1 Economic Outlook

1.1 Overview

The prospects of returning to macroeconomic stability improved in the initial months of FY10, with most key indicators continuing the positive trends that began in the closing months of FY09.

Table 1.1: Selected Economic Indicators

		FY08	FY09	FY10
Growth rate (percent)				
LSM	Jul-Oct	7.7	-5.0	0.7
Exports (fob)	Jul-Nov	6.5	12.0	-7.4
Imports (cif)	Jul-Nov	18.4	16.4	-23.0
Tax revenue (FBR)	Jul-Sep	11.6	27.7	0.6
CPI (12 month ma)	Nov	7.6	19.1	14.6
Private sector credit	Jul-5th Dec	5.8	4.4	0.9
Money supply (M2)	Jul-5th Dec	4.8	0.6	4.2
billion US dollars	-	-	-	-
Total liquid reserves[1]	end-Nov	15.7	9.1	13.7
Home remittances	Jul-Nov	2.6	2.9	3.8
Net foreign investment	Jul-Nov	2.1	1.4	1.1
percent of GDP[2]				
Fiscal deficit	Jul-Sep	1.5	1.1	1.5
Trade deficit	Jul-Nov	4.4	5.3	3.1
Current a/c deficit	Jul-Nov	2.9	4.4	0.8

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

Available data on agriculture and the industrial sector, is in line with the expectations of a modest recovery in economic growth during FY10. While the performance of major crops during FY10 *kharif* (April-October 2009) cropping season was below expectations, growth in large-scale manufacturing has recovered substantially after recording a 20.6 percent YoY decline in March 2009 (see **Table 1.1**). Similarly, a sharp reduction in inflation, contained government borrowings from SBP, substantial contraction in external imbalances, the stability in the rupee-US$ parity, and easing monetary stance, are all likely to support economic stability. However, the drop in overall volume of trade, poor tax growth, risk of lower than expected aid receipts and, in particular, a rise in the fiscal deficit, highlight the fragility of the improvement and pose continuing risk to the recovery.

With the country engaged in a war against militants and facing weak international demand, policy options are relatively limited. In particular, the operations against militants in some northern regions of the country have resulted in additional expenditures, putting pressures on the federal budget. It is quite difficult to contain such discretionary government spending. Not surprisingly, the fiscal deficit for Q1-FY10 is reported at 1.5 percent of GDP as compared to 1.1 percent in Q1-FY09. However, it can be argued that the accommodative fiscal stance has

probably helped trigger at least part of the modest recovery in aggregate demand, thus supporting business and consumer confidence. Business confidence was probably also helped by signs of a mild recovery in the global economy, which has improved export prospects somewhat. Nonetheless, the rising fiscal imbalance and greater quasi-fiscal activities have increased the risks to macroeconomic stability. Below expectation growth in external funding for budgetary support, and restricted access to borrowings from the central bank mean that the financing needed by the government from commercial banks has ballooned. To put this in perspective, a significant contribution to the 4.2 percent year-to-date (YTD) increase in broad money supply during Jul-Nov FY10 (compared to only 0.6 percent YTD last year) has essentially stemmed from fiscal and quasi-fiscal activities. By contrast, net private sector credit growth during the same period was an anemic 0.9 percent YTD.

Weak private demand for credit and the risk-averse behavior of banks allowed the government to finance its increased spending in FY10 without crowding out private sector activities. There is now evidence that this room will not persist for long. In this case, continued excessive fiscal needs can have adverse implications for market liquidity, interest rates and credit to private sector, which in turn will limit the central bank's ability to further reduce the policy rate. The continued fiscal stimulus could also complement an expected rise in imported inflation, raising the risk of resurgence in domestic prices.

