Three Years of Prime Minister Shaukat Aziz's Government

By

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Mr. Shaukat Aziz's Government is completing its third year in office on 28th August 2007. In these three years his government has not only consolidated the economic recovery that began in early 2000 but also the economy of Pakistan continued to gain traction as it experienced the longest spell of its strongest growth in the last three years. The outcomes of the recently concluded fiscal year indicate that Pakistan's upbeat economic momentum remains on track. Economic growth accelerated to 7.0 percent in 2006-07 at the back of robust growth in agriculture, manufacturing and services. Pakistan's growth performance over the last three years has been striking. Average real GDP growth at 7.5 percent during 2004-07 was the best performance since many decades, and it now seems that Pakistan has decisively broken out of the low growth rut that it was in for more than one decade. Economic growth has been notably stable and resilient. Compared with other emerging economies in Asia, this puts Pakistan as one of the fastest growing economies in the region along with China, India, and Vietnam. The good performance has resulted from a combination of generally sound economic policies, on-going structural reforms and a benign international economic environment. Based on the performance of half-a-decade in general and the last three years in particular of strong, stable, resilient and broad-based economic growth it appears that Pakistan's economy will continue to be a high mean, low variance economy over the medium-term.

Pakistan is in the midst of its strongest economic expansion phase and its growth momentum is broad-based. All the three major sectors, namely, agriculture, industry and services have provided support to strong economic growth. The commodity-producing sectors *(agriculture and industry)* contributed almost 2/5th and services sectors contributed the remaining 3/5th to the average real GDP growth of 7.5 percent in the last three years. Within the commodity-producing sectors, the contribution of agriculture alone has been 13 percent while 27 percent contribution came from industry. Services sectors as a whole contributed almost 60 percent to economic growth during the last three years.

The last few years' economic growth is mainly driven by strong domestic demand with investment taking lead over consumption for the first time in the period under consideration. Net exports appear to have been a drag on overall growth during the period. Almost 88 percent contribution to growth came from consumption while investment contributed 38 percent. Net exports contributed negatively to the extent of 26 percent. The last three years economic growth has benefited from higher consumption and investment demand owing to a growing middle class and favorable demographics. Increased contribution of investment to growth in 2006-07 is a healthy development as it will engender employment growth which

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will support consumption demand and together they will play an important role in sustaining strong growth momentum in the medium-term.

Needless to say Pakistan's economy continues to maintain a solid pace of expansion over the last three years. This recovery has been strong, rapid and sustained. During the last three years (2004-07), Pakistan's economy continues to perform impressively and its economic fundamentals have gained further strength. The most important achievements of the period include: (i) a strong average economic growth of 7.5 percent despite the pursuance of tight monetary policy resulting in interest rate hike; (ii) a strong recovery in overall agricultural growth at 4.4 percent and major crops at 7.1 percent at the back of highest ever production of wheat *(23.52 million tons)* in the country's history and an impressive 22.6 percent increase in sugarcane production *(54.7 million tons: the second highest production level in the history)*; (iii) large-scale manufacturing continues to grow strongly at 13.1 percent, *albeit* at a somewhat less torrid pace in 2006-07; (iv) the overall services sector continue to maintain solid pace of expansion at 8.7 percent; (v) with strong average economic growth of over 7.5 percent during the last three years, Pakistan continues to maintain its position as one of the fastest growing economies in the Asian region; (vi) the real per capita GDP grew by 5.7 percent; (vii) per capita income in current dollar term increased from $ 669 in 2003-04 to $ 925 in 2006-07 – an increase of 38.3 percent in the last three years; (viii) a sharp pick up in overall investment reaching at a new height of 23 percent of GDP and most notably, private investment remained buoyant owing to the persistence of strong consumer demand, (ix) despite monetary policy tightening the credit to private sector continued to grow strongly (24.6%) at the back of improving investment climate; (x) a significant abatement of price pressure indicating a steady deceleration from 9.3 percent in 2004-05 to 7.8 percent in 2006-07 owing to pursuance of tight monetary policy on the one hand and improvement of supply situation on the other; (xi) on the fiscal side, the average budget deficit remained at less than 4.0 percent of GDP and revenue collection target of the Federal Board of Revenue (FBR) not only achieved but consistently surpassed the target; (xii) across all measures of vulnerability to external shocks, Pakistan's debt profile has improved significantly over the past three years — public debt declined from 67.1 percent to 55.2 percent of GDP and external debt and liabilities declined from 36.0 percent to 28.0 percent; (xiii) highest ever workers remittances at $ 5.5 billion in 2006-07- a record so far in Pakistan's economic history, (xiv) highest ever foreign investment flows at $ 8.4 billion in 2006-07 as compared to $ 1.6 billion in 2004-05, emerging as the single largest source of external finance after exports in 2006-07; (xv) exchange rate continues to remain stable despite widening of trade and current account deficits, clearly indicating strong inflows of external resources; and (xvi) the successful launch of several sovereign bonds in international debt capital market with many times over subscription have been the defining moment in Pakistan's history as it reflected a strong vote of confidence by global investors on Pakistan's current economic prospects and future economic outlook.

