THE STATE OF PAKISTAN'S ECONOMY
First Quarterly Report for FY07

1.1 Overview
Likelihood of achieving 7 percent growth target for FY07 remains strong despite visible challenges in meeting growth target of industry and agriculture. While an anticipated recovery in large scale manfacturing is likely to be realized, it seems that achieving the 13 percent growth target may prove difficult. Similarly, the weak performance by the three major *kharif* crops (cotton, rice and maize) had reduced the probability of a sharp rebound by agriculture, though even here, the value-addition is likely to be an improvement over the preceding year if the contribution from livestock and the wheat crop remain strong. This suggests that achievement of the annual growth target will require the services sector to turn in an above-target growth.

Encouragingly, although real growth remained strong and seems likely to exceed the FY06 levels, inflationary pressures eased somewhat during FY07 (see **Table 1.1**), suggesting the tight monetary policy is striking an appropriate balance, i.e., gradually removing excess stimulus from the economy, without dampening the growth momentum. However, this should not lead to complacency; on the one hand, the downtrend in the inflation over the past 12 months clearly shows a degree of instability, and on the other, reducing domestic inflation further is essential to improving the competitiveness of Pakistan's exports, and ensuring a better return to domestic savers.

Table 1.1: Selected Economic Indicators

		FY05	FY06	FY07
Growth rate (percent)				
Large scale manufacturing	Jul-Sep	26.9	8.8	9.7
Exports (FOB)	Jul-Nov	13.6	13.8	7.3
Imports (FOB)	Jul-Nov	51.5	33.2	13.9
Tax revenue (CBR)	Jul-Oct	22.5	20.8	17.9
CPI (12 month MA)	Jul-Nov	7.3	9.0	7.9
Private sector credit	Jul-Nov	12.9	10.9	5.9
Money supply (M2)	Jul-Nov	5.5	3.0	3.3
million US Dollars				
Total liquid reserves[1]	End-Nov	11,987	11,263	12,338
Home remittances	Jul-Nov	1,610	1,684	2,093
Foreign private investment	Jul-Nov	371	1,023	2,100
percent of GDP[2]				
Fiscal deficit	Jul-Sep	0.4	0.5	1.0
Trade deficit	Jul-Nov	1.48	2.81	3.10
Current a/c deficit	Jul-Nov	-0.60	-2.38	-2.69

1. With SBP & commercial banks.

2. Based on full-year GDP in the denominator.

It is also important to note that not all of the instability in inflation can be addressed through monetary policy. Core inflation has already dipped significantly and the present high levels of inflation and its greater variability are both principally driven by food inflation, which is largely determined by factors other than monetary policy. This does not imply that monetary policy cannot play any role in containing food inflation, but rather that the cost of monetary policy actions to contain it should be weighed cautiously. The food inflation pressures in Pakistan could be better controlled through by (1) improvement in supply of key staples, and (2) administrative measures as were taken in the month of *Ramadan*.

Another challenge to containing inflationary pressures is from the divergence between the expansionary fiscal policy and tight monetary policy, and the volatility in the government borrowings from the banking system (and particularly from SBP). The need to catalyze improvements in infrastructure and boost development (and particularly to reconstruct areas devasted by the October 2005 earthequake) means that it will be difficult to substantially reduce the fiscal stimulus in the near term. Unfortunately, the resulting added burden on monetary policy means that the offsetting monetary tightening will need to continue for a longer period.

Fiscal pressures have primarily originated from higher growth in development expenditure, although slowdown in revenue growth has also added to the stress. While weakness in non-tax receipts is not unexpected (and could potentially be reversed in H2-FY07), the slowdown in key CBR taxes is more of a concern. Specifically, the sharp deceleration in imports during FY07 appears to have impacted indirect tax collections, which have remained below target through the initial months of FY07.

It is noteworthy that aggregate collections have nonetheless been strong due to a welcome, but unexpected surge in direct tax receipts. It is hoped that CBR will be able to recoup the shortfall in indirect taxes from this recovery in direct taxes. However, if any revenue shortfalls do emerge, the impact on fiscal accounts should be sterilized through curtailing expenditure (particularly discretionary non-development spending). Such a clear demonstration of commitment to fiscal discipline would likely be crucial in reassuring international investors, thereby supporting a further improvement in the country's credit ratings, and helping domestic companies access international capital markets on more favorable terms.

Moreover, in order to reduce the impact of fiscal developments on monetary policy, it is important that government reduce the uncertaintyassociated with its borrowings (e.g., a start could be made by publishing its quarterly borrowing targets at the beginning of the period) and reduce its dependence on borrowings from the central bank. The government has indeed sought to do the latter by reversing its ban on institutional investments in NSS, but this mode of increasing non-bank borrowings has significant drawbacks (see **Special Section 1 on NSS**), and it is important that the government focus instead on raising funds through issuance of tradable long-term paper, i.e., PIBs.

