

Pakistan

Economic Update

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Economic Policy and Poverty Team
South Asia Region

The World Bank

SUMMARY

GDP growth in Pakistan's export markets is likely to continue to fall sharply in 2009, which would translate into a starker-than-projected decline of Pakistan's export growth in the medium term, put pressure on Pakistan's external balances and complicate growth recovery. Risks to the domestic financial sector may increase, and it seems almost certain that even the downward-revised revenue target will not be met in this fiscal year. Stringent implementation of the government's IMF-supported economic stabilization program will be critical to success, and timely responses of fiscal and monetary authorities to emerging risks will be essential to ensure it remains on track.

Pakistan's macroeconomic imbalances are rooted in the sharp rise in international prices of oil and food in 2007/08, combined with policy inaction and internal political turmoil. To avoid a balance of payments crisis and default on foreign debt payments, the authorities developed the stabilization program, which was supported by the IMF through a 23-month Stand-By Arrangement (SBA) in November 2008. The program includes a medium-term macroeconomic framework with fiscal and monetary tightening to bring down inflation and reduce the external current account deficit to sustainable levels. At the first quarterly review of the SBA in February 2009, the stabilization program remained on track.

The rapid decline in international commodity and oil prices since August 2008 has reduced the risks, facilitated improvement in the external position and the achievement of targets. However, given the global economic crisis, the medium-term outlook presents significant downside risks. The sharp deterioration in the global economic and financial outlook poses significant risks to exports, remittances and external financing. Even though projections in these areas as well as forecasts about the speed of real economy recovery were significantly moderated during the first program review in February 2009, they may still turn out to be optimistic.

BACKGROUND

Table 1: Consolidated Federal and Provincial Fiscal Accounts, 2006/07-2007/08

(Percent of GDP)

	2006/07		2007/08	
	Budget	Actual	Budget	Actual
Total Revenue (excl.)	13.3	14.9	14.9	14.3
Tax Revenue	10.3	10.2	11.0	10.4
Non-tax Revenue	3.0	4.7	3.9	3.9
Total Expenditure	17.5	19.2	18.8	21.7
Current	12.8	15.8	13.7	17.7
Of which : Interest	2.7	4.2	3.8	4.7
Federal Subsidies	1.0	1.2	1.1	3.8
Defense	2.8	2.9	2.8	2.7
Other Current	6.2	7.5	6.0	6.6
Development	4.7	4.9	5.2	4.0
Budget deficit (excl.)	-4.2	-4.3	-4.0	-7.4
Financing	4.2	4.3	4.0	7.4
External	4.2	2.3	2.0	1.4
Domestic	4.2	2.0	2.0	6.0
Non-bank	4.2	0.9	1.7	1.0
Bank	4.2	1.2	0.3	5.0
Memo item: GDP (Rs in	8,808	8,707	9,970	10,478

In 2007/08, the sharp rise in international prices of oil and food (specifically wheat), in combination with policy inaction and internal political turmoil, led to rapidly expanding macroeconomic imbalances in Pakistan. Both fiscal and current account balances widened significantly. In the absence of adequate remedial policy measures to address the imbalances - in particular not passing on the international price increases to domestic consumers - the economy began to adjust through a slowdown in growth and rising inflation.

Spending overruns led to a sharp increase in the 2007/08 fiscal deficit to 7.4 percent of GDP, compared

to the budget target of 4.0 percent of GDP (see **Table 1**). Expenditures exceeded the budget target by about 2.9 percent of GDP, while revenues fell short of the target by about 0.6 percent of GDP.

About 80 percent of the fiscal deficit increase was driven by international oil and commodity price increases. The rise in the budget deficit was mostly caused by the overrun of 2.7 percent of GDP in budgetary subsidies (to 3.8 percent of GDP from the budget target of 1.1 percent of GDP) owing to the spike in international commodity and oil prices (see **Table 2**). From 2006/07 to 2007/08, the domestic price of Pakistani oil imports increased by about 60 percent on average. Yet, in an attempt to protect households and businesses from domestic price adjustments, the government kept domestic petroleum prices unchanged until March 2008. This resulted in overruns of 1.4 percent of GDP in the petroleum, oil, and lubricants (POL) subsidy, and of 0.6 percent of GDP in the electricity subsidy. Furthermore, the rise in international wheat and fertilizer prices led to an overrun of 0.5 percent of GDP in expenditure on the wheat and fertilizer subsidy.

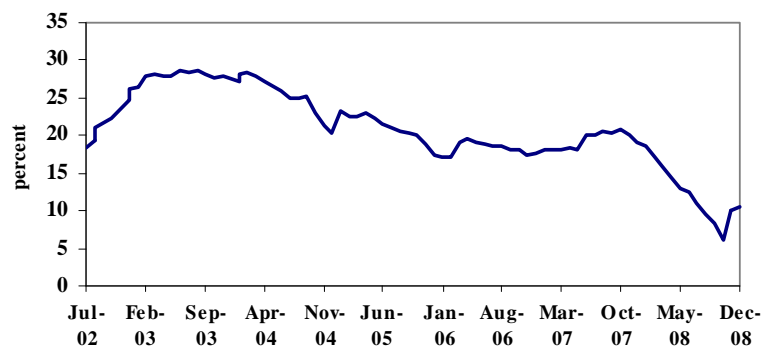
Beyond the rise in government subsidies, an overrun in interest payments by 0.9 percent of GDP due to an underestimation of interest liabilities in the budget contributed to the increase in the budget deficit. The rise in the budget deficit would have been even higher without the 1.2 percent of GDP under-run in development spending.

