THE STATE OF PAKISTAN'S ECONOMY

Third Quarterly Report for FY07

1.1 Overview

Recent statistics indicate that the economy is likely to show robust growth for the fourth successive year, with real GDP growth now expected to exceed the 7 percent annual target in FY07. Moreover, the growth is expected to be quite broad based. The unexpectedly strong out turn by agriculture following the record wheat crop and upward revision in key *kharif* numbers means that agricultural growth is forecast to exceed the annual 4.5 percent growth target. The industrial growth is also expected to be stronger than that in the previous year, though it may not reach the FY07 target. Similarly, the services sector is expected to continue with its growth momentum for yet another year; while growth in the *wholesale & retail trade* sub-sector is likely to slow somewhat, reflecting the deceleration in imports, the remaining services sub-sectors are expected to continue to record high growth.

The strength of aggregate demand reflected in the growth figures clearly belies claims that the monetary tightening has stifled growth in the economy. Quite to the contrary, it seems that monetary policy has struck an appropriate balance by protecting the growth momentum of the economy, while attempting only to remove excessive monetary stimulus from the economy. Unfortunately, the impact of the latter in reducing inflationary pressures has been offset partially by the rise in food inflation, and supply-side pressures. Thus, even as non-food inflation weakened, overall CPI inflation declined only gradually, falling from 11.1 percent in April 2005 to 6.9 percent by April 2007 (see **Table 1.1**), however still above the 6.5 percent target for FY07.

Table 1.1: Selected Economic Indicators

Jul-Mar or as mentioned

		FY05	FY06	FY07
Growth rates (percent)				
LSM		18.7	9.9	9.8*
Exports (fob)		14.3	18.0	3.5
Imports (cif)		37.6	43.2	8.1
Tax revenue (CBR)		13.5	22.1	21.9
CPI (12m MA)	end-Apr	9.0	8.2	7.8
Private sector credit	Jul-Apr	28.6	20.2	13.0
Money supply (M2)	Jul-Apr	13.7	10.8	12.1
billion US Dollars				
Total liquid reserves[1]	end-Apr	13.0	13.1	13.7
Home remittances		3.1	3.2	3.9
Foreign investment		1.4	3.3	5.6
percent of GDP[2]				
Fiscal deficit	Jul-Dec	1.2	1.8	1.9
Trade deficit		3.8	6.7	6.8
Current account deficit		1.0	3.3	4.1

* September 2006 data point. More recent data is not available.
[1] With SBP & commercial banks.
[2] Based on full-year GDP in the denominator.

It needs to be recognized that food inflation is typically less responsive to monetary tightening and therefore monetary policy should not respond aggressively to *temporary* shocks in food prices. At the same time, it is also clear that a continuing focus on tight monetary policy will be critical so that the *second-round* impacts of the high food inflation do not add to underlying inflationary pressures in the economy. SBP depends more on market dynamics and government's administrative measures to contain food inflation while retaining a tightening bias to ensure that inflationary expectations are contained.

The challenge to the modulation of monetary policy is increased by the recent acceleration in the growth of monetary aggregates. Through most of FY07, even when seeking a broad reduction in aggregate demand, the SBP remained mindful of the pressures on the textile sector, and on exports, which faced rising competitive pressures. Thus, a substantial portion of the credit availed by these sectors in FY07 was provided on concessional terms by the central bank. This included a total of Rs 332.8 billion during Jul-April 28, FY07 as gross disbursement from refinancing facility (Rs 43.8 billion disbursed under the LTF-EOP[1] scheme and another Rs 289.0 billion through the export refinance scheme).

It must be recognized that the subsidy implicit in the provision of concessional re-financing by SBP is only part of the cost of supporting the strategic sectors; additional (less visible) costs include the downstream implications on reserve money growth and consequent lagged impact on inflation, fiscal costs (as SBP profits erode, reducing the pass through to government), as well as reducing the incentives for banks to generate deposits by raising returns.

