THE STATE OF PAKISTAN'S ECONOMY
Second Quarterly Report for FY05

1.1 Overview

The most significant development for the domestic economy in recent months has been the sharp improvement in the fortunes of the agriculture sector. On the one hand, revised number for the cotton crop placed the *kharif* FY05 agri-growth considerably higher than earlier estimates, while on the other, timely rains have erased the looming threat of a below-target wheat crop.[1] As a result, it seems quite likely that agricultural growth during FY05 will exceed the 4.0 percent annual target. Moreover, mid-year data suggests that Large Scale Manufacturing (LSM) growth too remains quite strong at 16.1 percent YoY (see **Table 1.1**), well over the 12.0 percent annual growth target. The projected improvement in the performance of both industry and agriculture, together with the expected above target performance by the services sector means that real GDP growth during FY05 will be broad-based and very likely exceed the 6.6 percent target by a substantial margin. The acceleration in the domestic economy *appears* to have contributed also to a decline in the unemployment rate in the economy as measured in the Labor Force Survey 2003-04 report published recently (see **Special Section** for details).

Table 1.1: Major Macroeconomic Indicators

	July-December		
	FY03	**FY04**	**FY05**
growth rates(percent)			
Large-scale manufacturing[1]	4.8	17.9	16.1
Exports	16.6	13.2	10.5
Imports	18.7	14.1	34.8
Tax revenues (CBR)	21.1	9.7	7.4
CPI (12-month moving average)	3.7	2.9	7.4
Private sector credit (CBs)	10.1	21.2	19.5
Money supply (M2)	8.6	9.0	9.8
million US Dollars			
Total liquid reserves[2]	9,336	12,172	11,987
Home remittances[3]	2,019	1,862	1,946
Foreign private investment	573	259	504
percent of GDP[4]			
Fiscal deficit	1.4	0.6	1.3
Trade deficit	0.9	0.9	2.5
Current a/c balance	2.8	1.9	-0.9

[1] Based on: 91 items for FY03; 100 items for FY04 & FY05.
[2] With SBP & scheduled banks. End December.
[3] Excluding receipts on a/c of Kuwait war affectees & Hajj.
[4] Calculated by taking fiscal year GDP but variable numbers on quarter basis. Projected GDP for FY05 has been used.

[1] In fact, the increase in the reservoir levels and expected improvement in water supplies from snow melt (following heavy snowfall) appear to have ensured adequate supplies for the next cropping season (*kharif* FY06) as well.

However, sustaining this acceleration in economic activity has also entailed costs to the domestic economy. In particular, following the substantial increase in industrial capacity utilization, the economy is showing some signs of overheating, as reflected in the sharp widening of the trade deficit, and the persistent strength of inflation in the economy.

The strong performance of the economy was underpinned by an exceptional rise in private sector credit during July-February FY05.[2] Indeed, the record increase of Rs 322.5 billion in net credit to the private sector during the period incorporated both, a sharp rise in working capital credit (reflecting the rising capacity utilization in the economy and the bumper cotton crop) as well as a strong rise in investment credit (showing the improvement in business confidence in the face of high capacity utilization and sustained demand). This credit growth has been the primary factor behind a strong 10.9 percent YoY rise in M2 during July-February FY05 against the 11.2 percent YoY rise seen in the corresponding period of FY04. The fact that the strong credit growth has been evident despite a 300 basis point increase in the benchmark interest rates during July-March FY05 underscores the fact that monetary policy was largely accommodative.

In fact, while CPI inflation has certainly weakened after peaking at 9.3 percent in June 2004, the decline (due to a deceleration in food prices) had been modest and there was again resurgence in CPI inflation to reach a seven year high of 9.9 percent in February 2005 (mainly reflecting the rising HRI). As a result, despite a rise in nominal interest rate, the weighted average lending rates, in real terms, have remained negative. Moreover, core inflation has continued to rise steadily during the period. Given that non-food inflation may be further boosted by the transmission of rising international oil prices to the domestic economy, and that inflationary pressures may also be supported by the increasing capacity utilization in the economy, a rise in interest rates clearly seems desirable.

