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Growth and Investment

I. INTRODUCTION

The economy has considerably lost significant growth momentum during last three years as the economic growth averaged just 2.6 percent as against 5.3 percent in the preceding eight years. There are many reasons for deceleration of growth momentum like massive terms of trade shock of 2008, global financial crisis, intensification of war on terror, security hazards and high profile killings.

During the year 2010-11, the economy's capacity to withstand internal and external pressures of extreme nature was tested by devastating floods that engulfed one-fifth of the country, jeopardize fiscal consolidation efforts of the government already recovering from rehabilitation of half a million internally displaced persons (IDPs) from Sawat. The problem was further compounded by paucity of resources as a result of lukewarm response from development partners. The economy was also confronted with inherited structural problems like acute energy shortages and fiscal profligacy. The government is striving hard to win political support for sustainability and ownership of critical reforms in the areas of taxation and power sector.

The domestic environment is still affected by the intensification of war on terror and volatile security situation while external environment is affected by uncertainties surrounding external inflows and oil prices. Notwithstanding substantial improvement in the current account balance, the external sector vulnerabilities needs a review especially in the backdrop of spike in international crude oil prices which bounced back from as low as \$33 per barrel in January 2009 to beyond \$120 in May 2011. Pakistan economy still faces pressures from higher inflation driven mainly by spike in food prices, acute power

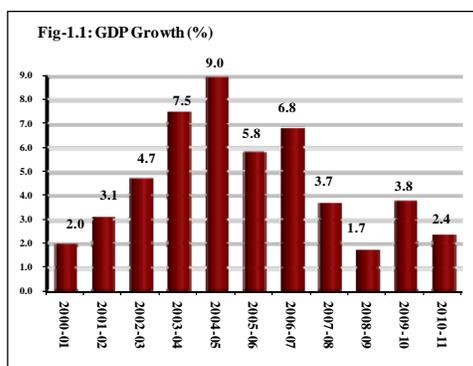
shortages, modest growth in tax revenues amidst rising security related expenditure thereby, putting pressure on fiscal deficit; lower than anticipated inflows and growing absolute financing requirements. Abatement of inflationary pressure remained oblivious and prices depicted stubbornness. Pakistan's economy weathered an unprecedented set of challenges during 2010-11, however, the resolve to take challenges head on is even greater.

The economy suffered a significant supply shock in the aftermath of devastating floods of July 2010 in addition to massive disruptions in provision of energy. A spill-over effect of the European debt crisis was felt on debt and fiscal sustainability of Pakistan. Finally, the year witnessed the intensification of domestic security challenge which has exacted an extremely high cost on the economy, both in terms of direct costs of the fight against extremism, as well as in terms of a knock-on effect on investment inflows and market confidence. A significant collateral impact has been borne by Pakistan in terms of the squeezing of fiscal space for critical development and social sector expenditures that hampered growth prospects in future.

Real GDP growth in the outgoing year is now estimated at 2.4 percent compared to 3.8 percent in the previous fiscal year. This compares with 4.4 percent projected growth for the global GDP, 6.5 percent growth in developing countries and 8.7 percent in South Asia. The commodity producing sector recorded a rise of only 0.5 percent – the lowest since 1992-93. The figure of 2.4 percent incorporates July-February 2010-11 figure of LSM growth at 0.98 percent, however, inclusion of March 2011 number (leading to July-March growth to 1.7 percent), the figure of GDP growth may go up if reviewed by the National Accounts Committee. The services sector on the back of

public administration & defence, and social services, contributed lion's share of this modest growth rate. Gross fixed investment declined substantially, from 22.5 percent of GDP in 2006-07 to 13.4 percent provisionally in 2010-11. This is the lowest ever investment rate in four decades. More importantly the private sector witnessed a significant fall and recorded lowest ratio since 1998-99. This implies a significant deterioration in the job creating ability of the economy.

While the economic environment in Pakistan remained inhospitable for growth and investment during 2010-11, a comprehensive growth strategy is being evolved, to increase productivity, efficiency, and competitiveness of the economy, and to ensure high growth rates that are both sustainable as well as more equitable. In addition, and equally fundamentally, a pivotal element of the stabilization program included putting in place direct income support measures to protect the poor and vulnerable sections of the population through BISP. The government is now expanding the social safety net to a broader platform of social development, the scale of which is unprecedented in Pakistan's history.



Despite negative effects on the economy of a host of challenges during 2010-11, especially with regard to growth, when viewed in the global context, Pakistan's economic performance has not been out of sync with its peers, as highlighted in the following section.

Global developments

The world economy is moving from a post-crisis bounce-back phase of the recovery to slower but still solid growth this year and next, with developing countries contributing almost half of

global growth. Global economy is witnessing a kind of transformation from single pole (US) economy to multi-polar economy. The growth powerhouse is gradually shifting more towards emerging economies rather than developed economies as was the practice before. The World Economic Outlook estimates that global GDP, after expanding by 5.0 percent in 2010, will slow to 4.4 percent in 2011, before it reaches 4.5 percent in 2012. The recovery is not able to mitigate concerns regarding high unemployment in advanced economies, while new macroeconomic challenges are building-up in many emerging economies.

The handoff from public to private demand is progressing and trying to dispel the impression that diminishing fiscal policy support might fuel recession. However, weak sovereign balance sheets and high funding requirements of banks and sovereigns are posing downside risks to recovery in advanced economies. Downside risks to upbeat in developing economies is emanating from higher commodity prices, notably for crude oil, geopolitical uncertainty especially in the Middle East as well as overheating and booming asset markets. Strengthening the recovery in developed economies will require keeping monetary policy accommodative, inflation expectations well anchored, and implementing fiscal consolidation plans supported by stronger fiscal rules and institutions.

US has to make a sizable dent in the projected medium-term twin deficits either through broader measures such as social security and tax reforms or trim discretionary spending. In Japan, the immediate fiscal priority is to support reconstruction and after tackling reconstruction, fiscal strategy should focus on bringing down the public debt ratio over the medium term. In the euro area, despite significant progress, markets remain apprehensive about the prospects of countries under market pressure.

In the euro area significant progress is made by providing low-cost, and flexible funding to support strong fiscal adjustment, bank restructuring, and reforms to promote competitiveness and growth. However, to bridge trust deficit, credible and ambitious stress tests for

euro area banks should be introduced in addition to prevalent restructuring and recapitalization programs.

