This report is based on the data available up to end-November 2007.

THE STATE OF PAKISTAN'S ECONOMY
First Quarterly Report for FY08

1.1 Economic Outlook

Pakistan's economy performed reasonably well in the initial months of FY08, coping with the increased uncertainties in the domestic and international economic environment. Nonetheless, risks to the economy are increasing, as it is clear that neither the global nor the domestic economic environment is as benign as in past years.

The political noise ahead of the upcoming elections is impacting investor sentiment somewhat. While the domestic economy seemed relatively unscathed, like rest of the Asia, from the turmoil in the international capital markets, the global impact of the sub-prime mortgage crisis is still-unfolding. Pakistan has had substantial success in managing its large external account imbalances in recent years, but these imbalances have grown in FY08, increasing the risk that the country could be impacted adversely, particularly if the domestic demand pressures grow in forthcoming months and if problems in the international credit markets worsen.

Table 1.1: Selected Economic Indicators

		FY06	FY07	FY08
Growth rate (percent)				
Large scale manufacturing	Jul-Sep	9.0	10.4	6.9
Exports (FOB)	Jul-Oct	14.6	4.1	10.9
Imports (FOB)	Jul-Oct	37.4	14.5	3.4
Tax revenue (CBR)	Jul-Oct	20.8	17.9	14.4
CPI (12 month MA)	Nov	9.0	7.9	7.6
Private sector credit [3]	Jul- 1st Dec	12.2	7.0	5.4
Money supply (M2) [3]	Jul-1st Dec	3.4	4.2	4.2
million US Dollars				
Total liquid reserves[1]	End-Nov	11,255	12,298	15,778
Home remittances	Jul-Oct	1,372	1,644	2,081
Foreign private investment	Jul-Oct	696	1,741	1,642
percent of GDP[2]				
Fiscal deficit	Jul-Sep	0.5	1	1.6
Trade deficit	Jul-Oct	2.1	2.5	2.0
Current a/c deficit	Jul-Oct	1.7	2.4	1.8

1. With SBP & commercial banks.

2. Based on full-year GDP in the denominator. For FY08 estimated full year GDP has been used.

The threat of renewed macroeconomic complications, after five years of good performance, would be further heightened if prompt actions are not undertaken to correct the recent deterioration in fiscal indicators. The fiscal imbalance has already led to a substantial rise in government borrowings from the central bank, which rose to Rs 191.3 billion during July-December 1 FY08, exceeding both quarterly and annual ceilings and preceding years trend. This has enhanced monetary expansion significantly and is likely to fuel inflationary pressures, compounding the impact of the strength in international commodity prices.

The FY08 growth is also likely to be below the 7.2 percent annual target. The FY08 *kharif* harvest was hurt by the damage suffered by the cotton and rice crop due to floods and pest attacks. While the overall agri-growth target may yet be achievable, this would however require that the impact of the record sugarcane harvest be complemented by an exceptional showing of the *rabi* crops (especially by a substantially above-target wheat harvest) as well as a robust performance by the livestock sub-sector.

The aggregate growth of large-scale manufacturing (LSM) has decelerated in Q1-FY08 (see **Table 1.1**), although disaggregate data reveals a mixed picture. Production growth in many industries including fertilizer, pharmaceuticals, petroleum refining and few metal and engineering goods have rebounded strongly in FY08 after disappointing performances in the previous year. In contrast, the first quarter outcome of a larger number of industries reflects slower growth, often due to industry-specific circumstances. This is most evident in the cotton yarn and cloth (that suffered due to weak exports demand and a poor cotton crop), automobiles (the government relaxed imports), and edible oil & vegetable ghee (demand slackened in the face of nearly doubled prices).

The outlook for the services sector, which accounts for over half of value-added in the economy, remains positive. An acceleration in the *retail & wholesale trade* (with imports rising), higher profitability of the financial sector, and the robust growth in community services (helped by election-related activities) is expected to lead to strong growth for the sixth successive year. In short, it appears that despite the likelihood of some deceleration, the FY08 growth outcome is likely to remain reasonable (see **Table 1.2**).

