Pakistan

The unprecedented increase in global oil and food prices and domestic policy uncertainties in a turbulent political year stressed the economy in FY2008, as revealed in a slowdown in growth, a buildup in inflation, wide fiscal and current account deficits, a weaker currency, and a large drop in foreign reserves. Increased risk perception was seen in a downgrading of credit ratings, a rise in sovereign bond spreads, a slide in capital inflows, and declining access to international capital. With continued high oil prices, an ongoing power deficit, and tightened demand management policies to correct macroeconomic imbalances, economic growth in FY2009 is put at only 4.5%. High inflation will persist as domestic fuel, food, and power subsidies are rationalized. Although imbalances are expected to shrink they cannot be eliminated quickly. To move forward, a coherent and credible short- to medium-term economic stabilization and reform program needs to be adopted and implemented.

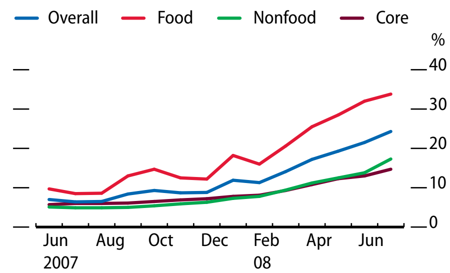
Updated assessment

FY2008 (ended June 2008) was a tumultuous year, and GDP growth slowed to 5.8%. Agriculture in particular suffered as major crops such as cotton and wheat failed to reach targets because of weather conditions, insufficient water, pest attacks, higher costs of fertilizer, and a delayed government announcement of the support price for wheat (which led to a lower sown area). Manufacturing growth—hit by a listless textile subsector, power shortages, and political disturbances in major industrial towns—fell by half to 5.4%, after averaging over 11% in the previous 4 fiscal years. Construction maintained relatively strong growth. Services remained the main economic driver, rising by 8.2%, backed by thriving wholesale and retail trade, a strong expansion in telecommunications, and robust financial activity.

Real private consumption was the largest contributor to growth from the demand side, underpinned by booming remittances and high food and fuel subsidies. Private investment in contrast stagnated, falling to 14.2% of GDP on account of political uncertainty, power shortages, and a downgrade in credit ratings. National savings as a share of GDP declined even more, widening the savings–investment gap. Net exports once again subtracted from growth as import volumes expanded markedly, with demand bolstered by domestic subsidies on oil and some food commodities.

Some pass-through of the substantial rise in international food and oil prices from 1 March 2008 (when the Government began raising administered prices), together with lower domestic food production, a depreciating currency, and strong consumption led to a surge in inflation in FY2008 (Figure 3.7.1). It averaged 12.0% for FY2008, the first time in 11 years it has hit double digits. Food inflation year on year reached 32% in June 2008 as prices of essential food commodities jumped, and

3.7.1 Inflation



Source: State Bank of Pakistan, available: http://sbp.org.pk, downloaded 13 August 2008.

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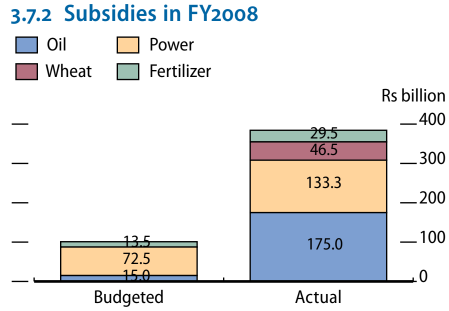
3.7.2 Subsidies in FY2008



Source: Ministry of Finance, federal budget documents, June 2008.

Click here for figure data

This chapter was written by Jesus Felipe of the Central and West Asia Department, ADB, Manila; and Safdar Parvez of the Pakistan Resident Mission, ADB, Islamabad.

accounted for much of the 21.5% increase in overall inflation in June (Box 3.7.1). It also fed into core inflation, which rose by 13.0% in June 2008, year on year. The State Bank of Pakistan (SBP), in its Monetary Policy Statement for July–December 2008, estimated that about one third of inflation came from the direct and indirect impacts of higher commodity prices in FY2008.

