Asian Development Outlook

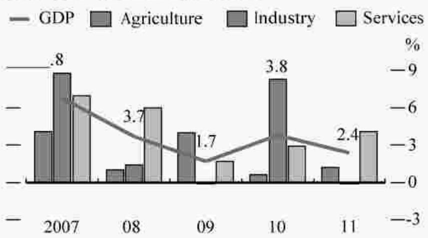
PAKISTAN

The economy was under pressure in FY2011 from the aftermath of extensive flood damage, energy shortages, security issues, and a burgeoning fiscal deficit-as well as persistently high inflation, despite monetary policy tightening. Still, the current account moved to a small surplus on strong exports and remittances. Growth is expected to pick up modestly in FY2012, largely on agriculture. However, to get the economy back on a high growth track Pakistan must overcome its long-standing macroeconomic and structural imbalances.

UPDATED ASSESSMENT

For the fourth year running, Pakistan was trapped in low growth in FY2011 (ending 30 June 2011). Severe floods in July-August 2010, higher oil prices, power shortages, and security pressures held GDP growth to an estimated 2.4% (Figure 3.7.1), slightly lower than the 2.5% projected in the Asian Development Outlook 2011 of April. Sector performance was uneven. Agriculture showed growth of only 1.2%, despite a pickup after the floods. Solid growth in livestock and minor crops as well as good wheat and sugarcane crops was offset by

3.7.1 GDP growth by sector

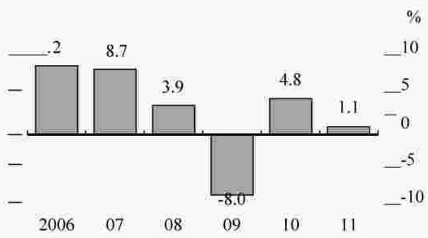


Source: Ministry of Finance. *Pakistan Economic Survey 2010–11*. http://www.finance.gov.pk

a fall in cotton and rice harvests.

Increasingly severe and unpredictable power outages undermined industry, which virtually stagnated (down 0.1%). This outcome was due to a large fall (about one-fifth) in electricity output, in part caused by a sharp drop in natural gas production and flood damage. Power supply problems in turn hit production in areas such as cement, metal industries, electronics, and textiles, as well as exporters' ability to deliver on schedule. Agro-based industries were less affected, bolstered by the good wheat and sugarcane harvests. Growth in large-scale manufacturing came in at 1.1% (Figure 3.7.2). Finally,

3.7.2 Large-scale manufacturing index growth



Sources: State Bank of Pakistan. *Economic Data*. http://www.sbp.org.pk (accessed 31 August 2011); Federal Bureau of Statistics. *Statistical Yearbook 2011*. http://www.statpak.gov.pk

construction eked out a mere 0.8% expansion as public spending shifted from projects to flood relief, and reconstruction work started only after a delay.

Services (up 4.1%) accounted for most of the growth. The expansion was led by public administration and defense (13.2%) as well as social services (7.8%), which were partly supported by external financing for flood relief. Growth slowed sharply in transport, storage, and communications services, partly on weakness in key public enterprises, including Pakistan Railways and Pakistan International Airlines. Their performance-as with so many public enterprises-remained impaired by lack of fiscal discipline and governance issues.

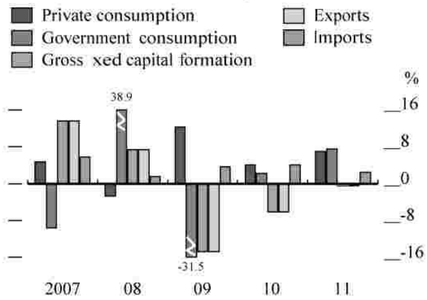
From the demand side, public and private consumption provided the only impetus to growth in FY2011 (Figure 3.7.3). Investment declined for the third straight year, taking the investment-to-GDP ratio to only

13.4% in FY2011, from 22.5% in FY2007. The poor showing stems from several factors, including the downdraft in the economy, weakness in the investment climate, and security issues.

Inflation surged after the summer 2010 floods, due largely to food supply shortages and higher transport costs. Food price inflation eased somewhat during the second half of the fiscal year, falling from a peak of 21.2% (year on year) in September to 15.7% by June, averaging 18% for FY2011. Overall inflation averaged 13.9%, up from 11.7% in the previous year (Figure 3.7.4). Inflation pressures are widespread, with more than half the items in the consumer basket posting double-digit increases during the year. Core inflation also stayed in double digits all year, underscoring the broad-based inflation pressures entrenched in the economy.

