

Government of Pakistan
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Economic Performance 2006-07: An Update

Pakistan's economy continues to gain traction as it experiences the longest spell of its strongest growth in years. The outcomes of the recently concluded fiscal year indicate that Pakistan's upbeat economic momentum remains on track. Economic growth accelerates to 7.0 percent in 2006-07 at the back of robust growth in agriculture, manufacturing and services. Economic growth has been notably stable and resilient. With economic growth at 7.0 percent in 2006-07, Pakistan's real GDP has grown at an average rate of 7.0 percent per annum during the last five years (2003-07) and over 7.5 percent in the last four year (2004-07) in running. Compared with other emerging economies in Asia, this puts Pakistan as one of the fastest growing economies in the region along with China, India, and Vietnam. The good performance has resulted from a combination of generally sound economic policies, on-going structural reforms and a benign international economic environment. Based on the performance of half-a-decade of strong, stable, resilient and broad-based economic growth it appears that Pakistan's economy will continue to be a high mean, low variance economy over the medium-term.

Pakistan is in the midst of its strongest economic expansion phase and its growth momentum is broad-based. All the three major sectors, namely, agriculture, industry and services have provided support to strong economic growth. The commodity-producing sectors (*agriculture and industry*) contributed 2/5th and services sectors contributed remaining 3/5th to the real GDP growth of 7.0 percent in 2006-07. Within the commodity-producing sectors, the contribution of agriculture alone has been 15 percent (*or 1.1 percentage point*) while 25 percent (*or 1.8 percentage point*) contribution to 2006-07 growth came from industry. Services sectors as a whole contributed almost 60 percent (*or 4.2 percentage points*) to FY07's strong economic growth.

Current economic growth is mainly driven by strong domestic demand with investment taking lead over consumption for the first time in the last three years. Net exports appear to have been a drag on overall growth in 2006-07. Almost 53 percent contribution to 2006-07's growth came from investment while consumption contributed 50 percent. Net exports contributed negatively to the extent of 3.0 percent. The last fiscal year's economic growth has benefited from higher consumption and investment demand owing to a growing middle class and favorable demographics. Increased contribution of investment to growth is a healthy development as it will engender employment growth which will support consumption demand and together they will play an important role in sustaining strong growth momentum in the medium-term.

Needless to say Pakistan's economy continues to maintain a solid pace of expansion since the fiscal year 2002-03. This recovery has been strong, rapid and sustained. During the fiscal year 2006-07, Pakistan's economy continues to perform impressively and its economic fundamentals have gained further strength. The most important achievements of this year include: (i) a strong economic growth of 7.0 percent despite the pursuance of tight monetary policy resulting in interest rate increases; (ii) a strong recovery in overall agricultural growth at 5.0 percent and major crops at 7.6 percent at the back of highest ever production of wheat (*23.52 million tons*) in the country's history and an impressive 22.6 percent increase in sugarcane production (*54.7 million tons: the second highest production level in the history*); (iii) large-scale manufacturing continue to grow robustly at 8.8 percent, *albeit* at a somewhat less torrid pace than 2005-06; (iv) the overall services sector continue to maintain solid pace of expansion at 8.0 percent; (v) with strong average economic growth of over 7.5 percent during the last four years, Pakistan continues to maintain its position as one of the fastest growing economies in the Asian region; (vi) the real per capita GDP grew by 5.2 percent and has maintained an average growth of 5.5 percent per annum over the last four years; (vii)

