Pakistan

Growth strengthened further in FY2005 to its fastest rate in two decades, dragging inflation sharply higher and weakening the external balance. In the first half of FY2006, growth softened, but inflation remained fairly high and the balance-of-payments deficit continued to widen. Nevertheless, the economy is expected to maintain its strong showing over the full year. Over the medium term, the outlook is favorable for growth in the range of 6–8%, though this requires the Government to maintain its robust performance in economic management, greater investment to ease infrastructure bottlenecks, and continued security and political stability. Relief efforts and reconstruction in response to the October 2005 earthquake that caused great loss of life and privation as well as substantial property damage is a huge burden for the country, even though international assistance has been extensive and pledged aid should cover the financial costs of the disaster.

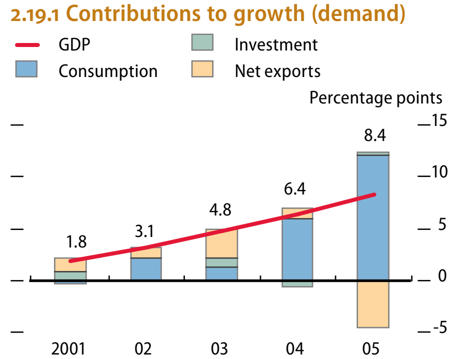
Economic performance

For the last 3 years, growth in gross domestic product (GDP) has been significantly above the medium-term trend, rising to 8.4% in FY2005 (ended 30 June 2005)—the highest rate in the last two decades (Figure 2.19.1). With the population rising by 1.9%, per capita income improved by 5.9%. On the demand side, private consumption increased by 16.8%, and led GDP growth for the second consecutive year. The positive impact of net exports on GDP growth seen in the preceding 4 years turned negative in FY2005, as the balance-of-payments position weakened. Gross domestic investment, which has stagnated at about 17% of GDP in the last 5 years, declined by 0.5 percentage points in FY2005.

On the supply side, for the second year in a row GDP growth was in good part driven by the industry sector, which expanded by 10.2% (Figure 2.19.2). Large-scale manufacturing, which constitutes half of the sector, has powered forward in the last 3 years. Growth in agriculture in FY2005, at 7.5%, was the highest for a decade, reflecting record growth in cotton production, in value terms the country's second-largest crop, after wheat. Services also achieved strong growth, of 7.9%, on the back of strong expansion in the financial sector, telecoms services, and wholesale and retail trade.

The first half of FY2006 was marked by a slowdown in both industry and agriculture. Output of cotton declined by an estimated 10.9% from an all-time high of 14.6 million bales harvested in FY2005. Production of sugarcane, another major summer crop, is also estimated lower than last year. The growth of large-scale manufacturing slowed to 8.7% in the first quarter of FY2006 from 24.9% in the same period of last year, primarily due to capacity constraints and the high-base effect. Among individual industries in the first quarter, growth of textiles tumbled to 7.2% from 29.6% year on year. Automobile assembly and electronics, which has

2.19.1 Contributions to growth (demand)



Source: Federal Bureau of Statistics, available: http://www.statpak.gov.pk/depts/fbs/statistics/national_accounts/national_accounts.html, downloaded 27 January 2006.

shown the fastest expansion among subsectors in the last 2–3 years, also decelerated.

The services sector continued its fast rise in the first half of FY2006. Increasing competition and aggressive marketing campaigns by new entrants in telecoms generated a surge in services, particularly in terms of mobile phone connections, which nearly doubled from 12.5 million as of 30 June 2005 to 23.1 million 7 months later. The effects of recent years' reforms and privatization continued to boost the banking system, which constitutes the bulk of the financial sector (Box 2.19.1).

Inflation accelerated in FY2005 after 5 years of price stability. Annual inflation, based on the consumer price index, more than doubled to 9.3% from 4.6%, mainly because of higher food prices and rising housing rents. Due to a sharp increase in domestic oil prices, transport costs also jumped. Core (nonfood, non-oil) inflation also doubled, from 3.7% to 7.4%.

