Pakistan

Buoyant growth, improved macroeconomic fundamentals, and strengthened international credit ratings have been the economy's hallmarks in recent years. In fiscal year (FY) 2006, high oil prices, a weak agricultural performance, as well as the effect of the October 2005 earthquake, trimmed the expansion, while strong demand-side pressures have exposed macroeconomic stresses. The economy is expected to pick up slightly in FY2007, reflecting some strengthening in agriculture and manufacturing. Inflation is set to moderate, after a further tightening of monetary policy, but still come in above the central bank's target. Spurred by an expansionary, pro-growth fiscal policy, the budget deficit will widen slightly, as will the current account deficit. The medium-term outlook remains positive, but macroeconomic stability has to be maintained and structural issues addressed.

Economic performance

The economy has grown strongly over the past 3 years, at an average pace of 7.5%. After expanding at high rates in the preceding 2 years, the economy slowed in FY2006 (ended 30 June 2006), but still maintained a robust outturn of 6.6% (Figure 2.19.1). On the demand side, private consumption, boosted by continued rapid expansion in consumer credit and higher workers' remittances, continued to be a lead contributor to GDP growth for the third year running (Figure 2.19.2). Private sector credit expanded by about 24%. Total investment spending (fixed and inventories) rose to 20.0% of GDP in nominal terms, mainly because of a sharp increase in private investment.

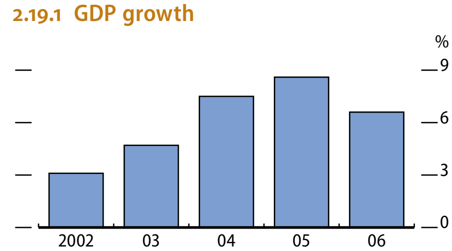
Over the last 3 years, improved business confidence and rising inflows of foreign direct investment (FDI) have buoyed private investment, but negative real interest rates on bank deposits and rising consumer demand have helped push down national savings, further widening the investment–savings gap. With a sharp rise in the current account deficit, the contribution of net exports of goods and nonfactor services became negative for the first time in 6 years.

On the supply side, GDP's deceleration in FY2006 was due to a sharp decline in agricultural growth and slower year-on-year growth in manufacturing, attributable to capacity constraints and the high-base effect. Services, in contrast, accounting for slightly more than half of GDP, gained further steam and recorded their fastest-ever growth rate of 8.8%.

In recent years, the Government's strong macroeconomic policies, high growth rates, increases in pro-poor spending, and burgeoning workers' remittances have all contributed to a steep decline in the incidence of poverty and the unemployment rate. According to official statistics, the proportion of the population living below the poverty line fell sharply from 34.5% in FY2001 to 23.9% in FY2005; in absolute terms, the number of poor people fell from 49 million to 37 million. The unemployment rate declined from 7.7% in FY2004 to 6.2% in FY2006.

Based on recent years' macroeconomic improvements and the strong

2.19.1 GDP growth



Source: State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 6 February 2007.

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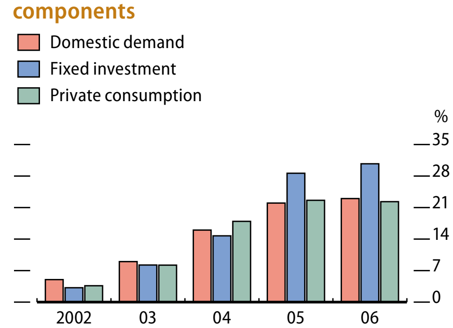
2.19.2 Growth of nominal demand components



Source: Federal Bureau of Statistics, available: http://www.statpak.gov.pk, downloaded 6 February 2007.

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growth potential of the economy, Standard and Poor's in December 2006 announced upgrades for credit ratings to B+ for foreign currency, BB for local currency long-term ratings, and B for short-term sovereign ratings.

Strong demand, catalyzed by increased investment and consumption expenditure, as well as the rise in workers' remittances, has outstripped supply and helped stoke inflationary pressures. Inflation, after peaking at 9.3% in FY2005, remained high at 7.9% in FY2006. The first half of FY2007 witnessed no change in inflation, as rising food prices offset easing oil and nonfood commodity prices. Food inflation rose to 12.7% at end-December 2006 from 7.8% at end-June (Figure 2.19.3), lifted by higher prices of milk as well as by edible oil and wheat, pulled by rising international levels.

