

June 2011

# Pakistan Economic Update



*Poverty Reduction, Economic  
Management, Finance and Private  
Sector Development, SAR*

The World Bank

## Summary

- *Pakistan's economic outlook has significantly deteriorated since the floods of July-August 2010, which affected all provinces. The flood damage is estimated to be about US\$10 billion. Real GDP growth, which was projected to be 4.5 percent this year, is now expected to slow to somewhere around 2.5-3 percent.*
- *The external position has improved during the first ten months of FY2010/11 because of robust export growth and strong inflows of workers' remittances. As a result, the current account deficit fell from US\$3.9 billion (2 percent of GDP) in FY2009/10, to US\$748 million for the first ten months of FY2010/11. Foreign exchange reserves increased to US\$14.1 billion by end-February 2011, from US\$13.0 billion at end-June 2010.*
- *However, the major concern remains the large fiscal deficit. A shortfall in fiscal revenues and an overrun on electricity subsidies and security spending led to the budget deficit widening in the first half of the fiscal year to 2.9 percent of GDP (more than 70 percent of the full-year target). Last January, the Government estimated that unless urgent measures were taken, the consolidated fiscal deficit could go beyond 8 percent of GDP. Then, last March, in an attempt to contain the deficit below 6 percent of GDP, the government announced some one-off tax measures (through Presidential ordinances), removal of tax exemptions and zero ratings, measures to cut expenditure, and also raised power tariffs.*
- *Progress on critical structural reforms, especially in tax administration and the energy sector, has been steadily progressing. Pending consensus on the proposed broad-based value added tax, the government decided to improve the existing General Sales Tax. It recently removed several tax exemptions and launched several measures to improve tax administration, especially addressing large tax payers and tax evaders. The government has increased power tariffs and registered circular inter-agency debt; and it aims to reduce inefficiencies by an ongoing process of appointment of new management boards in all electricity companies. However, power subsidies remain high due to delays in implementing these tariff adjustments and rising input costs, like fuel. Together with other difficulties encountered by the sector, such as reduced allocations of the low-cost natural gas feedstock, these factors discourage investment by the private sector in electricity generation so that load-shedding continues to be a critical constraint on growth.*
- *The IMF-supported Stand-By Arrangement (SBA) has been off track since last June. Satisfactory expenditure containment and revenue collection from recent measures for fiscal consolidation, and a solid 2011/12 Finance bill could pave the way for resuming the SBA or opening talks for a new IMF program in the next fiscal year. Budget support from the World Bank remains dependent on establishing a satisfactory framework for economic stabilization and recovery.. Recently adopted steps may also contribute to regaining momentum on the key structural and institutional reforms that are essential not only for achieving price stabilization, but for fostering Pakistan's growth and sustaining poverty gains over the medium term.*

## Background

1. For the last three years, Pakistan has been making efforts to revive strong and sustained growth. The economy was badly destabilized by the turmoil in the international commodity and financial markets in 2007-2008 and the lack of adequate domestic policy responses to manage those external shocks. The task of stabilizing the economy and reviving the economic recovery has been made difficult by an adverse security situation and domestic politics that has prevented the government from taking timely required, but difficult, stabilization measures. The devastating floods in July-August last year and the recent increase in international oil and food prices have exacerbated the problem. In addition, Pakistan continues to face significant political challenges in achieving durable development. The domestic security situation as a result of campaign against terrorism is a direct and indirect tax on the costs of economic activity and the achievement of the kinds of social stability required to promote a supportive environment for businesses.

## Recent Economic Developments

2. Macroeconomic management in FY2010/11 has featured multiple weaknesses and policy slippages. Devastating floods during July-August 2010 added considerable strains to fragile economic conditions. The IMF-supported Stand-By Arrangement (SBA) went off track during this period due to a large fiscal expansion that, according to the Authorities, threatened to cause a budget deficit of 8.4 percent of GDP by end-FY2010/11. However, continued implementation of recently announced measures aimed at fiscal consolidation could pave the way for resumption of the SBA or talks for a new IMF program in the next fiscal year.<sup>1</sup>

## Weakening Economic Outlook

3. Pakistan's economic growth prospects for FY2010/11 received a serious blow as a consequence of unprecedented floods in the first quarter. The Annual Plan for FY2010/11 envisaged real GDP growth of 4.5 percent in FY2010/11, but now it is likely to grow in the 2.5-3 percent range. Heavy monsoon rains and floods not only caused colossal damage to agriculture, houses and physical infrastructure but added considerable strain to already-fragile economic conditions.

4. **Agriculture.** This sector, which provides 25 percent of the growth impetus, suffered a serious setback as floods damaged about one-fourth of the standing *kharif* crops. Hence, it is unlikely that the agricultural sector will be able to achieve its targeted growth of 3.8 percent this year. Its recovery depends largely on the performance of the *rabi* crops, particularly wheat, and the

<b>Table 1: Performance of Major Crops</b>						
<b>Production</b> ('000 tons; cotton '000 bales of 170.09 kg each)						
	<b>2009/10</b>	<b>% over 2008/09</b>	<b>2010/11<sup>T</sup></b>	<b>% over 2009/10</b>	<b>2010/11<sup>P</sup></b>	<b>% over 2009/10</b>
Cotton	12,705	7.7	14,010	10.3	11,556	-9.0
Sugarcane	49,373	-1.3	53,665	8.7	53,740	8.8
Rice	6,883	-1.0	6,048	-12.1	4,700	-31.7
Wheat	23,864	-0.7	25,000	4.8	23,500 - 24,500	-1.5
Gram	571	-22.9	619	8.4	623.3	9.2
Maize	3,477	-2.0	3,452	-0.7	3,501	0.7

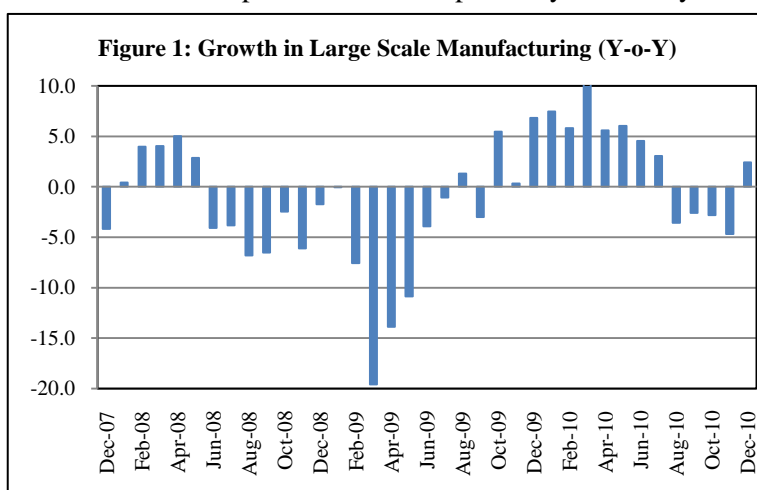
*Source: MINFAL*  
*Note: T: Target, P: Highly provisional estimates*

<sup>1</sup> There was considerable uncertainty in the medium-term economic outlook at the time this outlook was being prepared.

livestock sector. Preliminary assessment showed significant damage to area and production of major *kharif* crops (i.e., cotton and rice – Table 1). In the case of sugarcane only, production losses are likely to be offset by significant yield gains in the non-flood areas.

