

Annual Review
July 2006

Growing
Macroeconomic
Imbalances

Research Report No.64

Foreword

Social Policy and Development Centre (SPDC) is pleased to present its Annual Review of the State of the Economy in the light of the Pakistan Economic Survey 2005-06 and the Federal Budget 2006-07. The SPDC team has attempted to do an in-depth analysis of the new data and assess the macroeconomic and fiscal situation and policies. We have also examined the implication of our analysis for the poverty and social development picture.

The Review represents the efforts of SPDC to objectively present the situation with respect to the state of the economy. It points out the improvements in economic performance and an increase in the economy's sustainable rate of growth over the past few years, which are in part a result of the improved macroeconomic policy environment. It also highlights, however, the growing macroeconomic imbalances that manifest themselves in the form of a huge trade deficit, an increase in the fiscal deficit and the failure of inflation to recede at an acceptable pace. It is important to recognize that unless checked, these imbalances threaten the substantial gains that have been made in recent years. The Review also argues that for growth to translate into development to a greater extent, much more progress has to be made in reversing the growing income disparities and other inequalities.

We hope that all stakeholders - including policy makers, parliamentarians, academics, development practitioners, researchers, civil society activists, donors and business leaders - will find this Annual Review of Pakistan's economy of some use.



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Acronyms

ACGR	Annual Cumulative Growth Rate
CBR	Central Board of Revenue
CPI	Consumer Price Index
CVT	Capital Value Tax
ERRA	Earthquake Relief and Reconstruction Authority
FY	Fiscal Year
FBS	Federal Bureau of Statistics
GDP	Gross Domestic Product
GoP	Government of Pakistan
GRAP	Gender Reform Action Plan
GRBI	Gender Responsive Budgeting Initiative
IMF	International Monetary Fund
ISPM	Integrated Social Policy and Macroeconomic
LFS	Labour Force Survey
NFC	National Finance Commission
PIB	Pakistan Investment Bond
PRSP	Poverty Reduction Strategy Paper
PSDP	Public Sector Development Programme
PSLM	Pakistan Social and Living-Standards Measurement
REER	Real Effective Exchange Rate
SBP	State Bank of Pakistan
TCP	Trading Corporation of Pakistan
UN	United Nations
WAPDA	Water And Power Development Authority
WB	World Bank
WDP	Women in Distress Project

INTRODUCTION

Pakistan's economy decelerated in the Fiscal Year 2005-06 (FY06). It posted a growth rate of 6.6 percent as opposed to 8.4 percent in the previous year, according to data reported in the Government of Pakistan's (GoP) Economic Survey 2005-06. Although some slowdown in growth was expected, the performance is still quite impressive, especially given the devastating earthquake that hit the country in October 2005.

Nonetheless, there are some worrisome factors present in the macroeconomic situation that need to be addressed. One such factor is that the growth this year has become rather unbalanced. In particular, while the services sector continues to boom, there has been a significant slowdown of growth in the manufacturing sector, and in the agriculture sector. The uneven pace of growth raises some concerns about the extent to which transient factors, such as the unusually good cotton crop, may have been driving the recent growth in some sectors.

Moreover, the signs of stress and overheating that had emerged in the economy which SPDC flagged in the previous year's report have actually firmed up. This is partly as a result of an insufficient policy response. Increases in domestic demand have continued to outpace those in domestic production. And, while consumption has decelerated somewhat, its growth rate remains high, relative to what can be absorbed without further increases in the trade deficit. Investment growth appears to have picked up. However, with frequent and large revisions in data related to this activity in recent years, the investment picture - which is a critical element in any long-term growth strategy and in any discussion of the sustainability of high growth - remains clouded.

Although consumer price inflation has receded somewhat, it has not done so at a

pace that was originally envisaged and it remains high. And perhaps, more pertinent to the overall stance of macroeconomic policy, core inflation - which excludes food and energy costs from the headline Consumer Price Index (CPI) - has not gone down. These price pressures are consistent with the evidence of a positive output gap, which means that the level of output remains temporarily above the long-run productive capacity of the economy.

The growing gap between domestic demand and domestic production is, of course, being satisfied by a sharp increase in net imports. This has resulted in a trade deficit in the first nine months of FY06 that is more than double the deficit in the corresponding period of the previous fiscal year. Barring major adverse shocks, the financing of the trade deficit this year through a mixture of remittances, external borrowing, privatization proceeds and inflows related to earthquake-related reconstruction may not be that difficult. However, the current size of the trade deficit is clearly not sustainable in the long term.

Another growing imbalance is the fiscal deficit. The expansionary stance of fiscal policy adopted in the budget for FY06 is to be continued in the proposed budget for FY07. The fiscal deficit fuels domestic demand and thus it exacerbates pressures on the current account deficit. The other side of this coin is that by increasing the government's dissavings further, the fiscal deficit reduces already low national savings and widens the investment-savings gap, which has to be financed externally. To the extent that the deficit is financed by money creation, it also adds to inflationary pressures.

The proposed fiscal deficit for FY07 is largely driven by post-earthquake reconstruction expenditures and a very large increase in development expenditures. Of course, both these types of spending are essential and cannot be compromised. SPDC has been arguing for a meaningful increase in development

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expenditures for years and welcomes the sharp increase in allocation in this area. It is worth repeating, however, that the delivery, monitoring and utilization mechanisms of the Public Sector Development Programme (PSDP) need to be vastly improved for this programme to become more effective.

While the increases in government expenditures mentioned above are well-justified, much more could and should have been done on the expenditure-switching and tax revenue fronts to keep the fiscal deficit curtailed. Current expenditures are slated to be cut relative to the revised amounts of FY06. However, these revised amounts represent a significant overshooting of the original targets. This continues the tendency that has been going on year after year in which current expenditures exceed their targets by significant amounts.

The tax measures fall short of expectations. The much-touted new taxes levied amount to only 0.3 percent of projected Gross Domestic Product (GDP). Also, the changes in the existing income tax structure will make it less progressive. Although, the very low salary earners will receive some tax relief, the major relief under the new structure will go to the very high salary earners. Middle-income salary earners, on the other hand, will see their effective tax rates increase.

The modes of financing of the fiscal deficit proposed in the budget are also a cause for concern. In particular, there is heavy reliance on bank borrowings penciled in, which will complicate the task of achieving a 6½ percent inflation target for next year.

Shortly before its release, the Federal Budget 2006-07 was being heralded as one that would provide substantial relief to the common man and be pro-poor. The sharp increase in the allocation to development expenditures by the government as well as some other relief measures are evidence that it has lived up to this hype in some ways. In addition to measures specific to government

employees, other steps include a 25 percent rise in the minimum wage, an increase in the tax-exempt level of income and some tax cuts for low salary workers. But given that not enough has been done to raise overall tax revenues, the fiscal policy fuels inflationary pressures, which is anti-poor.

According to government figures based on a new household survey, there has been a phenomenal decrease in poverty in Pakistan from about 34 percent to about 24 percent over the past four years. The full data from the survey have not been publicly released yet to enable us to study this claim in detail. The very high economic growth rates in recent years would be expected to reduce poverty significantly. However, the claims of huge gains in poverty reduction seem difficult to reconcile in the face of some obvious partially offsetting poverty-increasing factors. These include high inflation and rising income inequality.

In summary, Pakistan has made impressive economic gains in recent years and the government has significantly improved macroeconomic stability and policy credibility. And no doubt, fostering private investment growth and growth in public infrastructure, as well as in expenditures on education and health, is vital to the objective of achieving a 7-8 percent sustainable rate of economic growth. But given that we are not there yet, that capacity constraints appear to have been reached and that inflation remains high, the overall growth of domestic demand needs to be checked in the short run.

At the moment, the growing macroeconomic imbalances pose serious downside risks to the economy. If unchecked, these imbalances could reach unsustainable proportions very quickly. Another possibility is that a major adverse shock, such as to remittances or to capital inflows, could make the existing levels of these imbalances unsustainable, even in the short run. Were either of these things to happen, something would have to give.

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Table 1
Growth by Sector

Sector	Growth Rates (Percent) At constant factor cost of FY00*				
	FY02	FY03	FY04	FY05	FY06
Total (GDP at Factor Cost)	3.1	4.7	7.5	8.6	6.6
Agriculture	0.1	4.3	2.3	6.7	2.5
Major Crops	-2.5	6.7	1.9	17.8	-3.6
Livestock	3.7	3.0	2.5	2.3	8.0
Others	-4.6	3.4	2.6	-2.4	0.4
Manufacturing	4.5	6.9	14.0	12.6	8.6
Services	4.8	5.2	5.9	8.0	8.8
Wholesale & Retail Trade	2.8	5.9	8.4	11.1	9.9
Finance & Insurance	17.2	-1.3	9.0	29.7	23.0
Others	4.7	5.5	4.1	3.7	6.1
Others	-0.7	-1.2	21.3	9.0	0.0

Source: GoP, Pakistan Economic Survey 2005-06
*FY00 = Fiscal Year 1999-2000. This notation is used throughout.

That something could include one or more of the following: a sharp slowdown in economic growth, a major correction in the exchange value of the Rupee and a large dent in Pakistan's stock of international reserves. In their quest for growth, policy makers cannot let these risks remain at their current levels without jeopardizing the very objective of high long-term sustainable growth with price stability.

MACROECONOMIC ANALYSIS

Growth

As was expected, output decelerated in FY06 with economic growth declining from a very high rate of 8.6 percent on the previous year to a slower but still robust pace of 6.6 percent (Table 1). The performance across sectors is much more uneven than in FY05. In particular, there is notable weakness in agriculture, with output in this sector increasing just 2.5 percent in FY06 compared to 6.7 percent the year before. Largely, this reflects a major turnaround in the production of major crops, which declined more

than 3½ percent this year after increasing a striking 18 percent in FY05. Growth in the manufacturing sector has also slowed significantly. The services sector, whose output recorded an 8.8 percent increase, remains the mainstay of the overall rise in economic activity. Within the services sector, particularly notable is the 23 percent growth in finance and insurance, following on the heels of nearly 30 percent growth in this sub-sector in FY05.

The supply-side sectoral contributions to growth are shown in Table 2. These are obtained by multiplying the sectoral growth rates in Table 1 with their respective shares in total output in the previous year. Note that of the 6.6 percent overall growth rate, the services sector accounts for 4.5 percentage points (or 68 percent of the total). This compares with a contribution of 4.1 percentage points (or 48 percent of the total) in the previous year from this sector. Finance and insurance alone, even though it has a very small share of 4 percent in overall output, is accounting for nearly a percentage point of the 6.6 percent growth in FY06 (or about 14 percent of the total).

Table 2
Sectoral Contributions to Growth

Sector	Contribution in Percentage Points At constant factor cost of FY00				
	FY02	FY03	FY04	FY05	FY06
Total (GDP at Factor Cost)	3.1	4.7	7.5	8.6	6.6
Agriculture	0.0	1.0	0.6	1.5	0.6
Major Crops	-0.2	0.5	0.2	1.4	-0.3
Livestock	0.4	0.4	0.3	0.3	0.8
Others	-0.2	0.1	0.1	-0.1	0.0
Manufacturing	0.7	1.1	2.3	2.2	1.5
Services	2.4	2.7	3.1	4.1	4.5
Wholesale & Retail Trade	0.5	1.1	1.5	2.0	1.8
Finance & Insurance	0.5	0.0	0.3	1.0	0.9
Others	1.4	1.7	1.3	1.1	1.7
Others	-0.1	-0.1	1.6	0.7	0.0

Source: SPDC estimates based on data from the GoP, Pakistan Economic Survey 2005-06

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By contrast, the contribution of agriculture to total growth has declined from 1.5 percentage points in FY05 (or 17 percent of total) to 0.6 percentage points in FY06 (or 9 percent of total); similarly that of manufacturing has declined from 2.2 percentage points (26 percent of total) to 1.5 percentage points (23 percent of total). The sources of growth have thus clearly become more concentrated and suggest the transient nature of the recent high growth in some sectors, particularly the role of an unusually good cotton crop in FY05 in the performance of agriculture.

This can be investigated in more detail through a standard growth accounting exercise. Using production functions estimated as part of SPDC's large-scale Integrated Social Policy and Macroeconomic (ISPM) model, we decompose growth into that due to changes in the quantity of inputs used and that which can be attributed to shifts in the production function (i.e. productivity gains - the ability to get more output from any given amount of inputs). Shifts to the production function can, in turn, be a result of both transient factors (such as weather-related shocks) and more permanent changes (such as due to technological improvements and government policies).

Table 3 shows that of the 8.6 percent overall growth in FY05, only 2.4 percentage points could be attributed to changes in the labour and capital inputs; the rest - 6.2 percentage points - was because of shifts in the production function. Moreover, of the 6.2 percentage points reflecting production function shifts, 3.9 percentage points could be accounted for by changes in the cotton

TABLE 3
Growth Accounting

	FY01	FY02	FY03	FY04	FY05	FY06
Total Growth (%)	2.0	3.1	4.7	7.5	8.6	6.6
<i>Contribution (% Points) of:</i>						
Inputs	2.6	3.4	2.4	3.3	2.4	2.4
<i>of which</i>						
Capital	1.4	1.3	1.3	1.0	1.2	1.4
Labour	1.2	2.1	1.1	2.3	1.2	1.0
Production Function Shifts	-0.7	-0.3	2.3	4.2	6.2	4.2
<i>of which</i>						
Change in Cotton Production	-0.4	-0.1	-0.4	-0.1	3.9	-1.2
Agriculture Growth (%)	-2.2	0.1	4.3	2.3	6.7	2.5
<i>Contribution (% Points) of:</i>						
Inputs	1.3	-3.3	0.7	2.3	0.9	0.6
<i>of which</i>						
Capital	0.0	0.0	0.0	0.0	-0.1	-0.1
Labour	0.8	-3.7	0.8	2.6	0.9	0.7
Production Function Shifts	-3.5	3.4	3.6	0.0	5.9	1.9
<i>of which</i>						
Change in Cotton Production	-0.5	-0.1	-0.4	-0.2	4.2	-1.3

Source: SPDC estimates.

crop output alone. This means that a rise in cotton production accounted for 45 percent of the total growth occurring in FY05. By contrast in FY06, while inputs added the same 2.4 percentage points to growth, the contribution of production function shifts decreased to 4.2 percentage points because a fall in the cotton crop output contributed negatively to overall production.

In the case of agricultural output, of the 6.7 percent growth in FY05, 5.9 percentage points could be accounted for by production function shifts, of which the increase in cotton production accounted for 4.2 percentage points. Thus, 63 percent of the total growth in agriculture during FY05 could be accounted for by the increase in cotton production. Given this, with the cotton crop taking away 1.3 percentage points from growth during FY06, it is not surprising that agriculture growth slowed sharply.