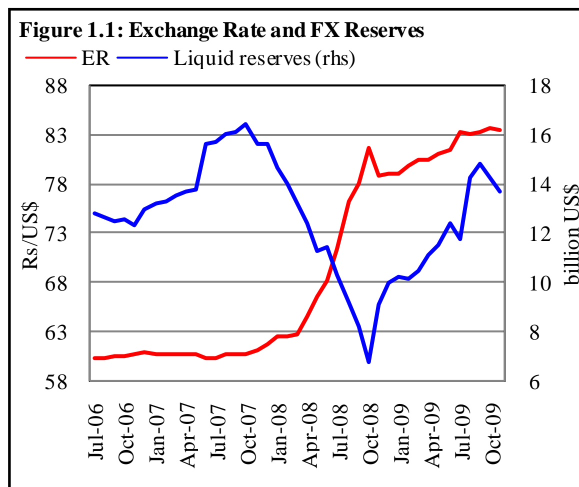
Although, headline CPI inflation dropped to 8.9 percent YoY in October 2009 (the lowest level in the preceding 26 months), it bounced back to 10.5 percent in the next month. Similarly, WPI inflation has seen a sharp jump in November 2009 to 12.5 percent, from only 3.8 percent YoY during the previous month. As a leading indicator, this shows growing inflationary pressures in the economy. This view is also reinforced by: a) an uptick in inflation measured by SPI in recent months, b) continued high levels of core inflation, as well as, c) strong CPI inflation numbers on a month-over-month basis for an extended period.

Indeed, it was concern over the combined impact of tight liquidity and risks of a re-emergence of inflationary pressures that led to only a measured easing of monetary policy. For example, while the central bank cut the policy rate by 50 basis points in November 2009, the reduction was lower than market expectations. The market was looking at a 100 bps reduction, in the backdrop of a sharp fall in headline inflation numbers and the considerable narrowing of current account deficit (83.9 percent lower YoY) during Jul-Nov FY10.

In any event, SBP caution seems justified, given the apparent reversal in inflation trends in November 2009. Moreover, in-house forecasts indicate the risk that an inflation uptrend could accelerate in H2-FY10 because of higher international commodity prices and lower than anticipated external receipts. The lower current account deficit during Jul-Nov FY10 is a result of strong growth in remittances, and a fall in imports (which more than offset the decline in exports). However, this improvement may not be sustained in the remaining months of FY10. Import demand, in particular, is projected to rise in months ahead with an expected revival in domestic manufacturing, and rising international commodity prices. At the same time, there are indications that the growth of some key exports (basmati rice, cement, etc.) may slow in the same period.

Similarly, the reasons for the strong improvement in remittances are still unclear, raising questions on the sustainability of the trend. Some analysts have raised concerns that this growth is mainly attributable to one-off transfers from expatriates who lost jobs in the Middle East, USA and Europe in the wake of the economic crisis. However, it is equally possible that a structural shift has taken place after the actions against alleged illegal activities by some foreign exchange companies. If so, recent SBP steps to facilitate remittances through official channels, could reinforce the positive trend.

Figure 1.1: Exchange Rate and FX Reserves



Despite this improvement in the current account projected for FY10, Pakistan's overall external account remains vulnerable. This is because financing a significantly lower current account deficit remains very challenging on account of low external inflows. Net investment flows into the country for Jul-Oct FY10 are already 15.5 percent lower YoY, and access to international debt markets remains severely constrained (particularly after the debt restructuring requested by Dubai World). In this environment, funding under the Stand-by Arrangement with IMF has been a key to shore up the country's foreign exchange reserves and moderate the depreciation of rupee (see **Figure 1.1**). These are important gains for overall macroeconomic stability but

maintaining these gains and ensuring continuity of the nascent economic recovery remains challenging for the remaining months of FY10.

1.2 Looking Forward

SBP estimates suggest that FY10 GDP growth is likely to be around the annual target of 3.3 percent, a little higher than the 2.0 percent seen in FY09 (see **Table 1.2**). The major impetus for this growth is expected to come from the services sector. Within the commodity producing sector, an improvement in industrial output is expected to be partially offset by weaker agriculture.

Similarly, the current account deficit is likely to improve further in FY10 relative to the previous year, though some expected revival in import demand from manufacturing and rising commodity prices may possibly contain the improvement going forward.

