PAKISTAN'S ECONOMY IN 2006:
Performance and Outlook

Pakistan Development Forum
Islamabad
May 10- 11, 2006

Poverty Reduction and Economic Management Sector Unit
South Asia Region

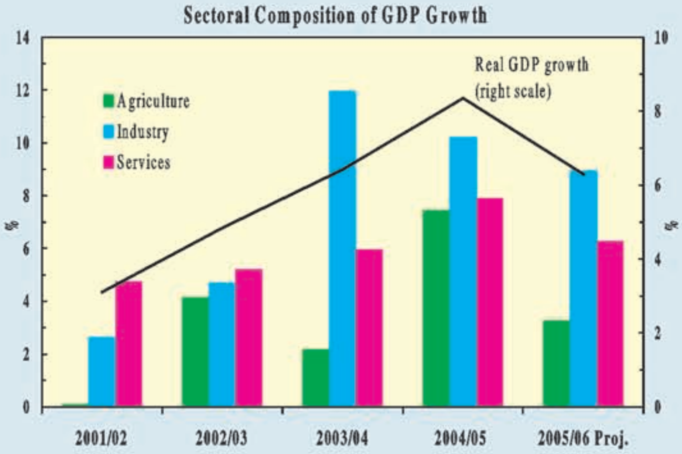
Document of the World Bank

Pakistan's Economy in 2006: Performance and Outlook

Performance

Pakistan's growth momentum remains strong. Gross Domestic Product (GDP) growth reached 8.4% in fiscal year 2004/05 (FY05), and is projected to reach 6.3% in 2005/06, in spite of the tragic earthquake of October 2005. The earthquake was a devastating event for the regions, families and businesses it affected directly. However, because the affected areas are poor, and Pakistan's aggregate GDP excludes Azad Jammu Kashmir, its impact on GDP in FY06 is projected to be less than 0.5 percentage points. In fact, as the bulk of reconstruction takes place, reconstruction activity may actually contribute to boost growth.

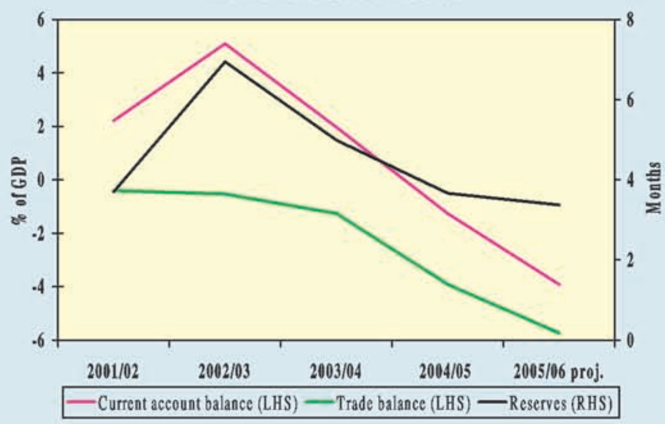
Sectoral Composition of GDP Growth



Source: Ministry of Finance; GoP; and WB staff projections for 2005/06
Note: GDP is at factor cost

Agricultural output, which contributes around one quarter to Pakistan's aggregated GDP, is projected to expand slower in FY06 than in FY05, which was an exceptionally good agricultural year. The Large Scale Manufacturing and services sectors, which contribute respectively about a quarter and half of GDP, are projected to continue to show robust growth. Nonetheless, the strong growth of the past few years has been the main driver of poverty reduction, which has declined sharply between 2001/02 and 2004/05.

External Balances and Reserves



Source: Ministry of Finance; GoP; and WB staff projections for 2005/06
Note: Reserves are in months of next year's projected imports of goods and non factor services

The key development over the past two years has been the increase in domestic demand pressures. These have translated into rising import demand and a rapidly growing current account deficit, and into inflation. According to State Bank of Pakistan (SBP) data, the current account has moved from a surplus of US$ 1.3 billion in FY04 to a deficit of US$ 1.8 billion in FY05. During the period July to February 2006, this deficit rose to US$ 4 billion, from US$ 1.1 billion in the corresponding period last fiscal year. For the whole of FY06, it is projected to rise to at least US$ 5.5 billion. The current account deficit is being financed through rising foreign direct investment – related partly to the privatization program, as well as through remittances, and external borrowing from international financial markets and multilateral agencies.