To help protect consumers from the impact of rising inflation, the Government provided large subsidies for oil products, electricity, imported wheat, and fertilizer. Although actual subsidies in FY2008 were much higher than had been budgeted (Figure 3.7.2 on previous page), many subsidies were not targeted and therefore had only a weak impact in protecting the poorest.

The large gap between actual and budgeted subsidies and higher interest payments overrode the impact of lower than targeted development expenditure, and resulted in a significant deterioration in the fiscal deficit, which substantially widened to 7.4% of GDP, surpassing the targeted deficit of 4.0%. The budgeted revenue target was achieved, helped by rising nontax collections; however, revenue growth did not match that of nominal GDP, causing the revenue-to-GDP ratio to fall to 14.3% from 14.9% in FY2007, while the tax-to-GDP ratio was stagnant at 10.0%.

To finance the burgeoning fiscal deficit in FY2008 at a time of dwindling external capital inflows (which covered only 26% of the fiscal deficit—Figure 3.7.3), and given the reluctance of commercial banks to purchase Treasury bills, the Government was compelled to borrow PRs689 billion from SBP (Table 3.7.1), equivalent to almost a third of total government expenditure. Government borrowing from SBP was the single largest contributor to the 15.4% growth in broad money supply, which was inconsistent with SBP's effort to contain monetary growth. That would have been higher still had it not been accompanied by a marked drop in net foreign assets of the banking system.

With regard to monetary measures in FY2008, SBP raised the discount rate three times by a cumulative 250 basis points and increased commercial banks' cash-reserve requirements. Real commercial lending rates stayed negative. Private sector credit grew by 16.5%, only slightly less than a year earlier. Nevertheless, high inflation persisted as a result of elevated commodity prices.

The fiscal slide, precipitated by the failure to pass on the hike in international oil prices,

3.7.1 Monetary aggregates (flows, PRs billion)

	FY2007	FY2008
Net domestic assets	**383.7**	**940.4**
of which:		
Domestic credit	478.5	1,025.3
Growth (%)	*15.8*	*29.3*
Government sector[a]	92.8	583.6
Nongovernment sector[b]	385.7	441.7
Net foreign assets	**274.6**	**-316.4**
State Bank of Pakistan	222.7	-307
Commercial (scheduled) banks	51.8	-9.4
Money supply (M2)	**658.3**	**624**
Growth (%)	*19.3*	*15.4*
Memorandum items		
Net budgetary support	102	554.6
From State Bank of Pakistan	58.6	688.7
From commercial (scheduled) banks	160.6	-134.2
Private sector credit	365.7	408.4
Growth (%)	*17.3*	*16.5*
Reserve money	209.1	260.9
Growth (%)	*20.9*	*21.6*

[a] Includes credit for commodity operations and net budgetary support. [b] Includes credit to private sector and public sector enterprises.

Source: State Bank of Pakistan, available: www.sbp.org.pk, downloaded 24 July 2008.

3.7.1 Impact of food and fuel price increases

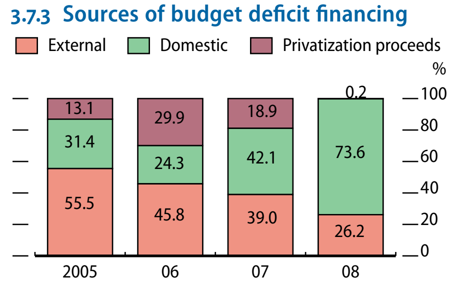
The recent increase in domestic prices in Pakistan has come from a few commodities, mainly wheat flour, rice, vegetable ghee, and fresh milk. In June 2008, their prices increased by 75%, 93.4%, 54.3%, and 22.7%, respectively, on a year-on-year basis. The box table shows each commodity's contribution to overall inflation in FY2007 and FY2008.

