Pakistan

Robust and broad-based growth marked FY2007 (ended June 2007). Vigorous domestic demand was the catalyst, but it also induced inflation pressures. Monetary policy was tightened while fiscal policy remained expansionary, and a key challenge will be to align the two policies more closely. Encouraging revenue performance helped keep the fiscal deficit unchanged relative to GDP, although the trade and current account deficits widened, financed by strong external inflows. A concern is that these inflows could slow or reverse. The present momentum is expected to continue in FY2008, moderated by the impact of tight monetary policy conditions, high international oil prices, and slow export growth.

Updated assessment

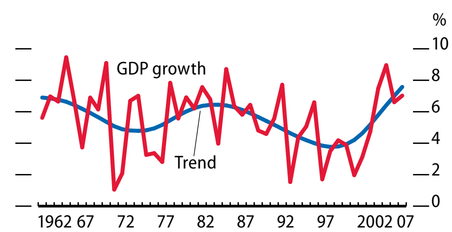
Underpinned by continued healthy domestic demand, the economy maintained its robust performance in FY2007, to achieve 7% growth (Figure 3.6.1). This outcome was broad based and supported by a solid recovery in agriculture (better availability of irrigation water), continued momentum in large-scale manufacturing, and sustained expansion of services. In recent years, growth from the demand side has been led by increased private consumption on rising per capita incomes, higher workers' remittances from abroad, and easier consumer credit (which, however, slowed sharply in FY2007 due to tighter monetary conditions).

In FY2007, private and government consumption contributed 45.4% of total output growth. For the first time in 4 years, total investment overtook private consumption as the largest contributor. This was the result of a strong expansion in real fixed investment of 20.6%, up from 17.6% in FY2006. As a share of GDP, total investment (including stocks) edged up from 21.8% to 23.0%. Several sectors, including manufacturing, construction, transport and communications, finance, and trade, witnessed high double-digit growth rates in private investment during the year.

On the production side, agriculture picked up in FY2007 (from stagnation in the previous year), posting 5.0% expansion. Large-scale manufacturing continued to grow briskly at 8.8%. However, as a result of unchanged raw cotton production and weakening export demand, the textile sector's performance was lackluster. Growth decelerated in the automobile sector too, as demand faltered, in part on the higher cost of consumer credit following a tightening of monetary policy. Rebuilding work in the regions that had been devastated by the October 2005 earthquake continued to boost a notable expansion in construction, just as greater private and foreign direct investment (FDI) did in the property sector.

Services, a major contributor to growth over the past 5 years, rose by 8.0%. Its momentum was spearheaded by the financial and telecommunications subsectors, both recipients of substantial amounts of

3.6.1 GDP growth



Note: Trend growth rates are calculated using a Hodrick-Prescott filter.

Source: Federal Bureau of Statistics, available: http://www.statpak.gov.pk, downloaded 21 August 2007.

Click here for figure data

FDI. Investment inflows resulting from the issuance of global depository receipts (securities listed and traded in a foreign stock exchange), as well as a series of mergers and acquisitions, further supported financial sector momentum.

Inflation, after averaging 8.6% in the previous 2 years, declined only marginally in FY2007 to 7.8% from 7.9% (Figure 3.6.2). Despite heightened global oil prices toward the end of the fiscal year, the Government did not raise domestic oil prices in response (having made some downward price adjustments in gasoline and diesel, in March 2007).

A tighter monetary policy brought down nonfood inflation markedly to 6.0% (from 8.6% in FY2006), which led to a moderation in overall core inflation (nonfood, nonenergy) to 5.5%, from 7.1%. But food prices, which make up 40% of the consumer price index, rose sharply by 10.3%, reflecting a combination of global trends and domestic factors: dependency on imports of edible oil, whose price increased; and a shortfall in local production of chilies, pulses, and fresh vegetables.

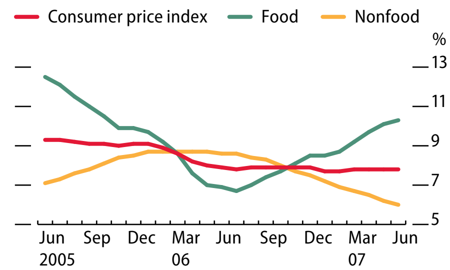
The State Bank of Pakistan (SBP), the central bank, tightened monetary policy for FY2007 to manage aggregate demand and so contain inflation pressures. In August 2006, it raised its discount rate (the main policy rate) from 9.0% to 9.5%; increased the statutory liquidity ratio from 15% to 18%; and raised the cash-reserve ratio for demand liabilities from 5% to 7%. However, the effectiveness of a tighter policy was confounded by unexpectedly large net capital account inflows which, despite a wider current account deficit, produced a very large overall balance-of-payments surplus.

