THE STATE OF PAKISTAN'S ECONOMY
Third Quarterly Report for FY04

Overview

Provisional estimates indicate that economic activity continued to accelerate through Q3-FY04, pushing the annual real GDP growth to an estimated 6.4 percent. This is not only significantly higher than the 5.3 percent target set for the year, and the 4.1 percent achieved in FY03, but also pushes the economy into the long-term growth trajectory of 6 percent growth per annum one year earlier than anticipated. This is particularly welcome as Pakistan's economic history suggests that a meaningful reduction in poverty has only been evident in periods when the economy sustained growth rates of 6 percent or higher.

The growth is all the more impressive given that agricultural output proved to be below expectations, recording 2.6 percent growth against the FY04 target of 4.2 percent. This was due to shocks suffered by both, the crops and the livestock sub-sectors. Fortunately, the resulting setback to growth was compensated by an exceptional performance by industry, led by very impressive growth in *large-scale manufacturing* (17.1 percent), *electricity & gas distribution* (22.5 percent) and *construction* (7.9 percent). This was complemented by a reasonably good showing by the services sector, which recorded above-target growth for the second successive year. The strong growth is, however, not without some costs, and there remain significant areas of concern.

Table 1.1: Economic Indicators

	July-May		
	FY02	**FY03**	**FY04**
Growth rates (percent)			
Large-scale manufacturing[1]	1.9	6.7	17.1
Exports	-1.0	21.1	11.8
Imports	-4.5	18.2	24.1
Tax revenues (CBR)	-0.5	15.0	12.8
CPI (12 month moving average)	3.4	3.3	4.0
Private sector credit (CBs)	5.1	18.9	34.8
Money supply (M2)	12.1	14.7	15.9
Million US Dollars			
Total liquid reserves[2]	5,586	10,524	12,438
Home remittances[3]	2,121	3,873	3,517
Foreign private investment	331	743	867
Percent of GDP[4]			
Fiscal deficit	4.3	3.7	3.3
Trade deficit	2.0	1.7	3.8
Current account balance	4.7	6.3	2.9

[1] Based on Jul-Mar
[2] End-May
[3] Based on Jul-Apr
[4] Calculated by taking fiscal year GDP but variable numbers on end-period basis.

In recent years, the SBP deliberately permitted the growth in money supply to significantly exceed that of nominal GDP, in a bid to boost economic activity. The success of this policy is most clearly evident in the phenomenal FY04 net private sector credit growth (to a record Rs 283.6 billion during July-May FY04, compared to the Rs 130.9 billion in July-May FY03), which was a key driver of the equally impressive growth in large-scale manufacturing during this period. While doing so, the SBP expected that inflationary pressures would remain contained by a combination of increased utilization of industrial capacity, the containment of aggregate demand within manageable limits and declining rupee cost of imports (due to low international commodity prices and an appreciating rupee). However, the build up in inflationary pressures in the economy was more rapid than anticipated, driven at least in part by supply shocks. This, together with the expectation of a continuation in inflationary pressures until October 2004, forced the SBP to raise interest rates somewhat in April and May 2004 to temper inflationary tendencies in the economy.

This said, it should be noted that SBP has not fully abandoned its easy monetary stance though it stands ready to move promptly to stave off inflationary pressures when required.[1] While interest rates are unlikely to fall, further evidence on movement of key variables will confirm whether a sharp rise is warranted or not. In particular, monetary policy-driven *non-food non-oil* inflation has to demonstrate a secular upward trend, thus shifting the balance of risk. Another contributory factor to this shift will be the likely behavior of international interest rates in the coming months.

Most of the rise in inflation so far has stemmed from a jump in food prices, particularly wheat. While an easy monetary policy admittedly facilitates speculative holdings, administrative measures are the more desirable policy response to such pressures. For example, the unwarranted rise in wheat prices could have been easily avoided if the government had increased its intervention capacity through timely imports.[2]

Another potentially negative development is the erosion in external account surpluses due to a combination of strong growth in aggregate demand and a decline in external account inflows by Q4-FY04. A fall in the current account surplus had been anticipated, with a moderation in the unusually high FY03

[1] The SBP monetary policy stance will be elaborated in the forthcoming Monetary Policy Statement, in view of the full-year data for FY04.

