Pakistan

Continued modest growth is expected in fiscal year 2010. Macroeconomic imbalances have narrowed and economic fundamentals have improved, but the security environment and an ongoing power crisis are both burdening the fiscal situation and obstructing a growth revival. That revival will depend on faster implementation of structural reforms to strengthen revenue mobilization, eliminate electricity outages, and transform the industrial and export sectors. Rapid fiscal improvements are also needed to underpin recovery, sustain the public sector development program, and prevent crowding out of the private sector.

Economic performance

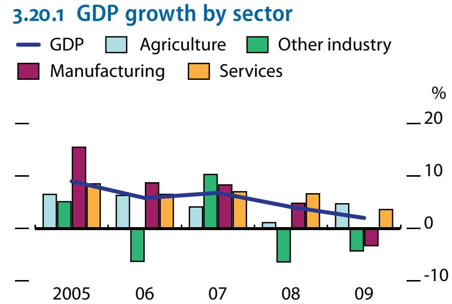
The country's recourse to an International Monetary Fund (IMF) program in November 2008 (see *ADO 2009* and *ADO 2009 Update*) and its need for fiscal and balance-of-payments stabilization coincided with the onslaught of the global recession, precluding any immediate fiscal or monetary policy response. This lack of response, together with the deteriorating security situation and electricity shortages, saw growth slow further to only 2.0% in FY2009 (ended June 2009), from 4.1% in FY2008 (and from an average of over 7% in the 4 years prior to that).

Manufacturing contracted (Figure 3.20.1), and trade and services slowed. Both public and private investment shrank. With economic growth down to near the rate of population growth, per capita incomes stagnated (Figure 3.20.2), affecting poverty rates. In this way, the difficult economic circumstances of FY2008 carried over into FY2009, and revealed how years of seemingly sustainable growth can unravel in a single year because of structural problems in the face of exogenous shocks and delayed policy response to such shocks.

The global downturn, security challenges, and energy shortages, by subduing industrial and export growth, also contributed to underachievement of tax collection targets in a year of expenditure overruns. The tax-to-GDP ratio in FY2009, for taxes collected by the Federal Board of Revenue, fell to a 10-year low of only 8.8%. This ratio indicates a lack of buoyancy in the tax system and calls for urgent reform in tax policy and administration.

The fiscal deficit was further undermined by the additional defense outlays necessitated by military action against extremists. The fiscal deficit target in FY2009 was, therefore, missed and at 5.2% of GDP, was 0.9 percentage points wider than projected. The target was overshot even though the government had started cutting subsidies and was reducing the public sector development program (PSDP) as part of its expenditure rationalization program. From 3.8% of GDP in FY2008, it cut subsidies to 1.9% of GDP in FY2009 (Figure 3.20.3), as it allowed domestic fuel prices to float with international prices.

3.20.1 GDP growth by sector



Source: Ministry of Finance. *Pakistan Economic Survey 2008–09*. http://www.finance.gov.pk

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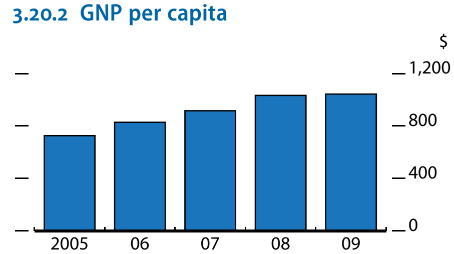
3.20.2 GNP per capita



Sources: Ministry of Finance. *Pakistan Economic Survey 2008–09*. http://www.finance.gov.pk; State Bank of Pakistan. *Annual Report 2008–09*. http://www.sbp.org.pk

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This chapter was written by Safdar Parvez and Farzana Noshab of the Pakistan Resident Mission, ADB, Islamabad.

Electricity subsidies, however, stayed very high at 44% of total subsidies in FY2009 and remained a significant budget burden. The government is phasing in a power tariff increase to reduce these subsidies, but since the tariff is expected to reach cost recovery only in the first quarter of FY2011, cash subsidies will continue to be paid over the rest of FY2010.

