirical evidence suggests that the rise in wheat and wheat flour inflation could trigger cost push inflation because of an increase in wages.[34]

Rise in administered prices

As a part of the fiscal consolidation undertaken by the government, power tariffs for household consumers were revised upwards by 15.8 percent during October 2013.[35] As anticipated, this increase fuelled headline inflation during Q2 -FY14 – just this accounted for an 8.1 percent increase in inflation during the second quarter.

Furthermore, the government also increased electricity tariffs for commercial and industrial users by 23.7 percent in August 2013. This too has filtered down to an increase in general price levels within the quarter.[36]

In addition to power tariffs, petrol and diesel prices were also revised upwards in October 2013. This, along with a low base because of the decline in CNG tariffs in November 2012, resulted in a sharp uptick in fuel price inflation in Q2-FY14.[37]

Global commodity prices remain subdued

On a positive note, global commodity prices remained soft almost throughout H1-FY14. As a matter of fact, international commodity prices fell slightly in Q2-FY14 compared to a marginal increase in Q1-FY14. Furthermore, the second quarter of FY14 witnessed a 0.7 percent appreciation in PKR against US Dollar after posting a 6.0 percent depreciation in Q1-FY14. With a stable PKR and

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incentive to farmers to sell their crop to the government, which may cause difficulties for government to build wheat reserves after arrival of crop.

[34] Labor cost constitutes around one-quarter of the total cost of production in the manufacturing and services sectors of the economy [Source: Choudhary, A., Naeem, S., Faheem, A., Hanif, N., and Pasha, F. (2011), "Formal Sector Price Discoveries: Preliminary Results, from a Developing Country," SBP Working Paper No. 42].

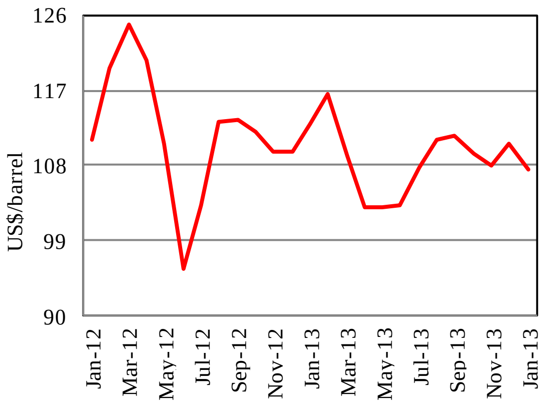
[35] Electricity tariffs were increased in the range of 15.5 to 23.8 percent for domestic users with monthly consumption above 200 kWh. In the prices data published by PBS, the same rate has been applied (with an average of 15.82) to all cities in the CPI basket effective from October 2013. However, KE (formerly KESC) is showing the pre-October 2013 tariffs on the bills to its customers in Karachi. This suggests that the increased tariff rate should have been incorporated in the city-wise prices data excluding Karachi.

[36] These findings are also confirmed by a price setting survey of formal (manufacturing and services) sector firms by SBP, which confirms that the increase in energy prices becomes part of output prices within a period of 3 to 9 months. Choudhary, A., Naeem, S., Faheem, A., Hanif, N., and Pasha, F. (2011), "Formal Sector Price Discoveries: Preliminary Results, from a Developing Country," SBP Working Paper No. 42.

[37] Fall in the prices of CNG drove the overall inflation down in November 2012, following the Supreme Court order that disputed the then mechanism for setting CNG prices.

subdued global prices, the impact of imported inflation and exchange rate pass through, is likely to be favorable going forward (**Figure 3.10**).

Figure 3.10: International Price - Brent Crude



Source: International Monetary Fund

Inflation Outlook

Some of the factors driving inflation in the first half of FY14 have started to ease. For instance, the pressure on PKR has eased, while perishable food items and global commodity prices should add to the muted inflation outlook. Furthermore, the latest 'SBP-IBA Consumer Confidence and Inflation Expectations Survey' suggests softening of inflationary expectations on account of stability in administered prices, in particular retail oil prices, and PKR against US Dollar.[38] The stability in food inflation pulled down headline YoY inflation to 7.9 percent in January 2014, from 9.2 percent in December 2013. Based on these factors, we project inflation to fall in the range of 8.5 to 9.5 percent during FY14. There are, however, risks that the government may announce an increase in gas tariffs, which had been anticipated in January 2014. The needed upward revision in gas tariffs would put pressure on inflation, as household gas tariffs figure prominently in the CPI basket.

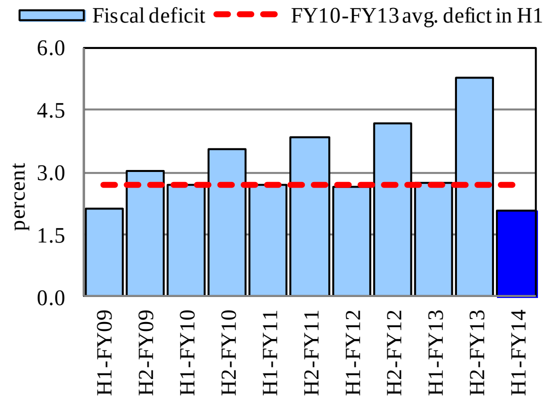
[38] For details, see SBP's Annual Report for FY13 Special Section 4.1

4 Fiscal Policy and Public Debt

4.1 Fiscal Operations

According to the Ministry of Finance data, fiscal indicators continued to show improvement during Q2-FY14, as the fiscal deficit for the first half fell to a four-year low of 2.1 percent of GDP (**Figure 4.1**). This was lower than the average deficit in the preceding four years.[1] More encouragingly, this was the first time after four years that primary balance turned to a surplus in the first half of a year.

Figure 4.1: Fiscal Deficit



Source: Ministry of Finance

This improvement was on account of a slowdown in expenditures and an increase in revenues (**Table 4.1**). Worryingly, development expenditures fell sharply during H1-FY14, declining by 10.5 percent YoY against an increase of 19.5 percent during the same period last year. Both, provincial and federal PSDP contributed to this decline. However, current expenditures also slowed down due to lower subsidies.

On the revenue side, FBR tax receipts posted growth of 16.8 percent for H1-FY14, against a nominal increase of 4.5 percent during the same period last year, which was mainly due to increase in tax rates and rise in general price level in the economy. However, according to our estimates FBR collections for H1-FY14 are short by around Rs 80 billion relative to the half year target, and will need to grow by 36.6 percent in the second half to achieve the target set for FY14. This would be challenging, given the pattern of revenues collection and the nature of tax reforms undertaken so far.[2]

[1] Fiscal deficit in H1-FY14 was 2.1 percent of GDP against 4 year average of 2.6.
[2] During the past five years, on average, FBR revenues recorded 13.4 percent YoY growth in the second half.

For the financing of the budget imbalance, the government mostly relied on domestic banking system during H1-FY14 (**Table 4.2**).[3] As regards public debt, the country witnessed Rs 996.9 billion addition in its stock of debt during H1-FY14. However, this entire increase was recorded in the first quarter, whereas Pakistan's public debt witnessed a marginal decline during the second quarter. This can be attributed to the narrowing of the fiscal deficit. Furthermore, repayments to IMF, and favourable exchange rate movement also improved the public external debt situation.[4]

Table 4.1: Summary of Fiscal Operations during H1

billion Rupees, growth in percent

	Absolute		YoY Growth	
	FY13	FY14	FY13	FY14
A. Revenue	1,461.8	1,684.5	28.8	15.2
Tax revenue	1,012.7	1,172.0	12.0	15.7
o/w FBR revenues	883.2	1,031.4	4.5	16.8
Non-tax	449.1	512.5	94.7	14.1
B. Expenditure	2,086.5	2,224.7	25.1	6.6
Current	1,721.7	1,887.6	23.1	9.6
Development	272.1	243.5	19.5	-10.5
Net lending	5.7	82.7	72.0	N-A
Statistical discrepancy	87.0	11.0	N-A	-87.4
Overall deficit (A-B)	624.7	540.1	17.3	-13.5
Deficit as % of GDP [1]				
Fiscal	-2.7	-2.1		
Revenue	-1.1	-0.8		
Primary	-0.3	0.2		

[1]Fiscal deficit for FY13 is calculated with the GDP with new base

Source: Ministry of Finance

Table 4.2: Financing of the Fiscal Deficit during H1

billion Rupees

	FY13	FY14
Total	624.7	540.1
External	-1.4	-43.5
Domestic	626.1	583.6
Bank	557.9	483.3
Nonbank	68.1	100.3

Source: Ministry of Finance

Notwithstanding the small decline in public debt, the significant shift towards the shortest tenor (i.e., 3-month securities), raises serious concerns about the maturity profile of Pakistan's public debt.[5] The over-reliance on short-term debt increases the vulnerability of the country's debt servicing to adverse movements in the interest rates, because the bulk of the debt

[3] These numbers will not match with the government borrowing numbers reported in **Table 3.1**. This is because MoF reports government borrowing on *cash basis*, while SBP's monetary survey is compiled on *accrual basis*.

[4] Transactional gains emerging from (6.8 percent) depreciation of Japanese Yen against US Dollar during Q2-FY14 resulted in Rs 78.9 billion reduction in the stock of public external debt in Q2-FY14. Furthermore, an appreciation in PKR during Q2-FY14 resulted in further Rs 16. 2 billion decline in the Rupee value of public external debt stock in this period.