Table 1.2: Projections of Major Macroeconomic Indicators

		FY10	
	FY09	**Annual Plan Targets**	**SBP Projections**
growth rates in percent			
GDP	2.0	3.3	2.5 - 3.5
Average CPI inflation	20.8	9.0	10.0 - 12.0
Monetary assets (M2)	9.6	-	12.0 - 13.0
billion US dollars			
Workers' remittances	7.8	7.0	7.8 - 8.8
Exports (fob-BoP data)	19.2	19.9	18.5 - 19.0
Imports (fob-BoP data)	31.7	28.7	30.5 - 31.0
percent of GDP			
Fiscal deficit	5.2	4.9	4.7 - 5.2
Current account deficit	5.3	5.3	3.7 - 4.7

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.

However, while average CPI inflation during FY10 is projected to decelerate significantly from FY09 levels, it is likely to remain higher than the annual target of 9.0 percent for the year. The adjustment in administered prices of key fuels amid rising international oil prices and cut in electricity subsidies, are important factors behind the expected strengthening of inflationary pressures.

The government will try to achieve the quarterly SBA targets for the budget deficit. However, given exceptional circumstances arising from the stepped-up campaign against militants, these targets may not be achieved due to huge expenditures on defense and the rehabilitation of internally displaced people. The indirect cost of war entails weaker growth in tax collections, as industrial and trade activities (which are the main contributors to fiscal revenue) remain dull due to security uncertainties.

Thus, a major challenge in the economy is to improve the tax-to-GDP ratio. The 0.6 percent YoY increase in tax collection during Jul-Nov FY10 is a source of concern; if this continues, Pakistan's tax-to-GDP ratio will decline from an already low 9.8 percent seen in FY09. In view of the needs of the structural second generation reforms in the economy, it is necessary to strengthen the capability of FBR, increase documentation, reduce exemptions, equal treatment of incomes from different sources, and accelerate the levy of a comprehensive VAT. Another challenge in public finance is the increasing level of contingent liabilities of the government. In particular, the energy sector circular debt issue has not been resolved yet, and the government's borrowings for commodity operations have not seen the expected seasonal retirement in Q2-FY10. Since, a large part of these loans has been availed by the TCP and PASSCO, this needs to be settled before it creates another circular debt problem.[1]

It must be stressed that excessive government involvement in commodity trade/finance, and the interference in market price setting, can be counter-productive and should be avoided. Cases of market failure are best handled through effective reforms and strengthening institutions like the Competition Commission of Pakistan.

[1] Wheat procurement in FY09 was over 9 million tons, substantially higher than the targeted 7 million tons that supplemented the existing stocks from imports in the preceding year. As a result, ample wheat stocks are lying with the provincial governments and agencies, much of which is without adequate storage facilities. This raises significant risks: a) given substantially lower international wheat prices, there may be some inward smuggling of cheaper wheat into the domestic market, b) there could be significant losses in case of rains, and, c) off-take from government wheat stocks could be significantly lower than anticipated. All of these raise corresponding concerns on banking sector liquidity.

1.3 Executive Summary

1.3.1 Real Sector

Agriculture

Initial estimates suggest that the performance of FY10 *kharif* crops has been significantly weaker than in the corresponding period last year. This was due to water shortages at sowing times and, more importantly, farmers' disappointment with prices received in the previous *kharif* season. The latter is particularly evident in the decline in area under rice and sugarcane cultivation. Conversely, the impact of favorable prices is reflected in the higher acreage under cotton during *kharif* FY10; cotton prices are currently at an all time high.

On the other hand, the announced support price for wheat may help the *rabi* crop; however, it is less likely that wheat could add significantly to growth given the high base set by the record FY09 crop. Early signals of poor *kharif* output, saturation in *rabi* and uncertain livestock due to decline in non-farm agri-credit, raise the risk of an overall weak performance of agriculture during the current fiscal year.

Large Scale Manufacturing

A modest improvement in aggregate demand was seen in Jul-Oct FY10 as manufacturing index increased by 0.7 percent compared with a decline of 5.0 percent in Jul-Oct FY09. This could be attributed to gradual easing in monetary policy and fiscal support as well as the impact of increase in farm incomes in FY09.