Among the most appreciated developments, during the last three years 2004-07, has been the improvement in performance of ***agriculture*** sector. This sector has registered an average growth rate of 4.3 percent during this period. During the current fiscal year as well over the last three years growth in the agriculture sector bounced back from a modest 1.6 percent last year to *5.0 percent*. The major crops registered an impressive growth of *7.6 percent* against a negative growth of 4.1 percent last year. The impressive growth in major crops owes partly to the bumper wheat and sugarcane crops and partly to the base effect as it is measured from a low base of last year. Wheat production was up by 10.5 percent to 23.5 million tons —the highest ever wheat production recorded in the country's history. The balanced use of fertilizer, availability of water during Rabi season, higher availability of agricultural credit and introduction of three new high yielding varieties of wheat have been responsible for record production of wheat this year. Sugarcane production, likewise, improved by *22.6 percent* last year to 54.8 million tons — the second highest size of the crop in the country's history. Cotton production at 13.0 million bales remained at last year's level. The performance of all other sub-sectors of agriculture also remained robust with the exception of minor crops and fishing.

Manufacturing is the second largest sector of the economy accounting for 19.1 percent of GDP. The overall manufacturing continued to post strong growth during the last three years. Overall manufacturing, on the back of strong growth in large scale manufacturing sector, grew at an average of 11.3 percent during the last three years. Large scale manufacturing (LSM), accounting for nearly 70 percent of overall manufacturing, also continued to post a strong growth during the period under consideration, albeit at a somewhat less torrid pace in 2006-07. The LSM sector grew at an average rate of 13.1 percent during 2004-07 and at 8.8 percent during 2006-07. The relatively slower pace of expansion in 2006-07 perhaps exhibits signs of moderation on account of higher capacity utilization, difficulties in the textile sector and lower than expected scale of operations of oil refineries. Several other factors have also contributed to the somewhat moderate pace of expansion of LSM such as: zero percent growth in raw cotton production which is a critical input in the textile industry thus limiting its growth; vegetable ghee and cooking oil which makes up nearly 5.5 percent of the LSM sector showed lackluster performance, most likely due to the unprecedented rise in international palm and soybean oil prices; and the performance of the automobile sector has been far less impressive this year as compared to previous five years due to the fall in domestic demand for cars on account of increasing auto financing rates. The high imports of used cars earlier in the fiscal year also dampened the performance of the domestic auto sector.

Per capita income is regarded as one of the key indicators of economic well being of any country. It simply indicates the average level of prosperity in the country or average standard of living of the people in the country. Per capita income, defined as GNP at market price in dollar terms divided by the country's population, surged from $ 669 in 2003-04 to $ 925 in 2006-07 – an increase of 38.3 percent. The main factors responsible for the sharp rise in per capita income in the recent years include: acceleration in real GDP growth, a stable exchange rate, and five fold increase in the inflows of workers remittances. Real per capita GDP is also an important indicator of the general well being of the people in the country. Real per capita GDP grew, on average 5.7 percent per annum during the last three years as against 1.4 percent in decade of the nineties.