Table 1.2: Major Economic Indicators

	Provisional FY07	FY08 Original targets	FY08 SBP projection
Growth rates (percent)			
GDP	7.0	7.2	6.6 – 7.0
Inflation	7.8	6.5	6.5 – 7.5
Monetary assets (M2)	19.3	13.7*	13.5 – 14.5
billion US Dollars			
Exports (fob-BoP data)	17.1	18.9	18.3
Imports (fob- BoP data)	27.0	29.6	28.9
Exports (fob-Customs data)	17.0	19.2	19.2
Imports (cif-Customs data)	30.5	32.3	32.3
Workers' remittances	5.5	5.8	6.0 – 6.5
percent of GDP			
Budgetary balance	-4.3	-4.0**	-4.0
Current account balance	-5.3	-5.0	-5.2

(*) Announced in MPS Jul-Dec FY08; (**) Budget estimates.

Strength in aggregate demand, compounded by the considerable impact of rising global commodity prices is also reflected in the persistence of high domestic inflation. The monetary tightening followed throughout FY07 and FY08 was successful in significantly reducing non-food inflation in Pakistan, but its pass through on headline CPI inflation was offset, particularly in the latter year, by the impact of the sustained increases in global food and energy commodity prices. Consumer price index (CPI) inflation rose to 9.3 percent YoY in October 2007 principally driven by a 14.7 percent YoY jump in CPI food inflation. A part of this jump reversed in November 2007, with overall CPI inflation coming down to 8.7 percent, as food inflation reported to be 12.7 percent, but even this is very high.

Food inflation is often volatile and short-lived, depending on crop cycles, etc. For example, just four items (wheat, rice, edible oil and milk) contributed around 75 percent of the domestic food inflation during November 2007. Of these, the direct and indirect impacts of increased demand for bio-fuels[1] are more evident in the prices of edible oil, and dairy products. Here there is less likelihood of relief, in the short-term, unless energy prices decline sharply. On the other hand, poor crops in major producing countries led to a surge in the international prices of rice and wheat, and the price of these may ease somewhat if global production recovers.

More troubling is the fact that the high and volatile food inflation is now increasingly influencing core inflation as well. Since May 2007 both measures of core inflation (i.e. non-food non-energy and the 20 percent trimmed mean) have been trending up. In other words, after resisting throughout FY07, the prices of a broader range of the CPI basket is now being impacted by the cost push of high commodity prices, as suppliers of goods and services raised prices to protect their margins. These inflationary pressures could rise further, if fiscal imperatives force the government to pass through the impact of the recent oil prices.

The risk of such a "second round" inflationary spiral was highlighted in the Monetary Policy Statement issued in July 2007. Since inflation in recent months had been driven substantially by supply-side factors such as food and energy prices, this has given rise to a debate over the need for monetary tightening. However, the emergence of a widening inflationary spiral in Pakistan as a result of the high commodity prices suggests that a tight monetary stance remains

[1] Rapid developments in the bio-fuel sector have transformed the global agricultural market. Large quantities of traditional food/feed crops have been diverted for producing renewable energy in the form of bio-ethanol (from sugarcane, corn/maize and wheat) to be blended with petrol, and bio-fuel.

appropriate. Were it not for the monetary tightening that helped curbed demand pressures, and kept core and headline inflation in check, inflationary trends would have been more significant in both FY07 and FY08.

Since a substantial part of the rise in food inflation is a global phenomenon, it tends to restrict the impact of available relief measures. While government is providing relief by the provision of key staples at subsidized rates through utility stores, its options for broader relief are, in the short-term, limited and involve challenging trade-offs.

(1) Any substantial subsidies involve fiscal costs as well problems in ensuring that it goes only to the vulnerable. For example, traders have the incentive to purchase goods at subsidized rates for re-sale at market prices.

