# Pakistan

The economy continues to be affected by structural problems, including a domestic energy crisis, a precipitous decline in investment, persistently high inflation, and security issues. Budget deficits remain high, driven by substantial subsidies and losses at state-owned enterprises, and tax revenue below target. The slow growth in recent years was exacerbated by widespread floods in FY2011. Unless progress can be made in resolving these fundamental problems, the growth outlook will stay modest.

## Economic assessment

Severe floods at the start of FY2011 (ended 30 June 2011) disrupted economic activity in most sectors in the first half of the year. A slight recovery during the second half—supported by higher prices for key exports and expanded services activity in part related to flood relief—kept growth positive at 2.4% for the year (Figure 3.20.1). Solid growth in livestock, minor crops, and wheat and sugarcane outweighed a marked fall in cotton and rice harvests to allow a 1.2% expansion in agriculture.

Industry, however, stagnated under the weight of energy shortages and low investment. Thus for the fourth year the economy was characterized by low growth (a period average of 3%), well below the estimated 7% needed to provide a firm basis to provide jobs to new labor-force entrants, increase per capita income, and reduce poverty.

A surge in workers' remittances, higher civil service salaries, greater farm income from increases in commodity prices, and higher outlays in the wake of the floods lifted total consumption expenditure by 7%, which accounted for more than 90% of GDP growth in FY2011.

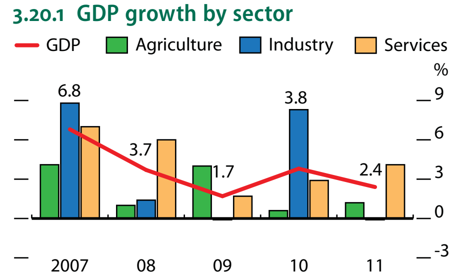
Investment continued to shrink, reflecting structural and security issues: gross fixed investment has declined for 4 years, from about 21% of GDP in FY2007 to 11.8% in FY2011 (Figure 3.20.2), the lowest rate since FY1974. This trend raises concerns that production capacity is being eroded, undermining growth prospects for the near and medium term.

Inflation, already under pressure from increasing global commodity prices, remained high, reflecting flood-related shortages, especially for food, and higher costs due to damaged transport networks. Peaking at more than 15% in December 2010, inflation eased modestly in the second half, and declined to 13.3% for the year to June 2011.

Responding to price pressures, the central bank tightened monetary policy in FY2011, raising the discount rate by 50 basis points in each of July, September, and November 2010, bringing it to 14%. As inflation stabilized and the balance of payments strengthened in the second half, the central bank made no further increases in the rate for the rest of FY2011.

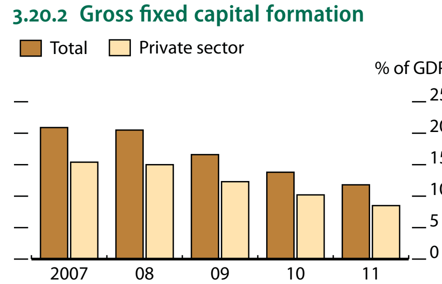
Higher than planned budget expenditure and declining foreign

**3.20.1 GDP growth by sector**




*Source:* Ministry of Finance. *Pakistan Economic Survey 2010–11*. http://www.finance.gov.pk

**3.20.2 Gross fixed capital formation**




*Source:* CEIC Data Company (accessed 23 March 2012).

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inflows caused the government to rely heavily on the banking system to finance the budget deficit in FY2011, continuing its pattern of taking the bulk of new bank lending (Figure 3.20.3). Credit to the government increased by 23.7% and was the main factor in pushing growth in money supply up to about 16% in FY2011, from 12.5% a year earlier, underpinning persistent inflationary pressures.

Credit to the private sector continued to expand slowly (4%), and was largely directed to higher working-capital requirements in the face of much higher prices for cotton and textiles, sugar, and edible oils. The vast majority of credit to corporate entities and to small and medium-sized enterprises apparently went to day-to-day operations rather than investment.

Fiscal imbalances grew in FY2011, as revenue shortfalls and current expenditure overruns led to a budget deficit of 6.6% of GDP (Figure 3.20.4), higher than the 4% target announced in the FY2011 budget. While the FY2011 deficit was boosted by outlays of PRs120 billion (0.6% of GDP) to partly clear accumulated debt in the energy sector, the bulk of the overrun from the targeted deficit reflected unrealistic revenue targets and underbudgeting for current outlays, particularly for subsidies.

