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

1.1 Economic Outlook

Pakistan's economy is showing increasing signs of stress by April 2008. A combination of adverse domestic and international developments is driving a broad deterioration in key macroeconomic indicators (see **Table 1.1**). Real GDP growth in FY08 is expected to drop below the 6 percent level for the first time in five years, annual inflation is poised to return to double digits, the fiscal deficit is forecast to rise substantially, and the annual current account deficit, as a percentage of GDP, is projected to be at an all-time high (see **Table 1.2**). The weakness in the external account is also reflected in weakening foreign exchange reserves (and a 7.3 percent YTD depreciation of the rupee by the first week of May 2008).

Table 1.1: Selected Economic Indicators

		FY06	FY07	FY08
Growth rate (percent)				
LSM	Jul-Mar	8.0	9.0	4.8
Exports (fob)	Jul-Apr	17.2	2.9	10.2
Imports (cif)	Jul-Apr	40.4	8.9	28.3
Tax revenue (FBR)	Jul-Apr	21.3	20.0	16.3
CPI (12 month MA)	Jul-Apr	8.2	7.8	9.8
Private sector credit	Jul-10th May	19.9	12.5	14.9
Money supply (M2)	Jul-10th May	12.3	14.1	9.0
billion US dollars				
Total liquid reserves[1]	end-Apr	13.1	13.7	12.3
Home remittances	Jul-Apr	3.6	4.5	5.3
Net foreign investment	Jul-Apr	4.0	5.9	3.6
percent of GDP[2]				
Fiscal deficit	Jul-Dec	1.8	1.9	3.6
Trade deficit	Jul-Apr	7.5	7.8	10.7
Current a/c deficit	Jul-Apr	3.1	4.6	7.0

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

However, despite the deterioration, it is also important to note that as a result of structural reforms and liberalization measures over the last fifteen years, the economy has fundamentally gained resilience. This suggests that a policy focus on regaining macroeconomic stability through further reforms, and corrective measures could quickly reinvigorate the growth momentum of the economy.

The most recent data clearly indicates that the slowdown in the economy during FY08 is principally in the commodity producing sectors. For example, the disappointing performance of important major crops contributed significantly to slowdown in agricultural growth during FY08. This sector is globally vulnerable to weather conditions, but in Pakistan farmers also suffer from policy risk in the pricing of agri-produce, insufficient regulation on quality of inputs (pesticides, seeds, etc.) and poor infrastructure (for water management, storage and processing facilities as well as lack of farm-to-market roads, etc.). Similarly, facilitation of institutional credit, as well as risk mitigation for farmers through active futures market and crop insurance, can allow a substantial increase in value-addition. Policy focus on the above areas can thus yield relatively quick returns in the form of higher productivity and lower post-production losses. Moreover, given that Pakistan is already a low-cost producer of many agri-commodities, and that international commodity prices seem likely to remain strong for years to come, agri-reforms offer broad-based gains in terms of income generation (and poverty reduction), support for lowering inflation, and higher exports. Interestingly, strategies to increase yield in agriculture also offer benefits for industry, raising hopes of low price inputs, and creating room for downstream value-added investment. This would also help diversify the country's manufacturing and export base, thus reducing output volatility.

Productivity improvements can also be important in containing domestic inflation. Inflation is already a serious policy concern for Pakistan, with CPI inflation at 17.2 percent YoY for April 2008, the highest level in a month since April, 1995. At least a part of this is driven by domestic supply-shocks that have compounded the impact of strong aggregate demand, and high international commodity prices. The latter, in particular have continued to rise, and the pass-through to the domestic consumers is increasing; administered prices are increasing, wages are facing upward pressure, and imported inflation is on an uptrend. This clearly indicates that restoring price stability in the short-run may prove challenging. Even fiscal measures (tariff cuts and subsidies), aiming to at least

Table 1.2: Projections of Major Economic Indicators

		FY08	
	FY07 P	**Original target**	**SBP projections**
Growth rates (percent)			
GDP	7.0	7.2	5.5 - 6.0
Inflation	7.8	6.5	11.0 - 12.0
Monetary assets (M2)	19.3	13.7*	17.0 - 19.0
billion US dollars			
Exports (fob-BoP data)	17.1	18.9	19.9
Imports (fob- BoP data)	27.0	29.6	34.0
Exports (fob-customs data)	17.0	19.2	18.3
Imports (cif-customs data)	30.5	32.3	39.0
Workers' remittances	5.5	5.8	6.2 - 6.7
percent of GDP			
Budgetary balance	-4.3	-4.0**	(-)6.5 – (-)7.0
Current account balance@	-5.3	-5.0	(-)7.3 – (-)7.8

*Announced in MPS Jul-Dec FY08; **Budget estimates.

