1 Economic Outlook and Executive Summary

1.1 Overview

Pakistan's economy remains stressed in the aftermath of the unprecedented floods and due to the continued delays in the implementation of key economic reforms. While the growing macroeconomic imbalances in the economy are still quite manageable, further delay in implementing critical structural adjustments risks significantly increasing the future costs to the economy.

Table 1.1: Selected Economic Indicators

		FY09	FY10	FY11
Growth rate (percent)				
LSM	Jul-Nov	-5.5	0.5	-2.3
Exports (fob)	Jul-Dec	9.4	-4.9	20.6
Imports (cif)	Jul-Dec	12.8	-16.3	19.6
Tax revenue (FBR)	Jul-Nov	26.2	7.1	7.6
CPI (12 month ma)	Dec	20.3	13.6	13.9
Private sector credit	Jul-Jan 8	5.4	2.9	4.1
Money supply (M2)	Jul-Jan 8	0.9	5.3	8.6
billion US dollars				
Total liquid reserves[1]	Jan 18	10.0	15.2	17.1
Home remittances	Jul-Dec	3.6	4.5	5.3
Net foreign investment	Jul-Dec	2.1	1.2	0.8
percent of GDP[2]				
Fiscal deficit	Jul-Sep	1.1	1.5	1.6
Trade deficit	July-Dec	5.0	3.3	2.9
Current a/c deficit	July-Dec	-4.8	-1.5	0.0

1. With SBP & commercial banks.

2. Based on full-year GDP in the denominator.

Uncertainty over the extent of damage to private and public infrastructure and the policy response to floods, direct and indirect impacts of supply disruptions, energy shortages and weak consumer & business confidence, took its toll on the domestic economy during the initial months of the fiscal year (see **Table 1.1**). The commodity producing sector suffered the most, as many crops were damaged and LSM growth plunged back into negative after recovering in FY10. Partly, as a consequence of floods, the government's fiscal position worsened, and the monetization of the deficit increased inflationary pressures, compounding the spike in prices of food staples.

The one bright spot in the economy, ironically helped somewhat by the floods, was the strength of the external sector. A jump in remittances and aid flows for flood relief, helped by robust growth in exports largely due to sharp increase in the prices of cotton overshadowed the growth in imports, turning the current account for July-December FY11 to a surplus. The current account surplus would not have been possible, were it not for the one-off flood related receipts and inflows on account of logistic support.

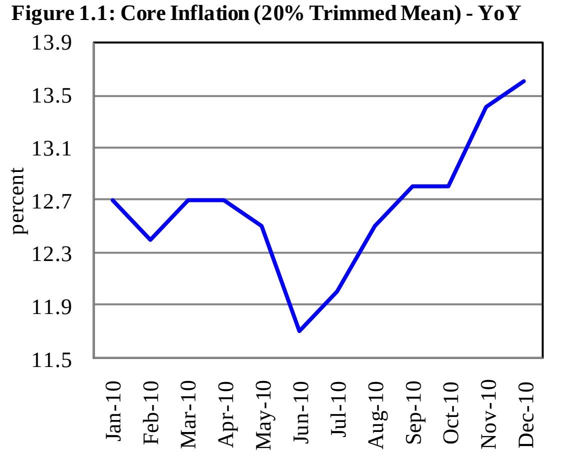
An unexpected source of support for the economy, particularly August 2010 onwards, emerged from the surprising strength in international commodity prices, and especially those of agri-products (see **Table 1.2**). Many crops saw considerable price rise. But this was a decidedly mixed blessing. On the one hand, the substantial windfall gains injected purchasing power in many rural areas and supported the growth in export receipts. But, on the other hand, inflationary pressures emanating from the floods were accentuated, with food inflation, in particular, heading for peaks seen in FY09. The rising energy prices were particularly disturbing, not only for the rising import bill, but also for its cost-push impact on inflation.