The State Bank of Pakistan (the central bank) kept interest rates high in FY2011. In July 2010, it raised the discount rate by 50 basis points to 13%. As inflation picked up and the fiscal position weakened, it increased the rate in September and November 2010. It then maintained that 14% rate in its next three successive policy

3.7.3 Growth of GDP components



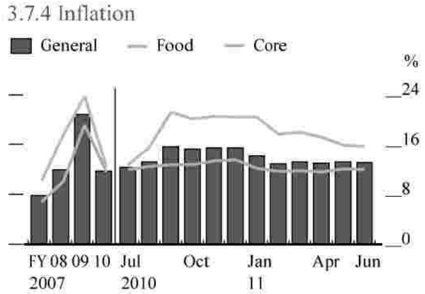
Source: Ministry of Finance. *Pakistan Economic Survey 2010–11*. http://www.finance.gov.pk

announcements (January, March, and May 2011), as the current account strengthened and government borrowing from the central bank fell off. In response to an expectation of easing inflation, the central bank reduced the rate to 13.5% in July 2011.

The provisional fiscal deficit for FY2011 is estimated at 6.2% of GDP, about the same as in FY2010. It surpassed the 4% of GDP budget target for FY2011 announced in June 2010 before the floods. Higher costs for subsidies and security, unforeseen flood-relief spending, and additional borrowing to ease liquidity shortages in the power sector contributed to pushing out the deficit. Current outlays were about PRs300 billion over budget, equivalent to 1.6% of GDP.

Estimated spending on defense (2.5%

3.7.4 Inflation



Source: State Bank of Pakistan. *Annual Report 2010–11* and *Economic Data*. http://www.sbp.org.pk (accessed 25 August 2011).

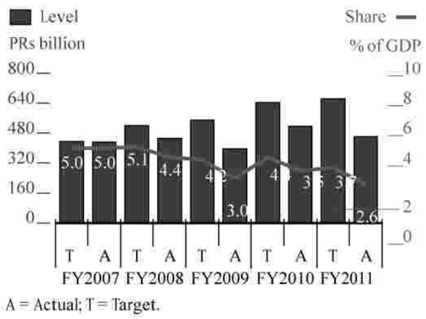
GDP), interest payments (4.0%), subsidies (2.2%), and pensions (0.5%) exceeded federal tax and nontax revenues by 0.6% of GDP. Adding government operating costs (1.1% of GDP), there is a gap between Federal Board of Revenue receipts and current spending of about 1.7% of GDP.

Development spending was cut to provide resources for flood relief and to contain the deficit. The public sector development program was set to increase by nearly 30% to PRs663 billion at the time of the FY2011 budget, with a federal allocation of about two-fifths of the total and the balance for provincial budgets. Spending, however, fell well short of target as resources were released for federal and provincial relief operations.

Estimated total development spending came to only PRs462 billion, or 2.6% of GDP (Figure 3.7.5).

The 16.7% estimated increase in federal tax revenue fell short of the 20% target, as a variety of revenue measures-including revocation of sectorwide exemptions in the sales tax scheme-proved politically difficult to enact. In response to slower than projected receipts, a surge in current spending, and a fall in foreign inflows,

3.7.5 Public sector development program



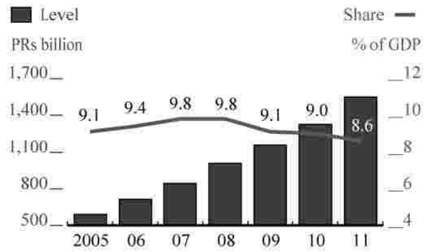
A = Actual; T = Target.

Source: Ministry of Finance, *Pakistan Economic Survey 2010–11* and *Federal Budget 2011–12*. http://www.finance.gov.pk

various short-term measures were put through for March-June 2011 (including a 15% income tax surcharge, an increase in special excise rates, and removal of the sales tax exemption for domestic and imported agricultural inputs such as tractors and fertilizers). They were expected to raise PRs56 billion (about 0.3% of GDP). But despite them, tax revenue is estimated to have fallen relative to GDP, from 9.0% in FY2010 to 8.6% in FY2011 (Figure 3.7.6).

Broad money growth accelerated to 15.9% from 12.5% in FY2010, largely owing to increased government borrowing. This item-all from commercial banks-jumped by 46% in FY2011 to PRs579.5 billion. Credit to the private sector inched up by about 4%, constrained by the economic slowdown. With investment activity in the doldrums, the credit growth largely

3.7.6 Tax collection by the Federal Board of Revenue



Source: State Bank of Pakistan. *Economic Data*. http://www.sbp.org.pk (accessed 31 August 2011).

reflected the additional working capital requirements of higher prices for key inputs and trade finance (in light of increased exports).

