

Pakistan

The economy advanced strongly in FY2006 (ended June 2006), despite the shocks of the devastating earthquake of 8 October 2005 and the continued surge in international oil prices. This marked a continuation of the fast growth stemming from the Government's far-reaching macroeconomic and structural reforms initiated in 2001, which subsequently propelled the economy to annual expansion of about 7% over 4 years. A new dynamism has taken hold in economic activity and social indicators have improved, which together augur well for continued rapid development. The main macroeconomic challenges are bringing down high inflation and containing the markedly growing trade and current account deficits, which are largely financed by nonrecurring inflows. Since these inflows accrue to the budget, fiscal adjustment is also an issue. Relative to the forecasts in *Asian Development Outlook 2006 (ADO 2006)* for FY2007, this Update makes little change to GDP growth, sees greater progress in reducing inflation, and projects a wider current account deficit.

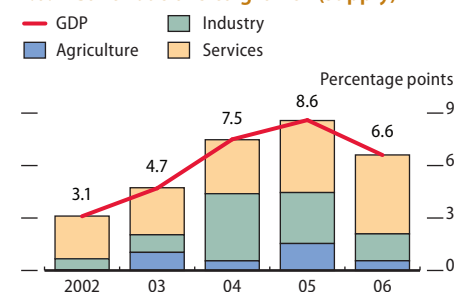
Updated assessment

The economy maintained robust growth of 6.6% in FY2006, coming in marginally higher than the *ADO 2006* projection of 6.5%. Slower growth (as expected, following a cyclical peak in the previous year) was seen in reduced contributions to GDP growth from agriculture and industry (Figure 2.6.1). Agriculture's very weak performance was in large part a reflection of lower output of the major crops of cotton (down 12.9% from the record high in FY2005) and sugarcane (off 6.2%), as the exceptionally favorable production conditions deteriorated somewhat in FY2006. Minor food crops also showed a lackluster outturn, though livestock picked up, growing by 8.0%.

Industrial expansion fell by about half, to 5.9%, from the prior-year level. This was mainly because growth in large-scale manufacturing declined to 9.0% from 15.6% on capacity constraints, availability and prices of some inputs, and scattered power outages toward the end of the year, as well as the high-base effect of FY2005. Construction activity also slowed somewhat, but remained robust at 9.2%.

In marked contrast, services (accounting for just over half of GDP) generated a further head of steam and recorded their highest ever growth of 8.8% in FY2006, providing a welcome fillip to the economy. Financial services, telecoms, and wholesale and retail trade all continued to expand rapidly, on the back of new retail banking services; a jump in the number of mobile telephone users to 34.5 million at end-June 2006 from 12.0 million a year earlier; and continued double-digit growth in exports and imports.

2.6.1 Contributions to growth (supply)



Source: Ministry of Finance, available at <http://www.finance.gov.pk>, downloaded 7 June 2006.

On the expenditure side, contributions to real GDP growth have varied widely over the past several years (Figure 2.6.2) with consumer spending prominent in the most recent years. In FY2005 and FY2006, investment expenditure strengthened substantially and amounted to 20.0% of GDP in FY2006, up from 16.8% in FY2002. In FY2005, the contribution of net exports turned negative, reflecting a surge in imports in the year; they were also a negative factor in FY2006.

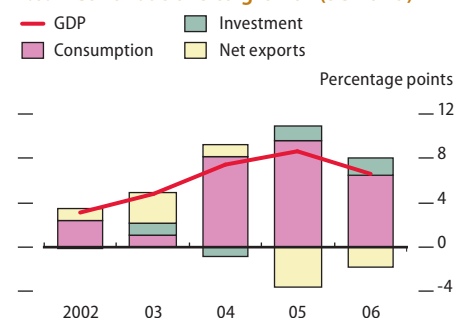
High inflation persisted for a second year in FY2006, though average consumer price inflation declined to 8.0% from 9.3% in the previous year (Figure 2.6.3). The reduction of price pressures was more apparent in the second half of FY2006, as food inflation declined to almost half its year-earlier level. High inflationary pressures prevailing in these 2 years—when the Pakistan rupee/dollar exchange rate was stable—were stoked in part by escalation in international prices, especially of oil; and in part by domestic supply constraints, especially for certain basic food items. However, the principal cause was an upsurge in domestic demand (Figure 2.6.4) fostered by the momentum of dynamic growth, and bolstered by increased credit availability, especially personal and housing credit.

