THE STATE OF PAKISTAN'S ECONOMY
Third Quarterly Report for FY06

1.1 Overview

Provisional estimates show that the country's long-term growth momentum remains intact, with real GDP growth exceeding 6 percent for the third successive year. While the 6.6 percent real GDP growth estimated for FY06 is relatively weaker than the 8.6 percent revised growth rate for FY05, this was not unexpected in light of historic trends and a high-base effect, as evident in the lower growth target (7 percent) for FY06. It must also be kept in mind that a substantial portion of the losses in agriculture simply reflected bad luck, e.g., even if *only* the cotton harvest had not been hit by inclement weather, it is possible that the FY06 growth target may have been exceeded.

Table 1.1: Major Macroeconomic Indicators

	Jul-to date		
	FY04	**FY05**	**FY06**
growth rates (percent)			
Large-scale manufacturing (Mar)	17.0	15.4	9.0
Exports-FBS (May)	11.8	16.2	16.7
Imports-FBS (May)	24.1	33.8	39.4
Tax revenues (CBR) (May)	12.4	13.6	22.0
CPI (12-m ma) (May)	4.0	9.3	8.0
PSC (CBs) (Jun 10)	29.6	29.7	19.5
Money supply (M2) (Jun 10)	17.1	16.2	13.3
million US Dollars			
Total liquid reserves[1] (May)	12,438	12,359	12,990
Home remittances (May)	3,516.6	3,809.8	4,136.3
Foreign private investment (Apr)	629.1	1,027.0	3,376
percent of GDP[2]			
Fiscal deficit (full year)	2.9	3.3	4.2
Underlying (ex-earthquake)		3.4	3.7
Trade deficit (Apr)	2.1	4.4	7.5
Current a/c balance (Apr)	2.2	-0.8	-3.3

[1] With SBP & scheduled banks. End-May.
[2] Calculated by taking fiscal year GDP. Projected GDP for FY06 has been used.

The strength of aggregate demand in the economy is quite encouraging (see **Table 1.1**), particularly given the impact of the global rise in energy costs. However, given that the fiscal stimulus from the recently announced budget for FY07 will add to demand and the emerging macroeconomic imbalances, there is a clear need for corrective policy measures to protect long-term growth prospects of the economy. The risks include the possibility of an increase in inflationary pressures, the gradual weakness in fiscal indicators, and the widening of the current account deficit.

The first of these may not be of serious *immediate* concern. The tight monetary policy being followed by the SBP clearly appears to be bearing fruit, with M2 growth falling to 13.3 percent for Jul-Jun 10, FY06, down from 16.2 percent in the

corresponding period last year. This fall is led principally by a deceleration in private sector credit to 19.5 percent in Jul-Jun 10 FY06 from 29.7 percent in the corresponding period of FY05.

The resulting *relative* slowdown in aggregate demand, coupled with supply-side improvements through: (1) better harvests (for some crops, particularly wheat), and (2) administrative measures by the government (including the use of cheap imports to discouraging cartels, etc.) have helped significantly reduce inflationary pressures in the economy. CPI inflation has dropped from 11.1 percent YoY in April 2005 to 7.1 in May 2006, and it is expected that the FY06 average inflation will fall within the 8 percent target, despite the unexpectedly high oil prices that prevailed throughout the year.

The second issue (i.e. the fiscal deficit) is a concern more in terms of the trends and structural weaknesses (and therefore the probable future impacts). While the fiscal deficit has indeed widened in FY05 and FY06, in both years the underlying figures are low, at 3.3 percent and 3.4 percent of GDP respectively (the latter number jumps to 4.2 percent of GDP only due to the impact of the earthquake relief efforts). The concern stems from the fact that the tax net has seen little broadening in recent years, and continues to exclude (or under-tax) a substantial portion of the economy. It is therefore not surprising that the growth in the economy is not matched by a corresponding increase in tax revenues. To put this in perspective, if the tax-to-GDP ratio had been maintained even at the low FY01-05 average of 10.8 percent, the government would have had additional resources of Rs 27.4 billion in FY06 alone.

