

# 1 Economic Outlook

## 1.1 Overview

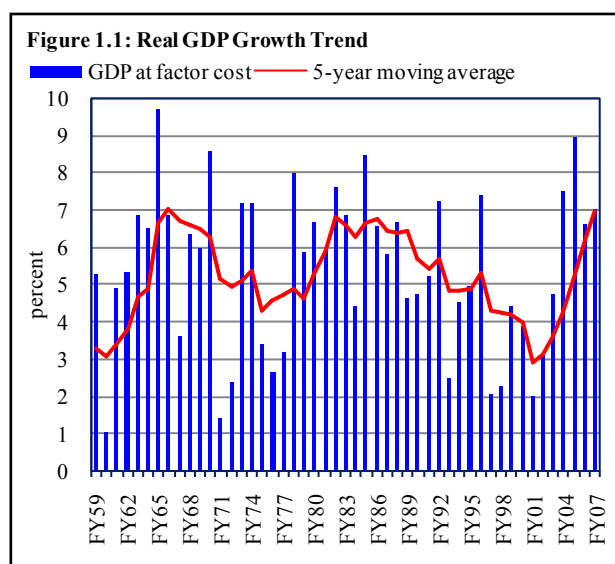
Pakistan's economy recorded one of the fastest growth rates in Asia during FY07. Real GDP growth accelerated to 7.0 percent that was surpassed only by China and India. This was the third consecutive year in which growth was supported by an acceleration in real investment. Sound macroeconomic policies have successfully transformed the initial consumption-led growth impetus of a few years back to a greater role for sustainable investment-led growth. With the investment to GDP ratio at a record 23 percent, complemented by a surge in domestic private investment and record FDI flows, the economy looks well-poised to continue on a high growth trajectory in coming years.

Besides growth and investment, several other key macroeconomic variables also showed substantial improvement in FY07 when compared with last year. More specifically, and in proportion to GDP, national savings rose, the external debt burden declined and total revenue increased while the budget deficit stayed at last year's level of 4.3 percent of GDP (see **Table 1.1**). However, key macroeconomic challenges remain to be fully addressed yet. The current account deficit widened further in FY07, the tax to GDP ratio is still very low, and inflation remained stubbornly high, showing only a sluggish decline in FY07.

The FY07 economic performance has propelled the five-year average real GDP growth rate to approximately 7 percent (see **Figure 1.1**). The last time such high growth levels were sustained, in the FY79-FY83 period, the country witnessed an appreciable reduction in poverty levels, and there is evidence that the current spell of sustained high growth is having a similar impact. Thus, given the high poverty levels in Pakistan, it is important to maintain the elevated growth rates in the medium to long term. This is a challenging target, particularly as the above average growth in recent years has stressed the productive capacity of the economy, which showed up in macroeconomic indicators such

as rising inflationary pressures, a widening external account deficit, etc. Clearly, if the economy is to continue growing at rates above historical norms, there is a need to implement policies and measures to stabilizing emerging macroeconomic imbalances. Sector specific supportive policies would also be required in order to remove growth bottlenecks and to help diversify the growth base of the economy.

Containing the high domestic inflation poses a key challenge. The decline in non-food inflation during FY07 shows that monetary policy was effective in containing demand-pull inflationary pressures, but the impact of the monetary tightening was muted by the unanticipated strength in food inflation<sup>1</sup>, an expansionary fiscal policy marked by central bank borrowings throughout FY07, and the need for concessional refinancing for strategic sector of the economy (textiles and exports). Monetary



<sup>1</sup> The impact of food inflation on overall CPI inflation is captured from the fact that the average CPI inflation for FY07 was 7.8 percent, well above the 6.5 percent annual target, even though non-food inflation dropped from 7.7 percent YoY in July 2006, to a three-year low of 4.2 percent YoY in May 2007.



A tight monetary posture is all the more important given the exceptional rise in monetary aggregates during FY07. The 19.3 percent M2 growth in the year was 5.3 percentage points higher than the annual target. The acceleration in the growth of broad money, particularly in the last month of FY07, risks exacerbating the demand pressures already visible in the economy towards the end of FY07. The resurgence in inflationary pressures is well captured by the two core inflation measures, each of which bottomed out in May 2007. After reaching 5.2 percent in May 2007, the non-food non-energy (NFNE) core inflation reached 6.0 percent in August 2007. Similarly the trimmed mean core inflation measure also reached a trough at 6.2 percent YoY in May 2007 before climbing to 6.7 percent YoY in August 2007. It is in this context, that the SBP made significant changes to its monetary policy framework in July 2007 by raising the policy rate by 50 basis points with effect from August 1, 2007, and complementing this tightening with non monetary measures to curtail reserve money growth. The SBP moved to limit the impact on monetary growth of the concessional financing for exports (by reducing provision of re-finance) and, for the first time, the SBP also advised the government to contain its borrowings from the central bank within a specified limit.

