1 Economic Outlook

1.1 Overview

Available provisional data by February 2010 shows that a moderate but fragile recovery is underway, aided by a gradual increase in aggregate demand following improvement in many key macroeconomic indicators. The most visible manifestation of this has been a recovery in manufacturing activity. Despite continuing energy shortages and rising production costs (especially of imported inputs and electricity),[1] large-scale manufacturing (LSM) activity gathered pace during H1-FY10 (see **Table 1.1**). The major impetus to this recovery is from strong domestic consumption demand (particularly for consumer durables).

Table 1.1: Selected Economic Indicators

		FY08	FY09	FY10
Growth rate (percent)				
LSM	Jul-Jan	5.6	-5.4	2.3
Exports (fob)[1]	Jul-Feb	7.4	3.5	2.7
Imports (cif)[1]	Jul-Feb	21.9	-1.5	-8.2
Tax revenue (FBR)	Jul-Dec	6.0	27.3	5.1
CPI (12 month ma)	Feb	8.4	21.7	12.6
Private sector credit	Jul- Feb	11.7	4.6	4.7
Money supply (M2)	Jul-Feb	7.4	2.0	5.7
billion US dollars				
Total liquid reserves[2]	end-Feb	14.1	10.1	14.8
Home remittances	Jul-Feb	4.1	4.9	5.8
Net foreign investment	Jul-Feb	2.8	1.9	1.0
percent of GDP[3]				
Fiscal deficit	Jul-Dec	3.5	1.9	2.7
Trade deficit	Jul-Feb	8.2	8.1	6.3
Current A/c deficit	Jul-Feb	7.7	6.8	2.2

1. Trade data compiled by FBS.
2. With SBP & commercial banks.
3. Based on full-year GDP in the denominator. For FY10, estimated full year GDP has been used.

The recovery in LSM has, in part, helped to compensate for the setbacks to major crops during Jul-Feb FY10 that have undermined hopes of reasonable growth in the agriculture sector during the full year. With the "major crops" sub-sector likely to record a decline in value-addition during the year - principally due to fall in the production of rice, sugarcane and an expected decline in wheat harvest - hopes of an overall positive contribution to growth by the agriculture sector now rest critically on a robust contribution by the 'minor crops' and 'livestock' sub-sectors. Encouragingly, there are some indications that the former, at least, is expected to do well in FY10.

1 Such as rising international commodity prices and reduction in domestic subsidy on power during recent months.

Indeed, ample domestic stocks of key staples and improved production of minor crops played an important role in bringing inflation down to 8.9 percent YoY by October 2009, 16.1 percentage points lower than a year ago, before it bounced back into double digits, reaching 13.0 by February 2010. The rigidity in inflation is principally due to: (a) rising international prices of many commodities amid supply shortages and a recovery in the global economy; (b) weakening of the rupee, particularly in December 2009 and January 2010, when SBP stopped providing forex liquidity support for oil imports; (c) a moderate recovery in the domestic economy, which also shows strength in aggregate demand; and, quite significantly (d) an upward adjustment in administered prices of power and key fuels.

At first glance, it appears that the inflationary pressures are concentrated in food and energy sub-groups of CPI. However, the fact that the "trimmed mean" core inflation measure continues to rise despite a decline in NFNE core inflation indicates that inflationary pressures are strengthening in the economy. It also points towards the possibility of strong second-round effects on prices of other goods and services due to increased cost of production and rise in cost of living.

The reversal of the earlier trend decline in inflation exemplifies the fragility of the improvements in the country's economic environment seen so far in FY10. Clearly, there is a need to vigilantly monitor the relative deterioration in macroeconomic indicators, and particularly those that had seen substantial improvement in the initial months of the year.

In fact, as indicated in the last monetary policy statement, it was precisely the potential (and emerging risks) to macroeconomic stability that had forced the SBP to move very cautiously in easing monetary policy, despite relative easing of inflation and weakness in aggregate demand towards the end of FY09 and the beginning of FY10. Thus, after reducing the policy rate by a cumulative 250 basis points during CY09, SBP kept its discount rate unchanged at 12.5 percent in succeeding months.

