

# State of the Economy

## Executive summary

A measure of macroeconomic stability achieved over the past two years has kindled a moderate recovery in the economy, despite one of the most serious economic crises in the country's recent history. The economy grew by a provisional 4.1% in the outgoing year, after a modest growth of 1.2% in 2008-09. However, the recovery is still fragile and the stabilization needs to be consolidated so that the gains over the past two difficult years are not lost.

First, the durability of the economic turnaround is far from assured given the significant challenges the economy faces. Second, not all sectors of the economy or regions of the country appear to have participated so far in the modest upturn. Finally, in order to meet the employment aspirations of the large number of entrants to the labour force, a higher sustained growth rate will need to be achieved in the medium-term.

A combination of limited fiscal space and rising spending, debt, and inflationary pressures, significantly reduce the government's ability to spend in order to stimulate the economy. Under the circumstances, the prudent course for policy in the near term remains the pursuit of greater fiscal consolidation through domestic resource mobilization, in conjunction with reducing the size of government, and improving the efficiency of public sector spending.

The macroeconomic context remains difficult in the near term with continuing challenges. The global economy remains in turmoil, with uncertain prospects for demand for Pakistan's exports. In addition, the energy and water shortage, and the internal security situation, could constrain growth in 2010-11. However, the economy could benefit from large initial productivity gains as capacity utilization begins to increase from a low base. For the longer term, however, without a resolution of Pakistan's perennial structural challenges, such as raising the level of domestic resource mobilization or promoting higher productivity in the economy, growth and investment will continue to be constrained, and the growth prospects volatile.

## Growth

Despite severe challenges, the economy has shown resilience in the outgoing year. Growth in Gross Domestic Product (GDP) for 2009/10, on an inflation-adjusted basis, has been recorded at a provisional 4.1%. This compares with GDP growth of 1.2% (revised) in the previous year.

For the outgoing year, the *Agriculture* sector grew an estimated 2%, against a target of 3.8%, and previous year's growth rate of 4%. While the *Crops* sub-sector declined 0.4% over the previous year, *Livestock* posted a healthy rise of 4.1%. Industrial output expanded by 4.9%, with *Large Scale Manufacturing (LSM)* posting a 4.4% rate of growth. The *Services* sector grew 4.6%, as compared to 1.6% in 2008-09.

Overall, the *Commodity Producing Sectors* are estimated to have expanded at a 3.6% pace, which represents a significant turnaround from the anaemic growth rates of the previous two fiscal years.

The stronger pace of economic growth in 2009-10 has occurred on the back of several favourable developments, which have included:

- ➔ Substantial transfers to the rural sector over the past two years via the government's crop support price policies, which, combined with higher worker remittances, have sustained aggregate demand in the economy;
- ➔ A larger-than-expected cotton output, which offset the moderately negative impact on the wheat crop caused by a delay in seasonal rains;
- ➔ An ongoing improvement in external demand for Pakistan's exports, mainly textiles;

The revision of previous year's growth rate, a downward adjustment from a provisional 2% to a revised 1.2%, has also provided support to the headline growth rate for the current year, with the impact estimated at over one percentage point.

The more positive outturn for economic growth in the current fiscal year comes in spite of costs the economy has had to bear in the last two years on account of the internal security situation, combined with the severe energy shortfall. The latter is estimated to have reduced overall GDP growth by approximately 2.0% in 2009-10. Despite the security situation, overall military spending as a proportion of budget outlays has declined. Another focus has been the rehabilitation of Internally Displaced Persons (IDPs) and reconstruction of affected areas. It is pertinent to note that during 2009, Pakistan had one of the largest IDPs population in the world, with an estimated over 3 million people displaced from their homes in Swat, Bajaur, Malakand division, and South Waziristan agency (SWA).

The timely availability of water for agriculture was also significantly lower this year, continuing a secular trend of decline over the past several years. Water availability has now become one of Pakistan's top inter-generational policy and development concerns.