[5] On end-December 2013, the share of 3m T-bills in public domestic debt stock rose to 19.5 percent, compared to a mere 1.8 percent on end-June 2013. Due to uncertainty about SBP's policy rate, banks shied away from investing in 6 & 12m paper, and focused primarily on 3m paper in Q2-FY14.

will be repaid within 3 months. This said, the trend has improved in the subsequent quarter.

The developments during H1-FY14 indicate that a reduction in subsidies, and increase in tax rates have succeeded in achieving the desired reduction in the fiscal deficit for now. However, we believe a sustainable improvement in the country's fiscal situation would require wide ranging reforms that address the following issues: (i) a sustainable increase in tax collection requires widening the tax net by removing exemptions;[6] (ii) while the phasing out of power subsidies is urgently required, there is a simultaneous need to initiate comprehensive energy sector reforms, to rule-out the build up of circular debt; (iii) to achieve a substantial reduction in the burden emanating from loss making PSEs, these entities need to be restructured/disinvested on a priority basis;[7] (iv) fiscal austerity based on curtailing development spending is not a desirable option, as it will further suppress growth, which would be counterproductive for debt reduction efforts;[8] (v) rebalance the maturity profile of domestic debt, to minimize interest-rate and roll-over risk, and spread out the debt servicing burden; and (vi) revitalize NSS products and make them more dynamic.

In overall terms, we maintain our view that the full-year fiscal performance will depend on subsidies and the possible need to again pay off the circular debt in the power sector; the performance of FBR; the inflows of CSF and proceeds from the auction of 3G licenses. Typically, budget deficits sharply increase during the second half of the year; our analysis shows that if the fiscal authorities succeed in containing the H2-FY14 deficit at the same level as the last four year (as a percentage of GDP), the deficit target of 6.0 -7.0 percent of GDP will not be exceeded.

4.2 Revenues

FBR Taxes

The increase in tax rates announced in the budget of FY14 helped FBR in improving tax collection during H1-FY14.[9] More specifically, tax collection by

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[6] On a positive note, however, realizing the need of expanding the tax net, a committee has been constituted by the government to spell out a strategy to phase out some of these tax exemptions.

[7] The government has met the structural benchmark on formulating the strategic plans for 31 PSEs.

[8] Inflation, interest rates, and stock-flow adjustments are some important determinants of debt dynamics. However, historically, output growth and fiscal adjustment were the main factors in 26 episodes of large debt reversals in advanced economies since 1980s. Source: Abbas S. Ali, Akitoby Bernardin, Andritzky Jochen, Berger Helge, Komatsuzaki Takuji, and Tyson Justin (2013), " Dealing with High debt in an Era of Low Growth", IMF Discussion Note IMF SDN/13/07

[9] For details, see **Box 4.1** in SBP's *1st Quarterly Report* for FY14.

FBR rose by 16.8 percent YoY in H1-FY14, compared to a meager 4.5 percent witnessed in the same period last year (**Table 4.3**). Around two-third of the entire increase in tax collection came from sales tax during H1-FY14. This was the only category that surpassed the half-year target on account of collection from sales of domestic goods and imports. In domestic sales, most of the increase can be traced to petroleum products, fertilizer, and cement, while the GST collection on imports improved due to pickup in imports of petroleum products, machinery and fertilizer. Custom duties, however, remained sluggish during this period.

Table 4.3: FBR Tax Collection during H1(Provisional)

billion Rupees

	Actual		% Growth		FY14 Target		% of Target Achieved	
	FY13	FY14	FY13	FY14	H1[1]	Total	H1	Total
A. Taxes on imports	317.7	356.8	3.0	12.3	374.0	800.0	95.4	44.6
Sales tax	209.7	246.7	-2.1	17.6	239.0	500.0	103.2	49.3
Custom duty	108.0	110.1	14.6	2.0	134.9	300.0	81.6	36.7
B. Tax on domestic businesses	234.1	292.7	4.8	25.0	323.4	715.0	90.4	40.9
Sales tax	182.4	235.0	6.4	28.8	233.7	513.0	100.5	45.8
FED	51.7	57.7	-0.5	11.5	89.7	202.0	63.8	28.5
C. Total indirect taxes (A+B)	551.8	649.4	3.8	17.7	697.4	1,515.0	93.1	42.9
D. Direct taxes	331.3	382.0	5.9	15.3	413.0	960.0	92.5	39.8
Total tax collection (C+D)	883.2	1,031.4	4.5	16.8	1,110.3	2,475.0	92.9	41.7

[1]SBP's internal estimates, based on FBR's performance in the past five years.

Source: Ministry of Finance

Revenues from direct taxes posted a 15.3 percent increase in H1-FY14, compared to 5.9 percent recorded in the same period last year. Furthermore, around one-third of the entire increase in FBR taxes came from direct taxes. Most of this increase can be traced to an increase in withholding tax collection on imports, telephone bills and salaries due to increase in rates.[10]

Non-tax revenues

Growth in non-tax revenues witnessed a sharp slowdown in H1-FY14 compared to the same period last year. Lower CSF inflows during this period, compared to the same period last year, resulted in a YoY slowdown in non-tax revenues in this period.[11]

[10] The withholding tax rate on mobile phone subscribers and prepaid card users was raised from 10 percent in FY13 to 15 percent in budget FY14.

[11] CSF inflows stood at Rs 34 billion in H1-FY14, compared to Rs 172 billion in the same period last year.

4.3 Expenditures

As mentioned above the pace of fiscal spending recorded slowdown in H1-FY14, compared to the same period last year. This was due to a decline in development spending and a decrease in the growth of current spending (**Table 4.4**).

Table 4.4: Fiscal Spending during H1

billion Rupees; growth in percent

			YoY Growth	
	FY13	**FY14**	**FY13**	**FY14**
Current expenditures	1,721.7	1,887.6	23.1	9.6
of which				
Interest payment	552.6	597.7	39.1	8.2
Domestic	508.0	559.3	39.7	10.1
Foreign	44.6	38.4	32.6	-13.9
Subsidies	166.0	136.0	N-A	-18.1
Defense	256.6	295.3	5.5	15.1
Provinces	476.1	541.4	3.9	14.2
Others	278.1	323.9	13.2	16.5
Development expenditures & net lending	277.8	326.2	20.3	17.4
Development	272.1	243.5	19.5	-10.5
-Federal	149.6	149.5	8.2	-0.1
-Provincial	122.5	94.0	37.0	-23.3
Net lending	5.7	82.7	72.0	N-A
Statistical discrepancy	87.0	11.0	N-A	-87.4
Total	2,086.5	2,224.7	25.1	6.6

Source: Ministry of Finance

A fall in the growth of debt servicing and subsidies, were responsible for lower current spending during H1-FY14.[12] However, debt servicing rose significantly in the second quarter mainly due to an increase in domestic debt payments.[13]

The reduction in power subsidies happened in conjunction with the re-accumulation of payables in the power sector.[14] This raises concerns about the sustainability of the improvement witnessed in the fiscal account. Although, the rationalization of power tariffs for residential and agricultural users in October 2013, is an important step towards eliminating fiscal burden of the power sector, there is a need to introduce broad based reforms in the energy sector to reduce transmission and distribution losses, improve the collection of bills, and ensure that subsidies are well targeted. In this regard, the increase in subsidies to the industrial sector is surprising (**Figure 4.2**). Tackling losses and improving

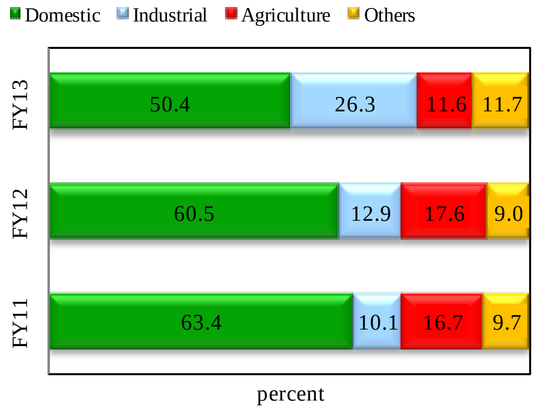
[12] Current expenditures, excluding subsidies and interest payment, recorded 15.0 percent YoY increase in H1-FY14.

[13] The increase in debt servicing was mostly led by a sharp increase in the payments on MRTBs and 3m T-bills. Due to unexpected fiscal slippages, government increased its reliance on SBP funding in the last quarter of FY13. Hence, the government borrowed a hefty Rs 530.7 billion from SBP in this period alone and the interest payments of this sum fell due in Q2-FY14. Furthermore, due to heavy reliance on 3m T-bills during Q1-FY14, compared to the same period last year, debt servicing burden for these securities also increased in Q2-FY14.

[14] In response to a question in the National Assembly on March 7, 2014, the Minister of Water and Power informed that the payables of the power sector stand at Rs 246.2 billion as of end-December 2013. A part of this amount may decline going forward, if the government decides to deduct the outstanding payables of the provinces to power sector at source.

collection, is also one of the core objectives of the National Power Policy announced by the government in Jun 2013.[15] However, there is a need to pace up the efforts to achieve these objectives to minimize the fiscal burden posed by the power sector. To put things into perspective, the amount of power subsidies, including the one-off settlement of circular debt stood at 2.9 percent of GDP in FY13.

