1 Economic Outlook

1.1 Overview

Pakistan's economy managed to grow by 2.4 percent in FY11, despite devastating floods in the early part of the fiscal year. One-fifth of the country's agricultural heartland was inundated, which interrupted production processes and disrupted the subsequent supply of both labor and capital. It is estimated that 6.6 million of Pakistan's labor force was out of work for 2 to 3 months, and capital stock worth US$ 2.6 billion (1.2 percent of GDP) was lost.[1]

While the international response to the devastation was below expectations, it is commendable that the government was able to address these challenges despite severe fiscal constraints.[2] Furthermore, the inherent resilience of the agri sector allowed it to post a bumper wheat crop in the *rabi* season and sizable production of minor crops (potato, onion, pulses, etc.), which spearheaded the revival. A spontaneous community effort towards rehabilitation and government support in the form of cash payments to flood affectees and providing free seeds and fertilizers, allowed the country to overcome this natural disaster.

However, the 2010 floods cannot mask the structural deficiencies in Pakistan's economy. For simplicity, we would identify four inter-related issues that need urgent policy attention to break out of Pakistan's current stagflation. First and foremost is the fiscal problem, specifically the lack of tax revenues; then is the spillover of fiscal slippages on domestic debt and the crowding out of the private sector; then, the acute shortage of power; and finally, the external sector.

The real sector

Although the agriculture sector managed to overcome the floods and posted real growth of 1.2 percent (double what had been posted in FY10), the manufacturing sector suffered a serious setback. Industrial growth was *negative* 0.1 percent in FY11, due to flood-driven supply chain interruptions; prolonged power outages; and reduction in gas supplies. Services, on the other hand, supported growth on the back of a rise in government salaries and defense spending. The overall growth in services was 4.1 percent in FY11, which was lower than the target 4.7 percent, but this still accounted for 90 percent of real GDP growth. Having said this, Pakistan fared poorly when compared to its neighbors in South Asia (**Table 1.1**). Both domestic and global factors are responsible, but we

Table 1.1: Real GDP Growth (percent)

	China	India	Sri Lanka	Bangladesh	Pakistan
2005	11.3	9.0	6.2	6.3	9.0
2006	12.7	9.5	7.7	6.5	5.8
2007	14.2	10.0	6.8	6.3	6.8
2008	9.6	6.2	6.0	6.0	3.7
2009	9.2	6.8	3.5	5.9	1.7
2010	10.3	10.1	8.0	6.4	3.8
2011p	9.5	7.8	7.0	6.3	2.4*

P = projected
* Actual growth taken from Pakistan Economic Survey
Source: IMF, WEO, September 2011

[1] The floods displaced over 20 million people. Taking the labor force participation rate at 33 percent, the labor force displaced worked out at 6.6 million. Damage to capital stock including public and residential buildings, commercial structure and contents, roads and railroads, have been estimated at US$ 2.6 billion (Hicks, M. J. and Burton, M. L. (2010); Preliminary Damage Estimates for Pakistani Flood Events, 2010; Center for Business and Economic Research, Ball State University).

[2] However, IMF provided support of US$ 453 million under its Emergency National Disaster Assistance on the request of Pakistan.

believe the domestic issues are more decisive and chronic. These include the collapse of fixed investment; acute energy shortages; urban violence and lawlessness; poor physical infrastructure; and institutional fragility.[3] The issue of fixed investment merits special mention; Pakistan's investment rate was only 13.4 percent in FY11, which is the lowest since FY74.[4] Since this is a leading indicator for economic growth and employment, the uncertain business climate (demand for loans) and the hesitation of banks to lend (supply) are jointly responsible for this state of affairs. Going forward, policymakers must focus on such basics if Pakistan's economy is to move forward.

Fiscal

Pakistan's fiscal position remained under stress during FY11, with a budget deficit of 6.6 percent of GDP, compared to a target of 4.0 percent (**Table 1.2**).[5] While a portion of this excess could be attributed to the floods, the real issue is the government's inability to implement fiscal reforms, and in some cases, not even being able to secure the required legislation.[6]

The implementation of the reformed general sales tax; the broadening of the income tax net to include agriculture and services; the phasing out of subsidies in a timely manner; and the restructuring of loss-making public sector enterprises – were either delayed, or not implemented. Ad-hoc measures, including a surcharge on income tax and an increase in federal excise duty, were no substitute for required reforms. These measures simply put a heavier burden on existing taxpayers, which could incentivize them to slip beneath the tax net. Realized tax revenues of Rs 1.7 trillion, fell short of the annual target by Rs 160 billion. The year-on-year increase in taxes could not even keep pace with nominal GDP (the base for taxation), which means tax revenues actually fell in real terms.