Table 2: Federal Government Subsidies, 2005/06-2007/08						
	<i>(percent of GDP)</i>					
	2005/06		2006/07		2007/08	
	Budget	Actual	Budget	Actual	Budget	Actual
Power sector utilities	0.7	0.6	0.6	0.7	0.7	1.3
Food subsidies	0.1	0.1	0.1	0.0	0.1	0.4
of which imported wheat	0.0	0.0	0.0	0.0	0.0	0.4
POL (refineries and OMC claims)	0.1	0.1	0.1	0.3	0.2	1.6
Fertilizer	0.1	0.1	0.2	0.1	0.1	0.3
R&D support to textile sector	0.0	0.0	0.0	0.1	0.0	0.2
Total Subsidies	0.9	0.8	1.0	1.2	1.1	3.8

In parallel, increased import bills and strong aggregate demand contributed to a widening of the current account deficit in 2007/08 - to 8.4 percent of GDP in 2007/08, compared to 4.8 percent in 2006/07. Over 50 percent of this increase (1.9 percent of GDP) was due to a 38 percent increase in the import price of petroleum per barrel. The trade deficit increased by about 58 percent year-on-year to 9.1 percent of GDP, mainly owing to sharp increases in the import bill. The import bill rose by about 31 percent, far higher than the targeted growth of 6.5 - 7.0 percent for 2007/08. The oil import bill jumped by about 56 percent, and the food import bill rose by about 46 percent on account of a sharp increase in the wheat import bill. Pakistan's gross national saving declined from 18.1 percent of GDP in 2006/07 to 13.2 percent of GDP in 2007/08. Gross capital formation declined more moderately, from 22.9 percent of GDP to 21.6 percent of GDP.

Pakistan's foreign reserves declined rapidly due to the large current account deficit, a reduction in net capital inflows, and inadequate adjustment of the exchange rate. While FDI flows remained relatively robust at US\$5.1 billion (albeit lower than in 2006/07) and remittances increased to US\$6.5 billion, portfolio investments declined as investor confidence plummeted. Also, donor

Figure 1: Net Reserves to Broad Money (%)



Source : State Bank of Pakistan.

inflows significantly dropped as the macroeconomic framework went off track, and the privatization process came to a halt in 2007/08. Furthermore, given the large spread on Pakistan sovereign bonds, borrowing from international capital markets was not an option. As a result, foreign reserves were drawn down to pay for imports. By the end of June 2008, the foreign exchange reserves of the State Bank of Pakistan had dropped to US\$8.6 billion, a fall of about US\$5.7 billion since October 2007. An additional US\$950 million was drawn from the now-depleted sinking fund. The decline in international liquidity is reflected in the sharp decrease of the ratio of State Bank reserves to broad money during the second half of 2007/08 (see **Figure 1**).

Even though the deterioration in the terms-of-trade put increasing pressure on the exchange rate, the Rupee-Dollar exchange rate remained broadly unchanged around Rs/US\$61 until December 2007. During the second half of 2007/08 SBP allowed some exchange rate flexibility and the exchange rate depreciated by 13 percent to reach Rs/US\$68.4 by the end of the fiscal year.

Faced with lower external financing and privatization receipts, the government resorted to direct borrowing from the State Bank for budget deficit financing. During 2007/08, government borrowing from the State Bank amounted to Rs. 689 billion, increasing to Rs. 1.1 trillion the total stock of government debt owed to the State Bank by the end June 2008.

The rise in government borrowing kept the growth of reserve money over 20 percent and fueled inflation (see **Figure 2**). The average CPI for 2007/08 was 12 percent, with year-on-year CPI at 21.5 percent at end June 2008. The State Bank responded to the rise in inflation by increasing the policy discount rate by a total of 200 bp by end-June 2008, but real interest rates remained negative by a large margin.

In response to the widening imbalances and supply side shocks, real GDP growth declined from 6.8 percent in 2006/07 to 5.8 percent in 2007/08. In agriculture, floods and pest attacks depressed rice and cotton production, while industrial production and services were constrained by acute power and gas shortages.

Pakistan's risk rating worsened as the economic situation deteriorated. Both Standard & Poor's and Moody's downgraded Pakistan's sovereign debt ratings in May 2008 (from B+ to B and from B1 to B2, respectively) owing to the sharp erosion in the fiscal position and the inadequate policy response to the worsening macroeconomic situation.

DEVELOPMENTS IN 2008/09

Recognizing the need to correct the macroeconomic imbalances, the government embarked on a concerted effort to stabilize the economy, starting with the 2008/09 budget. The budget, among other things, envisaged sizeable fiscal consolidation through power and fuel subsidy cuts and increased revenue effort. However, by November 2008 it was apparent that the budget measures were inadequate to contain the economic slide, now aggravated by the global financial crisis, and restore investor confidence.

