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

1.1 Overview
Midway through the fiscal year, available information suggests that real GDP growth during FY07 will remain close to the 7 percent annual target, despite some setbacks suffered by the commodity producing sub-sectors. Despite the underperformance of key *kharif* crops, a bumper wheat harvest and indications of strong outturn by the livestock sub-sector offer hopes of a recovery. Similarly, while data constraints inhibit a more robust forecast, the limited data set available suggests that industrial performance will also improve. Finally, the services sector, which pushed up GDP growth in the preceding years, is also expected to remain strong in FY07.

More importantly, the significant improvement (and stability) in the macroeconomic fundamentals, high growth rates in recent years, sustained policy focus on the implementation of reforms for the liberalization of the economy, and relative stability of the exchange rate, continues to attract investors, resulting in a substantial rise in investment, particularly Foreign Direct Investment (FDI). This improvement in investment will substantially boost the economy's prospects of managing macroeconomic imbalances and improving the prospects of sustaining high growth rates in years ahead.

Table 1.1: Selected Economic Indicators
Jul-Feb or as mentioned

		FY05	FY06	FY07
Growth rates (percent)				
Large scale manufacturing	Jul-Dec	22.7	8.7	9.8*
Exports (fob)		12.1	18.8	4.0
Imports (cif)		35.4	46.3	10.0
Tax revenue (CBR)	Jul-Jan	15.0	21.7	25.1
CPI (12 month MA)		8.2	8.9	7.7
Private sector credit		25.3	18.1	10.7
Money supply (M2)		10.9	8.7	7.7
million US Dollars				
Total liquid reserves[1]	End-Feb	12.7	11.5	13.4
Home remittances		2.6	2.8	3.4
Foreign investment	Jul-Jan	1.2	1.6	3.5
percent of GDP[2]				
Fiscal deficit	Jul-Dec	1.2	1.8	1.9
Trade deficit		2.7	5.8	6.1
Current account deficit	Jul-Jan	0.8	2.6	3.3

* September 2006 data point. More recent data is not available.
1. With SBP & commercial banks.
2. Based on full-year GDP in the denominator.

While the prospects of increasing investment is a necessary factor, it is equally important for policy makers to address economic stress points, such as the high (albeit decelerating) inflation, large current account deficit, fiscal risks (such as the low tax-to-GDP ratio) and low savings rates.

The measured monetary tightening implemented by the central bank over the last two years appears to be bearing fruit in FY07. While growth remains strong, headline CPI inflation has finally followed the decline in underlying (core) inflation, to reach 7.4 percent YoY by February 2007. However, the average annual inflation while declining to 7.7 percent is above the 6.5 percent annual target. Thus, given that instability in key CPI components persists, and that reserve money growth is high, the current policy must be sustained. Indeed, inflation must be contained in order to bring real returns to savers significantly positive. This would encourage domestic savings to rise from current low levels, lowering the country's dependence on potentially fickle foreign investment.

A part of the strength in aggregate demand is contributed by the expansionary fiscal policy followed so far in FY07 due to the necessary expenditures for rehabilitation of earthquake struck areas and for development requirements. Expenditures have grown 23.5 percent during Jul-Jan FY07, well above the budgeted annual growth, but fortunately these have been matched by an equally unexpected jump in revenues. The unexpected 61.9 percent YoY rise in direct tax collections is certainly welcome, compensating for the decline in import-based taxes as import growth subsided. However, the abrupt shift in the profile of CBR tax receipts underscores three points: (1) it is important to diversify the tax base, so that underperformance in a portion of the economy does not cause a disproportionate revenue losses; (2) one must carefully examine the underlying causes of the revenue growth to separate one-off factors from underlying (sustainable) factors, and; (3) it is crucial for fiscal discipline that expenditure growth be kept at levels consistent with sustainable revenue growth.

Finally, reflecting strong aggregate demand, the current account deficit widened 42.3 percent YoY to US$ 4.8 billion during Jul-Jan FY07. However, the monthly trend for the period shows a distinct declining trend, reflecting the precipitous drop in import growth as oil prices declined and the one-off impact of structural changes was absorbed by the economy. Moreover, in the short-run, the financing of the large current account deficit has eased somewhat given strong foreign investment and financing flows. Indeed, it is likely that despite the expected large fiscal and current account deficits the country's debt profile will continue to improve in FY07, with a continuing fall in the debt to GDP ratio.

It has to be recognized that import growth would have to remain in double digits if the economic growth is to be sustained at high levels, which in turn is contingent on the buildup of infrastructure,[1] substantial addition to industrial capacity, as well as rising imports of inputs (particularly energy). Thus, in order to support this required import growth it is imperative to significantly boost exports and encourage import substitution for products where Pakistan has competitive advantages (particularly in food commodities).

