

## **Pakistan - Economic Outlook and Prospects<sup>1</sup>**

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Economic turnaround of Pakistan has been remarkable and impressive. This is more obvious if one keeps in perspective

- (i) the context of the pre-2000 scenario when un-sustainability of macroeconomic imbalances and debt threatened medium term economic prospects;
- (ii) the fact that achievements and gains have been realized in the midst of economic complications caused by high oil prices, growing global and regional competition both for investment and trade and the fiscal consequences of the earthquake that rocked north-Pakistan in 2005; and
- (iii) that Pakistan opted to graduate from IMF's structural adjustment program and has since designed its own economic policies, steered their implementation and addressed effectively emerging challenges.

Aside from reducing and restructuring its external debt in a short period, the Government's resolve to unleash Pakistan's real economic potential has, within a period of 4-5 years, strengthened the country's fundamentals and has improved its medium term economic outlook and prospects. Sequentially, I propose to discuss:

- (i) key features of this success story
- (ii) structural reforms that have helped this turnaround
- (iii) medium term economic prospects and challenges

### **Economic Turnaround: Its Key Features and Structural Shifts**

FY05 was a record year for Pakistan. Its economic growth at 8.6% surpassed the average economic growth of 8.2% recorded for emerging Asia. Backed by significant across the board growth in all productive sectors, this growth has been primarily consumption led. Aggregate demand pressures were at an all time high as the per capita income grew and public had easy access to low interest credit for almost 4 years in a row. Four fold increase in remittances inflow since FY01 also contributed to strong demand. Pakistan's growth has trickled down as the poverty head count ratio declined to 25.4% relative to 32.1% in 2001 and the unemployment rate also declined to 6.2%.

The macroeconomic imbalances remained at manageable levels despite fiscal pressures, and the external current account registered a deficit relative to surpluses achieved in the preceding year. The higher aggregate demand manifested itself in the build up of inflationary pressures and CPI rose to 9.3% in FY05 –more than double the average inflation rate recorded in the preceding 4 years.

Prudent economic management has helped change the dynamics of external debt since FY00. Pakistan's external debt and liabilities fell by \$ 1.3 billion – down from \$37.9 billion in FY00 to \$ 35.8 billion by end-FY05 as it prepaid expensive debt and a part of debt was written off. The combined effect of this debt reduction and greater prudence in fresh

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<sup>1</sup> Speech delivered at the Adam Smith Institute at Thun, Switzerland, on June 27, 2006.

borrowing coupled with GDP growth, helped reduce the external debt and liabilities/GDP ratio to 32.5% by end-FY05 relative to 51.6% in FY00, and external debt and liabilities as a %age of foreign exchange earnings declined to 134% relative to almost 300% in FY00. Aside from the decline in external debt, the external debt burden also fell as a consequence of the real cost of borrowing. With the pace of foreign exchange earnings gaining momentum, the country's debt carrying capacity grew. At the centre of all these developments was the pursuance of prudent monetary, fiscal and exchange rate policies.

Against this background, S&P has revised its outlook on Pakistan: B+/Positive/B to B+/Stable/B for foreign currency, while keeping BB/Stable/B rating for local currency. Pakistan returned once again to the international capital markets earlier this year and the sovereign bond issue was oversubscribed. This reflected investor appetite for long term sovereign paper which was tightly priced relative to the earlier two issues: a \$500 million 5-year Eurobond in February 2004 which was priced @6.75% implying 370 bps spread over US Treasuries and a Sukuk for \$ 600 million issued in January 2005 carrying a yield of 220 bps over the six-month LIBOR. The benchmark set for Pakistan sovereign paper is expected to help Pakistan's firms with stronger balance sheets to turn to the international capital markets for raising their financing requirements. This has already been contemplated as the Oil and Gas Development Corporation plans to float a Global Deposit Receipt soon.

## **Enabling Policies**

**Fiscal Responsibility :** To promote fiscal stability and sustainability, the Government promulgated the *Fiscal Responsibility and Debt Limitation Act 2005* in June 2005 which encourages a steady reduction in revenue deficit to nil by 30th June 2008 and maintaining it thereafter and reducing the total public debt to sixty % of GDP by 2013 and below that limit thereafter.