Figure 4.2: Sector-Wise Distribution of Power Subsidies



Source: Ministry of Finance

4.4 Provincial Fiscal Operation

The consolidated financial position of the provinces has been improving since the devolution of powers to collect sales taxes on services. In FY12, Sindh started collecting these taxes followed by Punjab in FY13; KPK followed suit in FY14.

Table 4.5: Provincial Fiscal Operations during H1

billion Rupees

	Punjab		Sindh		KPK		Balochistan		All Provinces	
	FY13	FY14	FY13	FY14	FY13	FY14	FY13	FY14	FY13	FY14
A. Total revenue	340.4	349.6	213.9	230.7	112.4	132.5	74.2	87.2	740.9	800.1
Share in federal revenue	278.6	286.5	154.1	179.2	96.4	106.8	63.2	74	592.2	646.5
Taxes	36	45	32.3	36	1.9	5.7	0.5	0.9	70.7	87.6
Non-taxes	16.8	14.2	13.6	2	2.2	6.5	1.9	2.7	34.5	25.4
Federal loans & transfers	9	3.8	13.9	13.5	11.9	13.5	8.7	9.7	43.5	40.6
B. Total expenditure	274.1	295.7	168.3	186.7	100.5	99.7	55.7	53.2	598.6	635.4
Current	218.7	258.4	139.1	149.3	75.4	85.2	43	48.5	476.1	541.4
Development	55.3	37.3	29.3	37.4	25.1	14.5	12.7	4.7	122.5	94
Overall balance (A-B)	66.4	53.9	45.6	44	11.9	32.8	18.5	34	142.3	164.7

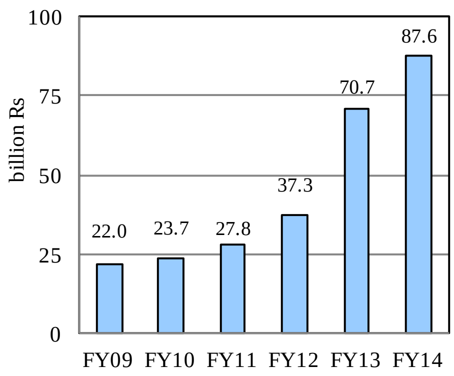
Source: Ministry of Finance

In this regard, KPK has shown exceptional performance, as tax collection more than doubled, after KPK established its Revenue Authority in August 2013.

[15] The National Power Policy aims at reducing the transmission losses from 25 percent to 16 percent and improvement in the collection of bills to 95 percent by FY17.

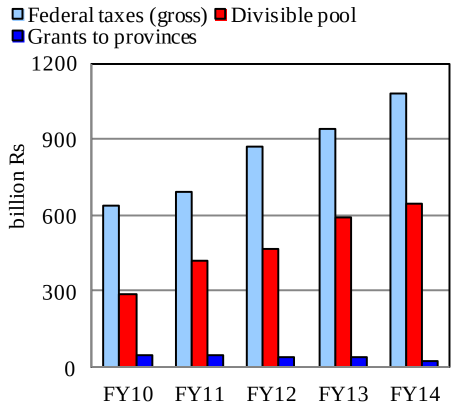
Resultantly, the consolidated provincial surplus has grown significantly from FY12 onwards. During H1-FY14, following an increase in federal transfers and a 23.9 percent increase in tax collections, provincial surpluses posted a 15.8 percent growth over the same period last year (**Table 4.5, Figure 4.3 a &4.3 b)**.

Figure 4.3a: Provincial Tax Collection



Source: Ministry of Finance

Figure 4.3b: Federal Transfers to Provinces-H1



Source: Ministry of Finance

Notwithstanding this increase, the expenditure side is a bit disconcerting due to a 23.3 percent YoY decline in the development expenditures. This can improve as the year progresses and the impact of last year's election related spending wears off. Current expenditures on the other hand, have increased by 13.7 percent; most of this increase came from Punjab, followed by Sindh and then Balochistan.

In terms of individual performances, Sindh posted the largest growth in expenditures, followed by Punjab during H1-FY14, compared to the same period last year. On the other hand, spending by the KPK government remained almost at the last year's level, whereas total expenditure declined by 4.5 percent in Baluchistan.

4.5 Public Debt

Pakistan's public debt recorded a large Rs 996.9 billion increase during H1-FY14, reaching Rs 15.5 trillion on end- December 2013. However, this entire increase was witnessed in the

Table 4.6: Pakistan's Public Debt Profile

billion Rupees

	Stock		Flows	
	Jun-13	Dec-13	Q1	Q2
Public Debt	**14,494.0**	**15,491.0**	**1,020.4**	**-23.5**
Public domestic debt	9,520.9	10,227.6	634.0	72.7
Public external debt	4,973.1	5,263.3	386.5	-96.2
Govt. external debt	4,311.1	4,637.9	361.1	-34.3
Debt from the IMF	434.8	379.4	6.5	-61.9
External liabilities	227.2	246.1	18.9	0.0

Source: State Bank of Pakistan

first quarter, as public debt recorded a marginal decline during Q2-FY14 (**Table 4.6**).[16] This was led by a sharp slowdown in the pace of accumulation of domestic debt stock in Q2-FY14, as well as a decline in the public external debt stock. Within domestic debt, almost the entire increase came from short-term debt (**Table 4.7**).[17]

Table 4.7: Domestic Debt- Change in Stock
billion Rupees

	H1	Q1	Q2
Domestic debt	706.7	634.0	72.7
Permanent debt	-4.5	-3.0	-1.5
Short-term debt	674.7	611.1	63.6
Unfunded debt	36.3	25.6	10.7
Foreign currency loans	0.2	0.3	0.0

Source: State Bank of Pakistan

Increasing reliance on 3m T-bills continued to complicate debt management

The stock of short-term debt posted Rs 674.7 billion increase in H1-FY14. The bulk of the increase was seen in the first quarter, which was driven by government borrowing from the central bank (**Table 4.8**).

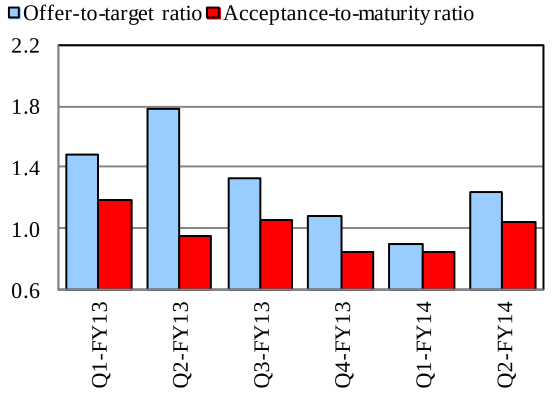
Table 4.8: Short-Term Debt – Change in Stock (FY14)
billion Rupees

	H1	Q1	Q2
Short-term	674.7	611.1	63.6
T-bills (Auctions)	39.7	-138.6	178.3
T-bills (SBP)	548.4	749.7	-201.3

Source: State Bank of Pakistan

Anticipating a hike in the policy rate, banks were reluctant to invest in T-bills throughout Q1-FY14. However, the second quarter of FY14 witnessed a revival in commercial banks' interest in T-bills; the offer-to-target ratio improved to 1.28 after dropping below 1 in the preceding quarter (**Figure 4.4**). Furthermore, after net retirement in the two preceding quarters, the net-of-maturity acceptance stood

Figure 4.4: T-Bills Auction Profile



Source: State Bank of Pakistan

[16] Compared to end-September 2013 position, public debt recorded Rs 23.6 billion decline on end-December 2013.
[17] The change in domestic debt stock during H1-FY14, will not match with the financing of fiscal deficit from domestic sources. This is because the change in debt stock takes into account gross borrowing of the government, while the financing numbers are net of government deposits.

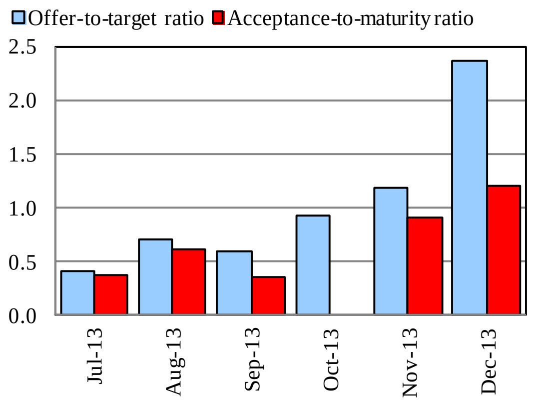
at Rs 98.2 billion in the second quarter of FY14.[18] However, due to market uncertainty about SBP's policy rate, banks shied away from investing in 6 & 12m paper, and focused primarily on 3m paper.[19] Hence, as of end-December 2013, the share of 3m T-bills in the entire T-bills stock increased to 67.3 percent from a mere 5.9 percent as of end-June 2013.