The foreign exchange reserves of the State Bank of Pakistan had dropped to US\$3.3 billion (about three weeks of imports) by mid-October 2008; the nominal exchange rate had depreciated

to Rs/US\$84; the government had borrowed an additional Rs. 356 billion from the State Bank during July-November 2008; the average CPI had risen to about 25 percent and core inflation to 18.9 percent by the end of November 2008 and the EMBI Global Bond spread of Pakistani sovereign bonds had climbed above 2,000 bp. In response to these developments, Moody's had further downgraded its ratings outlook for Pakistan sovereign bonds from stable to negative in September 2008 and the rating from B2 to B3 in October 2008. Similarly, Standard & Poor's had downgraded Pakistan's rating further from B to CCC+ in early October 2008 and to CCC in early November 2008.

Home-grown Stabilization Program and the Stand-By Arrangement (SBA)

To avoid a balance of payments crisis and default on foreign debt payments, the authorities developed a home-grown stabilization program, which was supported by the IMF through a 23-month Stand-By Arrangement (SBA) in November 2008. The program includes a medium-term macroeconomic framework, which envisages fiscal and monetary tightening to bring down inflation and reduce the external current account deficit to sustainable levels. The 2008/09 program framework supported by SBA builds on the 2008/09 budget, modified to account for higher inflation projections and greater exchange rate adjustment than envisaged at the time of the budget. The framework was revised during the first program review in February 2009 to take into account the impact of significantly deteriorated global economy, resulting lower exports, foreign inflows and growth prospects in the short and medium term, as well as the change in the terms of trade through lower international oil and food prices. **Table 3** summarizes the revised framework, and compares it with the initial November 2008/09 program framework for 2008/09.

The revised framework is built around the following economic parameters for 2008/09:

- *Real GDP growth of 2.5 percent*: the target was lowered from 3.4 percent owing to sharper than anticipated economic slowdown;
- *The fiscal deficit (excluding grants) of 4.3 percent of GDP*: the initial fiscal deficit target remained unchanged in nominal Rupee terms, but owing to the moderated GDP growth projection, the target as a share of GDP increased from 4.2 to 4.3 percent;
- *The current account deficit of 5.9 percent of GDP*: the initial target of 6.5 percent of GDP was revised downwards due to a larger than anticipated decline in imports; and
- *Annual average consumer price inflation at 20 percent*: the annual inflation target was adjusted downwards from 23 percent, as a result of falling food and energy prices and lower economic activity.

The fiscal deficit reduction is to be achieved by a combination of expenditure cuts and revenue increases, with the burden of adjustment falling primarily on expenditures. Overall revenues (excluding grants) are to be increased from 14.3 percent of GDP in 2007/08 to 15.2 percent of GDP in 2008/09 through a rise in tax revenues. Further, the reduction in the fiscal deficit relies on a consolidation of overall expenditures by about 2.5 percent of GDP to 19.3 percent of GDP. About half of the reduction is to come from current spending—primarily from cuts in fuel and power subsidies—and the other half from rationalization of development spending.

On the external side, the 2008/09 revised program framework projects a rapid decline in import growth (a 14.5 percent contraction) due to decreases in international commodity and oil prices, and the slowdown in economic activity. The decline in imports is expected to outweigh the

projected 5.5 percent contraction in exports, leading to a strong improvement in the trade balance. Both gross national savings and gross capital formation are predicted to further decline, with capital formation decreasing with the economic downturn.

The 2008/09 program framework assumes that the government's net borrowing from the State Bank will be zero on a quarterly basis from November 1, 2008 onwards, and that the government will rely increasingly on non-bank borrowing and external financing. This, in addition to a sharp decline in aggregate demand during the second half of 2008/09 is expected to bring down average annual inflation to the program target.

Initial Performance of the Economy under the SBA

At the first quarterly review of SBA in February 2009, the stabilization program remained on track. The rapid decline in international commodity and oil prices since August 2008 has reduced the risks, facilitated improvement in the external position and the achievement of targets. **Table 4** highlights the developments in select recent economic indicators by month during 2008/09.

Fiscal consolidation was on track at end December 2008 (see **Table 5**). The estimated half-year fiscal deficit (excluding grants) was 1.9 percent of GDP against the target of 2.0 percent of GDP set in November 2008. Savings on non-essential development spending and a reduction in power and fuel subsidies, facilitated by rapidly declining international oil prices, helped the fiscal deficit stay within the target, despite of weak revenue performance. During July-December 2008, recurrent and development expenditures were below their targets by 5 and 18 percent, respectively. On the recurrent side, the bulk of savings accrued from federal subsidies. Expenditure on federal subsidies (at 0.9 percent of GDP) was only 36 percent of the budgeted amount, as expenditure on fuel and food subsidies fell substantially short of the (pro-rated) budget targets. The authorities started passing on the international fuel price increases to consumers in March 2008, with the intention to eliminate fuel subsidies by end December 2008. The parity with international fuel prices was achieved ahead of time, in mid-October 2008, due largely to rapidly declining international oil prices. The authorities are also committed to eliminating the power sector subsidies by end June 2009. To achieve that, they increased electricity tariffs on average by 9 percent in February 2008 and 18 percent in November 2008. In parallel, stringent expenditure control measures adopted by the federal government and the impact of political transition in the provinces contributed to smaller-than-targeted development spending.