In the context of a continuing expansionary fiscal policy, the onus of demand management rests on monetary policy. The State Bank of Pakistan, the central bank, started tightening monetary policy in the second half of FY2005 by raising the discount rate by 150 basis points to 9.0%. In FY2006, it focused on draining liquidity from the market to push up the interest rate structure and contain credit expansion.

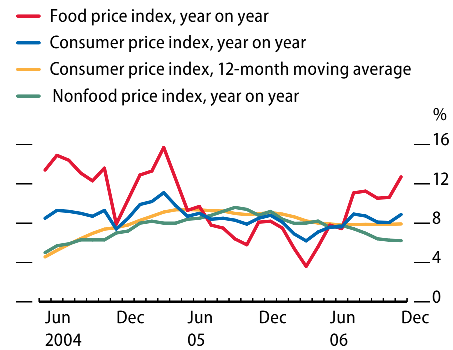
This policy succeeded in reducing growth in private sector credit and resulted in monetary growth that was below the increase in nominal GDP for the first time in 5 years. But, as high inflation persisted, the central bank further tightened monetary policy in July 2006 by raising the discount rate (by 50 basis points to 9.5%), the reserve requirement (on demand deposits by 200 basis points to 7.0%), and the liquidity requirement (by 300 basis points to 18.0% of demand and time deposits). Consequently, the average interest rate on new bank loans rose from 10.1% in June 2006 to 11.3% in December. Monetary growth declined (Figure 2.19.4) because of the decrease in domestic credit and the Government's reduced bank borrowing.

The State Bank of Pakistan continued a managed float policy and the nominal rupee/dollar parity rate remained stable in FY2006. With relatively high domestic inflation, the real effective exchange rate appreciated, which with strong domestic demand, contributed to the deterioration in the current account.

With advances in hand in structural reforms and macroeconomic fundamentals of recent years, the Government since FY2005 has pursued a pro-growth fiscal policy. Development outlays have sharply risen. Spending in the various pro-poor sectors defined in the poverty reduction strategy paper, in particular, increased from 4.8% of GDP in FY2005 to 5.6% the following year. Alongside this, unplanned spending on relief and reconstruction in areas affected by the October 2005 earthquake also contributed to a sharp increase in public expenditures in FY2006, raising the fiscal deficit to 4.2% of GDP (Figure 2.19.5). Excluding earthquake-related spending, the fiscal deficit was 3.4% of GDP, little changed from FY2005. The primary balance, however, which is a more accurate reflection of the Government's discretionary fiscal stance because it excludes the impact of interest payments, turned into a deficit in FY2006 after being in surplus the preceding 4 years.

The current account of the balance of payments has recorded increasingly wide deficits in the last 2 years, after posting large surpluses in the preceding 3 years). In FY2006, the current account deficit,

2.19.3 Inflation



Source: Federal Bureau of Statistics, available: http://www.statpak.gov.pk, downloaded 20 January 2007.

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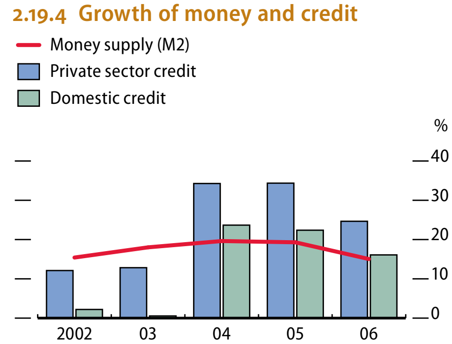
2.19.4 Growth of money and credit



Sources: Ministry of Finance, available: http://www.finance.gov.pk, downloaded 12 March 2007; State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 29 August 2006.

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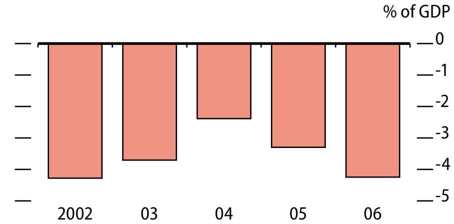
excluding official transfers, more than tripled to $5.7 billion, or 4.4% of GDP, from 1.6% of GDP in FY2005, as import growth outstripped export growth (reflecting higher oil prices and strong domestic demand; Figure 2.19.6). The deficit would have been larger still but for the very robust increase in workers' remittances to $4.6 billion.

