1 Overview and Outlook

The analysis in this report is confined to the period July-March FY12.

Although Pakistan's economy has shown some recovery in terms of GDP growth, key macro indicators still remain weak. Specifically, while inflationary pressures have eased compared to last year, inflation expectations are entrenched; the deterioration in the external account has been less adverse than expected, but financing the current account deficit remains challenging; and lastly, despite strong growth in tax collection, there are pressures on the fiscal account. Furthermore, energy shortages and low investment continue to compromise the economy's capacity for growth.

According to the recently released official National Income Accounts, economic growth is 3.7 percent during FY12 – higher than the 3.0 percent realized in the previous year, but less than the target of 4.2 percent.[1] Nevertheless, this performance is notable, given the considerable damage to the cotton crop due to floods in August 2011; ongoing energy shortages; the rise in international oil prices; and security concerns.

This growth has also been more broad-based with a larger contribution from the commodity producing sectors compared to FY11. Moreover, as in the past, growth has been driven by a sharp increase in domestic consumption (both private and public), which was

Table 1.1: Selected Economic Indicators

		FY10	FY11	FY12
Growth rate (percent)				
LSM	Jul-Mar	0.4	-0.6	1.1
Exports (fob-PBS)	Jul-Mar	5.2	26.0	-3.0
Imports (cif-PBS)	Jul-Mar	-3.9	15.6	14.7
Tax revenue (FBR)	Jul-Mar	11.6	12.2	25.5
CPI (period average)[1]	Jul-Mar	9.4	14.0	10.8
Private sector credit	Jul-Mar	4.7	7.1	6.4
Money supply (M2)	Jul-Mar	6.0	9.4	8.1
billion US dollars				
Total liquid reserves[2]	31st Mar	15.0	17.7	16.5
Home remittances	Jul-Mar	6.6	8.0	9.7
Net foreign investment	Jul-Mar	1.2	1.3	0.4
percent of GDP[3]				
Fiscal deficit	Jul-Mar	4.2	4.3	4.3
Trade deficit	Jul-Mar	4.6	3.8	5.0
Current a/c deficit	Jul-Mar	1.8	0.0	1.3

[1] Base year-FY08
[2] With SBP & commercial banks
[3] Based on full-year GDP in the denominator
Source: State Bank of Pakistan

---

[1] One may keep in mind that GDP growth for FY11 was revised upward from 2.4 percent (provisional estimates) to 3.0 percent, which means a base-effect has come into play.

partially offset by a decline in domestic investment and external demand. The continuous decline in investment for the fourth consecutive year, is a source of growing concern, as it will stifle the long term growth of the economy.

Energy shortages continue to constrain growth and conservation efforts alone cannot bridge the shortfall. During Jul-Mar FY12, power generation recorded a marginal increase, with no notable rise in gas supplies. At the same time, and despite efforts to resolve the circular debt problem, liquidity constraints in the power sector have worsened due to higher international oil prices.

While these challenges will continue to shape the outlook for the economy, it is important that GDP data should reflect the changing nature and composition of the country's economic activities. Pakistan Bureau of Statistics (PBS) is already in the process of rebasing the national income accounts. We expect that PBS would also consider releasing GDP estimates on a quarterly basis, which is now a norm in emerging markets. It will help get a more accurate and timely picture of the real economy, which will allow for more proactive policy corrections.

While low investment and energy shortages have direct growth implications, the persistently high fiscal deficit remains a major risk to the macro-economy. Current information suggests a budget deficit of 4.3 percent of GDP for Jul-Mar FY12, and it appears that the budgetary gap for the full year will exceed the revised target of 4.7 percent. Overall revenues are lower than expected.[2]

Furthermore, though the growth in current expenditure is lower compared to the previous year, the government has enhanced its development spending.[3] While such spending should improve the country's long-term growth prospects, this also creates financing pressures. At the same time, despite efforts to reform public sector enterprises, the operational efficiency of key PSEs (e.g. PIA, Pakistan Railways and Pakistan Steel) has not improved. This continues to add to the country's fiscal burden.

In terms of financing this gap, the government relied more on domestic sources as external financing dried up. The government borrowed Rs 847.5 billion in Jul-

[2] While FBR tax collection posted strong growth, other revenues were less than expectations. For example, auction of 3G licenses got delayed, receipts of coalition support fund did not materialize, and provinces posted lower than expected surpluses.

