51810

September, 2009

Pakistan Economic Update

Economic Policy and Poverty Team
South Asia Region

The World Bank

Summary

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

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

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

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

- *Failure to improve revenue generation will leave Pakistan increasingly vulnerable to shocks, and jeopardize the country's development efforts by limiting the resources necessary for planned investments in human and physical infrastructure. There is a risk that Pakistan may repeat past mistakes. Pakistan's high economic growth in the earlier part of this decade was driven in part by external financing and an expansionary fiscal stance, while revenues and savings stagnated. This reliance on external financing left the economy vulnerable to external shocks, which came in 2007/08 and, in the absence of corrective measures, brought about a balance of payments crisis. To reduce the economy's vulnerability to shocks and avoid repetition of past mistakes, stepping up domestic revenue mobilization is critical.*

[1] This is report was prepared by Satu Kristiina Kahkonen, with Muhammad Waheed and Saadia Refaqat.

Background

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

2. The volatile political and security environment has complicated policy-making and impeded implementation of the stabilization program. Political tensions between the two leading parties, the Pakistan People's Party (PPP) and Pakistan Muslim League-Nawaz (PML-N), intensified in the second half of 2008/09 and culminated in the "long march of lawyers" in March 2009. Since then political volatility has subsided somewhat. Terrorist attacks have, however, continued. The attack on the Sri Lankan cricket team and bombing of a five-star hotel in Peshawar were among them. Furthermore, Pakistan engaged in a full-fledged war with militants in the Federally Administered Tribal Areas (FATA) and portions of the Northwest Frontier Province (NWFP) in May 2009, as an agreement to allow Sharia law (Nizam-e-Adal regulation) in the Swat administrative district in April 2009 quickly fell apart. Full scale military operations have led to about 2.7 million internally displaced persons. Taking care of these people as well as reconstructing the conflict-damaged areas will add to the fiscal burden. Frequent changes in the country's economic management have as well continued, adding instability to policy-making.

Economic Performance under the Stabilization Program

3. The stabilization program has remained broadly on track, though at times with substantial difficulty. The first IMF review of the program was completed in March 2009, but the completion of the second review was delayed until August 2009.

4. The rapid decline in international commodity and oil prices during 2008/09 reduced the risks, facilitated improvement in the external position and led to the achievement of some, but not all, program targets (see Table 1, below, for the macro-economic framework program). While the economy started stabilizing towards the end of the fiscal year, overall economic performance has remained mixed.

