

Pakistan

Summary

ADO 2005 forecast an improvement in GDP growth in FY2005 (ended 30 June 2005), based on all-time-high cotton output, an expected bumper wheat crop, double-digit growth in large-scale manufacturing, and rapid expansion in the telecoms and financial sectors. On the downside, record private sector credit growth, strong domestic demand, and high oil prices were expected to add to inflationary pressures. High oil prices and strong economic growth were expected to worsen the balance-of-payments position.

The GDP growth outcome for FY2005 beat expectations, with output in manufacturing and agriculture surprising on the upside. But because of steeper than projected increases in oil prices, shortages of essential food items, and strong domestic demand, inflation was also higher than forecast. As expected, the current account surplus on the balance of payments turned into a deficit. This *Update* trims the GDP growth forecast for FY2006, and raises significantly the projections for inflation and the current account deficit as it takes into account much higher baseline oil prices.

International oil prices hit \$70 a barrel in August 2005. Sustained, high oil prices above the baseline would pose a serious risk for the FY2006 forecasts of GDP growth, inflation, the balance of payments, and the fiscal deficit.

Updated assessment

The acceleration in economic growth in FY2005 was much stronger than forecast in *ADO 2005*. Indeed, at 8.4%, GDP growth was the highest in two decades. All major sectors played a part. Industry expanded by 10.2%, mainly due to rapid

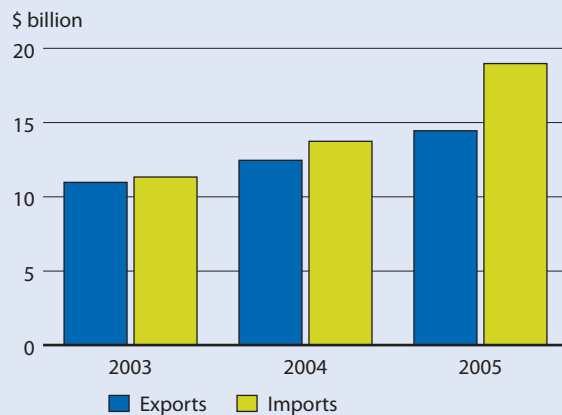
growth of large-scale manufacturing, which, accounting for almost half of value added in industry, grew by 15.4%. The rapid expansion of this subsector was underpinned by strong domestic demand, in turn fueled by record growth in private sector credit, higher incomes of farmers, and stronger remittances. However, value added in generation and distribution of electricity and gas rose at a much slower pace than in FY2004, mainly because of declines in hydropower generation.

Agriculture recorded strong growth of 7.5% in FY2005, the best in 9 years—and higher than forecast in *ADO 2005*. Production of cotton shot up by 45.5% to 14.6 million bales, the highest-ever level. Wheat also turned in a bumper crop, showing an increase of 8.2% on the previous year. Favorable weather, expanded agricultural credit, and greater use of fertilizers were the major contributory factors.

Services sector growth accelerated slightly to 7.9% in FY2005. As forecast in *ADO 2005*, telecoms expanded vigorously as new private companies started their operations. In some subsectors that are still small, growth was extremely rapid. For example, the number of mobile telephone connections surged by 150% to 12.5 million. Finance, strengthened by reforms and privatization over the past several years, grew by 21.8%. Wholesale and retail trade was the other main growth subsector, expanding by 12.0%; it benefited from robust expansion in commodity-producing sectors, a sharp rise in imports, and double-digit growth in exports (Figure 2.6).

Inflation in FY2005 was higher than forecast in *ADO 2005*, with, at 9.3%, the average CPI rising at its fastest in 8 years. Shortages of essential food items, higher housing rents, a steep

Figure 2.6 Exports and imports, Pakistan, FY2003–FY2005



Source: State Bank of Pakistan, available: http://www.sbp.org.pk/ecodata/Balancepayment_BPM5.pdf, downloaded 11 August 2005.

rise in oil prices, and strong domestic demand (largely fed by the boom in private sector credit) all played a role.