The above results suggest that when evaluating Pakistan's growth spurt in recent years, it is important to distinguish between changes that can be accounted for by

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Table 4
Growth by Expenditure

Sector	Growth Rates (percent) At constant market prices of FY00				
	FY04*	FY05*	FY04**	FY05**	FY06
Total (GDP at Market Prices)	6.4	7.8	8.3	7.3	6.2
Consumption	7.5	15.2	10.4	11.9	7.8
Private	8.2	16.8	11.5	13.1	8.1
Public	2.1	2.3	1.4	1.7	4.8
Fixed Investment	-4.4	1.5	-6.1	9.3	10.3
Private	-11.0	4.8	-8.0	9.6	11.0
Public	14.0	-5.6	-1.0	8.5	8.6
Exports	-1.5	7.6	-1.5	9.6	12.9
Imports	-8.6	44.1	-8.6	40.5	23.9

Source: GoP, Pakistan Economic Survey 2004-05 and 2005-06

*As reported in Economic Survey 2004-05

** As reported in Economic Survey 2005-06

temporary factors (such as unusually good crops or an extraordinary rise in remittances) and those that are more long term (such as technological improvements, human capital upgradation and long-lasting changes in government policies).

Table 4 presents the growth rates of the demand-side components of real GDP measured at market prices. The recent boom in consumption and imports appears to have cooled down, but real total consumption still increased by nearly 8 percent and real imports by a hefty 24 percent in FY06. Thus, growth in these two components of demand remains high, relative to the capacity of the economy to absorb it.

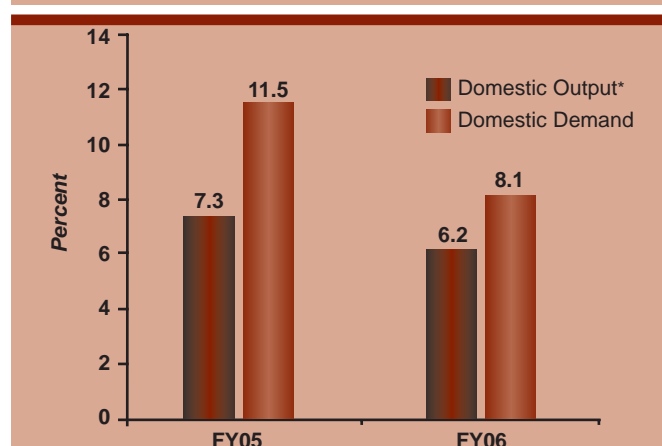
The investment position appears to have improved. According to data from the latest Pakistan Economic Survey, real fixed investment increased by more than 9 percent in FY05 and by more than 10 percent in FY06, after declining by 6 percent in FY04 (Table 4). However, it should be noted that the investment data for the past two years have been revised substantially. As the Table shows, while real fixed investment in FY05 registered an increase of 9.3 percent according to

the Economic Survey, 2005-06, the same year's investment increase had been just 1.5 percent according to the 2004-05 Survey. Similarly, private investment growth for FY05 has been revised upwards from 4.8 percent to 9.6 percent and public investment for the same year has been revised upwards from a decline of 5.6 percent to an increase of 8.5 percent. By contrast, according to the latest Survey, in FY04 public investment had declined by 1 percent as opposed to increasing by 14 percent as reported in the previous Survey.

There is hardly any explanation provided in the latest Economic Survey of the sources and reasons for these revisions. Therefore, one cannot help but conclude that the true investment picture remains clouded.

Chart 1 depicts that in FY05, the growth rate of domestic demand (the sum of private and public consumption and investment), at 11½ percent, far outpaced the growth rate of domestic production, at about 7½ percent. Similarly, in FY06 while domestic production

Chart 1
Growth of Domestic Demand and Domestic Output



*As measured by GDP at constant market prices of FY00

Source: SPDC computations based on data from the GoP, Pakistan Economic Survey 2005-06

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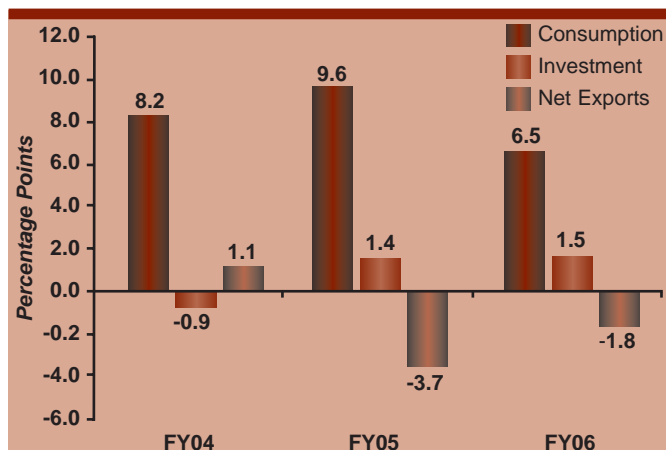
grew by just over 6 percent, domestic demand increased by more than 8 percent. This has now put the level of domestic demand at more than the level of domestic supply. In this environment, if domestic demand continues to outpace domestic supply, it will become very difficult to bring down inflation to its target value of 6½ percent.

Chart 2 depicts the contributions to growth of different types of expenditure. Consumption is by far the primary driver of growth in the economy on the demand side. While the contribution of investment to overall growth turned positive after FY04, it remains on the order of about one-fifth of the contribution of consumption. The contribution of consumption at about 6.5 percentage points in FY06 was more than the growth in real GDP at market prices itself (6.2 percent). The contributions of consumption and investment imply that net exports shaved off about 1.8 percentage points from growth in FY06.

Savings-Investment Dilemma

The gap between domestic demand and domestic production is, of course, being satisfied by greater imports, which leads to an increase in the trade deficit on goods and services. The other side of this coin is the gap between domestic investment and

Chart 2
Contributions to Growth of Expenditure Components



Source: SPDC computations based on data from the GoP, Pakistan Economic Survey 2005-06

domestic savings. Pakistan is suffering from a low investment rate, an even lower savings rate and a growing investment-savings gap.

Investment rates are shown in Table 5. Here it matters whether we consider real or nominal values. The government claims a much-improved investment situation, with the investment-to-output ratio now touching 20 percent. But, note that this holds only when considering the variables in nominal terms and when including changes in inventories. If instead we look at fixed investment, the nominal investment-to-nominal GDP ratio is estimated to be about 18½ percent in FY06 as the Table shows. This still represents an improvement relative to the previous six years, when it hovered at around 15-16 percent. The improvement appears to be more concentrated in private investment.

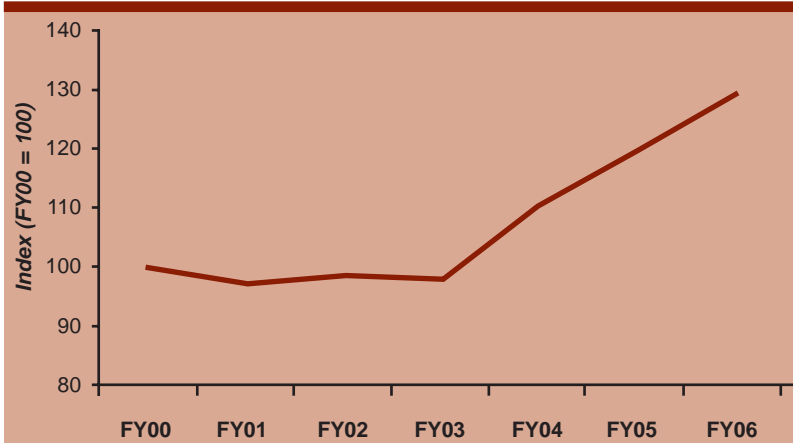
A somewhat different picture emerges when we consider real investment as a share of real output. This has

Table 5
Investment Rates

	FY00	FY01	FY02	FY03	FY04	FY05	FY06
<i>As % of GDP (Nominal)</i>							
Fixed Investment	15.9	15.8	15.5	15.3	15.0	16.5	18.4
Public	5.6	5.7	4.2	4.0	4.0	4.4	4.8
Private	10.3	10.2	11.3	11.3	10.9	12.1	13.6
<i>As % of GDP (Real)</i>							
Fixed Investment	15.9	16.3	15.7	15.6	13.6	13.8	14.3
Public	5.6	5.9	4.3	4.1	3.8	3.8	3.9
Private	10.3	10.4	11.4	11.5	9.9	10.0	10.5

Source: GoP, Pakistan Economic Survey 2005-06

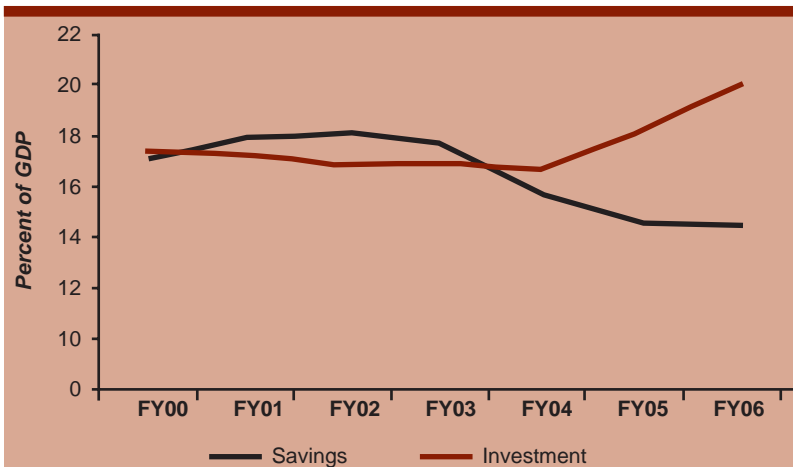
Chart 3
Relative Price of Private Investment



Source: SPDC computations based on data from the GoP, Pakistan Economic Survey 2005-06

increased only modestly to 14.3 percent in FY06, compared with 13.6 percent in FY04 and 13.8 percent in FY05. And, it is less than the 15-16 percent share seen in the first few years of this century. Thus, when measured in real terms, both the private investment-to-output ratio as well as public investment-to-output ratio are down from their values in FY02 and FY03, although there has been a slight improvement after

Chart 4
Nominal Savings and Investment



Source: SPDC computations based on data from the GoP, Pakistan Economic Survey 2005-06

that.

The explanation for these differences is that the relative price of capital has been rising. As shown in Chart 3, the relative price of investment (measured as the ratio of the private investment price deflator to the GDP price deflator) has increased about 30 percent since FY03. Since the relative price of capital is part of the user cost of capital, a rise in it is not particularly an encouraging situation for investment prospects. In any case, Pakistan's investment-to-

GDP ratio needs to be substantially higher to be able to sustain a 7 percent rate of economic growth over a long period of time.

Savings data are not readily available in real terms and hence when comparing investment and savings rates, we are constrained to use nominal data. The situation is depicted in Chart 4. Although both savings and investment rates were rather low, from FY01 through FY03, the savings rate was slightly higher than the investment rate. In FY04, an investment-savings gap developed and has widened since then, with the nominal savings-to-output ratio falling steadily and the nominal investment-to-output ratio rising steadily.

The low investment rate relative to what is required in the long run to sustain high growth has led to demands from some quarters to lower interest rates in a bid to stimulate investment. But simple economic analysis would suggest that lower

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interest rates are not the answer to Pakistan's investment problems. To begin with, there is a distinction between nominal and real interest rates. Investment demand depends on long-term real interest rates, not nominal interest rates. If we take the nominal yield on the latest 10-year maturity Pakistan Investment Bond (PIB) of 9.8 percent and assume a long-term inflation rate of 6 percent, this leads to a long-term real interest rate of 3.8 percent; thus, real interest rates are not as high as nominal interest rates would seem to suggest.

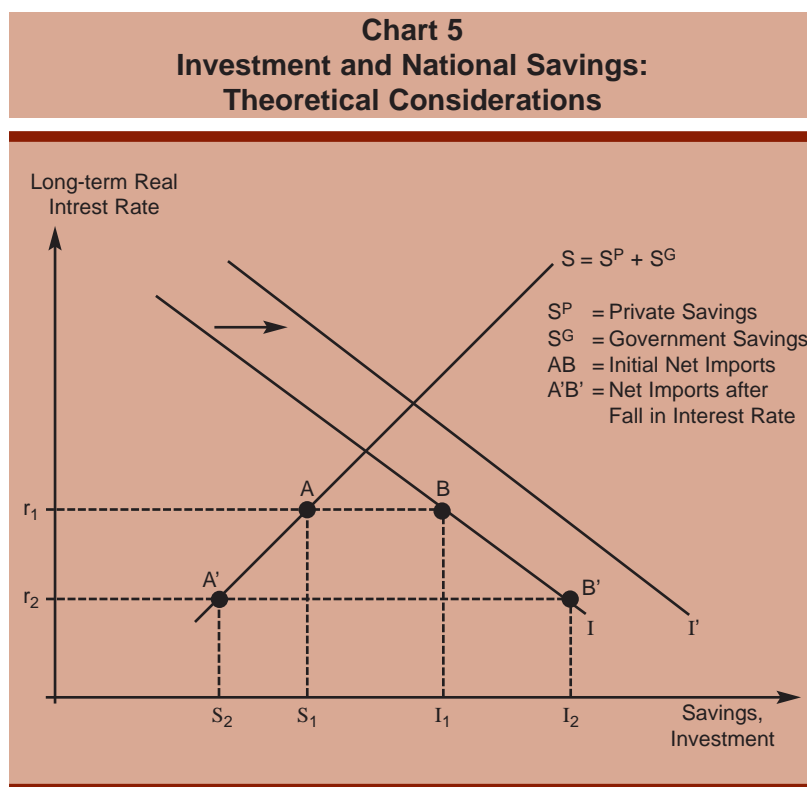
But, suppose expected inflation over a 10-year horizon is a lot lower and the real yields a lot higher. Lowering the real interest rate is still not the right answer. To understand this, consider Chart 5, which plots hypothetical investment and national savings levels as a function of the real interest rate. The real interest rate is an important component of the cost of capital and when it falls, the demand for investment goods increases. This is because more

investment projects become profitable if the cost of capital is lower. Therefore, the investment curve is downward sloping. The supply of domestic national savings, on the other hand, is a positive function of the real rate of return obtained on those savings. Hence, the savings curve is upward sloping. Suppose we start at a long-term real interest rate of r_1 , the investment level is I_1 and national savings level is S_1 . The investment-savings gap, AB, represents net imports of goods and services, or the trade deficit on goods and services.

Now suppose the real interest rate is lowered from r_1 to r_2 . This will stimulate investment demand along the investment schedule to I_2 . But at the same time, the lower interest rate would discourage the supply of domestic savings to S_2 . The question is: how will the resulting increase in investment be financed and how will the increased demand for goods and services be satisfied? The answer is: with imports, of course, with a consequent further widening

of the current account deficit and its accompanying problems. Given the already very high growth of imports, it is unlikely that a further acceleration in imports could be matched by an equivalent acceleration in exports. Thus, the large current account deficit would persist, leading to currency depreciation and inflation pressures, which sooner or later would become self-fulfilling.

