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THE STATE OF PAKISTAN'S ECONOMY
Second Quarterly Report for FY07

1.1 Overview
Midway through the fiscal year, available information suggests that real GDP growth during FY07 will remain close to the 7 percent annual target, despite some setbacks suffered by the commodity producing sub-sectors. Despite the underperformance of key *kharif* crops, a bumper wheat harvest and indications of strong outturn by the livestock sub-sector offer hopes of a recovery. Similarly, while data constraints inhibit a more robust forecast, the limited data set available suggests that industrial performance will also improve. Finally, the services sector, which pushed up GDP growth in the preceding years, is also expected to remain strong in FY07.

More importantly, the significant improvement (and stability) in the macroeconomic fundamentals, high growth rates in recent years, sustained policy focus on the implementation of reforms for the liberalization of the economy, and relative stability of the exchange rate, continues to attract investors, resulting in a substantial rise in investment, particularly Foreign Direct Investment (FDI). This improvement in investment will substantially boost the economy's prospects of managing macroeconomic imbalances and improving the prospects of sustaining high growth rates in years ahead.

Table 1.1: Selected Economic Indicators
Jul-Feb or as mentioned

		FY05	FY06	FY07
Growth rates (percent)				
Large scale manufacturing	Jul-Dec	22.7	8.7	9.8*
Exports (fob)		12.1	18.8	4.0
Imports (cif)		35.4	46.3	10.0
Tax revenue (CBR)	Jul-Jan	15.0	21.7	25.1
CPI (12 month MA)		8.2	8.9	7.7
Private sector credit		25.3	18.1	10.7
Money supply (M2)		10.9	8.7	7.7
million US Dollars				
Total liquid reserves[1]	End-Feb	12.7	11.5	13.4
Home remittances		2.6	2.8	3.4
Foreign investment	Jul-Jan	1.2	1.6	3.5
percent of GDP[2]				
Fiscal deficit	Jul-Dec	1.2	1.8	1.9
Trade deficit		2.7	5.8	6.1
Current account deficit	Jul-Jan	0.8	2.6	3.3

* September 2006 data point. More recent data is not available.
1. With SBP & commercial banks.
2. Based on full-year GDP in the denominator.

While the prospects of increasing investment is a necessary factor, it is equally important for policy makers to address economic stress points, such as the high (albeit decelerating) inflation, large current account deficit, fiscal risks (such as the low tax-to-GDP ratio) and low savings rates.

The measured monetary tightening implemented by the central bank over the last two years appears to be bearing fruit in FY07. While growth remains strong, headline CPI inflation has finally followed the decline in underlying (core) inflation, to reach 7.4 percent YoY by February 2007. However, the average annual inflation while declining to 7.7 percent is above the 6.5 percent annual target. Thus, given that instability in key CPI components persists, and that reserve money growth is high, the current policy must be sustained. Indeed, inflation must be contained in order to bring real returns to savers significantly positive. This would encourage domestic savings to rise from current low levels, lowering the country's dependence on potentially fickle foreign investment.

A part of the strength in aggregate demand is contributed by the expansionary fiscal policy followed so far in FY07 due to the necessary expenditures for rehabilitation of earthquake struck areas and for development requirements. Expenditures have grown 23.5 percent during Jul-Jan FY07, well above the budgeted annual growth, but fortunately these have been matched by an equally unexpected jump in revenues. The unexpected 61.9 percent YoY rise in direct tax collections is certainly welcome, compensating for the decline in import-based taxes as import growth subsided. However, the abrupt shift in the profile of CBR tax receipts underscores three points: (1) it is important to diversify the tax base, so that underperformance in a portion of the economy does not cause a disproportionate revenue losses; (2) one must carefully examine the underlying causes of the revenue growth to separate one-off factors from underlying (sustainable) factors, and; (3) it is crucial for fiscal discipline that expenditure growth be kept at levels consistent with sustainable revenue growth.

Finally, reflecting strong aggregate demand, the current account deficit widened 42.3 percent YoY to US$ 4.8 billion during Jul-Jan FY07. However, the monthly trend for the period shows a distinct declining trend, reflecting the precipitous drop in import growth as oil prices declined and the one-off impact of structural changes was absorbed by the economy. Moreover, in the short-run, the financing of the large current account deficit has eased somewhat given strong foreign investment and financing flows. Indeed, it is likely that despite the expected large fiscal and current account deficits the country's debt profile will continue to improve in FY07, with a continuing fall in the debt to GDP ratio.

It has to be recognized that import growth would have to remain in double digits if the economic growth is to be sustained at high levels, which in turn is contingent on the buildup of infrastructure,[1] substantial addition to industrial capacity, as well as rising imports of inputs (particularly energy). Thus, in order to support this required import growth it is imperative to significantly boost exports and encourage import substitution for products where Pakistan has competitive advantages (particularly in food commodities).

However, the slowdown in export growth from double digits in the last 4 years to low single digits in FY07 needs to be carefully examined in order to ascertain the underlying problems and appropriate policy responses. The importance of sustaining strong export growth cannot be overstated.

A turnaround in exports will need to be supported by measures to reduce the cost of doing business (reducing red-tape and eliminating unnecessary regulations, ending multiplicity of taxes and agencies, etc.), facilitate supply chain improvements and provide a flexible labor market, as well measures focusing on the issues of productivity enhancement, quality improvement, costs & scale economies, product & geographical diversification, etc. Recognizing these needs, the government has established the Competitive Support Fund and National Textile Strategy Committee to explore policy options.

1.2 Forward Looking

SBP projections indicate that FY07 real GDP growth is likely to grow in the range of 6.6 - 7.2 percent, close to the annual target of 7.0 percent and above the desired 6.0 percent long-term growth for the economy. The achievement of the upper bound of the forecast however, would be critically dependent on a strong performance by large scale manufacturing and the livestock sub-sector (where investments have increased). As a direct consequence of this strong aggregate demand as well as some commodity price shocks, average inflation for the FY07 is forecast to remain in the 6.7 - 7.5 percent range, well above the annual target, although still substantially lower relative to the preceding year (see **Table 1.2**).

While the fiscal deficit is expected to be contained within the annual target, it is significant that aggregate expenditure growth has been much greater than budgeted, and the growth of the deficit has been contained only due to extraordinarily strong direct tax receipts. Fortunately, the government is already seeking to explore options to widen the tax net to under taxed areas in order to raise the tax-to-GDP ratio.

[1] The approval process is underway for ten oil-based projects with a cumulative capacity of 2355 MW and an estimated cost of US$ 1,766 million. (Source: http://www.ppib.gov.pk)

The current account deficit is projected to widen during FY07 as, despite a sharp fall, growth in imports remains higher than that of exports. However, as the economy continues to expand strongly, this does not pose a significant macroeconomic risk in the short term, particularly due to availability of debt on favorable terms and strong investment flows.

Table 1.2: Major Economic Indicators

	Provisional FY06	FY07 Original targets	FY07 SBP projection
Growth rates (percent)			
GDP	6.6	7.0	6.6 – 7.2
Inflation	7.9	6.5	6.7 – 7.5
Monetary assets (M2)	15.2	13.5	13.5 – 14.5
billion US Dollars			
Exports (fob-bop data)	16.6	19.8	17.9
Imports (fob- bop data)	25.0	27.4	27.2
Exports (fob-Customs data)	16.5	18.6	17.2
Imports (cif-Customs data)	28.6	28.0	30.7
Workers' remittances	4.6	4.5	5.3 - 5.5
percent of GDP			
Budgetary deficit	4.2	4.2	4.2
Current account deficit	3.9	4.3	4.5

Over the medium term, investment policy in Pakistan has to be directed to take advantage of the growing investment flows (both domestic and foreign) in order to help stimulate industrial growth and its diversification, as well as to help remove infrastructure gaps and bottlenecks. In particular, agriculture policy will need to focus on encouraging investment for the implementation of large water resource projects, supporting market-based pricing (e.g., as done for rice and wheat) and improving transmission of pricing signals to farmers (e.g., through introduction of a commodity futures market), as well as improvements in transportation and storage infrastructure. Similarly, investment in industry has to be encouraged to support value-addition in textiles, increase agri-product processing and allow the country to diversify production into the medium and high-end technology products such as electronic goods, automobiles, engineering goods, etc.

However, allocative efficiency demands that the direction of investment flows must not be mandated by government, and that rewards and risk mitigation be done principally by market pricing pressures. This, in turn, means that: (1) the market prices should not be distorted by collusive behaviors of participants; and that (2) financial markets are able to efficiently allocate capital and help mitigate risk.

Both require policy interventions. The government has already focused on the creation of the Monopolies Control Authority (with supportive legislation expected soon). Along the same lines, capital market reforms need to be further deepened. Aside from the need to boost liquidity of equity and debt markets, curbing a high degree of speculative transactions would minimize bouts of instability and market manipulation.

Given the importance of long-term debt markets to support investment, particularly in infrastructure projects, to increase domestic savings, and to improve the risk profile of commercial banks (which currently face mismatches in lending and deposit profiles), Pakistan needs to foster the development of a long-term institutional savings industry (pension and provident funds, mutual funds, etc.). Implementation of capital market reforms, aiming to encourage investment rather than speculation and improving risk management will also improve financial sector stability.

1.3 Executive Summary

Agriculture

The prospects of a strong FY07 *rabi* harvest have improved significantly. The extended rainy season and snowfall have increased water availability and encouraged farmers to increase the planted area and raise the use of quality input. The latter also well supported by the government policies such as the subsidy on non-urea fertilizers, media campaign to educate farmers for the use of a balanced mix of urea and DAP, as well as a rise in the support price of wheat. A good rabi harvest is expected to help offset the adverse impacts of relatively weak *kharif* crops (cotton, rice and maize) on the overall agriculture growth. Nonetheless, the growth of the crops sub-sector will likely remain below the FY07 target, although it will still represent an improvement over FY06. Thus, hopes of achieving the aggregate agri growth target rest on very good outturn by the livestock sub-sector.

Large Scale Manufacturing

In the absence of the usual data on aggregate large scale manufacturing, the analysis is limited to the sugar, automobile, cement, fertilizer, and petroleum products industries (that certainly is not representative of developments in overall LSM). According to the limited available information, the *cement* industry showed remarkable growth in production during H1-FY07, mainly attributed to enhanced installed capacity during the last five years and rise in local as well as external demand. Similarly, the *sugar* industry recorded 15.5 percent rise in production in H1-FY07 as against a fall of 40.5 percent in H1-FY06. This rise mainly reflects the 15.2 percent increase in the sugarcane harvest during *kharif* FY07.

The *automobiles* sector recorded a growth of 6.8 percent during H1-FY07; significantly lower than the 28.6 percent seen in H1-FY06 and the lowest during the last five years. This slowdown is largely a result of (1) capacity constraints, (2) slowing demand growth, and (3) imports of used vehicles.

Fertilizer industry is facing capacity constraints due to rapid growth in the production in recent years, temporary shutdown of a plant for capacity expansion and revamping, and slowdown in urea demand due to sustained rise in the prices of urea amidst delay in the purchase of fertilizer during Jul-Oct 2006 in anticipation of subsidy on non-urea.

A mismatch in the production mix and the demand growth patterns resulted in output decline by 6.6 percent in *petroleum products*.

Prices

The underlying inflationary pressures in the economy continued to ease in FY07, with Consumer Price Index (CPI) inflation finally dipping below 7 percent YoY in January 2007, for the first time in 8 months,[2] and WPI inflation continuing its trend decline to fall to a 25-month low of 5.1 percent YoY by February 2007. Even more significant, from a policy perspective, is the relative stability of the downtrend in core inflation (as measured by the non-food non-energy component of the CPI), which has declined steadily since April 2005 to 5.7 percent YoY by February 2007. While the other important measure of core inflation, (i.e., the 20 percent trimmed mean) witnessed a relatively smaller decrease in October-February FY07, in each month of this period it remained the same or below that in the corresponding month of FY06.

The broad reduction in underlying inflationary pressures in FY07, as evidenced by the weakening in core inflation, suggests that aggregate demand pressures in the economy are being reined-in by the continued tight monetary policy. However, the sharp deceleration in the overall CPI inflation in January 2007 mainly incorporates the impact of an exceptionally strong deceleration in food price inflation as prices of many key staples fell to more normal levels, after staying at exceptionally high levels in the preceding months.

Money and Banking

The M2 growth has decelerated to 7.7 percent during Jul-Feb FY07 period compared to 8.7 percent during the corresponding period of previous year. The

[2] CPI inflation decelerated to 7.4 percent YoY during February 2007 compared with 8.0 percent YoY in February 2006.

deceleration in M2 growth is principally due to a decline in growth of private sector credit. The resultant reduction in excess aggregate demand has resulted in further moderating inflationary expectations as evident from a continued downtrend in core inflation that has slowed to 5.3 percent YoY in January 2007 from 8.8 percent YoY in January 2006. More importantly, this slowdown in inflationary pressures has been achieved without significantly affecting the growth momentum.

Although the year-on-year growth in private sector credit was strong at 15.7 percent on 24th February 2007, the impact of the reduction in excess aggregate demand on private sector credit growth was compounded by structural problems in the real sector of the economy that reduced its ability to absorb additional credit at the same pace as in the past two years. The impact of this was also compounded by the recent mergers/acquisitions in the banking sector, and consequent slowdown in credit operations. This was most evident in the agriculture and consumer credit market segments. Further, the lending capacities of banks also constrained as some of the banks are trying to improve their risk management practices. A third contribution was from delays in initiation of major infrastructure projects, e.g., power projects. Credit growth is expected to accelerate as structural factors are resolved and the infrastructure projects come online.

The reserve money has increased sharply by 15.3 percent during Jul-Feb FY07 compared to 9.6 percent growth in Jul-Feb FY06. The key reason for the rise in reserve money growth is SBP's support to the export sector and the need to meet the long-term investment demand. The SBP first lowered the export refinance rate in July 2006; thereby reducing the cost of financing to industry to around 300 bps below market and later in September 2006 offered a debt swap option to textile sector to convert their fixed investment loans into relatively cheaper LTF-EOP facility.[3] The incentives led to a Rs 58.0 billion surge in financing (provided by the SBP) and pushed up the reserve money growth.

Another contribution to reserve money growth was the pattern and behavior of government borrowings. Although the budgetary borrowings from the SBP declined in Jan-Feb FY07, and aggregate bank borrowings are markedly low during Jul-Feb FY07 compared to the corresponding period of previous year; this was possible mainly due to greater availability of financing from external and non-bank sources November 2006 onwards. In particular, the impact of decline in SBP's NDA due to lower government borrowings was offset by the rise in NFA.

[3] The LTF-EOP scheme offers fund for 3-7 years at 600-700 bps below the market rate.

Thus, the reserve money growth has continued unabated with a change only in its composition.

Going forward, the large foreign exchange inflow since November 2006 is a major challenge to SBP. In addition to making the country's balance of payments outlook positive for FY07, these foreign currency inflows would also exert upward pressures on reserve money growth. Both the government and the private sector are expected to benefit from these foreign currency inflows, and in a situation where the reserve money growth is already considerably high, such inflows would make liquidity management by the central bank more challenging. One obvious policy response from central bank could be the sterilization of monetary impact stemming from such inflows.

Fiscal Developments

The recent fiscal numbers show that the government is comfortably placed to meet the FY07 targets, with exceptionally strong direct tax collections and robust non-tax revenues offsetting a substantial increase in expenditures.

Although fiscal balance deteriorated marginally during H1-FY07, but the other fiscal balance indicators showed a little improvement. The growth in tax revenues – the strongest for the last five years – mainly came from the direct taxes that offset the fall in import taxes due to slowdown in imports. Aggregate CBR tax collections surpassed the target of Rs 436.0 billion with a collection of Rs 462.7 billion during Jul-Jan FY07, but the collection of indirect taxes remained below its target. Expenditure grew 23.5 percent YoY to Rs 783.8 billion. The rise in expenditure mainly came from the current expenditure that increased due to surge in interest payments and other general public services.

Balance of Payments

Pakistan's external account position further improved during Jul-Jan FY07 both with respect to the immediately preceding quarter and the corresponding period last year despite worsening of the current account deficit.

Although the current account deficit widened to US$ 4.8 billion during Jul-Jan FY07, the monthly trend shows distinct declining trend. However, despite the slowdown in the monthly growth of current account deficit during Jul-Jan FY07, on average the current account deficit has remained higher than during Jul-Jan FY06.

The main cause for the rise in the current account deficit was the abnormal slowdown in exports, which has persisted since January 2005. This has offset part of the gains from the anticipated weakening in imports.

In the meantime, in addition to the apparent decline in the monthly current account deficit, another point of comfort is the large capital and financial account surplus. Not only these surpluses more than offset the current account deficit, it is encouraging to note that almost half of the inflows in the capital and financial account comprised of equity flows.

The impact of the strong financial account flows is evident on the exchange rate and the foreign exchange reserves of the country. The reserves increased to US$ 13.4 billion by end-Feb FY07 from US$ 13.1 billion at the end of FY06. In the absence of any untoward pressure on the reserves, the Pakistani currency remained broadly stable vis-à-vis US dollar throughout the Jul-Feb FY07 period. However, the real effective exchange rate (REER) appreciated by 2.5 percent despite 2.6 percent depreciation in nominal effective exchange rate (NEER), due to a 5.2 percent rise in relative price index.

***Foreign Trade*[4]**

The slowdown in import and export growth rates that emerged in the second half of FY06 continued throughout FY07 as well. Unfortunately, despite a precipitous decline, the growth rate for imports remains higher than that of exports (and is on a larger base). Consequently, the trade deficit continued to widen, albeit at a much slower pace.

The fall in the import growth rate is largely in line with expectations. Specifically, with the lower oil prices and absorption of one-off impact of structural changes such as opening up of telecom and auto sectors, the slow down in import growth was expected. In fact, as a result of lower import growth the trade deficit would have begun to shrink, had the exports grew even at a relatively low growth of 12.6 percent seen in the previous five years.

A part of the exports slowdown can be explained by factors such as the adverse impact on textile exports to the EU following the loss of Generalized System of Preference (GSP) and persistence of the discriminatory antidumping duty on bed linen from Pakistan. Similarly, rice exports have also dropped due to a poor

[4] The analysis is based on the provisional data provided by Federal Bureau of Statistics, which is subject to revisions. This data may not tally with the exchange record numbers reported in the section on *Balance of Payments*.

harvest, while exports of refined petroleum products, carpets and leather dropped due to adverse industry dynamics. However, the broader deceleration in export growth is still puzzling.

In the aforementioned situation there is need to focus more strongly on strategies for the promotion of exports (and import substitution) by focusing on the issues of productivity enhancement, quality improvement, costs & scale economies, product & geographical diversification as well as creating a pro-industry and investment-friendly environment in the country.

2 Real Sector

2.1 Agriculture Sector Performance

The prospects of a strong FY07 *rabi* harvests have brightened significantly. The extended rainy season (and snowfall) means that water availability is the best seen since FY00, and the impact of this has been complemented by the continued access to credit and the availability of other inputs (fertilizer, credit, etc. - see **Table 2.1**). The *rabi* crops are also expected to benefit from supportive government policies such as the subsidy on non-urea fertilizers, the media campaign to educate farmers about the use of a balanced mix of urea and DAP, as well as a rise in the support price of wheat.

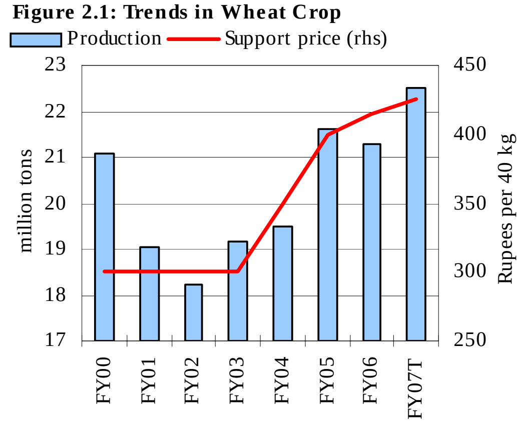
Table 2.1: Availability of Inputs (Jul-Dec)

	FY05	FY06	FY07
Rain fall (cm)	296.8	549.3	673.9
Water availability at canal heads (MAF)	82.2	93.1	103.5
Credit disbursement* (billion Rs)	57.5	71.7	81.0
Fertilizer off-take (million tons)	3.8	3.8	3.8

* Jul-Jan
Sources: 1. Planning & Development Division
2. IRSA
3. Agriculture Credit Department, SBP

It is important to note that timely announcement of support policy measures is a crucial factor for yielding effective results. **Figure 2.1** illustrates that during the period (FY00-FY03) when support price for wheat was left unchanged; production of wheat remained around 19 million tons. In contrast, a major stimulus to production was evident due to the continued rise in the support price of wheat since FY04 as an effective incentive to farmers. As a result, the realized harvest of wheat exceeded 20 million tons each year.

Figure 2.1: Trends in Wheat Crop



It is hoped that a good performance of *rabi* crops would also help to compensate, in part, for the disappointing performance of three major *kharif* crops (cotton, rice and maize) during FY07. While the decline in the harvests of all these crops was principally driven by a fall in the area under cultivation,[1] the cotton crop also suffered due to viral attacks (see **Table 2.2**). In aggregate, however, the growth of crops sub-sector will likely remain below the FY07 target, although it will still represent an improvement over the FY06 performance. Meeting the agriculture growth target in FY07 would therefore require the livestock sub-sector to growth well above target.

Table 2.2: Major Crops – Area, Production and Yield

Crops	FY05	FY06T	FY06P	FY07T	FY07E	% change in FY07 over FY06
Area Under Cultivation (000' hectares)						
Cotton	3,229	3,247	3,100	3,250	2,951	-4.8
Sugarcane	967	955	907	1,005	1,017	12.1
Rice	2,520	2,533	2,621	2,575	2,475	-5.6
Wheat	8,358	8,415	8,355	8,459	8,420	0.8
Gram	1,109	1,113	1,066	1,051	-	-
Maize	945	971	1,030	1,001	1,027	-0.3
Production (000 tons; cotton in 000' bales of 170kg each)						
Cotton	14,600	15,000	13,000	13,820	12,500	-3.8
Sugarcane	47,224	50,095	44,651	50,500	51,444	15.2
Rice	5,025	5,000	5,547	5,693	5,400	-2.7
Wheat	21,612	22,000	21,708	22,000	22,500	3.6
Gram	766	853	536	610	707	31.9
Maize	2,520	2,905	3,560	3,279	2,918	-18.0
Yield (Kg/hectare)						
Cotton	769	785	713	723	720	1.0
Sugarcane	48,836	52,455	49,229	50,249	50,584	2.8
Rice	1,994	1,974	2,116	2,211	2,182	3.1
Wheat	2,586	2,614	2,598	2,601	2,672	2.8
Gram	691	766	503	580	-	-
Maize	2,667	2,992	3,456	3,276	2,841	-17.8

P: Provisional; T: Target; E: Estimates

Note: Wheat and Gram production targets were revised to 22500 and 707 thousand tons respectively for FY07.

Source: MINFAL

[1] The area under cotton and rice was principally hit by flooding, while the lower cultivation of maize mainly reflected the substitution with sugarcane.

Crop Sub-sector

Wheat

Encouraged by higher support prices, increased irrigation water availability, the subsidy on the purchase of non-urea fertilizers, and favorable weather conditions, growers increased the cultivated area for wheat. Latest available data (for January 23, 2007) indicated that this had risen by 0.7 percent YoY (or 56 thousand hectares),[2] achieving the cultivation area target for the year.[3] Clearly, in effect, the delayed beginning of the sugarcane-crushing season has not had a materially adverse impact on the area under wheat, though it can be argued that the area under wheat may have been even higher were it not for this delay.

Furthermore, the crop is also expected to benefit from significant and widespread rains during December 2006 and February 2007; the rains at this stage are likely to lead to heavier wheat kernel and reduce pest incidence. While the unseasonal rains have also caused minor damage in some areas, in net terms Pakistan is expected to record yet another bumper wheat harvest, if conditions remain favorable.

In anticipation of a bumper wheat harvest, the SBP has proactively moved to allow ample credit lines to the private sector for the purchase of wheat, in order to ensure the timely off-take of wheat stocks by traders (see **Box 2.1**).

This said, effective policy measures for other crops are also required to assure incentives to farmers. For example, continued dispute on the pricing for the sugarcane crop is not only hurting farmers, it is also damaging for the future growth prospects of the crop as well as agriculture. Price disputes resulted in delays in crushing, thus area under the crop remained occupied. To avoid such issues, effective regulations may be helpful. Though, regulations generally create distortions, however if market failures do not permit the efficient outcome then regulations can indeed help to achieve better results.

[2] Pertain to 8th-23rd January 2007.

[3] It is possible that final data will show that cultivated area was above target.

Box 2.1: Financial Support for Wheat Marketing
In order to strengthen wheat marketing, banks will extend funds to flour mills and licensed traders for procurement of indigenous wheat for FY07 crop, subject to the following terms:

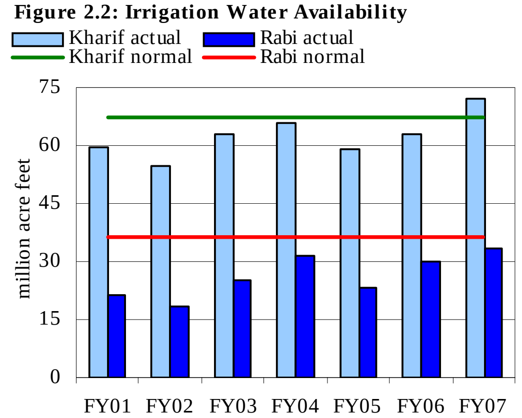
1. Banks will determine the rate of mark-up on lending to the private sector for the purpose of wheat procurement depending upon the risk profile of each borrower. Though lending to the government agencies for wheat procurement is secured against the government guarantee, it is expected that the relative mark-up rate would be competitive in comparison to the rate charged to their borrowers in the private sector;
2. Banks may fix minimum margin requirement of 10 percent of the value of the wheat stock. However, banks shall not provide any financial facilities (funded or non-funded) to enable borrowers to meet the margin requirements;
3. Loans provided to the private sector will be for the procurement of indigenous wheat only and shall be repayable on or before January 31, 2008 positively;
4. Banks are also allowed to provide facilities for wheat procurement by the seed processing plants, in line with their lending policies and the capacity/production plans of the seed processing plants;
5. Banks shall ensure that the loans provided under the wheat procurement policy 2006 have been adjusted as per terms of SMED Circular No. 05 dated 14-03-2006. Fresh financing to the eligible borrowers for procurement of wheat during 2007 shall start from commencement of wheat procurement season 2007 in respective provinces, on arrival of new crop in the market;
6. Banks will continue to submit a weekly statement in respect of financing to private sector for wheat procurement as per the prescribed format already in use; and
7. The lending shall be in compliance with the Prudential Regulations and other instructions of SBP issued from time to time.

