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

1.1 Overview

While Pakistan's economy remains on a high-growth trajectory during FY06, the real GDP growth rate for the year seems increasingly likely to be lower than the 7 percent target. The expectation of the slowdown relative to the FY06 annual target owes principally to the (estimated) weakness in the commodity producing sectors of the economy, the impact of which will be partially offset by an anticipated above-target performance of the services sector.

It is important to understand here that the forecast deceleration in economic activity during FY06 does not presage a general weakening of the trend growth of the economy. With the substantial investments in the current (and preceding) year, strong domestic demand, buoyant exports and a relative improvement in FDI (even after excluding privatization receipts), the economy is poised to deliver real growth rates in excess of 6 percent through the decade, provided that progress is made towards removing infrastructural bottlenecks, implementing second generation reforms to improve institutions and governance, as well as to further liberalize the economy. Moreover, in the short-run, it would be necessary to address emerging macroeconomic imbalances while these are still small and not threatening.

Table 1.1: Major Macroeconomic Indicators

	July-December		
	FY04	**FY05**	**FY06**
growth rates(percent)			
Large-scale manufacturing	19.0	21.2	--
Exports	13.2	10.9	23.7
Imports	14.1	35.0	53.1
Tax revenues (CBR)	13.7	15.0	21.7
CPI (12-month moving average)	2.9	7.5	9.1
Private sector credit	13.2	22.3	17.4
Money supply (M2)	9.0	9.8	8.1
million US$			
Total liquid reserves[1]	12,172	11,987	11,712
Home remittances	1,874	1,946	2,055
Foreign private investment	198	452	1,411
percent of GDP[2]			
Fiscal deficit	0.6	1.2	1.8
Trade deficit	0.8	2.2	4.5
Current a/c balance	0.9	-0.7	-2.3

[1] With SBP & scheduled banks. End December.
[2] Calculated by taking fiscal year GDP but variable numbers on half yearly basis. Projected GDP has been used for FY06.

Some of the key macroeconomic imbalances include the downtrend in savings that has led to a widening savings investment gap, the growth of the trade deficit (and concomitant rise in the current account deficit) and, a weakening in fiscal indicators (even after adjusting for exceptional earthquake related spending) (see

Table 1.1). Also, while inflationary pressures show a very welcome decline, the downtrend is still unsettled, and inflation remains at relatively high levels.

While inflation has declined from double-digit near term highs in FY05 and is expected to fall to the 8 percent levels by end-FY06, it must be recognized that reducing it further is necessary for a host of reasons. These include the need to encourage a rise in savings (by keeping real returns on savings positive), maintaining the purchasing power of incomes, making exports more competitive (by holding down the cost of production and thus lowering pressure on the exchange rate), etc.

It is important to realize here that while the tight monetary posture of the central bank, (supported by the government's administrative measures) has contributed to a reduction in inflationary pressures, aggregate demand remains strong. During July-Feb FY06, private sector credit growth was a very substantial 18.1 percent, albeit weaker than the 25.3 percent rise seen in the comparable period of FY05, and while growth in LSM also decelerated, this appears to owe more to factors other than a substantial weakness in demand (e.g. capacity constraints, high-base effects, technical problems, etc.). In this background, a reduction in the volatility of inflation and establishment of a clear downtrend will be important priorities for the central bank, and therefore, the possibility of a further monetary tightening cannot be ruled out.

However the monetary policy will need to be supported by fiscal prudence. While fiscal discipline had been good in recent years, there appears to be a trend deterioration in fiscal indicators during FY05 and FY06. The revenue balance is in deficit in both years, and even the primary balance deteriorated significantly in FY06. Going forward, not only does the government need to maintain low fiscal deficits, these should primarily be caused by developmental rather than current expenditure. While development spending generates economic activity to pay off the debt, current spending only adds to the debt burden.

Moreover, the mode of financing the fiscal deficit is also important. Borrowings from domestic sources other than SBP simply result in a shift of demand from the private sector to the government, but borrowings from SBP are more inflationary as they add to aggregate demand, and therefore financing of the deficit should be through a healthy mix of bank and non-bank borrowings. It should be recalled that the large Rs 178.2 billion increase in budgetary borrowing from SBP during July-Feb FY06 was an important driver of monetary expansion in the period. A part of the government's greater reliance on SBP borrowings was driven by weak non-bank receipts, but another contribution was also due to the non-issuance of

long-term treasury bonds; almost half of the Rs 31.0 billion net retirement of government borrowings from scheduled banks was due to maturities of these instruments. It is important that the government make fresh PIB issues to lower dependence on SBP borrowings and to provide a market driven benchmark, which is needed for the development of the corporate bond market.