Contribution to year-on-year inflation by category (percentage points)

Item	FY2007	FY2008
Food	3.90	12.93
Wheat flour	0.35	3.83
Rice	0.65	1.25
Vegetable ghee	1.02	1.45
Milk fresh	0.85	1.51
Others	1.03	4.89
Transport and communication	-0.22	1.82
Gasoline (petrol)	-0.12	0.71
All others	3.32	6.78
Overall inflation (%)	7.00	21.53

Source: Staff estimates.

3.7.3 Sources of budget deficit financing



Sources: Ministry of Finance, *Pakistan Economic Survey 2007–08*; State Bank of Pakistan, *Monetary Policy Statement July–December 2008*.

Click here for figure data

became intertwined with the corresponding rise in the oil import bill, which was driven higher by both price and quantity increases. The direct subsidy on diesel and kerosene oil—the Price Differential Claim paid to oil-marketing companies, as well as the implicit subsidy through a reduction in the Petroleum Development Levy—helped sustain the high oil demand. The 2-weekly adjustment mechanism in domestic oil prices to respond to changes in international prices had been suspended in May 2006, and oil price adjustments only restarted in 1 March this year, with five subsequent upward moves through 21 July. So far, the adjustment to counter the impact of the rise in international prices has been incomplete (Box 3.7.2), although the Government has committed itself to eliminating all subsidies on oil products by December this year.

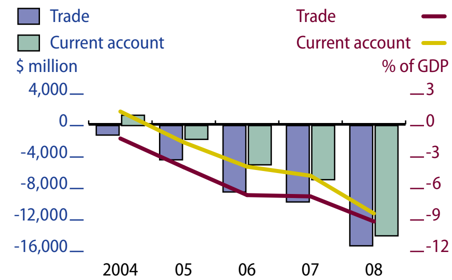
Oil imports increased by 43% in FY2008, and reached $10.5 billion. This was the major cause of the worsening trade deficit, which soared by 57.4% to $15.3 billion, even though the annual export target of $19.2 billion was exceeded. The main reasons for the good export performance were higher rice exports, which increased by 40% following sluggish production and export restrictions in the major rice-producing countries and higher international prices; the trebling of cement exports resulting from strong demand by Middle East and African countries; and strong growth of exports of chemical products, especially plastic materials. These categories' robust performance compensated for the continued stagnation of textile exports, which stemmed from strong international competition, domestic production losses due to power shortages, and disruption caused by the political and security situation.

The food import bill swelled by 46% and was another key contributor to the trade deficit, driven by $1.52 billion imports of edible oil and $571 million of wheat imports as domestic consumption outstripped supply. The overall trade deficit and deterioration in the services and income accounts resulted in a huge $14.0 billion current account deficit, or 8.4% of GDP (Figure 3.7.4). This deficit would have been even wider had it not been for workers' buoyant remittances, which, helped by the oil boom in the Middle East, continued to grow by 17.4% to total $6.5 billion in FY2008.

The heavy fiscal and current account deficits struck at a time when capital inflows slowed over anxieties concerning the domestic political and security situation and the turmoil in international credit markets. Led by a significant drop in portfolio investment, foreign private investment fell by 38.4% (despite the resilience of foreign direct investment, which was unchanged from a year earlier). This decline, along with a stall in the privatization program, was indicative of investors' concern over the weakened fundamentals of the economy. The larger current account deficit thus resulted in a significant drawdown of foreign exchange reserves, as capital inflows slowed. Overall foreign exchange reserves fell by almost a third, from a high of $16.5 billion in October 2007 to $11.3 billion in June and to $9.4 billion as of 22 August 2008 (Figure 3.7.5).