Agriculture Inputs

Irrigation Water

Higher than normal monsoon rains in 2006 together with the winter rains in December 2006 and February 2007 have pushed up water availability for *rabi* crops to the highest levels since FY00 (see **Figure 2.2**). In particular, the higher rains in February 2007 raised the irrigation water availability approximately by 1.8 MAF[4] for the *rabi* FY07 season, 11.3 percent higher over *rabi* FY06.

Figure 2.2: Irrigation Water Availability



[4] IRSA revised irrigation water availability from 31.6 MAF to 33.4 MAF for FY07 *rabi* season.

The rains in February 2007 would particularly benefit the wheat crop, which is in the reproduction stage. In addition, these rains would also lead to increase production of vegetables and fruits. This spell of rainfall may prove to be exceptionally beneficial for Balochistan province, the *Cholistan* desert and its adjacent areas, as it will encourage growth of natural fodder for animals, increase foliage and improve water resources. Further, these rains also diluted the impact of the acute shortage of irrigation water in Punjab's southern regions[5] due to the on-going execution of the project for the modernization and rehabilitation of *Taunsa* Barrage.

The widespread rains and snowfalls in February 2007, in the Northern areas have also improved the water storage in *Tarbela* and *Mangla* dams, with prospects of adequate supply of irrigation water for the coming *kharif* crops.

Fertilizer off-take

Despite higher farm incomes, better irrigation water availability and higher credit disbursement by banks, fertilizer off-take declined in H1-FY07.

This was mainly because farmers delayed purchases in anticipation of a subsidy on non-urea fertilizers. As evident from **Table 2.3**, the entire net decline in fertilizer off-take during Jul-Dec FY07 was due to a fall in sales during July-October FY07 ahead of the November 2006 subsidy announcement. Subsequently, off-take has risen very substantially. In fact, significant increase of 30.9 percent during Nov-Dec FY07 almost offset the impact of decline in fertilizer off-take during Jul-Oct FY07.

Table 2.3: Growth in Fertilizer Off-take

percent

	FY06	FY07
Urea		
Jul-Dec	2.1	-6.1
Jul-Oct	12.7	-23.4
Nov-Dec	-11.0	20.9
DAP		
Jul-Dec	-0.8	12.1
Jul-Oct	-4.6	-15.4
Nov-Dec	6.7	60.7
Total		
Jul-Dec	1.3	-1.2
Jul-Oct	7.4	-21.2
Nov-Dec	-7.1	30.9

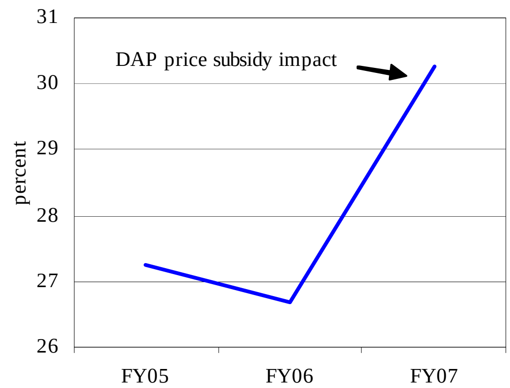
Interestingly, while no subsidy had been expected for urea, off-take of this had also dipped along with that of DAP. This correlation is explained by the fact that

[5] Muzaffargarh, Rajanpur, Jampur, Kot Mithan, Fazilpur and Dera Ghazi Khan.

hitherto urea (which has an implicit price subsidy) had been used excessively in Pakistan, at the expense of DAP (the domestic price of which follows international trends). Thus, as the promised subsidy on non-urea fertilizers promised to bring down DAP prices to more affordable levels, farmers held back on excessive use of urea as well, ahead of the subsidy announcement.

Thereafter, while the sales of both types of fertilizers witnessed a significant increase during Nov-Dec FY07, reflecting the more balanced fertilizer usage, the share of DAP fertilizer off-take is now higher (see **Figure 2.3**). This trend was also helped by greater awareness of the farmers following an aggressive media campaign launched by the government.

Figure 2.3: DAP Share in Fertilizer Off-take (H1)



Agriculture Credit[6]

The agri-credit disbursement during FY07 was expected to decelerate from the exceptional levels in the past three years. This is implicit in the 16.4 percent YoY disbursement growth target for the year, as compared to the 26.4 percent rise in FY06. However, the 13.0 percent rise seen during Jul-Jan FY07 is much weaker than anticipated (see **Table 2.4** and **Figure 2.4**).

Table 2.4: Credit to Agriculture Sector (Jul-Jan)
billion Rupees

Banks	Disbursement			Recovery			Net Credit[1]	
	FY06	FY07	Growth	FY06	FY07	Growth	FY06	FY07
Big 5 CBs[2]	37.6	37.9	0.9	20.6	35.4	72.0	17.0	2.5
ZTBL	22.6	27.2	20.4	22.7	25.9	14.1	-0.1	1.3
PPCBL	3.3	4.0	22.1	3.5	3.4	-3.2	-0.2	0.7
DPBs	8.2	11.8	44.3	2.9	9.6	231.9	5.3	2.2
All banks	71.7	81.0	13.0	49.7	74.3	49.6	22.0	6.7

[1] Net Credit = disbursement minus recovery
[2] Includes: NBP, HBL, MCB, UBL, and ABL

This deceleration is principally due to a decline in the disbursement of the loans for development purposes, which fell by 19.9 percent YoY during Jul-Jan FY07. In contrast, the disbursement of production loans rose by 19.8 percent YoY in the same period.

Figure 2.4: Agriculture Credit Disbursement

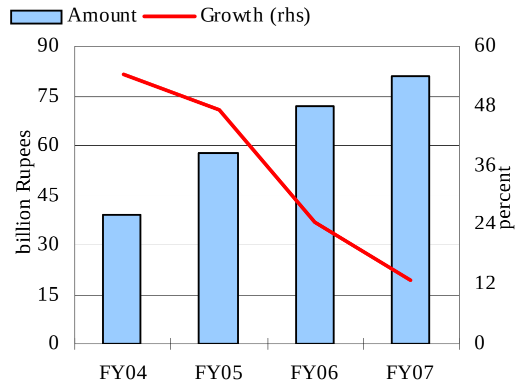


Table 2.5: Growth in Agriculture Credit (Jul-Jan)

percent

	FY05	FY06	FY07
ABL	45.8	50.7	9.7
HBL	97.1	47.9	-22.2
MCB	46.8	4.3	35.6
NBP	51.2	29.4	13.5
UBL	14.5	83.5	-3.9
Sub-total 5-big CBs	**56.8**	**39.3**	**0.9**
5-Big CBs excl. HBL	*43.2*	*35.2*	*12.7*
ZTBL	26.1	9.9	20.4
PPCBL	10.9	-29.0	22.1
DPBs	281.9	54.0	44.3
Grand total	**94.1**	**27.2**	**12.9**

Moreover, the relative deceleration in aggregate disbursement of loans by banks is largely contributed by a single commercial bank that was undergoing an organizational restructuring (see **Table 2.5**).[7] This would suggest that the pace of agri-credit disbursement may pick up in following years. While this is possible that the disbursement would gather pace in H2-FY07, it must be kept in mind that the larger portion of agri-credit disbursement generally occurs during H1-FY07, and that the restructuring of another large development finance institution could also hamper agri-credit growth in FY07. Finally, growth in disbursement by domestic private banks (DPBs) is also slowed probably due to a relative weakness in their recovery ratio in Jul-Jan FY07.

In addition, a significant increase in disbursement for production purposes and a decline in development loans is also reflecting relative interest rate sensitivity for

[6] Analysis of trends in overall agri-credit is based on data for Jul-Jan FY07; however, detailed analysis (number of borrowers and purpose-wise credit) is based on data for Jul-Dec FY07.

[7] Excluding HBL, the agri-credit disbursements are seen to increase by 20.6 percent YoY.

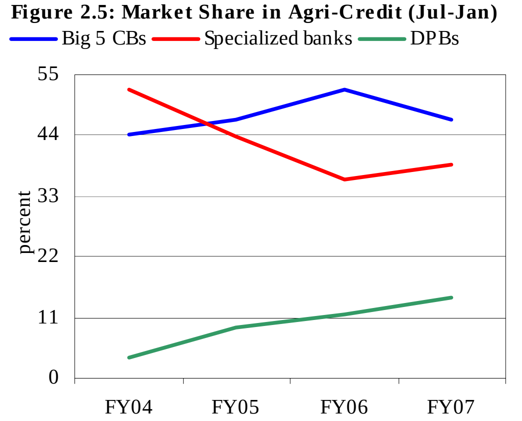
long-term agri-loans. It should also be noted that while higher number of tractors sold during Jul-Dec FY07, the share of the number of tractors financed by the institutions to total sale declined from 44.0 percent in H1-FY06 to 29.9 percent in H1-FY07. This suggests that the farmers opted to utilize their own resources mainly due to improved farm incomes.

Institutional Performance

Agri-credit disbursement by big 5-commercial banks (CBs) witnessed a rise of only 0.9 percent during Jul-Jan FY07, well below the 39.3 percent growth seen in the same period of FY06. Adjusted for the decline by HBL, the growth in disbursement reached double digits. Although, the growth in disbursement by DPBs decelerated, it is nonetheless a strong 44.3 percent in Jul-Jan FY07. The major support to agriculture credit during this period also came from an improved performance of specialized banks (ZTBL and PPCBL).

The performance of different groups is also mirrored in their respective shares in agri-credit market (see **Figure 2.5**). The rising share of CBs saw a decline for the first time since FY00 while DPBs consistently and gradually increased their share in agriculture credit market. It appears that the specialized banks are also making efforts to maintain their effective presence in the agriculture market. However, given the increasing competition with the innovative and aggressive commercial banks, specialized banks have to broaden their deposit base amidst increased operational efficiency through organizational restructuring and introduce innovative new attractive financial products for the farmers.

Figure 2.5: Market Share in Agri-Credit (Jul-Jan)



Credit Recovery

Credit recovery, as a percentage of disbursements, increased by 22.4 percentage points during Jul-Jan FY07 in contrast to a 42.1 percentage point decline seen in the same period of FY06. The improvement is attributed to commercial banks only, as a moderation in recovery ratios of both specialized banks partially offset the gains by commercial banks (see **Table 2.6)**.

Number of Borrowers

The number of agri-credit borrowers reached 536.3 thousand by H1-FY07, up by 0.8 percent over H1-FY06 (see **Table 2.7**). The increase is entirely attributed to 1.7 percent rise in the number of borrowers in the farm sector, which more than offset the decline of 12.1 percent in the number of borrowers from non-farm sector during H1-FY07. In particular, despite a relatively weak performance of CBs, increase in their number of borrowers is encouraging.

Table 2.6: Credit Recovery Pattern (Jul-Jan)

	Recovery as % of disbursement	
Banks	**FY06**	**FY07**
Big 5 CBs[1]	54.8	93.4
ZTBL	100.6	95.3
PPCBL	105	83.2
DPBs	35.3	81.1
All banks	**69.3**	**91.8**

[1] Includes: NBP, HBL, MCB, UBL, and ABL.

Table 2.7: Number of Borrowers - Agri-Sector (H1)

000 number

Banks	**FY06**	**FY07**	**% Change**
Big 5 CBs[1]	210.8	216.1	2.5
ZTBL	217.6	211.4	-2.8
PPCBL	83.7	89.9	7.4
DPBs	19.8	19.2	-3.2
All banks	531.9	536.3	0.8

[1] Includes: NBP, HBL, MCB, UBL, ABL

Table 2.8: Borrowers in Non-farm Sector

numbers

	Small	**Large**	**Total**
H1-FY06	33313	940	34253
H1-FY07	28732	1390	30122

Though, the disbursement to the non-farm sector rose during H1-FY07, the number of borrowers declined by 12.1 percent (see **Table 2.8**). While, the number of large non-farm borrowers saw a significant rise during H1-FY07, it was more than offset by a sharp decline in the number of small borrowers in this period. This is despite the government's efforts to reduce poverty through providing credit access for the improvement of livestock sub-sector. In fact, rise in the number of large borrowers is also encouraging given their ability to implement modern techniques to increase productivity.

Purpose-wise Credit Disbursement

The credit disbursement for the purchase of tractors declined by 31.1 percent during H1-FY07 compared with a rise of 8.9 percent in H1-FY06 (see **Table 2.9**). Surprisingly, despite a slowdown in fertilizers off-take, credit taken for fertilizers purchase saw an increase of 17.8 percent in H1-FY07. The significantly higher disbursement for fertilizer would probably accelerate the fertilizer off-take in months ahead.

The credit disbursement slowdown is principally driven by a decline in development loans in H1-FY07 compared with 17.1 percent rise seen in the same period last year, mainly on account of lower credit taken for the purchase of tractors.

Table 2.9: Purpose-wise Credit Disbursement (H1)

		FY06	FY07	% change
Tractor	000 number	10.5	7.4	-29.6
	billion Rs	3.3	2.3	-31.1
Fertilizers	billion Rs	19.5	23.0	17.8
% Share in total credit disbursement				
Tractor		5.2	3.1	
Fertilizers		31.2	32.1	

Encouragingly, corporate farming is getting increasingly popular as amount disbursed for the corporate farming rose sharply to Rs 1.9 billion in H1-FY07 compared with only Rs 0.7 billion in H1-FY06.

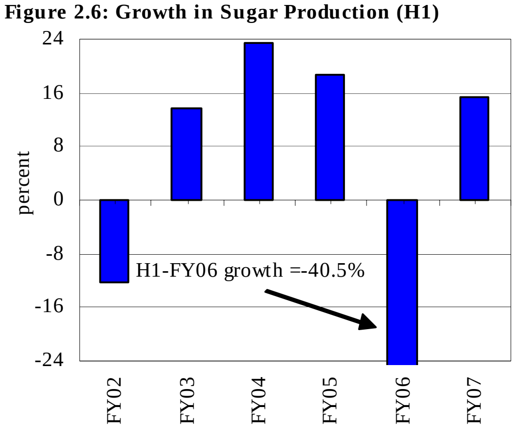
2.2 Large Scale Manufacturing

In the absence of any indicators of aggregate manufacturing[8] the following analysis focuses essentially to production trends in individual large scale manufacturing industries, based on limited data received from various industrial associations and committees.[9] Therefore, this analysis may not be representative of developments in overall LSM, and it may also not be consistent with the trends reported in the preceding SBP reports. This said, the LSM data for Q1-FY07 and limited information for Q2-FY07 suggests that LSM growth is slightly higher during H1-FY07 compared with the corresponding period of FY06.

Sugar

According to PSMA data, the *sugar* industry, which has about one third weight in food group, recorded 15.5 percent growth in H1-FY07 as against a fall of 40.5 percent in H1-FY06 (see **Figure 2.6**). This increase in production is mainly attributed to a 15.2 percent rise in the sugarcane harvest during FY06. Farmers cultivated sugarcane with greater enthusiasm in FY07 due to record high prices realized during FY06 season. However, significant inventories with the mills, a liberal import policy and a decline in international prices of sugar resulted in a fall in the domestic prices of both sugarcane and sugar, finally causing the government to impose duties[10] on sugar imports.

Figure 2.6: Growth in Sugar Production (H1)



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[8] Delay in release of usual monthly data set (of about 100 items) on large scale manufacturing by the Federal Bureau of Statistics after September 2007, make it impossible to make any assessment of industrial performance. The failure to provide timely data is quite troubling, not only for the implications for macroeconomic decision-making but also for the damage to the credibility of the institution (and official statistics).

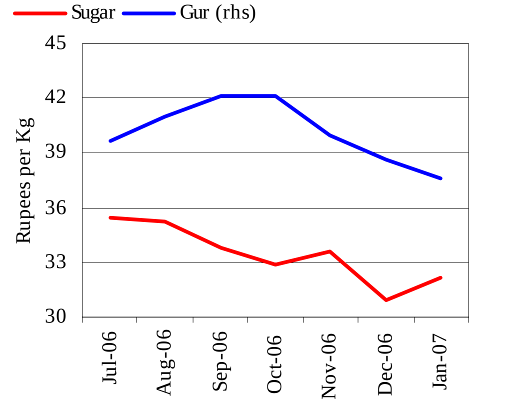
[9] These associations/committees included Pakistan Automobile Manufacturing Association, All Pakistan Cement Manufacturers Association, National Fertilizer Development Corporation, Oil Companies Advisory Committee and Pakistan Sugar Mills Association.

[10] According to the S.R.O. 1074 (1) 2006, issued by government of Pakistan, the 5.0 percent regulatory duty levied on the import of raw cane sugar, raw beet sugar, white crystalline cane sugar and white crystalline beet sugar with effect from 14th October, 2006.

It may be noted that FY07 growth for the production of sugar may have been even higher were it not for the delays in the commencement of the crushing season[11] mainly due to continuing differences between the Pakistan Sugar Mills Association (PSMA), and farmers on the prices for sugarcane.

The sugar industry is also facing competition from the rapidly emerging cottage industry of *gur* manufacturing. The farmers now have the choice to sell their produce either to sugar mills or to the *gur* contractors, they bring their mobile gur manufacturing plant in the field and often pay higher *cash* price for sugarcane to the farmers than offered by sugar mills. The recent surge in gur prices enables the gur manufacturers to pay higher price for sugarcane crop (see **Figure 2.7**).

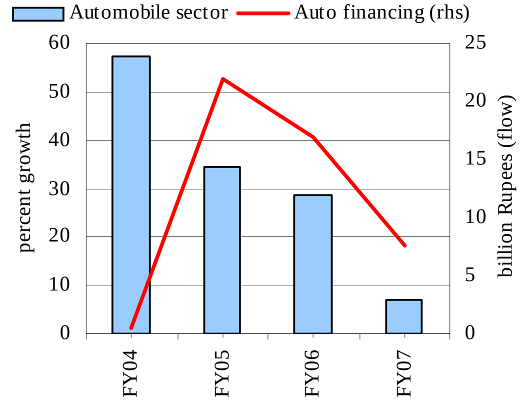
Figure 2.7: Prices of Sugar and Gur



Automobile

The *automobiles* sector recorded a single digit growth of 6.8 percent during H1-FY07, which is not only lower than the strong growth of 28.6 percent in the same period of the preceding year but also the lowest during the last five years (see **Figure 2.8**).[12] While, the capacity constraints restricted the growth in the production, weakening demand and

Figure 2.8: Impact of Auto Financing (H1)



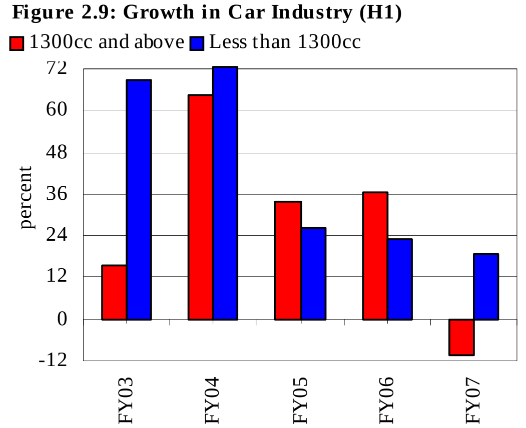
[11] According to Sugar Factories Controlling Act 1950, the crushing season in Pakistan start from 1st October every year. Due to environmental and seasonal changes, on 9th October 2006 the government and PSMA agreed to start the crushing season in Sindh from the mid November and both in Punjab and NWFP from 1st December.

[12] This analysis is based on the classification and information provided by PAMA for July-December, which is quite different from the FBS classification.

import of used vehicles are responsible for a relatively muted growth in demand for domestic automobiles. In light of continued delivery lags and premium on domestic automobiles, the Government has announced an auto policy to fill the demand and supply gap and overcome the problems facing by auto sector (see **Box 1**).

The surge in the growth of automobile industry in recent years was mainly attributed to increased income as well as easy access to auto financing. In particular, a declining trend in auto financing is also impacting growth of the automobile sector since more than 70 percent automobiles are financed by commercial banks and the cash sales are relatively quite low.

Figure 2.9: Growth in Car Industry (H1)



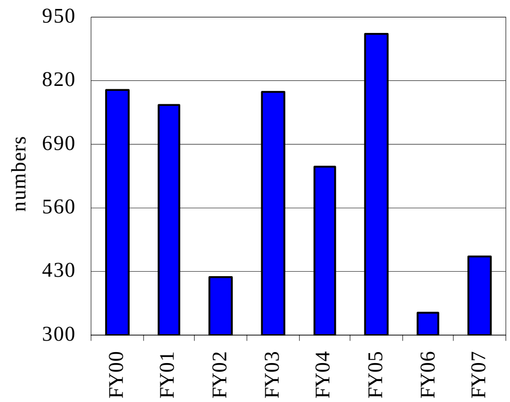
Within the *automobile* industry, the growth in the production of *cars & jeeps* decelerated to 8.4 percent in the first six months of the current fiscal year as compared with a substantial 30.5 percent growth in H1-FY06. In particular, the production of high capacity engine *cars*[13] (1300cc and above) declined by 10.4 percent in H1-FY07 as against a strong growth of 36.6 percent during the same period of the previous year (see **Figure 2.9**). Stiff competition from imported used cars, poor response of customers regarding the newly introduced models, relatively higher prices of domestic cars and higher interest rates are the main reasons cited for the weaker performance of this category of automobiles.

Similarly, a slowdown of 3.4 percent was observed in the production of *tractors* during H1-FY07, which is lower than the 14.5 percent growth seen in the same period of preceding year. The capacity constraints and the government decision to allow the import of tractors are the main causes of deceleration in tractor production. However, the local manufacturers claim that since the permission of

[13] Within the high capacity engine cars, Toyota corolla brand is the only one which has registered a higher growth of 20.9 percent in H1-FY07 as compared with 17.9 percent during the same period of last year. While the production of all other assemblers declined during this period.

government to import tractors to help the farming community has not hit the booking of local manufactured tractors. It is also claimed that farmers prefer to buy from those producers who provide after-sales service in rural areas and dealers of imported tractors have no such services.

Figure 2.10: Production of Buses (H1)



The recovery in the output of buses was mainly due to government's institutional buying, (about 80 percent of the total sale of buses), 15 percent fall in the prices of local manufactured buses after the issuance of a notification[14] by CBR regarding zero-rated sales tax on local supply of dedicated CNG buses and other buses meant for transportation for passengers. It is interesting to observe from **Figure 2.10** that the output of the buses generally has a very short cycle due to a narrow base, impacting largely from government policies as well as initiatives by the private sector.

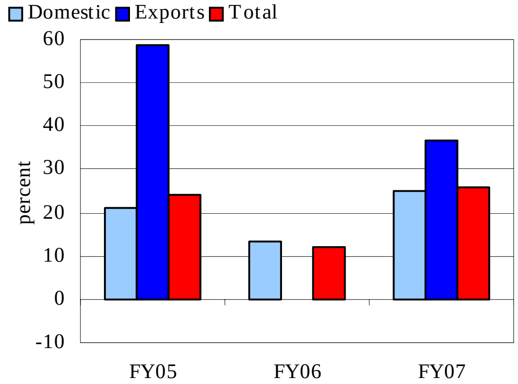
The major drag to automobile industry growth was from the decline in the production of motorcycles/scooters, down by 13.5 percent during H1-FY07 compared with 34.3 percent strong growth. The production of motorcycles declined for the first time since FY00. The production of motorcycles in the reported sector remained depressed during H1-FY07 mainly due to rising market share of non-members of PAMA (Chinese bikes assemblers) on the back of lower prices. Moreover, decline in cotton and rice harvests (as well as lower realized prices for cotton) also made a direct impact on the sale of bikes in the rural areas, where farmers used to purchase new bikes after a better crop.

[14] According to SRO.1270 (I)/2006, sales tax zero-rating would be on import and local supply of dedicated CNG buses and all other buses meant for transportation of 40 or more passengers, whether in CBU or CKD condition covered under the Pakistan Customs Tariff (PCT) Heading 8702. Sales tax would also be charged at the rate of zero-per cent on the import and local supply. Purpose-built taxis, whether in CBU or CKD, built on girder chassis and have following features: Attack resistance central division along with payment tray; wheelchair compartment with folding ramp and taximeter and two-way radio system, notification added.

Cement

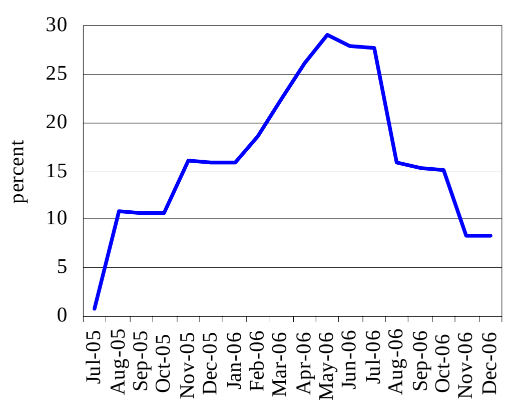
The cement industry performed well during H1-FY07 with total sales rising 26.0 percent YoY, significantly higher than 12.1 percent growth seen in the H1-FY06. The remarkable performance of cement sector is attributed to the (1) enhanced installed capacity[15] during the last five years, (2) rise in local demand as well as (3) strong external demand (see **Figure 2.11**).