The current account deficit was easily financed through non-debt-creating inflows and concessional loans from multilateral agencies. In fact, the overall balance of payments posted a substantial improvement in FY2006. Official foreign exchange reserves rose, and the external debt-to-GDP ratio remained on a downward trajectory, declining further to 28% in FY2006 from 31% in FY2005. However, ever-greater reliance on privatization proceeds, official grants, and portfolio investment, which together financed 45.3% of the current account deficit, raises issues of sustainability of financing large deficits over the medium and long term.

The improved policy environment has stimulated a multifold increase in FDI in recent years, which has risen from $483 million in FY2002 to $3,451 million in FY2006. The first half of FY2007 saw an inflow of $1,873 million. About 70% of total FDI is concentrated in just four sectors: telecommunications, oil and gas exploration, petroleum refineries, and financial businesses.

Privatization picked up further in FY2006 when two large entities—the Pakistan Telecommunication Company Limited and the Karachi Electric Supply Company—were privatized. A sum of $1.5 billion was raised in privatization proceeds, which represented 43% of total FDI in FY2006. In the last few years, the Government has also used the domestic stock market for selling the shares of public sector enterprises to the general public to broaden the base of share holdings. In December 2006, it ventured into the international equity market for the first time in several years, raising $731 million in global depository receipts issued by the Oil and Gas Development Corporation on the London Stock Exchange.

2.19.5 Budget balance



Source: Ministry of Finance, available: http://www.finance.gov.pk, downloaded 9 March 2007.

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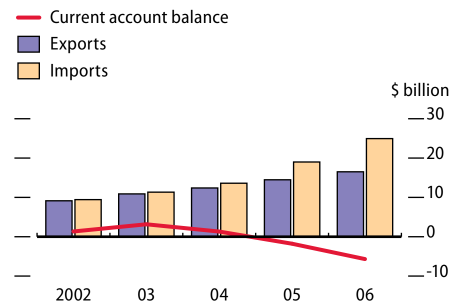
2.19.6 Balance-of-payments indicators



Source: State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 12 March 2007.

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Economic prospects

The prognosis for FY2007 and FY2008 is based on the assumptions that the authorities will continue, or perhaps strengthen, the economic reforms of recent years, and that they will press on with relieving the macroeconomic stresses that have emerged in the last couple of years. It is assumed that the central bank will continue its tight monetary policy and pursue a flexible exchange rate policy. Globally, economic growth in the United States (US) and the European Union (EU), the country's two largest trading partners, is assumed to slow somewhat, as is the growth of world trade volume.

The sharp rise in investment last year and moderation in oil prices are expected to boost growth in FY2007. However, shortages of natural gas and suspension of its supply to a number of industrial units to meet the rising demand for household consumption (because of exceptionally cold weather) will likely depress industrial growth, which along with the ongoing slowdown in exports, will dampen the expansion. Agriculture and manufacturing have improved in the first half of FY2007, and services appear to be growing robustly, but somewhat less quickly than last year.

2.19.1 Selected economic indicators

	2007	2008
GDP growth	6.8	6.5
Inflation	7.0	6.5
Current account balance (% of GDP)	-4.5	-3.9

Source: Staff estimates.

With developments to date, the economy is projected to grow by 6.8% in FY2007, a solid expansion but essentially unchanged from a year ago (Figure 2.19.7).

In agriculture, production of the major summer crops in FY2007 has shown improvement. The higher offtake of fertilizers and a substantial increase in production loans for agriculture, as well as greater availability of water, all augur well for winter crops. The new package of incentives for livestock, announced in the FY2007 budget, and high prices of livestock products throughout last year, will also boost livestock production. Agriculture is projected to grow by 4.0% in FY2007.

Large-scale manufacturing, which constitutes almost half of the value added in industry, is expected to grow by 8.6%, supported by incentives provided in this year's budget. Growth in textiles and clothing, however, is expected to soften, on lower than targeted output of cotton and weakening export demand. The significantly larger public sector development program, reconstruction of earthquake-affected areas, and greater supply of cement will all boost construction output in FY2007. Hydropower generation will be bolstered by greater rainfall and availability of water in the two main water reservoirs. In all, industrial growth should pick up to 8.6%.

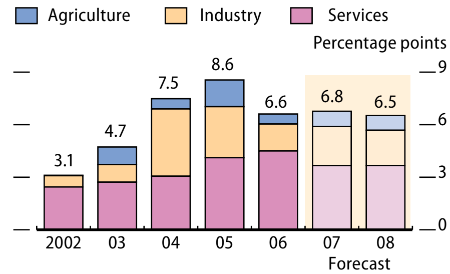
In services, rising foreign investment in telecoms and privatization of the Pakistan Telecommunication Company last year will help sustain vigorous growth. Strengthened by reforms, privatization, and ongoing mergers and acquisitions, the financial sector is expected to stay lively. It will be further spurred by the planned flotation of new global depository receipts for some financial institutions. However, the growth of wholesale and retail trade will slow because of decelerating exports and imports. Services as a whole is projected to grow by more than 7% in FY2007, somewhat off last year's fast pace.