Demand pressures on prices have been partly mitigated by a spillover into a large volume of imports, while the main policy response has been to tighten the monetary stance. Supply constraints have been addressed by lowered tariffs on some food items and by expanded import programs for certain staple foods. In addition, budget expenditures have been raised on items that should, in time, raise agricultural productivity. Some success on the inflation front was achieved in the past fiscal year as policies took hold; however, year-on-year core inflation at 6.3% in June 2006 was still uncomfortably high, though 1.1 percentage points lower than a year earlier.

The State Bank of Pakistan (SBP) raised its discount rate from 7.5% to 9.0% in April 2005, but coming late in the fiscal year the move had relatively small impact on annual inflation. The implementation of a tighter monetary stance in FY2006 did not, though, include a change in the policy rate: SBP focused on draining liquidity from the interbank market to push up the whole interest rate structure and thereby rein in the expansion in credit. Despite the fact that the 6-month treasury bill rate stayed negative in real terms through most of FY2006, the average lending rate charged by banks in real terms was positive from the start of the year and, at 10.1% in June 2006, was 250 basis points above year-on-year consumer price inflation for the month. SBP's approach worked, and over the year growth of private sector credit decelerated markedly to 23.5% from 34.4% in FY2005 (Figure 2.6.5). Also in the period, overall monetary expansion (M2) moderated to 15.0%, from 19.3%, and was less than the 17.2% increase in nominal GDP.

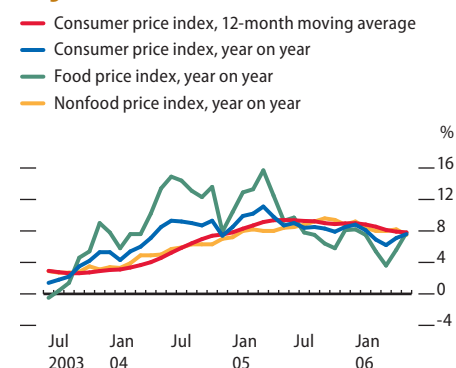
The general government budget remained expansionary in FY2006, with expenditure up by about 27%, reflecting a policy seeking to sharply raise spending on poverty reduction and to improve infrastructure. The overall fiscal deficit worsened to 4.2% of GDP, against a target of 3.8% (though excluding unplanned spending related to the 8 October earthquake, the deficit was only 3.4%). While the budgeted expansion in tax revenue was realized, the increasing importance of receipts from the United States for logistics support for operations in Afghanistan, of

2.6.2 Contributions to growth (demand)



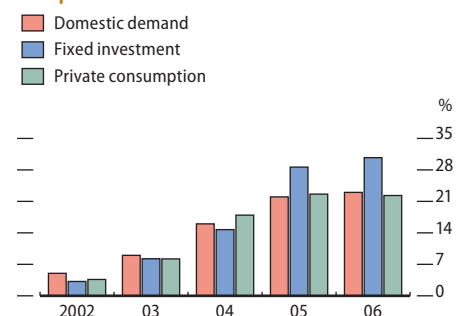
Source: Ministry of Finance, available: <http://www.finance.gov.pk>, downloaded 7 June 2006.

2.6.3 Inflation



Sources: Ministry of Finance, available: <http://www.finance.gov.pk>; State Bank of Pakistan, available: <http://www.sbp.org.pk>, downloaded 7 August 2006; CEIC Data Company Ltd., downloaded 16 August 2006.

2.6.4 Growth of nominal demand components



Source: Federal Bureau of Statistics, available: <http://www.statpak.gov.pk>, downloaded 11 August 2006.

privatization proceeds, and of foreign grants—together amounting to 2.4% of GDP—raises the issue of sustaining expenditure over the long term.

The balance-of-payments position worsened markedly in FY2006, as imports powered ahead by 31.3%, against only 14.0% growth in exports. Oil imports leaped by 66.6%, accounting for one third of the rise in the import bill (Figure 2.6.6). This outsized jump in oil imports (relative to higher oil prices in this period) reflects buying under long-term contracts as earlier price rises are now showing up with a time lag. Apart from this, the increase in non-oil imports (they account for about three fourths of total imports) was striking at 32.1%, reflecting the large expansion in domestic demand. Accordingly, the trade deficit deteriorated sharply. The current account deficit rose to \$5.7 billion, or 4.4% of GDP, from 1.6% in FY2005.

