Pakistan

Pakistan's economy faces considerable challenges. Floods in summer 2010 hit agricultural output and damaged transport and communication. Still high inflation, though recently falling, may well accelerate. Fiscal developments are worrisome: the rollback in recent oil price rises, a partial increase in electricity tariffs, delays in carrying out revenue-increasing measures, broad tax exemptions for residents of flood-affected areas, and continued heavy fiscal support to state-owned enterprises add to pressures on the fiscal deficit. The current account balance is improving, but capital and financial inflows continue to decline. Still, despite devastation and economic distress, growth will likely stay positive.

Economic performance

Pakistan's economic performance in FY2010 (ended June 2010) and into FY2011 reflects largely the same structural weaknesses that contributed to its FY2008 macroeconomic crisis. Energy shortages and security issues held the economic rebound for FY2010 to 4.1% (Figure 3.20.1), slowing growth for FY2008–FY2010 to an average of only 3%, well below the 8% needed to create jobs for the predominately young population.

Little recent progress has therefore been made in raising per capita incomes or reducing poverty. Delays in implementing policy measures and fiscal management practices necessary for macro stability have undermined investment in infrastructure and production capacity.

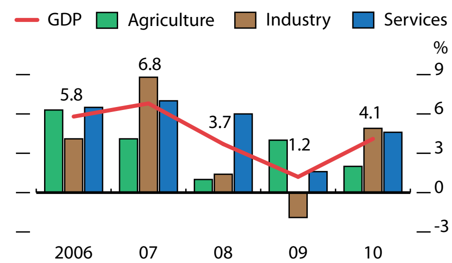
The modest expansion in FY2010 benefited from fiscal and monetary policies in FY2009 that eased macroeconomic imbalances by year-end, and from a decline in inflation that improved consumer confidence. Higher remittances provided additional support to an expansion of private consumption, as did improvements in rural income from increases in administered commodity prices. Heightened security concerns lifted public consumption, pushing total consumption's contribution to growth to nearly 80%.

From the supply side, transitory improvements in large-scale manufacturing partly reversed 2 years of declines and supported a recovery in services, led by wholesale and retail trade. Agriculture expanded by a modest 2%, due to weak performance by major crops.

The fragility of the recovery was underscored by continued investment contractions. Infrastructure shortages and security issues contributed to a 5.1% decline of gross private capital formation. Gross fixed capital formation contracted by 2.0% in FY2010, coming on the heels of an 11.3% decline the previous year.

FY2010 also saw a third consecutive year of declines in investment in large-scale manufacturing (down 15.4%) and electricity and gas (11.0% lower). Overall, the steady decline in total gross fixed investment as a

3.20.1 GDP growth by sector



Source: Ministry of Finance. *Pakistan Economic Survey 2009–10.* http://www.finance.gov.pk

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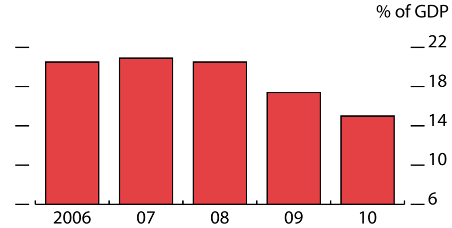
3.20.2 Fixed investment



Source: Ministry of Finance. *Pakistan Economic Survey 2009–10.* http://www.finance.gov.pk

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This chapter was written by Dawn Elizabeth Rehm of the Central and West Asia Department, ADB, Manila; and Farzana Noshab of the Pakistan Resident Mission, ADB, Islamabad.

share of GDP from 20.5% in FY2006 to 15.0% in FY2010 will crimp future growth prospects (Figure 3.20.2). Private savings have similarly declined, owing in part to the failure of key asset rates to keep pace with inflation, leading to either negligible or negative real returns.

Pakistan's fiscal balance deteriorated in FY2010, reflecting delays in putting through planned policy measures to improve revenue performance and limit the burden on the deficit of losses at state-owned enterprises (SOEs) and of energy-related subsidies. It widened from 5.3% of GDP in FY2009 to 6.3% in FY2010 (Figure 3.20.3), well in excess of the (revised) target of 5.1%. Revenue targets in the FY2010 budget, too, were missed and Federal Board of Revenue (FBR) tax receipts continued to decline as a share of GDP, reaching a 30-year low of 9.0% in FY2010.

Pakistan's current budget expenditure is relatively rigid, and it is difficult to offset overruns in one category with reductions in another. Inflexible current expenditure (such as security, interest, and pensions) alone absorbed revenue of 7.4% of GDP in FY2010, or about 82% of FBR tax receipts. Subsidies amounted to another 1.7% of GDP.

