1 Economic Outlook

1.1 Overview

Pakistan's economy witnessed a moderate but fragile recovery during FY10. Helped by a modest improvement in business and consumer confidence, relatively supportive monetary and fiscal policies, and some good fortune (in the shape of declining international prices) real GDP growth rose to 4.1 percent (see **Table 1.1**), compared with an anemic 1.2 percent in annual FY09. The lower commodity prices and relatively weak demand also contributed to a deceleration in inflation, which fell to 11.7 percent from a multi-decade high of 20.8 percent, as well as to the decline in the current account deficit to only 2 percent of GDP in FY10 from 5.7 percent of GDP in the previous year.

While these developments marked an improvement from the FY09 picture, fundamental structural weaknesses in the economy remained unaddressed. For example, some key reforms failed to gather traction: (1) persistent disagreements led to the deferment of a proposed expansion of the tax net through the introduction of a broad based GST, (2) the proposed restructuring of public sector enterprises, to improve efficiency and lower the fiscal burden, did not take place; and, (3) after some initial work, there was little or no progress in either resolving the energy sector debt chain (the so-called "circular debt" problem)[1] or substantially improving electricity supply.

The principal structural problem, however, was the weak fiscal performance; the fiscal deficit bounced back to 6.3 percent of GDP in FY10, i.e., 1.1 percentage points higher than in the previous year. The initial Rs 1.6 trillion tax revenue targets for FY10 had looked optimistic, incorporating a record 29.8 percent annual growth, compared with an average growth of 14.6 percent over the preceding five years. The eventual Rs 77 billion shortfall in total revenues was therefore not very surprising, given the absence of any significant measures to expand the tax base or to exploit the existing tax base more effectively.

The slippage on the expenditure side was more disappointing. Admittedly, there are significant rigidities in government spending, including debt servicing, defense, the government salary bill, etc. However, there appears little evidence of efforts to contain the growth in even the discretionary components. In this context, the 10.7 percent YoY growth in subsidies and losses of PSEs, was particularly disappointing. To put this in perspective, in FY10 these expenditures, as a percentage of GDP, were almost equal to the combined total for health and education. This is by no means an acceptable situation.

A large part of the rise in subsidies and PSEs losses is a function of the continuing government intervention in market pricing of goods and services. Such interventions are typically undesirable, as they encourage over-consumption, reduce incentives to increase efficiency, and lead to mis-allocation of resources. The continuing electricity shortages in the country are a case in point, essentially representing the consequence of excessive government interventions, over the years, to keep down energy tariffs. The low tariffs discouraged investment to add generation capacity while

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[1] Circular debt is a situation when one entity facing problems in its cash inflows, holds back payments to its suppliers and creditors which may result into a surge in its receivables and payables of multiple entities in a supply chain. In Pakistan's energy sector this problem has become severe for the last couple of years. For example, PEPCO collects tariff from its customers (i.e. KESC and government departments including Railways, PIA, Pakistan Steel Mills and provincial and federal government departments) for the supply of electricity and tariff subsidy form government, and pays its suppliers (IPPs, OMCs, and gas companies) for the procurement of power and fuel. Government is not fully compensating PEPCO against subsidy amount and PEPCO is also not receiving payments from its customers. As a result, PEPCO delay (or suspend) payments to its suppliers.

simultaneously encouraging consumption. The resulting power shortages have led to production losses, declining productivity (and competiveness) of local businesses, and forced significant investment by local businesses in relatively inefficient, small scale power generation units. Similarly, in recent years, government interventions in agri-markets had unintended consequences by discouraging exporters (by raising the risk of policy volatility), and crowding out private investment by raising the cost of capital. Indeed, the skewed incentives for banks to meet the government's substantial appetite for funds, rather than increase private sector's credit, illustrated by the fact that banks' CARs continued to improve during FY10 even though their non-performing loans increased.

In short, the FY10 fiscal performance, characterized by continuing expansion in fiscal and quasi-fiscal operations, crowded out and otherwise undermined private sector activities, supported the persistence of double-digit inflation, and increased the total public debt and liabilities substantially, from 68.7 percent of GDP in FY09 to 69.5 percent in FY10. All these developments raise questions about the medium-term sustainability of growth.