However, inter-corporate debt in the energy sector increased sharply from Rs. 51 billion in mid-October 2008 to about Rs. 147 billion at end January 2009. While there are several reasons for the debt, including delayed payments to energy companies, this highlights the continued need for fiscal adjustment.

Table 3: Medium-Term Macroeconomic Framework

	Actual		Initial	Revised	Projections				
	2006/07	2007/08	Program 2008/09	Program 2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
Output and prices	<i>(Annual changes; in percent)</i>								
Real GDP at factor cost	6.8	5.8	3.4	2.5	4.0	5.0	6.0	6.5	7.0
Consumer prices (period average)	7.8	12.0	23.0	20.0	6.0	5.5	5.5	5.5	6.0
Pakistani rupees per U.S. dollar (period average)	1.3	..	..	..	..	..	..	..	..
Saving and Investment	<i>(In percent of GDP)</i>								
Gross national saving	18.1	13.2	13.5	14.2	15.6	17.3	18.6	19.7	21.5
Gross capital formation /1	22.9	21.6	20.0	20.1	19.9	21.6	23.0	23.9	25.2
Public finances									
Revenue and grants	15.2	14.6	15.1	15.4	16.0	16.8	17.4	17.7	17.9
Revenue	14.8	14.3	14.9	15.2	15.8	16.4	17.0	17.3	17.5
Tax revenue	10.9	10.4	11.0	11.3	12.0	12.8	13.5	13.9	14.3
<i>of which</i> : Federal Board of Revenue	9.7	9.6	10.2	10.0	10.6	11.5	12.3	12.7	13.1
Non-tax revenue	3.9	3.9	3.9	3.9	3.8	3.7	3.5	3.4	3.3
Grants	0.3	0.3	0.2	0.2	0.2	0.4	0.4	0.4	0.4
Expenditure (including statistical discrepancy) /2	20.6	21.8	19.0	19.3	19.2	19.4	19.7	19.6	19.7
Current expenditure	15.8	17.7	16.0	16.1	15.2	14.2	14.1	14.0	13.8
Interest	4.2	4.7	4.6	4.8	4.7	3.5	3.1	2.8	2.5
Other federal	6.9	8.9	7.6	7.3	6.3	6.4	6.6	6.7	6.9
Provincial	4.6	4.2	3.9	4.0	4.2	4.3	4.4	4.5	4.5
Development expenditure	4.9	4.0	3.0	3.2	4.0	5.2	5.7	5.6	5.9
of which: one-off-outlays	0.5	0.2	0.2	0.2	0.1	0.0	0.0	0.0	0.0
Net lending	-0.1	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Statistical discrepancy	-1.4	0.1	0.1	0.2	0.0	0.0	0.0	0.0	0.0
Overall balance									
Underlying (excluding grants and one-off-outlays)	-3.9	-7.3	-4.0	-4.1	-3.3	-3.0	-2.7	-2.3	-2.1
Excluding grants	-4.3	-7.4	-4.2	-4.3	-3.4	-3.0	-2.7	-2.3	-2.1
Including grants	-4.0	-7.1	-4.0	-4.2	-3.2	-2.6	-2.3	-1.9	-1.7
Financing	4.0	7.1	4.0	4.2	3.2	2.6	2.3	1.9	1.8
External	2.0	1.2	2.5	1.4	1.0	1.5	2.1	1.9	1.8
off which; privatization receipts	0.6	0.0	1.1	0.0	0.2	0.2	0.4	0.1	0.1
Domestic	2.0	6.0	1.6	2.8	2.2	1.1	0.2	0.0	0.0
Total government debt	54.1	57.4	54.6	56.9	55.3	54.1	52.1	49.9	47.4
External government debt	24.2	26.2	26.9	27.8	26.2	26.2	26.2	26.3	26.0
Domestic government debt	29.9	31.2	27.7	29.1	29.1	27.9	25.8	23.6	21.4
Monetary sector	<i>(Annual changes; in percent)</i>								
Net foreign assets	8.1	-7.8	-4.9	-3.4	-1.4	..	..	..	..
Net domestic assets	11.3	23.2	15.7	11.8	12.1	..	..	..	..
Broad money	19.3	15.3	10.8	8.4	10.6	..	..	..	..
Private credit	17.2	16.4	25.2	8.3	14.2	..	..	..	..
Six-month treasury bill rate (period average; in %)	8.8	9.6	12.7	..	..	..	..	..	..
External sector									
Merchandise exports, U.S. dollars (growth rate; in %)	4.4	16.5	12.0	-5.5	1.5	6.2	8.0	8.0	8.5
Merchandise imports, U.S. dollars (growth rate; in %)	8.0	31.2	1.1	-14.5	-5.5	6.8	7.0	7.6	6.8
Current account including official current transfers (as % of GDP)	-4.8	-8.4	-6.5	-5.9	-4.3	-4.3	-4.3	-4.2	-3.7
Gross official reserves (in millions of U.S. dollars) /3	14,302	8,591	8,591	9,091	10,591	11,091	11,891	11,891	12,891
In months of next year's imports of goods and services	3.8	2.7	2.1	3.0	3.3	3.2	3.2	3.0	3.0
Memorandum Items:									
Real effective exchange rate (annual average; percentage change)	0.5	-0.8	..	..	..	..	..	..	..
Real per capita GDP (percentage change) /4	5.1	4.1	1.6	0.9	2.4	3.4	4.4	4.9	5.4
GDP at market prices (in billions of Pakistani rupees)	8,723	10,478	13,384	12,970	14,298	15,838	17,712	19,901	22,572
GDP at market prices (in billions of U.S. dollars)	144.0	167.6	..	162.6	171.0	180.8	193.1	207.4	224.0