Strong import growth has led to a rapidly-rising trade deficit, which in turn fuelled the current account deficit. As a result, the current account moved from a surplus of 2% of GDP in 2003/04 to a projected deficit of 4% of GDP in 2005/06, despite strong growth in exports. Rapidly growing imports of oil, due to rising international oil prices, explain only one-third of the growth in total imports in FY06. However, non-oil imports have increased by 38%. This includes import growth of 40% of consumer goods, 49% of raw materials, and 31% of capital goods.

Pakistan's Major Exports (US$ million)

	July to March		
	2004/05	2005/06	% growth
Primary Commodities	**951**	**1,161**	**22**
Rice	625	835	34
Fish & Fish Preparations	101	132	30
Textile Manufactures	**6,041**	**7,201**	**19**
Cotton Cloth	1,336	1,557	16
Knitwear	1,217	1,270	4
Bed Wear	943	1,494	58
Other Manufactures	**2,064**	**2,460**	**19**
Petroleum Products	312	563	81
Sports Goods	216	228	6
Leather Manufactures	375	541	44
Chemicals And Pharmacy Products	282	300	6
Engineering Goods	123	135	10
Others	**1,126**	**1,251**	**11**
Total	**10,183**	**12,073**	**19**

Source: Federal Bureau of Statistics.

Exports have expanded by 17% in FY05, and by 19% during the period July to March FY06 over the corresponding period last year, led by the textile manufacturing and leather sectors. Non-traditional exports also grew fast, including exports of engineering goods and chemical and pharmaceutical goods, but their share in total exports remained at about 21%. Hence, Pakistan's export base remains heavily concentrated in a few sectors, leaving Pakistan vulnerable to terms of trade shocks or changes in external demand in these sectors.

Pakistan's Major Imports (US$ million)

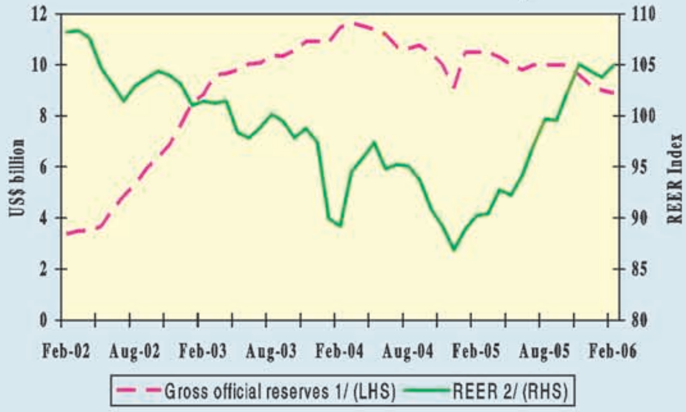
	July to March		
	2004/05	2005/06	% growth
Capital Goods	**1,453**	**1,572**	**31**
Power Generating Machinery	275	399	45
Textile Machinery	700	654	-7
Construction & Mining Machinery	107	138	29
Consumer Goods & Durables	**2,297**	**3,132**	**40**
Electrical Machinery	239	344	44
Roadmotor Vehicles	719	1,014	41
Palm Oil	512	539	5
Paper & Paper Board etc	134	174	30
Raw Materials	**6,565**	**9,676**	**49**
Petroleum Products	1,195	1,834	53
Petroleum Crude	1,611	2,782	73
Fertilizer Manufactured	275	488	77
Plastic Materials	587	757	29
Iron And Steel	633	1,048	65
Others	**4,131**	**6,313**	**53**
Raw Materials	2,014	3,092	54
Consumer	535	822	54
Capital	1,581	2,399	52
Total Imports (Cif)	**14,446**	**20,693**	**43**
Total Imports (excluding POL group)	**11,639**	**16,077**	**38**

Source: Federal Bureau of Statistics.