[3] During Jul-Mar FY12, the consolidated figure shows that Rs 421 billion has been utilized as development spending. Although this is only 57.1 percent of the annual target, during the corresponding period of FY11, only 38.5 percent of the full year target had been used. In effect, the government has sharply increased development spending.

Mar FY12 from domestic sources, compared to Rs 700.1 billion in the corresponding period of FY11.[4] Lately, this has been increasingly skewed towards borrowing from the central bank.

Such borrowing is inflationary and a risk to macro-stability. Currently, two Acts – namely the Fiscal Responsibility and Debt Limitation (FRDL) Act (2005) and the newly amended SBP Act (2012) – provide guidelines on overall debt stocks and borrowing from the central bank, respectively. As things stand, adherence to these limits has not been met. For example, while the government was set a net quarterly limit of zero for its borrowings from the central bank, it has borrowed Rs 70.8 billion during Q3-FY12; it also borrowed Rs 227.9 billion during the second quarter.

The large fiscal deficit has resulted in a sharp increase in Pakistan's debt. Government domestic debt recorded an increase of Rs 1.2 trillion during Jul-Mar 2012 to reach Rs 7.2 trillion. Furthermore, there is greater reliance on short term borrowing. This is creating liquidity management problems for the central bank, and *rollover* and *interest rate* risks for the government.

This challenge can be gauged from the T-bill auction calendar for Q4-FY12. The target amount for the fourth quarter is Rs 995 billion; of that, Rs 964.3 billion is simply to rollover maturing T-bills. With a change in banks' preference towards 3-month T-bills, it is expected that the maturity profile of the existing debt may shorten further, which would, in turn, make SBP's liquidity management even more difficult.

So far, SBP has been providing liquidity support to the market to ensure the smooth functioning of the financial markets and payment systems. Although this is meant to be temporary liquidity support, it appears to have become a permanent feature. Needless to say, these injections have inflationary implications.

Although inflationary pressures have eased as compared to last year, inflationary expectations are still entrenched, and headline CPI inflation remains in double digits.[5] More importantly, the diffusion of inflation across different commodity

[4] This excludes borrowing of Rs 391 billion to partially settle the payables in the energy and commodity sectors.
[5] Inflation had rebounded to double digit after receding to below 10 percent for only one month. The re-surge in inflation was expected (passing on of higher international oil prices and the revision in gas tariffs; government borrowing from the central bank accelerated during the quarter; and increased energy shortages in the winter worsened aggregate supply).

groups has increased. In this context, increase in government borrowing from SBP may further stoke inflationary expectations.

With the government's growing appetite for funding, banks have little incentive to finance the private sector. At the same time, demand for private sector credit is likely to be dampened this year, as loans to private businesses increased by only 1.8 percent in Jul-Mar FY12 – the lowest growth rate in the past 10 years. The slowdown is concentrated in working capital and trade financing.[6] However, there are indications that fixed investment loans have bottomed out.

Finally, in the external sector, developments in Q3-FY12 were less adverse than we had expected. Larger inflows of remittances and a lower trade deficit, explain this relative improvement. Having said this, the current account deficit during Jul-Mar FY12 is US$ 3.1 billion, compared to a deficit of US$ 10.0 *million* in the corresponding period last year. More importantly, the expected inflows under Coalition Support Fund (CSF); the auction of 3G licenses; and arrears from PTCL privatization, did not materialize during the quarter. Nevertheless, foreign exchange reserves fell to US$ 16.4 billion by end-March 2012, from US$ 18.2 at end June 2011. SBP's reserves declined throughout FY12, whereas FX reserves of scheduled banks increased during this period.

The lower trade deficit during Q3-FY12 is particularly welcome when seen in the context of domestic energy shortages; international oil prices; and the sluggish recovery in global demand.

Looking forward

As mentioned earlier, persistent inflation and pressure on the fiscal and current accounts, remain the key challenges for the economy.

Given the recent trend in CPI inflation, SBP has revised its forecast downward by 0.5 percentage points (see **Table 1.2**). On the other hand, despite the lesser than expected pressures on external account in Q3, SBP maintains its forecast for the current account deficit for the year.

Finally, in terms of the fiscal deficit range, the upside risk dominates given efforts to resolve the circular debt problem; continuing losses in public sector enterprises;

[6] This is due to decline in cotton prices, partial settlement of circular debt, government support to sugar industry, retirement under foreign currency loans following depreciation of the Rupee against the US Dollar.

impediments in CSF; and the realization that receipts from the auction of 3G licenses is unlikely to be materialized this fiscal year.