On a positive note, the government was able to contain its spending compared to FY10. Budgetary expenditure in FY11 was 18.9 percent of GDP, against 20.5 percent in the preceding year. While this is a welcome development, the details merit a word of caution. First, a portion of public sector *development* spending was utilized to rehabilitate flood affectees, and to revive agricultural activities. In our view, the sharp reduction in development spending will continue to dampen fixed investment, which lowers future growth prospects. Second, federal subsidies were three times higher than envisaged in the budget, which implies resource misallocation. And finally, loss-making PSEs continue to hemorrhage and drain scarce fiscal resources – Pakistan Railway, PIA and Pakistan Steel are classical examples of the heavy cost of poor governance to the economy (see Boxes 2.4 & 2.5 in Chapter 2).

Domestic debt & crowding out

The large fiscal deficit directly impacted Pakistan's debt burden, as the stock of public debt and liabilities (accumulated deficits) posted an increase of Rs 1,763 billion in FY11, to Rs 11.0 trillion (60.9 percent of GDP). Interest payments alone accounted for 32.8 percent of government revenues last fiscal year, which means a further squeeze on the government's ability to use fiscal policy to promote economic growth.

[3] Institutional fragility stems from non-merit based appointments, frequent transfers and postings, short-lived top positions in key institutions, and external interferences in the functioning of public institutions.

[4] For detail discussion on this issue, see Chapter 4.

[5] This includes the payment to settle the circular debt.

[6] At the start of FY11, the government had committed to implement the Value Added Tax (VAT) during the year. After opposition from businessmen and some Parliamentarians, this was renamed as the Reformed GST. The RGST Bill was formulated in H2-FY11, and approved by the Standing Committees of both the Senate and the National Assembly. The RGST Bill was tabled in the National Assembly in May 2011, but there has been no follow up since.

However, Pakistan's external debt remains comfortable, especially within the context of the acute problems facing the Eurozone. During FY11, most of the increase was on account of currency revaluation, as the dollar lost value against other hard currencies. The funding that Pakistan actually received during FY11 was largely utilized for the servicing of external debt.

The financing of the fiscal deficit was, and still remains, challenging. With a decline in external funding following the suspension of the IMF Stand-By Arrangement (SBA), the government had little choice but to rely increasingly on domestic sources. During FY11, the government borrowed Rs 1.1 trillion from domestic resources, which accounted for 91.0 percent of the fiscal deficit. Within domestic sources, the heavy reliance on commercial banks not only crowded-out the private sector, but also complicated monetary management, as banks focused increasingly on short-term T-bills to place their surplus liquidity.

Table 1.2: Selected Macroeconomic Indicators

	FY08	FY09	FY10	FY11	
				Targets	Actual
% Growth					
Real GDP (at factor cost)	3.7	1.7	3.8	4.5	2.4
Agriculture	1.0	4.0	0.6	3.8	1.2
Large-scale manufacturing	4.0	-8.1	4.9	4.9	1.0
Services	6.0	1.7	2.9	4.7	4.1
Consumer price index (FY01 =100)	12.0	20.8	11.7	9.5	13.9
Sensitive price indicator (FY01 = 100)	14.2	22.7	13.2		17.8
Monetary assets (M2)	15.4	9.6	12.5		15.9
Private sector credit	16.5	0.6	3.9		4.0
Exports (f.o.b.)	12.2	-7.2	9.1		28.6
Imports (c.i.f.)	30.9	-12.9	-0.3		16.4
Million US $					
Remittances	6,451.2	7,811.4	8,905.9		11,201.0
Official liquid Foreign exchange reserves	11,398.7	12,425.2	16,750.4		18,243.8
% of GDP					
Total investment	22.1	18.2	15.4	15.4	13.4
National savings	13.6	12.5	13.1	13.2	13.6
Total revenue	13.7	13.2	13.8	15.2	12.5
Tax revenue	9.9	9.8	10.0	11.0	9.4
Current expenditure	14.8	12.9	13.6	14.8	16.1
Development expenditure	2.5	1.9	2.1	4.3	2.8
Budgetary deficit	7.6	5.3	6.3	4.0	6.6
Current account balance	-8.5	-5.7	-2.2		0.1
Public debt	60.7	61.6	62.2		60.9
Domestic debt	32.0	30.3	31.4		33.3
Foreign debt	29.9	32.6	31.6		28.2
External liabilities	0.9	0.8	1.5		1.2