Table 1: Medium-term Macroeconomic Framework

	Actual		Initial Program	Revised Program	Est.	Initial Program	Revised Program	Proj.				
	2006/07	2007/08	2008/09	2008/09	2008/09	2009/10	2009/10	2009/10	2010/11	2011/12	2012/13	2013/14
Output and prices	*(Annual changes; in percent)*											
Real GDP at factor cost	6.8	4.1	3.4	2.5	2.0	4.0	4.0	3.0	4.0	4.5	5.0	5.5
Consumer prices (period average)	7.8	12.0	23.0	20.0	20.8	6.0	6.0	10.0	7.0	6.0	6.0	6.0
Pakistani rupees per U.S. dollar (period average)	1.3	3.2	..	..	25.8	..	..	..	..	..	..	..
Saving and Investment	*(In percent of GDP)*											
Gross national saving	18.1	13.2	13.5	14.2	14.6	15.6	15.6	14.3	15.8	16.5	17.2	18.8
Gross capital formation /1	22.9	21.6	20.0	20.1	19.7	19.9	19.9	19.0	21.1	21.6	21.6	22.2
Public finances												
Revenue and grants	15.2	14.6	15.1	15.4	14.4	16.0	16.0	15.2	15.4	16.0	16.3	16.6
Revenue	14.8	14.3	14.9	15.2	14.2	15.8	15.8	14.6	15.0	15.8	16.1	16.4
Tax revenue	10.9	10.6	11.0	11.3	10.2	12.0	11.9	10.7	11.4	12.2	12.7	13.0
of which: Federal Board of Revenue	9.7	9.8	10.2	10.0	8.8	10.6	10.6	9.3	10.1	10.9	11.5	11.9
Non-tax revenue	3.9	3.9	3.9	3.9	3.9	3.8	3.8	3.8	3.7	3.5	3.3	3.3
Grants /2	0.3	0.8	0.7	0.6	0.3	0.2	0.6	0.6	0.4	0.2	0.2	0.2
Expenditure (including statistical discrepancy) /3	20.6	22.2	19.0	19.3	19.0	19.2	19.2	19.3	19.3	19.0	19.0	19.2
Current expenditure	15.8	18.1	16.0	16.1	16.3	15.2	15.2	15.7	14.8	14.3	14.2	14.0
Interest /4	4.2	4.8	4.6	4.8	4.8	4.7	4.7	4.4	3.8	3.4	3.1	2.7
Other federal /5	6.9	9.0	7.6	7.3	7.3	6.3	6.4	7.3	6.5	6.3	6.5	6.7
Provincial	4.6	3.8	3.9	4.0	4.2	4.2	4.2	4.0	4.4	4.5	4.6	4.6
Development expenditure	4.9	4.1	3.0	3.2	2.8	4.0	4.0	3.5	4.5	4.7	4.9	5.1
of which: one-off-outlays	0.5	0.2	0.2	0.2	0.2	0.1	0.1	0.2	0.0	0.0	0.0	0.0
Net lending	-0.1	-0.3	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0
Statistical discrepancy	-1.4	0.0	0.1	0.2	0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Overall balance												
Underlying (excluding grants and one-off-outlays)	-3.9	-8.2	-4.5	-4.6	-5.0	-3.3	-3.7	-4.5	-4.3	-3.2	-2.9	-2.8
Excluding grants	-4.3	-8.4	-4.7	-4.8	-5.2	-3.4	-3.8	-4.7	-4.3	-3.2	-2.9	-2.8
Including grants	-4.0	-7.6	-4.0	-4.2	-4.9	-3.2	-3.2	-4.1	-3.9	-3.0	-2.7	-2.6
Financing /6	4.0	7.3	4.0	4.2	5.0	3.2	3.2	4.2	3.8	3.0	2.8	2.6
External	2.0	1.2	2.5	1.4	0.9	1.0	1.0	1.8	2.8	2.9	2.5	2.3
off which; privatization receipts	0.6	0.0	0.0	0.0	0.0	0.2	0.0	0.0	0.2	0.2	0.1	0.1
Domestic	2.0	6.1	1.6	2.8	4.1	2.2	2.2	2.4	1.0	0.1	0.3	0.3
Total government debt /7	54.1	58.4	54.6	56.9	56.0	55.3	55.4	56.8	57.1	57.1	56.8	56.3
External government debt /7	24.2	26.7	26.9	27.9	26.0	26.2	26.2	25.6	27.6	29.8	31.5	32.9
Domestic government debt	29.9	31.8	27.7	29.1	30.0	29.1	29.1	31.3	29.6	27.3	25.3	23.4
Monetary sector	*(Annual changes; in percent)*											
Net foreign assets	8.1	-7.8	-4.9	-3.4	-3.2	-1.4	-1.4	1.9	..	..	..	..
Net domestic assets	11.3	23.2	15.7	11.8	12.8	12.1	12.1	11.1	..	..	..	..
Broad money	19.3	15.3	10.8	8.4	9.6	10.6	10.6	13.0	..	..	..	..
Private credit	17.2	16.4	25.2	8.3	0.7	14.2	14.1	14.8	..	..	..	..
Six-month treasury bill rate (period average; in %)	8.8	9.6	12.7	..	13.1	..	..	..	..	..	..	..
External sector												
Merchandise exports, U.S. dollars (growth rate; in %)	4.4	18.2	12.0	-5.5	-7.4	1.5	1.6	-2.5	3.4	5.3	7.1	7.7
Merchandise imports, U.S. dollars (growth rate; in %)	8.0	31.4	1.1	-14.5	-12.9	-5.5	-5.5	-2.4	4.8	4.0	3.8	4.2
Current account including official current transfers (as % of GDP)	-4.8	-8.3	-6.5	-5.9	-5.1	-4.3	-4.3	-4.7	-5.3	-5.0	-4.3	-3.4
Gross official reserves (in millions of U.S. dollars) /8	14,302	8,591	8,591	9,091	9,114	10,591	10,591	13,474	15,100	14,600	13,100	12,100
In months of next year's imports of goods and services	3.8	2.7	2.1	3.0	2.9	3.3	3.3	4.1	4.4	4.1	3.5	3.1
Memorandum Items:												
Real effective exchange rate (annual average; percentage change)	0.5	-0.8	..	..	..	..	..	..	..	..	..	..
Real per capita GDP (percentage change)	5.1	4.1	..	..	2.0	..	..	3.0	4.0	4.5	5.0	5.5
GDP at market prices (in billions of Pakistani rupees)	8,723	10,284	13,384	12,970	13,095	14,298	14,298	14,837	16,510	18,288	20,355	22,763
GDP at market prices (in billions of U.S. dollars)	144.0	164.5	..	162.6	166.5	171.0	171.0	178.7	184.2	194.3	205.9	219.3