Indeed, the concessional credit provided by the central bank was an important factor in the strong growth in reserve money during July-April FY07. The impact of this was compounded by the substantial increase in government borrowings from the banking system, and rising net foreign assets of the banking system. Partially, as a result, growth in broad money during the period rose to 12.1 percent by April 28, 2007, significantly higher than the 10.8 percent growth during the corresponding period of FY06.

Another important development in FY07 was the change in the credit growth profile.

- Firstly, even though the growth in private sector decelerated substantially during the first nine months of FY07, the bulk of the fall owed to a few specific sectors. Specifically while there was a sharp deceleration in

[1] Long-term financing for export oriented projects.

consumer credit, the business loans presented a mixed picture, with many businesses witnessing a strong increase in credit demand (including telecommunications, food processing industries, and apparel industries). In other words, there appears to be a healthy shift in the credit demand centers in the economy.

- Secondly, a part of the deceleration in credit demand owed to supply-side constraints, as a few large banks scaled down their credit activities either due to internal restructuring (e.g. to improve risk management, and credit extension services, etc.) or as a consequence of mergers & acquisitions. In fact, a substantial part of the deceleration in credit off-take is contributed by just a few institutions.
- Thirdly, while investment credit demand witnessed a decline, this essentially reflected lower demand in industries that had already substantially increased capacities in recent years (e.g. textiles and cement), as well as delays in the initiation of major infrastructure projects (e.g. power projects).

The above discussion suggests that at least a part of the deceleration in the private sector credit growth seen in FY07 may not persist in FY08. In other words, the high reserve money growth in FY07, together with the rising demand for private sectors credit, raises the risk to a strong resurgence in excess aggregate demand, and consequently inflationary pressures in FY08.

This makes it even more important that fiscal policy be aligned with monetary policy in months ahead. The rise in the fiscal deficit in recent years has been essentially an unavoidable function of the post-earthquake reconstruction activities and of the heavy development investments required to build up infrastructure and invest in human capital to enhance the productive capacity of the economy. At the same time the government has also tried to avoid the build-up in fiscal imbalances by committing to a 4.2 percent of GDP cap on the fiscal deficit target. However, despite significant success in increasing non-bank borrowings in FY07, particularly following the resumption of significant PIB issuances and a recovery in (net) NSS receipts, there is a worrying dependence on borrowings from the central bank. The risk to monetary stability posed by heavy budgetary borrowings is highlighted by the Feb-Apr FY07 fiscal financing activities, with the government raising Rs 195.7 billion from the scheduled banks, *net* of maturities, but retiring only Rs 58.4 billion of its central bank loans.

Another significant challenge to monetary stability stems, ironically, from the Pakistan's comfort in financing the country's growing current account deficit. While the growth in the current account deficit has decelerated sharply as FY07 progressed (mainly because of sharp compression in import growth), in absolute terms it has grown to US$ 6.0 billion by March 2007. While this was comfortably financed by even larger surpluses in the financial and capital account (with substantial non-debt components), the country's success in attracting international capital has led to a large jump in the NFA of the banking system, adding to liquidity in the domestic markets.

1.2 Looking Forward

Real GDP growth is now estimated to comfortably reach the annual growth target of 7.0 percent in FY07 (see **Table 1.2**), and could potentially exceed it, if LSM growth reaches double digits, livestock growth exceed targets and the services sector growth remains on target. However, the continued strength in aggregate demand, together with the resilience in food inflation, has meant that despite sustained monetary tightening the downtrend in inflation has been very gradual, and variable. As a result, domestic inflation is now forecast to remain in a relatively higher range than forecast earlier, and well above its annual target for FY07.