Thus, generating higher investment demand through lower real interest rates would not lead to sustainable growth. What we need is a shift in the whole investment demand function - that is, a higher investment demand at any



given level of interest rates, shown as a rightward shift in the investment curve in Chart 5. Such a shift in investment demand can occur through tax incentives provided for investment, for example, but the only really sustained way to achieve it is through an increase in productivity. As productivity increases, more investment projects become profitable at any given interest rate (or cost of capital) and investment demand increases. Productivity-induced increases in investment demand are, therefore, the best way of achieving sustained economic growth. And, even though such increases would by themselves still worsen the current account deficit, an increase in the current account deficit caused by productivity increases can at least more easily be financed without alarm bells going off.

Of course, the best outcome would be to keep the current account deficit from widening in the first place with an increase in investment. For that, a simultaneous shift in the supply of national savings is needed - that is, a higher desired national savings level for any given interest rate. How to shift the savings supply function is a more difficult question to answer for many developing economies, including Pakistan. But some relevant considerations in the case of Pakistan are given below.

National savings consists of private savings and government savings. The latter is negative because the government is running a deficit - that is, the government "dissaves." So, one way to increase national savings is for the government to run a smaller deficit and decrease its dissavings. This hasn't happened in the current budget.

Turning to private domestic savings, this consists of the part of national income that is not spent on consumer goods or in paying taxes. People put their savings into bank deposits, financial assets such as stocks and bonds and also other assets, such as real estate. One question that is increasingly being asked is whether

depositors are getting rates of return on their deposits that are adequate. For example, real (inflation-adjusted) rates of returns on bank deposits are negative and the spread on loan rates versus deposit rates is currently 7.4 percent. It needs to be researched whether such a high spread is consistent with the confluence of competitive market forces, or whether depositors are not getting a fair rate of return because of some reason.

There also appears to be a lack of enough instruments available for savers. For example, the most recent PIB auction resulted in an issuance of such instruments after a period of more than two years. The government canceled several PIB auctions, or bids were not accepted. The government should be more willing to issue domestic bonds at market interest rates and develop a yield curve rather than preferring to borrow from the State Bank of Pakistan (SBP) in the current inflationary environment. Researchers must also study the demographic patterns in Pakistan and their likely impact on private savings.

The bottom line is that lower interest rates in the present environment with capacity constraints having been reached will just increase domestic demand beyond the capacity of the economy to support that demand through increased domestic production. This will just further fuel inflationary expectations and current account pressures. Both fiscal and monetary policies need to be tight until fundamental shifts in the domestic investment and savings functions can be achieved.

Inflation

Inflation has picked up sharply since FY04. In FY05, the rate of increase of the CPI almost touched double digits. In FY06, this "headline" inflation declined somewhat, falling to about 8 percent from 9.3 percent, but this decline is much less than what was being forecast earlier.

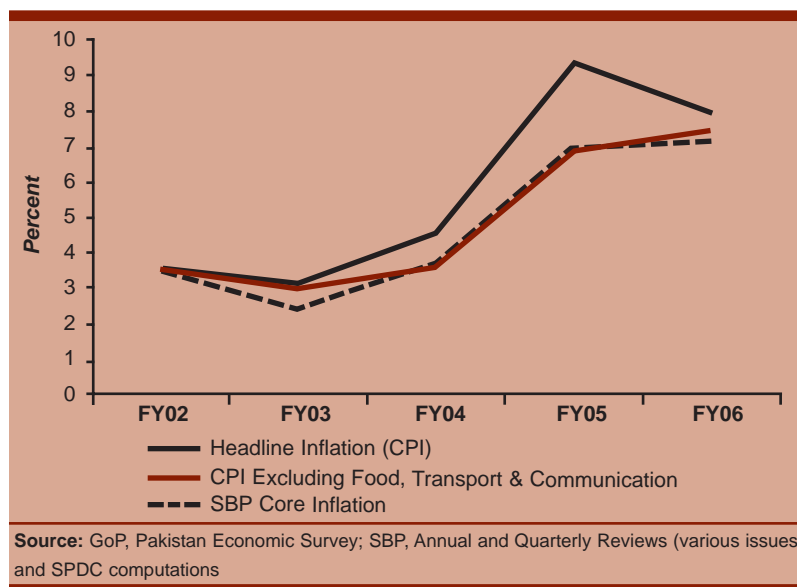
Growing Macroeconomic Imbalances

Moreover, “core” inflation - which excludes food and energy items - as reported in the Economic Survey has increased slightly, to 7.2 percent (Chart 6). The government's history of core inflation does not go back too many years. But note from Chart 6 that inflation, as measured by the CPI excluding food and transport and communications components, closely tracks the official SBP core inflation measure.

A supposed trade-off between inflation and growth is often the subject of discussion in Pakistan these days. However, the exact relationship between growth and inflation can vary depending on the state of the economy. An economy can experience high growth without an increase in inflation if its productive capacity (or potential output) is also expanding rapidly, so that supply is more than keeping pace with demand. It can also experience rapid growth without inflationary pressures if output produced is well below potential so that there is much spare capacity and the economy has a lot of “catching up” to do. However, once capacity constraints are reached and actual output has caught up with potential output, inflation starts to pick up as growth takes place. From this point, if demand keeps increasing at a rate greater than the rate of increase in the productive capacity, this only leads to higher inflation in the long run without any additional economic growth - or worse, a negative effect on growth.

Although, the relationship between growth and inflation can vary, what economic theory tells us is that there should be a stable positive relationship between inflation and the output gap - or the deviation of actual output from potential

Chart 6
Average CPI Inflation



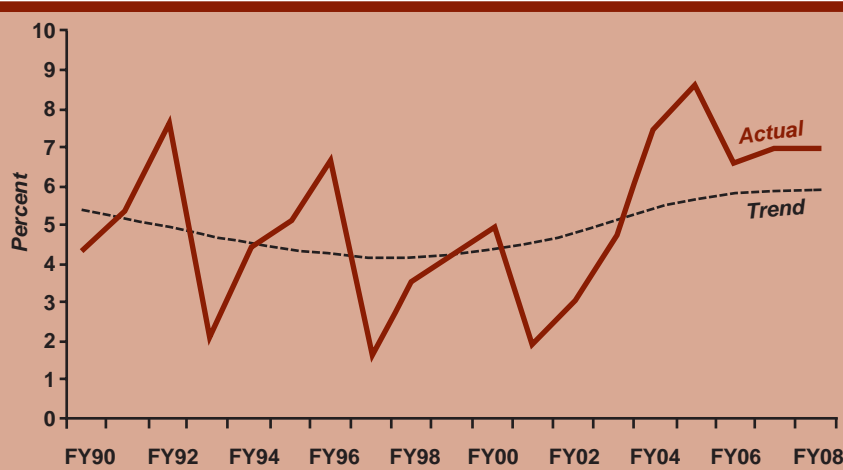
output. Potential output measures the productive capacity of an economy under the assumption of full employment of all factors of production and with all the policy and structural changes that have taken place being built in.

Potential output is difficult to measure, particularly in the case of developing countries. One method often used is to equate potential output to the long-run trend in output that emerges from applying sophisticated statistical techniques to the behaviour of actual output. Assuming a target growth rate of 7 percent in FY07 and FY08, the picture that is implied by such an exercise in the case of Pakistan is shown in Chart 7. The Chart illustrates that there has been a notable shift since FY00 in potential output growth, which has increased from a low point of about 4 percent then, to about 6 percent now. This is a creditable achievement.

The other important feature of Chart 7 to note is that for the past three years actual growth has been above the potential growth. As depicted in Chart 8, this has made the output gap positive since FY05 and is growing. Historically, as also can be seen

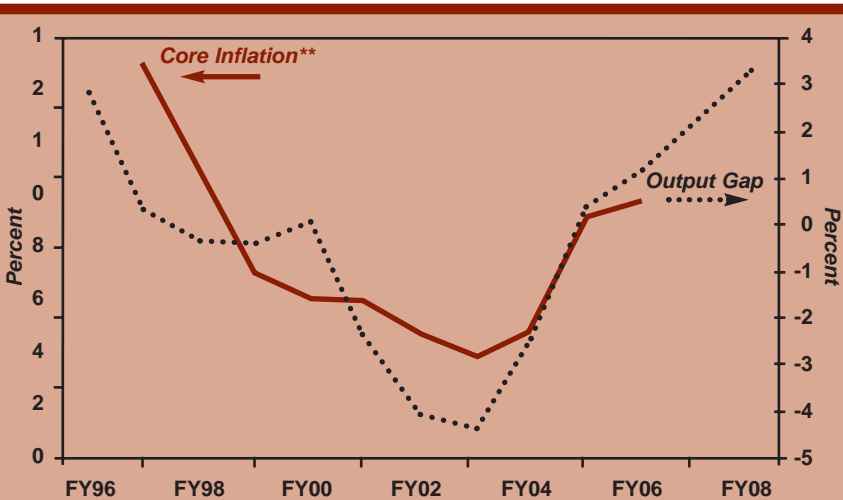
Growing Macroeconomic Imbalances

Chart 7
Actual* and Trend Real GDP Growth



*For FY07 and FY08 projected growth of 7 percent has been used
Source: Actual is from the GoP, Pakistan Economic Survey 2004-05. Trend is SPDC estimate based on popular statistical filter (Hodrick-Prescott Filter)

Chart 8
Output Gap* and Inflation



*Output Gap is percent deviation of actual output from potential output. Potential output is computed from a statistical filter (Hodrick Prescott Filter). Growth of 7% is assumed in FY07 and FY08 in computing the projected output gaps for these years
 **Using CPI, excluding food and transport and communications components
Source: SPDC estimates

implication is that, if growth is targeted to be 7 percent or above and domestic demand grows in line with it, then the output gap will keep growing as shown in the Chart and pressures on core inflation will mount further rather than recede. Of course, this whole analysis depends on the accuracy of the particular measure of potential output used, about which, admittedly, there is considerable uncertainty. But the possibility of a growing output gap should, at the least, be considered an important risk factor for Pakistan's economy at the moment.

The output gap can, of course, be a function of the myriad things that can affect domestic demand and potential output in the economy. It might be useful to consider the role of some factors that can be linked to variables that are influenced by monetary policy. In this connection, a recent International Monetary Fund (IMF) study has shown, using monthly data, that inflation in Pakistan in recent years can partly be explained by lagged growth of credit

from the Chart, the output gap has a strong positive correlation with core inflation. The

to the private sector and lagged growth of money.¹ Here we illustrate the point with

¹Khan, Mohsin S. and Axel Schimmelpfennig, 2006, "Inflation in Pakistan: Money or Wheat?" IMF Working Paper, WP/06/60.

Growing Macroeconomic Imbalances

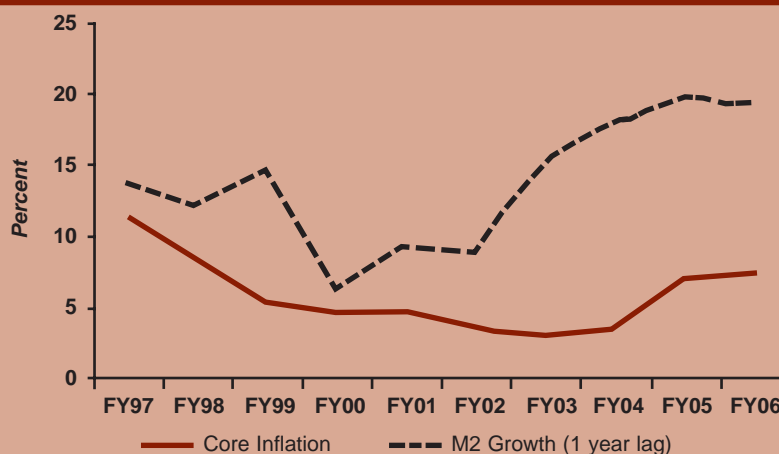
annual data. The downward trend in inflation from the mid-1990s to FY01 was accompanied by generally falling money growth rates, while the upward trend since FY03 has been accompanied by rising money growth rates (Chart 9). The general rise in core inflation since FY03 has also been accompanied by increases in private sector credit growth (Chart 10). Charts 9 and 10 suggest that monetary policy could be tightened further in an effort to contain inflation. But it should also be noted that both monetary and fiscal policies affect the output gap and, therefore, inflation. The output gap can still keep growing even with a tight monetary policy, if fiscal policy remains loose.

All in all, the above analysis suggests that without significant cooling of domestic demand, it will be very difficult for the government to achieve its inflation target of 6½ percent for FY07.

External Sector

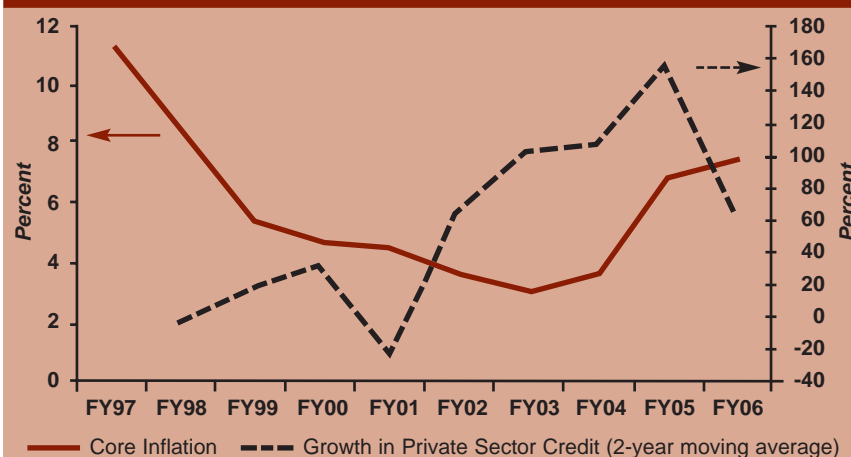
Following a three-fold rise in FY05, the trade deficit has further doubled in the first nine months of FY06 to \$6.1 billion from \$3.2 billion over the corresponding period in the previous year (Table 6). At an annual rate, this amounts to a trade deficit of \$8.1

Chart 9
Inflation and M2 Growth



Source: SBP, Annual Reports and SPDC computations

Chart 10
Inflation and Credit Growth



Source: GoP, Pakistan Economic Survey 2005-06

billion, or roughly 5½ percent of GDP. The increase in the deficit reflects a surge of 30 percent in imports (f.o.b) in the first nine months of FY06 versus a rise in exports (f.o.b.) of about 11 percent. In the case of Pakistan, a rise in merchandise imports also brings forth an increased demand for shipping and insurance services, which are also largely imported. Hence, the external deficit on services has also widened, as

Growing Macroeconomic Imbalances

Table 6
Current Account

	FY04	FY05	July - March	
			FY05	FY06
Trade Balance	-1208	-4352	-3202	-6104
Exports (f.o.b)	12396	14401	10641	11854
Imports (f.o.b)	-13604	-18753	-13843	-17958
Services (Net)	-3594	-5841	-4230	-5393
Receipts	2894	3837	2717	3383
Payments	-6488	-9678	-6947	-8776
Shipment	-1253	-1713	-1281	-1622
Investment Income	-2394	-2823	-1895	-2413
Others	-1763	-2866	-2044	-3748
Private Unrequited Transfers (net)	6116	8440	6251	6801
Workers Remittances	3871	4168	3050	3228
Current Account Balance	1314	-1753	-1181	-4695
Trade Balance as % of GDP	3.3	5.6	-	-
Current Account Balance as % of GDP	1.4	-1.6	-	-

Source: GoP, Pakistan Economic Survey, 2005-06

shown in Table 6, from \$4.2 billion in the first nine months of FY05 to \$5.4 billion in the corresponding period of FY06. This represents a 27 percent rise in the services deficit and the deficit on services is now 88 percent of the merchandise trade deficit.