/1 Including changes in inventories. Investment data recorded by the Federal Bureau of Statistics are said to be underreport true activity.
/2 For 2009/10 projections, this figures includes unidentified IDP-grants in the amount of US$ 404 million.
/3 Expenditure on social assistance in 2008/09 is budgeted at 0.5 percent of GDP. The program will target an additional 0.3-0.5 percent of GDP.
/4 For 2007/08, financing figure has been provided by the Ministry of Finance.
/5 In 2007/08, Rs 23 billion (0.3 percent of GDP) of current expenditure has been reclassified as development expenditure.
/6 Includes statistical discrepancy nd spending related to the 2005 earthquake.
/7 Excludes obligations to the IMF, military debt, commercial loans, and short-term debt.
/8 Excluding gold, foreign deposits of commercial banks held with the State Bank of Pakistan.
Sources: Government of Pakistan for the historical years, and IMF projections.

5. Even though economic activity slowed significantly, due to reduced domestic and global demand, preliminary estimates suggest that the economy still grew by 2.0 percent in 2008/09. This was 0.5 percent below the program target. Agriculture, which contributes about one-fifth of GDP, grew robustly by 4.7 percent (in particular wheat, maize and rice) as a result of favorable weather conditions. The services sector, which has provided over half of the growth impulse over the past three years, also continued to grow by 3.6 percent. By contrast, industry, which contributes about one-quarter of GDP, continued its contraction, by 3.6 percent in 2008/09. Large-scale manufacturing, which makes up about half of the industrial value added, registered negative growth.2 The contraction was particularly pronounced in electronics, food, automobile, and petroleum industries. In addition to the decline in demand, these industries were adversely affected by rising power shortages and the deterioration in law and order.

6. The current account deficit narrowed beyond the set target of 5.9 percent of GDP to 5.1 percent of GDP in 2008/09, driven by a deceleration in imports (exceeding that of exports) and growing workers' remittances. Exports contracted by 6 percent as external demand declined, due to the global recession. Imports in turn declined by over 10 percent as international oil and commodity prices fell sharply, the rupee depreciated and aggregate domestic demand contracted. Table 3 shows that the contraction in imports was wide-spread and not limited to only a few sectors.