(2) Subsidies can also raise allocation inefficiencies. Inappropriate subsidies may destroy the economic incentives for producers, ensuring that shortages persist for years.

It should also be remembered that the domestic economy is now more open and prone to external shocks than ever before. This has important policy implications going forward. First, domestic prices will be more sensitive to the changes in international prices, despite domestic availability. For example, Pakistan has sufficient exportable surplus of rice in FY07, but following a rise in the international prices of rice, domestic prices also increased. Second (and more important), the difference between farm gate and import prices have to be narrowed in order to provide incentives to farmers. This is probably the only way to ensure sustainable productivity gains and smooth supply of agri-produce in the medium to long-run. This would involve measures to enhance productivity, encouraging market competition, and increasing investment in food processing and storage, etc.

Macroeconomic sustainability during the course of an inflationary period is critical. After relatively subdued growth in the initial months of FY08, the growth of M2 has accelerated in November 2007 and onwards, pushing the Jul-1st Dec FY08 growth to 4.2 percent (almost unchanged from that in corresponding period of FY07). This was led largely by government borrowing, that offset the impact of a moderation in private sector growth. The M2 growth still is manageable given that in the first 5 months, the net foreign assets flows grew slower than in the preceding year, and that reserve money growth during FY08 has been sharply lower than in the previous year. The growth in the reserve money during Jul- 1st

Dec FY08 has been only 6.3 percent, as compared to 11.8 percent in the corresponding period last year.

The recovery in the growth of private sector credit (net) September 2007 onwards indicates that aggregate demand remains reasonably strong, that there is substantial room for banks to lend (as credit-deposit ratio is low and the liquidity position of banks is eased by OMOs as and when required), and that some of the factors that temporarily depressed demand in FY07, are now abating. Banks that had slowed credit activities due to merger and acquisition activity (such as Standard Chartered Bank and ABN Amro) are regaining momentum, and seasonal demand is picking up. Moreover, there is the possibility that financing of long-delayed power projects may also be seen in FY08. It is also likely that companies which met their demand from external borrowings in earlier periods may revert to the domestic markets given the widening of spreads overseas.

All key fiscal performance indicators have deteriorated significantly in Q1-FY08 (see **Table 1.3**). This is reflected in the higher recourse to the central bank borrowing in recent weeks (which is infusing pressure on core inflation) despite higher receipts from the National Savings Schemes and the Pakistan Investment Bonds. The government's budgetary borrowings from the banking system during July- 1st Dec FY08 rose by Rs 191.3 billion compared to Rs 97.6 billion over the corresponding period in FY07. Importantly, the revenue balance[2] moved from a surplus in the first quarters of the preceding years to a deficit in Q1-FY08, despite an impressive growth of 22.3 percent in total revenues during Q1-FY08. The current trend indicates that the fiscal deficit target will not be met unless appropriate corrective measures are taken promptly.

Table 1.3: Fiscal Performance Indicators (Jul-Sep)

as percent of GDP[1]

	FY06	FY07	FY08
Fiscal balance	-0.5	-1.0	-1.6
Primary balance	0.1	-0.3	-0.5
Revenue balance	0.2	0.1	-0.3

Source: Ministry of Finance

[1] Based on projected full-year GDP

Another challenge is the country's large external current account deficit. Recent evidence indicates that the modest contraction seen in July-October, 2007 is unlikely to continue in months ahead. The trade deficit remains high, although it did benefit from an export pick up (though growth remained below FY04-06 trends) and an import compression. While the continued growth in remittances by

[2] Revenue balance measures the saving capacity of the government and is calculated as the difference between total revenue and current expenditures.

22 percent was encouraging, its impact was diluted by continued service and income account deficits. During July-October 2007, Pakistan recorded a surplus of US$ 3.2 billion in the capital and financial account compared to US$ 2.8 billion last year. Most of the surplus emerged from debt flows as the equity flows were impacted by US$ 2.0 billion gross outflows in SCRA during Jul-Nov FY08 and postponement of new privatization programs. Given the commitments in the pipeline, momentum in foreign flows could pick up further in the last quarter, possibly supported also by the floatation of global deposit receipts.