As a result, private sector credit only grew by 4.0 percent in FY11, as compared to an increase of 74.5 percent in government borrowing from commercial banks. In our view, since commercial banks were lending to the government at attractive rates, this left little incentive to fund private businesses. This suited commercial banks as investments in government securities are risk-free and carry no capital requirements for credit risk. Having said this, it is important to note that demand for private sector credit was also low, as borrowing was limited to running finance, with little interest in fixed investment.

Unfortunately, this crowding-out was to be expected, as the government shifted away from central bank financing during the second half of FY11. This shift towards commercial bank financing was required to manage inflationary expectations, as SBP and MoF came to an understanding (in late 2010) to keep government borrowing below September 2010 levels. Nevertheless, the delayed impact of central bank financing in the first half of FY11 persisted to keep inflationary pressures high throughout the year.

More importantly, retail prices also increased because of supply side factors, including the impact of floods and the rise in international commodity prices. Food inflation was particularly hard hit, posting a sharp 21.3 percent year-on-year increase in September 2010, compared with 10.4 percent in the same month a year earlier – food inflation remained about 19 percent in the first half of FY11. With headline CPI inflation also in double-digits throughout the year (it averaged 13.7 percent for the year [7]), SBP resorted to monetary tightening with an increase in the policy rate from 12.5 percent in end-FY10, to 14.0 percent in November 2010 – for the remaining part of FY11, the policy rate was kept unchanged.

Energy

Acknowledging the importance of energy as a key factor of production, this *Annual Report* will devote a full chapter to assess Pakistan's energy shortage.[8] Estimates from the Planning Commission claim that about 3-4 percent of GDP may have been lost because of power outages in FY11, with a concentrated impact on the manufacturing sector. The government's response to this energy shortfall was threefold: (1) rental power projects (RPPs) were commissioned to increase generation capacity; (2) the government released Rs 120 billion to resolve the inter-agency circular debt problem, which was undermining energy production; and (3) electricity tariffs were increased to pass on the higher cost of production. In spite of these measures, the overall situation remained largely unchanged.

In our view, commissioning RPPs to increase generation capacity was misplaced, as Pakistan is operating well below its installed capacity due to the circular debt problem.[9] One must also note that the Rs 120 billion injected by the government (to restart the funding of furnace oil) only happened in May 2011. In effect, for most of FY11, the acute problems in the power sector went unaddressed.

Governance

In the final analysis, all the economic problems highlighted above can be traced to poor governance (**Box 1.1**). Economic

Box 1.1: Governance

Governance consists of the traditions and institutions by which authority in a country is exercised. This includes the process by which governments are selected, monitored and replaced; the capacity of the government to effectively formulate and implement sound policies; and the respect of citizens and the state for the institutions that govern economic and social interactions among them.

The World Bank prepares six indicators of governance for over 200 economies. These are: (1) voice and accountability; (2) political stability and absence of violence; (3) government effectiveness; (4) regulatory quality; (5) rule of law and; (6) control of corruption.

World Bank
[http://info.worldbank.org/governance/wgi/index.asp]

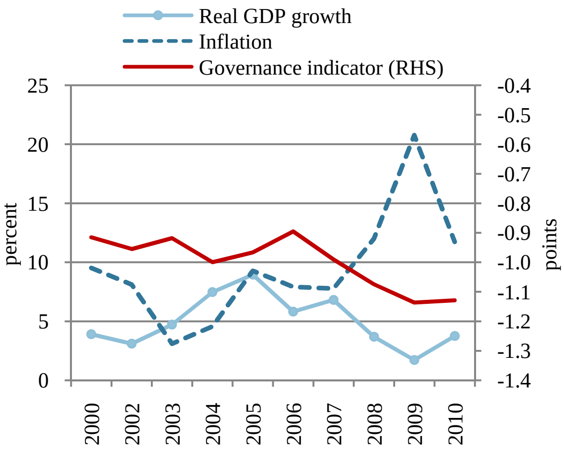
[7] The inflation numbers are based on new CPI data (FY08=100). And food inflation is calculated from weighted average of indices of three groups: (a) Food & Non-Alcoholic Beverages; (b) Alcoholic Beverages & Tobacco; and (c) Restaurants and hotels.
[8] See Chapter 3.
[9] If looking at GENCOs, we believe that the capacity utilization could be as low as 50-60 percent of installed capacity.