Reflecting this higher surplus, net foreign assets of the banking system registered a sharp increase to PRs286 billion in FY2007. This boosted broad money supply (M2) growth to 19.3%, which overshot its 13.5% growth target. The sharp rise in SBP net foreign assets, plus much larger use of its special refinance facilities (for industry and exports) resulted in exceptionally high growth of 20.9% in reserve money, keeping liquidity conditions easy at banks.

With the high levels of net foreign exchange inflows, the central bank stepped up its purchases in the interbank market to maintain the currency steady against the US dollar at slightly above PRs60/$1 during the year. While it succeeded in avoiding nominal appreciation against the dollar, it incurred the cost of an increase in M2 and reserve money which, in turn, will most likely have a continuing inflation impact. (The decline in the US dollar against other currencies largely offset inflation differentials and the real effective exchange rate appreciated by marginally less than 1% in FY2007.) Open-market operations by SBP were sufficient to avoid a drop in bank lending rates, which changed little over the year. Private sector credit growth slowed to 16.9%, its lowest level in 3 years (Figure 3.6.3).

Fiscal policy remained expansionary. Actual total public expenditure in FY2007 at PRs1,675 billion was higher than planned and 19.5% greater than the previous year, while actual development spending rose to PRs433.7 billion (Figure 3.6.4). Borrowing from SBP was high for most of FY2007. An offshore $750 million bond issue in May 2007, however, helped the Government make a large repayment of its outstanding credit from the central bank at the end of the fiscal year. This masked SBP's

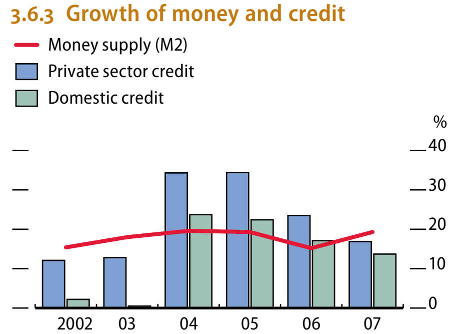
3.6.2 Inflation, 12-month moving average



Source: State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 31 August 2007.

Click here for figure data

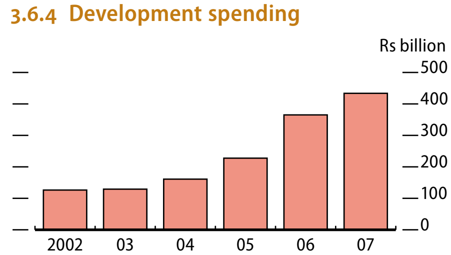
3.6.3 Growth of money and credit



Sources: Ministry of Finance, available: http://www.finance.gov.pk; State Bank of Pakistan, available: http://www.sbp.org.pk, both downloaded 8 September 2007.

Click here for figure data

3.6.4 Development spending



Source: Ministry of Finance, *Economic Survey 2006-07*, available: http://www.finance.gov.pk, downloaded 31 August 2007.

Click here for figure data

intrayear problems in controlling reserve money to achieve its policy targets, and highlights the need for closer alignment between monetary and fiscal policies to manage aggregate demand more effectively.

Nonbank borrowings through the national savings schemes and long-term Pakistan investment bonds picked up sharply in FY2007. Greater reliance on these sources, rather than domestic bank borrowing or the issue of foreign bonds, would limit the adverse macroeconomic consequences of an expansionary budget policy that seeks to rapidly advance development spending.

Tax receipts remained buoyant, exceeding the target. On the back of improved revenue collection and administration reforms, direct taxes in particular registered impressive growth of 48%. Accordingly, the share of direct taxes in total tax collected by the Central Board of Revenue rose to 39.4% from 31.6% a year earlier. This performance kept the budget deficit to 4.3% of GDP (Figure 3.6.5).

Export growth decelerated to a disappointing 3.3%, from 14.9% in FY2006. One reason was slower growth in textile exports (which account for around 60% of total exports), which appears to stem from greater international competition in the postquota era. Another important factor was marked weakness in the performance of the other exports category. The ultimate causes of poor exports are grounded in long-term and deep structural issues relating to the lack of diversification of export industries, poor compliance with quality standards, and concentration of exports in a small number of markets.

