

Pakistan: Economic Outlook and Perspectives

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Let me start off, by first thanking the Federation of Pakistan Chamber of Commerce and Industry (FPCCI) and its office bearers and other members for inviting me at FPCCI.

The economy of Pakistan continues to perform well. This is commendable given the political noise in the country and the growing challenges in international economic and financial markets. 2000 onwards by and large world economy enjoyed a fairly benign economic environment. However it is now certain, more than in the last few weeks that financial and economic vulnerabilities have grown across the world and is likely to impact global outlook. Upfront it has to be acknowledged that despite these adverse developments by all accounts the world thus far has persevered recent shocks quite well given that underlying financial health and macroeconomic fundamentals of both advanced and emerging economies were quite strong.

Among the key factor impacting global economy is the financial market turmoil. It originated in U.S Subprime mortgage markets in 2006 but spread with incremental speed from June 2007 into the money markets and transcended boundaries hitting Europe and other economies and resulting in unprecedented liquidity crisis in advanced financial markets as manifested by the rising spreads in credit markets. Financial and economic costs of this episode are still being unfolded but are large. It has already caused US and Europe central banks to inject liquidity and prompted losses of close to \$300 billion in US subprime markets (of \$1.2 trillion). The losses are bound to further rise as interest rates resets on these transactions hit the borrowers further. Furthermore, profitability of a number of large and strategic commercial banks has been lowered as banks had to write off and provision for the losses on their own balance sheets of sub-prime and other asset backed commercial paper as well as assume loss making off balance sheet transactions, while rescuing structured vehicles and/or troubled affiliates. The financial market turmoil has impacted private equity and debt markets where spreads have risen. The problems of subprime mortgages market are now well acknowledged to drag the housing sector of U.S and its growth.

Additional risks which cloud global economic prospects are rise in inflationary pressures given volatile oil markets and rise in commodity prices going beyond precious and industrial metals to foods such as wheat, soybean oil and palm oil that have reached record highs during 2007. Weakening dollar has further amplified the oil price surge. Combined with financial turbulence this is now inducing investors to diversify away from dollar denominated financial assets to commodities – this second round impact carries risks of magnifying the inflationary pressures.

With this backdrop, I propose to provide briefly Pakistan's economic update attempting to lay down some emerging trends for FY08 which require stronger vigilance at economic policy making level and industry and private sector to be more responsive. In general, it has to be underscored that despite domestic and international events, Pakistan economic prospects remain strong.

Barring impact of international commodities prices which I will discuss shortly, Pakistan financial markets have remained by and large insulated from the financial market turmoil as it did not have exposure to mortgage or other asset backed securities. The external sector which has thus far been manageable could however see some spill over impact of US slow down if it turns out to be more severe.

Notwithstanding this conjecture, some emerging trends could have implications for economic outcome of FY08. On production side, growth is likely to be impacted by setback to two major crops i.e. cotton and rice as they were hit by pest attacks and other problems. Part of the agriculture crop shortfalls could be offset by the higher than expected other crops, for instance sugarcane harvest is likely to touch new high level of 62.3 million tons – up by 13.5% relative to last year.

July-October 2007 data for industrial production while preliminary reflects mixed picture. Production growth in construction related industries appear reasonable including cement, wood, paints and varnish units, followed by fertilizer, pharmaceuticals, petroleum refining and few metal and engineering good. In these sectors, Pakistan can reduce rate of import dependency (such as petroleum refining where production capacity is 13.2 million tons relative to consumption which is 18 million tons) through capacity augmentation and even consider exploiting export markets. In contrast to some of these sectors, first quarter results of some industries reflect slower growth. For instance deceleration in cotton yarn and cloth, which has a weight of 20.6% in large scale manufacturing value added, and footwear, automobile, edible oil and vegetable ghee is evident. While demand remained strong, slowdown in manufacturing sector emerged because of combination of reasons including demand for import substitutes (as Government relaxed imports of automobile), slowdown in export demand and increase in raw material prices such as palm oil which recorded 73% growth in value of imports.

Both local manufactures and the Government need to take measures to improve competitiveness of domestic goods. Ensuring quality through innovation, skill development and technological up-gradation, reducing costs through scale, diversifying product-line in line with the market demand, and achieving self sufficiency in raw materials etc. are some of the areas where entrepreneurs need to concentrate. Adversities in production sectors is however likely to be offset by the continued buoyant performance of services sector which accounts for over half of value added of GDP.

Down turn in inflation, despite its slippage from target, was notable in FY07 relative to trends in preceding couple of years. However, surge in food prices is visible. Consumer price index (CPI) rose to 9.3% in October 2007 on YoY basis mainly due to a jump in food-CPI by 14.7% on YoY basis. Seasonal factors such as Ramazan, higher international food prices, and domestic supply shortages contributed to the pressures on food-CPI.