However, plagued by a multitude of structural issues, the recovery remained weak and patchy: a) although ginning numbers were strong, high lint and yarn exports resulted in raw material shortages for high-value added industries, bringing overall textile growth in the negative, b) automobile sales showed promising growth following a decline in both vehicle and fuel prices; but despite this, refinery production declined owing to the unsettled circular debt, c) domestic cement sales are expected to be impressive as modest recovery was seen in construction activities evident in high YoY growth in production of building material items (e.g., billets) as well as import of steel in October 2009. Nonetheless, export prospects are uncertain given capacity augmentations in importing countries as well as slowdown in construction industry in Afghanistan and Gulf.

With such unbalanced patterns of domestic recovery, expected upturn in global prices that will push up domestic energy costs, and lower sugarcane harvest

coupled with fears of late crushing (which could impede growth in sugar industry), the outlook for industry in FY10 remains uncertain.

1.3.2 Prices

Domestic inflationary pressures eased significantly during the first five months of FY10 compared with the corresponding period of FY09. Inflation measured by consumer price index (CPI) and the sensitive price indicator (SPI) declined, with CPI inflation YoY dropping to 10.5 percent YoY in November 2009, after reaching single digits (8.9 percent) during October 2009, for the first time in the preceding 21 months. While an uptick in November is largely attributed to higher food prices on account of Eid-ul-Adha, the recent disinflationary process is a result of: a) improvement in supply of most of the key staples (except sugar), b) constraints on the government's monetization of the fiscal deficit, c) lagged impact of tight monetary stance, and d) a decline in imported inflation.

However, variability in monthly inflation rates in WPI inflation (YoY) raises concern over the sustainability of the downtrend, particularly in the second half of the fiscal year. The risk of resurgence in inflationary pressures is also evident from strong core inflation. Both indicators, the non-food non-energy (NFNE) and 20 percent trimmed mean, though declining since H2-FY09, remained high. One of the main reasons for the persistence in both measures of core inflation, is the double digit increase in house rent index (HRI) despite an easing since June 2009. HRI has around 46 percent weight in NFNE and 29 percent weight in trimmed mean, hence, the pace of decline in core inflation is slow relative to headline inflation.

Moreover, the rising trend in international commodity prices, particularly crude oil, metals and some food items (e.g., rice and sugar) is likely to fuel inflationary pressures in the economy. The risk of higher inflation in food commodities also stems from weak monsoons in India, which would likely have negative spillovers on domestic prices.

1.3.3 Money and Banking

SBP continued to gradually ease monetary policy in FY10, reducing the policy rate by 150 bps in two rounds.[2] On cumulative basis, this means a reduction of 250 bps in the policy discount rate since the beginning of current easing cycle in April 2009. These policy measures were supported by substantial moderation in demand pressures. For instance, a very sharp drop in headline inflation, i.e., from

[2] A policy rate cut of 100 basis points in August 2009 was followed by another 50 basis point reduction in November 2009.

24.7 percent in November 2008 to 10.5 percent in November 2009; persistent YoY fall in import growth (particularly the negative growth in import volumes during Jul-Nov FY10) and the low growth in private sector credit expansion. The scale and speed of the decline in inflation suggest that the tight monetary policy and sharply constrained monetization of the fiscal deficit have eased excess demand pressures that had plagued the economy in the previous three years. This disinflationary impact received further support from lower imported inflation[3] and improved domestic production of key staples.

However, the expansionary fiscal stance in Q1-FY10 (the deficit increased by Rs 223.7 billion compared with a rise of Rs 137.7 billion in the same quarter last year) has had some repercussions. For example:

1. A part of the growing deficit was financed through an IMF bridge finance loan, the inflationary impact of which is similar to that of deficit monetization.
2. The large jump in deficit, and lower recourse to SBP finance, meant that despite higher non-bank financing, government borrowings from commercial banks increased substantially. Net budgetary borrowing from scheduled banks was Rs 166.0 billion during Jul-5th Dec FY10 compared with a net retirement of Rs 67.0 billion in the corresponding period last year.
3. Strong government demand for financing, and low deposit growth is now constraining banks' ability and willingness to take additional exposure; this means an element of crowding out of private investment.