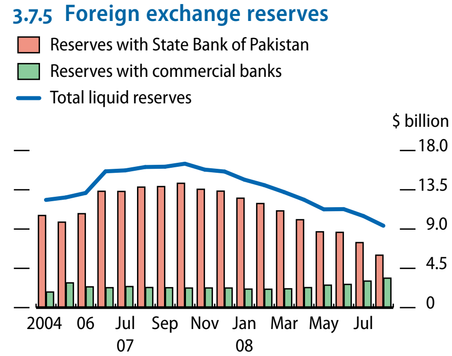
The Karachi Stock Market, which until recently had seen one of the largest price runups in developing Asia, succumbed to political uncertainty and weakened economic fundamentals as the KSE-100 index started falling precipitously, after peaking at 15,677 on 18 April 2008, to drop below 10,000 on 4 August (Figure 3.7.6).

3.7.4 Trade and current account balances



Source: State Bank of Pakistan, *Annual Report,* various years.
Click here for figure data

3.7.5 Foreign exchange reserves



Source: State Bank of Pakistan, available: http://sbp.org.pk, downloaded 1 September 2008.
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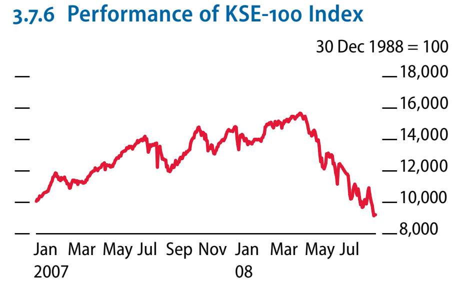
3.7.6 Performance of KSE-100 Index



Source: Karachi Stock Exchange, available: http://www.kse.net.pk, downloaded 1 September 2008.
Click here for figure data

3.7.2 Oil subsidies and pass-through to consumers

On 1 March 2008, the Government started adjusting upward the administered prices of key fuel items, partially passing on the impact of higher prices to consumers. The price that consumers pay equals the import parity price of oil minus the Price Differential Claim paid by the Government; the margins of the oil-marketing companies and dealers; and inland freight and taxes (excise duty, Petroleum Development Levy, and sales tax).

The Price Differential Claim is the direct subsidy paid by the Government on the import price of kerosene and light diesel oil, and is paid directly by the Government to the oil-marketing companies. In addition, the Government provides an implicit subsidy in the form of a reduction in Petroleum Development Levy to stabilize the domestic price of kerosene and light diesel oil. In the case of high-octane and regular gasoline, the Price Differential Claim subsidy was introduced in June 2008 but was eliminated on both products from 1 July this year.

The upper part of the box table shows the absolute levels of import and domestic prices of kerosene, light diesel oil, and high-octane and regular gasoline. The left side of the lower part of the table shows the Price Differential Claim in absolute terms and as percentage of the total import price. In absolute terms, subsidies on kerosene and light diesel oil increased until July 2008, but then sharply fell in August 2008 as the Government started reducing the Price Differential Claim following the decline in international oil prices. As a percentage of the total import price, the subsidies on kerosene and light diesel oil have declined from their peak levels in May 2008 and registered a significant fall in August 2008.

The right side of the lower part of the box table provides the ratio of domestic to total import prices, which is a proxy for the pass-through, that is, how much of the increase in import prices has been passed on to consumers. These figures indicate that the Government continues to subsidize kerosene and light diesel oil; a return of their price ratios to July 2007 levels would restore margins and taxes and bring subsidies back to a range of 15–20% of the import price that prevailed at that time.

The price ratios for high-octane and regular gasoline are near or exceed the July 2007 level, indicating restoration of the earlier tax rates and margins. Using an average exchange rate of PRs76.51/$1, regular gasoline in August sold for $1.13 per liter and light diesel oil for $0.74 per liter.

