THE STATE OF PAKISTAN'S ECONOMY
Second Quarterly Report for FY04

1.1 Overview

The improvement in Pakistan's economy, apparent for last several quarters, has been strongly reinforced by the acceleration in industrial activities during the Q2-FY04. Consequently, mid-way through the financial year, it seems highly probable that the real GDP growth during FY04 will be comfortably above the 5.3 percent target for the year, with a concurrent improvement in many macroeconomic indicators.

While there is a concern that agricultural growth could possibly be a little subdued by the impact of the below-target cotton harvest, it appears that any such weakness will be offset by the exceptional industrial growth (see **Table 1.1**).

Table 1.1: Economic Indicators

	July-December		
	FY02	**FY03**	**FY04**
growth rates(percent)			
Large-scale manufacturing[1]	0.9	5.3	14.7
Exports	-0.4	16.6	13.2
Imports	-9.6	18.7	14.1
Tax revenues (CBR)	-4.1	15.4	14.4
CPI (12-month moving average)	3.3	3.6	3.1
Private sector credit (CBs)	8.5	10.1	18.8
Money supply (M2)	8.1	8.6	9.0
million US Dollars			
Total liquid reserves[2]	4,807	9,336	12,172
Home remittances[3]	898.6	2,018.7	1,861.6
Foreign private investment	204	541	277
percent of GDP[4]			
Fiscal deficit	2.8	1.6	0.8
Trade deficit	0.7	0.9	0.9
Current a/c balance	2.2	3.4	2.4

[1] Based on 91 items.
[2] With SBP & scheduled banks. End December.
[3] Excluding receipts on a/c of Kuwait war affectees & Hajj.
[4] Based on full yearly GDP. GoP projection used for FY04 GDP.

The improvement in the country's economic environment is emphatically punctuated by indicators such as the record high exports, the sharp rise in imports of machinery and inputs, the continuing surge in capacity utilization; the strong growth in taxes (despite the absence of a major expansion in the tax net) and, above all, the record growth in net private sector credit.

On the other hand, some evident weaknesses cloud the signal improvements in most areas of the macro economy. Anecdotal evidence suggests that unemployment though falling gradually,[4] remains significant, and, realistically

[4] This received some support from the rise in income taxes from salaries and wages during H1-FY04.

speaking, with the economy still performing below the 6 percent long-term growth trajectory, the likelihood of *immediate* relief is low. Another, more recent, concern is the specter of rising inflation. While overall CPI inflation is still low relative to that in past years, there is clear evidence of a gradual up trend. Moreover, it is pertinent to note that with inflationary pressures particularly evident in food staples, driving *food* inflation to a 6-year high in December 2003, the incidence of inflation falls disproportionately on the most vulnerable (low income groups who are the least prepared to absorb this burden). The upsurge in *food* inflation, that appears driven by supply shocks as well as less than adroit management, clearly points to the considerable scope for improvement in managing the agri-product supply chain.[5]

The rising inflation, which led to negative real short term rates, was a crucial determinant in raising market expectations of a tightening of momentary policy through most of H1-FY04. However the food price dominated profile of inflation (which is typically less sensitive to interest rates), coupled with the potential negative consequence of a premature hike in interest rates on growth prospects, led the SBP to keep its monetary posture unchanged. The underlying factors for the SBP policy stance were mainly the continued (though lower) external account surpluses, very weak up trend in *non-food, non-oil* inflation, persistent weakness in international interest rates and lower than expected fiscal deficit. Nonetheless, SBP continues to closely monitor price trends and stands ready to respond aggressively to contain any surge in inflation beyond tolerable limits.

