1 Economic Outlook

1.1 Overview

A variety of adversities took a heavy toll on Pakistan's economy during FY09. The previous fiscal year had ended with both, the fiscal and current account deficits at record highs, amid sustained increase in inflationary pressures. These macroeconomic stresses worsened in the initial months of FY09. Inflationary pressures continued to mount, reflecting the pass through of rising commodity prices in the international markets, and the excess domestic demand pressures in the economy that were supported by the lagged impact of the monetization of fiscal deficit. The resulting demand stimulus, also fed the already unsustainable current account deficit, which continued to grow.

The impact of these developments on the domestic economy was compounded by the worsening global financial crises that severely dented global aggregate demand, decimated liquidity in the international capital markets, and reduced investor confidence. Pakistan saw a sharp reversal of the earlier net portfolio investment receipts, and foreign direct investment flows fell sharply, even as the access to international capital markets disappeared. The decline in capital and financial account receipts (net foreign investment declined by 51.1 percent during FY09 on top of a 35.3 percent decline in the previous year), in the face of a widening current account deficit, led to a substantial depletion of the country's foreign exchange reserves, severe reduction in domestic liquidity, and a further impetus to domestic inflation (as the exchange rate depreciated).

The worsening macroeconomic fundamentals also began to seriously impinge on the real economy as purchasing power was being rapidly eroded by stubbornly high inflation and the impact on production was worsened by a crippling energy crisis (partly due to the evolution of a chain of unpaid receivables, i.e., the energy sector circular debt), an uncertain law & order situation, and increasingly conservative lending by domestic banks. The widening macroeconomic imbalances and rapid depletion of the country's foreign exchange reserves raised serious risks to the domestic economy that finally forced economic authorities to implement an aggressive, macroeconomic stabilization program, with the support of an IMF Stand-By Arrangement. This program emphasized effective fiscal tightening (mainly through phasing-out subsidies) and implementing tax reforms, with support from a tight monetary policy.

The crux of the macroeconomic policy involved tightening monetary and fiscal conditions to contain the demand for domestic goods (to curb inflationary pressures), foreign goods (to cut imports and mitigate exchange rate pressures), as well as other measures to remove (or ease) structural bottlenecks.

The macroeconomic stabilization program in FY09 resulted in considerable fiscal consolidation during the year. Specifically, overall fiscal deficit dropped to Rs 680.4 billion during FY09 from Rs 777.2 billion in the preceding year. As a percentage of GDP, the fiscal improvement led to a reduction in the budget deficit by 2.4 percentage points to 5.2 percent during FY09 (see **Table 1.1**). The consolidation of fiscal balance largely represents a steep deceleration in the growth of total expenditures.

The decline in fiscal spending in FY09 was mainly evident in the removal of subsidies as well as cut in development expenditures. In particular, government improved the pass-through of international oil price to the domestic economy,[1] and reduced some energy-related subsidies. It also sought to address the circular debt issue that had led to liquidity shortages in energy sector companies,

---

[1] For instance, electricity tariff for industrial use increased by 23.8 percent (12-m moving average) in FY09 compared with 14.9 percent in FY08.

hindering the already constrained power supply and hampering domestic production. The efforts at fiscal consolidation through reduction of development spending were less welcome, contributing directly to the slowdown in the construction sub-sector.

Table 1.1: Selected Macroeconomic Indicators

						FY09	
	FY04	FY05	FY06	FY07	FY08	Targets	Actual
				percent			
Real GDP (at factor cost)[1]	7.5	9.0	5.8	6.8	4.1	5.5	2.0
Agriculture	2.4	6.5	6.3	4.1	1.1	3.5	4.7
Major crops	1.7	17.7	-3.9	7.7	-6.4	4.5	7.7
Manufacturing	14.0	15.5	8.7	8.3	4.8	5.5	-3.3
Large-scale	18.1	19.9	8.3	8.7	4.0	6.1	-7.7[2]
Services sector	5.8	8.5	6.5	7.0	6.6	6.1	3.6
Consumer price index (FY01 =100)	4.6	9.3	7.9	7.8	12.0	11.0	20.8
Sensitive price indicator (FY01 = 100)	6.0	11.1	7.8	9.4	14.2	-	22.7
Monetary assets (M2)	19.6	19.3	15.2	19.3	15.3	14.0	9.6
Private sector credit	34.3	34.4	23.5	17.3	16.5	-	0.7
Exports (f.o.b.)	10.3	16.9	14.3	3.2	12.2	16.0	-6.7
Imports (c.i.f.)	27.6	32.1	38.8	6.9	30.9	6.5	-12.9
Official liquid FE reserves[3] (million US$)	12,389	12,598	13,122	15,646	11,399	-	12,425
				As percent of GDP			
Total investment	16.6	19.1	22.1	22.5	22	21.5	19.7
National savings	17.9	17.5	17.7	17.4	13.4	14.3	14.3
Total revenue	14.1	13.8	14.2	14.9	14.6	14.7	14.1
Tax revenue	9.8	9.7	9.9	10.2	10.2	10.7	9.2
Budgetary expenditure	16.4	17.2	18.5	19.2	22.1	19.5	19.3
Budgetary deficit	2.3	3.3	4.3	4.3	7.6	4.7	5.2
Current account balance	1.8	-1.4	-3.9	-4.8	-8.4	-	-5.3
Total debt (including explicit liabilities)	71.4	65.8	59.5	57.9	62.4	-	62.2
Domestic debt	35.1	32.8	30.1	29.9	31.8	-	29.4
Foreign debt	34.4	31.3	28.2	27.0	29.5	-	31.5
Explicit liabilities	2.0	1.7	1.3	1.0	1.1	-	1.3