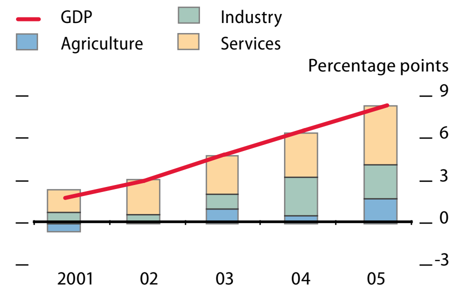
In the first 7 months of FY2006, despite a deceleration in rising food prices, annualized consumer price inflation declined only marginally, from 9.3% to 9.1%, as the impact of lower food prices was virtually canceled out by a sharp increase in oil prices. Annualized food inflation declined from 12.5% to 9.7%, as the Government liberalized imports of livestock, sugar, wheat, and other essential food items. Because of increases in world oil prices and the pass-through to domestic consumers, inflation for fuel, lighting, and transport accelerated sharply from 6.0% in June 2005 to 11.3% in January 2006. On the demand side, robust growth in private sector credit, though somewhat less than in FY2005, also continued to put pressure on prices, and annualized core inflation nudged up from 7.4% in June 2005 to 8.0% in January 2006.

2.19.1 Privatization

The privatization of state enterprises has picked up steam. Some large entities, such as Habib Bank Limited, Pakistan Telecommunication Company, and Karachi Electric Supply Company, have been privatized in the last couple of years. In FY2005, privatization transactions worth PRs43.0 billion ($0.7 billion) were completed, compared with a total of PRs32.7 billion in FY2004. The sale of government shares through public offers, which diversifies the ownership of corporate shares and strengthens the capital market, continued to play a significant role. In FY2005, government shares valued at PRs11.2 billion were sold through the stock market. In the first 8.5 months of FY2006, government equity of PRs200 billion ($3.3 billion) in seven enterprises was sold. The largest privatization transaction, involving the sale of 26% of the shares of Pakistan Telecommunication Company for PRs155.0 billion to Etisalat, a United Arab Emirates company, was finalized on 10 March 2006.

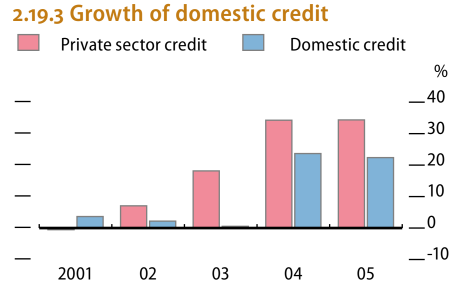
Privatization of public enterprises, as well as allowing the private sector to establish new operations in areas previously reserved for the state, has had a positive effect on the economy, particularly in banking, telecoms, and oil and gas. These three sectors have expanded very rapidly and attracted substantial foreign investment in recent years. Largely because of greater competition, the quality of banking and telecoms services has improved significantly. In addition, the coverage of mobile telephone services has doubled in each of the last 3 years.

2.19.2 Contributions to growth (supply)



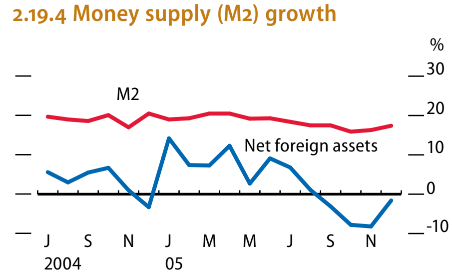
Source: Federal Bureau of Statistics, available: http://www.statpak.gov.pk/depts/fbs/statistics/national_accounts/national_accounts.html, downloaded 27 January 2006.

2.19.3 Growth of domestic credit



Sources: State Bank of Pakistan, available: http://www.sbp.org.pk/ecodata/profile_massets.pdf; Ministry of Finance, available: http://www.finance.gov.pk/survey/chapters/06-Money%20and%20Credit.PDF, downloaded 15 March 2006.

2.19.4 Money supply (M2) growth



Source: CEIC Data Company Ltd., downloaded 31 March 2006.

Despite rising inflation in FY2005, the State Bank of Pakistan (SBP) delayed aggressive tightening of monetary policy until the beginning of the fourth quarter, when it markedly raised the discount rate from 7.5% to 9.0%. SBP also allowed the interest rate on 6-month treasury bills to edge up. However, the real interest rate on bank loans remained negative throughout FY2005, and the net flow of credit to the private sector touched an all-time high (Figure 2.19.3).