policies will be ineffective unless they are supported by strong institutions and are consistent with other government policies.[10]

A cross-country comparison shows that institutional weakness at all levels of government; the judiciary; civil services; law enforcement; regulatory bodies; and agencies for oversight and accountability, are directly responsible for poor economic growth.[11] These institutions put together make up the governance structure of an economy.

In the case of Pakistan, most governance indicators have weakened in recent years (**Figure 1.1**).[12] The business environment has also been undermined by institutional weakness. In a recent study on the ease of *doing business* released by the World Bank, Pakistan slipped from 96 to 105, out of 183 countries evaluated. Out of the ten specific topical criteria, Pakistan scored poorly for the availability of electricity (at 166), followed by issues in paying taxes (at 158).[13] Pakistan's political leadership must take credible steps to stop the slide.

Figure 1.1: Governance and Economic Performance



Note: Governance indicator is average of World Bank's six indicators of governance.

Source: World Bank

1.2 Global Economic Conditions

As this document is being prepared, the global economy is at the precipice of another recession. This recession could be even more severe than the sub-prime mortgage crisis, as the underlying cause is market borrowing by many OECD countries to finance unsustainable fiscal deficits. The current problem has been triggered in the European periphery, with the market pricing in the real possibility that Greece, Italy, Spain, Portugal and Ireland, may be pushed into sovereign default.

As shown in **Figure 1.2**, GDP growth is down across-the-board in the OECD, while inflation continues to edge up. With interest rates at near-zero levels already, central banks in the US and UK continue with quantitative easing (printing currency notes) to encourage banks to lend and consumers to spend. However, as individuals emulate sovereigns to reduce debt levels, much of this additional liquidity is not having the desired effect, as households prefer to pay down their debts rather than spend.

A credible solution for Europe has still not been hammered out. It appears that Germany is at odds with the rest of Europe (and the US) regarding the role of the central bank in financing the government. The quantitative easing undertaken by the US and the UK has been politely rejected by the ECB, primarily because of German discomfort with inflationary finance and the bitter memories with the hyper-inflation after WWI. Furthermore, although commercial banks have agreed to write-off 50 percent of Greek commercial debt, getting the fiscal austerity in place

[10] Hall, R.E. and C. I. Jones (1999); Why Do Some Countries Produce So Much More Output per Worker than Others? *Quarterly Journal of Economics*; 114:1.
[11] Planning Commission of Pakistan (2011); Annual Plan 2011-12, Chapter 1, page 3.
[12] Kaufmann, D., A. Kraay and M. Mastruzzi (2010); The Worldwide Governance Indicators: A Summary of Methodology, Data and Analytical Issues; World Bank Policy Research Working Paper No. 5430.
[13] http://www.doingbusiness.org/data/exploreeconomies/pakistan/

is proving to be much more difficult. The recent resignation of the leadership of Greece and Italy reveals the political cost of the austerity, and the almost impossible balancing act of keeping commercial lenders from increasing the risk premium, against the fiscal austerity that people are willing to accept.

In view of this, central banks in the OECD have adopted unorthodox policy prescription – both the Fed and the Bank of England have disclosed their commitment to keep interest rates at near-zero levels till 2013, with little thought about what could happen to inflation with the waves of quantitative easing. Furthermore, with unemployment rates refusing to fall, and the disenfranchised viewing this as a class struggle (e.g. the Occupy Wall Street movement), OECD governments are under tremendous pressure to push growth (and job creation) even at the expense of inflation. In our view, the Eurozone and the US may have little choice but to be more restrained with fiscal austerity, and accept rising domestic inflation for the next several years.