[1] During FY09 sectoral shares in GDP were as follows: agriculture (21.8 percent), industry (24.3 percent) and services (53.8 percent).

[2] Jul-June FY09 growth rate is -8.2.

[3] Foreign exchange reserves include CRR/SLR on FE-25 deposits.

Note: Targets are based on Annual Plan, Trade Policy and Annual Budget Statement for FY09

With fiscal and monetary policies both moving to restrict demand, there was a visible decrease in aggregate demand pressures in the economy. The deceleration in aggregate demand received a further impetus from the continuing (albeit lower) macroeconomic imbalances, weak investor confidence, energy shortages, and the continued risk-averse behavior of domestic financial institutions. The impact of this was most evident in the large scale manufacturing (LSM); growth in this sector had already turned negative by the final month of FY08, and this trend gathered pace through all of FY09, resulting in the largest-ever (and longest continuous monthly) decline in Pakistan's history. Largely as a consequence of the negative 8.2 percent annual growth in LSM, real GDP growth for FY09 dropped to 2.0 percent – the lowest in the last eight years.

The weakness in the domestic economy would have been even greater were it not for above-target growth by agriculture sector, despite weaker growth in fertilizer off-take, largely helped by prevailing higher prices of agri-produce and favorable weather. The performance of agriculture sector was key to the achievement of positive GDP growth in FY09, as it also provided support to services sector growth, through increased trading, transportation, and storage activities. Another positive impact of this remarkable growth was a significant improvement in supply of key staples, which also helped contain food inflation.

All of the above developments were reflected, November 2008 onwards, in a sharp slowdown in net private sector credit growth and a contraction in current account deficit. The collapse of private sector credit in H2-FY09 resulted in a net annual contraction of 6.0 percent; though the second-half of each year generally coincides with retirement phase of credit cycle, the decline in credit during H2-FY09 was exceptional. More importantly, this was a broad-based phenomenon, as (a) a large number of industries have witnessed substantial retirement during H2-FY09; and (b) the slowdown was visible in both incremental demand for running finance and in fixed investment loans.

The combined impact of the fiscal consolidation and the weaker private sector activity meant that money supply growth dropped to 9.6 percent in FY09 from a robust growth of 15.3 percent last year.[2] The reduction in reserve money growth was even steeper, dropping from 22.3 percent in FY08 to only 1.9 percent in FY09, primarily due to rapid depletion in the net foreign assets of SBP.

In addition to the weakening aggregate demand, the contraction in the current account deficit, November 2008 onwards, was aided by the lagged impact of declining international commodity prices. The pass-through of this decline in the domestic economy was muted by the substantial depreciation of the rupee, as well as market structure issues (e.g., due to non-competitive markets, lower domestic fuel prices did not lead to a fall in transportation charges), the lower international prices did eliminate (or at least weakened) one factor *fueling* inflationary expectations.

However, the slowdown in exports was disappointing but not unexpected given weakness in major economies, decline in international commodity prices and domestic energy shortages. Accordingly, SBP extended its support to the export sector by providing 100 percent refinancing facility for EFS at concessional rates, to shield the priority sector from the impact of tight monetary policy. Encouragingly, despite significant weakness, the performance of exports turned out to be better than imports, which saw a sharp decline during FY09. Another positive in the external sector was the surge in workers' remittances to US$ 7.8 billion during FY09, up by 21.1 percent. As a result of a lower trade deficit and increased remittances, current account deficit narrowed to 5.3 percent of GDP in FY09 from a record 8.4 percent of GDP in the preceding year. However, the impact of financial turmoil and global recession is evident in the declining external inflows under FDI and portfolio investment. Nonetheless, the declining monthly current account deficit, recovery in the country's foreign exchange reserves, and most importantly, the access to further bilateral and multilateral assistance following the IMF imprimatur on Pakistan's stabilization efforts substantially revived confidence in the domestic currency.