Buoyed by higher commodity prices (especially for cotton and textiles), a surge in workers' remittances to $11.2 billion, flood-related assistance, and inflows from the US Coalition Support Fund, the current account posted an unexpected, small surplus of $436 million (Figure 3.7.7).

Merchandise exports recorded a rise of 29%, half due to textiles, and the other half to food (surplus wheat stocks were exported) and a strong gain in other manufactured exports (Figure 3.7.8).

Imports, reversing the decline of the previous 2 years, climbed by 14.5%. With their estimated volume up by only about 1%, nearly all the import increase reflected high prices for petroleum products, food, and intermediate goods, including large

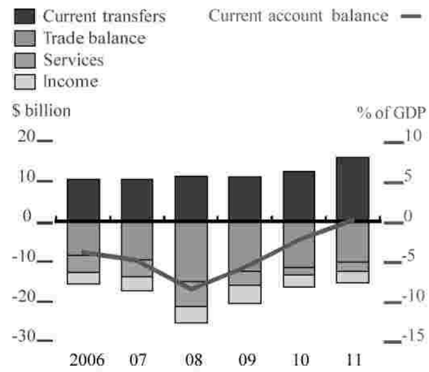
3.7.1 Select economic indicators (%)

	2011		2011	
	ADO 2011	*Update*	*ADO 2011*	*Update*
GDP growth	2.5	2.4	3.7	3.7
Inflation	16.0	13.9	13.0	13.0
Current acct. bal (share of GDP)	-1.7	0.2	-2.3	-1.3

Source: ADB estimates.

postflood requirements of raw cotton. Imports of machinery fell by about 5% as higher imports of telecommunications

3.7.7 Components of the current account balance



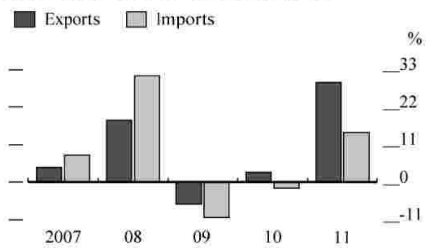
Source: State Bank of Pakistan. *Economic Data*. http://www.sbp.org.pk (accessed 31 August 2011).

and textile machinery were outweighed by a decline in imports of power generation, office, and electrical equipment (reflecting weak investment activity).

The financial account surplus fell to only $1.9 billion in FY2011-from $5.1 billion in the previous year and $9.9 billion in FY2007-largely due to a large drop in official borrowing. Modest inflows of portfolio investment partly offset the slight reduction of direct investment inflows (on lower telecommunications and oil and gas exploration), which slowed to $1.6 billion.

Foreign exchange reserves strengthened

3.7.8 Growth in merchandise trade



Source: State Bank of Pakistan. *Economic Data*. http://www.sbp.org.pk (accessed 31 August 2011).

to $18.2 billion and, with positive developments in the external account, helped stabilize the exchange rate vis-à-vis the US dollar: the Pakistan rupee depreciated by only 2.0% in FY2011, after a 6.3% drop the year before.

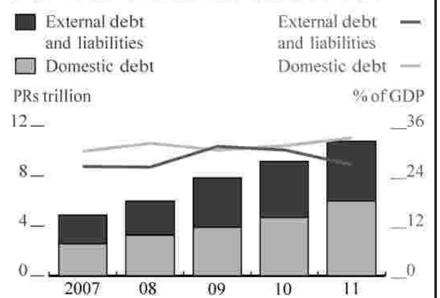
Domestic public debt rose by 29.2% to PRs6.0 trillion (33.3% of GDP) by end-FY2011, while external public debt rose to $56.3 billion (PRs4.8 trillion), or 26.6% of GDP (Figure 3.7.9). The average maturity for domestic public debt has fallen to 18 months and, with interest rates above 12%, interest costs were equivalent to about 35% of federal tax revenue in FY2011. The shortening maturity for domestic debt raises both rollover and interest rate risk. Most external debt is, though, contracted at a modest average interest rate and relatively long tenors.

PROSPECTS

The economy is forecast to strengthen slightly in FY2012 from FY2011, to 3.7%, buttressed by agriculture's expected recovery (albeit depending on weather conditions) and continued expansion of services. Growth in large-scale manufacturing is likely to be muted, given that power supplies are unlikely to improve much. Repairs to the transport network should provide some relief from high transport costs.

