

PAKISTAN'S STABILITY ENHANCES MEDIUM-TERM ECONOMIC PROSPECTS

I. Asian Development Outlook 2003 Released

ISLAMABAD, PAKISTAN (2 May 2003) – Buoyed by continued macroeconomic stability, Pakistan's economy is expected to grow 4.5% in fiscal 2003 and 5% in fiscal 2004, according to a major Asian Development Bank (ADB) report released on 28 April.

The *Asian Development Outlook 2003 (ADO)*, an annual ADB publication that forecasts economic trends in the region, says that the medium-term economic prospects greatly improved in FY2002. This was on account of stable macroeconomic conditions with the narrowing of the fiscal deficit to 5.1 percent, increase in total revenues by 15 percent, and reduction in the rate of inflation to 3.5 percent. Further, Pakistan's balance of payments improved significantly due to a sharp increase in foreign remittances and larger inflows of foreign loans and grants, with the result that the balance of payments showed a large surplus of \$2.7 billion on the current account. This sharp improvement continued in the first three months of FY2003, with the current account remaining in surplus by \$1.2 billion. Pakistan's external debt and liabilities also declined in FY2002 as the State Bank of Pakistan retired its expensive short-term liabilities from \$37.1 billion at the end of FY2001 to \$36.5 billion at the end of FY2002. Pakistan's gross domestic product (GDP) grew 3.6% in fiscal 2002 compared to 2.5 percent in FY2001.

In terms of supply-side sectors, the improvement in GDP growth performance was driven by agriculture, which expanded by 1.4 percent, despite the continuing effects of drought, after a contraction of 2.6 percent in FY2001. The services sector also accelerated to 5.1 percent growth in FY2002 from 4.8 percent in FY2001. However, large-scale manufacturing was the sub-sector most affected by the aftermath of September 11, and growth declined from 8.6 percent in FY2001 to 4 percent in FY2002.

The ADO warns, however, that the positive future growth outlook is subject to such risks as the possibility of renewed tensions on the border with India, political uncertainties that may unfold given that coalition governments are in place in the center and three provinces, and global economic uncertainties.

The optimism for the coming years is based on an improved outlook for the agriculture and industry sectors. Both supply and demand factors are expected to boost economic activity in these sectors. On the supply side, in agriculture, increased availability of water and water-saving techniques and changes in cropping patterns to cope with drought should boost production. In the industrial sector, the textile industry is better placed for increased production after heavy investment in the past two years. On the other hand, domestic demand is increasing due to large remittances

Media Inquiries Only

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Marshuk Ali Shah
Tel: (92-51) 282-5011
Email: mshah@adb.org

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Internet site: <http://www.adb.org>



and an associated increase in construction activity as well as aggressive marketing of consumer credit by financial institutions. The service sector is expected to maintain a growth rate of 5.5%.

With economic uncertainty greatly reduced by Pakistan's improved macroeconomic fundamentals, and reduced political uncertainty following the smooth transfer of power to elected federal and provincial governments in October 2002, and the new Government's commitment to the ongoing reform program, total investment is expected to show marked improvement in the medium term, rising to 16% of GDP by FY2004.

The modernization of the textile industry of the past years has started showing results with a substantial increase in the industry's output and in export volumes. Overall exports are projected to expand 12% in fiscal 2003 and 10% in fiscal 2004. Increased domestic activity, particularly higher growth rate in manufacturing is likely to lead to strong growth in imports, which are expected to be expected to rise by about 14% in FY2003 and 10% in FY2004, doubling the trade deficit in FY 2003 from the previous year.

Foreign Direct Investment (FDI) is expected to pick up significantly in the medium term provided that the domestic political situation remains stable, and that there is no recurrence of subregional tensions. The planned major privatizations such as that of the Pakistan State Oil and Habib Bank Limited are likely to be the major factors increasing FDI during the next two years.

The outstanding external debt stock is expected to be maintained at about \$32 billion over the medium term, with further improvement in the debt profile, as expensive short-term debt is replaced by long-term concessional borrowings. External debt servicing is therefore projected to fall to some 20 percent of foreign exchange earnings by FY2004.

The Government's success in maintaining macroeconomic stability over the last year has greatly improved the medium-term prospects for the economy. If the Government continues to pursue sound macroeconomic policies and to implement the planned governance and economic reforms, it should be possible to achieve the set goals of sustained growth and poverty reduction.

II. Pakistan Economic Update (July 2002 – March 2003)

The Pakistan Resident Mission has also simultaneously released its regular Pakistan Economic Update for the July 2002 – March 2003 period, which confirms Pakistan's encouraging economic outlook as described in the ADO above. The Update notes that key macroeconomic fundamentals at the beginning of FY2003 in Pakistan were better than at any time in the past decade. The real sector of the economy had also started showing signs of recovery in the second half of FY2002. These gains were further consolidated in the first nine months of FY2003, when the current account surplus increased; foreign exchange reserves touched new heights; the overall fiscal deficit declined; the inflation rate remained low; and both agriculture and manufacturing showed healthy growth. Developments thus far indicate that the target of 4.5 percent growth in GDP in FY2003 is likely to be surpassed.