However, the slowdown in export growth from double digits in the last 4 years to low single digits in FY07 needs to be carefully examined in order to ascertain the underlying problems and appropriate policy responses. The importance of sustaining strong export growth cannot be overstated.

A turnaround in exports will need to be supported by measures to reduce the cost of doing business (reducing red-tape and eliminating unnecessary regulations, ending multiplicity of taxes and agencies, etc.), facilitate supply chain improvements and provide a flexible labor market, as well measures focusing on the issues of productivity enhancement, quality improvement, costs & scale economies, product & geographical diversification, etc. Recognizing these needs, the government has established the Competitive Support Fund and National Textile Strategy Committee to explore policy options.

1.2 Forward Looking

SBP projections indicate that FY07 real GDP growth is likely to grow in the range of 6.6 - 7.2 percent, close to the annual target of 7.0 percent and above the desired 6.0 percent long-term growth for the economy. The achievement of the upper bound of the forecast however, would be critically dependent on a strong performance by large scale manufacturing and the livestock sub-sector (where investments have increased). As a direct consequence of this strong aggregate demand as well as some commodity price shocks, average inflation for the FY07 is forecast to remain in the 6.7 - 7.5 percent range, well above the annual target, although still substantially lower relative to the preceding year (see **Table 1.2**).

While the fiscal deficit is expected to be contained within the annual target, it is significant that aggregate expenditure growth has been much greater than budgeted, and the growth of the deficit has been contained only due to extraordinarily strong direct tax receipts. Fortunately, the government is already seeking to explore options to widen the tax net to under taxed areas in order to raise the tax-to-GDP ratio.

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[1] The approval process is underway for ten oil-based projects with a cumulative capacity of 2355 MW and an estimated cost of US$ 1,766 million. (Source: http://www.ppib.gov.pk)

The current account deficit is projected to widen during FY07 as, despite a sharp fall, growth in imports remains higher than that of exports. However, as the economy continues to expand strongly, this does not pose a significant macroeconomic risk in the short term, particularly due to availability of debt on favorable terms and strong investment flows.

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)	16.6	19.8	17.9
Imports (fob- bop data)	25.0	27.4	27.2
Exports (fob-Customs data)	16.5	18.6	17.2
Imports (cif-Customs data)	28.6	28.0	30.7
Workers' remittances	4.6	4.5	5.3 - 5.5
percent of GDP			
Budgetary deficit	4.2	4.2	4.2
Current account deficit	3.9	4.3	4.5

Over the medium term, investment policy in Pakistan has to be directed to take advantage of the growing investment flows (both domestic and foreign) in order to help stimulate industrial growth and its diversification, as well as to help remove infrastructure gaps and bottlenecks. In particular, agriculture policy will need to focus on encouraging investment for the implementation of large water resource projects, supporting market-based pricing (e.g., as done for rice and wheat) and improving transmission of pricing signals to farmers (e.g., through introduction of a commodity futures market), as well as improvements in transportation and storage infrastructure. Similarly, investment in industry has to be encouraged to support value-addition in textiles, increase agri-product processing and allow the country to diversify production into the medium and high-end technology products such as electronic goods, automobiles, engineering goods, etc.

However, allocative efficiency demands that the direction of investment flows must not be mandated by government, and that rewards and risk mitigation be done principally by market pricing pressures. This, in turn, means that: (1) the market prices should not be distorted by collusive behaviors of participants; and that (2) financial markets are able to efficiently allocate capital and help mitigate risk.

Both require policy interventions. The government has already focused on the creation of the Monopolies Control Authority (with supportive legislation expected soon). Along the same lines, capital market reforms need to be further deepened. Aside from the need to boost liquidity of equity and debt markets, curbing a high degree of speculative transactions would minimize bouts of instability and market manipulation.

Given the importance of long-term debt markets to support investment, particularly in infrastructure projects, to increase domestic savings, and to improve the risk profile of commercial banks (which currently face mismatches in lending and deposit profiles), Pakistan needs to foster the development of a long-term institutional savings industry (pension and provident funds, mutual funds, etc.). Implementation of capital market reforms, aiming to encourage investment rather than speculation and improving risk management will also improve financial sector stability.

1.3 Executive Summary

Agriculture

The prospects of a strong FY07 *rabi* harvest have improved significantly. The extended rainy season and snowfall have increased water availability and encouraged farmers to increase the planted area and raise the use of quality input. The latter also well supported by the government policies such as the subsidy on non-urea fertilizers, media campaign to educate farmers for the use of a balanced mix of urea and DAP, as well as a rise in the support price of wheat. A good rabi harvest is expected to help offset the adverse impacts of relatively weak *kharif* crops (cotton, rice and maize) on the overall agriculture growth. Nonetheless, the growth of the crops sub-sector will likely remain below the FY07 target, although it will still represent an improvement over FY06. Thus, hopes of achieving the aggregate agri growth target rest on very good outturn by the livestock sub-sector.

