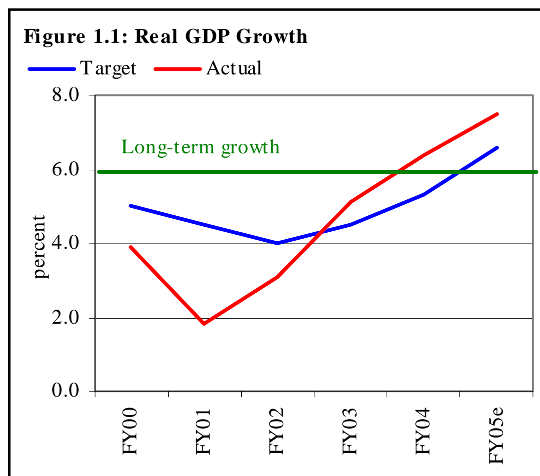
THE STATE OF PAKISTAN'S ECONOMY
Third Quarterly Report for FY05

Overview

With less than two months to the end of the fiscal year, it is quite encouraging that the economy is still continuing to accelerate, and well set to exceed the annual growth target for the third successive year (see **Figure 1.1**). Indeed, SBP growth forecast for FY05 remains unchanged, with real GDP growth expected to be between 7.4 and 7.8 percent – the highest levels for the last 13 years. However, if along with large-scale manufacturing and major crops, other sub-sectors[1] also grow above target, then FY05 GDP growth is likely to surpass the estimated upper range and may even exceed 8.0 percent. More encouragingly, unlike the preceding fiscal year, this growth is expected to be shared by all major sectors of the economy.

Figure 1.1: Real GDP Growth



In fact, the growth in agriculture, industry and the services sectors is expected to be substantially above target. Particularly noteworthy is the sharp jump in agri-growth as a result of which the contribution of the sector to GDP growth is expected to increase from 9.3 percent in FY04 to approximately 18 percent during FY05. The sharp improvement in this labor-intensive sector is suggestive of an improvement in the pattern and quality of growth leading to employment generation and poverty reduction. The high growth in FY05 is thus particularly welcome. Historically, in Pakistan, sustained economic growth of over 6 percent has been correlated with a meaningful reduction in poverty levels. The challenge for policy makers now is to sustain this growth momentum in the years ahead. This is no easy task, given that the country now faces significant macroeconomic challenges.

[1] Livestock, construction, electricity & gas distribution, wholesale & retail trade and transport & communication etc.

Inflationary pressures, for example, are clearly on the rise, and if unaddressed could lead to a significant hardening of inflationary expectations in the economy, with serious repercussions on long-term growth. The growing external sector imbalances are also a source of concern; while these are clearly sustainable in the short-run, sustained large external account deficits are equally clearly undesirable. Another potentially serious threat is the re-emergence of rigidities in expenditures (e.g. the rising interest rates will raise debt servicing costs) that threaten to eat fiscal space generated through the reforms of yesteryears.

Inflationary pressures, that had been building up in the preceding year, remained unexpectedly strong in FY05 with CPI inflation persisting in the 9 to 10 percent range through most of Jul-Mar FY05. This is due to both supply and demand pressures in the economy. An important contributor to the jump in aggregate demand during FY05 was the record growth in net credit to the private sector, which surged to Rs 362 billion by the third week of April, 2005 even significantly higher than the Rs 325.2 billion for the *whole* of FY04. While this clearly aided the acceleration in many sectors of the economy, the resulting strength in demand, oil price hike and supply constraints in food inevitably contributed to price rises as well. International price shocks for key commodities such as oil (with prices up 30.7 percent YoY), fertilizers (up 10.8 percent YoY), etc during March 2005 exacerbated the pressures. High prices of yet other commodities such as wheat and cement were sustained by institutional and regulatory weaknesses.

