THE STATE OF PAKISTAN'S ECONOMY
First Quarterly Report for FY05

1.1 Overview

Both agriculture and industry performed better than anticipated during the initial months of FY05, laying a strong foundation for the economy to exceed the 6.6 percent real GDP growth target for the year. Provisional estimates place value-addition by *Kharif* crops slightly above target following a robust cotton production. The growth of approximately 14 percent YoY recorded by *LSM* during Q1-FY05 is also well above the 12.0 percent annual target.

Table 1.1: Economic Indicators (Jul-Sep)

	FY02	FY03	FY04	FY05
Growth rates(percent)				
Large-scale manufacturing[1]	3.4	3.7	11.7	13.96
Exports	1.8	14.3	14.7	17.3
Imports	-8.3	10.9	12.1	38.5
Tax revenues (CBR)	-3.1	16.6	4.1	33.6
CPI (12 m moving average)	4.1	3.6	2.6	7.3
Private sector credit (CBs)	-1.8	-4.2	2.5	5.4
Money supply (M2)	-0.5	2.1	2.1	5.7
million US Dollars				
Total liquid reserves[2]	3,295	8,244	11,389	12,338
Home remittances[3]	263.8	926.6	906.5	983.2
Foreign private investment	21.9	167.4	88.9	201.8
percent of GDP[4]				
Fiscal deficit	1.7	1	0.9	0.4
Trade deficit	0.4	0.3	0.2	3.5
Current a/c balance	-0.1	2.1	1.6	0.16

[1] Based on 91 items.
[2] With SBP & with banks. End September.
[3] Excluding receipts on a/c of Kuwait war affectees & Hajj.
[4] Calculated by taking fiscal year GDP but variable numbers on quarter basis.

However, while leading indicators suggest that the services sector will turn in a strong full-year performance, the outlook for agriculture and industry during H2-FY05 still remains uncertain. Specifically, hopes of achieving the full-year agri-growth target rest crucially on the wheat harvest, which may be substantially below target due to a worsening water supply. Similarly, the prospects for industry are clouded by concerns over the impact of the increased competition in global textile markets post-December 2004 on Pakistan's exports.

The latter concern has been boosted particularly by the apparent fall in exports in key textile categories in months leading to December 2004. This has led to calls for the central bank to hold down interest rates ahead of this transition. However, a closer look at leading indicators does not suggest grounds for excessive pessimism on export prospects. The industry has invested heavily in BMR and capacity enhancements, imports of raw material has remained strong, and net credit growth (particularly for working capital) has risen sharply even as the price of a key input – cotton – has dropped because of a bumper cotton crop.

In any case, while the potential structural shifts can indeed be an important factor in the SBP's short-term monetary posture, the central bank has also to keep in view the inflation trends in the country. Although the data for recent months indicate that the acceleration in inflation may be tapering off, it is also true that CPI inflation remains pegged stubbornly around the 9 percent levels (against an annual target of 5 percent) and core inflation is still continuing upwards (although here too, the trend is weakening). Finally, inflationary pressures would have been boosted by the recent increase in domestic oil prices, and the risk could rise further if water shortages result in lower supply of agri-produce.

It is important to note that any attempt to maintain low interest rates for an extended period in the face of high inflation is counter productive for the economy, e.g. any gain to exporters from uneconomically low interest rates would be quickly lost to the rising cost of inputs as inflationary expectations take hold. It should also be kept in mind that average real lending rates are already negative, and a continuation of this would encourage non-productive borrowings and speculative activities. Accordingly, it would be prudent for the central bank to carefully monitor developments in the light of December 2004 data and to assess whether the balance of risks justifies a *further* tightening of the monetary stance.

