Governor's Message

Assessment of Economy

Pakistan has well illustrated its ability to achieve a high growth track record and to offer promising prospects to investors both domestic and international. Key achievements of Pakistan were its average growth of 7.3 percent over FY04-FY07 period supported by a fair degree of macroeconomic stability. This helped restore confidence in foreign investors as evident from the capital inflows averaging around US$ 4.0 billion annually between FY04-FY07. Concurrently, an improvement in the sovereign rating to B+ helped the government to raise sovereign debt from almost all international centers, of close to US$ 6.1 billion, and this environment provided opportunity to stretch the maturities of borrowings. These resources helped raise the foreign exchange reserves levels to US$16.4 billion by October 2007 – a record high. It has to be, however, recognized that most Asian economies did well during this period as the global economic environment was conducive and world financial centers thrived with liquidity, and markets did well promoting cross border flows.

After showing its strengths and potential for the past few years, Pakistan faced a difficult fiscal year in 2007/2008 as the high economic growth path was disrupted. Domestic resource mobilization lagged behind investment requirements and delays in structural reforms in core infrastructure sectors resulted in acute power shortages, impacting overall economic performance. Investment demand was impacted as evident from fall in investment to GDP ratio fell to 21.6 percent in FY08 from 22.9 percent in FY07. With savings to GDP ratio falling to 13.9 percent in FY08 from 17.8 percent in FY07, despite lower investment demand, the saving-investment gap widened by 3.2 percentage points. The decline in savings and investment rates both are sources of concern. On one hand, a fall in investment spending has tendency to dampen economic growth. On the other hand, a drop in savings increased pressure on the external account to finance the investment needs of the economy.

The incipient economic stress magnified as the country faced unprecedented set of exogenous and endogenous shocks that eroded hard earned economic gains. Fiscal Year 2007/2008 -- an aberration and a deviation – has been adversely impacted because of multiple factors:

- Global commodity price shock hit Pakistan most as the country is heavily dependent on oil imports and the intensity of surge in international prices was severe and consumption remained robust as the pass through was delayed due to political transition.

- Lower-than expected performance in real productive sectors was due to high international commodity prices, energy shortages, uncertainty during political transition, and below target harvest of some key crops that were hit by water shortages.

- Fiscal management weaknesses surfaced more glaringly as the budget for 2007/2008 was observed to be grossly underestimated and the spending was not aligned properly to the resource availability. This structural weakness has been inherent given the stagnant tax/GDP ratio for some years, the fiscal gap rose as the country had to bear higher than budgeted interest and subsidies expenses that together rose to 8.4 percent of GDP.

- The fiscal deficit turned out to be 7.4 percent GDP, which was almost 3.4 percent above the budget target. Widening fiscal deficit coupled with the rising oil and other importable international prices doubled the external current account deficit to 8.4 percent of GDP.

- Macroeconomic imbalances were clearly unsustainable as evident from the significant drawdown of the foreign exchange reserves which declined by 27.1 percent and reached US$ 11.4 billion by end June and US$ 6.4 billion by November 25, 2008. Growing uncertainty emanating from drift in FX reserves combined with the weakening macroeconomic fundamentals did result in cumulative depreciation in rupee by 23.3 percent between July 2007 and November 25, 2008.

Besides the drawdown of liquidity, the aggregate demand pressures, which have clearly outstripped the supply availability, have intensified the inflationary pressures. By October 2008, year on year Consumer Price Index inflation rose to record highs of around 25 percent with food inflation hitting 31.7 percent and core inflation rising to 18.3 percent. Notwithstanding these shocks the economy has shown remarkable resilience as Pakistan continued to finance all its import and debt/other payment obligations.