Oil prices, subsidies, and pass-through

Oil prices, international and domestic

	Kerosene (PRs per liter)		Light diesel oil (PRs per liter)		High-octane gasoline (PRs per liter)		Gasoline (PRs per liter)	
	Total import price	Domestic price	Total import price	Domestic price	Total import price	Domestic price	Total import price	Domestic price
July 2007	33.45	35.23	30.84	32.57	35.05	64.88	34.22	53.70
January 2008	43.27	35.23	40.86	32.57	43.23	64.88	42.26	53.70
May	62.63	41.44	58.17	44.59	52.76	80.77	51.63	68.81
June	70.58	49.73	66.73	49.05	61.25	88.85	59.98	75.69
July	77.69	58.37	73.07	56.50	66.48	96.08	65.11	86.66
August	66.23	58.37	61.57	56.50	55.81	96.08	50.27	86.66

Price Differential Claim (subsidies)

	PRs per liter		As share of import parity price (%)	
	Kerosene	Light diesel oil	Kerosene	Light diesel oil
July 2007	5.33	5.58	15.9	18.1
January 2008	17.9	16.3	41.4	39.9
May	32.14	23.86	51.3	41.0
June	33.57	29.04	47.6	43.5
July	33.93	29.4	43.7	40.2
August	18.47	16.82	27.9	27.3

Pass-through to consumers

	Ratio of domestic price to total import price (%)			
	Kerosene	Light diesel oil	High-octane gasoline	Gasoline
July 2007	105	106	185	157
January 2008	81	80	150	127
May	66	77	153	133
June	70	74	145	126
July	75	77	145	133
August	88	92	172	172

Source: Staff estimates.

Negative market sentiment was reinforced in May when Standard and Poor's downgraded Pakistan's debt rating from B+ to B and its long-term local currency rating from BB to BB-. Moody's quickly followed suit. This market pessimism translated into a risk premium of 912 basis points on the spread of sovereign bonds by 19 August 2008, and consequently plans to access international capital markets through sovereign bond issuance and global depository receipts were deferred (Figure 3.7.7).

Undermined by the current account deficit, the slowdown in capital inflows, and the drop in reserves, the rupee–dollar exchange rate depreciated by 12% between 1 July 2007 and 30 June 2008 (Figure 3.7.8). Subsequently it depreciated further by about 11% through end-August. Higher interest rates were insufficient to arrest the decline of the rupee and, since end-April this year, SBP has adopted administrative measures, including suspending forward booking of imports, reducing advance payments against imports' letters of credit, and requiring foreign exchange companies both to obtain approval for transactions of over $50,000 and to surrender their "surplus" foreign currency to SBP. The sharp depreciation in the nominal exchange rate overshadowed the upward movement in the relative price index, such that the real effective exchange rate depreciated by 2.3% over the four quarters of FY2008 (Figure 3.7.9).

Prospects

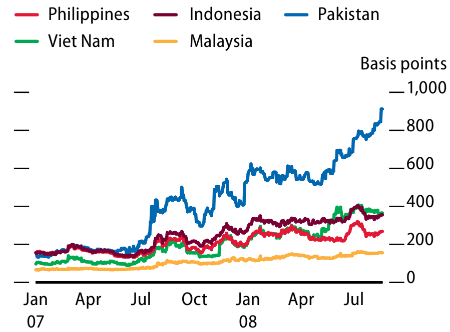
Economic projections for FY2009 are based on the following assumptions: political tensions will lessen leading to a more stable political environment, though uncertainty and security concerns will continue to affect economic decision making and investors' confidence; the stabilization measures announced in the budget to rationalize subsidies and curb demand will be implemented and overall demand management policies will be tight; international oil prices will remain high (as assumed in the baseline for this *Update*); and the pass-through of price adjustments related to the ending of oil subsidies as well as continued power shortages will increase the cost of doing business and therefore exacerbate inflation.

On these assumptions, growth in FY2009 is expected to remain subdued at 4.5%, with a continued slowdown in commodity-producing sectors. Domestic spending will have to rise less than output for the current account deficit to shrink. In these circumstances, export growth becomes crucial, as it will help make the current adjustment less painful. The faster the growth in exports the smaller the reduction in growth required to close the deficit.