Sound fiscal management helped Pakistan reduce its overall fiscal deficit, from an average of 7% of GDP in the 1990s to around 4% in recent years. Although the deficit levels are higher than what is desirable this reflects the strains of (i) the recent loss to the budget of the Petroleum Development Levy (PDL) as the oil price increase has not been passed to the domestic consumers, (ii) the low tax/GDP ratio, even though tax collections in nominal terms have been higher, and are expected to support a modest increase of 0.4% in the tax/GDP ratio for FY07, (iii) higher transfer to provincial governments, (iv) unforeseen spending on earthquake, and (v) determination of the Government to raise both infrastructure and social expenditures which for some time were not raised in real terms.

Despite these fiscal strains, key structural changes are notable. Aside from near elimination of the revenue deficit, prudent fiscal management has helped reduce the share of interest payments in the total outlay from 33% in FY02 to 17.6% in FY05 – a 15 percentage points decline in just four years. This in turn helped achieve primary surplus. In wake of these developments the public debt burden continued to decline to 62.5% of GDP from 84% in FY00. Over the medium term, greater fiscal sustainability can only be achieved if there are more substantive tax reforms which extend the tax base beyond the corporate and professional tax payers. It is with this intention that the Government has now started to tax the financial services industry, though the agriculture sector and other services remain outside the ambit of the tax regime.

**Monetary Policy** now for some years has been largely supportive of the dual objective of promoting economic growth and price stability. It achieves this goal by targeting monetary aggregates (broad money supply growth as intermediate target and reserve money as operational target) in accordance with real GDP growth and inflation targets. The fiscal responsibility legislation and central bank's mandate to formulate, conduct and implement its monetary policy combined to somewhat help reduce the fiscal subservience of monetary policy. With the rising inflationary pressure in FY05, the central bank raised its discount rate by 1.5% to 9% in April 2005 and maintained its tight monetary stance by conducting frequent Open Market Operations (OMO) to manage liquidity, while minimizing the volatility in overnight rates. The policy stance has yielded results as headline CPI has reduced by 1.4% to 7.9% in FY06, in line with the annual target of 8%.

Like other developing countries where transmission mechanisms are not immediately obvious or efficient, it takes well over a year or more for high interest rates to curb the credit growth. Thus far while credit growth has decelerated, it remains fairly robust as demand pressures from both public and private sector remained high during the course of the year.

Consequently, it is no surprise that while food CPI decelerated as the Government eased constraints by allowing imports of essential products (sugar, cement and selected pulses) and enhanced its distribution mechanism, the core inflation (excluding volatile components of CPI i.e. food and energy) is 7.1% for FY06. Although the rate of pass-through from the higher prices of energy and other commodities to core consumer price inflation appears to have remained relatively low, the cumulative increases in energy and commodity prices have been large enough to account for the recent inflationary pressures in core CPI.

Anecdotal reports suggest that the labor market in Pakistan is tight. While labor productivity remains low, the wage increases will generate additional pressures. Over the medium term, managing inflationary expectations and perceptions and designing an appropriate monetary stance, which aligns economic activity with the economy's productive capacity, will remain a challenge.

**Financial Sector Reforms :** Consistent with trends observed in growing Asia, structural changes in financial markets have been remarkable and significant. First, a word on the financial sector's scope and scale :

- Financial assets grew by 70% over the past five years and in CY05 reached Rs 5.1 trillion (\$ 85 billion), equivalent to 80% of GDP;
- The banking sector grew at a faster pace relative to non-bank sectors and accounts for 71% of the financial industry assets;
- Market capitalization of the stock exchange grew steadily and recently peaked at 44% of GDP relative to 10.3% in June FY00;

Latest Financial Sector Assessment for Pakistan and the Banking Sector Review 2005,<sup>2</sup> which will be released by July 2006, together lend comfort that:

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<sup>2</sup> Annual publications of State Bank of Pakistan

- (i) Banking sector profitability (after tax), at over \$1 billion, is at an all time high and the return on assets (after tax) increased to 1.9 % in CY05<sup>3</sup> from 1.2 % in CY04; surpassing the relevant international benchmark. The rapid growth in profits also resulted in considerably higher return on equity (after tax), which improved to 25.8 %<sup>4</sup> from 20.3% in CY04.
- (ii) Falling NPLs to loans and net NPLs to net loans ratios improved to 8%<sup>5</sup> and 2.1%<sup>6</sup> in CY05 respectively.
- (iii) With strong profits, declining NPLs and fresh capital injections, the solvency position of the banking system strengthened further. Capital adequacy ratio (CAR) increased to 11.3 %<sup>7</sup> from 10.5 % in CY04.
- (iv) Despite losing some momentum in FY06, the overall performance of the corporate sector, which is the major user of banks' funds, remained satisfactory.