Table-1.1: Comparative Real GDP Growth Rates (%)

Region/Country	2007-08	2008-09	2009-10	2010-11	2011-12
World GDP		-0.5	5.0	4.4	4.5
Euro Area	0.4	-4.1	1.7	1.6	1.8
United States	0.0	-2.6	2.8	2.8	2.9
Japan	-1.2	-6.3	3.9	1.4	2.1
Germany	0.7	-4.7	3.5	2.5	2.1
Canada	0.5	-2.5	3.1	2.8	2.6
Developing Countries		2.7	7.3	6.5	6.5
China	9.6	9.2	10.3	9.6	9.5
Hong Kong SAR	2.3	-2.7	6.8	5.4	4.2
Korea	2.3	0.2	6.1	4.5	4.2
Singapore	6.6	0.6	2.8	3.3	3.0
Vietnam	6.3	5.3	6.8	6.3	6.8
		ASEAN			
Indonesia	6.0	4.6	6.1	6.2	6.5
Malaysia	4.7	-1.7	7.2	5.5	5.2
Thailand	2.5	-2.3	7.8	4.0	4.5
Philippines	3.7	1.1	7.3	5.0	5.0
		South Asia			
India	6.2	6.8	10.4	8.2	7.8
Bangladesh	6.0	5.8	6.0	6.3	6.6
Sri Lanka	6.0	3.8	9.1	6.9	6.5
<i>Pakistan</i>	3.7	1.7	3.8	2.4	4.2
		Middle East			
Saudi Arabia	4.2	0.6	3.7	7.5	3.0
Kuwait	5.0	-5.2	2.0	5.3	5.1
Iran	1.0	0.1	1.0	0.0	3.0
Egypt	7.2	4.7	5.1	1.0	4.0
		Africa			
Algeria	2.4	2.4	3.3	3.6	3.2
Morocco	5.6	4.9	3.2	3.9	4.6
Tunisia	4.5	3.1	3.7	1.3	5.6
Nigeria	6.0	7.0	8.4	6.9	6.6
Kenya	1.6	2.6	5.0	5.7	6.5
South Africa	3.6	-1.7	2.8	3.5	3.8

Source: World Economic Outlook (IMF), April 2011.

Developing countries are expected to grow by 7.3 percent in 2010 and then stabilize at 6.5 percent in 2011 and 2012. They will continue to outstrip growth in high-income countries, which is projected at 3.0 percent in 2010, 2.4 in 2011 and 2.6 percent in 2012 [See Table-1.1]. In most developing countries, GDP has regained levels that would have prevailed had there been no boom-bust cycle. The recovery in several economies in emerging Europe and Central Asia and in some high-income countries is tentative if corrective domestic policies, high household debt

and unemployment, and weak housing and banking sectors are not taken care of.

In much of Latin America and Asia and in low-income countries in sub-Saharan Africa, economic growth returned to pre-crisis peaks, and many economies have already moved into expansionary mode. Resurgence of growth momentum is being boosted by accommodative macroeconomic policies, rising exports and commodity prices, and in some cases rising capital inflows. Growth prospects in sub-Saharan Africa are buoyant on

the back of sustained strength in domestic demand and rising global demand for commodities. Economic prospects in the Middle East are contingent upon political stability. Emerging economies of Eastern Europe and Commonwealth of Independent States (CIS) were heavily affected by the crisis, but now growth is rebounding.

South Asia's real GDP growth accelerated to an estimated 8.7 percent in 2010-11 from 7.0 percent in 2009-10, buoyed by very strong growth in India, which represents 80 percent of regional GDP. Excluding India, regional GDP growth (on a fiscal year basis) firmed to a modest 5.1 percent from 4.3 percent the year before. On a calendar year basis, GDP for the region as a whole is estimated to have expanded 8.4 percent in 2010 after 5.3 percent in 2009 and to 4.8 percent in 2010 from 3.8 percent in 2009 if India is excluded.

These strong growth rates mainly reflect robust domestic demand, supported by macroeconomic policy stimulus measures, and a revival in investor and consumer sentiment along with improved external demand and stronger private capital inflows. In Pakistan, however, a standstill on policy implementation, severe disruption tied to massive flooding and continued security problems have constrained economic activity. Macroeconomic policy in South Asia is accommodative, given the strength of regional economic activity and relative to other regions (where growth has generally not gained as strong of a footing). While policy interest-rates have been raised (beginning in mid-March 2010 in India, and, in November 2010, in Bangladesh and Pakistan), monetary policy normalization is incomplete and real interest rates remain negative.

Box-1: Impact of Higher Food and Crude Oil Prices on GDP Growth

The year-on-year increase in global food prices is 34.2 percent and for Brent crude oil 39.9 percent in February 2011. This hike in international prices have begun to be reflected in domestic prices in developing Asian economies—the nearly 30% increase in global food prices in January has translated to an average of about 10 percent food inflation in a number of regional economies and ultimately reflecting in hikes in general inflation rates. It is also expected that these will have impacts on the performance of the broader economy. ADB uses the Oxford Economics global model to assess such impacts by generating projections of key economic variables for a sample of 10 developing Asian economies [China; Hong Kong China, India; Indonesia; South Korea; Malaysia; Philippines; Singapore; Taipei, China; and Thailand].

The Study assumes that monetary authorities in the region will adopt a gradual tightening stance in the next 2 years as recovery takes firm hold. Using this model, the Study traces the impacts on developing Asia of the continued rise in commodity prices. Two scenarios were adopted to simulate the effects of global price hike on gross domestic product (GDP) growth of the 10 regional economies. Worldwide food prices have risen by an average of 31.2 percent in the first 2 months of 2011 compared to year-ago levels. For Scenario 1, therefore, the study look at the effects of a 30 percent average increase in the global prices of food in 2011 from the 2010 level. Assuming that the food price shock is temporary, in 2012, we revert to the rate of change currently assumed in the model (5 percent decline).

In the second scenario, the international price of Brent crude oil is assumed to rise as well in 2011 on top of the assumed hike in global food prices. Increases in global crude oil prices have implications for movements in input costs such as fertilizer prices, irrigation with diesel pumps, and general transport costs. For Scenario 2, the increases in both global food and Brent crude oil prices are assumed to reach 30 percent this year on average. The assumed rates of change in the model for food and Brent crude oil prices witness a 5 percent decline for food and 3.1 percent decline for Brent crude oil in 2012.

Now the results of these two scenarios can be compared with a baseline that maintains the global prices of food and Brent crude oil in 2011 and 2012 to the average levels recorded in 2010. The simulation results from Scenario 1 suggest that increases in global food prices would lead to higher inflation and slower economic expansion in developing Asia. Net food importers are expected to be hardest hit by the international commodity price inflation. Singapore is highly vulnerable to inflationary pressures because it completely reliant on the global food market. Inflation is also expected to rise in countries with a large share of food in the consumer price index.

As consumer prices increase forces Central Banks to raise policy rates to exercise control over domestic inflation.

Higher interest rates will pull down investment rates, and higher inflation will crimp private consumption. The combined effect of these two forces will bring down GDP growth for some food-importing countries by up to 0.6 percentage points this year.