The import bill rose by 43% over the corresponding period in the previous year, to US$ 20.7 billion during July to March FY06, with all categories of imports showing strong increases. The increase on payment basis (i.e. as per the SBP data) is somewhat smaller. The SBP data shows a growth of 29% for the first 8 months of FY06 (vs the same period of FY05). This is partly due to leads and lags in payments, but partly due to statistical discrepancies. According to the Government, the most important statistical discrepancy arises due non-inclusion of imports arriving at dry ports in the FY05 data (but included in the FY06 data). As expected in a rapidly growing economy, the highest increase (53%) is in the import of raw materials. However, consumer goods in general, and consumer durables (including vehicles) in particular, have also shown a sharp increase. This growth is partly due to tariff adjustments made in the FY06 (and previous) budgets, but mainly because of strong demand generated by the excess liquidity in the economy and an appreciating rupee.

The Pakistani Rupee has appreciated by 18% between February 2004 and February 2006 vis-a-vis Pakistan's trading partners. While *de jure* the national currency follows a managed float, *de facto* it appears to have been pegged to the US dollar over the past few years. As the inflation differential between Pakistan and the US economy has widened, and the nominal Pak Rupee/USD rate has barely changed, the rupee has appreciated. This has further encouraged import growth, and may have contributed to discouraging exports in non-traditional sectors, which did not benefit from special tax treatment (such as the zero-rating of GST) reserved for traditional exporters.

Gross Offical Reserves and Real Effective Exchange Rate

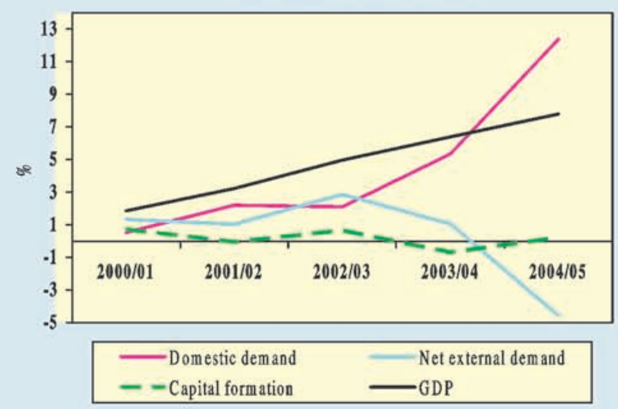


Source: State Bank of Pakistan; and WB staff calculations.
1/ Excluding gold, foreign deposits held with the SBP, and net of outstanding short-term foreign currency swap and forward contracts
2/ Real Effective Exchange Rate (REER) Index is calculated by measuring the change in Pakistan's nominal exchange rate (US$/Pak Rs.) and CPI Inflation relative to its major trading partners.

Hence, while aggregated export growth has been robust (in spite of the appreciating rupee), since FY03, domestic demand has overtaken external demand as the driving force behind GDP growth. This has been the result of an accommodative monetary stance, which has translated into low interest rates and rapid growth in domestic credit.

Monetary policy has led to a rapid growth of monetary aggregates and in FY05 finally translated into an increase in the general price level (as measured by the Consumer Price Index-CPI and the Wholesale Price Index), and contributed to a sharp increase of asset prices (land and equities). The CPI increased by 9.3% in FY05 – the largest annual increase in eight years. Large excess liquidity and increasing energy prices implied continued inflationary pressures in FY06, despite some containment of money supply. During the first 3 quarters of FY06, consumer prices increased by 8.3%, compared to the first 3 quarters of FY05.

Contribution to GDP Growth



Source: Ministry of Finance; GoP. GDP in constant prices 1999-2000
Note: GDP is in market prices