Table 1.2: Changes in Wholesale Prices
percent YoY

	Dec-09	Dec-10
Outputs		
Cotton	48.9	111.2
Sugarcane	43.6	63.4
Rice	-9.7	17.9
Tomatoes	-18.8	189.8
Potatoes	3.6	14.7
Onions	-1.5	130.4
Inputs		
Diesel	20.4	14.5
Fertilizers	-10.8	18.6

The combination of revisions in energy (fuel and electricity) prices, higher margins on many agri-products (as traders took advantage of perceived supply shortages and administrative weaknesses), rising cost of imports (as international commodity prices began to firm up), and the demand stimulus from the monetization of the fiscal deficit all contributed significantly to the rise in inflation to 15.5 percent YoY in December 2010, up from 12.3 percent YoY in the first month of the fiscal year. The trimmed mean core inflation measure, too, continued to rise (see **Figure 1.1**).

Figure 1.1: Core Inflation (20% Trimmed Mean) - YoY



While food inflation is expected to ease in the second half of the fiscal year, it is unlikely to approach single digit in FY11. Moreover, rising international commodity prices, and fiscal measures (to raise revenues, reduce energy subsidies, etc.) will spur the rise in non-food inflation. In this context, it becomes even more important for policy to ensure that demand-pull inflationary pressures are kept to a minimum.

The rise in the consolidated fiscal deficit during Q1-FY11 to 1.6 percent of GDP is therefore disquieting. This is 0.1 percent of GDP higher than the corresponding figure last year, even though the FY11 annual target agreed with the IMF is 1.6 percent of GDP *lower* than recorded in FY10. Moreover, while provinces had recorded a deficit last year, this year the provinces are expected to show an aggregate surplus of 0.3 percent of GDP.

A part of the increase in the fiscal deficit is explainable; being a consequence of higher security related expenditures and the floods. However, anecdotal evidence suggests that another significant contribution was made by “subsidies”, representing the partial payments of arrears on energy subsidies and for commodity operations. But, a larger contribution to the growth in the fiscal deficit came from significant weakness in revenues, and especially the fall in non-tax revenues.

The spending shock (e.g., for flood relief), as well as the unexpected weakness in the receipts (also partly a consequence of floods) only underline the urgent need to broaden the tax base, and rationalize spending growth, to better insulate the economy from shocks. There are some signs of progress in containing expenditure, with cuts in development spending, moves towards reduction in subsidies, and progress towards the devolution of ministries to provinces, but much remains to be done. The substantial revenue measure, a VAT based sales tax, however, remains mired in controversy.

The larger fiscal deficit, relatively disappointing availability of non-bank finance, and a surprising reluctance to borrow from the market (i.e., all bids in the PIB auctions were rejected) contributed to resurgence in monetization of the deficit. Government budgetary support borrowings from SBP rose by Rs 153.9 billion in July- Jan 8, FY11, up 19.3 percent YoY. As a result, despite a small pick-up in net private sector credit off-take, it was the government sector that, yet again, dominated the 15.94 percent YoY M2 growth during the period.

The nominal 5.0 percent YoY growth in net credit extended to the private sector, during the same period appears somewhat encouraging at first look. However, given that the entire increase was for working capital, and that input costs have increased for many industries, in real terms private credit off-take has probably contracted. The combination of increasing NPLs and high risk-adjusted returns on government paper is clearly crowding out more productive private sector activities. The growing exposure of banks to government related lending has already led to a downgrading of some standalone bank financial strength rating (BFSR) of five Pakistani major banks by Moodys – a major credit rating agency.

The demand pressures of the fiscal expansion and monetization, concerns over the direct and indirect consequences of cost-push shocks, and underlying structural weaknesses in the external account led the central bank to steadily increase the policy rate by a cumulative 150 basis points in the first half of FY11.

Despite the 101.1 percent YoY decline in the July-December FY11 current account deficit, the overall external account has deteriorated. Specifically, capital and financial account receipts have continued to fall in this period, recording a surplus of US$ 887 million, in contrast to US$ 3.0 billion in the corresponding period last year. The situation looks grimmer taking into account:

(1) An expected fall in the flood related receipts in the months ahead.
(2) Increase in commodity prices, especially for energy that will strain the import bill.
(3) Failure to make substantial progress in economic reforms could continue to weigh upon external capital and financial account receipts.

In the absence of external inflows, the financing of an anticipated current account deficit will put pressure on the country's forex reserves. Maintaining an adequate level of reserves is a pre-requisite to ensure reduced volatility in the exchange rate.

