1 Economic Outlook

1.1 Overview

The urgency for macroeconomic stabilization is now evident throughout the economy, which has been severely buffeted by the concurrent unfolding of several adverse developments, particularly through H2-FY08, and into the initial months of FY09. Global shocks such as an extraordinary and unanticipated rise in food and energy commodity prices, and disruptions in the international financial markets, as well as domestic shocks and policy decisions contributed significantly to the imbalances in the economy.

Domestic production was hit by the energy shortages, disappointing harvest of some key cash crops, and policy uncertainty during the transition of governments. Consequently real GDP growth declined to 5.8 percent in FY08, down considerably from the 6.8 percent growth recorded in the previous year (see **Table 1.2**). Weaker domestic production coupled with strong domestic demand and commodity prices shocks led directly to rising inflationary pressures, a widening current account deficit, declining foreign exchange reserves, rising public debt, a depreciating rupee, etc.

Table 1.1: Key Macroeconomic Developments in FY08

	Unit	Jul-Oct	Nov-Jun	Jul-Jun
CPI inflation	period average	7.6	14.1	12.0
CPI inflation (end-period)	YoY	9.3	21.5	21.5
Government borrowing from SBP	billion Rs	23.3	665.4	688.7
Current a/c deficit	% of GDP	1.8	6.6	8.4
LSM growth	percent	7.6	2.4	3.7

The escalation in inflationary pressures was particularly strong in H2-FY08. Annualized CPI inflation soared to 12.0 percent during FY08 compared with 7.8 percent in the preceding year (see **Table 1.1**). The rise in CPI inflation had been muted during the initial months of FY08, reflecting the effect of earlier monetary tightening by SBP. Notwithstanding, inflationary pressures then rose sharply as: (1) demand-supply imbalances worsened; and (2) the impact of the record increases in international commodity prices was also particularly strong in Pakistan, as the country's ability to absorb the shocks was constrained due to large fiscal and external current account deficits.[1]

The consequent acceleration in inflationary pressures (as evident by a surge in CPI inflation (YoY) from 7.0 percent in June 2007 to 21.5 percent by June 2008) quickly swamped repeated moves by the SBP to further tighten monetary policy and improve its transmission.

Monetization of the large (7.4 percent of GDP) FY08 fiscal deficit aggravated inflation. During FY08, the government borrowed Rs 688.7 billion from SBP for budgetary support which is around 90 percent of the total financing requirement of the government for the year. As a result, the stock of MRTBs with SBP reached Rs 1,053 billion by end-June 2008 from Rs 452.1 billion at end-June 2007. Though the growth in broad money aggregates (M2) decelerated, the reserve money growth reached 21.6 percent during FY08 compared to 20.9 percent in FY07. Demand for domestic credit (both for the government and the private sector) rose steeply to 29.3 percent during FY08 from 15.8 percent in FY07. Furthermore, the unpredictable rise in government borrowings resulted in high growth in reserve money and weakened the transmission of policy rates to retail rates.

[1] The latter was because large fiscal and current accounts deficits severely constrained the government's ability to buffer the domestic economy. The fiscal and external account deficits touched 11-year and all-time highs respectively, during FY08.

