1 Economic Outlook

1.1 Overview

As the year progressed, it became clearer that economic performance of the country would remain weak in FY09. A moderation in economic growth was expected and embedded in a lower growth target for FY09, but developments during the first four months of the fiscal year made it obvious that even this lower growth target would be difficult to achieve. These developments included stubbornly high inflation, massive deterioration in external accounts, and declining industrial output.

Table 1.1: Selected Economic Indicators

		FY07	FY08	FY09
Growth rate (percent)				
LSM	Jul-Mar	9.1	5.0	-7.7
Exports (fob)	Jul-Apr	2.9	9.9	-3.0
Imports (cif)	Jul-Apr	8.9	28.3	-9.8
Tax revenue (FBR)	Jul-Apr	20.0	16.3	17.7
CPI (12 month MA)	Apr	7.8	9.8	22.0
Private sector credit	Jul-Apr	13.0	15.0	1.7
Money supply (M2)	Jul-Apr	11.8	8.4	1.9
billion US dollars				
Total liquid reserves[1]	end-April	13.7	12.4	11.2
Home remittances	Jul-Apr	4.5	5.3	6.4
Net foreign investment	Jul-Aprr	5.9	3.9	2.2
percent of GDP[2]				
Fiscal deficit	Jul-Mar	3.1	4.7	3.1
Trade deficit	Jul-Mar	5.3	6.6	5.7
Current a/c deficit	Jul-Mar	4.3	5.7	4.6

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

Nonetheless, by the end of Q2-FY09 some semblance of macroeconomic stability was beginning to emerge, as the government focused on restoring macroeconomic stability, and entered into a Stand By Arrangement (SBA) with the IMF in support of its reform program. This improvement continued in the third quarter of FY09, as these reforms took hold and the economy benefitted from a sharp decline in international commodity prices and other favorable developments. Inflation began to decline, the current account deficit narrowed substantially with a corresponding stability in the exchange rate, and fiscal discipline was maintained with the fiscal deficit being reported to be 3.1 percent of GDP for July-March FY09. While this improvement in macroeconomic indicators is very encouraging, the economy is not out of the woods yet. Major macroeconomic indicators show underlying weaknesses which, if not addressed, could hamper economic recovery.

The record wheat and rice harvests together with the likelihood of good production in minor crops and of fodder backs expectations that growth in the crops sub-sector of agriculture will exceed the FY09 annual target. A reasonable performance from the livestock sector, supporting all this, will help take the overall agri-sector growth close to, or over, the annual target. Also, notwithstanding a slowdown in the *trade*, and the *transportation & communication* sub-sectors, the services sector is also expected to perform well.

However, the substantial negative growth in large scale manufacturing (LSM) (see **Table 1.1**), remains a major drag on prospects of improving real GDP growth. While the decline in LSM growth is a reflection of weaker domestic and external demand, other domestic factors have a significant contribution as well. These include infrastructural bottlenecks (e.g. power and gas shortages), increasing risk averseness of banks (this has lowered access, and increased cost of credit, for both businesses and consumers), as well as persistent inflationary pressures.

In this context, the recent easing of inflationary pressures is indeed encouraging. The headline inflation - measured by consumer price index (CPI) - dropped to 17.2 percent on year-on-year (YoY) basis in April 2009 from its peak of 25.3 percent YoY in August 2008. In particular, a sharp downtrend in food inflation is a welcome development as this component of CPI affects low income groups the most. CPI food inflation fell from its peak of 34.1 percent YoY during August 2008 to 17.0 percent in April 2009.

The downtrend in inflation owes to both, favorable international and domestic developments, as well as a deceleration in domestic demand. The latter, in particular, reflects the monetary tightening by the central bank, as well as the complementary improvement in fiscal discipline, especially post November 2008. It is worth noting that the acceleration in the fall of inflation is becoming visible only after the monetization of the fiscal deficit was halted. The weakness in demand pressures amid fiscal prudence, lagged impact of relatively lower international commodity prices, bumper wheat and rice harvests as well as better supply management of key staples have augmented the gains of tight monetary policy.