Table 1.2: Major Economic Indicators

	Provisional FY06	FY07 Original targets	FY07 SBP projection
Growth rates (percent)			
GDP	6.6	7.0	6.8 – 7.2
Inflation	7.9	6.5	7.5 – 7.8
Monetary assets (M2)	15.2	13.5	14.5 – 15.5
billion US Dollars			
Exports (fob)[1]	16.6	19.8	17.6
Imports (fob)[1]	25.0	27.4	27.2
Exports (fob)[2]	16.5	18.6	17.2
Imports (cif)[2]	28.6	28.0	30.2
Workers' remittances	4.6	4.5	5.3- 5.5
percent of GDP			
Budgetary balance	-4.2	-4.2	-4.2
Current account balance	-3.9	-4.3	-4.8

[1] BoP data, [2] Customs data

It is important that appropriate monetary policy be sustained as price stability is important to sustain long-term growth and for poverty reduction. In particular, it must be recognized that inflation has particularly adverse consequences for low-income groups, which generally have no means to hedge themselves from sustained high inflation, in contrast to high income groups that can partially offset the impact through investment in real assets.

The challenge to monetary policy is compounded by the unexpectedly strong resurgence in broad money in recent months, with M2 growth forecast to exceed the original 13.5 percent target, to fall in the range of 14.5 – 15.5 percent. A part of this is a consequence of the concessional re-finance to strategically important sectors of the economy, which significantly raised reserve money growth in FY07, and will consequently have knock-on impacts by raising monetary growth in subsequent periods.

The impact on reserve money growth of this development has been compounded by the heavy reliance on central bank borrowings by the government and the growth in NFA of the banking system. The impact of the former may be limited, if the government appropriately ensures that the SBP borrowings are retired as external and domestic non-bank receipts improve. However, the resurgence in NFA of the banking system poses an additional challenge – the country needs sustain these flows, but it is simultaneously imperative to sterilize the monetary impact of these flows in order to contain inflationary pressures.

The need to sustain the external flows is implicit in the growth of the current account deficit during FY07, which is now forecast to rise to 4.8 percent of GDP, up from the initial forecast of 4.5 percent of GDP. It is a source of comfort that the monthly growth in the current account deficit continues to decelerate, and that the current account deficit is likely to be comfortably financed in the short-run, particularly given strong international liquidity flows towards emerging markets.

However, it should also be kept in mind that international capital flows can be volatile, and are sensitive to a host of domestic and global factors (both economic as well as political). The long run health of the economy, however, requires a lower sustainable current account deficit, concurrent with a rise in the domestic savings rate and a gradual reduction in the fiscal deficit. For the latter to be sustainable, there is need to build upon the welcome growth in the tax receipts in July-March FY07. A graduated increase in the tax-to-GDP ratio, as proposed by CBR, is essential if the government is to sustainably finance the development spending required to raise the long-term growth potential of the economy.

1.3 Executive Summary

Agriculture

A record wheat harvest, and upward revision in the production figures for key *kharif* FY07 crops has raised the prospects of a strong recovery by the agriculture sector in FY07. Resultantly, it is estimated that growth for major crops could reach as high as 5.8 percent in FY07, significantly higher than the target growth of 4.3 percent for the year. In particular, the most significant contribution to the improvement in the agri-growth estimates was from the exceptional FY07 wheat harvest. The 23 million tons wheat harvest is not only well above the target of 22.5 million tons, it is the largest ever recorded in Pakistan.

On the expectations of higher irrigation water availability and continued policy support,[2] production targets for *kharif* crops for FY08 have been fixed higher as compared with the realized harvests in FY07. However, actual performance will depend critically on market prices and favorable weather conditions. On the former count, the FY07 increases in price of cotton and rice and persistently high sugarcane prices will be encouraging for the farmers in FY08.

The banking system provided its supportive role to agriculture sector by meeting the growing financial needs of the farming sector. Agriculture credit disbursement rose to Rs 111.2 billion during Jul-Mar FY07, up by 22 percent relative to the corresponding period of FY06. This growth is well above the 16.4 percent annual target, though 1.5 percentage points lower than seen in Jul-Mar FY06. The pace of agri-credit disbursement suggests that Rs 160 billion annual target for FY07 would be met comfortably.