5. Though hugely damaging, the floods and heavy monsoon rains have improved underground water and soil moisture levels, significantly improving prospects for *rabi* crops. A record wheat harvest is possible, due to a significant increase in production of the crop in un-irrigated areas because of plentiful water availability. Since wheat is the main staple of Pakistan, accounting for two-thirds of national cereal consumption, a bumper harvest would be especially welcome in the face of rising international commodity prices. Livestock, worth half of agricultural output, also suffered losses due to the floods. However, ample availability of water reservoirs and green pastures for livestock feeding, are likely to be instrumental in sustaining recovery in this sector in the coming months.

6. **Manufacturing.** The large-scale manufacturing sector contracted by 1.8 percent during July-December 2010 compared to 1.6 percent growth in the same period last year, but turned positive in December 2010 (Figure 1). This contraction was not unexpected as it was primarily driven by flood damage to agro-based industries, petroleum refining, and damage to the infrastructure. Looking forward, the performance of commodity-producing sectors is expected to turn positive due to a better wheat crop and higher sugarcane production. Consequently, the performance of large-scale manufacturing should improve on the back of strong agri-price support demand,<sup>2</sup> and the expected recovery in the agriculture sector. Moreover, the manufacturing sector upturn will continue to be supported by growth in the consumer durables and engineering items, which posted robust growth in the first six months of FY2010/11. Furthermore, cement, which contracted in the first half of FY2010/11, is expected to provide positive impetus in the remainder of the fiscal year, due to a pick-up in flood damage construction repair activities, and improved winter-harvest earnings.



7. The performance of export-based industries remained mix. Pharmaceuticals and electric fans both lost ground in non-traditional markets, whereas textiles, chemicals and leather exports were boosted by a gradual recovery in the United States and European Union markets. Unlike chemicals and leather, where higher exports are driven by quantum growth, textiles are showing higher export value due to increased profitability, which in turn has been driven by a continued rise in international cotton and yarn prices. On the flip side, the petroleum and steel sectors continued to contract sharply. Petroleum production remained low despite higher crude oil imports, as the country’s largest refinery had to close down for more than a month due to floods, and the steel sector faced severe input shortages due to infrastructural flood damage.

8. **Services sector.** Services provide more than half of the growth impulse, and are likely to post strong growth in FY2010/11. Preliminary available information indicates that three sub-sectors – wholesale and retail trade, other services, and transport storage and communication, which collectively account for over 70 percent of services growth – are performing quite well. The early indication is that

<sup>2</sup> Y-o-y Rs/kg prices of potatoes, onions, and tomatoes rose by 22 percent, 76 percent and 76 percent in July-December 2010. At the same time, the Rs/maund cotton and Rs/kg sugar prices increased by almost 103 percent and 39 percent.

growth in services is being led by the social and community sub-sector because of flood-relief activity and rehabilitation work. Other sub-sectors are also sustaining the growth momentum. For instance, the credit to retail trade grew by 44 percent in the first eight months of FY2010/11, compared to the same period last year, and telecom imports posted a healthy 14 percent growth in the first five months of FY2010/11 over the period last year.

9. Early signs of recovery in the manufacturing and services sector are evident. This recovery is being supported by sustained private demand on the back of higher nominal incomes: a 50 percent increase in government employees' salaries, sharp increase in the prices of most of agricultural products that partly offset the decline in rural incomes caused by poor harvests last year, and significant rise in workers' remittances. Continued prospect of recovery in these sectors will crucially depend on the improvement in the prevailing law and order situation in the country, as well as the resolution of the energy crisis.

## External Imbalances Narrow but Fiscal Position Worsens

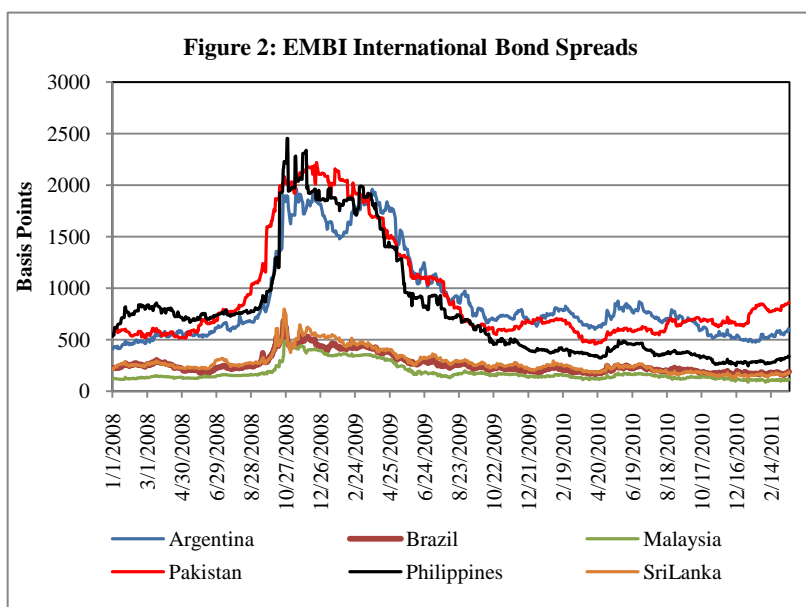
### 10. The external position continued to improve.

The current account has shown substantial and unexpected improvement in first seven months of FY2010/11. Robust growth of 20.3 percent in exports is the main reason for this encouraging development (Table 2). Of the incremental increase in export earnings July 2010 to January 2011, nearly US\$1.7 billion came from higher international commodity prices, especially the main exports, textiles and rice. Positive terms of trade were more visible in the textile and food sectors as higher prices brought US\$1.1 billion and US\$0.4 billion of additional export earnings compared to the period last year. Imports rose by 10.4 percent during the first seven months of FY2010/11, rising incrementally by US\$3.3 billion, with one-third of it coming from higher costs of petroleum crude and products and edible oil. The overall trade balance improved by 5.6 percent, however. Further support to the external current account was provided by strong inflows of remittances – US\$6.1 billion – and disbursement of US\$743 million in Coalition Support Funds (CSF). The growth in remittances can be attributed to the joint initiative of the State Bank of Pakistan, Ministry of Finance and Overseas Pakistanis Ministries launching the Pakistan Remittance Initiative (PRI). Overall, the external current account recorded a marginal deficit of US\$81 million in the first seven months of FY2010/11 (Table 2).