A shortfall in the inflow of external assistance, including from the *Friends of Pakistan* consortium, combined with delays in the release of refunds from the *Coalition Support Fund*, led to heavy borrowing by the government in domestic credit markets, leading to valid fears of crowding out of credit to the private sector.

Signs of a turnaround in segments of the economy notwithstanding, there are continuing areas of concern and reasons for caution. The recovery in economic growth is fragile, and will remain so till the weaknesses in the macroeconomic framework are forcefully addressed. In order to effectively provide sustainable employment opportunities for the young entrants to the labour force, a higher growth will be needed. In fact, according to the latest *Labour Force Survey* (for 2008-09), the unemployment rate has increased to 5.5% (from 5.2%), largely due to the increase in urban unemployment to 7.1% (from 6.3%).

Furthermore, the observed trend of improvement in the headline growth rate is likely to have been restricted to the more formal, and hence larger-scale, part of the economy, given its relatively greater insulation from energy shortages. The small and microenterprise sectors, which employ the bulk of the non-agricultural labour force, and are less well captured in the national accounts data, are much less

insulated, and therefore significantly more vulnerable to shocks such as wide spread disruptions to energy supply.

It is important to address the structural constraints to long run sustainable growth. This will also provide greater visibility to markets and investors with regard to Pakistan's economic prospects in the medium to longer term, and will be a key catalyst for higher private capital inflows and investment.

Given the long standing constraints under which macroeconomic policy is operating, with high inflation, low domestic resource mobilization, and rising debt servicing pressure, it is clear that Pakistan cannot afford an expansionary policy stance at this stage. A policy stimulus, without the requisite reserves or fiscal space, will only worsen macroeconomic imbalances. On the other hand, greater fiscal consolidation can have longer lasting and more far-reaching effects on growth, by reducing the crowding out of the private sector through public sector borrowing leading to lower interest rates.

### **Investment**

At current market prices, Gross Fixed Capital Formation (GFCF) has been estimated to have declined 0.6%, after recording a 5.5% increase in 2008-09. A decline in fixed investment by the private sector has accounted for the overall change, with an estimated contraction of 3.5% for the year. The bulk of the decline has occurred in *Electricity & Gas, Large Scale Manufacturing, Transport & Communication, and Finance & Insurance*.

Clearly, this development is not salutary for the long run prospects of the economy. However, given the challenging circumstances in which the economy had to operate during 2009-10, it is not surprising that the private investment response has remained subdued. A substantial decline in Foreign Direct Investment (FDI) inflows for the period also contributed to the decline in fixed investment in 2009-10. FDI accounts for a high share of gross fixed investment in Pakistan, with a share of close to 20 percent.

The decline in FDI inflows was in line with the steep drop in global flows of Foreign Direct Investment (FDI), which fell 32 percent in 2009 according to estimates of the International Institute of Finance (IIF). For the period July to April 2009-10, FDI totalled US\$ 1.8 billion as compared to US\$ 3.2 billion in the same period of FY09. This represents a decline of 45 percent.

A large part of the decline in FDI for the period was recorded under Telecommunications (a net decline of US\$ 607 million), and Financial Services (a fall of US\$ 548 million). Combined, the decline in these two sectors, which related to a few "lumpy" transactions last year, amounted to 81 percent of the overall reduction in FDI in 2009-10. Investment levels in some sectors remained healthy, including in *Oil and Gas exploration* (FDI of US\$ 605 million), *Communications* (US\$ 222 million), *Transport* (US\$ 104 million), *Construction* (US\$ 86 million), and *Paper and Pulp* (US\$ 81 million). Despite a steep decline, inflow of FDI into *Financial Services* was recorded at US\$ 133 million for the period.

A worrying development was the large net disinvestment recorded under the IT Services sector for the year (amounting to US\$ 95 million). Overall, out of the major industry categories, 12 recorded higher FDI for the period, while 24 industries witnessed a net reduction in FDI inflow.