Note that for a number of economies, the impacts on GDP growth are stronger in 2012 compared to 2011, as the model takes time to adjust to the exogenous shock in food prices. In India, Indonesia, and Malaysia, in particular, the adverse effects of the increase in global food prices in 2011 tend to take a larger toll on GDP growth in 2012 rather than in 2011.

Under Scenario 2, international food and crude oil prices both rising by 30 percent in 2011 and moderately falling in 2012, the impacts on inflation are much larger, particularly because consumer prices for fuel tend to move with global oil prices. The impacts on GDP growth are also more pronounced, with an estimated decline of up to 1.5 percentage points in 2011. The impact would be much higher in net importers of both food and crude oil. Larger hikes in global commodity prices are expected to result in even bigger impacts on GDP growth in developing Asian economies. For illustrative purposes, we trace the impacts of a 50 percent rise in global food prices in 2011 and find that GDP growth in food-importing countries in the region could fall by up to 1.2 percentage points in 2011. When both international prices of food and Brent crude oil increase by 50% this year, GDP growth could decline by up to 2.8 percentage points. These results assume that central banks adjust policy rates in response to the rise in inflation rates.

[Source: Global Food Price Inflation in Developing Asia: March 2011, Asian Development Bank]

The growth strategy being followed in the past, had invariably produced boom-bust cycles, while international experience suggests, the economies that have sustained high growth over substantial periods (say, two or more decades) have seen a lasting reduction in poverty. East Asian countries such as Korea, Malaysia, China, Taiwan, Singapore, and Hong Kong offer clear examples of sustained growth. Macroeconomic stability is the key to sustain high economic growth for longer periods. The persistence of high economic growth and not a short sequence of bust and boom that characterized the Pakistan economy over the years is the best hope for poverty alleviation and better income distribution. The government is embarking on a fundamental change of the development paradigm and the new growth strategy seeks to foster sustainable and more equitable growth by means of structural improvements in the productive sectors of Pakistan's economy.

After analyzing the overall growth, investment and consumption, it is imperative to look into the growth performance of the various components of Gross National Product for the year 2010-11 in the historical context. The performance of the various components of national income over the last two and a half decades is summarized in Table 1.2.

II. Commodity Producing Sector (CPS)

The Commodity Producing Sector (CPS) has performed below par during the last two decades, mainly owing to persistent slowdown in the growth of agriculture sector. It is comprised of production sectors like agriculture and industry. Its share in the GDP has declined from 49.3 percent in 1999-2000 to 46.7 percent, which implies deterioration in the job creating ability of the economy. The erosion of share of agriculture by 5 percentage points is mainly responsible for this decline. Much alarming thing than share of GDP is loss of growth momentum in the agriculture sector as its growth decelerated from 5.4 percent in 1980s to 4.4 percent in the 1990s and then to just 2.7 percent in the last decade of 2000s. Barring small and medium manufacturing, and livestock subsectors, the growth performance of its main components remained lackluster at best. In the industrial sector the massive negative contribution from electricity and gas distribution sector to the GDP growth is neutralized by positive contributions from manufacturing sector but still its overall contribution remained fractionally negative. Adding contributions from agriculture sector, the overall contribution to the GDP growth stood at 10 percent. This is the performance of the CPS that has not been seen in more than a decade [See Table 1.2].

**Table 1.2: Growth Performance of Components of Gross National Product
(% Growth at Constant Factor Cost)**

	1980's	1990's	2000's	2004-05	2007-08	2008-09	2009-10	2010-11
Commodity Producing Sector	6.5	4.6	4.5	9.5	1.3	1.8	4.7	0.5
1. Agriculture	5.4	4.4	2.7	6.5	1.0	4.0	0.6	1.2
- Major Crops	3.4	3.5	1.7	17.7	-6.4	7.8	-2.4	-4.0
- Minor Crops	4.1	4.6	0.2	1.5	10.9	-1.2	-7.8	4.8
- Livestock	5.3	6.4	4.5	2.3	4.2	3.1	4.3	3.7
- Fishing	7.3	3.6	4.0	0.6	9.2	2.3	1.4	1.9
- Forestry	6.4	-5.2	-4.0	-32.4	-13.0	-3.0	2.2	-0.4
2. Mining & Quarrying	9.5	2.7	5.7	10.0	4.4	-0.5	2.2	0.4
3. Manufacturing	8.2	4.8	7.4	15.5	4.8	-3.6	5.5	3.0
- Large Scale	8.2	3.6	7.8	19.9	4.0	-8.1	4.9	1.0
- Small Scale *	8.4	7.8	4.6	7.5	7.5	7.5	7.5	7.5
4. Construction	4.7	2.6	6.0	18.6	-5.5	-11.2	28.4	0.8
5. Electricity & Gas Distribution	10.1	7.4	5.0	-5.7	-23.6	59.0	17.7	-21.1
Services Sector	6.6	4.6	5.1	8.5	6.0	1.7	2.9	4.1
6. Transport, Storage and Comm.	6.2	5.1	3.7	3.4	3.8	3.6	2.8	1.3
7. Wholesale & Retail Trade	7.2	3.7	4.6	12.0	5.3	-1.4	4.6	3.9
8. Finance & Insurance	6.0	5.8	9.1	30.8	11.1	-7.6	-11.3	-6.3
9. Ownership of Dwellings	7.9	5.3	3.5	3.5	3.5	3.5	3.5	1.8
10. Public Administration & Defence	5.4	2.8	4.5	0.6	1.2	3.6	2.5	13.2
11. Services	6.5	6.5	7.6	6.6	9.8	8.9	7.8	7.1
12. GDP (Constant Factor Cost)	6.1	4.6	4.8	9.0	3.7	1.7	3.8	2.4
13. GNP (Constant Factor Cost)	5.5	4.0	5.3	8.7	3.7	2.2	4.8	2.9

* Slaughtering is included in small scale

Source: FBS

II.i. Agriculture

The share of agriculture in GDP gradually shrank to 20.9 percent in 2010-11 from 25.9 percent of GDP in 1999-2000. Notwithstanding, declining share overwhelming majority of the population depends directly or indirectly on income streams generated by the agriculture sector. The agriculture sector remained the dominant sector with its job absorption ability and it still absorbs 44 percent of the country's labour force. It gives a kick-start to aggregate demand for industrial goods and services as well.

Erosion of growth momentum in the sector raises some serious policy question regarding viability of the sector. From water management to disbursement of agriculture credit, mechanization, availability of quality inputs including seeds, fertilizer and pesticides, a holistic policy package aimed at addressing structural issues is required to reap full potential of the sector. Diversification towards less weather sensitive areas like livestock can be done very easily. Revamping agriculture is critical for enhancing job creating ability of the economy.

