THE STATE OF PAKISTAN'S ECONOMY
Second Quarterly Report for FY08

1.1 Economic Outlook

The country's economy continues to show resilience to domestic and international shocks. Although these have taken their toll, the economy is expected to turn in a reasonable growth performance during FY08, albeit substantially lower than target. So far, the principal drag on the year's growth has been the outcome of *kharif* harvests and the slowdown in LSM growth (particularly in December 2007). The services sector, on the other hand, seems set to show good performance for the sixth consecutive year.

Table 1.1: Selected Economic Indicators

		FY06	FY07	FY08
Growth rate (percent)				
LSM	Jul-Dec	8.7	8.3	4.5
Exports (fob)	Jul-Feb	18.8	3.4	7.9
Imports (fob)	Jul-Feb	46.3	9.9	21.9
Tax revenue (FBR)	Jul-Jan	21.8	25.1	10.6
CPI (12 month MA)	Jul-Feb	8.9	7.7	8.4
Private sector credit	Jul-1st Mar	18.9	11.2	11.7
Money supply (M2)	Jul-1st Mar	9.5	8.7	7.1
billion US dollars				
Total liquid reserves[1]	end-Feb	11.5	13.3	14.1
Home remittances	Jul-Jan	2.4	3.0	3.6
Net foreign investment	Jul-Jan	1.5	3.4	2.3
percent of GDP[2]				
Fiscal deficit	Jul-Dec	1.8	1.9	3.6
Trade deficit	Jul-Feb	5.9	6.2	7.9
Current a/c deficit	Jul-Jan	2.7	3.6	4.8

1. With SBP & commercial banks.
2. Based on full-year GDP in the denominator. For FY08 estimated full-year GDP has been used.

However, growing macroeconomic imbalances, particularly the widening fiscal and current account deficits continued to create complications and add to inflationary pressures. On the other hand, Pakistan has so far largely been untouched by the continuing turmoil in the international credit markets.

The rise in the fiscal deficit during H1-FY08 has more troubling implications than the increase in the previous year. The modest increase in the fiscal deficit during the preceding two years had been relatively less troubling, as (1) revenue growth had remained strong, and (2) rise in spending essentially reflected the impact of post-earthquake relief and reconstruction (excluding this, the fiscal deficit remained below 4.0 percent of GDP); these substantive expenditures would fall sharply in a few years. In both years, the current expenditure during the first half of the fiscal year had remained below 7.0 percent of the full year GDP. In contrast, the fiscal deficit during the first half of FY08 is estimated to be roughly 3.6 percent of the estimated annual GDP - nearly twice the figures for the last two years. This incorporates a decline in revenue growth, as well as rising current spending.

A part of the deceleration in revenue growth during H1-FY08 is likely to be reversed as substantial non-tax receipts are expected in the later half of the fiscal year. However, the annual growth in tax collections is likely to remain weak relative to the previous year. Another troubling aspect is that the fiscal deficit may be understated. Evidence suggests that at least a part of the subsidy on fuel prices during Jul-Feb FY08 was not financed from government account.[1]

Reducing the fiscal deficit in the remaining part of the fiscal year will thus be challenging, but is nonetheless essential. Support to aggregate demand due to fiscal deficit contributed directly to a rise in monetary aggregates, raising inflationary pressures, complicating monetary management, and stoking the growth of the current account deficit. International credit rating agencies have already cited the growth of the fiscal deficit as a key negative indicator for Pakistan's sovereign credit rating.

The combination of rising fiscal deficit and weak external receipts has pushed the government borrowings from SBP to a record Rs 359.3 billion during Jul-1st Mar FY08, compared to only Rs 25.6 billion in the corresponding period of last fiscal year. This has been instrumental in sustaining the growth in broad money (M2) for the period at 17.6 percent YoY, significantly offsetting the central bank's efforts to tighten monetary policy.

The government borrowings from the central bank are also the most inflationary form of financing the deficit. It seems likely that the exceptionally strong growth in these borrowings supported a rise in inflation. The impact of this was significantly augmented by the unanticipated strength of international commodity prices. Moreover, the rise in food prices was probably also aggravated by anti-competitive market structures and practices in the domestic market, as well as supply disruptions. The government has limited options to ease inflationary pressures. Efforts to reduce government subsidies on fuel will raise inflation in the short-run. Further, given limited fiscal space, any subsidies need to be carefully targeted and should be limited in scope.

