



**Government of Pakistan
Finance Division
Principal Economic Adviser's Wing

**PAKISTAN ECONOMIC UPDATE
First Quarter Fiscal Year 2009-10
(July-September 2009)**

A. REAL SECTOR

- **After several months of output decline/sluggishness, the real sector of the economy – large scale manufacturing and exports, in particular – is signaling an incipient recovery.**
 - Production in the Large Scale Manufacturing (LSM) sector grew by positive 0.9 percent in August 2009 versus August 2008 – after recording 13 successive months of negative growth till July.
 - August’s figure represents the fifth consecutive month of improvement since the trough of -19.7 percent contraction in LSM output hit in March 2009.
 - Adjusted for a decline in Petroleum Products (-6.3 percent, weight in LSM: 5.3 percent) due to the circular debt issue, and in Steel (barring Coke, weight in LSM: 3.5 percent) on account of ongoing production difficulties, the rate of growth in overall LSM production was positive 1.01 percent in August. On the flip side, a 25 percent jump in Cement production (weight in LSM: 4.1 percent), due in large part to domestic sales, provided an unusually large fillip to headline LSM growth.

Table 1: Change in Key Economic Indicators

Y/Y chg.(%)	Trough	As of:	Current	As of:	Change from Trough:	
					Absolute	In %
Large Scale Manufacturing	-20%	March 2009	+0.9%	August 2009	n.m.	n.m.
Exports	-26%	March 2009	-14%	September 2009	n.m.	n.m.
Inflation (CPI)	-25%	August 2008	10%	September 2009	n.m.	n.m.
Fx reserves (in USD bn)	\$6,716	October 2008	\$14,500	September 2009	\$7,784	116%
Pak Credit Default Swap (CDS, bps)	3,000	October 2008	800	September 2009	2,200	73%
Pak '16 Eurobond – spread over UST	24.3%	Dec 18, 2008	6.3%	October 1, 2009	18.0%	n.m.
KSE-100 Index	4,815	Jan 26, 2009	9,350	September 30, 2009	4,535	94%

Source: Principal Economic Adviser’s Wing, Finance Division

- After recording a -5.4 percent year-on-year decline in August, the lowest contraction since December 2008, export growth has slipped to -14.2 percent for September. This



has interrupted the trend of a moderating rate of decline since the near term trough of -26 percent registered in March this year.

- On a positive note, however, forward-looking indicators such as the level of export orders are depicting a strong upward trend for the near term, especially in the textile sector.
- **However, given the shortfall in electricity availability, combined with the disturbed internal security situation, particularly in NWFP, it is more than likely that the early signs of improvement in parts of the economy are restricted so far to the formal, large-scale sector.**