### **Stabilization**

Pakistan has achieved impressive initial gains in restoring macroeconomic stability in the aftermath of the balance of payments crisis of 2008. As a result of determined policy effort:

- ➔ The fiscal deficit was reduced to 5.2 percent of GDP in 2008/09, from 7.6 percent of GDP in 2007/08, a fiscal adjustment of 2.4 percent of GDP. For 2009/10, the fiscal deficit is aimed to be kept in check at 5.1 percent of GDP, despite the absorption of unprecedented security-related spending.
- ➔ The external current account deficit was contained to 5.6 percent of GDP (US\$ 9.3 billion) in 2008/09, from a high of 8.3 percent of GDP in 2007/08 (US\$ 13.9 billion). The current account deficit is expected to decline to under 3 percent of GDP in the current year;
- ➔ Foreign exchange reserves have been rebuilt to nearly US\$ 15 billion, from their low of under US\$ 6 billion in October 2008, though much of the accumulation is due to releases from the IMF;
- ➔ Inflation declined from 25% in October 2008, to a recent low of 8.9% in October 2009, though it has accelerated sharply of recent and is showing persistence;
- ➔ International credit rating agencies upgraded Pakistan (from CCC+ to B- by S&P, while Moody's revised its outlook to *Stable* [August 2009]);

However, challenges in consolidating these early gains have emerged, with inflation in the economy reappearing, and fiscal pressures increasing.

### **Inflation**

After a period of containment, inflationary pressure has intensified since October last year on account of a number of adverse developments, including the washing out of the base effect from the previous year and a sharp spike in global commodity prices that has persisted since 2008 and which is exerting strong upward **pressure** on domestic prices. To some extent, this also reflects the excessive public sector borrowing, as well as adjustments in public utility prices, generated by losses in the public sector enterprises, especially electricity.

As a result, after easing to a recent low of 8.9% in October 2009, overall CPI inflation accelerated to 13.3% year-on-year in April, with food inflation at 14.5% and non-food inflation at 12.2%. Core inflation, as measured by the rate of increase in prices of non-food, non-energy components of the CPI basket, registered an increase of 10.6% year-on-year. On a period-average basis, overall inflation was recorded at 11.5% for July to April. The State Bank of Pakistan expects the average CPI inflation for the current fiscal year to remain close to 12%.

The refuelling of inflationary pressure is evident in all price indices, with the Wholesale Price Index (WPI) rising steeply, from, from 0.3% in August 2009 to 22% in April 2010. Similarly, the Sensitive Price Index (SPI) has recorded a 16.7% year-on-year increase for April, versus 6.7% in October 2009.

The resurgence of inflation is not restricted to Pakistan and is both a global as well as a regional phenomenon, though with varying orders of magnitude. Global food inflation, as proxied by the UN's Food and Agricultural Organisation's FAO Food Prices Index, had risen to 20 percent year-on-year in January 2010, before declining to 13 percent in April, while India's food price inflation rose over 19 percent year-on-year in December 2009, before settling at 17 percent in March. By comparison, year-on-year CPI food inflation in Pakistan was recorded at 14.5 percent in April.

In terms of mitigation strategies, policy options have been limited for much of the current fiscal year in the backdrop of high – and rising – international commodity prices. Imports under these conditions are not likely to dampen domestic prices, except to the extent of excess pressure caused by domestic

shortfalls, if any.

Improved availability through better administrative measures against hoarding is likely to have some effect at the margin. This will have a greater effect, however, if employed in conjunction with close vigilance of use of bank credit for commodity purchases by the private sector. The revival of the price magistracy system can also be an effective “localized” tool in the fight against price inflation in essential food items.