Table 1.1: Selected Macroeconomic Indicators

						FY10	
	FY05	FY06	FY07	FY08	FY09	Targets	Actual
Growth rates (percent)							
Real GDP (at factor cost) [1]	9.0	5.8	6.8	3.7	1.2	3.3	4.1
Agriculture	6.5	6.3	4.1	1.0	4.0	3.8	2.0
Major crops	17.7	-3.9	7.7	-6.4	7.3	3.5	-0.2
Manufacturing	15.5	8.7	8.3	4.8	-3.7	1.8	5.2
Large-scale [2]	19.9	8.3	8.7	4.0	-8.2	1.0	4.4
Services sector	8.5	6.5	7.0	6.0	1.6	3.9	4.6
Consumer price index (FY01 =100)	9.3	7.9	7.8	12	20.8	9.0	11.7
Sensitive price indicator (FY01 = 100)	11.1	7.8	9.4	14.2	22.7	-	13.2
Monetary assets (M2)	19.3	15.2	19.3	15.3	9.6	-	12.5
Private sector credit	34.4	23.5	17.3	16.5	0.6	-	3.9
Exports (f.o.b.)	16.9	14.3	3.2	12.2	-7.1	-1.7	9.4
Imports (c.i.f.)	32.1	38.8	6.9	30.9	-12.9	-5.6	-0.3
Official liquid FE reserves (million US$)	12,598	13,193	16,634	11,567	12,763	-	16,904
As percent of GDP							
Total investment	17.5	20.5	20.9	20.4	17.4	20	15.2
National savings	17.5	17.7	17.4	13.4	13.2	14.7	13.8
Total revenue	13.8	14.1	15.0	14.6	14.5	14.7	14.2
Tax revenue	10.0	10.2	10.6	10.4	10.3	10.5	10.0
Budgetary expenditure	17.2	18.4	19.3	22.2	19.9	19.4	20.5
Budgetary deficit	3.3	4.3	4.4	7.6	5.3	4.9	6.3
Current account balance	-1.4	-3.9	-4.8	-8.4	-5.7	-5.3	-2.0
Total debt and liabilities	-	62.6	60.5	65.3	68.7	-	69.5
Domestic debt	-	31.8	31.3	33.3	32.6	-	34.3
Foreign debt	31.3	28.7	27.5	29.9	32.6	-	31.8
Total liabilities	-	2.1	1.7	2.1	3.5	-	3.5

[1] During FY10 sectoral shares in GDP were as follows: agriculture (21.5 percent), industry (25.2 percent) and services (53.3 percent).
[2] Jul-June FY09 growth was negative 8.2 percent and Jul-June FY10 growth was 4.8 percent.
Note: Targets are based on Annual Plan and Annual Budget Statement for FY10.

While the expansionary fiscal policy and subsequent partial monetization of this deficit were important contributors to (demand pull) inflation in the economy, ironically, even the efforts to reduce the burden of subsidies also generated (cost push) inflation. Thus, inflationary pressures which had eased significantly in H1-FY10 due to weak demand, and a sharp decline in imported inflation, re-surged strongly and gained resilience in the second half of the fiscal year,[2] as the government increasingly passed-through the rising energy costs to consumers. This cost-push

[2] Headline CPI inflation which was averaged 10.1 percent in H1-FY10, jumped to 13.1 percent in H2-FY10.

inflation was an inevitable cost of having delayed tariff adjustments in earlier years, i.e., the inflationary pressures that should have been smoothed over a number of years had to be accommodated in FY10. These adjustments were essential for economic efficiency in the medium to long term. The persistence in inflation during H2-FY10 was further reinforced by higher food inflation. The latter was principally a result of: (a) increased cost of transportation, (b) surge in the prices of imported food commodities, mainly pulses, spices, milk powder etc. and (c) continued demand-supply gaps in a number of food commodities (sugar, meat, etc.) either due to poor harvests/production or strong external demand.
A fall in inflation during H1-FY10, as well as a relative improvement in the macroeconomic situation had helped the central bank's decision to ease monetary policy to support an economic recovery. Thus, SBP cut policy rate by 100 basis points (bps) in August 2009 and by another 50 bps in November 2009. But as the burgeoning fiscal deficit, and unexpectedly low external receipts, raised the risk of a relapse into macroeconomic instability, and as inflationary pressures resurged in H2-FY10, the SBP Monetary Policy Committee (MPC) decided to pause the easing cycle. In the interim, the central bank continued to provide liquidity in the banking system to reduce volatility in overnight rate, but these rates remained close to the policy rate during most of FY10, principally due to government's higher financing needs for budgetary and quasi-fiscal activities.[3]