Entering into fiscal year 2008/2009, the government and the central bank have together developed a macroeconomic stabilization package whose implementation is well underway and has helped to have a buy-in from the international agencies. This program is now a corner stone of the Stand-By Arrangement negotiated with the International Monetary Fund for the 23- month period.[1] Macroeconomic stabilization is needed for proper and effective fiscal tightening to ensure that the monetary tightening, which has preceded fiscal tightening, yields the desired impact on inflationary pressures. On fiscal side, the government has phased out most subsidies and remaining will be rationalized, while the tax administration reforms will provide an impetus to revenues, which with the re-installing of the privatization process, will help in financing poverty alleviation programs.

The government has now widely acknowledged the inflationary impact of its sizeable borrowings from the central bank that reached undesirable levels close to Rs 380 billion during Jul-November 2008. This reflects strains of new borrowings as well as the rollover of the maturing treasury bills which could not be settled in the wake of spending requirements for the last 18 months or so.

The fiscal pressures and other exchange policy complications required a high vigilance from the central bank. During fiscal year 2007/2008, the central bank had to tighten its monetary policy stance in three rounds, which cumulatively resulted in increase in SBP Policy rate by 350 basis points. With the unabated rise in core inflation, once again SBP raised policy rate by 200 basis points in the current year. This has raised an intense debate on merits and demerits of monetary tightening, which has been questioned, particularly as the central bank, given legislative weaknesses, has not been able to effectively curb the inflationary borrowings by the government. On its part the central bank's message to the public is as follows:

i. Monetary policy does bring price stability though its impact filters down with a lag given that the speed of monetary transmission mechanism is hindered by the economic and financial sector distortions – typically observed in developing countries but distorted more in present environment because of the lack of consistency of fiscal policy with monetary stance.

ii. Monetary policy cannot work in isolation from fiscal policy -- recognizing this, the central bank law was modified some years back to provide for establishment of the Monetary and Fiscal Coordination mechanism and to empower the Central Board of the SBP to impose limits on government borrowings. The protracted political transition has made it difficult for the governments to adhere to limits imposed by the central bank on government borrowings. Budget for fiscal year 2008/2009 has an explicit statement that for the first time binds the government to net zero borrowing from the central bank. There has, however, been continued

[1] First tranche of US$ 3.1 billion has already been received on November 26, 2008.

high recourse to the central bank borrowings during July-October 2008 but now efforts are underway to tap alternate sources of financing for budget ranging from commercial banks (as the rise in SBP policy rates are facilitating better subscription in treasury bills), national saving schemes and external financing to meet the fiscal demands.

iii. Abstracting from short term management complexities of economic management, central bank in its Monetary Policy Statements has categorically been recommending appropriate amendments in the *Fiscal Responsibility and Debt Limitation Act, 2005* to impose legal bar on central bank borrowings to ensure that borrowings are more ways and means advances rather than a source of government financing.

iv. Monetary policy adopted by SBP has given greater weight to inflation risk relative to growth in past months but due regard has been built in policy stance so as not to stifle productive sectors. Explicit measures taken in this context include (a) appropriate liquidity management using both, the monetary management and other, tools available. During the last two months SBP released close to Rs320 billion liquidity to supplement commercial banks own liquidity generation, (b) release of 100 percent SBP refinance of export financing requirements both for working capital and long term investment requirements, and (c) the central bank enhanced and augmented its auction system by ensuring the industry has access to the schedule of treasury bill auctions.

v. Inevitably the exceptionally high trade deficit in FY08 was financed by the drawdown of foreign exchange reserves. Monetary policy stance has to be flexible in line with the emerging developments. Pressures continue to be high on external current account deficit which has been significant in the first four months of current fiscal year. At the same time, it has to be recognized that there is likely to be some easing of import demand as the global commodity prices, including oil, have fallen; in FY08 oil imports alone accounted for 74.8 percent of the external current account deficit and absorbed almost 52 percent of the export earnings.

Measures adopted under (iv) above have helped private sector get adequate resources as evident from the 21.2 percent growth in private sector credit over last 16 months. The monetary tightening will help in curbing inflation. Fighting inflation is considered desirable for both the industry and public whose purchasing power has eroded.