In FY2008, on the back of the expected continuing strength in services and stable growth in manufacturing, GDP is projected to slow slightly to 6.5%. This is still solid performance but less than the projected 7.6% in the Government's Medium-Term Development Framework. The buildup of macroeconomic imbalances and the consequent tight monetary conditions, emerging capacity constraints, infrastructure bottlenecks, and issues of competitiveness in exports of textiles and clothing—on which the economy is overdependent (Box 2.19.1)—are some of the key constraints to reaching the Framework's target.

Inflation is expected to decline further in FY2007, under the weight of continued tight monetary conditions. After resisting demands for cutting domestic prices of petroleum products for 9 months, the Government finally lowered these prices in January 2007. This will have a damping effect on prices throughout the economy in the coming months, as will the slower monetary growth last year. But, because of the upsurge in food prices and higher prices of raw materials, inflation is projected at 7.0%, above the central bank's target of 6.5%. Sustained tight money is likely to take inflation down to 6.5% in FY2008 (Figure 2.19.8).

With projected strong GDP growth, ongoing tax reforms, extension of the tax net to real estate transactions, and higher tax rates on some financial services in the FY2007 budget, tax receipts are expected to maintain double-digit growth and be above the budget target. Despite a

2.19.7 Contributions to growth (supply)



Sources: State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 6 February 2007; staff estimates.

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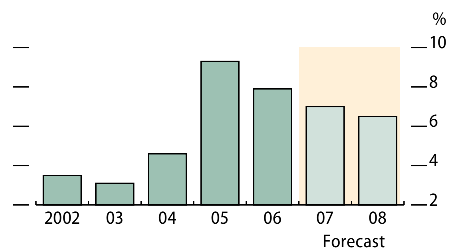
2.19.8 Inflation



Sources: State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 6 February 2007; staff estimates.

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2.19.1 Export performance

Over the past 5 years, merchandise exports have delivered over 12% average annual growth, as they have benefited from an enabling policy environment, low inflation, the low cost of credit, and general upturn in economic activity. In FY2005 and FY2006, they grew by 16.6% and 15.4%, respectively, but started decelerating in the second half of FY2006, to just over 6.5%, and to 5.0% in the first half of FY2007. Some of the deceleration stems from the high-base effect, but the underlying causes appear structural.

The main issue is exports' heavy reliance on textiles as well as limited geographic diversification. Between them, textiles and clothing, cotton, leather, rice, and sports goods account for over three quarters of total exports—textiles and clothing alone for three fifths. Thus a downturn in these segments has a significant overall impact.

Conversely, immediately after the ending of quotas, textile exports accelerated strongly, to 16.8% in FY2006 from 6.6% the year before. Increasingly, however, textile exports have come under competitive pressure from Bangladesh, People's Republic of China, and India, specifically in the higher value-added categories that have traditionally not been a strength of the Pakistani textile sector. This pressure, in turn, has led to a fall in international export prices. Consequently, Pakistani textile exports increased by only 4.3% by value in the first half of FY2007 (box table). The low expected cotton production in 2007 will further hit textile exports, as will the removal of restrictions on textile exports from the People's Republic of China in 2008.

Another issue is that the bulk of Pakistan's trade is with a handful of countries, particularly in Europe and North America. It is expected that the growth in trading volumes in those regions will decline in 2007, hitting Pakistan's exports there.

Export growth of major commodities

Commodity	FY2005	FY2006	July–Dec 2005	July–Dec 2006
Textiles and clothing	6.6	16.8	32.5	4.3
Rice	47.1	19.3	46.4	1.2
Leather and leather products	18.7	16.1	31.3	-26.3
Sports goods	-3.0	13.4	6.9	-14.4

Thus, lack of export diversification—for products and markets—is the main reason for recent sluggish performance. Trade policy should therefore focus on developing strategies for diversification and enhancing export competitiveness.

decrease in the domestic oil price, the petroleum levy will likely continue to yield significant income, as will receipts from the US for logistics support operations for Afghanistan. Current expenditures, though, are expected to exceed the budget estimate, because of expected overruns in the interest payment on domestic debt. On balance, the fiscal deficit is likely to rise to 4.5% of GDP in FY2007, coming in at the planned level.

