THE STATE OF PAKISTAN'S ECONOMY
Second Quarterly Report for FY09

1.1 Economic Outlook

Recent trends in most macroeconomic variables suggest that the disciplined implementation of the macroeconomic stabilization program is bearing fruit. With an improvement in fiscal discipline complementing the tightening of monetary policy, aggregate demand has seen a meaningful contraction. This has improved prospects for low inflation; while inflation is still very high, there is an expectation that it will decelerate sharply in the final quarter of the fiscal year. Also, there is a distinct improvement in the external sector, with a fall in the cumulative Jul-Feb FY09 trade deficit – the first reduction for this period in seven years. The narrowing trade deficit and robust remittances have also engineered a reduction in the current account deficit, allowing for a buildup of the country's foreign exchange reserves.

Notwithstanding this improvement, the short-term growth outlook is still difficult, with LSM growth in particular being hit (see **Table 1.1**) by a sharp reduction in demand from both domestic and international factors. Domestic industrial production particularly, has been badly affected by energy shortages, deterioration in the law and order situation, and constricted access to finance (as banks became increasingly risk averse). At the same time, while the direct impact of the international financial crisis on Pakistan has been relatively limited so far, there were significant indirect implications. These include a sharp pull back in some domestic asset markets (real estate and equities), constrained investment flows, and a fall in business confidence.

Table 1.1: Selected Economic Indicators

		FY07	FY08	FY09
	Growth rate (percent)			
LSM	Jul-Jan	8.3	5.6	-5.4
Exports (fob)	Jul-Feb	3.4	7.4	4.3
Imports (cif)	Jul-Feb	9.9	21.9	-1.5
Tax revenue (FBR)	Jul-Feb	22.8	13.6	20.4
CPI (12 month MA)	Feb	7.7	8.4	21.7
Private sector credit	Jul-Feb	11.2	11.7	4.6
Money supply (M2)	Jul-Feb	8.4	7.4	2.3
	billion US dollars			
Total liquid reserves[1]	end-Feb	13.3	14.0	10.1
Home remittances	Jul-Feb	3.4	4.1	4.9
Net foreign investment	Jul-Feb	4.5	2.6	1.9
	percent of GDP[2]			
Fiscal deficit	Jul-Dec	1.9	3.4	1.9
Trade deficit	Jul-Feb	6.2	7.5	6.9
Current a/c deficit	Jul-Feb	4.1	5.2	4.5

1. With SBP & commercial banks.
2. Based on full-year GDP in the denominator. For FY09 estimated full-year GDP provided by MoF has been used.

As the global economic environment continues to deteriorate (see **Box 1.1**), access to international capital markets looks to become even more difficult, and risks to both, exports and remittances, have increased. The changing economic environment thus has serious medium term implications, particularly for growth prospects, given the country's diminished ability to finance even moderate fiscal and external account deficits.

The government has already made significant reductions in the fiscal deficit, bringing it down to 1.9 percent of (estimated annual) GDP for H1-FY09 from 3.4 percent of GDP in H1-FY08. Equally important is the capping of the monetization of the fiscal deficit at end-October 2008 level.[1]

This reduced an important source of inflationary pressures, rendering fiscal policy more consistent with the monetary stance. While certainly necessary in the short run, the reductions in the fiscal deficit seen so far are neither sustainable nor sufficient:

- the sharp cut in development spending was probably justified and necessary in FY09. However, given the underdeveloped capital markets, the lack of a framework for public-private partnerships for infrastructure, and the country's growing investment needs, it is simply not desirable for the government to keep development spending at low levels;

- there are significant rigidities in government expenditures. In particular, defense spending and interest costs on the country's rising debt absorb approximately three-fourths of revenues;

- there is now a greater risk that even a lower fiscal deficit will crowd out private investment. This is because of the country's sharply constrained access to international capital markets as well as the slower deposit growth in banks. Moreover, the recent shift to volume-based auctions of government papers means that domestic interest rates will be more sensitive to the government's funding demands.