Table 1.1: Economic Indicators (Jul-Mar)

	FY03	**FY04**	**FY05**
Growth rates(percent)			
Large-scale manufacturing[1]	6.7	17.1	15.0
Exports	20.2	13.3	14.6
Imports	22.8	16.3	37.8
Tax revenues (CBR)	15.0	13.9	13.5
CPI (12 m moving average)	3.6	3.4	8.6
Private sector credit (CBs)[2]	13.3	25.8	29.0
Money supply (M2)	12.0	12.3	13.1
million US Dollars			
Total liquid reserves[3]	10,312	12,580	12,787
Home remittances	3,230	2,875	3,051
Foreign private investment	665	587	901
percent of GDP[4]			
Fiscal deficit[5]	2.1	1.6	1.3
Trade deficit	1.4	1.7	4.1
Current a/c balance[6]	4.3	2.1	-1.1

[1] For FY05, data upto Jul-Feb.
[2] Includes investments.
[3] With SBP & commercial banks.
[4] Calculated by taking fiscal year GDP.
[5] For FY05, data upto Jul-Dec.
[6] For FY05, data upto Jul-Feb.

In recent years, the SBP had consciously followed expansionary and accommodative monetary policy in order to create and sustain the acceleration of

the economy to levels necessary for meaningful employment generation and poverty reduction. However, with real GDP growth now expected to climb to over 8 percent in FY05 and inflationary pressures remaining unabated, the SBP has tilted increasingly towards tightening monetary policy. Not only have 3-month T-bill yields been raised 563 basis points during Jul-May FY05, the discount rate too has been raised by 150 basis points, and the SBP is also more frequently resorting to OMOs in order to improve the transmission of monetary policy to the market. As a consequence it is anticipated that the overall growth in M2 during FY05 is likely to be well below the expected growth in nominal GDP. While this is not expected to subdue inflationary pressures immediately, the tightening will ensure that core inflation will gradually be contained at significantly lower levels.

However, as mentioned earlier, the non-core components of CPI inflation will need to be addressed more through administrative rather than monetary policy measures. The recent decision to import critical food commodities is a step in the right direction. At the same time, the central bank must also be careful to ensure that monetary tightening does not drive the economy into recession. Nevertheless, the current balance of risk brought about by recent tightening is towards containing inflation without prejudice to achievable growth in GDP.

If the long-term growth is to be sustained, the momentum of the fiscal reforms must also be sustained. While both revenue and expenditure growth had been targeted, the focus of the first phase of the fiscal reforms had principally been on the latter, i.e. reduced debt servicing payments. The improvement here is creditable. The rise in tax revenues was in consonance with the nominal growth of GDP during the FY00-03 period and the current spending was also kept under control. However, FY04 and the current year developments suggest that this momentum may be significantly weakening. While the 13.5 percent growth in CBR tax revenues during Jul-Mar FY05 is acceptable by historical standards, the receipts have clearly not kept pace with the growth of the economy i.e. tax buoyancy remained low.[2] This needs to be addressed urgently, if the government is to be able to increase development spending to sustain the long-term growth momentum of the economy.

Less of a threat, but nonetheless a concern, is the weakness in the external account. Specifically, in contrast to the large surpluses recorded in the recent past,

[2] While part of the weakness in the growth of tax receipts during FY05 may explainable by the elimination of the sales tax on cotton, and some further rationalization of the tax structure, this does not fully explain the decline.

Jul-Feb FY05 has witnessed a current account deficit of US$ 1.1 billion, following a surge in imports. To the extent that (1) the larger part of the emergent deficit is caused by a rise in machinery and inputs (adding to the productive capacity of the economy); (2) the size of this deficit is small relative to the economy, and (3) Pakistan continues to have access to non-debt creating capital flows and low-cost external financing, the external account deficit is quite manageable in the short-term. This is the case at present. Current account deficit is likely to be small 1.9 percent of GDP and will be easily financed through foreign investment and low-cost multilateral loans. This has kept the external debt ratios on the downward trajectory (33.3 percent of GDP) and also allowed the exchange rate to remain relatively stable with the country's foreign exchange reserves have climbed to US$ 13.0 billion by end-April 2005, up 5.5 percent YTD. In the longer term however, the rising investment in machinery and inputs should be reflected in higher export earnings as well as import substitution.