Interestingly, the 161 basis point rise in 6-month T-bill yields through July-November FY05 has not yet made an appreciable dent in the demand for credit. Net credit to the private sector has risen by Rs 163.2 billion during this period, substantially higher than the Rs 124.8 billion recorded in the corresponding period of the previous year. Surprisingly, despite the exceptional rise in net credit to the private sector, as well as a 111 percent YoY rise in budgetary borrowings of the government, M2 growth remained a modest 5.7 percent during July-November FY05, in line with the 11.5 percent annual credit plan target. This is because not only has the growth in Net Foreign Assets of the banking system slowed, the impact of higher private and government borrowings was significantly offset by the contractionary impact of *other items (net)* and reduced public sector enterprise borrowings. Unfortunately, since a part of the former can represent transitory impacts, this suggests that M2 growth may accelerate in the months ahead.

Ironically, a comfort point for the SBP here is that the growth in reserve money (and therefore M2) is likely to be moderated by the net outflows under the external account. The cumulative current account, in particular, turned into a deficit, largely due to a strong surge in imports; during July-November FY05, the import bill rose to US$ 7.9 billion, up a startling 49.3 percent YoY.[1] The resulting short-term panic in the inter-bank forex market led the SBP to formally commit to provide foreign exchange for key commodity imports (largely petroleum and wheat). The consequent drain on SBP reserves has partially contained the growth in reserve money.

The SBP support for the Rupee is simply a continuation of the policy seen during preceding years of providing a degree of stability to the economy. The SBP had earlier purchased forex in the inter-bank market to prevent an *abrupt* appreciation of the Rupee during FY03 and part of FY04, and similarly, it has sought to prevent a sharp depreciation in the latter half of FY04 and the beginning of FY05. This does not mean that the parity will remain unchanged – only that any change would be gradual, and stability in the market will be maintained.

It is in this perspective that the SBP had initially allowed the Rupee to weaken in the inter-bank market, until it became clear that decline of the Rupee was increasingly driven by excessive speculation, forcing a self-fulfilling decline of the domestic currency. It is only in this context that a drain on forex reserves is justified, and a central bank has to therefore strike a balance between allowing the local currency to find its footing in the market, and preventing instability. It should be kept in mind that the SBP's ability to intervene heavily in the inter-bank market stemmed directly from the much-criticized "*large*" reserve holdings, and it shows that the presence of substantial central bank reserves play an important role in enhancing confidence on the stability of (and thus preventing 'runs' on) the domestic currency.

Looking Ahead

In FY05, Pakistan's economy seems likely to exceed the growth recorded in the preceding year. Despite the evident water shortages plaguing the *Rabi* crop outlook, the net gains from the major kharif crops, means that the crops sub-sector growth is not expected to be substantially below the FY05 target. Moreover, while industrial growth is expected to witness a deceleration from that in the preceding year, it is nonetheless expected to be significantly above the annual target; while external demand is likely to remain strong (amidst the continuing strength of the global economy), the greater impetus to this growth seems to be emerging from sustained domestic demand (led by *construction, automobiles* and *electronics*). The strongest support to real GDP growth, however, is anticipated

[1] There are some concerns over the quality of the import data. Specifically, the reported growth in oil imports is at significant variance from historical trends and elasticities. Nonetheless it is instructive to note that non-oil imports also show a rise of over 37 percent YoY.

from a broad-based improvement in the services sector. As a result, SBP forecasts indicate that overall real GDP growth is likely to fall in the range of 6.5 to 7.1 percent during FY05.