per capita income in current dollar term was up by 11.0 percent to \$ 925; (viii) a sharp pick up in overall investment reaching at a new height of 23 percent of GDP and most notably, private investment remained buoyant owing to the persistence of strong consumer demand, (ix) despite monetary policy tightening the credit to private sector continue to grow strongly (12.2%) at the back of improving investment climate; (x) a significant abatement of price pressure indicating a steady deceleration in core inflation (*non-food non-energy*) from an average of 7.7 percent in 2005-06 to 6.0 percent in 2006-07 owing to pursuance of tight monetary policy; (xi) on the fiscal side, the overall budget deficit target (*4.2% of GDP*) and revenue collection target of the Federal Board of Revenue (FBR) are achieved; (xii) across all measures of vulnerability to external shocks, Pakistan's debt profile has improved significantly over 2005-06— public debt declined from 56.9 percent to 53.4 percent of GDP and external debt and liabilities declined from 29.4 percent to 27.1 percent; (xiii) highest ever workers remittances at around \$ 5.5 billion, (xiv) highest ever foreign investment flows at around \$ 6.5 billion, emerging as the single largest source of external finance after exports; (xv) exchange rate continues to remain stable despite widening of trade and current account deficits, clearly indicating strong inflows of external resources; and (xvi) the successful launch of a new \$ 750 million 10-year 144 A sovereign bond in international debt capital market with seven times over subscription has been the defining moment in Pakistan's history as it reflected a strong vote of confidence by global investors on Pakistan's current economic prospects and future economic outlook.

Among the most appreciated developments, during fiscal year 2006-07, was the improvement in performance of *agriculture* sector. Growth in the agriculture sector bounced back from a modest 1.6 percent in 2005-06 to *5.0 percent* in 2006-07. The major crops registered an impressive growth of *7.6 percent* against a negative growth of 4.1 percent in FY06. The impressive growth in major crops owes partly to the bumper wheat and sugarcane crops and partly to the base effect as it is measured from a low base of last year. Wheat production was up by 10.5 percent to 23.5 million tons —the highest ever wheat production recorded in the country's history. The balanced use of fertilizer, availability of water during Rabi season, higher availability of agricultural credit and introduction of three new high yielding varieties of wheat have been responsible for record production of wheat during 2006-07. Sugarcane production, likewise, improved by *22.6 percent* in 2005-06 to 54.8 million tons — the second highest size of the crop in the country's history. Cotton production at 13.0 million bales remained at 2005-06's level. The performance of all other sub-sectors of agriculture also remained robust with the exception of minor crops and fishing.

Monetary policy stance of the SBP has undergone considerable changes over the last 6-7 years gradually switching from an easy monetary policy to the current aggressive tight monetary stance. During the fiscal year 2006-07, the SBP took several additional policy measures in different phases as part of monetary policy tightening. In the first phase, the SBP raised the Statutory Liquidity Ratio (SLR) from 15 percent to 18 percent and Cash Reserve Ratio (CRR) for commercial banks from 5 to 7 percent. The SBP also raised the discount rate (policy rate) from 9 percent to 9.5 percent. The increase in interest rate was in line with the international rising trends in interest rates and prevailing inflationary pressures on the economy. The SBP, through its tight monetary policy, aimed at curbing strong domestic demand, which was one of the main driving forces fueling inflation, by curtailing the lending ability of the commercial banks to the private sector. Notwithstanding the tight monetary policy stance the SBP continued to strike a balance between promoting growth and controlling inflation on the one hand and maintaining a stable exchange rate environment on the other. Tight monetary policy stance is likely to continue until inflationary pressures are significantly eased off.

Pakistan's total liquid *foreign exchange reserves* stood at \$ 15.1 billion at the end of June 2007, considerably higher than the end-June 2006 level of US\$ 13.1 billion. Many factors contributed towards this comfortable position of reserves. The most prominent among those are: private transfers that include remittances, floatation of bonds, higher FDI flows and privatization proceeds.

The *stock market* continued to maintain its strong performance and achieved new heights by creating many new records during the fiscal year 2006-07. The KSE-100 Index crossed the barrier of 12000 marks for the second time in the history of capital market and touched an all time high on May 31st, 2007. The index stood at 9989 points at the end of the fiscal year 2005-06 which has risen by 38 percent since then to 13772 points until June 2007. The improved performance of the stock market can mainly be attributed to a number of factors including: (i) continuous improvement in the country's economic fundamentals, (ii) government's commitment to maintain its economic reform and pro-market policies, (iii) stability in exchange rate as a result of strong build up in foreign exchange reserves, (iv) regionally cheap valuation driving foreign interest in Pakistan's stock market, (v) large-scale merger and acquisition in the banking, telecom and other sectors of the economy (vi) improving Pakistan's geo-political relationship with neighbors as well as globally, resulting in decline in political risk premium of the country, (vii) successful GDR offerings of the OGDCL and MCB Bank, amounting to \$ 888 million and (viii) increase in Pakistan's coverage by large international brokerage firms and investment banks.

