1 Overview

1.1 Overview

Provisional estimates put forward by the National Income Accounts Committee show GDP growth at 2.4 percent for FY11, lower than the growth of 3.8 percent in the previous year. In the context of the prevailing security concerns, the exogenous shock from rising oil prices and the impact of the unprecedented floods, this decline is broadly in line with SBP's expectations.

Table 1.1: Selected Economic Indicators

		FY09	FY10	FY11
Growth rate (percent)				
GDP (at factor cost)	Jul-Jun	1.7	3.8	2.4
Agriculture	Jul-Jun	4.0	0.6	1.2
Major crops	Jul-Jun	7.8	-2.4	-4.0
Minor crops	Jul-Jun	-1.2	-7.8	4.8
Livestock	Jul-Jun	3.1	4.3	3.7
Industry	Jul-Jun	-0.1	8.3	-0.1
LSM	Jul-Jun	-8.1	4.9	1.0
Services	Jul-Jun	1.7	2.9	4.1
Exports (fob)	Jul-Apr	-3.4	7.3	28.1
Imports (cif)	Jul-Apr	-9.8	-2.8	14.7
Tax revenue (FBR)	Jul-Apr	19.9	11.6	12.2
CPI (12 month ma)	May	21.5	11.8	13.9
Private sector credit	Jul-4th June	-0.1	2.8	3.3
Money supply (M2)	Jul-4th June	6.5	9.8	13.7
billion US dollars				
Total liquid reserves[1]	31st May	11.6	16.0	17.2
Home remittances	Jul-Apr	6.3	7.3	9.0
Net foreign investment	Jul-Apr	2.2	1.6	1.4
percent of GDP[2]				
Fiscal deficit	Jul-Mar	3.2	4.3	4.5
Trade deficit	Jul-Apr	8.7	6.9	5.8
Current a/c deficit	Jul-Apr	-5.5	-1.9	0.3

1. With SBP & commercial banks.
2. Based on full-year GDP in the denominator.

On a positive note, the post-flood recovery in wheat, sugarcane and minor crops helped agricultural growth surpass previous year's level. However, rural incomes may not rise proportionately due to lower market prices of wheat and rising input costs (e.g. diesel and fertilizer).

In the manufacturing sector, demand for products, particularly textiles, autos, fertilizer, cement, and POL remained strong. Nevertheless, despite this strong demand, supply constraints – particularly the shortfall in energy – created production bottlenecks, which led to a significant slowdown in industrial growth.

In our view, the growth outlook will be shaped by policy responses to several key domestic challenges: (1) energy shortages, which are restricting growth; (2) the high fiscal deficit whose financing has become difficult – partly owing to the backlog arising from the nonrecognition of power sector subsidies of earlier years as reflected in the circular debt; (3) build-up of domestic debt, raising concerns for macro stability; and (4) inflationary pressures which are not receding readily. The subsequent discussion will elaborate these challenges.

1. The growing energy shortages:

In the energy sector, gas supply constraints have become more binding and this shortage is affecting broader economic growth. For example, textile units generally rely on natural gas not only for power generation but also for production. Fertilizer output and power generation have been affected by gas-load management in particular, and the resulting power shortages have created production constraints in several industries.

Going forward, the policy challenge is to distribute available gas supplies efficiently amongst competing users. Keeping this in view, the ECC recently decided to divert gas supply to the fertilizer sector,[1] recognizing the importance of stable agricultural input prices and saving foreign exchange on imported fertilizer.

In the context of a sustainable energy policy, we believe that feasible alternatives to furnace oil (for power generation) need to be developed urgently. Furthermore, the potential role of imported gas is unquestionable in the medium-term, and policy emphasis must be directed towards developing the necessary infrastructure to use imported gas. More importantly, a better policy option going forward is to rationalize tariffs for different users of this scarce resource and improve the gas pricing structure to incentivize further exploration and extraction.

2. A rising fiscal deficit:

The government is facing difficulties in containing the fiscal deficit. Information available upto March 2011 puts the budget deficit at 4.5 percent of GDP, slightly higher than the deficit of 4.3 percent in the corresponding period of the previous year. The sectors experiencing growth still remain either outside the tax net or are lightly taxed (e.g. agriculture and services).

Although revenue growth has been weak for most of the year, additional measures were introduced in the fourth quarter. The government has also managed to contain spending – showing its commitment to pursue prudent macroeconomic policies, although much of the burden has been borne by development

[1] According to the arrangement, gas supplies of 40 mmcfd will be diverted to the fertilizer sector at the expense of the power sector, which will run its plants on diesel instead. The fertilizer sector will compensate the federal government for two-thirds of the additional cost incurred by running the power plants on diesel instead of gas.

expenditures. In addition, a reduction in power sector subsidies has been pledged in an effort to resolve problems in the energy sector. Furthermore, FBR is making efforts to improve tax compliance.