Despite the increase in costs of production, consumers' electricity tariffs had not been increased for several years before FY2008 when the oil price hike substantially raised generation costs and the need for much higher tariff differential subsidies. The lack, however, of timely subsidy payments created an "intercorporate circular debt" problem—when distribution companies could not pay power producers, who, in turn, could not pay fuel suppliers.

This led to power plants' inability to produce at optimum capacity, thus adding to existing power shortages. Load shedding has continued, with power shortages peaking at 5,000 megawatts in the summer time. To improve operations in the power sector, the government in September 2009 paid off part of its circular debt while paying interest on its outstanding obligations. The circular debt is now being transferred to a debt-holding company for servicing and resolution.

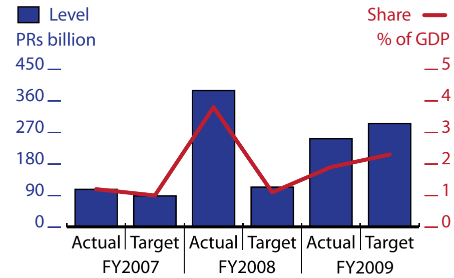
The PSDP, already slashed to 4.4% of GDP in FY2008 (from a targeted 5.1% of GDP), was cut further in FY2009 to 3.0% of GDP as part of the effort to rein in the deficit (Figure 3.20.4). As a result, expenditure on education fell further to 2.1% of GDP in FY2009 from the already low 2.5% of GDP in FY2008, and on health from 0.6% to 0.5% in the same period. Such weak social sector expenditures are difficult to justify in a country whose human development index ranking of 141 places it toward the bottom.

Even with the cuts in subsidies and the PSDP, financing the deficit in FY2009 posed major problems at a time when few foreign resources were available: only 22% of the deficit was financed with external resources compared with 53% in FY2007. More than half the domestic financing was arranged through banks. The higher cut-off yields encouraged banks to invest in Treasury bills when their eagerness to lend to the private sector was dented by a higher concentration of nonperforming loans and a risky business environment.

The government's preemption of banking sector funds in this way resulted in lower availability of credit for the private sector. The private sector's demand for credit had also diminished on account of higher interest rates and other constraining structural factors, such as electricity shortages. As a result, private sector credit nosedived to a negligible net level in FY2009 (Figure 3.20.5).

In the high inflation environment of late FY2008 and the first half of FY2009—spawned by higher food and nonfood prices and reduction of oil and energy subsidies—the State Bank of Pakistan (SBP) sharply tightened monetary policy through hikes in the policy discount rate. The policy rate peaked at 15% in October 2008 as year-on-year inflation surged (Figure 3.20.6). The rate was then gradually brought down by 250 basis points from April to November 2009, as there was a trend decline in year-on-year inflation that receded to less than 9% by October 2009. Both food and nonfood consumer price indexes had fallen sharply by then. Despite the private sector's demand for a sharper cut in interest rates, the

3.20.3 Subsidies



Source: Ministry of Finance. *Annual Budget Statements*. http://www.finance.gov.pk

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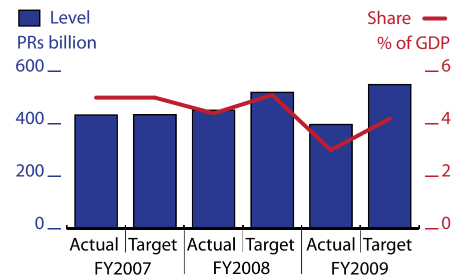
3.20.4 Public sector development program



Source: Ministry of Finance. *Pakistan Economic Survey 2008–09*. http://www.finance.gov.pk

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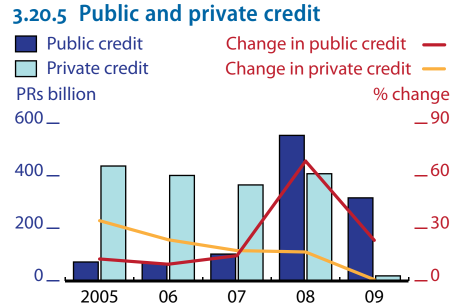
3.20.5 Public and private credit



Sources: Ministry of Finance. *Pakistan Economic Survey 2008–09*. http://www.finance.gov.pk; State Bank of Pakistan. http://www.sbp.org.pk (accessed 11 March 2010).

