

Pakistan

Improved economic fundamentals have enhanced the resilience of the economy and helped absorb shocks, including higher global oil prices and 2005's devastating earthquake. But growth has generated a heavy imbalance in the external current account, which could affect economic momentum. The current account deficit has been financed largely from strong incoming foreign investment. External sources have also been employed, increasingly, to finance the fiscal deficit. Issues of long-term sustainability therefore arise, especially in a context of high global oil and commodity prices and domestic political uncertainties.

Economic performance

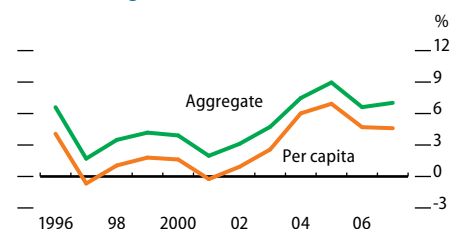
At 7.0%, growth was strong in FY2007 (ended June 2007) for the fourth consecutive year (Figure 3.20.1). This trend has lifted per capita income and consumption levels, and reduced poverty incidence by 10.5 percentage points between FY2001 and FY2005 (Figure 3.20.2). Employment increased steadily according to labor force statistics, with 8.6 million new jobs created between FY2002 and FY2006. The resulting decline in unemployment from 8.3% to 6.2% compensated for the sharp rise in the latter half of the 1990s. However, the high level of youth unemployment remains worrying (Box 3.20.1) and income distribution deteriorated between FY2001 and FY2005 with the Gini coefficient rising moderately from 0.28 to 0.30.

Having remained the main contributor to economic growth in FY2004 to FY2006 (Figure 3.20.3), real consumption growth decelerated to 3.8% in FY2007 (having peaked at 11.7% in FY2005), on account of tightening monetary policy, rising interest rates, and declining consumer lending. Moderating but still-buoyant consumption, coupled with rising investment, bolstered aggregate demand.

Total investment increased to 23.0% of GDP in FY2007 from 21.8% the year before, to become the primary contributor to growth for the first time. Private investment increased to 16.2% of GDP from 15.4%, supported by improving business confidence and an increase in public investment. Private savings increased between FY2005 and FY2007 but, given continued strong consumption, the rise in savings was not enough to finance the expanded private investment. This pushed the private savings-investment gap to 3.4% of GDP in FY2007 from 2.9% in FY2006 (Figure 3.20.4).

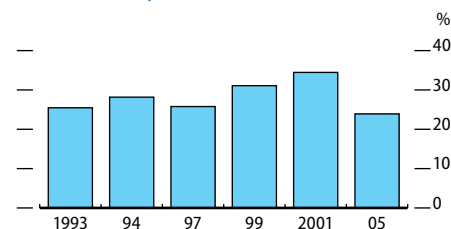
Foreign direct investment (FDI) reached a record \$5.1 billion in FY2007, or 3.6% of GDP, up from 2.7% of GDP a year earlier. The privatization program provided the early impetus for the rise in FDI, centered on services (primarily banks and telecommunications). But

3.20.1 GDP growth



Source: Ministry of Finance, *Pakistan Economic Survey*, various issues.

3.20.2 Poverty trends



Source: Ministry of Finance, *Pakistan Economic Survey*, various issues.

3.20.1 Demographic transition and youth unemployment

The Government has placed a priority on achieving a “demographic dividend” from falling fertility rates and child dependency ratios, and a rising share of young entrants into the labor force. Fertility rates have declined from over six in the 1970s to four in FY2006, and the share of the young (0–14 years) in the total population from 44.5% in 1981 to 36.8% in 2006. The share of the working age group (15–59 years) increased from 48.5% to 57.2% over this period.

This demographic transition could catalyze the country’s economic transformation, provided that the growing population in the working age group can be meaningfully absorbed in the labor force and can increase its productivity levels by acquiring improved education and training.

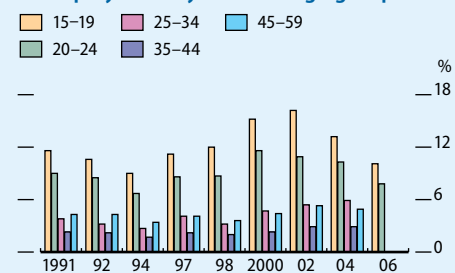
A demographic dividend is often accompanied by a rapid rise in the participation rates of the younger working age population. The overall labor force participation rate showed a modest increase of 2.3% between FY2004 and FY2006, reaching 32.2% in the latter year. The increase in the participation rate of the younger working age population subgroup (15–29 years) ranged from 1% to 2.5%, and on average grew less than the overall participation rate. The female participation rate also increased, but remained low (13.3% in FY2006). It needs to rise faster for the country to reap the benefits of the demographic transition.