This conservative monetary stance continues to attract criticism from industry at large. This is quite understandable, since there are pressures on the domestic economy, due to the global economic slowdown, and energy costs have also increased. However, given the weakness in the country's fiscal outlook and risks to external flows, and rising inflation, policy options for Pakistan are quite limited.

The fiscal outlook appears especially challenging. Existing rigidities in current expenditures have been exacerbated in FY10 by the strong buildup in domestic and external debt, and rising military spending for anti-terrorist operations. Moreover, spending has also been boosted by efforts to address the growing energy sector circular debt logjam, as well as the less desirable policy to ensure higher-than-market price for farmers. Although development spending increased by 69.6 percent during H1-FY10, even this is below the levels implied in the original budgeted amount for FY10.

The impact of these developments, together with weak revenue generation and considerable lags in the receipts of coalition support funds, contributed to a rise in the fiscal deficit. It rose to approximately 2.7 percent of GDP in H1-FY10, in contrast to 1.9 percent of GDP in H1-FY09. More significantly, the original FY10 fiscal deficit target of 4.9 percent of GDP looks unachievable even after incorporating the proposed large reduction in development spending. The latter is certainly not a welcome development, with negative implication for the country's long-term growth potential. But it is worth noting here that the government's ability to protect development spending has been severely cramped by the non-availability of expected external aid flows from FoDP.

Lower than planned availability of external financing also significantly increased the government's reliance on financing from scheduled banks. This demand was compounded by higher demand for credit from PSEs and for commodity operations, thereby squeezing market liquidity and crowding out the private sector.

This forced SBP to aggressively inject liquidity, allowing banks to accommodate a small seasonal recovery in credit demand from the private sector during Q2-FY10. Thus, while M2 growth accelerated from an anemic 2.0 percent in Jul-Feb FY09 to a more robust 5.7 percent in the corresponding period of FY10, the larger part of this was contributed by government sector activities, including quasi-fiscal activities, e.g. the government's commodity operations, interventions to reduce the stock of energy sector subsidy arrears, etc.

Unlike the fiscal accounts, external account balances show significant year-on-year improvement during the aggregate Jul-Feb FY10 period. Specifically, the current account deficit dropped from 6.8 percent of GDP in Jul-Feb FY09 to 2.2 percent of GDP in Jul-Feb FY10, as a large drop in imports overshadowed a smaller decline in exports[2], and remittances saw a 17.7 percent YoY rise in the same period. Consequently, the country's foreign exchange reserves rose to US$ 14.8 billion by end-February 2010, from a low of US$ 6.8 billion in October 2008.

The good news on the external sector ends here. A monthly disaggregation for the period shows that most of this improvement was concentrated in the first quarter of the fiscal year. Thereafter, the YoY trends have steadily deteriorated, with an uptrend in imports relative to exports, and slowdown in remittances inflows. The trends in the financial and capital accounts are also discouraging: of the US$ 3.7 billion surplus for Jul-Feb FY10, approximately US$ 2.8 billion was recorded in Q1-FY10. Moreover, practically all of the external sector financing was in the form of debt, significantly adding to the country's vulnerability to external shocks.

Similarly, even as continued inflows on account of the IMF Stand-By Arrangement pushed up the country's foreign exchange reserves, the rupee depreciated sharply between mid-December 2009 and mid-Feb 2010. The rupee weakned because SBP stopped providing liquidity support for oil payments in the inter-bank forex market in mid-December 2009, over a month ahead of schedule. The impact of additional demand for dollar was further compounded due to increase in demand for POL imports in recent months, as well as some (temporary) rumor-driven rise in the informal (kerb) exchange rate market.

1.2 Looking Forward

Despite an anticipated decline in value addition by major crops (having a share of about 38 percent in agriculture value addition), an above-target recovery in manufacturing, strong rebound by the construction sector and reasonable performance by the services sector are likely to sustain a modest revival in growth during FY10. SBP growth estimates remain unchanged from the previous quarter, with real GDP growth for the year projected to fall in the range of 2.5 – 3.5 percent (see **Table 1.2**).