The fall in international commodity prices, which helped lower inflationary pressures during the first half of FY10, also contributed to the improvement in the current account deficit during FY10. While this was also seen in FY09, the FY10 decline in the import bill was complemented by improvements in all other major heads (see **Table 1.2**). Consequently, as a percentage of GDP, the current account deficit narrowed from an unsustainable 5.7 percent of GDP, to a five-year low of 2.0 percent of GDP in FY10.

Table 1.2: Sources of Improvement in Current Account Balance
percent share

	FY09	FY10
Trade balance	**50.9**	**20.9**
Exports	-28.3	8.9
Imports	-79.2	-12.0
Services	**66.7**	**29.5**
Income	**-10.6**	**19.8**
Current Transfers	**-7.0**	**29.8**
Workers' remittances	29.5	19.0
CAB	100.0	100.0

The exports performance was particularly encouraging, being led by a 25.2 percent YoY growth in H2-FY10 compared to a decline of 4.0 percent YoY during the preceding six months. Similarly, remittances saw a robust 14.0 percent YoY increase during the year, despite an economic slowdown in countries that source a large part of the flows. This appears to reflect, in part, the increased usage of formal channels for these transfer payments.

The very substantial decline in the current account overshadowed a deterioration in the financial account, allowing the overall external account balance to record a surplus in FY10, after a gap of two years. Accordingly, the country's foreign exchange reserves rose to USD 16.9 billion by end-June 2010. The combination of declining imports and higher reserves meant that the import coverage improved to 28.8 weeks – the highest since FY07. In this context, the 4.8 percent depreciation of the Rupee during FY10 would appear puzzling. The explanation lies in the fact that the larger part of the financing for the current account deficit was in the form of loans from multilateral agencies (predominantly the IMF), which do not enter the inter-bank market. Moreover, the SBP has also stopped the provision of liquidity for oil purchases, with the inter-bank market shouldering this additional demand as well.

[3] Finally, as risks continued to mount, SBP reversed its policy posture in July 2010, raising its policy rate by 50 bps to 13 percent.

1.2 Looking Forward

The macroeconomic framework embedded in the FY11 Annual Development Program targets have suffered a serious setback early into the year as large areas of the country were devastated by widespread rains and unprecedented floods. Large parts of the country's agricultural heartland were particularly hit hard by these floods, with significant damages to standing *kharif* crops (e.g., cotton, rice and, sugarcane) and livestock. The economy also suffered extensive damage to infrastructure (bridges, road networks, gas/power plants, and some industrial units such as rice mills, ginning factories, etc.), productivity losses from supply-disruptions, the large-scale displacement of people, etc. According to some estimates, up to 20 million people have been displaced and are living without shelter, food, clean drinking water, and basic health facilities. The relief and rehabilitation task is gigantic, and despite considerable international assistance, and large-scale public mobilization, the resources available are likely to be quite inadequate against anticipated needs.

Table 1.3: Major Economic Indicators

		FY11	
	FY10^{P}	Annual Plan Targets	SBP Projections
Growth rates in percent			
GDP	4.1	4.5	2.0 - 3.0
Average CPI Inflation	11.7	9.5	13.5 - 14.5
Monetary assets (M2)	12.5	-	12.0 - 13.0
Billion US Dollars			
Workers' remittances	8.9	9.0	9.5 - 10.5
Exports (fob-BoP data)	19.6	20.0	20.0 - 21.0
Imports (fob- BoP data)	31.0	31.7	34.0 - 35.0
Percent of GDP			
Fiscal deficit	6.3	4.0*	5.0 – 6.0
Current account deficit	2.0	3.4	3.0 – 4.0

^{P}: Provisional
*: This was announced in the budget; however, this number rose to 5.2 percent of GDP as per announced consolidated federal and provincial budgets.
Note: Targets of fiscal and current account deficit to GDP ratios are based on Nominal GDP in the Budget document for FY11, while their projections are based on projected (higher) nominal GDP for the year.