As a consequence of all these developments, inflationary pressures in the domestic economy began easing, with all key price indices depicting a clear downward trajectory of inflation in H2-FY09. In particular, CPI food inflation dropped from its peak 34.1 percent in August 2008 to 10.5 percent by July 2009, helping headline CPI inflation decline from its peak level of 25.3 percent to 11.2 percent in this period. The persistence in core inflation seen during H1-FY09, also weakened, depicting a declining trend January 2009 onwards. This downturn in inflation accelerated further in 2009. In particular, YoY CPI inflation for the year fell to 13.1 percent from its peak of 25.3 percent in August 2009.

[2] Resultantly, in terms of GDP the broad money reached to a lowest level (39.2 percent) in the last seven years.

Notwithstanding this, as the inflation levels through most of the year were high, the annual average inflation for the year was well above target. For example, the average CPI inflation for FY09 was 20.8 percent, compared to only 12.0 percent for the previous year, and significantly higher than the target of 11 percent. Indeed the annual average inflation measured by all price indices in FY09 is the highest since FY76.

The weakening of inflationary pressures in the economy, together with evidence of a declining aggregate demand and evident narrowing of the twin deficits, allowed the central bank to finally initiate monetary easing. Thus, SBP reduced its policy discount rate twice in 2009 – by 100 bps each time – in April 2009 and August 2009.

It is being argued by some analysts that in light of the 14.2 percentage point fall in CPI inflation, from the 25.3 percent peak in August 2008, to a 19-month low of 11.2 percent by July 2009, the central bank should have reduced its policy rate more aggressively, particularly in light of the continuing weakness in growth. However, multidimensional risks to the nascent recovery guided the SBP to adopt a more measured monetary response. These risks include the following:

Table 1.2: Major Economic Indicators

		FY10	
	FY09	**Annual Plan Targets**	**Projections**
Growth rates in percent			
GDP	2.0	3.3	2.5-3.5
Average CPI Inflation	20.8	9.0	10.0 - 12.0
Monetary assets (M2)	9.6	-	12.0 - 13.0
Billion US Dollars			
Workers' remittances	7.8	7.0	7.5 - 8.5
Exports (fob-BoP data)	19.2	19.9	18.0 - 19.0
Imports (fob- BoP data)	31.7	28.7	30.5 - 31.5
Percent of GDP			
Fiscal deficit	5.2	4.9	4.7-5.2
Current account deficit	5.3	5.3	4.7-5.2

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.

1. Despite some slowdown, core inflation remained high; pointing towards persistence of inflationary pressures in the economy. Further, month-over-month (MoM) inflation also indicates that strong inflationary pressures are re-emerging.

2. Recent upward movement in international commodity prices, particularly crude and palm oil, as these may also strengthen domestic inflationary expectations. Effective from September 1, 2009, an upward revision in the domestic prices of key fuel and its downstream impact on transport fares indicates the seriousness of these risks.

3. An expected recovery in domestic manufacturing sector coupled with rising international prices would adversely impact external imbalances. A small recovery in import growth in July 2009 is a case in point. It must be remembered that the international financial environment is not favorable. This means Pakistan will face challenges in financing even a relatively small current account deficit. This challenge would become all the more formidable if there are slippages in expected foreign exchange receipts or widening of the current account deficit.

4. Weak fiscal position with a rigid expenditure block (as there is a need to increase spending on priority areas such as infrastructure development and post-conflict rehabilitation), together with the risk of slippages on revenue targets, raises risks to overall macroeconomic stability.

   In particular, expectations about fiscal deficit, to fall from 7.6 percent of GDP to 4.3 percent in FY09, proved incorrect due to the combined impact of shortfall in tax revenues and breaches in current expenditures. It may be noted that this slippage was probably unavoidable given unforeseen circumstances in terms of the substantial military operations against the militants in northern Pakistan and consequents costs of supporting IDPs and their rehabilitation.

The macroeconomic stabilization program has led to considerable improvements in key indicators, helped by favorable exogenous developments, and provided the foundations for a gradual shift from stabilization polices towards those fostering a resumption of growth. However, the improvements in the economy are still fragile, and could be reversed in short run by adverse shocks or any failure in the disciplined implementation of supportive reforms.

1.2 Looking Forward

A gradual recovery is underway during FY10, and real GDP growth is likely to be close to the target of 3.3 percent for the year (see **Table 1.2**). Signs of recovery include: (a) a rise in imports during July 2009, which points towards a possible pick up in domestic demand; (b) decline in LSM growth was only 4.4 percent YoY by June 2009 relative to a record 20.7 percent YoY fall recorded in March 2009; and (c) resolution of circular debt problem would also support production activities in oil and energy sectors.