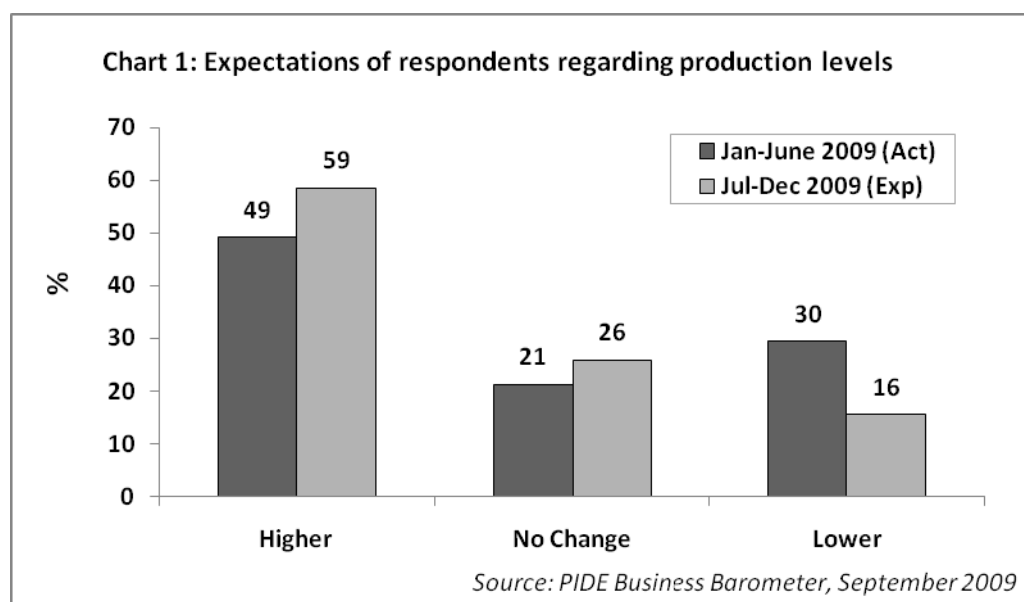
B. INVESTMENT

- **Investment conditions, as well as intentions, appear to have improved noticeably over the past few months, but are still subject to considerable uncertainty.**
 - Net bank credit to the private sector has contracted over the past several months, declining by 6.2 percent as of August 2009 versus August 2008.¹ However, nearly half of the decline is attributable to a steep rise in provisioning for non-performing loans. On a *gross* basis (before provisioning), off-take of bank credit by the private sector has declined a more modest 3 percent.
 - A number of factors appear to have contributed so far to the sluggish off-take of bank credit by the private sector, including:
 - ◇ A sharp slowdown in domestic economic activity since 2008 on account of:
 - I) Stabilization policies put in place to rectify the large imbalances in the economy built up since 2007;
 - II) The transmission of the large external terms of trade shock experienced over 2007-2008;
 - III) A marked deterioration of the internal security situation;
 - IV) Growing energy shortages; and,
 - V) The fall-out on investment levels from the global financial crisis.
 - ◇ Heightened risk-aversion on the part of banks, following rising loan defaults and payment difficulties by borrowers;

¹ As measured by changes in corresponding end-period stock.



- ◇ A process of de-leveraging and balance sheet repair underway in the corporate sector.
- Following the recent upgrades of Pakistan’s credit ratings by Standard and Poor’s, and of the sovereign outlook by Moody’s, market as well as investor sentiment has been boosted. The KSE has rallied sharply, rising 31 percent since end-June 2009, before a recent sell-off, for a cumulative gain of 63 percent from January 1 to September 30. Foreign portfolio investment has risen to US\$ 208 million in July-September 2009, after recording a decline of US\$ 1,032 million during fiscal year 2008/09.
- Reflecting a more buoyant investor sentiment, Pakistan’s 5 year Credit Default Swap (CDS) has fallen dramatically, improving from a peak of 3,000 basis points to a current 800 basis points. Similarly, the prices of the country’s outstanding dollar-denominated sovereign Eurobonds have rallied strongly, depicting a turnaround in investor expectations regarding Pakistan’s economy.
- The incipient improvement in domestic business sentiment is reflected in the findings of the recently released **PIDE Business Barometer**, which attempts to capture the expectations of firms regarding economic conditions for the six months ahead period via a survey of companies listed on the Karachi Stock Exchange (KSE). Nearly 60 percent of the firms surveyed expected higher production for the July to December 2009 period.



- A marked improvement in investor sentiment notwithstanding, a recent spate of high-profile militant attacks across the country threatens to interrupt the continuation of the turnaround.

In addition, other potential risks to the growth and investment outlook, many of which are not insignificant, emanate from the following factors:

- The continuing mis-match between electricity demand and supply;
- The painfully slow pace of materialisation of Friends of Democratic Pakistan (FoDP) pledges, which is severely constraining the budgetary position and is hampering the government’s efforts to reflate the economy via fiscal stimulus;
- A faster pace of release of external assistance is critical on another front. Without external support, the government’s reliance on the domestic banking sector has increased sharply, leading to valid fears of possible pre-emption at some stage by the government sector of private sector credit needs;²
- A projected water shortage for *Rabi* crops of 24 percent over last year’s availability;
- An ongoing virulent attack of *leaf curl virus* on the cotton crop in parts of southern and central Punjab;
- A seasonal gas shortage during November to February which is expected to be substantially higher this winter, with some estimates suggesting a shortfall exceeding the 1 billion cubic feet per day (bcfd) mark in January 2010;
- The operation of a *base effect* in agriculture;
- Any further deterioration of the internal security situation following the start of a new military campaign against militants in South Waziristan.

Given the magnitude of uncertainty associated with the growth outcome in the current fiscal year, the range for estimated growth in the economy for 2009/10 is wider than usual. On current trends, our estimate of real GDP growth for 2009/10 is between 2 and 3 percent.

² *Prima facie*, this does not appear to have occurred as yet since private sector demand is still weak, while risk aversion by banks is still strong. However, as the economy begins to pick steam, concern of potential “crowding out” of the private sector from the formal credit market could become stronger.



