

Pakistan

Economic Update

September 2009

Economic Policy and Poverty Team
South Asia Region

The World Bank

SUMMARY

Stabilization efforts since November 2008 together with a decline in international commodity prices have succeeded in reducing external imbalances, rebuilding foreign exchange reserves, and lowering inflation in Pakistan. However, the macroeconomic situation remains fragile and the medium-term outlook uncertain. Progress with the implementation of reforms has been uneven, with inadequate measures taken to boost revenue mobilization and control public spending. The volatile political and security environment has complicated policy-making and made the implementation of stabilization measures challenging. Also, while the acute phase of the global financial crisis seems to be ending, global recovery will be gradual and take time. In the meantime, there are significant risks to exports, remittances and external financing. The fiscal year 2009/10 looks difficult.

Economic activity significantly slowed down in 2008/09. The current account deficit narrowed to 5.1 percent of GDP driven by a sharp contraction in imports which exceeded that in exports, and growing workers' remittances. While remittances increased, financial inflows (such as FDI and portfolio investment) dropped sharply—by over 37 percent—owing to macroeconomic instability, deteriorating security situation and global recession. Despite these developments, thanks to IMF disbursements, SBP foreign exchange reserves rebounded to about US\$9.1 billion (2.9 months of imports) by end-June 2009.

However, fiscal problems continued during 2008/09 and the fiscal deficit target was exceeded by 0.9 percent of GDP, amounting to 5.2 percent of GDP. Overall revenues fell substantially short of the target—by one percentage point of GDP—primarily owing to a drop in tax revenues as the economic slowdown reduced the buoyancy of Pakistan's two main tax bases (manufacturing and imports). FBR tax revenues declined from 9.8 to 8.8 percent of GDP. At the same time, federal government's attempts to control spending were thwarted by high provincial spending.

The first two months of 2009/10 suggest that fiscal instability will continue, and the first quarter fiscal deficit target will likely be missed. Revenues have continued underperforming: FBR tax collection during July-August 2009 increased only by 3.6 percent compared to 19.5 percent required to reach the annual target. Also, provincial governments have continued spending at high levels, and power subsidies have remained unaddressed by the federal government.

Failure to raise revenues going forward would further heighten Pakistan's vulnerability to shocks, and jeopardize country's development efforts by limiting resources available for planned investments in human and physical infrastructure. There is a risk that Pakistan may repeat past mistakes. Pakistan's high economic growth in the earlier part of this decade was in part explained by heavy reliance on external financing and on expansionary fiscal stance, while revenues and savings remained stagnant. This reliance on external financing left the economy vulnerable to external shocks, which came in 2007/08 and, in the absence of corrective measures, led to a balance of payments crisis. To reduce the economy's vulnerability to shocks and avoid the repeat of past mistakes, stepping up domestic revenue mobilization would be critical.

BACKGROUND

1. In November 2008, to avoid a default on foreign debt payments, the authorities developed a home-grown stabilization program, which was supported by the IMF through a Stand-By Arrangement (SBA). In 2007/08, the sharp rise in international oil and food (specifically wheat) prices, in combination with policy inaction and internal political turmoil, had led to rapidly expanding macroeconomic imbalances in Pakistan. In the absence of adequate remedial policy measures to address the imbalances—in particular not passing on the international price increases to domestic consumers, but covering price increases through rising subsidies—the economy slid to a balance of payments crisis. By mid-October 2008 the foreign exchange reserves of the State Bank of Pakistan (SBP) had dropped to about three weeks of imports (US\$3.3 billion), nominal exchange rate had significantly depreciated, monetization of government debt was in full swing and led to a rapid rise in inflation, and the EMBI Global Bond spread of Pakistani sovereign bonds had climbed to above 2,000 bp. In response, the stabilization program envisaged fiscal and monetary tightening to bring down inflation and reduce the external current account deficit to sustainable levels.

2. The volatile political and security environment has complicated policy-making and made the implementation of the stabilization program challenging since its launch. Political tensions between the two leading parties PPP and PML-N intensified in the second half of 2008/09 and culminated in the “long march of lawyers” in March 2009. Since then political volatility has somewhat subsided. Terrorist attacks have, however, continued. The attack on the Sri Lankan cricket team and bombing of a five star hotel in Peshawar were among them. Furthermore, Pakistan engaged in a full-fledged war with militants in the Federally Administered Tribal Areas (FATA) and portions of the Northwest Frontier Province (NWFP) in May 2009, as an agreement to allow Sharia law (Nizam-e-Adal regulation) in Swat in April 2009 quickly fell apart. Full scale military operations have led to about 2.7 million internally displaced persons (IDPs). Taking care of IDPs as well as reconstructing the conflict-damaged areas will be a challenge moving forward, and adding to the fiscal burden.

3. Frequent changes in the country’s economic management have also continued, adding instability to policy-making. While the Finance Minister has remained unchanged since November 2008, a new Governor took over SBP in early 2009, the Finance Secretary was replaced in March 2009, and the Chairman of the Bureau of Revenue of Revenue (FBR) in May 2009.