Finally, while import growth has decelerated sharply in recent months, this has not relieved pressures on monetary policy given the puzzling decline also visible in export growth that has led to a further widening of the trade deficit. While some weakness in exports was not surprising given the increasingly competitive international markets, the reported slowdown was quite unexpected. Moreover, it is not entirely consistent with trends in associated variables, such as the US and EU statistics on textile imports from Pakistan, as well as the exchange record data of SBP (all of which show stronger export growth than given by FBS data). This raises hopes that at least a part of the strong deceleration in exports growth may be a statistical artifact due to unusual leads and lags in reporting (this view seems to be supported by the exceptional 23.9 percent YoY rise in November 2006 exports).

However, even if a part of deceleration is a statistical phenomenon, there is no denying that exports growth has been adversely impacted by competitive pressures, which, in turn, is a major contributer to the widening of the current account deficit in FY07. This is in sharp contrast to the import-led deterioration in the deficit over the preceding two years. It is in this context that the SBP seeks to support the govenrment and exporters by focusing on reducing domestic inflation in order to help curtail increases in the cost of business and to reduce any appreciation of the rupee's real effective exchange rate.

In the meantime, while persistent large current account deficits are clearly undesirable in the medium term, Pakistan's current account deficit is not yet a serious problem, as (1) the current account deficit is forecast at 4.5 percent of GDP, which is not unmanagable; (2) the country is in a position to comfortably finance the deficit through strong non-debt flows as well as by taking on debt at relatively favorable terms; (3) and given that this is without significantly increasing country risk, as the external debt to GDP ratio will continue to decline despite the rise in absolute debt levels. The latter view is supported by the continuing upgrades to Pakistan's sovereign credit rating by leading international credit rating agencies.

Looking Ahead

SBP forecasts based on initial data indicate that the FY07 annual growth target remains achievable, although risks to the downside have increased (see **Table 1.2**) following the below target harvests of key *kharif* crops (cotton, rice and maize), and the possibility of growth in large-scale manufacturing slowing a little in the months ahead as a result of power shortages, capacity issues (e.g., fertilizer production may drop as major units close temporarily to implement expansions), and a relative easing of demand due to the tight monetary policy, etc.

Table 1.2: Major Economic Indicators

	Provisional FY06	FY07 Original targets	FY07 SBP projection
Growth rates (percent)			
GDP	6.6	7.0	6.6 – 7.2
Inflation	7.9	6.5	6.7 – 7.5
Monetary assets (M2)	15.2	13.5	13.5 – 14.5
billion US Dollars			
Exports (fob-BoP data)	16.5	-	17.9
Imports (fob- BoP data)	24.9	-	27.2
Exports (fob-Customs data)	16.5	-	17.2
Imports (cif-Customs data)	28.5	-	30.7
Workers' remittances	4.6	5.0	5.0 – 5.4
percent of GDP			
Budgetary balance	-4.2	-4.2	-4.2
Current account balance	-3.9	-4.3	-4.5

However, M2 growth is forecast to be stronger than estimated earlier as the contractionary impact of net foreign assets of the banking system during Jul-Nov FY07 has been lower than anticipated, due to the unexpectedly robust net receipts in the external account. The latter is likely to overshadow the impact of the deceleration in private sector credit. The continued strength of aggregate demand, the unexpected strength in broad money and, most importantly, the recent uptrend in food prices reinforces the view that the inflation outcome for FY07 is likely to be higher than the annual target.

It is in this context that the SBP continues to stress the importance of retaining a tight monetary posture, in order to reduce the excessive monetary stimulus in the economy. The direction of monetary policy will need to be supported by the fiscal policy by avoiding any expansion in the targeted fiscal deficit (the target looks achievable; however some risks have emerged as a reuslt of the slowdown in import-based taxes), improving predictability in borrowings from banking system and raising non-bank borrowings through PIBs rather than NSS. The greater liquidity in larger market-based issues would also improve price discovery leading to improved long-term debt benchmarks, helping develop domestic debt markets. It should be kept in mind that healthy, liquid domestic debt markets are not only essential to long-term international investment in infrastructure projects etc, but can lead to an improvement in the balance of payments. To put this in perspective, it is important to realize that in order to remain competitive in the intenational markets and sustain economic growth, the country desperately needs to considerably augment and improve its infrastructure. This will only be possible by attracting significant private sector participation in these projects. This will be difficult without long-term debt markets.