Table 1.2: Major Economic Indicators

		FY05	
growth rates (percent)	**FY04***	**Original targets**	**SBP projections**
GDP	6.4	6.6	6.5 - 7.1
Inflation	4.6	5.0	7.6 - 8.2
Monetary assets (M2)	19.6	11.5	13.0
Net domestic assets	*23.7*	*13.1*	*21.7*
Private sector credit incl. PSEs	*28.0*	*15.0*	*30.0*
Total revenue	11.4	5.4	7.2
Total expenditures	7.9	7.0	7.8
billion US Dollars			
Exports	13.3	13.7	13.7
Imports	14.6	16.7	18.5
Workers' remittances	3.9	3.7	4.0
percent of GDP			
Fiscal deficit	3.3	3.3	3.1
Current account balance	1.9	0.3	-0.8
Private investment	11.7	11.9	12.1

(*): provisional

The downside risks to the economy in the current year stem from higher inflationary expectations and a worsening trade balance. The combination of supply-issues for key commodities, strong domestic demand, and high international commodity prices are projected to push annual CPI inflation during FY05 well over the 5 percent target, to the 7.6 to 8.2 percent range. This forecast is based on the assumption that: (1) large and timely wheat import and supply will contain the prices of wheat and wheat products in the months ahead; and, (2) that domestic oil prices will decline in the months ahead, in line with an anticipated weakening of international oil prices during H2-FY05.

While the stronger contribution of supply-factors in the higher projected inflation for FY05 suggests a weaker role of monetary policy, the fact that core inflation also remain on an uptrend means the monetary overhang needs to be contained sooner rather than later. In fact, it is anticipated that a continued expansion of net private sector credit, will be offset partially by: (1) a lower rise of government borrowings from the banking system and (2) the impact of a fall in SBP reserves. As a result, M2 growth is expected to be contained to approximately 13 percent by end-FY05. While this is certainly above the annual target of 11.5 percent, it will nonetheless be significantly below the estimated nominal GDP growth, reducing part of the monetary overhang that has developed in recent years.

A sustained increase in the import bill – reflecting high commodity prices (especially oil), and rising imports of machinery and raw materials – is projected to widen the trade deficit. This is likely to lead to a modest current account deficit in FY05, since exports are not expected to be significantly above target, and remittances are anticipated to depict only a small increase over the year. The excessive preoccupation on the trade deficit in Pakistan by analysts and the media does tend to exaggerate the importance of one of the three components of the current account balance. The key variable to watch is the current account that provides a total picture of the external financing needs or accumulation.

Ironically, the exceptional growth in imports is also likely to help reduce the fiscal deficit by significantly pushing up import-based taxes, augmenting the remarkable buoyancy witnessed in tax growth during Q1-FY05. As a result of relative fiscal discipline and high revenues, as well as high nominal GDP growth, the fiscal deficit is expected to be contained within budgetary targets. However one point of concern is the strong increase in the current expenditure. The 25 percent YoY rise in current expenditure of the provincial governments appears particularly disturbing.

Table 1.3: Major Macroeconomic Indicators

	Average 1980s	**SBP projections FY05**
Growth (percent)		
Real GDP	6.5	6.5 - 7.1
CPI inflation	7.2	7.6 - 8.2
M2 growth	13.2	13.0
as percent of GDP		
Budgetary balance	-7.1	-3.1
Current account balance	-3.9	-0.8

A question is often raised; is the current profile of macroeconomic variables, which has remarkable parallels with the boom cycle of the 1980s, sustainable? An analysis of the differences in the 2000s compared to the 1980s can be summarized as follows: (1) the fiscal profile is in much better shape; (2) the current account deficit too, is far narrower than in the earlier decade; (3) the relatively lower twin deficits in the current decade are reflected in an attendant improvement in the country's debt profile, in contrast to the continued deterioration witnessed in the earlier decade; (4) while the twin deficits of the 1980s were driven principally by rising consumption (eroding the real productive capacity of the economy), the data for the first half of the current decade shows that the fiscal disciple remains intact, and that the current account deficit is driven principally by investments (in machinery and raw materials), that add to productive capacity of the economy in real terms.

Historically, it can be argued that the large debt-creating twin deficits, as well as an inattention to infrastructure and human resource development, were important factors in the non-sustainability of the upward growth path. If so, the improvements in these factors clearly offer scope for sustaining the current growth momentum during (and well beyond) the current decade, quite contrary to the business cycles witnessed in Pakistan so far.