To supplement its monetary policy stance, the central bank has been strengthening the financial system and this has paid off as the banking system has weathered the economic stress of last 12 months well. Despite monetary tightening, banking industry which has geared itself properly over the years under a fairly well regulated and well supervised regime, has continued to be supportive of the growing demands of the economy both in the public as well as private sector. With the setback to the stock market and other nonbank financial intermediaries, the banking sector has also been meeting the gaps in financing created by the weak trends in these sectors, while helping meeting the credit demands of these segments of financial markets.

Though the central bank has now been in monetary tightening phase for almost 4 years starting from 2005, the evidence over FY05-FY08 reveals that real GDP during this period grew, on an average, by 6.8 percent. During this period, the productive sector witnessed a sharp expansion in credit growth that averaged 22.9 percent per annum and also rose as a proportion of GDP from 24.3 percent in FY04 to 29.2 percent in FY08 and has remained robust even in the recent months of FY09 -- with later months admittedly reflecting impact of inflation on working capital requirements. The setbacks to growth have not been due to interest expenses (as these constitute a very small fraction of the cost of goods sold) but more the consequences of inflation that impact input costs as well as wages in

addition to the infrastructure and cost of doing business constraints that magnified in the recent years as the electricity outages grew.

Private sector credit distribution has been well balanced in line with the demand and complexion of the manufacturing sector. Business sector advances grew by 22.3 percent and agriculture credit grew all time high to Rs 211.6 billion. Export refinance has been also growing aggressively and now will be 100 percent backed by SBP refinance facility. Credit diversification to newer and emerging sector is now surfacing though it has to be recognized that business viability and creditworthiness have been more dominant criteria as expected in banking industry. This has helped reduce the nonperforming loans (NPLs) which despite the shocks to the economy remain low and in fact net NPLs declined to 1.1 percent of advances.

Financial markets have and will continue to play a key role in economic revival but to maintain the health of the banking system, it is critical that broader administrative and sector specific constraints are alleviated to enhance the absorptive capacity of credit. Real sector reforms have lagged behind the banking sector reforms and unless former is effectively addressed it carries the risk of hurting the banking sector prospects. Concurrently, continued efforts are warranted to ensure fiscal tightening is in line with the revised fiscal deficit target of 4.3 percent of GDP as deviation from it would cause renewed monetary complication which has consequence for private sector.

Executive Summary

Real Sector

Pakistan's economic growth moderated to 5.8 percent in FY08 (well below the target of 7.2 percent) due to a combination of domestic (e.g. energy shortages, some disappointing crop harvests, and rising political uncertainty) and external factors (including a rise in international commodity prices and lower capital inflows). Energy shortages, capacity and input constraints and political disruption severely impacted industrial sector performance. Similarly, critical water shortages at sowing time, incidence of viral attacks, and a disproportionate rise in fertilizer prices, etc weakened the performance of major crops. As a result, the contribution of commodity producing sector to overall GDP growth in FY08 was the lowest in the last six years. An important contributor to the slowdown in GDP growth was the weak investment demand in the country; reflecting investors' cautious response to political uncertainty, law and order situation and inflation expectations.

Agriculture: Agriculture sector growth fell to record lows of 1.5 percent during FY08 -- significantly lower than the 4.8 percent target for the year, as well as, the lowest growth since FY03. Shortfalls in wheat and cotton output overshadowed the record sugarcane harvest and relatively improved performance of minor crops, livestock and fishing sub-sectors during FY08. Major crops sub-sector performance was disappointing because of issues surrounding resource management and pricing policy for crops. For instance, area under cultivation of cotton, rice and wheat fell because of water shortages at sowing time. Moreover, as the government delayed announcement of pricing policy, there were delays in harvesting of wheat crop. Stubbornly high prices of fertilizers and pesticides also led to lower usage of these inputs, resulting in depressed yields.

Growth in agriculture credit disbursements rose to Rs 211.6 billion in FY08, up by 25.4 percent. The domestic private banks fared well in both, disbursements and in the recoveries, while specialized banks could not maintain their market share. A strong jump in the number of borrowers was also a welcome development during FY08.