From July 2005 to mid-February 2006 (the first 7.5 months of FY2006), SBP somewhat softened its monetary policy and, though monetary growth slowed (Figure 2.19.4), this in fact stemmed from a heavy fall in net foreign assets in the banking system. Expansion of domestic credit, in contrast, accelerated to 14.3% from 11.5% in the same period of FY2005, pushed by a sharp rise in government borrowing for financing the budget deficit. Private sector credit also showed appreciable growth of 17.3%. By rejecting bids for the 6-month treasury bills in December 2005 and again in February 2006, SBP sent a signal to the market that it would not allow the short-term interest rate to rise sharply. The increase in the weighted average interest rate on 6-month treasury bills in the first 8 months of FY2006 was only 33 basis points, compared with 245 basis points in the 3 months before that. The lending rate is only marginally above inflation at its current level.

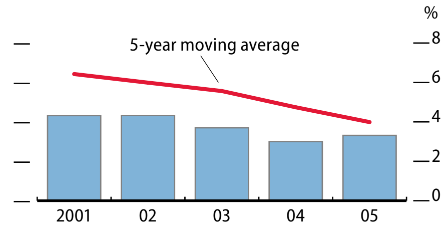
With the aim of promoting growth, the Government pursued an expansionary fiscal policy in FY2005, marking a shift in emphasis from the fiscal consolidation of the previous 5 years. It lifted development spending by 41.9%, pushing the fiscal deficit to 3.3% of GDP, after the deficit had declined almost continuously in the 5 years to FY2004 (Figure 2.19.5).

The expansionary fiscal policy of FY2005 continued in the first half of FY2006, and the fiscal deficit widened to 1.8% of GDP from 1.3% year on year. Revenue increased at double digits in the period, but spending growth outstripped that, mainly because of a jump in development spending. Tax receipts, which account for more than four fifths of total government receipts, showed a healthy rise. Even revenue from the petroleum levy almost doubled in the first half of FY2006, as the increase in domestic prices of petroleum products put through in September and October 2005 was not reversed when global oil prices declined in November and December. The jump in development spending seen in FY2005 continued into the first half of FY2006. Current spending also showed strong growth.

Deregulation of prices of petroleum products in earlier years had eliminated subsidies. However, as world oil prices climbed higher in FY2005 and FY2006, the Government felt unable to pass on the full price increase to domestic consumers, and allowed subsidies to reemerge between 1 April and 31 October 2005 on both kerosene and diesel, whose prices have an impact on low-income groups. On gasoline also, the rate of the petroleum development levy was reduced to zero between 16 March and 31 October 2005, but the levy has since been reimposed. Because of the temporary decline in world oil prices in late 2005, the rate of the levy on gasoline was lifted sharply, as earlier increases in domestic prices were not reversed.

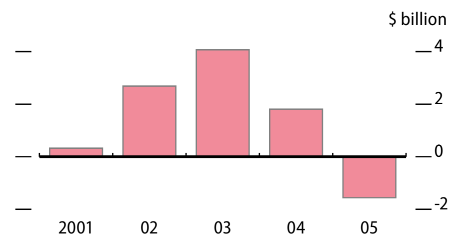
The high import growth of the preceding 2 years continued in FY2005

2.19.5 Budget deficit



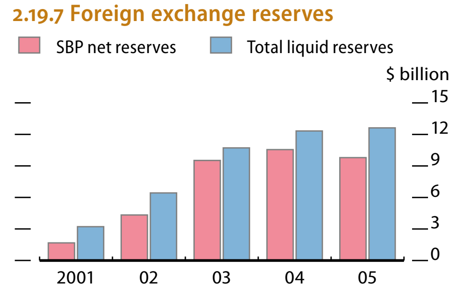
Source: Ministry of Finance, available: http://www.finance.gov.pk/survey/chapters/05-Fiscal.PDF, downloaded 27 January 2006.

2.19.6 Current account balance



Source: State Bank of Pakistan, available: http://www.sbp.org.pk/reports/stat_reviews/Jan_06/Pakistan_Balance_of_Payment.pdf, downloaded 27 January 2006.

2.19.7 Foreign exchange reserves



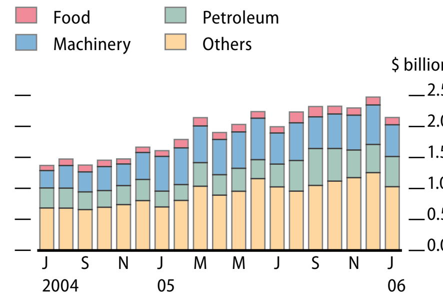
Source: State Bank of Pakistan, available: http://www.sbp.org.pk/ecodata/forex.pdf, downloaded 6 March 2006.

and resulted in a weakening of the balance of payments. The current account, excluding official transfers, turned into a deficit of $1.8 billion, after recording large surpluses in the preceding 3 years (Figure 2.19.6). Although total foreign exchange reserves held by the banking system continued to rise, albeit more slowly, reserves held by SBP declined for the first time in 5 years (Figure 2.19.7). Because of periodic interventions by SBP in the interbank market, to support the Pakistan rupee, the domestic currency's depreciation was only 2.9% in FY2005.