In the longer run, improvements in agricultural productivity hold the key to mitigation of food price inflation. So far, governments have followed an extensive farming policy, using the crop support price as an intervention tool. However, there are clear limitations to this strategy, including the diminishing responsiveness of output to price incentives, the impact on the general price level, and the implication for recourse to budgetary resources, especially in the case of wheat. A shift to more *intensive* agriculture is the need of the hour, with returns to farmers linked to better yields (volume-based) rather than to a price-based mechanism of support.

A further critical element in the containment of price pressure in the economy will be continuation of prudent macroeconomic policies, including monetary policy, which is essential to prevent a spill-over from food and energy components of the CPI to the broader household consumption basket – which to some extent is inevitable under the circumstances. Demand management is still an essential component of the overall policy mix to prevent an entrenchment of inflationary expectations. Segments of society vulnerable to the effects of policy-induced price adjustments will require wider – but better targeted – coverage of social safety nets.

### **Poverty & Income Inequality**

In the absence of an official recent poverty survey, it is unclear what the distributional effects of developments in the global as well as domestic economic landscape over the past two years have been. The reduction in inflation from 25 percent to single digits represents the most significant benefit of the stabilization as far as the poor are concerned. Yet greater unemployment and the fairly steep adjustment in administered prices of food and energy, has, in all likelihood, adversely impacted vulnerable segments of the population, especially those on low and fixed incomes, and in the urban areas.

On the other hand, a substantial rise in inflows of worker remittances, partly in response to a government policy initiative, combined with unprecedented transfers in 2008 and 2009 to the rural economy under the government’s crop procurement program, are likely to have provided significant support to large segments of the population. Cash transfers under the *Benazir Income Support Program (BISP)*, amounting to an estimated Rs. 35 billion in 2009-10, are very likely to have been an additional source of support to those in need.

Hence, on the whole, a more careful examination of the distributional impact of recent developments is required, in order to design better-targeted policy responses.

### **Public finances**

Pakistan’s public finances have come under increasing strain over the past two years due, in large part, to substantial outlays on electricity subsidies. Despite a sharp upward adjustment over the past two years, amounting to over 60% for some consumer categories, electricity tariffs have still not reached

cost-recovery for the public sector utilities. In large part, this is due to two adverse developments in operation for much of the last over one year. First, lower rainfall reduced power generation from the dams. Second, the adverse shift in the energy generation mix towards fuel oil, has been accompanied by a near-doubling of international oil prices between January 2009 and April 2010.

The continued haemorrhaging of fiscal resources by the power sector is also partly a result of unchanged end-user tariffs between 2003 and 2007.

Lower than budgeted external assistance pledges also compounded difficulties in fiscal management during 2009-10. It led to sharp cutbacks in outlays for the public sector development program, which had been pitched at an unrealistically high level.

The heavy recourse by the government to borrowing from the domestic banking system led to fears of crowding out of the private sector. However this was obviated by weak credit demand from the private sector, as well as improved liquidity in the banking system. Nonetheless, there was an unintended consequence: interest rates moved upward as a result.

After a sluggish start, however, and despite a difficult economic situation, tax collection has risen nearly 14% for July to April 2009-2010, as compared to the corresponding period of 2008-09. As a percent of GDP, however, tax collection remains low.

All told, the developments outlined above are likely to result in a moderate over-shoot of the budgeted target for the overall fiscal deficit. Against a budgeted 4.9% of GDP, the revised outturn in 2009-10 is projected to be 5.1%.

During the outgoing year, the basis was laid for two fundamental, potentially “game-changing”, developments in public finances. First, the Seventh National Finance Commission (NFC) Award was successfully concluded after a lapse of 19 years, with a fundamental shift in the basis for determining the vertical (from Centre to Provinces), as well as horizontal (between Provinces) distribution. Effective from July 1, 2010, the 7<sup>th</sup> NFC Award will more than double the quantum of annual resource transfer to the Provinces. With the devolution of expenditures to the Provinces under the 18<sup>th</sup> Constitutional Amendment set to become effective from 2011-12, the interim period is likely to cause a degree of strain on federal finances.