Unemployment has declined in recent years. But an age-group data breakdown shows that the younger

population has consistently experienced higher than average unemployment. In FY2004, the rates for age groups 15–19 years and 20–24 years, of 13.2% and 10.3%, respectively (Box figure) were well above the overall rate of 6.2%. Youth unemployment, therefore, remains a leading contributor to total unemployment.

That such a significant proportion of the young population is unemployed is a concern if the demographic dividend is to be secured. The apparent mismatch between the requirements of the labor market and the skills and qualifications of young labor force entrants needs to be reconciled, to improve these entrants’ employability prospects.

Unemployment by selected age group



Source: Federal Bureau of Statistics, *Pakistan Labour Force Survey*, various issues.

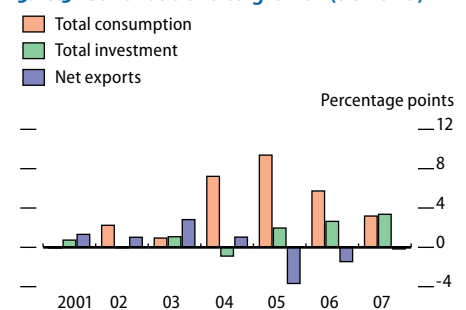
Source: G.M. Arif and Nusrat Chaudhry. 2007. “Demographic Transition, Education, and Youth Unemployment in Pakistan.” Asian Development Bank, Pakistan Resident Mission.

even without privatization, FDI flows averaged healthy annual growth of 72% over the 5 years FY2003 to FY2007, reflecting improved investor confidence in services (since very little foreign investment went into goods-producing sectors). Domestic investment in manufacturing grew by an annual average of 25% over the 4 years FY2004 to FY2007 and partly made up for the lack of foreign interest. Still, the slowing in textile exports in FY2007 for example, may in part stem from the failure to attract sizable FDI. As a result, manufacturing largely failed to realize any complementary advantages of FDI in terms of improved business management practices or modern technologies.

Even though stimulated by domestic investment, overall manufacturing growth decelerated to 8.4% in FY2007 from 10.0% in FY2006, due to slowing automobile, electronics, engineering, and textiles subsectors and to contraction in the fertilizer and paper subsectors. Weakening domestic demand and a rising power supply deficit were factors in manufacturing’s deceleration, such that its contribution to real GDP growth fell to 23% from a peak of 31% in FY2004 (Figure 3.20.5), when in fact structural transformation of the economy would have required the reverse.

Posting 5.0% expansion, agriculture rebounded on the back of strong

3.20.3 Contributions to growth (demand)



Source: Ministry of Finance, *Pakistan Economic Survey*, 2006/07.

wheat and sugarcane crops and robust performance of livestock: benign weather and strong uptake of agriculture credit catalyzed the sector's performance. Yet the economy's main growth driver remained services, with finance, insurance, and community and social services showing especially high expansion. The sector's contribution to GDP growth rose to 60.0% in FY2007.

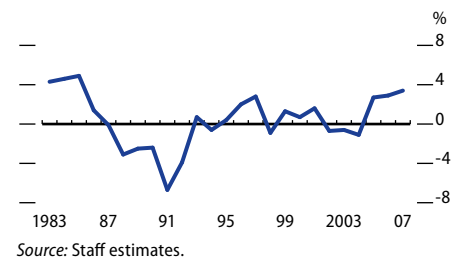
High growth in the services sector and the still-robust performance of industry strengthened government revenues. Direct tax collection leaped by 48% in FY2007 (resulting in an 18.2% increase in total tax collection), underpinned by an increase in corporate profits and overall improved tax administration. The resulting rise in the share of direct taxes in total taxes to 40% from 31.5% in the fiscal year improved the progressivity of the tax system. However, the tax base remained narrow with agriculture, retail trade, and other sectors significantly undertaxed. Consequently, the tax-to-GDP ratio continued to decline to 10.2% in FY2007 from 10.7% in FY2002, with the growth in nominal GDP outstripping the rise in tax revenues.