Figure 2.11: Growth in Cement Sale (H1)



The local cement dispatches rose by a remarkable 25.0 percent in the first six months of FY07 compared with 13.4 percent growth in the same period ofFY06. The rise in local demand mirrored the rising activity in the construction sector amidst relatively low domestic prices in H1-FY07 (see **Figure 2.12**). Similarly, export demand for cement registered a robust increase of 36.8 percent during H1-FY07 as against a fall of 0.2 percent during H1-FY06. Major markets for Pakistani cement exports are Afghanistan and the UAE. Government decisions regarding restoration of duty drawback on cement exports,[16] exemptions from federal excise duty & sales tax on exported cement and lower domestic prices in H1-FY07 are the key factors for the rise in cement exports during the first six

Figure 2.12: Changes in Domestic Cement Prices



[15] The installed capacity in cement industry is more than doubled during the last five years.

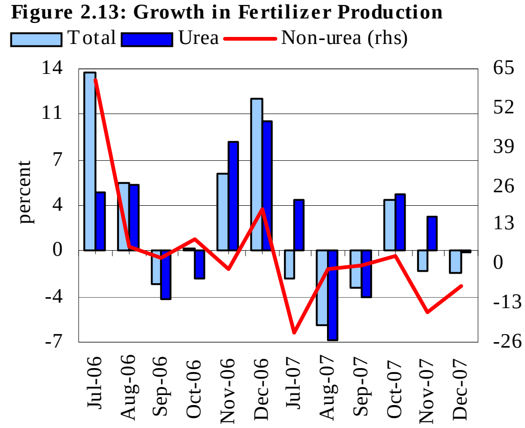
[16] The Central Board of Revenue (CBR) has allowed duty drawback at the rate of Rs 25.08 per ton on export of cement through a customs notification by amending the SRO 840 of 2006. The facility is effective, from September 27, 2006.

months of FY07.

Fertilizer

The Fertilizer industry is facing capacity constraints after seeing rapid growth in production in recent years. In H1-FY07 some other factors also contributed for a decline in the production of fertilizer, these include: (1) temporary shutdown of plant by one producer for a capacity expansion and revamping of another plant, (2) slowdown in demand due to untimely rains and decrease in fertilizer demand in expectation of a subsidy announcement by the government, and (3) a sustained rise in the prices of urea amidst subsidy on non-urea as well as greater awareness to use a balanced mix of the both of which reduced the urea demand.

Figure 2.13: Growth in Fertilizer Production



The slowdown in demand of fertilizer during H1-FY07 is also reflected in lower imports, which fell by 58.1 percent as compared with 69.1 percent growth in import during H1-FY06. As a result of softening demand as well as capacity issues, the output of *fertilizer* declined by 1.7 percent in H1-FY07 as against 5.5 percent growth during the same period of the preceding year (see **Figure 2.13**). The decline however was more pronounced in the production of non-urea fertilizer, which suggests that the impact of the delay in the purchases of fertilizers by the farmers in anticipation of subsidy announcement was stronger.

Petroleum Products

As in fertilizer, petroleum production also declined by 6.6 percent in the first six months of the current fiscal year as against a moderate growth of 2.5 percent in the corresponding period of the preceding year (see **Table 2.10**). The slowdown was mainly attributed to the mismatch in production mix and the demand growth patterns (see **Figure 2.14**). While refining operations produce various products in broadly fixed ratios, the demand growth has centered principally on diesel (as it is cheaper relative to petrol) and furnace oil (as demand for thermal electricity surged following a drop in hydro-electricity production). The consumption growth of petrol is also weakened due to substitution with CNG. Thus in order to avoid surpluses in other products, refineries chose to operate at lower capacities.

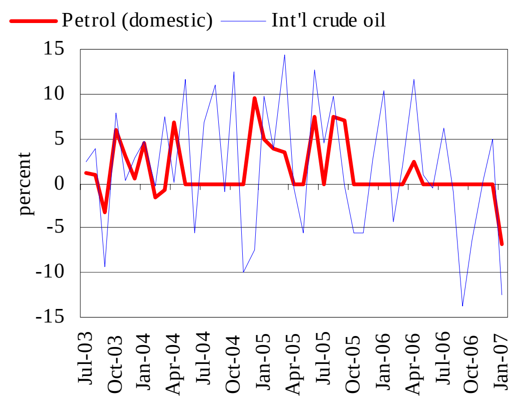
Indeed, while the domestic production of POL fell (as reflected in a 12.1 percent YoY drop in imports of crude oil in H1-FY07), the sale of petroleum products recorded a growth of 18.9 percent during H1-FY07. Moreover, imports of specific refined petroleum products rose in the same period. Specifically, import of furnace oil and high speed diesel witnessed robust increase of 63 percent and 33 percent respectively during Q1-FY07.[17]

Table 2.10: Production of POL Products (H1)

000 metric tons

	FY05	FY06	FY07
Jet fuel	536	646	610
Kerosene	88	104	102
Motor spirits	692	627	618
High speed diesel	1,807	1,728	1,555
Light speed diesel (n.o.s.)	103	63	77
Furnace oil	1,546	1,701	1,543
Lubricant oil	113	102	104
Jute batching oil	3	2	2
Solvent naphtha	347	423	420
Petroleum products (n.o.s.)	352	332	318
Total POL	5,588	5,727	5,348

Figure 2.14: Change in Oil Prices (MoM)



Electricity generation

Electricity generation is not part of the LSM. This analysis is based on the information received from FBS.

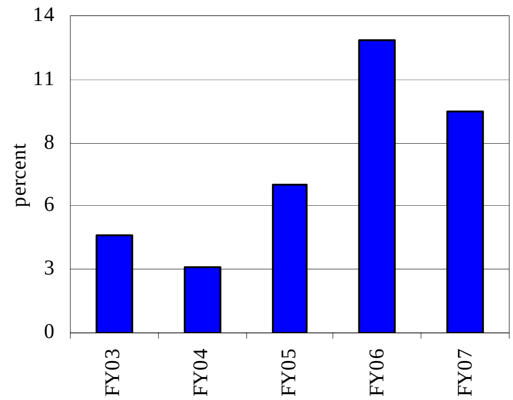
Electricity generation recorded a growth of 9.7 percent during H1-FY07 as compared with 12.9 percent growth during the same period of last year. Despite deceleration, first half year growth of current fiscal year is the second highest since FY03 (see **Figure 2.15**). Despite high growth, country is facing acute energy shortages, which further augmented due to sustained high growth. In this background, the government of Pakistan has announced a "policy for development of renewable energy for power generation" to overcome the energy shortage in the economy.

[17] Latest detailed item-wise data on trade is available upto Q1-FY07.

Box 1: Auto Industry Development Program (AIDP)

Due to its multiple affect and strong backward linkages (material such as steel, copper, , aluminum etc., plastics, glass, paints, electronics, capital equipment, trucking, warehouse and logistics) and forward linkages (dealership, credit & financing, advertising, repair & maintenance, petroleum products, goods station, insurance, services parts), the auto industry is considered as the key industry. The government has approved the five years auto policy (Auto Industry Development Program AIDP), designed in such a way that it should not hurt local industry but attract new investment. However, the government has decided not to change current import policy so that consumers' interests could also be protected. Cars import policy will continue in its existing shape and if premium becomes a public issue again, the government will take appropriate measures to protect the consumers' interest.

Figure 2.15: Growth in Electricity Generation (H1)



Salient features of AIDP are:

1. By FY12, the annual production of new cars would reach to 0.5 million as against a total of 0.2 million cars currently manufactured.
2. Five local auto manufacturers have assured the government that they will increase their total production of units up to 0.5 million by FY12 as shown in **Table 2.11**
3. Total investment in car manufacturing would reach Rs 225 billion by 2011-12 as compared to Rs 98 billion in FY06.
4. Reduction in tariff from 50 percent for localized parts of cars in FY07-FY09, followed by 47.5 percent in FY10, 45.0 per cent in FY11 and 45 percent in FY12.
5. A reduction in tariff is also proposed in the program. Tariff for non- localized parts has been proposed by 35 percent in FY07-08, followed by 32.5 percent in FY09-10 and 30 percent in FY11-FY12.
6. For Completely Built Unit (CBU), the tariff rate will be as follow:
   a. Up to 1500cc there will be 50 percent duty till FY12.
   b. From 1500cc to 1800cc 65.0 percent duty till FY09, followed by 60.0 percent duty till FY12.
   c. 1800cc and above, 75.0 percent duty till FY09 and 70.0 percent tariff till FY12.
7. For LCVs (CKD kits) the tariff rate will be as below:

Table 2.11: Car Production Capacity

000 numbers

	FY06	FY12
Honda	30	100
Suzuki	90	250
Indus	44	100
Dewan	44	48
Nissan	13	18

   a. For localized parts duty rate will be 50.0 percent upto FY09, 47.5 percent for FY10 and 45.0 percent for FY11-FY12.

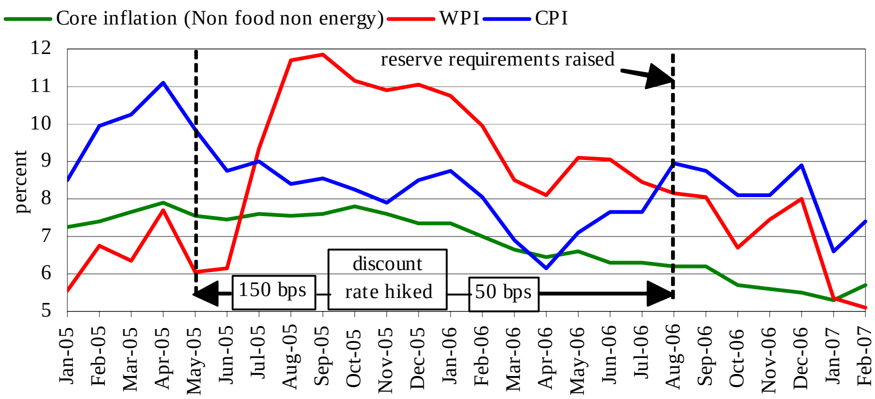
8. For non-localized, the duty rate will be 20.0 percent till FY12.
9. Tariff for CBU condition LCVs would be 60 percent till FY12.
10. Two automotive parks will be established; one each in Karachi and Lahore.
11. Auto engineering department in the universities and polytechnic institutes will be established.
12. In-house factory schools for the training of employees from within the entity and from the auto industry including the vendors will also be established.
13. Tax incentives in the form of deductions equivalent to 125 percent of the net expenses from the annual taxable income of such entities operating factory school.
14. For the tax incentives, duration of each course will not be less than eight months out of which half training will be imparted at the classroom level and rest at the shop floor, laboratories and at various areas of production/dispatch/stores etc.

3 Prices

3.1 Overview

The underlying inflationary pressures in the economy continued to ease in FY07, with Consumer Price Index (CPI) inflation finally dipping below 7 percent YoY in January 2007 for the first time in 7 months;[1] and WPI inflation continuing its trend decline to fall to a 25-month low of 5.1 percent YoY by February 2007 (see **Figure 3.1**). Even more significant, from a policy perspective, is the stability of the downtrend in core inflation (as measured by the non-food non-energy component of the CPI), which has declined steadily since April 2005 to 5.7 percent YoY by February 2007. While the other important measure of core inflation (i.e., the 20 percent trimmed mean) witnessed a relatively smaller decrease in October-February FY07, in each month it remained same or below that in the corresponding months of FY06.

Figure 3.1: Monetary Tightening Paying Dividends

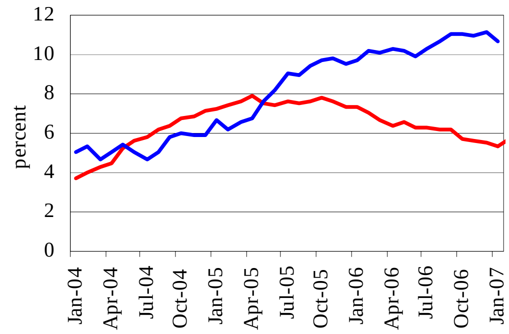


The broad reduction in underlying inflationary pressures in FY07 appears to be significantly driven by the tight monetary posture of the central bank (see **Figure 3.2**), suggesting that aggregate demand pressures in the economy are being reined-in by the continued tight monetary policy. However, the sharp slowdown in the overall CPI inflation in January 2007 mainly incorporates the impact of an exceptionally strong deceleration in food inflation as prices of many key staples

[1] CPI inflation decelerated to 7.4 percent YoY during February 2007 compared with 8.0 percent YoY in February 2006.

fell to more normal levels, after staying at exceptionally high peaks in the preceding months. Similarly, a reversal in CPI food inflation back into double digits level in February 2007 is mainly attributed to rise in the prices of rice, flour, some vegetables and fruits. In fact, it was mainly due to this abnormally high food price inflation that headline CPI inflation had remained stubbornly above the 8 percent levels through most of FY07.

Figure 3.2: Monetary Policy Stance & Inflation



In contrast, non-food inflation decelerated to 5.6 percent in February 2007 compared with 8.4 percent in February 2006, mainly on the back of continued monetary tightening and reduction in domestic prices of key fuels. As a result, the headline CPI inflation fell to 7.4 percent in February 2007 relative to 8.0 percent in the same month of 2006.

Table 3.1: Inflation Trends (February)

percent

	Year on Year[1]		12 month moving average[2]	
	FY06	**FY07**	**FY06**	**FY07**
CPI	**8.0**	**7.4**	**8.9**	**7.7**
Food	7.5	10.0	9.2	8.7
Non-food	8.4	5.6	8.7	6.9
House rent	9.4	6.3	11.2	7.3
WPI	**9.9**	**5.1**	**9.4**	**7.6**
Food	6.9	8.7	8.7	7.5
Non-food	12.2	2.6	10.0	7.7
SPI	**7.4**	**8.8**	**9.0**	**9.2**
Core[3]	**7.0**	**5.7**	**7.5**	**6.0**

[1] Change in Feb 2007 over Feb 2006

[2] Change in 12-month moving average of Feb 2007 over Feb 2006

[3] Non-food non-energy

Source: Federal Bureau of Statistics

However, despite the welcome decline in year-on-year inflation, it should be kept in mind that average annualized (12-month moving average) CPI inflation at 7.7 percent in February 2007 is still substantially higher relative to 6.5 percent annual target for FY07 (see **Table 3.1**). In fact, SBP projections remained unchanged, indicating that average CPI inflation for FY07 is likely to be in the range of 6.7 – 7.5 percent.

Given the still-high CPI inflation and the risk of a resurgence in food inflation,[2] SBP needs to retain its low inflation bias to raise real interest rates for savers, improve competitiveness of exports and sustain long-term growth in the economy.

3.2 Consumer Price Index

CPI inflation exhibited a volatile trend during the last few months principally driven from fluctuations in food inflation. Non-food inflation on the other hand witnessed a relatively stable downtrend since September 2005 (see **Figure 3.3**). Consequently, the contribution of food group to overall CPI inflation has increased from 38.3 percent in February 2006 to 55.4 percent in February 2007 (see **Figure 3.4**).

Figure 3.3: CPI Inflation - YoY

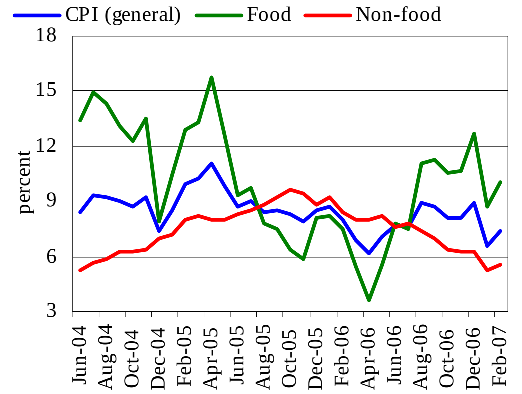
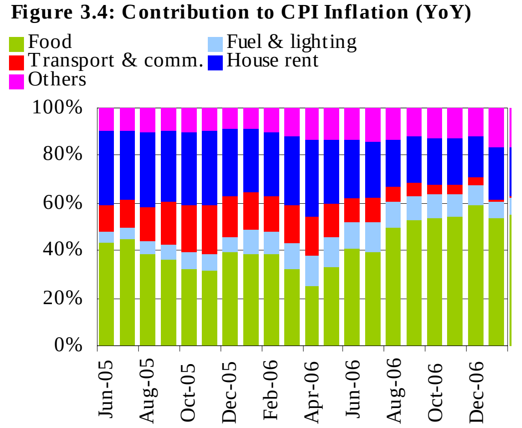


Figure 3.4: Contribution to CPI Inflation (YoY)



CPI Food Inflation

CPI food inflation hovered in double digits during most of the initial eight months of FY07. After witnessing a sharp decline in January 2007 to 8.7 percent, food inflation bounced back to 10.0 percent level in February 2007 compared with 7.5 percent in the corresponding month of FY06.

The rise principally represented an increase in the prices of some key food staples – wheat flour, milk, ghee as well as some fresh vegetables and fruits. For example, despite a negligible weight of 0.58 percent in overall CPI basket, the extraordinary rise in

[2] In contrast to the trend of the CPI and the WPI, Sensitive Price Indicator (SPI) inflation is still in double digits, principally reflecting continued upward pressures on essential items.

the prices of onions had contributed 13.2 percent to aggregate CPI inflation in February 2007 (see **Figure 3.5**).

It may be noted that the February 2007 reversal in CPI food inflation relative to January 2007 was mainly due to the fact that five items which were registering disinflation earlier, joined the groups of items which are contributing in persisting high CPI food inflation (see **Table 3.2**).

In particular, two commodities that are likely to contribute significantly to sustaining high food inflation in months ahead include milk and edible oil the prices of both of which are likely to be driven up following international trends.

For example, while domestic prices of cooking oil and vegetable ghee had remained quite stable until June 2006 despite significant declines in the international prices of soybean and palm oil, they are now headed up as international prices are rising (see **Figure 3.6**). Similarly, domestic milk prices are also expected to be driven upwards more by the influence of rising

Table 3.2: Change in the Prices of Food Items

number of items

Inflation range	Jul-06	Sep-06	Jan-07	Feb-07
Decline in prices	24	9	16	11
0% to 5%	30	29	20	20
5% to 10%	26	25	26	29
10% to 15%	10	22	27	24
15% to 20%	6	7	10	11
20% and above	15	20	10	13
Total items reported	**111**	**112**	**109**	**108**

Figure 3.5: Contribution to CPI Inflation

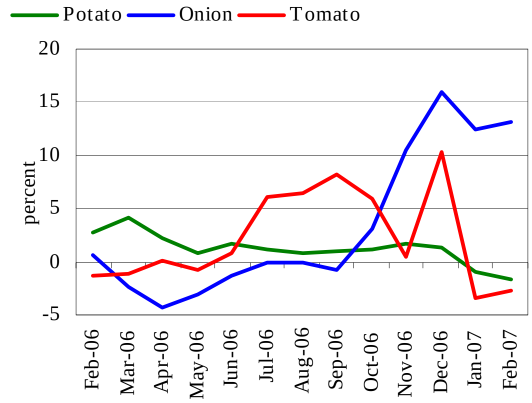
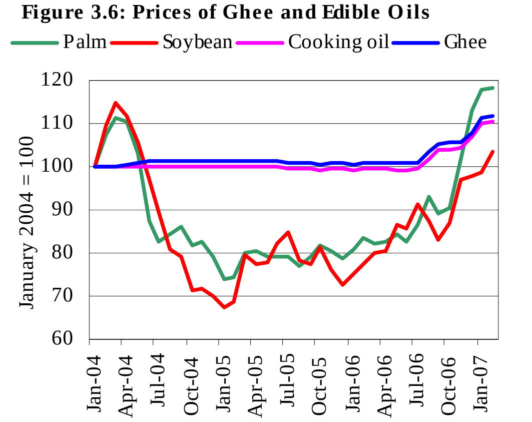


Figure 3.6: Prices of Ghee and Edible Oils

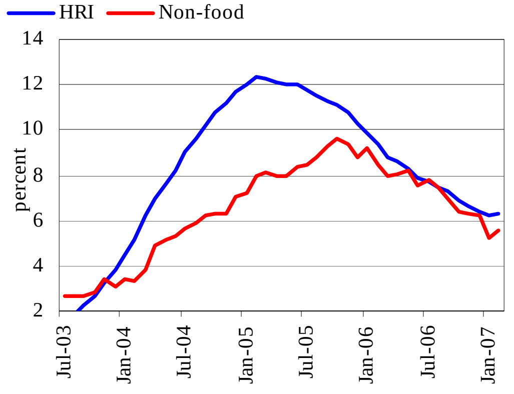


international prices rather than domestic cost-push factors.

CPI Non-food Inflation

CPI non-food inflation continued to decelerate, falling to 5.6 percent YoY in February 2007 as against 8.4 percent in February 2006. Nonetheless, it remained higher than the 5.2 percent seen in January 2007. While the deceleration in CPI non-food inflation was mainly due to a sharp decrease in the *transport & communication, fuel & lighting* and *house rent* sub-indices, the relative month over month (MoM) rise is largely attributed to a MoM up tick in *house rent index* (HRI) in February 2007 (see **Figure 3.7**).

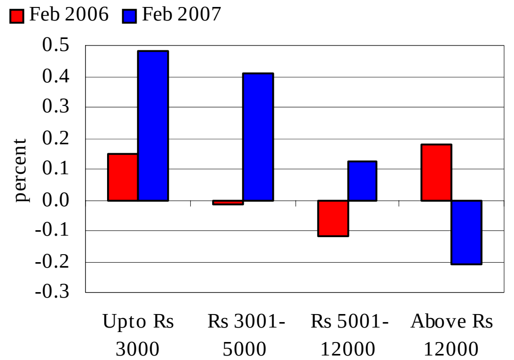
Figure 3.7: House Rent and CPI Non-food Inflation



The sharp deceleration in the CPI non-food YoY inflation is largely attributed to downward adjustment in the prices of key fuels by OCAC[3] as well as a decline in the prices of some automobiles (e.g. cars and motorcycle) due to a relative weakening in demand.

Some of the sub-indices of non-food group, nevertheless, showed higher growth in recent months of FY07 as compared with FY06. These include a*pparel, textile & footwear, household furniture & equipment, education*, and *medicare*. The most significant of these was *medicare* inflation, which jumped from 3.0 percent in February 2006 to 9.3 percent in February 2007.

Figure 3.8: Income Group-wise Inflation (Difference from Average CPI Inflation)



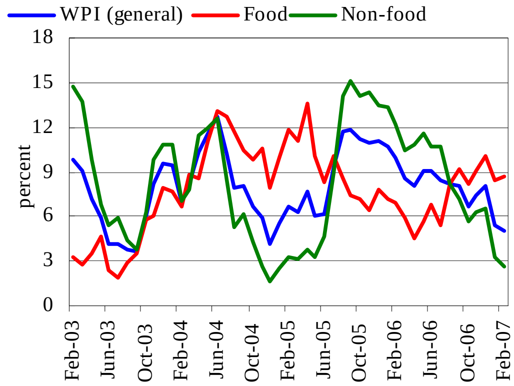
[3] Oil Companies Advisory Committee.

Income Group-wise Inflation

As mentioned earlier, the contribution of food inflation in overall CPI remained high in the first eight months of FY07, which resulted into a larger incidence of inflation on the low-income groups where food staples typically account for a greater proportion of total expenditure. Thus, in February 2007, the lowest income group (income up to Rs 3000 per household per month) witnessed higher inflation of 7.9 percent than the average CPI inflation of 7.4 percent, followed by 7.8 percent and 7.5 percent for the two middle-income groups (see **Figure 3.8**). In contrast, only the highest income group (with income above Rs 12,000 per month) witnessed lower than average inflation in February 2007.

3.3 Wholesale Price Index

Figure 3.9: Wholesale Price Inflation - YoY



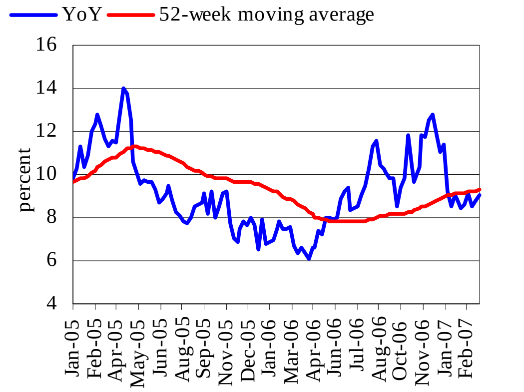
Inflation measured by Wholesale Price Index (WPI) generally maintained its downward trend throughout FY07 reaching 5.1 percent in February 2007, its lowest level in the preceding 25 months. Inflationary pressures appear to have eased in overall WPI inflation entirely due to a deceleration in WPI non-food inflation. While WPI non-food inflation witnessed a continued deceleration since July 2006, a part of this gain was offset by WPI food inflation, which is registering acceleration since August 2006 (see **Figure 3.9**). The major contribution to deceleration in non-food inflation stemmed from a disinflation by *fuel, lighting & lubricants* sub-index, principally reflecting downtrend in the international prices of POL.

As a result, the contribution of *fuel, lighting & lubricants* sub-index dropped significantly from a positive 55.7 percent in February 2006 to a negative 6.6 percent by February 2007. Consequently, the weighted contribution of non-food inflation in WPI fell from 70.8 percent during February 2006 to 30.1 percent in February 2007 (see **Figure 3.9**).