It should be noted that the low interest rates contributed to the growth and development of the consumer credit market, increased access of relatively cheap credit to agriculture, and played an important role in boosting the competitiveness of Pakistani exports, (particularly in the face of an appreciating rupee). All of this led directly to the Rs 182 billion net credit off take by the private sector during H1-FY04,[6] and the resulting jump in aggregate demand was further boosted by the improvement in agri-output (and rise in product prices) that added purchasing power in the rural areas. In light of this impetus to aggregate demand it is not at all surprising that large-scale manufacturing has seen broad based and robust

[5] The sharp jump in the prices of wheat is case in point. Anecdotal evidence suggests that at least part of the jump in wheat prices was driven by speculators withholding supply from the market. In any case, the potential shortage in supply was evident well in advance, and the market shortage could have been easily averted. As the grain from the new crops enters the market, the temporary contribution to inflation due to the high wheat prices is expected to disappear.
[6] To put this in perspective, the net credit expansion during the first half of FY04 alone is greater than the *sum* of the net credit growth during the past two years.

growth of 14.7 percent during H1-FY04, as against the 5.3 percent in the same period of FY03.

The sustained growth in the real sector during H1-FY04 was matched by the quite encouraging outcomes in most areas of the external account. Both exports and imports registered strong above-target growth, but the relatively higher growth in the latter meant that the trade deficit for H1-FY04 widened by 22.6 percent relative to H1-FY03. However, the composition of the import growth, driven by machinery and raw material imports, clearly shows that this worsening of the trade balance should not be a source of concern, being a precursor to productive economic activity. Similarly, while the remittances of US$ 1.9 billion received during H1-FY04 are certainly lower than in the corresponding period of FY03, they remain well above expectations.

As a result, the current account surplus remains significantly in the positive, at US$ 1.8 billion for H1-FY04. More importantly, the surplus persists even after adjusting for potentially non-repeating flows such as the receipts of logistics support, etc. Thus, external account surplus, while narrowing and moving in right direction (developing countries can not afford to export capital persistently), remained quite substantial during H1-FY04. Moreover, the SBP also ensured that the relative decline in this surplus did not have a significant negative impact on market liquidity, by lowering its interbank forex purchases, allowing the rupee to appreciate gradually in the inter-bank market.

Another encouraging development, which seems directly related to the FY04 performance of the economy as much as the tax reforms of preceding years, is the robust growth in tax revenues. CBR collections rose 14.4 percent YoY during H1-FY04, driving aggregate government revenues during the period, to Rs 379.1 billion. The allied demonstration of expenditure discipline contained the spending by the government to Rs 412.8 billion, ensuring that the budgetary deficit for H1-FY04 was a stunning Rs 32.0 billion *lower* than in H1-FY03. In fact, given that the Q1-FY04 deficit was higher, it is possible that Q2-FY04 actually witnessed a budgetary *surplus.* While it is true that this Q2-FY04 budgetary surplus may be quite ephemeral, reflecting leads and lags in fiscal flows, but nonetheless, there is no denying the steady decline in the fiscal imbalances over time, and the consequent macroeconomic gains.[7]

[7] In particular, the sharp (and continuing fall in the government's) funding requirements play an important role in sustain low interest rates and the consequent positive impact on the broader economy.

Looking Forward

The economic growth momentum is clearly still gathering pace. The good fortune of an improvement in water availability and reasonably favorable weather, complemented by the increased credit availability and incentive of higher prices, suggest that the FY04 agri-growth target is achievable, but only if the wheat harvest proves to be substantially above target (as seems possible). Similarly, large-scale manufacturing, construction, and transport are likely to continue benefiting from the availability of credit at low interest rates, while trade will additionally benefit from the recovery in the global economy. In fact, SBP staff forecasts put the FY04 real GDP growth within the 5.5 to 5.8 percent range.

However, benefits from the low cost of credit have not been without a price; the resulting fall in carrying costs have reduced an important constraint on speculative activities. The recent wheat shortages clearly illustrate the dangers to public welfare from unfettered private sector initiated in the absence of the discipline of a competitive market or government regulation. Illegal and immoral speculative activities need to be reined in through implementation of anti-trust legislation in letter and spirit, as otherwise such activities would undermine the public support for market liberalization, thereby threatening to lock the economy into a less efficient over-regulated paradigm.