Recognizing the economy-wide repercussions of food shortages, the federal budget for FY09 announced measures to promote agriculture production. These include an increase in subsidy on DAP fertilizer (to promote balanced mix of fertilizers), exemption of fertilizers and pesticides from excise

duty, increased fund allocation for maintenance of reservoirs, and improvement of irrigation network, to boost agriculture sector productivity. The impact of these polices is likely to be complemented by introduction of crop insurance scheme, initiated by SBP to help farmers invest in their crops without fear of heavy losses.

Industry: The industrial sector suffred a mix of economic, political and structural setbacks throughout FY08. Rising fuel and raw material prices and intensifying energy shortages in the country obstructed industial activities in FY08. The heightened political uncertainty and law & order issues during the year also took their toll. The provisional estimates place the FY08 industrial growth at 4.6 percent compared with 8.0 percent in FY07. Other than the construction sub-sector, all other industrial sub-sectors performed below their long-term trend in FY08.

Manufacturing sector growth continued to decline for the third consecutive year and posted the lowest growth in six years during FY08. Most of the slowdown was seen in large scale manufacturing (LSM), as growth in small scale manufacturing decelerated only slightly. Similar to FY07, the deceleration in LSM reflects a relative moderation in domestic demand, power and gas outages, as well as capacity and input constraints in certain industries. However, unlike FY07, the external demand for domestic manufactured goods increased in FY08.

Services. In sharp contrast to the weak performance by commodity producing sectors, the services sector showed above-target growth for the sixth time during the last seven years. The sector grew by 8.2 percent in FY08, significantly higher than the 7.2 percent annual target for the year, as well as the 7.6 percent growth seen in FY07. The resilience exhibited by the services sector helped keep GDP growth to a respectable level by contributing about three-fourth of the total value addition during FY08.

Prices

Inflationary pressures in the economy remained strong throughout FY08. All price indicators, including CPI, WPI, SPI and the GDP deflator, showed strengthening of inflation during the period.

Although, inflationary pressures started building up during the early months of FY08, an extraordinary sharp rise in inflation was witnessed in the last four months of the period. The strength in inflation during the first eight months of FY08 (i.e. Jul-Feb FY08) was mainly driven by domestic food inflation backed by strong aggregate demand pressures (well supported by an expansionary fiscal policy), high global commodity prices and domestic market imperfections. On the other hand, the steep rise in inflation during the last four months of FY08 was the result of unanticipated strength of international commodity prices, upward adjustment in administered prices of key fuels and pressures on prices of wheat (due to rationalization of its support price as well as artificial shortages in some parts of the country). A sharp depreciation of rupee during this period also fueled inflationary expectations in the economy pushing inflation to levels not seen in the last three decades.

Food inflation witnessed acceleration throughout FY08. In particular, a sharp surge in CPI food inflation was witnessed since March 2008 as a result of a steep rise in the prices of some essential food staples. Non-food inflation showed sharp uptrend in the second half of FY08 on account of pass-through of petroleum products prices to domestic consumers, rising air and road fares, and gas & electricity charges.

Given the severity of situation and to minimize the second round impacts of sustained high food inflation, the central bank tightened monetary policy during May 2008 through unusual interim monetary policy measures. As a result of the tight monetary stance, inflationary pressures are likely to ease from second quarter of FY09, assuming there is no further adjustment in fuel and utility prices, and international commodity prices remain stable (or weaken).

It is pertinent to note that the inflationary pressures were broad-based in FY08 compared to the previous fiscal year. This is evident from the trends exhibited by both measures of core inflation. An uptrend in core inflation indicates resilience in the inflationary pressures.

Monetary Policy

The sustained rise in global commodity prices and weaker domestic production led to unexpected rise in inflationary pressures in the economy during FY08. At the same time, the continued deterioration in current account balance was worsened by the demand stimulus of the extraordinary increase in government borrowings from SBP. Consequently, despite repeated monetary tightening undertaken during the year, CPI inflation reached a three-decade high by June 2008. More worryingly, core inflation - a measure that provides information about inflation outlook - rose to 17.2 percent on year-on-year basis by June 2008 from 8.7 percent in December 2007.