However, the sustainability of higher growth path warrants that Pakistan has to take advantage of the opportunities offered by the end of the ATC regime in January 2005. The domestic industry has certainly invested heavily to this end, but this needs to continue. Moreover, the government must support this endeavor by providing a conducive legal and regulatory environment (particularly social and environmental compliance), supportive infrastructure and logistic management, as well as through heavy investments in training and skill upgradation of the labor force. The latter is crucial to enable the substantial productivity increases needed to keep Pakistan's economy competitive and attract the necessary FDI.

Concomitantly, the strategic location of Pakistan as the least cost mover, supplier and buyer of internationally traded goods, energy supplies, and IT & financial services, to Central Asia, Western China, the Middle East and South Asia, can be exploited on the back of Gawadar Port and the highway network, oil and gas pipelines, hydel electricity imports and export, SAFTA, transit trade arrangements and liberalization of services trade.

In the shorter-term, there is also an opportunity for Pakistan to reduce the costs of business by reducing red-tape, improving governance, and ensuring policy continuity. One major opportunity lies with the reforms to WAPDA and KESC – studies show that the high cost and low reliability of energy supply is one of Pakistan's key competitive disadvantages. Another important bottleneck is the Karachi port; a substantial improvement in throughput (and attendant cost reductions) could make a crucial difference to the country's competitive standing.

1.2 Executive Summary

Agriculture

A strong cotton harvest helped the crops sub-sector perform above target during *kharif* FY05. However, water shortages during the *kharif* season affected the sugarcane and, to an extent, the rice harvest. Fertilizer off-take rose sharply by 19.6 percent YoY during Q1-FY05 on the back of strong demand for Urea as well as DAP. Agricultural credit also showed a significant expansion of Rs 20.6 billion during Q1-FY05 up 44 percent compared with the Rs 14.3 billion in Q1-FY04, mainly due to a substantial increase in the disbursements by domestic private banks.

Achievement of the current year's growth targets for the crop sub-sector now rests on the performance of the *Rabi* crops, especially wheat. If the predicted water shortages do not affect wheat production too strongly, the crop sub-sector should record positive growth.

Industry

Industrial sector growth remained strong at 9.4 percent during Q1-FY05, driven mainly by LSM. Production by LSM saw a rise of 14.0 percent during Q1-FY05, which is only slightly lower than the 15.0 percent growth in Q1-FY04; this was mainly contributed by *electronics*, *automobiles*, *fertilizer* sub-sectors. *Mining & quarrying* showed 21.7 percent growth in Q1-FY05, which is less than 34.4 percent growth during the same period of last year, but its weight in the overall index of industrial production is quite low.

The growth momentum of LSM, in particular, is supported by availability of bank credit. One of the bigger beneficiaries of the credit growth was the *electronics* sub-sector, which saw a strong growth of 53.6 percent similarly the *automobile* manufacturing sector saw 40.2 percent YoY growth in Q1-FY05.

The continued access to credit, a general boom in real estate investments, together with an increase in development expenditure by the government, also boosted construction activities in Q1-FY05. These, in turn, fostered growth in auxiliary industries, such as cement, paints & varnishes, glass sheets, wood, steel, etc.

An important development during Q1-FY05 is a slowdown in the *textile* sub-sector, which saw a lower growth of 2.4 percent against an increase of 8.5 percent in Q1-FY04. A part of the deceleration is probably a base effect, but the greater impact is probably due to the imposition of anti-dumping duty on the exports of some textile items by the European Union and a fall in the prices of products in key export categories such as art silk & synthetic textiles, towels etc.

Fiscal Developments

Q1-FY05 saw a remarkable improvement in the fiscal performance. A surprisingly strong 22.1 percent YoY growth in revenues more than offset a 10.0 percent YoY rise in expenditures to push the quarterly fiscal deficit to 0.4 percent of GDP.