The present expansionary fiscal policy poses a dilemma. On the one hand, the high fiscal deficit in recent years is driven primarily by development spending, particularly on infrastructure, which is quite necessary if the growth in the economy is to be sustained. On the other hand, tax reforms so far have not been able to increase the tax base in any significant way, although revenues from the existing tax base have grown significantly, as result of these reforms and a strong economy. The way out of this dilemma lies in restricting public investment to high priority sectors and public goods, encouraging public-private partnerships in the provision of infrastructure, and expanding the tax base rather than focusing on improving tax compliance alone. In the latter context, a large part of agriculture and the services sector, which account for over two-thirds of GDP, is largely out of the direct tax net. This is not sustainable.

An increased role of the private sector in the provision of infrastructure would not be possible without well-developed domestic financial markets, and particularly the debt markets. While Pakistan does have a liquid market for short-term government paper, the long-term domestic debt market is still under developed and corporate debt issues account for less than 1% of GDP. Development of the long-term debt markets is essential to support investment, and could spur an increase in domestic savings. The latter objective in particular could be fostered by the development of the savings institutions (pension and provident funds, mutual funds, etc.). The development of long-term debt markets is not done overnight, but the recent growth in fixed income mutual funds industry suggests that rapid progress is possible in some areas. The government has resumed PIB issues after a hiatus, but the amounts offered, net of maturities, are inadequate, and the absence of a regular calendar of issues, is also a deterrent to proper price discovery.

Sizeable PIB issuances, on a regular pre-announced schedule, would provide an improved long-term benchmark for market-based pricing of long-term risk, allowing for the development of a long-term corporate debt market. It would also reduce the government's reliance on central bank borrowings, which considerably complicate the SBP's liquidity management efforts, and distort the transmission of monetary signals.

The growing current account deficit, led principally by sharp slowdown in export growth, poses another key challenge to macroeconomic stability. In the immediate response to the emerging slowdown in exports early in FY07, the SBP increased the subsidy implicit in the export finance lending in July 2006. Subsequently, the effective cost to investors on the long-term concessional funding provided by SBP for investment was reduced, and the effective cost of investments in some key value-added export sectors was also lowered through debt swaps.

However, as the year progressed, there appeared to be little correlation between the provision of concessional credit and export growth. Moreover, the provision of concessional funding posed problems for effective liquidity management, weakened the transmission of monetary policy signals, and lowered incentives for banks to mobilize deposits, through FY07. Furthermore, a closer look at the FY07 export performance suggests that not all of deceleration in exports growth can be attributable only to weak competitiveness. For example some of the slowdown in the overall exports may be attributed to vagaries of nature such as crop failures and some other to the EU specific issues, i.e., adverse impact of antidumping duty, loss of duty free access to EU market and provision of same to Bangladesh and Sri Lanka and ban on fish & fish preparation export.

In short, while there is clearly a role for policy in supporting export growth, the greater benefits are likely to emerge from policies aiming to reduce the cost of doing business, removing bureaucratic hurdles, reducing the costs for energy and water, and lowering inflation in the economy, rather than short-term palliatives. In particular, subsidies are unsustainable given the shrinking fiscal space available to government. The substantial reforms and corrective policies needed to reduce external imbalances must focus on a long-term perspective rather than on the provision of *ad-hoc* short-term support.

Specifically, raising productivity in both agriculture and industry is key to improving the economic prospects for years ahead. The solution to structural problems lies in increased investment to raise production (and productivity). The agricultural sector, in particular, offers considerable scope for improvement, by increasing water storage capacity and distribution network, introduction of high yield and pest resistant varieties, introducing innovation in irrigation, e.g., drip irrigation at least for some selected crops, and improvement in water management including canal lining. Enormous gains can also be achieved by lower post harvest losses through mechanization, and development of storage and processing facilities.

However, much of the investment needed for this transformation is held back partly by the weakness in access to credit. Despite a tremendous improvement in agri-credit growth the access to institutional credit is still far from satisfactory. For example, it is estimated that over 200,000 farmers are without Pass Books<sup>2</sup> in Sindh alone. Indeed, despite increased financial deepening in recent years, a large part of the population is out of the network of the financial services. Financial inclusion of low-income group needs to focus on providing banking services (account opening, and access to credit as well as advice on issues relating to managing money). It is encouraging that the central bank and government are making efforts in this area, however, banking industry should also contribute to this effort as responsible corporate citizens. Post office banking, branches of microfinance institutions, NGOs can also contribute significantly. Such measures would be important in ensuring that the benefits of economic growth would be better transmitted through the economy.