Table 1.2: Major Economic Indicators (SBP Projections)

		FY04	
growth rates *(percent)*	**FY03^{P}**	**Original targets**	**SBP projections**
GDP	4.7	5.3	5.5 – 5.8
Agriculture	3.9	4.2	3.7 - 4.2
Industry	6.7	7.1	7.1 - 7.4
of which:			
Large-scale manufacturing	8.0	8.8	9.5 - 10.0
Services	4.2	4.9	5.0 - 5.5
Inflation	3.1	3.9	3.8 - 4.2
Monetary assets (M2)	18.0	11.0	16.0 – 17.0
billion US Dollars			
Exports	11.2	12.1	12.2
Imports	12.2	12.8	13.5
Workers' remittances	4.2	3.6	3.7
Forex reserves with SBP	10.0	NA	11.4
percent of GDP			
Fiscal deficit	4.4	4.0	3.8
Current account balance	7.6	1.6	3.7

^{P}: Provisional

It is worth noting that the presence of market collusion, the effective absence of regulatory bodies has contributed significantly to price pressures in many segments of the economy such as cement, automobiles, wheat, etc.   The relatively steep head-turning hikes in prices of the more "visible" commodities play an important role in raising the otherwise more modest inflationary expectations; this has probably been the case in the recent past as well. In the short term, however, SBP forecast indicate that CPI inflation will remain in the range of 3.8 to 4.2 percent in FY04, with the H2-FY04 inflation profile will likely dominated by *food* components. On the other hand, in the medium turn, the monetary overhang is likely to increasingly contribute to the gradual upward creep in *non-food, non-oil inflation*, suggesting caution on monetary expansion going forward. This, in turn, suggests some caution in the adjustments to the SBP monetary stance,

In particular, it may be desirable for the SBP to gradually scale down its forex market interventions. Given that the external surplus is likely to decline under pressure from a small deceleration in exports (due to the impact of higher effective tariff on key products), rising imports (due to an acceleration in economic activity) and the end of the Saudi oil facility, lower SBP purchases would permit the rupee-US$ exchange rate to remain relatively stable, while simultaneously containing the growth in monetary aggregates.

Another major theme visible from the Q2-FY04 developments is the fiscal space that is finally emerging as a result of past reforms and the growth in the economy. The economy has now suffered many years to low investments in health, education, infrastructure, etc. in the attempt to correct the burden of historic macroeconomic imbalances, and these inevitably have curtailed the economy's ability to accelerate growth. Thus, the increasing fiscal space must now be focused on redressing the social sector shortfalls expeditiously. One constraint often aired to support the inability to accelerated development expenditure is the lack of implementation capacity. However, this need not be a binding constraint, as the government could seek to take advantage of the managerial capacity available with reputable established private sector social service provider (a presentation of one such organization is presented in Special Section).

Finally, a combination of good fortune and the sound policy have placed Pakistan's macroeconomy on a sound footing, and the country stands on the verge of graduating successfully (hopefully permanently) from an IMF program. However, this should not imply a relaxation of macroeconomic discipline. Quite to the contrary, the continued progress of the country on a stable and sustainable high growth trajectory will depend crucially on sound policies. If anything, the government policies are likely to come under greater scrutiny as investors critically evaluate the government's commitment to consolidate and deepen the gains already made.

1.2 Executive Summary

Agriculture

Despite the negative impact of lower than the targeted cotton crop and the loss to poultry sector due to the 'bird flu' virus, agriculture sector is expected to record a reasonably good growth during FY04. In fact, the above target production of rice and sugarcane offset much of the impact of the relatively weak FY03 cotton crop. However, achieving the 4.2 percent growth target for agriculture during FY04 is only possible if the wheat harvest exceeds its target by a substantial margin and the livestock sub-sector remains at least on target.

Water availability improved further, reaching almost to the normal level in *kharif* FY04, and increasing by 30.1 percent in *rabi* FY04 compared to FY03. Prevailing higher prices of major crops, particularly for cotton, rice and wheat during FY03, and the expected higher prices during FY04, also provided an incentive to the farmers to increase production in FY04 by raising the cropped area and applying more inputs.

Among the important crops, cotton, rice and wheat were sown at larger area than in FY03; it also offset the decline witnessed in the area under sugarcane crop. The 10.1 percent increase in area of rice resulted in an 8.8 percent increase in production. Similarly, the above-target area under the wheat crop and extensive use of the fertilizers has raised expectations of an above target harvest. However, despite of an increase in the area under cotton, production dropped due to heavy pest attacks.