However, notwithstanding the modest improvement in the initial months of FY08, the annual current account deficit remains large; current SBP forecasts indicated that the annual FY08 deficit could remain around 5.2 percent of GDP, very close to the levels seen in the previous fiscal year. While the growth in exports during FY08 are expected to see a significant improvement over the weak growth in FY07, the gains are expected to be offset by a rising oil import bill (particularly if international oil prices remain high), and a jump in imports of machinery (particularly as power projects reach financial close).

1.2. Executive Summary

1.2.1 Agriculture Performance

Initial data for the FY08 *kharif* cropping season indicates that sugarcane harvest recorded a new high of 62.3 million tons. This owed not only of better water availability and favorable weather, but also reflected high sugarcane prices realized in the preceding years that encouraged farmers to bring more acreage under sugarcane and invest in improving the yield. The maize and rice crops also witnessed increases both in output and yield during *kharif* FY08, although the area under each of the crops declined. However, disappointing cotton and rice harvests, mainly as a result of lower acreage under the crops, offset much of these gains. In this background, it is clear that the realization of the 4.8 percent agriculture growth target for FY08 will now hinge on a good showing of *rabi* crops (the wheat harvest, in particular), as well as a robust performance by the livestock sub-sector.

In case of input performance, growth in agri-credit disbursement accelerated during the first four months of FY08. Following the extension of the subsidy on DAP, fertilizers off-take witnessed a strong growth during Q1-FY08 in contrast to decline seen in Q1-FY07.

1.2.2 Large Scale Manufacturing

LSM production data for Q1-FY08 suggests a deceleration in growth that reached only 6.9 percent, the lowest since FY03 during this period. Detailed analysis reveals that while aggregate demand has moderated somewhat, it still remains reasonably strong. Indeed, LSM growth adjusted for the electronics sub-sector remains unchanged at around 8.0 percent in the initial three months, close to the levels in the preceding year. The following reasons probably influenced the slowdown in certain manufacturing sectors; growing demand for import substitutes; slowdown in export demand; and increase in raw material prices.

Sustaining growth in LSM will require the continuation of macroeconomic stability, and continued reforms by both, public and private sector. It must be recognized that in the increasingly globalized economy, there is little room for subsidized or protected growth. Each industry needs to assess its competitive position and move to increase efficiency and productivity. Some of the needed reforms include; expanding the reach and competitiveness of the domestic markets, loosening bureaucratic regulation, and ensuring the availability of utilities at reasonable costs.

1.2.3 Prices

The underlying inflationary pressures in the economy firmed up in FY08, with Consumer Price Index (CPI) inflation surged to 8.7 percent YoY in November 2007. Similarly, Wholesale Price Index (WPI) inflation accelerated to double digits in November 2007. These inflationary pressures are mainly driven by high international commodity prices (both food and energy) and continued strength of domestic demand. The impact of persistent strong increases in the food and energy commodities is now also increasingly evident in the core inflation as well. Since June 2007 both measures of core inflation (i.e. *non-food non-energy* and *20% trimmed mean*) have been trending up. This implies that a broader range of CPI basket is now being impacted by the cost push of high commodity prices.

The emergence of a broader inflationary spiral in Pakistan suggests that a tight monetary stance remains appropriate in order to contain the further spread of inflationary pressures into the broader economy. Moreover a moderation in food inflation is desirable as increases in food prices can have substantial adverse impacts on low-income groups. While government is providing some relief by the provision of key staples at subsidized rates through utility stores, its options for broader relief are, in the short-term, limited and involve challenging trade-offs. Thus more sustainable and effective medium term polices are needed. These include measures to enhance productivity, encouraging market competition, and increasing investment in food processing and storage, etc. The emphasis on such medium-to-long term polices is particularly needed in light of the estimates given by Food and Agriculture Organization (FAO) and OECD that food prices will continue to increase between 20 to 50 percent over the next decade, from the average levels of the last ten years.