Revenue rose by 15.9%, well below the 26.2% pace envisaged in the budget, as enactment of planned revenue measures encountered political resistance. While flood-related tax surcharges (in force March–June 2011) helped lift receipts that quarter, general government tax revenue for FY2011 declined to 9.8% of GDP from 10.1% a year earlier.

Current expenditure was reduced from 16.7% of GDP to 16.1%, but still outstripped budgeted levels by 15.2%. Development spending—including flood relief—was held to 30% below target in an effort to narrow the expenditure–revenue gap. Within current expenditure, subsidies surged by 70% from a year earlier, to three times their budgeted allocation.

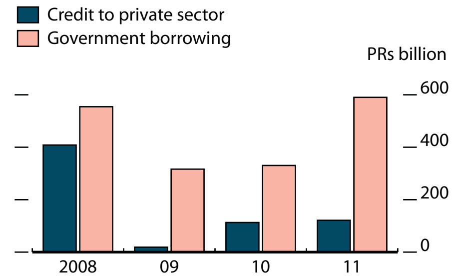
The balance of payments benefited from a doubling of cotton prices and higher food sales (mainly surplus wheat) that underlay a 28.9% expansion in exports. Imports grew by 14.9%, largely reflecting price rather than volume increases. Weak investment activity was mirrored in a decline in imports of much needed power generation and electrical equipment.

Buoyed by a strong expansion of remittances (up 25.8% to $11.2 billion), by flood-related grants, and by inflows from the United States (US) Coalition Support Fund, the current account posted a marginal surplus of 0.1% of GDP. The financial account recorded a surplus of $2.1 billion.

Foreign exchange assets of the banking system strengthened to $18.2 billion, with reserves of the State Bank of Pakistan (SBP) peaking at $14.8 billion at end-June 2011. Positive developments in the balance of payments helped stabilize the exchange rate against the US dollar: the Pakistan rupee depreciated by 2.0% in FY2011, following a 6.3% depreciation the year before.

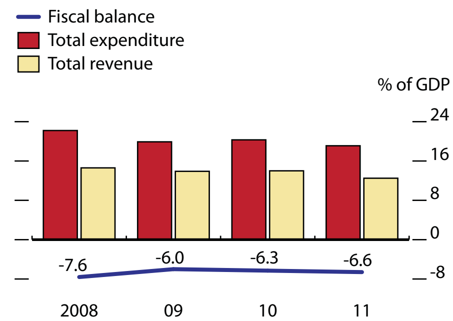
Public debt continued to climb in FY2011 (Figure 3.20.5). Domestic debt jumped by 29.2% to PRs6.0 trillion (33.3% of GDP). External debt increased to $57.9 billion but declined as a share of GDP (to 27.5%). Treasury debt sales were concentrated in short maturities for most of the year, bringing the average maturity of domestic debt to only 18 months.

**3.20.3 Banking sector credit (yearly flows)**



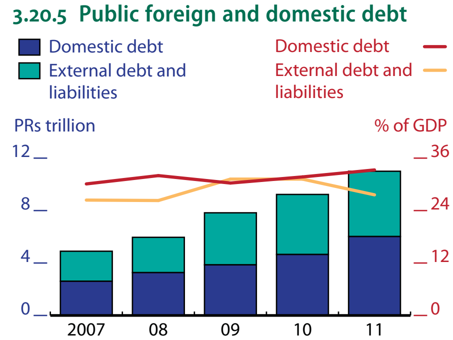

*Source:* State Bank of Pakistan. 2012. *Statistical Bulletin*. February. Table 2.5. http://www.sbp.org.pk

**3.20.4 Fiscal performance**




*Source:* Ministry of Finance. *Pakistan Economic Survey 2010–11*; Pakistan Fiscal Operations July-June 2011. http://www.finance.gov.pk

**3.20.5 Public foreign and domestic debt**




*Source:* State Bank of Pakistan. Economic Data. http://www.sbp.org.pk (accessed 3 March 2011).