The lack of buoyancy in the tax receipts needs to be addressed while the economy is still strong, as the costs of the re-distribution of the tax base are more palatable as long as sectoral profitability of hitherto under-taxed areas remains strong. Such measures would also strengthen the competitiveness of other sectors of the economy by allowing the government to reduce the tax burden in these sectors that currently carry a disproportionate share of the tax burden.

The third macroeconomic risk, the re-emergence and widening of the current account deficits from a surplus of US$ 1.8 billion in FY04 to a sizeable deficit of US$ 5.7 billion (annual estimate) in FY06 poses a more immediate policy dilemma. This phenomenon is inextricably linked with the strength of the domestic economy (as seen from the very substantial share of industrial inputs and machinery in the total import bill), the impact of liberalization of the economy (as seen in the rising imports of media and telecom equipment, as well as the fall in the effective tariff rates) and a sharp rise in oil prices. The policy options are

correspondingly complex, particularly given that (1) exports continue to rise strongly, suggesting that the problems could ease with time, as import growth reverts to (lower) historical norms, and (2) given that a heavy-handed, knee-jerk response could easily add disruptive volatility to the financial markets. Accordingly, with the current account deficit still low, at 4.3 percent of GDP (estimated) in FY06, and given the availability of external financing, the SBP opted to keep monetary policy tight to contain excessive volatility in the exchange rate and inflation.

1.2 Looking Forward

Despite a relative slowdown, all evidence indicates that the growth momentum of the economy remains strong, although growth is now more narrowly-based compared to the previous year. It is in light of this evident strenght in the economy that the government has set the GDP growth target of 7 percent for FY07, which at first glance, does not seem unreasonable.

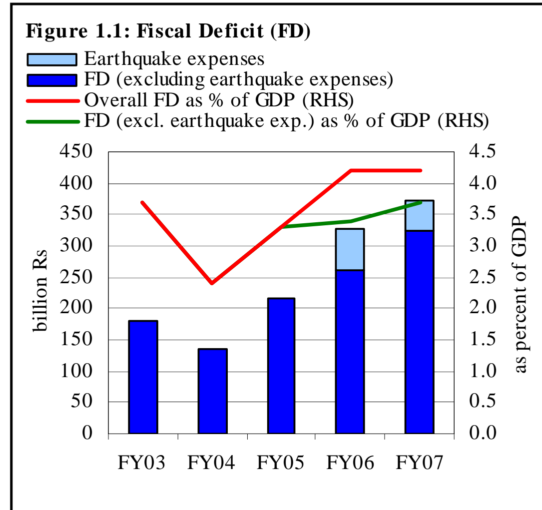
Table 1.2: Major Economic Indicators

	FY05 Revised	FY06		FY07 Targets/ projections
		Original targets	Prov. estimates	
growth rates (percent)				
GDP	8.6	7.0	6.6	7.0
Inflation	9.3	8.0	7.9	6.5
Monetary Assets (M2)	19.3	12.8	14.8	13.5
billion US$				
Exports (fob-Customs record)	14.4	-	16.8	19.5
Imports (cif-Customs record)	20.6	-	28.4	34.1
Workers' remittances	4.2	4.0	4.5	4.7
percent of GDP				
Budgetary balance	-3.3	-3.8	-4.2	-4.2
Current account balance (excluding official transfers)	-1.6	-2.1	-4.4	-5.7

In particular, it is quite possible that FY07 will see a strong agri-growth given the low base provided by the relatively poor performance by major crops in FY06. This in turn, would support an improved performance in key industries such as textiles and sugar, thus supporting growth in the large-scale manufacturing. However, FY07 could also see the drag from high oil prices (though the government has signaled that it will keep domestic prices in check by eliminating substantial taxes on key fuels), and from a continued tight monetary policy. On the last, arguments have been made that inflation is now on a downtrend, and therefore monetary policy can be safely loosened. However, given that aggregate demand is still strong, and that the economy will benefit also from the expansionary fiscal stance, a loosening of the monetary posture is clearly not advisable.