While the government has initiated a process, with the help of the World Bank and the Asian Development Bank, to make an assessment of the damages and the needs, this will take some time. But even a cursory assessment of the broad contours of the losses indicates that their repercussions will continue to stress the economy for many years.

It is therefore obvious that the economic priorities and targets for FY11, in particular, will see substantial revision, and all key macroeconomic indicators will likely record deterioration. For example, preliminary assessments in the aftermath of the flood indicate a much lower growth expectation. Indeed, the agri-sector growth risks turning negative unless Pakistan achieves very good wheat harvest. Conventional wisdom, would suggest that the improved water availability and increased fertility of alluvial soil (silt) deposited by floods would help support better crop harvests. Realizing this potential, however, entails a very quick and systematic effort to address key bottlenecks in affected areas, including restructuring of farmers' debts, rapid deployment of resources for drainage of low-lying areas, provision of quality inputs (seed, fertilizer, etc.).

It must also be recognized that farmers would be inclined to invest first in the provision of shelter for their families and only then in crops. This suggests the need to support farmers with cash grants for rebuilding as well as with the supply of inputs, if production is to be brought back to pre-flood scenario soon. Industrial growth will also suffer. Obvious direct losses include those of manufacturing units dependant on the cotton, sugarcane, and rice crops, as well as those suffering temporary supply disruptions. Also significant could be the indirect losses, as aggregate demand weakens, particularly from the flood stricken areas. Already, it seems likely that the consumer durables industries will see a substantial decline in demand.

In this backdrop, preliminary SBP forecasts, based on the incomplete information on flood losses, suggest that real GDP growth during FY11 is likely to be in the range of 2 to 3 percent against the target of 4.5 percent (see **Table 1.3**).

Not surprisingly, demands on the public exchequer are expected to rise sharply in FY11 to finance relief and reconstruction activities in the wake of the floods. The government correctly proposes to extract a temporary enhancement in revenue from the relatively affluent segments of the tax base, but the needs are still likely to exceed any reasonable increase in receipts. This raises two issues. First, it must be understood that while government interventions, in the terms of resources and policy, are essential to the scale and speed of any recovery, the government has neither the capacity nor the resources to deliver on all public expectations for relief and support. A large part of the reconstruction effort over the years will therefore depend substantially on private enterprise and on the broad support of civil society.

Second, the expected increase in fiscal pressures in FY11 is also an opportunity to undertake fundamental changes. Given the scale of the resources needed for rehabilitation and relief for flood stricken areas, there needs to be a political consensus on widening the tax base to hitherto untaxed (or under-taxed) segments of the economy, and plug leakages in the existing system. Such reforms will continue to pay dividends, over the years, even after the post-flood needs fade away. Similarly, the Federal and Provincial governments must carefully scrutinize and prioritize spending, both recurrent and non-recurrent, in order to create room for the new immediate demands as well as for the public investments needed to support growth in the medium term. Even before the floods, there had been practically little change in the roles, responsibilities, and structures in both levels of government, despite a substantial change in resource distribution to provinces under the latest National Finance Commission (NFC) Award[4]. This is not sustainable.

The extended persistence of double-digit inflation had already been a source of concern even ahead of the floods, particularly given the risk that an uptrend in food-commodity prices (e.g. wheat, edible oil, sugar, corn, etc.) could be compounded by any weakness in the exchange rate. Moreover, inflationary pressures were also expected to strengthen as a result of the recent 50 percent increase in government sector salaries, and anticipated rise in energy tariffs (as the government continued to reduce subsidies) and removal of GST exemptions to broaden the tax base.