/1 Including changes in inventories. Investment data recorded by the Federal Bureau of Statistics are said to be underreport true activity.

/2 Expenditure on social assistance in 2008/09 is budgeted at 0.5 percent of GDP. The program will target an additional 0.3-0.5 percent of GDP.

/3 Excluding gold, foreign deposits of commercial banks held with the State Bank of Pakistan.

/4 The Real per capita GDP for years FY11, FY12, FY13, and FY14, the population growth rate is assumed to be 1.6% p.a.

Sources: Government of Pakistan for the historical years, and IMF projections.

Table 4: Selected Recent Economic Indicators

				2007/08	2008/09								2008/09	
	2004/05	2005/06	2006/07		Jul	Aug	Sep	Oct	Nov	Dec	Jan	Jul-Jan		
International Commodity Prices														
Crude Oil, Dubai (end-period)	\$/bbl	1a/	40.2	57.6	60.9	90.3	123.2	110.3	90.0	59.4	47.1	37.1	43.2	
Wheat, US (average)	\$/mt	1b/	148.8	169.7	202.2	343.8	328.2	329.0	296.0	237.0	226.9	220.0	239.0	
Current Account Deficit	% of GDP		-1.4	-3.9	-4.8	-8.4	-0.6	-0.9	-0.8	-1.3	-0.5	-0.3	-0.3	-4.8
<i>of which:</i>														
Trade of Goods	% of GDP		-4.1	-6.5	-6.8	-9.1	-0.8	-0.9	-1.0	-1.0	-0.4	-0.7	-0.5	-5.2
Trade of Services	% of GDP		-3.0	-3.4	-2.9	-3.8	-0.3	-0.4	-0.1	-0.3	-0.2	-0.2	-0.1	-1.5
Workers' Remittances	% of GDP		3.8	3.6	3.8	3.8	0.4	0.4	0.4	0.3	0.4	0.4	0.4	2.6
Net Capital Flows	% of GDP	2/	1.0	4.9	7.4	4.9	-0.3	0.4	0.2	0.4	0.2	0.6	0.6	1.8
<i>of which:</i>														
Foreign Direct Investment	% of GDP		1.4	2.7	3.6	3.1	0.2	0.3	0.2	0.1	0.2	0.4	0.1	1.6
Portfolio Investment	% of GDP		0.6	0.7	2.3	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.1	0.2
Net Portfolio Investment (end-period)	\$ mn		620.0	964.0	3,288.0	41.0	-133	-218	-235	-250	-278	-308	-408	
EMBI Global Bond Spread (end-period)	bps		229	251	214	687	782	1,040	1,600	2,005	2,132	2,112	2,046	
Foreign Exchange Reserves (end-period)	\$ mn		9,805	10,765	13,345	8,625	6,968	5,760	4,866	3,379	6,001	6,619	6,793	
Exchange Rate (end-period)	Rs/\$		59.7	60.2	60.6	68.4	71.5	76.2	78.4	81.7	78.9	79.1	79.0	
Consumer Price Index	%, YoY growth		9.3	7.9	7.8	12.0	24.3	25.3	23.9	25.0	24.7	23.3	20.5	23.9
CPI food	%, YoY growth		12.5	6.9	10.3	17.6	33.8	34.1	29.9	31.7	30.4	27.9	21.6	29.8
CPI non-food and non-energy	%, YoY growth		7.2	7.5	5.9	8.4	14.7	16.4	17.3	18.3	18.9	18.8	18.9	17.6
6-month T-bill (% end-period)			7.9	8.4	8.9	11.5	11.5	11.5	12.7	12.7	14.0	14.0	14.0	
Reserve money	%, YoY growth		17.6	10.2	20.9	21.6	19.3	21.3	25.2	10.9	10.7	10.1	10.1	
Broad money	%, YoY growth		19.2	14.9	19.3	15.4	13.8	13.4	12.7	14.2	11.4	10.4	8.8	
Government Borrowing	Rs bn		91.1	86.9	92.8	583.8	<i>July - February 7, 2009</i>							
SBP	Rs bn		155.6	135.1	-58.6	688.7	324.4							
Scheduled Banks	Rs bn		-88.4	-68.0	160.6	-134.1	308.1							
							3.4							

Note 1: Period average unless indicated otherwise.