The government sharply curtailed the federal public sector development program (PSDP) to 3.5% of GDP to ease deficit pressure. Federal government borrowing from the State Bank of Pakistan (SBP), the central bank, as well as from commercial banks rose to PRs339.7 billion (2.3% of GDP), reflecting a widening deficit and lower external financing. Escalating losses from SOEs reached an estimated 1.7% of GDP for FY2010, adding to pressures.

Inflation fell to 11.7% in FY2010 from 20.8% in FY2009 (Figure 3.20.4). As it moderated, the SBP lowered the policy rate in steps from 14% to 12.5%. Broad money expanded by 12.5%, much faster than the 9.6% of the previous year.

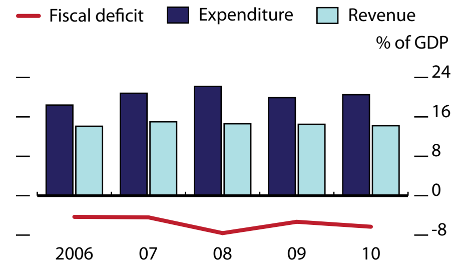
Developments in the external balances were mixed (Figure 3.20.5): the current account deficit narrowed, as imports declined by 1.7% with weaknesses in key industries (such as steel and oil refining) and a slump in investment; exports expanded by a modest 2.9% on higher exports of textiles, rice, and pharmaceuticals. Improvements in the service and income accounts contributed.

Yet financing the current account deficit became more difficult over the year: the capital and financial accounts fell by almost 13.4%, after a 26.2% decrease the year before. Foreign direct investment flows continued their downward path in response to infrastructure and security concerns, with communications, transport, and power accounting for much of the decline.

Gross reserves improved, benefiting from International Monetary Fund (IMF) releases under a stand-by arrangement, rising to $16.8 billion by end-FY2010. The nominal exchange rate depreciated by 6.3%, but inflation—high relative to trading partners'—lifted the real exchange rate by 1.0%.

Pakistan's public debt (excluding guarantees) as a share of GDP continued to climb in FY2010 (Figure 3.20.6). Government domestic debt amounted to 37.0% of GDP, including commodity debt and liabilities of SOEs. External debt rose to 31.9% of GDP, including 0.6% of GDP in external liabilities of SOEs. Interest payments due on domestic debt represent a heavy burden, accounting for 3.9% of GDP in FY2010, or

3.20.3 Fiscal indicators



Sources: Ministry of Finance. *Pakistan Economic Survey 2009–10* and Fiscal Operations July to June 2009–10. http://www.finance.gov.pk

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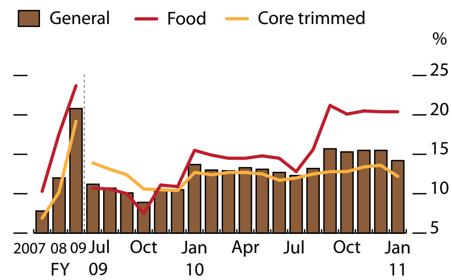
3.20.4 Year-on-year inflation



Note: Core trimmed inflation eliminates extreme outlying sample observations from the calculated average.

Sources: State Bank of Pakistan. *Annual Report 2009–2010* and Economic Data. http://www.sbp.org.pk (accessed 11 March 2011).

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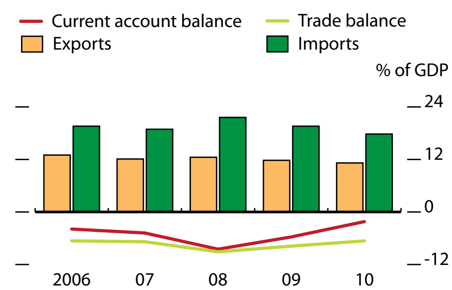
3.20.5 Current account indicators



Source: State Bank of Pakistan. Economic Data. http://www.sbp.org.pk (accessed 11 March 2011).

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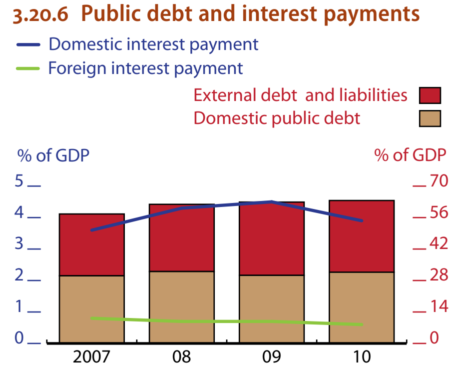
3.20.6 Public debt and interest payments



Sources: State Bank of Pakistan. *Annual Report 2009–2010* and *Statistical Bulletin March 2011*. http://www.sbp.org.pk.