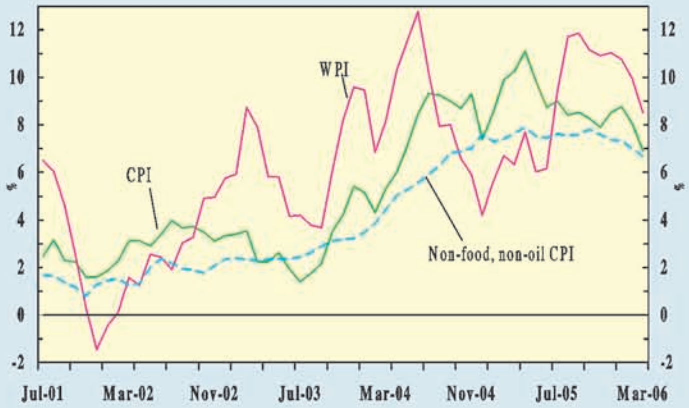
Credit to the private sector during the period July to March FY06 stood at Rs. 352.7 billion, higher than the full year target set by SBP in its credit plan of Rs. 330 billion. This is the fourth year in a row that the credit to the private sector has overshot the target set by the SBP and it is this credit expansion which is the driving force in the economic growth witnessed during the past three years.

After some increases in interest rates and the discount rate in mid 2005, the cut-off yield on Treasury bills has remained unchanged since November 2005. As a result, the real interest rate faced by the Government in its borrowing has often been zero or slightly negative in the past few months. Simultaneously, the levels of government borrowing have increased considerably over the past year. During the period July to March FY06, government borrowing increased to Rs. 76.3 billion as compared to Rs. 13.6 billion in the corresponding period last year. No long-term treasury bond (Pakistan Investment Bond) sales have taken place since 2004.

On average, lending rates have started to edge higher, while deposit rates have been slow to increase and have remained negative (in real terms) throughout much of the past few years. This has translated into extraordinary profits for commercial banks. To encourage savings, part of this increase in income has to be shared with deposit holders by taking measures to increase the deposit rates.

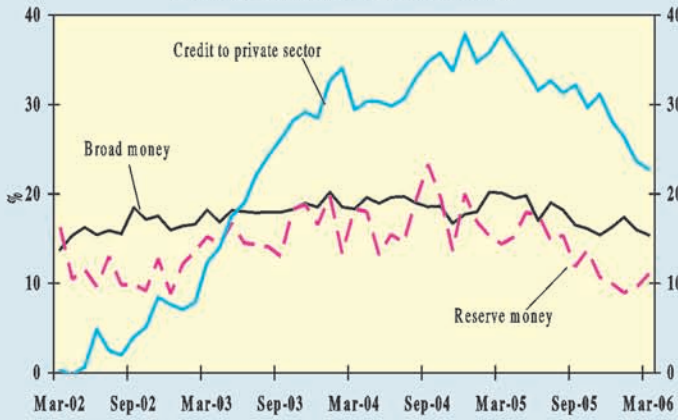
With real interest rates remaining low, and despite a modest upward movement in nominal rates, investment has shown a positive trend. Private investment increased from 11% of GDP in FY05 to a projected 14% in FY06. This increase in investment is being financed by a sharp increase in foreign savings, as domestic savings declined, leading to a significant widening of domestic resources gap. Despite this increase, investment remains only at 18% of GDP, lower than most countries of comparable income and certainly insufficient to sustain the rapid growth of 6 to 8% of GDP targeted by the government.

Prices (annual percent change)



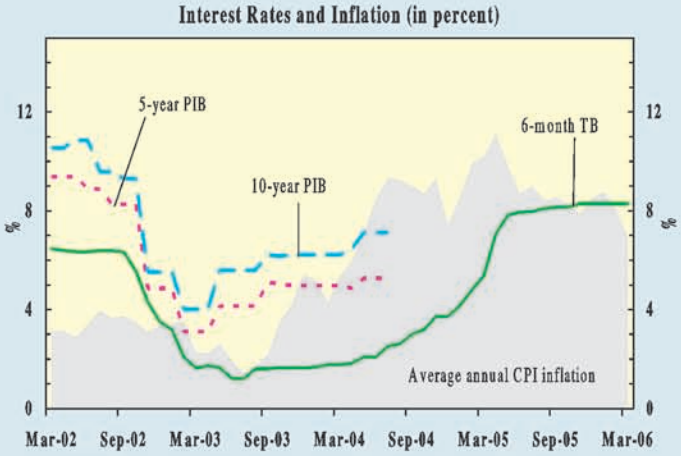
Source: Federal Bureau of Statistics and State Bank of Pakistan.