Despite sharp deceleration in imports the merchandise *trade deficit* widen on the back of abrupt and sharp deceleration in exports. The merchandise trade deficit widen to \$11.1 billion in the first ten months (July-April) of the current fiscal year as against \$ 9.5 billion in the same period last year. However, as percentage of GDP, trade deficit is likely to be 9.0 percent in 2006-07 as against 9.5 percent last year. Thus, trade deficit is expected to improve this year despite less than satisfactory performance of exports.

Workers' *remittances*, the third largest source of foreign exchange inflows after exports and foreign investment, continue to maintain its rising trend. Workers' remittances totaled \$ 5.5 billion in 2006-07 as against \$ 4.6 billion in the same period last year, depicting an increase of 19.5 percent– the highest ever in the country's history.

Pakistan's *current account balance* that slipped into red in 2004-05 after posting surpluses for three consecutive years remained in deficit in 2006-07. Pakistan's balance of payments shows a record increase in capital flows that has substantially offset a gradual widening of the current account deficit. Pakistan's current account deficit further widen to 5.0% of GDP in the 2006-07 from 4.4% of GDP in the same period last year. A striking feature of FY07 current account deficit is that it has widened even though the import growth has slowed to 10.2 percent but the performance of exports has been lack luster at best, resulting in widening of trade deficit. The current account deficit for the year is 5.0 percent of GDP as against 4.4 percent last year. However, the strong inflows in capital account will more than offset the current account deficit and add to the stock of foreign exchange reserves.

Foreign Direct Investment (FDI) in the recently concluded fiscal year amounted to \$ 5.12 billion which is 45 times higher than 2005-06. FDI has primarily come in four major areas: telecom, energy (*oil and gas, power, petroleum refineries*), banking and finance, and food and beverages. These four groups accounted for over 80 percent of FDI inflows. Other areas such as textile, chemicals and petro-chemicals, automobiles, construction and trade are also attracting FDI. Almost 78 percent of FDI has come from five countries, namely the UAE, US, UK, China and Netherlands. Foreign investment of this magnitude reflects the confidence of global investors on the current and future prospects of Pakistan economy.

Public debt burden continues to decline sharply for the seventh year in a row on account of prudent fiscal management. Public debt was 85 percent of GDP in 1999-2000 but has declined sharply to 55.2 percent in FY07 – a decline of around 30 percentage points in just seven years is one of the significant achievements of the government. During the year, public debt has declined from 57.2 percent in 2005-06 to 55.2 percent of GDP – a decline of 2.0 percentage points in one year. Public debt was 627 percent of total revenue in 1999-2000 but has declined to 370.5 percent in 2006-07 – a decline of 256 percentage points in seven years is not a mean achievement.

Rapid and broad-based economic growth over a prolonged period is essential for *poverty* reduction and improving distribution. Many developing countries have succeeded in boosting growth for a short period but only those that achieved higher economic growth over a long period have seen a lasting reduction in poverty. Strong economic growth, large inflow of remittances and Rs.2217 billion spending on social sector and poverty-related program during 2001/02 and 2006/07 have succeeded in reducing poverty in Pakistan. At the national level, headcount decreased from 34.46 percent in 2000-01 to 23.9 percent in 2004-05, depicting a substantial reduction of 10.5 percentage points over this period. In absolute numbers the count of poor persons has fallen from 49.23 million in 2001 to 36.45 million in 2004-05. While rural poverty declined even more sharply (*11.13 percentage points*) urban poverty also declined by 7.75 percentage points. It is generally argued that though poverty has declined in Pakistan, the gap between rich and poor has widened. The result suggests that though consumption inequality in Pakistan has increased marginally during 2001-05, consumption/ income equality in Pakistan is far less compared with many high, middle and low income countries.