During Q2-FY14, the government mainly aimed at rolling over the T-bills, which is reflected in acceptance-to-maturity ratio of 1.[20] As a result, the fiscal authorities had to rely on borrowing from the central bank to meet the deficit financing requirements. This caused the government to breach both the net borrowing target set by the IMF, as well as the zero quarterly borrowing limit from the central bank.[21]

Mobilization through PIBs witnessed revival

The stock of PIBs witnessed Rs 57.9 billion increase in H1-FY14, compared to Rs 145.1 billion increase posted in the same period last year. In fact Q1-FY14 witnessed Rs 21.2 billion decline in the PIB's stock, however, there was a change in the market sentiment in the second quarter, which led to the addition of Rs 79.1 billion in the PIBs stock in Q2-FY14.

Figure 4.5: PIB Auction Profile



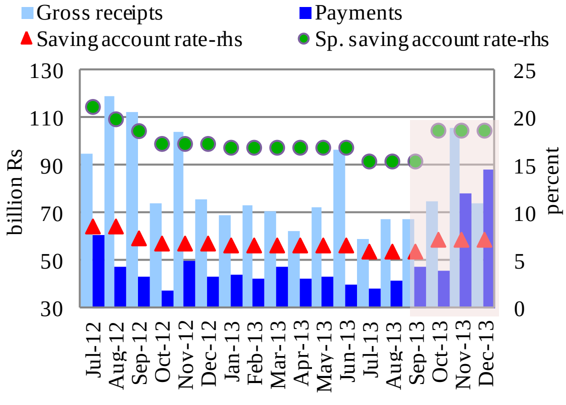
Source: State Bank of Pakistan

According to detailed analysis, the government mobilized Rs 105.6 billion through PIBs during Q2-FY14, which was the highest amount raised after four quarters. In anticipation of an increase in interest rates, market participation in PIB auctions remained moderate in Q1-FY14. The first auction in the second quarter was scrapped, due to a higher rate demanded by the

[18] Specifically, in the three auctions held after the MPS announcement in November 18, 2013, government mobilized greater than targeted amount.
[19] Of the entire amount offered in the T-bill auctions during Q2-FY14, 98.8 percent was offered for 3m bills alone.
[20] For the T-bills auctions, the target-to-maturity ratio stood at 0.93 in Q2-FY14.
[21] With the bilateral external inflows in February and March 2014, and other external inflows expected in H2-FY14, it will be easier to meet these targets going forward.

participants. However, the offered and the realized amounts improved in the subsequent two auctions, after the 50 bps increase announced on November 18, 2013 (**Figure 4.5**). The third auction, witnessed sizeable participation from non-bank institutions. Hence, the acceptance-to-target ratio reached 1.1 after dropping below 1 in all the earlier auctions held in FY14.[22]

Figure 4.6: Increase in Returns Driving up Gross Inflows



Source: State Bank of Pakistan

Upward revision in profit rates boosted gross inflows into NSS

Following the increase in the policy rate, profit rates on National Savings Schemes were also revised upwards on October 1, 2013. The 150 bps increase in the NSS rates, helped stem the downward trend in gross mobilization into these schemes (**Figure 4.6**).[23]

However, large encashment partly neutralized the impact of higher gross inflows, resulting in lower net inflows. More specifically, net mobilization stood at a mere Rs 58.9 billion in H1-FY14, compared to Rs 254.6 billion in the same period last year. This can be traced to the income support levy announced in the FY14 budget, which discouraged individuals

Table 4.9: Public External Debt & Liabilities

billion US$

	Stock		Flows	
	Jun-13	**Dec-13**	**Q1**	**Q2**
Public external debt	50.2	49.8	0.4	-0.8
Govt. debt	43.5	43.9	0.6	-0.2
IMF	4.4	3.6	-0.2	-0.6
Monetary authority liabilities	2.3	2.3	0.0	0.0
Memorandum item				
Debt servicing/FEE[1]	12	15.6		

[1]FEE: Foreign exchange earnings, which include exports of goods, services and income and current transfers.

Source: State Bank of Pakistan

[22] Result of the auction held on 30th January 2014 was even more encouraging, in which, the government raised Rs 199.2 billion.

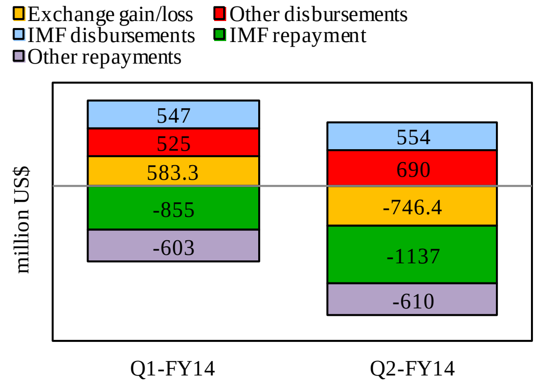
[23] For instance, the profit rates on savings account, special savings accounts, special savings certificates (registered) and regular income certificates were raised by 130 bps, 200 bps, 180 bps and 174 bps in October 2013, leading to Rs 62.5 billion increase in gross inflows in these schemes during Q2-FY14, compared to the preceding quarter.

from keeping their savings in the formal sector.[24]

Public External Debt & Liabilities

Pakistan's public external debt & liabilities posted US$ 370.5 million decline in H1-FY14, reaching US$ 49.8 billion as of end-December 2013. A detailed view reflects that after witnessing an increase during the first quarter, Pakistan's public external debt recorded US$ 755.5 million decline in Q2-FY14 (**Table 4.9**).

Figure 4.7: Factors of Change in Public External Debt Stock



D: Disbursement; R: Repayment

Source: State Bank of Pakistan and Economic Affairs Division

As discussed above, this improvement followed the large repayments to the IMF and favorable exchange rate movement during this period (**Figure 4.7**).[25]

In terms of debt servicing, the country's foreign exchange earnings could not keep pace with the huge debt payment which led to deterioration in the debt servicing-to-FEE ratio to 15.6 percent in H1-FY14, from 11.9 percent on end- June 2013.

[24] S.R.O No. 904(I)/2013. The government has imposed 0.5 percent income support levy in the budget for FY14 on movable assets. However, the recovery of this levy was stopped due to legal issues.

[25] The country has witnessed US$ 891 million net outflows to the IMF in H1-FY14, because of lumpy repayments, which more than offset US$ 1.1 billion inflows from the Fund during this period.

5 External Sector

5.1 Overview

The concerns over Pakistan's balance of payments remained during H1-FY14. While the current account deficit remained modest during the quarter, inadequate financial flows put the country's FX reserves under pressure (**Table 5.1**). In overall terms, the country's FX reserves declined by US$ 2.7 billion in H1-FY14. Having said this, a lumpy inflow of US$ 1.5 billion from a GCC country in March 2014, has substantially improved market sentiments in the FX market, with the PKR even dropping below 100 per US Dollar.

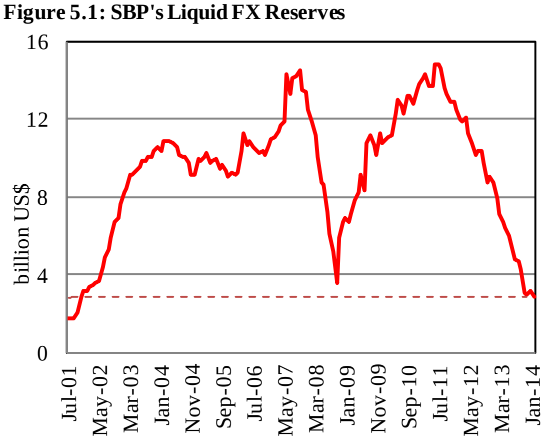
Table 5.1: Summary of External Account
million US$

	Q2		H1	
	FY13	**FY14**	**FY13**	**FY14**
Current account balance	**-522**	**-385**	**-83**	**-1,591**
Trade balance	-4,281	-4,047	-7,906	-8,290
Home remittances	3,518	3,863	7,117	7,790
Financial flows				
IMF loans (net)	-810	-583	-1,254	-891
Other FX loans (net)	263	-20	341	-169
Direct investment in Pakistan (net)	444	185	569	416
Liquid FX reserves (net change)	-1,064	-1,503	-1,430	-2,704
SBP's liquid reserves (net change)	-1,371	-1,214	-1,817	-2,528

Source: State Bank of Pakistan

Returning to the quarter under review, November 2013 was particularly difficult as Pakistan repaid US$ 725 million to the IMF.[1] By end-November 2013, SBP's liquid reserves had reached US$ 3.0 billion (**Figure 5.1**), and the PKR depreciated by 1.5 percent during the month.

Figure 5.1: SBP's Liquid FX Reserves



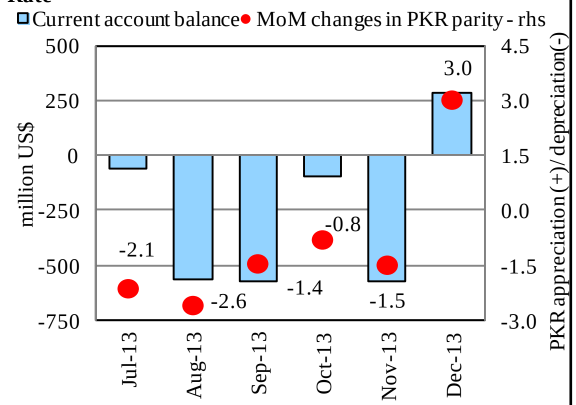
Source: State Bank of Pakistan

However, some improvement was witnessed in December

[1] This included US$ 577 million gross repayment of the SBA loan.

