



# Pakistan

## Economic Assessment

**E**conomic reforms of the past 4 years have made a major contribution to the strong economic recovery, which gained further momentum in FY2004 (ended 30 June 2004) and exceeded the growth forecast in *ADO 2004*. The current account of the balance of payments remained in surplus for the fourth consecutive year, though the size of the surplus fell significantly. Inflation emerged as an area of concern, as it took a sharp upturn and the annual rate exceeded the Government's target.

GDP growth accelerated to 6.4% from 5.1% in FY2003, with the industry sector contributing almost half of the expansion. Manufacturing, the major subsector, expanded due to the availability of excess capacity in most industries at the start of the year. Subsector growth was underpinned by a domestic demand surge originating in an increase in consumer credit, higher cash incomes of farmers, continuing strong levels of worker remittances, and faster economic growth. The Quantum Index of Large-Scale Manufacturing registered a gain of 18.1% compared with 8.0% in FY2003. Value added in generation and distribution of electricity and gas, the other key subsector in industry, rose by 22.5%, mainly because of steep rises in hydropower generation and production of gas. Value added in construction strengthened to 7.9%, also significantly stronger than in FY2003, because of a larger public sector development program, greater private sector investment, and more readily available housing finance from banks.

The 2.6% growth of agriculture in FY2004 was much lower than expected in *ADO 2004*, and had its basis in reduced cotton output (resulting from a widespread pest attack) and lower growth in wheat (due to adverse weather). However, higher prices of most major crops, particularly for cotton, rice, and wheat, led to a significant improvement in farmers' cash incomes.

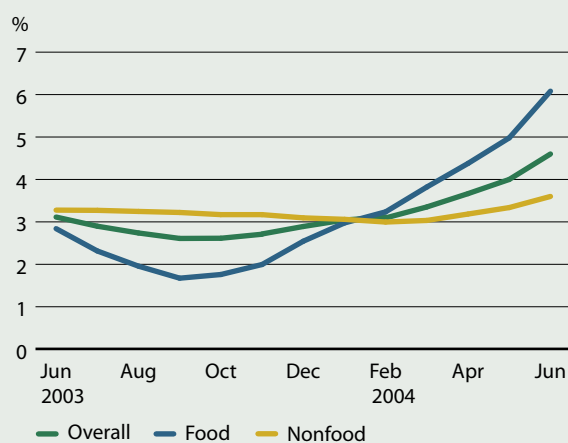
The services sector essentially maintained the FY2003 growth rate. Value added in wholesale and retail trade went up by 8.0%, reflecting recovery in domestic economic activity, acceleration in imports, and maintenance of the double-digit expansion in exports. Telecommunications services continued to power forward, and the number of cell phone subscribers more than doubled to 5.0 million. Growth in public administration and defense, however, was significantly less than in the previous year.

On the demand side, the impetus for growth came from investment and government consumption. Gross fixed capital formation in constant prices accelerated strongly to 14.7% from 1.0% in FY2003. Both the public and private sectors saw a recovery in investment. As a share of GDP, investment, inclusive of accumulation of stocks, climbed from 16.7% to 18.1%.

The Government kept its tight fiscal stance in FY2004 as a result of which the overall budget deficit declined further to 3.3% from 3.7% of GDP in FY2003. Government revenues strengthened by 8.3%, while the rise in spending was kept at 6.6%, despite sharp increases on development and defense of 17.6% and 12.7%, respectively. As a share of GDP, development expenditures moved up marginally from 2.7% to 2.8%, while defense expenditures remained unchanged at 3.3%. There was a welcome shift in sources of financing the fiscal deficit from high-cost nonbank borrowing to low-cost bank borrowing. This was the result of the ongoing rationalization of interest rates on National Saving Scheme instruments and the tightening of State Bank of Pakistan (SBP) controls on lending by banks against these instruments. Most debt indicators showed significant improvements, with the public debt-to-GDP ratio declining from 73.9% to 67.9%.

Inflation picked up in the second quarter of FY2004, to give 4.6% for the whole year compared with 3.1% in FY2003 (Figure 2.15). This stemmed

Figure 2.15 Inflation, Pakistan, June 2003–June 2004



Note: Data refer to 12-month moving average inflation rates.  
Source: Federal Bureau of Statistics.

from shortages in wheat (due to bad weather) and chicken (resulting from the avian flu crisis in January–February 2004), and from sharply higher house rents. However, SBP continued to pursue easy monetary policy through most of the year. Money supply growth accelerated slightly, and credit to the private sector increased to PRs301.2 billion, or nearly double the previous year's level.