Thus far, the increased bank financing of the deficit has probably not impinged on the private sector's ability to borrow from the banking sector. While the net growth in private sector credit has certainly slowed sharply, to a mere 4.6 percent in July-Feb FY09, from a robust 11.7 percent in the corresponding period last

[1] Under Stand-By Arrangement end-June 2009 target for stock of government borrowing from SBP is Rs 1,181 billion, which is significantly lower than Rs 1,271 billion end-October 2008 level.

year, the deceleration owes to factors other than "crowding out" by government. These include a slowing economic activity, a sharp fall in cost of raw materials, bursting of asset-price bubbles in key markets, rising financing costs (stemming from high liquidity and credit risk premium as well as monetary tightening), etc. The slower growth in private sector credit, together with SBP measures to increase banking sector liquidity and support bank's ability to lend by loosening capital requirements, allowed the government to increase borrowings from scheduled banks.

The risks to the external account are just as great a concern. If the feared slowdown in export growth and remittances proves serious then the government's ability to implement counter-cyclical policies to support the domestic economy will be even more constrained. (1) The country's ability to fund even short-term external deficits has already been hit by the severe depletion of FX reserves over the last 12 months; also, (2) despite meeting the targets under the Stand-By Arrangement, Pakistan is unlikely to received benefits at the same levels as in yester years. Typically, successful implementation of IMF program leads to increase investor confidence, thus encouraging international capital flows to the country. Unfortunately, the size and scope of the present international financial crisis suggests that such flows to Pakistan are unlikely to reach even (the relatively low)[2] levels achieved by the country in recent years. To put this in perspective, the Institute of International Finance estimates that private capital flows to emerging markets are likely to fall to just US$ 165 billion in 2009, less than a fifth of the peak of US$ 929 billion recorded in 2007. This suggests that even a moderate external deficit could lead to a direct impact on the exchange rate. This would have negative consequences for inflation and growth.

It may be noted that the disinflationary process in Pakistan is already slow, and an accelerated depreciation could potentially sustain this trend. Though headline CPI inflation showed some signs of respite after reaching to its three decade high level of 25.3 percent in August 2008, it has remained above 20 percent throughout FY09. More importantly, core inflation has yet to see a meaningful decline.

Some key impediments to a deceleration in inflationary pressures are: (1) second-round effects of increase in cost of living amidst persistent high inflation for over a year, (2) absence of weakness in the prices of some key staples during harvesting period in the current fiscal year due to government's policy decisions,[3] (3) low

[2] While these flows in Pakistan during FY07 were the highest ever recorded by the country, they were nonetheless low relative to that recorded by other emerging markets.

[3] e.g., support price for wheat increased by 52 percent, and procurement of rice by public sector to support prices.

pass-through of decline in international prices, as well as, (4) an offsetting impact of renewed increase in prices of a some key food staples (milk, meat, etc.). However, two important developments offer hope of significant relief late into FY09. The more supportive fiscal policy since November 2008, and lagged pass-through of the substantial decline in international commodity prices, is expected to contribute to a significant reduction in domestic inflation. This is already visible in a substantial decline in YoY WPI inflation from a peak of 35.7 percent in August 2008 to 15.0 percent in February 2009.

1.2 Looking Forward

The worsening outlook for the global economy, and drought in international capital markets mean that Pakistan's economic revival strategy must perforce focus on fostering domestic and regional demand. Moreover, lowering inflation and limiting the twin deficits, in particular, would be key to enabling a transition in macroeconomic policy from a stabilization framework to one focused on reviving growth. The recent trends in key macroeconomic variables are therefore quite encouraging.