The impact of the floods has strengthened these inflationary expectations for FY11; the August 2010 CPI, included a 15.6 percent YoY rise in its food component. However, SBP assessments suggest that the direct impact of the flood-related supply shock is likely to be limited. For example, the impact of flood/rain damages and shortages of minor crops are not expected to persist beyond 2 to 3 months as supply line improves and as fresh crops (e.g., vegetables) enter the market. Similarly, for some other products, any rise in domestic prices would be capped by low international prices. It is important to note that prices of dairy products were already continuing on a secular rise, even prior to the floods, due to sustained strong domestic and external demand. Livestock losses in the flood would exacerbate this rising trend, but only to a small extent.

An indirect, short-term cost-push factor, however, could come from the imposition of flood-related taxes. Similarly, post-flood reconstruction works may push up prices of building materials, but these would only be gradually reflected in the trends of the House Rent Index (HRI), which has a dominant weight in the CPI.[5] Thus, revised SBP forecasts suggest that annual average inflation for FY11 is

[4] The National Finance Commission is a constitutional body formed by the President of Pakistan that formulates some appropriate mechanism for revenue sharing between the federation and provinces. As per constitution, the NFC has to be constituted after every five years which consists of federal finance minister, four provincial finance ministers and some other members appointed by the President. The recommendations of the NFC are termed as NFC Award. Starting from 1974, seven NFC awards have been announced so far with the most recent, 7th NFC Award in December 2009 (see SBP's 1st Quarterly Report FY10 for detail on NFC).
[5] HRI weight is 23.43 percent in CPI basket.

likely to be in the range of 13.5 – 14.5 percent, up from both, the 9.5 percent target and earlier SBP forecast of 11.0 – 12.0 percent for the year.[6]

The worsening in most of Pakistan's macroeconomic variables, further complicate the monetary debate in FY11. On the one hand, there is the argument that the central bank should respond to the rising inflationary pressures and excessive increase in the fiscal deficit, and on the other, the demand-shock stemming from the flood damages argues for a countervailing monetary easing to help revive the faltering economy.

Finally, although a slight deterioration in the current account deficit was envisaged for FY11, reflecting the rising requirements for food imports (sugar, edible oil, etc.) as well as increased imports to support an anticipated improvement in economic activity. This outlook has deteriorated somewhat, post-floods. If fears of substantial losses in agricultural production (particularly cotton) prove correct, this could potentially lead to a higher trade deficit, offset only partially by an anticipated increase in current transfers. Provisional SBP forecast indicate that the current account to GDP ratio will likely rise to between 3-4 percent during FY11. However, financing even this moderate increase in the current account deficit may prove stressful for the economy, with rising pressures on the country's foreign exchange reserves and exchange rate.

In short, the negative shocks stemming from the floods have further exposed the existing structural weaknesses in the economy. Addressing these will require improvements in macroeconomic discipline as well as continued reforms to improve the resilience of the economy. The required reforms include those to improve productivity, strengthen public institutions, improve economic governance, and build social safety nets to protect vulnerable segments of the population. The important of the latter is all the more evident given the likely increase in the incidence of poverty in the wake of the floods.[7]

1.3 Executive Summary

1.3.1 Real Sector

Pakistan's economy witnessed a moderate recovery in FY10. Real GDP recorded 4.1 percent growth in FY10 against a multi-decade low of 1.2 percent in FY09.[8] This recovery, led by LSM and the services sector, was principally a reflection of improved consumer confidence, support from both fiscal and monetary policies,[9] as well as good fortune. This growth seems even more impressive given gradual reduction of a number of energy related government subsidies in accordance with IMF-SBA program.

Agriculture

FY10 agriculture growth dropped to 2.0 percent from 4.0 percent in the preceding year. This deceleration was entirely attributed to negative growth by the crops sub-sector, which partially offset the impact of an acceleration in livestock growth. The performance by the crops sub-sector suffered in FY10 due to: (a) water shortages, particularly at sowing times, (b) decline in the availability of certified seeds relative to FY09, and (c) uncertain price outlook for rice and sugarcane at sowing

[6] For details, see **Monetary Policy Statement July 2010**.
[7] Some studies indicated that Pakistan had made significant gains in reducing poverty over the last decade. , However, even here there was evidence that portion of these gains was marginal, with large populations clustered only slightly above the poverty line, which would be susceptible to economic shocks, such as from the recent floods.
[8] Pakistan recorded 1.0 percent real GDP growth in FY71.
[9] Fiscal measures announced in FY10 Budget included: removal of federal excise duty from automobiles and cement, as well as, various duties were eliminated or reduced on telecommunication services and import of cellular phones. Whereas, monetary policy eased as discount rate cut by a cumulative 150 bps in FY10.

period. These factors primarily led to a decline in area under cultivation and yields of major crops. However, on the better price outlook, acreage increased under cotton and wheat crops in FY10.