Table 1.2: Selected Macroeconomic Indicators

	FY03	FY04	FY05	FY06	FY07	FY08 Targets	FY08 Actual
				percent			
Real GDP (at factor cost)[1]	4.7	7.5	9.0	5.8	6.8	7.0	5.8
Agriculture	4.1	2.4	6.5	6.3	3.7	4.8	1.5
Major crops	6.8	1.7	17.7	-3.9	8.3	4.5	-3.0
Manufacturing	6.9	14.0	15.5	8.7	8.2	10.9	5.4
Large-scale	7.2	18.1	19.9	8.3	8.6	13.0	4.8
Services sector	5.2	5.8	8.5	6.5	7.6	7.1	8.2
Consumer price index (FY01 =100)	3.1	4.6	9.3	7.9	7.8	6.5	12.0
Sensitive price indicator (FY01 = 100)	3.8	6.0	11.1	7.8	9.4	-	14.2
Broad money (M2)	18.0	19.6	19.1	15.1	19.3	13.5	15.4
Reserve money	14.5	15.4	17.6	10.2	20.9	-	21.6
Private sector credit	18.2	34.3	34.4	23.5	17.3	-	16.5
Exports (f.o.b.)	22.2	10.3	16.9	14.3	3.2	13.1	13.2
Imports (c.i.f.)	18.2	27.6	32.1	38.8	6.9	5.8	30.9
Official liquid FE reserves[2] (million US$)	10,769	12,389	12,598	13,122	15,646	-	11,399
				As percent of GDP			
Total investment	16.8	16.6	19.1	22.1	22.9	23.8	21.6
National savings	20.8	17.9	17.5	18.2	17.8	18.8	13.9
Tax revenue	10.1	9.8	9.6	9.8	10.2	10.2	10.0
Total revenue	14.9	14.1	13.7	14.0	14.9	13.2	14.3
Budgetary expenditure	18.6	16.4	17.0	18.2	19.2	17.5	21.7
Budgetary deficit	3.7	2.3	3.3	4.2	4.3	4.2	7.4
External current account balance	4.9	1.8	-1.4	-3.9	-4.8	-	-8.4
Total debt (including explicit liabilities)	80.1	71.4	65.8	59.5	57.9	-	60.7
(a) Domestic debt	38.0	35.1	32.8	30.1	29.9	-	30.6
(b) Foreign debt	39.5	34.4	31.3	28.2	27.0	-	29.0
(c) Explicit liabilities	2.5	2.0	1.7	1.3	1.0	-	1.1

[1] During FY08 sectoral shares in GDP were as follows: agriculture (20.9 percent), industry (25.9 percent) and services (53.2 percent).

[2] Foreign exchange reserves include CRR/SLR on FE-25 deposits.

Note: Targets are based on Annual Plan, Trade Policy and Annual Budget Statement for FY08.

Fiscal accounts reflected strains since FY05, however given continued improvement in debt indicators, a sharp increase in developmental spending and earthquake related expenditures[2] generated political acceptability of fiscal expansion and complacency regarding its implications for macroeconomic stability. The slippage in fiscal accounts during FY08 is clearly unsustainable due to its adverse impacts on external accounts, inflationary outlook and debt indicators. The abrupt

[2] A part of this was a justifiable response to the aftermath of the October 2005 earthquake, but it is instructive to note that this negative trend is visible even after adjusting for these needed expenditures, as was repeatedly pointed out by SBP (for example, **Third Quarterly Report 2005-06**, page-2 & 55, **Annual Report 2005-06**, page-73; and **Annual Report 2006-07**, pages-8 & 50).

expansion of the fiscal deficit in FY08 reflects the combination of a slide in fiscal discipline, substantial maturities of very expensive domestic debt, as well as the consequences of a subsidy on some key prices in the economy. This raises some important considerations:

- First, sustainable economic growth requires that fiscal expenditures (particularly discretionary spending) be closely linked to the available resource envelope. In other words, growth in government spending must be dynamically linked to revenue trends, and the government's ability to borrow from the central bank be constrained through a legal framework.

- Second, significant effort is needed to increase tax elasticity and buoyancy. Wherever possible, public expenditure must be focused on the provision of public goods and addressing market failures only. Broadening the tax base will be a key, as economic theory clearly shows that heavy taxes invariably create distortions in the economy, leading to allocation inefficiencies.

- Third, the government needs to reduce its role in the determination of key prices in the economy. Pakistan's recent history is testament that the excessive involvement of government in pricing mechanisms can distort both consumption and production decisions.[3] In this context, the government's courageous decision to align key energy prices with international prices is appreciable.

The demand impetus from the fiscal deficit, and high international commodity prices, contributed to a worsening of the external current account. External current account deficit reached a record high of US$ 14.1 billion (8.4 percent of GDP) in FY08 relative to only US$ 7.0 billion (4.8 percent of GDP) in the previous year.

The impact of this sharp deterioration in Pakistan's external account was further exacerbated by a decline in the financial account surplus during the period. Prior to FY08, the congenial international and domestic environment had allowed Pakistan to comfortably finance its large (and growing) current account deficit through non-debt creating inflows, sovereign debt issues as well as concessional loans from multilateral agencies. However, as pointed out by SBP in various reports, the large deficits increased the risk that the economy could be hit by any slowdown in these financing flows. In particular, portfolio investment is notoriously volatile, and the rising share of these in the financial flows of recent years was a concern.