Figure 1.2: (A) Real GDP Growth

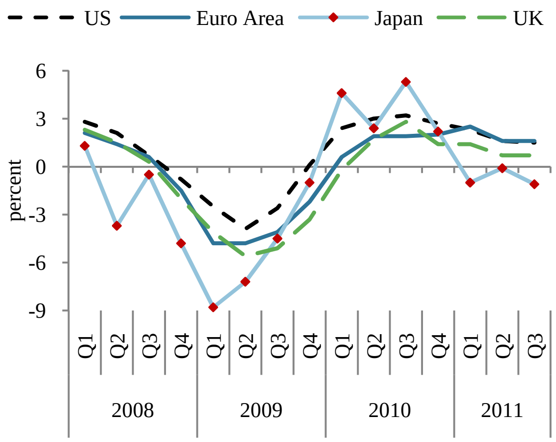
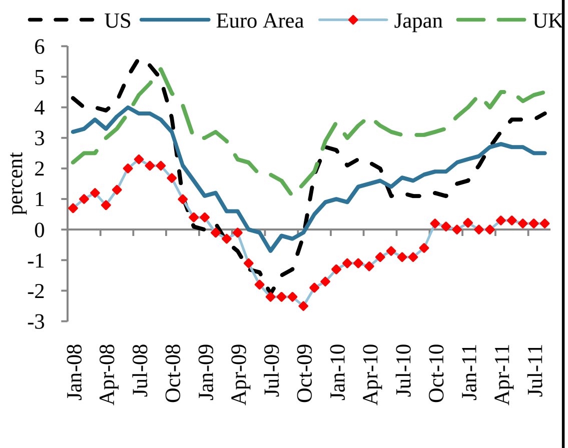
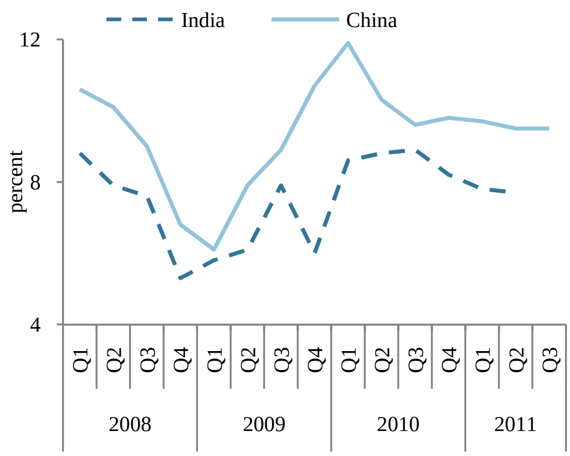


Figure 1.2: (B) Inflationary Trends



Asia on the other hand, continues to power ahead. With China and India leading the charge (see **Figure 1.3**), there is some hope that perhaps Asia has created some distance from the OECD, and has, so far, not been dragged down. However, if the downward slide in the OECD continues (which is likely), the export-led Asian Giants could see their growth prospects diminish.

Figure 1.3: Real GDP Growth



A comparison with the 2008 recession is instructive. While the exposure to toxic mortgages created extreme risk averseness amongst banks in 2008/09, sovereign bonds issued by the European periphery is now beginning to create the same level of weariness. In our view, the spillovers in this crisis could be worse – analysts are not just looking at *insolvent* countries, but also those which are facing a liquidity problem. The latter are seeing lending rates increase that is pushing them into a debt-trap, which in turn is further increasing borrowing costs.

Worse still, the huge contingent liabilities from entitlement programs (e.g. health insurance, pensions, state-funded medical support and higher education, etc.) have also appeared on the radar. Policymakers and opinion-makers in the West are grappling with the sheer size of sovereign, corporate, bank and household debt accumulated in the past, and its dynamics going forward. This has sparked a bitter debate between Republicans and Democrats in the US, which resulted in a downgrade of US sovereign debt in September 2011. This fundamental issue regarding the government's role in providing a minimal level of economic/social services, goes to the very heart of a democratic system – an increasingly older OECD population is trying to protect its claims on future financial assistance. These issues were largely absent in 2008, which perhaps allowed for a rapid policy response. The point to be made is that resolving the current issue will not be easy, and this will delay the rescue plan.