[1] Instead, in order to mitigate the financial difficulties of the various institutions (particularly the oil marketing companies) with unpaid price differential claims, the government provided guarantees against which these public and private sector institutions could borrow the amounts from financial institutions. Such a financing structure simply shifts most of the cost of the financing from the current fiscal year to the fiscal deficit in future years (when the principal amount is paid off).

Policy actions should not distort price signals, as these are essential to ensure investment and productivity increases needed to remove the shortages in future, as well as to modulate consumption. For example, the government's laudable desire to reduce current cost pressures in the domestic economy through a subsidy on key fuel prices, had the unintended consequence of supporting the widening of the current account deficit, as demand was not rationalized to reflect the higher international prices[2].

Table 1.2: Overall Import Growth of Textiles

	CY06	CY07
EU*	8.3	4.7
USA**	6.4	1.3

* Source: Eurostat (CY07 Data available for Jul-Oct)

**Source: US CY07 Census Bureau (data available for Jul-Nov)

The growth of the current account deficit indicates that the exceptional fiscal expansion supported aggregate demand in the economy. The impact of the strong domestic demand on the current account deficit was compounded by the weakness in demand for textile in key markets. During the Jul-Jan FY08, textile imports in both the US and the EU slowed significantly (see **Table 1.2**). Pakistan's textile exports also suffered in December 2007 due to extended business closures.[3]

The impact of the widening current account deficit, driven essentially by the trade deficit, on the country's overall balance was compounded by a decline in the financial & capital account balance in the same period. While FDI flows witnessed a year-on-year increase in Jul-Jan FY08. Portfolio investment observed a net outflow.

These developments highlight three points:

(1) Sustained large current account deficits pose risks to the country's macroeconomic stability. Over the last few years, Pakistan was able to comfortably sustain current account deficit due to favorable domestic and international investment conditions that encouraged large non-debt creating financial inflows into the country. As a result, Pakistan was not only able to run large deficit but also added to its foreign exchange reserves. However, that will be an increasingly risky strategy, given the stresses on the domestic economy as well as the relatively less favorable dynamics in the international capital markets.

[2] It is instructive to note that approximately 21 percent of the rise in the imports during Jul-Jan FY08 is on account of the oil bill.

[3] The impact of extended holidays for the *Eid* festival was compounded by political disruptions, following the assassination of a former prime minister.

(2) The volatility in portfolio investment points to the need to reduce dependence on these flows and the corresponding need to increase domestic savings. The latter, in particular would increase market depth and lower dependence on potentially volatile external flows.

(3) Pakistan's need to improve its infrastructure and its dependence on imported inputs, reducing the current account deficit to sustainable levels must perforce target export growth. The most efficient measure here would be those targeting a reduction in inflation, and to reduce the cost of doing business in Pakistan.

Given domestic turbulence and external shocks, SBP estimates suggest that FY08 real GDP growth would be in the range of 6.0-6.5 percent (see **Table 1.3**). This below target growth nonetheless remains strong. An unanticipated strength in international commodity prices is mainly responsible for cost push driven inflationary pressures in the economy. These pressures further intensified due to strong aggregate demand amidst a continuing fiscal stimulus. As a result, it is likely that FY08 inflation would be in the range of 8.0-9.0 percent, significantly above the target of 6.5 percent for the year.

Table 1.3: Major Economic Indicators

		FY08	
	Provisional FY07	**Original target**	**SBP projections**
Growth rates (percent)			
GDP	7.0	7.2	6.0 – 6.5*
Inflation	7.8	6.5	8.0 – 9.0
Monetary assets (M2)	19.3	13.7**	15.5 – 17.5
billion US dollars			
Exports (fob-BoP data)	17.1	18.9	19.7
Imports (fob- BoP data)	27.0	29.6	32.1
Exports (fob-customs data)	17.0	19.2	19.2
Imports (cif-customs data)	30.5	32.3	35.1
Workers' remittances	5.5	5.8	6.0 - 6.5
percent of GDP			
Budgetary balance	-4.3	-4.0***	-5.2
Current account balance	-5.3	-5.0	-6.0

*Estimated range is based on the assumption of 12.7 million bales of cotton and 24.0 million tonnes of wheat crop.
**Announced in MPS Jul-Dec FY08; ***Budget estimates.

