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Economy shows signs of improvement as fiscal discipline improves: SBP Report

Pakistan's macroeconomic indicators have started to show improvement due to disciplined implementation of the macroeconomic stabilization program as a result of which aggregate demand has seen a meaningful contraction, according to the Second Quarterly Report of the State Bank of Pakistan on the State of Economy released today.

The Report pointed out that demand pressures in the economy are easing due to improvement in fiscal discipline which has complemented a tight monetary policy. "This has improved prospects for low inflation; while inflation is still very high, there is an expectation that it will decelerate sharply in the final quarter of the fiscal year," it added.

The Report further pointed out that there is a distinct improvement in the external sector, with a fall in the cumulative July-February period of 2008-09 fiscal year (FY09) trade deficit, which is the first reduction for this period in seven years. The narrowing trade deficit and robust remittances have also engineered a reduction in the current account deficit, allowing for a buildup of the country's foreign exchange reserves, it added.

The Report said that it is hoped that a continued compression in the imports, principally attributed to weakness in domestic demand and lower import unit values will reduce the current account deficit, allowing Pakistan to build-up foreign exchange reserves.

It projected that during the current FY09 fiscal year, the country's economy is likely to expand between 2.5 percent to 3.5 percent and annualized inflation is expected to be around 19.5 percent to 20.5 percent whereas overall fiscal and current account deficits are likely to be between 4.3 percent to 4.7 percent and 5.8 percent to 6.2 percent of the GDP, respectively.

The Report said the fiscal consolidation has been a major priority under the macroeconomic stabilization agenda for FY09 which seems to be having an impact as the fiscal deficit for the first half of FY09 is estimated to have dropped to 1.9 percent of projected annual GDP compared to 3.4 percent in H1-FY08. "The fiscal deficit for H1-FY09 thus appears to be in line with the annual target set in the budget FY09 as well as that agreed with IMF under the Stand-By Arrangement," it added. The fiscal improvement thus far has largely been brought about by elimination of oil subsidies and a cut in development spending.

Similarly, the Report pointed out that after a sharp deterioration in July-October period of FY09, overall external account balance improved noticeably in the ensuing months, aided by a sharp fall in the current account deficit and a modest recovery in financial inflows.

Consequently, foreign exchange reserves increased and the rupee also recovered part of the losses suffered during Jul-Oct FY09. Thus, the aggregate 68.6 percent growth in overall external account deficit during the first eight months of FY09 was accrued essentially during the first four months of the period.

It said that all price indices i.e. CPI, WPI and SPI, witnessed a clear downtrend in recent months. After showing a continuous acceleration since March 2008, CPI inflation (YoY) started easing from November 2008; it fell to 21.1 percent in February 2009 as against a peak of 25.3 percent in August 2008. However, this inflation is higher compared to 20.5 percent in the preceding month and 11.3 percent in the same month last year.

The Report said that all indications are that agricultural growth will be reasonably good during FY09, despite the drag from 18.5 percent decline in sugarcane output during *kharif* FY09. "This assessment is based on an anticipated record wheat harvest (that would significantly improve the contribution by major crops), above target performance of minor crops and a reasonably good outturn by the livestock sub-sector,' it added.

However, going forward, the Report said that worsening outlook for the global economy, and drought in international capital markets mean that Pakistan's economic revival strategy must perforce focus on fostering domestic and regional demand. Moreover, lowering inflation and limiting the twin deficits, in particular, would be key to enabling a transition in macroeconomic policy from a stabilization framework to one focused on reviving growth, it said.

"In the short to medium-term, it would be imperative for Pakistan to rely on concessional external assistance to finance development expenditure," it said and added that the need for greater external assistance for Pakistan is underscored by the fact that the sources of domestic financing are either not available or remain risky due to its vulnerable external account position. Also, given the drying up of capital flows, official assistance seems to be the only option for countries like Pakistan to stimulate its economy to put it back on sustainable path of growth and development.

The detailed Report can be accessed at SBP's website www.sbp.org.pk.

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