The agriculture sector consists of crops, livestock, fishing and forestry sub-sectors. The crop sub-

sector is further divided into major crops (primarily wheat, cotton, rice, sugarcane, maize and gram) and minor crops (such as pulses, potatoes, onions, chilies and garlic). Historically, the crops sub-sector has had the largest share of the agriculture sector, but with changing patterns of income and expenditure, the crop sector accounts for 37 percent of agriculture. The crop sector has the potential to influence the overall performance of the agriculture sector and in the current year it recorded negative real growth of 4 percent but still higher output prices are manifested in higher production and import of durables. Recent trends point towards a reduction in the share of the crops sub-sector. The share of crops in agriculture has declined from 65.1 percent in 1990-91 to 37.5 percent in 2010-11. Global integration, rising incomes and living standards as well as changing dietary patterns across regions have caused a paradigm structural shift in consumption of livestock and dairy product. The share of livestock in agriculture has increased from 29.8 percent to 55.8 percent in the same period.

Agriculture sector has recorded a modest growth of 2.1 percent as compared to 0.6 percent achieved last year and a target of 3.8 percent for

the year. The sluggish performance is mainly attributed to a sharp downturn in the value addition in the major crops sub-sector owing to devastating floods impacting rice and cotton output but helped recovery in wheat output. The sugarcane benefited from excess availability of irrigation water. **Minor crops** registered a growth rate of 4.8 percent compared to the target of 3.0 percent and massive negative growth of 7.8 percent last year. Smaller sub-sector fishing posted a modest growth of 1.9 percent while forestry continued its historical negative growth by declining by 0.4 percent. A detailed analysis of the performance of each of the sub-sectors of agriculture is given below:

Major Crops accounting for 31.1 percent of agricultural value added registered negative growth of 4.0 percent compared to a negative growth of 2.4 percent last year and a target of 3.7 percent. Almost all major crops breached the target except sugarcane where production exceeded the target. The wheat which accounts for 13.1 percent of the agriculture and 39 percent of major crops has witnessed a record crop at 24.2 million tons — higher by 3.9 percent over last year's crop size. The rice crop recorded lowest ever production since 2002 owing to massive destruction of crop in the devastating floods. Another victim of floods is the important crop of cotton, with 6.9 percent stake in agriculture and 21.4 percent in value addition of major crops, witnessed 9.0 percent decline in its production at 11.6 million bales. Other major crops jawar, tobacco, barley, oil seeds and maize depicted mixed trends but their stake is small.

Minor crops, accounting for 10.9 percent of value added in overall agriculture, grew by 4.8 percent which is improvement on the 7.8 percent negative growth of last year. Production of pulses has declined by 18.1 percent which has added to the supply side shock to the food inflation. Vegetables contributed much of the growth in the minor crops by growing at 9.5 percent. The production of all fruits grew by 1.8 percent, out of which production of citrus fruits grew marginally by 0.9 percent whereas production of other fruits including dry fruits grew by 2.1 percent.

Livestock: With rising incomes, globalization and changing dietary patterns, the consumption of livestock products has increased significantly. The price of livestock items has remained a major contributor to inflationary pressures in Pakistan's economy for some time. The demand for livestock has grown at a phenomenal pace. The upsurge in prices has provided incentives for greater production and thus prospects for growth. The sector witnessed major setback in the aftermath of the floods as a result of massive displacement and loss of the livestock. The share of livestock in the value addition of agriculture sector inched up to 55.1 percent in 2010-11 as against 50.8 percent in 2006-07. The sector is providing the livelihoods to about 36 million people in the rural areas who depend directly or indirectly on the livestock and dairy sector. It accounts for 11.5 percent of GDP. Over the years, it has emerged as a major alternative source of income in the rural areas, particularly for the landless poor. Livestock includes: cattle, buffalos, sheep, goats, camels, horses, asses and mules. The livestock sector grew by 3.7 percent in 2010-11 compared to 4.2 percent last year. Poultry & products grew by 7.0 percent while milk production grew by 3.3 percent only. Given the price incentive available in the market, the livestock sector offer great prospects for economic growth.

Fisheries accounting for only 0.4 percent of GDP, recorded growth of 1.9 percent as against 1.4 percent growth of last year. Components of fisheries such as marine fishing and inland fishing, contributed to an overall increase in value addition in the *fisheries* sub-sector. Marine fisheries registered a growth of 0.7 percent compared to 1.2 percent last year. Inland fish segment also registered a growth of 1.9 percent compared to 1.4 percent of last year. **Forestry** accounts for 0.2 percent of GDP and value addition contracted by 0.4 percent compared to an expansion of 2.2 percent last year.

II.ii. Manufacturing

The manufacturing sector has been hard hit by international and domestic factors. Besides, law and order and acute power outages, resulting in loss of working hours, this sector has also fallen victim to rising cost of production. Continuous

power breakdowns are preventing industries from operating at far less than their optimal level. All these factors have caused a slowdown in output.

The *manufacturing sector* is witnessing gradual build-up in its share in the GDP during the last three years from 18.2 percent to 18.7 percent however, it is the lower than its peak level of 19.2 percent in 2007-08. Output in the manufacturing sector has witnessed expansion of 3 percent in 2010-11 as compared to expansion of 5.5 percent last year on the back of strong performance from small and medium manufacturing sector while large-scale manufacturing remained affected by structural problems and energy crisis. *Small and medium manufacturing sector* maintained its healthy growth of last year at 7.5 percent.

Large scale manufacturing which accounts for 12.1 percent stake in GDP faced the significant loss in growth momentum for last few years, and depicted a marginal growth of 0.98 percent during July-February 2010-11 compared to 4.9 percent in the same period last year. Slower growth is because of the fact that LSM remained victim of power outages and lower domestic demand. Deceleration in growth inhabits the impact of severity of energy shortages and electricity tariff hike leading to cost escalation. The positive terms of trade shock has helped improved competitiveness for textile sector in particular and other conventional exports based small and medium manufacturing sector. The underlying improvement is not reflected in large-scale manufacturing because they are mainly concentrated in the informal sector.

LSM is expected it to pick-up on the back of capacity enhancement in some industries like fertilizer, and steel, and likely improvement in the sugar production to 4.1 million tons this year. The impact of these positive developments will fed into the growth during the period February-June 2011.

Main contributors to this modest growth include; automobile (18.2 percent), leather products (14.9 percent), paper & board (4.5 percent), pharmaceuticals (3.9 percent), chemicals (3 percent), engineering items (2.5 percent), electronics (2.2 percent) and textile (1.0 percent).

However, some groups dragged index down with negative growth include; non-metallic minerals (10.7 percent), metallic industries (8.7 percent), fertilizers (6.8 percent), petroleum products (4.8 percent), tyres & tubes (4.8 percent) and food, beverages & tobacco (2.3 percent).