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43% of FBR revenue. External debt amortization payments, excluding amounts owed to the IMF, are relatively stable for FY2010–FY2013 at about $3.3 billion. Amounts due for FY2012 and beyond will be raised substantially by repayment obligations to the IMF.

Government borrowing in the form of advances for commodity operations rose sharply in FY2009, in response to the bumper crop and increases in government-set procurement prices for wheat. With domestic prices higher than international prices, excess inventory was not sold. As this inventory looked as if it would not be sold nor loans repaid, banks' lending rates for government commodity operations rose, to exceed those for the private sector.

Prospects

Severe floods in July–August 2010 have affected FY2011's prospects. Damage was less severe than initially feared, but agriculture and communications were hit hard. Total damage is put at more than $10 billion, half in agriculture. For other areas, notably power and transport, damage was mild but widespread.

Information for the first 6 months of FY2011 points to a 1.7% contraction of large-scale manufacturing centered on textiles, food processing, and petroleum products, bringing the large-scale manufacturing index for September 2010 to its lowest since July 2007 (Figure 3.20.7).

With growth prospects reduced to 2.5% for FY2011 (Figure 3.20.8), average growth for FY2008–FY2011 is seen falling to 2.9%. Persistent energy shortages and security issues are expected to hold growth to 3.7% for FY2012, providing scant improvement on recent trends.

Inflation accelerated after the floods, to 15.7% in September, reflecting actual and expected shortages. It remained above 15% through December, falling to 14.2% in January owing to a government-freeze on oil and electricity prices. It is expected to stay high through FY2011, for an average annual 16.0%, and is then expected to recede in FY2012 to 13.0% (moderation in international food prices is likely to be at least partly offset by electricity price rises).

Pakistan began FY2011 with a budget that was based on policy measures that proved difficult to carry out. Revenue targets called for 26% growth of tax receipts, well over the 5-year average of 14%. Meeting them would have been hard even if a reformed General Sales Tax had come into effect. A reformed tax was initially scheduled for July 2010, but the process remains politically contentious, and any changes to the tax will have a limited effect on FY2011 receipts.

This tardiness, combined with the impact of the floods and wide tax exemptions for those in flood-affected areas, held FBR tax revenue growth to 10.9% in the first 7 months of FY2011, making a further decline in the tax-to-GDP ratio likely (Figure 3.20.9). (Total fiscal resources have also been affected by declines in nontax revenue.)

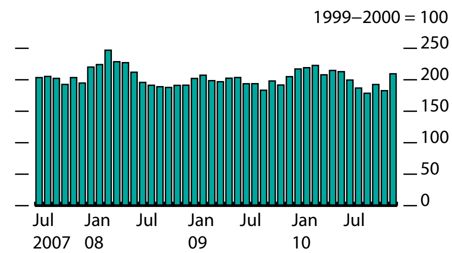
Current expenditure was under pressure due to a 50% wage increase for government workers, exacerbated by government failure to budget adequately for subsidies needed to cover the gap between notified and cost-recovery electricity tariffs. An annual budget allocation of

3.20.1 Selected economic indicators (%)

	2011	2012
GDP growth	2.5	3.7
Inflation	16.0	13.0
Current account balance (share of GDP)	-1.7	-2.3

Source: ADB estimates.

3.20.7 Large scale manufacturing index



Sources: Ministry of Finance. *Pakistan Economic Survey 2009–10*. http://www.finance.gov.pk; Federal Bureau of Statistics. http://www.statpak.gov.pk (accessed 11 March 2011).

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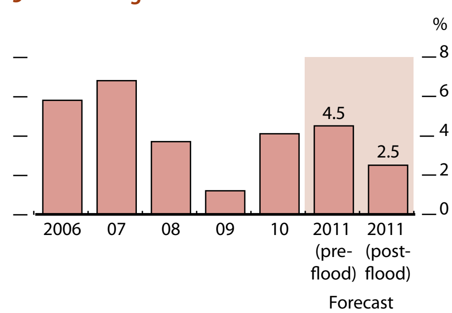
3.20.8 GDP growth



Sources: Ministry of Finance. *Pakistan Economic Survey 2009–10*. http://www.finance.gov.pk; ADB estimates.