The anticipated recovery may also be supported by the re-stocking of inventories and a small recovery in exports as the incipient recovery in major economies gathers pace. Consequently, growth in LSM production is likely to turn positive during the first quarter of FY10.

However, as clearly illustrated by developments in the last two years, and given the weak global economy, the most sustainable impetus to Pakistan's economy will have to come from the agriculture. Given favorable weather, and in light of high prices of agri-commodities, and supportive government policies, agri-sector performance is expected to be close to the FY10 target. In the medium to long term however, the upside potential is far greater, with heavy investments required in the sector to improve yields, lower post-harvest losses, improve water management, and increase value addition. This investment would ensure food security for the country (see **Box 1.1**), help contain inflationary pressures, lower the import bill, and offer considerable export prospects, in addition to the considerable potential for employment.

Moreover, a sharp fall in inflation in recent months has reduced uncertainty over relative prices and would support increase in investment demand. However, there remain significant risks to the inflation outlook as indicated earlier, although current SBP projections indicate that average annual inflation for FY10 is likely to drop to around 10-12 percent. While this is a little higher than the FY10 target of 9 percent, it still represents a significant improvement over the 20.8 percent figure for FY09.

The external sector too is expected to show a continuation of positive recent trends. Exports are expected to pick-up a little, especially if the energy crisis eases, helped by favorable exchange rate trends. Similarly the strong growth in remittances may continue, aided by the new initiative fostering increased usage of the formal system, and the concurrent crack down on illegal activities of exchange companies. Recently, as Pakistan's macroeconomic picture stabilized, portfolio flows have also resumed. This said, considerable risks remain, as imports are also expected to revive, and there are also risks that some anticipated foreign exchange flows may not be forthcoming or may be delayed.

Over the longer term, there are significant shifts already underway in international trade and commerce following the onset of the recent international crisis. Many Asian economies that suffered serious output losses due to their earlier focus on major Western economies are raising questions on their export-led growth models and are also increasing focus on regional trade. Pakistan has to be an active participant in this re-alignment, as it will be crucial to developing new trade markets and relations, and to diversify the export base.

Box 1.1 Food Security

A surge in international commodity prices during FY08 adversely impacted developing countries, many of which are net food importers with limited fiscal space to extend subsidies. The increase in commodity prices initially began from a sharp jump in crude oil prices. However, it quickly spread to food grains due to demand for bio-fuel, decline in output of some key staples in major producing countries, strong demand for agri produce and meat from emerging Asian economies with large population and consequent rising demand for animal feed. The rise in food commodity prices was significant and particularly developing countries faced economic and social crisis. The different policy responses of developing countries exacerbated the crisis.

Countries even with surplus food imposed ban on exports or fixed a minimum export price to ensure smooth domestic supplies as well as domestic price stability (for details see **Box 3.1 in *SBP Annual Report Vol-I for 2007-08***). Countries with substantial import requirements abolished import duties to absorb a part of the rise in food prices; however this measure helped maintain their demand for specific commodities, which put further pressures on international prices. Not only did these protectionist measures reduce the availability of food commodities for international trade, these also raised the importance of domestic food security.

In particular, recent report by FAO projected that agricultural commodities' prices will rise 10-30 percent over the next 10 years compared with their average of 1997-2006. Analysts believe that this shift can be attributed to long term factors, such as population growth, changes in dietary habits among the new middle class in emerging economies and demand for grains and oilseeds for production of bio-fuels. In addition, analysts fear reduction in cereals production going forward, for example, global grain supply is likely to reduce by 2.5 percent in 2009-10 cropping seasons.[3] Another important factors that can affect food prices are climatic change, global warming, and changing weather cycles. The recent increase in sugar prices, for example, is mainly a result of poor monsoon in India and excessive rains in Brazil.

From the point of view of food security, some rich countries including Saudi Arabia, Japan and South Korea have started to invest abroad by seeking fertile soil in developing countries to ensure supplies of key staples and reduce dependency on imports. Moreover, the G8 countries have stated that they will announce a 'food security initiative', committing more than US$ 12 billion for agricultural development in developing countries over the next three years.

In this backdrop, while ensuring food security is rather easy for countries with large agriculture sector such as Pakistan, this requires substantial investment in the farm sector. Specifically in Pakistan, efforts are needed to increase yields, as the present yields are lower than the potential levels. Farm mechanization, reduction in post harvest wastages, better water management, increase use of certified seeds, balanced use of fertilizers, efficient marketing of agri-produce (e.g., effective futures market), easy access to institutional credit, investment in infrastructure, transportation, storage and food processing are some important areas to begin with. There is immense potential that country can produce surplus food commodities and foreign exchange earnings can be increased through exports of dairy products, grains, fruits, vegetables, as well as fish & fish products. However, to capture foreign markets, investment in packaging, and improvement in phytosanitary standards are needed.