ECONOMIC PERFORMANCE UNDER THE STABILIZATION PROGRAM SO FAR

4. The stabilization program has remained broadly on track, though at times with substantial difficulty. The first program review was completed in March 2009, but the completion of the second review was delayed by months and finally concluded in August 2009.

5. The rapid decline in international commodity and oil prices during 2008/09 has reduced the risks, facilitated improvement in the external position and the achievement of program targets. Some of them were met, some missed in 2008/09. While the economy started stabilizing towards the end of the fiscal year, overall economic performance has remained mixed. Table 1 summarizes the medium-term macroeconomic framework the program is supporting.

Table 1: Medium-term Macroeconomic Framework

	Actual		Initial Program	Revised Program	Est.	Initial Program	Revised Program	Proj.				
	2006/07	2007/08	2008/09	2008/09	2008/09	2009/10	2009/10	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	4.1	3.4	2.5	2.0	4.0	4.0	3.0	4.0	4.5	5.0	5.5
Consumer prices (period average)	7.8	12.0	23.0	20.0	20.8	6.0	6.0	10.0	7.0	6.0	6.0	6.0
Pakistani rupees per U.S. dollar (period average)	1.3	3.2	..	..	25.8	..	..	..	..	..	..	..
Saving and Investment												
<i>(In percent of GDP)</i>												
Gross national saving	18.1	13.2	13.5	14.2	14.6	15.6	15.6	14.3	15.8	16.5	17.2	18.8
Gross capital formation /1	22.9	21.6	20.0	20.1	19.7	19.9	19.9	19.0	21.1	21.6	21.6	22.2
Public finances												
Revenue and grants	15.2	14.6	15.1	15.4	14.4	16.0	16.0	15.2	15.4	16.0	16.3	16.6
Revenue	14.8	14.3	14.9	15.2	14.2	15.8	15.8	14.6	15.0	15.8	16.1	16.4
Tax revenue	10.9	10.6	11.0	11.3	10.2	12.0	11.9	10.7	11.4	12.2	12.7	13.0
<i>of which: Federal Board of Revenue</i>	9.7	9.8	10.2	10.0	8.8	10.6	10.6	9.3	10.1	10.9	11.5	11.9
Non-tax revenue	3.9	3.9	3.9	3.9	3.9	3.8	3.8	3.8	3.7	3.5	3.3	3.3
Grants /2	0.3	0.8	0.7	0.6	0.3	0.2	0.6	0.6	0.4	0.2	0.2	0.2
Expenditure (including statistical discrepancy) /3	20.6	22.2	19.0	19.3	19.0	19.2	19.2	19.3	19.3	19.0	19.0	19.2
Current expenditure	15.8	18.1	16.0	16.1	16.3	15.2	15.2	15.7	14.8	14.3	14.2	14.0
Interest /4	4.2	4.8	4.6	4.8	4.8	4.7	4.7	4.4	3.8	3.4	3.1	2.7
Other federal /5	6.9	9.0	7.6	7.3	7.3	6.3	6.4	7.3	6.5	6.3	6.5	6.7
Provincial	4.6	3.8	3.9	4.0	4.2	4.2	4.2	4.0	4.4	4.5	4.6	4.6
Development expenditure	4.9	4.1	3.0	3.2	2.8	4.0	4.0	3.5	4.5	4.7	4.9	5.1
<i>of which: one-off-outlays</i>	0.5	0.2	0.2	0.2	0.2	0.1	0.1	0.2	0.0	0.0	0.0	0.0
Net lending	-0.1	-0.3	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0
Statistical discrepancy	-1.4	0.0	0.1	0.2	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance												
Underlying (excluding grants and one-off-outlays)	-3.9	-8.2	-4.5	-4.6	-5.0	-3.3	-3.7	-4.5	-4.3	-3.2	-2.9	-2.8
Excluding grants	-4.3	-8.4	-4.7	-4.8	-5.2	-3.4	-3.8	-4.7	-4.3	-3.2	-2.9	-2.8
Including grants	-4.0	-7.6	-4.0	-4.2	-4.9	-3.2	-3.2	-4.1	-3.9	-3.0	-2.7	-2.6
Financing /6												
External	4.0	7.3	4.0	4.2	5.0	3.2	3.2	4.2	3.8	3.0	2.8	2.6
<i>off which: privatization receipts</i>	2.0	1.2	2.5	1.4	0.9	1.0	1.0	1.8	2.8	2.9	2.5	2.3
Domestic	0.6	0.0	0.0	0.0	0.0	0.2	0.0	0.0	0.2	0.2	0.1	0.1
Domestic	2.0	6.1	1.6	2.8	4.1	2.2	2.2	2.4	1.0	0.1	0.3	0.3
Total government debt /7	54.1	58.4	54.6	56.9	56.0	55.3	55.4	56.8	57.1	57.1	56.8	56.3
External government debt /7	24.2	26.7	26.9	27.9	26.0	26.2	26.2	25.6	27.6	29.8	31.5	32.9
Domestic government debt	29.9	31.8	27.7	29.1	30.0	29.1	29.1	31.3	29.6	27.3	25.3	23.4
Monetary sector												
<i>(Annual changes; in percent)</i>												
Net foreign assets	8.1	-7.8	-4.9	-3.4	-3.2	-1.4	-1.4	1.9	..	..	..	..
Net domestic assets	11.3	23.2	15.7	11.8	12.8	12.1	12.1	11.1	..	..	..	..
Broad money	19.3	15.3	10.8	8.4	9.6	10.6	10.6	13.0	..	..	..	..
Private credit	17.2	16.4	25.2	8.3	0.7	14.2	14.1	14.8	..	..	..	..
Six-month treasury bill rate (period average; in %)	8.8	9.6	12.7	..	13.1	..	..	..	..	..	..	..
External sector												
Merchandise exports, U.S. dollars (growth rate; in %)	4.4	18.2	12.0	-5.5	-7.4	1.5	1.6	-2.5	3.4	5.3	7.1	7.7
Merchandise imports, U.S. dollars (growth rate; in %)	8.0	31.4	1.1	-14.5	-12.9	-5.5	-5.5	-2.4	4.8	4.0	3.8	4.2
Current account including official current transfers (as % of GDP)	-4.8	-8.3	-6.5	-5.9	-5.1	-4.3	-4.3	-4.7	-5.3	-5.0	-4.3	-3.4
Gross official reserves (in millions of U.S. dollars) /8	14,302	8,591	8,591	9,091	9,114	10,591	10,591	13,474	15,100	14,600	13,100	12,100
In months of next year's imports of goods and services	3.8	2.7	2.1	3.0	2.9	3.3	3.3	4.1	4.4	4.1	3.5	3.1
Memorandum Items:												
Real effective exchange rate (annual average; percentage change)	0.5	-0.8	..	..	..	..	..	..	..	..	..	..
Real per capita GDP (percentage change)	5.1	4.1	..	..	2.0	..	..	3.0	4.0	4.5	5.0	5.5
GDP at market prices (in billions of Pakistani rupees)	8,723	10,284	13,384	12,970	13,095	14,298	14,298	14,837	16,510	18,288	20,355	22,763
GDP at market prices (in billions of U.S. dollars)	144.0	164.5	..	162.6	166.5	171.0	171.0	178.7	184.2	194.3	205.9	219.3
<i>/1 Including changes in inventories. Investment data recorded by the Federal Bureau of Statistics are said to be underreport true activity.</i>												
<i>/2 For 2009/10 projections, this figures includes unidentified IDP-grants in the amount of US\$ 404 million.</i>												
<i>/3 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.</i>												
<i>/4 For 2007/08, financing figure has been provided by the Ministry of Finance.</i>												
<i>/5 In 2007/08, Rs 23 billion (0.3 percent of GDP) of current expenditure has been reclassified as development expenditure.</i>												
<i>/6 Includes statistical discrepancy and spending related to the 2005 earthquake.</i>												
<i>/7 Excludes obligations to the IMF, military debt, commercial loans, and short-term debt.</i>												
<i>/8 Excluding gold, foreign deposits of commercial banks held with the State Bank of Pakistan.</i>												
<i>Sources: Government of Pakistan for the historical years, and IMF projections.</i>												