[2] In fact, in view of reports of below-target wheat procurement and the low stocks available with the government, there may be a need to import up to 2.0 million tonnes of wheat to avoid a future flare-up in prices.

remittances, and an acceleration in imports as the economy recovered. These expectations duly materialized. While imports did see a sharp jump, rising 24.1 percent YoY to US$ 13.7 billion during July-May FY04, this was mainly due to a welcome rise in the demand for machinery and raw materials. Moreover, during most of the year, the current account remained comfortably in surplus, aided by a strong growth in exports (up 11.8 percent YoY to US$ 11.1 billion during July-May 2004) and robust remittances (the FY04 total is expected to reach US$ 3.8 billion, slightly above target).

However, this position worsened significantly during H2-FY04 due to combination of an oil price shock and other recurring (loss of Saudi Oil Facility) and one-time (debt pre-payments) factors. Fortunately, given that the import growth seems driven principally by the increasing productive capacity of the economy, even the reversal in the current account does not cause much concern at this juncture, as it represents an increasing utilization of savings by the domestic economy to productive ends. Nonetheless, if the external account deficit worsens significantly, the SBP may have to reconsider its exchange rate stance accordingly, but even in that case, any necessary adjustments are expected to be gradual.

A third area of concern in the macroeconomic environment is the FY04 CBR performance. While tax receipts for FY04 are expected to be meet targets, this clearly represents an underperformance of the CBR in relation to higher nominal GDP, increased volume of production of goods and services in the economy, and larger than expected imports. The tax to GDP ratio has, in fact, fallen to 11.0 percent taking the revised base. This suggests the need for some corrective actions to step up tax collection and prevent shortfalls in future, under less positive conditions.

Looking Forward

The major challenge for the economic managers of Pakistan is to ensure the continuation of the FY04 growth momentum in the succeeding financial years. In particular, given that the weak agricultural growth during FY04 was principally caused by non-systemic factors (untimely rains, bird flu virus attack, etc.), and given the likelihood of reasonable water availability, it should be feasible for the FY05 agriculture growth target to be surpassed comfortably. This achievement is particularly critical because of the close link between higher agriculture incomes and the lowering of the incidence of poverty in the country.

Similarly, industrial growth too is likely to remain robust, led by the continuing strength of large-scale manufacturing. While the growth in this sector will almost

certainly witness a deceleration from the exceptional FY04 levels, leading indicators such as the healthy growth in raw material imports, the continuing strength of machinery imports, the strong working capital disbursements during January-May FY04, etc., reinforce the view that the industrial growth target will be realized. But, as this report shows, capacity constraints are likely to hit many sub-sectors sooner than later. Investments in these activities should be stepped up.

Finally, given that the growth in the commodity producing sectors is traditionally mirrored in many key components of the services sectors, here too, FY05 growth targets are likely to be achieved. In fact, this view is supported by the increasing investment in the *transport and communications* sub-sector, particularly in telecommunications and airlines. All in all, from the indicators available at present, the 6.6 percent real GDP growth target for FY05 seems achievable.

An area of serious concern for the policy makers should be the construction sector. The growth in this sector has a large potential to generate employment, not only directly (utilizing skilled and unskilled labor) but also through its strong linkages with other allied employment intensive industries (notably cement, steel, paints, ceramics, glass, bricks, electric cables, woodwork, etc.). The steep rise in the prices of construction material had threatened to weaken the growth momentum in this sector, and it is hoped that the FY05 budget measures will help somewhat in alleviating this threat. Moreover, it is hoped that the provincial governments will also introduce measures to support this industry. Two important constraints holding down the growth in this sector are the release of new land in urban areas and the lack of a system to ensure clear land title. If these two constraints are not eased quickly, much of the general populace will be prevented from accessing one significant benefit of the financial sector reforms – the broad availability of mortgage loans.

It is important to note that while strong growth will indeed lead to employment generation and poverty reduction, the structure of the growth also has important implications for the *speed* of this transition. This view is punctuated by two clear facts:

(1) The acceleration in the labor force growth due to the demographic transition of the 1980s means that Pakistan's economy has to grow at an accelerated pace simply to maintain the status quo. In fact, this may be an important contributor to the general perception that the evident growth in the economy has yet to significantly impact unemployment.