Similarly, the resurgence in inflationary pressures due to revival in aggregate demand, exchange rate pass-through, etc. have so far, not exceeded levels already embedded in earlier SBP forecasts. The annual headline CPI inflation projection for FY10 also remains unchanged. An important risk to the inflation outlook, however, lies in the possibility of a revival in inflationary expectations if domestic demand picks up further or the pass through of rising international commodity prices increases.

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[2] Exports and imports numbers are based on exchange record (SBP) data and will not tally with the export import data presented in table 1.1which is based on FBS data.

Table 1.2: Projections of Major Macroeconomic Indicators

	FY09	FY10 Annual Plan Targets	FY10 SBP Projections
growth rates in percent			
GDP	2.0	3.3	2.5 - 3.5
Average CPI inflation	20.8	9.0	11.0 - 12.0
Monetary assets (M2)	9.6	-	14.5 – 15.5
billion US dollars			
Workers' remittances	7.8	7.0	8.0 - 8.5
Exports (fob-BoP data)	19.2	19.9	18.7 - 19.2
Imports (fob-BoP data)	31.7	28.7	30.5 - 31.0
percent of GDP			
Fiscal deficit	5.2	4.9	5.0 - 5.5
Current account deficit	5.3	5.3	3.2 – 3.8

Note: Targets of fiscal and current account deficit to GDP ratios are based on nominal GDP in the budget document for FY10, while their projections are based on projected (higher) nominal GDP for the year.

Encouragingly, due to a better than expected performance by the exports in recent months and robust performance of remittances earlier in the year, the current account deficit has narrowed more than projected earlier. Thus, even incorporating relatively less positive trend in months ahead, it seems likely that the full year FY10 deficit will be lower than earlier SBP forecasts. Current projections suggest that the FY10 current account deficit is likely to fall in the range of 3.2 – 3.8 percent of GDP, which represents a 0.5 - 1.1 percent of GDP improvement from the earlier estimates. A key risk to this more positive assessment, however, lies in the possibility of a further large (US$ 5 – 10 / barrel) increase in international oil prices.

In contrast, FY10 fiscal deficit is estimated to be higher on account of extraordinary defense related spending and weakness in revenue collection. In recent consultations with IMF, need for a cut in PSDP and relaxation in fiscal deficit target was also recognized. Accordingly, the fiscal deficit is projected to lie in a range of 5.0 – 5.5 percent of GDP during FY10.

In brief, the economic outlook is mixed. While inflation decelerated significantly during FY10 compared with the preceding year, inflationary pressures have decisively remerged in recent months. Similarly, although, the current account deficit witnessed improvement, sustaining it at low levels will be challenging given rising import requirements of the economy, and evident weakness in the pace of growth in remittances. Prospects for real GDP growth are better relative to the preceding year. However, this level of growth is not adequate to generate required employment opportunities. It should be remembered that the growth in labor force is higher than the preceding years due to: (1) induction of new people into the job market, and (2) an encouraging increase in female participation in job market.

This situation reinforces the need for serious policy efforts to achieve sustained high growth. This needs both macroeconomic stability (low inflation, prudent fiscal stance, low current account deficit, high investment and savings), and political stability, including improvement in law & order and security conditions. Implementation of structural reforms focused on elimination of subsidies, reduced role of government in price setting, formulation of effective regulations to ensure optimum market-based outcome, are needed to sustain growth and enhance resilience of the economy. These must also be complemented with the introduction of second generation reforms centered on institution building and governance.

It is worth reiterating that while tax reforms are most readily legislated during times of economic stress, this is also the period where the revenue impact of reforms is most limited. In other words, revenue measures will gain most traction only when the economy recovers somewhat. This implies that, in the short run, there may be few options to contain the fiscal deficit. Nonetheless, aggressive fiscal reforms are key to achieving and retaining macroeconomic stability in the medium term. These need to focus on the entire range of options from increasing efficiency of public expenditures, reducing size of government, raising the tax-to-GDP ratio, etc.

There is little doubt that the government intervention cannot successfully stabilize the economy and simultaneously provide stimulus for growth. This means that fiscal policy must be carefully calibrated and prioritized by targeting either the provision of public goods or targeting market failures, and also create an enabling environment for provision of other services by the private sector. In this context, the government interventions in market pricing can be particularly distortionary. These can not only lead to inefficient production decisions, and entail very significant fiscal costs, the added political risk in market pricing can discourage private sector investments.