On an year-on-year basis CPI inflation, in particular, is expected to fall sharply in the final quarter of FY09, even though the annual average is expect to be quite high (see **Table 1.2**). Similarly, it is hoped that a continued compression in the imports, principally attributed to weakness in domestic demand, lower import unit values, as well as, depreciation of the rupee, will reduce the current account deficit, allowing Pakistan to build-up foreign exchange reserves. However, it is important to note that export earnings are also going down due to lower prices.[4]

Table 1.2: Projections of Major Economic Indicators

	FY08	FY09	
		Annual plan targets	Projections
growth rates in percent			
GDP	5.8	5.5	2.5 - 3.5
Average CPI Inflation	12.0	11.0	19.5 - 20.5
Monetary assets (M2)	15.3	14.0	7.0 – 9.0
billion US dollars			
Workers' remittances	6.5	7.7	7.3
Exports (fob-BoP data)	20.1	22.9	18.5 – 19.5
Imports (fob- BoP data)	35.4	37.2	30.0 - 31.0
percent of GDP			
Fiscal deficit	7.4	4.7	4.3 – 4.7
Current account deficit	8.4	7.2	5.8 – 6.2

Note: Targets of fiscal and current account deficit to GDP ratios are based on Nominal GDP in the Budget document for FY09, while their projections are based on projected (higher) nominal GDP for the year.

[4] There is also a risk to remittances, which have hitherto grown strongly despite a global recession. It is possible that an income effect (due to recession and lower oil prices) has been offset by a reversal

The realization of the expected sustained fall in domestic inflation, and increase in foreign exchange reserves would allow for easing of monetary policy. However, this is not necessarily expected to herald a recovery in manufacturing activity. Not only does monetary easing impact the real sector with a lag, industry will remain constrained by other bottlenecks such as energy shortages, high risk premiums on credit, etc. This means that real GDP growth will remain relatively weak in FY09, despite a reasonably good showing by both agriculture and the services sectors.

Any acceleration in growth in the following years too may require a supportive increase in development spending, as well as a targeted increase in spending on social safety nets. Unfortunately, this would not be possible without significant shifts in taxation and expenditure. The most important area for the government is to implement reforms in the country's taxation system. As emphasized in the IMF SBA, an increase in tax-to-GDP ratio is necessary for fiscal sustainability. A focus on expanding the tax base rather than raising the tax rate is required. Most of the services (particularly trade, transport, professional services etc.) and agriculture sectors need to be taxed commensurately with their share in GDP. As such reforms bear fruit with time, it is important that they be initiated forthwith.

On the financing side, it will be important to accelerate the development of domestic capital markets. Not only will this reduce the government's need to borrow from the banking system, a vibrant debt market could help ease credit access concerns, increase efficiency of the banks (as they would have to compete for funds), and help foster savings.

In the short to medium-term, it would be imperative for Pakistan to rely on concessional external assistance to finance development expenditure. The need for greater external assistance for Pakistan is underscored by the fact that the sources of domestic financing are either not available or remain risky due to its vulnerable external account position. Also, given the drying up of capital flows, official assistance seems to be the only option for countries like Pakistan to stimulate its economy to put it back on sustainable path of growth and development.

It should be remembered that the country achieved high growth, low inflation, low fiscal deficit and either surplus or a negligible current account deficit during

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of capital flight to the Middle East (as the real estate bubble there collapse) and shift of inflows to the formal channels following a crackdown on the informal markets.

FY03-FY07 period. All of these gains were wiped out mainly due to commodity price shock. This rapid deterioration in domestic economy raises concerns and reminds that stagnated structural transformation needs policy intervention to sustain growth and increase the economy's ability to absorb shocks. Early restoration of structural reforms and second generation reforms is required here.

It is clear that outreach of financial services is still limited, despite some gains of earlier reforms in the sector. There is a dire need to develop financial sector and to increase intermediation, which is essential to raise rate of savings and sustained growth in the economy. It does not only means require focusing on increasing financial outreach in rural and far flung areas, but also that the development of long-term debt market, investment plans for pension funds, revitalization of mutual fund industry, and corporate bond markets are also necessary for efficient allocation of resources. Another benefit of financial depth would be in the form of more effective monetary policy transmission.

1.3 Executive Summary

1.3.1 Agriculture Sector

All indications are that agricultural growth will be reasonably good during FY09, despite the drag from 18.5 percent decline in sugarcane output during *kharif* FY09. This assessment is based on an anticipated record wheat harvest (that would significantly improve the contribution by major crops), above target performance of minor crops and a reasonably good outturn by the livestock sub-sector.