The rising fiscal account deficit and its financing posed severe complications for the Monetary Policy Framework for FY08. Despite an already difficult fiscal position, the government decided to continue with large subsidies through most of FY08. The resulting large increase fiscal deficit was largely financed through central bank- the most inflationary source. During FY08, government borrowed Rs 688.7 billion from the SBP for budgetary support, instead of the net retirement recommended in the SBP's Monetary Policy Statement.

The widening fiscal deficit coupled with the rising international commodity prices contributed to dramatic worsening of the external account position of the country. Resultantly, the current account deficit for FY08 jumped abruptly to 8.4 percent of the GDP in FY08 from 4.8 percent deficit in FY07.

The effect of domestic demand pressures was also evident on private sector credit. Despite continued monetary tightening, growth in private sector credit gathered momentum after January 2008 and remained at 16.5 percent for FY08 – slightly lower than 17.3 percent rise witnessed in the previous year. This was despite a sharp deceleration in the demand for consumer credit for the second consecutive year in FY08.[2]

Historical trends suggests that the monetary tightening has been successful in contributing to long-run economic growth by creating an environment with a stable price level or a low and predictable rate of inflation.

Public Finance and Fiscal Policy

Deceleration in revenue growth coupled with a strong rise in total expenditures (driven by exceptionally large interest payments and current subsidies) caused serious deterioration in all key fiscal performance indicators during FY08. In particular, fiscal deficit in FY08 reached 7.4 percent of GDP, a level not observed since FY99, against the budget target of 4.0 percent of GDP for the year and compared to 4.3 percent of GDP witnessed in the preceding year. Also, primary and revenue balances (measured as a percentage of GDP) moved into deficit during FY08, after hovering around zero in the preceding years.

The revenue balance[3] moved into deficit during FY08, reaching 3.4 percent of GDP against a budgeted surplus of 1.0 percent of GDP. This is truly troubling since the Fiscal Responsibility and

[2] Growth in consumer credit decelerated sharply to 3.1 percent during FY08 compared to 43.5 percent and 17.0 percent growth witnessed in FY06 and FY07.

[3] Revenue balance measures the saving capacity of the government and is calculated as the difference between total revenues and current expenditures.

Debt Limitation (FRDL) Act 2005 requires the revenue balance to be at least zero, as a percent of GDP, by FY08 and beyond.

Primary balance[4], as a share of GDP, recorded a deficit of 2.7 percent in FY08 compared to a deficit of 0.1 percent in FY07. Despite large amount of interest payments, the worsening of primary balance is mainly attributable to high growth in current expenditures.

Domestic and External Debt
After consistent improvement from FY01 to FY07, Pakistan's debt position deteriorated sharply in FY08, reflecting the country's large fiscal and current account deficits, as well as slowing economic growth. The stock of Pakistan's total debt and liabilities (TDL) increased by 26.9 percent YoY to Rs 6,417.4 billion, with a commensurate deterioration in the debt sustainability indicators. In particular, the ratio of TDL to GDP, a broad measure of the country's capacity to sustain debt, saw an end to a seven-year declining trend, rising in FY08 to 60.1 percent.

The sharp increase in TDL stock during FY08 was contributed almost equally by domestic and external debt; growth in both categories accelerated sharply. The growth in explicit liabilities however was only slightly higher than FY07. Acceleration in the growth of domestic debt, not only reflected the larger FY08 fiscal deficit relative to the previous year, but also the relatively low availability of external financing receipts. The accelerated growth in the rupee value of external debt in FY08, on the other hand, reflected not only a larger current account deficit, but also a decline in non-debt external flows as well as the depreciation of the rupee.