Pakistan must average 7% annual growth to absorb the 3% increase in its labor force each year. Its population is young, with more than 65% under the age of 30. Yet recent experience-with average economic growth of less than 3% in FY2008-FY2010-has been too little to take advantage of these favorable demographics. The National Economic Council recently endorsed a Framework for Economic Growth to guide efforts to improve future growth and employment prospects (Box 3.7.1).

3.7.9 Public external and domestic debt



Source: State Bank of Pakistan. *Economic Data.* http://www.sbp.org.pk (accessed 31 August 2011).

Slow growth in agriculture in recent years reflects the general decline of the sector since the rapid growth of the 1980s, when it expanded by more than 5% a year on average. Water shortages and low investment in irrigation infrastructure over the years have led to a general decline in agriculture productivity. Agriculture needs structural reforms to bring about higher productivity, transformation, and diversification, but with the sector accounting for 44% of total employment, such reforms would reduce labor requirements, and so other sectors would have to create jobs to absorb agriculture's released workers.

Inflation is expected to stay high, easing back only slightly to an average of 13.0% in FY2012 because of the planned upward adjustments in domestic electricity prices, the restoration of automatic pass-through of fuel price increases to consumers, and strong inflation expectations built into the economy.

Realizing the budget for FY2012-with a lower deficit of 4.0% of GDP-largely depends on containing subsidies (Figure 3.7.10) and boosting revenues. The budget is expected to gain from steps to cut power and other subsidies by 57% relative to FY2011. While efficiency gains in the power sector have somewhat reduced the need for tariff differential subsidies, ending subsidies depends on the pace of power sector reforms. Revenue receipts are projected to increase by 23% from FY2011, relying primarily on efforts to curtail tax evasion. The FY2012 budget ended sales tax exemptions for 500 items, but reduced the sales tax by 1% to 16%.

3.7.1 Framework for Economic Growth

The National Economic Council endorsed a framework for economic growth in May 2011 to exploit the economy's expanding labor force.

The framework takes a holistic approach promoting competitive markets, higher productivity, better governance and public service delivery, innovation, and entrepreneurship. It aims to restore Pakistan's annual GDP expansion to 7%-the estimated rate needed to absorb new labor force entrants-by streamlining the public sector and fostering private sector-led growth.

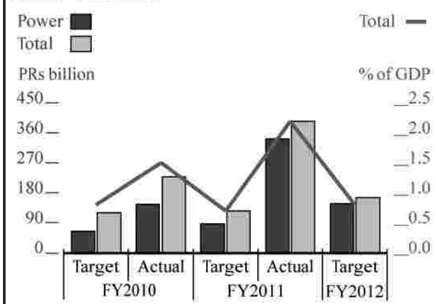
For the latter, it prioritizes addressing growth-inhibiting rigidities in the legal and regulatory framework (including zoning laws, land ownership issues); improving governance and cultivating appropriate incentives; and shifting the government's role to one of regulation and strengthening the business environment.

The framework acknowledges the importance of raising the competitiveness of cities (as hubs for commerce) and building better physical connectivity-with a greater role for the private sector-as important change drivers.

Net external financing (excluding grants) for FY2011 is expected to be limited to only PRs8 billion, as repayments due on short-term loans amount to more than $1 billion. Given forecast external financing and grants of PRs127 billion, the rest of the targeted deficit (PRs716 billion) would need to be financed from domestic borrowing. Since the government has agreed to limit borrowing from the central bank in FY2012, commercial banks and nonbank institutions will need to provide financing of about 3.3% of GDP, as in FY2011.

The budget for FY2012 projects the public sector development program to expand to PRs730 billion, an increase of 58% over the FY2011 provisional figure. Achieving this ambitious target, in view of limited external resource availability, will depend on fully mobilizing budget resources and pushing through measures to contain current expenditure.

3.7.10 Subsidies



Source: Ministry of Finance. *Federal Budget 2011–12* and *2010–11.* http://www.finance.gov.pk

The current account is seen weakening in FY2012 because of slower export growth of 8% (mainly reflecting less favorable export prices) and import growth of 14% (mirroring still-high commodity prices and some economic strengthening). Workers' remittances are set to stay strong, providing a buffer for the larger trade deficit and limiting pressures on foreign exchange reserves as external debt service payments climb sharply. The current account deficit is projected at 1.3% of GDP, lower than the Asian Development Outlook 2011 projection of 2.3%.

"Source: Asian Development Outlook 2011 Update: Preparing for Demographic Transition"