Imports continued to surge in the first 7 months of FY2006, and the total import bill for the period was 30.5% higher year on year. Steeper world prices pushed up the cost of oil imports by 65.5% to $3.5 billion (in the first 7 months of the year). The rise in petroleum imports during the period was unusually large because of the lagged effect of earlier oil price increases (crude oil and oil products are purchased under long-term contracts). The continued strong domestic demand generated an upsurge in other imports (Figure 2.19.8), particularly consumer durables, machinery, and raw materials. The import of sugar to alleviate domestic shortages also featured prominently in the import bill. Despite substantial increases in exports of textiles and clothing (T&C) as well as rice, total export growth in the first 7 months of FY2006 was much slower than import growth, broadening the trade deficit by 84.5%. The deficit on the current account, at $3.4 billion, was 3.5 times as large as in the year-earlier period; almost half of this deficit was financed through nondebt-creating inflows in the form of foreign direct and equity portfolio investment.

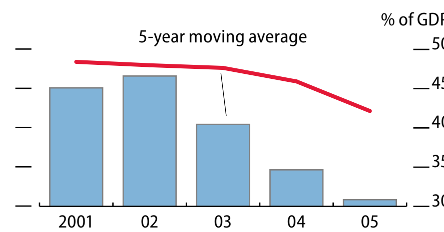
In spite of a large deficit on the current account, total foreign exchange reserves declined by only $1.2 billion to $11.4 billion, and reserves held by SBP declined by $841 million to $8.9 billion, in the first 8 months of FY2006. Some of the impact of the wider deficit on the current account was absorbed by a quick turnaround in the financial account. At their current level, SBP reserves are sufficient to finance 4.3 months of projected imports in FY2006. The exchange rate remained fairly stable, and the rupee/dollar rate depreciated slightly from Pakistan rupees (PRs) 59.67/$1 to PRs59.84/$1 during the first 7 months of FY2006. Pakistan's external debt and liabilities were trimmed by $589 million to $35.2 billion in the first half of FY2006. As a share of GDP, external debt has declined continuously in recent years, from 45% at end-June 2001 to 31% at end-June 2005, and further to 28.6% at end-December 2005 (Figure 2.19.9).

2.19.8 Imports by major commodity



Source: CEIC Data Company Ltd., downloaded 31 March 2006.

2.19.9 External debt



Source: State Bank of Pakistan, available: http://www.sbp.org.pk/ecodata/pakdebt.pdf, downloaded 30 January 2006.

Economic outlook

Prospects for FY2006 and FY2007

The outlook for FY2006 and FY2007 is based on the assumption that the economic policies pursued in the last half decade will be maintained (or strengthened), and that macroeconomic fundamentals will continue to improve. The outlook also presupposes that the Government will continue to use the fiscal space created over the past few years to improve physical infrastructure and finance pro-poor spending. SBP is seen as keeping to its tight monetary policy in the second half of FY2006 and containing monetary expansion to 12.8%, as specified in its Monetary Policy

2.19.1 Selected economic indicators

	2006	2007
GDP growth	6.5	7.3
Inflation	8.5	7.6
Current account balance (% of GDP)	-4.9	-3.1

Source: Staff estimates.

Statement for January–June 2006. On the external front, it is assumed that the global economy will maintain healthy growth and that oil prices will remain close to their current levels.

The growth of commodity-producing sectors so far in FY2006 has been lower than last year. High world oil prices will also depress economic growth, as will the 8 October earthquake, although its adverse impact has been estimated, in economic terms, to be relatively light (Box 2.19.2). The economy is projected to expand by 6.5% in FY2006, which is less than last year, but still very respectable (Figure 2.19.10).

The growth of agriculture is likely to slow in FY2006, mainly because of the smaller cotton and sugarcane crops. However, rice, wheat, and other crops are forecast to pick up. Livestock, which accounts for nearly half of value added in agriculture, may post only modest expansion, because the fear of avian flu has discouraged poultry farmers, and because livestock raising is one of the major economic activities in the five earthquake-affected districts of North-West Frontier Province. On this basis, agriculture is forecast to rise by 3.0%.