3.4 Sensitive Price Indicator

The SPI covers prices of 53 essential items of daily use (mostly kitchen items and some energy items, e.g., petrol and diesel). Like CPI food inflation, the SPI also rose sharply in February 2007. This is because more than 60 percent of the items included in the SPI basket are from the food group. During the period under review, weekly SPI inflation YoY was generally high and remained in the double digits (see **Figure 3.10**).

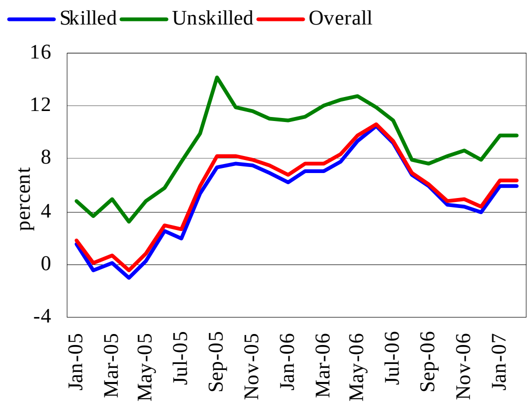
Figure 3.10: Weekly SPI Inflation



3.5 Wage Inflation in Construction Sector

Real wages in the construction sector continued to exhibit a rise through FY07, however the pace of rise marginally slowed. Specifically, real wages in construction sector witnessed a rise of 6.3 percent (YoY) in February 2007 compared with 7.6 percent increase seen in the same month of FY06 (see **Figure 3.11**).

Figure 3.11: Change in Real Wages - YoY



This slower growth stemmed from a deceleration in real wages for both skilled and unskilled workers but is more pronounced in the case of unskilled workers. Despite a sharper slowdown, real wages for unskilled workers rose by a strong 9.7 percent in February 2007 relative to 11.2 percent increase in February 2006. The rise in real wages for skilled workers was recorded at 5.9 percent YoY in February 2007 compared with 7.0 percent in the corresponding month of 2006. It may be noted that the real wages for construction workers witnessed a month over month acceleration in January and February 2007 compared with the first six months of FY07. The significant increase in real wages implies that (1) demand for construction labor is strong, as well as (2) domestic consumption demand would accelerate further. In particular, strong labor demand appears to reflect in increased construction activities in private sector as well as the focus on improving infrastructure by the government.

4 Money and Banking

4.1 Overview

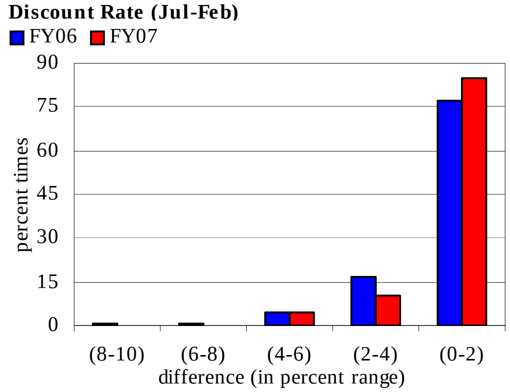
Although decelerating, CPI inflation remained high through Jul-Feb FY07 and therefore, in line with its policy bias towards maintaining price stability, SBP continued to focus on moderating the excess demand pressures in the economy by retaining its tight monetary policy throughout the period. However, at the same time, SBP was also mindful of the need to ensure the availability of credit for exporters and industrial investment in the textile sector to sustain long term economic growth. This was necessary to address recent slowdown in export growth and the resulting pressures on the external account.

Table 4.1: Key Monetary Aggregates

	Units	FY06	FY07
Reserve money growth (24th Feb)	percent	9.6	15.3
Credit to deposit ratio (average Jul-Feb)	percent	82.3	85.2
Overnight rates volatility (Jul-28th Feb)		0.16	0.14
Liquidity ratio	percent	30.3	30.1
Absorptions through OMOs (Jul-Feb)	number	44	46
Injections through OMOs (Jul-Feb)	number	18	4

Consistent with its objective of maintaining price stability, SBP not only raised reserve requirements for banks with effect from July 22, 2006 but also increased the discount rate by 50 bps to 9.5 percent a week later. In addition, SBP continued further with its frequent open market operations (OMOs) to drain excess liquidity from the inter-bank market (see **Table 4.1**). This is evident from a persistent narrow spread between the discount rate and overnight rate throughout Jul-Feb FY07 period (see **Figure 4.1**).[1] Finally, in order to improve liquidity management in the inter bank market, SBP raised the daily minimum reserve requirements for banks effective from January 18th 2007.[2]

Figure 4.1: Deviation of Overnight Rates from Discount Rate (Jul-Feb)



[1] It may be noted that due to increase in discount rate in July 2006, volatility in overnight rates computed as coefficient of variation is not directly comparable. The **Figure 4.1** clearly shows that

At the same time, SBP was also concerned about the recent slowdown in export growth and growing long-term investment needs in textile industry. Accordingly, SBP first lowered the export refinance rate in July 2006, thereby reducing the cost of financing to industry to around 300 bps below market rates.[3] This is in addition to the long term financing for export oriented projects (LTF-EOP) which is extended at 4-5 percent or 600-700 bps below market rates for 3-7 years.[4] Later in September 2006, SBP offered a debt swap option to textile sector to convert its fixed investment loans into relatively cheaper LTF-EOP facility.[5] Not only these measures led to additional liquidity injections into the economy, these also resulted in negative real lending rates on EFS and LTF-EOP.

Table 4.2: Composition of Money Supply (Jul-24th Feb)

	Growth (in percent)		Contribution to M2 growth	
	FY06	**FY07**	**FY06**	**FY07**
NDA	14.5	8.2	11.4	6.5
Non-government credit	17.4	10.1	10.5	6.5
Government borrowing	15.7	5.1	4.0	1.2
Other items (net)	-44.1	13.6	-3.1	-1.2
NFA	-12.7	6.0	-2.7	1.2
M2	**8.7**	**7.7**	**8.7**	**7.7**

Despite the liquidity injections, M2 growth has slowed, indicating that monetary policy has been effective (see **Table 4.2**). Specifically, M2 growth decelerated to 7.7 percent during Jul-Feb FY07 period compared to 8.7 percent during the corresponding period of previous year. This slowdown primarily stemmed from lower growth in non-government sector credit. Private sector credit growth remained strong despite structural constraints (see **Section** on **Credit to Private Sector** for details). On the other hand, the government borrowings from the banking system during Jul-Feb FY07 were also low, this was mainly on account of greater availability of external financing. The impact of this on reserve money was offset by a rise in net foreign assets (NFA) of the banking system.

the overnight rate has remained within a close range (0 - 2 percent) to the discount rate more of the times during Jul-Feb FY07 compared to the corresponding period of FY06.

[2] SBP increased the daily minimum requirements to 2 percent and 6 percent for time and demand liabilities (from earlier levels of 1 percent and 4 percent) respectively.

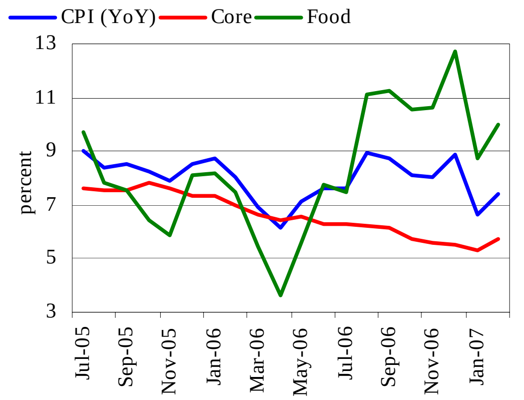
[3] SBP also capped the maximum margin/spread of banks at 1 percentage point from 1.5 percentage points earlier.

[4] In July 2006, the maximum margin/spread for banks/DFIs on loans under LTF-EOP was reduced from 3 percent per annum to 2 percent per annum.

[5] Textile sector received bulk of the outstanding export refinancing of Rs 134 billion and all of the LTF-EOP amounting to Rs 43.5 billion (as of February 2007). Of the total credit provided to textile sector during Jul-Feb FY07, 37 percent is concessional; excluding spinning (which is not eligible for EFS and LTF-EOP), the share of concessional financing rises to 83 percent.

SBP's continued focus on maintaining price stability has also resulted in a further moderation in inflationary expectations as evident from a continued downtrend in core inflation that has slowed to 5.7 percent YoY in February 2007 from 7.0 percent YoY in February 2006 (see **Figure 4.2**).

Figure 4.2: Inflation Trends



More importantly, this slowdown in inflationary pressures has been achieved without significantly affecting the growth momentum. Current SBP estimates suggest that the GDP growth will be higher than the FY06 level of 6.5 percent which is well above the long term growth trajectory.[6]

Indeed, it is important that SBP's monetary policy continue to focus on price stability if the high growth trend is to be sustained. This is because the high inflation has economic and social cost as it (1) negatively affects investment activities in the economy by creating uncertainty about the future output and input prices and profitability; (2) undermines confidence in the domestic currency; (3) diverts activities from efficient management and production towards maneuvering and speculation to benefit from inflation; (4) discourages long term contracts as resources are wasted on frequent negotiations; and (5) and exerts negative effect on consumer spending by reducing the real value of consumer wealth. Thus, the focus of the Central Bank should be on maintaining price stability. However, in doing so, it should be vigilant to a number of key risks and challenges to the monetary policy.

The *foremost* concern for the Central Bank is the overall CPI inflation that has remained stubbornly high throughout Jul-Feb FY07 and was increasing through most of the period. As a result, the overall CPI for FY07 is expected to be higher than the 6.5 percent target for the year.

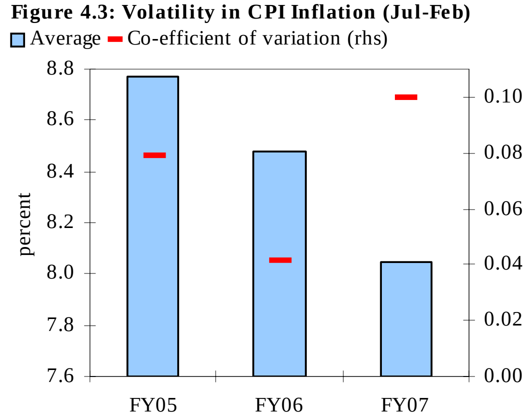
It is important to note that these inflationary pressures were mainly driven by persistently high food inflation reflecting supply shortages. This is evident from a

[6] The average growth rate for the period FY1951-2006 has been 5 percent.

sharp 4.0 percentage point decline in food inflation in January 2007 over January 2006. This clearly shows that to the extent inflationary pressures are emerging from high food prices, overall CPI will be less responsive to monetary policy changes.

This suggests that if SBP had firmly aimed at containing the overall CPI inflation to its target for the year, this would have required excessive monetary tightening, with a further rise in discount rate. This would have risked economic growth prospects particularly when the core inflation (that represents underlying excess demand pressures in the overall economy) has been showing steady decline. Further, it was expected that the lagged transmission of monetary tightening pursued in previous year as well as tightening measures taken in early FY07 will be sufficient in eliminating excessive demand pressures from the economy.

Figure 4.3: Volatility in CPI Inflation (Jul-Feb)



Nonetheless, SBP still remains concerned about high and volatile trends in overall CPI (even if it is driven by pressures stemming from supply-side disturbances) as this could potentially serve as a constraint in aligning inflation expectations with the Central Bank policy signal (see **Figure 4.3**).

A *second* concern for SBP's monetary policy is the sharp rise of 15.3 percent in reserve money during Jul-Feb FY07 compared to 9.6 percent growth realized during the corresponding period of the previous year (see **Table 4.3**). This high growth in reserve money does not bode well as it dilutes the Central Bank's monetary tightening even though it is not yet translated into a surge in overall M2 growth. The argument rests on the notion

Table 4.3: Reserve Money Growth (Jul-Feb)

	billion Rs		% share in change	
	FY06	**FY07**	**FY06**	**FY07**
Government sector	178.2	25.9	19.6	2.6
Private sector	-0.7	58.0	-0.1	5.8
NFA	-42.5	25.3	-4.7	2.5
Other items net	-45.9	45.9	-5.1	4.6
Others	-1.9	-1.8	-0.2	-0.2
Reserve money	**87.2**	**153.2**	**9.6**	**15.3**

that the reserve money is the most inflationary source of monetary growth that potentially weakens the expectations channel of monetary policy transmission.[7]

Ironically, a significant part of the reserve money growth during Jul-Feb FY07 was caused by debt swap facility offered by SBP to the textile sector that only resulted in liquidity injection in the banking system to the tune of Rs 36.5 billion.[8] Further as explained earlier, in addition to debt swap, SBP is also providing fresh concessional financing under LTF-EOP and export refinance facility.

It is important to note that these incentives provided by SBP have significant impact on reserve money growth. In fact, unless neutralized by SBP through its open market operations. The impact of loans extended under LTF-EOP scheme on reserve money would persist for some years as these loans have a maturity of 3-7 years. Similarly, although the EFS loans are short term in nature focusing on working capital requirements, their outstanding stock may remain high due to considerable interest rate differential between the prevailing market rates and the rates on these schemes.

Table 4.4: Deficit Financing[1]

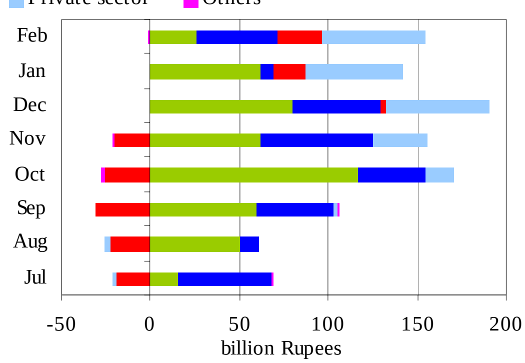
billion Rupees

	Jul-Dec FY06	Budgetary estimates FY07	Jul-Dec FY07
External	39.8	171	96.2
Non-bank	-6.7	8	25.3
Privatization proceeds	18.7	75	15.9
Sub-total	**51.8**	**254**	**137.5**
Total financing	**136.7**	**285**	**169.0**
Banking system	84.9	120	31.5

Source: Ministry of Finance (MoF), quarterly data.
[1] The MoF and SBP numbers differ due to differences in timings and definitions

[7] In the inflation expectation channels, credibility of the Central Bank plays the key role managing expectations regarding inflation. If economic agents believe on the Central Bank and are confident that inflation will be kept low in future, they will adjust the wages and salaries upwards only moderately. In addition, firms will consider the prevailing increase in costs as temporary and will maintain the prices stable. In this manner, expectations of low inflation can help central bank achieve price stability objective.
[8] In order to provide a relief to textile sector that was facing high financing cost on its earlier outstanding loans, SBP allowed a one time opportunity to refinance its market based fixed term loans availed from banks/DFIs for import of plant & machinery with loans under SBP's LTF-EOP scheme. The mark-up under LTF-EOP scheme remains fixed for the tenor of the loan and is significantly lower than the market rate. SBP provided banks the entire amount of the outstanding loans eligible under this facility at subsidized rates of LTF-EOP. As a result, banks received liquidity which they had locked in their long term loans to the textile sector.

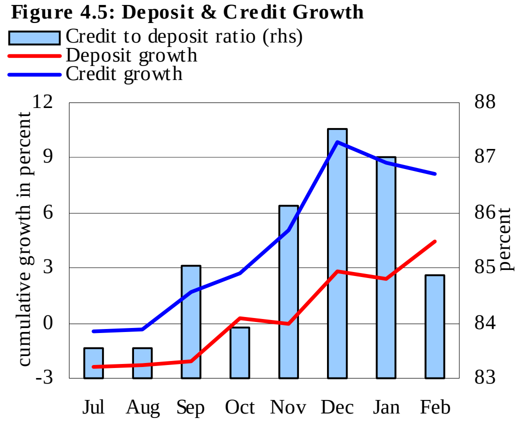
Figure 4.4: Composition of Reserve Money



Another major contributor to reserve money growth is the government borrowing from the Central Bank and external sector. As explained earlier, the budgetary borrowings from the SBP is markedly low during Jul-Feb FY07 compared to the corresponding period of previous year.

This was possible mainly due to greater availability of financing from external and non-bank sources (see **Table 4.4**).[9] Thus, though the government has retired part of its earlier borrowings from the SBP during the year, to the extent the retirements were caused by external inflows, the reserve money growth would change only in its composition (see **Figure 4.4**).

Figure 4.5: Deposit & Credit Growth



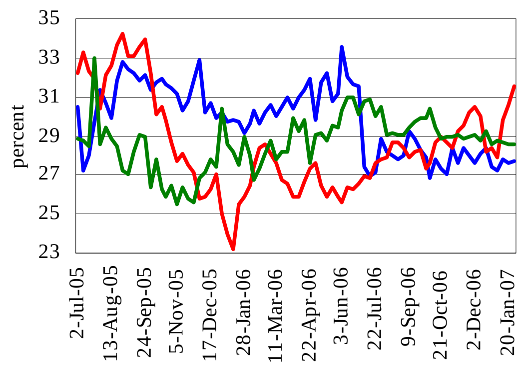
The SBP sterilized a substantial part of reserve money growth during Jul-Feb FY07, but it could not do so more aggressively because of the need to accommodate private sector credit growth demand, which had significantly outpaced the deposit growth during the period.

As seen in **Figure 4.5**, the credit to deposit ratio has remained quite large during the period and in some cases

[9] This is because (1) the government has sought to increase its non-bank borrowings through allowing institutions invest in NSS instruments and issuing PIBs; (2) government was able to retire part of the SBP debt by using Central Bank's profit transferred to the government during this period, and (3) as evident from **Table 4.4**, the availability of external financing during Jul-Dec FY07 is far greater than that in the corresponding period of the previous year.

went beyond 100 percent,[10] Further, liquidity ratio of smaller domestic banks and some foreign banks has declined despite the increased reserve requirements during the period (see **Figure 4.6**).

Figure 4.6: Liquidity Ratio of Domestic Banks

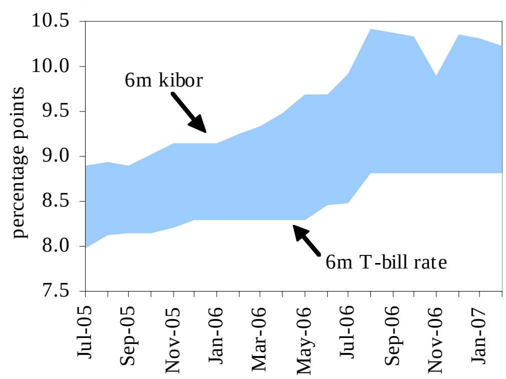


Liquidity ratio is calculated as total liquidity maintained by banks divided by the total demand and time liabilities.

The strong private sector credit demand and consequent availability of lending avenues suggest that a further rise in discount rate would have required to make banks' investment in government papers more attractive (thereby reducing the reserve money growth).

At the current rate, banks had limited incentives to lend to the government given (1) a widening spread between benchmark rates for corporate lending and the repo rate on government securities (see **Figure 4.7**); (2) absence of major risks on quality of private sector credit as evident from a decline in net NPLs to net loans ratio, and (3) more than required capital adequacy of banks[11] (see **Table 4.5**).[12] Certainly,

Figure 4.7: Spread Between Rates for Government and Corporate Lending



[10] At end-January 2007, five banks were operating with credit to deposit ratio above 100 percent.
[11] If the private sector credit runs the sufficient risk of default, the risk averse banks revert to investments in government paper at the cost of higher yields. Likewise, the increase in risk weighted assets of banks goes beyond the standard minimum capital, banks have to switch assets from private credit to government credit.
[12] In fact, limited interest of banks in government paper was the reason why at first place government had to borrow excessively from the SBP throughout Jul-Nov FY07 to finance its deficits.

given the need to support private sector credit demand, rise in discount rate and further tightening of the market liquidity was not desirable.

Going forward, the large foreign exchange inflow since November 2006 is an emerging challenge to SBP. In addition to making country's balance of payments outlook positive for FY07, the expected strength in H2-FY07 foreign currency inflows would also exert upward pressures on reserve money growth.

Table 4.5: Asset Quality of Banks

	Net NPLs to net loans	
	Dec-05	**Dec-06**
Public sector commercial banks	1.2	1.5
Local private banks	1.8	1.0
Foreign banks	-0.6	-1.0
Commercial banks	***1.5***	***1.0***
Specialized banks	28.5	19.5
All banks	**2.4**	**1.5**

Interestingly, both the government and the private sector are expected to benefit from these foreign currency inflows, and in a situation where the reserve money growth is already considerably high, strong inflows would make liquidity management by the Central Bank more challenging.

One obvious policy response from Central Bank would be the sterilization of monetary impact of such inflows. The government has already reduced its reliance on SBP borrowings, and this direction needs to continue and the stock of SBP borrowing further reduced. This implies that counterpart funding should not be used to *increase* expenditures.

On the positive side, SBP is also expecting an increase in liquidity in the inter-bank market during H2-FY07 as the demand for private sector credit slows down in line with the credit cycle. The expected lower demand for private sector credit, recent rise in deposits growth,[13] and Rupee counterpart of the expected foreign exchange inflows are likely to improve liquidity position of banks, and thereby inducing them to invest more in government papers. This in turn will allow SBP to mop up excess liquidity without necessarily raising the discount rate.[14]

[13] Although the deposit growth during Jul-Feb FY07 slowed down to 4.8 percent from 5.9 percent during the corresponding period of FY06, monthly data suggest that the deposit growth is gaining pace since October 2006 onward (see **Figure 4.19a**).
[14] It may be pointed out that banks are already showing interest in T-bills as evident from net offer (i.e., offers net of maturity) of Rs 180.2 billion by banks in the last four auctions held during Jan-Mar FY07 against Rs 75.1 billion offered net of maturity in the preceding 15 auctions during Jul-Feb FY07 period. This renewed interest of commercial banks in T-bills has allowed government to retire its debt held by the Central Bank. This process is effectively transferring T-bill holdings from Central Bank to the commercial banks, thereby helping in containing reserve money growth.

4.2 Monetary Survey

Growth in money supply (M2) during Jul-Feb FY07 slowed to 7.7 percent from 8.7 percent during the same period of FY06 (see **Table 4.6**).

Contrary to the Jul-Feb FY06, when the monetary growth was entirely due to net domestic assets (NDA) as net foreign assets (NFA) were showing a contraction; the expansion in M2 during Jul-Feb FY07 was contributed by the increases in both NDA and NFA.

However, the *slowdown* in monetary growth during Jul-Feb FY07 stemmed entirely from the NDA. The NFA, on the other hand, has registered a slight increase during Jul-Feb FY07.

Table 4.6: Monetary Survey (Flows)

billion Rupees

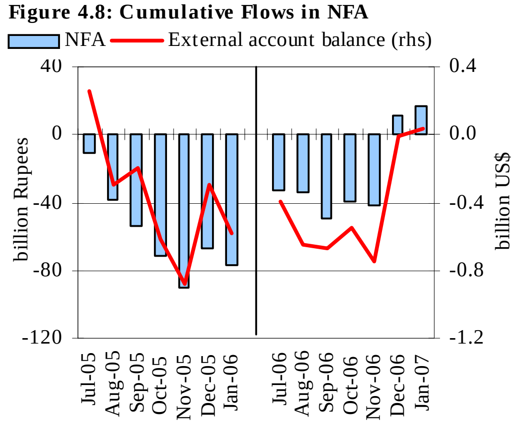
	Credit Plan FY07	Jul-Feb FY06	Jul-Feb FY07
Money Supply (M2)	**459.9**	257.5	264.3
Growth rate (in percent)		8.8	7.7
NFA	**9.8**	-80.9	41.1
SBP		-42.5	25.3
Scheduled banks		-38.4	15.8
NDA	**450.1**	338.4	223.2
SBP		130.4	70.0
Scheduled banks		208.0	153.3
A. Government borrowing	**130.1**	118.3	42.6
Budgetary support	**120.1**	148.8	78.1
SBP		178.2	25.9
Scheduled banks		-29.5	52.3
Commodity operations	**10**	-29.2	-33.6
B. Credit to non-govt. sector	**395**	310.8	222.2
Private sector	390	310.6	227.1
PSEs	5	1.5	-5.2
C. Other Items (net)	**-75**	-90.7	-41.6
SBP		-45.9	46.0
Scheduled banks		-44.8	-87.5

Net Foreign Assets (NFA)

The NFA of the banking system registered an expansion of Rs 41.1 billion Jul-Feb FY07 compared to the contraction of Rs 80.9 billion during the corresponding period of the preceding year.

This is reflective of the improvements in country's balance of payments (see **Figure 4.8**). While the

Figure 4.8: Cumulative Flows in NFA



current account deficit continued to rise during Jul-Feb FY07, Pakistan has seen large financial account surplus during the period, which has resulted in an expansion of the NFA of the banking system.

The major factors responsible for large foreign exchange inflows included a relatively higher growth in workers' remittances and foreign investments (both FDI and portfolio), foreign inflows through Global Depository Receipts (GDRs)[15] and relatively slower increase in trade-related foreign currency loans.

