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Economy grows by 2.4% in FY11 despite devastating floods: SBP Annual Report

Pakistan's economy managed to grow by 2.4 percent in fiscal year 2010-11 (FY11), despite devastating floods in the early part of FY11, says the State Bank's Annual Report on the State of the Economy released today.

It said that one-fifth of the country's agricultural heartland was inundated, which interrupted production processes and disrupted the subsequent supply of both labor and capital. It is estimated that 6.6 million of Pakistan's labor force was out of work for 2 to 3 months, and capital stock worth US$ 2.6 billion (1.2 percent of GDP) was lost, the Report added.

SBP Report said that while the international response to the devastation was below expectations, it is commendable that the government was able to address these challenges despite severe fiscal constraints. Furthermore, the inherent resilience of the agri. sector allowed it to post a bumper wheat crop in the rabi season and sizable production of minor crops (potato, onion, pulses, etc.), which spearheaded the revival, the Report said, adding that a spontaneous community effort towards rehabilitation and government support in the form of cash payments to flood affectees and providing free seeds and fertilizers, allowed the country to overcome this natural disaster.

According to the Report, the manufacturing sector suffered a serious setback. Industrial growth was negative 0.1 percent in FY11, due to flood-driven supply chain interruptions; prolonged power outages; and reduction in gas supplies. Services, on the other hand, supported growth on the back of a rise in government salaries and defense spending. The overall growth in services was 4.1 percent in FY11, which was lower than the target 4.7 percent, but this still accounted for 90 percent of real GDP growth, the Report added.

It said that Pakistan's fiscal position remained under stress during FY11, with a budget deficit of 6.6 percent of GDP, compared to a target of 4.0 percent. The implementation of the reformed general sales tax; the broadening of the income tax net to include agriculture and services; the phasing out of subsidies in a timely manner; and the restructuring of loss-making public sector enterprises – were either delayed, or not implemented, the Report added.

On a positive note, the government was able to contain its spending compared to FY10. Budgetary expenditure in FY11 was 18.9 percent of GDP, against 20.5 percent in the preceding year, the Report said, adding that the large fiscal deficit directly impacted Pakistan's debt burden, as the stock of public debt and liabilities (accumulated deficits) posted an increase of Rs 1,763 billion in FY11, to Rs 11.0 trillion (60.9 percent of GDP). Interest payments alone accounted for 32.8 percent of government revenues last fiscal year, which means a further squeeze on the government's ability to use fiscal policy to promote economic growth, it added.

However, Pakistan's external debt remains comfortable, especially within the context of the acute problems facing the Eurozone, the Report said and added that during FY11, most of the increase was on account of currency revaluation, as the dollar lost value against other hard currencies. The funding that Pakistan actually received during FY11 was largely utilized for the servicing of external debt, it added.

SBP Report stressed that the financing of the fiscal deficit was, and still remains, challenging. 'With a decline in external funding following the suspension of the IMF Stand-By Arrangement (SBA), the government had little choice but to rely increasingly on domestic sources. During FY11, the government borrowed Rs 1.1 trillion from domestic resources, which accounted for 91.0 percent of the fiscal deficit,' it said, adding that within domestic sources, the heavy reliance on commercial banks not only crowded-out the private sector, but also complicated monetary management, as banks focused increasingly on short-term T-bills to place their surplus liquidity.

As a result, private sector credit only grew by 4.0 percent in FY11, as compared to an increase of 74.5 percent in government borrowing from commercial banks, it said adding: 'In our view, since commercial banks were lending to the government at attractive rates, this left little incentive to fund private businesses.'

It said that retail prices also increased because of supply side factors, including the impact of floods and the rise in international commodity prices. 'Food inflation was particularly hard hit, posting a sharp 21.3 percent year-on-year increase in September 2010, compared with 10.4 percent in the same month a year earlier – food inflation remained about 19 percent in the first half of FY11, SBP Report said, adding that with headline CPI inflation also in double-digits throughout the year (it averaged 13.7 percent for the year), SBP resorted to monetary tightening with an increase in the policy rate from 12.5 percent in end-FY10, to 14.0 percent in November 2010 – for the remaining part of FY11, the policy rate was kept unchanged.

Acknowledging the importance of energy as a key factor of production, the Report devoted a full chapter to assess Pakistan's energy shortage. It pointed out that the government's response to energy shortfall was threefold: (1) commissioning of rental power projects (RPPs); (2) resolving circular debt issue by injecting Rs 120 billion; and (3) increasing electricity tariffs to pass on the higher cost of production. In spite of these measures, the overall situation remained largely unchanged.

The Report said that commissioning Rental Power Projects (RPPs) to increase generation capacity was misplaced, as Pakistan is operating well below its installed capacity due to the circular debt problem. It also noted that the Rs 120 billion injected by the government (to restart the funding of furnace oil) only happened in May 2011. In effect, for most of FY11, the acute problems in the power sector went unaddressed, the Report added.

Presenting the FY12 projections, the SBP Report said: 'we project GDP growth to be in the range of 3-4 percent' and added that the likelihood of achieving the non-tax revenue target (as shown in Federal Budget) is also low for several reasons. 'In view of this, SBP projects a fiscal deficit of 5.5 to 6.5 percent of GDP, with a bias on the upside,' it said, adding: 'In our view, policymakers may consider formulating a comprehensive medium-term fiscal reform masterplan, which is staggered and sequenced on the basis of the hard lessons of the recent past.' 'Coordinated documentation; transparent collection with oversight; an equitable plan to capture all commercial businesses and institutions into the tax net; a restructuring agenda for loss-making PSEs; and a credible enforcement mechanism, must anchor this masterplan,' the Report added.

SBP expects inflation to be within a band of 11.5 – 12.5 percent in FY12, which is broadly in line with the Annual Plan target of 12 percent,' the Report added.

On the monetary policy side, the Report said, the sharp cut in the discount rate in FY12, has surprised the market. 'With inflation easing somewhat and banks increasingly inclined to place funds with the government, the degree of crowding out of the private sector required policy intervention' it said, adding that although SBP is still watchful to ensure that lending rates do not become negative in real terms, we share global concerns about stagnant growth and rising unemployment.' SBP identified a window of opportunity, whereby private investment and employment generation would be given due importance, the Report said adding that there was also a need to halt the growing dominance of debt servicing in the federal budget.

'Finally, the outlook for Pakistan's current account balance remains a source of concern, but we remain hopeful of some upside on strong worker remittances and a possible recession in the global economy,' the Report said and added: 'Although data for the first four months of FY12 shows a current account deficit of $1.6 billion, we attribute this to temporary events (bulky oil payments and a seasonal pause in remittances in September 2011, and an engineered shortage of hard currency in the parallel FX market).' Going forward, we expect a current account deficit of 1.5 to 2.5 percent of GDP, which is relatively small given our past performance, it said, however adding that the financing of this current account deficit could be challenging.

'We also think the market is over-reacting to Pakistan's FX debt payments in FY12. One must realize that while repayments on the IMF's US$ 8.9 billion SBA will start this fiscal year, outflows are only US$ 1.4 billion and are scheduled for the latter half of the fiscal year, the Report pointed out.

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