(2) There are serious imbalances in the skills demanded by the buoyant economic sectors and the output produced by educational institutions and training centers. The establishment of training and vocational institutes has been given

high priority this year but the new skills will become available only in the medium to long term.

It is therefore important that the growth policies for the short-to-medium term perspective are strong tilted in favor of sectors that use more of the country's most abundant resource – unskilled labor.

In the longer term however, the rising global competition, and the increasing dominance of relatively capital intensive industries suggests that Pakistan has to sharply increase investment in general education and technical training in order to remain competitive.

Executive Summary

GDP

The real GDP witnessed an impressive 6.4 percent growth in FY04 as against a target of 5.3 percent for the year and 5.1 percent in the preceding year. The above-target FY04 performance is mainly based on strong growth in the manufacturing sector, which recorded a robust increase of 13.4 percent as against 6.9 percent in FY03. However, growth in the agriculture sector, marred by various unexpected shocks, remained below target.

Agriculture

Provisional estimates indicate that the agricultural sector growth will decelerate to 2.6 percent in FY04, well below both the 4.2 percent annual sectoral growth target as well as the 4.1 percent growth achieved in FY03. The possibility of a weakness in agricultural growth had emerged by *kharif* FY04 because of a below-target cotton crop, and this was confirmed by the non-realization of a bumper wheat crop.

However, support to agricultural growth came from a record output of rice and a rise in the production of sugarcane, both of which owed mostly to better availability of irrigation water and other crop inputs. Canal-head water availability improved by 9.0 percent during Crop Year 2004, which consequently resulted in an increase in area under cultivation during the year.

Credit disbursement to the agriculture sector during July-March FY04 witnessed an exceptional growth of 27.4 percent over the corresponding period of the previous year, with increasing share in financing coming from the commercial banks. Higher credit disbursement for tractor purchase was another prominent feature of the disbursement portfolio during FY04.

Industry

The performance of the industrial sector remained remarkably strong during FY04. The GDP originating from industry, consisting of manufacturing, construction, mining & quarrying and electricity & gas distribution, witnessed a 13.1 percent increase, the strongest growth since 1970. This extraordinary performance of the industrial sector was largely due to strong growth in manufacturing output. Construction and electricity & gas distribution sectors also recorded sharp acceleration in growth. However, value addition in mining & quarrying remained unchanged.

Within manufacturing, large-scale manufacturing (LSM), grew by 17.1 percent during July-March FY04, compared to a 6.7 percent growth in the corresponding period of the previous year. The strong LSM growth was also distributed across various LSM sub-sectors, but growth in the production of automobiles, electronics, chemicals, fertilizers, and construction-related industries was particularly high.

Strong domestic demand (stimulated by increased availability of cheap bank credit) and an expansion in exports prompted manufacturers to enhance existing capacities. While industries such as textiles, automobiles and electronics have already realized expansion in capacity during the last couple of years and this process is expected to continue, expansion in capacities has to be accelerated in capital-intensive industries such as steel, fertilizer and cement.

Fiscal

Revised budgetary estimates for the federal government indicate that fiscal discipline remained strong in FY04. Overall revenue receipts of the federal government rose by a robust 8.7 percent, largely supported by the CBR tax collections,[3] even as expenditure growth (excluding repayment of external debt) remained subdued. Furthermore, a spick in defense expenditures was largely offset by a modest decline in interest payments.

The rise in revenue receipts and lower expenditure growth in turn, underpinned a significant progress towards fiscal consolidation. Specifically, consolidated FY04 budgetary deficit of the federal and provincial governments not only saw a reduction of Rs 3.2 billion to Rs 177.4 billion compared with that in the preceding year, but also remained below the target for the year.

[3] The realized 8.7 percent rise in overall revenue receipts is well above the original estimated target growth of 4.1 percent during FY04.

Despite the visible improvement in overall budgetary position, the decline in consolidated development expenditures of the federal and provincial government remained a source of concern. A revised figure of Rs 154.4 billion for FY04, although substantially higher as compared to the preceding year, fell short of target by Rs 5.6 billion.

