1 Overview and Economic Outlook

1.1. Overview

Despite various economic and social challenges, with the passage of months, it can be said that the country's macroeconomic environment has improved. The April 2010 inflation of 13.3 percent YoY implies that average annual inflation for FY10 will be close to 12 percent; significantly lower than 20.8 percent for the previous year. The current account deficit has also fallen sharply (see **Table 1.1**) with foreign exchange reserves improving, and, although the fiscal deficit is expected to be above target, borrowings from the central bank have so far, been relatively low, relative to past years. The resulting improvement in business confidence, together with reasonable harvests, expansionary fiscal stance, and a small recovery in the global economy have fostered growth. in FY10. Real GDP growth for FY10 is estimated at 4.1 percent against the annual target for 3.3 percent.

Table 1.1: Selected Economic Indicators

		FY08	FY09	FY10
Growth rate (percent)				
LSM	Jul-Mar	5.1	-7.4	4.4
Exports (fob)	Jul-Apr	9.9	-3.4	8
Imports (cif)	Jul-Apr	28.3	-9.8	-2.8
Tax revenue (FBR)	Jul-Mar	13.9	19.9	11.6
CPI (12 mma)	Apr	9.8	22.0	11.8
Private sector credit	Jul-Apr	15.5	1.5	5.0
Money supply (M2)	Jul-Apr	9.3	2.4	8.1
billion US Dollars				
Total liquid reserves[1]	end-Apr	12.4	11.6	14.9
Home remittances	Jul-Apr	5.3	6.4	7.3
Net foreign investment	Jul-Apr	3.8	2.2	1.7
percent of GDP[2]				
Fiscal deficit	Jul-Dec	3.5	2.0	2.7
Trade deficit	Jul-Apr	10.0	8.7	6.9
Current a/c deficit	Jul-Apr	6.7	5.5	1.7

[1] With SBP & commercial banks.
[2] Based on full-year GDP in the denominator. For FY10, provisional estimates by FBS full year GDP has been used.

But these macroeconomic silver linings accompany clouds that carry considerable risks to the fragile recovery currently underway. Despite the deceleration in inflation it remains high, and there has been resurgence in inflation in recent months. Increases in international commodity prices (particularly oil) threaten to accelerate this rising trend, and raise the risk that the external account imbalances will also increase in months ahead. The latter risk is all the more worrying given that the country is already facing problems in financing a current account deficit that is substantially lower than in the previous year. Similarly, if the fiscal deficit continues to increase, the risks to macroeconomic stability will rise, particularly if there is higher recourse to budgetary borrowings from the central bank and if the

use of quasi-fiscal operations is not contained. It should be noted that although budgetary borrowings from the central bank have so far been contained in FY10 (relative to levels in preceding years), the resulting rise in government sector credit demands means that this has been at the risk of seriously crowding out private investment. Thus, as public sector investment has reportedly also been curtailed in H2-FY10, this raises questions about the medium-term sustainability of the economic recovery.

For example, although large scale manufacturing (LSM) sector witnessed a better than expected growth during the first eight months of FY10, this has been made possible by capacities built up by investments in yester years. Thus, as business confidence improved and aggregate demand increased, LSM was in a position to respond, *despite* continuing energy shortages, law & order issues as well as financial constraints. However, if aggregate demand further gathers pace, the slowdown in investments could potentially constrain future output growth, and add to pressures on the external account and inflation.

In other words, the increase in the fiscal deficit FY08 onwards poses risks to macroeconomic stability. This impact of the fiscal deficit is compounded by the substantial increase in quasi-fiscal activities in recent years that have not only contributed to the build-up of inter-locking debt chains (circular debt) in the energy and agri-commodity sectors, but also raised the financial costs for all borrowers in the economy, restricting output growth.