While low inflation would help providing impetus to growth in years ahead, a disappointing level of national savings and low investment need immediate attention. Specifically, during FY03 and FY04, imports were financed through current account flows. Unfortunately, thereafter imports continued to grow; the growth in non-debt creating forex inflows was no longer keeping pace with the growing needs of the economy. This is reflected in the widening current account deficit, and resulting in a rising savings-investment gap. This means that in years ahead the country will be increasingly constrained in its ability to meet the growing consumption and investment needs without generating inflationary pressures and an accelerated growth in the country's debt stock, unless there are substantial policy revisions and sustained reforms to meet the challenge of increasing both investment (to increase productive capacity) and savings (to fund Pakistan's investment needs).

Unfortunately, the growth in the imports, and therefore the current account deficit, cannot be easily contained. Data suggests that much of the growth in imports comprises of either capital goods or input for industries. Curtailing these *directly* would therefore result in significant fall in economic activities. Moreover, some further growth in imports is inevitable for a developing economy such as Pakistan, particularly as it seeks to address infrastructural shortcomings.

The large current account deficit can be sustained in FY06, but hard choice will have to be made in future years, if it continues to persist. The policy options available will revolve around reducing the need for imports by containing the growth in aggregate demand, promoting exports, and attracting non-debt creating flows (e.g. FDI). Less desirable options would be to fund the current account deficits through a mix of privatization receipts and higher debt levels or a significant drawdown of the country's foreign exchange reserves.

Future Outlook

Current SBP forecasts indicate that real GDP growth will fall in the range of 6.3 - 6.8 percent during FY06 (see **Table 1.2**). Initial data suggests that the wheat crop may prove to be at (or slightly above) the 21 million tonnes target, but this will still not be sufficient to offset the drag of disappointing *rabi* harvests - cotton and sugarcane. The trends in Large Scale Manufacturing (LSM) growth are, however,

unclear, due to non-availability of adequate data from the Federal Bureau of Statistics. The SBP GDP estimate therefore incorporates the limited FBS data releases to date, and other available market information, and may be subject to revision when the complete FBS data set becomes available.

Table 1.2: Major Economic Indicators

	Provisional FY05	FY06 Original targets	FY06 SBP projection
growth rates (percent)			
GDP	8.4	7.0	6.3-6.8
Inflation	9.3	8.0	7.7-8.3
Monetary assets (M2)	19.3	12.8	14.3
billion US$			
Exports (fob-Customs record)	14.4	-	16.9
Imports (cif-Customs record)	20.6	-	28.8
Workers' remittances	4.2	4.0	4.3
percent of GDP			
Budgetary balance	-3.3	-3.8	-4.5
Current account balance	-1.4	-2.2	-4.7

Headline inflation is projected to fall in the 7.7 – 8.3 percent range during FY06. While the deceleration is certainly welcome, the downtrend in inflation may prove unstable, and could pose a challenge to macroeconomic stability. SBP will therefore continue to retain a tight monetary stance. However, it is important to note that monetary policy alone will not be able to contain all of the rise in inflationary pressures. In particular, there is an urgent need for the government to supplement its very laudable supply-side measures with policies to address market structure problems. Specifically, anecdotal evidence clearly suggests that in recent years, speculative hoarding and collusive price setting have been significant contributors to domestic inflationary pressures in markets for many key commodities. Such pressures respond more to legal and administrative measures, and are less sensitive to monetary tightening.

In contrast to the welcome decline in inflation, the external balance deteriorated significantly in FY06. Although remittances are expected to show reasonable growth and exports are likely to remain strong, the current account deficit is expected to swell to 4.7 percent of GDP by end-FY06. While this is not low, it is quite sustainable in the short run. In the longer run, however, large current account deficits cannot be sustained, as these would initiate a vicious circle of debt creation, exchange rate deprecation and inflation.

In summary, given the fast growing trends of aggressive globalization and increasing regional competition, Pakistan can ill afford to derail its macroeconomic stability which, besides political stability, has been the lynchpin of restoring both domestic and foreign investor confidence. Macroeconomic management today is complicated by Pakistan's need to continue growing which does require it to stretch its both financial and physical resource base, and the

country will have to carefully gauge its priorities in seeking to meet these challenges.