Nontax revenues strengthened by over 26% in FY2007. The impact of the overall improved revenue position on the fiscal situation was, however, checked by a sharp increase in current expenditures led by interest payments and continued expansion in development spending, the latter of which rose to 5.0% of GDP in FY2007. Total expenditures rose to 19.2% of GDP, overshooting the 17–18% band that, in recent years, had been achieved through prudent fiscal management. The fiscal stance remained expansionary (Figure 3.20.6), and the fiscal deficit in FY2007 stayed at around 4.3% of GDP for the second year, in part to meet the additional expenditure requirements for earthquake reconstruction, but also on account of increased development and current expenditures. The revenue balance and the primary balance continued to register deficits in FY2007, such that the development budget was financed through borrowing.

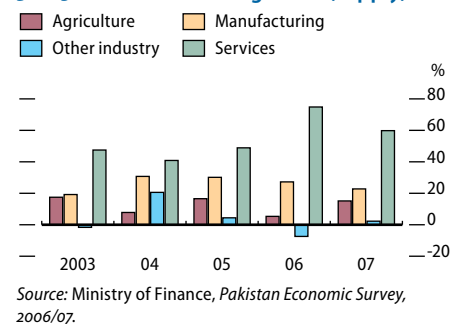
With expansionary investment and fiscal stances, the trade balance has been in deficit since FY2005, with rapidly rising imports outpacing exports (Figure 3.20.7). Imports in FY2007 rose sluggishly, however, amid tighter credit conditions and slowing international oil price rises. Machinery imports slackened their pace, recording a decline in textile machinery and telecommunications imports after the completion of substantial investment to modernize these subsectors. However, imports of power-generating and construction machinery climbed strongly. Food imports declined, given buoyant domestic wheat production. Exports performed poorly, slowing to only 4.4% growth, down from an average of 16% over the previous 4 years. Decelerating textile exports and shrinking nontextile exports were the main factors. Consequently, the trade deficit in FY2007 rose sharply to 6.8% of GDP.

This, alongside the deficits in the services and income accounts, exacerbated the current account deficit. On services, the continued United States contribution (\$1.2 billion in FY2007) to the Government for military logistics did not offset the impact of higher shipping and transportation costs, and the deficit rose to \$4.2 billion. The income account deficit suffered from increased repatriation of investment income flows and rose to \$3.6 billion. Even though workers' remittances rose to

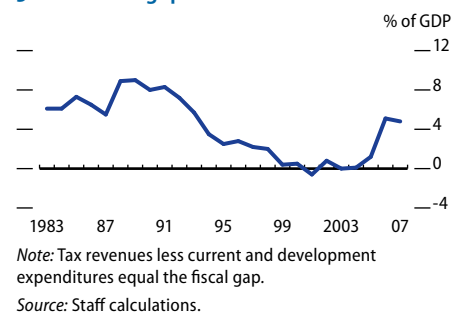
3.20.4 Private investment–savings gap (% of GDP)



3.20.5 Contributions to growth (supply)



3.20.6 Fiscal gap



\$5.5 billion in FY2007 from \$4.6 billion in FY2006, the current account deficit widened sharply to \$6.9 billion (4.8% of GDP) in FY2007 compared with \$5.0 billion in FY2006 (3.9% of GDP).

The key issue with managing the external current account deficit (and its counterpart savings- investment gap) as well as the fiscal deficit, is whether these twin deficits can be financed sustainably over time. The present pattern of financing relies heavily on external inflows to the financial account, which are of course volatile.

With a record-breaking surplus of \$10.1 billion in FY2007, the financial account financed the current account deficit (Figure 3.20.8). FDI jumped and portfolio investment tripled to \$3.3 billion. Official development assistance too remained significant. External resources financed as much as 53% of the fiscal deficit, or about \$3.3 billion, in FY2007 (Figure 3.20.9). Such external financing allowed the Government to diversify its borrowing base and reduce its reliance on domestic banks, but also created adverse implications for the external account through increased interest payments for loan-based financing and profit repatriation for investment-based financing. The savings-investment gap was financed with external resource inflows, the need for which may further increase if investment continues to climb at rates higher than that of national savings.