@: without official transfers P: provisional

Note: Targets set by Government of Pakistan. SBP projections have been estimated outcome on the basis of information available by mid-May, 2008.

partially protect the broad populace from rising food and energy commodity prices, are likely to prove unsustainable, given the already large fiscal deficit. Any such measures need to be carefully targeted at only the very poor and vulnerable.

In this environment, it becomes all the more important that monetary policy be calibrated to squelch demand-led inflationary pressures in the economy. Over the last 6 months, expansionary fiscal policy has overshadowed and substantially weakened the impact of sustained monetary tightening by SBP. This impact of the heavy government borrowings has been particularly evident in FY08, with the borrowings rising to a record Rs 551.0 billion by 10th May, 2008 (compared to only Rs 45.7 billion in the corresponding period of FY07), almost doubling the total outstanding stock of borrowings to Rs 940.6 billion. This trend cannot be sustained without risking a substantial further acceleration in inflation.

In other words, the government has to urgently address the growth of the fiscal deficit as well as to diversify its financing away from the central bank. While information on fiscal developments is only available for H1-FY08, SBP assessment indicates that the Jul-Mar FY08 fiscal deficit (as a ratio of GDP) is likely to be greater than the FY07 annual figure. The new government has indicated an intention to broaden the tax base and rein-in expenditure growth in support of macroeconomic stability. It has also indicated an intention to diversify the financing of the deficit and reduce dependence on the central bank borrowings. For the economy to retain its high growth momentum, it is important that these goals are achieved.

Over time, the removal of the excessive fiscal stimulus, the increase in administered energy prices, the recent exchange rate adjustments and continued tight monetary stance[1] are also expected to help correct the substantial increase in the country's trade deficit. This correction is overdue. With food and petroleum imports constituting more than half of the rise in imports, there is a limited scope for import compression in the short-run. Moreover, it is likely that the country will need to raise imports to strengthen its infrastructure, particularly of power generation. Thus, policy focus needs to remain on addressing structural impediments to export growth in medium to long term. Typically subsidies do not incentivize efficiency, raise fiscal costs, and often lead to "gaming" to maximize rent seeking rather than increased productivity. Therefore, policies must instead

[1] Effective from May 23, 2008, SBP increased its policy discount rate by 150bps and reserve requirements by 100bps. At the same time, SBP imposed a cash margin requirement of 35 percent on selected imports. Furthermore, effective from June 1, 2008, banks are required to pay a minimum profit of 5 percent on PLS/Savings Accounts.

focus on structural reforms to reduce cost of doing business, ensure efficient provision of key inputs (water, power etc.), improvement of logistics chains, etc.

In addition significant gains in foreign exchange earnings may be achieved by boosting services exports such as IT services, tourism etc. and focusing on increasing remittances by benefitting from labor market opportunities in East Asian economies and the Middle East. Productivity gains likely to be accrued from skilled labor will have spillover effects in attracting FDI, enhancing workers' remittances as well as increasing exports of goods and services.

As of end-April 2008, the trade deficit recorded in the balance of payments has reached US$ 12.7 billion, contributing directly to the record current account deficit. The stress on the economy as a result of this has been compounded by the continuing problems in the international financial markets. While the country has largely been unaffected by the direct impact of these disruptions, investors are increasingly risk averse, with a reduction in liquidity flows to emerging economies. This makes financing the deficits more challenging.

In absence of hefty foreign investment inflows (both direct and portfolio) as evident in FY07, rising current account imbalance and weak performance of exports resulted in a depletion of foreign exchange reserves. A natural outcome of these developments is weakening of rupee against major currencies, which was further augmented due to appreciation of the US dollar in recent week.

1.2 Executive Summary

1.2.1 Real Sector

Agriculture

Recent information points to an increased risk of a decline in aggregate value-addition by important major crops in FY08 relative to the previous year. It was hoped that a wheat harvest close to the annual target would offset much of the drag from the disappointing aggregate performance of the FY08 kharif harvest. But some reports suggest that wheat production in FY08 may also turn out to be substantially below the target. If these concerns prove correct then a weak performance by major crops would drag the annual growth substantially below the annual target.