In agriculture, cotton production is likely to fall short of target due to a reduction in the sown area and to a meal-bug virus attack. (Lower cotton production will hurt the textile industry.) It is too early to predict the winter wheat crop, which will depend on the availability of water and on the supply response of farmers to the expected adjustment in the procurement price to bring it close to international prices. Robust growth in services is expected to continue, although the sector will be affected by the tax measures announced in the budget and by power shortages.

On the demand side, private consumption in FY2009 will be hit by higher prices as food, oil, and power subsidies are rationalized.

3.7.7 JPMorgan Emerging Market Bond Index sovereign stripped spreads



Source: Datastream, downloaded 19 August 2008.

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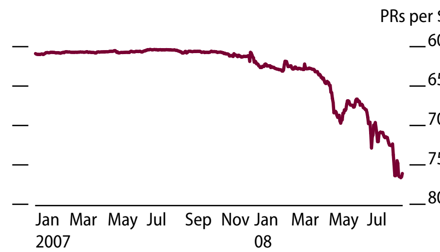
3.7.8 Daily exchange rate



Source: CEIC Data Company Ltd., downloaded 1 September 2008.

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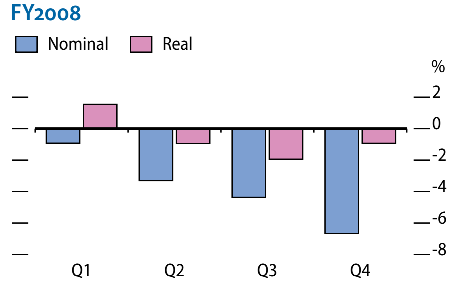
3.7.9 Change in effective exchange rates, FY2008



Source: State Bank of Pakistan, *Statistical Bulletin*, August 2008, available: http://www.sbp.org.pk.

Click here for figure data

Government expenditure will be suppressed by measures announced in the budget to contain current spending. Investment levels will be restrained by uncertainty, low capital inflows, and power shortages. The present power shortages are a result of chronic underinvestment in new generation capacity, high operational inefficiencies due to the lack of expansion of the power transmission and distribution infrastructure, and delayed institutional reforms. Although the Government is undertaking investment and reform in all these areas, the demand–supply gap will remain until new generation capacity comes on stream and the transmission and distribution infrastructure is upgraded.

With the Government setting out to progressively rationalize the oil subsidy by passing on higher prices to consumers and by reducing the subsidy between the full-cost producer price and tariffs charged for electricity, average inflation is projected to reach 20.0% in FY2009, higher than the government target of 11.0%. The planned adjustment of the domestic procurement wheat price will contribute to higher food inflation.

SBP has increased the discount rate several times since June 2007, taking it from 9.5% to 13.0% (Figure 3.7.10), and yet inflation has climbed. Moreover, the ensuing increase in the Karachi interbank offered rate has led to a rise in bank lending rates. SBP's interest rate tightening should increase the attractiveness of Treasury bills for commercial banks, and this would help reduce the Government's dependence on borrowing from SBP. An efficient way to achieve this objective, as recognized by SBP in the Monetary Policy Statement for July–December 2008, would be to limit the amount that the Government can borrow from SBP and encourage long-term nonbank borrowings. Achieving that statement's target of a 14% increase in money supply in FY2009, which is lower than in FY2008, would require strict limits on budget access to SBP credit.

To the extent that inflation in Pakistan is driven by high commodity prices, monetary tightening will have a limited impact on inflation and will most likely aggravate the economy's other structural problems. Excessive dependence on higher interest rates to stabilize prices will make firms reluctant to use debt financing and therefore push them to rely more heavily on self-financing, which might lead to less efficient capital allocation. Moreover, unless interest rates are raised significantly, it will probably take a long time for monetary policy to have an impact on the economy and inflation.