Large Scale Manufacturing

In the absence of the usual data on aggregate large scale manufacturing, the analysis is limited to the sugar, automobile, cement, fertilizer, and petroleum products industries (that certainly is not representative of developments in overall LSM). According to the limited available information, the *cement* industry showed remarkable growth in production during H1-FY07, mainly attributed to enhanced installed capacity during the last five years and rise in local as well as external demand. Similarly, the *sugar* industry recorded 15.5 percent rise in production in H1-FY07 as against a fall of 40.5 percent in H1-FY06. This rise mainly reflects the 15.2 percent increase in the sugarcane harvest during *kharif* FY07.

The *automobiles* sector recorded a growth of 6.8 percent during H1-FY07; significantly lower than the 28.6 percent seen in H1-FY06 and the lowest during the last five years. This slowdown is largely a result of (1) capacity constraints, (2) slowing demand growth, and (3) imports of used vehicles.

Fertilizer industry is facing capacity constraints due to rapid growth in the production in recent years, temporary shutdown of a plant for capacity expansion and revamping, and slowdown in urea demand due to sustained rise in the prices of urea amidst delay in the purchase of fertilizer during Jul-Oct 2006 in anticipation of subsidy on non-urea.

A mismatch in the production mix and the demand growth patterns resulted in output decline by 6.6 percent in *petroleum products*.

Prices

The underlying inflationary pressures in the economy continued to ease in FY07, with Consumer Price Index (CPI) inflation finally dipping below 7 percent YoY in January 2007, for the first time in 8 months,[2] and WPI inflation continuing its trend decline to fall to a 25-month low of 5.1 percent YoY by February 2007. Even more significant, from a policy perspective, is the relative stability of the downtrend in core inflation (as measured by the non-food non-energy component of the CPI), which has declined steadily since April 2005 to 5.7 percent YoY by February 2007. While the other important measure of core inflation, (i.e., the 20 percent trimmed mean) witnessed a relatively smaller decrease in October-February FY07, in each month of this period it remained the same or below that in the corresponding month of FY06.

The broad reduction in underlying inflationary pressures in FY07, as evidenced by the weakening in core inflation, suggests that aggregate demand pressures in the economy are being reined-in by the continued tight monetary policy. However, the sharp deceleration in the overall CPI inflation in January 2007 mainly incorporates the impact of an exceptionally strong deceleration in food price inflation as prices of many key staples fell to more normal levels, after staying at exceptionally high levels in the preceding months.

Money and Banking

The M2 growth has decelerated to 7.7 percent during Jul-Feb FY07 period compared to 8.7 percent during the corresponding period of previous year. The

[2] CPI inflation decelerated to 7.4 percent YoY during February 2007 compared with 8.0 percent YoY in February 2006.

deceleration in M2 growth is principally due to a decline in growth of private sector credit. The resultant reduction in excess aggregate demand has resulted in further moderating inflationary expectations as evident from a continued downtrend in core inflation that has slowed to 5.3 percent YoY in January 2007 from 8.8 percent YoY in January 2006. More importantly, this slowdown in inflationary pressures has been achieved without significantly affecting the growth momentum.

Although the year-on-year growth in private sector credit was strong at 15.7 percent on 24th February 2007, the impact of the reduction in excess aggregate demand on private sector credit growth was compounded by structural problems in the real sector of the economy that reduced its ability to absorb additional credit at the same pace as in the past two years. The impact of this was also compounded by the recent mergers/acquisitions in the banking sector, and consequent slowdown in credit operations. This was most evident in the agriculture and consumer credit market segments. Further, the lending capacities of banks also constrained as some of the banks are trying to improve their risk management practices. A third contribution was from delays in initiation of major infrastructure projects, e.g., power projects. Credit growth is expected to accelerate as structural factors are resolved and the infrastructure projects come online.

The reserve money has increased sharply by 15.3 percent during Jul-Feb FY07 compared to 9.6 percent growth in Jul-Feb FY06. The key reason for the rise in reserve money growth is SBP's support to the export sector and the need to meet the long-term investment demand. The SBP first lowered the export refinance rate in July 2006; thereby reducing the cost of financing to industry to around 300 bps below market and later in September 2006 offered a debt swap option to textile sector to convert their fixed investment loans into relatively cheaper LTF-EOP facility.[3] The incentives led to a Rs 58.0 billion surge in financing (provided by the SBP) and pushed up the reserve money growth.