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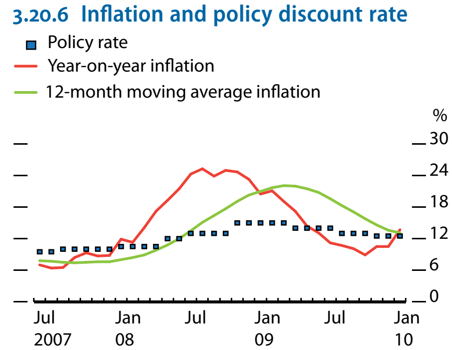
3.20.6 Inflation and policy discount rate



Source: State Bank of Pakistan. http://www.sbp.org.pk (accessed 11 March 2010).

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SBP's measured response at that time, mindful of the downside risks to inflation, was nonetheless appropriate. (The sharp resurgence in year-on-year inflation in January 2010 was to prove this later.)

The economic slowdown in FY2009, combined with tighter demand management policies, the fall in international oil prices, and a depreciated currency, led to a sharp fall in imports of over 10% in FY2009 (Figure 3.20.7). As exports fell by more than 6%, because of lower international demand, domestic security challenges, and electricity shortages, the trade deficit narrowed. High double-digit inflation diminished any competitiveness advantage exports might have gained due to a 16.4% depreciation in the average nominal effective exchange rate in FY2009 (Figure 3.20.8). The average real effective exchange rate depreciated by only 0.9%, while the competitiveness of exports remained blocked by structural bottlenecks.

The contraction in the trade deficit was complemented by a steep 48% shrinkage in the services account deficit. That account improved mainly due to receipts for logistical support to the United States in Afghanistan and to a decline in outflows from foreign exchange companies following administrative measures taken by the SBP. The current account deficit in FY2009 fell by a third to 5.6% of GDP (Figure 3.20.9), helped by remittances that continued to defy the global recession, growing by 21%.

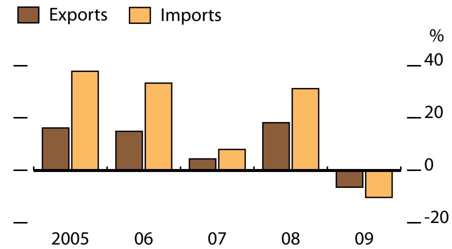
Foreign direct investment (FDI) and net portfolio investment together fell to half the level of the preceding year, on account of the global economic slowdown and the domestic situation (Figure 3.20.10). Approximately 55% of the $9.3 billion current account deficit was financed by disbursements from multilateral institutions and aid agencies. This implies a high dependence on official borrowings that not only makes current account financing vulnerable but also has adverse implications for the country's external debt profile.

Foreign reserves recovered strongly by end-FY2009 (Figure 3.20.11) with the IMF's support for the balance of payments totaling $12.4 billion (and further to $15.1 billion by end-December 2009). But the ratio of reserves to external debt still declined, as higher reserves were offset by new external debt, which shot up by $6.3 billion in FY2009. This buildup of debt reversed, for the first time in 6 years, the trend decline in the ratio of external debt to GDP, which increased to 30.4% in FY2009 from 27.0% in FY2008. External debt grew by 14.1% in dollar terms, but jumped by 36% in Pakistan rupee terms, over the same period (Figure 3.20.12).

Domestic debt rose by PRs587 billion to PRs3.9 trillion in FY2009 (or 29.4% of GDP); almost half the increase was short term. Overall public debt continued to hover around 61% of GDP. Debt-servicing ratios therefore deteriorated, and debt servicing consumed more than half the total tax revenue in FY2009, representing a major drain on fiscal resources.

Although the IMF's third review in January 2010 of the ongoing standby arrangement projects that Pakistan's debt-to-GDP ratios will begin to decline from FY2012, it also shows that the external and public debt trajectories from the baseline are vulnerable to shocks, such as those arising from lower growth, higher imbalances, lower FDI, and larger local currency depreciation. Consequently, the fiscal and current account deficits need to be contained and higher non-debt-creating

3.20.7 Trade growth



Source: State Bank of Pakistan, *Annual Report 2008–09*. http://www.sbp.org.pk (accessed 11 March 2010).