The results from PSLM 2004-05 on social indicators when compared with PIHS 2000-01 reveal interesting facts with respects access to various services of bottom 20 percent of population to top 20 percent of the population. The results show that not only access to services improved faster for the poor, the disparities in access between the poor and the rich has narrowed. The results from PSLM 2005-06 have been released recently. The new results suggest that most of the indicators pertaining to education such as gross and net enrollment at primary level and literacy rate have improved significantly over the last 5 years (*2001-2006*). As regards, health indicators, children immunization, incident of diarrhea and infant mortality have improved appreciably. Infant mortality is down from 82 to 70 during 2001-06. Contraceptive prevalence rate has improved and consequently the total fertility rate has registered decline from 4.5 to 3.8 in 7 years.

While the economy of Pakistan has gained further traction in 2006-07, there are however, some *weaker areas* that need to be highlighted. First and foremost is the sharp pick up in the prices of some of the essential food items. Over the last decade, with a few exceptions, inflation around the world has been at retreat. More recently, with a pick-up in growth, inflation has started to rise again. Pakistan's economy exhibited a similar trend with a low inflation environment for last several years with a sharp pick-up in 2004-05 and a gradual abatement of price pressure thereafter. The rate of inflation averaged 7.8 percent in the fiscal year under consideration – marginally lower than last year for the same period – but certainly above the target of 6.5 percent for the year. Based on the above facts it is clear that the inflation over the period under consideration has largely been driven by higher food inflation. This food inflation has been fueled by a combination of global trends in the prices of several commodities and local supply – and demand – driven factors. Globally, higher prices of edible oil (palm oil and soybean) and dependency on their imports transmitted higher international prices to domestic prices. It may be pointed out that higher food inflation is now a global phenomenon as many countries around the world (*for example India and China*) are also experiencing higher food inflation. Furthermore, shortfall in domestic production of pulses, rice, chillies, other vegetable items (onion, tomato, etc) and fruits also contributed to the rise in domestic food prices. There are a few key food items which are widely consumed and whose prices remained high during the year and therefore contributed to the pick-up in food inflation. These items include: rice, masur and gram pulses, milk powder, vegetable ghee and cooking oil, red chillies, onions and tomato. On the other hand, the prices of some essential food items were lower this year compared with last year. These items include: moong pulse, sugar, chicken, potato etc. Non-food inflation in general and core inflation in particular have declined as a result of tightening of monetary policy during the year.

The challenge for the government is therefore to maintain a balance between the supply and demand for essential food items by enhancing domestic production and augmenting their supplies in the shortest possible time through imports in the event of shortfall in the production of these items. The key to addressing this challenge is to give due importance to minor crops, and livestock and dairy sectors which have been neglected by successive governments. The relative roles of these two sub-sectors, which

together account for 62 percent of agricultural value added, in keeping food prices stable need to be emphasized and given due attention.

As stated in the beginning, while Pakistan has made remarkable progress in its economic performance, undertaken wide ranging structural reforms, achieved both macroeconomic stability and strong growth, sharply reduced poverty, yet there is no room for complacency. Indeed the Government is far from complacent for the challenges are several, but then so are the opportunities. The important thing is that both challenges and opportunities have been identified and appropriate steps have ready been initiated. Therefore in the years to come we can assume that the day is not far away when Pakistan will be on the top rung of the ladder of prosperity and will become an economic power to reckon with.

Outlook for 2007-08

Economic outlook/forecast for the current financial year 2007-08 on the basis of healthy macro-economic indicators remains extremely favorable. Building on the same positive trajectory as last year, real GDP growth is expected to increase to 7.2 % in 2007-08 ably supported by agriculture (4.8 %) and large scale manufacturing (10.5 %). Last year over all CPI based inflation averaged 7.8 %, however inflation for this year has been targeted at 6.5 %. Investment has also been forecasted to increase to 23.5 % of GDP as compared to last fiscal year's figure of 23.0 % of GDP. On the external side of the accounts, current account was enumerated at 4.9 % of GDP in 2006-07, this year it has been projected to decline to 4.7 % of GDP. Fiscal deficit on the other hand has been targeted to decline to 4.0 % of GDP in the ongoing financial year as against 4.3 % in 2006-07. As regards financing of budget deficit is concerned, the Government is expecting Rs. 29 billion as grants. Therefore, total financing requirements will be Rs. 370 billion, of which Rs. 220 billion will come from external sources. Within external financing Rs. 113 billion is expected as privatization proceeds. However, remaining Rs. 147 billion will come from domestic sources.