Monetary Growth (annual percent change)



Source: State Bank of Pakistan

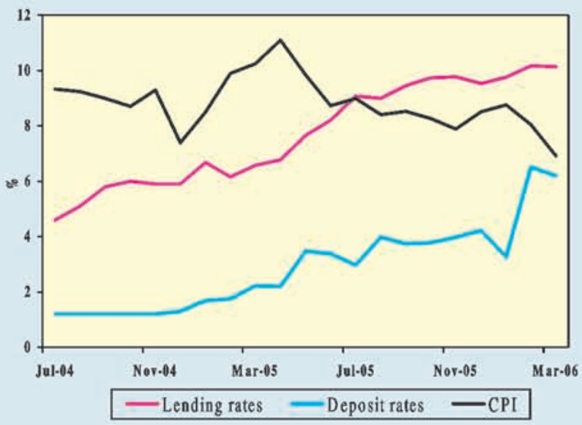
Interest Rates and Inflation (in percent)



Source: State Bank of Pakistan

The fiscal deficit is projected to rise to 4.4% of GDP in FY06, from an original (pre-earthquake) budget projection of 3.8%, primarily on account of earthquake relief and reconstruction expenditures. During the first nine months of FY06, collection of CBR revenue increased by 22% over the same period of FY05; however, the cost of reconstruction and relief operations in the aftermath of the earthquake is leading to higher expenditure by the government.

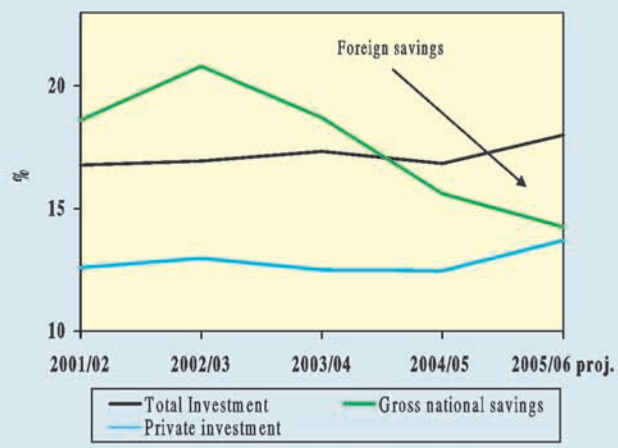
Average Lending and Deposit Rates



Source: State Bank of Pakistan

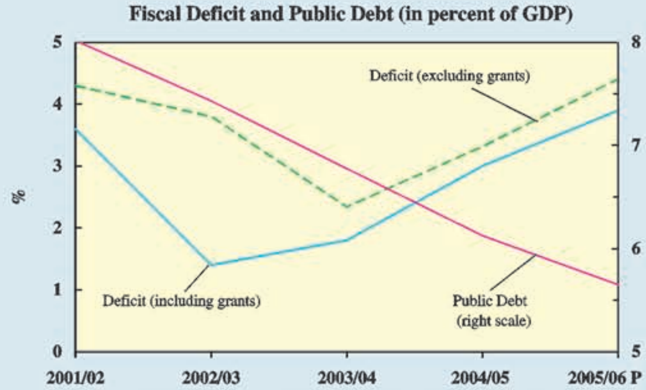
Fiscal performance has been affected over the past two years by four major factors. The first is the decline in revenues due to a decline in Petroleum Development Levy (PDL) collections of 0.6 percentage points of GDP in FY05. In FY06, PDL collections are projected to remsain very low. This was the result of the government's attempt to shield consumers from increases in international oil prices by reducing (and in some petroleum products completely eliminating) taxation through PDL collections. The second factor is the poor performance of tax revenue collections in FY05, when CBR tax collections declined by 0.4 percentage points of GDP in FY05. The main reasons behind this were the very limited taxation of the fast-growing agriculture and services sectors; tax exemptions and concessions to particular sectors which, after having declined in 2000-2003, have again crept up; and finally continued administrative weaknesses in tax administration. Together, the first two factors account for an increase of one percent of GDP in the fiscal deficit in FY05. Tax collections at the provincial level remained very weak, well below 1% of GDP – compared to 5-9% of GDP in other federations. The third factor is the increase in expenditures, especially over the past years – education and PSDP expenditures have increased, but so have civil service wages and defense. The three factors described above account for the projected increase in deficit, from 2.3% of GDP in FY04, to 3.8% of GDP in FY06. In addition, during the current fiscal year, the unanticipated impact of expenditures on relief and recovery due to the earthquake is expected to add an extra 0.5% of GDP to the deficit.