1.2 Executive Summary

Agriculture

Hopes of a strong recovery in agricultural growth during FY07 on the back of improved water availability, continued access to credit, and ease in the prices of fertilizers have decreased following the lackluster performance of key major *kharif* crops. The initial production estimates of cotton, rice and maize posted a weak growth, which overshadowed the impact of the strong growth in sugarcane production during FY07 relative to the preceding year. As a result, realization of the FY07 agricultural growth target will be possible if the livestock sub-sector performance is well above target.

Large Scale Manufacturing

Growth in *large scale manufacturing* (LSM) accelerated in Q1-FY07, rising to 9.7 percent as compared with the 8.8 percent growth seen in Q1-FY06. This was primarily due to acceleration in the production in the *textile, electronics, chemicals* and *metal* industries. However, LSM growth acceleration is not broad-based.

The *electronics* sub-sector recorded an extraordinary 41.6 percent YoY growth during Q1-FY07 as against 9.2 percent YoY growth in the same period of previous year. Strong income growth, better access to credit, and the efforts of power utilities to modernize and extension in their distribution networks are the main factors behind the extraordinary performance of the electronics sub-sector.

As with electronics, the growth in the *textiles* sub-group also rose to 12.4 percent during Q1-FY07 as against a decline of 0.9 percent in the same period last year. This growth is the second highest for any first quarter during the last six years. The growth recorded in textile production appears to be supported by the acceleration in the growth of the *chemicals* sub-sector to 10.1 percent during Q1-FY07 as compared with 8.2 percent growth during Q1-FY06.

Metals sub-sector also grew by 14.5 percent during Q1-FY07 against the decline in the production by 4.1 percent during the same period last year. The improvement can be attributed to the streamlining of production by Pakistan Steel after completion of repairs of its coke oven batteries in the last quarter of FY06.

The *automobiles* sector registered a growth of only 11.1 percent during Q1-FY07, which is not only lower than the strong growth of 33.1 percent in the same period of the preceding year but also the lowest during the last six years.

The production of *fertilizer* also fell in Jul-Oct FY07, dropping by 1.7 percent as against a rise of 3.7 percent growth during the same period of the preceding year. This decline was mainly due to capacity constraints as well as lower demand on the back of untimely rain and an anticipated subsidy announcement by the government.

Prices

Although, on average, inflationary pressures appear to be weakening in the economy, the downtrend is unstable. This is evident in the benchmark Consumer Price Index (CPI) inflation, which jumped to 8.9 percent in August 2006 before dipping to 8.1 percent YoY during October 2006 and remained at the same level in November 2006, slightly higher than the 7.9 percent YoY in November 2005. The instability emerged essentially due to the volatility in food prices, particularly stemming from (1) supply-side disturbances on account of rains and floods, and (2) the impact of increases in international prices of some key food items.

A welcome development, from the monetary policy perspective, however, is that non-food inflation now appears to be trending downwards. This deceleration in non-food inflation is clearly mirrored in the easing of core inflation. The non-food non-energy (NFNE) measure of core inflation dipped to 5.6 percent YoY in November 2006 compared with 7.6 percent YoY for the corresponding month of 2005, suggesting that demand pressures in the economy are being reined-in by the continued tight monetary policy.

As with the core inflation, the Wholesale Price Index (WPI) inflation exhibited a steady downtrend, with the overall WPI inflation coming down to 7.5 percent YoY in November 2006 compared with 10.9 percent in November 2005. The major contribution to the decline in WPI is from the non-food group, which outweighed the acceleration in the food group prices.

Unfortunately, despite the moderation in inflationary pressures, CPI inflation is still close to the 8 percent levels by November 2006, which is significantly higher than the annual average inflation target of 6.5 percent for FY07. Given that core inflation is likely to remain contained through the remaining months of FY07 as a result of a tight monetary policy, it is important that its impact is supplemented by measures to address food inflation and high energy prices. Volatile, double-digit food inflation is particularly undesirable in view of its greater adverse impact on low-income groups. Moreover, it is a source of disquiet for monetary policy as well since inflationary expectations are based on overall inflationary trend. There is a need for effective administrative measures (as exercised in the month of Ramadan) to discourage profiteering on food items.

Money and Banking

The impact of monetary tightening pursued in FY06 as well as the policy signals through the FY07 changes, is already evident in the slowdown in private sector credit growth, which has dropped to 5.9 percent during Jul-Nov FY07 against the 10.9 percent growth witnessed in the corresponding period of FY06. Moreover, core inflation, as measured by non-food non energy inflation has slowed to 5.6 percent (YoY) in November 2006 from 7.6 percent (YoY) in November 2005.