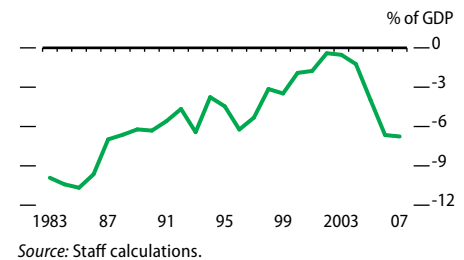
High external inflows put upward pressure on the exchange rate and complicated monetary policy management. The State Bank of Pakistan (SBP) stabilized the exchange rate by purchasing excess foreign exchange, securing only a modest appreciation in the real exchange rate in FY2007 (Figure 3.20.10). This, however, led to an almost fourfold increase in net foreign assets of SBP, which despite the sterilization efforts, failed to restrain M2, which grew by 19.3% in FY2007, much higher than SBP's target of 13.5% (Figure 3.20.11).

Higher than targeted growth in M2 was seen even though SBP had, in view of the inflation pressure, tightened monetary policy at the start of the fiscal year by raising the reserve requirements for banks, increasing the policy rate, and draining excess liquidity from the market. Nonfood and core inflation fell during the year. But this was offset by a 72% increase in food prices, resulting in a rate of inflation that continued to hover around 8% in FY2007 (Figure 3.20.12). While economywide data on wages are unavailable, evidence from construction activity indicates significant real wage growth on the back of that industry's ongoing boom.

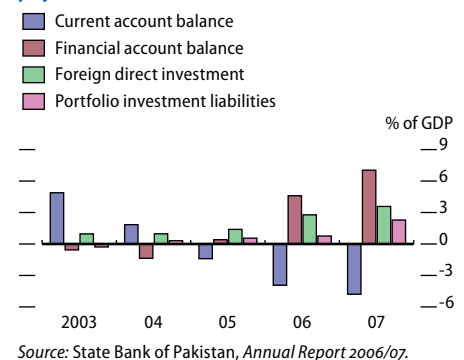
Besides external financing, domestic financing of the fiscal deficit also created problems for monetary policy management as the Government raised its borrowings from SBP in the first half of FY2007, though most of this debt was retired in the second half with the availability of Eurobond and other foreign receipts. The Government also resorted to higher nonbank borrowings from the National Saving Scheme and long-term Pakistan Investment Bonds, which together helped contain monetization of the deficit.

The overall experience with monetary management in FY2007 compelled SBP to adopt a new monetary framework to improve its control over reserve money growth and inflation. In August 2007, it imposed quarterly ceilings on its lending to the Government, curtailed its role in export refinancing, and raised its discount rate by a further

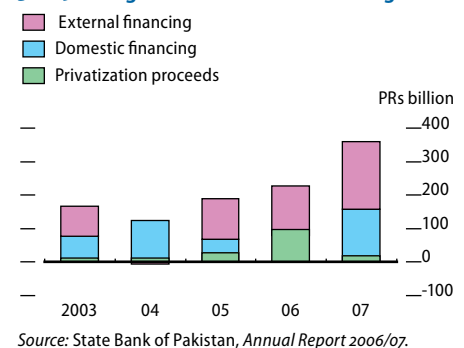
3.20.7 Trade sector share in GDP



3.20.8 Selected components of balance of payments



3.20.9 Budget deficit and its financing



50 basis points. For this framework to work, the fiscal deficit needs to be contained and its financing arranged through balanced recourse to domestic and external sources. On the domestic side, bank borrowing by government requires restraint, with greater nonbank financing through Pakistan Investment Bonds and other instruments. The tax base itself needs to widen considerably to enhance revenue collection.

Equally, the pressure on the external account to finance the deficits should not be allowed to erode the sustainability of the external debt trajectory. External debt rose from \$34.0 billion in FY2005 to \$38.7 billion in FY2007 in response to the buildup of the twin deficits. Debt sustainability, however, continued to improve, with the ratio of external debt to GDP declining from 46.1% in FY2002 to 26.9% in FY2007 (Figure 3.20.13).

The ratio of external debt to foreign exchange earnings had also fallen for several years until FY2006, but the rising debt level and lackluster export earnings that year resulted in a small increase in this ratio. In view of this and the ending of the debt relief obtained by Pakistan from the Paris Club in FY2002, with debt repayments due to restart in 2008, continued careful management and monitoring of external debt become critical.