II.iii. Mining and Quarrying

Extraction of minerals and ores through efficient mining and quarrying provides convenient and economical access to raw materials and provides a competitive edge to developing countries. The mining and quarrying sector witnessed the second lowest growth in more than a decade and grew by 0.4 percent in 2010-11 as compared to 2.2 percent growth last year and a target of 2.1 percent. The contribution of this sector towards GDP has shrunk considerably at around 2.4 percent from peak 2.7 percent in 2004-05. Within the sector, the output of crude oil and natural gas has increased by modest 0.7 percent and 1.1 percent, respectively, whereas, the extraction of coal registered substantial decline of 10.6 percent. Because much of the country's mining reserves exist in remote areas, infrastructure improvements are necessary to attract higher investment in this sector and as investment in mining is coming from abroad, improvement in the security situation is crucial in boosting this sector.

II.iv. Services Sector

The services sector has emerged as the main driver of economic growth in recent years and it outpaced the growth in commodity producing sectors during last one decade. Pakistan has also seen a major transformation in the economic structure and the share of the services sector has risen to 53.3 percent in 2010-11 which is highest share in last two decades. The services sector grew by 4.1 percent against the target of 4.7 percent and actual outcome of 2.9 percent.

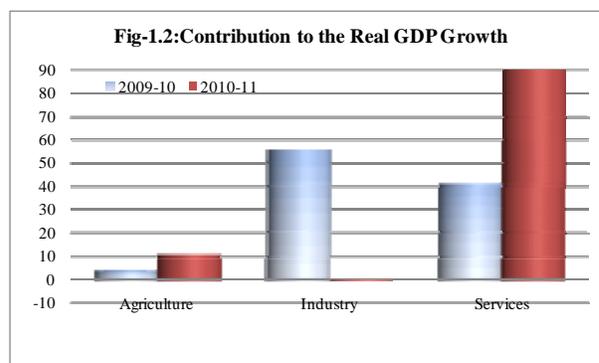
The services sector has made a contribution of 90 percent to the GDP growth. The services sector has been an important contributor to Pakistan's economic growth over the past many years. In the decade of 2000s it has grown at an average of 5.5 percent annually which is lower than its average growth of 6.6 percent in the 1980s but higher than its growth in the 1990s. The continuing buoyant

trend, even while growth in the industrial sectors has been slowing, implies that the services sector in Pakistan has been relatively insulated from the challenges faced by the rest of the economy and has been better able to cope with them.

The sector consists of the following sub-sectors: Transport, storage and communication; wholesale & retail trade; finance and insurance; ownership of dwellings; public administration and defence; and social services. The current year's performance is dominated by public administration and defence and social services where value addition grew by 13.2 percent and 7.1 percent, respectively. The former because of 50 percent pay rise for government servants and higher defence spending, the later because of logistics support and flood generated social activities. **Finance and insurance sector** displayed a contraction in value addition for the last three years as its value addition decreased on average by 8.4 percent. However, on the eve of the global financial meltdown the contagion is well observed in Pakistan's banking and financial sector. The performance of this sector shows that Pakistan's financial sector is integrated in the world economy and feeling the heat of the financial crisis plaguing international financial markets. Finance and insurance sector recorded negative growth of 6.3 percent in 2010-11 as against contraction of 11.3 percent last year. The **Transport, Storage and Communication** sub-sector depicted a sharp deceleration in growth during the last three years as it grew on average 2.5 percent in as compared to 3.8 percent witnessed in the last eight years preceding these three years. Value added in this **sector** is based primarily on the profits and losses of Pakistan Railways, Pakistan International Airlines and other airlines, Pakistan Posts & Courier Services, Pak Telecom and motor vehicles of different kinds on the road. Mechanized road transport has depicted a growth of 2.8 percent, followed by storage (3.8 percent). The value addition of Pakistan Railways has declined substantially. Other sectors that showed a decline are; communication (12.1 percent) and pipeline transport (15.9 percent). Value added in the **wholesale and retail trade sector** is based on the margins taken by traders on the transaction of commodities traded in the wholesale and retail

market. In 2010-11, this sector grew at 3.9 percent as compared to 4.6 percent last year and the target for the year of 5.1 percent.

Public administration and defence posted a stellar growth of 13.2 percent as compared to 2.5 percent in last year. The estimates of this sector are based on budgeted figures of federal, provincial, district and local governments. The performance of this sector far outstripped the target of 5.0 percent mainly due to a positive change in the wage component of public sector employees, and an increase in defense and security related expenditures. Growth in the **Ownership of Dwellings** has remained constant at 3.5 percent for the past 5 years but it was badly impacted by other factors. **Social Services Sector** grew by 7.1 percent which is slightly higher than the target of 5.0 percent but lower than last year's actual growth of 7.8 percent.



III. Contribution to Real GDP Growth (Production Approach)

The contribution to economic growth is spearheaded by the services sector with 90 percent stake while only 10.0 percent contribution came from the Commodity Producing Sector (CPS). One of the important components of CPS, manufacturing alone contributed 23 percent to real GDP growth; however, this is more than neutralized by 25.4 percent negative contribution of relatively smaller sector, electricity and gas distribution. Thanks to 10.7 percent positive contribution from the agriculture, the overall negative contribution of the industrial sector could not prevent commodity producing sector to contribute positive 10.7 percent to the GDP growth.

The overall below par performance of the Commodity Producing Sector was overshadowed by exceptional growth in the Services sector. The modest growth of just 2.4 percent is shared between CPS (0.24) and services sector (2.15). Within the CPS, agriculture contributed 0.26 percentage points or 10.7 percent to overall GDP growth (a significant increase from its contribution of only 3.4 percent last year) while industry dragged 0.02 percentage points or 0.7 percent to neutralize to some fraction of positive

contribution of the agriculture sector [See table 1.3 and fig. 2 for details]. In the services sector major contributions to GDP growth came from public admn and defence (0.79 percentage points or 33.1 percent), wholesale & retail trade (0.65 percentage points or 27.1 percent) and social services (0.84 percentage points or 38.6 percent). Going forward diversification in favour of more positive contribution from commodity producing sector is required for a more inclusive growth.