Another contribution to reserve money growth was the pattern and behavior of government borrowings. Although the budgetary borrowings from the SBP declined in Jan-Feb FY07, and aggregate bank borrowings are markedly low during Jul-Feb FY07 compared to the corresponding period of previous year; this was possible mainly due to greater availability of financing from external and non-bank sources November 2006 onwards. In particular, the impact of decline in SBP's NDA due to lower government borrowings was offset by the rise in NFA.

[3] The LTF-EOP scheme offers fund for 3-7 years at 600-700 bps below the market rate.

Thus, the reserve money growth has continued unabated with a change only in its composition.

Going forward, the large foreign exchange inflow since November 2006 is a major challenge to SBP. In addition to making the country's balance of payments outlook positive for FY07, these foreign currency inflows would also exert upward pressures on reserve money growth. Both the government and the private sector are expected to benefit from these foreign currency inflows, and in a situation where the reserve money growth is already considerably high, such inflows would make liquidity management by the central bank more challenging. One obvious policy response from central bank could be the sterilization of monetary impact stemming from such inflows.

Fiscal Developments

The recent fiscal numbers show that the government is comfortably placed to meet the FY07 targets, with exceptionally strong direct tax collections and robust non-tax revenues offsetting a substantial increase in expenditures.

Although fiscal balance deteriorated marginally during H1-FY07, but the other fiscal balance indicators showed a little improvement. The growth in tax revenues – the strongest for the last five years – mainly came from the direct taxes that offset the fall in import taxes due to slowdown in imports. Aggregate CBR tax collections surpassed the target of Rs 436.0 billion with a collection of Rs 462.7 billion during Jul-Jan FY07, but the collection of indirect taxes remained below its target. Expenditure grew 23.5 percent YoY to Rs 783.8 billion. The rise in expenditure mainly came from the current expenditure that increased due to surge in interest payments and other general public services.

Balance of Payments

Pakistan's external account position further improved during Jul-Jan FY07 both with respect to the immediately preceding quarter and the corresponding period last year despite worsening of the current account deficit.

Although the current account deficit widened to US$ 4.8 billion during Jul-Jan FY07, the monthly trend shows distinct declining trend. However, despite the slowdown in the monthly growth of current account deficit during Jul-Jan FY07, on average the current account deficit has remained higher than during Jul-Jan FY06.

The main cause for the rise in the current account deficit was the abnormal slowdown in exports, which has persisted since January 2005. This has offset part of the gains from the anticipated weakening in imports.

In the meantime, in addition to the apparent decline in the monthly current account deficit, another point of comfort is the large capital and financial account surplus. Not only these surpluses more than offset the current account deficit, it is encouraging to note that almost half of the inflows in the capital and financial account comprised of equity flows.

The impact of the strong financial account flows is evident on the exchange rate and the foreign exchange reserves of the country. The reserves increased to US$ 13.4 billion by end-Feb FY07 from US$ 13.1 billion at the end of FY06. In the absence of any untoward pressure on the reserves, the Pakistani currency remained broadly stable vis-à-vis US dollar throughout the Jul-Feb FY07 period. However, the real effective exchange rate (REER) appreciated by 2.5 percent despite 2.6 percent depreciation in nominal effective exchange rate (NEER), due to a 5.2 percent rise in relative price index.

Foreign Trade[4]

The slowdown in import and export growth rates that emerged in the second half of FY06 continued throughout FY07 as well. Unfortunately, despite a precipitous decline, the growth rate for imports remains higher than that of exports (and is on a larger base). Consequently, the trade deficit continued to widen, albeit at a much slower pace.

The fall in the import growth rate is largely in line with expectations. Specifically, with the lower oil prices and absorption of one-off impact of structural changes such as opening up of telecom and auto sectors, the slow down in import growth was expected. In fact, as a result of lower import growth the trade deficit would have begun to shrink, had the exports grew even at a relatively low growth of 12.6 percent seen in the previous five years.

A part of the exports slowdown can be explained by factors such as the adverse impact on textile exports to the EU following the loss of Generalized System of Preference (GSP) and persistence of the discriminatory antidumping duty on bed linen from Pakistan. Similarly, rice exports have also dropped due to a poor

[4] 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*.

harvest, while exports of refined petroleum products, carpets and leather dropped due to adverse industry dynamics. However, the broader deceleration in export growth is still puzzling.

In the aforementioned situation there is need to focus more strongly on strategies for the promotion of exports (and import substitution) by focusing on the issues of productivity enhancement, quality improvement, costs & scale economies, product & geographical diversification as well as creating a pro-industry and investment-friendly environment in the country.