The combination of strong aggregate demand, relatively high domestic inflation (raising the cost of domestic production relative to imports), and liberal access to credit, has contributed strongly to the rise in the trade deficit during H1-FY05; imports of machinery and industrial inputs, and the rise in the oil bill account for the bulk of the rise in the country's overall import bill during the period. Given that the rise in these imports is a pre-requisite to sustaining the growth momentum of GDP through higher industrial output and exports, and in light of the fact that the overall current account deficit is still well within historical norms (at

[2] Monetary data as of February 26, 2005.

approximately one percent of GDP) and that Pakistan is still receiving substantial amounts of low-cost external assistance, a short-term widening of the trade deficit should be quite manageable, without any serious negative repercussions.

However, an implicit assumption here is that a larger part of the widening trade deficit is by industries focused on exports or import substitution, rather than merely catering to an increase in domestic consumption. Indeed, in recent years, textile exports, in particular, have responded well to rising investment (and attending increase in textile machinery imports).

While the export growth momentum has faltered in recent months, a more disaggregated analysis suggests that this stems principally from the imposition of anti-dumping duties on key exports and loss of the GSP access to the EU market, rather than any structural weakness in the industry. The impact of these external shocks on domestic industry could be mitigated somewhat through negotiations with trading partners as well as by providing fiscal relief to the affected sub-sectors. It is worthwhile pointing out here that while short-term measures could entail some fiscal costs, in the medium term the industry would benefit more from new investment in modernization, the reduction in red-tape, improvement in the transport infrastructure and a continuation of structural reforms.

In this context, the nexus between export growth and domestic inflation becomes increasingly important. The relatively high domestic inflation means that the cost base for domestic producers is rising, rendering them relatively less competitive, as reflected in the rise of the REER.[3] In fact, even the expected gains to Pakistani exporters from the relative appreciation of the Euro vis-à-vis the US Dollar did not materialize due to the changes in the Euroland trade environment. This suggests that the policy-induced stability in the exchange rate may need to be revisited, to the extent needed, to reduce the pro-import bias inherent in stable exchange rates and high domestic inflation.

Finally, while it is true that a relatively small current account deficit could be comfortably financed in the short term through external borrowings, the ready access to relatively cheap credit would entail the continuation of fiscal discipline, and demonstrated commitment to pro-growth macroeconomic reforms. This would be essential to reassure investors looking to buy Pakistan debt, as well as to sustain (and accelerate) the increase in FDI flows into Pakistan. This is a grave responsibility on the legislature.

[3] Real Effective Exchange Rate.

In this regard, the recent enactment of the fiscal responsibility and debt limitation law is a good first step. However, it is now doubly important that the credibility of this law be reinforced by strong implementation. A point of concern in this regard is the sharp 21.3 percent (Rs 75 billion) *rise* in current expenditure during H1-FY05, accounting for 83.4 percent of the total increase in spending during the period). The high Rs 79.6 billion budgetary deficit during the period was admittedly also a function of a fall in PDL receipts due to a freeze on key domestic POL product prices, as well as low growth in GST receipts (due to a one-time effect arising from the end of the levy on cotton). However, while CBR tax collections at Rs 303.7 billion are still a little above target for H1-FY05, it is troubling that the receipts have not grown in line with the above-target GDP growth.

Looking Ahead

The growth rate of Pakistan's economy is expected to accelerate in FY05, with real GDP growth projected to exceed the 7 percent level for the first time since FY96. Revised SBP forecasts indicate that real GDP growth is likely to fall in the range of 7.4 to 7.8 percent during FY05, up from the 6.4 to 7.1 percent range projected earlier (see **Table 1.2**).

This improvement is principally a reflection of the bumper cotton crop and the improved prospects for water availability. These two factors have raised hopes that agricultural growth will substantially exceed the 4.0 percent annual target, even if the wheat production falls marginally below the 20.8 million tonnes target for the year.