Table 1.3: Sectoral Contribution to the GDP growth (% Points)

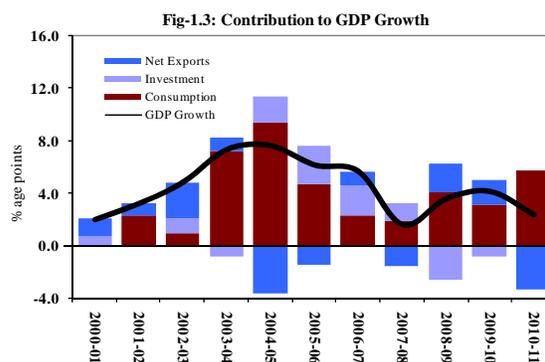
Sector	2006-07	2007-08	2008-09	2009-10	2010-11
Agriculture	0.92	0.23	0.86	0.13	0.26
Industry	2.28	0.38	-0.03	2.09	-0.02
- Manufacturing	1.55	0.92	-0.69	1.01	0.55
Services	3.61	3.08	0.89	1.54	2.15
Real GDP (Fc)	6.81	3.68	1.72	3.76	2.39

Source: Federal Bureau of Statistics.

IV. Contribution to Economic Growth (Aggregate Demand Side Analysis)

Consumption, investment, net exports are figuratively described as the 'three horses of Troika' that drives economic growth. In all economies the expansion of output is the sum of consumption (both private and government) plus investment (public and private) plus net exports of goods and services (exports minus imports). Pakistan's economic growth like many other developing countries is historically characterized as consumption-led growth. The consumption remained the major driver of growth as it accounts for 85 percent share in overall GDP and with real growth of 7 percent in private consumption and 7.5 percent in government consumption in 2010-11, the growth kept its heavy dependence on consumption amidst massive demand compression measures and stabilization efforts since 2008. The GDP market price grew by 2.4 percent contrary to 4.1 percent growth in the GDP factor cost. The contribution of the consumption sharply decelerated from over 100 percent in the last two years to just 76.5 percent in 2010-11. Within consumption, the private consumption remained very strong and contributed twice as much to the GDP and ample support from government consumption; however, net exports dragged the contribution down by a huge margin. The share of investment in real GDP (mp) growth remained

negative for the third consecutive year, implying structural weaknesses in the economy.



The terms of trade in real terms has improved for the last three years significantly as the exports prices outpaced the import prices, thereby leading to Real Effective Exchange Rate (REER) appreciation. However, buoyancy in exports is not supported by increases in quantum terms and it is purely price effect which is leading exports in the current fiscal year. As we exclude price impact in calculating real exports, the contribution of net exports is neutralizing 59 percent of the contribution from other sectors. The contribution of net exports has traditionally been negative for most part of our history and but it had contributed positively by accounting for big chunk of real GDP (mp) growth in 2009-10. The balance

between investment and consumption which had improved during second half of 2000s, adversely

disturbed in the last three years (2008-09 to 2010-11) [See Table 1.4 and Fig. 1.3].

Table-1.4: Composition of GDP Growth

Flows	Point Contribution						
	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11
Private Consumption	9.2	0.8	3.4	-1.9	8.3	3.0	5.1
Public Consumption	0.1	3.9	-1.1	3.8	-4.2	0.2	0.6
Total Consumption [C]	9.4	4.7	2.3	1.9	4.1	3.2	5.8
Gross Fixed Investment	1.8	2.9	2.2	1.3	-2.7	-0.9	-0.05
Change in Stocks	0.1	0.1	0.1	0.0	0.1	0.1	0.04
Total Investment [I]	2.0	2.9	2.3	1.3	-2.7	-0.9	-0.02
Exports (Goods & Serv.) [X]	1.7	1.8	0.4	-1.0	-0.6	2.5	-2.5
Imports (Goods & Serv.) [M]	5.4	3.2	-0.7	0.6	-2.7	0.6	0.9
Net Exports [X-M]	-3.7	-1.5	1.1	-1.6	2.2	1.8	-3.4
Aggregate Demand (C+I+X)	13.0	9.4	5.0	2.2	0.9	4.8	3.3
Domestic Demand (C+I)	11.3	7.6	4.6	3.2	1.4	2.3	5.7
GDP MP	7.7	6.2	5.7	1.6	3.6	4.1	2.4

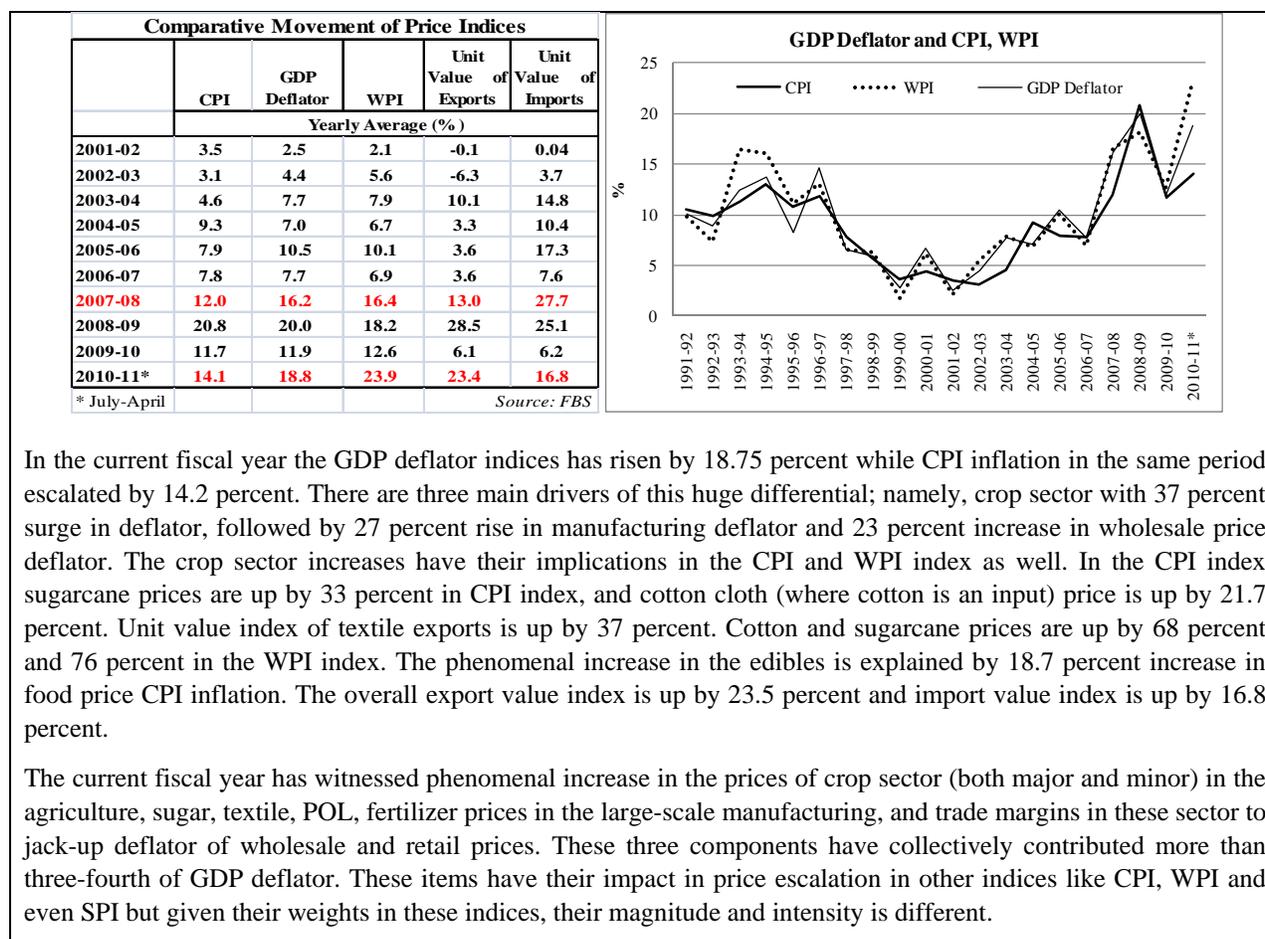
Source: Federal Bureau of Statistics.