The consolidated revenue receipts stood at Rs 202.3 billion, showing a net improvement of Rs 36.7 billion in Q1-FY05 over the same period of FY04. While total tax revenues rose by 19.1 percent during Q1-FY05, the non-tax revenues registered a growth of 30.3 percent. On the other hand, consolidated expenditures increased by 10.0 percent YoY during Q1-FY05 to reach Rs 227.1 billion. Due to the exceptional rise in revenues during the quarter, the financing requirements during the Q1-FY05 dropped to a mere Rs 24.9 billion (down 39.2 percent YoY).

Money and Banking

The pressures for higher interest rates that emerged in May 2004 continued into the initial months of FY05 with substantial increase in domestic CPI inflation as well as persistent weakness in the external account.

While the reserve money growth of 13.5 percent during Jul-Nov FY05 was only marginally lower than that in the corresponding period of the previous year, the 5.7 percent monetary expansion during Jul-Nov FY05 (contributed almost entirely by NDA) was considerably lower than the 7.9 percent expansion (contributed by both NDA and NFA) in the corresponding period of FY04.

In fact, the Jul-Nov FY05 period witnessed a substantial increase in commercial banks NFA, which was largely subdued by a decline in SBP NFA. In terms of NDA growth, the comparison between Jul-Nov periods of FY04 and FY05 shows that the contribution of both government net budgetary borrowings and private sector credit increased significantly during FY05.

The government's financing needs fell from Rs 40.9 billion in Q1-FY04 to Rs 24.9 billion in Q1-FY05. Moreover, the substantial financing through external and non-bank sources as well as larger privatization proceeds helped the government to *retire* banking system debt. However, subsequently there was a sharp rise in the net budgetary borrowings from the banking system during the months of October and November, thus reversing the Q1-FY05 position from net retirement to net borrowings for cumulative July-November FY05 period. There is also a visible shift in the profile of the government borrowings from the banking system with increased reliance on SBP borrowings.

The developments in the money market are reflective of the SBP monetary stance of containing a sharp rise in the interest rates. However, in response to concerns over the slow impact of monetary policy tightening on macro variables, SBP not only mopped up Rs 58 billion through OMOs but also accepted higher than the targeted amounts in two auctions in August 2004. This, along with seasonal pick up in credit demand in September 2004, left the market short and banks had to resort to discounting. Also, as SBP shifted the entire burden of government borrowing on itself, banks (especially smaller ones) gradually saw their holdings of the government securities eroding to uncomfortably low levels.

Banking Developments[2]

While additions in non-performing loans remained quite subdued at 5-year low, net credit registered an expansion of a remarkable Rs 52.7 billion in Q1-FY05 against Rs 0.8 billion in Q1-FY04. This was due to a sharp rise of Rs 65.7 billion in credit to private sector at the back of strong demand from corporate and consumer sectors, which more than offset the net retirements from the public sector. On the other hand, following the deceleration in M2 growth, the pace of banks' deposit mobilization slowed down. Besides, on account of continued expectations of Rupee depreciation, the currency composition of the deposit mobilization also changed, with a rising focus on foreign currency deposits.

Prices

Rising oil prices were an important contributor to global inflation, but the impact of this on the domestic economy was limited by the government's freeze on price of key petroleum products.

Domestic Jul-Nov 2004 inflation was driven by supply shocks as well as continuing increase in aggregate demand. In particular, food inflation made a dominant contribution to the rise in all three price indices (CPI, WPI and SPI).

By November 2004, rate of increase in inflation has been weakening. While growth in CPI inflation has stagnated, it remained high at 9.0 percent levels. On the other hand, year-on-year WPI inflation is declining. While core inflation (proxied by non-food non-oil inflation) is still rising, the increase in the pace is decelerating.

However, price pressures could be renewed if (1) wheat prices are not controlled through adequate timely inputs to meet any shortfall; and (2) if the government raises domestic oil prices.