Given that commodity prices are likely to remain strong, it is imperative that policies be framed to support farmers' ability to raise productivity substantially in the years ahead. Key areas requiring policy intervention remain the transmission of price gains (establishment of futures markets), risk mitigation (crop insurance, storage facilities), increasing investment in agri-sector infrastructure (water management, electricity, farm-to-market roads, etc.) and in value-addition chains (e.g. through processing).

The agriculture credit disbursement continued apace with its positive trends. The total agri disbursements amounting to Rs 157.6 billion during Jul-Apr FY08 - an increase of 34.9 percent YoY. The water shortage seen in rabi FY08 are likely to continue in first phase of *kharif* FY09, while improved water availability is anticipated from better monsoon rains during the second phase of *kharif* FY09 (June -September). Fertilizers off-take increased by 9.2 percent during July-March FY08.

Large Scale Manufacturing

Initial prospects of achieving a reasonable growth in LSM sector during FY08 were clouded by aggravating energy crisis coupled with high international commodity prices and political unrest through most of the year. As a result, the LSM sector posted a dismal growth of 4.8 percent in the first nine months of FY08 compared with 9.0 percent in the same period of FY07.

It appears that energy shortages had a broad-based impact on manufacturing activities. The impact was more pronounced on *metal* sub-sector which also faced a steep increase in international steel prices. Activities in *textiles* and c*hemicals* (especially caustic soda) industries were also affected by frequent energy disruptions as well as rising input cost.

Although a large number of industries (10 out of 15) delivered a weak performance; for some industries this was largely an outcome of short-term developments including poor FY08 cotton harvest (hurting textile and allied industries), political unrest through most of period (especially the economic losses in the aftermath of 27th December 2007), temporary closures of certain industrial units for maintenance and/or up-gradation (e.g., polyester fiber, paper and fertilizer), as well as power shortages (e.g., metal industries and manufacturers of caustic soda, among others).

Services

Information for the first nine months of FY08 suggests that the services sector is poised to achieve the annual targeted growth. The main contributors to this performance are wholesale & retail trade, transport storage & communication as well as public administration & defence sub-sectors. In addition, social & personal services seem well placed to contribute positively towards upbeat annual growth in services sector. However, growth in finance & insurance sub-sector appears to slow due to weaker profitability of the commercial banks, nonetheless remain strong in FY08.

1.2.2 Prices

The impact of strong global inflationary pressures on domestic inflation has also been compounded by the adjustments of administered prices of key fuels and wheat. All price indices have moved up significantly so far in FY08 and are significantly higher than the annual averages for the preceding five years. Consumer Price Index (CPI) inflation accelerated to 17.2 percent YoY during April, 2008 contributed by both food and non-food sub-groups. In particular, CPI food inflation reached to 25.5 percent in April, 2008.

The desired impact of tight monetary stance of SBP has been neutralized by huge government borrowings. Core inflation, measured by 20 percent trimmed mean, accelerated to double digits (14.1 percent - record high level) in April 2008. Persistence of inflationary pressures is also evident from non-food non-energy (NFNE) based core inflation that increased to 10.8 percent in April 2008.

1.2.3 Money and Banking

The conduct of monetary policy has become increasingly challenging for SBP as the fiscal year has progressed, and inflationary pressures are gaining further strength.

The inflationary pressures have gained momentum, due to a number of factors, including supply shocks and continuing strong demand. The former include a sustained increase in global commodity prices (including unprecedented hikes in food and energy prices). The demand pressures, on the other hand, were mostly reflected in a sharp rise in the fiscal deficit that was largely monetized through a record increase in government borrowings from the central bank.

The pass through of high global commodity prices to domestic inflation is significant, and has increased in recent years as (a) the economy has become more open in recent years, and (b) the government began to gradually pass-on the rise in cost of key fuel (petrol and diesel), which was earlier frozen, to the domestic consumers.

Since the current higher prices in international markets are forecast to persist well above their historical averages in the foreseeable future, it is anticipated that the resulting inflationary expectations will be more lasting. There is also evidence that the erosion in purchasing power and squeeze in profit margins due to sustained increase in food and commodity prices is contributing to second round of inflationary pressures. Without continued monetary tightening, the inflationary pressures may turn into a wage-price spiral.