However, the growth in monetary aggregates during Jul-Nov FY07 remained strong. This is because: (1) the deceleration in private sector credit has not been matched by an equally strong decline in government borrowings, which have remained significant; and (2) the contraction in NFA during Jul-Nov FY07 has been much lower than that in FY06.

The impact of continuing pressures on the external account was evident on the NFA of the banking system that showed a contraction of Rs 41.1 billion during Jul-Nov FY07, almost equally distributed between SBP and all commercial banks. However, it is important to note that the contraction in the NFA of the banking system during Jul-Nov FY07 was considerably lower than the sizeable reduction of Rs 90.5 billion witnessed during Jul-Nov FY06. This is largely because the NFA of commercial banks did not decline as sharply as in FY06.

The *government borrowings* from the banking system are higher and volatile. Although the government may be able to remain within the budgetary borrowing target of Rs 120 billion from the banking system for FY07, excessive borrowing during the course of the year is a source of concern for monetary policy, particularly because the government borrowing is entirely from the central bank, which is the most inflationary in nature as it contributes to reserve money growth.

The high government borrowings and the resulting rise in reserve money, has the potential of re-igniting inflationary pressures in the economy. If this happens, the time path for achieving a stable low inflation could be extended, as in the absence of low stable inflation, the central bank would have to keep interest rates high for a longer duration.

The government has however sought to increase its non-bank borrowings. Unfortunately, instead of raising these incremental funds entirely through PIB issues, the government has also re-allowed institutional investment in NSS. While the latter decision would, in theory, allow institutional investors to rollover large NSS maturities, this major policy reversal is likely to have significant negative implications for the development of the domestic debt market, and raise interest rate risk for the government.

In contrast to government borrowings, the private sector credit seems to be responding to interest rate signals from the central bank. Specifically, the growth in private sector credit during Jul-Nov FY07 has slowed down to 5.9 percent compared to 10.9 percent rise witnessed during the corresponding period of the previous year. However, so far, this slowdown in private sector credit growth is *not* a source of disquiet for SBP for the following reasons:

- The YoY growth in private sector credit remains very strong at 18.0 percent by 25th Nov 2006, although down from 31.9 percent last year.

- A review of monthly trends in private sector credit shows that the slowdown is largely concentrated in the month of September 2006. In fact, trends during October and November 2006 indicate presence of strong demand for private sector credit in the economy.

- The available evidence suggests that the slowdown in private sector credit is not broad-based as (1) the increased *net* retirement, particularly by the sugar manufacturers during Jul-Nov FY07 contained the growth in private sector credit; and (2) deceleration in bank credit against equities.

- More importantly, while the nominal lending rates are rising, the real lending rates are still very low. The real lending rates under export finance facility are even negative.

In sum, though the overall demand for credit by the private sector has decelerated, the slowdown is not broad-based. This suggests that monetary policy needs to remain tight.

However, while the transmission of the monetary policy on lending rates has improved over the last year, the impact on deposit rates has been less than desired, contributing to an unhealthy high banking spread. The available evidence shows that banks are mobilizing deposits at higher returns and the share of such deposits has been rising. Since the long-term deposits lower the maturity mismatch for banks and reduce liquidity risks, it was expected that the banking spread would decline. But in the meanwhile, lending rates have also risen thereby leading to a sharp rise in the banking spread (calculated on the basis of incremental loans and deposits) in recent months. Such a large spread can have a dampening effect on economic growth by discouraging savings.

Fiscal Developments

Developments in public finance during Q1-FY07 present a deterioration in the fiscal accounts. Fiscal deficit widened by 0.5 percent of GDP to 1.0 percent of GDP in Q1-FY07. The Q1-FY07 fiscal deficit (as percent of GDP) is not yet inconsistent with meeting the annual target of 4.2 percent of GDP. For example, the Q1-FY03 fiscal deficit had been 0.8 percent of GDP, but full year outcome was 3.7 percent of GDP. However, in that year the growth in CBR taxes had been exceptionally strong at 9.6 percent of GDP (a level achieved in FY97 but never since). The FY07 tax target is close to this level, at 9.5 percent of GDP, and attaining it will be important to meeting the overall fiscal deficit target for the year. Unfortunately, given the recent moderation in import growth, and the high dependence of tax receipts on import-based taxes, achievement of the CBR tax target may prove challenging.