Although a tightening of expenditure policies, such as fiscal discipline, helps keep inflation in check, it also acts as a deflationary force resulting in underused production capacity and higher unemployment. A more effective anti-inflation tool would be identifying and eliminating fiscal programs that induce an inflationary bias in the economy, combined with pushing through moderate increases in interest rates to limit excessive credit expansion. Finally, to prevent a wage-price spiral, the authorities might consider implementing policies that link nominal wage increases to productivity increases and that limit increases in firms' markups, through, for example, tripartite (state, employer, worker) agreements.

The Government expects a significant reduction in the fiscal deficit as a result of the measures adopted in the FY2009 federal budget. These aim to reduce subsidies, curtail general government expenditure, and

3.7.2 Selected economic indicators (%)

	2008		2009	
	ADO 2008	*Update*	*ADO 2008*	*Update*
GDP growth	6.3	5.8	6.5	4.5
Inflation	8.0	12.0	6.5	20.0
Current acct. bal. (share of GDP)	-6.3	-8.4	-5.8	-8.0

Source: Staff estimates.

boost revenues. A rationalization of the large public sector development program announced in the budget will help contain public spending. However, the difficulties in achieving a planned increase in tax revenues of almost 25%, a 20% increase in public sector salaries and pensions, and the projected slowdown in growth imply that the fiscal deficit will likely exceed the government target of 4.7% of GDP—but the outcome should, though, be much better than in FY2008.

Despite the need to reduce the budget deficit, a crucial requirement is protecting the poor from the impact of high oil and food prices. In this regard, the social protection programs announced by the Government in the budget need to be implemented quickly. As part of this effort, the Government has launched the PRs34 billion Benazir Income Support Program, under which qualified beneficiaries will receive PRs1,000 a month.

Despite possible reduced oil consumption as a result of ending domestic subsidies, international oil prices are expected to remain relatively high and this will result in a continued heavy oil import bill. However, the projected slowdown in the economy, tight monetary policy, SBP's administrative steps to stabilize the exchange rate, and higher customs duties imposed in the budget on nonessential items will discourage non-oil imports particularly. As a result, imports are projected to grow at the relatively slow pace of 9.5% (in nominal US dollars) in FY2009. The Government's trade policy has set an export target of $22.1 billion, 10% higher than FY2008's exports. Even if this target is met, with slower growth in industry and weak global demand conditions, projected import growth will still result in a large trade deficit.

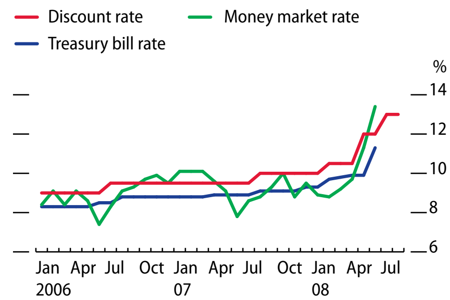
Taking account of continued growth in remittances, the current account deficit is projected to be marginally smaller than in FY2008, at 8.0% of GDP. The financing of the large fiscal and current account deficits will remain major challenges. If Pakistan's request to, for example, Saudi Arabia to grant a deferred-payment facility for oil is granted, this will help reduce pressure to finance the current account deficit. The long-term solution to the external deficits, however, involves a substantial upgrading and diversification of the export base.

Economic prospects for FY2009 remain sobering and require steadfast commitment by the Government to implement the various adjustment targets it has set for itself. It will need to maintain fiscal discipline, persist in cutting down untargeted subsidies and in passing through price increases (while compensating the poor adequately), and reduce reliance on borrowing from SBP. The reform program should also aim for a significant reduction in the current account deficit. Unless export growth picks up, this will require a significant reduction in domestic demand.

In parallel, the Government also needs to generate greater external inflows in order to increase foreign reserves through privatization, access to capital markets, and support from international development partners, besides pursuing and finalizing the Saudi oil facility.

Finally, over the medium term, the Government needs to implement programs that promote upgrading and diversification of the economic base. Potential risks include further increases in political uncertainty and a deterioration in the security situation on the country's western border.

3.7.10 Interest rates



Source: International Monetary Fund, *International Financial Statistics*, downloaded 1 September 2008.

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