

EMBASSY OF PAKISTAN  
ECONOMIC DIVISION

## Pakistan Macroeconomic Outlook for 2010-11

**The global recovery** is evolving better than expected but strength of rebound is moderate in many economies because of severity of the 2008-2009 recessions. World output is expected to expand by 4 ¼ percent in 2010. Global activity is recovering at varying speeds, lukewarm in many of the advanced economies but solidly in most emerging and developing economies. Money markets have stabilized, equity markets have rebounded, and the credit cycle may be turning up. In advanced economies, the tightening of bank lending standards is ending and credit crunch appears to be bottoming out. Prospective bank write-downs and loan loss provisions over 2007–2010 is estimated to \$2.3 trillion, two-thirds of which had been recognized at the end of 2009. Credit is accelerating in emerging Asia, stabilizing in Latin America and continues to contract at decelerating pace in emerging Europe. In a few advanced economies, rising public deficits and debt have contributed to a sharp increase in sovereign risk premiums, creating spillovers into other economies and markets.

**Advanced economies** are now expected to expand by 2¼ percent in 2010, following a more than 3 percent decline in output in 2009, and by 2½ percent in 2011. **Growth in emerging and developing economies** is expected to be over 6¼ percent during 2010–11, following a modest 2½ percent in 2009. The recovery under way in the major advanced economies will be relatively sluggish, both compared with recoveries following the major (but less deep) recessions of the mid-1970s, early 1980s, and early 1990s and compared with the recoveries forecast for many emerging economies. Several euro area economies that were hit particularly hard or have run out of macroeconomic policy room are likely to lag behind their major peers. By contrast, Australia and the **newly industrialized Asian economies** are off to a strong start and will likely stay in the lead. The pace of recovery will also diverge significantly among emerging and developing economies: the Asian economies, which suffered less during the downturn, are leading the recovery—in terms of both smaller output gaps and higher growth rates—and are forecast to continue to do so. **In sub-Saharan Africa**, most economies are expected to stay close to their potential output growth rates. Recovery in the

economies of emerging Europe and the CIS will continue to lag behind, with some exceptions.

**In China**, GDP growth exceeded the government's 8 percent target in 2009 and is expected to be close to 10 percent in both 2010 and 2011. What has been so far mainly a publicly driven growth path, built on infrastructure investment, is expected to turn toward stronger private consumption and investment. The **ASEAN-5** economies<sup>1</sup> are projected to grow by 5½ percent in 2010. Private domestic demand is expected to be the main driver of growth, with net exports playing a lesser role than in the past, reflecting stronger imports relative to historical standards. Australia's GDP growth is projected to be 3 percent in 2010 and 3½ percent in 2011, helped by strong demand for commodities, particularly from China. Growth in 2010 will be led by domestic demand, both private and public, with the pickup in commodity prices expected to boost investment in the resource sector. In Japan, exports have helped support a tentative recovery, but spillovers to autonomous domestic demand have so far been limited; domestic demand is likely to remain weak as a result of several factors, including the reemergence of deflation, continued excess capacity, and a weak labor market. Continued yen appreciation in 2010 could dampen the contribution of net exports to growth, particularly in comparison with the rest of Asia. As a result, the outlook depends crucially on planned fiscal policy support and the global upturn. GDP is projected to grow by 2 percent in 2010, supported by fiscal stimulus and rising exports.

Together with real and financial activity, cross border financial flows from advanced to emerging economies have picked up, primarily reflecting a recovery from deep retrenchment in 2008. Both equity and bond flows have accelerated. Key drivers behind the renewed capital flows include rapid growth in emerging economies, large yield differentials in their favour, and returning appetite for risk. It is expected that current account imbalances will rise noticeably as global trade continues to recover, financing improves, and commodity prices stabilize at higher levels.

**A stimulus-led recovery is under way in the United States**, but private demand remains soft. The labor market remains unusually weak. The recovery ahead is expected to be gradual, particularly when the **effects of the stimulus subsidy**. Real GDP is projected to grow by 3 percent in 2010. The recovery is expected to be tempered by households' continued need to rebuild wealth, the expected slow but necessary process of financial sector repair and deleveraging, and continued weakness in the labor market. The removal of policy stimulus will subtract from growth, which will moderate to 2.6 percent in 2011. Unemployment is projected to remain high in 2010, at 9½ percent (year-average basis), before declining to 8¼ percent in 2011 as employment

growth picks up. And inflation is expected to remain subdued, at 2 percent in 2010 and 1¾ percent in 2011, given continued economic slack.