Within the banking sector, the improvement in the NFA is explained by the improvements in the NFA of both the SBP and scheduled banks. It is interesting to see that the SBP NFA registered a growth of 4.5 percent, despite larger volumes of foreign exchange interventions during FY07 compared with the preceding year (see **Figure 4.9**). This phenomenon is explained by large inflows under external financing (mainly through Asian Development Bank), logistic support and GDRs that more than offset the impact of forex interventions.[16]

Figure 4.9: SBP Forex Interventions (Jul-Jan)

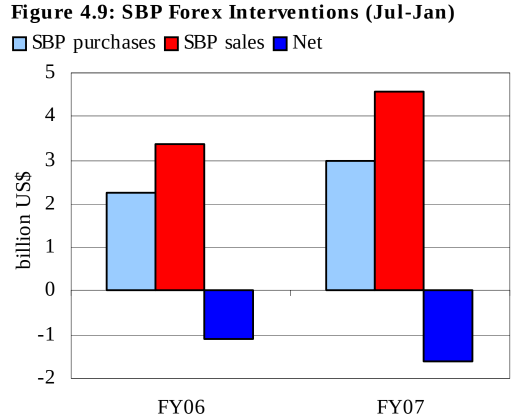
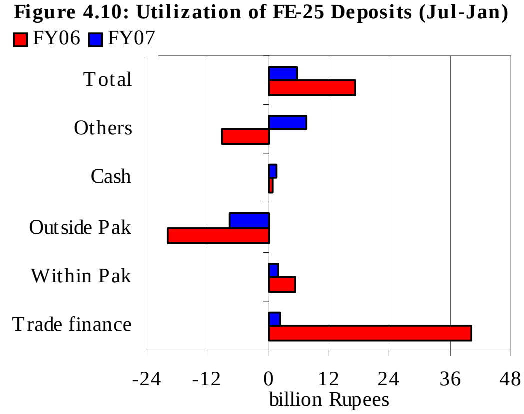


Figure 4.10: Utilization of FE-25 Deposits (Jul-Jan)



The NFA of the commercial banks, on the other hand, showed a net expansion of Rs 15.8 billion during Jul-Feb FY07 against a net contraction of Rs 38.4 billon during Jul-Feb FY06. The

[15] US$ 731 million were mobilized through issuing GDRs of OGDCL.
[16] See Section on **Balance of Payments** for details.

increase in NFA during Jul-Feb FY07 was on the back of slow growth in FE-25 trade loans and a higher increase in banks' nostros and placements outside Pakistan[17] during the period (see **Figure 4.10**).[18]

Net Domestic Assets (NDA)

The growth in the net domestic assets (NDA) of the banking system slowed during Jul-Feb FY07, contributed by the slowdown in NDA of both the SBP and the scheduled banks. The slowdown in SBP NDA stemmed entirely from relatively low budgetary borrowings from the SBP; part of which was offset by an increase in OIN and SBP claims on the scheduled banks. On the other hand, a deceleration in private sector credit and higher contraction in OIN contributed to the slowdown of scheduled banks' NDA.

Figure 4.11: Compositional Shift in Budgetary Finance

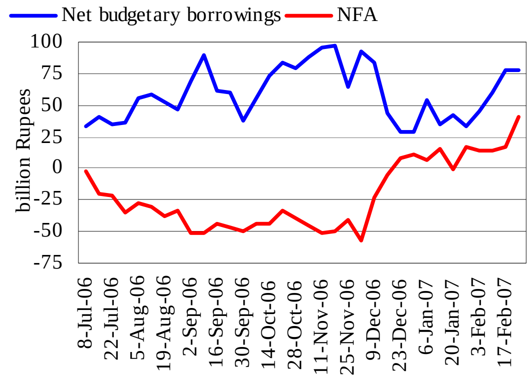
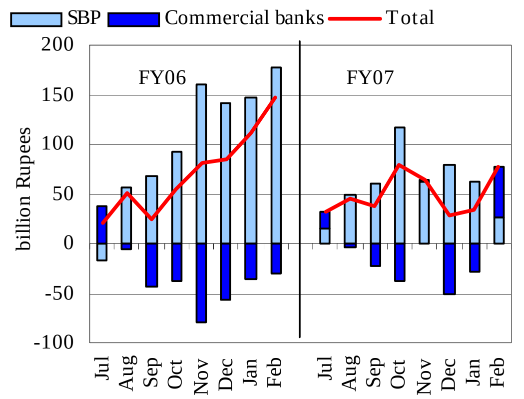


Figure 4.12 : Budgetary Borrowings



Government Borrowings

Although the government was running larger budget deficit during Jul-Feb FY07, the budgetary borrowings from the banking sector during Jul-Feb FY07 were less than half of the same during the preceding year.[19,20]

[17] In the absence of domestic demand for trade related loans, banks have to place foreign currency under FE-25 deposits either in their nostros or make investment in foreign securities.
[18] Please see section of **Private sector credit** for details.
[19] It may be recalled that the budgetary borrowings during Jul-Nov FY07 were smaller than Jul-Nov FY06, only slightly.

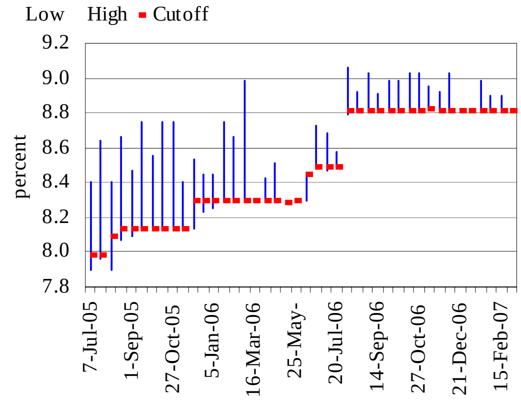
The lower borrowings were attributed mainly to an increase in the government's reliance on external financing post-November 2006 (see **Figure 4.11**).

The composition of the budgetary borrowings within the banking industry during Jul-Feb FY07 is in contrast with the preceding year. Although the Central Bank borrowings still constitute the bulk of the total, the borrowings from scheduled banks have also registered some increase (see **Figure 4.12**).

The increase in government borrowings from scheduled banks mainly reflects the shift in market expectations regarding changes in interest rates. In specific terms, during Jul-Feb FY06 banks, in anticipation of a rise in interest rates, were bidding at excessively high rates in T-bill auctions. Therefore, the government was borrowing directly from the SBP.

However, August 2007 onwards the market expectations of interest rate increases died out following the increase in reserve requirements and discount rate during July 2007 (see **Figure 4.13**). As a result, government's retirements to the scheduled banks registered a slowdown during Jul-Feb FY07 and even turned positive during February 2007.

Figure 4.13: Bid Pattern for 6 Month T-bill



Credit to Private Sector

Growth in credit to private sector decelerated during Jul-Feb FY07, rising by 10.7 percent YoY compared with the growth of 18.1 percent during the same period last year.

A close analysis of the data shows that the slowdown primarily stems from a deceleration in fixed investment loans (particularly in the textile sector), as the working capital requirements have actually accelerated. Excluding the textile

[20] SBP also transferred its profit of Rs 60 billion to the government in the month of November, which is showing a decline in net claims to the government.

sector, the growth in aggregate business sector advances has also seemed to have increased (see **Table 4.7**).

Table 4.7: Growth in Advances
percent

	Working capital		Fixed investment		Total	
	FY06	**FY07**	**FY06**	**FY07**	**FY06**	**FY07**
Business sector	15.4	15.8	13.7	6.7	14.8	13.0
Textiles	23.7	15.7	3.3	-10.5	17.2	8.1
Business excluding textiles	12.0	15.8	18.8	13.8	13.8	15.1

Working capital includes trade financing

It seems that the deceleration in demand for fixed investment loans is mainly due to structural problems in the real sector of the economy that reduced its ability to absorb additional credit at the same pace as in the past two years[21]. Furthermore, delays in initiation of major infrastructure projects, e.g., power projects, led to subdued demand for fixed investment loans. Credit growth is expected to accelerate as structural factors are resolved and the infrastructure projects come online.

4.8: Private Sector Advances (Jul-Jan)

	Absolute flows		% Growth	
billion Rupees	**FY06**	**FY07**	**FY06**	**FY07**
1. Private sector businesses	181.9	193.8	14.6	13.0
A. Agriculture	6.9	9.7	5.3	7.2
Major crops	5.2	16.3	7.1	20.4
B. Manufacturing	93.3	115.7	12.3	12.9
Sugar	2.2	-6.4	6.6	-11.8
Textiles	64.7	35.4	17.2	8.1
Paper and products	1.4	5.2	18.3	55.6
Coke and refined petroleum products	-1.2	5.7	-8.8	71.9
Cement	13.0	9.2	39.8	14.6
C. Electricity, gas and water	1.7	12.1	11.0	63.9
D. Construction	7.4	10.2	23.5	24.2
E. Commerce and trade	43.0	21.0	29.7	11.0
F. Transport, storage & communications	6.5	10.8	12.9	17.3
G. Other private business	5.5	5.1	17.6	15.5
2. Personal	53.9	34.3	21.7	10.0
Consumer financing	51.6	31.1	24.9	10.4

The impact of this on aggregate growth of advances was also compounded by the recent mergers /acquisitions in the banking sector, and consequent slowdown in credit operations. This was most evident in the agriculture and consumer credit market segments. Further, the lending capacities

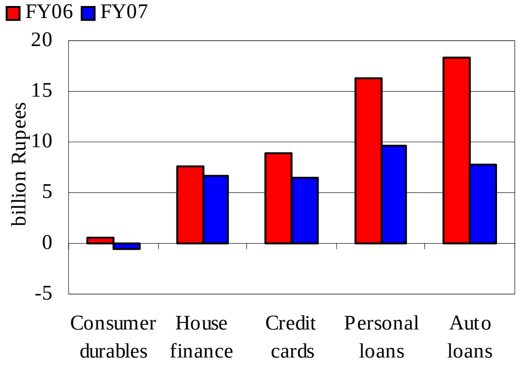
[21] For instance, the installed capacity in textiles and cement sector has already increased sizably in the past few years; therefore, the demand for fixed investment loans in these sectors has slowed down.

of banks also constrained as some of the banks are trying to improve their risk management practices.

Sectoral analysis

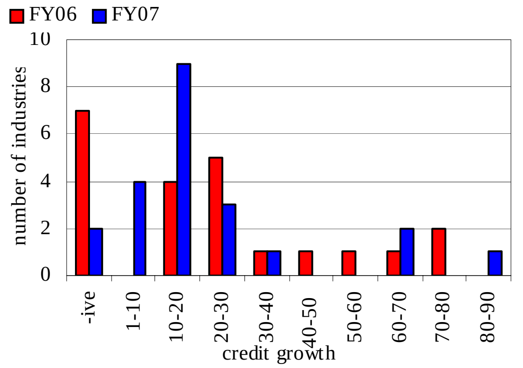
A sectoral analysis of the data shows that within business sector, the major slowdown came from the commerce and trade sector, the growth of which was only one third of the growth in the preceding year[22]. Further the growth in personal sector advances during Jul-Jan FY07 was almost half the growth during Jul-Jan FY06 (see **Table 4.8**)[23].

Figure 4.14: Change in Consumer Finance (Jul-Jan)



Within personal loans, all the consumer financing products registered slowdown, with loans for consumer durables showing net retirements (see **Figure 4.14**). The maturing of earlier consumer loans means that deceleration in net growth in consumer credit was to be expected. But the magnitude of the deceleration in FY07 suggests that the overall consumer credit demand has also moderated somewhat. Auto loans during Jul-Jan FY07 were less than half that during Jul-Jan FY06 attributed mainly to increase in interest rates.[24]

Figure 4.15 : Frequency Distribution of Credit Growth in Manufacturing Units (Jul-Jan)

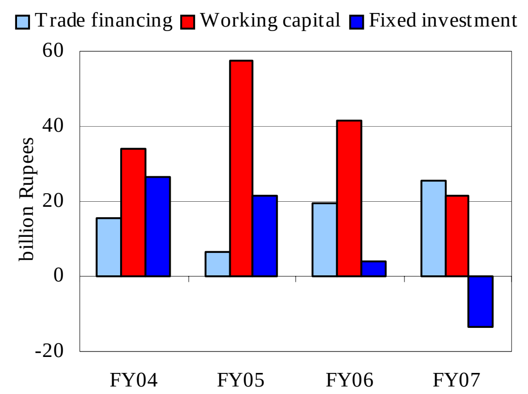


[22] The sector wise data on advances does not include banks' investments in shares and bonds of private corporate sector. The same is included in monetary survey data on private sector credit.
[23] Sector wise distribution of private sector credit is available for Jul-Jan FY07.
[24] The slowdown in auto loans is also reflected in a deceleration in production and imports of automobiles during the same period.

Encouragingly, the advances to manufacturing sector witnessed a higher growth during Jul-Jan FY07 compared to the preceding year. Number of sectors showing net retirements during Jul-Jan FY06 has declined during Jul-Jan FY07. Advances to most of the industries in manufacturing sector were showing a respectable growth (see **Figure 4.15**).[25]

Within the manufacturing sector, advances to textile industry registered major slowdown during Jul-Jan FY07 attributed mainly to certain industry specific factors. Most importantly demand for fixed investment loans fell sharply after exceptional growth in recent years when the industry was preparing for post MFA competition. The impact of this decline was compounded by a number of other factors that included; (1) the overall decline in the demand for Pakistani textile products from its major trading partners due to price and quality related issues; (2) increased prices of raw cotton due to a significant decline in cotton production; and (3) increase in cost of financing.

Figure 4.16: Credit to Textile Sector (Jul-Jan)



Interestingly, the trade related financing under textiles showed an increasing trend during Jul-Feb FY07 attributed mainly to a decline in EFS rates by 100 basis points during July 2006 and a decline in banks' margin by a 50 basis points (see **Figure 4.16**).

Sugar manufacturers showed a relatively net retirement of Rs 6.4 billion during Jul-Jan FY07 from an extension of Rs 2.2 billion advances during the same period last year. The major factors causing this slowdown were the decline in the sugar prices in the international market and sharp increase in sugarcane production domestically.[26]

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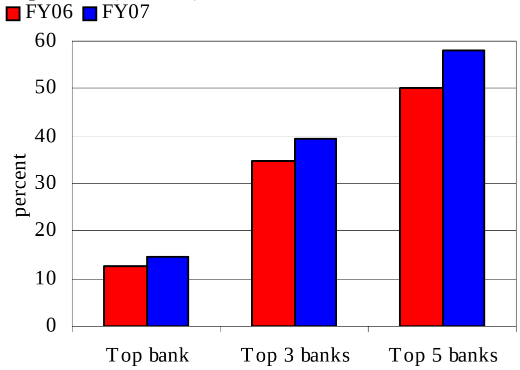
[25] While there were 9 industries showing growth in advances in the range of 5 to 30 percent during Jul-Jan FY06; this number increased to 15 during Jul-Jan FY07.

[26] Therefore, the demand for working capital loans remained low.

However, the strong advances growth in food products (especially rice processing), wearing apparel, fertilizer, basic metals, domestic appliance, electrical machinery, paper board & products industry, coke & refined petroleum products and steel industries more than offset the impact of slowdown in advances to textile and sugar.

The strongest growth in advances was seen in the telecommunication sector where net advances expanded by 17 percent during Jul-Jan FY07 compared to the growth of 13 percent during the same period last year. This was mainly because of the continuing need of operators to expand cell-phone networks due to competitive pressures.[27]

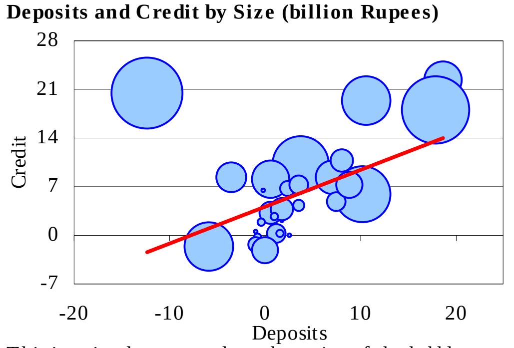
Figure 4.17: Bank Concentration in Credit Expansion (Jul-Jan)



Within the banking sector, it is interesting to note that the credit concentration was skewed towards banks with very large deposit bases. As shown in **Figure 4.17**, the credit concentration among banks during Jul-Jan FY07 was higher compared with the preceding year.

Further disaggregated data shows that a few large and medium sized banks (in terms of deposit base), have registered a higher credit expansion compared with the other domestic and foreign banks. Moreover, the lower credit growth by smaller

Figure 4.18: Scatter Plot of Increases in Banks' Deposits and Credit by Size (billion Rupees)



This is a simple scatter plot; where size of the bubble shows size of the bank

[27] The higher growth in credit to telecommunication sector is in addition to US$ 250 million worth International Bonds issued by Mobilink during Jul-Feb FY07.

banks was caused mainly by slow deposit mobilization; particularly during the period of seasonal off-take (see **Figure 4.18**).

Deposit Mobilization

The deposit growth during Jul-Feb FY07 slowed down to 4.8 percent from 5.9 percent during Jul-Feb FY06 (see **Figure 4.19a**). Encouragingly however, the currency to deposit ratio during the former period has mostly remained high throughout the period. However, the only exception was the month of December, explained primarily by the fall of Eid during the last week of the month (see **Figure 4.19b**).

Figure 4.19 (a): Cumulative Deposit

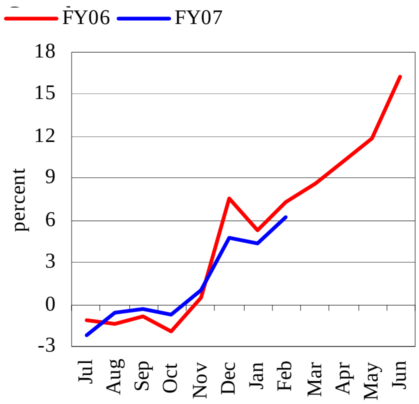


Figure 4.19 (b): Currency to Deposit Ratio

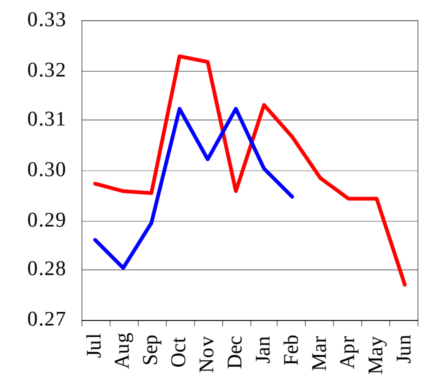


Figure 4.20 (a): Spread Between Returns on Rupee Deposits & FCAs

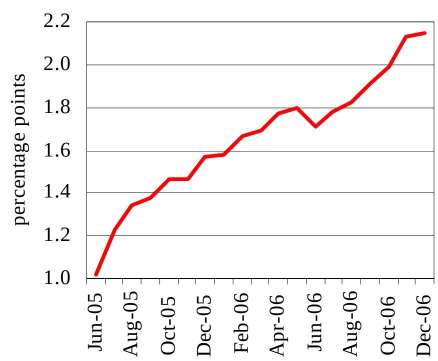
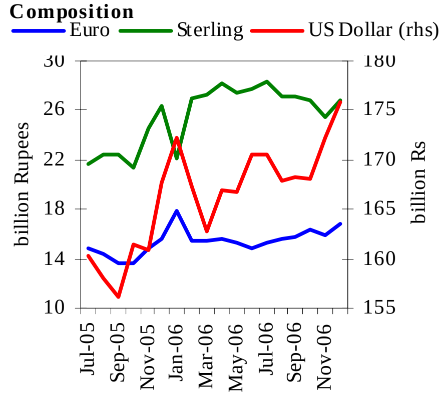


Figure 4.20 (b): FCA's Currency Composition



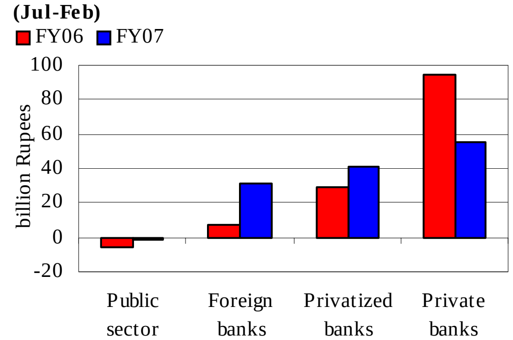
The currency composition of the deposits shows that the share of foreign currency deposits continued to decline in total deposits given the expectations of a stable exchange rate. Further the spread between interest rates on Rupee deposits and foreign currency accounts also widened during FY07 (see **Figure 4.20a**).

Within foreign currency deposits, Sterling and Yen deposits registered net withdrawals while the US dollar and Euro deposits almost halved compared with Jul-Feb FY06 (see **Figure 4.20b**).

A disaggregation of deposit mobilization within banking groups shows that most of the slowdown was registered in domestic private banks. The deposit mobilization of foreign banks and the large privatized banks, on the other hand, has remained higher during Jul-Feb FY07 compared with the preceding year (see **Figure 4.21**).

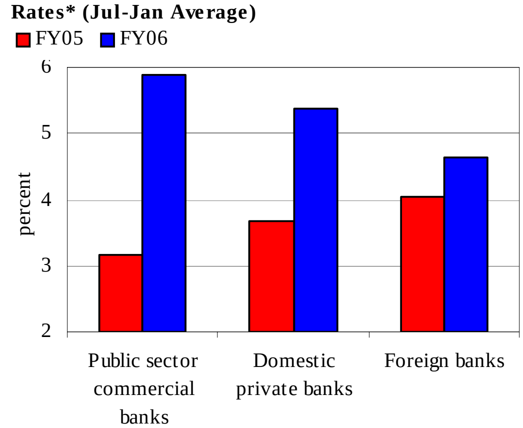
It is interesting to see the returns offered by PSCBs on deposits which were the lowest during Jul-Feb FY06 among banking groups. During Jul-Feb FY07, these banks raised deposit rates by 256 basis points and are now operating with the highest deposit rates (see **Figure 4.22**). Despite this sharp increase in deposit rates, the deposits of public sector

Figure 4.21: Group-wise Deposit Mobilization (Jul-Feb)



In both years, Standard Chartered Bank Pakistan Ltd. and Habib Bank AG Zurich Bank are included in Private banks.

Figure 4.22: Group-wise Incremental Deposit Rates* (Jul-Jan Average)



* Incremental deposit rate is the weighted average rate at which deposits are mobilized during a month.

banks registered net withdrawals. This phenomenon is explained mainly by the net withdrawals from deposits of public sector enterprises (PSEs) (see **Table 4.9**).

Encouragingly, the impact of monetary tightening has started appearing on banks' deposit rates. As mentioned earlier, the credit to deposit ratio during Jul-Feb FY07 has remained quite high thus creating liquidity constraints for the banks. Therefore, the banks have started mobilizing deposits at higher returns especially during the period of seasonal credit off-take (see **Figure 4.23**). Hence, a healthy competition has emerged within the banking sector as evident from aggressive advertising campaigns of banks' saving products.

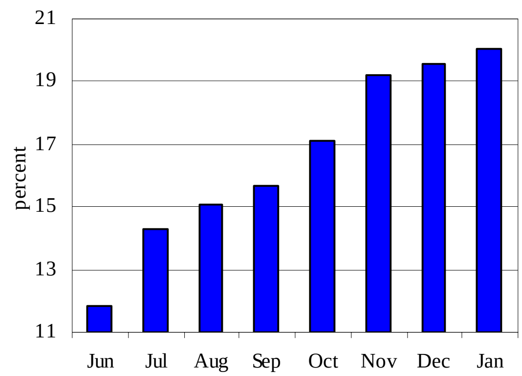
Table 4.9: Sector-wise Deposit Growth

in percent

	FY06	FY07
Government	4.3	3.7
PSEs	22.3	-6.0
NBFIs	85.8	28.7
Private business	-1.3	2.3
Manufacturing	-6.2	-4.0
Telecommunications	39.2	136.7
Personal	5.1	4.6

It is important to note that the increase in outstanding amount in national saving scheme (NSS) during Jul-Dec FY07 has so far been due to inflows in *Pensioners' saving accounts* and *Behbood Savings Certificate*. This suggests that the government's decision to allow institutional investment in national saving schemes (NSS) in September 2006 has so far not diverted savings from the banking system to the NSS. In other words, as funds flow into these schemes, the competition for deposits could intensify in months ahead benefiting depositors further.

Figure 4.23: Share of Deposits Mobilized Over 8 Percent Rate of Return in Total Stock

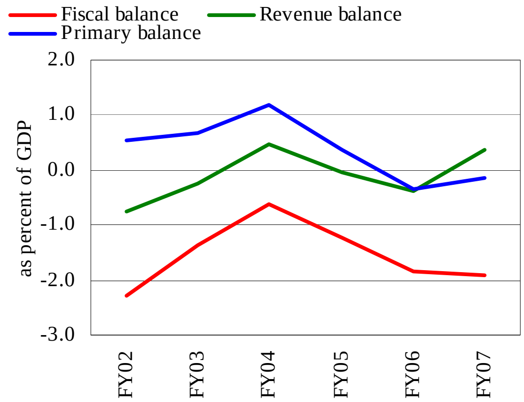


5 Fiscal Developments

5.1 Overview

The recent fiscal numbers show that the government is comfortably placed to meet the FY07 targets, with exceptionally strong direct tax collections and robust non-tax revenues offsetting a substantial increase in expenditures.

Figure 5.1: Balance Indicators during H1



While the H1-FY07 fiscal deficit is marginally higher than in the previous year (see **Figure 5.1**), the H2-FY07 picture is likely to see an improvement given that the earthquake-related H2-FY07 spending is expected to be a little lower and revenue growth stronger, than the respective H2-FY06 figures. In other words, the rising trend in the fiscal deficit seen in the past two years is expected to end in FY07. A similar trend is already evident in the primary balance, and more strikingly, in the revenue balance. Indeed, the latter depicts a small surplus in H1-FY07, after recording deficits in first half of each of the previous two fiscal years.

The improvement in the revenue balance is particularly noteworthy, indicating that the fiscal deficit is essentially being incurred for developmental spending, as envisaged in the FRDL Act 2005[1]. However, given that the performance on the revenue balance is already far ahead of the targets set in the Act, it is important to look for further improvements by revising these targets upwards to reflect the improvement in economic prospects.

Moreover, this needs to be done, even as the government raises development spending on education, health and infrastructure, in order to increase the

[1] The Fiscal Responsibility and Debt Limitation Act, 2005 (FRDL) target of achieving zero revenue balance by the end of FY08 has already been achieved in H1-FY07. Similarly, the FRDL target of achieving a public debt to GDP ratio below 60 percent by the end of FY13 has already been achieved by FY06.

productive capacity of the economy and attract investment. Therefore, it is imperative that the tax-to-GDP ratio be improved, and the tax net broadened, in order to sustainably create the required fiscal space. The H1-FY07 revenue performance is already on the right track, with revenues growing 23.5 percent YoY, due to strong tax and non-tax revenues, bringing the tax-to-GDP ratio for the period to 4.9 percent, as compared to 4.5 percent for H1-FY06.