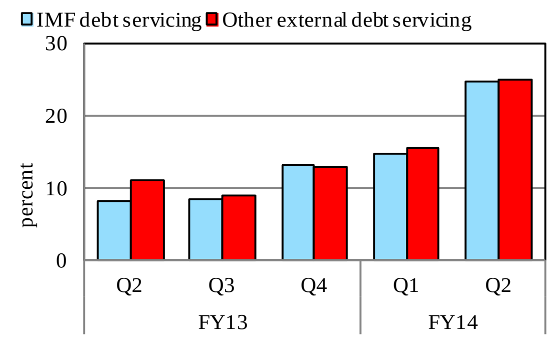
2013, which can be traced to: (i) a surplus in the current account; (ii) receipt of the second tranche of US$ 554 million EFF loan from the IMF; and (iii) lower SBA repayments to the IMF, as the bulk of the annual repayments were made in preceding months. Consequently, the PKR recovered – gaining 3.0 percent during the month (**Figure 5.2**). In fact, excluding CSF inflows, the current account improved significantly in December 2013, compared to the same month last year.[2] More importantly, SBP's adjusted NIR target for end-December 2013, was also met.

Figure 5.2: Performance of Current Account and Exchange Rate



Source: State Bank of Pakistan

Figure 5.3: Payment Burden on SBP's FX Reserves



Calculated as payments during the quarter, divided by SBP's liquid FX reserves at the start of the quarter

Source: State Bank of Pakistan

Current account deficit increased to US$ 1.6 billion in H1-FY14, compared to only US$ 0.1 billion in H1-FY13. This increase was concentrated mainly in Q1; in Q2-FY14, the deficit actually recorded a decline. Improvement in the current account in Q2-FY14 came mainly from a YoY decline in the trade deficit, and an impressive growth in home remittances.[3] However, this improvement was more than offset by deteriorating financial flows, as

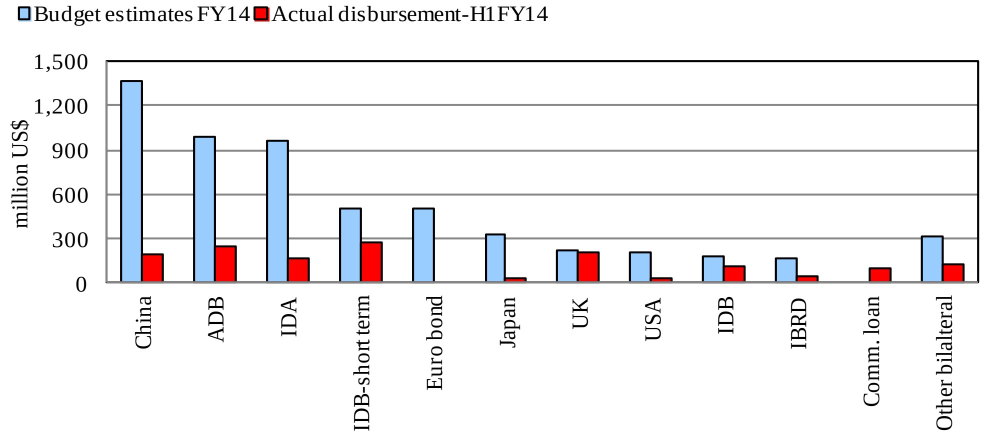
[2] In Q2-FY13, the country received CSF inflows of US$ 688 million, whereas in Q2-FY14, CSF inflows were only US$ 322 million.

[3] Trade deficit recorded a 5.5 percent YoY decline in Q2-FY14, whereas home remittances recorded 9.8 percent YoY increase in this period.

direct investment declined, and repayments of external loans far exceeded gross disbursements during Q2-FY14 (**Table 5.1**). IMF repayments were especially large, which alone used 24.6 percent of SBP's FX reserves during the quarter (**Figure 5.3**).

Having said this, the pressure on SBP's reserves should ease in the second half of the year. We take this view as Pakistan has overcome the lumpy repayments to the IMF, and for the remaining year, repayments will be largely offset by disbursements from the IMF.[4] While this factor alone is sufficient to reduce pressure on FX reserves in H2-FY14, the government is also expecting official FX inflows in the second half of FY14, through various sources. These include: (i) financial assistance from other IFIs that are linked to various projects in the country (**Figure 5.4**); (ii) inflows from bilateral creditors especially China and Japan; (iii) proceeds of PTCL privatization, and the auction of 3G licenses; (iv) CSF inflows of US$ 702 million (of which, US$ 352 million were received in February 2014); (v) issuance of a US$ 500 million Euro Bond expected in Q4-FY14; and (vi) other commercial loans.

Figure 5.4: Disbursement from External Creditors vis-a-vis Budget Estimates



Source: Economic Affairs Division, Ministry of Finance

Outlook for the current account also seems positive with favorable global commodity prices in months ahead. More specifically, after recording a temporary increase in December 2013, crude oil prices declined again in January 2014, and are expected to

[4] A net inflow of US$ 4.0 million is expected from the IMF in Q3-FY14, whereas a net outflow of US$ 75.0 million is expected in Q4-FY14.

stay soft for the rest of the year. Prices of metals and edible oil have also softened during the month, which will help contain import payments.[5] In contrast, cotton prices have surged in recent months which bode well for Pakistan's export earnings. In addition, the award of GSP Plus status by the EU is likely to support the country's exports. For the full year, therefore, we expect the current account deficit to remain less than US$ 3.5 billion.

5.2 Current Account

The current account posted a deficit of US$ 0.4 billion in Q2-FY14, compared to US$ 0.5 billion in the corresponding quarter of FY13 (**Table 5.2**). As mentioned earlier, this improvement came from a rise in home remittances, and a reduction in the trade deficit during the quarter. In overall terms, however, the first half of FY14 posted a much larger deficit compared to the corresponding period in FY13.

Table 5.2: Summary of the Current Account[1]
million US$

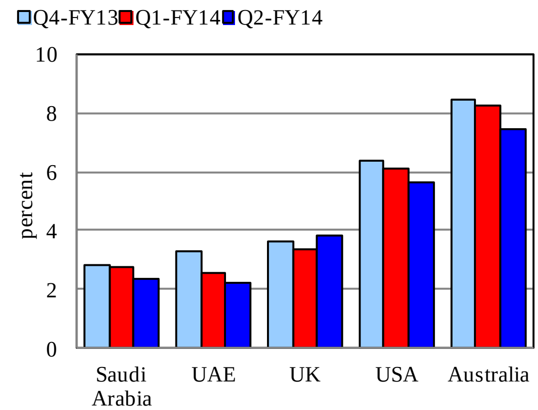
	Q1		Q2		H1	
	FY13	**FY14**	**FY13**	**FY14**	**FY13**	**FY14**
Current account balance	**439**	**-1,206**	**-522**	**-385**	**-83**	**-1,591**
Excl. CSF	-679	-1,206	-1,210	-707	-1,889	-1,913
I. Balance on trade in goods	**-3,625**	**-4,243**	**-4,281**	**-4,047**	**-7,906**	**-8,290**
Exports of goods FOB	6,151	6,275	6,003	6,273	12,154	12,548
Imports of goods FOB	9,776	10,518	10,284	10,320	20,060	20,838
II. Balance on trade in services	**108**	**-890**	**-155**	**-562**	**-47**	**-1,452**
Exports of services	2,173	992	2,058	1,384	4,231	2,376
o/w CSF	1,118	0	688	322	1,806	322
Imports of services	2,065	1,882	2,213	1,946	4,278	3,828
III. Balance on primary income[2]	**-692**	**-809**	**-1,020**	**-1,156**	**-1,712**	**-1,965**
IV. Balance on secondary income[3]	**4,648**	**4,736**	**4,934**	**5,380**	**9,582**	**10,116**
Home remittances	3,599	3,927	3,518	3,863	7,117	7,790
FE-25 deposits	67	125	276	315	343	440

[1]This table is prepared as per the 6th edition of the IMF's Balance of Payments and International Investment Position Manual (BPM-6).
[2]Primary income includes compensation of employees; dividend incomes; reinvested earnings; interest; rent; etc.
[3]Secondary income account shows current transfers between residents and non-residents.
Source: State Bank of Pakistan

[5] In FY13, Pakistan paid US$ 2.4 billion and US$ 2.0 billion for the import of metals and edible oil, respectively.

While trade deficit was higher in H1-FY14 compared to the same period last year, it recorded a YoY decline in Q2-FY14, mainly due to a rise in the country's exports (**Section 5.5**). Imports, on the other hand, were stagnant compared to the previous year. The deficit in services recorded a YoY increase in Q2-FY14, primarily because Pakistan received a smaller amount under CSF during the quarter compared to Q2-FY13.

Figure 5.5: Cost of Sending Remittance to Pakistan



Source: World Bank

A major positive in the current account was the 9.5 percent YoY growth in home remittances during H1-FY14. This increase could be attributed to: (i) an increase in number of Pakistanis working abroad;[6] (ii) the economic recovery in the GCC region; (iii) a decline in the cost of sending remittances (**Figure 5.5**);[7] (iv) increase in the cost of living in Pakistan; (v) continuous tightening of anti-money laundering policies; and (vi) greater involvement of domestic Islamic banks, and other small-sized banks in the remittance business.[8] While remittance growth in Q1-FY14 can be traced to the UK and Saudi Arabia, most of the increase during Q2-FY14 came from Dubai and Oman (**Figure 5.6**).