1.2 Looking Forward

The performance of the commodity producing sectors of the economy is expected to improve in months ahead. Expectations of a recovery in agriculture, will however, depend crucially on the wheat harvest (including increased production from the rain-fed – "*barani*" - areas), and the livestock sector. Similarly, large-scale manufacturing growth is expected to turn positive again in the months ahead, as strong agri-prices support demand, and with the additional capacities coming on-line in some industries.[1] However, the persistent energy shortages and growing arrears of energy payments will continue to be a drag on economic activity.
The commodity producing sector gains are expected to receive some support from a good showing of the services and the construction sectors. Thus, the SBP forecast remains unchanged from initial post-flood assessment that FY11 real GDP growth would be in the range of 2-3 percent (see **Table 1.3**).

[1] New capacity is coming online in fertilizer, cement and steel industries during FY11. Capacity is also adding up in oil refinery during FY11, however, it will be operational in FY12.

In contrast, inflationary pressures have strengthened more than anticipated during the first half of FY11. A part of this, reflecting post-flood shocks will fade away, as will part of the price rise of sugar (by mismanagement of supply), but the fiscal expansion, proposed reduction in energy subsidies, and prospects of rising imported inflation will continue to drive inflationary expectations. Consequently, SBP estimates for FY11 inflation have been revised upwards from 13.5 – 14.5 percent to 15.0 – 16.0 percent.

Table 1.3: Projections of Major Macroeconomic Indicators

	FY10	FY11	
		Annual plan targets	**SBP projections**
growth rates in percent			
GDP	4.1^{P}	4.5	2.0 - 3.0
Average CPI inflation	11.7	9.5	15.0 - 16.0
Monetary assets (M2)	12.5	-	14.0 - 15.0
billion US Dollars			
Workers' remittances	8.9	9.0	10.0 - 11.0
Exports (fob-BoP data)	19.7	20.0	22.0 - 23.0
Imports (fob-BoP data)	31.2	31.7	34.5 - 35.5
percent of GDP			
Fiscal deficit	6.3	4.0*	6.0 - 6.5
Current account deficit	2.3	3.4	1.0 - 2.0

^{P}: Provisional; (*): Overall fiscal deficit target announced in the federal budget; however, this number rose to 5.3 percent of GDP as per announced consolidated federal and provincial budgets.

Note: Targets of fiscal and current account deficit to GDP ratios are based on nominal GDP in the Budget document for FY11, while their projections are based on provisional estimates of nominal GDP for the year.

A rise in prices of food staples has also led to calls for the government to intervene to keep prices in check. Pakistan's experience in recent years suggests that government interventions lead to market distortions, e.g., low domestic prices for wheat in FY08 only led leakages of the grain to neighboring countries with smugglers, in essence, pocketing the subsidy at the expense of farmers and consumers. Strong prices encourage farmers to invest in higher yields and support domestic demand. Therefore, the only sustainable way to protect low income groups from inflation is by targeted subsidies and the creation of ample employment opportunities.

Pakistan's experience suggests that markets should be allowed to work, although there is a need for strong anti-trust regulation. The presence of an aggressive regulator can be a major comfort factor in encouraging competition and market based activities to improve efficiencies in the economy.

The fiscal performance however remains a source of concern, given the outstanding issues with expenditure management as well as revenue shortfalls. For example, a variety of opinions have been offered on tax reforms, including the much maligned RGST (essentially VAT implementation of the GST), a wealth tax, extending the income tax net to agri-incomes, levying a capital gain tax (not merely on financial assets), and improved tax governance.[2] In essence, the controversy is unnecessary, as arguably all of these proposals should be implemented to ensure widening of the tax base. This would then allow for a lowering of the average tax rate in the economy in order to improve competitiveness. In the final analysis, increased fiscal resources are necessary for macroeconomic stability to increase development spending (health, education, etc.). However, the importance of the VAT-based tax does not come from the immediate revenue bearing potential (as this may not be significant initially) but from the fact that, properly implemented, it gives economic agents an incentive to document their transactions (potentially leading to higher income tax collections as well).

The implementation of fiscal reforms and elimination of subsidies in the power sector are likely to broaden the tax net and reduce distortions in the economy. While, these reforms will induce cost-push inflationary pressures in the economy, in the short run, but these will help sustain high growth in the long run.

