Pakistan

The economy achieved a modest recovery in FY2010, as foreign reserves strengthened and inflation moderated. However, continued pressure from subsidies as well as weak tax receipts overwhelmed the targeted budget deficit. Assessing the medium-term outlook is problematic due to the devastating floods that began in early August and that clearly hit short-term growth. Coping with the human toll and the massive damage will be daunting. The urgency of fiscal reforms to create space for reconstruction and development funding is now more pressing than ever.

Updated assessment

Continued power shortages and security conditions held growth to a modest 4.1% in FY2010 (ended 30 June 2010), up from 1.2% in FY2009 (Figure 3.7.1). The severe energy shortfall is estimated to have reduced GDP growth by 2.0%–2.5%. Growth for the 3 years from FY2008 averaged 3.0%, substantially below the 6.2% pace recorded in the previous 6 years.

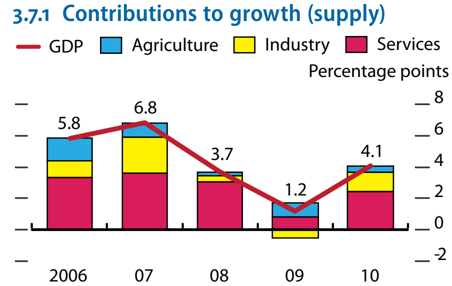
From the demand side, higher private and public consumption expenditure accounted for most of the expansion (Figure 3.7.2). Private consumption grew by 3.9% (accounting for two-thirds of GDP growth), fueled by gains in rural income buoyed, in turn, by better procurement prices and improved availability of consumer credit during the second half of FY2010. The resulting increase in demand for intermediate goods benefited from improved access to credit, bolstering corporate liquidity. Public sector consumption expanded by 13.4% (contributing about one-quarter of the rise in GDP), boosted by higher spending on public safety and internal security.

Unsurprisingly, investment remained weak in the context of subdued economic recovery and continued energy shortages. Total fixed capital formation contracted by 2.0% for the year: private investment dropped by 5.1%, more than offsetting a 6.5% increase on the public side. The decline in large-scale investment in manufacturing (15.4%) is a worrisome sign for the urgently needed strengthening and modernization of the structure of production, as are the very large contractions in investment for electricity and gas (11.0%) and transport and communications (14.1%), where additional capacities are needed to support sustained growth.

Net exports contributed moderately to growth, though this was mainly due to a fall in imports as exports expanded only modestly.

From the production side, a 4.6% expansion in services accounted for 59% of the rebound, led by stronger wholesale and retail trade and by an increase in public administration and defense. Gains in the sector were not uniform, however, and the finance and insurance subsectors continued to contract.

3.7.1 Contributions to growth (supply)



Source: Ministry of Finance. *Pakistan Economic Survey 2009–10*. http://www.finance.gov.pk

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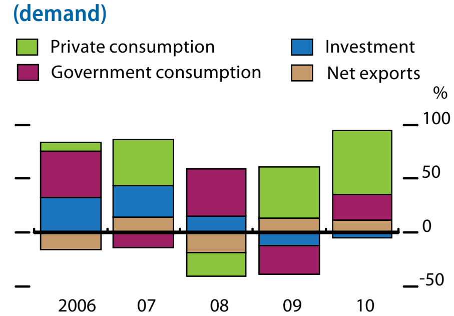
3.7.2 Share contributions to GDP growth (demand)



Source: Ministry of Finance. *Pakistan Economic Survey 2009–10*. http://www.finance.gov.pk

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This chapter was written by Dawn Elizabeth Rehm and Farzana Noshab of the Pakistan Resident Mission, ADB, Islamabad.

Large-scale manufacturing expanded by 4.8%, reversing the FY2009 contraction, with growth concentrated in areas associated with discretionary consumer spending, as well as pharmaceuticals (Figure 3.7.3). Production in the textile industry contracted as higher world prices for cotton yarn led to increased yarn exports, crimping supplies available to domestic value-added industries. Industry contributed 30% of overall growth, and the trend of a steady declining contribution by this sector to growth was reversed. The return of less favorable weather conditions kept agricultural growth to 2.0%, accounting for about 11% of the economic expansion.

Fiscal performance fell short of FY2010 budget targets. Planned policy reforms lost momentum as pressures on foreign reserves eased and calls for higher spending increased. The fiscal deficit at 6.3% of GDP was substantially higher than the 5.3% of GDP outcome in FY2009 and the deficit target of 5.1% of GDP (Figure 3.7.4). Even though the Public Sector Development Program was slashed by a fifth to 3.5% of GDP, this cut was insufficient to offset increased outlays for security, subsidies, and transfers to provincial governments.