Second, in a major policy effort to broaden the tax base, legislation was laid before the national as well as provincial assemblies to introduce an integrated, broad-based and modernized system of the GST (leading to a Value Added Tax (VAT)) as originally intended in 1990. Key elements include concerns about the lacunae introduced in the legal framework over time. This requires needed amendments to the law at both national and provincial levels. In addition, modernization of the tax administration to ensure arms length dealing with taxpayers, with verifiable and timely refunds, and addressing concerns with rent seeking and governance in the FBR. It is estimated that the move to VAT could yield up to 3 percent of GDP in additional revenue over a period of three to five years, although the estimates for the coming year by leading tax experts are appropriately modest at around 0.7 percent of GDP.

Looking ahead, easing the budget constraint assumes even greater urgency. Addressing two decades of under-investment in critical sectors of the economy – social sector, water reservoirs, physical infrastructure, including the increasing need for maintenance of existing capital stock – cannot be postponed for much longer and will require vast resources. Catering to a rapidly rising population, in

conjunction with the need to put in place targeted social safety nets, will further add to the resource requirements.

Meeting the expected expenditure requirements in the medium term will require redressing the fundamental weaknesses in the structure of public finances. These perennial weak links have remained unaddressed in the past, and include a low, and declining, ratio of tax collection to GDP; weak incentives for improvements in provincial finances, which could possibly have been weakened further by the new NFC award; and, leakages in public sector expenditure.

### **Economic reform**

Cognizant of the limitations of the growth strategy followed in the past, which has inevitably produced boom-bust cycles followed by a balance of payments crisis, the government has embarked on a fundamental change of the development paradigm.

The new development strategy seeks to foster sustainable and more equitable growth by means of structural improvements in the productive sectors of Pakistan's economy, involving a broad range of policy actions across sectors. The current status of some of the important reforms is as under:

- ➔ Raising the Tax-to-GDP ratio is a key pillar of the government's economic strategy. To this effect, a proposed law to implement a broad-based Value Added Tax (VAT) with minimal exemptions from July 1, 2010 has been presented to Parliament.
- ➔ In addition, other measures such as improving tax administration and reinstating tax audits have been taken. The cumulative effect of these policy measures is expected to be an increase of Pakistan's Tax-to-GDP ratio to 13 percent by 2013 (from 8.9 percent in 2008-09).
- ➔ Under *Social Protection*, the government has launched the Benazir Income Support Program (BISP). An allocation of Rs 70 billion has been made in the Federal Budget 2009-10, with the aim of targeting 5.5 million poor and vulnerable Households in Pakistan with a cash transfer of Rs 1,000 per month to each. The size of BISP makes it the largest social protection scheme in the country's history, and it works in conjunction with other safety nets such as *Bait-ul-Maal*, *Zakat Fund*, and provincial programmes such as the *Sasti Roti* scheme.
- ➔ A Cabinet Committee on Restructuring (CCoR) has been formed to restructure key Public Sector Enterprises (PIA, PEPCO, Railways, TCP, USC, Pakistan Steel Mills, NHA) with a view to stop leakages caused by annual losses amounting to approximately 1.5% of GDP. The eventual aim is to turnaround these PSEs into profitable, self-sustaining ventures under Public-Private Partnership mode.
- ➔ Under reform of the power sector, electricity tariffs have been raised between 40-55% in less than two years, in an effort to reduce the level of subsidies absorbed in the budget, while simultaneously moving to a full cost-recovery tariff for the power utilities. Under a new Act of parliament, adjustment in tariff for changes in fuel prices for power generation has been made automatic.
- ➔ The government successfully concluded the Seventh National Finance Commission (NFC) Award – only the fourth in Pakistan's entire history, and the first for the last 19 years. This Award greatly augments the quantum of resource transfer from the Centre to the Provinces.

