THE STATE OF PAKISTAN'S ECONOMY
First Quarterly Report for FY09

1.1 Economic Outlook

The sense of crisis gripping Pakistan's economy in the initial months of FY09 has visibly eased by November 2008, as the government moved to address the most immediate risks, and entered into a macroeconomic stabilization program to support medium-term reforms under the aegis of the IMF. The disbursement of the first tranche of US$ 3.0 billion by end-November 2008 under the program meant that any immediate risk of default on external obligations receded, with a substantial improvement in foreign exchange reserve adequacy indicators. Also, exports growth has strengthened and imports growth moderated somewhat (see **Table 1.1**). This lent strength to the rupee, reducing the impact of an important generator of inflationary pressures.

The gain on the external account was helped by a sharp decline in international commodity prices that is expected to substantially lower the country's import bill, offering the possibility of a decline in the country's very large current account deficit, and lower inflation. This supply-side improvement has been reinforced by the reasonably good performance of crops during *kharif* FY09 cropping season. These factors appear to have already halted the persistent uptrend in inflationary pressures in the economy. Together, they could also help support a very modest improvement in the growth outlook for FY09.

There is also substantial progress on containing fiscal imbalances, with the government moving bravely to reduce subsidies, contain growth in other spending and increase revenues. The result has been an encouraging improvement in some fiscal indicators, including a sharp fall in the fiscal deficit from 1.5 percent of GDP during Q1-FY08 to 1 percent of GDP in Q1-FY09. This figure appears consistent with the annual target embedded in the macroeconomic stabilization program framework.

Notwithstanding the relative positives, there is no room for complacency. While many of the country's macroeconomic indicators may no longer be worsening, the imbalances are nonetheless still quite large. Resolving them will require disciplined efforts over an extended timeframe. This challenge is all the greater because of the difficult international economic environment, which has restricted the country's ability to tap international capital markets and carries risks for other external receipts (exports, remittances, FDI, etc.).

Containing and bringing down the persistent high inflation in the economy will not be easy. The November 2008 CPI inflation of 24.7 percent YoY is only a little lower than the record high of 25.3 percent seen in August 2008, and both core inflation measures persist at, or close to, their record highs. This persistence, and the evidence of excess domestic demand, reflected in high government borrowings from the central bank and widening current account deficit, underpinned the central bank's decision to further tighten monetary policy in November 2008 by raising the policy rate by 200 basis points.

Table 1.1: Selected Economic Indicators

		FY07	FY08	FY09
	Growth rate (percent)			
LSM	Jul-Sep	11.3	7.3	-6.2
Exports (fob)	Jul-Nov	4.5	6.5	12.7
Imports (cif)	Jul-Nov	10.3	18.4	16.5
Tax revenue (FBR)	Jul-Nov	19.1	14.8	24.4
CPI (12 month MA)	Nov	7.9	7.6	19.1
Private sector credit	Jul-Nov	7.0	5.4	5.1
Money supply (M2)	Jul-Nov	3.9	4.0	-0.2
	billion US dollars			
Total liquid reserves[1]	end-Nov	12.3	15.7	9.1
Home remittances	Jul-Nov	2.1	2.6	3.0
Net foreign investment	Jul-Nov	2.0	1.8	1.4
	percent of GDP[2]			
Fiscal deficit	Jul-Sep	1.0	1.6	1.0
Trade deficit	Jul-Nov	3.1	4.6	4.9
Current a/c deficit	Jul-Nov	2.8	2.8	3.9

1. With SBP & commercial banks.
2. Based on full-year GDP in the denominator. For FY09 estimated full-year GDP has been used.

It is also important to note that domestic commodity prices did not decline in tandem with the sharp fall in international prices. A part of this apparent disconnect is explained by the significant depreciation of the Pakistani rupee[1] since June, which offset some gains from the large decline in international prices. The downward stickiness of prices probably also owes to market structure and other issues, which may be amenable to administrative and policy interventions by the government. Transportation costs, which have substantial impacts on prices of other products and that had been increased disproportionately more when fuel prices rose, provide a case in point; transport fares of the railways, airlines, commercial vehicles, most inter-city bus services, etc. were either not adjusted downwards or saw small changes, after the decline in domestic fuel prices. Anecdotal evidence suggests that this also holds true for trucking costs in many regions of the country.

Government interventions however must tread a fine line, encouraging market driven solutions while avoiding degeneration into price setting or the provision of subsidies. In particular, broad price subsidies often prove wasteful, and in any

1 Pak rupee depreciated by 13.4 percent during Jul-Dec 22, 2008.

case, entail fiscal costs which the budget can ill afford. A key test could come with the wheat harvest. The generous support price offered earlier may not be sustainable as international prices have collapsed. Extensive government purchases to support prices at this level would entail fiscal costs, lead to wastage (as millers would prefer lower, market-driven, prices) and potentially, raise imports.