Note 2: IMF projected GDP of US\$163 billion is used for 2008/09.

1a/ Source: GEM World Bank.

1b/ Source: IMF Primary Commodity Prices.

2/ Defined as the overall balance minus the current account balance.

During July-December 2008, national revenue collection reached Rs. 834 billion, which was 0.3 percent of GDP below the initial program target of 6.5 percent of GDP. The relatively weak performance was due to lower tax collection by the Federal Board of Revenue (FBR), as the sharp economic slowdown reduced the buoyancy of Pakistan's two main tax bases, manufacturing and imports. From July 2008 to January 2009, FBR tax revenues reached Rs. 628 billion, an increase of only 22 percent year-on-year compared to the initial program target of 35 percent. In response to these developments, the authorities decided to step up the tax audit efforts to cover part of the revenue shortfall, and the FBR revenue target was revised downwards from Rs. 1,360 billion to Rs 1,300 billion during the February 2009 program review. In addition, the government intends to compensate the shortfall in FBR revenues through higher petroleum development levy collection. The levy collection reached Rs. 29 billion during the first half of 2008/09, exceeding by over 100 percent the fiscal year target of Rs. 14 billion. Instead of passing on the international price decreases to consumers, the government has maintained a premium above the import parity levels to cover part of the tax revenue shortfall.

The external imbalances narrowed towards the end December 2008 on the back of a lower oil import bill. The monthly current account deficit dropped sharply from the peak of 1.3 percent of GDP in October 2008 to 0.3 percent of GDP in January 2009, bringing the July-January 2009 current account deficit to about 4.8 percent of GDP (US\$7.8 billion).

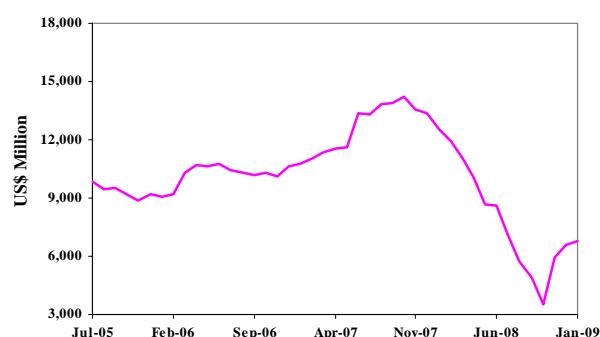
Imports are projected to decline further as Pakistan benefits from lower international oil prices. Table 5: Consolidated Federal and Provincial Fiscal Accounts, 2008/09

(Percent of GDP)

	Budget	July-December		Full-Year	
		Program	Actual	Initial Program	Revised Program
Revenue (excluding grants)	14.6	6.5	6.2	14.9	15.2
Tax revenue	10.8	4.7	4.6	11.0	11.3
Federal	10.3	4.5	4.4	10.5	10.9
FBR revenue	10.0	4.3	4.1	10.2	10.0
Oil and gas surcharges	0.4	0.2	0.3	0.4	0.9
Provincial	0.5	0.2	0.2	0.4	0.4
Nontax revenue	3.8	1.8	1.6	3.9	3.9
Federal	3.0	1.4	1.5	3.2	3.3
Provincial	0.8	0.3	0.2	0.7	0.6
Expenditure	19.2	8.4	7.9	19.0	19.4
Current expenditure	15.7	7.4	7.0	16.0	16.4
Federal	11.6	5.7	5.2	12.2	12.4
Interest	4.2	2.3	2.2	4.6	4.8
Other	7.4	3.4	3.0	7.6	7.6
Provincial	4.1	1.7	1.8	3.9	4.0
Development expenditure	3.5	1.0	0.9	3.0	3.0
Public Sector	3.5	1.0	0.9	3.0	2.9
Federal	2.3	0.6	0.5	1.8	1.8
Provincial	1.2	0.4	0.4	1.1	1.2
Net lending	0.0	0.0	0.0	0.0	0.0
Statistical discrepancy	0.0	0.1	0.2	0.1	0.2
Overall Deficit (excluding Financing)	-4.6	-2.0	-1.9	-4.2	-4.3
Financing	4.6	2.0	1.9	4.2	4.3
External	1.8	0.4	0.3	2.6	1.69
Domestic	2.8	1.5	1.6	1.6	2.7
Bank	0.8	1.1	1.4	0.7	1.5
Nonbank	2.0	0.4	0.2	0.9	1.2
Privatization receipts	0.0	0.0	0.0	0	0
Memo item: Nominal GDP	12.556	13.384	13.38	13.384	12.970

While net capital inflows during July 2008 to January 2009 almost halved from US\$5.1 billion in 2007/08 to US\$2.9 billion in 2008/09, foreign exchange reserves of the State Bank of Pakistan rose to about US\$6.9 billion by early February 2009 (see **Figure 3**). The rise in State Bank reserves reflects the release of the first SBA tranche of over US\$3.1 billion at the end of November 2008, in addition to other disbursements from development partners, interbank purchases from the State Bank and borrowing from foreign commercial creditors. The improvements in the current account and the reserve position have helped to stabilize the nominal exchange rate at about Rs/US\$80.