Balance of Payments

The overall balance recorded a net deficit of US$ 559 million in Q1-FY05 as compared to a net surplus of US$ 578 million during the corresponding quarter last year. Although the current account remained in surplus of US$ 124 million for Q1-FY05, this was relatively weak witnessing a substantial 89 percent YoY

[2] This part of the analysis is based on the latest available Banking Statistics up to end-Q1-FY05.

fall during the period. This fall was primarily driven by: (1) increasing imports mainly reflecting the accelerating aggregate demand in the domestic economy as well as high international commodity prices (especially oil prices); (2) a sharp reduction in non-structural flows; (3) shipment freight charges; and (4) increased net income outflows.

On the other hand, the financial account deficit increased to US$ 1,097 million during Q1-FY05. However, after adjusting one-off flows of US debt write-off (US$ 495 million) and the settlement of a US$ 100 million forex swap by PARCO to pre-pay external debt, the financial account deficit drop to US$ 502 million during Q1-FY05. This improvement owes primarily to: (1) increased foreign direct investment; (2) higher disbursement of non-food aid; and (3) the net inflow of US$ 100 million of short-term loans during Q1-FY05 as against a net outflow of US$ 52 million over the corresponding period last year.

Foreign Trade

The trade deficit for July-November FY05 rose to US$ 2.5 billion as compared to a mere US$ 0.4 billion during the corresponding period last year. This rise was caused by a steep growth of 49.3 percent in imports, which outstripped the 11.1 percent export growth during this period. In fact, the trade deficit had begun to widen significantly during the latter half of FY04, amidst a general rise in imports as economic activities accelerated, and international oil prices rose; approximately two thirds of the total FY04 imports were recorded in the last four months of the year. This trend appears to be continuing into FY05, with the Jul-Nov imports at 47.2 percent of the US$ 16.7 billion annual import target.

In particular, the oil import bill is abnormally high Jul-Nov FY05 due to very substantial growth in petroleum products imports (173.3 percent). Nonetheless, the reliability of these import numbers cannot be authenticated due to the change in data reporting system. In fact, this sharp jump in the import of oil products does not make sense either on the basis of elasticity estimates or historical trends of consumption.

Export performance, on the other hand, also raised a few concerns during this period. Country' textile sector recorded 2.4 percent rise during Jul-Nov FY05 as compared to the 11.8 percent growth during the same period lat year. This deceleration in this sector was caused by a sharp fall in two major categories namely: bed wear and synthetic textiles. This weakness in the performance of bed wear exports might be attributable to the imposition of antidumping duty on this category by the EU and the embargo imposed by the US on bed wear exports in mid-November 2004 to check over-shipments in this category. On the other hand, synthetic textile exports were affected by a significant rise in the price of polyester staple fiber due to rising international oil prices since April 2003.

Exchange Rate and Foreign Exchange Reserves

The lower current account surplus, coupled with net retirement of FE-25 foreign currency loans and increased forward booking by the importers, squeezed the inter-bank forex market liquidity, and thus added to the pressure on the Rupee during Q1-FY05. In fact, despite a significant SBP injections into the forex market during Jul-Oct 2004, the Rupee weakened by 5 percent to reach Rs 61.2/US$ by end-October 2004. in fact, it was not until SBP formally announced by end-October 2004 that it will provide foreign exchange for imports of key commodities such as oil, wheat and fertilizers, and took administrative measures to discourage excessive speculation, that the Rupee recovered some of its losses.

Pakistan’s overall foreign exchange reserves scaled down by US$ 548.9 million during July-November 2004 to reach US$ 11,179.1 million at the end November 2004. While SBP interventions in this period totaled US$ 724.2 million, SBP reserves fell only US$ 481 million because of additional inflows in the same period. Moreover, reserves with commercial banks increased in during this period due to both, incremental deposits as well as the retirement of FE-25 loans.