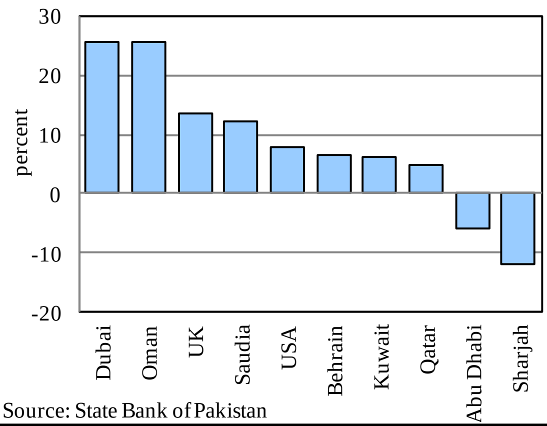
[6] According to the Bureau of Emigration and Overseas Employment, 0.6 million Pakistanis migrated to work abroad during 2013.

[7] Due to stiff competition in the remittance market, money transfer organizations (e.g., domestic commercial banks, Western Union, Money Gram, and Xpress Money, etc.) are striving to attract more customers by reducing transfer charges and exchange margins.

[8] The share of Islamic banks in total YoY *increase* in home remittances during Q2-FY14 was 19 percent, compared to only 3.9 percent in Q2-FY13.

It may, however, be noted that changing dynamics of the labor market throughout the GCC, can potentially weaken job opportunities for Pakistanis and other Asians in this region.[9] On the positive side, Pakistani banks are fast expanding their retail network with Money Transfer Organizations all across the world, to shift remittance inflows to the formal channel. As mentioned in the *First Quarterly Report* for FY14, the largest MTO – Western Union, is now offering free remittance services for Pakistanis for direct money transfers into bank deposits. In addition to this, domestic Islamic banks have also entered the remittances market recently, and are aggressively marketing their products to expatriate Pakistanis. Therefore, we are optimistic about the uptrend in remittances, and expect to meet the target of US$ 15.1 billion set in the Annual Plan for 2013-14.

Figure 5.6: YoY Growth in Remittances during Jul-Dec 2013



Source: State Bank of Pakistan

5.3 Financial Account

Although concerns on the financial account remained in place throughout H1-FY14, these were more pronounced during Q2-FY14 as foreign investments and debt inflows declined (**Table 5.3**).

<u>Foreign investment</u>

Direct investment in Pakistan fell by 26.9 percent YoY in H1-FY14, whereas FDI flows to developing economies posted a recovery.[10] This decline was seen primarily

[9] Presently, foreign workers constitute about 60 percent of the working population in GCC countries. Concern about the need to employ a larger number of nationals in the GCC, is likely to cap (or reduce) migrant workers from Asia. For instance, Saudi Arabia recently launched a crackdown on illegal immigrants, and has also changed the rules of sponsorship. Similarly, in Oman, the government has decided to restrict the share of foreign workers to 33 percent in total employment, from 39 percent presently. This will be done by reducing the wage-gap between public and private sector via increasing the minimum wages in private sector in a phased manner.

[10] Developing economies accounted for more than half of the global FDI in 2013, and reached a new high at an estimated US$ 759 billion. This increase was driven mainly by Latin American, Caribbean and

Table 5.3: Summary of the Financial Account[1]
million US$

	Q1		Q2		H1	
	FY13	**FY14**	**FY13**	**FY14**	**FY13**	**FY14**
Financial account	**406**	**-382**	**156**	**385**	**562**	**3**
Direct investment	**-102**	**-172**	**-419**	**-157**	**-521**	**-329**
Direct investment abroad	23	59	25	28	48	87
Direct investment in Pakistan	125	231	444	185	569	416
Portfolio investment	**-109**	**-107**	**5**	**48**	**-104**	**-59**
Portfolio investment abroad	5	1	17	26	22	27
Portfolio investment in Pakistan	114	108	12	-22	126	86
Other investment	**617**	**-103**	**570**	**492**	**1,187**	**389**
Net acquisition of financial assets	420	-195	624	167	1,044	-28
Central bank	0	0	0	0	0	0
Deposit-taking corporations	285	-190	418	298	703	108
General Government	-4	-2	2	2	-2	0
Other sector	139	-3	204	-133	343	-136
Net incurrence of liabilities	-197	-92	54	-325	-143	-417
Central bank	0	245	-2	0	-2	245
Deposit-taking corporations	-310	-5	-28	-155	-338	-160
General Government	17	-258	312	-113	329	-371
Disbursements	398	525	1,008	690	1,406	1,215
Amortization	381	783	696	803	1,077	1,586
Other sectors	96	-74	-228	-57	-132	-131

[1] This table is prepared as per the 6th edition of the IMF's Balance of Payments and International Investment Position Manual (BPM-6).
Source: State Bank of Pakistan

in Q2-FY14, when FDI posted a fall of 58.3 percent YoY. In our view, the negative perception about Pakistan that can be traced to the on-going war in Afghanistan has compounded the issues of energy availability and domestic security concerns; these together have led to a fall in foreign investment in the country. Nevertheless, the decline in FDI *within* the energy sector is worrisome (**Table 5.4**); in Q2-FY13,

African countries. FDI in BRICS (Brazil-Russia-India-China-South Africa) is estimated to have increased by 20.6 percent in 2013 over the previous year. As far as developing Asia was concerned, the performance of FDI in 2013 continued to diverge: 3 percent YoY growth in South Asia; 2 percent in South East Asia; 1 percent in East Asia; and -20 percent in West Asia – mainly due to political instability in Turkey, which recorded a YoY decline of 15 percent during the year. Within South Asia, India experienced FDI growth of 17 percent in 2013 (Source: Global Investment Trends Monitor, UNCTAD, No. 15, dated January 28, 2014).

there were considerable equity investments in oil & gas, and thermal power companies, which were not present in Q2-FY14.[11] Nonetheless, it is expected that FDI in the energy sector will pick up some pace in the second half of FY14. We take this view because the Ministry of Petroleum and Natural Resources has recently awarded 50 new blocks for oil and gas exploration to eight companies.[12] These include domestic companies, e.g., PPL and OGDCL, and foreign ones including Austria-based OMV Pakistan, and Canada-based Tallahhasse.[13]

Table 5.4: Direct Investment in Pakistan during Q2
million US$

		Inflow	Outflows	Net
	FY13	259.1	46.8	212.2
Energy	FY14	163.3	61.2	102.1
	FY13	378.7	146.9	231.8
Non-energy	FY14	287.1	204.0	83.1

Source: State Bank of Pakistan

Net FX Liabilities

Net FX liabilities declined by US$ 417 million in H1-FY14. This decline was concentrated mainly in the second quarter: in Q2-FY14, net FX liabilities declined by US$ 325 million, compared to an increase of US$ 54 million in Q2-FY13.[14] The decline in net FX liabilities was driven mainly by higher debt retirements by the government, which more than offset weak official disbursements (**Chapter 4**). In Q2-FY14, the government has made larger repayments to the IMF compared to Q2-FY13, on account of budgetary support and emergency and natural disaster assistance (ENDA). As far as disbursements are concerned, the government received only a small fraction of the full-year budgeted FX inflows during Jul-Dec FY14; the remaining inflows are expected to come in the second half of the year.

[11] This investment was in the form of acquisition of new exploration block by Italy-based ENI; and conversion of US$ 50 million debt finance into equity finance by two IFIs in the KE (previously KESC). Earlier, a debt finance of US$ 275 million was provided by the ADB and IFC partly for KE's one of the most efficient power plants, the 560 MW BQPS-II in 2010. As per the financing agreement, the two IFIs had the right to convert up to US$ 50 million of their debt into equity before Dec 31, 2012.

[12] Since the Ministry of petroleum and Natural Resources has recently awarded 50 new blocks for oil and gas exploration, it is expected that the FDI in this sector will pick up in H2-FY14. 21of these blocks are located in Baluchistan, 15 in Punjab, 8 in Khyber Pakhtunkhwa, and 6 in Sindh province. The total area of these blocks is about 103,348 Sq. Kms, which is around 38 percent of the area already under exploration.

[13] Source: http://www.mpnr.gov.pk/gop.

[14] This implies that gross loan disbursements were lower than gross retirements in Q2-FY14, and in net terms, the country has *repaid* US$ 325 million to the rest of the world. In Q2-FY13, there was a net *inflow* of US$ 54 million (net) from the rest of the world. BoP support from the IMF (i.e., SBA and EFF loans) is not included in the Financial Account.