Looking ahead

The major concern on the country's macroeconomic profile is the sharp rise in domestic inflation during FY05, which prompted a corresponding tightening of monetary policy. The next few months will be critical to determine whether inflationary pressures are receding as a result of the measures taken to augment supplies of critical food items and moderation of demand for bank credit by the private sector in response to rising interest rates.

However, SBP estimates indicate that real GDP growth will nonetheless comfortably cross the 7 percent mark in FY05 (see **Table 1.2**), for the first time since FY92. Indeed, as in that year, not only is the FY05 growth broad-based, both real private consumption and real investment are expected to register double-digit growth. While the growth in real investment had also been strong in FY04, the expected rise in real private consumption has not been evident for the last decade. This improvement is quite encouraging, suggesting

Table 1.2: Major Economic Indicators

growth rates (percent)	**FY04[1]**	**FY05 Targets**	**SBP proj. for FY05**	
			Earlier	**Revised**
GDP	6.4	6.6	7.4 - 7.8	7.4 - 7.8
Inflation	4.6	5.0	8.2 - 8.8	9.0 - 9.4
Monetary assets (M2)	19.6	14.5	14.6	15.8
Net domestic assets	23.7	17.3	18.8	16.4
Private sector credit incl. PSCEs	28.0	27.0	30.0	30.0
Private investment	17.9	13.1	17.2	17.2
billion US Dollars				
Exports	12.3	13.7	13.5	14.2
Imports	15.6	16.7	18.5	19.5
Workers' remittances	3.9	3.7	4.0	4.0
percent of GDP				
Fiscal deficit	3.3	3.3	3.2	3.2
Current a/c balance	5.0	0.3	-1.7	-1.8

[1] provisional

that the sustained recovery in the economy may finally be reflected in an improvement in consumer confidence. This bodes well for the sustainability of the economy's growth momentum. This said, it is important to acknowledge the likelihood that the FY06 real GDP growth will be a little lower than estimated for the current year, although it should still remain comfortably higher than the 6 percent long-term growth trajectory.[3]

However, now that it seems that the growth momentum has been initiated, it will be important that the government concentrate on second-generation reforms that are further needed to build on these gains. Firstly, the growth policy now needs to shift slightly, away from merely encouraging growth and focusing more on improving delivery of basic services and targeted interventions towards the poor. While in the long-term this will require larger spending and policy focus on health, education and infrastructure, in the short-term this implies the introduction of policies encouraging the growth of sectors with a greater absorption of relatively unskilled labor, such as agriculture and construction.

The government's revenue structure also needs to be revamped. The sectoral incidence of taxes in Pakistan is highly skewed as the burden falls disproportionately on large-scale manufacturing. The objective of fostering high-tech industries and exports cannot be achieved if this burden remains unabated. On the other hand, services sector and the marketable surplus in agriculture remain lightly taxed. Similarly, there is no system in place to tax the recent mammoth gains in the equity as well as real estate markets. A realignment of tax burden across the sectors and extending to untaxed income earners is highly essential to mobilize additional taxes while minimizing the evasion from excessively taxed sectors and segments.

The necessity for reform of the CBR is particularly underlined by a number of important developments, e.g., (1) despite the exceptionally strong GDP growth, high inflation and higher than anticipated depreciation of the rupee, tax collections are barely keeping pace with national income growth, indicating poor buoyancy, (2) the heavy reliance on the petroleum development levy meant that government's revenues suffered substantially when high international oil prices forced it to increase domestic prices less than proportionately (in order to protect the domestic economy), and (3) the shift from indirect taxes to direct taxes will lower the incidence of tax burden on the lower income groups.

[3] For one, history suggests that it is improbable that FY06 will see the repeat of the record wheat and cotton harvests seen in FY05. Similarly, the high-base set by the FY05 production, capacity constraints and the relatively tighter monetary stance of the SBP is likely to result in a slowing of industrial growth as well.