The improvement in the crops sub-sector appears to be helped by the significant gains to farmers in the previous cropping season amidst high commodity prices, as well as supportive government policies. The price signals were so clear in FY09 that farmers worked hard and invested to offset the impact of water shortages and non-availability of urea at controlled prices. These efforts were also supported by favorable weather conditions. This was particularly true for the *rabi* crops, which were helped by timely winter rains. Consequently, despite lower estimated water availability and urea shortages, the improvement in the performance of crops sub-sector during FY09 is remarkable. A decline in urea off-take also led to deceleration in agri-credit disbursement during Jul-Jan FY09.

1.3.2 Large Scale Manufacturing

Production in large scale manufacturing (LSM) witnessed a broad-based decline of 4.7 percent during Jul-Dec FY09 as against a 5.2 percent rise during the same period last year. In addition to greater energy shortages, a rise in input costs and

lower domestic and external demand, the following factors were also responsible for production decline; (a) upward adjustment in the prices of electricity, gas and diesel (b) prices of most of the industrial inputs remained relatively higher although international commodity prices started to ease somewhat from July 2008, (c) depreciation of rupee with a greater volatility also increased cost of inputs for a number of industries, as well as (d) global recession has also taken its toll on export driven industries (including textiles). Export-led industries also faced marketing problems due to security situation and country image, with attendant concerns over Pakistani producers' ability to meet delivery deadlines.

1.3.3 Services

Initial data suggests that growth in services sector is likely to decelerate during FY09, though it would remain higher than the growth in the commodity producing sector. Upbeat growth prospects are supported by a sharp increase in foreign direct investment in services sector during H1-FY09 (a rise of 24 percent), despite global liquidity constraints. Similarly, improved growth prospects for the *transportation & storage sub-sector*, reflect the relatively better production in major crops. For the remainder, a strong contribution by *finance & insurance* sector and augmented *administrative & defense* related fiscal spending will provide support to the growth outlook of the services sector during FY09. However, this may be offset somewhat by a decline in LSM production, lower quantum of imports, and shrinking profits in telecommunication may drag growth in services sector during the year under review.

1.3.4 Prices

All price indices i.e. CPI, WPI and SPI, witnessed a clear downtrend in recent months. After showing a continuous acceleration since March 2008, CPI inflation (YoY) started easing from November 2008; it fell to 21.1 percent in February 2009 as against a peak of 25.3 percent in August 2008. However, this inflation is higher compared to 20.5 percent in the preceding month and 11.3 percent in the same month last year. The relative slowdown in domestic inflation since September 2008 was mainly driven by the deceleration in domestic food inflation as exhibited by the food groups of both CPI and WPI. While WPI non-food inflation dropped in tandem with international commodity prices, CPI non-food inflation showed stubbornness upto February 2009.

1.3.5 Money and Banking

SBP continued to maintain a tight monetary policy stance during FY09 under the macroeconomic stabilization program. In fact , the discount rate was sharply raised by 200 bps on November 13, 2008, taking the FY09 cumulative increase to

300 bps.[5] The monetary measure was supported by constraints on deficit monetization, which in turn increased the consistency of the fiscal policy and the monetary tightening. Furthermore, monetary policy received substantial support from the sharp adjustments in the exchange rate during Mar-Oct 2008 period.

These measures seem to be bearing fruit as the persistent demand pressures in the economy have finally started to ease somewhat in recent months. This was obvious from (1) deceleration in domestic inflation as the YoY CPI inflation dropped to 20.5 percent in January 2009 from its peak of 25.3 percent in recorded August 2008. (2) a visible slowdown in import growth during Nov-Feb FY09 which helped to lower the current account deficit. This together with modest recovery in financial flows significantly reduced the pressure on country's forex reserves. (3) a deceleration in private sector credit to 5.5 percent during Jul-Jan FY09 from 9.9 percent in the corresponding period the of previous year. While some of the banks were reluctant to lend to private sector due to concerns on credit quality, credit demand from the private sector is also slowing down (4) weakening of demand stimulus from fiscal policy as fiscal deficit reduced and pace of government borrowing from the central bank declined sharply since December 2008 onwards.