Finally, the focus of labor market reforms should be on employment generation rather protectionist policies. The latter policies have typically resulted only in lower employment absorption and deterioration in the quality of employment i.e. increased contractual employment in the country. A flexible labor market, where hiring and firing is easy, ensures efficiency. It should be noted that a shortage of skilled and trainable labor in the country is a key bottleneck for productivity growth. It is therefore important that Pakistan's ample human resources, be productively harnessed by improving access of primary level education, policies to reduce the dropout ratio at the secondary level, and increased opportunities for vocational training.

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<sup>2</sup> The passbook issued by the provincial Revenue Departments defines land ownership and is a key collateral document for agri-credit.

## 1.2 Looking Ahead: Key Projections

Current SBP projections, based on the limited data availability to date, suggest that the economy will continue to grow strongly during FY08. The growth is anticipated to be broad-based, with the strong contributions expected from agriculture and the services sector.

Also the aggressive monetary tightening should help contain demand pressure in the economy, with monetary growth forecast to remain within the indicative target published in the Monetary Policy Statement for July-December FY08.

The slowdown is expected to be reflected mainly through moderate (but adequate) growth in private sector credit, lower government borrowings from SBP, and slower net growth in NFA of the banking system, consequent to changes in the monetary policy framework in FY08.

This is expected to keep domestic inflation close to the annual target in FY08. Key risks to the inflation outlook are:

- (1) Rising international energy prices: The domestic economy was partially insulated from the rise in international energy prices during FY07, due to the government's decision not to pass on to customers the increase in the prices of key fuels. This policy may not be sustainable if energy prices increase further.

- (2) High food commodity prices: Domestic prices of key food staples have already been affected by rising international prices, and the pass through could be aggravated if FY08 harvest of food crops is below expectations. Also, while the FY08 sugarcane crop is likely to be exceptionally good, the resulting decline in sugarcane prices and consequent price disputes between farmers and sugar mills could delay sugar production. Given that domestic sugar stocks could be exhausted by November 2007, any such delay could lead to a price spike. However, administrative measures (such as extension in the network of utility stores) and proactive imports would help alleviate any short-term shortages. A inter-ministerial task force has recommended a number of measures to alleviate food inflation in FY08 (see **Box 1.1**)

Finally, a further deceleration in imports growth, together with a small improvement in export growth, and a robust rise in remittances underpins the projected improvement in the current account deficit for FY08; while the deficit is expected to be larger than the FY07 figure in absolute terms, as a share of GDP, the deficit is expected to fall.

**Table 1.2: Major Economic Indicators**

	FY08		
	FY07	Annual Plan Targets	SBP projections
<i>growth rates (percent)</i>			
GDP	7.0	7.2	7.0 - 7.4
Inflation	7.8	6.5	6.0 - 7.0
Monetary assets (M2)*:	19.3	13.7	13.2 - 14.2
<i>billion US Dollars</i>			
Workers' remittances	5.5	5.8	6.0 - 6.5
Exports (fob-BoP data)	17.1	18.9	18.3
Imports (fob- BoP data)	27.0	29.6	28.9
Exports (fob-Customs data)	17.0	19.2	19.2
Imports (cif-Customs data)	30.5	32.3	32.3
<i>percent of GDP</i>			
Fiscal deficit**	4.3	4.0	4.0
Current account deficit	5.3	5.0	4.8

\*: M2 growth target was announced in Monetary Policy Statement for Jul-Dec 2007.

\*\* : Budget Estimates for FY08

## 1.3 Executive Summary

### 1.3.1 Economic Growth, Savings and Investment

Pakistan's economy witnessed a moderate recovery during FY07 with real GDP growth reaching the 7.0 percent target, as compared with 6.6 percent growth seen in FY06. This is the fourth successive year of sustained high growth in the economy, with the average annual growth accelerated to 7.0 percent during FY03-07 period. The continued strong performance of the services sector made the major contribution to the FY07 outcome. Growth in agriculture and industry also witnessed improvement over the previous year.

The disaggregation of the aggregate demand presents an encouraging scenario. Firstly, the growth in real private consumption remained stable, inching up from 3.3 percent during FY06 to 4.1 percent. Secondly (and more importantly) real gross fixed capital formation registered a double digit growth for the third consecutive year, accelerating to 20.6 percent in FY07, due to higher FDI inflows and an acceleration in public investment on the back of a higher PSDP. As a result of the increase in public and private investment, the investment to GDP ratio rose to a record 23.0 percent in FY07.