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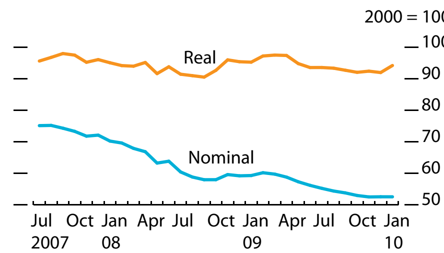
3.20.8 Effective exchange rates



Source: State Bank of Pakistan. 2010. *Statistical Bulletin*. March. http://www.sbp.org.pk

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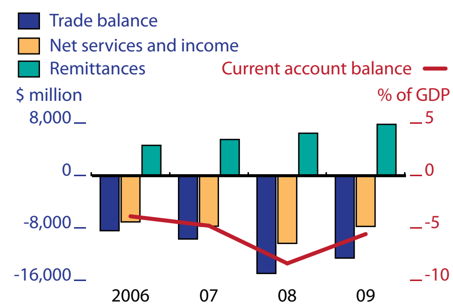
3.20.9 Current account indicators



Source: State Bank of Pakistan. *Annual Report 2008–09*. http://www.sbp.org.pk (accessed 11 March 2010).

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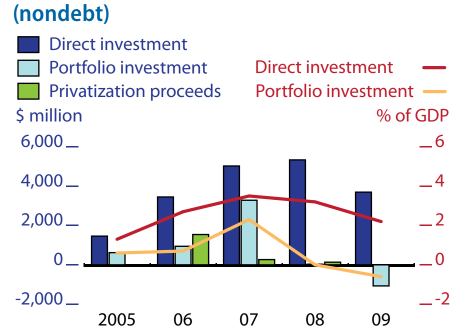
3.20.10 Financial account indicators (nondebt)



Source: State Bank of Pakistan. *Annual Report 2008–09*. http://www.sbp.org.pk (accessed 11 March 2010).

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inflows have to be resumed for debt sustainability to be maintained in the near and medium term.

Economic prospects

Pakistan's economic prospects over the next 2 years are predicated on a successful completion of the current IMF program by end-2010; a gradual improvement in the security situation; a phased reduction in electricity shortages as tariffs are rationalized and new power plants are commissioned; sustained implementation of fiscal reforms, particularly for tax and administration; a gradual economic recovery in the main trading partners; and political stability.

Growth in FY2010 is expected to modestly improve to 3.0%, backed by a slight recovery in manufacturing. This recovery, apparent in the first half of FY2010, reflects (among other factors) higher production for cement products for the local market and stronger domestic demand for automobiles. Textiles manufacturing, however, has continued to contract on account of lower cotton availability, electricity and gas shortages, and poorer relative product competitiveness in international markets.

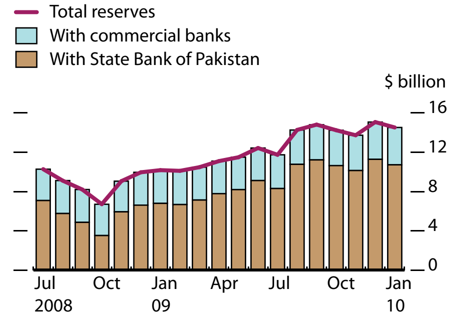
Agricultural growth in FY2010 is set to remain below the government's target owing to lower than targeted production of most major crops, such as sugarcane and cotton. Production of wheat, a winter crop, will be less than the target of 25 million tons due to water and seed shortages, delayed sowing, and higher input costs.

Slower growth in agriculture, only a modest recovery in manufacturing, and continued contraction in imports will all continue to drag down wholesale and retail trade. Following years of strong growth, telecommunications service providers, too, will need to consolidate operations (because of stronger competition and lower margins). Financial services could, however, perform better than in FY2009, as seen in slower growth in nonperforming loans in the first half of FY2010, improving profitability of banks following higher spreads, and banks' good capitalization. The services sector overall will grow only moderately.