7. Workers' remittances continued to grow in 2008/09, for the fifth consecutive year, rising by 21 percent. This strong growth was somewhat surprising, given the global economic recession. It is possible that these inflows reflected past savings of migrants, which they repatriated with their return to Pakistan. If this is true, the sustainability of the current account would be threatened.

Table 2: Balance of Payments Summary, US$ billion

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

Source: State Bank of Pakistan

Table 3: Imports (CIF), US$ billion

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

Source: Federal Bureau of Statistics

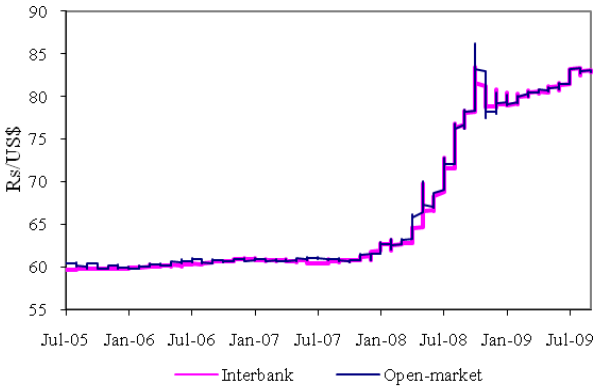
[2] The value added of large scale manufacturing which declined by 7.7 percent in 2008/09.

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

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

10. SBP foreign exchange reserves rebounded to about US$10.8 billion by end-August 2009, thanks to IMF disbursements. Improvements in the current account and reserve position in Pakistan as well as movements in US$ helped stabilize the nominal exchange rate at about Rs/US$83 by end-August 2009. The Rupee-Dollar nominal exchange rate depreciation slowed from 13.7 percent in the first half to 2.4 percent in the second half of 2008/09 (Figure 1).

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



Source: State Bank of Pakistan.

11. The external position improved significantly in the second half of 2008/09, but fiscal problems continued and, according to the provisional data, the fiscal deficit target was exceeded by 0.9 percent of GDP, as the deficit amounted to 5.2 percent of GDP in 2008/09. Revenues underperformed as the economy slowed. In addition, attempts to control spending largely failed.

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

13. Revenues continued underperforming in the first two months of 2009/10. FBR tax collection in July and August 2009 increased by only 3.6 percent, compared to the 19.5 percent required for the annual target. While direct and sales taxes grew by 2.9 percent and 9.7 percent, year-on-year, excise and custom duties collection contracted by 4.3 and 14 percent, year-on-year.

14. In light of the shortfall in revenues, the federal government attempted to reduce the fiscal deficit in 2008/09 by reducing spending, but its attempts were thwarted. Firstly, as power shortages increased, the government greatly diluted increases in power tariffs for political reasons. As a result, power subsidies remained high. Secondly, large overruns in provincial development expenditures compromised federal efforts. While federal development spending was below the target, provincial development expenditure exceeded the target. Most of this additional expenditure at the provincial level was financed by

borrowing from the banking system, mainly from the SBP, with adverse effects on money supply and inflation.

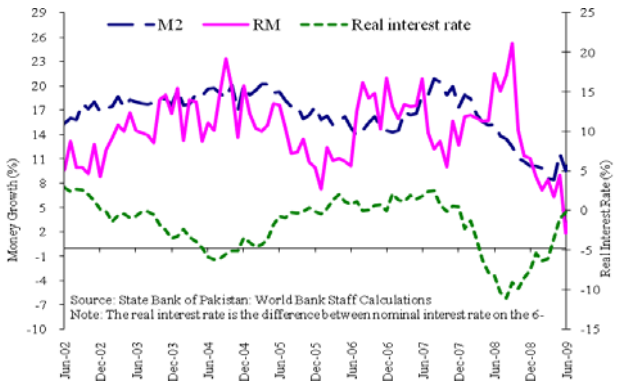
15. Developments in the first two months of 2009/10 suggest that these worrisome trends continue. Firstly, continued government inaction on power tariffs implies that electricity subsidies will remain high in 2009/10. Secondly, the subsidy bill is increasing significantly at the provincial level, as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