The data available so far shows that the government has made a fine start to containing the fiscal deficit. However, the fiscal improvement in Q1-FY09 appears largely based on reduction of oil subsidies and a cut in development spending. This is understandable since (1) any meaningful effort to expand revenues (particularly by broadening the tax base) will only work in an extended time frame, and (2) given fiscal rigidities in current expenditures (especially interest payments) the gains will not be available in the short term. In the medium term, such measures must be supplemented by policies to discipline growth in non-development expenditures and broaden the revenue base. This will provide the necessary fiscal space to ensure appropriate levels of public spending on social and infrastructure projects in the future.

A change in mind-set is also required in fiscal planning. Expenditure growth must be kept consistent with a realistic assessment of revenues, and appropriate adjustments made as the year progresses. This will ensure that the government will not crowd-out private sector investment, as the domestic banking sector would then have the space to meet the requirements of the private sector. Simultaneously, it is also imperative that the temptation for government to seek unlimited financing from the central bank be strictly restricted by law. Empirical international studies, and evidences from recent history in Pakistan, clearly demonstrate the dangers to macroeconomic stability resulting from heavy recourse to inflationary borrowings by governments from the central bank.

Acknowledging this, the government had already committed to zero additional budgetary borrowings from the central bank, and this has now been incorporated into the IMF supported macroeconomic stabilization program. The resulting elimination of the fiscal demand stimulus, a contractionary monetary policy, and declining international commodity prices will hopefully also shrink the large current account deficit.

Provisional data indicates that the growth of the current account deficit may have halted in November 2008. If as expected, a declining trend takes hold in succeeding months, this will significantly boost prospects for regaining macroeconomic stability. It must be kept in mind that the slide of the rupee value during Jul-Nov FY09 was mainly a function of continued deterioration in external balances, which resulted in depletion of forex reserves and also generated liquidity problems for the domestic financial markets.

This weakness of the rupee also contributed to the decline in investment inflows, and capital flight by investors. However, a crackdown on illegal forex transfers, and the near simultaneous entry into a stabilization program with the IMF, has helped the rupee recoup some of its earlier losses. A further boost to confidence in the local currency came from signs of slowing import growth.

The weakening in import growth is attributed to both, the substantial downtrend in international commodity prices as well as a relative ease in domestic demand.[2] However, lower commodity prices could also hit export prospects. The sharp fall in international rice prices means that in H2-FY09 it is likely that export quantum will grow but values may decline, relative to H2-FY08. The improvements in external sector are expected to be more visible during H2-FY09 and coupled with fiscal prudence could potentially have impacts on monetary policy.

First, an improvement in external accounts would enhance credibility and minimize the speculation of crisis, which would help SBP to manage liquidity in the banking system. Second, government's commitment not to resort to borrowings from the central bank would make it easier for the SBP to focus on eliminating earlier overhang created by monetization of the fiscal deficit. Third, absence of government borrowings from the central bank would help improve monetary policy transmission mechanism through reflecting true cost of funds in the money market. Finally, a relative contraction in fiscal deficit would help contain aggregate demand pressures, which would supplement monetary policy.

The stabilization efforts were underway even before the initiation of IMF program as government passed through the impact of higher international oil prices to domestic prices of key fuels Q4-FY08 onwards; fiscal consolidation during the first quarter of FY09 and monetary tightening by the central bank in May and July 2008 are examples of these efforts. In particular, the fiscal consolidation program of the government for FY09 consists of (1) substantial reduction in overall budget deficit, as a percent of GDP, through a mix of cut in expenditures (as a share of GDP) and a rise in tax revenues (as a share of GDP), and (2) a gradual elimination of government budgetary borrowings from SBP.

[2] For example, import quantum of crude oil, palm oil, soybean oil, fertilizers, iron & steel, rubber tyres and tubes declined during Jul-Nov FY09.

Despite these efforts, temporary liquidity shortages with the commercial banks were viewed as signs of financial crisis in the country. This led to a fresh round of speculative attack on domestic currency. Unfortunately, these developments coincided with the global financial and liquidity crises, thus it was perceived that the domestic crisis was also triggered due to the same reasons as faced by western financial institutions. The central bank assessed the situation and took important measures to ease liquidity in the financial system and stabilize the domestic currency.

1.2 Looking Forward

It is evident that Pakistan's economy needs effective policies and implementation of reforms in FY09 to regain macroeconomic stability in the midst of a challenging year. Real GDP growth is likely to be significantly lower than the annual target and inflation will breach its target with a wide margin (see **Table 1.2**). On a positive note, both fiscal and current account deficits are estimated to improve in FY09.

