

## PAKISTAN

**G**DP growth slowed in fiscal year 2001, largely due to a drought-induced decline in agriculture sector output, and exogenous factors such as high oil prices and the slowdown in global economic activity. Nonetheless, the Government continued to undertake far-reaching structural reforms whose impact will be apparent in the near term. Tax administration and balance-of-payments vulnerability remain areas of concern. The current political uncertainty in the subregion is likely to have serious implications for near-term growth prospects.

Economic Indicator (percent)	1998	1999	2000	2001		2002	
				Current	ADO 2001	Current	ADO 2001
GDP growth	2.0	4.2	3.9	2.6	3.8	3.0	4.7
Inflation rate	7.8	5.7	3.6	4.7	6.0	5.1	4.5
Current account/GDP	-3.0	-3.6	-2.1	-2.2	-1.7	-2.5	-1.0

**Economic Assessment.** Overall economic growth in 2001, now estimated at 2.6 percent, was lower than the 3.8 percent projection of ADO 2001 as well as the 3.9 percent expansion in 2000. This is explained primarily by a prolonged drought, increased world oil prices, and the slowdown in global economic activity. The drought adversely affected agriculture sector output and hydropower generation. The agriculture sector posted a contraction of 2.6 percent in 2001 compared to 6.1 percent growth in 2000, while nonagricultural GDP improved to 4.3 percent growth from 3.1 percent expansion in the previous year. Performance of the large-scale manufacturing sector was impressive, recording a growth rate of 7.8 percent after a contraction of 0.2 percent in 2000. This was, however, due mainly to a rebound in sugar production. The services sector also grew in 2001, by 2.6 percent.

During 2001, public investment rose by 4.6 percent in nominal terms, while private investment remained unchanged from its 2000 level. The latter has stayed low due to a lack of confidence among investors that the Government will persist in its economic reform policies. Private consumption also remained subdued due to the impact of stabilization policies aimed at curtailing aggregate demand and negative agricultural growth, which depressed rural incomes. Continuing—but smaller—fiscal deficits led to a higher rate of public consumption.

At 4.7 percent, full-year inflation was lower than the 6.0 percent projection made in ADO 2001, but higher than the 3.6 percent of the previous year. Higher inflation was attributable mainly to rises in oil and oil-product prices. During 2001, despite recessionary trends, the central bank pursued a tight monetary policy, principally to defend the exchange rate, which depreciated by 22.0 percent against the dollar over the year. Money supply

2001 refers to fiscal year 2000/01, ending 30 June.

(M2) growth in 2001 of 7.1 percent was significantly lower than the 11.3 percent projection of *ADO 2001* and the actual growth rate of 9.4 percent in 2000. Net budgetary borrowing in 2001 declined to PRs21.0 billion, from PRs40.0 billion in 2000, while credit to the nongovernment sector rose by 110 percent. The large increase in private sector credit offtake was due both to rationalization of the domestic interest rate structure, which resulted in a decline in interest rates, and to confidence of the private sector in the Government's economic reform program.

The slowdown in global economic activity and falling commodity prices adversely affected Pakistan's export performance. However, higher oil prices in the international market contributed to an increase in import values over 2000 levels. Export growth of 9.0 percent was significantly lower than the *ADO 2001* projection of 14.6 percent. Due to lower domestic economic activity, import growth of 5.9 percent was also lower than the *ADO 2001* projection of 9.3 percent. The resulting improvement in the trade deficit, together with workers' remittances—higher by \$232 million than the previous year—helped offset a sharp deterioration in the services account.

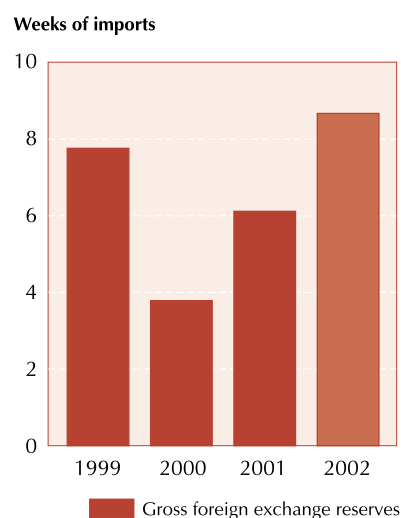
The current account deficit of \$1,340 million remained essentially unchanged in 2001, at 2.2 percent of GDP, from \$1,128 million in 2000 (2.1 percent of GDP). Weakening global economic activity and the lackluster performance of Asian financial markets had a negative impact on net foreign private investment in 2001, which amounted to just \$104 million (\$232 million in FDI and an outflow of \$128 million in portfolio investment). Reserves in 2001 were boosted by the central bank's purchase of \$2.1 billion from the open market, an increase of \$560 million over the 2000 level.

In 2001, revenue collections (tax and nontax) increased by 6.0 percent over 2000 levels. The tax revenue target was, however, frequently revised downward during the year, and actual collections were considerably below earlier projections. Government expenditures in 2001 were 2.3 percent below target, which, coupled with nontax revenue-enhancement measures, resulted in a budget deficit of 5.2 percent of GDP—the lowest fiscal deficit in the last 18 years. The Government plans to further reduce the fiscal deficit to 4.9 percent of GDP by the end of 2002—but given the events of 11 September, this may prove difficult to achieve.