This fiscal squeeze is attributable to both the lower revenue growth, as the total revenue to GDP fell from 3.1 percent in Q1-FY06 to 2.9 percent in Q1-FY07 and the rising expenditure. It is note worthy that the rise in expenditure to GDP ratio is only due to the unidentified expenditure that rose from 0.1 percent of GDP in Q1-FY06 to 0.4 percent of GDP in Q1-FY07. CBR though met its revenue target of Rs 236.2 billion with an actual collection of Rs 237.3 billion during Jul-Oct FY07 yet all the indirect taxes could not meet their respective targets. A moderate growth in imports and the large-scale manufacturing resulting in lower growth in tax collection by the CBR during first quarter, may keep the growth in indirect tax revenues relatively weak during FY07. Provincial governments, however, improved their position during first quarter. This better fiscal position stemmed from new formula of revenue sharing from federal divisible pool of tax revenue, except Balochistan, all the other provinces seem to be in a comfortable position.

Balance of Payments

Pakistan's overall external account position improved during Jul-Nov FY07 compared to the same period last year despite a worsening of the current account deficit. Specifically, while the current account deficit increased from US$ 3.1 billion to US$ 4.0 billion, an increase of 29.1 percent, the overall external account deficit shrank to US$ 0.73 billion in Jul-Nov FY07 compared to US$ 0.88 billion in Jul-Nov FY06.

As in the previous year, it was the surpluses in the *capital* and *financial* accounts that offset most of the deficit in the current account. The bulk of the 35.4 percent YoY increase in the aggregate surplus in the *capital* and *financial* accounts during Jul-Nov FY07 was contributed by foreign investment.

Although Pakistan was able to finance the Jul-Nov FY07 current account deficit relatively easily, the rise in the deficit nonetheless remains a source of some concern, particularly because unlike the previous years, it owed more to a substantial slowdown in the country's exports rather than an extraordinary rise in imports. Specifically, while the imports growth during Jul-Nov FY07 slowed substantially to 13.9 percent compared to 33.2 percent in the corresponding period last year, it was the unusual decline in the exports growth (that dropped to a mere 7.3 percent compared to 13.8 percent in the corresponding period last year), that drove the trade deficit up by 25.5 percent to US$ 4.5 billion.

In addition, the current account deficit was also adversely affected by an unusual rise in the income account deficit arising from a higher direct investment income outflows. The rise in the trade, services, and income account deficit was, however, mitigated to an extent by the increase in the current transfers, which increased by 13.4 percent during Jul-Nov FY07.

Due to substantial inflows, both on account of current transfers and foreign investment during Jul-Nov FY07, the impact of the widening current account on the country's reserves was relatively low. Pakistan's overall foreign exchange reserve declined by US$ 799.4 million during Jul-Nov FY07 compared to decline of US$ 1,321.6 million in the same period last year. Nevertheless, a result of the continuous pressures on the external sector, Pakistan's currency vis-à-vis US Dollar, depreciated by 1.1 percent during Jul-Nov FY07 as compared to the 0.1 percent in the corresponding period last year.

Foreign Trade[1]

The trade deficit continued to rise during Jul-Nov FY07, although the growth slowed substantially to 17.8 percent from the 147.5 percent YoY increase recorded during the corresponding period last year. This welcome deceleration in the growth of the trade deficit during Jul-Nov FY07 is principally due to the slowdown in the import growth.

Specifically, the moderation in import growth, which has been apparent since H2-FY06 further strengthened during Jul-Nov FY07 as all major imports categories other than *petroleum, machinery* and *other products*, recorded negative growth rates. As a result, the overall growth in imports fell to 10.4 percent during Jul-Nov FY07 against 54.3 percent rise in the corresponding period last year. Indeed, the trade deficit would have been even lower, had it not been for the unexpected sharp deceleration in export growth to 5.2 percent YoY during Jul-Nov FY07 compared to 22.3 percent YoY in Jul-Nov FY06.

A part of the decline in the exports growth is understandable given the more challenging economic environment as compared to a year earlier, both domestically and externally. Nevertheless, the magnitude of the slowdown in exports is still puzzling.

Specifically, while the FBS data shows a 3.3 percent decline in the textiles exports during Jul-Nov FY07, exchange records depict a growth of 11.0 percent. Furthermore, EU textiles and clothing imports from Pakistan also show a rise of 3.2 percent during Jul-Sep FY07,[2] and similarly, the US imports data show a rise of 8.8 percent in textile and clothing imports from Pakistan.[3] However, the November trade figures are some consolation; although detailed data is not yet available, the increase of 23.9 percent YoY in overall exports is nevertheless quite encouraging.

[1] The analysis is based on the provisional data provided by Federal Bureau of Statistics, which is subject to revisions. This data may not tally with the exchange record numbers reported in the section on *Balance of Payments*.
[2] Source: Eurostat.
[3] Source: US Census Bureau.