Comparative Performance of Key Economic Indicators

	Unit	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04	2004-05	2005-06	2006-07
I. Real Sector										
Real GDP Growth	%	4.2	3.9	1.8	3.1	4.7	7.5	9.0	6.6	7.0
Agriculture	%	1.9	6.1	-2.2	0.1	4.3	2.3	6.5	1.6	5.0
Large Scale Manuf.	%	3.6	1.5	11.0	3.5	7.2	18.1	19.9	10.7	8.8
Investment	% of GDP	15.6	17.4	17.2	16.8	16.9	16.6	18.1	21.7	23.0
National Savings	% of GDP	11.7	15.8	16.5	18.6	20.8	17.9	17.5	17.7	18.1
Inflation		5.7	3.6	4.4	3.5	3.1	4.6	9.3	7.9	7.8
- Food Inflation	%	5.9	2.2	3.6	2.5	2.9	6.0	12.5	6.9	10.3
- Non-Food Inflation	%	5.6	4.7	5.1	4.3	3.2	3.6	7.1	8.6	6.0
- Core Inflation		6.2	4.4	4.2	3.6	2.6	3.7	7.6	7.1	5.5
II. Fiscal Sector										
Revenue Collection (CBR)	Billion Rs	308.5	346.6	396.4	403.9	461.6	518.8	591	713	846
Fiscal Deficit	% of GDP	6.1	5.4	4.3	4.3	3.7	2.4	3.3	4.2	4.2
Public Debt	% of GDP	100.4	94.8	82.8	79.7	75.1	67.1	62.2	57.2	55.2
- of which foreign currency Denominated	% of GDP	53.1	45.8	42.3	40.8	36.7	32.0	29.4	26.6	24.6
Debt Servicing	% of Total Revenue	64.0	63.8	57.0	51.1	35.7	31.1	30.4	27.5	25.4
III. External Sector										
Exports (f.o.b)	Billion \$	7.5	8.2	8.9	9.1	10.9	12.4	14.5	16.5	17.1
Imports (f.o.b)	Billion \$	9.6	9.6	10.2	9.4	11.3	13.7	19.0	25.0	27.0
Trade Deficit	Billion \$	-2.1	-1.4	-1.3	-0.3	-0.4	-1.3	-4.5	-8.4	-9.9
Remittances	Billion \$	1.1	1.0	1.1	2.4	4.2	3.8	4.2	4.6	5.5
Current Account Balance	% of GDP Billion \$	-4.1 -2.43	-1.6 -1.14	-0.7 -0.51	0.1 1.34	3.8 3.17	1.4 1.31	-1.6 -1.77	-3.9 -5.0	-4.9 -7.0
Total Foreign Investment	Million \$	403.3	543.4	182.0	474.7	820.1	921.7	1676.6	4485.5	8428.3
Foreign Direct Investment	Million \$	376.0	470.0	322.4	484.7	798.0	949.4	1524	3521	5125
External Debt and Forex Liabilities	Billion \$	37.6	37.9	37.1	36.5	35.5	35.3	35.8	37.3	40.2
External Debt and Liabilities	% of Forex Earnings	347.1	297.2	259.5	236.8	181.2	164.9	137.2	117.3	122.5
Foreign Exchange Reserves	Billion \$	1.7	1.3	3.2	6.3	10.7	12.3	12.6	12.8	15.7
IV. Monetary & Capital Market										
Weighted Avg. Lending Rate	%	15.4	14.0	13.7	13.1	7.58	5.05	8.2	10.2	10.6
Credit to Private Sector	Rs. Billion	103.0	18.0	48.6	53.0	168.0	325.0	390.3	401.8	356.3
Stock Market (KSE Index)	1991=100	1055	1521	1366	1770	3403	5279	7450	9989	13772
Market Capitalization	Rs. Billion	286	392	339	408	746	1357.5	2036.7	2766.4	3980.8
Market Capitalization	\$ Billion	5.7	6.7	5.8	6.8	12.8	23.4	34.3	45.7	65.3

Source: Ministry of Finance