In conjunction with the higher resource transfer to the provinces, the Centre will also devolve some major functions/expenditure heads to the sub-national governments in line with the provisions of the

1973 Constitution.

### **External account**

Amid still-difficult global economic conditions, large costs to exports imposed by the war on terror, and a severe energy crisis faced by Pakistan's economy, the external sector witnessed an overall improvement during 2009-10. This recovery was mainly contributed by a sharp narrowing of the current account deficit which more than offset the declining financial account surplus during the period. In addition, macroeconomic stabilization measures taken by the government also significantly contributed to overall improvement in the external sector of Pakistan.

The external current account deficit is expected to contract to around 2.8 percent of GDP in the outgoing year. This large improvement is mainly on the back of a steep decline in imports for much of the year, improving exports as world demand is gradually restored, and a continued increase in worker remittances, which are expected to reach 4.8 percent of GDP for the full fiscal year. Worker remittances have increased from US\$ 6.4 billion in July-April 2008-09 to US\$ 7.3 billion in ten months of the current fiscal year (July-April). A large part of the recent increase in remittances, which appears to be secular in nature, has emanated from a policy initiative of the government in early 2009 called the *Pakistan Remittance Initiative (PRI)*. With the potential for formalising the remittances market estimated between US\$ 16 billion (World Bank) and US\$ 21 billion (PRI) annually, further success on this front can have far-reaching positive effects on stability of Pakistan's balance of payments in the years ahead.

An added factor that is likely to extend support to the external account in the months ahead, and possibly for much of 2010-11, is the collapse in global commodity prices induced by the Eurozone-wide contagion from the ongoing Greek debt crisis. Since the start of the difficulties in Greece earlier in 2010, international oil prices have fallen by over 11 percent. However, developments on this front could potentially also impact remittances and exports, especially if the fall out is not contained, and spreads to other regions. On balance, it appears for now that, in immediate terms at least, the deflation in import payments will outweigh the other factors, as evident from Figure 2. If so, this could insulate the external account from pressure in the near term.

### **Public debt**

Pakistan's total public debt stood at an estimated Rs. 8,160 billion as of end-March 2010. At this level, public debt is equivalent to 56% of GDP, and 379% of total budgeted revenue for the year. Of the total, Rupee-denominated debt amounted to 31% of GDP, while foreign currency-denominated debt was the equivalent of 25% of GDP.

The bulk of the increase in public debt in the first nine months of 2009-10 has been recorded under higher-cost domestic debt, with the government forced to borrow from the onshore credit markets in the absence of meaningful flows of external assistance, barring disbursements under the IMF loan. Domestic debt rose 22% in annualized terms during July to March. Another source of increase has been the depreciation of the Rupee against the US dollar between July 2009 and March 2010, amounting to 4.4%. The weaker Rupee added 17% to public debt in the first nine months of the year.

Public debt has risen rapidly since 2005-06. While the relative debt burden, measured either as a percent of GDP or of total revenue, does not depict a significant deterioration in the debt dynamic, the net annual addition to the debt stock has been fairly rapid over the past 4 years.



The primary sources of accumulation in the public debt stock since 2005-06 have been:

- ➔ Currency translation losses on foreign exchange-denominated debt. For 2007-08 and 2008-09, the cumulative depreciation of over 25% of the Rupee against the US Dollar is estimated to have increased the public debt stock by approximately Rs. 235 billion, or a total of 11% increase on this count alone over the past two years.
- ➔ Non-recognition of large subsidy payments to the oil and power sector from prior years that were absorbed in the budget in 2007-08 and 2008-09;
- ➔ A sharp reduction in non-debt creating inflows, such as FDI, in the wake of the global financial crisis;
- ➔ The augmented access to IMF resources provided to Pakistan in the form of the Stand By Arrangement (SBA) signed in November 2008, amounting to a total of US\$ 11.3 billion, of which approximately US\$ 7.3 billion has been disbursed;
- ➔ Overall, a lower inflow of external assistance, which forced the government to higher-cost domestic borrowing;
- ➔ Lumpy repayment of maturing Defence Savings Certificates (DSCs) since 2007, that had not been budgeted for;
- ➔ The inability of the government to take advantage of the historically low interest rate environment in the 2003 to 2007 period, by locking into longer tenure debt such as the five- and ten-year Pakistan Investment Bonds (PIBs).