1.2.4 Monetary Developments

Concerned by emerging uptrend in core inflation, as well as the risk of an inflationary upsurge from an exceptional rise in monetary aggregates towards the end of FY07, the SBP further raised its policy rate by 50 bps to 10 percent effective from August 1, 2007. This together with effective liquidity management has led to substantial slowdown in reserve money growth to 6.3 percent during July to mid-November 2007 period compared to 11.8 percent in corresponding period of FY07.

However, the growth in broad monetary aggregate (M2) remained 4.22 percent during Jul-1st Dec FY08; almost at the same level of 4.20 percent during the corresponding period of FY07. This M2 growth was primarily driven by the continued strong budgetary borrowings from the banking system.

These higher borrowings were despite greater mobilization under National Savings Schemes and Pakistan Investment Bonds, and higher receipts from external sources, and reflect the impact of a sharp rise in fiscal deficit during Q1-FY08. What is more worrying is the fact that during the recent weeks, government is relying heavily on borrowings from the central bank, which are more inflationary in nature and directly add to the reserve money growth.

The net credit to the private sector registered a deceleration during Jul-1st Dec FY08, increasing by 5.4 percent as compared with Rs 147.7 billion 7.0 percent in the corresponding period of FY07. It should be noted that a significant contribution to the slower FY08 growth is from the exceptional seasonal retirement seen in July 2007. Excluding this, the net credit growth sees a small rise.

It must also be kept in mind that the credit by the banking sector is also being supplemented by other sources of financing. Furthermore, there is evidence that some of the private entities are issuing TFCs/Sukuk bonds to refinance the borrowings from the scheduled banks. To the extent these TFCs/Sukuk bonds are held by the non-bank financial institutions, this would depress the net credit extended by the scheduled banks.

1.2.5 Fiscal Development

All key fiscal performance indicators deteriorated significantly in Q1-FY08. Both fiscal and primary deficits as percent of GDP increased significantly during Q1-FY08. More importantly, the revenue balance moved from a surplus in the first quarters of the preceding years to a deficit in Q1-FY08, despite an impressive growth of 22.3 percent in total revenues during Q1-FY08. This is worrisome as the Fiscal Responsibility and Debt Limitation Act binds the government to keep its revenue balance at least zero from FY08 onwards. The current trends suggest that the fiscal deficit target would not be achieved unless appropriate corrective measures are taken promptly. This is necessary to send a strong signal of the government's commitment to fiscal discipline and macroeconomic stability.

The higher fiscal deficit during Q1-FY08 is primarily associated with a surge in total expenditures, in particular the development expenditure which grew by a handsome 89.5 percent. Current expenditures also registered a high growth of 39.2 percent on account of a 100 percent rise in servicing of domestic debt. On the other hand, total revenues rose to Rs 312.6 billion, registering an impressive YoY growth of 22.3 percent during Q1-FY08 as compared to 8.1 percent growth in Q1-FY07. Though FBR met its revenue target of Rs 263.1 billion with an actual collection of Rs 271.4 billion during Jul-Oct FY08, growth in net tax collections decelerated due to slower growth in direct taxes. A high growth in imports resulted in improved collection under indirect taxes, partly offsetting the impact of lower growth in direct taxes.

1.2.6 External Sector

Balance of Payments

As a result of broad based improvement in current account balance and a continued rise in financial account surplus, Pakistan's external account deficit visibly declined to US$ 0.1 billion in July-October FY08 compared to US$ 0.55 billion in the corresponding period of FY07. This improvement is a combined impact of a higher surplus under capital & financial account and a lower current account deficit.

However, the current account deficit is (a) still very high and (b) it is likely that even the modest Jul-Oct FY08 improvement may not be sustained in the face of the rise in the international oil prices and expected increase in competition in textile exports. This is already suggested by the leading indicators for November and December 2007, with the foreign exchange reserves under pressure, large outflows from the SCRA account and a weakening of Pak Rupee against the US dollar.