#### *Agriculture*

Agricultural growth witnessed a recovery in FY07. This was primarily due to a considerably improved performance by the cropping sub-sector that overshadowed the impact of a moderation in the growth of the livestock sub-sector. The contribution of the remaining sub-sectors to overall agricultural growth was not material.

A sharp rise in value addition by crops, in turn, centered essentially around three major crops, i.e., wheat, sugarcane and gram, all of which recorded exceptionally strong growth during FY07, comfortably offsetting the disappointing growth in two other cash crops (cotton and rice).

The growth of the livestock sub-sector in FY07 is one of the strongest in a decade (exceeded only by the exceptional FY06 growth). Moreover, consequent to robust demand, this sub-sector is attracting investment in the production, processing, transportation and storage of dairy products. This augurs well for future growth prospects.

In recent years, agriculture credit disbursement has increased substantially reflecting improvements in access (as banks have aggressively expanded activities in the sector), and sustained demand (as farmers were encouraged by strong commodity prices, supportive policies and reasonable weather). This was also seen in FY07, when the annual target was exceeded by 5.5 percentage points to reach Rs 168.8 billion against Rs 137.5 billion disbursed in FY06.

#### *Industry*

The industrial sector witnessed a moderate recovery, with 6.8 percent growth during FY07 compared with 5.0 percent in FY06. This was the second consecutive fiscal year when growth targets for industrial sector remained unachieved. Within the industrial sector, the highest growth was observed in the construction sub-sector with value-addition rising by 17.2 percent in FY07, compared with only 5.7 percent in FY06. The FY07 growth is not only higher than the 7.0 percent target, it is also the second highest growth recorded by this sub-sector since FY76.

*Mining & quarrying* sector witnessed 5.6 percent YoY growth during FY07 which is not only higher than the 4.6 percent growth seen in FY06, but also well above the 3.2 percent growth target for FY07.

LSM growth remained a significant contributor to GDP growth during FY07 with value-addition rising by 8.8 percent, down from the 10.7 percent growth in the preceding year. This deceleration in

LSM growth appears to reflect a broad moderation in external and domestic aggregate demand, as well as capacity and input constraints in some industries. The textile sector contributed almost a quarter of the increase in value-addition in LSM during FY07.

The electricity and gas distribution sub-sector continued to record losses in FY07, with the value addition by this sub-group falling by 15.2 percent in FY07 on top of the decline of 23.8 percent in the preceding year.

### **Services**

For yet another year, the services sector growth remained well above target; the 8.0 percent increase in value-addition during FY07 was substantially above the 7.1 percent target. The FY07 target had been set lower than the 9.6 percent growth recorded in FY06 taking into account the anticipated deceleration in some of the larger sub-sectors of the services group, but the performance of two sub-sectors – *finance & insurance*, and *social & community services* – proved to be much better than forecast. The sustained strong growth by the services sector for the last six successive years has contributed to a structural shift in the economy, with services contributing over half of GDP in FY07.

### **National Savings**

During FY07, national savings rose sharply by 19.8 percent, raising its share in GDP to 18 percent, the highest in the last four years. It should be noted that despite a rise in FY07, Pakistan's savings to GDP ratio remains quite low relative to other emerging economies. To maintain the growth momentum, there is a need of investment flows in the economy without putting pressures on external balances. This is only possible by a rise in savings in the economy. The main causes of low savings in Pakistan include low per capita income, lack of proper saving infrastructure (particularly in small towns and rural areas) and high dependency ratio.

To increase the savings rate, it is necessary to expand the network of banks, microfinance institutions, and postal savings to the far flung areas with simple procedure and friendly atmosphere for small depositors. In addition, savings schemes for school/college students could also help inculcate savings behavior from an early age.

### **Investment**

The sustained high pace of growth in the economy is also reflected in a record level of investment during FY07. The total investment to GDP ratio rose to a record level of 23 percent in FY07, significantly higher than 21.7 percent seen in the preceding year as well as the annual target of 21.5 percent.

This impressive performance is a result of continued strength of domestic demand, a sharp rise in foreign direct investment (FDI)<sup>3</sup> as well as a healthy increase in the public sector development program (PSDP).

In real terms, total investment witnessed a growth of 20.6 percent, the highest-ever growth recorded for Pakistan. The sustained double digit growth in real investment for three years in a row is also an unprecedented phenomenon for Pakistan. The persistent increase in real investment reinforces the view that the current economic growth momentum would continue for a longer period. However, there is a need for effective implementation of second generation reforms, focusing on institution-building, improvement in governance, etc. so that the cost of doing business can be reduced substantially in years ahead.