US\$ billion				
	2009/10	July-Feb 2009/10	July-Feb 2010/11	% Growth
<b>i. Current account</b>	<b>-3.9</b>	<b>-3.1</b>	<b>-0.1</b>	97
Trade balance	-11.5	-6.8	-6.4	6
Export	19.7	11.0	13.2	20
Import	-31.2	-17.7	-19.6	10
Services net	-1.7	-1.8	-0.7	60
Income net	-3.3	-1.8	-1.6	9
Current transfers net	12.6	7.3	8.7	19
Remittances	8.9	5.2	6.1	18
<b>ii. Capital and Financial A/c</b>	<b>5.3</b>	<b>2.8</b>	<b>1.2</b>	-57
<i>Of which:</i>				
Direct investment	2.1	1.1	0.9	-14
Portfolio investment	-0.1	-0.3	0.2	173
Other Investment Assets	0.0	-0.2	-0.3	78
Other Investment Liabilities	3.1	2.2	0.4	-83
<b>iii. Errors and omissions</b>	<b>-0.1</b>	<b>0.6</b>	<b>0.2</b>	
<b>Overall balance</b>	<b>1.3</b>	<b>0.4</b>	<b>1.3</b>	-230
<b>SBP reserves</b>	<b>13.1</b>	<b>11.3</b>	<b>14.5</b>	29

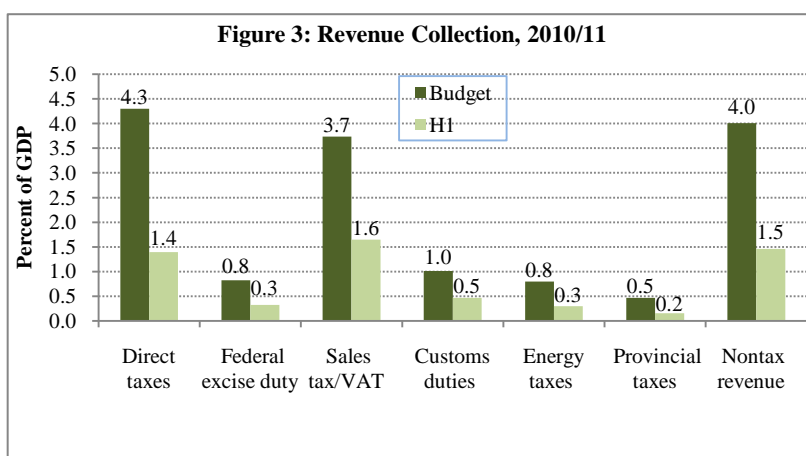
Source: State Bank of Pakistan

11. However, part of this positive impact on the balance of payments has been neutralized by small net inflows in capital and financial accounts. Capital and financial inflows of US\$1.2 billion from July 2010 to January 2011 show a deceleration of 57 percent over the same period last year due to declining foreign direct and portfolio investments and delays in disbursement of official loans. Perceived high country risk, relative to other emerging market economies, as reflected in the high credit default swap (CDS) points on Pakistan's foreign currency bonds,<sup>3</sup> is a main factor underlying the reluctance of foreigners to invest in the country (Figure 2). On the other hand, part of the projected foreign loans and grants did not materialize due to delays in implementation of economic reforms and limited administrative capacity on the part of the authorities. Indeed, on a net basis, the government received only US\$33 million of loans in first seven months of FY2010/11.



12. The overall balance of payments showed a surplus of US\$1.3 billion in the first seven months of FY2010/11 and the State Bank's foreign exchange reserves increased to US\$14.1 billion by end-February 2011, from US\$13 billion at end-June 2010. During this period, the foreign exchange market remained stable. Continued accumulation of foreign exchange reserves is required given significant repayments required for official loans, such as repayments and interest on IMF loans in 2011/12.<sup>4</sup>

13. **Fiscal volatility continued.** The FY2010/11 budget had set a fiscal deficit target of 4.0 percent of GDP, which implied an ambitious fiscal consolidation of 2.3 percent of GDP in one year. This sharp reduction in fiscal deficit was due mainly to a sizeable revenue collection effort of 0.8 percent of GDP, stringent austerity measures, including another sharp reduction in subsidies, and a budgetary expenditure reduction to 19 percent of GDP, from 20.5 percent in FY2009/10 (Table 3). Unfortunately, government's inability to introduce RGST and raise energy prices within the announced timeframe derailed the implementation of the budget. As a consequence, revenue collection continues to be subpar and power sector subsidies remain a major drain



<sup>3</sup> Pakistan's CDS points are hovering above 800 bps compared to about 300 and 150 bps for Sri Lanka and Philippines.

<sup>4</sup> IMF loans principal and interest repayments are expected to multiply by ten from around US\$138 million in FY2010/11 to US\$1.36 billion in FY2011/12, and to remain high thereafter.

on the budget. The floods exacerbated the fiscal imbalances. Overall, the deficit in the first half of the fiscal year ballooned to 2.9 percent of GDP (more than 70 percent of the full-year target).