6. Even though economic activity significantly slowed down owing to reduced domestic and global demand, preliminary estimates suggest that the economy still grew by 2.0 percent in 2008/09. This was 0.5 percent below the program target. Agriculture, which contributes about one-fifth of GDP, grew robustly by 4.7 percent (in particular wheat, maize and rice) as a result of favorable weather conditions. The services sector, which has provided over half of the growth impulse over the past three years, also continued to grow by 3.6 percent. By contrast, industry, which contributes about one-quarter of GDP, continued its contraction by 3.6 percent in 2008/09. Large-scale manufacturing, which makes up about half of the industrial value-added, registered negative growth.¹ The contraction was particularly pronounced in electronics, food, automobile, and petroleum industries. In addition to declined demand, these industries were adversely affected by rising power shortages and deteriorated law and order situation.

7. The current account deficit narrowed beyond the set target of 5.9 percent of GDP to 5.1 percent of GDP in 2008/09 driven by deceleration in imports which exceeded that of exports, and growing workers' remittances. Exports contracted by 6 percent as external demand declined owing to the global recession. Imports in turn declined by over 10 percent as international oil and commodity prices sharply fell, rupee depreciated and aggregate domestic demand contracted. Table 2 shows that contraction in imports was wide-spread and not limited to a couple of sectors.