While the banking system has grown significantly in strength, credit growth in a high inflation and a rising interest rate environment could pose a potential risk if the debt burden on banks' borrowers exceeds their capacities and potentially erodes their repayment capacity. So far, the exposure and default rates on advances to the consumer, SME and agriculture sector has been manageable as the risk management systems within banks have improved significantly. Greater disclosure requirements, strengthened corporate governance structure and Credit Information Bureau, which now provides access to the credit reports of all borrowers, irrespective of the loan amount, are all effective risk mitigants.

Pakistan is now embarking on the next phase of financial sector reforms which would focus on :

- (i) Further consolidation and restructuring of the banking sector;
- (ii) Strengthened risk management;
- (iii) Developing capacities to cater for unmet requirements of special segments of the economy and diverse needs;
- (iv) Diversification of the financial sector by further development of the securities and debt markets, which while fairly vibrant, need to play a more significant role in meeting the country's financing requirements; and
- (v) Promoting financial product innovation.

**Trade liberalization** has been underway steadily. With lifting of quotas and abolishment of several special and industry specific regulations, all goods are today freely importable and protection granted in the past to the domestic industry has been lifted. Maximum tariff rate has been reduced from 120% in 1985 to 25% since FY01 and tariff

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<sup>3</sup> 1.7% for Q1-CY06

<sup>4</sup> 21.5% for Q1-CY06

<sup>5</sup> 8.1% for Q1-CY06

<sup>6</sup> 1.9% for Q1-CY06

<sup>7</sup> 11.6% for Q1-CY06

bands have been reduced from 42 to 4. Almost half of the imports enjoy zero to 5% tariff and the simple average tariff is now only 8.5% on dutiable & exempt imports taken together and the SRO regime has been reduced to a bare minimum.

The trade policy aims to promote exports, which despite reaching \$16.5 billion in FY06 relative to averages of \$7-8 billion over early FY00, have to make more inroads to raise their share in world markets. Pakistan is launching a stronger drive to revive its exports which can only grow on a sustainable basis if there is (i) sufficient surplus to export, (ii) if there is product, sector and geographical diversification combined with value addition through capacity building and enhancement, (iii) textile industry which contributes close to 60% of export earnings positions, repositions itself to withstand new competitive forces emerging in the post quota regime, and (iv) the cost of infrastructure, which is still suffering from bottlenecks, is improved.

## **Medium Term Economic Prospects and Challenges**

**High growth rates can be sustained** Pakistan being at the crossroads of one of the ancient trade routes of the world and being richly endowed with natural resources has enormous potential and has shown increased resilience to withstand economic shocks both domestic and external. The economy is set to grow at around 7% in FY07. In FY06, despite set backs to agriculture and the industrial sector, the buoyancy in the services sector helped real GDP to grow by 6.6%. Structural changes underlying the real sectors, albeit slow, are emerging.

In agriculture, it is worth mentioning that Pakistan attained self sufficiency in major crops a long time back. Notwithstanding, disruptions in production are inevitable given the uncertain weather conditions as well as low yields which require far reaching efforts in research and extension and appropriate use of inputs that have benefited from the rise in agriculture credit and fertilizer input use. More exploitation of water resources is critical to ensure timely supplies of water. In agriculture, significance of livestock, poultry and dairy products is visible and encouraging. The former accounts for 46.8 % (FY05) of agricultural value added and about 10.7 % of the GDP, while providing livelihood to one third of the population, and the latter produces 28 billion liters of milk a year, whose value is more than that of the combined value of wheat and cotton.