Figure 3: SBP Foreign Exchange Reserves (End Period)

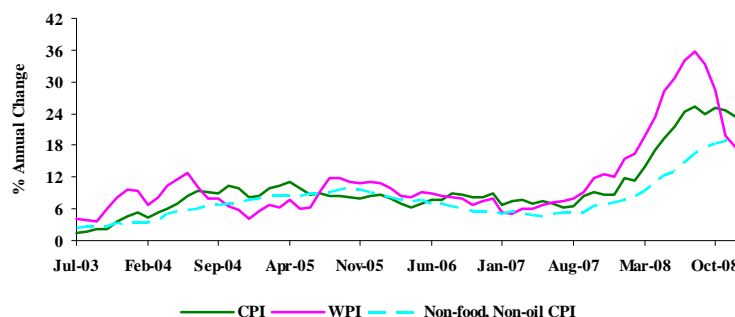


Source : State Bank of Pakistan.

Over the last few months, the government has met its financing needs mainly through non-bank borrowing. The T-bill market responded well to the 200 bp rise in the policy discount rate to 15 percent in mid-November 2008, and the increase in T-bill placements since then has enabled the government to reduce the level of net borrowing from SBP by end December 2008 to below the ceiling stipulated.

Improved aggregate demand management and lower commodity and oil prices have begun to reduce inflation. The monthly year-on-year CPI declined to 20.5 percent in January 2009, and food inflation to 21.6 percent (see **Figure 4**). However, core inflation (non-food, non-energy CPI) remained high, and reached 18.9 percent.

Figure 4: Inflation



Source: CPI, WPI and Non-food, non-oil CPI from Federal Bureau of Statistics, Pakistan.
 Note: Non-food, non-oil CPI is calculated by excluding food and energy items from CPI inflation.

Standard & Poor's upgraded

Pakistan's long-term foreign currency credit rating back to CCC+ in December 2008. However, the EMBI Global Bond spread of Pakistan sovereign bonds remained above 2,000 bp in early January 2009, suggesting that investor confidence remains fragile.

Despite favorable trends in the agricultural sector, domestic production and sales declined during the first half of 2008/09 compared to the previous year, due to power shortages, increased input costs, lower domestic demand, decreased private sector credit growth, and worsened prospects for exports. In particular, the growth of the large-scale manufacturing sector turned negative 4.7 percent. Owing to these trends, the real GDP growth target for 2008/09 has been reduced to 2.5 percent.

MEDIUM-TERM OUTLOOK

Given the global economic crisis, the medium-term outlook presents significant downside risks. The external environment is expected to deteriorate further, with global growth turning negative and a gradual recovery starting only 2010.

In the government's revised medium-term macroeconomic framework, Pakistan's real GDP growth is projected to remain low in 2008/09 and 2009/10, and increase gradually from 2.5 percent in 2008/09 to 6.5 percent by 2012/13 (see Table 3), although longer-term projections are particularly uncertain in view of the volatile global economic environment. Aided by increasing public investment—among other things in infrastructure, power, and transport—gross capital formation is projected to rise and contribute to growth recovery and facilitate private sector activity. In parallel, gradually increasing private sector credit growth is projected to help economic activity. Agriculture is showing good growth prospects, while manufacturing and services are expected to recover only gradually as the domestic aggregate demand picks up and the availability of power improves as a result of investments in power generation. With the

global recovery, exports are also projected gradually improve and reduce Pakistan's external vulnerability.

In the medium term, the government's revised macroeconomic framework targets projects a decline in the fiscal deficit (excluding grants) from 4.3 percent of GDP in 2008/09 to 2.3 percent of GDP in 2012/13. The cornerstone of this outlook is a significant increase in Federal Board of Revenue tax revenues which are projected to rise by 3.1 percentage points of GDP to 12.7 percent of GDP by 2012/13. Excluding grants, overall revenues are projected to rise from 14.3 percent of GDP in 2007/08 to 17.3 percent of GDP in 2012/13.

To meet the ambitious revenue targets, the authorities consider implementing bold and comprehensive tax policy and administration reforms. This would include quick and decisive implementation of value-added taxation (VAT) of goods and services, elimination of tax exemptions and zero-ratings, and revamping of the tax administration. This would be the key measure to expand the tax base and revenues, since currently services, which account for about 60 percent of GDP, currently remain outside the tax net. In the meantime, as part of the 2009/10 budget, the government may adopt significant legal changes to the current General Sales Tax (GST), moving it closer to VAT by minimizing exemptions and zero-ratings, and thereby broadening tax base and revenues. Significant untapped revenue potential remains also at the provincial level, which would warrant attention.