1.2 Executive Summary

Agriculture

The relative improvement in water availability and ample availability of agri-credit bodes well for the *rabi* FY06 crops. In particular, the wheat crop, which contributes the greater part of the value-addition by *rabi* crops, is expected to be a significant beneficiary, with better water availability offsetting the impact of delayed sowing in some key wheat growing districts. This is likely to be complemented by higher credit disbursements, enabling farmers to increase the use of quality inputs to increase productivity. Thus, with a little luck, wheat yields could surpass the record (2586kg/hectare) set last year. On the same lines, in aggregate, minor crops could also do significantly better than targeted during *rabi* FY06. However, even if this happens, the overall growth of the crops sub-sector may remain below target due to the considerable underperformance by two major *kharif* FY06 crops, i.e. cotton and sugarcane.

The overall performance of the agricultural sector could yet receive a significant boost, however, if growth in the livestock sector proves to be significantly above the 3.5 percent FY06 target. While there is little hard data to support this hope, anecdotal evidence suggests that above-target growth could be achieved. Specifically, the dairy industry seems poised to deliver significant production increases in FY06 on the back of sustained government and private sector efforts in recent years.

Large-scale Manufacturing

Trends in large-scale manufacturing cannot be clearly established due to non-availability of data from Federal Bureau of Statistics (the last complete data set on LSM production is available for September 2005). However, there is some evidence that LSM growth has decelerated in Jul-Jan FY06 relative to the corresponding period of FY05.

Available information suggests that while the largest industrial group in LSM, the *textiles* witnessed a satisfactory growth of 7.7 percent YoY during the first seven months of FY06, it is far below the 26.4 percent YoY growth witnessed in the corresponding period of FY05. Growth in textiles, despite a high base set in the preceding year and higher prices of cotton, was achieved on the back of continued strong external demand. Similarly, despite rising construction activities, a slowdown was observed in *non-metal* industries largely because of deceleration in

the growth of the cement industry, where production growth slowed to 8.8 percent in Jul-Jan FY06, reflecting capacity constraints.

The *chemical* industry also recorded deceleration, posting only 4.4 percent YoY growth in output during Jul-Jan FY06 primarily due to capacity constraints, in caustic soda production, where capacity utilization reached above 130 percent. Similar to *chemical* industry, *fertilizer* industry also facing capacity constraints witnessed 16.4 percent growth YoY as compared with 42.7 percent growth in the same period last year.

Contrary to above, *automobiles* industry showed acceleration in growth, recording a 28.2 percent rise in production during Jul-Jan FY06 over the strong 27.9 percent YoY growth in the preceding year.

Similar to *automobile* industry, growth in the *paper & board* sub-sector accelerated to 11.7 percent during Jul-Jan FY06 as compared to 4.5 percent during the corresponding period of FY05, mainly, due to expansion in production capacity by some manufacturers.

Prices

Inflationary pressures in the domestic economy weakened during most of the first eight months of FY06 primarily due to tight monetary stance, administrative measures and favorable movements in international prices of key commodities. While the rate of increase in the consumer price index has been declining since last quarter of FY05, the same in the wholesale price index has also started deceleration with the beginning of the second half of the current fiscal year.

The reduction in CPI inflation is particularly notable as it dropped from 9.3 percent YoY in June 2005 to 8.0 percent in February 2006 despite sustained high oil prices and the supply shocks. This drop in inflation was more pronounced in food inflation as compared to the non-food inflation. The core inflation, both measured as non-food non-energy inflation in consumer prices and 20 percent trimmed mean, also maintained its declining trend throughout the first eight months of FY06. Inflation in wholesale price index remained high around 11 percent during the first half of the current fiscal year; however, it declined to below 10 percent by February 2006. The decline in WPI inflation is quite broad-based, with all the sub-groups of the index recording deceleration.
Keeping in view the current scenario of key economic indicators and macroeconomic policy environment, SBP forecasts suggest that the average annual inflation for FY06 is likely to be in the neighborhood of the 8 percent annual target.

Fiscal Developments

The government's fiscal position witnessed a moderate deterioration during H1-FY06 despite recording the strongest growth in tax revenues in recent years. Not only did the CBR surpass its tax collection target for the period by 4.7 percent, POL receipts and non-tax revenues also remained above budgetary expectations. Unfortunately, the impact of these gains was offset by the rising expenditures. Consequently, in addition to the decline in fiscal and revenue deficits, the primary balance also slipped into deficit after recording surpluses over the years.

The weakness in the fiscal indicators was primarily due to the spending required for relief and rehabilitation efforts for the earthquake struck regions of the country. However, this increased spending does not explain all of the deterioration; the Ministry of Finance has put the earthquake-related increase in spending at Rs 30 billion, and even after adjusting for this amount, the fiscal indicators for H1-FY06 continue to depict a weakening *trend*, relative to corresponding periods of the preceding two years.