Other worrying features were that the current account deficit rose so strongly, despite receipts of \$1.1 billion from the United States for logistics support; and that one third of current account deficit financing was nonrecurrent, and related to inflows from privatizations and foreign investment in equities. The heavy reliance on these nonrecurrent and sometimes volatile inflows is a major issue for sustaining such high levels of both imports and the current account deficit, highlighting the Government's need to strengthen the underlying fundamentals of the balance of payments.

In addition to the privatization and equity inflows, a large surplus on the financial account in FY2006 was buoyed by substantial private capital inflows (both direct investment and borrowing) and a moderate expansion in government borrowing, including an \$800 million Eurobond issue that was well received by the market. An overall \$1,328 million payments surplus raised foreign exchange reserves to \$10.8 billion at end-June 2006. The nominal exchange rate stayed in a narrow range throughout the fiscal year, closing at PRs60.2/\$ at end-June 2006.

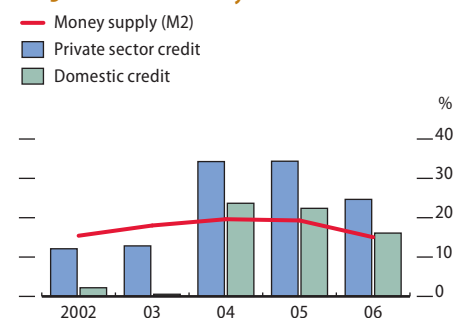
High economic growth in recent years and a significant increase in pro-poor public expenditure has had a positive impact on poverty reduction, as consumption poverty (measured by the national poverty line) fell to 23.9% in FY2005 from 34.5% in FY2001. Poverty declined in both rural and urban areas. The literacy rate and primary school enrollment also improved, as did the national unemployment rate, moving from 8.3% in FY2002 to 6.5% in the first half of FY2006.

The privatization of state-owned enterprises accelerated in FY2006, when government assets worth PRs196 billion (\$3.3 billion) were sold, compared with PRs43 billion (\$0.7 billion) in FY2005. With the sale of 26% of the shares of Pakistan Telecommunication Company in January 2006 and the transfer of its management to the private sector, almost the entire telecoms sector is now in private hands. As a result of privatization and reforms in the past several years, telecoms and banking have emerged as two of the most vibrant sectors in the economy.

Prospects

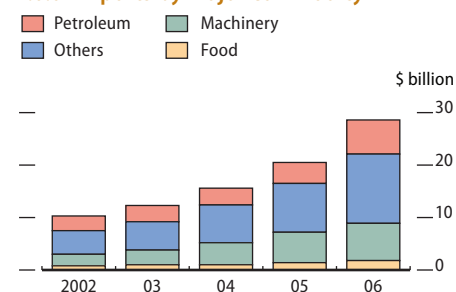
As well as the *Update's* baseline conditions for the global economy, forecasts for FY2007 are based on the assumption that the prudent economic policies pursued in the past 6 years will be continued and

2.6.5 Growth of money and credit



Sources: Ministry of Finance, available: <http://www.finance.gov.pk>, downloaded 14 August 2006; State Bank of Pakistan, available: <http://www.sbp.org.pk>, downloaded 29 August 2006.

2.6.6 Imports by major commodity



Source: CEIC Data Company Ltd., downloaded 18 August 2006.

that macroeconomic stresses that have emerged in the last 2 years will be addressed. Most important, the *Update's* forecasts presuppose that SBP will carry out monetary tightening and that budget reliance on SBP finance will be consistent with attainment of the monetary objectives.

FY2007 production conditions in the main commodity-producing sectors are expected to improve from FY2006. A positive outlook is also underpinned by a substantial strengthening in investment in FY2006 and forecasts of yet further increases the following year. GDP growth in FY2007 is now projected at 7.0%, slightly below the *ADO 2006* expectation.

Substantial public sector investment in irrigation in the last few years and a sharp increase in imports of agricultural machinery in FY2006 are seen boosting agricultural output, as will the duty-free import of tractors, enhanced subsidies on fertilizers, and the new package of incentives for the livestock subsector, announced in the FY2007 budget. Assuming normal weather conditions, agriculture is projected to grow by 4.5% in FY2007.

Growth in industry is expected to rebound to 9.1%. New investments, especially in the textile, cement, and fertilizer subsectors, and incentives provided in the FY2007 budget for exports of leather and footwear goods, and marble, as well as for rice-processing plants, should buoy output. In services, heavy foreign investment in telecoms in recent years will help the subsector maintain fast momentum in FY2007. Strengthened by reforms and privatization, the financial services industry will also maintain robust growth. Nevertheless, services-sector growth as a whole is projected to slow to a more sustainable 7.1% in FY2007, following the very rapid rises of the last 2 years.