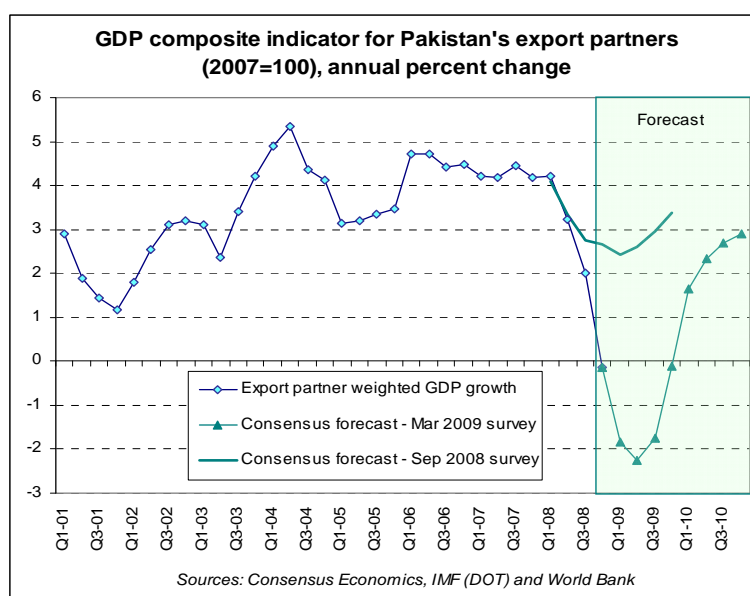
Owing to this sizeable revenue effort, total expenditures are projected to slowly climb back to about 20 percent of GDP in 2012/13. In line with current projections of low oil and commodity prices, and following the elimination of power and fuel subsidies and maturing of the remainder of high interest-yielding Defense Savings Certificates, current expenditures will decline as a share of GDP and make space for a steady increase in development spending from 3.2 percent of GDP in 2008/09 to 5.6 percent of GDP in 2012/13.

The external current account deficit is projected to decline to about 4.2 percent of GDP by 2012/13. Foreign exchange reserves are expected to build-up from US\$9.1 billion by end-June 2009 to about US\$11.9 billion by end-June 2012/13. The sharp decline in international commodity prices, reduced private sector credit growth, and the economic recession are expected to curtail import growth in 2008/09 and 2009/10. Exports are projected to start recovering from 2009/10 onwards with gradual global recovery and imports from 2010/11 onwards, but the growth of both remains moderate during the medium term. Remittances are projected to grow over the medium term. Foreign direct investment, after a drop in 2008/09, is projected to start gradually recovering in 2009/10 with the re-launch of the privatization process, and portfolio flows are predicted to turn positive only from 2010/11 onwards.

In the medium term, increased productivity and export competitiveness are necessary to generate growth and reduce external vulnerability. To this aim, structural reforms to strengthen the investment climate and competitive environment are required. These will include measures to ease firm entry and exit, reduce barriers to competition and trade, and enhance the labor market flexibility. In addition, efforts to improve the financial sustainability and efficiency of the power sector will be essential to attract investment in new power generation.

CONCLUSION

Over the last few months, the stabilization efforts together with a decline in international commodity prices have succeeded in reducing external imbalances, rebuilding foreign exchange reserves, narrowing fiscal overruns and lowering inflation. However, the sharp deterioration in the global economic and financial outlook poses significant risks to exports, remittances and external financing. Even though projections in these areas as well as forecasts about the speed of real economy recovery were significantly moderated during the first program review in February 2009, they may still turn out to be optimistic. For example, economic growth countries to which Pakistan exports is likely to continue to fall sharply in 2009 (see **Figure 5**), which would translate into a decline in Pakistan's export growth, put pressure on Pakistan's external balances and complicate growth recovery. The risks to the domestic financial sector may increase. The medium-term revenue projections are ambitious and will be difficult to meet. The March 2009 Federal Board of Revenue tax collections fell short of the downward revised revenue target.



This highlights the need for a rigorous implementation of reforms, while protecting core development spending, in particular social spending, to ease the adjustment for the poor and vulnerable people. Stringent implementation of the economic program will be critical to success, and timely responses of fiscal and monetary authorities to emerging risks will be essential to ensure it remains on track. In the current economic environment, any medium-term projections are uncertain and regular adjustments are necessary in response to changed circumstances. ■

WORLD BANK ASSISTANCE FY09

<i>Product Name</i>	IDA Million US\$	IBRD Million US\$	Current Status
Investment Projects			
Social Safety Nets TA Project	60		Preparation
PPAF III	265		Preparation
National Transport Corridor TA	25		Preparation
Punjab Education Program	350		Preparation
Thar Coal and Power	25		Preparation
Sindh Education Program	300		Preparation
3 rd Partnership for Polio Eradication	70		Preparation
Policy Based Operations			
PRESO	500		Delivered
Higher Education DPL	100		Preparation
Social Safety Nets DPL	200		Preparation
Major AAA Products			
Public Financial Management & Accountability Sindh			Delivered
Access to Finance			Delivered
Investment Climate Assessment			Delivered
Tax Policy Report			Delivered
Northern Areas Economic Report			Preparation
Public Expenditure Review			Preparation
Poverty Assessment			Preparation
Health Sector Review			Preparation
NWFP Mining Sector Policy Note			Preparation
Public Expenditure/Financial Accountability Assessment			Preparation