Growth in exports decelerated while that in imports accelerated in the second half of FY2004. For the full year, exports rose by 13.5%, mainly due to higher world prices, and imports by 21.2%. The current account surplus fell by more than half to \$1.8 billion in FY2004. This was the result of a more than threefold widening of the trade deficit, a sharp rise in the services deficit, a reduction in official transfers due to discontinuation of the Saudi Oil Facility in January 2004, and a decline in worker remittances.

In the previous 2 years, SBP had been intervening in the foreign exchange market, as a net buyer of foreign exchange to prevent undue appreciation of the Pakistan rupee. In contrast, in the latter part of FY2004, SBP emerged as a net seller to prevent a sharp fall of the currency. For the year as a whole, the domestic currency depreciated slightly against the dollar by 0.3% after a 4.4% appreciation in FY2003. Foreign exchange reserves grew unspectacularly by 10.8% to \$10.6 billion, in comparison with FY2003 when they more than

doubled. External debt outstanding remained virtually the same at \$33.4 billion; debt indicators improved further with the debt-to-GDP ratio declining to 35.2% from 40.5% in FY2003.

### Policy Developments

The FY2005 federal budget and trade policy contain various policy measures that reflect the Government's commitment to continue the structural reforms initiated in the last 4 years, and to move on to "second generation" reforms. The budget changes the focus from fiscal consolidation to promoting economic growth, taking full advantage of the fiscal space created by improvements in revenue generation and reductions in interest payments, in order to expand development expenditures and trim business costs for the private sector.

The budget announced several measures to accelerate growth—particularly in agriculture, industry, housing and construction, and business activities—and to further improve tax administration.

To promote investment in agriculture, the import duty on tractor models not manufactured locally was reduced and no general sales tax (GST) or withholding tax is to be levied. Neither will duty or GST be applied to imports of specified agricultural machinery and implements not manufactured locally. The budget also exempted from GST agricultural machinery manufactured locally.

So that industry can meet the challenges of increased international competition resulting from further liberalization of trade under the WTO regime—particularly the impact of the ending of MFA textile and clothing quotas by year-end—the cost of investment has been eased by lowering the customs duty on imports of machinery, not manufactured locally, and exempting it from GST. Tariff protection for locally manufactured capital goods has been lessened to induce efficiency in the engineering industry and to lower the cost of locally manufactured machinery for investors. Customs duty on a large number of industrial raw materials has been brought down significantly, which will benefit such key industries as iron and steel, plastics, locally manufactured plant and machinery, and chemicals and dyes. Multiple GST

**Table 2.16 Selected Economic Indicators, Pakistan, 2004–2005, %**

Item	2004		2005	
	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update	ADO 2004 Update
GDP growth	5.5	6.4	5.8	6.5
Inflation (CPI)	4.0	4.6	4.0	5.5
Current account/GDP	3.0	1.9	2.1	-1.3

Source: Staff estimates.

rates ranging from 15% to 23% have been replaced with a 15% standard rate. Ginned cotton, raw hides, and leather have been exempted from GST, which will ease cash-flow problems for processors.

The housing and construction industry has been identified as one of four priority areas for growth and poverty reduction. To encourage investment in the industry, the government budget abolished excise duty on paints and lowered import duties on a range of building materials, including steel and steel products, as well as construction machinery. It has also exempted construction machinery from GST and withholding tax.

To tackle the long-standing problems of harassment of business activities, the central Government in the budget announced steps to ensure that provincial governments limit interventions by various departments, such as the shop inspectorate or the labor and electricity departments. In contrast to past practice, their visits to industrial units will be preannounced with appropriate notice.

As part of steps to improve tax administration and move to a “business friendly” tax collection system, the Government already set up one large taxpayers’ unit in Karachi in July 2002 and one medium taxpayers’ unit in Lahore in September that year, providing one place where taxpayers can pay all their taxes (corporate income tax, GST, and excise duty). They have been very effective in realizing greater tax receipts in their areas, as well as increasing taxpayers’ satisfaction. Building on this positive experience, the FY2005 budget provides for the establishment of one more large taxpayers’ unit and five more medium taxpayers’ units. In addition, the GST refund system is being reformed to cut back on delays and the need for interaction with tax officials.

For its part, the trade policy aims to enhance competitiveness, diversify exports, and promote investment in the country. In order to take advantage of global industrial restructuring, particularly relocation of the textile industry from industrial to developing countries, the trade policy has allowed relocation of projects to Pakistan without any import duty. This should accelerate the ongoing modernization of the domestic textile industry, aiding its preparation for the end of the MFA quota regime. The trade policy has also provided fiscal incentives for developing testing facilities, obtaining international certification, and establishing facilities to meet environmental requirements.