Money and Credit

During Q3-FY04, the SBP continued to face significant challenges to its efforts to moderate the expectations of a rise in both the interest rate and the exchange rate. These expectations remained focused on a visible narrowing of the external account surplus and expected jump in government borrowings from the banking system. These expectations were compounded by the rise in domestic inflation and global interest rates. In practice, however, the pace of the rise in cut-off yields by the SBP in T-bill auctions was slower than the market demand. The small increases in T-bill yields owed principally to an expectation that inflationary pressures would remain benign throughout FY04, facilitating stronger growth in credit demand. The low interest rate policy probably helped accelerate the momentum of private sector credit, which took net credit growth during July-May FY04 to Rs 283.6 billion - an all-time high for this period of the fiscal year.

The exceptionally sharp jump in both private sector credit and government borrowings resulted in rapid growth in the Net Domestic Assets (NDA) of the banking system during Jul-May FY04 as against a significant decline during Jul-May FY03. Moreover, FY04 also witnessed a reduction in net external inflows, reducing the augmentation in Net Foreign Assets (NFA) of the banking system relative to FY03. Thus, in sharp contrast to the July-May FY03 NFA driven monetary expansion of 14.7 percent, the 15.9 percent monetary expansion during July-May FY04 was largely a function of NDA growth.

Money Market

After the reversal of the December 2003 upsurge in short-term rates, the market entered a period of relative stability. While it continued to expect a modest increase in demand for government borrowing, and was also concerned about the steady increase in domestic inflation, rising international interest rates, and a narrowing current account surplus, the SBP has successfully contained the expectations of a sharp rise in interest rates by allowing only a very gradual increase in T-bill cut-offs.

Thus short-term interest rates only saw a modest increase during Q3-FY04. However, as in Q2-FY04, market expectations were jolted by the April 2004 announcement of an unexpectedly large PIB auction. This, together with an

unseasonal acceleration in inflation, as well as an incremental narrowing of the current account revived expectations of a large movement in interest rates.

Banking

The exceptionally strong H1-FY04 net credit expansion continued in Q3-FY04, which led to strong performance during Jan-May 2004 of the banking sector. Deposits mobilization also witnessed a significant rise of Rs 144.2 billion during the same period, as compared to Rs 102.6 billion during Jan-May 2003. However, unlike FY03 when the deposit growth was primarily driven by a current account surplus, strong deposit mobilization during FY04 came from an exceptional rise in domestic credit growth and the portfolio shift away from investments in the National Saving Schemes (NSS).

Other significant developments in the banking sector include: (1) the introduction of separate Prudential Regulations for Corporate and Commercial Banking, SME Financing and Consumer Financing; and (2) the inter-connectivity of the two ATM switches in the country.

Finally, the outstanding stock of NPLs of the banking sector again saw a decline of Rs 3.1 billion to Rs 207 billion during Q3-FY04. As a result, the *NPLs to total advances* and *net NPLs to net advances* ratios also saw visible improvement during the period.

Prices

The rising global inflationary trend is clearly impacting prospects for domestic inflation. However, the influence of the higher international prices of key products such as crude oil, edible oil, and cotton on the domestic economy, although gradually growing, is still limited. Thus, the strengthening domestic inflation rate during FY04 remains largely explainable by domestic factors, particularly food prices.

The influence of *food* inflation in the overall price pressures on the economy is particularly evident in the movements of the headline Consumer Price Index (CPI). The deceleration in the marginal CPI inflation during the initial months of Q3-FY04 was owed principally to a slowdown in food inflation, as was the subsequent acceleration.

Moreover, the unexpected strength of *food* inflation was complemented by the rise in *non-food* CPI inflation due to the continued (and un-seasonal) rise of international oil prices as well as robust increase in the prices of construction

material on the back of strong demand, in addition to stronger than expected growth in the economy and the continued easy monetary posture of the SBP.

As a result of the impetus by both food and non-food components, CPI inflation rebounded to record a year-on-year increase of 7.1 percent during May 2004 - the highest YoY CPI inflation for any month during the preceding six years and a mere 2.6 percent in May 2003. In annualized terms, CPI inflation swiftly reached to 4.0 percent in May 2004 after bottoming out at 2.6 percent in October 2003.

In this background, high *food* inflation shows the incidence of inflation on low-income groups. For this income group, the benefits of high economic growth in terms of higher per capita income would be substantially eroded due to high *food* inflation.