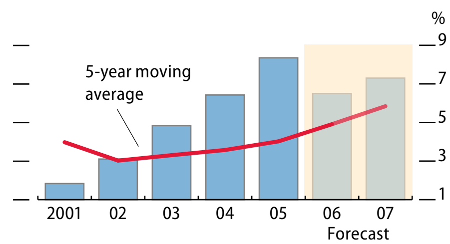
Despite a slowdown attributable to capacity constraints, large-scale manufacturing is likely to record about 10% growth in FY2006, as liberal incentives announced for export industries, particularly T&C, will boost production. Among the industry sector's two other subsectors, construction is expected to sustain high growth in FY2006 because of the large increase in the public sector development program in the FY2006 budget and ongoing reconstruction work in the earthquake-hit areas. The other subsector, generation and distribution of electricity, is likely to perform better because of higher water levels in reservoirs.

In services, the privatization of Pakistan Telecommunication Company Limited will give a further boost to telecoms. Banking is expected to continue its rapid growth. Wholesale and retail trade will benefit from double-digit rises in imports and exports. All told, services are likely to expand by 6–7% in FY2006.

The import of sugar, wheat, and other food items has already improved the food supply and significantly reduced food inflation. Tight monetary policy, if pursued consistently, will also damp core inflation. However, the reluctance of SBP to allow further increases in short-term interest rates is keeping lending rates only marginally positive (in real terms), and with the Government's borrowing from the banking system on the rise, SBP will soon need to decide whether the economy is tipping toward a significant slowdown or much higher inflation, and adjust its policy accordingly. In these circumstances, inflation is not expected to come down quickly and FY2006 should see it moderating only slightly to 8.5% (Figure 2.19.11).

With robust (albeit lower than projected) economic growth and a sharp increase in imports (particularly of items subject to high tariff rates such as automobiles), the budget target for tax revenue is likely to be achieved in FY2006. Nontax revenue may exceed the target because of higher receipts from the United States (US) for "logistics" support. There was some loss of revenue in the first quarter of the year due to the Government's policy of insulating domestic consumers from increases in world oil prices, but this loss was more than recovered after upward adjustments in domestic oil prices in September and October 2005.

2.19.10 GDP growth



Sources: Federal Bureau of Statistics, available: http://www.statpak.gov.pk/depts/fbs/statistics/national_accounts/national_accounts.html, downloaded 27 January 2006; staff estimates.

2.19.2 Economic impact of the earthquake

An earthquake measuring 7.6 on the Richter scale struck Pakistan on 8 October 2005, causing massive destruction of houses and physical infrastructure and leading to many thousands of deaths in three districts in Azad Jammu and Kashmir (AJK) and five districts in North-West Frontier Province. The earthquake killed at least 73,000 people, injured another 70,000, and left 2.8 million people without shelter. The disaster has imposed a huge economic burden on the country in the form of relief and reconstruction, involving rebuilding of lost assets and restoration of services. All basic services, such as education, health, water supply and sanitation, and public administration have been severely disrupted by the destruction of the physical infrastructure and by numerous deaths among personnel providing these services. A report prepared by the Asian Development Bank and the World Bank has estimated the cost of earthquake relief and reconstruction at PRs309 billion, or $5.2 billion, which amounts to 25.8% of consolidated expenditure of the federal and provincial governments in FY2005. Of this, PRs101 billion is for relief operations and PRs208 billion for reconstruction.

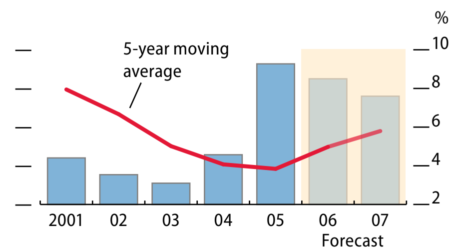
In addition to these costs, the destruction of physical infrastructure and disruption to services have adversely affected economic activities and gross domestic product (GDP) growth. However, the adverse impact on overall GDP growth is unlikely to be significant—perhaps 0.4% in FY2006—as the affected areas did not have much economic activity. Within affected districts, output losses are estimated at 25.0% in North-West Frontier Province and 52.0% in AJK. (For historical reasons, the latter is not included in Pakistan's GDP. When AJK's GDP is included, the impact of the earthquake on national GDP growth in FY2006 rises to 0.7%.) Reconstruction could also have a positive impact on GDP, but that will be seen mostly in FY2007 and FY2008. According to the report, the additional expenditure required for relief and reconstruction after the earthquake could raise the fiscal deficit in FY2006 by 0.6–1.0% if there is no offsetting increase in revenue or reduction in expenditure. The balance of payments is already under pressure. The additional imports of food, fuel, and construction materials will add to this.