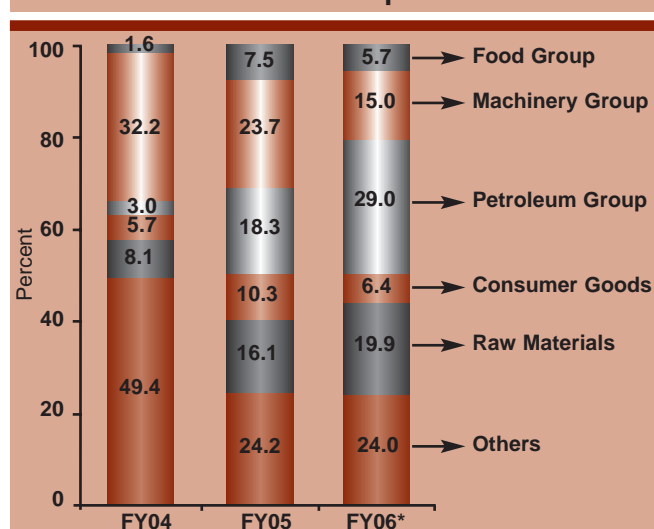
As Table 6 shows, overall private net transfers and workers remittances have increased somewhat. However, the sharp widening of the deficit on goods and services has meant that the overall current account deficit has widened in the first nine months of FY06 to \$4.7 billion, about four times its value in the corresponding period of FY05. At an annual rate, the current account deficit is about \$6.3 billion, or more than 4 percent of GDP.

The details of the import growth can be seen in Table 7. There has been a sharp increase in the import of goods in the petroleum group, which rose 65 percent in the first nine months of FY06 because of rising world oil prices. Imports in the raw materials and machinery group categories have continued to record robust growth, but there has also been substantial growth in

imports of consumer goods as well as goods falling in the 'Others' category. Thus, machinery imports and imports of raw material do not account for the bulk of the increases in imports. This can be seen by considering the contributions to import growth of different types of imports, displayed in Chart 11. The petroleum group accounts for about 29 percent of the growth in imports in FY06, while machinery and raw materials imports together account for another 35 percent. Thus, more than one-third of the import growth is accounted for by imports in categories other than these three.

Moreover, imports of machinery and raw materials have accounted for about 40 percent of total import growth in FY04 and FY05, but this has not led to the kind of surge in investment and, in turn, in exports that was expected. With the level of imports now substantially above that of exports, export

Chart 11
Contributions to Import Growth



*July - March

Source: SPDC computations based on data from the GoP, Pakistan Economic Survey 2005-06

Growing Macroeconomic Imbalances

Table 7
Major Imports

(Values in US\$ Million)

	FY04		FY05		Growth (%)		July-March FY05		July-March FY06		July-March Growth (%)	
	Value	% Share	Value	% Share	Value	Quantity	Value	% Share	Value	% Share	Value	Quantity
Food Group	1033.3	6.6	1408.8	6.8	36.34		990.7	6.9	1346.7	6.5	35.9	
Wheat Unmilled	23.6		93.0		294.1	295.2	70.1		94.6		34.9	99.1
Tea	192.5		222.6		15.6	16.1	174.4		180.1		3.3	0.7
Soyabean Oil	45.6		54.5		19.5	-9.2	48.9		13.2		-72.9	-70.9
Palm Oil	613.0		703.2		14.7	19.6	511.5		544.4		6.4	15.6
Pulses	74.9		122.5		63.6	43.1	83.2		125.9		51.3	40.0
Others	83.7		213.0		154.5		102.5		388.5		279.0	
Machinery Group	3309.5	21.2	4493.9	21.8	35.8		3034.6	21.0	3970.5	19.2	30.8	
Power Generating	277.8		392.6		41.3	-	275.3		398.6		44.8	-
Office Machinery	209.5		273.5		30.5	-	193.9		197.9		2.1	-
Textile	598.0		928.6		55.3	-	700.0		664.2		-6.5	-
Construction & Mining	101.5		140.5		38.4	-	107.4		138.5		29.0	-
Aircraft, Ships & Boats	789.8		169.2		-78.6	-	132.8		90.9		-31.6	-
Agricultural Machinery	37.7		73.8		95.8	-	43.9		91.7		108.9	-
Others	1295.2		2515.7		94.2	-	1581.3		2398.7		51.7	-
Petroleum Group	3166.6	20.3	4080.7	19.8	28.9		2806.6	19.4	4615.8	22.3	64.5	
Petroleum Products	1401.4		1931.9		37.9	5.7	1195.4		1834.2		53.4	-5.1
Petroleum Crude	1765.1		2148.8		21.7	-0.4	1611.2		2781.6		72.6	-2.3
Consumer Goods	910.9	5.8	1424.3	6.9	56.4		957.7	6.6	1358.2	6.6	41.8	
Electrical & Apparatus	258.1		355.5		37.7	-	238.5		344.1		44.3	-
Road Motor Vehicles	652.8		1068.8		63.7	-	719.2		1014.1		41.0	-
Raw Materials	2797.7	17.9	3604.7	17.5	28.8		3446.9	23.9	4692.9	22.7	36.1	
Synthetic Fibre	106.1		146.9		38.5	13.9	109.1		188.3		72.6	83.2
Synthetic & Artificial Silk Yarn	118		130.2		10.3	2.3	100.3		178.2		77.7	73.7
Fertilizer	284.7		416.9		46.4	22.7	275.3		488.5		77.4	66.8
Insecticides	124.1		139.7		12.6	0.4	107.1		91.8		-14.3	-19.6
Plastic Material	549.3		792.9		44.3	12.8	587.0		757.1		29.0	16.6
Iron & Steel	512.0		222.1		-56.6	48.0	793.2		1314.0		65.7	41.5
Other Chemical Products	1564.9		1962.8		25.4	-	1474.9		1675.0		13.6	-
Others	4373.8	28.1	5585.7	27.1	27.7		3209.5	22.2	4709.2	22.8	46.7	
Total	15591.8	100.0	20598.1	100.0	32.11		14446	100.0	20693.2	100.0	43.2	

Source: GOP, Pakistan Economic Survey 2005-06 and the SBP Annual Report 2004-05

**Table 8
Major Exports**

	(Values in US\$ Million)														
	FY04			FY05			Growth (%)			July-March FY05			July-March FY06		
	Value	% Share		Value	% Share		Value	% Share	Quantity	Value	% Share		Value	% Share	Quantity
Primary Commodities	1264.4	10.3		1657.6	11.5		31.1			1171.1	11.5		1357.7	11.2	
Rice	634.5			932.3		46.9	58.6			625.0			835.2		32.9
Raw cotton	47.7			110		130.6	213.8			96.8			53.9		-50.0
Fish & Fish Preparation	152.9			138.9		-9.2	-6.3			101.5			132.1		20.0
Leather Tanned	252			303.6		20.6	14.9			219.7			196.8		-12.8
Fruits	102.7			90.7		-11.7	-21.1			74.8			90.3		17.5
Vegetables	31.3			34.9		11.5	-37.8			15.4			18.5		-2.7
Tobacco	13.3			11.4		-14.3	-			7.0			4.4		-37.1
Spices	19.1			14.2		-25.7	-			10.4			17.5		63.1
Oil seeds, Nuts and Kernels	11.2			21.6		92.9	53.8			20.5			8.9		-53.3
Textile Manufactures	8073.0	65.6		8465.0	58.8	4.9				6041.0	59.3		7201.5	59.7	
Cotton Yarn	1126.9			1054.7		-6.4	1.0			760.1			983.5		34.7
Cotton Cloth	1711.5			1858.3		8.6	-0.6			1336.3			1556.5		15.1
Knitwear	1458.7			1631.5		11.8	6.8			1217.2			1269.8		7.2
Bedwear	1383.3			1446.8		4.6	8.1			943.2			1494.3		57.7
Towels	403.5			519.9		28.8	36.5			376.1			421.1		13.5
Readymade Garments	993.3			1086.0		9.3	23.7			765.1			1002.1		16.7
Synthetic Textiles	470.8			297.8		-36.7	-39.1			232.0			146.3		-32.1
Made-up Articles	416.6			466.0		11.9	-			357.6			309.2		-
Others	108.4			104.0		-4.1	-			53.4			18.7		-
Other Manufactures	1897.4	15.4		2357.5	16.4	24.3				1827.7	17.9		2263.2	18.7	
Carpets, Rugs & Mats	231.4			277.8		20.1	20.2			198.2			199.8		0.8
Petroleum & Petroleum Products	294.5			495.6		68.3	28.9			311.6			563.3		39.7
Sports Goods	324.8			307.1		-5.4	-17.6			216.1			228.4		5.7
Leather Manufactures	414.3			526.3		27.0	111.9			375.3			540.5		-2.1
Footwear	10.8			182.7		37.8	50.1			71.5			95.1		-
Surgical Goods & Instruments	132.6			34.3		15.6	4.6			136.5			117.3		-14.1
Cutlery	29.7			8.7		-24.8	-2.9			23.4			25.3		8.4
Onyx Manufactured	263.0			452.6		72.1	189.6			6.4			9.1		41.0
Chemicals & Pharmaceuticals	100.0					-	-			282.5			299.6		6.1
Engineering Goods	28.2					-	-			122.8			135.4		10.3
Gems & Jewelry	9.7					-	-			18.5			12.6		-31.7
Furniture	46.9			72.4		54.5	25.6			9.1			8.1		-10.0
Molasses										55.9			28.7		-48.6
Others	1079	8.8		1911	13.3	77.2				1142.9	11.2		1250.5	10.4	9.4
Total	12313.3	100.0		14391.0	100.0	16.9				10182.7	100.0		12072.9	100.0	18.6

Source: GoP, Pakistan Economic Survey 2005-06 and the SBP Annual Report 2004-05

Growing Macroeconomic Imbalances

growth would have to outpace import growth by a considerable margin for the trade gap to close. This cannot happen without a sharp slowdown in import growth.

The growth rates of major exports are shown in Table 8. Data from the first nine months of FY06 show that growth in exports of primary commodities has slowed, largely reflecting a fall in exports of raw cotton and of tobacco. However, this has been more than made up by an increase in the growth of exports of textiles manufactures, which rose 19 percent in value in the first nine months of FY06. In some categories of textiles, values have risen faster than quantities, suggesting an increase in unit values, while in other categories unit values have fallen. Exports of other manufactures have also continued to grow at the strong pace of last year of around 24 percent. However, non-traditional "other" exports have seen a slowdown in growth from 77 percent last year to just 10 percent in the first nine months of FY06, suggesting that not enough diversification is taking place in exports.

Overall, export performance appears to have been satisfactory and it is the surge in imports - rather than weak export performance - which is behind the sharp widening of Pakistan's current account deficit.

The financing of the trade deficit on goods and services is the subject of Table 9.

Net transfer payments reached \$6.8 billion in the first nine months of FY06, which was higher than transfer payments in the same months of FY05. About half of these transfer payments constitute remittances from abroad. However, because the trade and services gap increased from \$7.4 billion to \$11.5 billion, these transfer payments were able to finance only about 59 percent of the deficit as opposed to 84 percent previously. Thus, other modes of financing have had to increase, with the primary source of the increase being long-term capital inflows, which more than doubled.

It seems that the current account deficit can be financed in the short run through privatization receipts, borrowing from abroad, remittances and other transfer payments, as well as earthquake reconstruction-related inflows. However, there is a risk of the sudden slippage of these flows in the future. This is especially so in the current environment of lower global appetite for risk, which is leading to withdrawal of assets from emerging market countries. If the financing were to dry up, either a large loss of international reserves or a sudden correction in the current account deficit would have to occur. This correction, in turn, usually comes in one of two forms - import compression through a sharp slowdown in economic growth or a sudden and large depreciation of

Table 9
Financing of the Trade Deficit on Goods and Services

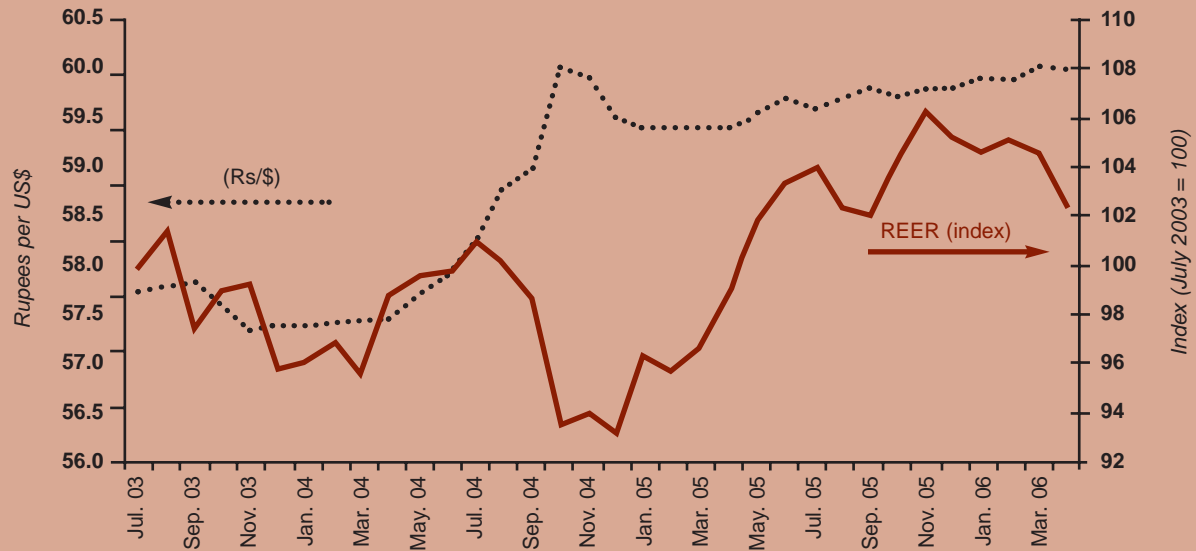
(US\$ Million)

	FY04	FY05	July - March	
			FY05	FY06
Trade Deficit (Goods & Services)	4802	10193	7432	11497
Financing of Trade Deficit				
Transfer Payments (net)	6116	8440	6251	6801
<i>of which workers remittances</i>	3871	4168	3050	3228
Long-term Capital (net)	-201	2552	1633	3905
Medium and Short-term Capital/Assets (net)	-95	482	553	562
Exceptional Financing	-55	-55	-55	-55
Change in Reserves	-826	-372	-510	-124
Errors and Omissions (net)	-137	-854	-440	408

Source: GoP, Pakistan Economic Survey 2005-06

Growing Macroeconomic Imbalances

Chart 12
Nominal and Real Effective Exchange Rates



Source: GoP, Pakistan Economic Survey and the SBP Annual Report 2004-05 (Statistical Table 9.2)

the exchange rate, which makes imports more expensive.