The impact of the higher international commodity prices and strong domestic demand is also reflected in the deteriorating external imbalances during FY08. The current account deficit is projected to be around 6.0 percent of GDP during FY08 reflecting the rising imports growth (led by rising commodity prices) and slow growth in textile exports.

1.2 Executive Summary

1.2.1 Real Sector

Agriculture

Information available by mid-February 2008 suggests that agriculture sector is likely to record reasonable growth during the fiscal year. Prospects of achieving the targeted 4.8 percent growth for the year remain dim. The record sugarcane and maize harvests, anticipated good wheat harvest, and above-target growth in minor crops, are unlikely to overcome the drag from the disappointing performance of some major *kharif* crops (cotton and rice). Livestock sub-sector, hit by bird flu virus may see some slowdown in growth.

Relatively weak aggregate performance of the crops, in the face of strong international prices of most agri-commodities, indicate not only the sector's vulnerability to the vagaries of nature but also the urgent need to enact reforms targeting distortions in the incentive structure for farmers, and the substantial wastage due to inadequate infrastructure. Investment in farm-to-market roads, agri-storage facilities, and small processing units can significantly reduce wastage and increase value addition in agriculture.

Institutional credit disbursement to agri-sector increased significantly by Rs 23.8 billion to Rs 104.8 billion during Jul-Jan FY08. The growth in agri-credit disbursement was due to aggressive lending by commercial banks. A sharp jump in non-farm credit also contributed in agri-credit growth acceleration during Jul-Jan FY08. The substantial rise in commercial bank lending compensated for a contraction in lending by the specialized banks during Jul-Jan FY08.

The aggregate fertilizer off-take witnessed recovery during Jul-Jan FY08 in contrast to a decline during the corresponding period of FY07. This growth was entirely driven by significantly higher off-take of urea. Despite a significant subsidy on DAP fertilizer,[4] its off-take saw a sharp decline in Jul-Jan FY08 amid a much sharper increase in international prices.

Large Scale Manufacturing

Pakistan's large scale manufacturing (LSM) has been encountering headwinds since the start of FY08. Domestic as well as external factors are responsible for the relatively slower growth in this sector compared to the stellar performance of

[4] Subsidy of Rs 470 per 50 kg bag of DAP fertilizer was extended for the FY08 cropping seasons to encourage farmers to use a balanced mix of fertilizers.

preceding years. These factors include: the continued strong increases in the international commodity prices, domestic energy woes and dampened demand (particularly for textile exports). Economic losses in the aftermath of December 27, 2007 have further weakened the chances of meeting the annual target. Overall, the slowdown in LSM during H1-FY08 was broad based and was seen in 11 out of 15 industrial groups. Of these, paper & board, metals, fertilizer and electronics industries registered a decline in production. In contrast to these under-performers, pharmaceuticals, POL, cement, engineering and wood industries depict reasonably strong growth.

Services

Most of the indicators for the services sector suggest robust growth in this sector during the first half of FY08. Wholesale and retail trade seems likely to perform well given a significant increase in imports (which accounts for more than half of the value addition in this sub-sector). This sub-sector is also likely to benefit from expansion in the network of domestic and foreign chain stores.

In the transport & communication sub-sector, a relative weakness in transportation sub-sector could be offset by a strong growth in the electronic media and tele-communication sub-sectors on the back of government's liberal policy as well as large FDI in recent years. In particular, expansion in cellular services is impressive as cellular density has more than doubled during July 2006 to December 2007.

The combined impact of a likely improvement in the profitability of the overall banking sector, coupled with some improvement in value-addition by other financial institutions is expected to support the high growth momentum in finance & insurance sub-sector as well. In addition, growth in value addition by public administration & defense as well as community & social services (other services) is likely to be strong.

1.2.2 Prices

Inflationary pressures in the domestic economy have continued to mount throughout Jul-Feb FY08, with particularly sharp increases in the later months of the period, despite the central bank's efforts to contain the growth in aggregate demand. The headline CPI inflation rose to 11.3 percent (YoY) in February 2008 from 7.0 percent in June 2007. This reflects not only the stimulus from the expansionary fiscal policy but also the unanticipated strength of international commodity prices. The impact for food commodity prices was probably also aggravated by anti-competitive market structures and practices in the domestic market, as well as supply disruptions.