Having said this, the similarities with the 2008 Credit Crunch are also disconcerting. The largest global banks are vulnerable; their creditworthiness is being downgraded by rating agencies; they need urgent recapitalization to pacify an increasingly jittery market; and there is a fear that if Greece stumbles into a disorderly default, banks will stop lending to each other, triggering another credit crunch on both sides of the Atlantic.

The root of the problem in the Eurozone, is the monetary union. In a monetary union, a common monetary policy is just the most tangible manifestation of the union – monetary union also requires a coordinated fiscal policy amongst member countries, which goes beyond simply setting annual fiscal deficit ceilings. This fiscal coordination was glaringly omitted since the Euro was first introduced, and subsequent fiscal deficit ceilings were blatantly breached. The current crisis took time to manifest, but did not elicit a credible response till a market panic firmly took hold.

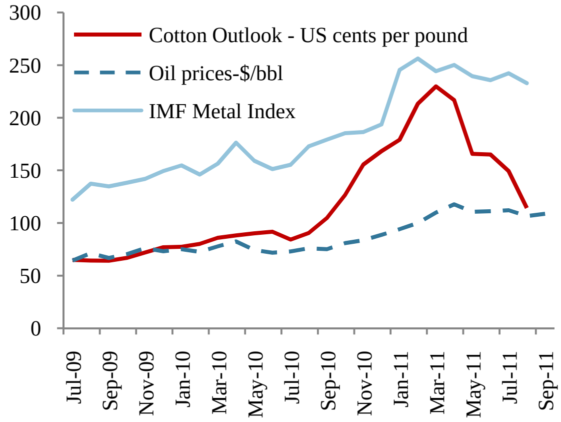
Going forward, the public hesitation of the fiscally conservative (e.g. Germany) to bailout the others (e.g. Greece), is understandably undermining Europe's ability to take decisive action. Unlike 2008, when the Fed and the US Government took immediate and customized (and sometimes controversial) steps to give comfort to the market, Europe's leadership is already late with a credible rescue plan, and all the indications suggest this hesitation will continue. In view of this, the outlook for OECD remains bleak.

External sector

With such a global outlook, analysts in Pakistan are understandably concerned. The immediate worry is the possible slowdown in our exports, as the US and EU are the primary destination for Pakistani goods. We cannot deny this risk, but would suggest the outlook is not as worrying as may appear at first glance. Given Pakistan's track record of precarious external deficits, perhaps analysts and market participants tend to expect the worst.

One must realize that Pakistan's current account balance in FY11 was positive for the first time in six years, and import coverage is still a healthy 26.6 weeks. The trade deficit narrowed to US$ 10.5 billion, which was largely financed by strong growth in worker remittances that reached a record US$ 11.2 billion. In terms of what to expect in FY12, especially within the context of a global recession, the following points should be considered.

Figure 1.4: International Commodity Prices



Source: IMF, EIA

The bulk of Pakistan's exports are low-end textiles, which are not likely to experience a fall in demand as they are income inelastic. If anything, Pakistan's export receipts may be hit harder by the price effect if cotton prices continue to soften. However, as shown in **Figure 1.4**, the negative price effect may not be as pronounced going forward, as current international prices are where they were before the spike started in mid-2010.

With the US Dollar viewed universally as the safest currency (despite serious economic challenges facing the US), we are of the view that the Dollar will not lose ground against other hard currencies. This means if the OECD goes into another recession, there is a possibility that oil prices (denominated in US$) may fall, which will give some comfort to Pakistan's BoP in the remaining part of FY12.

Worker remittances have been strong in recent months, which some claim will be undermined by another global recession. In our view, a key reason for the growth in official remittances is the increasing use of banking channels compared to informal avenues – this was given a boost with US sanctions against Iran in late 2010, which focused on capital flows in and out of the GCC. To attract a greater share of worker remittances via commercial banks, the parallel FX market will have to be closely monitored to ensure the kerb premium remains low.

A more uncertain issue is the fate of expat Pakistanis as the global recession takes hold. With growing concern about job losses as developed countries retrench, and the specific vulnerability of global banks and financial institutions, there is some concern that expat Pakistanis may return. This carries an upside in terms of the savings they will bring with them; this short-term boost may however be neutralized by lower remittances in the future.

Having said all this, Pakistan's economic outlook is not totally counter-cyclical with the global economy. A recession in the OECD will hurt FDI, and the recent cut in domestic interest rates may discourage fixed income inflows. The only consolation is these amounts are likely to be small and should not have a serious impact on Pakistan's external sector.