8. Workers' remittances continued growing for the fifth consecutive year in 2008/09, and registered 21 percent growth during 2008/09. Given global economic recession, this strong growth was somewhat surprising. One option is that these inflows reflected past savings of migrants which they

	2007/08	2008/09	Jul-Dec 2008/09	Jan-Jun 2008/09
i. Current account	-13.9	-8.9	-7.6	-1.3
Trade balance	-15.0	-12.5	-8.0	-4.5
Export	20.4	19.2	10.2	9.0
Import	-35.4	-31.7	-18.2	-13.5
Services net	-6.5	-3.2	-2.3	-1.0
Income net	-3.9	-4.3	-2.3	-2.0
Current transfers net	11.5	11.2	5.0	6.2
Remittances	6.5	7.8	3.6	4.2
ii. Capital and Financial A/c	8.3	5.2	2.7	2.4
<i>Of which:</i>				
Direct investment	5.3	3.7	2.3	1.4
Portfolio investment	0.0	-1.1	-0.2	-0.9
Other Investment	0.0	0.5	0.4	0.1
Other Investment Liab.	2.7	1.9	0.1	1.8
iii. Errors and omissions	0.1	0.4	-0.2	0.6
Overall balance	-5.5	-3.3	-5.1	1.8
SBP reserves	8.6	9.1		

Source: State Bank of Pakistan

	2007/08	2008/09	2007/08	2008/09
Food Group	4.21	4.00	55%	-5%
<i>of which:</i>				
Wheat Un-milled	0.86	0.84	1972%	-2%
Palm Oil	1.62	1.38	81%	-15%
Machinery Group	7.38	6.60	12%	-11%
<i>of which:</i>				
Power Generating Machinery	1.18	1.78	67%	51%
Textile Machinery	0.44	0.21	-13%	-52%
Elec. Machinery and Apparatus	0.76	0.78	18%	3%
Other Machinery	2.06	2.24	8%	9%
Transport Group	2.27	1.26	-4%	-44%
<i>of which:</i>				
Road Motor Vehicles	1.34	0.93	-5%	-31%
Air crafts, Ships and Boats	0.90	0.32	-3%	-64%
Petroleum Group	11.47	9.48	56%	-17%
<i>of which:</i>				
Petroleum Products	6.24	5.50	67%	-12%
Petroleum Crude	5.22	3.98	45%	-24%
Textile Group	2.34	1.66	50%	-29%
<i>of which:</i>				
Raw Cotton	1.29	0.64	101%	-51%
Synthetic Fibre	0.28	0.31	21%	9%
Agricultural & chemical Group	5.81	5.25	32%	-9%
<i>of which:</i>				
Fertilizer Manufactured	0.89	0.49	99%	-45%
Other Chemicals	2.97	2.94	31%	-1%
Metal Group	2.62	2.69	1%	3%
Miscellaneous Group	0.74	0.67	13%	-10%
All other Items	3.14	3.22	35%	2%
Total Imports	39.97	34.84	31%	-13%

Source: Federal Bureau of Statistics

¹ The value added of large scale manufacturing which declined by 7.7 percent in 2008/09.

brought back as they returned to Pakistan. If true, going forward the sustainability of the current account would be at risk.

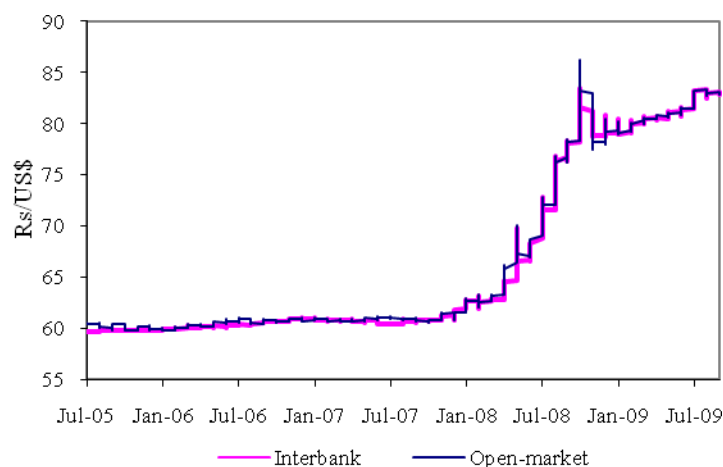
9. The narrowing of the current account deficit continued during the first two months of 2009/10. Exports continued contracting at 19 percent which was sharper than anticipated, but imports decreased even more, by 23 percent. Strong remittance inflows continued, with about 25 percent year-on-year growth.

10. While remittances increased, financial inflows dropped sharply in 2008/09—by over 37 percent—owing to macroeconomic instability, deteriorating security situation and global recession. Net foreign direct investment declined to US\$3.7 billion, and there was a net outflow of US\$1.1 billion in foreign portfolio investment during 2008/09. However, net capital inflows started recovering during the first two months of 2009/10.

11. SBP foreign exchange reserves rebounded to about US\$10.8 billion by end-August 2009, thanks to IMF disbursements.

Improvements in the current account and reserve position helped stabilize the nominal exchange rate at about at about Rs/US\$83 by end-August 2009. The Rupee-Dollar nominal exchange rate depreciation slowed down from 13.7 percent during the first half to 2.4 percent during the second half of 2008/09 (see Figure 1).

Figure 1: Interbank and Open-market Exchange Rate (Rs/US\$)



Source: State Bank of Pakistan.

12. While the external position significantly improved in the second half of 2008/09, fiscal problems continued and, according to the provisional data, the fiscal deficit target was exceeded by 0.9 percent of GDP, as the deficit amounted to 5.2 percent of GDP in 2008/09 (see Table 4). Revenues underperformed as the economy slowed down. In addition, attempts to control spending to large extent failed.