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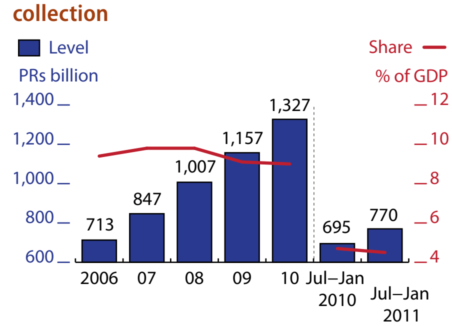
3.20.9 Federal Board of Revenue tax collection



Source: State Bank of Pakistan. http://www.sbp.org.pk (accessed 11 March 2011).

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PRs30 billion to cover the tariff differential turned out well short of expected cost, and because of lack of policy measures total energy-related subsidies are expected to reach PRs200 billion. Part of this gap was to be covered by 2% monthly increases in electricity tariffs to bring them into line with cost recovery. Energy-related circular debt (due to payment arrears in the sector), which stood at PRs446 billion at end-FY2010, is expected to surge by end-FY2011.

For a third year, overruns on recurrent spending were met with a compression of the federal PSDP (Figure 3.20.10). For the first half of FY2011, only PRs66 billion was made available for PSDP activities, less than 25% of the PRs280 billion earmarked in the FY2011 federal budget, with spending limited to key projects and priority development programs. The federal PSDP for FY2011 faced a further cut of PRs100 billion on a lack of resources. The government is giving priority to completing projects. The remainder of the PSDP (PRs373 billion) in the combined provincial budgets is also under substantial pressure from resource constraints.

With a fiscal deficit at 2.9% of GDP in the first half of FY2011, the annual fiscal target was also revised to 5.5% under the weight of higher international food and energy prices, escalating subsidies, and subdued revenue performance.

With lower foreign funding, deficit financing is expected to rely heavily on the domestic banking system. After easing in FY2010, government borrowing from that source has surged in FY2011, reaching PRs379 billion by 12 February, compared with PRs330.4 billion for FY2010 as a whole (Figure 3.20.11). Of this, about 34% reflected borrowing from the SBP, consistent with commitments from the government in late January to roll back borrowing from the SBP to September 2010 levels.

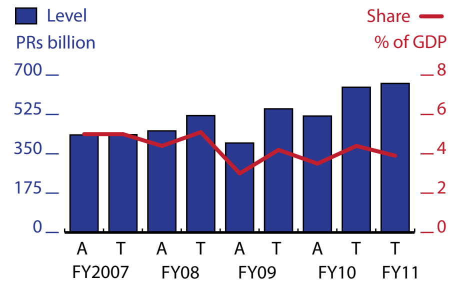
Credit to the private sector picked up but remained on the low side for various reasons. Banks expressed a preference for low-risk lending to government to offset flood-related increases in nonperforming loans, while weak postflood economic activity and rising borrowing costs held back demand for borrowing.

The pace of government borrowing from the banking system has supported a rapid expansion of broad money and reserve money: broad money growth for FY2011 through 26 February 2011 was much higher (7.7%) than in the same period of FY2010 (5.7%); the equivalent figures for reserve money were 14.9.% and 10.6%.

In response to the increase in inflation and growing evidence of its likely persistence, the SBP increased the policy rate in three successive 50 basis point increments from August 2010 to end-November 2010, bringing the rate back to 14.0% and reversing the cuts of FY2010 (Figure 3.20.12). In January 2011, the SBP left the policy rate unchanged, partly on the basis of commitments from the government to limit borrowing from the central bank.

Fiscal prospects for FY2012 are likely to improve as the political environment eases sufficiently to implement the revenue-enhancing and fiscal-management initiatives. Progress is expected in implementing reforms for the energy sector consistent with a move toward financial viability with a phased elimination of subsidy requirements, leaving enhanced fiscal space for development programs.

3.20.10 Public sector development program



A = Actual; T = Target.

Source: Ministry of Finance. *Fiscal Operations*. Various issues. http://www.finance.gov.pk

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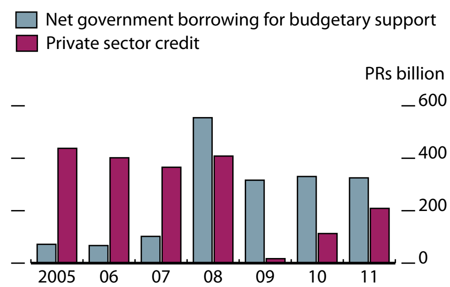
3.20.11 Budgetary and private sector credit



Note: 2011 data cover the period July 2010 to February 2011.