While domestic demand had been visibly easing since November 2008, the pace of the improvement was initially unclear, and there were lingering risks on the external accounts as well as in the relative resilience in core inflation. These risks precluded an immediate easing of monetary policy, and accordingly the January 2009 monetary policy statement kept the policy rate unchanged.

Notwithstanding this, the measures introduced in the wake of the liquidity shock in October 2008 meant that KIBOR eased, particularly due to non-enforcement of the implicit interest rate corridor by SBP, which effectively diluted the impact of the policy stance on the already-stressed domestic economy. To support industry and particularly the export-oriented sectors, that were pressured by the impact of the global recession, measures were introduced such as; easing access to concessional financing schemes, and lengthening maturities. The central bank also injected appropriate liquidity to meet banking system's increased demands for commodity operations and settlement of circular debt. However, by April 2009, broad money (M2) growth was still quite weak, at 1.9 percent year-to-date, down sharply from 8.4 percent in the corresponding period last year, reflecting continued deceleration in domestic demand. As a result of this, SBP projections suggest that deceleration in inflation will be much sharper in the next few months. This is also evident from the successive fall in the core inflation during March and April 2009.

The projected improvement encouraged SBP to gradually shift its policy bias towards supporting growth in the economy. Thus, as other macroeconomic indicators improved further, this allowed the central bank a 100 bps reduction in the policy rate, bringing it to 14 percent effective from April 21, 2009.

It has been argued that the substantial improvement in macroeconomic indicators, should have allowed for a sharper reduction in the policy rate; particularly when the growth indicators show a substantial slowdown in the economy, and inflation is projected to fall sharply. Indeed, the market had already envisaged the possible cut in the policy rate, ahead of the April reduction, observing low inflationary pressures in the economy, the expectation is evident from the downtrend in the market rates since January 2009. Such a measure would have been possible, were it not for the risks attached to the current macroeconomic situation. These risks include anticipated shortfalls in fiscal receipts, the uncertain international environment which adds uncertainty to Pakistan's ability to finance even a narrower current account deficit, as well as the fact that the accelerated decline in inflation is, so far, more an expectation than a fact.

The fiscal deficit for July-Mar FY09 is reported at 3.1 percent of GDP, which is consistent with the annual target, but there are significant issues with both, the sustainability of this trend over the full year, and the quality of this reduction in the deficit.

(1) The growth in tax collections has already slowed, and may decline further in Q4-FY09. Also, non-tax revenue receipts, which had hitherto supported overall revenue growth, are also expected to weaken in the same quarter

(e.g. rising international prices are expected to squeeze receipts of petroleum development levy).

(2) The government's expenditure budget will also be stretched by the ongoing war on terror, the need to support an estimated more than a million internally displaced persons (IDPs) fleeing the conflict areas.

(3) It is important to stress the "improvement" in the fiscal picture as a result of the sharp cut on development spending is neither sustainable nor desirable. Particularly in the context of the socioeconomic conditions that support the extremist militants, it is crucial that the government increase its spending on health, education, and strengthening social safety nets.

The anticipated weaker performance of revenues, and increase in expenditures both point to the risk of slippage in the fiscal deficit target, and a contingent increase in financing requirements. The pertinent point here is that the lower demand for private sector credit and increased risk averseness of banks during the year so far, allowed the government to increase borrowings from commercial banks without putting upward pressure on interest rates. However, recent developments suggest that this room is fast eroding, and significant additional government demand would increase the risk of crowding out the private sector.