Going forward, the impact of the credit slowdown on inflation may be substantially augmented by a continuing decline in food inflation following the implementation of the recently announced administrative measures and subsidies by the government. This suggests that the 6.5 percent average inflation targeted for FY07 may not be unachieveable. However, there are some risks to this relatively benign picture. Oil prices are at historical highs, with attendant risks to price stability and growth. Moreover, the broadest inflation measure, the GDP deflator, is estimated at 10.3 percent for FY06, up sharply from 8.8 percent in the preceding year, suggesting that inflationary pressures still persist in the economy. The path of future monetary policy becomes further complicated by both, the proposed expansionary fiscal policy (see **Figure 1.1**) as well as the uncertainty on the degree of monetization of the fiscal deficit.

Figure 1.1: Fiscal Deficit (FD)



On the positive side, over half of the increase in government expenditure during FY07 is on account of development spending (which will add to the economy's future growth), and there is also a substantial one-off element (Rs 50 billion in earthquake related spending) to the proposed rise. However, it is troubling to note that even adjusting for the earthquake related spending, there is a gradual weakening in the underlying trend of the fiscal deficit (see **Figure 1.1**). Although the CBR taxes have grown strongly in recent years, the tax-to-GDP ratio remains low, having declined from 11.5 in FY03 to 10.4 in FY06. It is in this backdrop that the government's intention of keeping the fiscal deficit at 4.2 percent of GDP has already drawn reproof from the rating agency Standard & Poors. The fiscal position would worsen if the 18.6 percent growth target for FY07 tax revenues is not achieved. However, this possibility seems remote. On the one hand, measures to expand the tax base will support strong growth in receipts, while on the other hand, the government will also have the possibility of raising revenues from the Petroleum Development Levy (PDL). The FY07 budget does not envisage any revenues from this source, in contrast to the Rs 20.2 billion collection (estimate) for FY06,

but the government has the option to revise this decision in case of serious revenue shortfalls.

The expansionary fiscal stance will add to aggregate demand, and therefore to inflationary pressures. The impact could be worsened if the government depends heavily on central bank borrowings to finance the deficit. The budget for FY07 envisages a receipt of Rs 35 billion from SBP profits,[1] which suggests that this may be the case, and therefore the burden of containing inflationary pressures will fall disproportionately on monetary policy.

This is amply clear also from the trends in the external account, where strong aggregate demand, together with rising oil prices, has led to a sharp 39.4 percent hike in imports during Jul-May FY06, substantially overshadowing the 16.7 percent rise in exports in the same period. While the exceptional growth in imports is certain to moderate in FY07 (despite an anticipated rise in the oil import bill, especially following an anticipated dip in hydroelectricity generation), it is important that the export growth momentum be sustained. Indeed, while data shows that the exceptional growth in imports may already be slowing considerably, export growth is also weakening, suggesting the need for greater support for exporters in the forthcoming trade policy, and that the projects to improve domestic logistics chain and infrastructure be expedited. This also requires that the central bank remain vigilant against inflation, as price stability will be a key competitive advantage for the country.

The current account deficit is envisaged at US$ 6.3 billion or 4.3 percent of targeted GDP in the Annual Plan for FY07. While this deficit seems high, privatization receipts and strong aid inflows are anticipated to offset much of the impact during FY07. This, however, would primarily depend on the realization of the anticipated moderation in import growth, as foreseen in the annual plan, and continued strong export growth. If, as suggested by SBP projections, the current account deficit proves to be substantially higher, it would be extremely difficult to sustain without either substantially raising external debt, recourse to an undesirable drawdown in reserves, or strong measures to contain aggregate demand or a more focused policy of containing external demand.

[1] A substantial portion of the central bank's profitability is from the interest earned on its holdings of government securities (principally accrued through the financing of government fiscal deficits).