## Economic prospects

The economy is expected to grow modestly without a more predictable energy supply and improved investment flows. Evidence from the FY2011 Household Integrated Economic Survey indicates a widening income gap between rich and poor, with income for the two lowest quintiles (40% of the population) growing more slowly than the average. In addition, food inflation has averaged 18% a year for the past 3 years (much higher than overall inflation), ensuring that a larger share of income, particularly for the lower quintiles, is required to meet this essential need. With low investment and economic growth below the pace needed to accommodate the predominately young population, the rich–poor income gap is set to widen further.

Energy outages and damage to the cotton crop from floods (for the second consecutive year) in early FY2012 are expected to hold fiscal year growth to 3.6%. The impact of substantial gas and power load-shedding from December 2011 and continuing into FY2012 is holding down both manufacturing output and export performance.

Moreover, textile manufacturers report substantial reductions in orders this year, as unpredictable energy outages prevented many of them from meeting their production commitments last year. Manufacturers' associations have expressed concerns that energy outages will nullify any potential gains from European Union tariff waiver concessions (on 75 items, including textiles, approved in February 2012).

With little relief expected for power shortages and assuming no major floods similar to those experienced in the past 2 years, economic growth in FY2013 is forecast to strengthen marginally to 4.0%. Private and government consumption expenditure should continue to drive growth, as investment remains depressed.

After slowing to 9.7% in December 2011, inflation (year on year) picked up to 11% in February 2012 (Figure 3.20.6). Core inflation remains near double digits, pointing to continued persistence of inflationary pressures. Increases in energy prices in March 2012 and further expected adjustments will keep upward pressure on prices. For FY2012 as a whole, average inflation is projected at 12.0%. On assumptions of a strengthened budget performance and broad stability in oil and other global commodity prices, inflation could ease to 10.0% in FY2013.

Slower inflation and measures by the government to contain borrowing from the SBP supported an easing of monetary policy. In two separate steps (July and October 2011), the central bank reduced the policy rate by 200 basis points to 12%. With a weakening overall balance of payments, however, and a decline in reserves, the SBP has kept the rate at 12%.

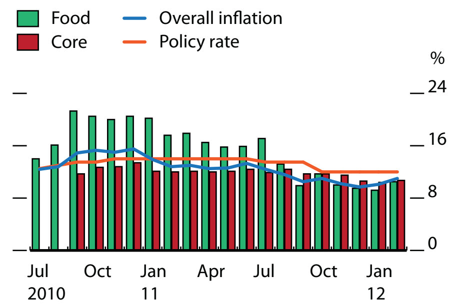
Fiscal developments for FY2012 present a mixed picture. Federal Board of Revenue collections are much improved, running a full 33% ahead of last year's performance for the first 6 months (Figure 3.20.7). This reflects improved economic activity in the first half of the year, as well as extension of the flood-related tax surcharges and improvements to tax administration. Yet it is unclear that the overall revenue target for FY2012 will be achieved, as this in part depends on the sale of third-generation telecoms licenses in the latter part FY2012—a sale already rescheduled over the past 2 years.

**3.20.1 Selected economic indicators (%)**

| | 2012 | 2013 |
|---|---|---|
| GDP growth | 3.6 | 4.0 |
| Inflation | 12.0 | 10.0 |
| Current account balance (share of GDP) | -1.8 | -1.9 |

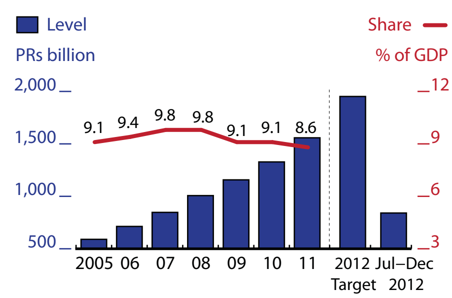
*Source:* ADB estimates.

**3.20.6 Inflation and policy rate**




*Source:* State Bank of Pakistan. Economic Data. http://www.sbp.org.pk (accessed 3 March 2011).

**3.20.7 Federal Board of Revenue tax collections**




*Sources:* Ministry of Finance. *Pakistan Economic Survey 2010–11*; Federal Board of Revenue. http://www.fbr.gov.pk (accessed 26 Jan 2012).