External Sector
Balance of Payments: The deterioration in current account deficit continued for the fourth successive year, touching 8.4 percent of GDP during FY08. This is the highest level in the last thirty years. The impact of this sharp deterioration on Pakistan's external account was further exacerbated by a decline in the financial account surplus during the period. Consequently, the Rupee/US$ exchange rate, and SBP foreign exchange reserves, remained under pressure.

In FY08, the impact of strong domestic aggregate demand on the deteriorating current account deficit was compounded by a host of external and domestic factors. Pakistan faced an unprecedented rise in global oil and other commodity prices, as well as a slowdown in major textile export markets. At the same time, import demand was stoked by lower production growth in the real sector (amid power shortages, disappointing crops, etc.) and a very expansionary fiscal policy. The attempts to protect local economy from rising commodity prices also proved expensive due to extensive trading and smuggling of the subsidized goods. All of these factors contributed considerably in the current account deterioration in FY08. The only factor which provided some respite was the continued rise in workers' remittances which increased by 17.4 percent during FY08.

On the financing side, as the global financial crisis unfolded in FY08, and country risk perception was heightened by domestic political developments; the country's ability to tap international capital markets was severely impaired. Planned privatization transactions had to be deferred, sovereign debt issues postponed, and portfolio investment plunged. The fall in capital inflows also resulted in drawdown of foreign exchange reserves and mounting pressure on exchange rate during the period.

The fall in capital inflows in the wake of sharply widening current account deficit and the resultant drawdown of foreign exchange reserves necessitate adjustments. The global experience suggests that

[4] Primary balance helps assess the sustainability of the fiscal deficit. It highlights the *current* discretionary budgetary stance by excluding the impact of interest payments (that are caused by past policies).

current account adjustments take place either through a sharp deceleration in domestic demand, a depreciation of the real effective exchange rate or some mix of the two.

Foreign Trade: Trade deficit widened for the sixth consecutive year reaching unprecedented level of US$ 20.7 billion during FY08. The exceptional surge in the deficit is attributed to a sharp rise in imports which overshadowed a yet sound growth in exports during this period. Overall exports posted a strong recovery, reaching all time high of US$ 19.2 billion, slightly above the annual export target set for FY08.

The strong growth in imports was a consequence of higher international commodity prices, domestic shortages of wheat and cotton crops, and revival in demand in some sectors e.g. power generation, chemicals, etc. In particular, a significant part of total increase in imports was caused by rising international oil prices. Export growth was led by non-textile sector, whereas textile sector witnessed decline during FY08.

Socio-economic Developments

Pakistan being the sixth most populous country of the world has been trying to check its population growth rate which has declined to 1.8 percent in 2008 from 2.1 percent in 2000. Successful government interventions have led to a decline in head-count ratio that has declined from 34.5 percent in 2000-01 to 22.3 percent in 2005-06. However, a large segment of population hovers around the poverty line. Contrary to the declining trend of absolute poverty in Pakistan, the consumption inequality has increased reflecting a rise in rich-poor divide.

Educational indicators have shown improvement at the national level during FY07 compared to FY06. Literacy rate estimated at 55 percent in FY07 registering a one percentage point increase over FY06. Gross enrollment rate increased by 4 percentage points while net enrollment rate witnessed an increase of 3 percentage points to touch 56 percent in FY07. However Pakistan lags behind in targets set by the Millennium Development Declaration. Moreover the gender parity index of the sector is also deteriorating.

Pakistan has the highest infant mortality rate (IMR) and under 5 mortality rate (U5MR) among South Asian countries and is lagging behind in achieving its health related millennium development goals (MDGs). With the current rate of decline, the Medium Term Development Framework (MTDF) target for IMR is likely to be achieved, but MDG IMR target appears challenging. Both MTDF and MDG targets for U5MR seem ambitious and challenging in view of the current status

Key socioeconomic indicators of the country indicate a need for more dedicated efforts. The government is giving high priority to macroeconomic stability and social sector development in the country. There is however a need to allocate more funds for the social uplift of the poor and vulnerable, while ensuring an efficient and transparent allocation of these resources.