A sound ***fiscal*** position is an essential prerequisite for achieving macroeconomic stability which is increasingly recognized as a critical ingredient for promoting strong and sustained economic growth and lasting poverty reduction. The importance of sound fiscal policy cannot be overemphasized in the case of Pakistan as it's chronically high consolidated budget deficit (7 percent of GDP) and rising public debt burden (over 100 percent of GDP) have been the economy's Achille's heal in the 1990s. Pakistan has experienced serious macroeconomic imbalances in the nineties mainly on account of its fiscal profligacy and accordingly paid a heavy price in terms of deceleration in economic growth and investment and associated rise in the levels of poverty. Considerable efforts have been made over the last seven years to inculcate financial discipline by pursuing a sound fiscal policy. Pakistan has succeeded in reducing fiscal deficit from an average of 7 percent of GDP in the decades of 1980s and 1990s to an average of 3.5 percent during the last seven years and an average of 3.9 percent of GDP during the last three years (which also includes expenditure on earthquake).

Public debt burden continues to decline sharply for the seventh year in a row and more significantly in the last three years on account of prudent fiscal management. Public debt was 96 percent of GDP in 1999-2000 but declined sharply to 75.1 percent in 2003-04 – a decline of 21 percentage points in just three years is one of the significant achievements of the government. During the last three years, public debt has declined from 75.1 percent in 2003-04 to 55.2 percent of GDP in 2006-07 – a decline of almost 20.0 percentage points. Public debt was 589 percent of total revenue in 1999-2000 but declined to 470.0 percent in 2003-04 – a decline of 119 percentage points in three years is again not a mean achievement. During the last three years public debt as percentage of revenue declined from 470 percent to 370.5 percent – a decline of almost 100 percentage points.

Monetary policy stance of the SBP has undergone considerable changes over the last 6-7 years gradually switching from an easy monetary policy to the current aggressive tight monetary stance. During the last three years 2004-07, the SBP has taken several additional policy measures in different phases as part of monetary policy tightening. The increase in interest rate as a result of tight monetary policy has been in line with the international rising trends in interest rates and prevailing inflationary pressures on the economy. The SBP, through its tight monetary policy, aimed at curbing strong domestic demand, which was one of the main driving forces fueling inflation, by curtailing the lending ability of the commercial banks to the private sector. Notwithstanding the tight monetary policy stance the SBP has continued to strike a balance between promoting growth and controlling inflation on the one hand and maintaining a stable exchange rate environment on the other. Tight monetary policy stance is likely to continue until inflationary pressures are significantly eased off.

The ***stock market*** continued to maintain its strong performance and achieved new heights by creating many new records during the fiscal year 2004-07. The KSE-100 Index crossed the barrier of 12000 marks for the second time in the history of capital market and touched an all time high on May 31st, 2007. The index stood at 7450 points in 2004-05 which increased to 9989 points at the end of the fiscal year 2005-06 which has risen further by 24 percent since then to 13772 points in 2006-07. The improved performance of the stock market can mainly be attributed to a number of factors including: (i) continuous improvement in the country's economic fundamentals, (ii) government's commitment to maintain its economic reform and pro-market policies, (iii) stability in exchange rate as a result of strong build up in foreign exchange reserves, (iv) regionally cheap valuation driving foreign interest in Pakistan's stock market, (v) large-scale merger and acquisition in the banking, telecom and other sectors of the economy (vi) improving Pakistan's geo-political relationship with neighbors as well as globally, resulting in decline in political risk premium of the country, (vii) successful GDR offerings of the OGDC and MCB Bank, amounting to $ 888 million and (viii) increase in Pakistan's coverage by large international brokerage firms and investment banks.

Pakistan's ***current account balance*** that slipped into red in 2004-05 after posting surpluses for three consecutive years remained in deficit in 2006-07. Pakistan's balance of payments shows a record increase in capital flows that has substantially offset a gradual widening of the current account deficit. Pakistan's current account deficit further widened to 5.0% of GDP in the fiscal year 2006-07 from 4.4% in 2005-06 and 1.6% in 2004-05. A striking feature of this current account deficit is that it has widened even though the import growth has slowed to 10.2 percent but the performance of exports has been lackluster at best, resulting in widening of trade deficit. The current account deficit for the year is around 5 percent of GDP as against 4.4 percent last year. The strong inflows in capital account more than offset the current account deficit and added to the stock of foreign exchange reserves which reached to $ 15.7 billion at the end of 2006-07.