CPI food inflation (YoY) started to strengthen since September 2007 and was recorded at 16.0 percent in February 2008 after reaching to a local peak of 18.2 percent during January 2008; the highest level seen since April 1995. The rise in the food inflation is now increasingly being supplemented by acceleration in non-food prices. The latter is driven partly by high energy prices, but there is also evidence that the sustained rise in food and energy prices is engendering broad second round effects on inflation. This view is supported by the sustained increase in both measures of core inflation, seen since June 2007. On a YoY basis, NFNE (non-food, non-energy) core inflation increased to 8.1 percent in February 2008 (the highest since November 2005) from 6.0 percent in February 2007.

The inflationary pressures in the economy stemmed from strong aggregate demand were further strengthened due to rising international commodity prices (both food and energy), supply disruptions, and market inefficiencies. The latter can clearly be tackled through fiscal and administrative measures. However, given evidence that these cost push inflationary pressures are generating second round inflationary cycle, continued monetary tightening was essential and guided the SBP decision to accentuate its monetary tightening. The monetary measures aimed at siphoning out the excess demand in the economy need to be supplemented by greater fiscal discipline, as well as administrative and policy measures to correct market distortions.

1.2.3 Money and Banking

The sustained increase in food commodity prices and the impact of rising costs of oil products led to unexpected rise in inflationary pressures in the economy during the first half of FY08. At the same time, risks to macroeconomic stability increased considerably as the fiscal and current account deficits turned out to be considerably wider than envisaged in the monetary policy framework. These developments eroded the impact of monetary tightening measures undertaken in August 2007, and increased the risks of further surge in inflationary pressures.

The rising fiscal deficit and its financing posed severe complications for the Monetary Policy Framework for FY08. Besides adding to aggregate demand pressures in the economy, the impact of higher fiscal deficit was also evident in a sharp rise in budgetary borrowings from the central bank –the most inflationary in nature. The borrowings from SBP reached Rs 359.3 billion during Jul-1st Mar FY08, instead of the net retirement recommended in the Monetary Policy Statement for Jul-Dec FY08. The sharp rise in budgetary borrowings was the major driving force behind the high annualized M2 growth. YoY M2 growth of

17.6 percent as on 1st March 2008 is a source of concern for SBP as it has the potential to add to the excess demand pressures in the economy.

SBP responded aggressively by further raising its policy discount rate by 50 bps to 10.5 percent and the cash reserve requirement of the banking system by 100 bps on current deposits effective from 1st February 2008.

SBP believes that monetary policy can best contribute to long-run economic growth by creating an environment with a stable price level or a low and predictable rate of inflation. In the medium term stable prices also help in moderating the fluctuations in output. In this backdrop, addressing widening macroeconomic imbalances becomes essential as these imbalances not only add to inflationary pressures, but also harm economic growth prospects.

The importance of low and stable inflation in achieving high long run growth also provides a cornerstone for monetary and fiscal policy coordination. It is therefore essential that government improves its fiscal discipline and limits its borrowings from the central bank within the targets recommended in the monetary policy framework. Otherwise, the time path for achieving a stable and low inflation would be extended, raising the cost of adjustment for economic agents.

The available data suggests that private sector credit has grown by 11.7 percent during Jul-1st Mar FY08; slightly higher than that in the corresponding period of the preceding year. The demand for working capital is on the rise as (1) delays in the settlement of price differential claims led IPPs and OMCs to resort to financing from bank sources for their working capital requirements, and (2) a sharp surge in raw material prices, both in the domestic and global markets, had pushed up the credit demand from the corporate sector.

Although the demand for fixed investment loans moderated in a number of industries, this is more a reflection of the fact that some industries had already expanded their activities in recent years, whereas others are using foreign currency loans & investments and issuing debt in the domestic market.

1.2.4 Fiscal Developments

Deterioration in key fiscal indicators seen during Q1-FY08, accelerated sharply in the next quarter, as revenue growth stagnated, even when expenditures continued to rise. As a result, the cumulative fiscal deficit for H1-FY08 as a percent of (estimated) annual GDP was almost twice that seen in the previous two years, reaching a seven-year high for the period. Similarly, the revenue deficit and the primary deficit ratios for H1-FY08 increased substantially relative to the preceding years.