Economic prospects

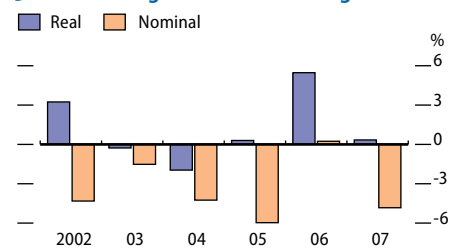
Growth is expected to moderate to 6.3% in FY2008 and then pick up slightly to 6.5% in FY2009, underpinned by consumption expenditures. These forecasts are lower than the average 7% growth rate of recent years, as the ongoing power and gas shortages caused by an aging energy infrastructure, chronic underinvestment in expansion and maintenance, and unsustainable pricing regimes slow production and constrain domestic and foreign investment.

Political uncertainty and the security environment in the lead-up to the recent general elections and the subsequent formation of a new government have impacted on capital inflows, and may curtail investment, dragging down performance. Revenue shortfalls produced by slowing economic activity and expenditure overruns may limit fiscal space and reduce public investment, which in turn may affect private investment and growth. In addition, continued tight monetary policy conditions in view of persistent inflation could serve to damp demand and limit any expansion.

The growth of agriculture will be lower than earlier expected because of pest attacks and floods. Accompanying the resulting shortfall in cotton production is moderating textile manufacturing sector growth and an overall slowdown in large-scale manufacturing in the first half of FY2008. Textile exports continue to grow slowly. The projected softening of the global economy and ongoing power shortages could rein in exports further. Services are expected to maintain robust growth, buttressed by a strong performance from private telecommunications companies.

Despite tight monetary conditions and moderating growth, inflation is expected to overshoot SBP's target of 6.5% and reach 8.0%, reflecting continued pressure on food prices and the pass-through of some higher global oil prices. Recognizing that continued monetary policy

3.20.10 Average effective exchange rate



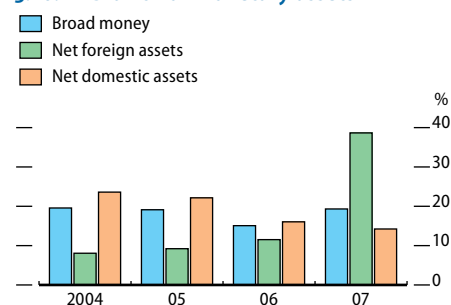
Source: State Bank of Pakistan, Annual Report 2006/07.

3.20.1 Selected economic indicators

	2008	2009
GDP growth	6.3	6.5
Inflation	8.0	6.5
Current account balance (% of GDP)	-6.3	-5.8

Source: Staff estimates.

3.20.11 Growth of monetary assets



Source: State Bank of Pakistan.

tightening will have only a limited impact on controlling food inflation, the Government has announced various administrative measures, such as banning export of wheat and allowing its import, cracking down on hoarding, expanding the network of utility stores that provide subsidized food items, and most recently raising the procurement price of wheat to improve the supply response.

Still, inflation pressures have persisted, with food prices rising to 11.6% in January 2008 (based on a 12-month moving average), compared with 8.5% a year earlier. The broadening of this pressure to nonfood, non-oil items visible in the first half of FY2008 and the increase in utility prices in January 2008 could add further inflation pressure. In FY2009, inflation is projected to decline to around 6.5% as food prices stabilize with easing of supply-side constraints.

The fiscal deficit will likely exceed the Government's target of 4% of GDP for FY2008 (it slipped to 3.6% of GDP in the first half of FY2008 from 1.9% in the same period a year earlier), mainly on higher interest payments and a rise in development expenditures. In an election year, the Government deferred the pass-through of the higher international oil prices to consumers until 1 March. But as this was small relative to the international oil price rise, the subsidy expanded to an estimated PR\$60 billion (0.6% of GDP) in the first half of FY2008.

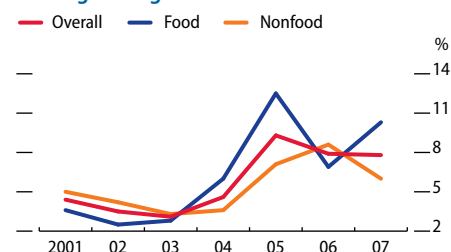
On the revenue side, as a result of slowing economic activity in the first half of FY2008, tax collection by the Federal Board of Revenue stayed below the target for the first half of the fiscal year. Direct tax collection fell relative to the same period of FY2007.