Source: State Bank of Pakistan. http://www.sbp.org.pk (accessed 11 March 2011).

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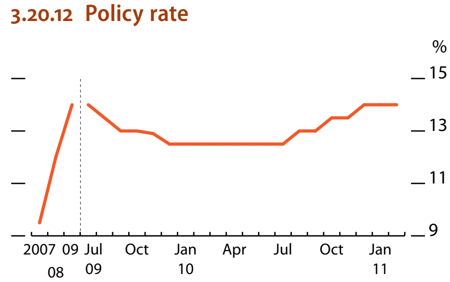
3.20.12 Policy rate



Source: State Bank of Pakistan. *Annual Report 2009–2010*. http://www.sbp.org.pk

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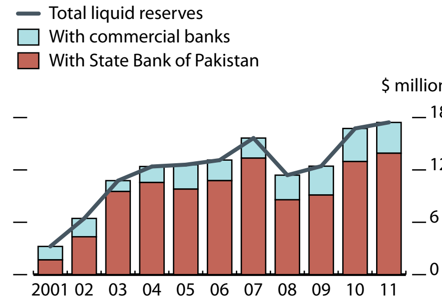
The extensive pickup of Treasury bills bought by the SBP through December 2010 reflected government reluctance to allow auction cutoff rates to rise enough for commercial banks to participate. Without a sufficient increase in 1-year bill rates, most purchases have shifted to shorter maturities of 3 and 6 months. In recent auctions, most banks' bids for bills with a maturity longer than 6 months have not been high enough to be accepted. But with an average maturity falling to 1.5 years, the possibility of roll-over risk and disorder in the auction market rises. The likely outcome is that, in time, the government will have to pay higher interest rates to fund its borrowing requirements.

Pakistan's external reserves reached a record high of $17.4 billion in early February 2011 (Figure 3.20.13), amounting to more than 5 months of imports of goods and services. This buildup essentially reflects IMF releases of $7.1 billion under the stand-by arrangement, an additional $450 million in emergency support in September 2010, and support from the Coalition Support Fund ($633 million) at end-December 2010. The central bank's holdings of liquid foreign exchange reserves ended FY2010 at $13.9 billion.

While import growth remains modest, a significant expansion of exports during the first 7 months of FY2011 moved the current account deficit into near balance, at 0.5% of GDP, but it is expected to widen to 1.7% for full-year FY2011, reflecting higher international food and commodity prices. For the first 7 months of FY2011, exports of textiles and rice showed strong growth in value terms, mainly on higher world prices. Remittances increased further, broadly in line with inflation, but non-debt-creating inflows continued to decline, with private FDI inflows about 16% below the same period of the previous year (Figure 3.20.14).

The current account deficit is expected to edge upward in FY2012 to 2.3% of GDP as projected declines in global food and commodity prices are more than offset by the impact of improved growth and increased demand for imports, including for postflood reconstruction.

3.20.13 Foreign exchange reserves



Note: Data for 2011 are as of 12 February.
Source: State Bank of Pakistan. http://www.sbp.org.pk (accessed 11 March 2011).
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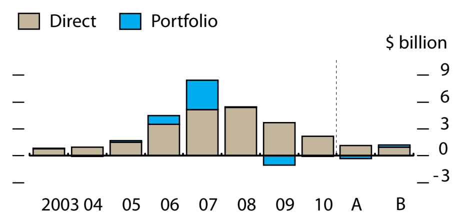
3.20.14 Foreign direct and portfolio investment, net inflows



A = July 2009–Jan 2010; B = July 2010–Jan 2011.
Source: State Bank of Pakistan. http://www.sbp.org.pk (accessed 11 March 2011).
Click here for figure data

Development challenges

The government recognizes that current subsidy requirements and support for SOEs are incompatible with creating the fiscal space needed to support investment in infrastructure and technology for a diversified and higher-value-added export base. The current pattern of lower imports, lower development spending, and exploding unproductive current outlays undermines domestic and external confidence in the economy's prospects and deters investment. Pakistan therefore needs to develop a systematically transparent revenue policy, and operate it effectively.

Elsewhere, energy shortfalls are lowering real growth by at least 2 percentage points annually. While the federal government increased electricity tariffs by 37% in FY2010, its decision not to push through with incremental monthly step-ups represents a reversal of its efforts to reach cost recovery. Again, it will be critical to design and implement policies that bring the sector to financial viability.