	2008/09	2009/10	2010/11			
	Actual	P. Actual	Budget	Q1	Q2	H1
<b>Revenue and grants</b>	<b>14.7</b>	<b>14.5</b>	<b>15.6</b>	<b>2.4</b>	<b>3.5</b>	<b>5.9</b>
Total revenue	14.5	14.2	15.0	2.3	3.4	5.8
Tax revenue	10.4	10.2	11.0	1.9	2.4	4.3
Federal	10.1	9.8	10.6	1.8	2.3	4.1
FBR revenue	9.1	9.0	9.7	1.7	2.2	3.8
Direct taxes	3.5	3.6	4.3	0.6	0.8	1.4
Federal excise duty	0.9	0.8	0.8	0.1	0.2	0.3
Sales tax/VAT	3.6	3.5	3.7	0.8	0.9	1.6
Customs duties	1.2	1.1	1.0	0.2	0.3	0.5
Petroleum surcharge	0.9	0.6	0.6	0.1	0.1	0.2
Gas surcharge and other	0.1	0.2	0.2	0.0	0.1	0.1
Provincial	0.4	0.4	0.5	0.1	0.1	0.2
Nontax revenue	4.1	3.9	4.0	0.5	1.0	1.5
Federal	3.4	3.5	3.4	0.4	0.9	1.3
Provincial	0.7	0.5	0.6	0.1	0.1	0.2
Grants	0.2	0.3	0.5	0.1	0.0	0.1
<i>Of which: IDP grants</i>	0.0	0.2	0.0	0.0	0.0	0.0
<b>Expenditure</b>	<b>19.6</b>	<b>20.5</b>	<b>19.0</b>	<b>4.0</b>	<b>4.7</b>	<b>8.6</b>
Current expenditure	16.4	16.9	15.4	3.4	3.7	7.1
Federal	12.1	12.6	11.1	2.5	2.6	5.1
Interest	5.0	4.4	4.1	0.9	0.9	1.8
Domestic	4.4	3.9	3.6	0.9	0.8	1.6
Foreign	0.6	0.4	0.5	0.1	0.1	0.2
Other	7.1	8.3	7.0	1.6	1.7	3.3
<i>Of which : subsidies</i>	1.9	1.5	0.8	0.4	0.2	0.6
<i>Of which : grants</i>	1.1	2.5	1.7	0.3	0.4	0.7
<i>Of which: Cash transfers to poor households 2/</i>	0.2	0.4	0.3	0.0	0.0	0.0
Provincial	4.3	4.3	4.4	0.9	1.1	2.0
Development expenditure and net lending	3.2	3.8	3.6	0.3	0.8	1.1
Public Sector Development Program	3.1	3.5	3.6	0.2	0.5	0.7
Federal	1.5	1.8	1.6	0.2	0.2	0.4
<i>Of which: One-off expenditure</i>	0.2	0.2	0.0	0.0	0.0	0.0
Provincial	1.6	1.8	2.0	0.1	0.3	0.3
Net lending	0.1	0.3	0.0	0.0	0.3	0.4
Statistical discrepancy and flood-related expenditure	0.3	0.0	0.0	0.0	0.2	0.2
<b>Overall Deficit (excluding grants)</b>	<b>-5.3</b>	<b>-6.3</b>	<b>-4.0</b>	<b>1.6</b>	<b>1.3</b>	<b>2.9</b>
<b>Overall Deficit (including grants)</b>	<b>-5.2</b>	<b>-6.0</b>	<b>-3.4</b>	<b>1.5</b>	<b>1.2</b>	<b>2.8</b>
<b>Financing</b>	<b>5.2</b>	<b>6.0</b>	<b>3.5</b>	<b>1.5</b>	<b>1.2</b>	<b>2.8</b>
External	0.9	0.9	0.5	0.3	0.1	0.2
<i>Of which: privatization receipts</i>	0.0	0.0	0.0	0.0	0.0	0.0
<i>Of which: IMF</i>	0.0	0.6	0.0	0.0	0.0	0.0
Domestic	4.3	5.1	2.9	1.3	1.3	2.6
Bank	2.5	2.1	1.0	0.7	1.0	1.7
SBP	0.0	0.3	0.0	0.7	0.2	0.5
Scheduled Banks	2.5	1.8	1.0	0.0	1.2	1.2
Nonbank	1.8	3.0	1.9	0.6	0.3	0.9

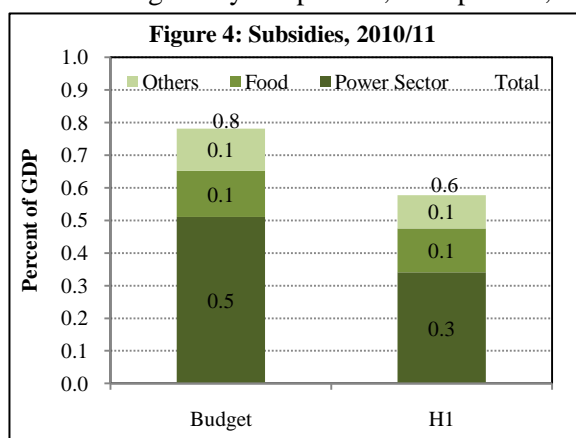
14. Lack of consensus on introducing broad-based value added tax made it difficult to mobilize initial revenue target of Rs 1667 billion. (Figure 3). Most of additional revenue collection effort in the FY2010/11 budget depended on improving the tax structure and administration at federal level. However, with mounting pressure from the business community and lack of political support from allies and the opposition, the government had to postpone implementation of RGST for the time being.. In addition, revenue from the petroleum levy lagged as domestic oil prices failed to keep pace with the increase in international oil market prices.<sup>5</sup>

15. Inadequate revenue mobilization remains one of the most critical challenges (Figure 3 and Table

4). Total revenue collection during the first half of the fiscal year was only 5.9 percent of GDP (compared to 6.1 percent of GDP in the first half of FY2009/10). Federal tax collection continued to underperform during the first eight months of FY2010/11 (Table 4) compared with the government’s reform program and budget, growing by 10.3 percent instead of the 26 percent increase required to meet the budget target. All taxes performed below target.

	2009/10	2010/11 <sup>T</sup>	2010/11 July-Feb (Actual Coll.)	Required Growth vis- à-vis target	Y-oY Growth Actual (July-Feb 2011)
Direct tax	528.6	657.7	309.3	24.4%	5.8%
Indirect taxes	798.8	1,010.0	563.8	26.4%	13.0%
Custom	161.5	181.0	108.4	12.1%	3.8%
Federal Excise	121.2	154.0	77.5	27.1%	14.9%
Sales tax	516.1	675.0	377.9	30.8%	13.6%
<b>Total</b>	<b>1,327.4</b>	<b>1,667.7</b>	<b>873.1</b>	<b>25.6%</b>	<b>10.3%</b>

Collection from direct taxes, sales tax, excises and customs duties grew by 5.8 percent, 13.6 percent, 14.9 percent, and 3.8 percent, compared to the required increases of 24.4 percent, 30.8 percent, 27.1 percent and 12.1 percent. Pakistan’s tax structure suffers from low buoyancy levels across the tax structure, which reveals the existence of narrow tax bases and a skewed tax structure. For the period 1980-2010, tax buoyancy in Pakistan turns out to be about 0.93. This means that given an overall low response of tax revenues to economic growth there is continuous need for the government to introduce short-term discretionary measures (as the government did recently in a bid to narrow the growing revenue gap). Revenue collection during the current fiscal year was also harmed by floods directly in a slowing of economic activity and indirectly through federal and provincial governments’ decisions to exempt flood-affected areas from collection of all taxes.



16. Power tariff increases and efforts to reduce sector inefficiencies were not enough to lower power-sector subsidies significantly. Besides weak revenue mobilization, large power-sector subsidies have been sizable. These subsidies are provided mainly to cover the losses of distribution companies arising partly from the insufficient adjustment in electricity tariffs and partly from large systemic inefficiencies. Significant but delayed increases (of about 80 percent, cumulatively) have been made in power sector tariffs in the last three years, but rising input costs have upstaged any improvement in the financial position of the power sector. Delays in implementing the power reform plan and rising input costs caused the power-sector subsidies to remain high, at 0.3 percent of GDP, during the first half of the fiscal year. In

<sup>5</sup> Due to political pressures, the January 2011 increase in the domestic price for petroleum products was reversed and that of March 2011 was reduced by one-half.



addition, because they tend to be “frontloaded”, and partly because of the floods, food and other subsidies also remained high during the first six months of FY2010/11 (Figure 4). As a result, subsidy payments in this time amounted to 80 percent of the full-year budget target.