Despite the implementation of an automated pass-through of input price increases to electricity tariffs, the overrun on energy subsidies is expected to be more than triple the amount budgeted, at slightly above 2% of GDP, as key energy-efficiency measures have been delayed and state-owned enterprises continue to absorb the losses. Taken together, uncertainties over nontax revenue and higher than targeted current expenditure point to a budget deficit in excess of the 4.7% of GDP target.

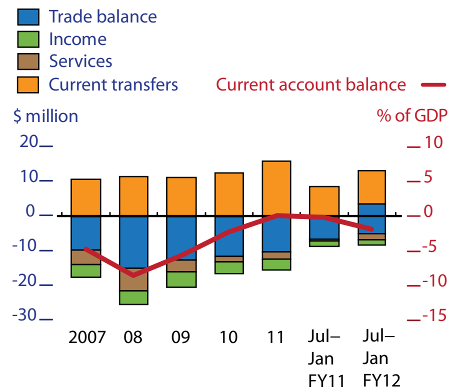
The external accounts are increasingly fragile, as the current account returns to deficit (Figure 3.20.8), with scant cushion from the financial and capital accounts. Lower prices for key export commodities, particularly cotton, combined with higher import prices, pushed the current account from near balance for the first 7 months of FY2011 to a deficit of $2.6 billion (1.8% of GDP) by end-January 2012. The deficit is expected to remain unchanged as a share of GDP over the rest of FY2012—as strong growth in remittances continues to offset a widening trade balance—increasing slightly to 1.9% in FY2013.

Growth in export receipts slowed to 7.2% for the first 7 months of FY2012 from 20.1% for the same period the previous year, as cotton prices declined and export industries were hit by increased load-shedding. Imports were 17.7% higher, largely reflecting substantial payments for oil. The services account showed similar signs of deterioration, with services exports contracting by 22.0% as inflows from the US Coalition Support Fund declined.

Workers' remittances expanded by 23.4% during July 2011–February 2012, slightly slower than the pace for the same period a year earlier.

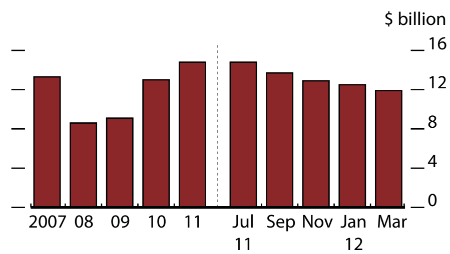
Official foreign exchange reserves declined by $2.4 billion in the first 7 months of FY2012 (Figure 3.20.9), reflecting the current account deficit and a sharp narrowing of the capital and financial account surplus as inflows continued to fall and debt service payments mount. Reacting to pressure on reserves, the Pakistan rupee depreciated by 5.7% against the US dollar in the first 8 months (Figure 3.20.10).

**3.20.8 Components of the current account balance**



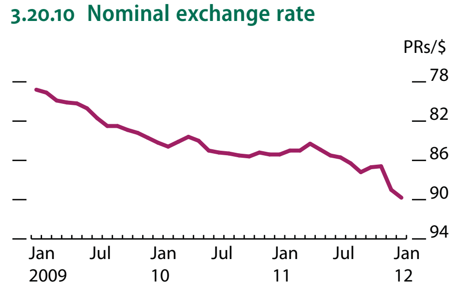

*Source:* State Bank of Pakistan. Economic Data. http://www.sbp.org.pk (accessed 26 January 2012).

**3.20.9 Liquid foreign exchange reserves with the State Bank of Pakistan**




*Source:* State Bank of Pakistan. http://www.sbp.org.pk (accessed 1 February 2012).

**3.20.10 Nominal exchange rate**




*Source:* State Bank of Pakistan. 2012. *Statistical Bulletin*. February. http://www.sbp.org.pk

## Policy challenge—efficiency constraints

Power is the main constraint for economic growth, as load-shedding intensifies and becomes less predictable (Box 3.20.1). Estimates from the Planning Commission suggest that losses arising from power and gas shortages held down GDP growth by 3–4 percentage points in FY2011 and FY2012. Improved management of power resources could ameliorate predictability of load-shedding to allow the private sector to better schedule work and minimize costs.