Consequently divergence between headline and core inflation grew; core inflation which came down to almost 5% in May 07 and remained below average inflation forecast of 6.5% has shown signs of picking up. Pressure on core inflation reflect (i) the lingering impact of significant growth in monetary expansion in the last few weeks of FY07 as was predicted in the Monetary Policy Statement of July 2007 and (ii) the second round impact of food prices.

As inflationary pressures mount, debates on effectiveness of monetary policy on inflation are triggered afresh. Central bank is undoubtedly able to more directly impact core inflation and evidence in FY06-07 has shown that monetary policy has paid dividends in bringing down core

inflation. Higher non-core inflation penetrates economy in different ways (i) it impacts consumer purchasing powers since cutting down essentials is difficult and there is low price elasticity of food and energy, (ii) even if the Government delays the direct pass through of energy prices to consumers, businesses often pass through immediately higher costs of energy on to their consumers, and (iii) with inflationary trends persisting consumers and producers higher inflationary expectations set in trends too. Higher inflation expectations have become self fulfilling as they have impacted wage setting and pricing decisions now.

Inflation currently is a global phenomena and driven largely by commodity price trends both in energy and food. Inflationary pressures are likely to persist as international wheat prices are up by 50-60% because of Australian drought, low world stock and continued high demand. Similarly palm oil prices are up by 94% in international markets and soybean by 57% due to low production, rising consumption and its application for feed and energy uses. In the same way, prices of milk and its products have risen by almost 100% in some markets because of reduced EU subsidies, short global supplies and rise in consumption.

Inflationary pressures could rise, since fiscal imperatives now demand for Government to pass through the impact of the recent oil prices that reached close to \$100 bpl in international markets. The direct effect of the recent oil price rise on headline inflation in the United States is estimated to be around ½ percentage point by the end of the year.

But for the tight monetary policy that curbed demand pressures and kept core and headline inflation in check, inflationary trends would have been more significant in Pakistan. However, SBP may find that it has less room for maneuver if the higher fuel costs have second round effects on other prices and wages.

Macroeconomic sustainability during the course of inflationary period is critical. July to early November data reveals that money supply is growing at 3.2% (compared to 2.5% in July-Nov FY07), and at 20.1 percent on YoY basis largely because of the pressures of Government borrowing and improvement in net foreign assets (NFA). M2 growth is still manageable given that in the first 5 months, private sector credit demand grew slower than preceding year.

Fiscal pressures appear to be strong as the Government despite higher receipts from the National Savings Schemes and the Pakistan Investment Bonds, has resorted to central bank borrowing. The Government budgetary borrowings from the banking system during July-10 November 2007 rose by Rs 146 billion compared to Rs101 billion over the corresponding period in 2006. Recent requirements have meant higher recourse to the central bank borrowing which is infusing pressure on core inflation.

Abstracting from medium term challenges, the external current account deficit over July-October, 2007 has reflected modest level of contraction over the last year. Trade deficit remained high but did benefit from export pick up (though growth remained below FY04-06 trends) import compression and was financed by the continued growth in remittances by 22%. During July-October 2007, Pakistan recorded a surplus of \$3.2 billion in the capital and financial account compared to \$2.8 billion last year.

Most of the surplus emerged from debt flows as the equity flows were impacted by outflows in SCRA restricting the net inflow to US\$ 124.4 million during July-21 to November 2007 and postponement of launching of new privatization. Given the commitments in pipeline, momentum in foreign flows will pick up further in the last quarter supported also by the floatation

of global deposit receipts whose timing is now coordinated with the settling of domestic scenario and world financial markets which currently exhibit high spreads.

Strong economic activities along with increasing foreign exchange flows have resulted in visible changes in the foreign exchange market in recent years. In FY07, the foreign exchange market grew substantially in both capacity and volumes. Market volumes of foreign exchange transactions grew steadily during the year, and reached US\$ 68.5 billion in Q4-FY07, compared to US\$ 55.4 billion during the same period last year.

SBP took a number of initiatives in response to the changing market dynamics. The business hours for the foreign exchange market were extended in January 2007, thus enabling the banks to cater to their customers' needs more effectively. In addition, the bases for calculating Foreign Exchange Exposure Limit (FEEL) of banks was revised from 10% to 15% of their paid-up capital in March 2007, which increased the overall exposure limit of the commercial banks from US\$200 million to approximately US\$325million, thus facilitating banks to more effectively manage and price large volume transactions for their customers.

The USD/PKR Exchange Rate continued to be market-determined, and any market intervention is always aimed at moderating the rate of change or diluting any excessive volatility in the exchange rate, rather than establishing any level for it. SBP as a policy doesn't target any specific exchange rate level and the rate is driven by prevailing demand and supply conditions.