The growth in tax revenues – the strongest for the last five years – is quite encouraging, particularly given that the indirect tax receipts of the CBR have grown by only 8.3 percent in H1-FY07, much lower than the 16.8 percent growth target for the period, and 17.2 percent rise recorded in corresponding period last year. The risk of a deceleration in the growth of these receipts has already been evident in the previous year, given the high dependence of the growth in these receipts on imports and the likelihood that the extraordinary rise in imports could not continue for long. Fortunately, even as this risk materialized in H1-FY07, the impact of the resulting weakness in CBR indirect tax collections was offset by the exceptional strength of direct tax receipts in the period.

The rise in direct tax collections is certainly very welcome. However, the abrupt shift in the profile of CBR tax receipts underscores three points:

(1) It is important to diversify the tax base, so that underperformance in a portion of the economy does not cause disproportionate revenue losses.
(2) One must carefully examine the underlying causes of the revenue growth to separate one-off factors from underlying (sustainable) factors.
(3) It is crucial for fiscal discipline that expenditure growth is kept at levels consistent with sustainable revenue growth.

The expenditures grew by 23.5 percent YoY during H1-FY07, slightly lower than the 26.1 percent seen in H1-FY06. At face value, the greater discipline in expenditures appears essentially to reflect lower than anticipated development expenditures of Rs 149.3 billion (only 34 percent of the annual target). However, this interpretation is rendered uncertain by the large block of unidentified expenditure (Rs 54.4 billion or 0.6 percent of GDP). If this unidentified spending essentially comprises of development expenditure, this would be quite welcome. On the other hand, if it largely comprises current spending, greater fiscal discipline would clearly be warranted.

5.2 Revenues

The strong growth in both tax and non-tax revenues during H1-FY07, has meant that total receipts already account for 52.8 percent of the annual revenue target (see **Table 5.1**). Thus, given that larger part of the tax collections is typically

Table 5.1: Consolidated Fiscal Operations during H1 (billion Rupees)

							YoY % change	
Head	**FY02**	**FY03**	**FY04**	**FY05**	**FY06**	**FY07**	**FY06**	**FY07**
Revenues	**263.9**	**332.9**	**379.1**	**423.8**	**497.8**	**614.8**	**17.5**	**23.5**
Tax revenue*	184.7	219.6	244.5	284.4	343.3	433.4	20.7	26.3
Non-tax revenue	79.3	113.2	134.5	139.4	154.6	181.3	10.9	17.3
Expenditure	**363.8**	**398.6**	**412.8**	**503.3**	**634.5**	**783.8**	**26.1**	**23.5**
Current	296.7	345.1	352.5	427.5	525.3	581.4	22.9	10.7
Development	50.9	51.5	56.8	81.6	128.3	149.3	57.2	16.4
Net lending to PSEs	6.8	2.7	7.0	4.7	-0.4	-1.3	-108.9	-
Unidentified	9.4	-0.8	-3.4	-10.4	-18.6	54.4	79.3	-
Fiscal balance	**-99.9**	**-65.7**	**-33.7**	**-79.6**	**-136.7**	**-169.0**	**71.8**	**23.6**
As percent of GDP**								
Revenues	6.0	6.9	6.7	6.4	6.5	7.0	-	-
Tax revenue	4.2	4.6	4.3	4.3	4.5	4.9	-	-
Non-tax revenue	1.8	2.3	2.4	2.1	2.0	2.1	-	-
Expenditure	8.3	8.3	7.3	7.6	8.2	8.9	-	-
Current	6.7	7.2	6.2	6.5	6.8	6.6	-	-
Development	1.2	1.1	1.0	1.2	1.7	1.7	-	-
Net lending to PSEs	0.2	0.1	0.1	0.1	0.0	0.0	-	-
Unidentified	0.2	0.0	-0.1	-0.2	-0.2	0.6	-	-
Fiscal balance	**-2.3**	**-1.4**	**-0.6**	**-1.2**	**-1.8**	**-1.9**	-	-

Source: Ministry of Finance
* Surcharges are subtracted from tax revenue and added to non-tax revenue for analysis purpose as per MoF format.
** GDP base 1999-2000.

made during the second half of the fiscal year, it appears that revenue targets for FY07 are likely to be comfortably achieved.

The improved revenue performance is particularly driven by CBR tax collections, which typically account for over 90 percent of tax collections. These rose 26.3 percent YoY in the period, exceeding the target by 7.0 percent.[2]

Similarly, non-tax revenues at Rs 181.3 billion were 17.3 percent higher than last year, mainly due to strong increases in dividend receipts, transfer of profits from SBP and oil & gas surcharge collections, all of which offset the decline in profits from PTA, defense receipts and interest receipts (see **Table 5.2**).

5.3 Expenditures

Total expenditure reached to Rs 783.8 billion with a YoY growth of 23.5 percent of which current expenditure stood at Rs 581.4 billion while the development

[2] The data for Jul-Jan FY07 continues to support the view that annual collections will considerably exceed the target, with receipts of Rs 462.7 billion, about 6.1 percent above the targets for the period.

Table 5.2: Non-tax Revenue (Jul-Dec)
billion Rupees

	FY02	FY03	FY04	FY05	FY06	FY07
Profit of post office / PTA	0.0	-	0.4	17.7	10.5	0.1
Interest	8.8	4.6	12.4	7.1	7.6	4.3
Dividend	15.2	24.3	25.5	32.4	27.3	33.8
SBP profit	12.0	6.0	0.0	0.0	3.9	39.2
Defence	0.0	0.0	0.0	40.6	46.5	27.2
Royalties on gas & oil					10.2	14.1
Sales proceeds & royalties	6.6	7.7	6.5	8.1		0.0
Citizenship, naturalizations & passport fee					2.7	2.7
Development surcharge on petroleum	7.1	11.6	8.9	9.0	9.9	18.0
Development surcharge on gas	17.2	21.9	24.3	4.7	9.4	15.8
Other civil administration	1.7	20.9	35.7	0.9	0.9	0.0
Miscellaneous	10.6	16.1	20.9	18.7	25.7	26.2
Total	**79.3**	**113.2**	**134.5**	**139.4**	**154.6**	**181.3**

Source: Ministry of Finance

expenditure remained low at Rs 149.3 billion (see **Table 5.1**). However, unidentified expenditure was very high, at Rs 54.4 billion (0.6 percent of GDP), which adds considerable uncertainty to the analysis of fiscal trends.[3]

Based on booked expenditure, the overall growth in current expenditure is quite modest relative to the previous year.[4] This rise is essentially caused by a steep rise in domestic interest payments and an increase in *other general public service* spending. While the former is a function of the high reliance on short term debt and rise in interest rates as well as the maturities of high yield long term debt issued a decade ago; the increase in the latter needs to be carefully reviewed as it could imply weakening in fiscal discipline. Encouragingly, defence expenditure declined to Rs 114.9 billion in H1-FY07 as compared to Rs 119.0 billion in H1-FY06 (see **Table 5.3**).

Development expenditure at Rs 149.3 billion remained 1.7 percent of GDP, the same as in H1-FY06. Total PSDP during H1-FY07 works out to be only 34

[3] To illustrate, adding this unidentified expenditure to the current expenditure, drastically increases the growth of current expenditure from 10.7 percent to a disquieting 25.5 percent. On the other hand, if entirely categorized under development expenditure, the growth jumps from 16.4 percent to 58.8 percent YoY.

[4] It may be noted that current expenditure for FY07 is not strictly comparable with the previous year, as the expenditure incurred on earthquake hit areas was a part of current expenditure in FY06, while for FY07 it has been added to budgeted allocations for development expenditure. The impact cannot be disentangled as details of the earthquake related spending have not been provided separate for the two periods.

Table 5.3: Composition of Expenditure (Jul-Dec)

billion Rupees

					YoY percent change	
	FY04	**FY05**	**FY06**	**FY07**	**FY06**	**FY07**
Current expenditure	352.5	427.5	525.3	581.4	22.9	10.7
of which						
Interest payments	98.8	104.2	111.4	155.8	6.9	39.8
Domestic	76.3	82.9	89.8	131.3	8.3	46.2
Foreign	22.5	21.3	21.6	24.5	1.4	13.4
Defence	87.3	101.1	119.0	114.9	17.8	-3.4
Other general services	-	21.5	20.8	50.6	-3.2	143.6
Development and net lending	63.7	86.3	127.8	147.9	48.2	15.7
PSDP	56.8	81.6	128.3	149.3	57.2	16.4
Net lending	7.0	4.7	-0.4	-1.3	-108.9	216.2

Source: Ministry of Finance

* GDP base 1999-2000

percent of the target set for FY07 being far lower than that of 45 percent of the budgeted target achieved during H1-FY06. However, this may simply reflect that the development spending has not yet been booked appropriately.

5.4 Financing

The total financing requirements of the government stood at Rs 169 billion during H1-FY07 (see **Table 5.4**). Almost 57 percent of this was met through external resources in which gross receipts from program loans provided Rs 43.5 billion while project aid added Rs 17.6 billion.

Table 5.4: Financing of Budget Deficit (Jul-Dec)

billion Rupees

			Share in percent	
	FY06	**FY07**	**FY06**	**FY07**
Financing through	136.7	169.0	100.0	100.0
External resources (net)	39.8	96.2	29.1	57.0
Internal resources	96.9	72.7	70.9	43.0
Domestic non-bank*	-6.7	28.5	-4.9	16.9
Banking system	84.9	28.3	62.1	16.7
Privatization proceeds	18.7	15.9	13.7	9.4

Source: Ministry of Finance

*Adjusted for FY07

Of the total domestic financing, bank and non-banks contributed equally with Rs 28.3 and Rs 28.5 billion respectively.[5] Finally, privatization proceeds also helped in financing the fiscal deficit by Rs 15.9 billion.

[5] For further details see sections on *Government Borrowings and Domestic Debt*

Table 5.5: Tax Collection
billion Rupees

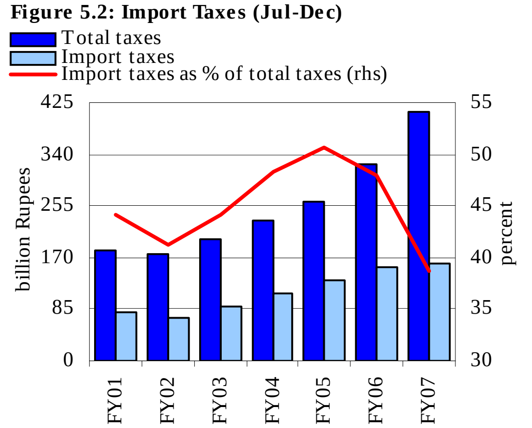
Heads	Target		Net tax collection (Jul-Jan)		YoY percent change		Percent of target	
	FY07	Jul-Jan	FY06	FY07	FY06	FY07	FY07	Jul-Jan
Direct taxes	264.7	136.0	114.4	185.2	30.8	61.9	69.9	136.1
Indirect taxes	570.3	300.0	255.4	277.5	18.1	8.6	48.7	92.5
Sales tax	343.8	182.3	154.9	171.0	20.5	10.4	49.7	93.8
Federal excise duty	69.0	35.6	29.5	36.2	6.2	22.6	52.4	101.6
Customs	157.5	82.1	71.0	70.3	18.5	-1.0	44.7	85.7
Total	835.0	436.0	369.8	462.7	21.8	25.1	55.4	106.1

Source: Central Board of Revenue

5.5 CBR Tax Collection

The CBR surpassed the Jul-Jan target of Rs 436.0 billion, with a collection of Rs 462.7 billion, up 25.1 percent YoY (see **Table 5.5**). Although import-related taxes,[6] that typically contribute over half of the CBR tax receipts, suffered due to a deceleration in import growth[7] (see **Figure 5.2**), the impact of this was offset by the unanticipated strong surge in direct taxes as a result of strong corporate profitability (see **Figure 5.3**).

Figure 5.2: Import Taxes (Jul-Dec)



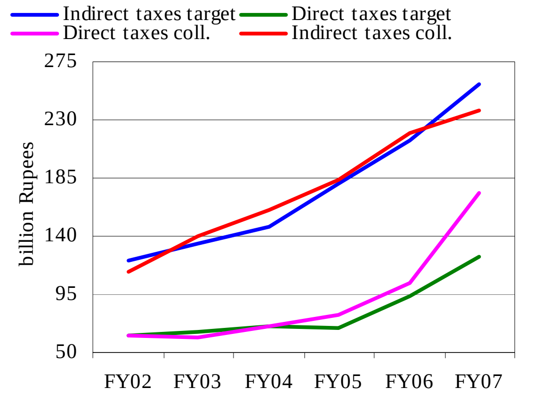
The strong tax receipts are expected to push up the FY07 tax buoyancy and the tax-to-GDP ratio significantly, but Pakistan's performance continues to lag regional benchmarks, as well as those in developing countries.[8]

[6] These include customs duty, sales tax and withholding tax on imports.
[7] The revenue loss during Jul-Dec is estimated to be Rs 19 billion due to fall in imports (CBR Quarterly Review vol. 6, No.2, October – December 2006).
[8] According to Government Finance Statistics of the IMF, the ratio is around 40 percent for high income countries, 25 percent for middle income countries and about 18 percent in low income countries.

Gross Collection and Refunds

The gross tax collection rose sharply by 23.0 percent YoY in Jul-Jan FY07 - the highest collection growth rate for the last 7 years - to reach Rs 517.0 billion, even as the growth in refunds fell from 11.9 percent of gross tax collection in Jul-Jan FY06 to 10.5 percent during Jul-Jan FY07 (see **Figure 5.4)**. However, the sharp downtrend in refunds seen in the last two years does not seem likely to continue in forthcoming years as the affect of zero-rating of inputs for export-oriented products, that was introduced in FY04, has already been realized. Therefore, the refund-to-gross-collection ratio is likely to stabilize at the current levels.

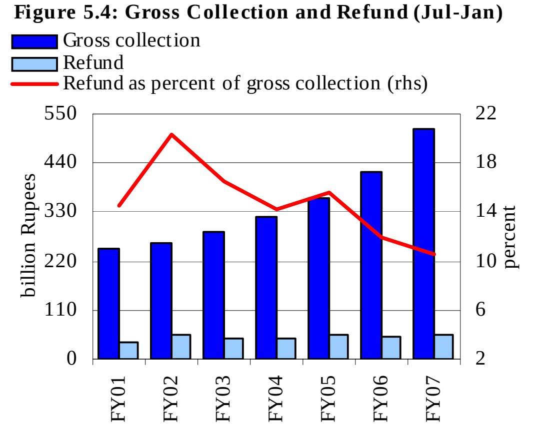
Figure 5.3: CBR Targets vs. Collection (Jul-Jan)



Direct Taxes

The collection from direct taxes rose 61.9 percent YoY in July-Jan FY07 to Rs 185.2 billion, 36.1 percent higher than the target for the period. As a result, the share of direct taxes in total revenue increased from an average of 33 percent for the pervious three years to 40 percent in Jul-Jan FY07 (see **Table 5.5**).

Figure 5.4: Gross Collection and Refund (Jul-Jan)



A break up of the direct tax collection, available for the H1-FY07 period, shows that about 97 percent of the direct tax collection of Rs 172.7 billion came from income tax. Of this, Rs 104.3 billion were realized through voluntary payments that rose by 113.6 percent over the last year (see **Table 5.5a**), superseding withholding tax, as the major contributor to income tax collections. This sharp jump in voluntary payments is mainly due to the higher corporate profits that increased the overall tax collection from direct taxes. Private companies provided Rs 54.6 billion, public companies Rs 47.2 billion, while banking companies provided Rs 35.5 billion to the gross receipt of Rs 137.3 billion during HI-FY07. The gross receipts were up 66.4 percent YoY compared to the previous year (see **Table 5.5b**).

Withholding tax receipts remained strong, providing Rs 77.9 billion to national exchequer during H1-FY07 contributing 46.7 percent to the total income tax collection. Of the withholding taxes major contributor remained contracts (Rs 26.2 billion), salaries (Rs 7.4 billion) and imports (Rs 13.1 billion).

Table 5.5a: Major Components of Income Tax during H1

billion Rupees

							YoY % change	
	FY02	**FY03**	**FY04**	**FY05**	**FY06**	**FY07**	**FY06**	**FY07**
Voluntary payments	26.7	24.2	26.5	35.9	48.8	104.3	35.9	113.6
Collection on demand	4.7	4.5	5.6	3.7	5.6	4.4	50.1	-20.7
Withholding taxes	35.1	37.0	42.2	46.8	60.3	77.9	28.9	29.2
Others	3.1	2.5	0.6	0.4	0.1	0.0	-75.0	-100.0
Gross total	69.6	68.3	74.9	86.9	114.7	186.6	32.1	62.6
Refund/rebate	6.9	6.6	4.9	10.5	15.3	19.7	45.9	28.9
Total net	62.8	61.7	70.0	76.4	99.5	166.9	30.2	67.8

Source: Central Board of Revenue

Indirect Taxes

The collections from indirect taxes totaled Rs 277.5 billion during Jul-Jan FY07 falling 7.5 percent short of the target. This shortfall is mainly attributable to the slowdown in the import growth that hit the collections from customs duty and the import-related sales tax receipts (see **Table 5.5**).

Table 5.5b: Income Tax Collection from Corporate Sector

billion Rupees

			YoY change	
	FY06	**FY07**	**Absolute**	**Percent**
Public companies	27.8	47.2	19.4	69.8
Private companies	38.7	54.6	15.9	41.1
Banking companies	16	35.5	19.5	121.9
Gross corporate tax	82.5	137.3	54.8	66.4

Source: Central Board of Revenue

Sales Tax

Sales tax collection stood at Rs 171.0 billion against the target of Rs 182.3 billion during Jul-Jan FY07. This amount is however 10.4 percent higher than the FY06 collection during the same period. A breakup of the sales tax shows that due to a slowdown in imports, import-related sales tax collections lagged Rs 8.6 billion

(9.2 percent) behind its target of Rs 93.9 billion for the first half of FY07. Apart from import related sales tax, domestic sales tax also slightly lagged behind its target (by Rs 1.3 billion) due to higher refunds to the power sector. The major revenue spinners of domestic sales tax remained telecom, POL, natural gas, sugar, cigarettes, cement and beverages (see **Table 5.5c**).

Federal Excise Duty
Collection from federal excise duty surpassed its target of Rs 35.6 billion and reached to Rs 36.2 billion. Of the indirect taxes, federal excise duty is the only tax head that could meet the target for the period.

The major revenue spinners in excise duty remained cigarettes and tobacco (Rs 10.6 billion), cement (7.0 billion), beverages and concentrates (Rs 3 billion) and natural gas (Rs 2.8 billion). The collection from the natural gas is not as high as its historical perspective, mainly due to the substantial input claims on major explores and suppliers during the first half of the fiscal year 2007.

Customs Duty
Due to slowdown in imports from 50.0 percent YoY growth during Jul-Jan FY06, to 9.1 percent YoY growth in Jul-Jan FY07, the customs duties collection (Rs 70.3

Table 5.5c: Major Revenue Spinners of Sales Tax (domestic)
billion Rupees

			YoY change	
	H1-FY06	**H1-FY07**	**Absolute**	**Percent**
Telecom services	11.8	17.1	5.3	44.8
POL products including LPG	12.6	14.6	2.0	15.8
Natural gas	6.3	5.7	-0.6	-9.6
Sugar	3.3	4.8	1.4	42.6
Cigarettes	2.0	2.9	0.9	42.8
Cement	2.3	2.5	0.2	8.3
Services excluding telecom	1.9	2.2	0.2	12.3
Beverages	1.4	1.7	0.3	20.1
Auto parts	1.1	1.3	0.2	21.5
Iron & steel products	0.8	1.0	0.2	26.8
Sub total	43.6	53.8	53.8	23.2
Others	25.6	34.7	54.8	35.8
Gross	**69.2**	**88.5**	**55.8**	**27.9**
Refund	17.2	23.0	56.8	34.0
Net sales tax (domestic)	**52.0**	**65.4**	**57.8**	**25.8**

billion) fell 14.3 percent short of target (see **Table 5.5**). However, the major revenue came from vehicles, edible oil and waxes, POL products and electrical machinery.

5.6 Provincial Finance

Aggregate provincial revenues rose 11.9 percent YoY to Rs 215.7 billion during H1-FY07. The larger part of these revenues represented the federal tax assignments,[9] while the aggregate collections from provincial taxes remained low at Rs 17.0 billion, witnessing a 1.4 percent YoY decline. On the other hand, non-tax revenues rose slightly by 1.8 percent to Rs 18.3 billion. The lower tax base and revenue mobilization by provinces poses a serious fiscal risk to their efforts to retire expensive cash development loans in order to increase their fiscal space, and expand development expenditure (see **Table 5.6**).

On the other hand, relatively moderate growth is evident in all provinces as the expenditure growth in H1-FY07 fell to 18.4 percent YoY as compared to 27.9 percent YoY in the corresponding period last year. The trend of premature retirement of the CDL remains in progress and the net repayment of all provinces on account of cash development loan stood at Rs 4.4 billion, which would further help improve the fiscal position of the provinces.

The aggregate overall deficit of provinces increased sharply from 12.1 billion in H1-FY06 to Rs 26.9 billion in H1-FY07. The details of provincial finance show that this is principally due to the Punjab whose deficit increased from Rs 5.7 billion in H1-FY06 to Rs 33.0 billion in H1-FY07. In contrast, the other three provinces saw improvements in their overall fiscal position during H1-FY07. The prime reason for the increase in the overall deficit of the Punjab is the rise in both the current and the development expenditure. The current expenditure increased from Rs 70.9 billion in H1-FY06 to Rs 100.3 billion in H1-FY07, while the development expenditure rose from Rs 44.7 billion to Rs 55.4 billion (up 24 percent YoY).

[9] One of the major contributing factors to the improvement in provincial finance is the revision of NFC award that increased the provincial share in federal tax receipts. For details see **Box: Revenue Sharing** in the *The State of Pakistan's Economy - First Quarterly Report 2006-2007.*

Table 5.6: Summary of Consolidated Provincial Finance during H1
billion Rupees

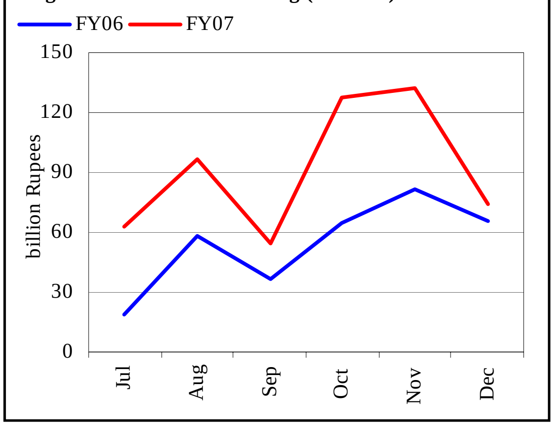
						YoY % change	
	FY03	FY04	FY05	FY06	FY07	FY06	FY07
Total revenue	**118.7**	**126.5**	**153.5**	**192.8**	**215.7**	**25.6**	**11.9**
Provincial share in federal revenue	81.5	90.5	113.2	126.2	170.2	11.5	34.8
Provincial taxes	10.7	13.7	16.5	17.2	17.0	4.6	-1.4
Provincial non-tax	8.4	11.2	9.7	18.0	18.3	85.7	1.8
Federal loans and transfers/grants	18.1	11.1	14.1	31.4	10.3	122.0	-67.1
Total expenditure	**139.7**	**135.2**	**160.2**	**204.9**	**242.7**	**27.9**	**18.4**
Current expenditure	119.7	113.6	129.3	160.2	187.2	23.8	16.9
Development expenditure	20.0	21.6	30.9	44.7	55.4	44.8	24.0
Overall balance	**-21.0**	**-8.7**	**-6.8**	**-12.1**	**-26.9**	**78.9**	**122.8**
Financing	**2.7**	**-2.0**	**8.8**	**-8.2**	**-0.8**	**-193.0**	**-90.1**
Domestic	2.7	-2.0	8.8	-8.2	-0.8	-193.0	-90.1

Source: Ministry of Finance

5.7 Government Borrowings[10]

While the government's overall financing needs from domestic resources during H1-FY07 were almost same as they were in H1-FY06 (see **Figure 5.5**), the sources were more diverse, as the availability of non-bank resources to the government during H1-FY07 reduced the dependence on bank borrowings.

Figure 5.5: Total Borrowing (Jul-Dec)



As shown in **Table 5.7**, non-bank resources were bolstered by sales of PIBs worth Rs 16.3 billion during H1-FY07 (none were sold in the corresponding period last year), and higher net mobilization from NSS.

[10] The government borrowing numbers do consider the impact of government deposits with the banking system whereas the debt numbers do not.

The latter rose by Rs 22.2 billion during H1-FY07, against a net retirement of Rs 2.3 billion during H1-FY06. This change was seen even before the government's decision to allow institutional investment in NSS,[11] and to remove the lock-up period of one month for Defence Saving Certificate (DSCs), Special Saving Certificates (SSCs), and Special Saving Accounts (SSAs). Indeed, these decisions do not appear to have resulted in any substantial increase in NSS net receipts, so far.