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<sup>3</sup> For details see **Section 7.3.2**.

### 1.3.2 Prices

Inflationary pressures visibly declined in the domestic economy during the initial months of FY07, helping pull down the inflation numbers for the period below that in the preceding fiscal year. This evident deceleration in inflation, shown by all of the price indices, mainly reflects the impact of weaker growth in the prices of non-food components. The latter indicates a significant contribution by policies to contain excessive growth in aggregate demand.

Despite these gains, the eventual FY07 inflation outcome was disappointing, given that the average annual CPI inflation of 7.8 percent was considerably higher than the 6.5 percent target for the year. The inability to achieve the inflation objective was principally due to the unexpected strength of food price inflation during the year, which considerably offset the gains from (1) the demand management policies and (2) the government subsidies that partially cushioned the domestic economy from high international oil prices.

### 1.3.3 Public Finance

A surge was observed in direct tax collections and in non-tax revenues during FY07 but the fiscal deficit for the year rose to 4.3 percent of GDP a little higher than the target of 4.2 percent. The relatively higher fiscal deficit during FY06 and FY07 is mainly attributed to the exceptional expenditure on account of relief and rehabilitation of earthquake affected areas. In FY07 it is also supported by strong growth in current expenditure.<sup>4</sup>

The large increase in current expenditure, driven by a sharp rise in debt servicing costs, overshadowed the impact of a substantial increase in revenues. The above-target 22.9 percent increase in CBR tax collection pushed up the tax-to-GDP ratio to 10.2 percent in FY07, up from 9.9 percent in the previous year. The strong growth in CBR taxes was caused by an extraordinary growth of 48.2 in direct tax collection during FY07. However, the weak performance in indirect taxes partially offset the impact of this rise. The exceptional tax collection was equally supported by 26.2 percent YoY growth in non-tax revenue.

Reliance to finance the fiscal deficit of Rs 377.5 billion was almost on external and domestic resources during FY07. The major sources of external financing during FY07 were program loans/commodity aid, project aid and borrowings from international capital market through the issuance of various bonds. Domestically, the government obtained an amount of Rs 177.8 billion that was on almost same level in FY06. But a compositional shift in financing was observed in domestic sources as in FY06 government used a large amount of Rs 97 billion from privatization proceeds to finance the deficit that remained at Rs 19 billion in FY07.

The total provincial revenue receipts stood at Rs 483.4 billion during FY07 with tax revenue contributing Rs 400.1 billion. All the provinces recorded revenue surpluses accompanied with a substantial rise in development expenditure. The provincial share in federal tax receipts increased from 89.1 percent in FY06 to 91.6 percent in FY07.

### 1.3.4 Money and Banking

SBP continued to maintain a tight monetary policy during FY07. This was desirable to further moderate aggregate demand pressures in the economy which were still present despite continued monetary tightening since September 2004. The presence of excessive demand pressures was already obvious in terms of high inflation through most of FY06.

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<sup>4</sup> It should be noted that on adjusting for expenditure on account of relief and rehabilitation of earthquake affected areas, a better picture emerges with overall fiscal deficit in FY07 increasing only marginally to 3.9 percent of GDP from 3.8 percent the preceding year.



The inflation target for FY07 was set 6.5 percent compared to a high inflation of 7.9 percent in FY06. However, the monetary management during FY07 was complicated by the dual mandate of maintaining price stability and economic growth that required SBP to avoid significant slippage in targeted real GDP growth for FY07 that could have occurred due to excessive tightening.

In this backdrop, the monetary policy framework for FY07 envisaged a further slowdown in monetary expansion (M2) to 13.5 percent from 15.1 percent growth realized in FY06. Simultaneously, as export growth continued to weaken, SBP took measures to partially shelter strategic sectors (textiles, and exports).

In order to achieve the broad money target, SBP first raised the reserve requirements for banks and then increased its policy rate by 50 basis points to 9.5 percent. At the same time, SBP also continued to drain excess liquidity from the inter-bank market and maintained the overnight rates persistently close to the discount rate through most of FY07. In addition, the SBP provided support to the exporters in the form of reducing rates on export finance scheme (EFS), and a debt-swap facility for strategic sector of the economy that substantially reduced the cost of fixed investment loans acquired in recent years.