The dismal performance of crops was somewhat compensated by an above target growth by livestock sub-sector, which helped achieve a positive growth by the agriculture sector in FY10. The healthy livestock growth was attributed to growing domestic and external demand.

In contrast to weaker crop production, export of agri-commodities showed a healthy growth[10] in FY10. Strong foreign demand and weaker harvests in other key producing countries supported the growth in exports of Irri & other rice, livestock, fruits & vegetables, spice and other food items in traditional as well as new markets.

Growth rate of agriculture credit disbursement dropped to a decade low of 6.5 percent in FY10. Correspondingly, agri-credit disbursement target was missed by 4.6 percent in FY10. Fertilizer off-take of both urea and DAP registered a strong growth during FY10 compared with a small increase in the previous year. This rise was mainly driven by: (a) relatively lower prices of nutrients particularly DAP and (b) better prices of most of the agri produce, particularly wheat.

Industry

The domestic industrial sector managed to recover from the longest-ever period of decline in the previous year, recording a growth of 4.9 percent during FY10. The recovery came mainly due to supportive macroeconomic policies, relatively lower inflation, improved prospects of global economy, and better credit availability. The FY10 growth rate was the fourth highest for the decade, but was below the 10-year average of 5.7 percent. The industrial growth during FY10 stemmed mainly from a rebound in manufacturing and construction sectors as government reversed some of the tax measures taken last year, which had showed the growth in these sectors.

Construction sector exhibited a strong 15.3 percent growth in FY10 compared with a contraction of 11.2 percent in FY09. This remarkable performance was driven mainly by a decline in building material prices, which, in turn, was caused by reduction of duty on cement sales, and decline in global prices of coal, iron, and wood. Anecdotal evidence suggests that most of the construction growth was led by private sector.

Large-scale manufacturing (LSM) recovered from the previous year's distressing performance and registered a respectable growth of 4.8 percent during FY10. Overall slowdown in inflation and favorable developments in global demand caused production increases in consumer and export industries. However, the second round effect of consumer and external demand growth on the production of intermediate goods was limited mainly due to financial constraints (e.g., metals and POL). Therefore LSM growth across sectors varied significantly, with half of the sub-sectors exhibiting strong growth while the other half continued to register declining growth.

The performance of mining & quarrying sub-sector worsened further, as production declined by 1.7 percent in FY10 on top of a fall of 0.2 percent in the preceding year. The decline was caused mainly by lower production of crude oil and coal during FY10.

Services

Although, it fueled growth since FY02, services sector growth had reached a 50-year low during FY09. However, the services sector rebounded strongly again in FY10 with 4.6 percent growth. The higher growth was a reflection of pick up in commodity producing sector activities and was evident

[10] In value terms (US$)

mainly in higher than expected contributions of wholesale & retail trade, public services, telecom, and personal services.

However, while some of the developments observed in FY10 can be singled out as being transient – for example, the negative growth in financial sector and the high growth in public administration and defense – others are reflective of more enduring trends that emerged during the 2000s decade. Rapid growth has been observed in technical and skill-based services, such as telecommunications, software development, as well as in accounting and finance.

Investment & Savings

Investment declined for the second consecutive year in FY10. Hence, more importantly, investment-to-GDP ratio declined for the third consecutive year. This decline was mainly evident in industrial and services sector. Major factors constraining investment growth were: (a) reluctance of foreign investors to invest in Pakistan due to negative country image, (b) domestic banks invested more in government papers, (c) intense competition in cellular business that limited investments in this sector, and (d) uncertainties regarding strength of global recovery.