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ADB NR /03

Marshuk Ali Shah
Tel: (92-51) 282-5011
Email: mshah@adb.org

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Internet site: <http://www.adb.org>



A. Macroeconomic Developments

Domestic Sector: Performance of both agriculture and manufacturing sectors so far has been better than last year. Value-added in agriculture sector is likely to grow by 2.5-3.0 percent during FY2003 compared with a growth of 1.4 percent in FY2002.

Large-scale manufacturing production increased by 5.2 percent in the first half of FY2003, compared with 1.8 percent in the corresponding period of last year. The sector is likely to sustain and even improve its performance in the second half of the year, with the result that value-added in the sector is expected to grow by about 6.0 percent in FY2003 compared with a growth of 4.0 percent last year. Demand factors are also supporting growth in the services sector. With both commodity producing and services sectors expected to perform significantly better than last year, the overall GDP growth in FY2003 is likely to exceed the target of 4.5 percent.

Price stability seen in the first nine months of the year is likely to continue for the rest of the year and inflation in FY2003 is expected to remain at about 3.5 percent. With a stable price environment, the State Bank of Pakistan (SBP) continued to maintain an easy monetary stance in the first nine months of FY2003. The rate of interest on 6-month treasury bills declined to 2.1 percent on 6 March 2003, compared with 6.3 percent as of end-June 2002. There was a sharp increase in private sector demand for credit. Due to excess liquidity in the market and low interest rates, share prices maintained a generally rising trend during the first nine months of FY2003, except for a temporary decline in January and February 2003 triggered by uncertainty generated by the threat of impending war in Iraq.

Pakistan's fiscal position improved significantly in the first half of FY2003, with the overall fiscal deficit declining to 1.6 percent of GDP, compared with 2.7 percent recorded in the same period of last year. If the current trends in revenues and expenditure continue, it should be possible to achieve the fiscal deficit target of 4.6 percent for FY2003.

External Sector: The upturn in exports and imports observed in the second half of FY2002 gained momentum in the first three quarters of FY2003, when exports grew by 20.2 percent and imports by 22.8 percent. Despite a sharp increase in the balance of trade deficit, the current account surplus, excluding official transfers, increased by three and a half times to \$1,959 million in the first eight months of the year, mainly because of lower interest payments and higher level of remittances. The capital account also showed a substantial improvement. Foreign exchange reserves held by the SBP increased by 67 percent to \$8,449 million by the end of February 2003, sufficient to cover 28 weeks of imports of goods and non-factor services.

Despite the Iraq war and increase in freight charges due to war risk premium, the export target of \$10.4 billion for the year is expected to be achieved and even surpassed. Similarly, the imports will exceed the annual target of 11.1 billion. However, with continued high level of workers' remittances and lower interest payments, Pakistan should end the year with a comfortable current account surplus of about \$2.5 billion.

B. Economic Policies and Reforms

The Government continued to implement the economic policies and reforms initiated during the last three years. It demonstrated its commitment to macroeconomic stability and past

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agreements by implementing even sensitive but necessary measures such as bi-weekly market based adjustment of domestic prices of petroleum products. Since the last Economic Update, policy developments in two areas, privatization and anti-corruption, are worth highlighting.

The process of privatization accelerated and Rs 19.0 billion was realized from the sale of state-owned enterprises in the first nine months of FY2003, which is almost equal to the privatization proceeds realized in the whole of FY2002. Privatization of nationalized commercial banks gained momentum. The sale of government equity in selected state-owned enterprises (SOEs) through the stock market is one of the two pillars of the new privatization strategy evolved by the Privatization Commission. The other pillar of the strategy is the sale of majority shares and transfer of management of large SOEs such as Pakistan State Oil, Pakistan Telecommunication Company, Habib Bank Limited, etc.

The President approved the National Anti-corruption Strategy (NACS) on 24 October 2002. The strategy revolves around prevention, monitoring and combating of corruption. In addition to strengthening the National Integrity System, it endorses all the ongoing reforms, whose implementation will provide an enabling environment for combating corruption and prescribes the use of various anti-corruption tools. Implementation has already started in some of the prioritized areas, like monitoring of asset declarations of public servants and setting up of vigilance units in the public sector.

C. Increase in Poverty Reduction Expenditure

During the first half of FY2003, pro-poor budgetary expenditures were increased substantially; additional intermediate human development indicators were selected for regular monitoring and reporting; and Zakat funds were increasingly used to help the poor get out of poverty on a permanent basis. However, the breakdown of pro-poor budgetary expenditures by sub-sectors reveals that the core pro-poor expenditures (i.e., expenditures on primary and secondary education, health, population planning, social security and welfare, food support program, and rural development) showed relatively smaller increases.

D. Outlook

Against the backdrop of the above developments, it is likely GDP growth target of 4.5 percent in FY2003 will be surpassed. Heavy rains in January and February have further improved the outlook for the agriculture sector. At the same time, improved availability of water will boost generation of hydel electricity and increase value-added in the energy sector. Larger increases in production in the large-scale manufacturing in the second quarter of FY2003, steady acceleration in the export growth, falling interest rates, pick-up in private sector credit growth, and continued aggressive marketing of consumer credit by banks and leasing companies point to further improvement in the performance of the manufacturing sector in the second half of the year. Continued high level of remittances is boosting construction activity and raising demand for inputs for construction.

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