Large-Scale Manufacturing (LSM)

The detailed LSM data of 100 items for Q1-FY07 and limited information for Q2-Q3 of current fiscal year implied that *LSM* growth may be higher during Jul-Mar FY07 as compared with the corresponding period of FY06, but suggests that the 13.0 percent growth target of *LSM* sector for FY07 may not be achieved.

Major industries supporting the recovery in LSM included textiles, sugar, cement and basic metals. The automobile industry, however, registered a slowdown in growth during Jul-March FY07 relative to the corresponding period of FY06. However, industries such as fertilizer, paper & board and engineering saw a decline in production during this period mainly due to weakness in demand and temporary shut down for maintenance as well as expansion.

Prices

Strong increases in food inflation continued to underpin inflationary pressures in the economy, and offset much of the gains from the abatement of non-food inflation through a tight monetary policy. Thus, principally due to rising food prices, CPI and SPI measures of inflation both recorded year-on-year increases in April 2007, after steep falls in the previous months (when food inflation had dropped sharply). The influence of food inflation is also evident in the WPI; although the WPI inflation has seen a year-on-year drop this is simply because a surge in its food component was largely offset by a sharper decline in its non-food elements.

[2] Continuity of subsidy on DAP fertilizers.

Inflationary pressures are particularly evident in headline CPI inflation which accelerated to 6.9 percent YoY in April 2007 compared with 6.2 percent YoY in April 2006, despite a significant ease in non-food inflation. The deceleration in non-food inflation is mainly attributed to slowdown in the sub-groups of *fuel & lighting, transport & communication* and *house rent*.

As a result of the unexpected resilience of food inflation and likely pressures in near term due to increases in the prices of milk and edible oil etc., SBP forecast for FY07 has been revised upwards from 6.7 – 7.5 percent to 7.5 – 7.8 percent.

Money and Banking

The key challenge for SBP monetary policy during FY07 has been to maintain a balance between sustaining strong economic growth and low and stable inflation. While the economic growth momentum remains intact, the headline CPI inflation has been stubbornly high at an average of 7.9 percent during Jul-Apr FY07. This is mainly due to continuing pressures on food inflation, as the slowdown in food inflation, expected during H2-FY07, did not materialize. SBP recognizes that food inflation is typically less responsive to monetary tightening and therefore the monetary policy should not respond aggressively to temporary shocks in food prices. Thus, SBP depends more on market dynamics and government's administrative measures to contain food inflation while retaining a tightening bias to ensure that inflationary expectations are contained.

A more challenging development has been the sharp increase in monetary aggregate (M2) growth. In fact, the M2 growth which has been showing gradual slowdown relative to the corresponding period till February 2007, [3]accelerated sharply afterwards to reach 12.1 percent during Jul-Apr FY07 compared to 10.8 percent rise during Jul-Apr FY06. Unfortunately, the underlying causes of the recent M2 growth (i.e., strong government borrowings and rise in net foreign assets) leave the central bank with a dilemma.

Specifically, the government borrowing from the banking system for budgetary support and net foreign assets (NFA) has been the key reasons for this sharp rise in M2 growth in recent months; these together contribute 3.6 percentage points to the total rise of 4.0 percentage points in M2 during Mar-Apr FY07.

Growth in credit to private sector slowed from 20.2 percent during Jul-Apr FY06 to 13.0 percent during Jul-Apr FY07, suggesting that the monetary policy has been

[3] The money supply has risen by 7.7 percent during the initial eight months of FY07 (i.e., Jul-Feb FY07) which was lower than 8.6 percent growth witnessed during the corresponding period of FY06.

reasonably successful in reducing excess demand in the economy. Nevertheless, the disaggregated data shows that the slowdown in private sector credit during Jul-Apr FY07 was concentrated in few business sectors, e.g., textiles, cement industries and commerce sector as well as in personal loans.