Increased risk averseness of banks played an important role in slower expansion of credit to the private sectors during FY09. However, banks' ability to sustain this trend into FY10 was probably assisted by the ever-rising demand from the government sector for bank borrowings. A look at the pattern of the growth in broad money (M2) during the two years clearly testifies this argument. A substantial part of the growth in broad money during FY10, in particular, is principally due to borrowings by the government sector (see **Table 1.2**).

Table 1.2: Contribution of Government Sector to M2 growth (Jul-Apr)
flows in billion Rupees, growth in percent

	Flows		Growth	
	FY09	**FY10**	**FY09**	**FY10**
Broad money (M2)	114.1	414.0	2.4	8.1
of which				
Government borrowing	315.2	325.0	20.9	16.0
Credit to private sector	43.4	144.3	1.5	5.0

The existing fiscal rigidities meant that an increase in the full year fiscal deficit was probably unavoidable in FY10 given the additional need for army operations against militants, and to help the resulting internally displaced population. However, even after excluding defense services, the growth in current spending

for H1-FY10 is high at 15.7 percent YoY. Moreover, the impact of the high fiscal deficit was compounded by shortfall in external receipts. The latter contributed to lower liquidity in the banking system and problems in financing the current account deficit.

Table 1.3: External Accounts
billion US Dollar

	Jul-Apr		FY10		
	FY09	**FY10**	**Q1**	**Q2**	**Jan-Apr**
A-Current account balance	-9.0	-3.1	-0.6	-1.5	-0.9
B-Financial/capital balance	4.5	3.9	2.8	0.5	0.7

The central bank continued to inject liquidity in the banking system during most of the year to mitigate part of the impact of the pressures from fiscal and quasi-fiscal operations, but overnight rates have remained close to the ceiling during most of the fiscal year. Similarly, despite a sharp decline in the current account deficit, the overall external account position remains vulnerable, since financing receipts have also plummeted (see **Table 1.3**). It should be remembered that the sustainability of the current account depends on a country's ability to finance it (preferably from the non-debt creating inflows).

Indeed, the risks to macroeconomic stability from the fiscal and external deficits, as well as resurgence in CPI inflation were key parameters in the SBP inability to further ease its monetary stance. Ironically, it was the government's decision to lower fiscal imbalances and reduce allocational inefficiencies that proved to be a key contributor to this revival of inflation. The reduction in subsidy on power and upward adjustment in the domestic prices of key fuels following rising international prices was immediately felt in the domestic economy.

In particular, the impact of rising fuel prices on transportation was immediately seen in higher prices of food commodities. Consequently, headline inflation rose to 13.3 percent in April 2010. While sharply lower than the 17.2 percent seen in the same month of the preceding year, it was nonetheless high. Moreover, the impact was greatest on the purchasing power of low-income groups due to persistent high food inflation. The significant role of essential energy and food prices in the current CPI inflation uptrend also raises the risk of higher second round inflationary impacts.

The latter could be further compounded if imported inflation becomes a greater concern. Fortunately the substantial assistance from the IMF has supported an increase in the country's foreign exchange reserves, and underpinned the relative stability of the exchange rate. Pakistan has to move aggressively to attract fresh

investment by implementing additional reforms to increase economic efficiency and improve the business environment.

Steps to increase investment must also be accompanied by measures to foster savings. In this regard, SBP is looking to increase the access of people to the financial system, and also introducing projects to improve the transmission of policy rates to savers. The greater impact is likely to be through improving institutional savings, for which there is an urgent need to reform the institutional structure of pension and provident funds in the country, to foster the expansion of the pool of long-term savings.

1.2 Looking Forward

Initial provisional estimates by FBS are in conformity with the earlier SBP assessment of a rebound in real GDP growth; it is estimated at 4.1 percent for FY10 from an anemic 1.2 percent in the preceding year. The recovery was contributed mainly by above target growth in the livestock and LSM sub-sectors as well as the services sector.