National savings as a percent of GDP were at 13.8 percent in FY10, up by 0.6 percentage points over the preceding year. Although savings rate has improved, the level of saving rate in Pakistan especially with respect to investment remained low. It appears that this low level of national savings is an outcome of multiple factors, including (a) dis-saving by the public sector on the back of lower tax base and a rigid current expenditures block; (b) loss making public sector commercial enterprises; (c) higher penetration of small and medium scale units in local business industry which restricts growth in corporate savings; (d) low per capita income and low (or negative) real interest rate; and (f) lack of appropriate instruments of financial savings with limited access to financial services to the rural population.

1.3.2 Prices

Consumer Price Index (CPI) inflation fell substantially to 11.7 percent during FY10 compared with 20.8 percent in FY09. However, FY10 inflation was higher than the 9.0 percent target for the year. Inflation target could not be achieved for the fourth consecutive year since FY06. Similarly, inflation measured by Wholesale Price Index (WPI), Sensitive Price Indicator (SPI), and GDP deflator[11] showing significant deceleration during FY10, but remained in double digits.

A break-up of headline Consumer Price Index (CPI) reveals that while inflationary pressures eased during the first half of FY10, these resurged January 2010 onwards.[12] During the second half of the fiscal year, CPI inflation moved in a narrow range of 12.7 to 13.7 percent. The downtrend in the first half of FY10 was a combined impact of: (a) continuation of tight monetary stance; (b) fiscal consolidation in FY09 relative to FY08, which resulted in a net retirement in the budgetary borrowings from the central bank; (c) a sharp decline in international commodity prices, as well as, improvement in domestic supply of most of the food commodities on the back of better harvests in FY09.[13]

However, most of these disinflationary factors reversed direction in the second half of FY10. Moreover, inflationary expectations strengthened due to reductions in energy related subsidies during the year. For example, upward revision in energy tariffs and diesel prices resulted in higher production and transportation costs. Pressures on exchange rate in January 2010 when SBP passed on

[11] GDP deflator is the broadest measure of inflation. This is the ratio of nominal GDP and real GDP. Percent change of GDP deflators for two periods provides inflation for this measure.

[12] Average CPI inflation was 10.3 percent in H1-FY10 and 13.1 percent during H2-FY10.

[13] Major crops grew by 7.3 percent in FY09.

all oil import payments to the inter-bank market, and reversal in fiscal stance with monetization of deficit also contributed higher inflation in H2-FY10.

1.3.3 Money & Banking

The SBP's monetary policy stance over FY10 reflects its efforts to strike a balance between supporting the domestic recovery, and arresting resurgent inflationary pressures. At the start of the fiscal year, the SBP continued lowering its policy rate as inflation declined to less than half of its FY09 peak. This provided the necessary room to support the domestic recovery, and the policy rate was reduced by a cumulative 150 bps during H1-FY10. However, further easing in the policy rate was put on hold for the remainder of the fiscal year due to resurfacing risks to price stability from an uncertain fiscal position amid delays in external financing flows, and pressures from adjustments in administered prices.

In terms of monetary aggregates, broad money (M2) grew by 12.5 percent in FY10, compared with 9.6 percent in the previous year. This reflects an expansion in both Net Domestic Assets (NDA), and Net Foreign Assets (NFA) of the banking system. The improvement in NFA was driven by a surplus in the financial account due to various official inflows that offset the deficit in the current account. Growth in NDA of the banking system slowed to 12.9 percent in FY10, compared with 14.9 percent in the previous year. This deceleration is explained by a moderation in all components of NDA, except private sector credit. However, despite lower budgetary borrowing compared with FY09, the government breached both IMF quarterly ceilings on borrowing from the central bank during H2-FY10.

Private sector credit staged a modest recovery posting 3.5 percent growth in FY10, compared with 0.5 percent in the previous year. However in real terms, credit to the private sector contracted by 13.9 percent, in contrast to a growth of 1.3 percent in FY09.

The performance of the banking sector over CY 09 reflects a shift in banks' risk preferences, strong government demand for bank finance and amendments in regulations by the SBP. While robust government demand for credit, accompanied by banks' risk aversion – amid rising Non Performing Loans (NPLs), and higher regulatory capital requirements improved the solvency of the banking system. Banking profitability improved to Rs 54.4 billion – after falling for two consecutive years - mainly due to amendments in prudential regulations that lowered banks' provisioning expenses.