1.3 Executive Summary

Economic Growth

According to provisional estimates of national income accounts, real GDP remained at its long-term growth path in FY06 with a growth rate of 6.6 percent. While this growth is marginally lower than the 7.0 percent annual target, this is quite impressive given the aftermath of the earthquake, the relatively poor harvests of key crops, the impact of high oil prices and rising domestic interest rates. The greater contribution to this high growth rate is by the services sector, which exhibited a remarkable 8.8 percent growth during FY06 as compared to the 4.3 percent growth of the commodity-producing sector in the same period. Within the services sector, the highest growth was seen in *finance & insurance* (23.0 percent) followed by *wholesale & retail trade* (9.9 percent).

Agriculture

The disappointing performance of key *kharif* cash crops (cotton and sugarcane) coupled with below-target production of wheat and minor crops, dragged down the agricultural growth to 2.5 percent during FY06 from 6.7 percent last year. The value addition by crops showed a decline of 2.3 percent during the year compared to previous year mainly due to lower production of cotton, sugarcane and grams. However, the livestock sub-sector posted strong growth of 8.0 percent in FY06.

It is encouraging that the off-take of fertilizers increased sharply (by 12.1 percent) despite rise in prices. Both urea and DAP witnessed higher growth rates of 11.1 percent and 15.7 percent during Jul-Apr FY06 respectively compared with corresponding figures of 5.0 percent and 7.7 percent in FY05.

The growth in agriculture credit disbursement, on the other hand, decelerated to 25.7 percent YoY (Rs 116.96 billion) in Jul-May FY06 as against a robust growth of 50.4 percent YoY in the corresponding period of FY05 which probably reflects the rising interest rates in the economy. The growth in loan recoveries also decelerated, but this is smaller than that in disbursements and, as a result, recoveries as a percent of disbursements have increased during the year.

Large-scale Manufacturing

Provisional estimates indicate that LSM growth has fallen significantly from 15.6 percent in FY05 to 9.0 percent during the current fiscal year; and is lower than the FY06 target of 13.0 percent. Moreover, the data for Jul-Mar FY06 shows that the deceleration is quite broad based with most of the sub-groups showing growth below that in the previous year. The only sectors showing higher growth included food, leather, pharmaceutical, paper & board. The sector which has the largest

weight in LSM, i.e., textiles, saw growth slow to 4.0 percent during Jul-Mar FY06 as compared with a 28.7 percent growth seen in the same period of FY05. A substantial contribution to this slowdown was from a deceleration in the production growth of cotton yarn & cotton cloth and a decline in the production of ginned cotton.

A sharp deceleration was also seen in the *petroleum and lubricant* (POL) and *fertilizer* industries, which recorded growth rates of 2.3 percent and 9.8 percent respectively during Jul-Mar FY06 as compared corresponding FY05 figures of 11.7 percent and 37.2 percent respectively. While the growth in the *automobiles* industry also declined, it remained a robust 27.7 percent during Jul-Mar FY06, only a little lower than the 31.5 percent for Jul-Mar FY05.

Capacity utilization in LSM declined by 1.3 percentage points in Jul-Mar FY06 as compared with a *rise* of 0.5 percentage points during the same period of FY05. However, this was essentially due to Pak Steel Mills, where production has dropped steeply due to a major technical fault. Excluding the impact of the latter, LSM capacity utilization was 1.1 percentage points higher than in the corresponding period of last year, even after capacity additions in some industries.

Prices

Inflationary pressures generally weakened throughout the current fiscal year due to tight monetary stance since April 2005, and administrative measures to improve the supply of key commodities.

Inflation measured by the Consumer Price Index (CPI) increased to 7.1 percent YoY in May 2006, which is significantly lower than the 9.8 percent inflation in May 2005. The deceleration in CPI inflation stemmed essentially from decelerating CPI food inflation, which declined to 5.6 percent in May 2006 down from 12.5 percent in the corresponding month last year. CPI non-food inflation, on the other hand, weakened modestly, remaining above 8 percent during Jul-May FY06.