Table 1.2: Projections of Major Economic Indicators

	FY08	FY09	
		Annual plan targets	Projections
growth rates in percent			
GDP	5.8	5.5	3.5 - 4.5
Average CPI Inflation	12.0	11.0	20.0 - 22.0
Monetary assets (M2)	15.3	14.0	11.0 - 12.0
billion US dollars			
Workers' remittances	6.5	7.7	7.5
Exports (fob-BoP data)	20.1	22.9	20.5 - 22.0
Imports (fob- BoP data)	35.4	37.2	33.5 - 35.0
percent of GDP			
Fiscal deficit	7.4	4.7	4.3 – 4.8
Current account deficit	8.4	7.2	6.2 - 6.8

Note: Targets of fiscal and current account deficit to GDP ratios are based on Nominal GDP in the Budget document for FY09, while their projections are based on projected (higher) nominal GDP for the year.

Amongst the biggest challenges for the government will be to ensure the pass through of decline in international commodity prices to consumers. In this background, while recent downward adjustments in the administered prices of key fuels[3] is appreciable, the reversal in transport fares and goods transportation charges is almost negligible. This behavior is not unexpected given (1) when prices moves upward quickly, they generally do not come down as fast; and (2) inflationary expectations remain strong. Moreover, while commodity price shock was quite strong, it was believed that these prices will remain stubbornly high for at least a decade or so.[4] However, these prices have unexpectedly plummeted dramatically due to deepening global recession. Firms and traders would like to take some time to adjust their prices and margins in these circumstances. Consumer awareness, role

[3] Petrol, diesel, kerosene oil and LPG.

[4] http://www.fao.org/newsroom/en/news/2008/1000849/index.html

of media, quicker settlement of import duties and other taxes may be required to accelerate disinflationary process in the economy.

Similarly, global recession and risk averse behavior of investor would likely to severely impact international trade and level of forex inflows in the economy. SBP estimates for both imports and exports have been revised downwards, with a more pronounced effect on imports. At the same time in the event of shortfall of external financing, the burden of financing fiscal deficit will disproportionately fall on the domestic commercial banks, since government has committed not to borrow incrementally from the central bank. In addition, FDI inflows may be substantially lower than in recent years, in which case, pressures on forex reserves could remain strong. Both possible developments indicate continuing risk on interest rates and exchange rate, and thus the need for continued vigilance by policymakers.

1.3 Executive Summary

1.3.1 Agriculture

Initial data suggests that agricultural growth in the current fiscal year could be significantly better than in FY08, notwithstanding a sharp fall in sugarcane harvest. This expectation is based on a record rice harvest of 6.5 million tones, a small improvement in cotton production during *Kharif* FY09, supported by the possibility of a record wheat harvest. Initial information also raises the possibility of a very good showing by minor crops and reasonable growth in the livestock sub-sectors. The improvement in the *kharif* crops is remarkable given continued water shortages. It suggests that better prices and credit availability may have encouraged farmers to increase investment in crops. Further, widespread rains during mid-December 2008, raise hopes for higher *rabi* plantation and harvesting.

Some important policy measures announced in the FY09 budget (and later) to encourage farmers may have played important role. These include: (1) increase in support prices of wheat for FY09 crop, (2) a 25 percent higher agri-credit target for FY09 compared with the FY08 target, with enhancement in indicative per acre credit limit for major and minor crops, orchards and fishery by an average 70 percent, (3) increase in subsidy for DAP, (4) starting of crop insurance scheme, and (5) exemption of GST on fertilizers and pesticides etc.

1.3.2 Large Scale Manufacturing
Large scale manufacturing (LSM) continued to decline, as it registered a negative growth of 6.2 percent in Q1-FY09 as against a reasonable growth of 7.3 percent in Q1-FY08. This decline in LSM production is broad-based. Seven sub-sectors (having 72.4 percent weight) out of fifteen registered decline, while three (having 15.3 percent weight) registered a growth of less than one percent.

This disappointing outcome is a result of a number of factors including: severe energy shortages, deterioration in domestic law & order situation, impact of pass through of international oil prices, sharp depreciation in rupee - US dollar parity and most importantly, weak external demand on the back of global recession and slowdown in domestic demand.

1.3.3 Services
Services sector has exhibited resilience to fluctuations in economic activity in recent years. This is also evident in continued growth in FDI in the services sector, despite slowdown in overall economic activities in the country.

Key indicators of services sector during Q1-FY09 present a mixed scenario. While, some sectors such as *wholesale & retail trade* and *transportation & communication* are likely to show a weak performance relative to the preceding year, *community & social services, finance & insurance* as well as *public administration & defence* are estimated to exhibit a strong growth for yet another year.

