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Economy needs effective policies and reforms to regain stability: SBP First Quarterly Report

Pakistan needs effective policies and implementation of reforms in fiscal year 2008-09 (FY09) to regain macroeconomic stability and meet economic challenges, according to State Bank of Pakistan's First Quarterly Report for FY09 released today.

The Report, however, pointed out that the sense of crisis gripping the country'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 International Monetary Fund.

It said the disbursement of the first tranche of $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, export growth has strengthened and import growth moderated somewhat. "This lent strength to the rupee, reducing the impact of an important generator of inflationary pressures," it added.

The Report said 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," it said and added 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 Report said and added 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," it added.

However, notwithstanding the relative positives, there is no room for complacency, the Report asserted. "While many of the country's macroeconomic indicators may no longer be worsening, the imbalances are nonetheless still quite large," it said and added 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.)," it said.

The Report said that real Gross Domestic Product growth is likely to be significantly lower than the annual target and inflation will breach its target with a wide margin. On a positive note, however, both fiscal and current account deficits are estimated to improve in FY09, it added.

It pointed out that amongst the biggest challenges for the Government will be to ensure the pass through of the decline in international commodity prices to consumers. In this background, while recent downward adjustments in the administered prices of key fuels is appreciable, transport fares and goods transportation charges were "either not adjusted downwards or saw small changes", it said.

The Report maintained that global recession and risk averse behavior of investor would likely to severely impact international trade and level of foreign exchange inflows in the economy. "SBP estimates for both imports and exports have been revised downwards, with a more pronounced effect on imports," it said and added 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, foreign direct investment inflows may be substantially lower than in recent years, in which case, pressures on foreign exchange 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," it added.

According to SBP's First Quarterly Report 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 tonnes, a small improvement in cotton production during *Kharif* FY09, supported by the possibility of a record wheat harvest," it said and added initial information also raises the possibility of a very good showing by minor crops and reasonable growth in the livestock sub-sectors.

However, 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, as seven sub-sectors (having 72.4 percent weight) out of fifteen registered a decline, while three (having 15.3 percent weight) registered a growth of less than one percent, it said.

"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 parity and most importantly, weak external demand on the back of global recession and slowdown in domestic demand," it pointed out.

Referring to services sector, the report said that the 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," it added.

According to the Report, 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 wholesale price index inflation has been observed during the later months, it said.

The Report said that the State Bank 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. It said 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, it added.

Referring to fiscal developments, the Report said that 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, it added.

The Report said 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 17.5 percent against the US dollar by end-October 2008, before recovering somewhat after Pakistan gained IMF support for a macroeconomic stabilization program.

The Report said that during July-November period of 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 $1.4 billion compared to the same period last year. However, the combined impact of lower commodity prices and easing of domestic demand pressure are likely to reduce the trade deficit going forward, it added.

The detailed Report can be accessed at SBP's website www.sbp.org.pk.

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