At the same time, the already high fiscal deficit is not only limiting the scope for containing the pass through of global inflation through subsidies and tariff reduction, challenges for monetary policy have been compounded as the government is relying more on borrowings from the central bank – which is the most inflationary source of financing. Moreover, the liquidity injections from unpredictable government borrowings have weakened the transmission of policy interest rates to retail rates. In order to meet the above challenges, SBP is maintaining a tight monetary policy stance. However, this stance needs to be supported by fiscal prudence.

The overall credit demand is also strong despite a significant slowdown in credit growth to consumers, energy shortages and operational bottlenecks in major industries. This was mainly attributed to (1) rise in working capital requirements due to higher input costs; (2) the need for bridge financing to settle price differential claims of OMCs and IPPs; as well as (3) the higher fixed investment (visible in a few sectors, e.g. textile, refineries and power) in the month of March 2008.

1.2.4 Fiscal Developments

Although official statistics on public finance for July-Mar FY08 are not yet available, SBP forecast suggests that the budget deficit for Jul-Mar FY08 (as a percentage of the estimated FY08 GDP) is likely to be significantly higher than the full-year FY07 figure.

The growth in government revenues in Q3-FY08 is expected to recover from the low of 1.8 percent seen during H1-FY08 as: (1) FBR tax receipts, which contribute the bulk of government revenues, have increased by 31.3 percent in Q3-FY08 compared to 6.0 percent during H1-FY08, and (2) non-tax revenues have been bolstered with the disbursement of budgetary support grants of US$ 281.7 million and US$ 300 million from USA and Saudi Arabia respectively.

Government domestic borrowing during July-Mar FY08 grew strongly, reflecting a strong year-on-year increase in the deficit, and little change in external financing from FY07. Thus, with net retirements of borrowings from commercial banks and only Rs 1.7 billion in privatization proceeds (against Rs 75 billion budgeted for FY08), the government borrowings from the central bank continued to rise sharply. Indeed, incremental government borrowings from SBP as of May 10, 2008 have reached Rs 551.0 billion, pushing the outstanding stock of treasury bills with SBP to Rs 940.6 billion. This development has significantly augmented inflationary pressures in the economy, and raised risks to macroeconomic stability.

After a sharp rise of 6.4 percent in second quarter, the growth in the domestic debt moderated to 5.5 percent in Q3-FY08. Although, government availed substantial financing from SBP in this quarter, growth in floating debt decelerated due to significant retirements by the commercial banks, resulting in a moderation in debt growth during Q3-FY08.

1.2.5 External Sector

Balance of Payments

The deterioration in Pakistan's overall balance of payment accelerated during Jul-Apr FY08. On the one hand, the current account deficit continued to expand while on the other, financial and capital account surplus shrank. Consequently, the country's foreign exchange reserves fell to US$ 11.5 billion and the rupee depreciated by 13.4 percent against US dollar by 22nd May, 2008.

A large part of the deterioration in current account deficit emanated Nov 2007 onwards on account of substantial increase in import bill. The rise in import bill, in turn, was driven by both high prices and demand factors, with former having the greater role. The rise in import bill was accompanied with rising freight charges which together overshadowed improvement in export growth and impressive increase in current transfers in the period under review.

The financial & capital account surplus declined during Jul-Apr FY08, mainly due to substantial fall in foreign portfolio investment[2], which resulted due to: (a) outflow from stock market, and (b) due to delay in floatation of Global Depository Receipts (GDRs) and (c) delay in issuance of euro bonds.

Trade Account

Pakistan's merchandise trade deficit widened to a record high of US$ 16.8 billion during Jul-Apr FY08, which is 37.8 percent higher than the annual trade deficit target. The deficit was fueled by a very strong surge in imports as well as below - target export growth. While the 10.2 percent YoY export growth during the Jul-Apr FY08 was an improvement over the previous year, it was nonetheless significantly lower than the 12.4 percent growth targeted for the period.[3] The surge in imports was caused by both higher aggregate demand and rising

[2] The foreign portfolio investment declined to US$ 118 million during Jul-Apr FY08 from US$ 1758 million in the same period of last year.

[3] The FY08 annual growth target for exports for was set at 13.1 percent in the trade policy.

international commodity prices. Growth in exports on the other hand was led by non textiles, while textile exports registered a fall in the period under review.