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

17. Total government debt as a percentage of GDP declined to 56.0 percent in 2008/09, and domestic and external government debt declining to 26 percent and 30 percent. During 2009/10, the domestic debt-to-GDP ratio is expected to decline further, but the ratio for external debt is projected to rise to 31.3 percent, reflecting the reliance on external sources for budget financing. Debt sustainability analysis suggests that external debt service remains manageable, but it subject to substantial downside risks, such as lower than projected growth and FDI inflows and higher than projected current account deficit, interest rates and exchange rate depreciation.

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

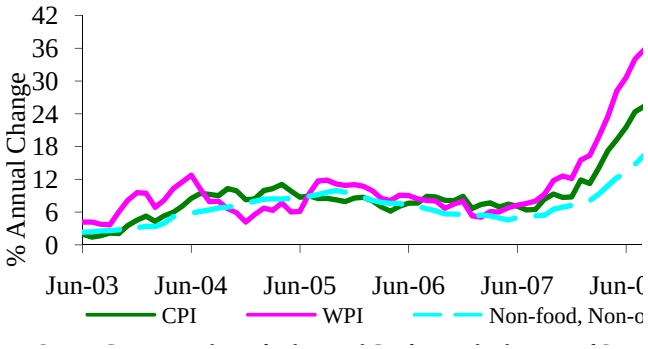
Figure 2: Money Supply, Credit and Real Interest Rates



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

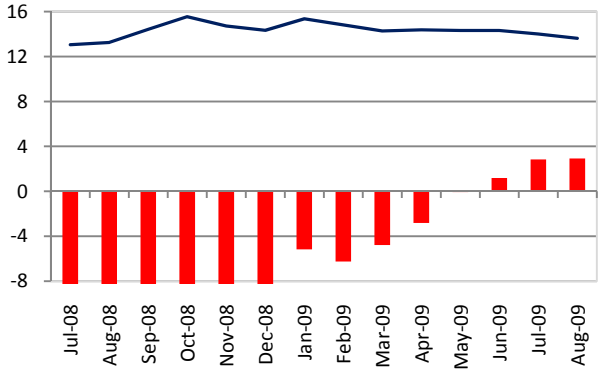
20. Inflation declined in the second half of 2008/09 as a result of reduced aggregate demand and international commodity and oil prices, but core inflation remained high at end-June 2009. The annual average CPI inflation for 2008/09 stood at 20.8 percent, which was consistent with the program target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

Figure 3: Inflation



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

Figure 4: Nominal and Real Weighted Lending Rates



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

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

Progress with Structural Reforms

24. Progress with structural reforms has been mixed, and in key areas lackluster. On the positive side, the automatic fuel price adjustment mechanism, which was re-introduced in early 2009, has been operating and domestic prices of fuel products have been adjusted monthly, consistent with the changes in the import parity price. Also, the pilot of the Benazir Income Support Program - with a new targeting instrument, the poverty scorecard – has been completed, and its full roll-out is expected to start soon, after substantial delay due to capacity constraints. The government has also taken steps to strengthen its debt management.

25. However, progress with revenue reforms in recent months has been weak, due to resistance from vested interests and a lack of political will - demonstrated by the decline in tax revenues as a share of GDP. The government had intended to amend the legislation governing General Sales Tax in the 2009/10 budget, making it more like Value-Added Tax, by broadening the tax base with a significant reduction in zero-ratings and exemptions, thus increasing revenue. However, this did not happen. Furthermore, the long-overdue restructuring of the FBR, which was announced at the beginning of 2009, was stalled in May by a court case of the customs group which opposed the reform. The restructuring was resumed in July and is expected to be completed by end-September 2009.