Any destabilizing of macroeconomic balances due to additional earthquake-related expenditure could make it more difficult to achieve the longer-term twin goals of sustaining rapid growth and reducing poverty. Recognizing the fact that, even after the Government has cut low-priority spending and mobilized additional resources, it will be unable to absorb the full financial impact of the earthquake on its own, international donors pledged assistance of about $6 billion at a donors' conference held in Islamabad on 19 November 2005.

For its part, public spending may exceed the budget estimate by a wide margin because of outlays on reconstruction in the earthquake-hit areas. Also, GDP growth in FY2006 is expected to be lower than the original projection of 7.0%, as given in the Medium-Term Development Framework 2005–2010. As a result, the budget deficit could rise to 4.2% of GDP compared with the budget target of 3.8%.

High oil prices added more than $1.4 billion to Pakistan's import bill in the first 7 months of FY2006. As prices are projected to stay at currently elevated levels, they alone will push up imports by more than

2.19.11 Inflation

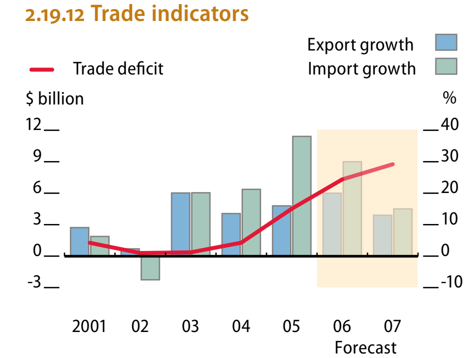


Sources: Federal Bureau of Statistics, available: http://www.statpak.gov.pk/depts/fbs/statistics/price_statistics/monthly_price_indices/mpi9/mpi_summary.pdf, downloaded 27 January 2006; staff estimates.

$2 billion, or about 10%, in FY2006. The liberalization of imports of fully built-up cars, sugar, and wheat, and continued high domestic demand, will lift imports further, by a projected 30%. On the export side, large investments in the textile industry in the last few years, the ending of quotas by 31 December 2004, and projected robust growth in world trade augur well, with exports likely surging by about 20%. However, because of the much larger growth in imports than exports, the trade deficit will widen to above $7.0 billion, and the current account deficit to $5.5 billion–6.0 billion, or 4.5–4.9% of GDP (Figure 2.19.12).

The ongoing capacity expansion and balancing, modernization, and restructuring in key industries, as indicated by strong expansion in private sector credit and by a sharp rise in imports of machinery, will help the industry sector sustain its high growth trajectory in FY2007. The telecoms and oil and gas sectors are also expected to continue robust growth, given substantial inflows of foreign investment and technical know-how attracted by the improved policy environment of recent years. Heavy investment in agricultural mechanization in FY2006 should also boost sector output in FY2007. The improved financial and telecoms services will also help economic activity. Economic growth is, therefore, likely to be above 7.0% in FY2007. The relaxation of capacity constraints and continued tight monetary policy, as well as a high-base effect, is expected to bring down inflation in FY2007. The ongoing substantial investment, particularly in T&C, will result in a higher exportable surplus and value addition, and greater import substitution, thus improving the balance of payments.

2.19.12 Trade indicators



Sources: State Bank of Pakistan, available: http://www.sbp.org.pk/reports/stat_reviews/Jan_06/Pakistan_Balance_of_Payment.pdf, downloaded 27 January 2006; staff estimates.

Medium-term outlook

The outlook for the economy is positive and the Government's growth target of 6–8% looks achievable. Recent substantial public sector investment in irrigation and private investment in agricultural mechanization should boost agricultural growth. The ending of quotas for T&C, as well as the substantial investment in the industry over the past several years, will continue to strengthen manufacturing's expansion (Box 2.19.3). Improving relations with India and increased trade with other countries in Asia, including the People's Republic of China (PRC), will also help the economy. The boom in services, particularly banking and telecoms, is likely to continue, principally because the policy environment has become very favorable with the deregulation and privatization of the past few years. Finally, also significantly strengthened through reforms and privatization, banking is well positioned to support economic growth by channeling savings to productive uses.