#### **Box 1: Financial Sector in Pakistan**

In the aftermath of the global financial crisis, Pakistan’s financial sector has remained relatively robust, having weathered the crisis well. However, domestic problems in security, law and order, power supply and tight fiscal policy coupled with recent floods have burdened the banking industry with increased credit risks.

Non-performing loans (NPLs) increased from 2009 to 2010, with the NPL-to-loan ratio reaching 14 percent by September 2010 – substantially higher than that of regional peer countries such as Bangladesh (8.7 percent) and Sri Lanka (8.9 percent). The most vulnerable sectors are small and medium enterprises (SMEs) where the NPL-to-loan ratio reached 25 percent, and the mortgage loans and agriculture sector where it rose to approximately 20 percent.

In terms of liquidity, the banking system has experienced a slight contraction. While the key liquidity indicators (liquid assets-to-total assets and loans-to-deposits) have improved significantly since the liquidity stress of December 2008, they have deteriorated slightly since June 2010. Ratios of liquid assets-to-total assets and loans-to-deposits were 33.6 percent and 59.7 percent in September 2010.

The banking system has maintained respectable solvency and profitability indicators because of the sound performance of large banks. The capital adequacy ratio of the banking sector in September 2010 (13.8 percent) was still above the regulatory requirement of 10 percent. As for profitability, the banks’ return on assets (1.6 percent) and return on equity (16.2 percent) were satisfactory.

Financial sector penetration remains low. Although access to finance is widely recognized as a tool to achieving meaningful economic inclusion and poverty alleviation, most Pakistani households do not participate in the formal financial system; only 14 percent use a financial product or service such as savings, credit, insurance or payment. Many of these are SMEs and micro-entrepreneurs, which have difficulty in accessing financial services.

Continued public-sector borrowing from banks for fiscal support makes it more difficult for the private sector (especially SMEs) to secure funding. Coupled with the National Savings Schemes (NSS), the public sector has mobilized funding from both the non-banking and the banking sector. The public sector’s excessive reliance on these funding schemes might undermine the sound growth of the private sector-based and domestic market-based funding structure in Pakistan.

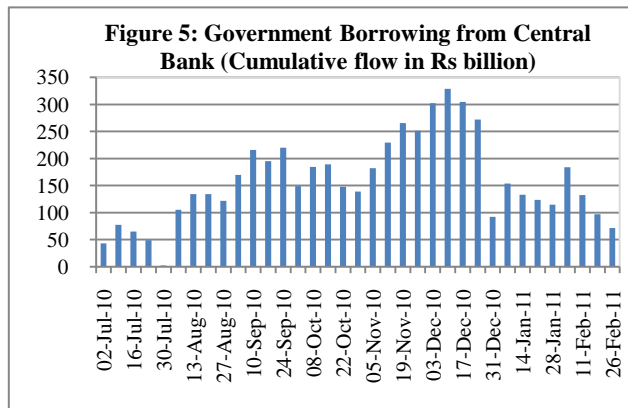
The insurance sector and other non-bank financial companies (NBFCs) remain underdeveloped and appear to have suffered somewhat more than the banking sector from the effects of the financial crisis. NBFCs enjoy only 6 percent of total financial-sector assets compared with 92 percent for the banking sector. It is important for Pakistan to develop a comprehensive strategy to promote and develop this sector. At the same time, it is essential to address the governance, regulation and supervisory issues under the leadership of the Securities and Exchange Commission of Pakistan to attract investors and satisfy the demands of potential clients.

17. Monetary expansion has contributed to inflation. Increasing demand for credit by the government resulted in substantial monetary expansion of Rs445 billion between July 1, 2010 and February 26, 2011 compared with Rs295 in the same period last year (Table 5). Net Foreign Assets (NFA) of the banking system in that period increased by Rs146 billion, in step with foreign exchange reserve build-up. This healthy expansion in NFA and Net Domestic Assets of the banking system, were the main contributors to

monetary expansion. Overall government borrowing from the banking system for budgetary support in this time was high: Rs325 billion. Due to a shortfall in domestic revenues and external financing, and over-shooting of budgeted expenditures, the government borrowed substantially from the State Bank. However, from December 2010 a clear downward trend in its cumulative borrowing is apparent (Figure 5). In addition, during this period the government raised approximately Rs253 billion from commercial banks through T-bill auctions.

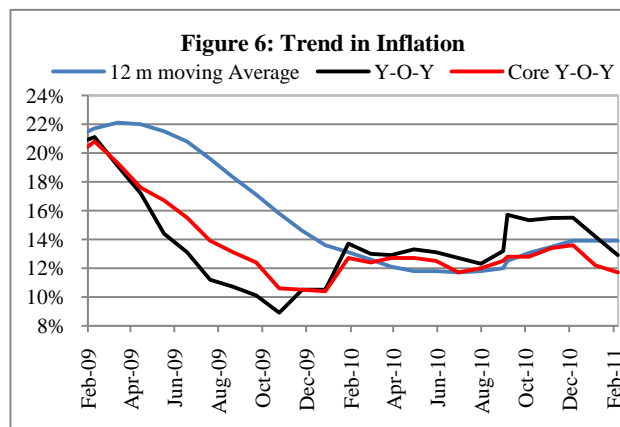
	From July 1 to		
	2009/10	27-Feb-10	26-Feb-11
<b>Broad money (M2)</b>	<b>640</b>	<b>294.7</b>	<b>444.6</b>
(Year-on-Year growth)	12.5	5.7	7.7
<b>Net Foreign Assets</b>	<b>28.1</b>	<b>61.4</b>	<b>146.1</b>
<b>Net Domestic Assets</b>	<b>611.9</b>	<b>233.3</b>	<b>298.470</b>
of which			
Net Government borrowing from SBP	330.4	240.1	325.2
from scheduled banks	44	61.0	71.8
Credit to private sector	286.4	179.2	253.4
Credit to public sector enterprises	112.9	137.9	208.8
<b>Reserve money</b>	<b>85</b>	<b>89.2</b>	<b>21.5</b>
(Year-on-Year growth)	171.7	159.4	251.6
	11.4	10.6	15.0
Banking System Deposits	494.8	128.9	208.1

