THE STATE OF PAKISTAN'S ECONOMY
First Quarterly Report for FY06

1.1 Overview

Initial data on the commodity-producing sectors indicates that the performance of Pakistan's economy during FY06 will be weaker than in the preceding year; specifically, growth in large scale manufacturing has decelerated sharply, and the production in two of the four major *kharif* crops was significantly below target. Much of this slowdown is not unexpected, as is reflected in the 7.0 percent real GDP growth target set in the Annual Development Plan for the year, against the 8.4 percent growth achieved in FY05. While, the FY06 growth target is still *not* out of reach, achieving it might prove to be a challenge.

Specifically, in agriculture, while the value-addition by major crops is expected to fall well below the target, this may yet be compensated by an anticipated above target performance by the minor crops and livestock sub-sectors. Similarly, while industrial growth may remain a little below target, activity is expected to remain strong due to an expected recovery by LSM in succeeding quarters (as credit demand remains relatively strong), a bouyant contruction sector, and improved electricity & gas distribution. Finally, growth in the services sector is also expected to turn in a strong performance.

Table 1.1: Selected Economic Indicators

		FY04	FY05	FY06
Growth rate (percent)				
Large scale manufacturing		16.1	24.9	8.7
Exports	Jul-Oct	14.2	12.8	22.8
Imports	Jul-Oct	13.0	34.5	54.0
Tax revenue (CBR)	Jul-Sep	4.1	30.8	18.6
CPI (12 m moving ave)	Jul-Nov	2.7	7.3	9.0
Private sector credit	Jul-Nov	13.1	12.9	10.8
Money supply (M2)	Jul-Nov	7.9	5.5	3.0
million US Dollars				
Total liquid reserves[2]	End Jun	12,327.9	12,617.6	11,330.1
Home remittances[3]	Jul-Oct	1,235.0	1,318.2	1,375.2
Foreign private investment	Jul-Oct	106	270	657
percent of GDP[4]				
Fiscal deficit	Jul-Sep	0.7	0.4	0.5
Trade deficit	Jul-Oct	0.33	1.16	2.65
Current a/c balance	Jul-Oct	1.55	-0.11	-1.60

1. Based on 91 items
2. With SBP and commercial banks (end-November for FY06)
3. Excluding receipts on a/c of Kuwait war affectees and Hajj
4. Based on full-year GDP in the denominator.

In any event, while the contribution to FY06 growth by individual sub-sectors of the economy is likely to differ from earlier expectations, SBP estimates suggest that real GDP growth will range between 6.0-6.6 percent.

The relative slowdown in economic activity, together with an improvement in food supply (stemming from better minor crop harvests and the government's supply-side interventions), is contributing to a relative weakening in domestic inflation. CPI inflation continued a trend decline throughout the first 5 months of FY06, consequently dropping from the peak of 11.1 percent YoY in April 2005 to reach 7.9 percent YoY by end-November 2005. This raises hopes that the eventual annual inflation will remain close to the 8.0 percent target for FY06. Two assumptions that underlie this expectation are: (1) that monetary policy will remain tight, and (2) fuel prices will not see a significant rise in the remaining months of the fiscal year.

Although monetary expansion has been contained to 3.0 percent during July-Nov FY06, as compared to the 5.0 percent increase seen in the corresponding period of FY05, demand for private sector credit remained strong, and most importantly despite a small dip in November 2005, core inflation persists at a relatively high 7.6 percent YoY. This suggests that inflationary pressures may still be persisting in the economy, and the SBP therefore has to be particulalry vigilant, given that M2 growth may accelerate in the quarters ahead (reinvigorating inflation), pressed by both, high government borrowings for budgetary support and the realization of external assistance.

It is important to note here that much of the external assistance received for rehabilation of the earthquake affected areas is likely to be excluded from budgetary financing, and the government borrowings may remain strong during FY06, adding to reserve money growth. The latter view is supported by expectation that the growth in government expenditures will remain strong (especially the encouraging rise in development spending), and an evident weakness in the structure of tax receipts – approximately 75 percent of the growth in tax receipts during Q1-FY06 stemmed from import-based taxes, led by a sharp rise in imports. Thus, tax receipts may be adversly impacted by any slowdown in imports in future quarters.