However, implementation of fiscal reforms still poses political challenges. For instance, structural problems that require difficult policy decisions for fiscal consolidation (e.g. expanding the base of GST through the withdrawal of exemptions, tax on agri-income, and restructuring and privatization of PSEs[2]) are pending resolution and awaiting multi-partisan consensus.

As far as financing is concerned, the government has had little option but to rely on domestic sources to finance a growing fiscal gap. More specifically, while borrowing from SBP was largely contained at end-September 2010 levels, the abrupt change from April 2011 onwards (the government borrowed over Rs 350 billion from the central bank during 31st March – 3rd May 2011) merits some explanation:

> Firstly, a large part of this borrowing was meant to internalize the growing quasi-fiscal expense (e.g. the circular debt in energy) into the budget. In other words, this borrowing is actually financing the *carry-over* of quasi-fiscal deficits from previous years. This one-off adjustment is likely to add an additional burden of approximately 0.6 percent of GDP (in FY11) over the target deficit the government is working with. Hence, against the government target of 5.5 percent of GDP, the country is likely to end up with a fiscal gap of close to 6.0 percent of GDP in FY11 – after paying off Rs 120 billion for old dues reflected in the stock of the circular debt of the power sector. The final budget deficit will depend upon the realization of the targets of FBR revenues and provincial surpluses.
>
> Secondly, SBP is already shifting a portion of this borrowing to the market through outright OMOs, and we expect that government borrowing from SBP will converge to the end-September 2010 level by the end of the current fiscal year as committed by the government.

3. Implications for domestic debt:

The impact of the widening fiscal deficit is clearly visible in the sharply rising domestic debt. Outstanding government domestic debt reached Rs 5,594 billion

[2] Loss making PSEs (e.g. Railways, PIA and Pakistan Steel) continue to be a huge drag on the country's narrow resource base. Support to such PSEs was about 1.6 percent of government's total current spending during July-March FY11.

(31.8 percent of estimated GDP) which is more than double the stock at end-June 2007. This sharp growth in debt stock is fueling concerns about macro stability and monetary management.

In addition, the maturity profile of domestic debt reveals that the government has to rollover the entire stock of Rs 2,854 billion of short term debt at least once a year. Any surge in credit demand from other sectors of the economy could elevate rollover risk,[3] and could also expose the government to interest rate risk.[4]

4. Stubborn inflationary pressures:
Fiscal discipline and restrictions on government borrowing from SBP are necessary to contain inflationary expectations, which we believe have become ingrained in recent months. In overall terms, although the post-flood hike in CPI inflation has largely dissipated, inflation is stubborn, in excess of 13 percent. Possible reasons could include: (a) the lagged impact of government borrowings from SBP during Jul-Sep 2010; (b) frequent upward adjustments in utility and POL prices;[5] (c) increase in commodity prices; and (d) the rising trend in the house rent index (HRI).

On a positive note, despite these major challenges, the external sector showed significant improvement. Specifically, rising prices of value added textiles and strong growth in remittances pushed the current account into a surplus of US$ 748 million (Jul-Apr 2011) from a deficit of US$ 3.5 billion in the corresponding period of the preceding year. Textile exports managed to post strong growth despite efforts by competitor countries to hinder concessionary access of Pakistani products in developed markets. The steady growth in remittances is a welcome development – for the first time in Pakistan's history, monthly remittances crossed the US$1 billion mark for two consecutive months (March and April 2011).

This comfort from the external account together with broadly contained government borrowings from the central bank, allowed SBP to hold the policy rate at 14 percent in the last three policy announcements (January, March and May 2011). These decisions reveal a shift when compared to the cumulative increase of 150 bps implemented during H1-FY11. For effective monetary management,

[3] Countries generally face rollover risk when their debt is about to mature and needs to be converted into a new debt, but liquidity shortage makes this rollover very costly.
[4] A risk attached to movement in interest rate, i.e. changes in interest rates affect the debt servicing of the country.
[5] While tariff adjustments have direct impact on inflation, we should also realize that timely pass-through of tariff would help contain the borrowing requirement of the government.

maintaining government borrowings from SBP at end-September 2010 levels will be critical.

1.2 Outlook

For agriculture, we are optimistic about the next cotton crop for several reasons: (a) higher cotton prices during FY10 encouraged farmers to increase acreage for the next crop; (b) there is a shift towards more productive (and disease resistive) BT cotton seeds; and (c) water availability is expected to improve over last year. Rising fertilizer prices are the key downside risk at the moment.

The government has set the wheat procurement target at 6.57 million tones, which is lower than the target for the previous year. However, we feel the government may come under pressure to exceed this target since the market price of wheat is considerably lower than its support price while banks appear to be willing to finance the additional procurement. This could feed the circular debt problem and also crowd out the private sector at the margin.