The higher utilization of inputs was common to all the crops. The farmers spent higher amounts on purchase of the farm inputs and farm implements, taking advantage of the easier access to low cost bank credit. This was one contributor to the 30 percent increase in agri-credit off take from banks in H1-FY04 compared to H1-FY03.

Industrial Production

An acceleration in industrial production during Q2-FY04 (compared to Q1-FY04), led to a remarkable aggregate growth of 12.4 percent during the H1-FY04 compare to a 5.1 percent growth in the corresponding period last year. This strong growth in industrial production owes largely to a 14.7 percent growth in large-scale manufacturing (LSM), with a supporting contribution from the 6.7 percent increase in electricity generation. The aggregate improvement in these two more than offset the negative contribution by mining industries (mainly on account of declines recorded in the production of crude oil and coal).

The LSM growth was broad based during H1-FY04 as all the sub-sectors witnessed marked improvement in production. In fact, contrary to the expectations, sugar production too witnessed a sharp increase of 23.5 percent during H1-FY04 compared to 13.6 percent increase last year.

The impressive growth in most of the LSM sub-sectors largely owes to higher demand on the back of a confluence of factors such as availability of cheap consumer financing, strong growth in exports (especially of textiles), higher farm income, lower funding cost etc.

Fiscal

The Q2-FY04 fiscal performance seems quite remarkable, as the Rs 33.7 billion consolidated budget deficit reported for H1-FY04 is *lower* than the Rs 40.9 billion recorded for Q1-FY04. In other words, it seems that the quarter under review recorded the first ever fiscal surplus since sub-annual data was made available in FY01. In terms of GDP, the consolidated budgetary deficit for H1-FY04 is a mere 0.8 percent, comfortably within the 4.0 percent annual target for FY04 and approximately half of the corresponding period last year.

The support came both from disciplined expenditures as well as a robust growth in revenues during H1-FY04. While the spending growth was contained to 3.6 percent (vs. the 4.0 percent average target for FY04), a 13.9 percent revenue growth for the period substantially exceeded the 5.3 percent average growth target for FY04.

Both tax and non-tax receipts contributed strongly to the aggregate revenue growth. While the former benefited from strong CBR tax collections; higher interest and dividend income largely due to improving health of financial and non-financial institutions coupled with logistic support receipts from US helped the rise in non-tax revenues.

CBR Q2-FY04 tax receipts jumped 22.8 percent YoY to Rs 136.4 billion, pushing the cumulative H1-FY04 tax revenues to Rs 230.4 billion - well above the Rs 218.1 billion target for the period. The strength of the CBR performance is also underlined by the fact that, other than direct taxes (which were marginally below target), receipts under all tax heads comfortably achieved the respective H1-FY04 targets.

Money and Credit

Q2-FY04 was a challenging period for the SBP as it strove to manage market expectations of a rise in rupee interest rates while simultaneously ensuring that the rupee remained on the path of a gradual appreciation. The market expectations were based on an anticipated tightening of market liquidity and acceleration in headline inflation. From the SBP's perspective, the market liquidity was probably sufficient to accommodate the increasing demands from both, government and private sector, without significantly impacting domestic interest rates. Regarding acceleration in headline inflation, the SBP perceives that: (1) food inflation played a significant role in the acceleration in CPI inflation, much of which stemmed from supply shocks rather than monetary policy, and (2) small acceleration in inflation was tolerable for the economy, as inflation was, as yet, too low to cause serious damage. Thus, the SBP considered it appropriate to maintain its easy monetary stance to support the economy's progress towards a higher long-term growth trajectory.

The persistent low interest rates probably helped accelerate the momentum of private sector credit, taking the net credit growth during H1-FY04 to Rs 182 billion, more than twice the credit extended during H1-FY03. While this large net credit demand probably does owe to the strong economic recovery, it also represents a significant structural shift, which stems from the development of the consumer credit market, the entry of private commercial banks into the agri-credit market and the reduction of the government's role in commodity market.