Improvement in the country's export performance will also require, moving away from the rebate-based model and increased attention to addressing structural and sector specific issues that hamper the country's export performance.[4] In addition, an earlier resolution of the energy crisis and improvement in physical and human capital base is also likely to lead to a persistent improvement in the country's export competitiveness by reducing inefficiencies.

The government faces significant risks, also, to its fiscal targets. Demands for expenditure continue to rise, even as revenue targets are increasingly looking uncertain in the wake of the economic slowdown and low import growth. Thus, the government needs to act aggressively on improving the tax base and reducing the fiscal deficit to sustainable levels. Raising the very low tax-to-GDP ratio will be difficult in a weak economic environment, but it is nonetheless important to make a start sooner rather than later. Moreover, it is imperative that the tax burden be more equitable, spread across different sectors of the economy, particularly services and agriculture. A gradual documentation of important economic activities is imperative, particularly in the services sectors such as wholesale & retail trade, hotels & restaurants, consultancy services by all professionals, transportation, etc. Over a period of time, this would enable the creation of a database of approximate sales volumes and incomes of different entities.

[3] International Grains Council's Market Report No. 392; http://www.igc.org.uk/en/downloads/gmrsummary/gmrsumme.pdf
[4] For details see section on Exports.

Similarly, the structure of the expenditure block needs to be changed. While current expenditures, usually non-productive in nature, should be curtailed, spending on human and physical infrastructure should be increased. Increase in development spending would help raise productivity and lead to crowding in private investment by reducing the cost of doing business. It is important to mention here that the present investment to GDP ratio is significantly low as compared to other regional economies. More worrisome is the trend in national savings, which is unable to cater even relatively low levels of investment in the country. This suggests that low savings rate is a key contributor to macroeconomic imbalances in Pakistan.

The problem of high fiscal deficits is compounded by limited options of financing this deficit. It must be kept in mind that during FY09, the governments' ability to finance its deficit, without crowding out, was helped by the collapse of private credit demand (and risk averse banks). This state of affairs is unlikely to continue. The resulting urgency to develop a savings culture and foster the development of savings institutions in Pakistan has become even greater in light of the recent international financial crisis. Capital flows to developing countries had already begun dropping by FY07, and likely to remain constrained for some years. Countries such as Pakistan, which still has significant macroeconomic imbalances, will face problems in accessing international capital market at reasonable cost. Thus, it is imperative to mobilize domestic savings to finance a greater part of domestic investment. To mobilize savings, it is necessary to build savings institutions that can tap pension and provident funds. In addition, establishment of efficient secondary debt market, particularly for tradable government paper, is also needed to offer competitive returns on savings and increase public participants. A side benefit of such developments is likely to be improvement in the efficiency of the banking system, and improved monetary policy transmission.

1.3 Executive Summary

1.3.1 Real Sector

Pakistan's economic growth moderated further in FY09 to 2.0 percent compared with a CAGR of 6.8 percent during FY02-FY07 and 4.2 percent in FY08 mainly due to weakened domestic demand caused by high inflation and depressed consumer credit market, reduction in most energy-related subsidies, slowdown in public sector development programs, and energy shortages. Similar to FY08, investment demand was the major contributor to the slowdown in FY09 GDP growth mainly due to unstable security situation and aggravating macroeconomic imbalances in the initial months of FY09. Public consumption also declined, showing that fiscal consolidation efforts have begun to take hold. Some support to the GDP growth came from the agriculture sector that rebounded during FY09 on the back of favorable weather and anticipation of higher prices.

Agriculture

A robust performance by agriculture sector provided a major impetus to FY09 GDP growth, with both, the crops and the livestock sub-sectors exhibiting above-target growth. The particularly impressive contribution by crops was a result of higher prices, and favorable weather that helped mitigate uncertainty over fertilizer prices and lower availability of canal water. The weakness in usage of inputs was reflected in lower growth of fertilizer off-take and the fact that growth in credit disbursement for the agri-sector decelerated during FY09. This suggests that even the strong yields seen in FY09 could be comfortably exceeded, given a supportive environment and favorable weather.

The most prominent feature of the FY09 agri-growth profile is the record harvest of three major crops (wheat, rice and maize), that helped major crops record an impressive growth of 7.7 percent in FY09 against the target of 4.5 percent. The growth in minor crops was also impressive despite production declines in crops such as canola, onions, mangoes and some pulses; the 3.6 percent growth seen in FY09 was higher than the target of 2.0 percent.