Fiscal Developments

Consolidated data on fiscal accounts will only be available by the end May but the government has indicated that it remains committed to achieving the fiscal deficit target of 4.2 percent of GDP. However, the relative slowdown in the CBR taxes January 2007 onwards (dipped from 26.7 percent in H1-FY07 to 12.3 percent in Q3-FY07) indicates that expenditure growth would need to be monitored closely.

The CBR significantly surpassed its tax collection target during Jul-Mar FY07 with actual collection of Rs 597 billion despite slowdown in growth of collections. Indirect tax collection stood at Rs 359.2 billion against the target of Rs 396.8 billion. This shortfall is the result of sharp decline in the import growth that fell from 43.2 percent YoY in Q3-FY06 to 8.1 percent YoY in Q3-FY07, reducing the import-related taxes substantially.

Another significant development is the sharp rise in domestic borrowing by the end of Q3-FY07, which mainly reflected the relatively lower availability of external financing compared to the corresponding period of FY06. The aggregate government borrowings for deficit financing from domestic sources stood at Rs 190.5 billion during Jul-Mar FY07, which was nearly four-times the Jul-Mar FY06 borrowings. However, external borrowings are expected to increase during Q4-FY07 due to an expected sovereign debt issue, which would reduce the government domestic borrowings.

An encouraging development was that, unlike the previous year, the government was able to substantially increase its non-bank borrowings in Jul-Mar FY07, as well as sourcing a greater proportion of its banking system borrowings from scheduled banks. The government also raised its non-bank borrowings as a result of PIB auctions and improved NSS receipts.

Balance of Payment

Pakistan's current account deficit continued to widen during Jul-Mar FY07, rising to a record US$ 6.0 billion, up sharply from the corresponding period of FY06. Encouragingly, the data also shows a distinct improvement in the pace of the growth of the current account deficit that has fallen sharply, with Q3-FY07 even witnessing a marginal (and probably temporary) year-on-year decline, largely reflecting the sharp deceleration in the trade deficit during the course of FY07.

Moreover, Pakistan continued to record large surpluses in the capital and financial account that comfortably offset the current account deficits. As a result, the overall external account recorded a surplus of US$ 373 million during the first nine months of the current fiscal year.

Pakistan's exchange rate remained broadly stable moving within a narrow band of 60.2-60.9 Rs/US$ during Jul-Mar FY07. However, the real effective exchange rate (REER) appreciated by 2.06 percent during this period primarily due to the rise in the relative prices compared to its trading partners.

Foreign Trade

During Jul-Mar FY07, imports and exports could record only 8.1 percent and 3.5 percent growth respectively, in contrast to high double- digit growth in the same periods of the preceding four years. Thus, while the trade deficit continued to widen, the pace of the increase was appreciably slower, falling to 14.6 percent during Jul-Mar FY07 as compared to an average growth of 88 percent during the corresponding period of the last four years.

Unfortunately, the gains from the (largely) anticipated deceleration in import growth have been offset by an unexpected weakness in export growth. The abrupt deceleration in export growth in FY07, after strong increases in the previous four successive years, is a source of some disquiet. The sluggishness in exports growth originated from a combination of factors, which include one-off supply shocks, EU-specific preferences & safeguards, as well as some competitive pressures.

Going forward, the rising trend of commodity prices in the international market, higher demand for furnace oil by the thermal power plants and anticipated increase in the import of power generating machinery may put upward pressure on the import bill. On the export side, Pakistan's textile industry needs to be more competitive as it would face increased competition in international markets after the abolishing of China specific textile and clothing safeguards in 2008 by the EU and the US.

In this backdrop, there is need to focus on devising a comprehensive export promotion strategy to narrow down the trade gap. Major issues to be addressed in the export strategy are: a) lack of exports diversification, b) supply side constraints, c) low labor productivity, d) relatively low quality of products, e) delay in the adoption of international standards, f) lack of scale economies, and g) inefficiencies caused by infrastructural bottlenecks.