Thus, as the global financial crisis unfolded in FY08, and the country risk perception was further heightened by domestic economic and political developments, Pakistan's ability to tap international capital markets was severely impaired. Planned privatization transactions had to be deferred, sovereign debt issues postponed, and portfolio investment plunged. The fall in capital inflows also resulted in drawdown of foreign exchange reserves and mounting pressure on exchange rate during the period, which was further intensified by heavy speculative activity in the forex market. Consequently, by end June FY08, reserves stood at US$ 11.3 billion witnessing a depletion of US$ 5.1 billion, while exchange rate depreciated by 11.5 percent.

Fresh and unprecedented build-up of imbalances in the external account requires demand management and exchange rate adjustments. Since adopting free float exchange rate regime in 1999, except for the initial years, the favorable balance of inflows and outflows enabled Pakistan not only to build up reserves but also to keep a relatively stable exchange rate. However, as this balance turned

[3] For example, the subsidized consumption of key fuels contributed directly to the expansion of the fiscal deficit. The burden on the exchequer spiraled as a sharp rise in international prices was not passed on to consumers. The rising demand also widened the external account deficit in FY08 (as domestic fuel consumption was not rationalized).

unfavorable and outflows far exceeded inflows, the country had little option but to fall back on the forex reserves that had been accumulated in the past few years. Consequently the reserves declined. With demand for foreign currency far exceeding supply, the Rs/US$ exchange rate depreciated sharply. Although SBP intervened in markets to reduce excessive volatility, seeking a moderation in the slide of the rupee, this policy by definition, cannot be a permanent solution. Empirical evidence clearly shows that any attempts to hold on to any particular exchange rate in the face of a fundamental imbalance, would have been futile and resulted in an even faster depletion of reserves.

The pressures on the economy have only intensified in the initial months of FY09, as seen in all key macroeconomic indicators, and downgrades of the country's sovereign credit ratings. Inflation is persisting at 25 percent levels in October 2008, with food inflation touching a staggering 31.7 percent YoY. The inflationary pressures appear to be supported by the continued monetization of the deficit; government budgetary borrowings from the central bank during Jul-Nov 17, FY08 reached Rs 378.9 billion, as compared to Rs 74.7 billion in the same period last year. The growth of the external account deficit has also accelerated sharply. It grew 98 percent YoY to reach almost US$ 6.0 billion during Jul-Oct FY09, as compared to US$ 3.0 billion in the corresponding period last year. At the same time, international financing flows have also dropped sharply to a mere US$ 1.1 billion from US$ 3.1 billion in Jul-Oct FY08, reflecting weakening fundamentals of the domestic economy, and the deepening international financial crisis.

The drain on the country's foreign exchange reserves therefore accelerated. After declining by US$ 5.1 billion in the eight months from the end-October 2007 peak of US$ 16.5 billion by end-June 2008, the reserves dropped to US$ 6.8 billion by end-October, 2008 – a fall of US$ 4.6 billion in just four months.

The falling reserves put substantial pressure on the exchange rate, and drained liquidity from the inter-bank rupee market (as the central bank mopped up domestic currency against the provision of forex liquidity). So great was the liquidity drain that interest rates in the money market spiked, triggering rumors of a runs on banks. The SBP therefore moved promptly to diffuse the liquidity risks by easing statutory reserve requirements and taking other measures.

Recent decline in commodity prices reflects a mixed blessing. The recent broad-based decline in international commodity prices appears to offer significant relief on the external account in months ahead. The prices of key commodity imports such as petroleum products, edible oil, wheat, steel, etc. have all seen substantial declines (often ranging between 35 to 45 percent) from their recent peaks. Accordingly, as newer import deals are inked, Pakistan's import bill is expected to decline sharply. However, as the decline in international commodity prices reflects the expectation of substantial economic slowdown in key exports markets, there is a risk that the overall trade deficit may not shrink as sharply as anticipated. Indeed, if exports weaken substantially, and/or remittances from the weakening economies (e.g. the US) slow, the overall external current account deficit could widen.