Private consumption reached to its largest share of GDP in the last decade at 76.8 percent and accounted for 217 percent of real GDP growth and total consumption with 85.8 percent stake in size of GDP accounted for 244 percent of GDP (mp) growth. Most alarming part of the composition of aggregate demand is coming from fixed investment. Its contribution to economic growth has become fractionally negative and it is third year in a row when investment is negatively contributing towards economic growth. The improvement in the current account balance was unable to translate into positive contribution of net exports. The obvious reason being imports are driven by quantum impact whereas; exports are driven by price factor. Elimination of price effect in real GDP growth reinforced a huge negative contribution of the net export sector emanating mainly from exports.

The investment rate was rising since 2004-05, and reached its peak of 22.5 percent of GDP in 2006-07, however, amidst extraordinary headwinds, the investment to GDP ratio declined since then persistently to 13.4 percent of GDP in 2010-11. Domestic demand remained strength of Pakistan's growth experience and this year too, domestic demand on the back of higher agriculture prices driven buoyant private consumption remained the hallmark of the modest growth this year. National savings have shown their inadequacy for financing even the lower level of investment in the country. The national savings rate has nosedived to 13.0 percent of GDP in 2010-11 compared to 13.1 percent of GDP last year.

Box-2: GDP Deflator and its relation with Other Price Indices

It is norm around the world to analyze price situation through various indices. The coverage, composition and weights of basket of each index are always different. Abnormal increase in decrease of one or few items may affect different indices differently. In Pakistan's case, four prices indices are commonly referred to for different purposes. CPI, WPI and SPI are three most common indices available every month. The incidence of inflation in these three indices is totally different. The GDP deflator is one index which is available only once in a year. If we look into the data of last 21 years, one thing is interesting; GDP deflator always fell well between CPI and WPI. The price movement in four major crops has always determined the differential between two indices. The support price adjustment of wheat in 2007-08 from Rs.625 per 40 Kg to Rs.950 per 40 Kg have caused the major difference in the two indices and CPI index surged by 12 percent while WPI indices surged by 16 percent.



In the current fiscal year the GDP deflator indices has risen by 18.75 percent while CPI inflation in the same period escalated by 14.2 percent. There are three main drivers of this huge differential; namely, crop sector with 37 percent surge in deflator, followed by 27 percent rise in manufacturing deflator and 23 percent increase in wholesale price deflator. The crop sector increases have their implications in the CPI and WPI index as well. In the CPI index sugarcane prices are up by 33 percent in CPI index, and cotton cloth (where cotton is an input) price is up by 21.7 percent. Unit value index of textile exports is up by 37 percent. Cotton and sugarcane prices are up by 68 percent and 76 percent in the WPI index. The phenomenal increase in the edibles is explained by 18.7 percent increase in food price CPI inflation. The overall export value index is up by 23.5 percent and import value index is up by 16.8 percent.

The current fiscal year has witnessed phenomenal increase in the prices of crop sector (both major and minor) in the agriculture, sugar, textile, POL, fertilizer prices in the large-scale manufacturing, and trade margins in these sector to jack-up deflator of wholesale and retail prices. These three components have collectively contributed more than three-fourth of GDP deflator. These items have their impact in price escalation in other indices like CPI, WPI and even SPI but given their weights in these indices, their magnitude and intensity is different.

V. Composition of the GDP

The process of transformation has accelerated in Pakistan in recent years. The structure of the GDP has undergone substantial change during the last four decades [see Table 1.5 for details]. There has been a marked shift away from the commodity producing sector (CPS) which accounted for almost 62 percent of the GDP in 1969-70, its share has declined to 46.7 percent in 2010-11 — a decline of 15.3 percentage points. The decline in the share of CPS is fully accounted for by the equal rise in the share of services sector. A further breakdown of the CPS shows that the share of the agriculture sector has been falling over time. In 1969-70, agriculture accounted for 38.9 percent of GDP, but steadily decreased in the share over the years and has seen it fall to 20.9 percent in 2010-11. The share of agriculture in GDP has declined by 5.0 percentage points in the last 11 years alone while the share of the manufacturing sector has increased by 4 percentage points in the same

period. It implies that the space created by the agriculture sector is occupied by the manufacturing sector.

The structural problems of the agriculture sectors like stagnant yields, lack of corporate farming, absence of quality seeds and other inputs, the contribution of agriculture to overall GDP is bound to shrink further in the coming years as rapid growth in industry and services sector outpaces the growth in agriculture.

During the last two decades, the major impetus to economic growth has come from the services sector which has emerged as the main driver of the economic growth. Thus, its share in the GDP has increased substantially. Within the services sector, almost all the components have raised their contribution over the last three and a half decades. The share of manufacturing in GDP has remained stagnant at around 14.7 percent for 30 years until

1999-2000. Its contribution to GDP has increased only during the last 10 years - rising from 14.7 percent in 1999-2000 to 18.7 percent in 2010-11.