The stability of the exchange rate, though with healthy two-way volatility, has helped bring more confidence to the international investors to attract long-term investment into the economy as well as to our local corporate to amicably price their goods & services. On the current FY'08 YTD basis, PKR showed marginal weakness against the USD with a point-to-point nominal depreciation of about 1.28% as compared to depreciation of 0.25% and 0.97% in the last two fiscal years.

The PKR was amongst the few currencies of the region, which depicted a marginal depreciation, compared to number of other regional currencies such as Indian Rupee, Thai Baht, Malaysian Ringitt, and Chinese Yuan gained significant strength against USD during the period. Hence in relation to the regional currencies PKR weakened significantly which brought price competitiveness to our exporters.

	PKR	INR	BDT	LKR	MYR	CNY	THB
CURRENCY	PAKISTAN	INDIA	B' DESH	S' LANKA	MALAYSIA	CHINA	THAILAND
% Δ FY 08 ¹	-1.28%	2.58%	0.73%	0.88%	2.78%	2.81%	1.58%
% Δ Since June 06	-0.82%	14.62%	-0.18%	-7.85%	8.96%	6.31%	16.77%
% Δ FY 07	-0.25%	11.54%	-1.28%	-7.20%	6.05%	4.75%	17.06%

1 Up to Nov 26, 2007

* -ve % shows depreciation against USD, +ve show appreciation against USD

To continue providing stimulus, SBP has facilitated banks liquidity management by regular and effective auction and open market operations. The rise in discount rate in July 2007 helped sterilization of foreign inflows that in June 2007 alone shot to Rs 214 billion and added 5 percentage point to monetary expansion. Weekly weighted average overnight rate remained within the interest rate band on two percentage points over July-November 2007 and below the discount rate. In the first few months, the demand for credit was low but because of a variety of factors including seasonality and timing of crop procurement, wait and see attitude for new investments, and banks positioning themselves to develop their systems in wake of growing

defaults in selected sectors particularly consumer financing and agriculture where lending did grow exceptionally.

However credit for private sector is gaining momentum, as it has started to pick up since the last week of September 2007. First, there is substantial room for banks to lend as credit-deposit ratio is around 60-65% and liquidity position of banks is eased by OMOs as and when required. Second, private sector IPPs are now maturing for drawdown of credit. Third, banks that had slowed down because of merger and acquisition activity such as Standard Chartered Bank and ABN Amoro are likely to regain their credit growth activity with more vigour. Fourth, companies which met their demand from external borrowings are likely to revert to domestic markets given the widening of spreads overseas. Finally, banks are now provisioning for loan losses which remain manageable. With these developments private sector credit is expected to gain momentum.

Growing liquidity and competition forced banks to lend close to and in some instances below KIBOR and overall there was softening of lending rates. Resultantly, the benchmark KIBOR has also shown rationalization and 6-month KIBOR has registered a decrease of 61bp on a Y-o-Y basis and is currently around 10.0%, despite the increase in Discount Rate by 50bp. Banks have also been responsive on deposit side to the central bank calls. In November, Pakistan Banking Association announced a consensus view of the industry to raise deposit rates for saving accounts to minimum of 4% and also prior to that there have been series of announcement of new products for investors holding certain balances with commercial banks. These measures along with the zero CRR for long dated deposits and moral suasion of central banks has resulted in growth in share of time deposits and rise in weighted deposit rates by 181 bps on fresh deposits / 157 bps on outstanding deposits, relative to December 2005.

SBP has further been facilitating both the export and long term refinancing. The outstanding funds provided by the State Bank and banks to Exporters at 7.5% reached Rs132 billion as on 3-11-2007– which is higher than last year's trends. SBP has honoured applications for around Rs 6.8 billion LTFEOP contracted prior to July 2007. At the same time, it announced the implementation of 3% interest rate subsidy for spinning sector and continued to pay R&D support expeditiously which has now reached Rs25 billion on a cumulative basis since its introduction and SBP disposed off almost 270,000 cases of it. The scheme for Long Term Financing Facility will be operationalized in January 2008 as soon as the details of its workings have been well understood by the commercial banks. This is a broad based facility which will make available long term credit for fabric, garments, made up, towels , rice processing, leather & Leather garments, sports goods, carpet & wool, surgical instruments in the core categories, and fisheries, poultry & meat, engineering goods etc in the developmental categories of industrial sectors and is expected to finance both domestic and imported plant and machinery equipment for all exporters reporting exports of Rs 300 million annually or fifty percent of their production capacity whichever is lower. In order to facilitate matters banks are now allowed to make advance payments upto 100% of fob or cfr value of goods against firm registered contracts and LCs. Exporters are allowed issuance of bill of lading on document acceptance and document payment basis and also can retain 10% of export proceeds in the foreign currency accounts.

In conclusion, our economic assessment and support for industry should help provide for clear direction of economic trends and expectation, while positioning industry to plan its futuristic investment in accordance with market incentives.