Capital Market

The key indicators of market activity of KSE, the leading stock exchange of the country, showed marked improvement during the first 11 months of FY04 with the period witnessing new all-time highs for the KSE-100 index, market turnover and capitalization.

The increase in the market capitalization is particularly significant. It had jumped to 27.0 percent of GDP at end-May 2004 (from 9.5 percent at end-June 2003). The market liquidity indicators also improved.

There were ten fresh floatations during Jan-May 2004, which compares very well to only thirteen in the last three years. More importantly, most of the public offerings were heavily oversubscribed

In contrast to the visible improvement in equity markets, the corporate debt market remained almost inactive during the Jan-May 2004 period with only one issue of Rs 0.8 million compared with seven listed issues worth Rs 2.7 billion in Q3-FY04. The lower activity in the corporate debt market largely reflects the availability of cheaper finance from commercial banks.

External

Balance of Payments

The deterioration in Pakistan's external account balance, which was already evident in H1-FY04, accelerated sharply in Q3-FY04, with the period witnessing a deficit of US$ 79 million against a surplus of US$ 1288 million in Q3-FY03. Cumulatively, the external account recorded a surplus of US$ 911 million during July-April FY04 as compared to the US$ 4047 million in the corresponding FY03

period. The weakness in the external account is largely attributable to both, a substantial reduction in current account surplus and an increase in the capital account deficit during the period.
A closer look at the current account balance indicates that the 71.3 percent fall in Q3-FY04 over the preceding quarter was primarily driven by: (1) a widening trade deficit, caused by higher oil prices and rising imports of machinery and equipment; (2) higher services outflows (e.g., *travel* and *shipment* payments); (3) a decline in *logistic support* receipts; and (4) termination of the Saudi Oil Facility (SOF).

While the termination of the SOF, logistic support and pre-payment of external loans will confer a degree of stability in future, they did cause short-term pressures on external payments. At the same time, the capital account posted a sharp reversal from a surplus of US$ 98 million in Q3-FY03 to deficit of US$ 547 million during Q3-FY04. This was mainly driven by the prepayment of US$ 1.1 billion expensive loans to the ADB, which overshadowed the rise in inflows due to higher portfolio investment (from the Eurobond issue), an increase in project loans and higher supplier's credit inflow.

Trade

The trade deficit registered a 128.2 percent rise during Jul-May FY04 over the same period last year reaching US$ 2.7 billion. The rise in trade deficit is largely due to the 24.1 percent growth in imports as exports rose by a modest 11.8 percent. The increase in the import bill was mainly driven by higher import of capital goods and raw materials amid increasing economic activity. In exports, the textile sector remained the largest contributor followed by the *other manufactures* sub-group. The achievement of strong growth in textile exports is attributable to both, rising export volumes and higher unit values; however, the impact of the latter remained greater. Textile exports in four categories namely cotton fabrics, knitwear, bed wear and cotton yarn crossed US$ 1 billion each. Among the major non-textile exports, rice performed well by recording 15 percent YoY growth, mainly due to higher basmati rice exports.

Exchange Rate

The trend appreciation of the rupee in recent years appears to have bottomed out after touching a three year low of Rs 57.21/US$ in November 2003. Since then the rupee has *depreciated* by approximately 0.9 percent until end-May 2004, raising some expectations of a further weakening of the rupee. Given that the persistence of this trend could significantly harden these expectations, it is very important to assess the causes of the recent weakness of the rupee.

While the current account continued to record surpluses until Q3-FY04, these were shrinking, and by April 2004 the current account recorded a small deficit. Clearly, the exchange rate movement is reflecting this underlying trend. The key factors in the trend reversal in exchange rate movements include: (1) widening of the trade deficit, (2) end of the Saudi Oil Facility (SOF), (3) slowdown in foreign currency loans, (4) pre-payment of some expensive external debt, and (5) a rise in the stock of outstanding export bills.

Foreign Exchange Reserves

The weakeness in Pakistan's external account flows is quite evident in the changes in the total forex reserves post-January 2004, with the January-May 2004 reserve accumulation totalling US$ 341.0 million as compared to US$ 1453.0 million during H1-FY04. However, even this relative weak growth, that took reserves to US$ 12.5 billion by end-May 2004, helped improve the import coverage ratio to approximately 51 weeks, despite a sharp increase in the average monthly import bill.