Table 1.4: Projections of Major Macroeconomic Indicators

	FY09	FY10	
		Annual plan targets	SBP projections
growth rates in percent			
GDP*	1.2[R]	3.3	4.1
Average CPI inflation	20.8	9.0	11.5 - 12.5
Monetary assets (M2)	9.6	-	13.5 – 14.5
billion US Dollars			
Workers' remittances	7.8	7.0	8.5 – 9.0
Exports (fob-BoP data)	19.1	19.9	19.5 – 20.0
Imports (fob-BoP data)	31.7	28.7	31.0 - 31.5
percent of GDP			
Fiscal deficit	5.3	4.9	5.1 - 5.6
Current account deficit	5.7	5.3	2.2 – 2.8

Note: Targets of fiscal and current account deficit to GDP ratios are based on nominal GDP in the budget document for FY10, while their projections are based on provisional estimates of nominal GDP for the year by FBS.
R: Revised; (*): Show provisional estimates by FBS; retrieved on May 21, 2010 from http://www.statpak.gov.pk/depts/fbs/statistics/national_accounts/national_accounts.html

As far as inflation is concerned, resurgence in inflationary pressures during H2-FY10 was anticipated. However, the impact of adjustment in power tariff was further fueled by sharp rise in international prices of oil, cotton, and metals. In contrast, benefits of a fall in international prices of wheat were not passed on to the consumers, ironically, as a result of government interventions in market mechanisms. In view of these, SBP forecasts suggest that annual average headline CPI inflation will be slightly higher than estimated earlier, falling in the range of 11.5 – 12.5 percent during FY10 (see **Table 1.4**). The upward revision in the forecast range indicates that inflationary pressures strengthened in the economy.

Encouragingly, projections for current account deficit indicate an improved picture, with the deficit now expected to fall even lower, in the range of 2.2 - 2.8

percent of GDP during FY10, substantially lower from earlier forecasts of 3.2-3.8 percent of GDP and actual deficit of 5.7 percent of GDP seen in FY09. This improvement is mainly due to an impressive performance of exports and workers' remittances.

However, the fiscal performance remained lackluster. SBP estimates for fiscal deficit have been revised upwards to 5.1 - 5.6 percent of GDP. Although the main factor for pressures on fiscal accounts is rising current expenditure, a low tax to GDP ratio is also a source of concern. Implementation of value added tax (VAT) could be an appropriate remedy if supported by appropriate systems to curtail misuse of VAT refunds. Even though tax collection is likely to drop during the initial phase of implementation, tax collection and documentation in the economy will improve in later years.

Equally critical is the efficient use of taxpayers' money. Government has to reduce quasi fiscal activities and aggressively privatize loss making public sector commercial entities. Improvement in governance, institution building and effective enforcement of investor friendly laws are prerequisites for sustainable growth. Both good governance and effective legislation could attract substantial investment, which is needed to exploit the potential of the economy and accelerate employment generation. Such a structural transformation is needed to accelerate employment generation in the economy.

For example, progress is needed towards protecting intellectual property rights (IPRs) and enforcing contracts, in order to encourage innovation. While recognition and enforcement of intellectual property rights is a concern globally (particularly in emerging markets), Pakistan lags behind many countries. Similarly, the domestic construction industry could be encouraged, if tenancy laws could be reformed such that these are neither biased towards tenants nor distinctly in favor of landlords. Adoption of best international practices regarding tenancy laws may attract massive investment in housing sector and help bridge the gap between demand and supply.

Finally, the provision of basic utilities and infrastructure is equally important. While LSM has grown despite energy shortages, it is quite likely that the impact on small & medium manufacturers and traders has been quite severe, with consequent loss of output and employment. The impact of power outages on SMEs was compounded with the rising prices of key fuels and non-availability of gas. The roots of energy shortages lie, in part, in inappropriate pricing and an inefficient distribution system. The continued provision of untargeted subsidies generated a cobweb of debt in the energy sector, with negative repercussions for

output growth. For example, as a conseuqunce of a debt build-up domestic refineries and IPPs are working below capacity. On a broader note there is a need for lower direct government intervention in market prices, with market structure problems being handled by independent regulatory authorities such as the Competition Commission of Pakistan.