Actual development spending rose by 7.8% but was significantly below its planned level. Reductions in development spending, which fell 14.5% short of its planned level, cut heavily into infrastructure outlays. This compression of development spending to rein in the deficit is both undesirable and counterproductive, as substantial infrastructure improvements are needed to support investment in the delivery of basic public services.

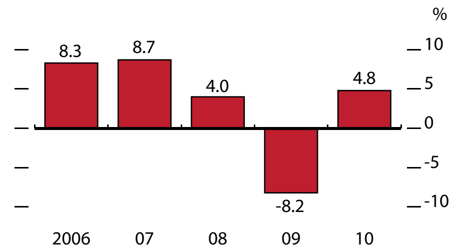
Overruns on current expenditure by the federal government for FY2010 amounted to 0.6% of GDP, with increases in security spending and other transfers, and a surge in energy-related subsidies. Despite a 37% rise in customer tariffs, power-related subsidies ballooned from the budgeted 0.5% of GDP to 1.0%, as tariff increases were insufficient for cost recovery. Total subsidies (including fertilizer and food) climbed to 1.6% of GDP.

The ratio of federal tax revenue to GDP fell to its lowest level in more than 30 years, as tax collection declined from 9.1% of GDP in FY2009 to 9.0% (Figure 3.7.5), well below the 9.4% target. A major factor was the sustained contraction of the telecommunications and finance sectors, both of which are heavy taxpayers.

The fiscal position is even more precarious than implied by the budget deficit alone. Net tax revenue available to the federal government (9.0% of GDP) was well short of current outlays (12.0% of GDP) in FY2010. Notably, the combined total of subsidy outlays (1.6% of GDP), defense spending (2.6% of GDP), interest costs (4.4% of GDP), and pensions (0.5% of GDP) amounted to 9.1% of GDP. General operating expenses of the federal government (2.9% of GDP) are thus left to be financed by borrowings (Figure 3.7.6). Additional pressure on domestic credit markets came from escalating losses of state-owned enterprises in recent years, which amounted to an estimated PRs245 billion or 1.7% of GDP in FY2010.

After declining to a low of 8.9% year on year in October 2009, inflation climbed back into double digits in the second half of FY2010, and was 12.7% in June 2010 (Figure 3.7.7). Second-half pressures came

3.7.3 Production growth of large-scale manufacturing



Sources: Ministry of Finance. *Pakistan Economic Survey 2009–10*. http://www.finance.gov.pk; State Bank of Pakistan. http://www.sbp.org.pk (accessed 8 September 2010).

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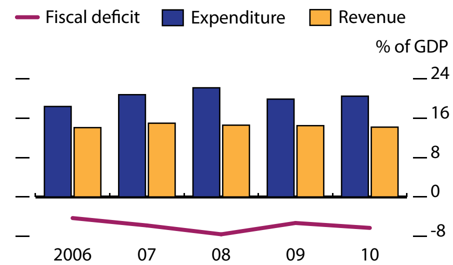
3.7.4 Fiscal indicators



Sources: Ministry of Finance. *Pakistan Economic Survey 2009–10* and Fiscal Operations July to June 2009–10. http://www.finance.gov.pk (accessed 8 September 2010).

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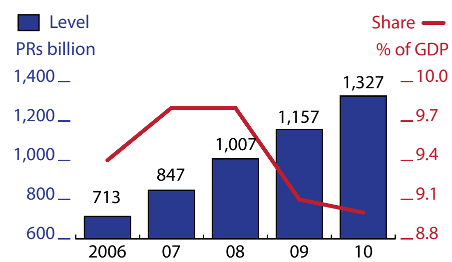
3.7.5 Federal Board of Revenue tax collection



Sources: Ministry of Finance. *Pakistan Economic Survey 2009–10*. http://www.finance.gov.pk; State Bank of Pakistan. http://www.sbp.org.pk (accessed 8 September 2010).

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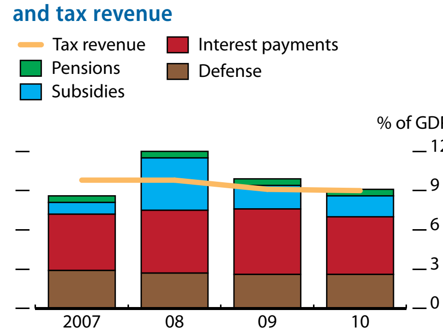
3.7.6 Federal nonoperating expenditure and tax revenue



Sources: Ministry of Finance. *Pakistan Economic Survey 2009–10*. http://www.finance.gov.pk; State Bank of Pakistan. http://www.sbp.org.pk (accessed 8 September 2010).