GDP growth is expected to reach about 4.0% in FY2011 as private sector investment picks up following gradual improvement in the security situation and fewer electricity shortages, and as public investment accelerates, supported by an improved fiscal situation with value-added tax (VAT) and other administrative tax reforms kicking in from 1 July 2010. Manufacturing growth is also expected to be stronger, as is agriculture's (to a lesser degree) on the back of higher commodity prices. Higher real sector expansion with larger international trade volumes and an improving financial sector should catalyze further growth in services.

The modest growth projected for FY2010 will make it hard for the Federal Board of Revenue to achieve its revenue target. However, higher oil and electricity prices (by way of larger customs revenues and sales tax receipts) will compensate somewhat for lower direct tax collections. Yet with higher than budgeted defense spending, the fiscal deficit target of 4.9% of GDP for FY2010 will be missed, and the government is now

3.20.11 Foreign exchange reserves



Source: State Bank of Pakistan. http://www.sbp.org.pk (accessed 3 March 2010).

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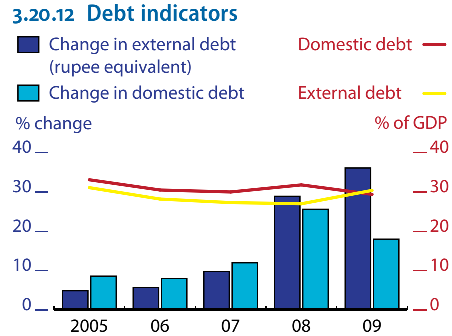
3.20.12 Debt indicators



Source: State Bank of Pakistan. *Annual Report 2008–09.* http://www.sbp.org.pk (accessed 3 March 2010).

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3.20.1 Selected economic indicators (%)

	2010	2011
GDP growth	3.0	4.0
Inflation	12.0	8.0
Current account balance (share of GDP)	-3.6	-4.2

Source: ADB estimates.

targeting a deficit of 5.1%. But this too could be overshot in case of further shortfalls in tax and nontax revenues.

Even with this larger fiscal deficit target, PSDP spending, although higher in the first half of FY2010 than in the same period in FY2009, will need to be reduced to accommodate higher defense spending, and will end up being lower than planned under the budget for FY2010. To contain current expenditure, the government in December 2009 announced austerity measures including reducing the number of federal ministries and slashing administrative expenses related to the offices of the President and the Prime Minister. It also set up a cabinet committee to restructure loss-making state-owned enterprises. For 2011, resource pressures will continue to weigh on the central government, owing to restructuring of shared taxes and responsibilities between the central and state governments (Box 3.20.1).

The key issue with the fiscal deficit remains its financing. A much larger than planned recourse to the domestic credit market to finance the deficit was required in FY2009 as external sources of financing dried up. The trend continued in the first half of FY2010. To this end, in the first 8 months of FY2010, the government borrowed PRs191 billion from commercial banks, although it kept borrowings from the central bank in check.

In addition to bank financing, nonbank domestic financing of the deficit mainly through the National Saving Schemes jumped sharply. Such borrowings at end-2009 relative to end-2008 were PRs300 billion higher. Continued high levels of domestic financing from bank and nonbank sources is unsustainable from the standpoint of fiscal stability and not desirable from the perspective of mobilization of deposits by commercial banks, credit availability for the private sector, and growth.

Continued recourse to such sources is partly due to the delays in foreign disbursements projected under the Friends of Democratic Pakistan (FODP) aid group—a part of these unrealized disbursements is being temporarily made up by the IMF's bridge-financing under the standby arrangement. The fiscal framework for FY2010 had relied heavily on such external resources for financing. The fiscal deficit target for the year might yet need to be scaled back if the projected FODP disbursements are not realized.

Inflation in FY2010 is expected to fall from its peak of the previous fiscal year due to the base effect, a sharp year-on-year decline in both food and nonfood prices between July and October 2009, and a continued relatively tight monetary policy. But at a forecast 12.0%, it is still high. Looking ahead, domestic oil prices will increase in line with international prices with an automatic pass-through mechanism in place. Phased increases in electricity tariffs will also contribute to maintaining momentum in inflation during the fiscal year. In FY2011, improvement in domestic food supplies and continued fiscal and monetary discipline will help moderate inflation to 8.0%.