The ease in demand pressures together with lowering of inflation expectations also had implications for domestic liquidity; market interest rates have already started softening. This means that the effect of tight monetary policy has eased considerably. The definitive easing of the monetary policy is however constrained by the developments on the external account and the stubbornly high core inflation.

In monetary aggregate terms, the YoY growth in broad money (M2) decelerated sharply to 9.8 percent as on 21st Feb FY09 compared to 18.2 percent in the corresponding period last year. The slowdown in M2 growth was essentially a reflection of strong contraction in net foreign assets (NFA) of the banking system. Net domestic assets (NDA) however increased by 23.2 percent on YoY basis on Feb 21, 2009.

The deposits mobilization by banks remained notably weak during Jul-Jan FY09 as overall deposits of the banking system declined by 1.8 percent on cumulative basis. This was in sharp contrast to deposit growth of 3.4 percent during the corresponding period of the previous year. Encouragingly, the recent trends suggest that the steep fall in YoY deposit growth seems to have bottomed out.

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[5] SBP had earlier increased its policy rate by 100 bps on 30th July 2008.

The asset quality of the banking system has shown considerable deterioration during Jul-Dec 2008. At the same time, the provisioning made by banks was relatively low probably as SBP allowed banks to avail the benefit of 30 percent of Forced Sale Value (FSV) of collateral while calculating provisioning requirement. As a result, net NPLs more than doubled and the coverage ratio weakened sharply during Jul-Dec 2008.

1.3.6 Fiscal Developments

Fiscal consolidation has been a major priority under the macroeconomic stabilization agenda for FY09. This seems to be having an impact; the fiscal deficit for H1-FY09 is estimated to have dropped to 1.9 percent of projected annual GDP compared to 3.4 percent in H1-FY08. The fiscal deficit for H1-FY09 thus appears to be in line with the annual target set in the budget FY09 as well as that agreed with IMF under the Stand-By Arrangement.

Understandably, the fiscal improvement thus far has largely been brought about by elimination of oil subsidies and a cut in development spending. Total revenues, as percent of GDP, recovered slightly during H1-FY09 after the sharp decline witnessed in H1-FY08. The marginal improvement came exclusively from increase in non-tax revenues. Stagnation of tax revenues, as a percent of GDP, yet again underscores the significance of fiscal prudence. While there is need for a line-by-line review of government budget outlays, long term sustainability of fiscal accounts would require expansion of total revenues, particularly by broadening the tax base.

Broadening the tax base is key to a sustainable macroeconomic framework, particularly as access to external financing is increasingly difficult. This forces greater reliance on domestic financing, with a concomitant high risk of crowding out of private investment.

The large drop in H1-FY09 fiscal deficit is clearly reflected in the negative growth of the sources of budgetary financing. The government received Rs 141.1 billion in gross external inflows in H1-FY09. However, Rs 104.1 billion external outflows on account of repayment of external debt left only Rs 37.0 billion, in net terms, for financing of budget deficit. With lesser availability of budgetary financing through external sources, government's reliance on domestic financing increased sharply.

Within domestic sources of budgetary financing, non-bank's contribution also witnessed a strong contraction. Consequently, banking system had to meet much

of the government's budgetary requirements during H1-FY09. Thus, despite a 20.8 percent YoY decline in H1-FY09, the share of banking system in domestic sources of financing rose to 85.2 percent compared to 80.9 percent in the corresponding period last year.

1.3.7 Balance of Payments

After sharp deterioration in Jul-Oct FY09, overall external account balance improved noticeably in the ensuing months, aided by a sharp fall in the current account deficit and a modest recovery in financial inflows. Consequently, foreign exchange reserves increased and the rupee also recovered part of the losses suffered during Jul-Oct FY09. Thus, the aggregate 68.6 percent growth in overall external account deficit during the first eight months of FY09 was accrued essentially during the first four months of the period

A significant part of the Jul-Oct FY09 deterioration in current account deficit owed to steep rise in import growth mainly on account of higher import price. The subsequent improvement owed to both the lower quantum of imports (as demand was compressed by monetary tightening and weaker rupee) as well as large fall in import prices. This contraction in import bill complemented the rise in remittances to contain the current account deficit. Thus current account deficit during Jul-Feb FY09 was lower (13.8 percent) compared with the same period last year.