FY2005's 17.0% monetary growth was also only marginally lower than growth in nominal GDP and, together with the monetary overhang from earlier years, contributed to a generally accommodative environment. Despite the sharp upswing in inflation, the State Bank of Pakistan only began tightening in April 2005, raising the discount rate and the interest rate on 6-month treasury bills. However, the average interest rate on new loans by banks showed a much smaller rise and remained negative in real terms, generating strong private sector credit growth. To address inflationary pressures arising from shortages of essential commodities, the Government focused on improving supply through administrative and fiscal measures. In the FY2006 budget, it announced exemptions or reductions in tariffs and other taxes on various essential items to reduce prices.

Despite the shortfall in revenues from tax on oil, total revenues in FY2005 were higher than budgeted because of a significant increase in nontax revenues. However, spending on defense and for meeting contingent liabilities both saw overruns. As a result, the fiscal deficit of PRs209 billion exceeded the target set in the FY2005 budget. The primary surplus of

PRs11.0 billion was also lower than last year. However, as a share of GDP, the 3.2% fiscal deficit remained essentially on target because of the higher than expected growth in the economy.

The first two and a half months of calendar year 2005 saw the KSE-100 index surge by 65.7% to 10,303 on 15 March. This was driven by higher corporate earnings, privatization of SOEs through the stock market, a large injection of foreign portfolio investment, and speculative buying. The subsequent technical correction turned into a sharp sell-off and the index declined by about 37% to 6,467 on 27 May, before rising again to 7,450 on 30 June to establish a 41.1% gain for FY2005. The extreme volatility of equity prices since January was due to speculation as well as to uncertainty generated by the planned replacement of carryover transactions on margin financing.

The robust economic growth, strong domestic demand, and higher oil prices pushed imports 38.1% higher in FY2005. Higher oil prices and volumes lifted the oil import bill by 20.4% to \$3.8 billion. Growth of nonfood non-oil imports was also buoyant, with particularly large rises seen in imports of machinery, chemicals, and metals. On the revenue side of the account, export growth—though in double digits—fell short of import growth by a wide margin, resulting in a more than threefold widening of the trade deficit to \$4.5 billion. This, along with a sharply expanded deficit on the services account, turned the current account surplus into a deficit, despite a 7.7% increase in workers' remittances. However, the current account deficit as a share of GDP was less than forecast in *ADO 2005* because of higher than estimated current transfers.

The bulk of the current account deficit was financed through concessionary foreign loans, FDI, debt forgiveness by the US, and funds mobilized through an Islamic bond. Disbursement of concessionary foreign loans more than doubled to \$2.2 billion, and actual FDI was up by 60% to \$1.5 billion.

Foreign exchange reserves held by the State Bank of Pakistan declined by \$700 million to \$9.8 billion in FY2005, or sufficient for about 5 months of imports. After depreciating by 3.6% against the dollar in the first 4 months of the fiscal year, the exchange rate remained stable.

The benefits of the strong economy are

Table 2.6 Selected economic indicators, Pakistan, 2005–2006, %

Item	2005		2006	
	ADO 2005	Update	ADO 2005	Update
GDP growth	7.0	8.4	7.0	6.5
Inflation (CPI)	7.5	9.3	5.0	8.5
Current account/GDP	-1.7	-1.4	-1.6	-2.8

Source: Staff estimates.

making an impact on the quality of life. The first district-level Social and Living Standards Survey conducted among a sample of 76,520 households in FY2005 showed a significant improvement in social indicators from FY2001. In the education sector, enrollment rates at primary, middle, and secondary levels, as well as adult literacy, have all improved. In the health sector, immunization rates among children have significantly increased, along with a rise in prenatal and postnatal consultations.

Prospects

Sound macroeconomic fundamentals, enhanced private investment, and a significant expansion in the public sector development program will bolster the economy in FY2006, though their positive impact is now expected to be diminished by the increase in global oil prices. The net result is that the economy is now projected to grow by 6.5%, i.e., 0.5 percentage point lower than forecast in *ADO 2005*. Having peaked in FY2005, inflation is expected to decline somewhat during FY2006. The balance of payments is likely to come under further pressure as high economic growth and oil prices push up imports.