In terms of servicing of the public debt, interest payments were budgeted at 4.4% of GDP for 2009-10, while total debt servicing including repayment of foreign loans and credits, was budgeted at 5.8% of GDP. Budget estimates of interest and principal repayment of foreign loans and credits during 2009-10 amounted to nearly 40% of total revenue, and approximately 30% of expenditure.

It is important to note, however, that the figure for public debt does not include publicly-guaranteed debt, such as borrowing by state-owned enterprises for commodity operations against an explicit government guarantee. In addition, in line with international convention and past practice, only that portion of the IMF loan that has been used for deficit financing by the government is recorded under public debt, while the remainder is shown under “monetary authorities” (i.e. the central bank).

In the context of a rising stock of public debt, it is important to make the nexus between, on the one hand, the weak tax effort that has characterised Pakistan’s policy landscape for the last several decades, and on the other, the reversal of the favourable debt dynamic that had been set in motion earlier. If Pakistan’s tax-to-GDP ratio had been a modest 13% since 2005, when economic conditions were extremely favourable for a breakthrough in broadening the tax base, instead of around 10%, the public debt would have been around 44% of GDP currently, or a full 12% of GDP lower. The lower public debt stock would have translated into savings in interest payments since FY05, which would have represented a substantial expansion of the resource envelope the government is currently working with.

### **Outlook for the economy**

The medium term prospects for the economy are promising, provided the current path of reform is not abandoned. Pakistan has achieved fairly impressive early success in its efforts to stabilize the economy from a parlous state of affairs in the aftermath of the macroeconomic crisis of 2008. Protecting the

recovery is of paramount importance, and the government needs to keep a restrictive stance on public spending. Greater realism about the prospects and accurate forecasts about resources and available funds for the development plans at each level of government is needed.

A number of interlinked actions are needed in the coming year:

- ➔ Checking inflation—this involves limiting borrowing by the government and the public sector.
- ➔ Bringing people to the centre stage, by appropriately designed employment and training programs to protect those in strife-affected areas, and new entrants to the labour force.
- ➔ But there are major risks to the growth and stabilization prospects if there is
  - Non-implementation of the reform of the GST, leading to a VAT, or other significant tax broadening measures;
  - This might affect the phased nature of fiscal devolution envisaged under the Eighteenth Constitutional amendment (to be effective from 2011-12), in the context of the front-loaded transfers to the provinces under the Seventh NFC Award (effective from July 1, 2010);
  - Larger-than-budgeted security related expenditures;
  - Inadequate targeting of subsidies,
  - Failing to reform public sector enterprises, including the power sector, with no resolution of the energy circular debt issue;
  - Continued overhang of commodity financing debt stock, if unchecked, threatens to constrict access to bank credit by the private sector, while simultaneously increasing the interest rates in the economy;
  - A deterioration of the internal security situation.

The tipping of the world economy into a severe recession in the wake of the Euro-zone debt crisis, could hurt Pakistan's exports as well as remittances on the one hand, but could reduce international prices of key commodities such as oil, on the other.

With relatively low levels of capacity utilization in the economy, a turnaround in investor confidence can unleash large productivity gains even with low levels of fixed investment. Nonetheless, overall, a combination of rising fiscal pressures, a developing debt overhang, and an uncertain path of inflation in the near term, significantly reduces policy space to stimulate the economy.

For the longer term, efforts to meaningfully address Pakistan's perennial structural challenges, such as the abysmally low tax/GDP ratio and low overall productivity in the economy, are more than likely to unlock Pakistan's substantial economic potential.