Source: State Bank of Pakistan



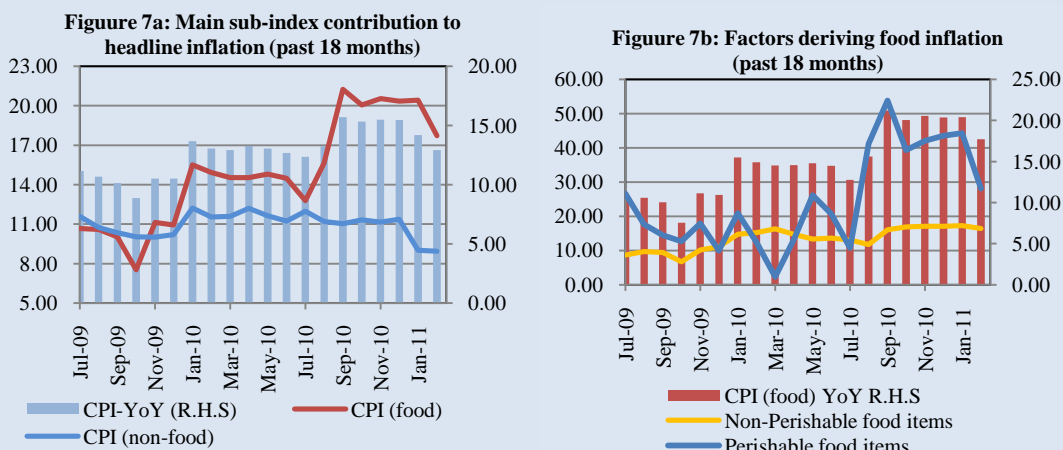
18. In the face of slightly rising Non-Performing Loans (Box 1: *Financial Sector in Pakistan*), banks maintained a risk-averse behavior towards private sector credit. Higher interest rates, too, had a dampening effect on private sector borrowing. At the sectoral level, seasonal requirements by the manufacturing sector, notably textiles, rose to Rs209 billion during the first eight months of FY2010/11. The higher credit requirement by the textile sector stemmed mainly from higher cotton prices, which doubled those of last season.

19. Inflationary pressures, already high at the beginning of FY2010/11, remained elevated (Figure 6 and Box 2: *Stubbornness of Headline Inflation in Pakistan*). Headline CPI inflation jumped to 15.7 percent year-on-year in September 2010 and was still 15.5 percent in December. Average inflation, having fallen to 11.7 percent in FY2009/10, rose to 14.3 percent from July 2010 to February 2011, though it decreased slightly in March. Not only did some of the factors contributing to inflation persist, the floods drove up overall inflation by temporarily raising food prices, as well as electricity and gas rates. Rising



international commodity prices, such as price of petroleum, oil and lubricants products, also intensified domestic inflationary pressures.

### Box 2: Stubbornness of Headline Inflation in Pakistan



Inflationary pressures remained persistent in Pakistan’s economy over the last 18 months. Headline inflation, y-o-y, during this period rose from 11.2 percent in July 2009 to 12.9 percent in February 2011, averaging at 14.3 percent in the first eight months of FY2010/11 (Figure 7a). A breakdown of this inflation reveals that inflationary pressure eased during the first half of FY2009/10, but surged after January 2010 due to: (i) upward revision in electricity tariffs (the base tariff in FY2009/10 increased by 17 percent, almost 70 percent of it taking place in the latter half of the fiscal year); (ii) steady increases in the international price of oil which created significant pass-through effect on transportation-related costs; (iii) State Bank of Pakistan’s decision to transfer all oil-related payments to the interbank; and (iv) deterioration of the fiscal stance and its financing through monetization. Consequently, Pakistan entered FY2010/11 with strengthened inflationary expectations.

The unprecedented floods of July-August 2010 further added to headline inflation y-o-y, which jumped to 15.7 percent in September 2010 from 12.3 percent in July 2010 (Figure 7a). This jump was due mainly to a sharp increase in food inflation as a result of supply shortages of perishable foods and partly due to rising prices of international commodities. Although this spike was not unexpected, headline inflation remained stubborn afterwards (Figure 7b), because in the months following the floods demand for perishable food items (a 12.5 percent weight in the food inflation basket) remained high. Main factors contributing to this were: (i) extensive damage to onion and tomato crops in India which created strong demand for these crops from Pakistan; and (ii) strong demand for Pakistani potatoes from Sri-Lanka and Russia. Moreover, prices of non-perishable food items, too, maintained upward pressure on food inflation and, subsequently, headline inflation, particularly post-September 2010. This appeared to be driven by: (i) sustained strong demand pressures from increased public-sector wages (a 50 percent increase in government salaries was announced in the budget); (ii) higher wages for daily labor; and (iii) higher transportation costs, etc. Consequently, inflationary pressure in the Pakistan economy remained firm.

Looking ahead, CPI headline inflation in the remaining months of FY2010/11 is likely to remain in double digits and high inflationary expectations may continue, because many of the contributing factors will continue. For instance, international commodity prices are rising, the international price of oil has risen sharply due to conflict in the Middle East, which will have an indirect pass-through effect on transportation-related costs, electricity prices are expected to rise in the remaining months, there is strong external demand for key food staples, and monetization of the fiscal deficit will continue to have an impact. Consequently, the State Bank of Pakistan has revised projections of average CPI inflation for FY2010/11 to be in the range of 15-16 percent, along with a high probability of double-digit inflation in FY2011/12 (see State Bank of Pakistan, Monetary Policy Statement, January 2011).

## Progress with Structural Reforms

With the economic focus of the past six months on recovery from the floods, progress with structural reforms has been limited.

- The government made persistent efforts to build consensus on introducing VAT. The economic team of the Government engaged in intense dialogue with all parliamentary parties spanning over a month. However, the requisite support was not forthcoming. However, the government promised to revisit the program next fiscal year and showed its commitment to broadening the tax base by eliminating major exemptions of recent years, except in the health sector. Meanwhile, despite strong resistance by opposition political parties and even from its own allies, in mid-March the government approved a flood surcharge levy, increased the special excise duty on imports and imposed a 17 percent sales tax on sales of tractors. It also increased the ex-factory rate on sugar, removed sales-tax exemptions on fertilizers, pesticides and plant machinery, and eliminated zero-rate sales taxes on garments, carpets, leather, surgical and sports goods. The combined fiscal impact of these tax measures are aimed at preserving the tax ratio at a similar level as last year.
- Regarding public expenditure management issues, besides adopted measures to contain expenditure, the government has been implementing automatic monthly adjustment in power tariffs to accommodate changes in fuel costs and prices, and reduce subsidies. By December 2010 it had increased the base tariff by 11 percent. Last March, it increased the power tariff by 2 percent across the country with a surcharge. This increase applies to all consumers, except lifeline-poor households who use less than 50 units per month. The surcharge is expected to generate about Rs900 million to Rs1 billion a month. Overall, the combined fiscal impact of these tax and expenditure measures are aimed at cutting the consolidated fiscal deficit to below 6 percent of GDP.
- There has been some progress with debt management. The Ministry of Finance has prepared a draft medium-term strategy to strengthen debt management and facilitate the development of an effective government securities market. The strategy was approved by the Debt Management Committee in July last year. The debt office is actively monitoring and implementing the debt management strategy and also preparing a debt sustainability analysis with World Bank support. However, it will have to keep its focus in order to keep the strategy valid and effective.
- The government has proposed amendments of the State Bank of Pakistan act 1956 (SBP Act) to assure monetary and financial stability by enhancing autonomy of SBP. The amendments were approved by the cabinet, and are scheduled to be tabled before the National Assembly. The amendments include an establishment of a “New Monetary Policy Committee” with statutory status and restrictions of total amount of lending by SBP to the GoP.
- Finally, recent investment climate assessments indicate that addressing the problems in the power sector is urgently required. The insufficient quantity and poor quality of electricity is cited as an important constraint to private sector growth. The combination of problems in regulation, management, and pricing, as well as the reduced allocations of natural gas (one of the cheaper feed-stocks for electricity generation), have discouraged investment and left generation capacity unable to meet about one-third of energy demand. As noted above, this also has a major fiscal impact.