Investment and Savings (in percent of GDP)



Source: Ministry of Finance; GoP; and WB staff projections for 2005/06

Fiscal Deficit and Public Debt (in percent of GDP)



Source: Ministry of Finance; GoP; and WB staff projections for 2005/06

Other than the impact of earthquake, the fiscal situation has remained on target. Fiscal data for the first half of the fiscal year indicate that overall revenues were higher by 18%, with surcharges being higher by 40%, over the corresponding period last year. Within CBR revenue, direct taxes were higher by 29%, sales tax by 23%, and customs duties by 19%, while excise duties declined by 3%. The total expenditure was higher than last year by 26%. The increase of 22% in current expenditure was largely contributed by a 33% increase in pro-poor spending. Development expenditure was higher by a significant 48%, showing improved project implementation.

The larger-than-targeted deficit is being financed by concessional foreign borrowing and borrowing from the central bank. The meeting of debt reduction targets that the Government has set itself under the Fiscal Responsibility and Debt Limitation Law will therefore depend on the Government's ability to enhance its revenue through broad-basing and more effective collection of taxes, as well as to limit unnecessary and wasteful spending. It will also depend on the willingness of the donor community to provide the Government with grant and concessional financing as per their commitments made at the November 19 2005 Earthquake Conference.

Outlook

Pakistan's economy has shown great resilience in the face of the devastating earthquake, and future growth prospects for the economy are good. To sustain rapid growth over an extended period of time, Pakistan needs to increase its investment rate, and the productivity of investments. For this to happen, the strategy will need to (i) sustain reforms to reduce the cost of doing business (for an analysis of these reforms, see 2006 World Bank Growth and Export Competitiveness Report), continue ongoing efforts to address Pakistan's perceived image problem, as well as the root causes of this image, as they affect the perceptions of potential investors in Pakistan; (ii) invest in public infrastructure and education and health, to encourage productivity of labor and innovation, and improve living standards directly; and (iii) address the root causes of the growing macroeconomic imbalances on the current account, and sustain the competitiveness of the Pakistani rupee.

If high oil prices persist, they may affect growth negatively. Higher petroleum price increases have affected Pakistan's economic growth only to a limited extent, because the government chose to partly shield consumers from higher prices. It is unlikely that the government would be able to continue to absorb the oil price shock on the budget, and hence. In the absence of monetary policy response, they may also translate into higher inflation.

Pakistan Selected Economic Indicators

	2002/03	2003/04	2004/05	2005/06 Proj.
Output and prices		*(Annual changes in percent)*		
Real GDP fc	4.8	6.4	8.4	6.3
Real per capita GDP	2.3	4.4	6.4	4.3
Consumer prices	3.1	4.6	9.3	8.2
Consolidated government budget balance		*(In percent of GDP)*		
Excluding grants	-3.8	-2.3	-3.3	-4.4
Net of Earthquake Impact	..	..	..	*-3.6*
Including grants	-1.4	-1.8	-3.0	-3.9
Net of Earthquake Impact	..	..	..	*-3.1*
Public Debt		*(In percent of GDP)*		
Total PublicDebt	74.3	67.7	61.2	56.5
Domestic Debt	39.3	36.4	32.9	31.4
External Debt	35.0	31.4	28.3	25.1
External Sector				
Exports (annual % changes)	19.1	13.8	15.9	16.7
Imports (annual % changes)	20.2	20.1	37.6	28.0
Current account balance (% of GDP)	5.1	2.0	-1.3	-3.9
Gross Offical Reserves (in millions of US$)/1	10,251	10,564	9,805	10,549

Source: MoF and SBP; WB staff projections for 2005/06.
1/ Excluding gold, foreign deposits held with the SBP, and net of outstanding short-term foreign currency swap and forward contracts