13. Revenue collection fell short of the target in 2008/09. According to preliminary data, total revenue collection was 14.2 percent of GDP, which was 1.0 percent of GDP below the revised program target. The shortfall was primarily due to lower than projected tax collection of FBR, as the economic slowdown reduced the buoyancy of Pakistan's two main tax bases (manufacturing and imports). Instead of the planned increase of 0.4 percent of GDP, revenues dropped sharply by 1.4 percent of GDP to 8.8 percent of GDP. In the absence of additional tax policy measures introduced during the year, government compensated the rising shortfall in FBR revenues by increasing the petroleum development levy (PDL) during the second half of the fiscal year instead of passing on the international price decreases to consumers. However, even that was not enough to close the revenue gap.

14. Revenues continued underperforming in the first two months of 2009/10. FBR tax collection during July-August 2009 increased only by 3.6 percent compared to 19.5 percent required to reach the annual target. While direct and sales taxes grew by 2.9 percent and 9.7 percent, respectively, excise and

custom duties collection contracted by 4.3 and 14 percent, respectively, compared to the corresponding period last year.

15. In light of the shortfall in revenues, the federal government attempted to reduce the fiscal deficit in 2008/09 by reducing spending, but its attempts were thwarted. First, as power shortages increased, the government greatly diluted increases in power tariffs for political reasons. As a result, power subsidies remained high. Second, large overruns in provincial development expenditures compromised federal efforts. While federal development spending was below the target, provincial development expenditure exceeded the target. Most of this additional expenditure at the provincial level was financed by borrowing from the banking system, mainly from the State Bank of Pakistan, with adverse implications on money supply and inflation.

16. Developments in the first two months of 2009/10 suggest that these worrisome trends continue. First, continued government inaction on power tariffs implies that electricity subsidies will remain high in 2009/10. Second, the subsidy bill is increasing significantly at the provincial level, as Sindh has followed Punjab in launching a provincial income support program. In addition, Punjab has doubled its wheat procurement target, implying a large increase in wheat subsidy. Moreover, large subsidies are allocated to the provision of wheat and wheat flour to poorer segments of the society at substantially reduced rates. Similarly, subsidies are being provided both at federal and provincial level for agricultural tractors and fertilizers. Finally, the federal scheme of providing loans to people for starting small business is also likely to have a significant impact on the fiscal situation.

17. Since November 2008, Government has met its financing needs mainly through non-bank borrowing. Consistent with the stabilization program, government's net borrowing from SBP has been zero on a quarterly basis. The increase in T-bill placements since mid-November 2008 has enabled government to reduce the level of monetization and rely on other sources of financing. Borrowing from scheduled banks was sharply up in 2008/09.

18. Total government debt as percentage of GDP declined to 56.0 percent in 2008/09, domestic and external government debt declining to 26 and 30 percent, respectively. During 2009/10, the domestic debt to GDP ratio is expected to decline further, but the ratio for external debt is projected to rise to 31.3 percent reflecting the reliance on external sources for budget financing.

19. As government borrowing from banks and non-banks has increased, credit to private sector has been crowded out and fallen dramatically: from Rs 408 billion in 2007/08 to Rs 19 billion in 2008/09. Large government borrowing to finance budgetary needs, increased credit disbursements for commodity operations, and the surge in credit demand by public sector enterprises has allowed banks to avoid relatively risky private sector. In addition, the steep fall is in part a result of reduced domestic and external demand as economic activity has slowed down. Also, risk-aversion of scheduled banks due to rising non-performing loans (NPLs) has affected the supply of credit. By end-June 2009, NPLs had reached Rs 398 billion, largely originating from the textile sector, but the NPL to total loans ratio at 11.5 percent has remained unchanged since end-March 2009.

20. Due to these developments, the net domestic assets of the banking system expanded during 2008/09. However, the contraction in net foreign assets of the banking system had somewhat dragged monetary expansion. From July 1, 2008 to June 30, 2009, broad money and reserve money grew by 9.6 percent and 1.9 percent, respectively, year-on-year (see Figure 2).

21. Inflation declined in the second half of 2008/09 as a result of reduced aggregate demand and international commodity and oil prices, but core inflation remained high at end-June 2009. The annual average CPI inflation for 2008/09 stood at 20.8 percent, which was consistent with the program target (see Figure 3). Year-on-year inflation fell rapidly from its peak of 25.0 percent in October 2008 to 13.1 percent in June 2009. Similarly, year-on-year food inflation declined to 10.5 percent in June 2009. However, core inflation (non-food, non-energy CPI), which measures the underlying inflationary pressures, was still high at 15.9 percent in June. Furthermore, month-on-month CPI has been on the rise since June 2009, with food inflation appearing to be the main driver. At end-August 2009, food inflation stood at 10.6 percent and core inflation at 12.6 percent, suggesting that tackling inflation remains a challenge.

22. Consistent with fallen inflation, 6-month KIBOR declined to 12.76 percent by end-June 2009 (see Figure 4), and nominal lending rates followed. Scheduled banks' weighted average lending rates (WALR) on incremental loans declined to 14.3 percent. This falling trend has continued during the first two months of 2009/10. Also, the State Bank of Pakistan (SBP) announced a 100bps cut in the policy discount rate to 13 percent in August 2009. Given falling inflation, real WALR has been rising steadily and been positive since June 2009.