Because Pakistan’s exports have an extremely narrow base, the trade policy aims at export product diversification by promoting nontraditional exports, such as exports of horticultural products, furniture, and finished products of granite and marble. The trade policy has various incentives, including payment out of the Export Development Fund of the first 6% of the interest rate on investment loans taken for setting up greenhouses and cool-chain infrastructure. Another incentive is a freight subsidy from Pakistan Horticulture Development and Export Board on horticultural products for exporters complying with standards developed by the board. A 25% freight subsidy is also to be provided to exporters of furniture, and finished products of granite and marble.

### Outlook for FY2005

With sound macroeconomic fundamentals, private investment picking up, and the sharp increase in the public sector development program, the economy is now projected to grow by 6.5% in FY2005, compared with the 5.8% forecast in *ADO 2004*. However, as money supply has been growing much faster than nominal GDP over the past 3 years, the resulting large liquidity overhang will put pressure on prices. Also, with the surge in oil prices and with most domestic industries approaching full capacity, the inflation forecast for FY2005 has been raised from 4.0% to 5.5%. Monetary policy will tighten in FY2005; however, the SBP has indicated that it will ensure gradual increases in interest rates that do not adversely

affect the growth momentum. From the surplus forecast in *ADO 2004*, the current account is now projected to move into deficit, as imports grow faster than exports and as official transfers decline.

Agricultural growth is likely to be stronger than in FY2004, but because of emerging water shortages, it is difficult to make any accurate predictions. Rice and sugarcane are likely to suffer, as availability of water for the summer crops is 20–30% lower than in FY2004 and the area sown under sugarcane has declined by 11.3%. An anticipated shortage of water in the country's two main reservoirs poses a major risk for the winter crops, which depend heavily on canal irrigation. However, cotton production is likely to strengthen by 7–9% in FY2005 because of a higher sown area of about 7% and a lower incidence of pest attacks due to dry weather. Performance of the livestock subsector is forecast to pick up, primarily because of a recovery in the poultry subsector, which was hurt by avian flu in FY2004. On the basis of these factors, agriculture is expected to grow by about 3.5% in FY2005.

Growth in manufacturing in FY2005 will be lower than a year earlier, but is still likely to be in the double-digit range, given the strong recovery in sector investment seen in FY2004. A raft of incentives, such as reduction in import duties on industrial raw materials and machinery, together with liberalization of imports of second-hand machinery and incentives for exports, is expected to further boost investment and production in manufacturing. An anticipated larger cotton crop and lower cotton prices will help the textile subsector. The envisaged increase in interest rates is unlikely to hurt manufacturing, because interest rates will still be low.

In the services sector, telecommunications growth is likely to accelerate further with new licenses issued for mobile telephone, long distance international, fixed local loop, and wireless local loop services, as well as for new television and radio channels. Introduction of wireless local loop services will open up rural areas to telecommunications services. The banking industry is also expected to register robust expansion, induced by reforms and privatization.

With GDP growth expected to remain well

above 6.0% and imports maintaining a double-digit increase, tax revenues should grow by about 12% in FY2005. As public debt indicators are projected to improve further, debt servicing, the largest budget expenditure item, is likely to remain under control. Similarly, defense expenditures are expected to stay on target, given a significant improvement in relations with India. The fiscal deficit target of 3.5% of GDP for FY2005 is therefore likely to be achieved.

Rapid economic growth, continuing high oil prices, and the planned import of 1 million tons of wheat in FY2005 point to imports maintaining their 20% rise. With the termination of textile and clothing quotas at year-end, exports are expected to sustain their strong performance of the last 2 years, supported by the industry's substantial restructuring and modernization, and grow by 12.0%. With imports outpacing exports, the trade deficit will widen further. The deficit on the services account is also expected to increase due to anticipated higher expenditures on shipping and lower receipts from the US for logistics support for the conflict in Afghanistan. These, along with the lower official transfers because of the full-year impact of the discontinuation of the Saudi Oil Facility, will push the current account to a deficit of \$1.3 billion or 1.3% of GDP. This is likely to put pressure on exchange rate.

The medium-term prospects for the economy are positive because of the substantial improvements in macroeconomic fundamentals over the last 3–4 years and the sharp pickup in investment in FY2004. In addition, improving relations with India may well lead to an upturn in trade between the two countries and greater foreign investment, and so boost growth. However, several downside risks are apparent. International oil prices have been very volatile in recent months and, if they remain high, projections for imports, the fiscal deficit, and inflation will have to be revised upward. High oil prices could also damp the global economic recovery, so lowering Pakistan's export growth. On the domestic front, water availability for the winter crops is now projected to be significantly lower than in FY2004. Finally, the possibility of an increase in terrorist incidents cannot be ruled out.