Table 5.7: Bank and Non-bank Borrowings - Cumulative

billion Rupees

	FY06		FY07	
	Bank	**Non-bank**	**Bank**	**Non-bank**
Jul	21.2	-1.4	32.3	13.1
Aug	51.0	2.5	45.9	23.4
Sep	24.5	2.5	38.1	14.5
Oct	54.9	5.1	78.8	17.6
Nov	81.6	4.3	63.7	20.8
Dec	84.9	1.1	28.3	21.6

As a result of the net surplus from non-bank resources, the government budgetary borrowing from the banking system during H1-FY07 witnessed a fall of 66 percent YoY. However the government continued to borrow exclusively from the SBP and retired debt held by scheduled banks (see **Table 5.8**).

Table 5.8: Composition of Banking System Borrowing – Cumulative

billion Rupees

	FY06		FY07	
	SBP	**Sch banks**	**SBP**	**Sch banks**
Jul	-16.1	37.3	14.9	17.5
Aug	55.8	-4.8	49.9	-4.0
Sep	67.9	-43.4	60.1	-22.0
Oct	93.3	-38.3	117.1	-38.3
Nov	161.0	-79.4	62.0	1.7
Dec	142.4	-57.5	79.3	-51.0

5.8 Domestic Debt

The 2.8 percent YoY rise in domestic debt during H1-FY07 was substantially lower than the 6.3 percent rise in H1-FY06. In absolute terms, H1-FY07 recorded an increase of Rs 64.3 billion in domestic debt, which was only 48.2 percent of H1-FY06 increase in domestic debt. Primarily, this lower domestic debt growth was a result

Table 5.9: Domestic Debt

billion Rupees

	Jun-05	Dec-05	Jun-06	Dec-06
Permanent	500.9	484.7	499.8	517.5
Floating	778.2	926.8	940.2	965.2
Unfunded	854.0	855.1	859.2	880.8
Total	2133.1	2266.6	2299.2	2363.5

[11] Following institutions are allowed to invest in NSS: Non-profit bodies, registered charities, public sector enterprises excluding banks, private educational and health institutions, Employees Old Age Benefit Institution (EOBI), private corporate sector registered with the SECP excluding banks.

of larger external sector borrowings (including GDRs), that lowered the government domestic borrowing needs.

Another significant change in H1-FY07 was the marginal increase in average debt maturity profile as a result of the greater long term non-bank borrowings and the retirement of short-term debt.

According to NSS data, the gross sale of NSS instruments[12] was Rs 191.8 billion during H1-FY07, which was marginally smaller than the H1-FY06 gross sale. However, the gross encashments of these instruments (including early encashment) was lower in H1-FY07 compared to the corresponding period. The decline in encashments was primarily due to smaller encashment of Special Savings Certificates (SSCs). The heavy encashment of SSCs during H1-FY06 may be connected to heavy buying during FY03 due to interest rate arbitrage opportunities at that time.[13]

Table 5.10: Gross Payments and Receipts of Treasury Bills (Jul-Dec)

billion Rupees

	FY06		FY07	
	Payments	**Receipts**	**Payments**	**Receipts**
MTBs	542.6	493.9	378.9	354.7
MRTBs*	420.9	619.1	697.5	746.7

* MRTBs are used for replenishment and MTBs are issued in auctions.

In sharp contrast to a net decline of Rs 9.9 billion in the stock of PIBs recorded during H1-FY06, there was an increase in PIB stock by Rs 21.4 billion during H1-FY07.[14] Since the short-term Rupee interest rates were on the rise during H1-FY06, the government was unable to conduct successful PIB auctions, therefore the maturity of older PIBs during this period resulted in decline in PIB stock. In comparison, as the short-term rates were stable during H1-FY07, the government was able to mobilize Rs 36.6 billion, which more than off-set PIB maturities of Rs 15.1 billion in this period.

The net fund mobilization from NSS coupled with higher net government borrowings through PIBs during H1-FY07 resulted in marginally lower dependence on financing through treasury bills. There was a net increase of Rs 24.9 billion in the stock of total treasury bills during H1-FY07, which was substantially lower than Rs 148.6 billion increase recorded in H1-FY06.

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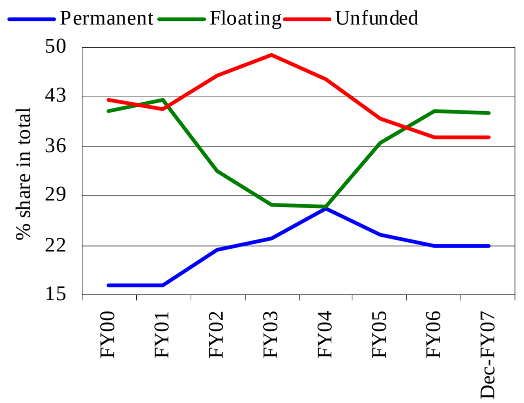
[12] Including Prize Bonds.
[13] See **SBP Annual Report 2002-03** for details.
[14] A bank-non-bank break up reveals that around 75 percent of the H1-FY07 PIB issues were held by non-bank.

The ownership profile of the short term debt also changed slightly. The stock of treasury bills with scheduled banks and non-bank (MTBs) was depleted by Rs 24.2 billion during H1-FY07 compared with a depletion of Rs 49.6 billion in the corresponding period last year. The stock of treasury bills with SBP (MRTBs) increased by only Rs 49. 2 billion during H1-FY07, which was around one-fourth of H1-FY06 rise. Despite the fact that maturity of MTBs was substantially smaller in FY07 relative to FY06, the short term debt portfolio continued to tilt towards SBP debt (replenishment) (see **Table 5.10**).

As a result of the developments mentioned above, the domestic debt profile marginally changed. Specifically, the shares of *Permanent Debt* and *Unfunded Debt* slightly increased on the cost of *Floating Debt* share during H1-FY07. If this pattern continues in H2-FY07, it would alter the trend observed during last few years (see **Figure 5.6**).

Figure 5.6: Composition of Domestic Debt



This change also has implications for debt servicing costs. Specifically, the debt servicing cost may increase initially as the longer term debt is costlier than short term debt in general, however the debt servicing burden would be less vulnerable to adverse interest rates movements.

5.9 Debt Management Strategy

A key development in Pakistan debt management is *'The Fiscal Responsibility and Debt Limitation (FRDL) Act, 2005'*, which came into effect from June 20, 2005. This Act envisaged a reduction in debt to GDP ratio by 2.5 percentage points every year and bringing down it to 60 percent by end-June 2013. Remarkably, this target was met within one year of the promulgation of the Act; by end of FY06, when debt to GDP ratio was as low as 57.8 percent despite the fact that the budgetary expenditures increased substantially on account of earthquake relief. The developments in FY07 so far suggest that the debt to GDP ratio further declined reflecting the continual improvement in economy's ability to sustain debt.

On the country's debt sustainability position, the Debt Policy Coordination Office (DPCO), Ministry of Finance issued the first *Debt Policy Statement 2006-07 (DPS)* on January 31, 2007 as required by the FRDL Act 2005.[15] According to Section 7 of the Act, this statement has to provide an assessment of federal government's debt policies in the light of sound fiscal and debt management principles, evaluation of external and domestic borrowing strategies (and advice on them), evaluation of nominal and real cost of borrowing and suggestions on cost reduction ways, and assessment of government debt exposure.

The first DPS claims that due to credible debt reduction strategies followed by the government after the Debt Committee recommendations coupled with successive high GDP growth rates, Pakistan's debt burden reduced substantially during last 7 years. The subsequent fiscal space enabled the government to increase PSDP spending. The Statement also warns that the country's debt burden will increase in next decade if sufficient revenues are not generated to finance future large infrastructure projects.

Moreover, the DPCO staff calculations reveal that real cost of public debt was -1.7 percent during July 2003-September 2007 period, which was substantially lower than 2000-03 debt cost. The Statement also defends the massive government borrowings through treasury bills (both MTBs and MRTBs) during FY05-FY06. According to the Statement, there were two reasons for this strategy. First, due to an unstable interest rate environment, there was limited issuance of PIBs in this period (the Statement also argues that the government borrowing needs from the banking sector was low which is self-contradictory). Second, there was lower than expected net inflow in NSS in same period.

In fact, initially the government opted to borrow through cheaper short term papers (at very low rate at that time) and avoided to pay term premium. However the increasing short term debt became more vulnerable to short-term interest rate movements. This strategy might be treated as short sighted, which is evident in the fact that the short term interest rates climbed to nearly 9 percent per annum by August 2006, nearly 300 basis points higher than the cost of 10-year PIB in June 2003. The government probably missed the opportunity of locking long-term funds at very low cost in a low interest rate scenario during FY03-FY04; this was highlighted in SBP Annual Report FY05. As soon as the government realized this fact, it resumed PIBs sales; since May 2006, the government has mobilized Rs 59.7 billion through 4 successful PIB auctions[16].

[15] A summary of DPS is placed in **Box 5.2**.
[16] Latest auction was held on March 5, 2007 in which government realized Rs 14.9 billion.

Under FRDL Act 2005, Ministry of Finance is required to present Fiscal Policy Statement and Debt Policy Statement by the end of January each year. Following boxes (**Box 5.1 and 5.2**) are the summaries of the statements.

Box 5.1: Summary of Fiscal Policy Statement 2006-07

Debt Policy Coordination Office (DPCO), Ministry of Finance has issued first *Fiscal Policy Statement (FPS) 2006-07* on January 31, 2007 to fulfill the requirement laid out under Section 6 of the Fiscal Responsibility and Debt Limitation (FRDL) Act 2005. The Act requires preparing the FPS having analysis of key macroeconomic indicators and how fiscal indicators accord with the principles of sound fiscal and debt management. The Act also requires setting of strategic priorities of federal government for the financial year.

After discussing the rationale for rule-based fiscal policies and principles of taxation, the statement focuses on recent fiscal policy developments. A growth-oriented prudent and sustainable fiscal policy stance has been adopted. This stance focuses on lowering debt service, alleviating poverty and investing in infrastructure. The report mentions that in recent years, Pakistan made considerable improvement on fiscal front squeezing fiscal deficit from an average 7.0 percent of GDP during 1990s to 3.4 percent in FY06 (4.2 percent including earthquake spending).

Government has made a significant progress in designing the framework of financial accounting principles and procedures according to international standards and has modernized the audit procedures also. Now government is moving ahead on its agenda to improve expenditure management and fiscal transparency. Government has re-engineered its economic and financial management functions, e.g., adoption of internationally recognized standards of accounting and legal framework. The New Accounting Model (NAM) has been used for the federal budget.

Sustainability of fiscal policy is vital for a sustainable debt path and government has included this in FRDL Act.2005. As a result, debt to GDP ratio is declining and revenue deficit targets are likely to be met by 2008. Fiscal discipline is maintained and government is in position to meet the projected target of overall fiscal deficit. Process of Medium Term Budgetary Framework (MTBF) has initiated in order to allow spending agencies to plan their programs in a consistent and coherent way.

Being aware of the importance of public private partnership, the government is in progress to develop a framework in collaboration of ADB to develop an infrastructure level consistent with government's economic growth targets. The infrastructure project development facility has been set up with for this purpose. Debt management strategy of the government is showing positive results visible by declining trends in public debt to GDP ratio. Reduction in fiscal deficit and current account deficits, lowering the cost of borrowing, raising revenues and foreign exchange earnings are the key features of government strategy.

Going forward, Pakistan will have to allocate substantially larger resources for strengthening the country's physical and human infrastructure to sustain the growth momentum. The challenge will be to enhance tax-to GDP ratio in order to generate the resources required to finance human and infrastructure development. Tax base also needs broadening and this will enable the government to reduce marginal tax rates which will help to stimulate investment and production in the country and ensuring a fair distribution of the tax burden among various sectors of the economy.

Box 5.2: Summary of Debt Policy Statement 2006-07

First *Debt Policy Statement 2006-07* was issued on January 31, 2007 by Debt Policy Coordination Office (DPCO), Ministry of Finance to fulfill the requirement of Section 7 of the Fiscal Responsibility and Debt Limitation (FRDL) Act 2005. This Act ensures responsible and accountable fiscal management by all governments –present and future—and would encourage informed public debate about fiscal policy. The statement provides an overview of the public debt as well as external debt and liabilities. The *Statement* highlights that:

1. In the last 5 years, Pakistan has recorded some of the highest growth rates in recent history, which has enhanced the country's ability to carry debt.
2. As a result of government's credible strategy, the public debt to GDP ratio dropped to 56 percent by the end of FY06 from almost 80 percent at the end of FY02.
3. The public debt as percent of GDP reduced by 5.5 percentage points during FY06, which was significantly higher than 2.5 percentage points decline as required by FRDL Act 2005.
4. The public debt as percent of total revenue also declined from 562 percent to 394 percent during FY02-FY06.
5. There was a rise of 7.1 percent in domestic debt during FY06, which came primarily from floating debt.
6. The debt servicing as percent to total revenue as well as current expenditure declined substantially during FY02-FY06.
7. The external debt to GDP ratio decreased to 28.9 percent at end-FY06 from 51.0 percent at end-FY02.
8. Pakistan received US$ 2.6 billion external loans and borrowed US$ 0.8 billion through long term papers sold in global capital market.
9. Pakistan's sovereign foreign bond rating was revised in November 2006 by Moody's firm from B2 to B1 which is just 3 notches below investment grade.
10. Sum total of new guarantees issued by the government on loans during FY06 were less than 0.2 percent of GDP, which is much smaller than the room (of 2 percent) provided in FRDL Act 2005.
11. Although the current trend in debt indicators is positive, sustaining this momentum will be continuing challenge. The large infrastructure projects envisaged in the next decade will increase the debt burden if these projects are largely financed by external borrowings.
12. The real cost of public debt during July 2003-September 2007 was -1.7 percent partly because of high domestic inflation as well as low domestic interest rates.
13. The maturity profile of external debt till FY37 shows a fairly smooth payment schedule—maximum payment in any given year is around US$ 1.6 billion—assuming that all agreed loans are disbursed completely and no new loans are taken.

The statement also reveals the government plans to put in place several measures to meet its twin objective of borrowing at minimum cost while keeping risks in check and of developing an efficient local currency sovereign debt market. The salient features of the debt management strategy are:

1. The DPCO will publish every quarter an analytical report on debt.
2. The DPCO will establish links with the four debt management units (SBP, EAD, NSS and Budget Wing) in order to develop an updated e-database.
3. The government will announce a regular calendar for PIB auction, most likely on a quarterly basis clearly indicating the targets.
4. The government will reconsider the primary dealers (PDs) system for PIB auction since many PDs have held onto PIBs instead of selling to non-bank investor.
5. The government will reduce the stock of MRTBs at a measured pace by replacing them with PIBs/MTBs.
6. The government will adopt a more balanced approach for borrowings through NSS instruments and consider to modify them in order to make them more market-based.
7. The government will develop a comprehensive external borrowing strategy in coming years, which is consistent with borrowing constraints such as saving-investment gap, amortization payments, reserve targets and, most importantly, government's medium-term development priorities.
8. The government will continue to tap international capital market through issuance of sovereign bonds (both conventional and Islamic) and keep Pakistan on the radar screen of global investor.

9. The DPCO will develop a framework for regularly assessing the revaluation of debt arising from changes in cross-country exchange rates as well as changes in estimated debt servicing.
10. The government will closely monitor that portion of external debt, which is on floating rates, and develop a framework to assess the forthcoming risks arising in global capital market.
11. The government will use various interest rates and cross-country swap arrangements that would hedge the exposure to external debt.
12. The government will undertake a study to document the current process of approval and reporting of government guarantees in the Government of Pakistan.
13. The DPCO will create mechanisms for exchange of information on regular basis with those units in the government which issue or approve guarantees.

6 External Sector

6.1 Balance of Payments

Pakistan's external account position further improved during Jul-Jan FY07 both with respect to the preceding quarter as well as the corresponding period last year, despite a worsening of the current account deficit (see **Table 6.1**).

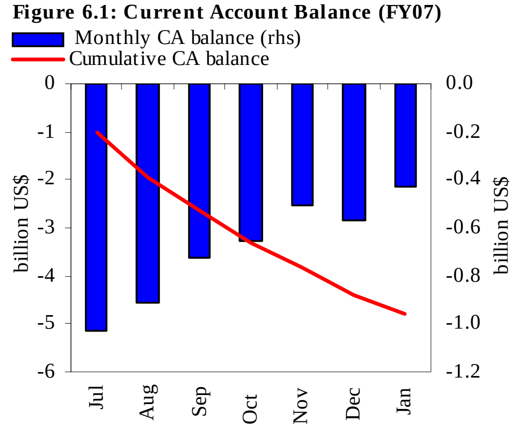
Table 6.1: Summary of Balance of Payments

million US$

	Jul-Jan		Change
	FY06	FY07	
A. Current account balance	-3,381	-4,811	-1,430
1. Trade balance	-4,903	-6,106	-1,203
B. Capital account (net)	104	139	35
C. Financial account (net)	2,456	4,367	1,911
D. Errors and omission (net)	238	341	103
E. Overall balance (=A+B+C+D)	-583	36	619

Although the current account deficit widened to US$ 4.8 billion during Jul-Jan FY07, the monthly trend shows a distinct declining trend (see **Figure 6.1**). However, despite the slowdown in the monthly current account deficit during Jul-Jan FY07, on average the current account deficit has remained higher than during Jul-Jan FY06.

Figure 6.1: Current Account Balance (FY07)



The main cause for the rise in the current account deficit was the abnormal slowdown in exports, which has persisted since January 2006. This has offset part of the gains from the anticipated weakening in imports. The slowdown in exports, however, is still puzzling given the fact that the Pakistan's two major importers of textile products; EU and the US show healthy growth in their imports from Pakistan. Textiles imports from Pakistan by US during Jul-Dec FY07 have increased by 12.0 percent and by EU 8.0 percent for the period Jul-Oct FY07. [1]

[1] Source: US Census Bureau and Eurostat

Imports growth on the other hand, has declined predictably. In contrast to previous years when higher fuel prices and machinery imports had fueled the exceptional growth in total imports, during Jul-Jan FY07 lower growth in these two heads, along with others has been instrumental in bringing down the overall imports growth. Going forward, the oil imports are likely to remain subdued due to, lower oil prices as well as lower demand for furnace oil for power generation (courtesy of higher rainfalls). On the other hand, imports of power generation machinery may provide impetus to imports of machinery. Thus while import growth may continue to be low, boosting exports would remain key to containing the current account deficit

In the meantime, in addition to the visible decline in the monthly current account deficit, another point of comfort is the large capital and financial account surplus. Not only these surpluses more than offset the current account deficit, it is encouraging to note that almost half of the inflows in the capital and financial account comprised of equity flows.

FDI inflows during Jul-Jan FY07 increased to US$ 2.1 billion from US$ 1.2 billion recorded during the same period last year, indicating growing investor's confidence in Pakistan's economy. FDI is expected to cross US$ 5.0 billion by end of FY07. An encouraging aspect of the rise in the FDI inflows during Jul-Jan FY07 is the higher reinvested earnings, which increased to US$ 508 million during Jul-Jan FY07 as compared to US$ 313 million during Jul-Jan FY06. The reinvested earnings are expected to be around US$ 1.0 billion by end of FY07.

Portfolio investment of US$ 1.4 billion during Jul-Jan FY07 was also significantly higher than US$ 0.31 billion recorded in the corresponding period of FY06. The rise in both the portfolio and the foreign direct investment indicates that foreign investors view favorably the long-term economic prospects of the country despite a deterioration in some of the macroeconomic indicators in the recent years.

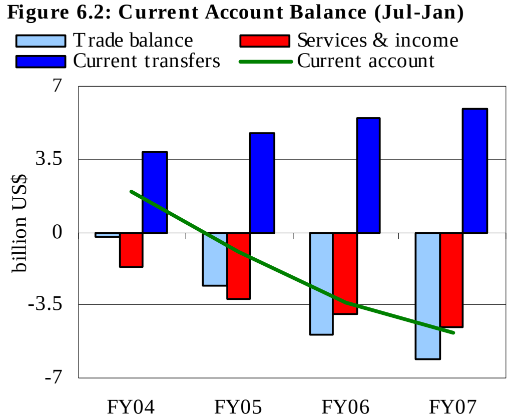
The impact of the strong financial account flows is evident on the exchange rate and the foreign exchange reserves of the country. The reserves increased to US$ 13.2 billion by end January FY07 from US$ 13.1 billion at the end of FY06, showing an increase of US$ 61.0 million during Jul-Jan FY07. The reserves held by SBP increased by US$ 31.5 million to US$ 10.8 billion whereas the reserves held by commercial banks increased by US$ 29.4 million to US$ 2.4 billion at the end of January FY07, compared to end-June FY06.

In the absence of any untoward pressure the Pak Rupee remained broadly stable vis-à-vis US Dollar throughout the Jul-Feb FY07 period, the Rupee depreciated only slightly (0.80 percent) against the Dollar. The real effective exchange rate (REER), however, appreciated by 2.5 percent due to 5.2 percent growth in relative price index, despite 2.6 percent depreciation in nominal effective exchange rate (NEER) index, emphasizing once again the need for curtailing domestic inflation.

Current Account Balance

The current account deficit that re-emerged in May 2004 continued to swell; reaching US$ 4.8 billion during Jul-Jan FY07 (see **Table 6.2**). However, as stated earlier, the monthly trend in the current account deficit is quite encouraging, its growth rate appears to be tapering down. Monthly data reveals that since the re-emergence of the current account deficit, the monthly current account deficit reached its highest level at US$ 1.0 billion in July 2006, after which it has continuously declined. Although it is too early to make any strong conclusions, it appears that the current account deficit might have peaked; given the slowdown in imports and strong growth in current transfers (see **Figure 6.2**), if exports improve even moderately, the declining trend in the current account would continue.

Figure 6.2: Current Account Balance (Jul-Jan)



This said, the fact that current account deficit is still growing and the average deficit of Jul-Jan FY07 is higher compared to Jul-Jan FY06, the annual FY07 current account deficit is still likely to be substantially higher than FY06.

Trade Balance[2]

The trade balance during Jul-Jan FY07 recorded a deficit of US$ 6.1 billion against a deficit of US$ 4.9 billion in the corresponding period of the previous year. The declining trend in exports persisted through most of Jul-Jan FY07 with the exception of the month of November when YoY monthly exports growth jumped

[2] This section is based on exchange record compiled by SBP that does not tally with more detailed custom data used in **sub-section 6.2**. In BoP, the trade data is recorded on the realization of actual receipts and payments), while trade section is based on customs data, which records transactions on the basis of physical movement of goods.

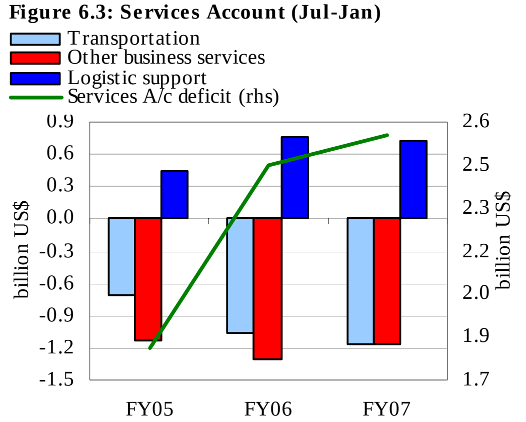
Table 6.2: Current Account Balance (Jul-Jan)
million US$

	FY06	FY07	Change
1. Trade balance	-4,903	-6,106	-1,203
Exports	9,166	9,705	539
Imports	14,069	15,811	1,742
2. Services (net)	-2,452	-2,557	-105
Transportation and travel	-1,797	-2,016	-219
Other business services	-1,307	-1,174	133
Government services	881	787	-94
of which logistic support	756	723	-33
Others	-229	-154	75
3. Income (net)	-1,497	-2,032	-535
Investment income(net)	-1,500	-2,036	-536
Direct investment	-1,135	-1,678	-543
of which: profit & dividend	-254	-354	-100
Purchase of crude oil & minerals	-577	-831	-254
Portfolio investment	-86	-113	-27
4. Current transfers (net)	5,471	5,884	413
Private transfers	5,242	5,666	424
Workers' remittances	2,446	2,959	513
FCA-residents	295	51	-244
Official transfers	229	218	-11
Current account balance (1+2+3+4)	**-3,381**	**-4,811**	**-1,430**

Source: Statistics and Data Warehouse Department, SBP

to 19.6 percent and revived hopes for achieving the annual exports growth target of 13.8 percent. Unlike exports, the slowdown in imports was largely according to expectations. Import growth fell to 12.4 percent during Jul-Jan FY07 sharply lower than the 32.1 percent growth in the corresponding period of last year, with all major heads except for "*others*" showing a deceleration (for details see ***Section 6.2*** *on* ***Foreign Trade***).

Figure 6.3: Services Account (Jul-Jan)



Services (Net)
The services account deficit marginally widened to US$ 2.6 billion during Jul-Jan FY07 as compared to US$ 2.5 billion in the same period last year showing only 4.0 percent growth as compared to 35 percent growth in the previous year (see **Figure 6.3**). The principal contribution to this deceleration was the corresponding slowdown in import growth. A smaller contribution was also due to the absence of one-off outflows for construction services. The payments for construction services declined by US$ 86 million during Jul-Jan FY07 as compared to the same period in FY06. The higher payments for construction services during Jul-Jan FY06 were related to the Ghazi Brotha Dam. Another factor responsible for the decline in services deficit during Jul-Jan FY07 is low deficit of US$ 1.2 billion recorded in *other business* services as compared to US$ 1.3 billion deficit in the corresponding period of last year.

Income (Net)
The income account deficit increased to US$ 2.0 billion during Jul-Jan FY07 from US$ 1.5 billion recorded in the corresponding period of FY06. The expansion of US$ 0.5 billion YoY income deficit during Jul-Jan FY07 was mainly due to higher repatriation of profits and dividends, purchase of crude oil and reinvested earnings. The data on profit and dividend outflows of top 30 companies generating these flows reveals that these were mainly by the telecommunication, oil, power, and banking sectors.