The money market witnessed tighter liquidity conditions compared with FY09. This was mainly due to lower than expected retirement under commodity operation loans, and increased government reliance on budgetary borrowing from the banking system. However, the introduction of the interest rate corridor by the SBP as part of changes to the monetary policy framework, limited volatility in the overnight repo rate – the operational target of monetary policy.

1.3.4 Public Finance

The government envisaged a narrowing of budget deficit from 5.3 percent of GDP to 4.9 percent with a sharp increase in revenues (particularly tax revenues) and containment of current expenditures in the budget estimates for FY10. However, in terms of actual performance, all the fiscal targets of the government were missed during the year. The overall budget deficit rose to 6.3 percent of the GDP that was Rs 929.1 billion in absolute terms against a target of Rs 722.1 billion. The worsening of the fiscal outlook was broadly a result of greater than budgeted disbursement of subsidies, increased security outlays on war on terror and below target tax revenue generation both by FBR and provinces during FY10.

On the financing side the non-availability of budgeted external financing caused pressures on domestic sources almost throughout FY10. Although a large share of the total financing requirement

was met through non-bank sources, the government had to resort to monetization of the deficit as well. As a result the limits imposed by IMF on borrowings from the SBP were breached during the last two quarters of FY10.

1.3.5 Domestic & External Debt

Led by a large fiscal deficit, Pakistan's total debt and liability's stock (TDL) recorded a considerable increase during FY10. Specifically TDL stock reached Rs 10.2 trillion by June 30, 2010, which represents almost doubling of the TDL stock from the end-FY07 figure. [14] Resultantly, the TDL stock to GDP ratio also worsened from 60.5 percent in FY07 to 69.5 percent in FY10. In terms of composition, due to lower than projected availability of external financing, increase in debt stock witnessed more reliance on domestic debt sources for the financing of the fiscal deficit during FY10.

1.3.6 External Sector

Balance of Payments

During FY10, Pakistan's current account deficit contracted sharply by 62.1 percent. As a result, despite lower surplus in the financial account compared to FY09 the overall external accounts recorded a surplus of US$ 1.3 billion after a gap of two years.

The improvement in the current account owed to contraction in the trade account and rise in the invisible account surplus. The trade account improved not only due to 2.3 percent YoY fall in imports but also due to almost 3 percent YoY increase in country's exports. Besides the trade account, improvement in the invisible account, which came about as a result of higher receipts under logistic support, lower payments under other business services, and larger inflows under workers' remittances also contributed to significant contraction in the current account deficit.

Financial account surplus declined to US$ 4.9 billion in FY10 against US$ 5.6 billion recorded in FY09. This deterioration was due to fall in both, investment and loan inflows. In case of investment, while foreign direct investment declined by more than 40 percent YoY, outflows from portfolio investment were limited to US$ 63 million against US$ 1.0 billion in FY09. Loan inflows also recorded a decline of 10 percent during FY10. A major part of the loans were received from the IMF under a Stand-By Agreement (SBA).

As a result of improved external sector performance, foreign exchange reserves reached an all time high of US$ 16.9 billion as of end June 2010 up from 1US$ 2.8 billion in the previous year. This also helped in achieving relative stability in the exchange rate during FY10 despite shifting of oil related payments to inter- bank. Pak rupee depreciated by 4.8 percent in FY10 against 15.7 percent recorded last year.

Trade Account (FBS data)

Pakistan's trade deficit continued to narrow for the second consecutive year, reaching the level of US$ 15.3 billion. Unlike the preceding year, in which the entire improvement in trade account was on account of fall in imports, in FY10 it was the remarkable YoY growth of 9.4 percent in exports that led to 10.3 percent YoY contraction in the trade deficit. As a result, trade deficit to GDP ratio improved to 8.7 percent in FY10 from 10.6 percent in FY09. Furthermore, while the increase in exports largely owed to higher quantum of goods, the fall in the import bill was mainly a result of lower prices.

[14]During FY10 country's TDL stock stood at Rs 9.4 trillion, which represents 86.4 percent growth over the TDL stock during FY07.