Workers' ***remittances***, the third largest source of foreign exchange inflows after exports and foreign investment, continue to maintain its rising trend during the last couple of years. Workers' remittances totaled almost $ 5.5 billion in the fiscal year 2006-07 as against $ 4.6 billion in 2005-06 and $ 4.2 billion in 2004-05, totaling $ 14.3 billion in the last three years.

Total Foreign Investment reached at all time high in the country's history and amounted to $ 8.42 billion or 5.9% of GDP during 2006-07as against $ 4.48 billion in 2005-06 and $ 1.67 billion in 2004-05. Foreign Direct Investment – an important component of foreign investment - amounted to $ 5.1 billion in 2006-07 which is 45 times higher than 2005-06 and 236 times more than 2004-05. During this period FDI has primarily come in four major areas: telecom, energy *(oil and gas, power, petroleum refineries),* banking and finance, and food and beverages. These four groups accounted for over 80 percent of FDI inflows. Other areas such as textile, chemicals and petro-chemicals, automobiles, construction and trade are also attracting FDI. Almost 78 percent of FDI has come from five countries, namely the UAE, US, UK, China and Netherlands. Foreign investment of this magnitude reflects the confidence of global investors on the current and future prospects of Pakistan economy.

Pakistan's total liquid ***foreign exchange reserves*** stood at $15.7 billion at the end of July 2007, considerably higher than the end-June 2006 level of US$ 13.1 billion. These strategic reserves have also grown considerably from being $12.6 billion in 2004-05 to $15.7 billion in July 2007 – an increase of $3.1 billion in just three years. Many factors contributed towards this comfortable position of reserves. The most prominent among those are: private transfers that include remittances, floatation of bonds, higher FDI flows and privatization proceeds to name a few.

Rapid and broad-based economic growth over a prolonged period is essential for ***poverty*** reduction and improving distribution. Many developing countries have succeeded in boosting growth for a short period but only those that achieved higher economic growth over a long period have seen a lasting reduction in poverty. Strong economic growth, large inflow of remittances and Rs.2217 billion spending on social sector and poverty-related program during 2001/02 till 2006/07 have succeeded in reducing poverty in Pakistan. At the national level, headcount decreased from 34.46 percent in 2000-01 to 23.9 percent in 2004-05, depicting a substantial reduction of 10.5 percentage points over this period. In absolute numbers the count of poor persons has fallen from 49.23 million in 2001 to 36.45 million in 2004-05. While rural poverty declined even more sharply *(11.13 percentage points)* urban poverty also declined by 7.75 percentage points. It is generally argued that though poverty has declined in Pakistan, the gap between rich and poor has widened. The result suggests that though consumption inequality in Pakistan has increased marginally during 2001-05, Pakistan is by far one of the least unequal countries of the world[2].

The results from PSLM 2004-05 on social indicators when compared with PIHS 2000-01 reveal interesting facts with respects access to various services of bottom 20 percent of population to top 20 percent of the population. The results show that not only access to services improved faster for the poor, the disparities in access between the poor and the rich has narrowed. This fact, besides the PSLM 2004-05 survey, also becomes evident from the employment generation figures available for the last few years. About 11.8 million new jobs have been created between 1999-07. Out of these 11.8 million new jobs, 6.1 million have been created just during the last three years. This figure of enhancement of employment opportunities speaks volumes regarding the general direction of various government policies. Areas favored by these job openings were the IT sector, services sector, call centers, financial institutions, telecom sector etc. in addition, the results from PSLM 2005-06 have also been released recently. The new results suggest that most of the indicators pertaining to education such as gross and net enrollment at primary level and literacy rate have improved significantly over the last 5 years *(2001-2006)*. As regards, health indicators, children immunization, incident of diarrhea and infant mortality have improved appreciably. Infant mortality is

[2] Economist Magazine (Asia), 11th August 2007

down from 82 to 70 during 2001-06. Contraceptive prevalence rate has improved and consequently the total fertility rate has registered decline from 4.5 to 3.8 in 7 years.