5.4 Reserves and Exchange rate

Table 5.5: Pakistan's Liquid FX Reserves

billion US$

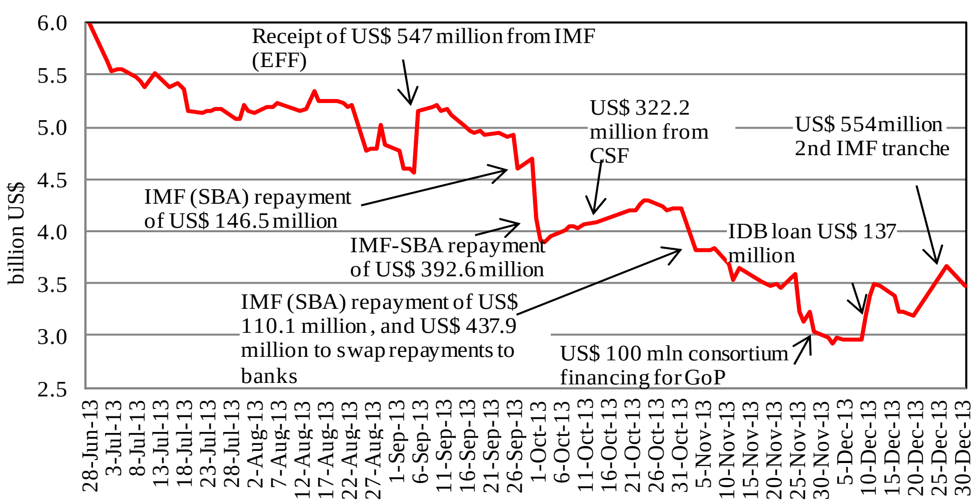
	SBP	Commercial banks	Total	Weeks of imports
Jun-13	6.0	5.0	11.0	14.3
Jul-13	5.2	5.1	10.3	13.3
Aug-13	4.8	5.2	10.0	12.9
Sep-13	4.7	5.1	9.8	12.5
Oct-13	4.2	5.3	9.5	12.2
Nov-13	3.0	5.2	8.2	10.6
Dec-13	3.5	4.8	8.3	10.6

Source: State Bank of Pakistan

The country's liquid FX reserves declined by US$ 2.7 billion during H1-FY14, to reach US$ 8.3 billion at end-December 2013 – a level not sufficient to meet the benchmark 3-months of imports (**Table 5.5**). Since pressure on FX reserves was anticipated, the government had been arranging short-term BoP support from various sources. In this respect, the government was able to arrange a commercial loan of US$ 225 million, of which US$ 100 million was realized in November 2013, and the rest was disbursed after H1-FY14.

Within the banking system, the decline in SBP's FX reserves was more pronounced, since most of the FX pressure came from official payments. In fact, by the end of the first week of December 2013, SBP's reserves fell to US$ 2.9 billion – the lowest level since November 2001. In subsequent weeks, there was some recovery following the receipt of US$ 544 million from the IMF, which shored up SBP's reserves to US$ 3.5

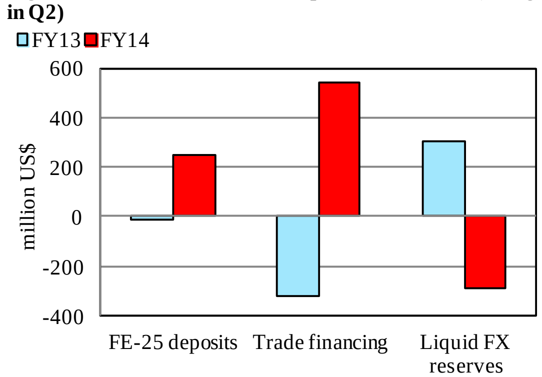
Figure 5.7: SBP Liquid FX Reserves



Source: State Bank of Pakistan

billion (**Figure 5.7**). Encouragingly, SBP's adjusted NIR target for end-December 2013 agreed with the IMF, was duly met.

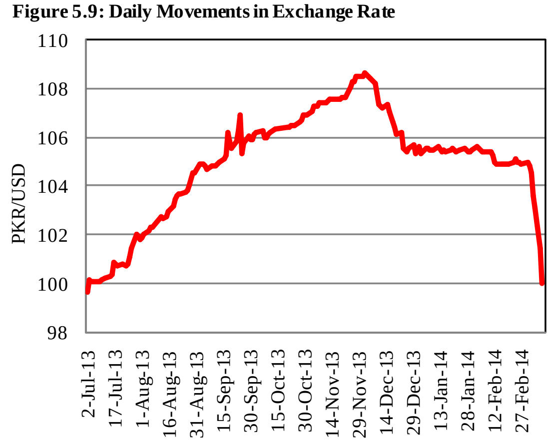
Figure 5.8: Commercial Banks' Liquid FX Reserves* (changes in Q2)



*Calculated as total FE-25 deposits minus FX loans extended for trade financing
Source: State Bank of Pakistan

Commercial banks' reserves also posted a decline of US$ 0.3 billion during Q2-FY14. This decline was due to a sharp increase in FX lending by banks for trade financing, which more than offset the rise in mobilization of FX deposits during the quarter (**Figure 5.8**). A relatively stable PKR was mainly responsible for a revival in FX lending during Q2-FY14, as interest rate differential between PKR and FX lending was slightly lower than the corresponding quarter of FY13. More specifically, local importers were facing an average interest rate differential of 8.2 percentage points during Q2-FY13 between PKR and US Dollar loans; importers could not draw on this margin due to uncertainty in financial flows and PKR trend. In Q2-FY14, although the interest rate differential declined to 7.0 percentage points, the trend in PKR was much favorable, as Rupee appreciation reduced the cost of borrowing.

Figure 5.9: Daily Movements in Exchange Rate



Source: State Bank of Pakistan

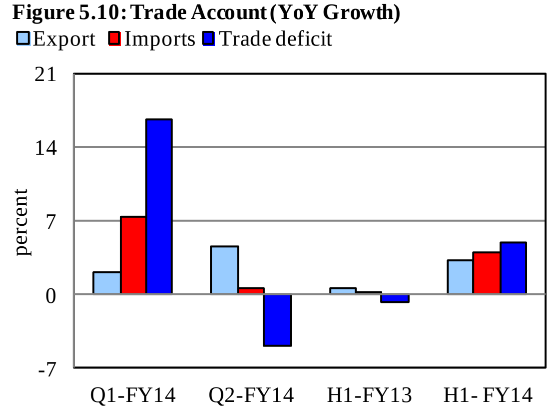
In overall terms, PKR gained 0.7 percent against the US Dollar during Q2-FY14, compared to a depreciation of 6.0 percent in the preceding quarter. This was driven mainly by a surplus in the current account in December 2013, which caused a

PKR appreciation of 3.0 percent during the month. This appreciation more than offset the PKR depreciation during October and November 2013 that had taken the PKR parity to 108.5 (**Figure 5.9**). By the time Pakistan received the second IMF tranche, the PKR had already gained 2.2 percent to settle around 106.15 PKR/USD.[15] After remaining stable throughout January and February 2014, the PKR appreciated significantly in March, following a shift in sentiments in the FX market (**Chapter 1**).

5.5 Trade Account[16]

The trade deficit reached US$ 8.3 billion during H1-FY14, posting 4.9 percent increase compared to the same period last year. This entire deterioration was witnessed in Q1-FY14,[17] whereas the second quarter recorded a 5.5 percent improvement in the deficit compared to the same period last year (**Figure 5.10**). This improvement in the second quarter can be traced to a 4.5 percent YoY rise in exports, which outpaced a marginal 0.3 percent increase in imports during the quarter.[18]

Figure 5.10: Trade Account (YoY Growth)



Source: State Bank of Pakistan

The narrowing of the trade deficit in the second quarter can be traced to: (i) the announced award of GSP Plus status to Pakistan that boosted textile exports, as exporters have been strengthening their business contacts with the EU importers for the last few months; (ii) better international prices of rice were reflected in higher exports; and

[15] The PKR had appreciated by 2.2 percent during the period end-November to 20th December 2013. Pakistan received 2nd tranche of EFF loan in the fourth week.

[16] The analysis in this section is based on exchange record data reported by SBP, which differs from the customs record data reported by the Pakistan Bureau of Statistics.

[17] The deterioration in trade account during Q1-FY14 was mainly due to higher POL imports after the settlement of circular debt that ensured smoother energy supplies, and the increased CNG load shedding for road motor vehicles that raised the demand for motor spirit in the country.

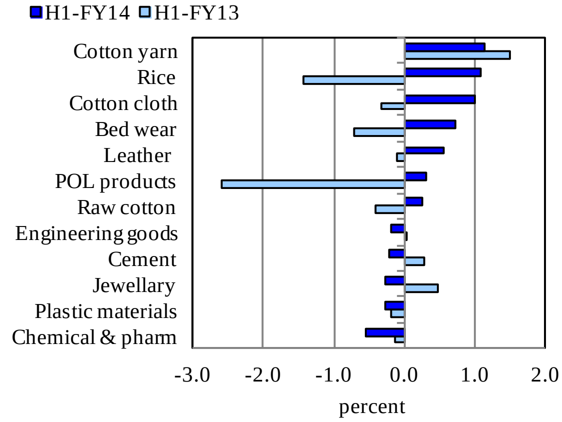
[18] Trade deficit declined in all three months of Q2-FY14.

(iii) a significant decline in crude petroleum and raw cotton imports.