The improved agri-sector growth outlook also suggests a small incremental impact on the FY05 services sector growth. However, the

Table 1.2: Major Economic Indicators

		FY05	
	Provisional FY04	**Original targets**	**Revised SBP projections**
growth rates (percent)			
GDP	6.4	6.6	7.4 - 7.8
Inflation	4.6	5	8.2 - 8.8
Monetary assets (M2)	19.6	11.5	14.6
Net domestic assets	*23.7*	*13.1*	*18.8*
Private sector credit incl. PSCEs	*28.0*	*15.0*	*30.0*
billion US Dollars			
Exports	12.3	13.7	13.5
Imports	15.6	16.7	18.5
Workers' remittances	3.9	3.7	4.0
percent of GDP			
Fiscal deficit	3.3	3.3	3.2
Current account balance	5.0	0.3	-1.7
Private investment	11.7	11.9	12.1

industrial growth outlook for the period largely remains unchanged, with domestic demand expected to be the key growth driver (led by the *construction, automobiles* and *electronics* sub-sectors), supported by reasonably strong exports.

As a result, not only is the FY05 real GDP growth likely to be broad-based, it is also likely to surpass the annual target by over one percentage point for the third successive year.

In the longer term, however the sustainability of the real sector growth, in particular, demands a substantial rise in public, foreign, and private investment. The government is already poised to invest significantly in water development and management schemes to ensure the continuation of the agri-sector growth momentum. Similarly, the strength of private sector investment credit growth and imports of machinery suggests that the growth momentum will be sustained for most industries. A significant investment gap however, is visble in a crucial industry – fertilizers – which is already operating beyond installed capacity and where projected demand increase significantly outstrips the projected rise in domestic production. Given the importance of this industry to both agriculture and industrial growth, it is essential that investment here be urgently encouraged through supportive industry-specific policies. Additional foreign investment is also needed particularly in *oil & gas*, *telecommunications* and *physical infrastructure*.

For labor intensive investment and employment generation, the banking system will have to strengthen its delivery capacity for agriculture, livestock, microfinance and small & medium enterprises. This investment will have to be supplemented by public works program in rural areas.

The concern about sustained inflationary pressures in the economy is quite real as it threatens the long-term macroeconomic stability (and therefore growth) in the economy. Earlier SBP projections had placed the likely FY05 inflation in the 7.6 to 8.2 percent range. However, this had assumed that the government would continue to shield the domestic economy from large part of the rise in international oil prices, and that food inflation would be contained as the government pro-actively sought to assure amply supplies of key food staples to avoid speculative attacks. As these assumptions have not been substantiated, SBP has revised upward its projections for FY05 inflation to the 8.2 to 8.8 percent range. The higher inflation will necessitate a further tightening of monetary policy in the coming months.

In the longer term, the rise in the prices of real assets, particularly in the real estate market is also a source of considerable concern, threatening to undo many of the gains expected from the liberal access of credit to the economy. In particular, if the growth in real asset prices rises substantially beyond the access of the larger part of the populace, this can have serious repercussion for the economy, by encouraging consumption rather than increased investment. The proposed measures to end *benami*[4] land holdings (increasing documentation of land transactions in general), release of fresh land for real estate development[5] and larger disinvestments of publicly held stocks, together with a steady increase in the yields on financial assets, may prove useful in countering an excessive rise in assets prices.

A lesser concern for the economy, in the short term, is the rise in the external account deficits. In particular, the increasing capacity utilization in domestic industry, and a resulting rise in investment will likely keep the trade balance under pressure in the months ahead, first due to higher demand for machinery and then from rising demand for inputs. As a result, SBP forecasts indicate that the current account deficit is likely to reach 1.7 percent of GDP. However, as mentioned earlier, this is manageable as long as the low cost external disbursement, foreign direct investment and nonresident deposits continue to flow in.

1.2 Executive Summary

Agriculture

The prospects of meeting the FY05 agri-sector growth targets have improved significantly in recent months. Firstly, the value-addition by the *kharif* FY05 crops seems certain to be considerably higher than the initial estimates, with the revised cotton production figure exceeding 14.0 million bales (as compared to the earlier estimate of 11.6 million bales and the FY05 target of 10.7 million bales). Secondly, fears of a serious water shortage for the *rabi* FY05 season have abated significantly following timely rains as well as heavy snowfalls. The improved water availability has given rise to hopes that the wheat harvest will be at least close to the FY05 target. Not only did the precipitation improve water availability prospects, the timings of the rains probably also allowed farmers to increase areas under cultivation, particularly in rain-fed areas.