1.3.4 Prices
Inflationary pressures remained strong in the economy during the first five months of FY09. In particular, consumer price index (CPI) and the sensitive price indicator (SPI) have seen strong YoY increases in the period. However after recording strong growth (YoY) during the first two months of FY09, a significant decline in WPI inflation has been observed during the later months.

Core inflation, measured by both non-food non-energy (NFNE) and 20% trimmed mean, strengthened during the first five months of FY09. Strength in core inflation is indicating the persistence of inflationary pressures.

1.3.5 Money and Banking
SBP undertook aggressive monetary tightening during FY09, further increasing the policy rate by 300 bps in two rounds. On a cumulative basis, this means a 550 bps increase during the last 18 months. These policy measures were in response to

carryover of macroeconomic stresses of the preceding year, which had grown in size during the current year. For example;

(1) Although YoY CPI inflation declined from its peak, domestic inflation has remained high. While the surge in food prices have retreated somewhat, non-food inflation shows little effect of the sharp decline in international commodity prices.

(2) Furthermore, external current account deficit, which was mainly reflecting domestic demand pressures, increased sharply during FY09. There is a risk that possible weakening of exports and remittance inflows may even offset the anticipated relief in overall import bill for the country due to recent broad-based decline in international commodity prices.

(3) Moreover, continuing monetization of the deficit was not only providing a stimulus to domestic demand but has also greatly diluted the impact of earlier monetary tightening. Government budgetary borrowings from the central bank during Jul-Nov 2008 reached Rs 356.4 billion, as compared to Rs 169.4 billion in the same period last year.

The excessive government borrowings from central bank posed difficulties in liquidity management, which became more complex due to (1) a substantial drain of the rupee liquidity from the inter-bank market by October 2008 following substantial pressure on external account; (2) a heavy withdrawal of deposits owing to seasonal cash demand around Eid, and (3) rumor-induced panic withdrawal of deposits in October 2008. This induced SBP to announce a number of temporary measures to accommodate liquidity shortfalls.

In terms of monetary aggregates, the YoY growth in M2 decelerated steeply to 10.7 percent by end-November 2008 – the lowest growth seen during the last seven years. Indeed, an extraordinarily strong contraction in net foreign assets (NFA) of the banking system more than offset a sharp rise in budgetary borrowings from the central bank and continued strong demand for credit (both from public sector enterprise and private sector).

1.3.6 Fiscal Developments

The large fiscal deficit in FY08 and the adverse economic consequences of its financing from SBP placed fiscal consolidation at the top of government's macroeconomic stabilization agenda for FY09.

Not surprisingly, the Q1-FY09 fiscal performance improved consequent to the policy shift, with the overall fiscal deficit estimated to have dropped to 1 percent of annual GDP. This is consistent with the annual fiscal deficit target set under the IMF stabilization program. The reduction in fiscal deficit in Q1-FY09 was brought about mainly by a drastic cut in development expenditures.

1.3.7 External Sector

Balance of Payments

Pakistan's external account remained under stress through Jul-Nov FY09, as acceleration in the growth of the current account deficit, and sharply reduced financial & capital account inflows drew the country's foreign currency reserves to perilously low levels. Not surprisingly, the rupee also weakened substantially in the period, depreciating by as much as 16.3 percent against the US dollar by end-October 2008, before recovering somewhat after Pakistan gained IMF support for a macroeconomic stabilization program.

Although there were indications of slowdown in domestic demand, higher import prices during Jul-Nov FY09 continued to propel import growth. It was only when the slowdown in the domestic demand was complemented by lower import prices in November 2008 that the import bill declined 23.9 percent YoY. Lower import bill combined with the rise in remittances in November narrowed the current account deficit somewhat for the Jul-Nov 2008 period.

On the financing side, deteriorating macro economic imbalances, sharp depreciation in Pak rupee against US dollar, and substantial fall in stock market and consequential increase in the country's default risk along with downward revision by the credit rating agencies, deterred foreign exchange inflows during the period under review. As a result, surplus in financial account recorded significant 62.0 percent fall during Jul-Nov FY09 in contrast to an increase in the corresponding periods of last three successive years.

Trade Account

During Jul-Nov FY09, strong growth in imports, mainly due to higher import prices, outpaced the otherwise substantial improvement in export growth causing the trade deficit for the period to widen by US$ 1.4 billion compared to the same period last year. Interestingly, this rise in the deficit accrued entirely during Q1-FY09; while still large, the monthly deficit saw a YoY decline in each of the next two months.

The fact that (1) a large share of the overall import increase was contributed by price impact, while the share of quantum impact in the total import increase was negative and (2) growth of non-food & non-oil imports recorded a sharp deceleration during Jul-Nov FY09, both point toward easing of demand pressures during Jul-Nov FY09. The combined impact of lower commodity prices and easing of domestic demand pressure are likely to reduce the trade deficit going forward.