After powering forward over the last 2 years, large-scale manufacturing is expected to settle to a more sustainable, but still robust, growth rate of about 11% in FY2006. Substantial production capacity built in the last 2 years will come on line during the year. Exemption of major export industries from the general sales tax and withdrawal of import duty on raw materials and other supplies in the FY2006 budget will also boost production.

Agricultural growth is likely to decline in FY2006, mainly because of the high-base effect. It will also be difficult to sustain last year's

record-high cotton output because of already heavier monsoon rains and greater moisture than last year, which increase crop vulnerability to pests. Further, the damage caused by recent floods to standing crops will depress agricultural production. Conversely, the greater availability of water will benefit water-intensive crops such as rice and sugarcane, while the prospect of greater water reserves than last year will also help winter crops. The lower import duty rates on tractors and fiscal incentives for the livestock sector, announced in the FY2006 budget, will also support agriculture by encouraging investment. Given these factors, growth of agriculture is projected at 3.0% in FY2006.

In the services sector, the recent surge in telecoms is likely to be sustained in FY2006, based on substantial investments made last year by private telecoms service providers, and on the introduction of wireless local loop services that will open up rural areas. The banking sector is also expected to register robust growth once more.

Imports are forecast to grow at about 18% in FY2006 because of continuing fast economic growth, a larger oil bill, and the planned import of wheat and other essential food items. For their part, exports are expected to benefit from liberal incentives for export industries announced in the FY2006 budget, continuation of the textile industry's restructuring and modernization of the past several years, and the ending of quotas under the Multifibre Arrangement in January 2005. Although the expected deceleration of the global economy relative to FY2005 will weigh on exports, they are still likely to show brisk growth of about 15%. The deficit on the trade and services accounts are expected to widen. As a result, the current account deficit will expand to about \$3.5 billion, or 2.8% of GDP, though its financing is not expected to present a problem because of anticipated substantially larger privatization-related FDI in FY2006.

Further tightening of monetary policy and the opening up of imports of essential food items, particularly from India, will damp inflationary pressures in FY2006. However, expansionary fiscal policy, high oil prices, and the large monetary overhang may make it difficult to contain inflation, which is therefore projected to decline only marginally to 8.5% in FY2006.

With fast GDP growth and even stronger import expansion, as well as ongoing improvements in tax administration, taxes collected by the Central Board of Revenue are projected to grow by 17% in FY2006. However, high oil prices are likely to have a negative fiscal impact of about PRs30 billion (0.4% of GDP) in the form of revenue loss due to lower petroleum surcharges and additional subsidies to oil marketing companies and refineries. This is likely to be more or less offset by higher than budgeted receipts from the US for logistics support for its operations in Afghanistan. Debt servicing will remain on target because of efforts in recent years that have significantly improved the debt structure. Increases in defense expenditures are also projected to be limited. However, large rises projected in development expenditures and in government servants' salaries and pensions will contribute to a higher fiscal deficit in FY2006, though it will remain below 4.0% of GDP.

With sound macroeconomic fundamentals, the Government's pro-growth policies, an expected pickup in private investment, and an increase in development spending, medium-term prospects for the economy look good. Improved relations with

India and a possible upturn in bilateral trade will also boost growth in the medium term. Easing of external security concerns is also likely to promote foreign investment. Accordingly, it is projected that the high economic growth will be sustained in FY2007, inflation will be brought down a little, the fiscal deficit will be kept below 4.0% of GDP, and the current account deficit will be maintained at 2.5–3.0% of GDP. The deficit in the current account of the balance of payments represents a return to more normal circumstances for a developing country like Pakistan that needs net foreign borrowing to accelerate development. The projected deficit can be easily financed through FDI (including privatization proceeds) and soft loans.

Two risks to these economic projections need to be mentioned. First, international oil prices are continuing to rise and have been very volatile. If they remain at their current levels, or go higher, projections for imports, the fiscal deficit, and inflation may have to be revised upward, while any negative impact on the global economy could lead to lower growth of exports. Second, the security situation remains uncertain. Any deterioration could harm both domestic and foreign investment.