Inflation and the growing imbalance in the external sector are potential risks to the country's medium-term economic prospects. Without appropriate policy action, risks may build up. On the fiscal side, any large expansion in public expenditure in the lead-up to the 2007 general elections may weaken the budgetary position. It is assumed that the economic policies pursued by the present Government will ensure that the hard-won fiscal discipline is not dissipated. A possible downturn in the US economy after 2006 could hurt Pakistan's economy by crimping exports. In the longer run, the overall continuing low level of investment—despite recent increases in specific sectors—could depress economic growth.

2.19.3 Textiles and clothing

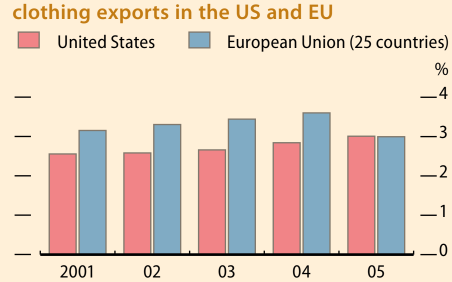
The elimination of quantitative restrictions on textile and clothing (T&C) exports under World Trade Organization agreements on 31 December 2004 has significant implications for the economy. With T&C accounting for more than two thirds of total exports, approximately 10% of value added in gross domestic product, and almost 40% of industrial employment, the opening of the global T&C market will have substantial repercussions on Pakistan's exports and the economy. In terms of policy developments, in addition to the end of quotas, substantial progress in privatization made in recent years in banking, telecoms, and oil and gas has started lifting these sectors' performance levels.

Pakistan's policy of free trade in cotton, the liberal import policy for textile machinery and other inputs, and the gradual deregulation of investment-approval procedures all resulted in substantial investment in modernization of the country's T&C sector over the past few years. It was generally thought that the T&C sector was well positioned to benefit when developed countries opened their markets for these exports, and in fact export data for 11 months from January 2005 bear this out: T&C exports rose by slightly over 20% year on year. Bed linen emerged as the leading contributor to the increase, with receipts surging by 45% to $1.7 billion year on year. Volume growth was even more impressive, at 48%. This was achieved despite the 13.1% antidumping duty imposed by the European Union (EU). The second-largest contributor was cotton cloth, with exports climbing by 30% to $2.1 billion. Exports of readymade garments, the third-largest contributor to higher T&C exports, jumped by 54% to $1.3 billion. Exports of knitwear and synthetic textiles, however, fell.

Notwithstanding the increase in the country's T&C exports, Pakistan's share in the EU, the largest market for the country's T&C exports, declined by 0.6 percentage points to 3.0% in 2005. Its share in the United States market, which is the second largest market for the country's T&C exports, increased only marginally by 0.2 percentage points (box figure). Among competitor exporters of T&C, the PRC's share rose by 7.6 percentage points in the EU and by 6.7 percentage points in the US. India gained 0.7 percentage points and 0.8 percentage points, respectively.

Imposition of antidumping duty on imports of bed linen, as well as the loss of preferential access to the EU market under the Generalized System of Preferences (GSP), may have disadvantaged Pakistan's T&C exports to the EU. High business costs, coupled with low labor productivity, also seem to have undermined the country's competitiveness in the international T&C export market. While the action by the EU to reduce antidumping duty is expected to boost bed linen exports, the ineligibility of the country's T&C exports to the EU's "GSP+," together with the fact that Bangladesh, Sri Lanka, and Viet Nam have been given this concession, will continue to hurt Pakistan's exports. Free trade agreements between the US and many of Pakistan's competitors in clothing exports, as well as the trade diversion effect of the May 2005 inclusion of 10 east European countries in the EU (itself one of the top three T&C exporters), could also affect the country's potential gains in exports.

Market shares of Pakistan's textile and clothing exports in the US and EU



Note: Value for EU in 2005 is through November only.
Sources: US Census Bureau, available: http://www.census.gov/foreign-trade/statistics; Eurostat, available: http://epp.eurostat.cec.eu.int/portal/page?_pageid=1090,30070682,1090_30298591&_dad=portal&_schema=PORTAL, downloaded 13 February 2006.