Imports have seen an extraordinary 54 percent YoY growth during July-October FY06, substantially higher than the robust 22.8 percent rise in exports during the same period. As a result, the trade deficit has widened to US$ 3.37 billion, pushing the current account deficit to US$ 2.04 billion (1.6 percent of estimated GDP). This will substantially raise the pressure for corrective action. However, it should be noted here that any adjustments are unlikely to be abrupt or add to market volatility, as Pakistan's external account receipts are expected to increase during FY06, and foreign currency reserves remain strong.

Looking forward

The economic outlook for Pakistan present a mixed picture. On the one hand, real GDP growth is likely to remain well above the 6 percent long-term trajectory, and there is a strong expectation that CPI inflation will remain at the 8 percent level, in line with the annual target, by end-June 2006. However, potential emergence of large fiscal and external imbalances pose threats to the sustainability of these positive trends.

While inflaiton is falling, it needs to be reduced further even at the cost of sacrificing some growth in the short-term. This is essential, as a fall in inflation will allow for an easing of monetary policy, thereby supporting long-term growth and countering any cyclical downtrend. The elimination of emerging macroeconomic imbalances will also be essential to sustaining long term growth in the economy.

Similalry, while fiscal discipline is required, this cannot be at the expense of development expenditures, as this would lower the productive capacity of the economy, thereby contributing to even greater deficits in future. Therefore, improvements in the fiscal environment must necessarily stem from a widening of the tax base. In particular, the increasing dependance of overall revenues on just a few sectors of the economy poses serious risks to fiscal stability (as shocks to these sectors can derail the fiscal discipline), and contraints the growth of the sectors which currently carry the tax burden of the whole economy.

Table 1.2: Major Economic Indicators

	Provisional FY05	FY06 Original targets	FY06 SBP projections
growth rates (percent)			
GDP	8.4	7.0	6.0-6.6
Inflation	9.3	8.0	7.5-8.5
Monetary assets (M2)	19.3	12.8	13.1
billion US Dollars			
Exports fob			16.7
Imports cif			27.1
Workers' remittances	4.2	4.0	4.3
percent of GDP			
Budgetary balance	-3.3	-3.8	-4.3
Current account balance	-1.4	-2.1	-4.4

Moreover, while recent increases in development spending bode well for the growth prospects of the economy, it is important to ensure that even within development spending there is a balance between the creation and maintenance of physical infrastructure, and raising the productivity of human capital through investment in health and education. This is true even for the earthquake affected areas, where initial focus may be greater on the re-creation of housing and infrastructure. It may be pointed out that a key risk to the country's growth potential is the lack of a substantial cadre of managers, skilled technicians, and trainable general labor force.[1] The shortage of skilled labor is already particularly evident in the high growth, sunrise industries in Pakistan, including telecommunications, IT, high value-added textiles, telecast media, finance, etc. This is indeed a tragedy for Pakistan, where persistent skill-set mismatches, which depite employment opportunites, keep unemployment high, raise poverty and lower the country's growth potential.

Finally, containing the external imbalances will also be a challenging job, given the increasingly open economy and the need to sustain productive imports. In the short run, the country can sustain even the higher current account deficits, given the ample availability of foreign currency financing at relatively low costs, and strong foreign account reserves. However, the resort to these can only be a temporary phenomenon, and is not sustainable for extended periods, without engendering serious distortions in the economy. Moreover, even targeted fiscal interventions are unlikely to succeed in containing import growth and run the risk of introducing distortions in the economy. The required adjustments must therefore be borne by export oriented policies, rather than by containing imports.

[1] Towards a prosperous Pakistan: A strategy for Rapid Industrial growth, MOI. GoP, January 2005.

1.2 Executive Summary

Agriculture
Provisional data on the major *kharif* crops suggests that value-added by these may not only fall below targets but even below the levels seen in FY05. Thus the overall FY06 agricultural growth target will depend on an exceptional *rabi* harvest, and above-target growth in the minor crops and livestock sectors.

Given the likelihood of adequate fertilizers availability, the timely announcement of support prices, ample agricultural credit and improved water availability the prospect of a good *rabi* harvest is very much likely. Also, indirect evidence, in the form of a fall in prices of many minor crop products, as well as some anecdotal evidence, raises hopes that production of many minor crops may exceed target. Similarly, increased focus of microfinance institutions on the livestock sector in recent years could lead to an above target outcome in this sector as well. Thus, all in all by the end of Q1-FY06, the prospects of the agriculture sector annual growth reach close to the target, are bright.