Similarly, resurgence in international commodity prices poses risks to the assessment of a continued sharp deceleration in inflation in the months ahead. In particular, a rise in international oil prices would have adverse consequences for domestic inflation as well as the external account balance. In recent months, current account deficit witnessed improvement relative to the corresponding period, for the first time in five years. This is mainly attributed to a substantial fall in import growth, and sustained strong growth in remittances that continued during Dec-Apr FY09.[1]

However, flows under financial and capital accounts are relatively lower compared with the preceding years, causing a rise in overall external account deficit. A fall in financial inflows is the result of combined impact of both external and domestic factors. Financial flows towards emerging economies have generally significantly shrank amid financial turmoil and recession. On the domestic front, poor law & order and security situation, and political noise have led to net outflows of portfolio investment. While, Pakistan's ability to access

[1] As per the exchange record data, imports recorded a YoY decline of 36.8 percent in Q3-FY09, export declined by 16.9 percent, while workers' remittances increased by a healthy 21.4 percent.

international financial market is constrained, any shortfall in external inflows would add to pressures on monetary policy.

In short, the limited gains in key macroeconomic indicators should not lead to complacency as the quality of these improvement and challenges to economy are some factors of disquiet. For example, a decline in fiscal deficit would have been a welcome development to the extent achieved through lower growth in current spending (see **Table 1.2**). The reduction in development expenditure is not desirable, as it would have detrimental impacts on country's human and physical infrastructure. In the medium term, the only viable way to achieve sustainable improvements in fiscal accounts is to raise the tax-to-GDP ratio through increasing the tax net. This is because a substantial reduction in current expenditures is not possible without significant reduction in the size of government machinery, due to inflexible interest payments and expenses under defense and civil administration. Similarly, an increase in tax rate may probably encourage tax evasion.

Table 1.2: Projections of Major Economic Indicators

		FY09	
	FY08	Annual plan targets	Projections
	growth rates in percent		
GDP	5.8	5.5	2.0 - 3.0
Average CPI Inflation	12	11	20.5 - 21.5
Monetary assets (M2)	15.3	14	8.0 – 10.0
	billion US dollars		
Workers' remittances	6.5	7.7	7.5
Exports (fob-BoP data)	20.1	22.9	18.5 - 19.5
Imports (fob-BoP data)	35.4	37.2	30.5 - 31.5
	percent of GDP		
Fiscal deficit	7.4	4.7	4.0 – 4.5
Current account deficit	8.4	7.2	5.0 – 5.5

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.

Another area of concern is the gradual improvement in current account deficit, which is principally driven by a decline in import growth. It should be kept in mind that there exists quite uncertainty over the pace of growth in workers' remittances. In addition, country would also have higher debt servicing in coming years. These two factors reinforce the common view that sustainable improvement can be achieved only through increasing exports by product and market diversification with gains in productivity. These are not easy tasks. Increase in market diversification requires quality products with a good name of the country and congenial environment to buyers of Pakistani products to visit production venues and observe the processes. A large number of buyers required to do this to satisfy their developed countries clients about safety standards and environmental as well as social issues. Similarly, product diversification needs investment, expertise, spending in research and development.

Finally, a practical solution is to enhance productivity in the medium term. However, it cannot be achieved without providing basic education and health facilities to masses, as well as efficient physical infrastructure including credible low cost energy, transportation and postal systems. The country can achieve all these despite huge investment requirements. However, there is a need to implement second generation reforms to improve governance, strengthen institutions and reform legal as well as regulatory system.

1.2 Executive Summary

1.2.1 Agriculture Sector

Robust growth by major crops, despite lower water availability and decline in fertilizer off-take, is principally a reflection of anticipated higher prices, and good luck in terms of favorable weather. The good performance by major crops appears to be more impressive given a substantial decline in sugarcane harvest during FY09. Similarly, growth in production of some pulses, oilseeds and horticulture crops indicates a better performance by minor crops during FY09. More importantly, growth in livestock benefited from higher supply of fodder, following the extended monsoon and winter rains as well as absence of any major incident of diseases during FY09.

All these developments suggest that FY09 agriculture growth would be reasonably good and that could have been even better if sufficient inputs - irrigation water, fertilizers and certified seeds - could have been used.