These problems are compounded by a significant increase in quasi-fiscal activities, such as financing of the circular debt, and borrowings by various public sector enterprises (PSEs), and government borrowing for commodity operation.

In terms of monetary aggregates, the YoY growth in M2 after witnessing the lowest level of 8.0 percent in April 2009 during the last eight years, reached 13.4 percent by December 05, 2009. This improvement came entirely from YoY rise in net foreign assets (NFA) of the banking system, as net domestic assets (NDA) of the banking system decelerated markedly by end-November 2009. Deposit mobilization by banks shows some recovery; on a cumulative basis, deposits recorded a growth of 0.1 percent during Jul-Nov FY10 in sharp contrast to previous year, when deposits contracted by 3.8 percent.

[3] This was because of a relatively stable rupee and low international commodity prices in FY10.

1.3.4 Fiscal Developments

The Q1-FY10 fiscal deficit came in at 1.5 percent of projected annual GDP, raising concerns over the government's ability to meet the annual target of 4.9 percent of GDP. A significant part of the slippage owed to an unexpected rise in spending (e.g., increase in government wages, anti-militancy operations, etc.) and delays in some revenue receipts. If these factors are excluded, the quarterly fiscal deficit should be below 1.2 percent target for the first quarter of FY10.

One concern, however, is the heavier contribution of non-tax revenues within overall revenues during Q1-FY10. This is because jumps in non-tax revenues are unpredictable, and are often not sustainable. For example, non-tax revenues would have fallen by Rs 47.8 billion, had there not been a Rs 70 billion transfer from SBP profits to the government in Q1-FY10.

Despite sharp increase in fiscal deficit, financing from domestic sources has grown only moderately, because of the significant rise in net external financing. Also, quite encouragingly, the government has reduced its reliance on inflationary borrowing from the central bank.

The government faces very difficult choices, with considerable pressure to increase social sector spending and build infrastructure, even as the cost of the anti-militancy campaign continues to mount. At the same time, the weak economy constrains its ability to raise revenues from an unchanged tax base. This suggests the need to urgently work towards broadening the tax base to provide needed essential services and public goods.

A major success in fiscal policy, however, is the recent agreement between the federal and provincial governments on the 7th National Finance Commission (NFC) Award (see **Special Section 2** for details).

1.3.5 External Sector

Balance of Payments

Pakistan's external accounts improved significantly during Q1-FY10 compared to the same period last year. This improvement owed to both, a marked contraction in the current account deficit and an increase in the financial account surplus.

The major impetus came from a contraction in the trade account deficit, but the services and income account deficits also contracted significantly, reflecting lower economic activity. Current transfers were particularly robust recording 43.9

percent rise on account of increase in both, workers' remittances as well as other transfers.

The financing side also recorded marked improvement with the financial account surplus rising by 34.9 percent during Jul-Nov FY10. This improvement was primarily driven by increased inflows from the IFIs. Although net foreign investment contracted by 22.4 percent, net portfolio investment returned to positive territory, contributing US$ 301 million during Jul-Nov, against a decline of US$ 182 million in the corresponding period last year. Foreign direct investment, on the other hand, did not show any signs of recovery and declined by 52.3 percent during the period under review.

As a result of the improvement in the overall external account, Pakistan was able to rebuild its foreign exchange reserves, which reached US$ 14.5 billion by end Nov 2009. The foreign exchange market also exhibited relative stability, and exchange rate depreciated by only 2.6 percent during Jul-Nov 2009 compared to 13.3 percent in the corresponding period last year.

Trade Account

Pakistan's trade deficit declined significantly by 37.6 percent YoY during Jul-Nov FY10, in contrast to a 20.8 percent rise in the same period last year. The decline in the trade deficit was entirely due to 23.0 percent YoY fall in the import bill as exports continued to decline, recording 7.4 percent YoY fall.

The contraction in imports was a result of restrained demand, better domestic production of some commodities (wheat and cotton), as well as fall in international commodity prices. Of these, however, the impact of the fall in the international commodity prices was strongest.

Like imports, the fall in exports was also broad-based. Growth in all the main categories, including food, textile, petroleum as well as other manufacturers groups, either extended their decline from the previous year or turned negative.