1.3 Executive Summary

Agriculture sector

Growth prospects for agriculture sector remain weak in contrast to the strong growth seen last year. Negative contribution by the two major crops of FY10 *kharif* (rice and sugarcane) and expected decline in wheat harvest are mainly responsible for this gloomy outlook. The major contributory factors for lower area under cultivation and relatively weak performance by these crops were: (a) water shortages; and (b) realization of lower prices in the preceding season for rice and sugarcane.

An overall decline in area under major crops, conservative lending by domestic private banks (DPBs) and weakness in demand for credit by the non-farm sector led to slowdown in agri-credit disbursement during Jul-Jan FY10. On the positive side, relatively lower prices of fertilizer and higher farm incomes in FY09 encouraged farmers to use fertilizers aggressively. Fertilizer off-take also increased due to government support in terms of maintaining a higher support price for FY10 wheat crop despite a substantial decline in international prices of the grain.

Large Scale Manufacturing
The pace of recovery in LSM subsector increased in Q2-FY10 largely in response to rising domestic demand. Most of the recovery emanated from the consumer durable industries as demand for automobiles & allied industries increased sharply despite the QoQ increase in prices. Furthermore, revival in construction activities in both public and private sector resulted in a sharp increase in demand for cement and steel during the quarter. Cement sector benefited also from recovery in external demand as exports to North African countries showed a steep rise. Resource based industries, however, presented a mixed picture. Where the low-value-added textile sector benefited from a good cotton crop and a simultaneous shortage of cotton globally, the local sugar industry suffered from lower sugarcane production.

Nonetheless, it will be extremely challenging to sustain the growth seen in Jul-Jan FY10 period given the prevalent energy shortages in the country. In addition to energy insufficiency, local manufacturers are also confronting the rising cost pressures, since electricity and gas tariffs have increased from January 2010. Furthermore, the rise in global commodity prices from Q2-FY10 has also put significant pressures on production costs. If manufacturers tend to shift the cost burdens on the consumers, demand may tumble as consumers' purchasing power has already been hit by rising food prices.

Prices
Inflationary pressures strengthened in the economy in recent months. Resurgence in inflation during recent months is mainly attributed to: (a) rise in the administered prices of energy[3] and key fuels by the government, (b) depreciation of rupee, and (c) a temporary supply shock due to bad weather (fog) in Punjab.

[3] An upward adjustment in electricity and gas tariff is part of the efforts to reduce subsidy, thus help reduce burden on fiscal budget.

Moreover, relatively higher international commodity prices of sugar, rice and crude oil also fueled inflationary pressures in the economy.

Specifically, headline CPI inflation fell to 13.0 percent YoY in Feb 2010 after bottomed out at 8.9 percent in October 2009. The surge in CPI inflation in recent months is principally contributed by rise in the prices of food items and administered prices of key fuels and electricity tariffs. This is also evident in a lower core inflation measured by excluding food and energy items (NFNE) from the CPI basket relative to core inflation measured by 20% trimmed mean. While NFNE inflation registered at 10.1 percent, 20% trimmed mean inflation recorded at 12.4 percent in Feb 2010. Relatively higher core inflation measured by trimmed mean also indicates that inflationary pressures are substantially broad based within food and energy sub-groups. This also points towards rigidity in inflationary pressures in the economy. More importantly, since inflationary pressures concentrated in food and energy sub-groups, this indicates possibility of strong second-round effects on the prices of other goods and services due to rising costs of production and increase in cost of living.

Money and Banking

SBP kept the policy rate unchanged at 12.5 percent in January 2010. This was because of rebounding inflationary pressures, lingering risks on external current account though reduced from last year level and persistent weakness in the fiscal account.