In contrast to inflation, the current account deficit (CAD) is likely to deteriorate in H2-FY11. A significantly strong growth in imports is expected to more than offset the gains from rise in exports and workers' remittances. The financing of the CAD will be challenging as inflows under financial accounts are likely to be significantly lower. In this perspective, the continuation of the structural adjustment program of IMF would be helpful in softening the external financial constraints, as well as to enhance the resilience and robustness of the economy.

[2] One intriguing suggestion is for the introduction of a temporary windfall tax on some specific agri commodities that have seen an extraordinary run up in prices. The proceeds of the one-off levy could be dedicated to flood relief, significantly augmenting the availability of resources for reconstruction, etc.

1.3 Executive Summary

1.3.1 Real Sector

Economic recovery suffered a setback in early FY11 as floods damaged about one-fourth of the country's agriculture heartland. Not only were crops and livestock destroyed by the floods, a number of agro-based industries, power plants and other manufacturing activities were also disrupted. However, an expected good performance by the services sector will provide support to GDP growth in FY11. Furthermore, a disproportionate rise in the prices of almost all agricultural produce led to a significant increase in the nominal income of the farmers, offsetting part of the negative impact of floods on domestic demand.

Agriculture

Kharif crops were planted on 9.7 million hectares, but heavy rains and floods damaged standing crops on approximately 2.4 million hectares. Initial assessments indicate significant severe losses to rice, cotton, maize, pulses, vegetables and fruits. However, losses to the sugarcane crop in flood areas were partially offset by an increase in yield in non-flood regions due to rains. On the positive side, floods and extended heavy monsoon rains raised the underground water table and soil moisture level, and increased water availability in reservoirs, improving prospects for the FY11 *rabi* cropping season.

Large-Scale Manufacturing

Cumulative large-scale manufacturing (LSM) production declined by 2.3 percent YoY during Jul-Nov FY11 compared with 0.5 percent growth in Jul-Nov FY10. This decline was principally driven by temporary disruptions and raw material shortages caused by unfavorable weather. Particularly, construction activity declined partly owing to cut backs in public development expenditure, production came to a stop in the country's largest refinery due to inundation, and the textile sector had to face raw material shortages for yet another year. The damage to road networks and power infrastructure also impeded overall industrial performance. It is expected that continued strength in private aggregate domestic would support positive growth in manufacturing.

The external sector had a mixed effect on local industry. Export demand declined for cement, pharmaceutical, and electric fans, as Pakistani manufacturers lost ground in some of the export markets captured in the past two years. However, a gradual demand recovery in the US and Europe provided a boost to the leather and textile sector with the export receipts of the latter growing largely as a result of the sharp increase in prices of cotton. For textiles, higher export prices in FY11 improved profit margins in comparison of regional peers.

Services

The services sector is expected to surpass its official growth target for FY11 on the back of strong growth in *social, community, and personal services* led by massive relief and rehabilitation efforts undertaken in flood-affected areas. The *finance & insurance* and *transport, storage, and communication* are also likely to have substantial growth contribution, as is reflected by the performance of these sectors during Q1-FY11.

1.3.2 Prices

Inflationary pressures significantly strengthened in recent months as headline inflation increased to 15.5 percent in November 2010 from 10.5 percent last year. This rise is attributed to supply shortages of most of the perishable food commodities due to floods and rains; the direct impact of pass through of rising international commodity prices; indirect impact of increased fuel prices on the transportation cost; upward adjustment in electricity tariff, as well as strong external demand for some key food staples and monetization of the fiscal deficit.

Strong inflationary pressures are also evident from core inflation measured by 20% trimmed mean measure, which rose to 13.4 percent in November 2010 from 10.5 percent during the same period last year. Core inflation measured by non-food-non-energy (NFNE) was recorded at 9.5 percent in November 2010 compared with 10.6 percent during the corresponding month last year, showing that the current inflationary pressures are mainly stemming from food and energy components of CPI basket.

1.3.3 Money and Banking

The SBP raised its policy rate by 50 bps in each of the three rate decisions during H1-FY11, taking it to 14 percent. At the start of the fiscal year, continued demand induced pressures on prices and macro stability prompted the central bank to begin tightening its policy stance. Soon after, the supply-shock from monsoon flooding heightened existing concerns over growth and inflation – notably food prices. While this complicated calibration of the policy stance; the monetary implications of the increasing monetization of the fiscal deficit – amid persistence in inflation - left the central bank with little choice but to continue tightening in the next two policy meetings.