The risk of a further deterioration in fiscal performance needs to be guarded against. Some key risks include: (1) an exceptionally strong rise in imports underpinned the H1-FY06 rise in CBR tax revenues, accounting for 48.0 percent of the share in collections (receipts could therefore slowdown if, as expected, import growth falls back to historical norms); and (2) dependence on potentially volatile non-tax revenues.

Thus, there is clear need for further tax effort to raise the tax-GDP ratio substantially over the next few years. In this context, the reported plan of the CBR to seek a one percentage point increase in the tax-GDP ratio in the next five years needs to be vigorously implemented. Particular attention needs to be given to the broad-basing of the tax net and improving collections from under-taxed areas of the economy such as agriculture, the services sectors, and equity markets

Money and Banking

Monetary policy remained tight throughout July-Feb FY06; while the benchmark 6-month T-bill rate was kept almost unchanged, SBP increased its interventions during the period to ensure that short-term inter-bank market rates remained close to the discount rate. The higher inter-bank rates, amidst declining market liquidity and rising credit-deposit ratio of the banking sector, contributed significantly to the 196 basis point increase in the weighted average lending rate during July-Feb FY06, and a consequent relative deceleration in non-government credit growth. Although credit growth to private sector remained strong at 18.1 percent during

Jul-Feb FY06, it was substantially lower than the very high growth of 25.3 percent during Jul-Feb FY05. Thus, the lower monetary expansion during the period was contributed principally by the slowdown in non-government credit growth, and depletion in banking system NFA.

Large government borrowing during Jul-Feb FY06, which contributed significantly to the M2 growth was mainly due to the relief spending needs of the earthquake affected areas, retirement of long-term government paper (PIBs and FIBs), and less than anticipated receipts from NSS instruments. However, when the anticipated external receipts (PTCL privatization, Euro bond etc) materialize, some of the decline in NFA of the banking system caused by the external account deficits will be reversed, and there will also be an offsetting fall in government borrowings from the banking system. Although, such a development would have no material change on overall M2 growth for the full year it would bring the government borrowing and the NFA close to annual targets. SBP estimates indicate M2 growth is likely to slow from 19.3 percent in FY05 to an estimated 14.3 percent in FY06,[1] which would be slightly below the rise in nominal GDP for the first time since FY02.

External Sector

Pakistan's overall external account deficit narrowed marginally during Jul- Jan FY06 to US$ 0.58 billion from US$ 0.61 billion in the corresponding period of FY05. While the current account deficit posted substantial deterioration of US$ 2.4 billion during Jul-Jan FY06 on YoY basis, this was more than offset by a significant increase in the *capital & financial account* surplus.

This sharp deterioration in the current account was principally due to higher import related activities that include: (1) an exceptional 31 percent YoY rise in imports during Jul-Jan FY06 (based on exchange record), which overshadowed a reasonably strong 13 percent YoY growth in exports; and (2) higher import freight payments, which increased the services account deficit.

Approximately 28.0 percent[2] of the July-Feb FY06 growth in imports is due to the higher POL import bill, and even this owes mainly to rising international prices. Similarly, another substantial portion of the growth in imports during the period is due to a rise in machinery imports, most of which is catering to the economy's rising demand to increase productive capacity and improve infrastructure. It has been argued that the domestic economic growth has also stoked the import

[1] SBP projections
[2] Based on FBS data.

demand for some consumer durables as well, particularly of cell phone, personal cars, TV, refrigerator etc. However, this is not a consequential development as their share in overall imports growth during FY06 is very small.[3]

As the current transfers posted modest growth during Jul-Jan FY06, most of the deterioration in the trade deficit translated into the current account. However, a significant increase in the *capital & financial account* surplus more than offset the deterioration in the current account.

A further analysis of financial account inflows however highlights some concerns. While a substantial part of the improvement in financial flows was contributed by foreign private investment especially rising FDI, including a substantial sum of US$ 255 million received as privatization proceeds that are one-time flow. Further, portfolio investment also saw a substantial rise during Jul-Jan F06; the volatile nature of this flow reduces its desirability as a source of financing.

Medium to long term policy options must therefore revolve around reducing the need for imports (e.g. reducing energy imports by promoting energy efficiency and raising domestic production), promoting exports, and attracting non-debt creating flows (e.g. FDI). Although the current account deficits could also be financed through a mix of privatization receipts and higher debt or a drawdown of reserves, these are less desirable options.

[3]The detailed FBS data available for up to October 2005 shows that the share of consumer imports (cell phone, personal cars, TV, refrigerator, air conditioners etc.) in total imports was only 5.7 percent during Jul-Oct FY06 compared to 3.2 percent during corresponding period last year.