1.3 Executive Summary

Real Sector

Agriculture

Despite water shortages and unfavorable weather conditions during FY10, agriculture sector is expected to achieve a reasonable growth of 3.0 percent; close to the average growth of the last 10 years. Contrary to expectations that growth by minor crops would be strong due to switch over of area from major to minor crops, recent information suggests that most of the minor crops also suffered from lower winter rains during FY10.

One positive was that adequate fertilizer and agri-credit was available to undertake agri-activities during FY10. Another positive development during FY10 was a significant contribution of agriculture in exports. This resulted in relatively higher domestic prices of most surplus agri-produce, and would encourage farmers to invest to increase output.

Large-Scale Manufacturing (LSM)

After posting a modest recovery in H1-FY10, LSM growth gathered further pace in Q3-FY10. Re-entry of commercial banks in consumer financing helped strengthen the demand for consumer durables, especially automobiles, despite rising cost pressures. Moreover, export-based industries, particularly value-added textile, finally picked-up in response to improved global demand as well as domestic policies.

The rising demand was absorbed by the available capacities in LSM sector without entailing any significant pressure on prices. The trend in capacity utilization in Jul-Feb FY10, however, was mixed; it increased in case of automobiles, electronics and cement sectors, and declined in petroleum and steel mainly due to liquidity constraints. Nonetheless, it appears that despite the available capacities in many sectors, sustaining a decent growth in LSM, going forward, could be constrained due to energy insufficiency in the country.

In specific terms, supply of energy will be a major determinant of capacity utilization going forward. Particularly, industrial energy mix is progressively

shifting towards natural gas, a fuel that is also being increasingly demanded by CNG, household, and power sectors. The insignificant gas exploration activity in the country during the last few years means that the demand-supply gap has widened in recent years, which is restricting capacity utilization in many industries, especially in the small-scale sector. In the short run, there seems little hope of improvement, though rigorous gas and electricity conservation measures may offer some respite. However, in the longer-run, the construction of dams and utilization of untapped domestic coal and gas resources will be crucial to ensure sustainable industrial growth.

Prices

Headline CPI inflation (YoY) rose to 13.3 percent by April 2010, slightly higher than the 12.9 percent in the preceding month, but significantly higher than the short-term low of 8.9 percent in October 2009. Core inflation measured by 20% trimmed mean remained unchanged during April 2010. However, core inflation measured by non-food non-energy (NFNE) increased to 10.6 percent during April 2010 compared with 9.9 percent in March 2010, showing that inflationary pressures were relatively broad-based in April 2010.

The increase in inflation in recent months is attributed to a number of factors, such as: (a) higher international commodity prices, particularly crude oil, metals, pulses and cotton; (b) upward adjustment in electricity tariffs and administered domestic fuel prices; (c) relatively weak harvests amid water shortages coupled with strong growth in exports of vegetables, fruits, livestock, etc., (d) expansionary fiscal stance; and (e) recovery in domestic economy.

Money and Banking

The SBP kept its policy rate unchanged at 12.5 percent in the last two consecutive monetary policy decisions; in January and March 2010.[1] A cautious approach to easing the policy rate was adopted to strike a balance between supporting the recovery in aggregate demand while guarding against the re-emergence of macroeconomic imbalances, including a resurgence of inflation.

The recent build-up in inflationary momentum largely reflecting the power tariff rationalization drive was compounded by global commodity price pressures. The situation was exacerbated by considerable deficit monetization as the government turned to the banking system to finance the rising deficit due to higher

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[1] The policy rate was cut by a cumulative 150 bps in H1-FY10; by 100 bps in August and 50 bps cut in November 2010.

expenditures amid elusive pledged foreign inflows. Resultantly, the government breached the IMF's March 2010 quarterly ceiling for deficit monetization.