Broad money supply (M2) expanded by 6.9 percent during Jul-Dec FY11, compared with 4.7 percent in the same period last year. Government led credit growth in the NDA of the banking system and a considerable rise in the NFA of scheduled banks provided the bulk of impetus to monetary expansion during the period under review. In addition, credit to the private sector also increased by Rs

81.8 billion during Jul-Dec FY11 – mainly reflecting increase in working capital loans on account of rise in the cost of inputs.

The deposit base of banks grew by 1.0 percent during Jul-Nov FY11, compared with 0.1 percent in the same period last year – mainly due to a large inflow of remittances in November and the sharp increase in the government borrowings from the SBP. Meanwhile, asset quality metrics of the banking industry deteriorated further; gross non-performing loans (NPLs) rose by Rs 34.2 billion, to Rs 494 billion during Q1-FY11. In the money markets, primary market activity during H1-FY11 was dominated by T-bills – where the government accepted Rs 199.6 billion net of maturities. The period under review also saw two successful auctions of the Ijara Sukuk, with acceptance of Rs 89.0 billion against a target of Rs 80.0 billion. While the first two PIB auctions resulted in rejection of all bids by the government, auction results improved considerably in the last two auctions of the period under review.

1.3.4 Fiscal Developments

The size of the fiscal deficit increased to 1.6 percent of projected annual GDP in Q1-FY11, regardless of the noticeable contraction in expenditures. The government reprioritized its spending pattern and scaled down the development expenditures to create space for the flood relief activities. However a significant part of fiscal slippage came from the revenue side, showing a fall in Q1-FY11; brought about by both a considerable fall in non-tax revenues and deceleration in tax revenues. Further, in the absence of ample alternate resources, the fragile fiscal stance forced the government to rely heavily on deficit monetization. All these developments suggest the need for urgent reforms in the taxation system for broadening the tax base and blocking leakages in revenue collection.

Domestic Debt and Liabilities

The total stock of domestic debt and liabilities posted an increase of 6.7 percent by end-Nov FY11 over the June FY10 stock. This increase in the domestic debt was witnessed on account of a higher fiscal deficit and limited availability of external financing. In terms of composition, the rise in total stock of domestic debt and liabilities came entirely from government's domestic debt, whereas commodity operations and PSEs debt experienced retirements during this period. Within government's domestic debt the increase in stock was led by government's huge borrowing from the central bank, while the stock of scheduled banks debt recorded only a nominal increase by end-Nov FY11.

1.3.5 External Sector

Balance of Payments

The current account deficit contracted by 72.3 percent during Jul-Nov FY11 compared to the same period last year. This contraction was the result of significant export growth, sustained inflows of workers' remittances, and private and official grants for flood relief. The financial account surplus, on the other hand, declined sharply to US$ 0.5 billion from US$ 2.2 billion. A large part of this decline was result of a sharp fall in other investments despite the emergency loan of US$453 million for flood relief given by the IMF. The lower capital and financial account surplus resulted in the decline of the overall external account to US$0.1 billion compared to US$0.94 billion last year. Nevertheless, the overall surplus did help in shoring up country's foreign exchange reserves that reached US$16.9 billion by end November 2010. This also kept the exchange rate relatively stable which depreciated by 0.35 percent during Jul-Nov FY11 compared to 2.6 percent in the same period last year.

Trade Account

Trade deficit widened by US$ 938.2 million during Jul-Nov FY11 in contrast to a contraction of US$ 3220.3 million during the same period last year. Unlike last year, the sharp fall in imports improved trade account, the deterioration recorded during FY11 is principally due to an increase of US$ 2288.2 million in the import bill which outpaced the rise of US$ 1350 in export earnings.

The acceleration in the imports was a result of a increased import quantum of food and textile items. Apart from the higher import demand, relatively higher international commodity prices further inflated the import bill. In case of exports, the high value added sector of the textile group displayed a decent performance amid improved external demand, its receipts rising principally because of higher cotton prices. Export of primary commodities such as cotton, fruits and vegetables declined in quantitative terms; however this impact was partially offset by the rise in export prices.