A third area where government intervention can pay rich dividends is in policies focused on improving the country's competitiveness, to enable exports to benefit from the opportunities offered by increasingly globalized markets. This is particularly true for textiles following the end of the quota regime. The policy options here are myriad, ranging from reducing costs of production (by lowering red-tape, reducing utility charges, improving infrastructure, etc.), enabling more flexible labor markets (by replacing outdated labor laws, investing in the production of a trainable labor force, etc.).

Executive Summary

Agriculture

Provisional estimates of *rabi* FY05 brought the crop sub-sector growth to double digits and subsequently raised the expectations of impressive agri growth rate at the end of FY05. The two major record bumper crops, cotton and wheat, during FY05 contributed significantly in this exceptional performance. As all other sub-sectors of the agriculture have not yet reported any noticeable problem (except some minor crop damage due to heavy rains), it is expected that the agricultural growth for FY05 will substantially exceed the annual target of 4.0 percent.

The major supporting factors for agricultural performance during FY05 included: (1) timely winter rains which resulted in zero water shortage during the last two months of rabi season, (2) increased offtake of fertilizer, and (3) substantial availability of agri credit. In particular, credit disbursement in agri sector reached 86.8 percent of the annual target for FY05 by March 2005 as compared to 73.1 percent in March 2004. Similarly, recovery of agri credit also witnessed a sharp rise of 39.7 percent during Jul-Mar FY05 as compared to 17.7 percent in Jul-Mar FY04.

Industrial Production

The index of industrial production (IIP) showed an estimated growth of 15.3 percent during Jul-Feb FY05, considerably lower than 19.9 percent recorded in the same period of FY04. However, the growth is certainly higher than the annual target of 9.8 percent for the year.

The slowdown in Jul-Feb FY05 growth rate relative to the preceding year is on account of deceleration in the growth of *large- scale manufacturing* (LSM) sub-sector which is about 70 percent of IIP.

More specifically, while the 15.0 percent YoY growth during the period is distinctly lower than 17.5 percent YoY increase seen in FY04, it is still substantially stronger than the average growth of 7.2 percent during FY01-FY03. In fact, only in January 2005 did the monthly LSM growth fall below average for earlier years, falling to 8.2 percent YoY (the lowest since November 2003). However, LSM growth bounced back again to above average in February 2005 to a robust 16.7 percent. In fact, it is likely that the LSM production will remain relatively strong through the remaining months of the financial year allowing the annual LSM growth to comfortably exceed the FY05 target.

As a result of continued strong growth in various industries, capacity utilization also witnessed a significant increase. The highest increase of 38.5 percentage points in the capacity utilization occurred in *electronics* industry during Jul-Feb FY05 on the back of strong credit led demand for home appliances.

Similarly, *automobile* industry witnessed a sharp increase in capacity utilization (by 21 percentage points) mainly on account of higher capacity utilization by tractors and motorcycles/rickshaws. Moreover, capacity utilization in *fertilizer, paper & board, industrial chemicals* and *steel* industries is either exceeding or approaching 100 percent during Jul-Feb FY05. These industries therefore required expansion in their existing production capacity to meet the growing demand.

Prices[4]

Concerns over inflationary pressures in the economy deepened by March 2005 as all three price indices bounced back from their near term troughs in December 2004. This was particularly evident in CPI inflation, which after dropping to 7.4 percent YoY in December 2004, climbed back to 10.3 percent YoY by March 2005 – a 90 month high, and the first time that CPI inflation has reached double-digits in more than seven years.

The key factors behind the resurgence in inflationary pressures appear to be the unexpected strength of petroleum product prices and subsequently, higher food prices. While wheat prices have indeed stabilized somewhat, the impact of this on domestic food inflation was more than offset by a number of factors. The most important of these was the government's decision to end the freeze on domestic prices of key fuels in mid-December 2004. The resulting successive increases in local fuel costs in the following months probably contributed to rising prices in the economy directly (e.g. by pushing transportation costs that, amongst others, form

[4] The April 2005 CPI data released on May 18, 2005 shows CPI inflation at 11.1 percent YoY.

an important part of food prices), as well as indirectly (by igniting inflationary expectations). The impact on food inflation, in particular, was then further exacerbated by other factors such as (1) a fall in the production of sugar and subsequent supply shortages, (2) rain damage to some key minor crops e.g., potatoes and onion; and possibly (3) speculative hoarding of some non-perishable food commodities.