With projected double-digit inflation this fiscal year, the SBP will need to carefully calibrate monetary policy to maintain price stability amid strong pressure to cut interest rates further to revive growth. Control of monetary aggregates will be complicated by the government's continued large borrowing requirements from commercial banks.

3.20.1 Strengthening fiscal federalism

An agreement in December 2009 on a new National Finance Commission award that distributes resources between the federal and the provincial governments and among provincial governments is important from the point of view of strengthening fiscal federalism.

Under the award, the share of provinces in the total divisible pool of federal taxes has been increased from 47.5% currently to 56% from the next fiscal year (FY2011) and further to 57.5% for the subsequent 4 years.

Consequently, the federal government would need to meet its fiscal obligations (interest payments, defense, large development projects, etc.) with a smaller share of the divisible pool, though the size of the pool is to be boosted by the new value-added tax and other revenue-generating measures.

This will require the federal government to rationalize and restructure its expenditure obligations over time and devolve greater expenditure responsibilities to the provinces. Provinces, in turn, will need to upgrade their capacity to effectively spend the additional resources.

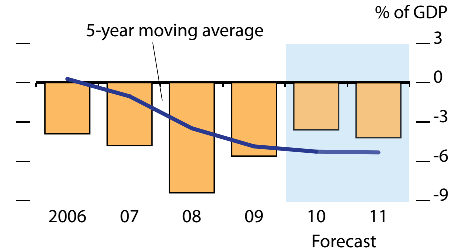
The provincial and federal governments will also need to coordinate more closely to maintain fiscal stability and meet the deficit targets.

Exports are predicted to contract once more in FY2010, although only by 1.4%. Inflation will limit depreciation of the real effective exchange rate and block increased export price competitiveness. Imports, too, will decline in FY2010 by about 2.4% from their level in FY2009 because of continued suppressed investment and economic activity. Backed by the still robust remittance inflows (up by 17.7% in the first 8 months), the current account deficit in FY2010 is projected to fall to 3.6% of GDP from 5.6% of GDP a year earlier.

The current account deficit (Figure 3.20.13) is expected to rise in FY2011 to 4.2% of GDP as imports grow by about 7.1% owing to recovery in non-oil imports, on account of stronger economic activity. Higher imports in FY2011 will, however, be offset to an extent by projected 4.2% growth in exports.

With FDI down sharply in the first 8 months of FY2010, financing the current account deficit will continue to depend heavily on debt-creating inflows from multilateral agencies, including FODP commitments. From FY2011, non-debt-creating inflows, such as foreign direct investment and privatization proceeds, could assume a greater share of such financing, but the outlook remains uncertain and debt sustainability remains a major concern.

3.20.13 Current account balance



Source: Asian Development Outlook database.

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Development challenges

Pakistan faces three interconnected development challenges. The first is its weak fiscal situation, marked by underperformance in government revenue over the years. The second is low growth and the challenge to revive it so as to create jobs and reduce poverty. The third is to improve the competitiveness of the economy so as to expand exports, sustain growth, and avoid balance-of-payments problems in the future.

Pakistan's economic crisis that erupted in FY2008 was essentially fiscal. To strengthen public finances, the government has embarked on an ambitious track of revenue reforms centering on institutionalizing the new VAT, which it estimates will yield an increase in the tax-to-GDP ratio of several percentage points. Tax administration reforms to strengthen compliance, reduce exemptions, and harmonize tax collection and monitoring systems are also under way. These reforms are critical to generate the fiscal space necessary to reinstate public investment and free up banking and nonbanking finance to support private investment.

Likewise, reforms toward a technically and financially sustainable power sector will release fiscal space and reduce the sector's strain on the budget, and, crucially, create an enabling environment for growth, investment, and business development. Medium- and long-term growth depends on sustained political commitment to these structural tax and power reforms.

Part of the competitiveness challenge is to generate a diversified, vibrant, and higher value-adding export base. Such a base will not only lead to a smaller current account deficit and improved debt profile, but will also result in higher growth and greater generation of jobs to absorb the country's growing labor force.