The fiscal performance is expected to improve in the remaining two quarters of the financial year, with greater discipline in spending being complemented by an anticipated improvement in revenues.[5] Nonetheless, it is likely that the annual fiscal deficit will exceed 4.0 percent of GDP target. The fiscal concerns are also heightened by the substantial (Rs 54.6 billion) issuance of contingent liabilities of the government in the first six months of FY08.

1.2.5 External Sector

Balance of Payments

Pakistan could not sustain the modest improvement in the current account deficit seen during Q1-FY08, and it widened sharply in succeeding months. Consequently, the cumulative Jul-Jan FY08 current account deficit rose by 47.1 percent YoY, compared to the 51.0 percent YoY increase in the same period of the previous year. The dominant contribution to the post-Q1-FY08 deterioration in the current account was from an abrupt rise in the country's oil bill, large one-off aircraft import, the impact of political disturbance in December 2007 as well as delays in the receipt of coalition support funds, all of which overshadowed the sustained increase in remittances.

The impact of the widening current account deficit on the country's overall external balance was compounded by a decline in the financial and capital account surplus in the same period. In particular, while FDI flows improved slightly, there was a precipitous US$ 1.4 billion drop in net foreign portfolio investment flows. The decline reflected the outflows partly from the equity markets due to perceptions of increased political risk, and partly due to the delays in the planned floatation of Global Depository Receipts (GDRs) in the face of global financial turmoil and a perceived increase in country risk.[6] Apart from the impact of the fall in portfolio investment was also lowered by a large rise in other investments, including FE-25 nostros, short-term loans, etc.

[5] The incentive to accelerate development spending ahead of the elections will no longer hold. Indeed, media reports indicate that concerned by the ballooning fiscal deficit, the government has sharply curtailed expenditure growth in H2-FY08.

[6] The impact of a general increase in risk-averseness in the troubled global financial market was compounded by the increased risk perceptions on Pakistan due to the pre-election uncertainty, particularly following the assassination of a former prime minister. As a result, the sovereign spread rose from 140 bps at end-June 2007 to 620 bps at end-January 2008 on 5 year bond.

Given that the decline in the financial account surplus was quite moderate, it is clear that the decline in the country's foreign exchange reserves essentially reflects the sharp increase in the current account deficit. Overall foreign exchange reserves declined to US$ 14.0 billion by end February of FY08 compared with US$ 15.6 billion as at the end June FY07.

As a result of worsening of external account during Jul-Jan FY08, Pak Rupee could not hold its grounds against the US dollar and depreciated by 3.5 percent during Jul-Feb FY08.

Foreign Trade[7]

Rising international commodity prices coupled with domestic supply constraints of some key commodities resulted in a 21.9 percent YoY rise in imports growth during Jul-Feb FY08 that outpaced 7.9 percent growth in exports during this period. Resultantly, the trade deficit recorded a sharp US$ 3.5 billion YoY increase during the period.

Almost half of the total increase in the import bill during Jul-Jan FY08 was contributed by rising international commodity prices: oil, fertilizers, palm oil, etc.[8,9] In addition, imports of wheat and cotton were necessitated due to domestic shortages. The import bill was further inflated due to a large one-off import in the category of *aircrafts, ships and boats*. In the absence of all these factors, import growth, and thus the trade deficit, would have been significantly lower than the current level.[10] The significant slowdown in the imports after adjusting for these factors represents a deceleration of the real demand for imports, which can, in part, be attributed to the tight monetary policy being pursued by SBP.

The growth in exports during Jul-Jan FY08 was entirely due to rise in the *non-textile* exports – mainly *other manufactures* and *petroleum group*; whereas *textile* exports recorded 3.4 percent YoY fall during this period. The decline in the textile exports was broad based with only the exports of synthetic textiles, ready-made garments and textile made-ups registering positive growth.

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[7] This analysis is based on the provisional data provided by Federal Bureau of Statistics, which is subject to revisions. This data may not tally with the exchange record numbers reported in the section on *Balance of Payments.*

[8] The price impact for the 50.2 percent imports for which price and quantum data was available was around 49 percent of the total rise in the import bill during Jul-Jan FY08.

[9] The broad analysis of trade deficit is based on Jul-Feb FY08 data. However the detailed exports and imports trends are discussed for the period Jul-Jan FY08, since detailed monthly data is not available for February FY08.

[10] In the absence of these two factors, the import growth for Jul-Jan FY08 would have been mere 4.6 percent, which implies a trade deficit of US$ 7.9 billion for this period.