Figure 2: Money Supply, Credit and Real Interest Rates

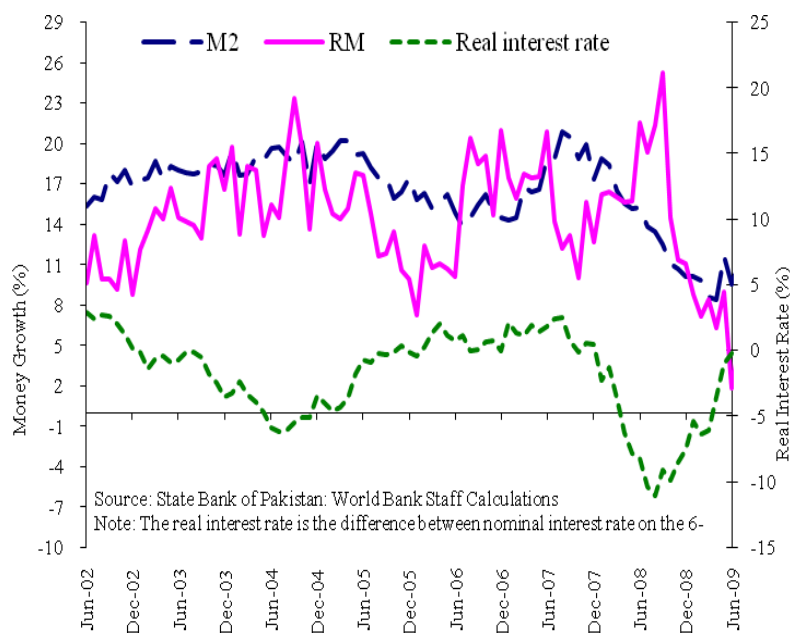
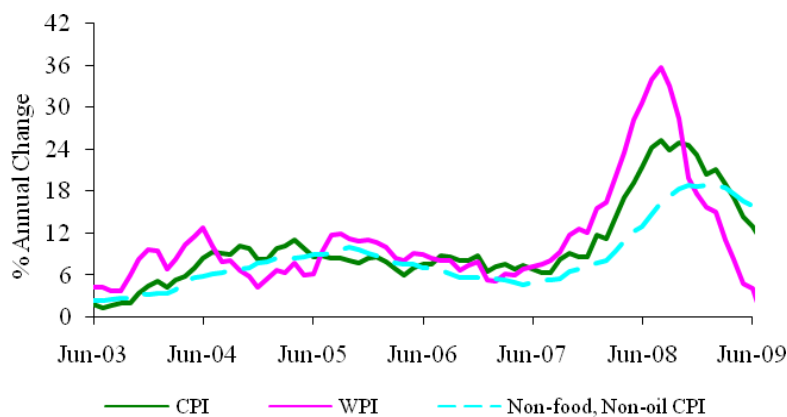


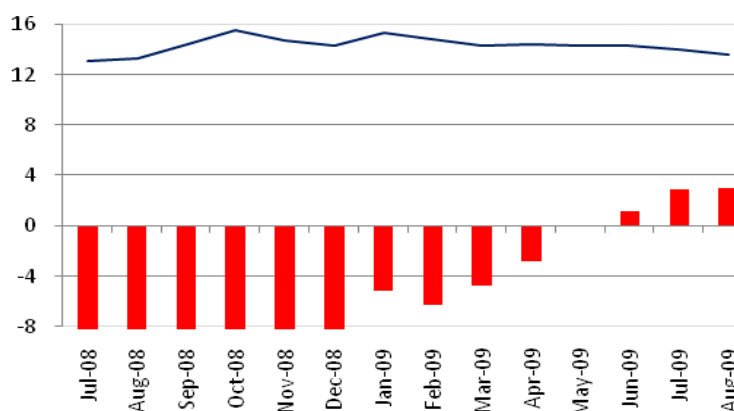
Figure 3: Inflation



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.

23. SBP introduced a corridor for the money market overnight repo rate in August 2009. In this framework, the overnight rate is allowed to oscillate within the range of 300 basis points corridor, with SBP policy rate as its ceiling. This implies that banks can now deposit their surplus funds with SBP. The corridor arrangement is expected to reduce volatility in the overnight rate and reduce noise about monetary policy signals.

Figure 4: Nominal and Real Weighted Lending Rates



24. The EMBI Global Bond spread narrowed in the second half of 2008/09, suggesting improving investor confidence. The spread declined to 1,037 bps by end-June 2009 from the peak of 2,222 bps in late December 2008. The Karachi Stock Exchange also started recovering. During the first two months of 2009/10, the bond spread declined further to 673 bps by end-August 2009. Also, in mid-August 2009, Moody's raised the rating of Pakistan foreign currency denominated sovereign debt to B3 with stable outlook. Similarly, Standard and Poor's raised the rating of Pakistan's long term sovereign bond to B-. However, these rating upgrades were raised primarily on account of enhancement in the IMF-SBA credit facility.