C. PRICES

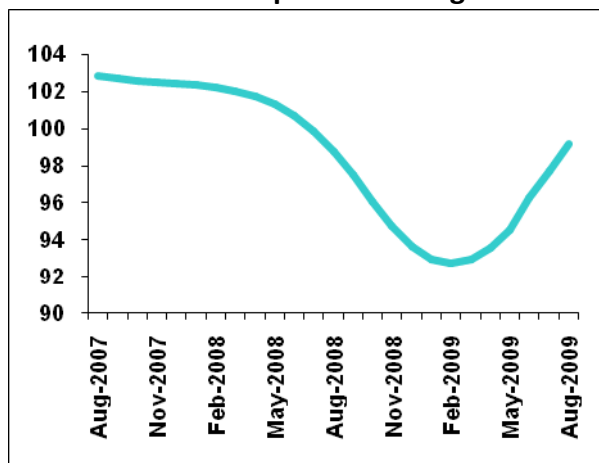
- **The trend of dis-inflation (a positive, but declining, rate of inflation) in the economy has continued for the eleventh consecutive month.**
 - Inflation as measured by the Consumer Price Index (CPI) has declined to 10.1 percent year-on-year in September (versus 23.9 percent in September 2008). The rate of inflation (year-on-year) has nearly halved in the past six months.
 - The decline in the rate of inflation has occurred due to both the *Food* as well as *Non-food* categories. Core inflation, measured as the rate of change in *Non-Food, Non-Energy* CPI, has decelerated to 11.9 percent in September.
 - In addition to the adoption of prudent macroeconomic policies, a strong *base effect* has also played a significant role in inducing disinflationary trends in the economy, with the unwinding of the effects of the sharp rise in energy and food prices that occurred during 2008. While month-on-month CPI inflation has decelerated in September after several months of elevated levels, the environment for price pressures in the economy appears less benign going forward, based on the following factors:
 - The base effect will wash out by December this year;
 - International oil prices have reversed near term course and crossed US\$80 as of third week of October, a rise of 15 percent since July 1;
 - The possibility of still higher electricity tariffs under the World Bank/Asian Development Bank-sponsored power sector reform;
 - The possibility of higher gas tariffs for end-users after the review of wellhead prices in December/January 2010.

D. BALANCE OF PAYMENTS

- **The external account position has continued to improve, but prospects for the balance of payments in 2009/10 hinge significantly on the magnitude and timing of external inflows, as well as on the outlook for international oil and commodity prices.**
 - The external current account balance swung to a surplus in September (US\$174 million) after posting a nominal deficit in August (US\$19 million). Lower imports and record-breaking inflows of worker remittances have contributed most to the turnaround.



- After recording an annual increase of 25 percent in 2008/09, remittances have continued to surge in the first quarter of 2009/10, crossing US\$800 million for the first time in September.
- Following a moderation in the rate of decline for five successive months, exports have recorded a fall of 14.2 percent year-on-year in September.
- However, reflecting a continuous, albeit gradual, improvement in global economic conditions especially in external trade (see Charts below), order books of Pakistani textile and apparel exporters are reported to be full for several months in advance.

Chart 2: OECD Composite Leading Indicator

Source: OECD

Chart 3: Baltic Dry Index

Source: Bloomberg

- Improvements in the Real Effective Exchange Rate (REER) since March, coinciding with the Indian Rupee's rapid appreciation and a decline in Pakistan's inflation rate since, are expected to underpin a firmer trend in the near term in exports.
- The contraction in imports has accelerated, with headline imports declining 36 percent year-on-year in September, led primarily by a sharp fall in oil payments (lower by US\$628 million) and food imports (down by US\$340 million).
- Import of autos in kit form for local assembly (i.e. in Completely Knocked Down, or CKD, mode) has remained 5 percent higher, reflecting the pick up in domestic auto sales and production even in the absence of bank financing.



E. TAX REVENUE

- **Reflecting the extent of the slowdown in the economy in 2008/09, and the impact of a change in tax filing dates, FBR tax collection for the first quarter of 2009/10 is up nominally.**
 - A sharp fall in sales and corporate profitability in prior periods, a 19 percent decline in the value of dutiable imports during July to September 2009, the impact of the internal restructuring of FBR, the fall out of the internal security situation on business conditions, and a change in the dates for filing advance tax (from September 30 to October 15), have all contributed to a nominal increase of 0.2 percent in overall tax collection.

Table 2: FBR Tax Collection in July-September (Rs. Billion)

Revenue Head	Target 2009-10	July – September		Change %
		2008-09	2009-10	
Direct Taxes	565	88.2	84.1	-4.7
Sales Tax	499	110.2	117.1	6.2
Federal Excise	152	25.5	28.4	11.5
Customs	162	38.2	33.1	-13.4
Total Net Collection	1,380	262.1	262.6	0.2

Source: FBR

- However, tax collection for the first quarter should be viewed in the context of a 35 percent increase in tax collection during July to September 2008 (versus corresponding period 2007), providing an unusually high base for comparison. In addition, adjusted for the estimated impact of advance tax collection shifted to next quarter (approximately Rs 25-29 billion), the tax collection effort has been above par under challenging circumstances.
- A pick up in economic activity, an early resolution of the energy crisis, an improvement in the internal security situation, a continuation of the trend of improvement in the global economy, and results of the restructuring of tax administration should all contribute towards achievement of the full year tax revenue target.



F. CONCLUSION

Leading indicators appear to be pointing to the fact that Pakistan’s economy is tentatively in a recovery phase after a deep and broad slowdown. If this trend is confirmed in the months ahead, with the economy still having to navigate through significant potential challenges and headwinds, the slowdown, for all its intensity, would have lasted for a lesser duration than initially feared.

Despite the fact that the economy appears to be recovering, however, moving to a sustained expansion is conceivably some way off. While an improvement in global economic conditions will be helpful in fostering the turnaround in the domestic economy, the biggest contribution will be made by the continuation of a deep and sustained commitment to wide-ranging structural reform.