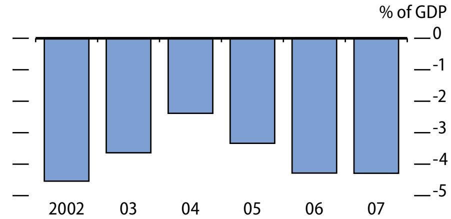
The growth of imports, too, in FY2007 saw a sharp deceleration, to 7.9%, from an average of 30% in the 3 previous fiscal years, reflecting the notable slowing in domestic consumption during the year: consumer and intermediate goods were virtually stagnant, (with large reductions in important items such as automobiles); oil imports moderated; but capital goods remained buoyant. Growth in oil imports also moderated. The trade deficit widened significantly in absolute levels but as a share of GDP was essentially static at 6.9%.

With a deterioration in the income account, the current account deficit (excluding official transfers) slumped to $7.5 billion (Figure 3.6.6). This represented a significant widening in dollar terms for the third year in a row, reaching 5.2% of GDP. Yet the deficit would have been even greater if workers' remittances had not increased by almost 20%, to $5.5 billion.

The financing of the current account deficit was again managed without difficulty, given that the financial account surplus amounted to an estimated $10.2 billion—a very large $4.3 billion advance relative to the previous year. However, the continuity of these flows is not ensured and thus raises questions about the deficit's sustainability. Nearly all the rise in the surplus came from non-debt-creating inflows that have financed the bulk of the large increases in the current account deficit of the past 3 years.

Total foreign private investment inflows nearly doubled to a record $8.4 billion from $4.5 billion a year earlier, including $5.1 billion in FDI (up from $3.5 billion; Box 3.6.1) and the balance of $3.3 billion in portfolio investment (up from $1.0 billion), mainly in equities. With a large $3.5 billion overall surplus, SBP foreign exchange reserves in FY2007

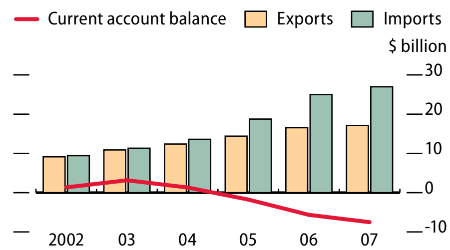
3.6.5 Budget balance



Source: Ministry of Finance, available: http://www.finance.gov.pk, downloaded 21 August 2007.

Click here for figure data

3.6.6 Current account indicators



Sources: Ministry of Finance, available: http://www.finance.gov.pk; State Bank of Pakistan, available: http://www.sbp.org.pk, both downloaded 31 August 2007.

Click here for figure data

3.6.7 Foreign exchange reserves

Sources: Ministry of Finance, available: http://www.finance.gov.pk; State Bank of Pakistan, available: http://www.sbp.org.pk, both downloaded 31 August 2007.

Click here for figure data

3.6.1 Trends in foreign direct investment

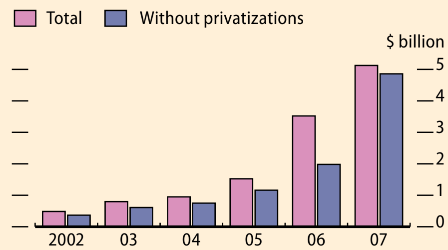
Foreign direct investment (FDI) has grown rapidly in recent years (Box figure). In FY2007, it reached an estimated $5.1 billion, for a year-on-year increase of 45.6%, and accounted for one half of the financial account surplus.

FDI flows have, however, been highly concentrated in four sectors: telecommunications, financial services, oil and gas, and tobacco and cigarettes. Together, these sectors accounted for three fourths of total FDI in the first 11 months of FY2007, with telecommunications on its own amounting to almost a third of total FDI. The largest investment in the telecoms sector in FY2007 came from the PRC, which amounted to about 16% of total FDI.

The financial sector was the second largest sector. Between July 2006 and May 2007, FDI amounted to $897 million, largely due to the consolidation in banking, which resulted in several large mergers and acquisitions. Investment in oil and gas exploration also rose significantly, by 77% compared with FY2006, and reached $480 million by May 2007. The tobacco and cigarette industry also registered a steep increase to $389 million in FY2007 from only $2.3 million in FY2006. This was mainly the result of an investment of $382 million by Philip Morris International to take over Lakson Tobacco.