While the rise in the price indices was disquieting, the fact that the increase was driven principally by POL and food product prices meant that SBP policy had a relatively small role in containing these supply-side pressures. In fact, the composition of the CPI inflation pressures suggests that anti-inflationary policies will need to focus more on administrative and fiscal measures.

Fiscal Developments

At first look the Jul-Mar FY05 CBR performance looks quite impressive, with net receipts totaling Rs 401.3 billion, up 13.6 percent YoY and exceeding target for the period by 1.3 percent. However, a more detailed analysis reveals some points of disquiet. Only in the first quarter of FY05 did collections exceed targets helped by exceptionally strong direct tax receipts (a massive 46.4 percent above target for the quarter). Unfortunately, in the succeeding two quarters, net receipts for both direct tax and the sales tax have dropped below the respective quarterly targets, which were only partially offset by the above-target receipts of other taxes. As a consequence, the aggregate tax receipts for Q2-FY05 and Q3-FY05 were respectively 2.4 percent and 4.8 percent below target.

Total refunds and rebates disbursed stood at Rs. 75.6 billion during the first nine months of FY05, depicted a rise of 23.0 percent over the same period last year. Refunds as a percentage of total gross collection during the period rose to 15.8 percent as against 14.8 percent recorded in FY04.

Direct taxes contributed Rs 119.5 billion in the total revenue receipts against the target of Rs 114.7 billion during the first nine months of FY05 registering a growth of 14.4 percent over the same period last year. Collection from indirect taxes registered a slightly lower growth of 13.2 percent and totaled Rs 281.8 billion during the period. In contrast to recent years, this growth emerges principally from robust customs duty collections (up 27.4 percent YoY) and CED receipts (up 19.3 percent YoY) rather than growth in sales tax receipts (up only 6.2 percent YoY). This is hardly surprising in view of tremendous surge in imports during the year.

Money, Credit and Banking

The monetary environment remained challenging for the central bank through Jul-Apr FY05 as it sought to strike a balance between containing an excessive rise in interest rates to support the recent surge in short-term growth; and tightening monetary policy to suppress the rising inflationary pressures in the economy. This task was further complicated by the structural changes in the economy as well as the credit cycle.

Therefore, the monetary response to a rise in inflationary pressures was quite subdued in the initial months as it was feared that too tight a monetary posture would seriously retard the growth momentum. However, the renewal of inflationary pressures following the hike in oil prices from mid-December 2004, and the increasing risk of a hardening of inflationary expectations clearly indicated that the tightening of monetary policy was needed to be accelerated. Accordingly, the discount rate was increased by 1.5 percentage points that strongly signaled the SBP's intent to raise interest rates. The successive 3-month T-bill auctions on April 14 and May 12 saw a massive 138 and 99 basis points increase in the acceptance cut-off.

Money supply during Jul-Apr FY05 increased by 12.9 percent (Rs 321.0 billion) against the revised full year target of 14.5 percent (Rs 360 billion). This growth in M2 was driven largely by an extraordinary increase in the net domestic assets (NDA) of the banking system. As in Jul-Apr FY04, the growth in NDA in Jul-Apr FY05 was mainly driven by a record increase in credit to private sector. NFA's contribution to Jul-Apr FY05 monetary expansion was Rs 69.5 billion as against Rs 52.2 billion in the corresponding period last year. This growth in the NFA of the banking system in Jul-Apr FY05 was more than double the full year growth of Rs 30 billion envisaged in the FY05 credit plan.