Although the government's fiscal position improved during H1-FY04, the Rs 9.7 billion retirement of government borrowings for budgetary support from the banking system during H1-FY04 was lower than in H1-FY04 (due to a decline in NSS inflows and lower net external receipts). Due to these developments, in sharp contrast to the NFA-driven 8.6 percent monetary expansion in H1-FY03, the 9.1 percent monetary expansion during H1-FY04 was largely a function of NDA growth. Other notable features of the H1-FY04 government borrowings were: (1) the continuing net retirement of commodity loans (totaling Rs 21.2 billion during H1-FY04), and (2) the accompanying fall in net credit to the PSEs.

As a result of the above, monetary expansion during H1-FY04 was marginally below the credit plan target. However, in contrast, growth in reserve money was substantially above the overall monetary growth.

Money Market

The market expectations of a sharp jump in interest rates that emerged in September 2003 strengthened and dominated developments in the inter-bank market during Q2-FY04. Arguably, the unexpectedly large PIB auction target provided the strongest boost to these market expectations that suggested a (hitherto unsuspected) strong appetite for funds by the government (particularly as the inaugural issue of 15-year and 20-year PIBs was still expected to be announced).

However, as the SBP focused firmly on stabilizing rates, and particularly the short-end of the yield curve, the market eventually (and gradually) scaled back its expectations, with rates dropping to stabilize at levels only a little higher than those at the beginning of Q2-FY04.

Q2-FY04 witnessed the auction of a PIB *Jumbo issue* – an extended issue of bonds with three distinct opening dates each in October, November and December 2003 respectively. This PIB issue effectively: (1) improved liquidity in long-term government securities resulting in an improvement in long-term yields, and (2) solved pricing problems arising from very high scarcity premiums. In addition, it is expected to help further develop the government bond market both in terms of size and liquidity.

Banking

Massive credit demand emanating from increasing economic activity, coupled with aggressive marketing by banks led to a quite remarkable Rs 136.3 billion rise in net credit during Q2-FY04. Banks funded this surge in credit demand through: (1) a continuing strong deposits growth (Rs 67.7 billion rise in Q2-FY04); (2) higher borrowings; and (3) depleting a portion of excess liquidity held in the form of low yielding government securities.

The changes in asset profile of the banking sector led a small rise in the net interest margin during Q2-FY04. This, together with the declining burden of NPLs, increase in fee based income, higher capital gains and the reduction in the tax rate helped banks' to increase their profitability, despite a YoY decline in interest rates.

In other developments, the SBP focus remained unchanged on the banking sector reforms aiming at strengthening supervision capabilities, improving soundness of the banking system and facilitating the enhancement of the banking services. Also, two important milestones were achieved during the quarter, i.e. the privatization of one the biggest public sector banks and the issuance of new business specific prudential regulations to facilitate lending to non-corporate borrowers.

Prices

The emerging inflationary pressures seen in Q1-FY04 strengthened in Q2-FY04 as all three price indices recorded an acceleration on a year-on-year (YoY) basis. In contrast to the downtrend visible in the corresponding periods in recent years, the end-December 2004 marginal inflation rates rose higher than the corresponding figures for December 2003. This in turn, pushed up the annualized inflation rates.

That fact that marginal inflation rates for all three indices have remained higher than the corresponding annualized rates throughout Q2-FY04 (i.e., annualized rates would rise going forward), and that these rates were trending higher throughout the quarter increased expectation of a monetary tightening.

Despite a low annualized CPI inflation, current surge in food inflation has affected low-income group the most, because of higher food inflation as this segment spends a larger proportion of their income on essential food items.

Specifically, lower income group (upto Rs 3000) saw an inflation rate of 6.5 percent as against 5.4 percent average inflation for all income groups and the 4.9 percent inflation recorded for the highest income group (above Rs 12,000) in this period.

Capital Market

Q2-FY04 witnessed an equity market rebound in November 2003 after a large and extended correction (that had started in mid-September 2003) on the back of: (1) positive developments on the political front (the ceasefire proposal and resumption of air and road links with India; and the resolution of LFO issue) as well as (2) on the economic front (the S&P upgrade of Pakistan's credit rating, and expectations of very good corporate results).