PROGRESS WITH STRUCTURAL REFORMS

25. Progress with structural reforms has been mixed, with progress in key areas lackluster. On the positive side, the automatic fuel price adjustment mechanism, which was re-introduced in early 2009, has been operating and domestic prices of fuel products have been adjusted monthly consistent with the changes in import parity price. Also, the pilot of the Benazir Income Support Program (BISP) with the new targeting instrument—the poverty scorecard—has been conducted and a full roll-out of the new targeting methodology is expected to start next, albeit with a substantial delay due to capacity constraints. Steps to strengthen government's debt management have also been taken.

26. However, progress with revenue reforms in the past months, owing to resistance from vested interests and lack of political will, has been weak, as demonstrated by declining tax revenues as a share of GDP. As part of the 2009/10 budget, government was to 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. However, this did not happen. Further, the long-due restructuring of FBR, which was launched at the beginning of 2009, was reversed in May owing to a court case by the customs group, which opposed the reform. After a delay, the restructuring process was re-launched in July and expected to be completed by end-September 2009.

27. Reforms to strengthen financial sustainability of the electricity sector have stalled. The authorities had committed to raise electricity tariffs and introduce monthly and quarterly tariff adjustment mechanisms so as to eliminate tariff differential subsidies by end-June 2009. However, the government failed to follow through on this commitment. The authorities recommitted in July 2009 to a tariff adjustment schedule and to the introduction of automatic tariff adjustment mechanisms with a view to

eliminating tariff differential subsidies by July 2010. But the implementation of the agreed measures has so far failed again.

28. While substantial steps were taken to establish a Treasury Single Account (TSA) in early 2009, since then the authorities have made limited progress to complete the transition. One of the key remaining steps would be to transfer the balances held by various government ministries and agencies in commercial banks (amounting to about US\$10 billion) to TSA and then close those accounts. However, owing to strong vested interests, progress on this area has also stalled for the time being.

MEDIUM-TERM OUTLOOK

29. While the economy has started to stabilize, the macroeconomic situation remains fragile and the medium-term outlook uncertain. As mentioned above, progress with the implementation of reforms has been uneven, with inadequate measures taken to boost revenue mobilization and control spending. Also, while the acute phase of the global financial crisis seems to be ending, global recovery will be gradual and take time. Thus the downside risks remain significant, and the fiscal year 2009/10 looks difficult.

30. Pakistan's real GDP growth is projected to start slowly recovering in 2009/10, and increase gradually from 3.0 percent in 2009/10 to 5.0 percent by 2012/13. Aided by increasing public investment—planned among other things in power and transport—gross capital formation is projected to rise and contribute to growth recovery and facilitate private sector activity gradually over time. Agriculture and services are showing good growth prospects, while manufacturing is still contracting and expected to recover only slowly over time as the domestic aggregate demand picks up and the availability of power improves as a result of planned investments in power generation. Exports are projected to continue contracting in 2009/10. Thereafter, with the global recovery, exports are projected very gradually improve and reduce Pakistan's external vulnerability over time. However, longer-term projections are particularly uncertain in view of the volatile global and domestic economic environment. Also, the short-term growth target seems optimistic and will likely be revised downwards during the fiscal year.

31. The external current account deficit is projected to narrow only slightly to 4.7 percent of GDP in 2009/10, but thereafter to widen again to above 5 percent of GDP before declining. The sharp decline in international commodity prices, reduced private sector credit growth, and the economic recession are expected to lead to further contraction in imports in 2009/10, which is expected to continue exceeding the contraction in exports. Remittances are also projected to contract by 13.6 percent in 2009/10, but pick-up thereafter again.

32. In the medium term, in particular in light of uncertainties about the recovery of global demand, increased productivity and export competitiveness are necessary to generate growth and reduce external vulnerability consistent with these projections. Pakistan's exports are poorly diversified both in terms of products and destination. Almost two thirds of them are textiles and their primary destination is the USA and EU. To this aim, structural reforms to strengthen the investment climate and competitive environment are required and urgent. These will include measures to ease firm entry and exit, reduce barriers to competition and trade, and enhance 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.

33. Outflows from the current account are projected to be more than offset by net inflows into the financial and capital account in the medium term, leading to an increase in foreign exchange reserves. Foreign exchange reserves are expected to build-up from US\$9.1 billion at end-June 2009 to about US\$13 billion by end-June 2012/13, yet the level of import cover is projected to fall from 4.4 months in 2010/11

to 3.1 in 2013/14. A significant portion of these inflows is projected to come in as FDI and foreign portfolio investment. FDI is expected to drop further in 2009/10 and thereafter start gradually recovering in 2010/11, and portfolio flows are predicted to turn positive from 2010/11 onwards. However, materialization of these inflows will hinge on the overall economic, political and security situation in the country, and is thus uncertain.