## Conclusion

20. The worst floods in recorded history and economic slowdown have given rise to valid concerns that the poverty-reduction gains of the early part of the last decade are eroding. While the country's external imbalances improved, fiscal imbalances widened significantly. As a result, excessive and inflationary government borrowing from the central bank has risen. Measures to boost domestic revenue collection, cap public spending, and resolve power-sector problems, remain significant challenges. Delayed though these adjustments are, the authorities are moving in the right direction, although much more needs to be done to ensure necessary fiscal consolidation. The challenge for the government is to satisfy a wide range of competing demands and pressing needs, and redouble its efforts to resolve sensitive structural issues which must be resolved to improve performance over the medium-term.

21. The Authorities have indicated that the FY2011/12 Finance Bill will aim at addressing near-term concerns, and enabling the economy to recover momentum for strong, sustained and pro-poor growth. In that regard, the government's intention to soon unveil a new growth strategy, which is being prepared with inputs from various donors, including the World Bank, is a welcome development. Bank lending support to Pakistan over the past year has been quite strong at over 1.5 billion (detailed in *World Bank Assistance to Pakistan in FY2010/11*, below)

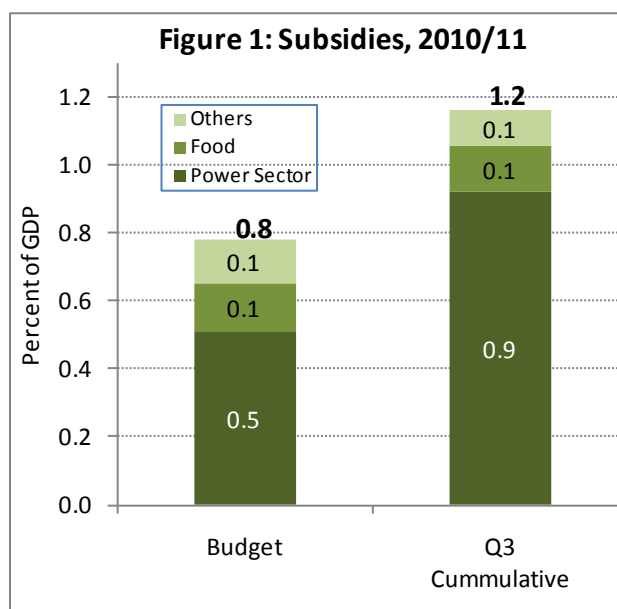
### World Bank Assistance to Pakistan in FY2010/11 (Up to April 2011)

Project	IDA (US\$ million)	IBRD (US\$ million)	Status of Preparation
Highways Rehab.	130		Approved, Pending Signing
Earthquake AF (Import Financing)	300		Signed and Effective
Punjab Barrages		146	Signed and effective
Karachi Port Improvement		115	Signed, pending effectiveness
KP/FATA Emergency	250		Approved. Pending signing and effectiveness
PIFRA II AF	24.5		Approved. Pending signing
Sindh Education AF	50		Approved. Pending signing and effectiveness
Punjab Education AF	50		Approved. Pending signing and effectiveness
Higher Education / Tertiary Education	300		Approved. Pending signing and effectiveness.
Flood Cash Transfer	125		Approved. Pending signing and effectiveness.
Sindh Skills Development	20		Negotiation stage, Board expected in end May
Polio Additional Financing	41		Negotiated. Board expected on April 21
<b>Total</b>	<b>1,291</b>	<b>261</b>	

## An Addendum on Power Sector Subsidy, the Debt Situation and the Eighteenth Constitutional Amendment

### Electricity subsidies and status of power sector reforms

Electricity subsidies continued to remain high during the first three quarters of 2010/11. In the 2010/11 budget, the government allocated Rs 134 billion (or 0.8 percent of GDP) for all types of budgetary subsidies, with almost two-thirds of this amount allocated to power sector subsidies. On the assumption of timely and full implementation of government's power sector action plan, the budget allocated only Rs 32 billion for tariff differential subsidy. This, however, was considered to be a gross underestimate by sector experts, who believed that this subsidy could be substantially higher than that sum. Moreover, the Tariff Adjustment Program was implemented with delays, but not fully in accordance to the reform of its legal requirements (i.e. notification of power sector tariffs at levels determined by the NEPRA). As a result, the government continued notifying a uniform tariff for all DISCOs (at the level relevant for least cost DISCO), which contributed to the sharp rise of tariff differential subsidies over its budgeted amount.



More recently, the government has increased its estimate of power sector subsidies (for 2010/11) to around Rs 190 billion, of which Rs 143 billion is for tariff differential subsidy. Although later than expected, on March 15, 2011 the Government notified tariff increases of two percent for most household consumers, increased the fixed charges to industrial and commercial consumers and introduced a two percent surcharge on all consumers other than households using up to 300kWh per month. Government also stated its intention to continue to increase tariffs by two percent each month between now and June 2011. The Ministry states it has limited the losses by a gradual increase in tariffs, lower generation costs due to enhanced generation from hydro sources during July-December, and managerial and administrative actions to limit generation from low efficiency/high cost generation plants, thus imposing some belt tightening on the utilities, by curtailing generation from inefficient units. Nonetheless, more needs to be done to eliminate subsidies to high-consuming households.