In terms of other indicators of stress, in addition to the size of the current account deficit itself, the literature on Early Warning Systems teaches us that real overvaluation of the currency can be a significant indicator of underlying stress on the external side. In the case of Pakistan, since late 2004, the Pakistani Rupee has depreciated only very modestly (by a total of just about 1 percent) against the US Dollar. However, the inflation differential between Pakistan and its trading partners has made the relative price of Pakistani goods - or the Real Effective Exchange Rate (REER) - 10 percent higher (Chart 12).

Moreover, even though the level of international reserves has not decreased

much, how many months of imports can be financed with these reserves - another standard indicator of stress - has recently taken a turn for the worse (Chart 13). This is because of the sharp increase in imports. It should be noted, though, that the value of

Chart 13
International Reserves Coverage of Imports



Source: SBP, Statistical Bulletin June 2006.

Growing Macroeconomic Imbalances

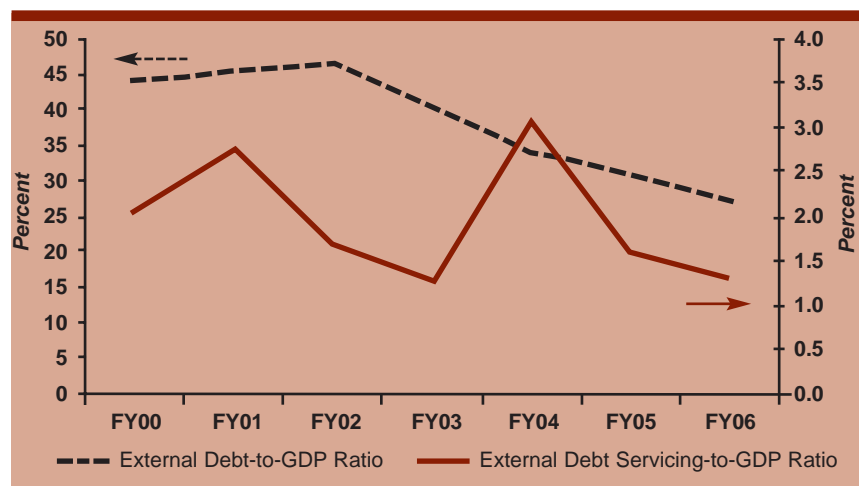
this variable is still significantly better than the historical average for Pakistan. Also, the external debt-to-GDP and external debt-servicing-to-GDP ratios, which are also standard indicators of stress, have continued to decline (Chart 14).

FISCAL ANALYSIS

Budget Deficit

The revised fiscal deficit of Rs328 billion for FY06 is Rs33 billion (or 11 percent) more than what was earlier budgeted (Table 10). Both net revenue receipts and government expenditures were higher than expected. As a percentage of GDP, however, the revised deficit stands at 4.2 percent, which is slightly lower than what was originally projected.

Chart 14
External Debt and Servicing



Source: GoP, Pakistan Economic Survey 2005-06

The deficit is projected to increase to about Rs394 billion in FY07, which would amount to 4.5 percent of GDP. This is under the assumption that the government's growth target of 7 percent and inflation target of 6½ percent are achieved. A 39 percent higher-than-revised and a 60 percent higher-than-budgeted level of

Table 10
The Federal Budget

(Rs Billion)

Categories	FY06		Growth (%) (2 over 1)	FY07	
	Budgeted (1)	Revised (2)		Budgeted (3)	Growth (%) (3 over 2)
Current Expenditures	826.5	918.8	11.2	879.8	-4.2
Minus Repayment of Foreign Loans	65.3	63.6	-2.7	56.3	-11.4
Current Expenditures (Excluding Repayments of Foreign Debt)	761.2	855.2	12.4	823.4	-3.7
Plus Development Expenditures	272.0	313.7	15.3	435.0	38.7
Minus Net Revenue Receipts	643.1	721.3	12.2	704.6	-2.3
Minus Self-financing of PSDP by Provinces	41.0	74.7	82.1	85.6	14.7
Minus Recovery of Loans from Provinces	14.4	14.7	1.6	16.0	9.0
Minus Provincial Surplus	33.5	27.0	-19.2	53.8	99.1
Minus Net Recovery of Loans from Others/ Net Lending to Others	6.2	3.6	-41.4	5.0	37.7
FISCAL DEFICIT	295.0	327.6	11.1	393.5	20.1
FISCAL DEFICIT as % of GDP	4.5	4.2		4.5p	

p = Projected based on 7% economic growth and 6.5% inflation

Source: GoP, Federal Budget in Brief 2006-07

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development expenditure (relative to FY06) largely drives the expected increase in the deficit. This includes Rs50 billion spending targeted for rehabilitation and reconstruction related to the earthquake. Current expenditures are expected to fall nearly 4 percent relative to revised estimates of FY06, but the revised estimates were significantly higher than those originally budgeted. Also contributing to an increase in the federal budget deficit is a decline of more than 2 percent in net revenue receipts, largely because of a decline in non-tax revenue receipts. However, from budgeted amounts of FY06, net revenue receipts are expected to increase 9½ percent.

According to the figures in Table 10, which follow the IMF methodology and are slightly different from the government's official figures, the budget deficit will become more than the government's own recommended ceiling of 4 percent of GDP. This will happen for the second consecutive year. If we subtract the unusual earthquake-related spending of \$50 billion, the projection of the fiscal deficit for FY07 decreases to just below 4 percent of GDP. But this is still an excessively expansionary stance for fiscal policy in an environment of growing macroeconomic imbalances. As

the government's dissavings increase, pressure on the investment savings gap rises which, in turn, increases the need for external financing. In addition, with domestic demand already high, relative to domestic production, the rise in demand from the increased deficit has to be satisfied by importing more. This also puts pressure on prices to rise further.

The fiscal situation highlights an important dilemma that the government currently faces. The allocated increase in development expenditures is to be welcomed because of its potential to reduce poverty. And earthquake rehabilitation and reconstruction is essential. But the large increase in the PSDP also creates pressures on fiscal imbalances, as discussed above. The dilemma is how to ward off those pressures without compromising on the development expenditures. The answer is: expenditure switching and raising a lot more government revenue. In these dimensions, the budget falls short, as we will discuss later.

The modes of financing the fiscal deficit are shown in Table 11. The revised figures indicate that net external resources (including external borrowing) and privatization proceeds ended up financing a

Table 11
Fiscal Deficit Financing

(Rs Billion)

Heads	FY06		Growth (%) (2 over 1)	FY07 Budgeted (3)	Growth (%) (3 over 2)
	Budgeted (1)	Revised (2)			
FINANCING OF THE DEFICIT	295.0	327.6	11.1	393.5	20.1
Non-Bank Borrowings	55.4	22.3	-59.8	6.7	-70.1
Share (%)	18.8	6.8	-	1.7	-
Net External Resources	121.6	148.5	22.1	171.7	15.7
Share (%)	41.2	45.3	-	43.6	-
Bank Borrowings	98.0	66.8	-31.8	140.1	109.6
Share (%)	33.2	20.4	-	35.6	-
Privatization Proceeds	20.0	90.0	350.0	75.0	-16.7
Share (%)	6.8	27.5	-	19.1	-

Source: GoP, Federal Budget in Brief 2006-07

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greater share of the deficit in FY06 than what was originally anticipated. Their respective share in the total financing were 45 percent and 28 percent, respectively. The share of bank borrowings (including that from the SBP) decreased in the revised figures to 20 percent from a 33 percent budgeted share. However, a fifth of the deficit was still financed by bank borrowings, which seem too high in an inflationary environment.

Moreover, in the proposed FY07 budget, bank borrowings are expected to increase 110 percent compared with the revised estimates of FY06, which would bring up the share of bank borrowing in total financing to 36 percent. This stance is highly inflationary. Domestic non-bank borrowings, which include issuance of domestic government bonds, are expected to decrease 70 percent relative to the revised estimates of FY06. This suggests that the government has very limited intention of attracting savings and issuing new PIBs during FY07. Privatization proceeds are expected to decline by 17 percent, but still yield a sizable amount of about Rs75 billion in FY07.

Expenditures

Table 12 provides a comparison of budgeted and actual federal expenditures. Revised figures indicate that the federal government's current expenditures for FY06 are now estimated to be about Rs918 billion, which is about 11 percent higher than what was budgeted. Revised estimates of defence expenditures are Rs241 billion while the budgeted amount was Rs224 billion. The overshooting rate of the target for defence expenditures has declined in FY06 if compared to the previous two years, but was still a significant 8 percent. Thus, there has been a continuation of the tendency for current expenditures to exceed their targets by substantial amounts. This has been happening year after year.

The target for development expenditures was met in FY05. This happened after a number of years. It was a welcome change, as such expenditures are more productive and, therefore, more growth-inducing and also potentially more pro-poor. In FY06, development expenditures are estimated to have been Rs314 billion, relative to a budgeted amount of Rs272 billion. However, according to the SBP's Second Quarterly Report for FY06, during the Jul-Dec period of that fiscal year, the extent of earthquake related spending was Rs30 billion. If we subtract this from the revised figures for development expenditures, the expenditures would be more or less on track.

A detailed analysis of the budgeted allocations in FY07 for development expenditures, relief and subsidy measures as well as current expenditures follows.

Table 12
Budgeted and Actual Federal Expenditure
(Rs Billion)

	FY03	FY04*	FY05*	FY06**
Current Expenditures				
Budget Estimates	608.0	645.2	700.8	826.5
Actual	673.3	714.0	784.7	918.8
Actual as % of B.E.	110.7	110.7	112.0	111.2
Defence				
Budget Estimates	146.0	160.3	193.9	223.5
Actual	160.1	180.5	216.3	241.1
Actual as % of B.E.	109.6	112.6	111.5	107.9
Debt Servicing				
Budget Estimates	289.7	256.0	265.3	301.4
Actual	257.4	317.7	274.7	304.8
Actual as % of B.E.	88.9	124.1	103.5	101.1
PSDP				
Budget Estimates	134.0	160.0	202.0	272.0
Actual	129.2	154.4	202.0	313.7
Actual as % of B.E.	96.4	96.5	100.0	115.3

*Revised estimates only for PSDP, not actuals

**Estimates are revised figures, not actuals

Source: SBP, Annual Report and the GoP, Federal Budget in Brief, various issues

Growing Macroeconomic Imbalances

Table 13
Development Expenditure

(Rs Billion)

Ministries/Divisions	FY06		FY07		Growth (%)
	Budget	Share in Total (%)	Budget	Share in Total (%)	
Federal	204.0	75.0	270.0	62.1	32.4
Infrastructural Development	92.9	34.2	119.5	27.5	28.6
WAPDA	48.9	18.0	70.7	16.2	44.6
Pakistan Atomic Energy Commission	6.3	2.3	9.8	2.3	57.0
Communications Division	24.3	8.9	25.6	5.9	5.0
Railways Division	10.8	4.0	10.9	2.5	1.1
Miscellaneous	2.7	1.0	2.5	0.6	-5.8
Social Development	85.3	31.4	119.0	27.4	39.6
Special Programme	19.1	7.0	34.4	7.9	80.3
Finance Division	11.1	4.1	9.0	2.1	-19.4
Education Division & HEC	15.1	5.5	22.9	5.3	51.8
Health Division	8.3	3.1	11.0	2.5	32.6
IT, Telecom, Science & Technology	5.2	1.9	7.7	1.8	47.1
Population Welfare Division	4.4	1.6	4.4	1.0	-1.4
Women Welfare Division	0.5	0.2	0.3	0.1	-41.1
KA & NA Division	8.8	3.2	10.7	2.5	21.2
States & Frontier Regions Division	5.2	1.9	6.2	1.4	20.4
Environment Division	2.9	1.1	5.8	1.3	97.7
Miscellaneous	4.7	1.7	6.7	1.5	44.3
Others	25.8	9.5	31.5	7.2	22.1
Food, Agriculture & Livestock Division	9.9	3.6	11.8	2.7	19.6
Interior Division	6.3	2.3	8.0	1.8	26.6
Law Justice & Human Rights Division	4.1	1.5	4.1	0.9	1.1
Miscellaneous	5.5	2.0	7.5	1.7	36.9
Provincial	68.0	25.0	115.0	26.4	69.1
Earthquake Related	0.0	-	50.0	11.5	-
Total Development Outlay*	272.0	100.0	435.0	100.0	59.9

*Revised estimate for FY06 is Rs313.7 billion

Source: SPDC Estimates based on GoP, PSDP 2006-07

Public Sector Development Programme

Table 13 provides a comparison of the budgeted allocations of various kinds of development expenditures in FY07 to those in FY06. Note that although revised figures for the total development outlays for FY06 are available, those for the components of development expenditures have not been reported in the GoP, PSDP 2006-07. Hence a detailed comparison of amounts allocated in FY07 versus revised estimates of FY06 for different types of development outlays is not easily possible.

The size of the PSDP has been increased by 60 percent, from Rs272 billion to Rs435 billion. Even if we exclude the Rs50 billion earmarked for the Earthquake Relief and Reconstruction Authority (ERRA), the increase in the PSDP would be nearly 42 percent. If these projections are realized, the share of development expenditures in total federal expenditures (excluding earthquake related expenditure) would go up to about 30 percent in FY07, from about 24 percent according to revised data of FY06.

Growing Macroeconomic Imbalances

As indicated in the Table, federal allocations for infrastructure development show an increase of about 29 percent while those for social development show a higher increase of about 40 percent. Their share in total allocation of development expenditures, however, is going down, but this is only because earthquake-related allocations constitute 11½ percent of the total. Of the Rs66 billion increase in budgeted amounts for the federal component of the PSDP in FY07, 33 percent is accounted for by an increase in Water and Power Development Authority (WAPDA) expenditures, 23 percent by special programmes and 12 percent by the education division. The spending by WAPDA remains largely on rural electrification facilities, which is a positive sign.