While the economy of Pakistan has gained further traction during 2004-07, there are however, some *weaker areas* that need to be highlighted. First and foremost is the sharp pick up in the prices of some of the essential food items. Over the last decade, with a few exceptions, inflation around the world has been at retreat. More recently, with a pick-up in growth, inflation has started to rise again. Pakistan's economy exhibited a similar trend with a low inflation environment for last three years with a sharp pick-up in 2004-05 and a gradual abatement of price pressure thereafter. The rate of inflation averaged 8.3 percent during the last three years. The average inflation for the year 2006-07 has been 7.8 percent. Based on the above facts it is clear that the inflation over the period under consideration has largely been driven by higher food inflation. This food inflation has been fueled by a combination of global trends in the prices of several commodities and local supply – and demand – driven factors. Globally, higher prices of edible oil (palm oil and soybean) and dependency on their imports transmitted higher international prices to domestic prices. It may be pointed out that higher food inflation is now a global phenomenon as many countries around the world *(for example India and China)* are also experiencing higher food inflation. Furthermore, shortfall in domestic production of pulses, rice, chilies, other vegetable items (onion, tomato, etc) and fruits also contributed to the rise in domestic food prices. There are a few key food items which are widely consumed and whose prices remained high during the year and therefore contributed to the pick-up in food inflation. These items include: rice, masur and gram pulses, milk powder, vegetable ghee and cooking oil, red chilies, onions and tomato. On the other hand, the prices of some essential food items were lower this year compared with last year. These items include: moong pulse, sugar, chicken, potato etc. Non-food inflation in general and core inflation in particular have declined as a result of tightening of monetary policy during the year.

The challenge for the government is therefore to maintain a balance between the supply and demand for essential food items by enhancing domestic production and augmenting their supplies in the shortest possible time through imports in the event of shortfall in the production of these items. The key to addressing this challenge is to give due importance to minor corps, and livestock and dairy sectors which have been neglected by successive governments. The relative roles of these two sub-sectors, which together account for 62 percent of agricultural value added, in keeping food prices stable need to be emphasized and given due attention. While Pakistan has made remarkable progress in its economic performance, undertaken wide-ranging structural reforms, achieved both macroeconomic stability and strong growth, sharply reduced poverty, yet there is no room for complacency. Although the present economic scenario holds immense expectations for the future but Pakistan's economic managers cannot rest on their laurels. A lot still remains to be done both on the external and the domestic front. For the forthcoming years numerous economic reforms, with the blessing of the international community, are on the cards and it can be safely said that the future will bring about more economic prosperity for the people of Pakistan.

Economic Performance of Shaukat Aziz Government

		2004-05	2005-06	2006-07
Real GDP Growth	%	9.0	6.6	7.0
Total Investment (As % of GDP)	%	19.1	21.7	23.0
Growth in Industrial Production (LSM)	%	19.9	10.7	8.8
Inflation	%	9.3	7.9	7.8
Revenue Collection (CBR)	Rs. Billion	588.8	712.8	846.0
Fiscal Deficit (As % of GDP)	%	3.3	4.2*	4.2*
Domestic Debt (As % of GDP)	%	32.8	30.0	28.4
Debt Servicing (As % of Total Revenue)	%	30.4	27.8	26.1
External Debt & Liabilities	$ Billion	35.8	37.2	40.2
External Debt and Liabilities (As % of GDP)	%	32.9	29.5	28.0
External Debt and Liabilities as % of Foreign Exchange Earnings	%	134.3	120.1	115.0
Exports	$ Billion	14.4	16.4	17.0
Imports	$ Billion	18.7	24.6	30.5
Remittances	$ Billion	4.2	4.6	5.5
Total Foreign Investment *-Foreign Direct Investment*	$ Million	1676.6 1524	4485.5 3521	8416.6 5125
Current Account Balance (As % of GDP)	%	-1.6	-4.4	-5.2
Foreign Exchange Reserves	$ Billion	12.6	12.8	15.1
		30-06-2005	**30-06-2006**	**30-06-2007**
Stock Market (KSE Index)		7450	9989.4	13772.5
Stock Market (Market Capitalization)	Rs. Billion $ Billion	2036.7 34.3	2766.4 45.7	3980.8 65.3

* This is including earthquake related spending.