ADB News Release

PAKISTAN RESIDENT MISSION, ASIAN DEVELOPMENT BANK

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ADB Releases Economic Update

The present report, which is the fifth in the series, provides an analysis of economic trends in Pakistan in fiscal year (FY) 2003, and presents outlook of the economy for FY2004 and for the medium term based on current trends. The report also reviews the progress in the area of poverty reduction, particularly with regard to public expenditure, and analyses the FY2004 federal budget.

Recovery in the real sector of the economy, which had started in the second half of FY2002, was further consolidated in FY2003. The economy grew at a pace not seen in the preceding six years, the fiscal deficit and inflation declined, and the current account surplus and foreign exchange reserves rose to all time high levels. Foundation has been laid for the economy to move to a higher growth path in the medium-term.

Domestic Sector

Growth: The economy's overall growth performance showed a sharp improvement in FY2003, with the real GDP growth rate increasing to 5.1 percent from 3.4 percent in FY2002. The improvement in GDP growth performance was broad-based, with agriculture, manufacturing, and services, all recording higher growth than FY2002. Agriculture, which had recorded negative growth in the preceding two years, grew by 4.2 percent in FY2003. Except cotton, all other major crops recorded robust growth. The large-scale manufacturing (LSM) sector grew by 8.7 percent compared with 4.9 percent in the preceding year. Growth in LSM production was led by sugar, automobiles, electronics, and cement, which together accounted for two-fifths of the growth in LSM. Growth of the services sector also increased to 5.3 percent in FY2003 from 4.1 percent in FY2002.

Investment and Saving: Despite recovery in domestic economic activity in FY2003, investment failed to pick up, and gross fixed investment remained stagnant at 13.1 percent of GDP. A marginal improvement in fixed capital formation in the private sector was offset by an equal decline in public investment. However, there was a sharp increase in foreign direct investment (FDI), which increased to US$798 million from US$485 million in FY2002. Gross national saving (GNS) also increased from 17.0 percent of GDP in FY2002 to 19.2 percent in FY2003, entirely due to a sharp increase in net factor income from abroad. Gross domestic savings, however, declined to 14.7 percent of GDP, compared with 16.1 percent in FY2002.

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Prices, Money and Capital Market: Inflation remained low during FY2003, with the annual rate of inflation declining to 3.1 percent from 3.5 percent in FY2002. In an environment of stable prices, the State Bank of Pakistan (SBP) continued to pursue an easy monetary stance in FY2003 to stimulate investment and growth. The rate of interest on 6-month treasury bills, which serves as a benchmark for all other interest rates, maintained a steep downward trend throughout the year. The average lending rate charged by banks on their advances declined from 13.1 percent to 7.6 percent. Private sector credit picked up and net borrowing by private sector, including export finance, was Rs 153.6 billion compared with Rs 37.7 billion in the preceding year, reflecting the upsurge in economic activity as much as an unprecedented decline in interest rates. There was a boom in the stock market in FY2003, when share prices and market capitalization almost doubled.

Fiscal Policy: The Government's fiscal position improved significantly in FY2003, with the overall fiscal deficit declining to 4.5 percent of GDP compared with 5.2 percent in FY2002. While revenues showed a robust growth, a large saving in interest payments enabled the Government to contain increase in expenditure. However, the much-needed fiscal space created by the savings in interest payments, was used up by increased expenditure on defense and subsidies. The FY2004 budget sets the overall fiscal deficit target at 4.0 percent of GDP. To realize the fiscal deficit target, the Federal Government's fiscal deficit is projected to decline from 4.9 percent of GDP to 4.7 percent and the provincial governments are expected to increase their surplus from 0.4 percent of GDP to 0.6 percent.

External Sector

Balance of Trade: Exports grew by 20.8 percent to $11.0 billion and imports by 17.9 percent to $12.2 billion, exceeding the targets set at the beginning of the year by a wide margin. Non-food, non-oil imports increased by 21.5 percent. Growth of exports was led by textiles, and that of imports by machinery. Both prices and quantities of exports recorded significant increases. There was some slowdown in the growth of imports in the last two months of FY2003, while export growth kept accelerating throughout the year. The trade deficit in FY2003, at $1,154 million, was 4.2 percent lower than in FY2002.

Current Account: The current account of the balance of payments showed a substantial improvement in FY2003, with the surplus, excluding official transfers, increasing by 144.6 percent to an all time high level of $3,273 million. As a percentage of GDP, the current account surplus increased from 2.3 percent in FY2002 to 4.2 percent in FY2003. Inclusive of official transfers, the surplus was US$5,256 million, or 6.7 percent of GDP. The improvement in the current account resulted mainly from structural improvements like lower interest payments and higher workers' remittances, which are likely to be sustained in future. Additional receipts for logistic support for operations in Afghanistan also helped.

Capital Account, Foreign Exchange Reserves, and External Debt: Mainly due to a sharp increase in foreign direct investment, the capital account deficit declined

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to $653 million in FY2003 compared with $1,107 million in FY2002. Foreign exchange reserves held by the SBP increased to $9.5 billion by the end of June 2003, compared with $4.3 billion as of end June 2003. Total foreign exchange reserves, including those held by commercial banks, stood at $10.7 billion. The SBP continued to pursue the policy of paying off high-cost foreign exchange liabilities in order to lower the country's external debt servicing liability.

Outlook

The Pakistan Government has made projections for FY2004 and FY2005 with respect to GDP growth, inflation, budgetary deficit, exports, imports, and current account of the balance of payments. With sound macroeconomic fundamentals and other favorable factors, the economy should be able to realize the GDP growth target of 5.3 percent set by the Government. Given better availability of water, the outlook for the agriculture sector is good, and the sector is likely to realize the growth target of 4.0 percent. Due to favorable demand and supply factors, large-scale manufacturing is likely to achieve the growth target of 8.8 percent set by the Government.

Given adequate supplies of food items, excess capacity in the manufacturing sector, and good prospects of stable exchange rate, the inflation rate target of 4.0 percent looks achievable. The budgetary deficit target of 4.0 percent of GDP, however, may be difficult to realize, mainly because of the persistence of large losses by PSEs and resulting need for subsidies.

Growth of both exports and imports is likely to exceed the targets of 6.6 percent and 4.9 percent, respectively, set by the Government. While there is likely to be some deceleration, Pakistan's exports may still grow by about 11-12 percent because of pick up expected in FY2004 in the US, European and Japanese economies. Also, with higher growth projected in the domestic economy, imports are expected to grow by about 10 percent. The surplus in the current account is projected to decline, but is still likely to be higher than Government's projection.

Modernization of the textile industry underway in the private sector for the last 3-4 years has already started showing results in the form of substantial increase in the industry's output and export volumes. The Government has also shifted its focus on increasing investment, growth, and employment, which is essential for reducing poverty. However, to promote investment, it is necessary to move on to second generation of reforms, particularly with regards to deregulation and elimination of procedural and other bottlenecks. Also, for continued improvement of macroeconomic fundamentals it is essential that the process of reduction of fiscal deficit be sustained. However, in the face of continuing losses of the two state-owned power companies, sustaining the process of fiscal adjustment will be difficult. Hence the Government needs to accord high priority to improving efficiency of the two state-owned power companies. If the Government continues to pursue sound macroeconomic policies and implement economic and governance reforms, it would be possible to achieve or even exceed the economic growth target of 5.8 percent, set for FY2005 in the medium-term macroeconomic framework.

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