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from higher global prices for food and energy and upward adjustments in electricity tariffs and administered domestic fuel prices. Inflation in FY2010 averaged 11.7%, well below the 20.8% of FY2009.

In a context of moderating inflation, the State Bank of Pakistan (SBP), the central bank, cut the discount rate by 150 basis points during the first 5 months of FY2010 to 12.5% in an effort to bolster economic activity. Broad money aggregates accelerated during the second half of the fiscal year as government recourse to bank financing surpassed FY2009's borrowing.

Overall, broad money expanded by 12.5% in FY2010, up from 9.6% in FY2009. For the year as a whole, federal government borrowing from the banking sector rose to PRs309.5 billion (2.1% of GDP), damping private sector credit availability. Banks exhibited a preference for buying government securities during the year, regarding lending to the private sector as involving too-difficult credit-risk assessment. As a result, private sector credit, despite showing improvement from the previous year, remained significantly lower than FY2008's level (Figure 3.7.8).

Concerned with the resurgence of inflation pressures in the second half of FY2010 and the expansionary effects of fiscal overruns, the SBP took a cautious stance in setting policies for FY2011, increasing its policy rate by 50 basis points in early August 2010.

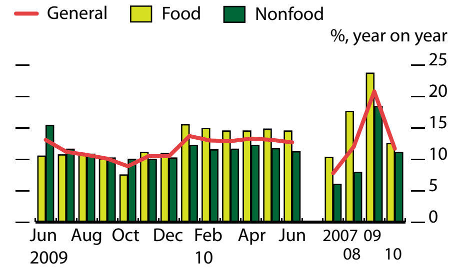
The current account deficit narrowed to $3.5 billion (2.0% of GDP) from $9.3 billion for FY2009, reflecting a contraction in the trade deficit and improvement in the invisibles accounts (Figure 3.7.9). On the trade front, imports declined by about 2.3% as financial weakness in two key industries (steel and oil refining) as well as a fall in investment crimped import demand. Moreover, exports recovered from a slump the previous year to expand by about 2.7%, with higher sales of rice, textiles, and pharmaceuticals.

About three-quarters of the improvement in the current account, however, came from a combination of a lower services account deficit (mainly owing to receipts of logistical support supporting the war against terror), lower interest payments, and continued strong growth (14%) in workers' remittances (Figure 3.7.10).

Although the current account deficit improved, financing became more difficult. The capital and financial account surplus fell by 14.8% to $5.2 billion in FY2010, though this was less steep than the 26.2% fall of FY2009. Foreign direct investment inflows fell by two-fifths to $2.2 billion, but a strengthening in other financing flows offset most of that. Unfortunately, much of the drop in such investment came in the communications, power, and transport sectors, where expansion in operating capacity is essential for faster economic growth.

Gross foreign exchange reserves, including commercial bank holdings, increased strongly in FY2010 to $16.8 billion (Figure 3.7.11). The gain came from the overall balance-of-payments surplus and net additions from International Monetary Fund funding under a standby arrangement. The exchange rate was relatively stable against the dollar, depreciating by 4.8% during FY2010. However, high inflation relative to trading partners' led the real effective exchange rate to appreciate by 8.3%, hurting export competitiveness (Figure 3.7.12).

3.7.7 Inflation



Source: State Bank of Pakistan. *Annual Report 2009–10*. http://www.sbp.org.pk

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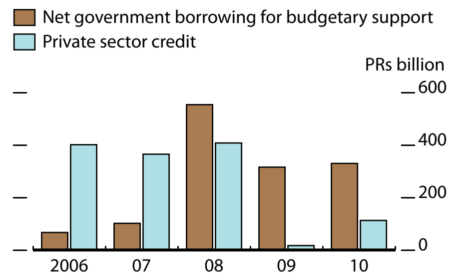
3.7.8 Bank financing of the deficit



Sources: Ministry of Finance. *Pakistan Economic Survey 2008–09*. http://www.finance.gov.pk; State Bank of Pakistan. http://www.sbp.org.pk (accessed 8 September 2010).