One negative aspect of the federal component of the PSDP is the almost 45 percent reduction in the allocation for women development, from Rs489 million in FY06 to Rs270 million in FY07. This will hamper gender-specific programmes such as the Gender Reform Action Plan (GRAP), the Economic Empowerment of Women ("Jafakash Aurat") and the Women in Distress Project (WDP). One reason for the decrease in allocation may be severe underutilization of this component in the past. Originally, an amount of Rs625 million was allocated for the Ministry of Women Development during FY05, but only a meager 18 percent was utilized according to revised figures. Subsequently, a reduced amount of Rs489 million was allocated in FY06, out of which Rs430 million (or about 88 percent) was estimated to have been utilized through June 2006.²

Overall, the much-increased allocation for development expenditures is potentially a very strong pro-poor aspect of the budget and should be lauded. Too often in the past when fiscal consolidation has had to take

place, the axe has fallen on the most productive and pro-poor kind of government expenditure, which are expenditures on development programmes. However, as SPDC has argued in the past - and it is a point worth repeating - the PSDP is seriously hampered by weak utilization, monitoring and delivery mechanisms. These need to be overhauled and vastly improved for the programme to become more effective. Moreover, given the GoP's commitment to gender equality and equitable development, much more information needs to be provided in the federal and provincial budgets to be able to analyze the gender aspects more fully.

Relief and Subsidy Measures

Before its release, the hype surrounding the Federal Budget 2006-07 was that it would provide substantial relief to the common man and be pro-poor. Besides the hefty increase in the size of the PSDP, there are some other relief and subsidy measures as well that need to be highlighted. Some of these measures target specific groups and would not benefit the general population. This includes an increase in the dearness allowance and pensions of government employees.

But there are some broader measures as well, such as an increase in the minimum wage from Rs3,000 per month to Rs4,000 per month, an increase in the tax exempt level of income from Rs100,000 per annum to Rs150,000 per annum and a decline in effective income tax rates for low-salaried workers. In addition, special tax concessions for women taxpayers have been made. This will reduce the female tax liability as compared to males. Perhaps, by encouraging women to join the labour force and enter the formal sector, this measure might lead to some improvement in the empowerment of women workers.

²SPDC wishes to thank researchers at the GoP, Gender Responsive Budgeting Initiative (GRBI) for providing useful information about gender aspects of the federal budget.

Growing Macroeconomic Imbalances

Table 14
Subsidy and Relief Measures

(Rs Billion)

	FY06				FY07		Growth (%) (5 over 3)
	Budget (1)	Share (%) (2)	Revised (3)	Share (%) (4)	Budget (5)	Share (%) (6)	
Power	55.0	59	44.0	53	59.0	54	34
Fuel	7.0	8	8.0	10	10.0	9	25
Food	4.0	4	4.0	5	12.0	11	200
<i>of which</i>							
TCP-Import of Sugar	0.6		0.6		5.2		
TCP-Import of Wheat	3.3		3.3		2.0		
Fertilizer	7.0	8	7.0	8	13.0	12	86
Safety Net	5.0	5	5.0	6	5.0	5	0
Pay/Pension Relief	15.0	16	15.0	18	10.0	9	-33
Total	93.0		83.0		109.0		31

Source: GoP, Federal Budget in Brief 2006-07

As shown in Table 14, there is an increase of 200 percent in food subsidies, from Rs4 billion (according to revised estimates of FY06) to Rs12 billion in FY07. This will take the share of food subsidies in total relief and subsidy allocations from 5 percent to 11 percent. Of the Rs12 billion total food subsidies in FY07, Rs7.2 billion will go to the Trading Corporation of Pakistan (TCP) for import of wheat and sugar. Of this Rs7.2 billion, Rs5.2 billion is earmarked for importing sugar alone. Thus, the food relief measures appear to be rather narrow-based.

According to government plans, a big chunk of the Rs8 billion increase in food subsidies is to be distributed through controlled prices of Daal (lentils) and other essential food items at Utility Stores (government-run subsidized essential items stores). It is questionable how effective this will be in making food more affordable to the vast majority of low-income people. Almost all of the 560 existing Utility Stores are located in the urban areas. With an urban population of about 56 million, this means that there is roughly one Utility Store per 100,000 persons in the urban areas alone. Balochistan has 20 Utility Stores for the whole province while there are 26 such

stores in Islamabad alone. The government is planning to increase the number of Utility Stores to 1,000 in 6 to 8 months, but even this increase will be inadequate. It is doubtful if those in most need of food relief will have adequate access to Utility Stores and even if they do, how will it be ensured that they are given priority for purchasing the limited quantities of the goods that are available at subsidized prices?

Furthermore, the recent price hikes are in many cases because of administrative loopholes and failures, which lead to excess profiteering and hoarding, rather than purely as a result of market forces. Using subsidies, without addressing these fundamental administrative problems, does not get rid of the root problem and sends the wrong message to hoarders, which is that their activities will be tolerated.

Table 14 also shows that fertilizer subsidies will rise from an estimated Rs7 billion in FY06 to a projected Rs13 billion in FY07. This is an increase of 86 percent. As in previous years, though, the power sector continues to dominate the allocation of government subsidies, with a share of more than 50 percent. These power subsidies are either ad hoc subsidies or subsidies to cushion WAPDA losses.

Growing Macroeconomic Imbalances

Table 15
Current Expenditure

Heads	FY06			FY07	
	Budgeted (1)	Revised (2)	Growth (%) (2 over 1)	Budgeted (3)	Growth (%) (3 over 2)
Total Current Expenditure	826.5	918.8	11.2	879.8	-4.2
<i>of which expenditure related to</i>					
Civil Administration	121.1	86.5	-28.6	133.2	54.0
Debt Servicing	301.4	304.8	1.1	295.8	-2.9
Defence Expenditure	223.5	241.1	7.9	250.2	3.8
Community, Social & Economic Services	100.8	115.2	14.3	126.5	9.8
Transfer Payments	79.8	171.2	114.7	74.0	-56.8
Provincial Grants	41.3	63.5	53.7	29.3	-53.9
Subsidies & Miscellaneous	27.7	96.5	248.0	33.2	-65.6
Other Transfers	10.7	11.2	4.6	11.5	2.8

Source: GoP, Federal Budget in Brief and Demand for Grants, 2006-07

Although there are relief measures in the budget, their importance should not be exaggerated. Not counting the tax relief discussed earlier, the government's total relief and subsidy measures for FY07 shown in Table 14 amount to Rs109 billion. This represents an increase of more than 30 percent. However, as a share of projected GDP, they are 1.2 percent, only slightly higher than the 1.1 percent of GDP they were estimated to be in FY06, according to the revised figures.

Other Current Expenditures

Selected major components of current expenditures are shown in Table 15. Total current expenditures are projected to be 4¼ percent less during FY07 than revised estimates for FY06. However, given the overshooting of the target by 11 percent in FY06, relative to budgeted amounts, they will still rise by about 6½ percent. This is equal to the target for the inflation rate, so that in real terms current expenditures are projected not to rise relative to budgeted amounts. Even if it is conceded that the projections will be achieved (in spite of the government's track record of this in the past), we would argue that the reigning in of current expenditures still does not go far enough. The development expenditures

that are so vital to long-term growth and in alleviation of poverty should partly be financed by expenditure switching, at least in real terms, so that current expenditures should rise at less than the rate of inflation from budgeted amounts and these budgeted amounts should not be overshoot.

Considering the components, Civil Administration expenditures are to go up by 54 percent from revised estimates, but this is partly explained by the fact that the revised estimates came below the original budgeted amount by nearly 30 percent. Defence expenditures are projected to increase a further 3.8 percent in FY07 after coming in at 8 percent above target in FY06. Debt servicing costs are slated to fall 3 percent relative to revised estimates, but this would be a challenge to achieve given the rising interest rates and the increase in the fiscal deficit.

Note that grants-in-aid to provinces and expenditure on subsidies are reduced significantly by 54 percent and 66 percent respectively. Although these expenditures did substantially exceed their targets in FY06, it does seem that the burden of controlling current expenditures seems to be falling more heavily on the kind of current expenditures that represent pro-poor services.

Table 16
Target and Actual Federal Receipts
(Rs Billion)

	FY03	FY04	FY05*	FY06**
Gross Revenue Receipts				
Target	674.9	728.4	796.3	927.4
Actual	703.7	772.0	875.7	1,022.7
Actual as % of Target	104.3	106.0	110.0	110.3
Tax Revenues (CBR)				
Target	460.6	510.0	580.0	690.0
Actual	461.0	510.0	590.4	704.0
Actual as % of Target	100.1	100.2	101.8	102.0
Direct Taxes				
Target	148.4	161.1	181.9	215.4
Actual	152.0	165.0	183.4	225.0
Actual as % of Target	102.4	102.4	100.8	104.5
Indirect Taxes‡				
Target	312.2	348.9	398.1	474.6
Actual	309.0	356.0	407.0	479.0
Actual as % of Target	99.0	102.0	102.2	100.9
Non-Tax Revenues				
Target	153.8	157.2	141.5	194.8
Actual	175.8	180.9	249.0	264.5
Actual as % of Target	114.3	115.0	176.0	135.8

Note: Non-Tax Revenue for FY04 & FY05 also includes Workers' Profit Participation Tax, Foreign Travel Tax and Airport Tax.

‡ Excluding ICT (Islamabad Capital Territory) Tax, which is a Non-CBR Tax.

* Revised estimates for Non-Tax Revenues, otherwise actuals

** All revised estimates instead of actuals.

Source: Targets and Revised Estimates are from the GoP, Federal Budget in Brief, various issues. Actuals are from SBP Annual Report, various issues and SBP website

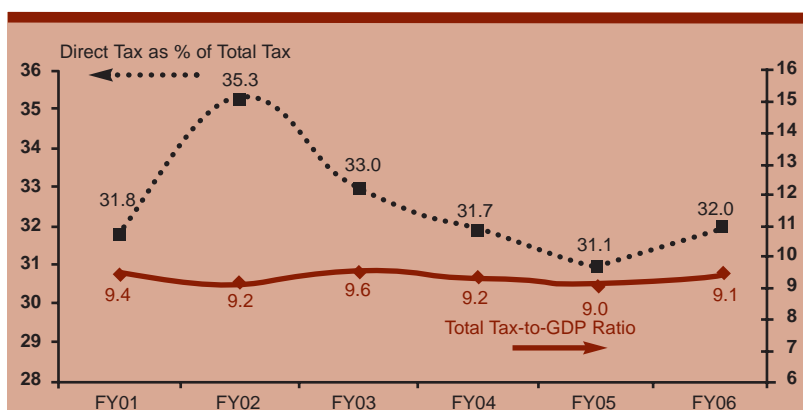
Revenues

Table 16 provides a comparison of budgeted and revised figures of gross revenue receipts and their components. Gross revenue receipts are estimated to have crossed the Rs1 trillion mark during FY06, more than 10 percent higher than the target set in last year's budget. This is largely driven by a 36 percent increase in non-tax revenue receipts compared to the budgeted amounts for these. Despite the strong performance in this category of receipts during the past few years, it should nonetheless be recognized that in the long run, this component is volatile and its sustainability cannot be counted upon.

Overall, Central Board of Revenue (CBR) tax receipts also came in above the target during FY06 by about 2 percent. Revenues from indirect taxes were at about their targeted level while those from direct taxes exceeded the target by about 5 percent. Although the target for tax revenues was met, two points with respect to this are worth emphasizing. First, the target being exceeded can partly be explained by the fact that inflation, and therefore, nominal income or the tax base, was higher than originally envisaged. As a

percentage of GDP, tax revenue hardly changed at all, increasing from 9 percent in FY05 to 9.1 percent in FY 06, as shown in Chart 15. Second, the Chart also shows that even though direct tax revenues as a share of total tax revenue have started to increase again, this ratio still remains low and significantly below the 35 percent level of FY02. The tax system needs to be made more progressive through an increase in direct taxes relative to indirect taxes.

Chart 15
Tax Shares (Percent)



Source: SPDC Computations based on the GoP, Pakistan Economic Survey 2005-06, SBP website and the Federal Budget in Brief 2006-07

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In FY07, CBR tax revenues are projected to increase to Rs829 billion from Rs704 billion in FY06. This is an increase of nearly 18 percent (Table 17). It would outpace the increase in nominal income, expected to be about 13½ percent, based on the government's target of 7 percent growth and 6½ percent inflation. However, given the low tax ratio, the difference in these growth rates would only raise the tax-to-GDP ratio by about ½

a percentage point, from 9.1 percent to 9.6 percent. This is low, even by developing country standards. A lot more tax revenue needs to be raised by the government for the pro-poor increases in development expenditures to be financed on a permanently sustainable basis. As can also be seen from the Table, direct tax revenues are expected to increase by 16.3 percent while indirect tax receipts are expected to go up by 18.3 percent. Thus, the share of direct taxes in the total is actually expected to fall slightly over the coming years, from about 32 percent to 31.6 percent.

The initiatives for new taxes in the FY07 budget fall well below expectations. Some new taxes, such as the Capital Value Tax (CVT) on property deals, have been introduced. However, the total tax revenue estimated from all new taxes in FY07 is about Rs25 billion, which amounts to just 0.3 percent of projected GDP. The exemption of taxes on capital gains from stock trading seems unjustified and should be withdrawn as soon as possible. All in all, the government has lost yet another opportunity for widening the tax net substantially through such measures as capital gains taxes and higher taxes on

Table 17
Growth in CBR Tax Collections

(Rs Billion)

	ACTUAL				Revised	Budgeted
	FY02	FY03	FY04	FY05	FY06	FY07
Tax Revenues	404	461	521	590	704	829
Growth (%)	-	14.0	13.1	13.4	19.2	17.7
Direct Taxes	143	152	165	183	225	262
Growth (%)	-	6.6	8.7	11.1	22.7	16.3
Indirect Taxes	262	309	356	407	479	567
Growth (%)	-	18.0	15.2	14.4	17.7	18.3
Customs Duties	48	69	91	115	136	157
Growth (%)	-	44.0	32.3	26.7	17.9	15.5
Federal Excise	47	45	46	53	57	68
Growth (%)	-	-5.2	1.8	16.6	6.4	20.5
Sales Tax	167	195	219	239	287	342
Growth (%)	-	17.2	12.3	8.8	20.1	19.2

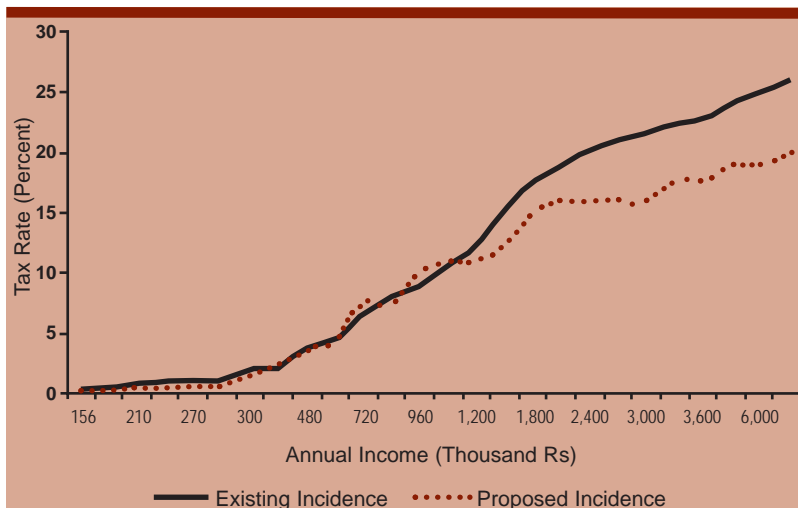
Source: SBP website and the GoP, Federal Budget in Brief 2006-07

income generated from services and agriculture.