Under the 2002 budget, defense expenditures have been kept constant at the previous year's level while development expenditures are projected to increase to 3.4 percent of GDP from 2.9 percent in 2001. However, the shortfall in revenue collections for the first two months of 2002 has led the Government once again to lower the tax collection target. Based on past experience, this suggests that actual development expenditures are likely to be reduced once more, in an attempt to meet the fiscal deficit target.

The 2002 budget represents the first year of a Medium-Term Budgetary Framework (MTBF), worked out with IMF under a standby arrangement agreed to in November 2000. Beginning in 2002 and ending in 2004, the MTBF envisages (i) an increase in the growth rate from 4.0 to 5.5 percent; (ii) increases in investment as a percentage of GDP from 15.2 to 16.5 percent and national savings from 13.0 percent to 15.0 percent; (iii) a reduction in

*Gross foreign exchange reserves were boosted in 2001*



Source: Government of Pakistan

the budget deficit from 4.9 to 3.6 percent; and (iv) a decline in the current account deficit from \$1.3 billion to \$1.0 billion.

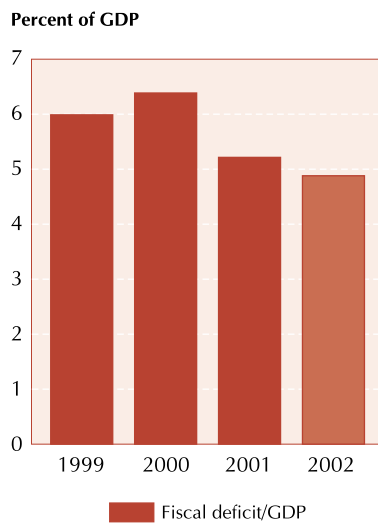
**Economic Management Issues.** The attainment of the MTBF targets will depend on the success of current measures to improve the efficiency of the economy, its market orientation, and the role of the private sector. The Government is constrained in its ability to increase development expenditures due to mounting public sector debt, from 88 percent of GDP in 1997 to 107 percent in 2001. Further problems have also been created by the recent changes in the composition of external debt from long-term, to medium- and short-term debt. The latter is due to the difficulties that Pakistan has faced in obtaining longer-term debt on concessional terms following the imposition of sanctions after the nuclear blasts of May 1998, and the need to make short-term borrowings to pay off existing debts. Against this backdrop, the slow pace of the Government's privatization's program, the inadequate performance of the tax administration regime, and subdued domestic and foreign investment are areas of concern.

IMF's standby arrangement ended on 30 September 2001. The Government has begun preliminary negotiations with IMF for longer-term financing under the Poverty Reduction Growth Facility, which it hopes to conclude by November 2001. In this context, the Government has prepared an interim poverty reduction strategy, which includes yearly expenditure targets for poverty reduction programs. Meanwhile, it plans to jump-start the economy by initiating large infrastructure projects in the roads and water sectors.

**Forecast.** Before early September, the Government projected GDP growth for 2002 at 4.0 percent on the basis of a modest recovery in agricultural output and related improvement in private consumption. More recent data, however, suggest that this winter season's wheat crop could be adversely affected by a shortage of irrigation water supply. The attacks on the US on 11 September, coming on top of an already weakening global economy, are also likely to have significant negative implications for Pakistan's economy in the short term. An immediate consequence of the attacks has been to increase freight charges to and from Pakistan due to the perception that the country is in a war zone. Several airlines have also stopped services to the country, leading to a reduction in available air cargo capacity. At the same time, domestic textile and garment manufacturers have suffered cancellations of export orders and a sharp drop in new orders stemming from weaker external demand, partly based on importers' anxieties that manufacturers will be unable to maintain their existing production schedules. The Ministry of Commerce has estimated that if Pakistan does not receive more favorable access to the US and EU markets now for its exports, the loss of export earnings (stemming from current events) could amount to \$1.5 billion.

The atmosphere of uncertainty is also having an adverse budgetary impact, as the Government has incurred additional expenses associated with an increased number of refugees, with maintaining law and order, and with

**The Government plans to further reduce the fiscal deficit by the end of 2002**



Source: Government of Pakistan

defense. Risk premiums have also increased sharply on sovereign debt in the aftermath of the 11 September attacks. The ramifications of these attacks have also led to a shortfall in revenue collections due to a slowdown in imports. For the month of September alone, the shortfall is estimated at PRs5.0 billion. Loss of investor confidence and the depressed state of the domestic stock market have led the Government to defer its privatization program, which was expected to bring in \$500 million in 2002. Actual private capital inflows are also now expected to be considerably below the Government's initial projection of some \$600 million. Although the economy is likely to gain from the recent removal of the remaining nuclear test-related sanctions, enhanced debt relief, and increased access to concessional aid, these are likely to be felt only with a lag.

While it is too early to gauge the full impact of the events of 11 September, under the assumption of a full-year loss to the economy of \$1 billion, GDP growth in 2002 is projected to slow to around 3.0 percent from earlier government projections of 4.0 percent. The current account deficit is also likely to widen somewhat in 2002 owing to more subdued export growth and reduced inflows of worker remittances and other private transfers. Even in the event that exports are granted free access to the US and EU, this is likely to be partly offset by reduced import demand resulting from depressed consumer sentiment in these markets. Inflation during 2002 is expected to pick up somewhat on account of rupee depreciation and an increase in utility prices.