Farmers' ability to increase investment in quality inputs may be reflected partially by slower than anticipated growth in agri-credit. The trends so far suggest that the annual target of Rs 250 billion would be missed, for the first time since FY05. This would be due to both demand and supply factors. However, for the next season, credit disbursement is expected to improve. For example, relatively stable fertilizer prices would help restore demand for agri-credit for inputs. Similarly, an ease in monetary policy and SBP measures to address liquidity shortages in the banking system would help improve supply of agri-credit in the months ahead.

1.2.2 Large-scale Manufacturing

Growth in large scale manufacturing (LSM) has been negative for the tenth consecutive month in Mar 2009, the longest period in which production continued to shrink. LSM growth dropped by 7.6 percent during July-Mar FY09 compared with a 5.0 percent rise in the corresponding period of FY08.

Weakness in domestic demand, worsening power shortages, structural problems and deterioration in law & order situation are some important factors responsible for the decline in LSM production. Similarly, decline in external demand and sharply lower fund flows amid global recession probably contributed to slowdown in domestic manufacturing activities.

Consumer durables industry witnessed drastic decline in production during July-Mar FY09. Domestic consumer durable industry largely produces for the local market and is relatively less competitive than the regional competitors. In particular, jeeps & cars sub-sector is the worst hit by the sluggish demand due to (1) continued increase in prices; (2) rise in cost of financing; as well as (3) lower availability of institutional financing given the risk averse behavior of banks amid increasing NPLs under consumer financing and liquidity problems.

Production decline in cooking oil & ghee industry is due to the combined impact of weaker domestic demand as well as uncertain international prices of key inputs. Similarly, textile industry suffered due to domestic as well as external shocks. Power outages, increase in utility charges and higher financial cost were some domestic factors responsible for a drag in textile sector, weak external demand amid global recession hurt production in this export driven sector. In contrast, drop in sugar production is entirely attributed to domestic factor i.e., lower sugarcane harvest during FY09.

1.2.3 Services

A slowdown in economic activities as well as poor law & order situation also impacted the performance of services sector during FY09. In contrast with stellar growth in recent years, services sector is expected to record below target growth in FY09.[2] In relation to domestic economic slowdown, foreign inflows of funds in services have eased up in FY09. Overall domestic economic slowdown witnessed in FY09, depicted by decline in large scale manufacturing, decrease in domestic demand and decline in exports as well as imports are factors impeding growth prospects in services. Outlook for trading activities is on the down side as the two major components of value addition in trading i.e. manufacturing and imports exhibit slowdown in FY09.

[2] Actual real growth in services has surpassed annual growth targets in three of the previous four fiscal years.

On the other hand, *finance & insurance* sub-sector also presents a mixed performance. The profits of commercial banks dropped substantially during the first three quarters of FY09. In contrast, SBP profits witnessed a substantial increase during this period. Moreover, other financial institutions; including, mutual funds, modarba companies and foreign exchange companies - whose earnings contain higher risk premia and are prone to fluctuation in rupee parity - were negatively impacted by capital market instability in H1-FY09 as well as high NSS returns. Transportation and communication are expected to benefit from relatively lower international oil prices and consolidation of revenues; in addition storage activities exhibit sharp increase in FY09.

1.2.4 Prices

The relative ease in inflationary pressures that began in Q2-FY09 continued into Q3-FY09 with all price indices exhibiting a declining trend. After reaching a record high in August 2008, CPI inflation (YoY) declined to 17.2 percent in April 2009. The recent downtrend in CPI inflation (YoY) was mainly attributed to declining domestic food inflation, principally a reflection of fall in international prices and smooth domestic supply of key staples. Signs of easing of inflationary pressures are also reflected by a decline in persistent component of inflation, which is measured by core inflation. The non-food non-energy (NFNE) and 20 percent trimmed mean, both the core inflation measures have shown signs of relative ease during April 2009.

Going forward CPI non-food inflation is also expected to ease as a result of lagged impact of tight monetary stance, declining international commodity prices, subdued inflationary expectations amid weaker domestic demand and absence of second-round effects due to a relative slowdown in food inflation. In line with CPI inflation (YoY) other price indices including WPI and SPI also witnessed a downtrend during Q3-FY09.