After declining steadily through most of Jul-Apr FY06, WPI inflation jumped back to 9.1 percent YoY in May 2006 up from 8.1 percent in the preceding month, and significantly higher than the 6.0 percent recorded in May 2005. This increase has been contributed both by food and non-food groups of WPI. SPI inflation also witnessed an increase of 7.7 percent during May 2006 which is significantly higher than the inflation of 6.4 percent seen in the preceding month.

Money and Banking

State Bank of Pakistan maintained a tight monetary policy throughout FY06 in order to contain inflationary pressures in the economy. The instrument used for containing monetary growth was predominantly open market operations through which the SBP drained excess liquidity from the inter-bank market without bringing any significant change in the benchmark 6-month T-bill rate. The discount rate was also kept unchanged during the period.

As a result of monetary tightening, monetary aggregates have been showing significant weakening by Jun 10 FY06 compared with the corresponding period of FY05. The growth in money supply (M2) decelerated to 13.3 percent during Jul-Jun 10 FY06 from 16.2 percent in the same period last year. This slowdown was driven primarily by the deceleration in the growth of both private sector credit and net foreign assets.

The downtrend in the NFA of the banking system during most of Jul-Jun 10 FY06 is driven by two apparently contradictory developments – the sharp widening of the country's current account deficit, and the firming expectations of exchange rate stability. Although the receipts from the PTCL privatization and the Eurobond issues prevented a net decline in the NFA of the banking system during the period, the growth is still significantly below the levels of the previous year.

The NDA of the banking system showed a growth of 16.0 percent during Jul-Jun 10 FY06 compared with the growth of 19.6 percent during the same period of FY05. As in the previous year, the current increase in NDA was driven principally by the growth in credit to the non-government sector.

By end-February 2006, government borrowing for budgetary support from the banking sector had exceeded the Rs 98.0 billion FY06 annual target by 64 percent, principally due to substantial borrowings from SBP. However, the inflows under PTCL privatization and the issuance of Eurobonds during March 2006 allowed the government to retire a large part of these borrowings. As a result, the cumulative government borrowings from the banking sector dropped to Rs 120 billion during 1st Jul-10th June FY06, which remains higher than that in the corresponding period of FY05.

The growth in private sector credit during 1st Jul-10th June FY06 was a little higher than the annual credit plan estimates for the year, but was significantly lower than the increase during the same period of FY05. This slowdown is despite the larger increases in trade-related loans and the private sector commodity finance during

Jul-May FY06 compared with the preceding year. This slowdown in the credit market appears to be driven by both demand and supply side factors.

Fiscal Sector

Fiscal indicators weakened for the second successive year in FY06. Not only has the fiscal deficit widened, the revenue and primary balances have also declined, primarily due to the impact of the earthquake relief and rehabilitation expenditures. Adjusting for these, the fiscal picture improves somewhat, with the re-emergence of primary and revenue surpluses, but the fiscal deficit continues to show a marginal increase. However, to the extent that the higher fiscal deficit stems from rising developmental spending, the increase is less of a problem.

Total revenue is estimated to reach Rs 1095.6 billion during FY06, up 21.7 percent YoY as compared to the growth of 13.8 percent YoY in FY05. Growth in both tax and non-tax revenue contributed to this achievement. In terms of individual taxes, the direct taxes and sales-tax surpassed their targets, while the collections on account of Federal Excise Duty (FED) and Customs duty remained below the respective targets.

Total expenditure in FY06 is estimated at Rs 1423.0 billion, up 27.4 percent YoY. Almost 55 percent of the total expenditure was accounted for by interest payments, defense, current subsidies and general administration. However, encouragingly, the growth in both the interest payments and defense expenditures was lower than in the previous year. The development expenditure increased 43.5 percent YoY to Rs 326.7 billion, mainly to expand infrastructure and on social development.

The overall budgetary deficit for FY06 works out to be Rs 327.4 billion, which is financed by external resources to the extent of Rs 118.3 billion and the rest is financed from internal resources. Of the internal resources, the government is likely to meet the financing gap from the banking sector (Rs 96.7 billion), from the non-bank (Rs 22.4 billion), and privatization proceeds (Rs 90 billion; of which Rs 55.2 billon has already been realized by the end of the third quarter of FY06).