Also, lower international commodity prices may not help reduce inflation. This is because the substantial depreciation of the rupee in recent months would raise import prices in rupee terms.

Thus, in the short-run, policy measures to shrink aggregate demand appear unavoidable. A combination of contractionary fiscal and monetary policies may also need to be supported, in the short-term only, by restrictive trade regime. If a moderation in demand can be implemented successfully, this would allow for a much-needed sharp contraction of both, the fiscal and current account deficits, as a percentage of GDP, in FY09 (see **Table 1.3**). As a consequence, real GDP growth is likely to fall well below the initial target level for FY09.

The impact of demand management policies on inflation will appear with some time lags. Headline inflation is likely to accelerate above 20 percent during FY09, before witnessing a fall. Expectation of a deceleration in inflation later in FY09 are contingent on a weakening of domestic demand (as impact of recent demand management measures percolates through the economy), improved domestic production in response to market price signals as well as some ease in international commodity prices as the global economy slows.

Table 1.3: Projections of Major Economic Indicators

	FY08	FY09	
		Annual plan targets	Projections
growth rates in percent			
GDP	5.8	5.5	3.5 - 4.5
Average CPI Inflation	12.0	11.0	20.0 - 22.0
Monetary assets (M2)	15.3	14.0	12.0 - 13.0
billion US Dollars			
Workers' remittances	6.5	7.7	7.5
Exports (fob-BoP data)	20.1	22.9	21.5 - 23.0
Imports (fob- BoP data)	35.4	37.2	35.5 - 36.0
percent of GDP			
Fiscal deficit	7.4	4.7	4.3 – 4.8
Current account deficit	8.4	7.2	6.2 - 6.8

Note: Targets of fiscal and current account deficit to GDP ratios are based on Nominal GDP in the Budget document for FY09, while their projections are based on projected (higher) nominal GDP for the year.

In terms of fiscal and administrative measures, even when acting to reduce demand, the government needs to be careful to ensure that the austerity is greater in the public sector, i.e., crowding out of private production and investment must be kept to a minimum. Second, there is a dire need to increase the share of investment in total aggregate demand, even as that of consumption is reduced. This will necessitate a delicate rebalancing of the incentives structure to promote both domestic savings and investment.

In the medium to long-term, to achieve a sustainable high growth and low inflation, country also needs to support investment by moving to remove structural bottlenecks, reduce the cost of doing business and increase productivity. This is not easy task and requires implementation of well sequenced structural reforms, introduction of second generation reforms, as well as attention to promoting public-private investment partnerships to develop physical infrastructure and human capital.

The role of second generation reforms is also important in conduct of economic policies. A key plank here will be building institutional capacities and improving governance in the economy. Pakistan is ranked second in South Asia according to World Bank's ranking in Cost of Doing Business 2009.However, Pakistan is ranked at 77 out of 182 countries. Similarly, Pakistan's rank dropped from 100 to 101 in Global Competitive Index (GCI) principally due to weakening in the perceived quality of public institution. This suggests that a lot more needs to be done.

Given that the country needs massive FDI inflows to achieve a rapid transformation towards industrialization, it is necessary to encourage this by reducing red tape, implement fast and transparent tax procedures, eliminate excessive regulatory bodies, simplify labor laws, make contract enforcement efficient by reducing costs and allowing quicker settlements of disputes, as well as making entry and exit of business firms less resource and time consuming.

Investment in physical and human resources is another important area for productivity gains. For example, Pakistan has enormous potential in increasing productivity in agriculture. Improvement in training and agri-extension services to gain benefits through increased use of certified seeds, use of appropriate mix of nutrients, mechanization of different activities from land leveling to harvesting, and use of low-water production techniques, may help manifold increase in productivity. Similar, opportunities are available in other segments of the economy.

Correcting the deterioration in macroeconomic imbalances is certain to entail difficult trade-offs, and the reforms will likely require disciplined implementation over an extended period, as the economy wears off the stresses from accumulated imbalances and adjusts to a tougher operating environment. However, history also shows us that appropriately planned and sequenced reforms can offer rich dividends, improving the resilience of economy to shocks and allowing more sustainable long-term growth.