SBP monetary policy proved effective in considerably moderating aggregate demand pressures in some sectors of the economy as reflected in a visible slowdown in import demand and private sector credit during FY07. The reduction in aggregate demand was also reflected in the continued downtrend in core inflation (NFNE). More importantly, the monetary tightening was clearly not excessive, given that the real GDP growth during FY07 comfortably achieved its target. Moreover, tight liquidity conditions in the inter-bank market probably helped in reducing speculative and unproductive demand for credit. In this perspective, it is encouraging to see that the demand for fixed investment loans during FY07 has remained intact, even a part of the slowdown visible in working capital loans appears short-lived (as a few structural factors limited the demand and supply of these loans during the year).

Unfortunately, the impact of the slowdown in aggregate demand pressures in the economy did not translate into a decline in overall CPI inflation during FY07. Average CPI inflation for the year was 1.3 percentage points higher than the annual target, mainly because the gains from a deceleration in aggregate demand growth in some sectors of the economy were largely offset by an unexpected strength in food inflation, particularly during H2-FY07. To put this in perspective, had food inflation in FY07 remained at the average level observed in FY06 (i.e., 6.9 percent), CPI inflation would have remained below the 6.5 percent target for the year.

Another problem for monetary policy was the abrupt rise in monetary aggregates during the last month of FY07, entirely caused by a surge in external receipts. As a result, M2 growth exceeded the annual target by 5.8 percentage points to reach 19.3 percent. Since the acceleration in the growth of monetary aggregates was concentrated in the last month of FY07, it probably had only a weak contribution to inflation in FY07, but is more likely to impact FY08 inflation. For that reason, the central bank undertook corrective monetary policy measures in July 2007.

A large part of the slippage in M2 target during FY07 stemmed from government borrowings. In particular, the sharp rise in net foreign assets (NFA) of the banking system during June 2007<sup>5</sup> principally reflected external financing needs for budgetary expenses of the government (such as

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<sup>5</sup> It is important to mention here that the sharp increase in SBP NFA during June 2007 did not cause a proportional rise in reserve money. This was due to both, (1) government retirement of SBP debt; and (2) SBP sterilization measures. In specific terms, the impact of increase in SBP NFA (of Rs 159.1 billion) during June 2007 on reserve money growth was partially offset through government retirements of Rs 80.6 billion to SBP and partially through SBP repo sale of government securities worth Rs 61.8 billion during the month.

receipts from Eurobond and GDR issues, US Aid inflows, multilateral loans, receipts against logistics support etc.). To put this in perspective, M2 growth during Jul-May FY07 was 14.1 percent which was slightly less than the nominal GDP growth of 14.7 percent for the year. This also suggests that the magnitude of slippage in M2 growth from its target would have been substantially lower had the budgetary finance from the external sector been incorporated more accurately in the monetary policy framework for FY07.

While the overall monetary indicators raised a few concerns from inflationary perspectives, financial soundness continued to exhibit improvement during FY07. More importantly, though the rise in interest rates did create some impact on the quality of loans, the stringent provisioning requirements as well as increased capital requirements did not allow the impact of loan quality on financial stability of the banking institutions. Not only did banks remain adequately capitalized, but the overall asset quality measured in terms of NPLs to loan ratio (net of provisioning) continued to decline.

### 1.3.5 Domestic & External Debt

Country's total stock of debt and liabilities (TDL) rose by 10 percent YoY in FY07 to reach Rs 5,023.6 billion. The major causative factors for this increase in TDL were the rising level of country's current account deficit and a large fiscal deficit that raised the financing needs of the country. Encouragingly, despite this increase in the TDL stock, the ratio of total debt & liabilities to GDP continued to decline which shows country's improved debt servicing potential. The TDL to GDP ratio for FY07 remained significantly below the target of 60 percent set for the country in the "Fiscal Responsibility and Debt Limitation Act 2005" to be achieved in FY13.

Pakistan's domestic debt stock increased sharply during FY07, registering a growth of 11.9 percent – much higher than the average growth of 7.7 percent during the preceding four year. This rise in stock is driven by the growth in the *floating debt* category which accounted for nearly two-thirds of the rise in domestic debt in FY07. The share of short term debt continued to rise and reached 43 percent during FY07. This rising share of short term domestic debt means increased vulnerability to adverse short-term interest rate movements, potentially rendering future debt management more difficult. An important feature for FY07 is the sharp rise of 57.1 percent in interest payments on domestic debt. The strongest contribution to the increase is probably from maturing high-cost, zero coupon instruments (DSCs) issued in late 1990s.