With the fiscal deficit widening, and external inflows remaining subdued, the Government's borrowings from SBP in FY2008 had risen more than threefold by 19 January 2008 relative to the same period in FY2007. This led to a sharp 90% increase in the net domestic assets of the banking system and resulted in an annualized growth of 19.2% in M2 (as against a targeted 13.6% in FY2008). The purpose of the August 2007 tightening of monetary policy to control monetary aggregates was thus frustrated and inflation persisted. Fearing accelerated inflation pressures, SBP once again tightened monetary policy in February 2008 by raising the policy discount rate by 50 basis points and increasing the cash-reserve requirements for 1-year deposits.

The current account deficit in the first 7 months of FY2008 worsened by 47% compared with the same period in FY2007, and is likely to widen to 6.3% of GDP for the full year. The current account deficit is under pressure because of a higher oil import bill and deteriorating income and services accounts, despite moderate growth in exports and continued strong receipts of workers' remittances. The trade gap widened by over 25% in the first 7 months of this fiscal year. Textile exports remained, and will continue to be, weak, on expected lower cotton production and increased regional competition as the effect is felt of the ending of safeguard measures imposed on clothing exports from the People's Republic of China by the European Union and the United States.

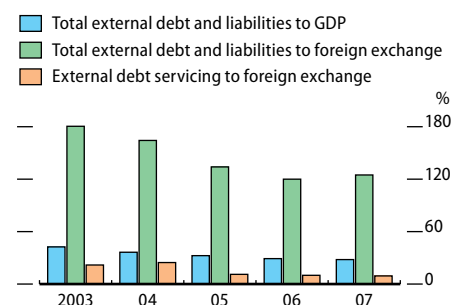
Higher shipping costs following the increase in oil prices will affect the services account further, which had already widened by almost 52% in the first 7 months of FY2008. The income account may also feel the strain of larger external borrowings by the Government to finance the

3.20.12 Consumer price index, 12-month moving average



Source: State Bank of Pakistan.

3.20.13 Selected debt-sustainability indicators



Source: State Bank of Pakistan, Annual Report 2006/07.

deficits, the increased cost of commercial borrowing resulting from the downgrading of Pakistan's credit rating outlook from stable to negative in early November 2007, and the start of payments in 2008 on the debt rescheduled by the Paris Club.

The financing of the current account deficit remains a key issue given the deterioration in the financial account caused by the halt in foreign portfolio investment in the first 7 months of FY2008. Difficulties in global financial markets could further affect capital inflows. In addition, planned issues of global depository receipts may not materialize. The declaration of emergency on 3 November 2007 and the downgrading of Pakistan's credit rating outlook resulted in a net outflow of \$243 million from special convertible Pakistan rupee accounts held by foreigners during the month. Altogether, net foreign investment tumbled by 34.9% in the first 7 months of FY2008 relative to the same period in FY2007, caused by a slowdown in FDI growth and virtually no portfolio investment as foreign investors shied away from the stock markets—a demonstration of the high level of volatility of such inflows.

With a weakened financial account, the burgeoning current account deficit led to a drawdown on SBP's foreign reserves of almost \$1.5 billion between 31 July 2007 and 15 February 2008. External debt rose by another \$2.5 billion in the first half of FY2008 as a consequence of the rising current account and fiscal deficits. The position needs to be closely monitored.

Development challenges

The economy has to build greater capacity to finance its investment needs with internal resources, namely savings. Pakistan can do this through structural improvements in three key areas. The first is to strengthen and diversify the manufacturing export base in view of the current concentration of exports in too few sectors, namely textiles, rice, leather, and petroleum products, and too few destinations, namely the United States, European Union, and United Arab Emirates.

Strengthening the competitiveness of exports through infrastructure improvements, particularly via investing in and reforming the power sector, ensuring higher product quality standards with improved labor force training, strengthening export presence in new markets such as the People's Republic of China and Central and South Asia, and attracting FDI in important manufacturing industries, will be key for developing a diversified export base.

The second improvement is to expand the tax base by bringing undertaxed sectors into the tax net. It is critical to mobilize greater domestic resources to reduce the call on external financing for balancing the budget and to sustainably enhance development expenditures.

The third is to boost national savings and reduce the savings-investment gap, and control excessive accumulation of external debt.