34. Over the medium term, Government's macroeconomic framework targets a decline in the fiscal deficit (excluding grants) from 4.9 percent of GDP in 2009/10 to 3.0 percent of GDP in 2012/13. The 2009/10 fiscal deficit target was increased from 3.4 to 4.9 percent of GDP to accommodate: spending (1.2 percent of GDP) expected to be financed with disbursements of pledges made by donors in the donor conference held in Tokyo in April 2009, and additional spending (0.3 percent of GDP) on IDPs.² At the Pakistan donor conference, donors pledged about US\$5.2 billion in additional financing, but actual disbursements have so far been slow to materialize.

35. The cornerstone of this outlook is a significant increase in tax revenues, which are projected to rise by 2.5 percentage points of GDP to 12.7 percent of GDP by 2012/13. Excluding grants, overall revenues are to rise from 14.1 percent of GDP in 2008/09 to 16.1 percent of GDP in 2012/13. To meet these ambitious revenue targets, the authorities have committed to implement comprehensive tax policy and administration reforms. This would include quick and decisive implementation of a broad-based value-added taxation (VAT) of goods and services, which the authorities plan to roll-out in July 2010. The VAT would be the key measure to expand the tax base and revenues. Currently services remain largely outside the tax net and a large share of goods is exempted from sales tax. These both issues are to be addressed as part of the VAT reform. Key steps to strengthen tax administration include restructuring of FBR for VAT implementation, strengthening of audits of taxpayers, and strengthening of enforcement through measures to control stop filers, short filers, and detect under-reporting via cross-checking. Significant untapped revenue potential—such as property and property transfer taxes, motor vehicle tax, agricultural income tax—remains also at the provincial level, which would warrant attention.

36. These revenue targets are ambitious and there is a significant risk that they will not be met. While the Ministry of Finance is committed to move ahead with the VAT in this fiscal year, its introduction as planned would require decisive action from the country's top leadership to bring provincial governments onboard and to control the vested interests.

37. Failure to raise revenues as planned would further heighten Pakistan's vulnerability to shocks, and jeopardize country's development efforts by limiting resources available for planned investments in human and physical infrastructure. There is a concern that Pakistan may repeat past mistakes. Pakistan's high economic growth earlier in this decade was in part explained by heavy reliance on external financing and on expansionary fiscal stance, while revenues and savings remained stagnant. This reliance on external financing left the economy vulnerable to external shocks, which came in 2007/08 and, in the absence of government corrective measures, led to a balance of payments crisis. To reduce the economy's vulnerability to shocks and avoid the repeat of past mistakes, stepping up domestic revenue mobilization would be critical.

38. If revenues were raised as planned, total expenditures could be maintained at about 19 percent of GDP over the medium term. Provided power subsidies are eliminated in 2010/11 as agreed and following maturing of the remainder of high interest-yielding Defense Savings Certificates, current expenditures are projected to gradually decline as a share of GDP and make space for a steady increase in development spending from 3.6 percent of GDP in 2009/10 to 4.9 percent of GDP in 2012/13.

² The additional spending on IDPs is to be financed through external grants. If these grants do not materialize, the fiscal deficit target will be brought down to 4.6 percent of GDP.

39. However, there is a sizeable risk that expenditures will overrun in 2009/10. The federal government does not seem to be in control of spending by provincial governments, whose planned budgets are inconsistent with limits envisaged in the national budget. Also, political will to reduce subsidies as planned seems limited.

CONCLUSIONS

40. Stabilization efforts together with a decline in international commodity prices have succeeded in reducing external imbalances, rebuilding foreign exchange reserves, and lowering inflation. However, owing to global economic recession, there are significant risks to exports, remittances and external financing. Also, there are significant risks to the fiscal framework. This highlights the need for a rigorous implementation of reforms. 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.

41. However, even though the stabilization program is home-grown, recent developments and limited progress with a number of key reforms suggest that the highest political level is not sufficiently convinced that the economic price of inaction outweighs the political cost of implementation. The ongoing conflict and geopolitical considerations as well as limited control over vested interests seem to be reinforcing this.

WORLD BANK ASSISTANCE IN FY10

<i>Product Name</i>	IDA Million US\$	IBRD Million US\$	Current Status
Investment Projects			
Social Protection DPL	200		Approved on Sept. 10
Higher Education DPC	100		Approved on Sept. 10
PRSC I	200		Preparation
Gas to Power Efficiency and Conservation		250	Preparation
Karachi Port Improvement Project		125	Preparation
Balochistan Education AF	14		Preparation
National Environment Policy TA	28		Preparation
Punjab Barrages Rehabilitation & Modernization		175	Preparation
Enhanced Nutrition for Mothers and Children Project	55		Preparation
Total	597	550	
Major AAA Products			
<i>Core Diagnostic Reports</i>			
Public Expend Review			Due Q2
Poverty Assessment			Due Q2
<i>Other Reports</i>			
Strategic Environmental, Poverty Social Assessment NTCIP			Due Q4
Health Sector Review			Due Q2
Northern Areas Economic Report			Due Q2
Doing Business in Pakistan			Due Q3
<i>Policy Notes</i>			
Revenue Mobilization: Policy and Administration			Due Q4
NWFP Mining Sector			Due Q2
SP Policy Note			Due Q4
Pakistan Post Crisis Needs Assessment			Due Q2