Pakistan's external debt and liabilities (EDL) rose to US\$ 40.1 billion during FY07, representing a US\$ 2.9 billion increase over the stock in FY06. The rise in the EDL stock constituted inflows from IDA, ADB, and the issuance of a new Eurobond. Private loan inflows also had a sizeable contribution in the increase of the debt stock. Encouragingly despite this rise in the stock of EDL, Pakistan's EDL to GDP ratio continued to improve, reflecting country's improved debt servicing ability. This improvement in debt ratios was probably an important factor that led to improvement in sovereign rating; Moody's up-graded country's foreign and local currency bond ratings to B1 from B2 in FY07.

Pakistan also witnessed an improvement in the maturity profile of its external debt stock in FY07. A significant share of the inflows received during FY07 had a long term maturity ranging from 15 – 40 years. The improved maturity structure of loan inflows to some extent offsets the effects of the floating interest rate structure of these loans.

During FY07, 62.5 percent share of the new inflows was on floating interest rates, including US\$ 750 million 10-year Eurobond issued by the country and a substantial portion of inflows from ADB. The rising share of such inflows in the total debt stock calls for the need of greater prudence in the future management of country's debt burden. A higher share of flexible rate loans might translate into increasing debt servicing burden for the country in case of adverse movements in these variable lending rates.

It is worth mentioning that in the coming years, country is likely to face higher burden of debt servicing as (1) repayments of the rescheduled non-ODA Paris club debt stock will resume from FY08, and (2) the maturities of the Eurobond issued in FY04 and Sukuk issued in FY05 will become due in FY09 and FY10 respectively. In addition, interest payments on various Eurobonds issued recently are likely to add to debt servicing burden in coming years. Therefore in order to maintain the same debt servicing capacity, the country's foreign exchange earnings, and particularly export earnings need to grow faster.

### 1.3.6 External Sector

#### *Balance of Payments*

As a result of a relative slowdown in the growth of the current account deficit and a record increase in investment inflows, Pakistan's external account surplus improved substantially to US\$ 3.7 billion during FY07 as compared to US\$ 1.3 billion in FY06. The FY07 moderation in the growth of current account deficit is attributable mainly to a sharp fall in the growth of imports (that compensated for an unexpected deceleration in exports) and strong increase in remittances (that partially offset the rise in investment income outflows).

The deceleration in the imports growth was expected in the wake of falling oil prices, improved domestic production of some key food items and overall slowdown in capacity expansion. However, the impact of lower import growth (8.1 percent)<sup>6</sup> in FY07 on the trade deficit was lost due to the unanticipated weakness in exports. Export growth fell from 14.3 percent in FY06 to only 3.2 percent in FY07. The slowdown in textiles exports was the major contributor to the decline in the overall exports growth, but the accompanying fall in exports of non-textile manufacturers and commodity producing sector made matters worse.

Nevertheless, an impressive rise in the foreign private investment continued to moderate the impact of growing current account deficit in FY07. Specifically, financial account surplus increased substantially from US\$ 5.8 billion in FY06 to a record surplus of US\$ 10.1 billion during FY07. This improvement in the financial account was largely contributed by equity flows rather than debt. Benefiting from the substantial surplus in the external account, Pakistan's overall reserves increased by US\$ 2.5 billion in FY07 compared to US\$ 524 million rise in FY06.

During FY07, Pak Rupee exhibited a mixed trend vis-à-vis benchmark currency US Dollar; depreciating by 1.14 percent in the first half and then appreciating by 0.81% in the second half of FY07. In the first half, the widening trade deficit drove the Rupee depreciation while in the second half, improved market related inflows helped Rupee to regain most of its lost ground, consequently the Rupee saw a net depreciation of 0.31 percent during FY07.

#### *Trade Account*

After persistent widening during last four years, the difference between import and export growth seems to be converging during FY07 on the back of substantial slowdown in import growth, from 38.7 percent in FY06 to 6.9 percent<sup>7</sup> in FY07. However, this welcome slowdown in import growth could not help in reducing the trade deficit due to a concurrent slowdown in export growth from an average 15.9 percent during last four years to 3.4 percent during FY07. As a consequent, the trade deficit reached an all time high of US\$ 13.5 billion during the period under review. Nonetheless, the trade deficit as compared to size of economy slightly declined from record high level of 9.46 percent during FY06 to 9.31 percent during FY07.

<sup>6</sup> Import and export data in balance of payments is based on exchange records compiled by the SBP.

<sup>7</sup> Trade data in this section is based on customs record compiled by the FBS.

The broad based slowdown in import growth is mainly attributed to (1) decline in global oil prices, (2) the reduction in excess demand, (3) gradual absorption of one-off impact of liberalizing of automobile & telecommunication sectors, and (4) improved domestic production of food items such as sugar and wheat.