Similarly, 3.7 percent growth in the livestock sub-sector is also above 3.2 percent annual target. The growth here was aided by positive market sentiments – both prices and demand remained strong for the livestock products – as well as favorable weather conditions. This year, there were no major incidences of virus attack in poultry or livestock animals in the country, and the sub-sector also benefited from better availability of fodder in non-irrigated fields following extended monsoon and winter rains.

Industry

The unprecedented weakness in industrial sector growth was caused principally by domestic developments. The economy was hit by deterioration in security and law and order situation and lower demand for major consumer durable goods as growth in real incomes weakened and credit contracted. Structural problems took their toll in the form of severe energy shortages, the circular debt issue, etc. To make things worse, net global economic contraction (the first since 1930s) did not allow export-based industries to compensate for depressed domestic demand. Other than mining & quarrying sub-sector, production in all major industrial sub-sectors declined during FY09. Most of the decline was contributed by LSM sub-sector which recorded first-ever decline during FY09. The decline in LSM was heavily concentrated in consumer durable and sugar industries. Excluding these two sub-groups, the LSM index shows a slight increase of 0.7 percent in FY09.

The construction industry registered a sharp decline of 10.8 percent in FY09 – the largest fall in 37 years. Sharp increase in building material prices during the first eight months of the year, besides significant cut in disbursement of PSDP funds and dearth of financing facilities caused the construction activities to shrink significantly.

The recovery seen in mining & quarrying sector during FY08 proved short-lived as the sector continued its downtrend in FY09 with growth declining by 3.1 percentage points for the year – the lowest in 11 years.

Large scale manufacturing largely failed to withstand the unfavorable domestic and international developments and registered significant decline of 8.2 percent in production. LSM growth (YoY) remained negative during 13 consecutive months (June 08- June09) for the first time ever. Within LSM, the production in export-based industries was relatively stable indicating that the major causative factors for the broad-based decline in LSM were largely domestic.

Services

Services sector grew by 3.6 percent during FY09- thelowest growth in the preceding eight years. Moreover, services sector missed its growth target for the second consecutive year in FY09; however the magnitude of slippage in FY09 was significantly higher than that observed in FY08. More importantly, the slowdown was not only sharp compared to high growth in recent years, it is evident in almost all major sub-sectors.

Though weakening activities in industrial sector slowed down the pace of *wholesale & retail* trade, major setback to services sector growth came from sharp weakening in *transport, storage & communication* as well as decline in *finance & insurance*. Lower corporate earnings due to stiff competition and increased taxation on cellular communication caused slowdown in communications sub-sector; whereas, rise in NPLs (that caused a sharp rise in provisioning expenses) and capital market instability in H1-FY09 were major reasons for an abrupt decline in value addition by *finance & insurance*.

Investment & Savings

Investment to GDP ratio declined for the second consecutive year to 19.7 percent in FY09 due to heightened security risk and on-going power crisis. Fiscal measures were also responsible in slowing down private investments in one of the fastest growing sectors of the economy.[5] Resultantly, aggregate investments during FY09 declined by 6.5 percent; largest fall in 40 years.

After a sharp slide in FY08, savings rate (national savings to GDP ratio) improved only slightly in FY09, remaining well below the average of 17.7 percent during the FY00-FY07 period. Specifically, the savings rate rose to 14.3 percent in FY09 from 13.4 in the preceding year. This improvement entirely attributed to a relative fiscal consolidation as public savings increased to 1.2 percent of GDP in FY09 as against dis-savings of 1.8 percent during FY08. In contrast, private savings deteriorated for the second successive year, declined to 13.2 percent of GDP, the lowest level since FY99.

After reaching to a record 8.6 percent of GDP in FY08, saving-investment gap narrowed by 3.2 percent during FY09 due to the combined impact of a rise in savings to GDP ratio and a decline in investment to GDP ratio. Unfortunately, instead of a healthy rise in savings rate, a sharp fall in investment rate was more pronounced in this reduction of the gap.

1.3.2 Prices

The underlying inflationary pressures in the domestic economy eased in FY09 as all major price indices, CPI, WPI and SPI depicted a steady declining trend after reaching peaks in August 2008. The downturn in inflation can be attributed to :(a) the impact of declining international commodity prices;(b) weakness in domestic demand amid efforts at fiscal consolidation, constraints on the monetization of fiscal deficit and the lagged impact of monetary tightening during most of the fiscal year, all of which led to dampening inflationary expectations. A very encouraging development in the latter half of FY09 was that the core inflation has also began to ease, although it is still quite high.