Industrial Production[2]
The *Index of Industrial Production* (IIP[3]), indicates that industrial growth weakened during Q1-FY06, registering a single digit growth of 6.1 percent, in contrast to the 19.0 percent growth witnessed during Q1-FY05. This slowdown in IIP is mainly attributed to a distinct deceleration in large scale manufacturing growth. *LSM* grew by 8.7 percent in Q1-FY06, substantially lower than 24.9 percent YoY growth recorded during the corresponding period of FY05, and also below the 13 percent YoY annual growth target. The number of sub-sectors witnessing growth in excess of 10 percent has fallen from 11 in Q1-FY05 to 8 during Q1-FY06.

One of the stronger contributions to the deceleration in LSM growth is from the textile sub-sector with 7.2 percent YoY growth in Q1-FY06 as against 29.6 percent YoY growth in Q1-FY05. Similarly, growth in the automobile sector also fell sharply to 32.3 percent YoY during Q1-FY06, from the 40.2 percent YoY increase seen in Q1-FY05. The other industries that witnessed a notably slower growth during Q1-FY06 relative to Q1-FY05 include food, beverages & tobacco, cement, fertilizer and electronics. In contrast, leather, pharmaceutical, paper &

[2] This analysis is based on the provisional data on *large scale manufacturing* (LSM) supplied by the Federal Bureau of Statistics.
[3] IIP is used as a proxy for industry to estimate the industrial production.

paper board and engineering industries saw a significant rise in growth during Q1-FY06.

Prices

Inflationary pressures that started weakening by the last quarter of FY05, further weakened during the first five months of FY06. CPI and SPI inflation (YoY) witnessed obvious slowdown during FY06, on the back of a sharp deceleration in *food* inflation. In contrast, WPI inflation exhibited a steep rising trend until September 2005 due to the rising PoL prices. However, this too showed some signs of easing during Oct-Nov 2005 mainly on account of softening in *food* and *fuel & lighting* sub-group inflation.

Specifically, after rising from 8.7 percent in October 2004, marginal (YoY) CPI inflation peaked in April 2005, before dropping to 7.9 percent by November 2005. While the earlier rise was dominated by rising *food* inflation, during the first five months of FY06 inflationary pressures were being driven principally from the CPI *non-food* group since mid-April 2005. In fact, the impact of a gradual deceleration in food inflation is partially offset by a sharp rise in the prices of key fuels. The rise in oil prices also led to a significant rise in transportation costs, thus supporting inflationary pressures to sustain. On the positive side, a continued deceleration in house rent index (HRI)[4] augmented the ease in food inflation during Jul-Nov 2005.

Fiscal Developments

The fiscal deficit widened marginally during Q1-FY06, rising to 0.5 percent of (estimated) GDP, as compared to approximately 0.4 percent of GDP in Q1-FY05. Fiscal accounts, however, presented a relatively stable position as the revenue balance remained unchanged at 0.2 percent of GDP and primary deficit declined to 0.1 percent of GDP in Q1-FY06 as compared to 0.4 percent in Q1-FY05. The deceleration in accounts is mainly because of development expenditure that presented a YoY growth of 58.6 percent; therefore, it is not a matter of great concern. However, given that fiscal performance post-Q1-FY06 is likely to deteriorate due to an expected rise in expenditures in the aftermath of the October 2005 earthquake, there is a need for greater vigilance in sustaining (and improving) revenue growth.

On the taxation side, CBR met its revenue targets for the quarter; however, the 21.0 percent growth in CBR revenues during the first quarter is mainly due to a

[4] HRI inflation fell from a peak of 12.3 percent (YoY) in March to 10.8 percent during November 2005.

massive increase in international trade taxes (approximately 76.5 percent of the total increase in CBR tax collections during Q1-FY06). This would suggest that CBR will have to gear up its efforts to meet the annual target of Rs 690 billion and focus on tax compliance and expanding the tax net.

Money and Banking

Q1-FY06 witnessed a monetary contraction, with M2 declining 0.3 percent in the period, in contrast to the 1.2 percent increase seen in Q1-FY05. This decline was dominated by a reduction in the NFA of the banking system, reflecting the increasing pressure on the country's external account, as NDA growth was relatively strong due to an increase in government borrowings for budgetary support and strong growth in private sector credit.

The lower growth in M2 together with the fall in CPI inflation from its 11.1 percent peak of April 2005 to 8.5 percent in September 2005, and the end of the steep uptrend in core inflation, together with the anticipated further lagged impact of earlier monetary tightening was instrumental in SBP' decision to hold the interest rates relatively unchanged through Q1-FY05. While benchmark rates did not change, SBP sought to support the transmission of the tight monetary posture by improving its inter-bank liquidity management.