[4] Whereby land holdings are not held in the name of the beneficial owner.

[5] The improvements in the real estate market, could not only add to investment credit growth, but also catalyze activity in the labor-intensive construction sector and auxiliary industries.

In fact, as a result of the rains by end-January 2005, the water balance for the remaining period of *rabi* FY05 i.e., February-March FY05 has significantly increased; with a 54.2 percent and 67.1 percent increase in the water balances for Punjab and Sindh respectively from the pre-rainfall levels. Moreover, the snowmelt from the heavy snowfall is also expected to ensure good water availability in the subsequent *kharif* FY06, season.

Another positive development in the agriculture sector is the 49.4 percent increase in agri credit disbursed during H1-FY05. The Rs 49.1 billion disbursed during H1-FY05 was 57.8 percent of the FY05 annual target; to put this in perspective, it should be noted that: (1) disbursements had never before crossed 51 percent of the target during a half year, and that (2) this was achieved despite a large increase in the target. This clearly indicates that the actual disbursement at the end of FY05 will surpass the annual target for the year. Although disbursement for fertilizer was also 29.1 percent higher during H1-FY05 as compared to H1-FY04, its offtake during *rabi* FY05 remained low compared to rabi FY04 mainly due to water shortage at the beginning of the *rabi* season, higher fertilizer prices and supply shortages.

Industrial Production

Industrial production, as measured by the Index of Industrial Production (IIP), recorded a robust growth of 15.4 percent YoY during H1-FY05, significantly higher than the 9.8 percent annual growth target. While the growth is certainly slower than the 21.0 percent YoY seen in H1-FY04, it is nonetheless impressive given the strong performance in almost all the months of H1-FY05. LSM continued to dominate the industrial growth profile, contributing approximately two-thirds of the overall industrial growth during the period and recording a growth rate of 16.1 percent YoY during H1-FY05.

While this suggests that the LSM annual growth target will very likely be exceeded, the growth *momentum* seems to have weakened somewhat. This deceleration appears to be largely attributable to both, capacity constraints as well as a high base effect.

Heavy investment in the textile industry along with high cotton output is beginning to appear in form of higher manufacture production in this sub-sector. During H1-FY05 the textile sector almost doubled its growth rate to 16 percent although it was disconcerting that the production of large units in value added items recorded a negative growth. Considering that almost one-third of LSM value added originates from textiles, the impact of this robust growth on exports and employment is likely to be favorable.

Similarly, fertilizer, electronics and automobiles sub-sectors witnessed impressive growth rates during H1-FY05, over an already high base set during the corresponding period of FY04. The availability of bank credit for consumers and agriculture partly contributed to the good performance by these sectors.

Prices

Inflationary pressures in the domestic economy remain worrisome. On the face of it, they appear to have peaked for the time being during H1-FY05, as the inflation measured by all three price indices moved down in unison after July 2004. In fact, the H1-FY05 downtrend in inflation is mainly attributable to a softening of food inflation. While FY05 food inflation is still high in all three indices by end-February 2005 compared to the preceding year; it is visibly lower than in July 2004.

The strength of CPI inflation (9.9 percent in February 2005), despite the evident weakness in food inflation, also highlights the rising core inflation in the economy. In fact, despite a gradual tightening of monetary policy, core inflation, both as (1) proxied by *non-food non-energy* prices and as (2) computed through the *trimmed* method, continues to mount steadily upwards. The largest contribution to core inflation, as measured by either of the two methods, is the Housing Rent Index (HRI). Not only does it has a dominant weight in both measures, the HRI has also steadily risen over the preceding 24 months.