Interest in the energy sector stocks was an important factor in the movements of the KSE-100 index during Q2-FY04 e.g. reports of a delay in the privatization process for PSO (apart from other factors) contributed to the decline of the KSE-100 during initial part of Q2-FY04. Similarly, the market rally in mid-November 2003 onwards was led by investor interest in energy sector scrips such as Pakistan Oil Fields and Hubco (amid expectations of an exceptional result announcement) and PSO (in anticipation of early privatization).

External

<u>BOP</u>

Pakistan's overall external account surplus witnessed a 60.3 percent reduction during H1-FY04 as compared to H1-FY03 reaching US$ 1.1 billion. The deterioration was evident in both the current account and the capital account.

While the current account surplus remained a very substantial US$ 1.8 billion during H1-FY04, it nonetheless represented a 21.7 percent YoY decline despite the impressive 61.2 percent reduction due to trade deficit (cash flows). This reduction in the current account balance during H1-FY04 owed to moderation in current transfers, higher services outflows on account of shipment, travel, and profit & dividend. The decline in the adjusted current account balance was more pronounced at 46.5 percent during H1-FY04 over H1-FY03, as net structural inflows decreased during the first half of current fiscal year, relative to corresponding period of the preceding year. This was due to a moderation in workers' remittances and the re-integration of informal travel outflows into the formal sector.

In contrast to the current account surplus, the deficit in the capital account rose to US$ 702 million during H1-FY04 compared to US$ 185 million during H1-FY03. This deterioration was primarily owed to a US$ 1.5 billion fall in inflows, which more than offset the US$ 0.96 billion decline in capital outflows during the quarter. The main factors leading to this outcome were: (1) lower foreign direct investment inflows; (2) a reduction in non-food aid from multilateral donors; (3) the retirement of trade related loans; and (4) an increase in the stock of outstanding export bills.

Consequently, the reduction in overall balance squeezed the liquidity in inter-bank market during H1-FY04 reducing SBP's reserves accumulation as it lowered the net purchases from inter-bank market to let the rupee appreciate gradually.

<u>Trade</u>

Notwithstanding the 13.2 percent growth in exports, trade deficit rose by 22.6 percent during H1-FY04 on account of higher import growth of 14.1 percent. This increase in import bill was largely due to the increased economic activity causing higher import of *capital goods* and *raw material for consumer goods*. Specifically, the imports of *machinery* and *agriculture & chemicals* groups rose substantially in this period. In exports, however, textile sector had the highest contribution in growth as usual, whereas primary and other manufactures group displayed marginal growth during H1-FY04.

Exports, however, were faced with various challenges during this period:

- Firstly, enormous hike in the cotton prices increasing input cost; and
- Imposition of anti-dumping duty on country's bed-wear exports to the EU effective from March 2004, adversely impacted the prospects for textile exports growth;

– EU announced withdrawal of the duty concession on its basmati rice imports from Pakistan from March 2004. This decision will hurt country's competitiveness in that market.

Exchange Rate Policy

The rupee resumed its gradual rise in Q2-FY04, shrugging off the temporary 0.2 percent dip during the preceding quarter to register a cumulative 0.6 percent appreciation during H1-FY04. This Q2-FY04 appreciation marked a decisive adjustment for the rupee, breaking it out of the narrow (Rs 0.15/US$) range that had been sustained since March 2003. It is important to note here that while the Q2-FY04 ascent of the rupee *did* mark the easing of lumpy end-Q1-FY04 payments pressures, the dominant factor shaping the direction of the rupee remained the modulated net forex purchases of the SBP, in line with its policy of allowing a gradual appreciation in the face of external account surpluses.

Foreign Exchange Reserves

Pakistan's liquid foreign exchange reserves rose by US$ 1.1 billion during H1-FY04, touching a new high at US$ 12.1 billion and improving the import coverage to approximately 50 weeks at end-December 2003. The major contributors to this significant buildup of reserves were the workers' remittances, FE-25 deposits, FDI, receipts against logistic support and grants.

The distribution of reserves between the SBP and the commercial banks witnessed some significant changes during H1-FY04. The net accumulation of reserves with the commercial banks that remained negative during FY03 turned positive during this period. The commercial banks reserves increased by US$ 463 million during H1-FY04.