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Pakistan's economy shows signs of improvement but weaknesses remain: SBP Report

Pakistan's economy continued to show macroeconomic stability in the third quarter of the current 2008-09 fiscal year (FY09) as the Government focused on macroeconomic reforms and the economy benefitted from a sharp decline in international commodity prices and other favorable developments.

According to the Third Quarterly Report of the State Bank of Pakistan on the State of the Economy released today, inflation began to decline, the current account deficit narrowed substantially with a corresponding stability in the exchange rate, and fiscal discipline was maintained with the fiscal deficit being reported to be 3.1 percent of GDP for July-March FY09.

However, the Report noted with caution: "while this improvement in macroeconomic indicators is very encouraging, the economy is not out of the woods yet. Major macroeconomic indicators show underlying weaknesses which, if not addressed, could hamper economic recovery."

The Report said that recent easing of inflationary pressures is indeed encouraging as the headline inflation - measured by consumer price index (CPI) - dropped to 17.2 percent on year-on-year (YoY) basis in April 2009 from its peak of 25.3 percent YoY in August 2008. In particular, a sharp downtrend in food inflation is a welcome development as this component of CPI affects low income groups the most. CPI food inflation fell from its peak of 34.1 percent YoY during August 2008 to 17.0 percent in April 2009.

It said the downtrend in inflation owes to both, favorable international and domestic developments, as well as a deceleration in domestic demand. The latter, in particular, reflects the monetary tightening by the State Bank, as well as the complementary improvement in fiscal discipline, especially after November 2008. It is worth noting that the acceleration in the fall of inflation is becoming visible only after the monetization of the fiscal deficit was halted, the Report added.

The Report projected that in FY09 average CPI inflation in the current fiscal year is expected to stay between 20.5 percent and 21.5 percent, whereas Gross Domestic Product growth is likely to be 2.0 percent to 3.0 percent and fiscal deficit may hover between 4.0 and 4.5 percent of GDP.

The Report said that in order to support industry and particularly the export-oriented sectors, which were pressured by the impact of the global recession, SBP introduced measures such as; easing access to concessional financing schemes, and lengthening maturities. The central bank also injected appropriate liquidity to meet banking system's increased demands for commodity operations and settlement of circular debt. However, by April 2009, broad money (M2) growth was still quite weak, at 1.9 percent year-to-date, down sharply from 8.4 percent in the corresponding period last year, reflecting continued deceleration in domestic demand. "As a result of this, SBP projections suggest that deceleration in inflation will be much sharper in the next few months. This is also evident from the successive fall in the core inflation during March and April 2009," it added.

It said this has encouraged SBP to gradually shift its policy bias towards supporting growth in the economy. Thus, as other macroeconomic indicators improved further, this allowed the central bank a 100 bps reduction in the policy rate, bringing it to 14 percent effective from April 21, 2009.

The Report said that the record wheat and rice harvests together with the likelihood of good production in minor crops and of fodder increase expectations that growth in the crops sub-sector of agriculture will exceed the FY09 annual target. "A reasonable performance from the livestock sector, supporting all this, will help take the overall agri-sector growth close to, or over, the annual target," it added.

However, it noted with concern that growth in large scale manufacturing (LSM) has been negative for the tenth consecutive month in March 2009, the longest period in which production continued to shrink. LSM growth dropped by 7.6 percent during July-Mar FY09 compared with a 5.0 percent rise in the corresponding period of FY08. This is the major drag on the prospects of improving real GDP growth, it added.

The Report pointed out that anticipated weaker performance of revenues, and increase in expenditures both point to the risk of slippage in the fiscal deficit target, and a contingent increase in financing requirements. Similarly, resurgence in international commodity prices poses risks to the assessment of a continued sharp deceleration in inflation in the months ahead. In particular, a rise in international oil prices would have adverse consequences for domestic inflation as well as the external account balance, it added.

In addition, the Report said the international inflows under financial and capital accounts are relatively lower compared with the preceding years, causing a rise in overall external account deficit. A fall in financial inflows is the result of combined impact of both external and domestic factors, the Report said. "While, Pakistan's ability to access international financial market is constrained, any shortfall in external inflows would add to pressures on monetary policy," the Report added.

"In short, the limited gains in key macroeconomic indicators should not lead to complacency as the quality of these improvement and challenges to economy are some factors of disquiet," it pointed out.

SBP Report suggested that reduction in development expenditure is not desirable, as it would have detrimental impacts on country's human and physical infrastructure. "In the medium term, the only viable way to achieve sustainable improvements in fiscal accounts is to raise the tax-to-GDP ratio through increasing the tax net," it said and added this is because a substantial reduction in current expenditures is not possible without significant reduction in the size of government machinery, due to inflexible interest payments and expenses under defense and civil administration.

The Report also stressed upon increasing exports by product and market diversification with gains in productivity. It underscored the need to implement second generation reforms to improve governance, strengthening institutions and reforming legal as well as regulatory system.

The detailed Report is available at SBP website www.sbp.org.pk.

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