In terms of monetary aggregate, M2 registered growth of 8.1 percent for Jul-Apr FY10 compared with 2.4 percent in the corresponding period last year. The improvement in M2 resulted from a robust growth in net domestic assets (NDA) which grew by 9.8 percent during Jul-Apr FY10 against 8.3 percent growth in the same period last year. On the other hand, net foreign assets (NFA) of the banking system witnessed a moderate decline; contracting by 7.2 percent during Jul-Apr FY10 compared with steep fall of 33.6 percent in the same period last year. In line with monetary expansion, deposits of the banking industry staged a recovery. They registered robust growth of 8.6 percent during Jul-Apr FY10, in stark contrast to a contraction of 0.2 percent in the same period last year.

Fiscal Developments

The budgetary data for Q3-FY10 is not yet available, but some preliminary information suggests that the fiscal sector remained under stress and the government is likely to miss its budget deficit target. Although the FBR has regained its revenue path in the third quarter of the year and non-tax revenue also propped up by appropriation of SBP profit in a considerable amount and realization of coalition support fund of US$ 349 million, the budget deficit is expected to be higher than the target. This primarily because of higher than budgeted public expenditures.

FBR improved its performance in the 3rd quarter of the year with 26 percent growth in the tax receipts. However, going forward, tax revenue target for FY10 will remain challenging as it would require a YoY growth of 37.6 percent during Q4-FY10 in order to attain Rs 1.38 trillion tax collection (budget) target for the year; compared with 5-year average tax revenue growth in the last quarter at 15.7 percent.

The aggregate government borrowing from domestic sources stood at Rs 535.3 billion during July-Mar FY10, which is significantly higher than the domestic budgetary requirements in the corresponding period of FY09. With shortfall in external borrowing for budgetary support, the widening budgetary imbalance was predominantly financed from banking system during Jul-Mar FY10 raising risks of crowding out of private investment.

External Sector

Balance of Payments

Aided by lower imports and sustained inflow of remittances, the current account deficit during Jul-Apr FY10 remained significantly lower than in the corresponding period last year. The impact of this improvement on overall external balance was, however, limited due to considerable fall in capital and financial account surplus during the period.

Apart from lower imports (accompanied with lower freight costs) and strong increase in current transfers, YoY contraction in current account deficit during Jul-Apr FY10 was also attributed to lower payments on account of repatriation of dividends and interest on debt. Likewise, lower outflows from foreign exchange companies and nominal increase in exports also contributed to this improvement in current account deficit.

On the financing side, however, surplus in financial account declined noticeably during Jul-Apr FY10 compared with the same period last year. This deterioration was on account of both, fall in equity and loan inflows. As a result, overall external account for Jul-Apr FY10 period recorded only a nominal surplus.

Country's reserves, nevertheless, improved by US$ 2.2 billion owing largely to one off SDR allocation by the IMF. Moreover, exchange rate also exhibited relative stability; depreciating by 3.9 percent during Jul-Apr FY10 as compared to 16.2 percent in the same period last year.

Trade Account

Trade deficit contracted by 13.9 percent during Jul-Apr FY10 against 15.6 percent decline recorded in the same period last year. This contraction in the trade deficit was the result of a 2.8 percent YoY fall in the imports, which was complimented by an encouraging 8.0 percent YoY rise in the exports.

The contraction in import bill was due to lower input prices that reduced the import bill in the first five months of FY10. This negative price impact more than offset the rise in quantum of imports during almost the entire Jul-Apr period. The recovery in exports was broadly led by food and textile group. In case of food group, exports increased on account of rise in quantum of rice, fruits and vegetables. Textile exports on the other hand, benefited from rise in the low value added categories exports, that is, raw cotton and cotton yarn.