On the financing side, though surplus in financial account during Jul-Feb FY09 period is considerably lower (50.0 percent) than the corresponding period of last year, modest revival in financial inflows was registered following the introduction of an IMF supported macroeconomic stabilization program in November 2008. In particular, foreign direct investment and the inflows categorized as other investment depicted considerable increase during November-Feb FY09 period.

1.3.8 Trade Account

For the first time in the last seven years, the trade deficit recorded YoY decline of 6.9 percent during the Jul-Feb FY09 period. This contraction was principally driven by imports compression, supported by fall in import prices and subsiding aggregate demand pressures. A moderate, increase in exports also helped in narrowing the trade deficit during the period. Almost all of this improvement emanated from November FY09 onward, after having deteriorated sharply during Jul-Oct FY09.

Expectation of continued decline in import prices and slowdown in aggregate demand pressures suggests further contraction in trade deficit in months ahead.

However, this contraction may be moderated by the further weakening in exports. In particular, fall in international demand in the wake of global recession and growing domestic problems e.g energy crises pose downside risks to exports during the rest of FY09.

Box 1: Global Economic Developments[6]

As was feared, the international financial crisis continued to worsen during H1-FY09 with devastating impact on the world economy. Most of the large economies face recession, with corollary negative impact on developing economies. With billions of dollars gone into various stimulus packages, policy makers are still not sure about the full extent of the losses. For example the IMF has now raised its estimate of the potential losses in U.S. originated credit assets held by banks and others from US$ 1.4 trillion in October 2008 to US$ 2.2 trillion.

In its January 2009 update to World Economic Outlook, IMF is now forecasting that the global recession will be much deeper and more protracted than previously envisaged. It may be pointed out that this is the 3rd downward revision in the world economic outlook by the IMF in the last four months.

Global growth is now expected to fall to 0.5 percent in 2009, with advanced economies expected to suffer their severest recession since World War II. Collectively, advanced economies are expected to contract by 2.0 percent in 2009, which is the first annual contraction in the post-war period.

Emerging economies are expected to slow sharply, growing by 3.3 percent in 2009. The IMF has also revised downward its economic growth forecast for China in 2009 by almost 2 percentage points to 6.7 per cent.

Latest IMF Projections

(year on year percent change)			Projections	
	2007	**2008**	**2009**	**2010**
World output[1]	5.2	3.4	0.5	3.0
Advanced economies	2.7	1.0	-2.0	1.1
United States	2.0	1.1	-1.6	1.6
Euro area	2.6	1.0	-2.0	0.2
Other advanced economies	4.6	1.9	-2.4	2.2
Emerging markets and developing economies[2]	8.3	6.3	3.3	5.0
Africa	6.2	5.2	3.4	4.9
Developing Asia	10.6	7.8	5.5	6.9

Source: IMF, *World Economic Outook,* January 2009.
1-The quarterly estimates and projections account for 90 percent of the world purchasing-power-parity weights
2-The quarterly estimates and projections account for approximately 76 percent of the emerging and developing countries

With markets remaining volatile, unemployment rising, and consumer and business confidence falling to record lows, policy makers are working on a two-pronged strategy. One part is to restore the health of the financial institutions to free-up the credit markets, while other part is to provide monetary and fiscal stimulus. Many central banks have taken strong actions to cut interest rates and improve credit provision. Similarly, many countries have also announced and are partially implementing sizeable stimulus packages.

While apparently workable, these remedial measures are not without downside risks. Restoring financial health may require nationalization of financial institutions with inherent inefficiencies. Fiscal stimulus packages would further widen fiscal deficits, which are already under strain because of the impact of asset price declines on revenues, as well as the cost of financial sector rescues.

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[6] Source World Economic Outlook Jan 28, 2009.

Similarly as long as financial institutions remain cash strapped monetary easing may not be very effective.