While energy shortages continue to impact a number of industries, some sectors could face new challenges. For example, the disruption in the global supply of auto parts from Japan may impact some manufacturers in Pakistan. In addition, auto manufacturers will face stiff competition from imported cars as the government has increased the age limit for used imported vehicles from 3 to 5 years.

In terms of fiscal management, going forward, desirable revenue generating measures (e.g. broadening of the tax base, improving documentation of the economic system, gradual elimination of un-targeted subsidies and curtailment of quasi-fiscal operations) are necessary to contain the fiscal deficit to below 4.5 percent of GDP in FY12.[6] These efforts need to be accompanied with better debt management to increase the tenor of domestic debt and lower risks associated with debt re-pricing and rollover.

While ensuring fiscal sustainability, these initiatives will also protect the external account position and rebuild confidence of the private sector and the country's international development partners. More importantly, this will help in reducing inflation and the crowding out of private sector credit, thereby facilitating investment, growth and employment opportunities.

---

[6] For more details on the Federal Budget for FY12, see **Box 1.1**.

The inflation outlook however is not very encouraging. International crude oil prices have increased by around 40 percent since the beginning of FY11, following the unrest in the Middle East and a shift from nuclear to thermal power generation in Japan after the earthquake. Overall, no significant easing in oil prices can be expected at this point.

In addition, the increase in palm oil prices is likely to impact domestic prices of vegetable oil and ghee. However, following a good *rabi* season, wheat and sugar prices have come down, which should contain, and perhaps ease food inflation in the months ahead.

There are real risks of reversal in Pakistan's external sector performance. Remittances – US$ 1.7 billion higher during Jul-Apr FY11 compared to the corresponding period of FY10 – cannot be forecast with much reliability. Imports may come under pressure given the sharp increase in crude oil prices in recent days, while the recovery in global demand appears fragile, and could hit Pakistan's textile exports. Furthermore, the price gain in textiles, which helped create a surplus in the current account during FY11, may not be available going forward following a sharp drop in cotton prices even during the off-peak season. Some exporters have also pointed out that buyers are already insisting on re-pricing of export contracts.

Recent political events could have adverse implications for the business environment and the external sector, especially with respect to future IFI flows and bilateral assistance. However, there are two reasons for comfort: first, the relative stability in financial markets is an indication that Pakistan has the ability to handle exogenous shocks; and second, net IFI inflows in the past two years have been low, which means a further curtailment is not likely to change the overall position in the external sector.

Box 1.1: Highlights of the Federal Budget for FY12

- Revenue growth of 23 percent (an increase of Rs 364 billion) appears challenging, since there are no additional revenue measures;
- In fact, the impact of tax measures in FY12 shows a net reduction of Rs 27 billion, while "administrative efforts" may bring in an additional Rs 50 billion;
- The 15 percent salary increase for government employees may have to be extended to provincial governments and PSEs; if this were to happen, provincial cash balances would be under pressure and the overall financing gap may widen beyond Rs 851 billion;
- Debt servicing, defence, and current subsidies account for 70 percent of current expenditures in FY12; the 4.5 percent reduction relies on a very sharp reduction in subsidies (especially in the power sector);
- Sharp reduction in external financing means greater reliance on domestic sources; privatization proceeds of Rs 70.4 billion would test the resolve of the government in view of political consensus that would be required to right-size PSEs.

Rupees (billion)	**Revised FY11**	**Budget FY12**	**YoY Growth**
Gross revenues	**2,235.9**	**2,732.2**	**22.2**
Net revenues (excluding provincial shares)	**1,238.2**	**1,528.9**	**23.5**
Tax revenue	1,679.4	2,074.2	23.5
FBR taxes	1,587.7	1,952.3	22.9
Non-tax revenue	556.5	658.0	18.2
SBP profit	185.0	200.0	8.1
Defence receipts	115.3	118.7	-11.1
Total expenditure	**2,394.6**	**2,504.5**	**4.6**
Current expenditure	**2,168.5**	**2,071.7**	**-4.5**
Debt servicing	698.6	791.0	13.2
Defence	444.6	495.2	11.4
Subsidies	395.8	166.4	-58.0
Development expenditure	**241.5**	**397.1**	**64.4**
PSDP	196.0	300.0	53.1
Federal budgetary gap	**-1,156.4**	**-975.6**	**-15.6**
Provincial cash balances	*119.8*	*124.9*	*4.3*
Overall budget deficit	**-1,036.6**	**-850.7**	**-17.9**
as percent of GDP	-5.7	-4.0	
Financing			
External resources	121.8	64.1	-47.4
Domestic			
Bank	452.2	303.5	-32.9
Non-bank	462.6	413.0	-10.7
Privatization	--	70.4	--

This page has been left blank intentionally