Of greater concern is Pakistan's relationship with the international financial institutions (IFIs), since official flows are larger than private capital flows. As discussed in the next section, SBP's projections for the current account balance show a deficit of 1.5 to 2.5 percent of GDP. The issue is not the size of the current account deficit (which is small by comparison to previous years), but the drying up of external inflows to fund the gap.

To summarize, while the outlook on the global economy is worrisome, we have reason to believe that Pakistan will largely be insulated from the negative spillover. The downsides for Pakistan are well known and discussed by the media, but the possible upsides are understated and perhaps not properly understood.

1.3 Looking Ahead

Before the start of FY12, policymakers forecast 4.2 percent economic growth on the basis of a positive outlook for cotton; a recovery in the manufacturing sector; and policy measures to address the energy shortage. However, the agricultural outlook has once again been adversely impacted by the floods in Sindh, which has damaged half of its area under cultivation. There is also some uncertainty about the supply of fertilizer for the wheat crop.[14]

[14] With the gas demand pressure in winter, it may be difficult to switch gas to domestic production of fertilizers. Thus the government has to import urea. However, given the logistic facilities at Pakistani ports, there is a risk that availability of urea at farm land could be delayed. Thus wheat production can be adversely affected.

In view of this, we project GDP growth to be in the range of 3-4 percent; we take some comfort from how the 2010 floods were managed (**Table 1.3**).

Table 1.3: Major Economic Indicators

	FY11[P]	FY12 Targets	FY12 SBP Projections
	percent growth		
GDP	2.4	4.2	3.0 – 4.0
CPI	13.7	12.0	11.5 – 12.5
Monetary assets	15.9	-	12.0 – 13.0
	billion US dollars		
Remittances	11.2	12.0	12.0– 13.0
Exports (fob)	25.4	25.8	24.6 – 25.1
Imports (fob)	35.7	38.0	40.3 – 41.0
	percent of GDP		
Fiscal deficit	6.6	4.0	5.5 – 6.5
Current account Deficit	-0.1	0.6	1.5 – 2.5

Note: Targets of fiscal and current account deficit to GDP ratios are based on Nominal GDP in the budget document for FY12, while their projections are based on projected (higher) nominal GDP for the year.

[P] Provisional

Having said this, we feel the government will again miss the 4 percent fiscal deficit target in FY12, with doubts on both expenditure and revenue targets. The floods in Sindh and a prolonged wave of dengue fever in Punjab, have created an unanticipated fiscal burden. Moreover, both provincial and federal governments are less likely to be frugal this fiscal year, not just as elections get closer, but also as provincial governments take greater responsibility for their fiscal affairs. In our view, the absence of an IMF program may also allow expenditures to stray off course, while prospects for additional revenue measures are dim.

The likelihood of achieving the non-tax revenue target (as shown in Federal Budget) is also low for several reasons: (a) the expected US$ 1250 million Coalition Support Fund is more uncertain as Pakistan's relations with the US are strained; (b) with the recent cut in the discount rate, SBP's profit could be less than the budgeted Rs 200 billion; and (c) there is little progress on the auction of 3-G telecom licenses, which had been budgeted to raise Rs 75 billion revenue in FY12. In view of this, SBP projects a fiscal deficit of 5.5 to 6.5 percent of GDP, with a bias on the upside.

All concerned parties realize the need to push broad-based fiscal reforms if sustainable growth is to be achieved. The main ingredients remain the same: (a) the political will to widen the tax base to include untaxed or under-taxed segments (agriculture and services); (b) plugging leakages in the collection machinery; (c) removing subsidies on electricity, fuel, and agricultural commodities, while targeting subsidies to underprivileged groups;[15] and (d) restructuring public sector enterprises, with a specific focus to reduce the monthly hemorrhaging that is adding to the government's fiscal burden.

The political dimension of these issues cannot be denied, which reinforces our view that difficult political decisions are required to get Pakistan's fiscal house in order. The current level of over-staffing; corruption and wastage; and politicized unions in the PSEs, makes for a very challenging environment. However, these precise issues plagued the nationalized commercial banks in the 1990s, yet they were successfully restructured and eventually privatized. In our view, PSEs need to be put back on the policy agenda; at the very least, credible management teams and a phased reform agenda must be formulated and made public.