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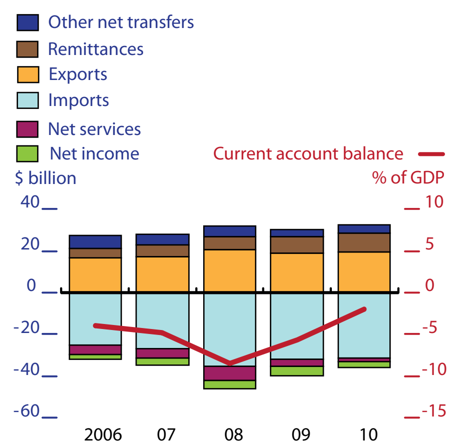
3.7.9 Components of the current account balance



Source: State Bank of Pakistan. http://www.sbp.org.pk (accessed 8 September 2010).

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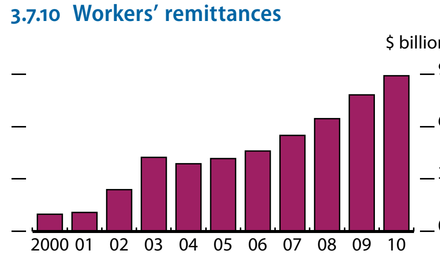
3.7.10 Workers' remittances



Source: State Bank of Pakistan. http://www.sbp.org.pk (accessed 8 September 2010).

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Prospects

The impact on economic prospects of the massive flooding that began in early August 2010 is difficult to quantify. A comprehensive damage and needs assessment will be completed only after publication of this *Asian Development Outlook* (*ADO*) *Update*. The picture should also be a little clearer when an international donors' conference is held in late November.

It seems evident, however, that the economic impact will be heavily negative in the short run, due to extensive damage and reallocation of resources to cater for urgent needs. As losses in crops and livestock, damage to infrastructure, and limited economic activity in a large part of the country will damp growth prospects in virtually every sector, such that tepid GDP growth of 2.5% is expected in FY2011. Nevertheless, reconstruction and rehabilitation activities will subsequently have a positive impact on GDP.

As the major transportation arteries of the country have been severely damaged, shortages of goods and services—even with rapidly ramped-up imports—are expected to put substantial upward pressure on prices. Moreover, the likelihood of delayed sowing of crops in the upcoming season and, potentially, in the following season will create shortages of food and other commodities while undermining farmers' incomes.

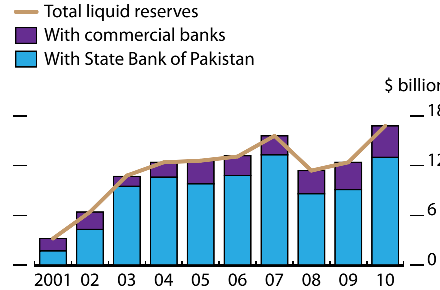
Inflation, for the most part induced by supply-side constraints, is expected to be higher than the 8.0% forecast in April's *ADO 2010*. This *Update* projects average inflation in FY2011 at 13.0%. The SBP in its Monetary Policy Statement for FY2011 projected inflation at 11%–12% (higher than the federal government target of 9.5%). The price hike emanating largely from the supply constraints will pose challenges for effective monetary management of the SBP. Also, while the central bank will find it difficult to fully implement its earlier monetary stance in the present circumstances, it will need to make substantial efforts to keep demand for credit from exacerbating inflation pressures.

Pressures on the current account will also intensify in FY2011. These will stem both from a steeper than earlier forecast rise in imports (reflecting the launch of reconstruction activity) and from domestic supply shortages pushing food, raw cotton, and other essential imports upward. Limits on existing infrastructure capacity and flood damage are expected to hold down export growth—already, flood-related damage has curtailed cotton and rice exports.

Still, workers' remittances, which increased by 13.2% in July–August 2010 over the same period the previous year, are expected to remain strong. If substantial grant aid is provided for relief, the deterioration in the current account deficit may be limited to 4.3% of GDP.

Flood-related expenditure will also alter the fiscal outcome, relative to the budget posted for FY2011, widening the fiscal deficit from the targeted 4.0% (Box 3.7.1). In this context, it will be even more important to address trends that were troublesome for the FY2010 outturn. Revenue measures are more urgent in view of the massive reconstruction requirements, as are improvements in revenue administration and collection.

3.7.11 Foreign exchange reserves



Source: State Bank of Pakistan. http://www.sbp.org.pk (accessed 8 September 2010).