Table 1.2: SBP Projections of Major Economic Indicators

		FY12	
	FY11	Targets	SBP Projections
Growth rates in percent			
GDP	2.4	4.2	3.7[1]
Average CPI Inflation	13.7	12.0	10.5-11.5
Monetary assets (M2)	15.9	-	13.0-14.0
Billion US Dollars			
Workers' remittances	11.2	12.0	13.0-13.5
Exports (fob-BoP data)	25.4	25.8	24.0-25.0
Imports (fob- BoP data)	35.8	38.0	40.0-40.5
Percent of GDP			
Fiscal deficit	6.6	4.7[2]	5.5-6.5[3]
Current account deficit	-0.1	0.6	1.5-2.5

Note: Targets of fiscal and current account deficit to GDP ratios are based on Nominal GDP in the budget document for FY12, while their projections are based on FBS provisional estimates of nominal GDP for the year.

[1] This shows PBS provisional estimates, instead of SBP's projections.

[2] This is the revised fiscal deficit target for FY12; original target was 4.0 percent of GDP.

[3] Upper end of the range assumes slippages in FBR tax revenues, zero receipts from 3G licenses, shortfall in Coalition Support Fund, balance budget of provincial governments, and overrun in expenditures.

Afterthought[7]

If one looks objectively at Pakistan's economy, it is clear that the system is facing serious challenges. The list is familiar: fiscal pressures that require an increasing volume of domestic financing; an energy shortage that entails economic and social costs; low investment that is undermining future growth; issues with law and order; and the neighboring war in Afghanistan.

At the risk of making too fine a point on the matter, Pakistan's economic data appears to suggest two things: first, that Pakistan has fallen behind its neighbors in South Asia; and two, even this below-potential growth is quite impressive when seen in the context of the challenges mentioned above. In our view, the latter point is not widely appreciated.

There is a growing sense that Pakistan's undocumented economy (the informal sector) is vibrant, and that official data understates the level of economic activity that can be seen. In effect, there seems to be a disconnect.

This disconnect becomes more obvious when one observes the economic plight of EU countries, which are barely able to contain the fall-out of the debt crisis that could threaten the very existence of the Euro. Since countries like Greece; the UK and Spain are now officially in recession, the telltale signs of a recession are worth listing:

[7] This section contains the thoughts of Dr Mushtaq A Khan, Chief Economic Adviser, SBP.

- Curtailed consumer demand (especially for consumer durables), as uncertainty takes hold;
- The resulting closure of small businesses;
- A slump in demand for luxury services like restaurants; cinema and overseas travel;
- A reduction is retail volumes and normal traffic flows;
- Construction activity slows down; and
- A growing number of unemployed mingling with a shrinking number of buyers in markets and shopping malls.

We do not really see this in Pakistan. Granted this is anecdotal as there is little hard data to verify this view, but anecdotal evidence is often the most current source of information to gauge how the economy is actually performing.

It is a stylized fact that the informal sector in Pakistan is buoyant, and is generating jobs; incomes; and demand for goods and services. This, in turn, is spilling over into the real sector that is documented. Hence, as discussed in Chapter 2, there are clear signs that construction is up, which is helping ancillary sub-sectors like steel; cement; chemicals; wood; glass; paints; etc.

Many would argue that a vibrant informal sector is a blessing, as it is driving formal economic activities, and keeping Pakistan from a full blown recession as seen in Europe. Furthermore, the increasingly precarious social safety net that is stoking public anger in Europe, may not be relevant in Pakistan where the extended family and community steps in to take care of the elderly, the unemployed, and the destitute. Although we would concede these points, it is important to keep things in perspective.

While social institutions like the extended family; mosques; neighborhood charities; ethnic/community organizations; etc., are robust and sustainable sources of social and economic uplift, the role of the state (beyond official safety nets) cannot be eliminated. More specifically, physical infrastructure and other public goods (e.g. security; law enforcement; judicial services and contract enforcement; recreational spaces; etc.) would be undersupplied by private organizations, which are required to promote sustainable economic activities. If the mind-set of absolute self-sufficiency becomes more entrenched, it may segment the economy.

As shown by the growing strength of Asian countries in the global economy, seeking larger markets that allows for economies of scale and specialization is necessary for economic prosperity. In this context, despite innate resistance, Pakistanis must accept documentation and the need to pay their taxes. Only this will ensure the state has the resources to create and maintain the type of the platform needed for higher and sustained economic growth.