**Continued weakness** in real estate (including the commercial sector) or fresh turbulence in financial markets could, however, weigh negatively on activity. Nevertheless, these risks could be off-set by more-resilient-than-expected private demand if confidence improves, by additional stimulus, or by a more-buoyant-than-expected inventory cycle. The balance of risks for 2011 and beyond remains on the downside. The medium-term fiscal outlook is daunting—under conservative assumptions about growth and interest rates and absent action, the **deficit would rise to 8 percent of GDP in 2020, with the federal debt exceeding 100 percent of GDP**—and significant additional adjustment would be needed to put public debt on a sustainable path. Meanwhile, the ongoing, extraordinarily accommodative stance of monetary policy should continue to support recovery. Although the Federal Reserve has communicated its exit strategy and continued to develop tools to implement the exit, it has also stressed its intention to maintain accommodation as needed. It has also signaled that it is committed to withdrawing excess liquidity and normalizing monetary policy gradually—an appropriate strategy in light of uncertainties about both the economic outlook and the strength of the monetary transmission mechanism, particularly given high excess liquidity and remaining weaknesses in financial sector balance sheets. It is less likely that current account deficits—which shrank substantially in the past year—will return to the unusually large levels that prevailed before the crisis.<sup>1</sup>

**Concerns of W-Shaped Recovery in the United States**---Some economists in the US is prognosticating **W-shaped or double dip** recovery based on high consumer savings, cautious spending, slow recovery in real estate, high unemployment rate and slow building up of banks assets. However, the proponents of **U-Shaped recovery** based on their argument on 2010 Q1 real GDP growth which is about 3 % mainly coming from consumer demand. **Various leading indicators point to an acceleration in Q2 GDP growth** - for example, ISM, stock prices, housing permits, the Employment Trends Index, credit spreads, the average workweek, and temporary employment. Retail sales finished Q1 in strong fashion, which gives Q2 consumer spending decent statistical momentum. And survey data hint at the potential for a large inventory rebuild.

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<sup>1</sup>. World Economic Outlook, April 2010

## **Outlook for Pakistan Economy**

Pakistan has achieved fairly impressive early success in its efforts to stabilize the economy from a parlous state of affairs in the aftermath of the macroeconomic crisis of 2008. Protecting the recovery is of paramount importance, and the government needs to keep a restrictive stance on public spending. Greater realism about the prospects and accurate forecasts about resources and available funds for the development plans at each level of government is needed.

The macroeconomic context remains difficult in the near term with continuing challenges. The global economy remains volatile with uncertain prospects for demand for Pakistan's exports. In addition, the energy and water shortage, and the internal security situation, could constrain growth in 2010-11. The medium term prospects for the economy are promising, provided the current path of reform is not abandoned. The economy could benefit from large initial productivity gains as capacity utilization begins to increase from a low base.

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

- Checking inflation—this involves limiting borrowing by the government and the public sector
- Bringing people to the centre stage, by appropriately designed employment and training programs to protect those in strife-affected areas, and new entrants to the labour force
- But there are major risks to the growth and stabilization prospects if there is:
  - Non-implementation of the reform of the GST, leading to a VAT, or other significant tax broadening measures. This might affect the phased nature of fiscal devolution envisaged under the Eighteenth Constitutional amendment (to be effective from 2011-12), in the context of the frontloaded transfers to the provinces under the Seventh NFC Award (effective from July 1, 2010)
  - Larger-than-budgeted security related expenditures
  - Inadequate targeting of subsidies
  - Failing to reform public sector enterprises, including the power sector, with no resolution of the energy circular debt issue

- Continued overhang of commodity financing debt stock, if unchecked, threatens to constrict access to bank credit by the private sector, while simultaneously increasing the interest rates in the economy
- A deterioration of the internal security situation.

The tipping of the world economy into a severe recession in the wake of the Euro-zone debt crisis or **W-shaped recession in the US**, could hurt Pakistan's exports as well as remittances on the one hand, but could reduce international prices of key commodities such as oil, on the other. With relatively low levels of capacity utilization in the economy, a turnaround in investor confidence can unleash large productivity gains even with low levels of fixed investment. Nonetheless, overall, a combination of rising fiscal pressures, a developing debt overhang, and an uncertain path of inflation in the near term, significantly reduces policy space to stimulate the economy. For the longer term, efforts to meaningfully address Pakistan's perennial structural challenges, such as the abysmally low tax/GDP ratio and low overall productivity in the economy, are more than likely to unlock Pakistan's substantial economic potential.<sup>2</sup>

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<sup>2</sup>. Economic Survey of Pakistan 2010