Money and Banking

Although the SBP raised interest rates steadily through the first 8 months of FY05, continuing the Q3-FY04 uptrend in interest rates, monetary policy largely remained accommodative; the weighted average lending rates remained negative in real terms and private sector credit rose by a record Rs 322.5 billion during the period.

To counter the inflationary trend, SBP has raised the benchmark 6-month T-bill interest rate by almost 300 basis points since June 2004 to approximately 5.20 percent by March 2, 2005 and furthermore has more frequently conducted OMOs in order to improve the transmission of the policy signal on to lending rates. However, so far, CPI inflation has weakened only slightly and core inflation has continued to trend higher. This would suggest that monetary policy needs to be tightened further.

This bias towards a relatively tighter monetary posture is evident in the revised Credit Plan for FY05 presented in February 2005, wherein M2 growth is envisaged at 14.5 percent, roughly in line with the then-expected growth in nominal GDP. More recent estimates suggest that the growth in money supply during FY05 may remain *below* the nominal GDP growth.

Overall monetary expansion during Jul-Feb FY05 continued to register significant growth and has increased by Rs 257.8 billion compared with Rs 230.1 billion in the corresponding period of FY04. While both, NDA and NFA contributed to the expansion, the contribution of the former was larger. The NFA of the banking system grew by Rs 38.9 billion during Jul-Feb FY05, higher than Rs 33.8 billion rise during the corresponding period of FY04.

NDA of the banking system increased by Rs 218.9 billion during Jul-Feb FY05 compared with the increase of Rs 196.3 billion in the corresponding period last year. A rise in the SBP NDA stemmed from the net retirement of government borrowings from commercial banks, which were substituted by borrowings from SBP. The smaller contribution of commercial banks in the FY05 NDA growth is because of the heavy net retirement of government borrowings, and contraction under *Other items (net)*, which offset most of the impact of the record growth in net credit to the private sector.

Fiscal Developments

A lower rate of revenue growth (largely due to a freeze on domestic oil prices)[6] and an acceleration in the consolidated expenditures during H1-FY05, caused the overall budgetary deficit to rise to Rs 79.6 billion, up 136.0 percent YoY.

A decline in tax revenues during Q2-FY05 dragged the overall revenue growth for the quarter to a mere 3.8 percent YoY, down sharply from the 22 percent YoY rise in Q1-FY05 and the 19.1 percent YoY growth witnessed in Q2-FY04. In fact, it was only the exceptionally strong receipts of Q1-FY05 that kept the aggregate H1-FY05 revenues on-track to meet the annual target.[7]

The impact of the Q2-FY05 slowdown in revenue receipts on the overall budgetary deficit was amplified by the 30.9 percent YoY jump in expenditures during the same period. While developmental expenditures rose by a welcome 43.7 percent YoY (to Rs 81.6 billion) during H1-FY05,[8] the dominant contribution

[6] Government had to suspend the collection of petroleum development levy (PDL) during the entire second quarter to keep the prices of POL products at the May 1, 2004 level.

[7] A part of the exceptional rise in tax receipts simply owed to a procedural change that shifted some receipts to September that had earlier been collected in October and November. Moreover, the Q1 collections also benefited from the introduction of the *Universal Self-Assessment Scheme* (USAS).

[8] As a result development expenditures as percent of GDP rose to 1.3 percent in H1-FY05 compared to the same period last year.

to the increase in spending was by a Rs 75.0 billion (21.3 percent YoY) increase in current expenditures. As a result, total consolidated expenditures registered a 21.9 percent YoY increase during the first half of FY05.

Balance of Payment

The external account recorded a large deficit for the second successive quarter during FY05. As a result, the aggregate H1-FY05 deficit reached US$ 1.2 billion, which was in sharp contrast to the surplus of around US$ 1.0 billion recorded in the corresponding period of the previous year. Almost all of the deterioration emerges from a large US$ 2.1 billion jump in the country's trade deficit from a mere US$ 0.2 billion in H1-FY04 to US$ 2.3 billion in H1-FY05.

The services account registered a higher net outflow of US$ 1.5 billion in H1-FY05 as compared to an outflow of only US$ 0.2 billion during the corresponding period of FY04. This deterioration in the services account owes to a large increase in outflows under *transportation*; and lower receipts of payments for logistic support.