Balance of Payments

The pressure on the country's external account increased substantially during FY06, as the current account deficit swelled to a historic peak of US$ 4.1 billion by end-Apr FY06, sharply higher than the US$ 0.94 billion deficit recorded in the corresponding period of FY05. Even more significantly, as a percentage of GDP the annual current account deficit is estimated to rise from an innocuous 1.4 percent of GDP in FY05 to a more troubling 3.2 percent of GDP in FY06,

indicating that a continued weakening would raise grave risks to the hard-won macroeconomic stability achieved in recent years.

As in the previous year, the deterioration in the current account deficit during Jul-Apr FY06 emanates essentially from the trade deficit, wherein the gains from a robust 13.0 percent increase in exports have been eclipsed by the exceptionally strong 28.5 percent increase in imports. Within the current account, the trade deficit of US$ 6.5 billion was accompanied by services account deficit of US$ 3.5 billion, up 36 percent from last year (mainly due to higher transportation and other business charges associated with higher imports). The Income account also recorded a deficit of US$ 2.1 billion. The rise in deficit in the trade, services and income account was partially offset by an increase in the current transfers, which rose from US$ 7.1 billion in Jul-Apr 2005 to US$ 8.1 billion in Jul-Apr 2006, largely on account of the worker remittances and increases in official grants.

Pakistan was however, successful in tapping the international markets to finance its deficit, attracting FDI (including for its privatization program) and in obtaining financing for developmental projects. All of these, together with rising portfolio investment, are reflected in the country's substantial US$ 5.0 billion financial account surplus during Jul-Apr FY06, as compared to a surplus of only US$ 24 million in the corresponding period of FY05. As a result, the overall balance witnessed a surplus of US$ 1.4 billion during Jul-Apr FY06.

This also helped sustain the *relative* stability of the exchange rate – the rupee depreciated only 0.88 percent against the US dollar during Jul-May FY06 to Rs 60.22/US$[2] - and sustaining SBP reserves around the US$ 10.6 billion mark by end-May 2006.

Trade Account [3]

The steadily widening trade deficit touched US$ 10.6 billion during Jul-May FY06, substantially higher than the US$ 5.5 billion recorded in the same period last year. The driving force behind the exceptionally high trade deficit remained the persistent surge in the import growth. During the period, the extraordinary import growth of 39.4 percent outstripped the otherwise healthy export growth of 16.7 percent.

The major contributors to the growth in imports were soaring international oil prices and machinery imports. In fact, the POL imports contributed almost one-

[2] Average of buying and selling inter-bank floating rate.
[3] The discussion in this section is based on FBS data.

third (32.2 percent) of the total import growth of 39.4 percent.[4] Machinery imports contributed another 22.7 percent of the annual import growth.

However, there is a discernible slowdown in the import growth from February 2006 onwards. The detailed analysis of the data shows that the growth in major heads is much lower in Feb-May 2006 compared to that in Jul-Jan 2006. Furthermore, almost 80 percent of the growth in the Feb-May period is being contributed by just two broad categories; 'petroleum' and 'other imports'. The share of machinery in imports growth has gone down from 29 percent in Jul-Jan 2006 to 5 percent in Feb-May 2006.

Export growth averaged a healthy 16.7 percent during Jul-May FY06, despite the increasing competition post-MFA (which has hit unit values in key export commodites), as well as punitive anti-dumping duties and loss of GSP benefits for textile exports to the EU region. However, a relative weakness in export growth in the latter half of FY06 is a matter of some concern, and it is hoped that with the recent reduction in antidumping duty by the European Union on Pakistan's bedwear exports (from 13.1 percent to 5.8 percent, effective May 7, 2006), and restoration of some GSP benefits (albeit at lower levels), export growth could revive in FY07.

[4] Almost the entire rise was due to high prices.