Balance of Payment

Pakistan's external account recorded a deficit of US$ 329 million during Jul-Mar FY05 which is in sharp contrast to a surplus of US$ 981 million in the corresponding period last year. Even as the financial account experinced major inflows (mainly due to the issuance of *Sukuk* and higher disbursement of non-food aid from ADB and the World Bank), these were completely offset by the current account deficit during the period under review. A further analysis reveals that the deterioration in current account emerges from a sharp rise in the trade and services account deficits during Jul-Mar FY05 mainly owing to a rise in imports (both oil and machinery) and other import-related charges (e.g., shipment charges).

The services account recorded a higher net outflow of US$ 2.4 billion in Jul-Mar FY05 as compared to only US$ 0.6 billion during the corresponding period of FY04. Net outflows increased almost under all major categories, such as transportation (due to higher imports), higher payment of royalties & license fees to the foreign companies operating in Pakistan; and lower receipts of payments for logistic support. These outflows in fact also offset the gains from lower net interest payments on external debt & liabilities.

The net receipts under *current transfers* recorded a YoY growth of 28.4 percent over the same period last year to reach US$ 6.3 billion during Jul-Mar FY05. Within private transfers, the remittances increased by US$ 176 million over the corresponding period last year. In addition, *other private transfers* saw a sharp rise that was primarily due to increasing integration of foreign exchange companies into formal channel and more Rupee conversion from the resident FCAs.

On the other hand, the adjusted financial account recorded a surplus of US$ 804 million compared to deficit of US$ 175 million during the same period preceding year[5]. This improvement in the financial account was owed to (1) US$ 600 million through the issuance of *Sukuk* (2) greater availability of non-food aid relative to corresponding period of the preceding year; (3) higher net foreign investment; and (4) net inflow of IDB short-term loans.

Foreign Trade

The overall trade deficit continued to surge steadily, reaching US$ 4.2 billion during Jul-Mar FY05 – the highest level ever reached in the history of Pakistan. This exceptional increase in trade deficit was on account of unusually strong 37.8 percent growth in imports during the period that more than offset the 15.0 percent growth in exports. On the positive side, monthly exports which had been witnessing slowdown in growth due to the impact of antidumping duty by EU on bed linen exports, have started recovering in Q3-FY05.

Exchange Rate & Foreign Exchange Reserves

Although the current account deficit widened steadily throughout Jul-Mar FY05, the Rupee witnesses a net depreciation of only 2.0 percent during this time. This relative stability of the domestic currency is probably the result of the SBP's

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[5] This refers to financial account adjusted for the pre-payment of US$ 1.106 billion to ADB in January 2004 and for a contra-entry of US debt write-off of US$ 495 million shown under the amortization of long-term official loans and US$ 100 million of settlement of foreign currency loans of commercial banks to repay PARCO loans during Q1-FY05.

public commitment to inject foreign exchange into the inter-bank market to meet large payments on account of strategic imports.[6]

Indeed, this commitment catalyzed the end of the panic-driven pressure on the domestic currency that had driven the Rupee to a FY05 low of Rs 61.37/US$ by end-October FY05 (a fall of 5.2 percent year-to-date), and subsequently helped the Rupee to recover part of its losses, reaching Rs 59.40/US$ by end-Mar 2005. In fact, such was the turnaround in market expectations, that the SBP was able to first gradually reduce its sales, and eventually to be a net purchases of foreign exchange in the interbank market – in March 2005, SBP made *net purchaser* from the inter-bank market, as liquidity increased, probably due to higher net lending against foreign currency deposits and substantial jump in remittances to US$ 443.7 million that month.

Pakistan's overall foreign exchange reserves recovered sharply from FY05 low of US$ 11.5 billion realized on December 16, 2004, and crossed the US$ 13 billion mark on April 19 2005. Interestingly this improvement of US$ 1,491 million in *overall* reserves comes almost entirely from SBP reserve holding that swelled by US$ 1,428 million since mid-December 2004 level. Commercial banks' reserves on the other hand did not experience any major change. The increased reserves set the reserves adequacy ratios at a comfortable position.

[6] On October 31, 2004, SBP made a formal commitment to provide foreign exchange for imports of key commodities such as oil, wheat and fertilizer.