26. Reforms to strengthen financial sustainability of the electricity sector have stalled. The authorities had committed to raise electricity tariffs and introduce monthly and quarterly tariff adjustment mechanisms so as to eliminate tariff differential subsidies by end-June 2009. However, the government failed to follow through on this commitment. The authorities recommitted in July 2009 to a tariff adjustment schedule and to the introduction of automatic tariff adjustment mechanisms with a view to eliminating tariff differential subsidies by July 2010. But the implementation of the agreed measures had still not begun by the time this report was delivered.

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

Medium-Term Outlook

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

29. Pakistan's real GDP growth is projected to start recovering slowly in 2009/10, and increase gradually from 3.0 percent in 2009/10 to 5.0 percent by 2012/13. Aided by increasing public investment — with plans most notably for power and transport — gross capital formation is projected to rise and contribute to growth recovery and facilitate private sector activity gradually. Agriculture and services are showing good growth prospects, while manufacturing is still contracting and expected to recover only slowly as domestic aggregate demand picks up and the availability of power improves with planned investments in power generation. Exports are projected to continue contracting in 2009/10. Thereafter, with the global recovery, exports are projected to gradually improve and reduce Pakistan's external

vulnerability. However, longer-term projections are particularly uncertain in view of the volatile global and domestic economic environment. Also, the short-term growth target seems optimistic and will likely be revised downwards during the fiscal year.

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

31. In the medium term, in particular in light of uncertainties about the recovery of global demand, increased productivity and export competitiveness are necessary to generate growth and reduce external vulnerability consistent with these projections. Pakistan's exports are poorly diversified, in terms of both products and destination; almost two thirds are textiles, primarily to the USA and EU. Structural reforms to strengthen the investment climate and competitive environment are therefore urgently required. These will include measures to ease firm entry and exit, reduce barriers to competition and trade and enhance labor market flexibility. In addition, efforts to improve the financial sustainability and efficiency of the power sector will be essential to attract investment in new power generation.

32. Outflows from the current account are projected to be more than offset by net inflows into the financial and capital account in the medium term, leading to an increase in foreign exchange reserves. Foreign exchange reserves are expected to build up from US$9.1 billion at end-June 2009 to about US$13 billion by end-June 2012/13, yet the level of import cover is projected to fall from 4.4 months in 2010/11 to 3.1 in 2013/14. A significant portion of these inflows is projected to come in as FDI and foreign portfolio investment. FDI is expected to drop further in 2009/10 and thereafter start gradually recovering through 2010/11, and portfolio flows are predicted to turn positive from 2010/11 onwards. However, realization of these inflows will depend on the overall economic, political and security situation in the country, and is thus uncertain.

33. In the medium term, the government's macroeconomic framework targets a decline in the fiscal deficit (excluding grants) from 4.9 percent of GDP in 2009/10 to 3.0 percent of GDP in 2012/13. The 2009/10 fiscal deficit target was adjusted upward from 3.4 to 4.9 percent of GDP to accommodate: spending (1.2 percent of GDP) that is expected to be financed with disbursements of pledges made by donors in the donor conference held in Tokyo in April 2009, and additional spending (0.3 percent of GDP) on internally displaced persons (IDPs)3. At the Pakistan donor conference, donors pledged about US$5.2 billion in additional financing, but actual disbursements have been slow to materialize.

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

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

transfer taxes, motor vehicle tax, agricultural income tax — remains also at the provincial level, which would warrant attention.

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

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

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

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

Conclusions

39. Stabilization efforts, together with a decline in international commodity prices, have succeeded in reducing external imbalances, rebuilding foreign exchange reserves, and lowering inflation. However, owing to global economic recession, there are significant risks to exports, remittances and external financing. Also, there are significant risks to the fiscal framework. This highlights the need for a rigorous implementation of reforms. Stringent implementation of the economic program will be critical to success, and timely responses of fiscal and monetary authorities to emerging risks will be essential to ensure it remains on track.

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

World Bank Assistance to Pakistan in FY10

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