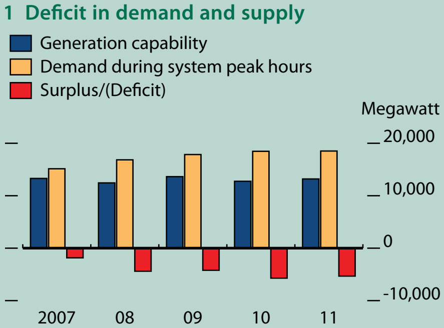
The current system, with tariff and collections below cost recovery, is a major deterrent to investment for capacity expansion in the sector. Cost recovery has not yet been achieved despite substantial increases in tariffs over the past 2 years, and measures to bring down costs have not been effective. For every unit of power sold, there is a loss to the sector reflected in the form of subsidies or accumulation of losses in the state-owned power companies. An outstanding accumulation of PRs220 billion was carried into FY2012, and an additional financing of 1–1.5% of GDP is likely to be required in FY2012. Implementation of many of the actions taken by the government has been complicated by legal challenges.

State-owned enterprises represent a heavy drain on fiscal resources. Pakistan Railways, Pakistan International Airlines, and Pakistan Steel Mills have incurred steep losses for the past several years. The challenge of improving efficiency and putting these enterprises on a viable commercial footing is formidable. Reforms are needed, including a separation of these enterprises from operational interference by government ministries.

### 3.20.1 Energy challenges

The power shortage is the main factor constraining economic growth. The supply-demand gap at peak hours reached over 5,000 megawatts (MW) in FY2011 (Box figure 1). This reduced economic output, hitting manufacturing the hardest.

1 Deficit in demand and supply




*Sources:* Government of Pakistan. National Electric Power Regulatory Authority (NEPRA). *State of Industry Report 2011.*

The cause of the power sector crisis can be divided into three pillars: cost-efficient generation capacity not keeping up with demand, financial issues, and management issues.

The supply–demand gap has widened because of a lack of investment in energy. The government has in fact added 1,604 MW to the system by commissioning six new independent power producers (1,264 MW) and a nuclear power plant (340 MW). A 49.5 MW wind power plant has recently obtained financing.

However, other domestic resources (hydro, gas, and coal) have not grown enough to cover demand, thereby increasing reliance on imported fuel oil. The energy mix has changed from predominantly hydro to thermal, which consists of domestic gas and imported fuel oil.

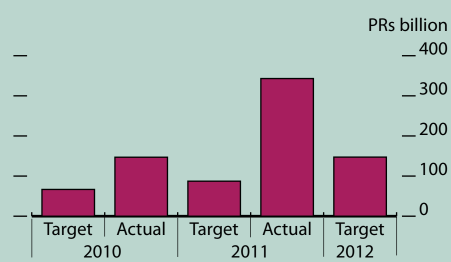
Industrial, retail, and fertilizer users are competing for the depleting gas supply, the preferred fuel for existing thermal plants. Plans to increase domestic gas production, import liquefied natural gas, pipe gas from neighboring countries, or bring in electricity from Central Asia have yet to materialize.

Financial issues are rooted in the fact that the cost-recovery tariff determined by the National Electric Power Regulatory Authority is not applied to customers. Thus the government bears the differential as a subsidy. Losses and costs excluded from the tariff formula also accumulate at the public sector company level. The lack of financing leads to arrears for the power generation and fuel companies.

Timely payment to these companies, essential for the sector's reliability, has become increasingly difficult, partly because of increased dependence on imported fuel, which is subject to wide price fluctuations. The cost of (oil-based) power generation in the country escalated by almost 40% in the 2 fiscal years ending FY2011. Despite steep increases in tariff and fuel price adjustments, customer tariffs remain below cost recovery, requiring large government subsidies to keep the system operating (Box figure 2).

The focus on massively increasing spending on power subsidies, reforms, and efficiency measures has been unable to remedy the accumulation of arrears in the system.

2 Power subsidies




*Sources:* Ministry of Finance. *Pakistan Economic Surrvey 2010–11*; Federal Budget 2011–12. http://www.finance.gov.pk

To improve management, the government has appointed independent boards for the public power companies to select chief executive officers for these companies. Efforts are also ongoing to decrease commercial and technical losses (around 20%). However, these efforts have been overshadowed by the increase in costs and unwillingness of some customers to pay the higher tariffs.

For a sustainable and reliable power sector, a multiyear plan with solid support from customers and other stakeholders needs to be implemented.