While, inflation is still high it is expected that the downtrend in inflation will gather pace in the next few months. Weak inflation expectations together with evident decline in domestic demand resulted in an ease in monetary policy in April 2009.

1.2.5 Money and Banking

SBP reduced the policy discount rate through a 100 bps to 14 percent effective from April 21, 2009. Though the demand pressures have been showing a downtrend since November 2008, the lowering of risks to external account position and a visible downtrend in stubbornly high core inflation allowed SBP to lower the policy rate.

While inflation has been quite stubborn over the last 6 months, this appears to be changing, as evident in the declining trend in the year-on-year figures for CPI inflation as well as both core inflation measures. Similarly, a sharp slowdown in country's import bill during Q3-FY09 helped substantially in narrowing the current account deficit to US$ 396 million in the same period.[3] This together with financial flows from International Financial Institutions (IFIs) led to a significant increase in SBP's foreign exchange position to US$ 7.8 billion at end-April 2009 from its low level of US$ 3.5 billion by end-October 2008.

Moreover, the private sector credit growth continued to show deceleration as it recorded net retirement of Rs 127.1 billion in Jan-Mar FY09 compared with net lending of Rs 203.1 billion in H1-FY09.[4] While the credit demand is slowing down, banks were also reluctant to lend to private sector due to rising credit quality concerns. On the fiscal side, the demand stimulus has continued to ease as fiscal discipline improved, and government reliance on central bank borrowing has further declined by end- March 2009.

The domestic liquidity condition, as a result of slowdown in domestic credit requirements by the government and private sector and sharp fall in pace of depletion of NFA of the banking system have continued, so far, remained relatively easy.[5] The impact of improvement in demand pressures on rupee liquidity is quite visible from the softening of market interest rates since January 2009.

The YoY growth in broad money (M2) decelerated sharply to 8.4 percent as on April 25, FY09 compared to 15.3 percent in the corresponding period last year. This was despite a considerable fall in pace of depletion of Net Foreign Assets (NFA) of the banking system. The sharp deceleration in M2 growth came from reduced credit requirement by the government and private sector. Resultantly, as on April 25, 2009, the YoY growth in Net Domestic Assets (NDA) of the banking system dropped to 16.9 percent from 22.6 percent a year earlier.

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[3] During Q3-FY08, the current account deficit was US$ 3.7 billion.

[4] The cumulative increase in private sector credit during Jul-25th April FY09 was only Rs 48.6 billion compared with Rs 371.3 billion in the corresponding period of the last year.

[5] While, in the month of October and November 2008 the continued decline in deposit growth exerted downward pressure on rupee liquidity, an abrupt and heavy withdrawal of deposits from the banking system further aggravated the situation. However, the SBP proactive liquidity management ensured the smooth functioning of inter-bank market.

The overall deposits mobilization by banks remained weak during July-Mar FY09 as overall deposits of the banking system witnessed a contraction of 0.6 percent on cumulative basis. This was despite a considerable ease in external current account pressures which was a significant source of erosion in deposit-base. Indeed, deceleration in private sector credit growth, higher competition from National Saving Scheme (NSS), and lower liquidity injections from SBP into banks following a lesser budgetary borrowings from the central bank limited the deposit growth in the period of analysis.

1.2.6 Fiscal Developments

Recent update on fiscal developments by Ministry of Finance indicates that the budget deficit for July-Mar FY09, as a percentage of the estimated FY09 GDP, is likely to remain at 3.1 percent compared with 4.7 percent in the corresponding period of FY08. Though broadly consistent with the annual fiscal deficit target for FY09, the quality of this fiscal improvement can only be judged once consolidated fiscal accounts are released.