However there are still risks in the economy that can put upward pressure on domestic inflation rate. These risks include: (a) strengthening demand pressures resulting from fiscal stimulus announced in FY10 budget and subsequent possible pressures on external account ;(b) possibility of strengthening inflationary expectations as a result of broad-based rebound in international commodity prices; (c) prospect of imported inflation if domestic currency weakens; and (d) weak fiscal position.

In this back ground, current median SBP forecasts suggest that the 9.5 percent annual FY10 inflation target may be exceeded by a small margin.

1.3.3 Money & Banking

The carryover of macroeconomic stresses, such as deterioration in current account deficit and demand stimulus of the extraordinary monetization of fiscal deficit, from the preceding year had grown considerably by early FY09. In response, central bank aggressively tightened its monetary policy, raising the policy rate twice (i.e., increase of 300 bps) in the first half of the fiscal year.

The tight monetary policy also helped in implementation of aggressive macroeconomic stabilization program initiated in November 2008. This program, which was accompanied by limiting incremental fiscal deficit monetization, finally started to pay dividends as the persistent demand pressures in the economy began to ease in subsequent months. This improvement, in turn, allowed SBP to reduce its policy discount rate within five months of the start of aggressive stabilization efforts, i.e., April 2009 onwards; with a cumulative reduction of 200 bps in policy rate in two steps.[6]

Indeed, persistent decrease in aggregate demand pressures in the economy was particularly evident from: a) an unusual deceleration of private sector credit, particularly during the second half. In addition to weakening domestic demand pressures, greater risk averseness on part of banks due to

[5] For example, increased taxes (FED and sales tax) on telecommunication services.
[6] 100 bps cut in April 2009 was followed by another reduction of 100 bps in August 2009.

rising NPLs led to slowdown in credit; b) contraction in current account deficit in response to gradual drop in YoY import growth; and c) the demand stimulus from the fiscal side continued to ease as fiscal discipline improved and the pace of incremental budgetary borrowing from the central bank lowered. Though in the wake of rehabilitation of IDPs fiscal expenditure increased significantly after March 2009, borrowing from central bank remained subdued.

As a consequence, inflationary pressures in the domestic economy also eased, helped by a concurrent fall in international commodity prices. In particular, YoY CPI inflation for the year fell to 13.1 percent from its peak of 25.3 percent in August 2008. More encouragingly, it appears that the second-round effects of high food inflation which was prevailing in the last few years, has bottomed out as; (a) stubbornly high food inflation witnessed sharp drop; and (b) inflation expectation-channel through which second-round impact transmitted in overall inflation, finally started to dampen.

M2 growth dropped to 9.6 percent in FY09 from a robust growth of 15.3 percent last year. Though the pace of depletion of Net Foreign Assets (NFA) of the banking system was checked significantly, a sharp deceleration in the growth of Net Domestic Assets (NDA) of the banking sector explains the deceleration in M2 growth. The slowdown in NDA in FY09 was largely due to a sharp contraction in private sector credit and budgetary borrowing from the banking sector. This was despite a sharp increase in credit demand from the commodity finance and public sector borrowing. The impact of lower pace of deficit monetization is also evident from a reduction in reserve money growth as it fell from 22.3 percent in FY08 to 1.9 percent in FY09.

In the banking sector, the strong performance during the last few years and subsequent strengthening of their capital base and more stringent provisioning requirement enabled banks to absorb shocks both domestic and external. In CY08, though the growth in capital base decelerated, banks are adequately capitalized. The economic slowdown has led to deterioration in asset quality; the build-up in NPLs has slowed down. Even in such difficult circumstances, banks have been able to post a profit of Rs 43 billion. While the overall growth in banking system deposits remained considerably weak, share of fixed deposits is growing gradually.

1.3.4 Public Finance

Successful implementation of the macroeconomic stabilization program in FY09 resulted in a reduction in budget deficit by 2.4 percentage points of GDP to 5.2 percent during FY09. The consolidation of fiscal balance during FY09 resulted largely from a steep deceleration in the growth in total expenditures. Total revenues, despite considerable acceleration in growth, as a share of GDP declined to 14.1 percent in FY09 from 14.6 percent last year.

Notwithstanding the fiscal improvement, reduction in overall fiscal deficit fell short of end-June FY09 target by Rs 118.2 billion. Quarterly trends show that accumulation of the budget deficit remained prudent till third quarter of FY09. However, end-June fiscal accounts saw a large addition to the fiscal deficit in Q4-FY09, reflecting IDP related expenditures and a surge in development spending by provinces.

Another major development during FY09 relates to the welcome shift in the composition of budgetary financing away from extremely inflationary borrowing from the central bank. Notwithstanding the reduction in fiscal deficit during FY09 and strict limits on the government's budgetary borrowing from SBP, fiscal sustainability would require persistence in fiscal consolidation. That, in turn, hinges crucially on undertaking significant structural reforms in the months and years ahead.