In the FY2007 budget, extension of the tax net to real estate transactions and raised tax rates on some financial services are expected to increase receipts at a very healthy double-digit rate, while nontax receipts are likely to exceed the budget estimate. Current expenditure, however, may exceed the budget target for two main reasons: a likely overrun in defense expenditure due to ongoing operations against militants; and possibly, greater domestic debt servicing. Various measures favoring low-income groups announced in the FY2007 budget may also raise current spending. On balance, the fiscal deficit, targeted at 4.2% of GDP in FY2007, including 0.6% for earthquake expenditure, is likely to increase to 5.0% of GDP (Figure 2.6.7), with the budget as a whole continuing to impart a strong expansionary impetus to the economy.

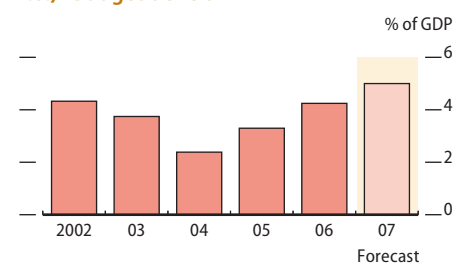
Inflation is forecast to decline in FY2007 to average 6.5%. However, this moderation depends crucially on SBP's implementing a tighter monetary policy to keep domestic demand in check. Already in July, SBP tightened its stance by raising its policy rate (the 3-day repo rate, which is its rediscount rate) from 9.0% to 9.5%, and adjusted upward both the banks' cash-reserve requirement ratio and their statutory liquidity requirement ratio. These measures are likely to impact on domestic demand, but only with a lag. SBP's Monetary Policy Statement for July–December 2006 set a program for FY2007 that envisages lowering growth in monetary assets (M2) to 13.5% and plans a reduction in private sector credit growth to 18.4%. Achieving these targets, aimed at reducing inflation to 6.5%, will again require SBP to focus on money market conditions to control reserve money appropriately.

2.6.1 Selected economic indicators, %

	2006		2007	
	<i>ADO</i> 2006	<i>Update</i>	<i>ADO</i> 2006	<i>Update</i>
GDP growth	6.5	6.6	7.3	7.0
Inflation	8.5	8.0	7.6	6.5
Current acct. bal. (share of GDP)	-4.9	-4.4	-3.1	-5.5

Sources: Ministry of Finance, available: <http://www.finance.gov.pk>, downloaded 7 June 2006; staff estimates.

2.6.7 Budget deficit

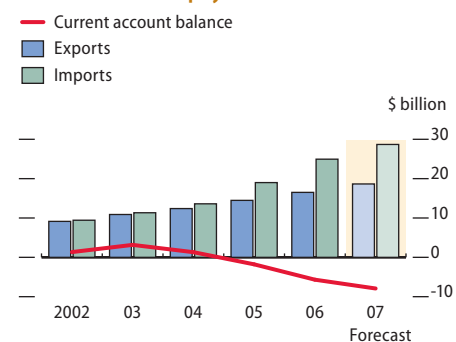


Sources: Ministry of Finance, available: <http://www.finance.gov.pk>, downloaded 7 June 2006; staff estimates.

Import growth is likely to decelerate in FY2007, though projected healthy GDP growth and the substantial increase forecast for investment will sustain high demand. Coming off FY2006 highs, import growth is expected to remain still vigorous at 15.0%. On the other side, taking account of projected strong expansion in global trade, continued safeguards specific to the People's Republic of China (a major competitor) imposed on certain garment and textile items by the United States and European Union, and the lower antidumping duty on Pakistan bed linen imports set by the European Union, total exports in FY2007 are expected to rise by 13.0%. With these main determinants, the current account deficit is now projected to increase to \$7.9 billion (Figure 2.6.8), or 5.5% of GDP, well above the 3.1% forecast in *ADO 2006*.

The burgeoning current account deficit, continuing high inflation, and latent power shortages are potential risks to the country's medium-term economic prospects. Moreover, additions to the pro-poor measures already announced in the FY2007 budget may, in the lead-up to the 2007 general elections, further weaken the budgetary position in the coming year.

2.6.8 Balance-of-payments indicators



Sources: Ministry of Finance, available: <http://www.finance.gov.pk>, downloaded 7 June 2006; staff estimates.