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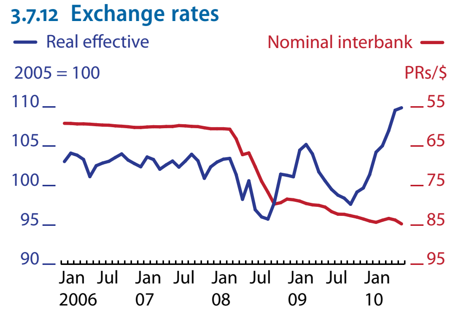
3.7.12 Exchange rates



Source: International Monetary Fund. International Financial Statistics online database (accessed 9 September 2010).

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3.7.1 Selected economic indicators (%)

	2010		2011	
	ADO 2010	*Update*	*ADO 2010*	*Update*
GDP growth[a]	-	4.1	-	2.5
Inflation	12.0	11.7	8.0	13.0
Current acct. bal. (share of GDP)	-3.6	-2.0	-4.2	-4.3

[a] In light of the government's revisions to the GDP series in June 2010, April's *ADO* GDP growth forecasts are not comparable with current forecasts and have been omitted.

Note: The projections for FY2011 are preliminary and subject to revision.

Source: ADB estimates.

3.7.1 Fiscal alignment

The massive flood-related devastation underscores the need for reprioritization on the fiscal front so as to expand fiscal space for reconstruction. The federal government in the budget for FY2011 has already emphasized its commitment to fiscal consolidation and to policies needed to support a robust expansion of the economy.

A 50% hike in government salaries reflected the recommendations of the Pay and Pension Commission, in an effort to offset the erosion of their real incomes in the past 3 years. To offset the expansionary impact of these provisions, the federal budget included a freeze on all nonsalary recurrent outlays at FY2010 levels and a rationalization of the Public Sector Development Program as well as a reduction in the salaries of ministers.

The budget for FY2011 also called for an aggressive 45% reduction in total subsidies, including a 67% reduction in allocations to cover electricity tariff differentials. These lower subsidies would require efficiency measures that produce saving equivalent to the 30%–40% increase in tariffs that would otherwise be required to meet cost recovery. Flood-related damage and social safety net requirements will necessarily impact the expected deficit for FY2011.

Policies for FY2011 recognize the inconsistency between current losses by state-owned enterprises (SOEs) and fiscal sustainability. Bank credit outstanding to SOEs reached 2.6% of GDP, and financing of commodity operations stood at 2.8% of GDP. Since it has not drawn up immediate plans to privatize key SOEs, the federal government has established a committee to develop an overall approach to improve their management and operation.

Total outstanding guarantees for SOEs at end-April 2010 amounted to 4.2% of GDP, underscoring the budget's vulnerability to SOEs, both in terms of their performance and their contingent liabilities. Privatization for some large SOEs is on hold for the moment, but measures to improve management and reduce their increasingly burdensome losses are urgent.

Specific tax measures in the FY2011 budget, which could lift tax revenue by 20%, include: a 1% increase in the goods and services tax to 17%; reforms to that tax from 1 October 2010 to improve revenue and limit cascading; a capital gains tax on stocks and shares; higher excise duties on cigarettes and household appliances; higher withholding taxes on commercial importers and air tickets; and improvements to revenue administration. Additional revenue measures are being formulated to generate revenue for relief and reconstruction.

The FY2011 budget targets a rise in federal government public sector development spending of about one-third relative to the FY2010 outturn, taking outlays up from 3.5% of GDP to 4.4% in FY2011. Moreover, investment spending was reprioritized to secure more timely completion of key ongoing projects in the areas of transportation, hydropower, and water.

Expectations regarding pledges made by the Friends of Democratic Pakistan in Tokyo in April 2009 have been revised downward in face of the slower than expected pace of disbursements in FY2010. External support in response to flood-related damage will contribute to higher increases in development spending with the magnitude of the increase for FY2011, among other factors, to be determined also by the absorptive capacity of the economy.

An alignment between expenditure and the policy priorities that provide the fiscal space to support critical investments in infrastructure is needed both to broaden the economic base and to achieve sustainable improvements to the current account. Lower imports, lower development spending, and an explosion of unproductive recurrent spending for subsidies simply increase the apparent risk to investment, reducing the inflows needed to put the economy on a sustainable path.

The drain of subsidy requirements for the energy sector also needs attention: while the federal government has increased consumer tariffs, a substantial gap remains, requiring a combination of efficiency gains and further tariff increases. The energy sector as a whole will need to be placed on a financially viable footing if the necessary investment in productive capacity is to be realized.

Both the magnitude and the composition of federal spending in recent years have undermined macroeconomic stability and sustainability, and these trends must change. The compression of development spending to accommodate runaway recurrent costs is not consistent with fiscal sustainability, and neither is an improvement in the external account built on restrained imports needed for investment and capital development.