Indicators of tax performance suggest a likely shortfall in tax collection (budget) target for FY09. During July-Apr FY09, FBR tax receipts amounted to Rs 898.6 billion compared with Rs 763.6 billion in the same period last year, reflecting a YoY increase of 17.7 percent. Although the YoY growth in tax receipts during July-Apr FY09 is moderately higher than the 16.3 percent rise experienced in the corresponding period of FY08, monthly trend projects a deceleration in FBR tax revenues for the entire fiscal year 2008-09. Even if FBR is able to arrest the downtrend in the growth of tax collection during the remaining months of FY09, the current pace of increase in tax receipts falls short of the 24.1 percent YoY growth required to attain the Rs 1250 annual budget target for FY09.

As a percent of annual target, total tax collection stands at 71.9 percent by end April 2009. Importantly, 74.5 percent and 78.6 percent of the annual budget target were achieved in the same period of FY08 and FY07 respectively. It merits mentioning here that the FBR tax collections fell short by Rs 17.8 billion in FY08. To achieve FY09 target of Rs 1250 billion would require FBR to amass almost 28 percent of the target amount in the remaining two months; indicating that the revenue target for FY09 will be hard to achieve keeping in view the prevailing economic conditions in the country.

The aggregate government borrowing from domestic sources stood at Rs 353.0 billion during July-Mar FY09, which is significantly lower than the domestic budgetary requirements in the corresponding period of FY08. With apparent shortfall in external borrowing for budgetary support, the decline in budgetary borrowing from domestic sources in July-Mar FY09 reflects improvement in fiscal balance.

1.2.7 Balance of Payments

The improvement in Pakistan's overall external account, which emerged in November FY09, continued in the subsequent months as well. A large part of this improvement during July-Apr FY09 is on account of 23.5 percent contraction in current account deficit. This contraction mainly owed to fall in imports, on the back of weakening aggregate demand pressures and falling import prices, and strong remittances growth.

Unlike the improvement in current account, capital & financial account deteriorated sharply during July-Apr FY09. This deterioration was contributed by a fall in both investment and loan inflows. While loan inflows revived to large extent after IMF support for macroeconomic stabilization program, foreign investment inflows continued their declining trend in the wake of worsening global financial crises. While loan inflows could further strengthen if pledges (worth US$ 5.28 billion) made in Friends of Democratic Pakistan (FODP) conference materialize, substantial recovery in foreign investment inflows is subject to the normalization of international financial market conditions and improvement of Pakistan's macroeconomic indicators.

The relative improvement in Pakistan's external accounts was reflected in foreign exchange reserves, which recorded sustained improvement Nov 08 onwards. Consequently by April 30 2009, foreign exchange reserves had climbed back to almost the end-June level of US$ 11.4 billion after hitting a low of US$ 6.8 billion in Oct 2008. This also alleviated pressures on the exchange rate, helping it to stabilize in the range of 78.8 and 80.8[6]

1.2.8 Trade Account

Trade deficit recorded a break from rising trend of the past six years, declining by 15.9 percent YoY during July-Apr FY09. This was principally led by a 9.8 percent YoY fall in imports that more than offset a small 3.0 percent YoY fall in exports during this period. A larger share of the improvement in trade deficit was observed during Jan-Apr FY09; due to a sharp 35.1 percent YoY fall in imports that outpaced a yet large 19.2 percent YoY fall in exports in this period. The fall in imports, in turn, was contributed by a shrinking import demand which was complemented by a large YoY decline in import unit values from the beginning of Jan FY09.

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[6] Between Dec 1st, 2008 and Apr 30th, 2009.

Unfortunately exports, after recording a decent performance during July-Oct FY09, recorded an accelerated deterioration November 08 onwards. This deterioration in export performance was the result of multifarious issues faced by exports. For instance structural obstacles, domestic energy crisis, and worsening law and order situation were some of the major issues that constrained export performance. The impact of these domestic impediments was complimented by deepening international recession from Q4-CY08, which further squeezed external demand for country's major exports leading to a YoY fall in exports for July-Apr FY09.

Nevertheless, given the expectation that the decline in imports will be much larger than the fall in exports, the trade deficit is expected to continue to decline in the remaining months of FY09. Thus overall, the trade deficit for FY09 is likely to be much lower than that in FY08.