On the other hand, the sudden decline in export growth is little confusing given the support to this sector in policy formulation<sup>8</sup>. The poor performance of exports becomes even more worrisome when analyzed in the perspective of better environment in the form of robust economic growth in the domestic<sup>9</sup> and key global markets. The slowdown in export growth was also broad based as the textile exports growth declined from last four years average of 14.4 percent to only 4.9 percent during FY07, whereas non-textile export growth declined from last four years' average of 19.2 percent to only 0.6 percent during FY07.

Poor rice, fruit and cotton crops together with EU ban on fish & fish preparations imports from Pakistan and industry specific issues are considered as the main contributory factors behind the sluggish growth in non-textile exports during FY07. On the other hand, slowdown in the textiles exports can be attributed to: (1) low quality of the textile products on account of contaminated cotton and unskilled labor, (2) concentration of exports in the low and middle value added textile items, (3) frequent power failures in the country, and (4) EU market specific issues such as the antidumping duty on the bedwear exports and only partial restoration of GSP facility.

Going forward, the rising cotton price which is main input for textile industry coupled with abolition of China specific textile and clothing safeguards in 2008 by EU and US, along with accession of Vietnam to WTO, are some factors that are likely to give tough time to Pakistan's textile industry. While, the rising cotton prices may not increase Pakistan's relative cost of production against its competitors as global cotton prices are also anticipated to rise, Pakistan's apparel exports to US and EU markets may weaken following the end of the US and EU safeguard measures imposed on China.

On the import side, uncertainly in the global oil prices, increasing commodity prices, anticipated increase in the import of telecom following China's investment in Pakistan's telecom sector and likely rise in power generating machinery may put upward pressure on the import bill. However, increase in hydro power generation on account of better water availability and capacity constrains in the thermal power generation may lead to slower growth of furnace oil import, thereby relieving some pressure from the overall oil import growth.

**Box 1.1: Recommendations by Inter-Ministerial Committee on Food Inflation**

The prices of food items in Pakistan rose sharply during FY07, leading the government to set up an Inter-Ministerial Committee to assess the causes of the increase and recommend corrective policy measures. The committee found that most of the rise in food inflation was caused by high prices of a small number of commodities. The increase in the prices of some of these food commodities was found to be structural in nature reflecting diverse factors, such as, rising international prices, where government intervention has a very limited role to play, in the short run. The committee therefore recommended a mix of short-term measures to alleviate the impact of high prices in the short run, as well as, policies to address the structural factors. The key policy recommendations focused on wheat, pulses, sugar, and dairy product prices

Wheat:

- The committee recommended that farmer profitability should be ensured so that the country should be self sufficient in wheat production. In order to achieve this, the committee has suggested that the government should provide support price and promote efficient farming practices resulting in cost reduction.

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<sup>8</sup> The export sector enjoys various fiscal and monetary incentives such as tax exemptions & rebates and concessional financing under Export Finance Scheme (EFS) & Long Term Financing of Export Oriented Projects (LTF-EOP).

<sup>9</sup> Some analysts argues that increasing contribution of non-export sectors like construction, finance & insurance, livestock and retail trade etc in the GDP growth during the recent years have weakened the GDP-export nexus.

- MINFAL has been assigned the task of formulating policies to increase productivity and cost reduction plans in collaboration with the provinces.

**Pluses:**

- The committee suggested controlling of pulse prices by adopting a policy of procuring the surplus pulses at market price and later releasing them regularly to maintain the target price and minimize speculators edge.
- Design a campaign to support farmers before planting. This may include ensuring availability of certified seed with incentives, and announcement of marketing support at support or market price.
- In case of gram, an aim to procure at least 25% of consumption and a regular intervention is needed to keep gram price from unnecessarily rising throughout the year.
- MINFAL has been asked to specially focus on the productivity of Mash and Masur and ensure marketability of production and sustain profitability of the farmers.
- MINFAL has been delegated the task to develop a focused strategy and work with the provinces to predict supply/demand timing, special funding window and incentives for improving farming practices.

**Sugar:**

- Farmers should be able to get at least minimum guaranteed support price.
- Provinces and Federal government should formulate sugarcane /sugar policy in consultation with stakeholders by September 15 every year.
- Sugar may not be imported until the duration of sugar season is determined by end March. However in case of abnormally high prices of sugar this condition may not be applied.
- Build up buffer stocks by importing or purchasing from the local mills and use these stocks to intervene to control sugar prices as and when needed.

**Livestock:**

- A breakthrough can only be made by attracting expatriates and using them to bridge the yawning knowledge gap. The government should facilitate best research practices and provide alternatives to fodder which is very expensive.