The changes made to the existing income tax structure also leave much to be desired. The exact provisions - under which the income tax rates have declined but will now be applicable to gross salary (including house rent and utility allowances) rather than just to basic salary only - will on the whole render the tax system less progressive. As shown in Chart 16, while these measures decrease the effective tax rates of low salary workers somewhat, they increase slightly the effective tax rates of middle-income salaried workers. More importantly, as can be seen clearly from the Chart, the most significant decline in the effective tax rates from these measures applies to the high-salaried workers - those earning a monthly gross income of Rs180,000 or more. This is because, given the limits on exemption of allowances in the previous system, most of the allowances of the high-salary class were already being taxed. This means that such workers will enjoy the lower tax rates without much increase in their taxable incomes. The resulting decline in the progressivity of the tax system will further increase income inequality.

Growing Macroeconomic Imbalances

Chart 16
Effective Tax Rates for Salary Income



Source: SPDC computations based on Budget Briefing 2006, Ford Rhodes Sidat Hyder and Company

Annual Cumulative Growth Rate (ACGR) of about 15 percent, increasing from Rs176 billion in FY03 to an estimated Rs265 billion in FY06. A particularly striking feature is that miscellaneous defence receipts are estimated to have accounted for Rs72 billion (or more than a quarter) of the total non-tax revenue. These receipts are mainly on account of army aviation facilities as well as receipts from the United Nations (UN), bolstered by Pakistan's role as an ally in the "War on Terror."

Table 18
Non-Tax Revenue

(Rs Billion)

	Revised Estimates				ACGR* (%)
	FY03	FY04	FY05	FY06	
Interest	54.0	67.3	61.1	45.2	-5.7
Provinces	28.0	26.4	24.3	21.6	-8.3
Local Bodies	10.7	12.4	13.1	15.0	11.9
Financial Institutions	4.2	5.4	5.3	4.8	4.7
Non- Financial Institutions	29.8	29.8	25.6	13.6	-23.0
WAPDA	26.5	27.6	23.6	11.1	-25.3
Other Autonm. Bodies/Corp.	3.2	2.1	2.0	2.5	-8.1
Govt. Servants, Commercial Deptt.,					
AJK & Others	3.5	4.7	6.9	5.2	14.2
Less: Estimated Shortfall	-22.2	-11.4	-14.0	-15.0	-12.2
Dividends & Returns	27.7	33.4	57.5	63.8	32.0
Defence	56.3	42.9	61.4	74.8	9.9
Effective & Non-Effective	2.5	2.5	2.9	3.0	5.7
Miscellaneous Receipts	53.8	40.4	58.5	71.9	10.1
All Others	37.8	37.3	69.0	80.7	28.8
TOTAL NON-TAX REVENUE	175.8	180.9	249.0	264.5	14.6

*ACGR = Annual Cumulative Growth Rate

Note: Prior to FY04, Non-Tax Revenue also includes Workers' Profit Participation Tax, Foreign Travel Tax and Airport Tax

Source: GoP, Explanatory Memorandum on Federal Receipts, various issues

Intergovernmental Relations

The government announced a new National Finance Commission (NFC) Award, the fourth NFC after the 1973 constitution, which will be applicable for the next five years. In the new NFC, the provincial share of the divisible pool is increased from 37.5 percent to 41.5 percent. In addition, a sixth of the sales tax, which was distributed as a grant to provinces to make up the abolition of octroi and Zila tax under the previous NFC, now becomes part of the divisible

Non-tax revenues are shown in Table 18. Since FY03, these have grown at an

pool. (See Box 1 for details of the NFC 2006 Award.)

Box 1

National Finance Commission Award: How Does it Work?

NFC Award includes three resources to be transferred to the provinces. These are:

Divisible Pool that includes taxes on income, Wealth Tax, CVT, taxes on sales and purchases, Sales Tax on Services (CE Mode), Custom Duties, Federal Excise (excluding excise duty on gas) and any other tax which may be levied by the federal government.

Straight Transfers that include royalties on crude oil and natural gas, Gas Development Surcharge, Excise Duty on Natural Gas and General Sales Tax on Services (Provincial Component).

Grants-in-Aid that usually target the most deprived provinces.

Revenue Distribution Formula under NFC 2006

After deducting 5 percent (and 6 percent in case of Income Tax) collection charge, federal government is liable to transfer the net proceeds of the divisible pool to the provinces on the basis of the following share.

Fiscal Year	% Share
2006-07	41.50
2007-08	42.50
2008-09	43.75
2009-10	45.00
2010-11 & onward	46.25

Out of the overall provincial share mentioned above, each province will get the proceeds based upon its population share, which is as follows:

Province	% Share of Population
Punjab	57.36
Sindh	23.71
NWFP	13.82
Balochistan	5.11

One-sixth of the Sales Tax, which remained the component of "Grants" under the previous NFC, has now been relocated to the divisible pool. Its distribution formula is different from the general divisible pool and is stated hereunder:

Province	% Share
Punjab	50.00
Sindh	34.85
NWFP	9.93
Balochistan	5.22

According to the NFC 2006, provincial governments will further transfer the whole amount of this one-sixth of Sales Tax to the district governments without retaining any part of it.

Under Straight Transfers, General Sales Tax (Provincial Component) is distributed among provinces on the basis of population share as mentioned above. The rest of the revenues, namely royalties on crude oil and natural gas, Gas Development Surcharge and Excise Duty on natural gas, are distributed among provinces on the basis of well-head production. Government deducts 2 percent collection charges before transferring them to the provinces.

Grants-in-Aid are distributed among provinces on the basis of the following shares:

Province	% Share
Punjab	11.00
Sindh	21.00
NWFP	35.00
Balochistan	33.00

The government highlights that the provinces will get an additional Rs94 billion in FY07 through divisible pool and straight transfers as compared to FY06. However, this is misleading for two reasons. First, it compares estimates of FY07 with budgeted figures rather than revised estimates for FY06. Second, the amount going to provinces would have increased to some extent in any case because of growth in the tax base. A more relevant and transparent procedure is to compare the resource allocation to provinces under the old and the new NFC Awards. This comparison is provided in Table 19. It shows that the

additional resource availability to the provinces as a result of the new NFC Award compared to what would have been the case with the old NFC Award is about Rs31 billion. In other words, of the increased budgeted allocation of Rs94 billion to the provinces, Rs63 billion would have occurred under the old NFC Award as well.

Table 20 highlights the transfers made by provincial governments to the federal government on account of interest payments, recovery of federal loans, PSDP self-financing and provincial surplus. Among these four heads, interest payments and loan repayments are physically

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Table 19
Additional Provincial Share in Revenue Receipts:
Comparison of the Old and New NFC

(Rs Billion)

	Provincial Share		Additional Provincial Share (2 minus 1)
	As per NFC 1997 (1)	As per NFC 2006 (2)	
Divisible Pool Transfers	290.1	321.1	30.9
Taxes on Income	90.9	100.6	9.7
Capital Value Tax	1.0	1.1	0.1
Overall Sales Tax	120.1	132.9	12.8
Federal Excise (Net of Gas)	22.1	24.5	2.4
Custom Duties	56.0	61.9	6.0
Straight Transfers	57.2	57.2	0.0
Royalty on Crude Oil	9.2	9.2	0.0
Royalty on Natural Gas	20.1	20.1	0.0
Gas Development Surcharge	17.7	17.7	0.0
Excise Duty on Natural Gas	5.9	5.9	0.0
G.S.T (Provincial)	4.3	4.3	0.0
Total Divisible Pool & Straight Transfers	347.3	378.3	30.9
Special Grants & Subventions*	29.3	29.3	0.0
Total Transfers through NFC Award	376.6	407.5	30.9

*One-sixth of the Sales Tax was the part under this head in NFC 97. It has been transferred to the divisible pool in NFC 06. Thus, it is assumed that the total amount remains the same under both NFC 1997 and NFC 2006.

Source: SPDC Estimates based on the GoP, Explanatory Memorandum on Federal Receipts and Federal Budget in Brief, 2006-07.

Table 20
Provincial Transfers to the Federal Government

(Rs Billion)

	Revised			Budget FY07
	FY 04	FY05	FY06	
Interest Receipts from Provinces	26.4	24.3	21.6	22.8
Recovery of Loans from Provinces	17.3	28.7	14.7	16.0
Self Financing of PSDP by Provinces	34.8	38.4	74.7	85.6
Provincial Surplus	14.3	6.2	27.0	53.8
Total Provincial Transfers (1 to 4)	92.8	97.6	138.0	178.2
Fiscal Deficit	173.9	246.0	327.6	393.5
Total Provincial Contribution in Containment of Fiscal Deficit (%)	53.4	39.7	42.1	45.3
Federal Transfers to Provinces*	243.8	280.6	364.9	407.5
Total Physical Provincial Transfers (1+2) to the Federal Government as % Federal Transfers to Provinces	17.9	18.9	9.9	9.5

* includes Divisible Pool Transfers, Straight Transfers and Special Grants and Subventions

Source: SPDC estimates based on the GoP, Federal Budget in Brief, various issues

transferred to the federal government by the provinces. The other two are not physically transferred, but add to total resources that the provinces contribute to in reducing the federal deficit. A positive development is that as a percentage of federal transfers to the provinces, the physical provincial transfers to the federal government in the form of interest payments and loan recovery have declined significantly since FY05.

POVERTY AND UNEMPLOYMENT

As discussed earlier, the Pakistan economy has shown an impressive growth trajectory for the last four years. For the first time since the revitalization of economic activity, the results of a representative and comparative household survey, Pakistan Social and Living-Standards Measurement (PSLM) Survey 2004-05, are available to analyze the impact of rapid economic growth and macroeconomic stability on poverty and income inequality.

Using a consistent methodology for defining and computing national and regional poverty incidences, SPDC keeps track record of intertemporal changes in poverty and the level of household income inequality. These indices are derived from the available unit record data of household surveys. Unfortunately, SPDC (and other independent research organizations and academic institutions to the best of our knowledge), have not yet been provided access to the latest household data from the PSLM 2004-05. As such, we are not in a position to directly participate in the debate on the poverty numbers. Nevertheless we will still attempt to do as much analysis as we can, based on the limited information we have.

Poverty

The GoP has declared a reduction of more than 10 percentage points in the poverty incidence over the 2001-2005

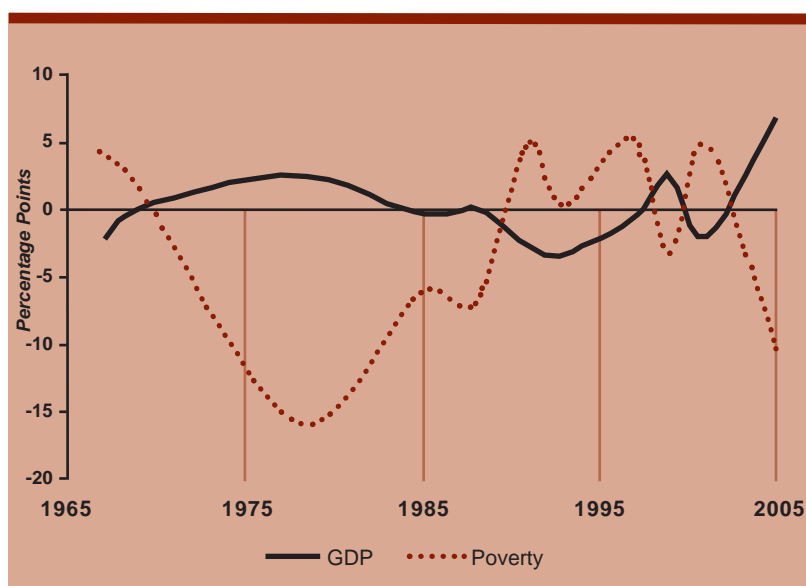
period, based on the new household survey. According to the Pakistan Economic Survey 2005-06, poverty has declined from about 34½ percent people living below the poverty line in 2001 to about 24 percent in 2005, or by 31 percent. This decline has been witnessed in rural as well as urban areas of the country. According to the government data, in urban areas, the incidence of poverty reduced from about 23 percent in 2001 to about 15 percent in 2005. And, in rural areas, it declined to around 28 percent in 2005 compared to 39 percent in 2001.

If the government figures are to be believed, this would be a phenomenal reduction in poverty over a period of just four years and a major international success story. The government argues that the latest figures strongly suggest that economic policies are moving in the right direction, the growth momentum is being sustained and the previously rising trend in poverty has been clearly reversed.

However, many among the researchers, the media and the public at large remain unconvinced and skeptical about the accuracy of the latest data on poverty. They usually - and it seems to SPDC, correctly - cite the rising trends in inflation (especially food prices), unemployment and level of inequality as factors that have tended to increase poverty and prevented the benefits of high growth from trickling down adequately to the poor segments of society. Poverty figures can be very sensitive to the exact methodology used and, therefore, the real situation is difficult to assess, especially without having access to the detailed data of the PSLM.

Based on the limited information we have, some reduction in the incidence of poverty over the 2001-2005 period seems plausible. The overall average annual growth rate of the economy over these four years was nearly 6 percent, compared to only 3.3 percent annually during the four years prior to that. There is now a virtual consensus among researchers that

Chart 17
Changes in GDP Growth and Poverty



Source: SPDC estimates and the GoP, Pakistan Economic Survey, various issues.

although economic growth may not always be a sufficient condition for poverty reduction, it is certainly a necessary one. Chart 17 illustrates the inverse relationship between poverty and economic growth in the case of Pakistan, based on data from 1965. This inverse relationship is consistent with poverty reduction over the past few years, given the strong growth trajectory. Moreover, the sharp increases in public spending concentrated on development programmes during the last three years has also created an enabling environment for poverty reduction. Another relevant factor is the timing of the two surveys. FY05 was an exceptionally good year in terms of growth and it was a bumper cotton crop whereas FY01 was a drought year.