Table 1.5: Sectoral Share in Gross Domestic Product(GDP)

(At Constant Factor Cost) (In %)						
	1969-70	1999-00	2004-05	2008-09	2009-10	2010-11
Commodity Producing Sector	61.6	49.3	48.7	47.1	47.6	46.7
1. Agriculture	38.9	25.9	22.4	21.8	21.2	20.9
- Major Crops	23.4	9.6	8.4	7.3	6.9	6.5
- Minor Crops	4.2	3.5	2.7	2.5	2.2	2.3
- Livestock	10.6	11.7	10.6	11.3	11.4	11.5
- Fishing	0.5	0.4	0.3	0.4	0.4	0.4
- Forestry	0.1	0.7	0.4	0.3	0.3	0.2
Industrial Sector	22.7	23.3	26.3	25.3	26.4	25.8
2. Mining & Quarrying	0.5	2.3	2.7	2.5	2.5	2.4
3. Manufacturing	16.0	14.7	18.3	18.2	18.6	18.7
- Large Scale	12.5	9.5	12.9	12.1	12.3	12.1
- Small Scale	3.5	5.2	4.1	4.7	4.9	5.1
4. Construction	4.2	2.5	2.1	2.1	2.6	2.5
5. Electricity & Gas Distribution	2.0	3.9	3.2	2.5	2.8	2.2
Services Sector	38.4	50.7	51.3	52.9	52.4	53.3
6. Transport, Storage & Communication	6.3	11.3	10.4	10.2	10.1	10.0
7. Wholesale and Retail Trade	13.8	17.5	18.7	16.8	17.0	17.2
8. Finance and Insurance	1.8	3.7	4.0	5.7	4.9	4.5
9. Ownership of Dwellings	3.4	3.1	2.9	2.8	2.7	2.7
10. Public Admn. & Defence	6.4	6.2	5.9	6.1	6.0	6.6
11. Other Services	6.7	9.0	9.5	11.3	11.8	12.3
12. GDP (Constant Factor Cost)	100.0	100.0	100.0	100.0	100.0	100.0

P Provisional

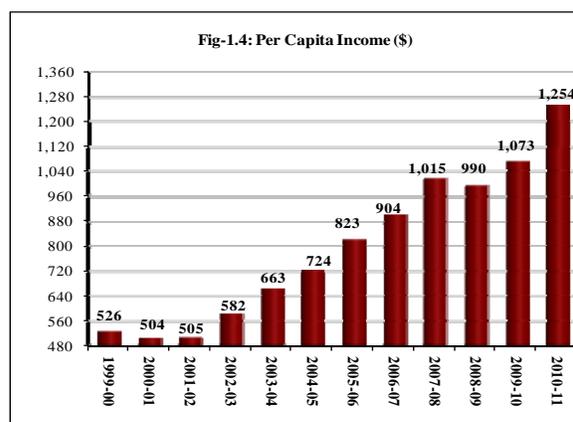
Source: Economic Adviser's Wing, Finance Division

VI. Per Capita Income

Per capita income imbeds a wide range of fluctuations behind the number, but still regarded as one of the foremost indicators of the depth of growth and general well-being of an economy. The historical importance and simplicity of per capita income as a measure of the average level of prosperity in an economy is well established. Per capita income grew by a meager 0.7 percent in 2010-11 as compared to 2.9 percent growth last year. This reflects the impact of slower economic growth. The per capita income in nominal terms grew by 19.9 percent.

The per capita income in dollar terms has increased from \$ 576 in 2002-03 to \$ 1254 in 2010-11, thereby registering fastest every growth of 16.9 percent [See Fig-1.4]. The main factors responsible for the sharp rise in per capita income include higher growth in nominal GDP, stable exchange rate and a four-fold increase in the

inflows of workers' remittances. Fig. 1.4 shows the improvement in per capita income during the last eleven years. The per capita income is reflecting the impact of recent economic slowdown.



VII. Investment and Savings

Investment is a key means for reviving economic growth to its historical levels. The total investment has declined from 22.5 percent of GDP in 2006-07 to 13.4 percent of GDP in 2010-11. Fixed investment has decreased to 18.1 percent of GDP from 20.4 percent last year. Gross fixed capital formation in real terms has contracted for third year in a row by 0.4 percent compared to a contraction of 57 percent last year. Even in nominal terms gross fixed capital formation increased by only 4.4 percent against decrease of 3.4 percent last year. Private sector investment on average contracted by 6 percent per

annum in real terms and recorded third contraction in a row. It contracted by 3.1 percent in nominal terms during 2010-11 as against contraction of 6.1 percent last year.

Public sector investment is crucial for catalyzing economic development and it has created spillover effects for private sector investment through massive increase in development spending particularly on infrastructure in the past [See Table-1.6]. However, squeeze on development expenditures made it to decelerate at a brisk pace. It decelerated from 5.6 percent of GDP in 2006-07 to just 3.3 percent in 2010-11.

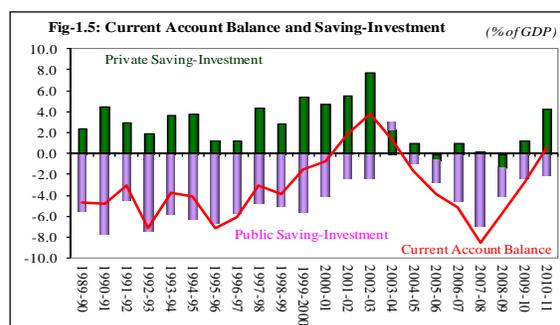
Table 1.6: Structure of Savings and Investment (As Percent of GDP)

Description	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10	2010-11P
Total Investment	16.9	16.6	19.1	22.1	22.5	22.1	18.2	15.4	13.4
Changes in Stock	1.7	1.6	1.6	1.6	1.6	1.6	1.6	1.6	1.6
Gross Fixed Investment	15.3	15.0	17.5	20.5	20.9	20.5	16.6	13.8	11.8
- Public Investment	4.0	4.0	4.3	4.8	5.6	5.4	4.3	3.6	3.3
- Private Investment	11.3	10.9	13.1	15.7	15.4	15.0	12.3	10.2	8.5
Foreign Savings	-3.8	-1.3	1.6	3.9	5.1	8.5	5.7	2.2	-0.4
National Savings	20.8	17.9	17.5	18.2	17.4	13.6	12.5	13.2	13.8
Domestic Savings	17.6	15.7	15.4	16.3	15.6	11.5	9.8	9.3	9.5

P: Provisional

Source: EA Wing Calculations

The contribution of national savings to the domestic investment is indirectly the mirror image of foreign savings required to meet investment demand. The requirement for foreign savings needed to finance the saving-investment gap simply reflects the current account deficit in the balance of payments. The marked improvement in the current account deficit is a reflection of narrowing savings-investment gap. If we disaggregate private and public savings-investment gaps, both gaps have improved to contribute in current account improvement [See Fig-1.5]. There are two ways of improving saving-investment gap; one is through increasing savings or through decreasing investment. Both in the public and private sectors saving-investment gaps, it is the fall in investment that has contributed to narrowing gap rather than increase in savings. Pakistan needs to gear up both savings and investment to enhance employment generating ability of the economy as well as more resource availability for investment.



National Savings at 13.8 percent of GDP in 2010-11 is reflecting one of the lowest savings in peer economies. Domestic savings has also declined substantially from 18.1 percent of GDP in 2001-01 to 9.5 percent of GDP in 2010-11. This is the lowest ever domestic savings level in almost two decades. The government remained major dis-saver while private sector savings are not adequate.

[Two special sections on cost of war on terror and Impact on Flood are given at the end].