In our view, policymakers may consider formulating a comprehensive medium-term fiscal reform *masterplan*, which is staggered and sequenced on the basis of the hard lessons of the recent past. Coordinated documentation; transparent collection with oversight; an equitable plan to capture all commercial businesses and institutions into the tax net; a restructuring agenda for loss-making PSEs; and a credible enforcement mechanism, must anchor this masterplan. These

[15] Subsidies, once given, are very hard to remove without multi-partisan consensus. The role of media is also very important to differentiate between the elite and poor beneficiaries of subsidies.

reforms will not be easy to implement, but prioritizing this initiative, and having the policy *will* to overcome the more vocal (and latent) resistance, will signal intent and give this effort a better chance of succeeding. In the current state of Pakistan's economy, there is no wiggle room left.

Even if preliminary steps are taken soon, the magnitude of the task is such that results will not be forthcoming in the near future; hence, financing the fiscal deficit gap in FY12 will be very challenging. The IMF has still not issued a Letter of Comfort to help Pakistan negotiate with the ADB and the World Bank. With dim prospects for external funding, the burden will once again fall on domestic sources. Despite the recent cut in the policy rate, SBP will continue to rely on the government to respect its borrowing ceiling from the central bank. Being realistic, we expect occasional breaches, but would urge the government to preemptively secure additional non-bank financing and also explore non-traditional avenues of external financing.

Although international oil and commodities prices may soften with sluggish OECD growth, we believe inflationary pressures are likely to persist because of several factors: (1) food inflation has been the driver behind headline CPI, and monetary policy may not be an appropriate tool for managing this problem; (2) the *diffusion* of inflation (the number of items in the CPI basket showing double-digit price rises) has increased and moved from food and energy to other items;[16] and (3) the recent increase in POL prices will hit food and non-food items across the board. Therefore, SBP expects inflation to be within a band of 11.5 – 12.5 percent in FY12, which is broadly in line with the Annual Plan target of 12 percent.

What we are less comfortable with, is the absence of a medium-to-long term strategy for the energy sector. We appreciate the government's recent effort to resolve the circular debt problem, and are optimistic this may help unlock financing and improve capacity utilization. However, given Pakistan's growing dependency on imported furnace oil, and the higher cost of base-load energy generation, the government must go beyond fire-fighting measures.

We also believe the economic costs of the energy shortage are understated. The primary impact is on small and medium size manufacturing units and service providers, which are not properly documented and therefore do not show up in our GDP numbers. Furthermore, the loss of employment is more severe, as these units tend to be labor intensive. The socio-political unrest triggered by the energy shortage in many parts of the country, is ominous. Large-scale projects that focus on alternative energy sources (like hydel and coal) must be launched.

On the monetary policy side, the sharp cut in the discount rate in FY12, has surprised the market. With inflation easing somewhat and banks increasingly inclined to place funds with the government, the degree of crowding out of the private sector required policy intervention. Although SBP is still watchful to ensure that lending rates do not become negative in real terms, we share global concerns about stagnant growth and rising unemployment. SBP identified a window of opportunity, whereby private investment and employment generation would be given due importance. There was also a need to halt the growing dominance of debt servicing in the federal budget.

Finally, the outlook for Pakistan's current account balance remains a source of concern, but we remain hopeful of some upside on strong worker remittances and a possible recession in the global economy. Although data for the first four months of FY12 shows a current account deficit of $1.6 billion, we attribute this to temporary events (bulky oil payments and a seasonal pause in remittances in September 2011, and an engineered shortage of hard currency in the parallel FX

[16] The possible upside is that a pass-through from non-food-non-energy items to the rest of the basket, is limited.

market).[17] Going forward, we expect a current account deficit of 1.5 to 2.5 percent of GDP, which is relatively small given our past performance. However, the financing of this current account deficit could be challenging.

We also think the market is over-reacting to Pakistan's FX debt payments in FY12. One must realize that while repayments on the IMF's US$ 8.9 billion SBA will start this fiscal year, outflows are only US$ 1.4 billion and are scheduled for the latter half of the fiscal year.

[17] Usually after Eid, there is a downturn in remittances inflows, which was witnessed in September this year. Moreover, the temporary rise in the *kerb* premium in September may also have diverted some remittances away from banking channels.

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