Although the manufacturing sector grew at 18% and 15% respectively in the preceding two years, decline in its growth rate is notable. The performance of this sector is impacted by some of the structural issues typical of Pakistan's manufacturing sector. Manufacturing sector is now beginning to slowly diversify and modernize itself. Presently, almost three-fourths of the production stems from the large-scale manufacturing sector. The key contributor is the textile and apparel group, though chemicals, petroleum, engineering, tyres and tubes, fertilizers, cement, and automobile and durable white goods are adding capacities and are likely to boost industrial production. SME Policy and enhanced flow of credit for this segment would eventually enhance the linkages of this sector.

**Macroeconomic Sustainability.** After a consistent reduction in macroeconomic imbalances over FY00-04, the fiscal and external current account deficits have been above targeted levels for FY06 and are likely to be in that range in FY07. Most notable is the

concern regarding trade deficit that is to range around \$8.2 billion in FY06.<sup>8</sup> Almost 45% of the increase in trade deficit for FY06 stemmed from the rise in import bill for crude oil and petroleum products.

Demand pressures are likely to grow further as the Government accelerates social and infrastructure programs, and segments of population and businesses benefit from the FY07 fiscal package. Infrastructure sector programs, while ambitious, are absolutely needed as businesses are set to grow, capacities are being enhanced, new industries and sectors are being opened up and development of industrial parks and additional EPZs are in the offing.

After a span of price stability, Pakistan continues to face inflationary pressures that emerged in late 2004 in response to an accommodative monetary policy. Thus far effective monetary management and administrative measures to ease product supplies have controlled inflation which is now well within single digits. With demand pressures expected to grow, SBP will continue to pursue monetary tightening but there will be need to strike an appropriate balance between promoting economic growth and price stability. Over the medium term, Pakistan is well positioned to deal with these emerging trends effectively.

**While the consumption demand would remain high, there are strong indications that investment has picked up** -- though perhaps not fully captured by national accounts statistics. Rising investment demand is confirmed by: **First**, the rise in gross fixed capital formation over the last two years by 29.6% in nominal terms and by about 9.8% in real terms. This has raised investment levels to Rs 1.42 trillion, equivalent to 20% of GDP and is likely to result in a reversal of the declining trend observed in the preceding years. Private investment accounts for two thirds of the gross fixed capital formation. **Second**, the rise in imports, which, excluding crude and POL products, grew by 35%. **Third**, the rise in private sector credit which, while decelerating, still grew by 19% in FY06 despite rising interest rates. **Fourth**, foreign direct investment flows, excluding privatization proceeds, also contributed to the rise in investment. **Finally**, high corporate profits have largely been reinvested in industry and there is a high degree of self financing taking place.

Furthermore, the Government is confident that all spade work undertaken in the last few years will now pay off as approved or lined up industrial and infrastructure investments take off. The Medium Term Development Framework (MTDF) anticipates a rise in the investment/GDP ratio of 20.7% by 2010. Early indications are that both domestic and foreign investors are upbeat about the future prospects, and there are already investment commitments lined up from Gulf states. During its economic transition, Pakistan will have to develop capacities to tolerate and finance the required level of trade deficit as fresh investments will bring in additional import demand. Over this period, leveraging non-debt foreign flows will be critical to finance and sustain the external current account deficit.

Growth prospects for Pakistan are fairly promising. Sustainability of investment trends would, among others, depend on Pakistan's success in improving the business climate by removing investment constraints, continuity in financial reforms coupled with strong vigilance of credit growth, and success in curbing inflationary pressures and tendencies within manageable levels. The World Bank report 'Doing Business in 2006' has placed Pakistan amongst the leading economic reformers of the world and the top one in South Asia. For foreign businesses, investing in Pakistan not only facilitates production but also provides

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<sup>8</sup> As reported by Statistics Department, State Bank of Pakistan

opportunities to export to the Middle East, and Central and South Asian markets. To attract investment, Pakistan has fully liberalized its incentives framework. All economic sectors are open to foreign investment, foreign investors are allowed to hold 100% foreign equity in all economic sectors, barring very few exceptions, and there is equal treatment given to local and foreign investors with flexibility to easily remit Royalty, Technical & Franchise Fee, Capital, Profits, Dividends etc. No Government sanction is required for setting up any industry, in terms of field of activity, location, and size. Tourism, housing and construction sector, computer software and information technology (IT) have been declared as industries and provided a set of tax incentives.