In terms of monetary aggregates, growth in Broad Money (M2) accelerated to 5.7 percent during Jul-Feb FY10 from 2.0 percent in the corresponding period of FY09. This improvement resulted entirely from an expansion in net domestic assets (NDA) of the banking system on the back of strong rise in private sector credit and increased recourse of government to finance its deficit from the banking system. On the other hand, trend improvement in the external account visible since December 2008, has started to reverse from October 2009 onwards. Resultantly, NFA of the banking system recorded a depletion of Rs 46.6 billion in Jul-Feb FY10; though much lower compared to last year's contraction. Deposit mobilization by banks shows some recovery since deposits recorded a growth of 4.6 percent during Jul-Feb FY10 in sharp contrast to the previous year when the deposit base contracted by 0.6 percent.

The trend decline in private sector credit, visible for twelve consecutive months, reversed from October 2009 as (1) the demand for seasonal finance (i.e. cotton, sugarcane and rice) picked-up, and (2) a mild recovery was seen in domestic demand. Consequently, cumulative credit to private sector grew by 4.7 percent during Jul-Feb FY10; slightly lower than the growth seen in the corresponding period a year earlier.[4]

Fiscal Developments

Key fiscal indicators improved in Q2-FY10 over the previous quarter, bringing the cumulative fiscal deficit for H1-FY10 to 2.7 percent of annual estimated GDP. This figure is consistent with the SBP forecast of budget deficit for the year.

The improvement in revenue growth during Q2-FY10 is largely due to increased direct tax collection. This was to be expected given that the traditional first quarter receipts had been pushed into the second quarter following extension of the deadline for filing income tax returns. Moreover, tax collection was also helped by a revival in the economy and rise in rupee value of imports.

On the expenditure side, the government was able to contain growth in total outlays during Q2-FY10. However, given the rigidities in current expenditure on account of the need to address buildup of energy sector circular debt, security related expenditure etc, the government has little choice but to cut development spending if pledges by FoDP are not realized and lags in reimbursement of Coalition Support Fund continue.

Balance of Payments

Improvement in the overall external accounts recorded during Q1-FY10 could not be sustained in the ensuing months (Oct-Feb). Considerable YoY decline in financial inflows during the latter period and trend reversal with regard to the improvement in CA deficit witnessed earlier led to a noticeable deterioration in overall external account during this period. Nonetheless, overall external account recorded sizeable YoY improvement for the aggregate Jul-Feb FY10 period.

Deterioration in the current account deficit during Oct-Feb period was contributed by both an expansion in the trade deficit and a contraction in invisible account surplus. On the financing side, the decline was primarily due to fall in net foreign investment flows. Significant fall in foreign direct investment along with payment of Sukuk bond worth US$ 600 million resulted in 61.2 percent decline in net foreign investment during the period under review. Furthermore, inflows from IFIs also remained subdued in the latter months of current fiscal year.

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[4] While the sharp rise in private sector credit during Q2-FY10 was entirely explained by a robust demand for incremental running finance; demand for fixed investment loans remained relatively lower.

The pressures on the country's reserves during Jul-Feb FY10 were visibly lower owing to improvement in the overall external account balance during this period. As a result the country's overall reserves climbed to US$ 15.1 billion against US$ 10.6 billion in the same period last year. The foreign exchange market also exhibited relative stability, and the exchange rate depreciated by only 4.3 percent during Jul-Feb FY10 compared to 14.5 percent in the corresponding period last year.

Trade Account

Pakistan's trade deficit contracted by 19.5 percent YoY during Jul-Feb FY10 as compared to a fall of 6.2 percent during the same period last year. This contraction was largely on account of a fall in the import bill which was supported by a marginal rise in exports.

The compression in imports was entirely due to price impact which outpaced the rising import quantum. However, with price impact also turning positive from December 2009 onwards, import growth has started to rebound. As far as exports are concerned, the recovery was observed both in textile as well as non-textile sectors particularly in Q2-FY10. Revival in external demand for textiles coupled with good production of cotton[5] resulted in an increase in exports of low value added products.[6] In non-textile sector, quantum growth for the fuel group in particular was remarkable during the period under review with major contribution coming from rice and fruits.

[5] Production of cotton in FY10 is 12.7 million bales in contrast to production of 12.1 million bales during FY09.

[6] Export growth of raw cotton and cotton yarn grew by 142.0 and 38.0 percent YoY respectively during Jul-Jan FY10.