The fact that the government was able to switch budgetary financing from SBP to commercial banks, with little upward pressure on interest rates, was largely a result of the collapse of private sector credit through FY09. However, significant interest rate pressures would emerge once credit to private sector picks up.

1.3.5 Domestic & External Debt

Pakistan's total debt and liabilities stock (TDL) recorded a substantial 27.0 percent increase in FY09, only slightly lower than the 27.4 percent growth in FY08. The continued strong growth in the stock of TDL in FY09, despite a small fiscal deficit, reflects the fact that imbalances in the overall fiscal account as well as the country's current account are still large. It also incorporates the lower availability of non-debt creating flows, the impact of the build-up reserves flowing, increased inflows of multilateral assistances as well as the increase in the rupee value of external debt due to adverse exchange rate movements. Consequently, overall debt sustainability indicators of the country remained under pressure for the second successive year in FY09. In particular, while the ratio of total debt to GDP witnessed slight improvement during FY09, it is still significantly higher than the low of 57.2 percent of GDP recorded in FY07. Also, the ratio of debt servicing to total revenues, which reflects the government's capacity to service the country's debt, rose to 49.1 percent in FY09 from 45.3 percent in FY08.

Also, the FRDL target of 2.5 percentage point reduction in the stock of TDL, as percent of GDP, in every financial year was not met for the second consecutive year. The deterioration in debt indicators necessitates an urgent revisit to the debt management policy for an early return to sustainable debt path.

1.3.6 External Sector

Balance of Payments

After sharp expansion in the last four successive years, the current account deficit contracted considerably to 5.3 percent of GDP during FY09 from 8.4 percent in FY08. This improvement in current account deficit more than offset the fall in financial account surplus during the period. Consequently, overall external account deficit declined by 40.1 percent in FY09.

The entire improvement in the annual external account picture accrued during the Nov-June FY09 period. During Jul-Oct FY09, higher import prices and sharp fall in financial inflows led to substantial pressure on exchange rate and rapid depletion of foreign exchange reserves. Given the severity of situation and inability to access international capital markets in light of global financial crisis, Pakistan had no option but to approach International Monetary Fund to avoid the risk of a BoP crisis. The subsequent implementation of a macroeconomic stabilization program led to a marked improvement in the external account position in the ensuing months (Nov-June FY09).

During Nov-June FY09, overall external accounts turned into surplus on the back of substantial contraction in current account deficit and limited recovery in loan inflows from multilateral agencies. Improvement in current account, in turn, largely owed to: (a) rapid fall in imports on the back of steep fall in import prices, subsiding aggregate demand pressures and exchange rate depreciation; and (b) impressive increase in remittances. This relative improvement was also reflected in exchange rate stability and rebuilding of foreign exchange reserves.

Looking ahead, maintaining improvement in external account would be challenging. On the one hand, further contraction in current account deficit would be difficult in the light of downside risk to remittances inflows and likely increase in imports owing to recovery of commodity prices in international market and revival of domestic economic activity. On the other hand, investment inflows are subjected to large risks as Pakistan's sovereign credit risk is still considerably high and prospects for world investment remain uncertain. Thus, Pakistan would have to rely on loan inflows to finance current account deficit.

Foreign Trade

Pakistan's trade performance recorded a significant improvement during FY09. Country's trade deficit recorded a large 18.5 percent YoY contraction during FY09, breaking from the rising trend witnessed since FY03. This was due to a 12.9 percent YoY fall in imports during FY09 which outpaced the impact of 6.7 percent YoY fall in exports during this period. In the wake of the global recession and a fall in international commodity prices, some slowdown in country's import and export growth was expected during FY09. The impact of these developments, however, was intensified by a broad range of domestic factors –especially the energy crisis that led to a greater than expected fall in both exports and imports during this period. Resultantly, exports and imports both recorded a broad based decline during FY09.

1.3.7 Socio-economic Development

A review of socioeconomic indicators of the country shows that there has been a marginal improvement in some of the health, education and employment indicators, while poverty in the country is expected to have risen, during FY09. Demographic indicators indicate that the country has the highest population growth rate in the South Asian region. Although the number of people below poverty line is expected to have increased, unemployment level has marginally declined during the year. Despite relative improvement as compared to previous years in health and education sectors, resource allocation in these areas remains the lowest in South Asia.

Government of Pakistan is pursing various socioeconomic programs to help the poor. However lack of employment opportunities, health and education facilities in the backdrop of rising poverty calls for a long term multipronged approach on part of the government to ensure relief to the vulnerable segments of society.