Import growth is set to decelerate in FY2007, on account of moderation in the oil import bill, weaker demand for consumer durables, and some rundown from an apparent buildup of inventories in FY2006 (Figure 2.19.9). Nevertheless, sustained growth and the forecast rise in investment are projected to keep import growth at about 9%. Exports too will rise, but the high domestic cost of production in the textile and garment sector as well as stiff competition from the People's Republic of China (PRC) and India are likely to restrict total export growth to about 8.0%. The current account deficit is projected to edge up to $6.5 billion, or 4.5% of GDP in FY2007. With the expected stabilization in GDP growth, cooling demand for consumer durables (on higher interest rates), and softening in oil prices, import growth is likely to be moderate in FY2008. As a result, the current account deficit could decline to $6.0 billion, or 3.9% of GDP (Figure 2.19.10).

In an environment of pro-growth government policies, a continuous increase in the public sector development program, and the projected rise in investment, the medium-term outlook for the economy is positive. Greater trade volumes with countries in the region, including the PRC, will also help. The boom in banking and telecoms is likely

to continue, as the policy environment for these sectors is favorable. Foreign hydrocarbons investments in recent years will have an output payoff. Finally, significantly strengthened through reforms and mergers and acquisitions, the banking system is well positioned to better channel savings to productive uses.

The growing current account deficit, continuing high inflation, and the emerging power and gas shortages are potential risks to the country's medium-term economic prospects. Any deterioration in the security environment would be another. In addition, the ending in 2008 of PRC-specific safeguards imposed by the US and EU against textile and clothing imports could further weaken Pakistan's textile export prospects.

Development challenges

After the so-called lost decade of the 1990s, the strong performance in the new decade so far is attributable to sound macroeconomic management policies and pursuit of structural reforms in key areas.

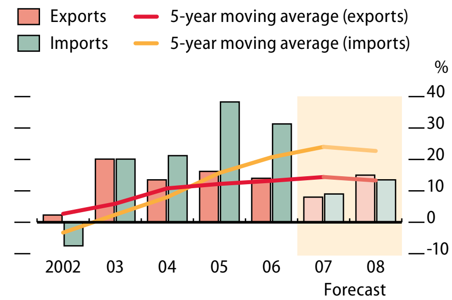
Still, important structural challenges remain and have to be tackled promptly to sustain the present growth trend. Despite healthier investment, the investment-to-GDP ratio is still low relative to countries that have experienced sustained strong growth. Even if investment in the country is underestimated, gross capital formation in 2004 was less than half of that in the PRC and about 60% of that in India or Thailand. Total factor productivity has improved, but insufficiently either to compensate for low investment or to sustain high growth.

Similarly, gross savings as a share of GDP needs to pick up substantially. In recent years, the demand-driven growth and negative real interest rates on bank deposits have contributed to low savings. Another issue is the narrow industrial base, which is linked to the lack of a diversified export base, which in turn must cope with rising international competition.

Human capital development remains a major structural challenge. Despite the recent rise in pro-poor spending, historical underinvestment in human capital has critical implications for growth and competitiveness. Public spending on education was only 2.0% of GDP in 2004, compared with 6.0% in Malaysia, 4.0% in Thailand, and 3.0% in the PRC and India. Unsurprisingly, the human development index rating was the lowest among these countries as well. The Government has, however, announced its commitment to increasing education expenditures to 4.0% of GDP. Finally, critical physical infrastructure bottlenecks impede high growth.

The Government is tackling these structural challenges over the medium term by committing to reform, by strengthening the enabling environment for investment, and by prioritizing resource allocation for infrastructure development and the social sectors.

2.19.9 Export and import growth



Sources: State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 6 February 2007; staff estimates.

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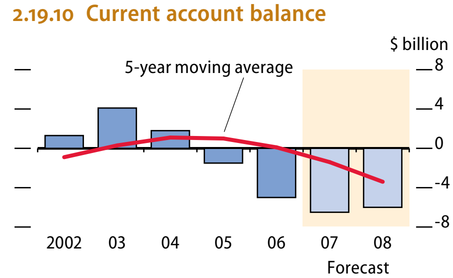
2.19.10 Current account balance



Sources: State Bank of Pakistan, available: http://www.sbp.org.pk, downloaded 6 February 2007; staff estimates.

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