The improvement in trade deficit, helped by the small recovery in export and lower growth in imports, was a key development in Jul-Oct FY08. The modest revival in export growth during the period is somewhat encouraging. But, even here it is important to note that (a) the export growth is still low and (b) the growth in textile exports, which have the largest share in Pakistan's total exports, have weakened from 8.9 percent during Jul-Oct FY07 to 6.3 percent during Jul-Oct FY08.

The compression in imports growth during Jul-Oct FY08 was caused mainly by a sharp drop in imports of consumer goods;[3] imports of capital goods and raw material imports continued to register positive growth during the period. A further compression in import growth, however, is also unlikely in the months ahead.

The improvement in overall external balance during Jul-Oct FY08 enabled the Pak rupee to maintain its parity vis-à-vis the US dollar. The liquidity comfort in the inter-bank market also allowed the central bank to shift part of the oil payments to the interbank market.[4] The partial shifting of oil payments to the interbank market together with healthy flows in the financial account increased the central bank liquid reserves by US$ 898.4 million to US$ 14.24 billion as on end October FY08. Likewise, the country's overall liquid foreign exchange reserves increased to US$ 16.4 billion by end October FY08.

In the subsequent months (November and mid December FY08), however, the external sector indicators witnessed some deterioration. As a result, the country's overall liquid foreign exchange reserves reduced to US$ 15.5 billion by December 12, FY08 and the SCRA account experienced out flow of US$ 173.8 million since the imposition of emergency to December 13, FY08. Likewise, Pak rupee depreciation increased to 1.4 percent during Jul to December 12, FY08 as compared to depreciation of 1.1 percent in the same period of last year.

Trade Account (FBS)

Trade deficit recorded a sharp 32.3 percent expansion during Jul-Nov FY08 and reached US$ 7.2 billion mainly on the back of higher import growth – a substantial 18.4 percent import growth outpaced a yet reasonable 7.5 percent growth in exports during Jul-Nov FY08. Monthly analysis reveals that most of the

[3] The detailed classification of imports showed that imports of consumer products fell by almost 11.6 percent during Jul-oct-FY08.

[4] The State Bank shifted payment of furnace oil to interbank market with effect from fourth July, FY08. It may be pointed out that State Bank of Pakistan was making all the oil payments from its reserves with effect from November 1, FY05.

acceleration in trade deficit (72 percent) was seen in October FY08 on account of a sharp 58.8 percent YoY rise in imports during this month. This was in turn caused by rising international oil prices as well as one-off rise in imports of aircraft and ships.

In case of exports, although the 7.5 percent growth during Jul-Nov FY08 was higher than 4.5 percent growth recorded in the corresponding period of the last year, this rise was narrowly based. Almost the entire contribution came from *"other manufactures"* and *"all other items"*, while other major categories recorded either negative or nominal growth. Specifically the textile sector, which until recently had been the main driver of the exports growth could only muster 1.0 percent growth, while the food and petroleum groups' exports declined.

Even the nominal growth in the textile sector was caused by rise in the low value added category of synthetic textiles and in knitwear exports. Exports of all the middle and high value added categories including garments, bed wear and towels experienced a fall. The sluggish performance of textile sector highlights the tough competition faced by this sector in its major markets. Pakistan textile exports to the US recorded 3.9 percent fall during Q1-FY08 as compared to Q1-FY07, whereas to EU country's textile exports recorded a marginal rise of 1.2 percent during Jul-Aug FY08 as compared to the same period last year.

This scenario suggests a possibility of further deceleration in textile export growth in the short term. Keeping in view the large share of textile exports in total exports, this might translate into the deceleration of overall export growth as well. The growth in imports on the other hand seems to have rebounded, which is evident from the broad based surge in imports witnessed in Jul-Oct FY08.