As such, by end-March the power sector subsidies have increased to Rs 158 billion (0.9 percent of GDP) (see Figure 1), with tariff differential subsidy alone increasing to Rs 130 billion. With

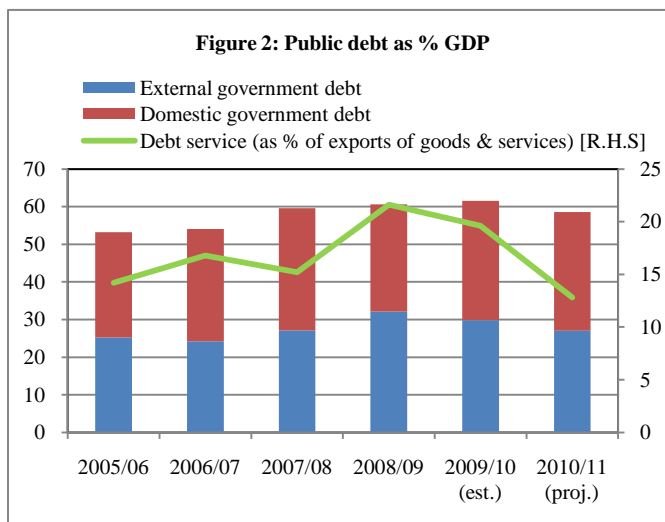
volatility in international oil markets, there is a possibility that power sector subsidies could increase to as high as Rs 227 billion (1.3 percent of GDP).

Government liabilities to the power sector accumulated up to the end of 2008/09 (commonly called as the “circular debt”), amounting to Rs 301 billion were transferred to Power Holding Company, a government owned entity. Government liabilities accumulated in 2009/10, estimated by MoF to be Rs 100 billion (Rs 140 billion by Ministry of Water and Power), resulting from subsidies not paid by government to the power distribution companies, are being carried as receivables on the balance sheets of the power companies. Government has stated its intention to address this problem by the end of 2010/11, but has not yet decided how this will be done. According to the government, it is current on its payment of subsidy in 2010/11 and expects to continue to make subsidy payments so as to avoid further accumulation of liabilities to the power sector.

The transfer of functions that were being performed by PEPCO to the utility companies is expected to be completed by June 30, 2011. The process of reconstituting the Boards of Directors (BODs) of the companies is now completed. Discussions on amendment of the NEPRA act, which, among others provisions, would give NEPRA, rather than the government, the right to notify the power tariffs, appear to have stalled, however.

### Pakistan Debt Situation:

Pakistan’s public-debt-to-GDP ratio in FY2009/10 (excluding obligations to the IMF) stood at 56.8 percent, lower than 57.3 percent of GDP in FY2008/09, and within the limit of 60 percent specified by the Fiscal Responsibility and Debt Limitation Law. In 2009/10, 48 percent of the debt was external while 52 percent was held domestically. In FY2010/11, total public debt (excluding obligations to the IMF) is further expected to decline by about 2.5 percent to 54.3 percent. Including IMF obligations, total public debt-to-GDP ratio is also projected to decrease from the peak of 61.5 percent of GDP in FY2009/10 to around 58.6 percent in FY2010/11. Of the two components of public debt, foreign debt has been relatively less expensive, as in 2009/10 interest liability on external debt constituted only 10 percent of the total interest payment of the government, down from 25 percent in 2001/02.



Nevertheless, despite these improvements, public debt remains an important source of vulnerability. At present, Pakistan’s public debt-to-revenue ratio exceeds 400 percent, and interest payments consume about one-third of budget revenues. Moreover, interest payments consume about one-third of budget revenues. In near-term, reliance on domestic sources has increased. The main reasons for this shift in borrowing were the non-materialization of Tokyo pledges, slow disbursement from multilateral and bilateral

donors and higher than budgeted fiscal deficit. However, an increasing focus towards domestic financing sources on top of higher domestic interest rates signifies a persistent burden on limited budgetary resources in the near term.

### **The Eighteenth Constitutional Amendment -- some important aspects**

The Eighteenth Constitutional Amendment makes more than one hundred changes to the Constitution of Pakistan, including some which could bring about substantive restructuring of the Pakistani government system. The main ones include:

**Limits on power of the President:** The Amendment has abolished, or limited, some key powers of the President, including the power to dismiss the government and Parliament, and restricting the power to enact a legal change through a Presidential Ordinance to one time only.

**Greater role for the Parliament and Prime Minister:** The amendment establishes the Prime Minister and the Federal Cabinet as the federal government and transfers the position of Chief Executive of the government from the President to the Prime Minister (Articles 90 and 99) and has removed limit on the Prime Minister(s) of serving no more than two terms in office (Article 91).

**Appointment and composition of judiciary:** To ensure autonomy of higher judiciary, the role of the government in appointment of judges to the superior courts have been reduced. These appointments will instead be handled by a two-tier system — a seven-member (later changed to nine members by the 19<sup>th</sup> Amendment) Judicial Commission headed by the Chief Justice of Pakistan will propose nominees for appointments and a special parliamentary committee, split evenly between the government and the opposition, will confirm these appointments.

**Protection of financial devolution:** The Eighteenth Amendment specifies that the future NFC Awards cannot reduce the share of provinces' below that given in the Seventh NFC Award (Article 160).

**Change in balance of powers between the federal and provincial governments:** Perhaps the most important change made by the 18th Amendment was to *eliminate* the “Concurrent List” of the Constitution. *The Concurrent List was an enumeration of governmental functions where both the federal and provincial governments were allowed to legislate.* Powers to legislate laws governing marriage, contracts, firearms possession, labor, educational curriculums, environmental pollution, bankruptcy, and 40 other diverse areas will now be devolved to the provinces and federal territories. Nonetheless, prior to eliminating the Concurrent List, some of the functions (e.g. electricity) were transferred to the Federal Legislative List. Overall, due to this Amendment, 18 federal ministries would cease to exist, with most of their functions devolved to the provinces, whereas delivery of these services in the Islamabad Capital Territory would be ensured through an alternative mechanism, which is yet to be devised.

In order to ensure a smooth transition process, the federal government established an “Implementation Commission” which is not only working on the modalities of this devolution,



but is also overseeing the process. To date, ten federal ministries, including all their associated assets, have been devolved to the provinces. These include Ministries of: (i) Culture; (ii) Education; (iii) Livestock and Dairy Development; (iv) Local Government and Rural Development; (v) Population Welfare; (vi) Social Welfare and Special Education; (vi) Special Initiatives; (viii) Tourism; (ix) Youth Affairs; and (x) Zakat and Usher. Although Higher Education Commission was also devolved to the province, due to confusion about its status, recent a Supreme Court verdict has kept HEC with the federal government until such time that a new legislation is promulgated to unambiguously transfer the Commission to provinces or to retain it at the federal level.

The devolution process has been somewhat slow mainly on account of reluctance of provincial governments to accept federal employees of the devolved ministries. The provinces feel that they can discharge the devolved functions and deliver these services using their own staff. Given the weak provincial capacity, this reluctance has created concerns whether the provinces will be able to do justice with the devolved functions. The Commission has decided to refer this issue to a joint sitting of the Parliament. Nonetheless, irrespective of whether these employees would stay with federal government or would be given to the provinces, the impact of the Amendment on federal (and provincial) budget would be small (about 1 percent of GDP).