Even with a record amount of FDI, efforts need to be made to lessen the level of concentration. Success will not only increase total FDI flows but will also result in reduced volatility attached to these flows. Unlike some other countries in the region, Pakistan attracts little FDI into manufacturing. This feature needs to be remedied to stimulate economic and employment growth, by bringing in improved technologies, business practices, and innovation so as to raise the level of manufacturing competitiveness and to accelerate structural change. In Part 2 of this *Update*, the role of FDI and wider supply-side considerations in promoting export performance are analyzed. Part 3 of *Asian Development Outlook 2007* discusses the role that diversification within manufacturing plays in promoting broader growth.

Inflow of foreign direct investment



Source: State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 21 August 2007.

Click here for figure data

climbed steeply to $13.3 billion (Figure 3.6.7). External debt as a share of GDP continued declining, to 26.9%.

Prospects

On the basis of strong demand, bolstered by increased private and public investment, the economy is seen keeping most of its momentum and achieving 6.5% growth in FY2008. The slight deceleration reflects several factors: the tightening of the monetary policy stance to contain consumer demand; the impact of high international oil prices; continued slow growth in exports, due mainly to greater international competition in the textile sector; and expected slow growth in the US economy (Pakistan's largest trading partner) in July–December 2007.

On 1 August 2007, SBP raised its discount rate from 9.5% to 10.0% and has recommended that the Government adopt quarterly ceilings for budgetary borrowings from itself. The central bank also took measures to limit refinancing from its special credit facilities. The tighter monetary policy is expected to continue to hold down nonfood inflation. The agricultural pickup in FY2007 should help ease the supply-side constraints that triggered food inflation, and good harvests in wheat, pulses, and sugar are likely to help stabilize their prices.

Overall, inflation in FY2008 is expected to subside to 6.5%. However, if the Government borrows more from the banking system to finance higher than budgeted expenditures resulting in a wider than planned

3.6.1 Selected economic indicators (%)

	2007		2008	
	ADO 2007	*Update*	*ADO 2007*	*Update*
GDP growth	6.8	7.0	6.5	6.5
Inflation	7.0	7.8	6.5	6.5
Current acct. bal. (share of GDP)	-4.5	-5.2	-3.9	-5.5

Source: Staff estimates.

deficit, or if external inflows are unexpectedly strong, SBP will likely find it difficult to offset the impact on the money supply and ultimately inflation.

The Government is to continue its expansionary fiscal policy in FY2008 as announced in the June budget, with an increase in salaries and pensions of government employees, larger subsidies, and a 20% hike in development spending. Expenditure on earthquake areas will continue, and relief and rehabilitation of districts in Sindh and Balochistan, badly affected by the recent rains and floods, will add to public spending. Servicing the domestic debt will also remain at high levels. The Central Board of Revenue expects receipts to stay robust, and the Government has set a 21% improvement target in revenue collection for FY2008. Taking these factors into account, the *Update* forecasts the fiscal deficit to be 4.2% of GDP in FY2008, slightly above the government budget plan of 4.0%.

On the external side, relatively slow growth in exports is projected because of continuing weakness in textiles, while import growth is expected to be elevated, reflecting a larger oil bill and continued robust expansion in investment. Accordingly, the trade deficit is likely to remain heavy at $11.4 billion or 7.1% of GDP. While the net services and income deficits will continue to widen, workers' remittances, targeted to reach $6.2 billion, should hold the current account deficit to $8.8 billion, or 5.5% of GDP, in FY2008. This level is well beyond the *ADO 2007* estimate of 3.9% of GDP.

Overall, Pakistan's growth over the 4-year period FY2003–2007 has averaged an impressive 7.5%, and this rate could be sustained in the medium term if two conditions are met: macroeconomic fundamentals remain strong, and policy commitment to governance and economic reform continues. Also, despite recent improvements, the still-low investment and savings rates represent a constraint to achieving and maintaining high growth, and that has to be addressed.

The lack of industrial and export diversification has to be rectified, to bring down persistent growth in the current account deficits to levels consistent with sustainable financing. As a matter of some urgency, ongoing power shortages, which could become a bottleneck to growth, need to be resolved. Yet the fundamental issue is a resolution of the current political uncertainties. The forthcoming presidential and parliamentary elections must be seen by the population as fair, and need to ensure the continuity and coherence of economic policy, so as to sustain economic and governance reforms.