The combined deficit on the trade and services accounts was to partially offset by the net receipts under *current transfers* of US$ 4.1 billion during H1-FY05, up 28.5 percent YoY from the US$ 3.2 billion recorded during the corresponding period of FY04. Within the private transfers, remittances and FCAs increased by US$ 72 million and US$ 209 million respectively, during H1-FY05 compared to the corresponding period of FY04.

Nonetheless, the overall current account balance turned to a deficit of US$ 884 million during H1-FY05 compared with a surplus of US$ 1.8 billion in H1-FY04.

The financial account deficit (adjusted for US debt write off of US$ 495 million) declined by 34.3 percent YoY to reach US$ 527 million. This improvement in the financial account owed to a surplus recorded during Q2-FY05 on account of (1) greater availability of non-food aid relative to corresponding period of the preceding year; (2) higher net foreign investment; and (3) net inflow of IDB short-term loans.

Foreign Trade

A continued rise in machinery and raw material imports, together with a slight (but unusual) fall in textile exports in Q2-FY05, led to a considerable widening of the trade deficit during H1-FY05. This increase in the deficit was recorded despite a US$ 648 million downward revision in petroleum product imports for the months of Oct & Nov 2004.

While the rise in machinery group imports was largely in line with the trade policy target set for FY05, the increase in imports of *agriculture & chemicals* and *petroleum* group seem to be exceeding the target level by a large margin.

The composition of *petroleum group* imports is changing in favor of import of crude oil. However, the aggregate import demand for petroleum products did not weaken due to greater dependence on thermal power generation that necessitated higher imports of furnace oil.

Exchange Rate & Foreign Exchange Reserves

The contraction in the current account put pressure on Rupee/US Dollar exchange that leading to a sharp rupee depreciation during the second quarter of FY05. These pressures were present despite continued support from SBP. Indeed, it was the risk of the self-sustaining pressure on the Rupee that finally forced the SBP to intervene more visibly in the inter-bank market by end-October 2004 by announcing its willingness to ensure ample availability of foreign exchange to meet lumpy payments for oil imports. This had an immediate impact on the inter-bank market, which was effectively assured that the exchange rate movements would not be too volatile. As the liquidity in the inter-bank market improved, the exchange rate stabilized even though the net interventions by the SBP were gradually reduced. In overall terms, the Rupee depreciated by 2 percent during July 2004 – February 2005 period, compared to 0.7 percent appreciation in Rupee/US Dollar exchange rate during the corresponding period last year.

It must be kept in mind that the SBP had intervened in the market during Q1-FY04 as well, but this had not been of great comfort to the market because the interventions were opaque. There was little information available for the market to assess the size of the interventions nor any way for it to determine to what extent to these would continue. These concerns were removed by the end-October 2004 SBP announcment referred above.

Not surprisingly, the larger and more systematic interventions by the SBP to inject foreign exchange into the inter-bank market led to immediate large decline in its forex reserves during Q2-FY05, compared to the preceding quarters. However, as inflows started coming in and speculative demand vanished from the market, the country's overall reserves touched a historic high level of US$ 12.78 billion by end February 2005, showing an increase of US$ 452.1 million since July 2004. The overall reserves have however undergone a significant compositional change during this period. Specifically, during Jul-Feb FY05 SBP's reserves declined by US$ 706.7 million, despite some major inflows, including disbursements by the World Bank and Asian Development Bank as well as receipts for *sukuk* offering.

On the other hand, reserves held by commercial banks increased by US$ 1,158.8 million due to both, increases in FE-25 forex deposits, as well as the retirements of forex loans extended by commerical banks.

External Debt and Liabilities
The stock of total debt and liabilities witnessed an increase of 4.1 percent during H1-FY05 mainly due to (1) fresh flows from multilateral institutions; and (2) increase in the value of Paris Club and multilateral debt stock on account of the appreciation of Yen and Euro vis-à-vis US Dollar. However, total external debt as percentage of GDP *declined* by one percentage point to 35 percent.