However, it also seems very plausible that the government figures on poverty reduction provide an exaggerated picture of the extent of the underlying downward trend in poverty. As has been pointed out by the World Bank (WB) for example, the poverty figures can be very sensitive to which prices

are used to adjust the nominal poverty line upward for inflation.³ Moreover, inflation and income inequality were rising during the 2001-2005 period, partially offsetting the gains made on the poverty front because of the strong economic growth. According to SPDC's large-scale model of the Pakistan economy, these offsets were substantial.

The inflation trend has already been discussed. Below we discuss the inequality trend in more detail.

Inequality

During recent years, the role of income and asset distribution in the determinants of poverty is widely acknowledged by researchers. Development and poverty reduction strategies in Pakistan, however, have been based largely on the "primacy of growth" or "trickle-down" paradigm, which implies a built-in mechanism for growth leading to greater inequality in the distribution of income, at least in the short run. The empirical research of SPDC reveals a positive relationship between growth and inequality in the case of Pakistan. This prevents growth from having as much of a poverty-reducing impact as is potentially possible.

Table 21 and Chart 18 show the growth in average per capita consumption expenditure by quintiles (from lowest to highest 20 percent of population). There is a large difference (almost four-fold) in the growth rates between the consumption of the richest 20 percent of the population and the poorest 20 percent. Although this is

³See the June 20, 2006 issue of Daily Dawn (front page story).

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Table 21
Average Per Capita Monthly Real Consumption Expenditure

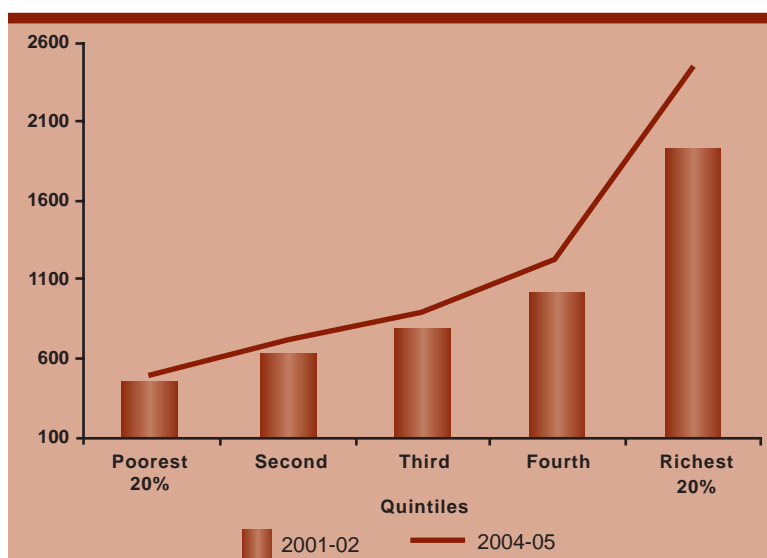
(Rs)

Expenditure Quintiles	HIES 2001-02	PSLM 2004-05 Nominal	PSLM 2004-05 Real	Average Annual Growth
Lowest 20% of Population	456	633	488	2.34
21-40% of Population	629	916	706	4.09
41-60% of Population	782	1169	901	5.09
61-80% of Population	1010	1590	1226	7.13
Highest 20% of Population	1928	3166	2441	8.87
Overall	965	1356	1045	2.78

Note: GDP Deflator for Consumption Expenditure is used to deflate 2005 figures.

Source: Average nominal quintile expenditures are taken from the GoP, PRSP Progress Report for the Second Quarter of Year 2005-06, www.finance.gov.pk

Chart 18
**Average Per Capita Monthly
Real Consumption Expenditure (Rs)**



Source: GoP, PRSP Progress Report for the Second Quarter of Year 2005-06, www.finance.gov.pk

based on consumption data, it does strongly suggest a worsening income distribution.

Unfortunately, SPDC cannot study the inequality trends more precisely by computing the income Gini coefficient - a widely used measure of income inequality - or income shares of the poorest and highest segments of the population. We will be able

to compute these standard measures of inequality only when we have all the unit record data from the latest household survey of 2004-05.

Employment

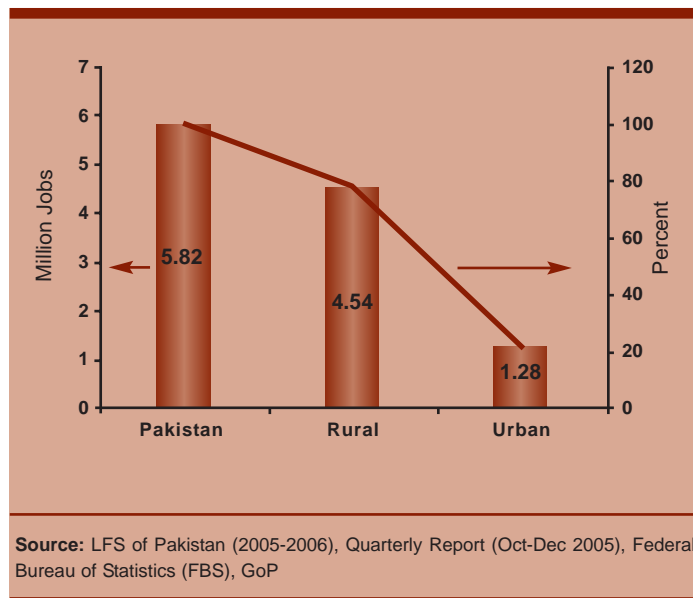
The annual Labour Force Survey (LFS) is routinely used to study changes in the employment situation in the country. The pertinent information is collected from a national representative sample of around 19,000 households spread over four quarters of the year in order to abstract from seasonal variations. However, the LFS for 2005-06 is being carried out for the first time ever on a quarterly basis. According to the methodological note of the

LFS, the total sample size has been evenly distributed into four distinct nationally representative sub-samples (around 8,000 households) each to be enumerated in a given quarter.

The LFS 2005-06 categorically advises that: "The survey has no previous quarterly reference to be contrasted with and, would

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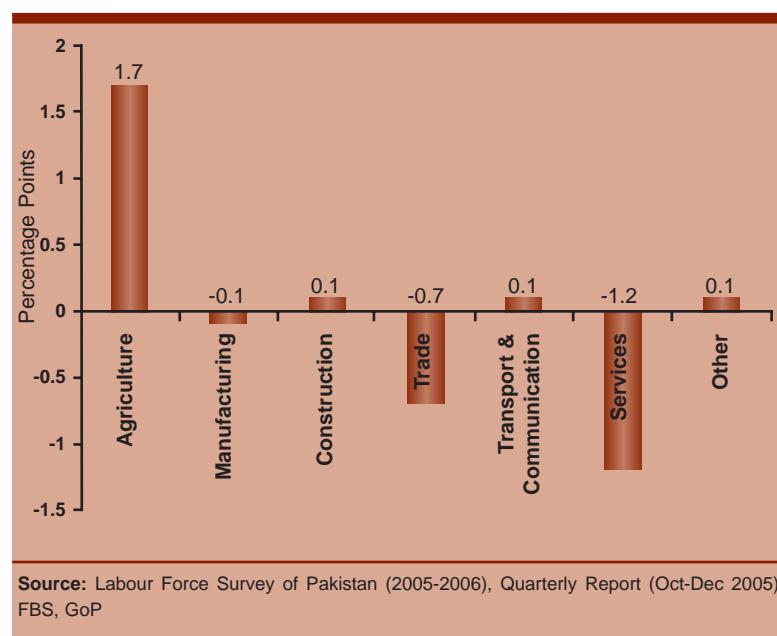
Chart 19
Changes in the Employed Labour Force
During 2004 and 2005



2005-06 compares the numbers in the new quarterly survey to numbers in the previous survey, which was based on annual data. Based on this comparison, it is argued that there has been an improvement on the employment front, which can safely be attributed to numerous factors, the flourishing economy being one of them and "we can safely say that the overall unemployment after years of staying unabated is finally retreating."

However, a closer look behind the aggregates reveals some peculiarities, which strongly suggest that the two LFSs are not comparable. According to analysis in the latest Pakistan Economic Survey, from FY04 to December 2005, 5.82 million new jobs have been created. Further scrutiny reveals, though, that this appears to be largely a rural

Chart 20
Changes in Sectoral Distribution of Employed Labour
Force During 2004 and 2005



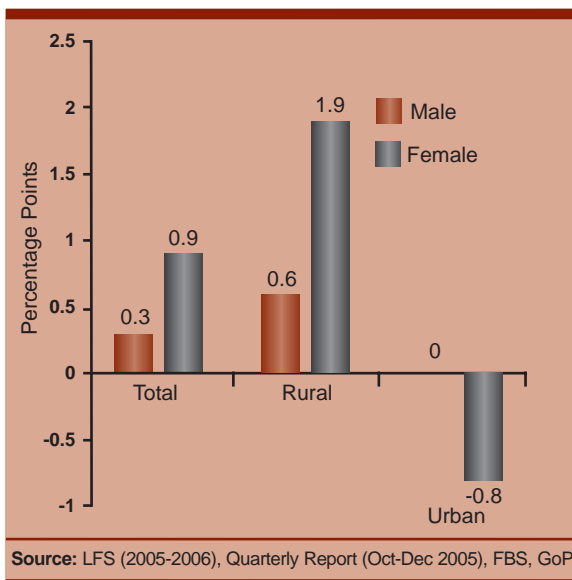
phenomenon, with 78 percent of the new jobs being created in rural areas (Chart 19). This seems implausible. Additionally, changes in the sectoral distribution of the employed labour force indicate a rising share of the agriculture sector and a declining share of trade and services (Chart 20). This is surprising given that trade and services have been the sectors where economic activity has expanded the most.

The changes in literacy rates between the period of the LFS 2003-04 and the LFS 2005-06 (which covers the two quarters July-September 2005 and October-December 2005) are shown in Chart 21. According to these data, there has been a marked increase

serve as a benchmark reference for the subsequent quarterly LFSs." Nonetheless, analysis in the Pakistan Economic Survey,

of about 2 percentage points in rural female literacy rates in comparison to a fall in urban

Chart 21
Changes in Literacy Rates
During 2004 and 2005



female literacy rates, which is very surprising, to say the least. Similarly, there has been no increase in urban male literacy rates according to the data, which is also implausible.

The above features of the data have been highlighted to support the argument that, most likely because of seasonal factors and changes in the sampling framework, the new quarterly LFS cannot be compared to the old annual LFS. Thus, any claims about the most recent trends in unemployment based on such a comparison, as in the Economic Survey of 2005-06, should be viewed with caution.

CONCLUSIONS

The analysis suggests that the environment of macroeconomic stability and structural changes that the government has promoted in recent years has contributed to putting the sustainable rate of growth of Pakistan's economy on an upward trajectory. However, it is unlikely that we are yet at a point where growth rates in the range of 7-8 percent or higher can be permanently

sustained. Although growth has averaged about 7½ percent over the past three years, this is partly due to some transient factors, such as a bumper cotton crop. In addition, the external environment has been favourable with a high level of foreign remittances. The considerable spare capacity that existed also partly explains the rapid growth. It meant that unemployed factors of production could be quickly utilized and the economy could grow very fast when demand was spurred.

Policy makers do not seem to be giving their due weight to these other factors, and this has led to domestic demand growing at an excessive pace and reaching a level that cannot be sustained by the productive capacity of the economy. This manifests itself in the growing macroeconomic imbalances that we have highlighted in this report. The growing imbalances threaten the very macroeconomic stability and policy credibility that has been so hard earned by the policy makers.

In particular, there are three main sources of concern about the macroeconomic situation at present. First, there is the ballooning trade deficit. Expressed at an annual rate, the trade deficit for the first nine months of FY06 is more than 6½ times the deficit that existed during FY04. It would be impossible to finance this kind of trade deficit for long, without going back down the path of macroeconomic instability and excessive levels of external debt. And it is also very unlikely that the imports of capital goods will lead to the kind of acceleration in the pace of exports that it would take to adequately closing the trade gap by itself. Thus, a high trade deficit carries with it the risk that a large correction has to occur through sudden import compression, which would be induced either by a recession or a sharp depreciation of the currency, or both.

Second, inflation has proved to be stubbornly high. Not very long ago, it was envisaged that inflation would recede to

about 5 percent in FY05. Instead, it was recorded at about 8 percent and today, as the analysis here suggests, there is adequate cause to wonder how the 6½ percent target for FY07 will be achieved. All the international evidence suggests that a persistently high inflation rate can erode the gains from economic growth very fast and it is bad news for the poverty situation as well. It is becoming increasingly clear that the high inflation rate in Pakistan is not purely a result of special supply-side factors such as world oil and food prices but also the consequence of the growing macroeconomic imbalances.

Third, fiscal policy continues to be expansionary. The Federal Budget for FY07 will add to the problem of growing macroeconomic imbalances. Moreover, the proposed modes of financing of the fiscal deficit entail a substantial amount of bank borrowings, which will be a source of inflationary pressures. It is important to emphasize that the earthquake reconstruction-related spending is necessary. Moreover, the large increase in the size of development expenditures is also to be welcomed. Public infrastructure spending and expenditures on education and health are vital to long-term growth and also because they are pro-poor. However, in order not to add to macroeconomic problems and be sustainable, such increases in development expenditure need to be financed with higher tax revenues. The measures announced in the budget for FY07 to expand the tax net fall well below what is needed. And, unfortunately, the Budget 07 foresees only a slight increase in the overall tax-to-GDP ratio.

Thus, the trade deficit, inflation and the fiscal deficit need to be controlled. This will involve letting domestic demand slow and, therefore, growth fall to a level that is sustainable. At the moment, there is no tradeoff between growth and inflation. The choices are to let growth slow somewhat with less price pressures and lower macroeconomic imbalances or to try to grow

faster than is possible with the result that growth will fall more abruptly and probably by more, with its attendant disruptive consequences.

Looking beyond the macroeconomic situation, the magnitude of poverty reduction that is being shown by the recently released official figures seems implausible to us. It seems likely that some decrease in poverty has taken place given the high rates of economic growth observed in recent years. But the higher inflation rate, the unemployment situation, a continuation of rising income inequality and other evidence suggest that growth has not had as much of a poverty-reducing effect as is potentially possible. The household data set on which the new official figures are based needs to be released immediately so that more informed debate on these issues can take place.

The Federal Budget for FY07 has some pro-poor elements. Since we have argued for fiscal consolidation above, it needs to be emphasized that the axe of this fiscal consolidation should not fall on the productive development expenditures or the relief measures in the budget as it has often been the case in the past. Instead, it should be achieved by expenditure-switching from non-productive to productive government spending as well as by increasing tax revenues. The tax revenues should be increased in a manner that does not decrease the progressivity of the tax system and should include efforts to expand the tax net in a more meaningful way than has been done in the recently announced budget.

High growth by itself will not eliminate poverty and lead to adequate social sector development. Although it certainly is a major factor, direct policy measures to control inflation, to generate more employment for the poor and to reverse the rising income and asset inequalities are also needed. Without these changes, economic growth will translate into development only to a limited extent, leaving behind large segments of the Pakistani society.



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