However, the outlook of the monetary aggregates changed significantly from October 2005 onwards. In particular, private sector credit and government borrowing from the banking system both began rising strongly. As a result, during July-Nov FY06, the banking sector NDA registered a growth of 6.7 percent compared with the growth of 6.2 percent in the corresponding period of FY05. This growth was enough to offset the continuing decline in NFA, and therefore the money supply registered a sharp rise during Oct-Nov FY06, pushing the cumulative M2 growth during July-Nov FY06 to 3.0 percent as compared to the 5.5 percent rise in July-Nov FY05.

Given that the relatively subdued M2 growth in July-Nov FY06 is owed entirely to the sharp drawdown in the net foreign assets, the likelihood that this negative trend in NFA would halt or reverse in coming months (due to inflow of earthquake related foreign assistance), SBP would need to be extremely careful to ensure that money supply growth remains consistent with long-term non-inflationary growth.

Pakistan's External Sector

The overall external balance of Pakistan recorded a deficit of US$ 0.5 billion during Jul-Oct FY06 against a US$ 1 billion deficit realized in Jul-Oct FY05.

This relative improvement was largely due to higher inflows in the financial account, which offset the sharp increase in the current account deficit.

The current account deficit deteriorated sharply to reach the level of US$ 2 billion during Jul-Oct FY06 compared to a small deficit of US$ 121 million during the corresponding period of FY05. This sharp deterioration was principally due to the 34 percent YoY rise in imports during Jul-Oct FY06, which overshadowed the healthy 14 percent YoY growth in exports.[5] Consequently, the trade deficit rose to US$ 2.6 billion during Jul-Oct FY06, as compared to a deficit of US$ 1.3 billion in the corresponding period of FY05.

In the case of imports, a significant contribution to the exceptionally strong growth during Jul-Oct FY06 was from international oil prices. In fact, petroleum group imports increased by YoY 73.2 percent to reach US$ 2.1 billion during Jul-Oct FY06. This increase in imports of the petroleum group was driven almost entirely by higher prices (import volumes fell by 2.2 percent YoY).

However, even on excluding the oil bill, import growth remains exceptionally strong at 48.8 percent YoY. The machinery group imports portrayed a substantial growth of 62.2 percent YoY during Jul-Oct FY06 as against the 33.5 percent YoY growth witnessed during the corresponding period of the last year.

This suggests that even though Pakistan's oil import bill could shrink somewhat in the months ahead as international oil prices retreat from their peaks, this may be offset by the growth in non-oil imports (particularly machinery, raw material and imports to support relief efforts in areas affected by the October 2005 earthquake).

The substantial increase in trade volumes also contributed to a 44 percent YoY deterioration in the services account deficit during this period. Besides, current transfers also witnessed a marginal deterioration. This was largely due to a fall in net private current transfers on account of lower net inflows in the resident foreign currency accounts as well as sluggish growth in worker's remittances.

However, fortunately this deterioration in the current account was offset by a substantial improvement in the financial account, mainly emanating from higher net foreign investment. Further higher receipts of project loan from Internatinal Development Agency (IDA), supplier's credit inflows along with low payments of other liabilities also contributed in the financial account improvement.

[5] Based on exchange record.

The net deficit in the overall external balance did not significantly pressure the exchange rate during this period, with the rupee-dollar parity remaining practically unchanged through Jul-Oct FY06. This relative stability was principally because SBP continued with its policy of meeting lumpy payments for import of key commodities, such as oil, wheat urea, etc. The SBP interventions, aimed at reducing market volatility, continued throughout Jul-Oct 2005, and led to a reduction in the SBP reserves.

The overall reserves fell by US$ 1.29 billion during Jul-Nov FY06 to touch US$ 11.3 billion by end-November 2005, down US$ 1.7 billion from the peak level of US$ 13.00 billion reached in April 2005. The decline is evident in both SBP and commercial bank reserves. SBP's reserves declined by US$ 900.7 million during Jul-Nov 2005, despite some major inflows, including disbursement by the IDA and Asian Development Bank (ADB), receipt from logistic support, privatization proceeds as well as purchases from the inter-bank market. Similarly, the reserves held by the commercial banks fell by US$ 387 million in the same period.