Exports

Exports posted 3.2 percent growth during H1-FY14 compared with 0.6 percent last year. More specifically, export growth was 4.5 percent in Q2-FY14, from 2.0 percent in the first quarter, even though the PKR parity had stabilized in Q2-FY14 compared to the quarter before. The increase in exports during the second quarter of FY14 was concentrated mainly in textiles, while some non-textile categories also recorded decent growth. Major items that recorded an improvement include: cotton yarn, rice, cotton cloth, bed wear, leather, etc. (**Figure 5.11**).

Figure 5.11: Contribution to Export Growth



Source: State Bank of Pakistan

Textiles

Pakistan's textile exports reached US$ 6.9 billion during H1-FY14, posting a 7.9 percent growth over that in the same period last year. Encouragingly, this increase emanated from both low and high value added categories (**Table 5.6**).

More specifically, cotton yarn exports recorded a significant 18.5 percent increase in Q2-FY14, compared to the same period last year. Pakistani exporters are taking advantage of a shift in China's import policy, which is focused on cotton yarn rather

Table 5.6: Textile Exports during H1

	Values in million US$		Contribution to textiles export growth (percent)	
	FY13	FY14	FY13	FY14
Textile	**6,362.8**	**6,866.8**	**100**	**100**
Cotton	86.3	118.0	18.4	6.3
Yarn	1,009.6	1,147.4	-64.4	27.3
Cotton cloth	1,287.3	1,408.9	14.2	24.1
Other textile materials	368.1	350.0	8.7	-3.6
Synthetic textile	234.6	218.1	52.7	-3.3
Knitwear	1,026.2	1,084.6	96.5	11.6
Bed wear	919.3	1,008.1	32.1	17.6
Towels	344.4	361.7	-5.5	3.4
Readymade garments	819.9	868.7	-45.0	9.7
Other made up articles	267.1	301.3	-7.8	6.8

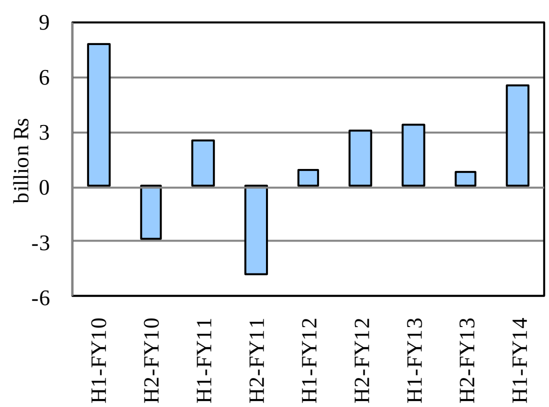
Source: State Bank of Pakistan

than raw cotton. If this trend continues, exports of cotton yarn will continue to show robust growth. Furthermore, duty free access provided by the EU under GSP Plus, bodes well for the entire textile sector. Pakistan mainly exports readymade garments; knitwear and bed wear to the EU, which is the mainstay of the country's textile sector.

According to market estimates, the possible gain to Pakistan's textile exports from GSP Plus lies in the range of US$ 0.5 – 1.0 billion annually. To capitalize these gains, textile exporters have started to increase their capacity, which is evident from the surge in fixed investment loans to the textile sector during H1-FY14 (**Figure 5.12**). Furthermore, the encouraging prospects of the country's textile exports have also attracted foreign investors, particularly from China.[19]

However, Pakistan may not be able to fully reap the benefits of this opportunity due to a number of domestic and external factors. The domestic factors include rising cost of production; low productivity; law and order issues; volatile prices of raw materials; and difficulty in achieving the required market standards. On the external, certain restrictions by the EU to safeguard its industry, could restrict Pakistan's gains from this facility.

Figure 5.12: Fixed Investment Loans to Textile Sector



Source: State Bank of Pakistan

Non-Textile Exports

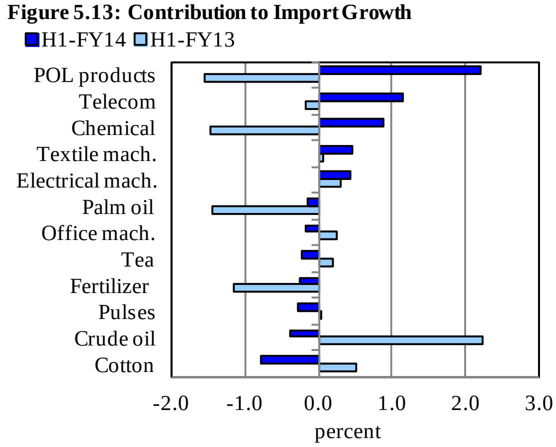
In non-textile exports, *rice* is the major source of foreign exchange earnings. Rice exports recovered strongly after two years and posted 17.6 percent growth during H1-FY14. Both basmati and non-basmati varieties of rice have contributed in this increase.

Leather *(tanned and manufactures)* also contributed significantly to exports growth. The Increase in leather exports

[19] Chinese investors are in the process of acquiring a 52 percent share of a large Pakistani textile company. This company is engaged in the business of manufacturing and export of knitwear and ready-made garments and has a wide customer range including brands like Addidas, Puma, Levis, Dockers, and Reebok.

can be traced to the higher demand from European countries, as our major competitor – China – has moved into high value-added products.

Figure 5.13: Contribution to Import Growth



Source: State Bank of Pakistan

Imports

Imports payments increased by 3.9 percent during H1-FY14, compared with 0.1 percent last year. However, the growth was significantly lower (0.6 percent) in the second quarter as compared with the first quarter (7.5 percent). This stagnation in imports was mainly due to decline in cotton, crude oil, pulses, fertilizers, and palm oil imports (**Figure 5.13**).

The fall in crude petroleum imports can be traced to sharp depreciation in the PKR till early December, and higher inventories which discouraged its imports.[20] On the other hand, import of raw cotton witnessed a significant decline compared to the same period last year because of early arrival of cotton in the market, and better cotton yield, especially in Punjab.

As regards telecom imports, in the run up to the auction of 3G licenses, a surge in telecom imports by cellular companies was already anticipated. Furthermore, textile machinery imports increased, as textile exporters strive to capitalize on improved access to the EU from January 2014.

[20] Crude imports recorded 15.4 percent YoY increase in Q1-FY14.

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:

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

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

   Monthly inflation (π_{MoMt}) = $\left(\dfrac{I_t}{I_{t-1}} - 1 \right) \times 100$

   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) **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 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

[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.

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.*

Acronyms

ADB	Asian Development Bank
BoP	Balance of Payment
bps	Basis Points
BRICS	Brazil-Russia-India-China-South Africa
BTPL	Bahria Town (Pvt.) Limited
CNG	Compressed Natural Gas
CPI	Consumer Price Index
CSF	Coalition Support Fund
DHCL	Dawood Hercules Chemical Limited
DISCO	Distribution Companies
EFERT	Engro Fertilizer
EFF	Extended Fund Facility
EFS	Export Financing Scheme
ENDA	Emergency National Disaster Assistance
EU	European Union
FBR	Federal Board of Revenue
FDI	Foreign Direct Investment
FED	Federal Excise Duty
FEE	Foreign Exchange Earnings
FFC	Fauji Fertilizer Company
FMCG	Fast Moving consumer Goods
FOB	Free on Board
FX/FE	Foreign Exchange
FY	Fiscal Year
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GIDC	Gas Infrastructure Development Cess
GSP	Generalized System of Preferences
GST	General Sales Tax
HIES	Household Integrated Economic Survey
IBA	Institute of Business Administration
IBC	Integrated Business Center
IMF	International Monetary Fund

KE	K-Electric
KESC	Karachi Electric supply company
Kg	Kilograms
KP/KPK	Khyber Pukhtunkhwa
LSM	Large Scale Manufacturing
M2	Broad Money Supply
Mof	Ministry of Finance
MPS	Monetary Policy Statement
MRTBs	Market related Treasury Bills
MT	Metric Tons
MTO	Money Transfer Operator
NADRA	National Database and Registration Authority
NBFC	Non-Bank Finance Companies
NBFI	Non-Banking Financial Institutions
NDA	Net Domestic Assets
NFA	Net Foreign Assets
NFNE	Non-Food Non-Energy
NIR	Net International Reserves
NSS	National Savings Scheme
OECD	Organization for Economic Co-operation and Development
OGDCL	Oil & Gas Development Company Limited
OMOs	Open Market Operations
OMV	Österr Mineralöl Verwaltung (Austrian Mineral Oil Administration)
PARL	Pak Arab Refinery Ltd
PBS	Pakistan Bureau of Statistics
PIA	Pakistan International Airline
PIB	Pakistan Investment Bond
PKR	Pakistani Rupee
PPL	Pakistan Petroleum Limited
PR	Pakistan Railways
PSDP	Public Sector Development Program
PSEs	Public Sector Enterprises
PSM	Pakistan Steel Mill
PSO	Pakistan State Oil

rhs	Right Hand Side
Rs	Rupees
SBA	Stand-by Arrangement
SBP	State Bank of Pakistan
SCB	Standard Chartered Bank
SRO	Statutory Regulatory Order
T-bills	Treasury Bills
T & D	Transmission & Distribution
UAE	United Arab Emirates
UK	United Kingdom
UNCTAD	United Nations Conference on Trade and Development
US/USA	United States of America
USD	US Dollar
WAPDA	Water and Power Development Authority
YoY	Year on Year
3G	3RD Generation