Current Transfers (net)
Current transfers recorded a US$ 413 million YoY increase during Jul-Jan FY07 to US$ 5.9 billion. However, the growth in these inflows declined to 7.5 percent YoY from 15 percent YoY in the corresponding period of FY06. The lower growth in current transfers was mainly contributed by fall in official transfers,[3] although the growth in private transfers also slowed to 8.1 percent during Jul-Jan FY07 against 10.7 percent in the corresponding period last year. The deceleration in the private transfers was mainly due to a US$ 244 million decline in resident FCAs. Workers' remittances on the other hand, showed impressive growth of 21 percent.

Workers' Remittances
Workers' remittances grew by 21.0 percent during Jul-Jan FY07, much higher than the 8.0 percent growth recorded during the same period last year (and FY06 growth of

[3] The decline in the official transfers was due to lower grant inflows on account of earthquake and budgetary support.

10.4 percent). The rise in the remittance at a time when exports growth is falling is indeed very welcome and has helped in reducing the growth in current account deficit.

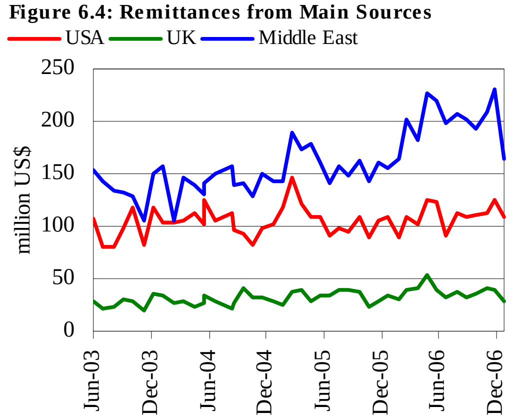
Country-wise data on remittances shows that USA, Saudi Arabia, UAE and UK remained the major source of remittances inflows (see **Table 6.3**). It is interesting to note that while the remittances have increased from all major source countries, the rise in remittances from the Middle East particularly stands out (see **Figure 6.4**). A particularly sharp jump in the remittances from the Middle East is evident in March 06 and volumes have sustained in ensuing months (except for January 07 when remittances registered a broad based decline). Average monthly remittances from the Middle East have jumped up from US$ 152.8 million in Jul-Jan FY06 to US$ 200.5 million during Jul-Jan FY07, while in the same period average monthly remittances from the USA has been more modest, rising from US$ 99.3 million to US$109.7.

Table 6.3: Workers' Remittances

million US$	July-Jan		Change
	FY06	FY07	
I. Gulf region	**710**	**960**	**250**
Bahrain	57	72	15
Kuwait	134	156	22
Qatar	61	90	29
Saudi Arabia	384	553	168
Sultanat-e-Oman	74	90	16
U.A.E.	360	444	84
II. U.S.A.	**695**	**768**	**73**
III. Other than Gulf & US	**1,031**	**1,230**	**199**
Canada	46	48	2
Germany	35	45	10
Japan	4	3	-1
Norway	9	11	2
U.K.	236	248	11
Other	701	876	175
Total	**2,436**	**2,958**	**522**
of which: exchange companies	358	500	142
Encashment of FEBCs & FCBCs	10	1	-9
Grand total	**2,447**	**2,959**	**513**

Source: Statistics and Data Warehouse Department, SBP

Figure 6.4: Remittances from Main Sources



Resident FCAs

During Jul-Jan FY07, resident FCAs show significantly lower net inflows of US$ 51 million as compared to net inflows of US$ 295 million during Jul-Jan FY06. The lower inflow in FCAs is a result of the relatively stable Rupee and lower returns offered on FCAs as compared to the Rupee deposits (for details see **Section 4** on Money and Banking).

Financial Account

The financial account surplus recorded US$ 1.9 billion YoY increase to reach US$ 4.4 billion during Jul-Jan FY07 (see **Table 6.4**). The main contributing factor for increase in financial account surplus was higher net foreign investments of US$ 3.4 billion during Jul-Jan FY07 as compared to US$ 1.5 billion during Jul-Jan FY06.

Table 6.4: Financial Account

million US$

	July-Jan		Change
	FY06	**FY07**	
Financial account (1-4)	2,456	4,367	1,911
1. Direct investment abroad	-19	-47	-28
2. Direct investment in Pakistan	1,244	2,096	852
of which: equity capital	931	1,586	655
Reinvested earnings	313	508	195
3. Portfolio investment	311	1,371	1,060
Equity securities (private)	400	499	99
Equity securities (public)	0	731	731
Debt securities (private)	0	198	198
Debt securities (public)	-103	-53	50
Net private investment (**1+2+3**)	1,536	3,420	1,884
4. Other investment	920	947	27
Assets	373	-63	-436
Outstanding exports bills (exports)	-173	-87	86
Outstanding exports bills (DMBs)	62	57	-5
Currency and deposits	483	-33	-516
Liabilities	547	1,010	463

Source: Statistics and Data Warehouse Department, SBP

Net Foreign Investment

During Jul-Jan FY07, net foreign investment recorded a rise of US$ 1.9 billion YoY due to substantial rise in both FDI and portfolio investment inflows. The net foreign investment of US$ 3.4 billion included US$ 2.1 billion foreign direct investment inflows and US$ 1.4 billion portfolio investment inflows.

During Jul-Jan FY07, foreign direct investment inflows recorded an impressive growth of 68.5 percent YoY. This figure further improves to 98.5 percent if we exclude privatization proceeds which declined from US$ 255 million in Jul-Jan FY06 to US$ 133 million in Jul-Jan FY07. Thus while privatization proceeds accounted for 20.5 percent of the FDI in Jul-Jan FY06; their contribution was limited to 6.4 percent in Jul-Jan FY07 FDI.

A major portion of the total FDI inflows of US$ 2.1 billion during Jul-Jan FY07 came in the months of September and December including: (1) US$ 197.6 million from Standard Chartered Bank's acquisition of Union Bank; (2) US$ 133 million installment of PTCL privatization proceeds; (3) US$ 170.8 million in the telecommunication sector, and (4) US$ 72.4 million from Habib Bank A.G Zurich's acquisition of Metropolitan Bank Ltd.

The major sources of FDI inflows during Jul-Jan FY07 were USA, UK, and UAE. The United States of America was the leading source of FDI with US$513 million or 24.5 percent, followed by United Kingdom with US$ 488 million or 23.3 percent and UAE with US$ 296 million 14.1 percent.

Sector wise distribution of FDI shows that financial sector, oil and gas exploration and communication sector remained the major recipients of FDI. FDI also increased in the construction, petroleum refining, textiles and trade, while it

Table 6.5: Top Ten Recipient Sectors of FDI

million US$

	Jul-Jan		Share in total FDI	
Economic group	**FY06**	**FY07**	**FY06**	**FY07**
Total FDI	**1,245**	**2,096**	**100**	**100**
of which:				
Construction	45	86	3.6	4.1
Financial business	128	554	10.3	26.4
Oil & gas explorations	174	328	14.0	15.7
Personal services	36	53	2.9	2.5
Petroleum refining	19	67	1.5	3.2
Power	292	102	23.5	4.9
Communications	346	546	27.8	26.1
Textiles	25	38	2.0	1.8
Trade	72	105	5.8	5.0
Transport equipment (automobiles)	19	28	1.5	1.3
Others	90	189	7.2	9.0

Source: Statistics and Data Warehouse Department, SBP declined in the power sector (see **Table 6.5**).

The impact of the FDI on growth is well documented. FDI plays an important role in the growth process through direct capital formation and through its spill over effects. Unfortunately, in Pakistan FDI has remained scanty until recently and it is difficult to get meaningful results on the impact of FDI on growth. However now that the FDI has become significant it is important to evaluate various aspects of this development, so that appropriate polices in this regard can be drawn. **Box 6.1** gives review of the literature and developments in FDI in Pakistan.

Portfolio investment inflows also registered a substantial increase of US$ 1.1 billion during Jul-Jan FY07 over the corresponding period last year (see **Table 6.4**). The portfolio investment of US$1.4 billion during Jul-Jan FY07 included MCB Bank's (MCB's) Global Depository Receipts (GDRs) of US$150 million from UK, OGDC's GDR proceeds of US$ 731 million, and investment in Mobilink's TFCs and Bonds of US$ 198 million.

Currency and Deposits and Related Trade Financing

The currency and deposits assets during Jul-Jan FY07 recorded a rise of US$ 33 million as compared to US$ 483 million fall during Jul-Jan FY06. The rise in currency and deposit assets during Jul-Jan FY07 was mainly due to FE-25 nostro deposits of banks, which increased by US$ 22 million during Jul-Jan FY07 as compared to US$ 454 million decrease recorded during Jul-Jan FY06. This rise in FE-25 nostros was mainly due a fall in FE-25 trade finance loans, which rose by only of US$ 37.8 million in Jul-Jan FY07 as compared to US$ 672.4 million during Jul-Jan FY06. The low interest in FE-25 loans principally reflected the availbiltiy of cheap EFS loans.

Foreign Long-term Loans

The long-term official loans recorded a net inflow of US$ 661 million during first seven months of FY07 as compared to the US$ 332 million net inflow seen during Jul-Jan FY06. The inflows during Jul-Jan FY07 were mainly due to a 42 percent increase in program loan receipts to US$ 839 million as compared to US$ 591 million received in the corresponding period of FY06. The program loan, received from Asian Development Bank (ADB) amounted to US$ 671 million during Jul-Jan FY07 (See **Table 6.6**). The amortization of loans declined to US$ 528 million during Jul-Jan FY07 as compared to US$ 600 million in the corresponding period during FY06.

Short-term Loans[4]

Short-term loans registered a net outflow of US$ 58 million during Jul-Jan FY07, as the impact of new inflows of US$ 225 million from IDB were more than off set by repayments of US$ 116 million to commercial creditors and US$ 167 million to IDB. Repayments to commercial creditors include a US$100 million of loan rollover (with an offsetting entry in the exceptional financing).

Table 6.6: Profile of ADB Loans (Jul-Jan FY07)
million US$

Total ADB loans	671
of which:	
Agricultural sector program	110
Punjab resource management program	100
Private participation in infrastructure program loan	200
Baluchistan devolved social services	133.5

Source: Economic Affairs Division

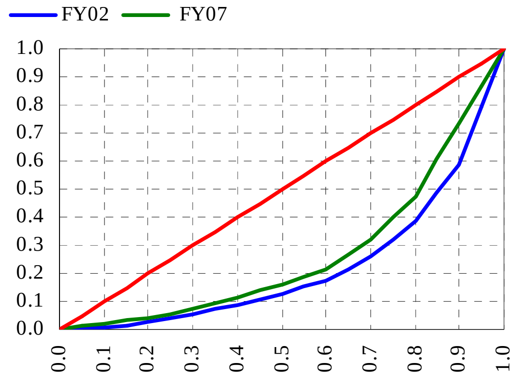
Private Loans

During Jul-Jan FY07, private loans witnessed net inflows of US$ 171 million, whereas, US$ 28 million net outflow was observed in this account during Jul-Jan FY06. Credit inflows of US$ 401 million included a US$ 211 million loan obtained by a domestic airline for the purchase of aircraft.

Box 6.1: Implications of FDI

The importance of foreign direct investment (FDI) as a source of direct capital financing in the economic development is well established. There is a vast literature which suggests foreign trade as one of the possible transmission channel from FDI to economic growth of the country. Indeed, the higher contribution of FDI in exportable industries leads to increase in the export capacity, while in case of imports, investment in import substitution industries can lower the demand for the imported goods by producing locally. In addition, FDI can be very important source of financing country's current account deficit, as in the case of Pakistan. Apart from direct source of financing, there are some spillover impacts of FDI such as transferring technology and market access in the economy. However, it is not necessary that all sectors may have the same potential to absorb technological changes, as pointed out by Hirschman (1958) "linkages are weak in agriculture and mining". Similarly, Kokko

Figure 6.5: Lorenz Curves for Sectoral Concentration of FDI (Jul-Jan)



[4] Short term loans contain commercial loans along with the IDB financing for oil imports.

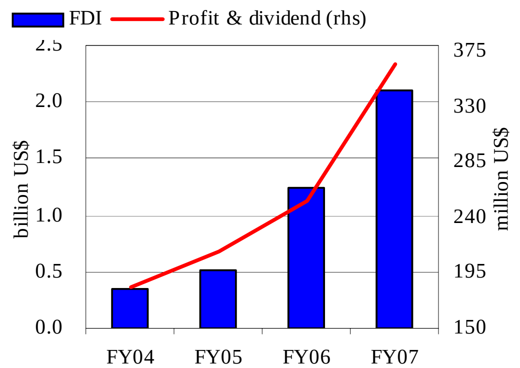
(1994)[5] argued that since some investments are classified as enclave investment[6] therefore there should not be the same spillover impact for all industries. Moreover, according to Findlay (1978) and Wang and Bloomstrom (1992)[7] the spillover impact of FDI, especially in terms of transferring technology, is more pronounced in manufacturing or services sector rather than the primary sector.

In this context, there are country experiences which are aligned with the above mentioned literature, and emphasize the importance of the sectoral composition of FDI in explaining the economic growth. Particularly, in case of India Chakraborty and Nunnenkamp (2006)[8] have found favorable growth effects of FDI for manufacturing sector and some transitory effects in services sector, while the relationship is weak for the primary sector. Similarly, in china many authors have documented that FDI has been beneficial to the country's economic development. For instance, Lardy (1996) stated that FDI has contributed to the rapid export growth of china.

There are also some concerns about potential costs of FDI such as profit outflows and effects on competition in the domestic market. Specifically, profit outflows that arise from FDI could further deteriorate the current account position by augmenting the investment income payments. According to UNCTAD (2002), "unregulated FDI flows can bring about serious difficulties to balance of payments owing to high import content and profit outflows related to multinational capital".

Pakistan's case: In Pakistan, FDI inflows have accelerated only recently, this can be gauged from the fact that from 1993 to 2003, i.e., in the ten years the FDI entering Pakistan totaled around US$ 6.0 billion and in the last 3 years, it has totaled US$ 8.1 billion. Since the rise in FDI in Pakistan is a recent phenomenon, therefore the overall sectoral contribution of FDI in the economic growth is still very limited. However, it is encouraging to note that the recent surge in FDI is mainly registered in the services and manufacturing sectors where the probability of positive effects on future economic prospects of the country is greater. Although the bulk of FDI flows appear to be concentrated in the three main sectors, the concentration has reduced perceptibly as evident from the Lorenz Curve [9](see **Figure 6.5**). Nevertheless, there is still need to

Figure 6.6: Impact of Foreign Direct Investment on Current Account (Jul-Jan)



[5] Kokko, A (1994). "*Technology, market characteristics and spillover*" Journal of Development Economics 43: 279-93
[6] These are investments which offer little scope for the local economy to benefit.
[7] Wang, J.Y and .Blomstrom (1992). "Foreign investment and technology transfers: A simple model." European Economic Review 36: 137-55.
[8] Chakraborty, C. and P.Nunnenkamp (2006). "Economic reforms, foreign direct investment and its economic effects in India." Kiel working paper No. 1272.
[9] The Lorenz curve for FDI is an effective way to measure the concentration of FDI flows among different sectors.

further diversify the FDI across various sectors.

As far as the cost of FDI is concerned, **Figure 6.6** clearly reflects the impact of increasing FDI on current account in form of rising profit and dividend outflow. Although in recent period the cost of FDI, in absolute terms, is as such not substantial but the rising trend of investment payments could raise some concerns in terms of contributing future current account deficit. In addition, it would also be pertinent to note, the amount repatriated against profit & dividend is growing faster in the preceding three years than the amount which is reinvested

6.2 Foreign Exchange Reserves & Exchange Rate

Country's foreign exchange reserves which peaked in June 2006 declined in the initial months of FY07 owing to record monthly current account deficit. However, a substantial rise in foreign inflows October 2006 onwards, and a downtrend in the monthly current account deficit, helped in increasing the reserves by US$ 229 million end-Feb FY07 over Jun-FY06 period (See **Figure 6.7**).

The increase in the reserves was principally due to the rise in the SBP reserves (excluding CRR), which increased by US$ 257 million during Jul-Feb FY07. The

Figure 6.7: Foreign Exchange Reserves

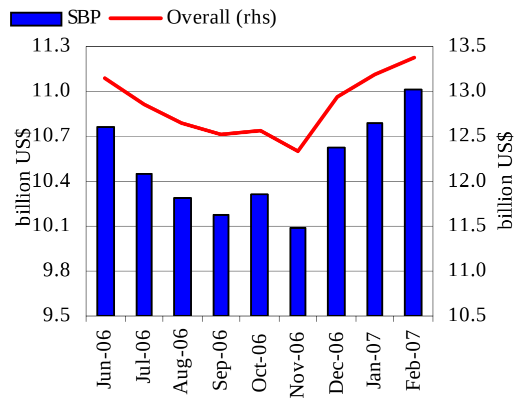


Table 6.7: Causative Factors of Changes in FE Reserve*

million US$

	Jul-Jan	
	FY06	**FY07**
SBP reserves as on end June	10,472.4	11,466.3
SBP reserves as on end Jan	9,791.2	11,531.8
Inflows	6,240.3	7,957.4
Purchases	3,660.7	2,988.1
Inter-bank purchases	3,660.7	2,988.1
Loans	759.6	1,231.0
ADB	350.1	789.3
Grants	122.6	61.7
Other receipts	1,697.4	3,676.6
USA-logistic support	756.1	658.9
Sale proceeds of KESC	255.0	-
OGDC	-	731.1
Pvt. proceeds of PTCL	200.0	133.2
Interest on dep./discount	168.4	323.8
Outflows	6,998.2	7,891.9
Sales	3,376.5	4,573.8
Inter-bank sales (ready)	93.0	174.0
Inter-bank sales (oil)	3,283.5	4,399.8
Debt servicing to donors	475.9	657.9
Other payments	3,145.8	2,660.2
Sugar LC - TCP	-	232.8
Change in SBP reserves	-757.9	65.5

* Including CRR

major inflows that contributed directly to the increase in the SBP reserves in this period came from the floatation of OGDC GDRs. In addition, part payment of PTCL privatization proceeds, ADB's support for various projects and payments received for the logistic support from USA and UK, FDI and other inflow also contributed to the rise in the SBP reserves. However, these were largely offset by outflows on account of oil and other payments which limited the rise in the SBP reserve to US$ 257 million (se7e **Table 6.7**).

Commercial bank's reserves on the other hand, did not show any significant change from end-June FY06 level and declined only marginally by US$ 27.4 million during Jul-Feb FY07.

Exchange Rate

Pakistan's exchange rate vis-à-vis US Dollar remained broadly stable and the nominal depreciation of 0.80 percent during Jul-Feb FY07 appears to be driven more by expectations rather than a weakness in the fundamentals. As the expectations peaked, the Rupee depreciated 1.14 percent but then recovered much of the loss (see **Figure 6.8**).

The Real Effective Exchange Rate (REER) of Pak Rupee, on the other hand, showed an appreciation of 2.5 percent against the basket of currencies during Jul-Feb FY07. However, in nominal terms, it depreciated against most of the basket currencies because of the weakness of US Dollar against major currencies in international markets. Consequently, the NEER index showed a depreciation of 2.6 percent during Jul-Feb FY07

Figure 6.8: Foreign Exchange Rate

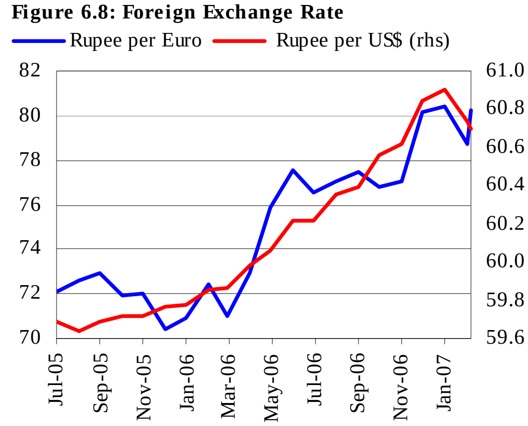
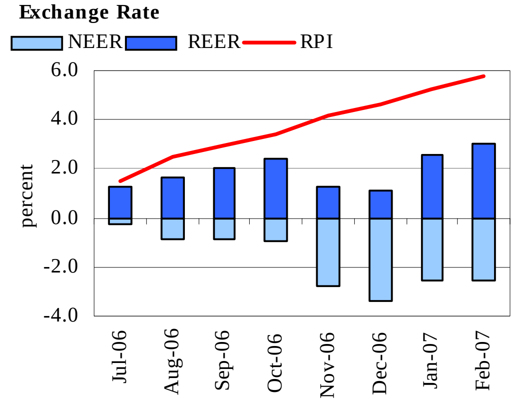


Figure 6.9: Cumulative App/Dep in Effective Exchange Rate



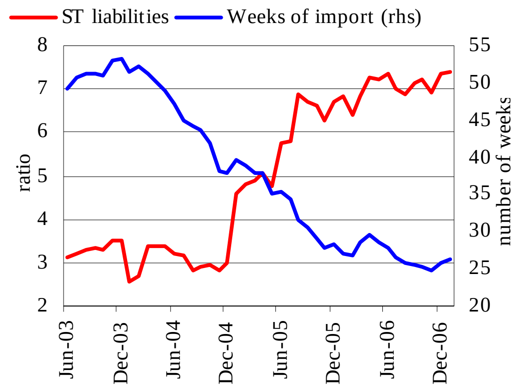
period. This gain in the form of nominal depreciation of the weighted index was offset due to relatively higher inflation in Pakistan compared to its primary trading partners and competitor countries. Therefore, the net result was the cumulative appreciation of the REER index by 2.5 percent during the first eight months of the current fiscal year which indicates the loss of external competitiveness of Pak Rupee and reinforces the need to bring down domestic inflation (See **Figure 6.9**).

Reserve Adequacy

Pakistan foreign currency reserves remained at comfortable levels both, in terms of weeks of imports and in terms of capacity to meet short-term liabilities. In terms of weeks of imports the reserve adequacy has come down from 53.2 weeks of imports in December 2003 to 26.3 weeks in February 2007 mainly due to a substantial rise in imports since December 2003 onwards. However, with slowdown in the import growth and with significant rise in reserves in recent months, the reserves adequacy has improved from 24.9 weeks of imports in November 2006 to 26.3 weeks of imports in February 2007.

Pakistan's capacity to pay short-term liabilities (all obligations falling within a year) has also improved, since most of the new debt comprises long-term loans with small current obligations (see **Figure 6.10**). However, going forward, this indicator could deteriorate if external flows fail to keep pace with the expected rise in short-term liabilities when grace period on old (rescheduled) debt ends.

Figure 6.10: Reserve Adequacy



6.2 Foreign Trade[10]

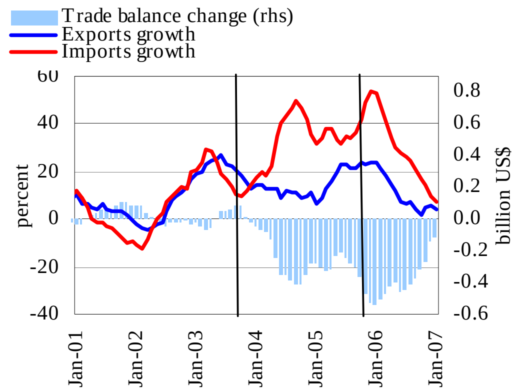
The slowdown in imports and exports growth rates that emerged in the second half of FY06 continued throughout FY07 as well (see **Table 6.8**). Unfortunately, despite a precipitous decline, the growth rate for imports remains higher than that of exports (and is on a larger base). Consequently, the trade deficit continued to widen, albeit at a much slower pace.

Table 6.8: Summary of Trade Balance (US$ million)

	Jul-Jan	
	FY06	FY07
Exports	9,271.9	9,630.0
% Growth	20.9	3.9
Imports	15,795.3	17,225.4
% Growth	50.0	9.1
Trade Balance	-6,523.4	-7,595.4
% Change	128.0	16.4

The fall in the imports growth rate is largely in line with expectations. This is because the extraordinary imports growth had been the function of a steep rise in international oil prices and structural changes in the economy. For example, textile machinery imports rose as industry readied for post-MFA competition, telecom imports rose following expansions and increased competition, and consumer products imports rose as the consumer finance market blossomed.

Figure 6.11: Exports and Imports (6-month MA)



However as oil prices fell and the one-off impact of structural changes was absorbed by the economy the extraordinary imports growth tapered off, broadly in line with expectations. Thus, if exports growth had remained at the relatively low average of 15.9 percent seen in the previous four years, the trade gap would have already begun to shrink. Unfortunately, the exports growth has dropped to a 4-year low (see **Figure 6.11**) and the trade deficit continued to widen, although at a much slower pace.

[10] The analysis is based on the provisional data provided by Federal Bureau of Statistics, which is subject to revisions. This data may not tally with the exchange record numbers reported in the section on *Balance of Payments*.

A part of the exports slowdown can be explained by factors such as the adverse impact on textile exports to the EU following the loss of Generalized System of Preference (GSP) and persistence of the discriminatory antidumping duty on bed linen exports from Pakistan. Similarly, rice exports have also dropped due to poor harvest, while exports of refined petroleum products, carpets and leather dropped due to industry dynamics. However, the broader deceleration in exports growth is still puzzling; this needs to be investigated in order to institute concrete policy measures.

The importance of sustaining strong exports growth cannot be overstated. It has to be recognized that import growth would have to remain in double digits if the economic growth is to be sustained at high levels, as this would require the buildup of infrastructure,[11] additions to industrial capacity as well as rising imports of inputs (particularly energy). Thus, in order to support this required imports growth, it is imperative to significantly boost exports and encourage imports substitution for products where Pakistan has competitive advantages (particularly in food commodities).

In the aforementioned situation there is need to delve on strategies for the promotion of exports by focusing on the issues of productivity enhancement, quality improvement, costs & scale economies, product & geographical diversification as well as creating a pro-industry and investment-friendly environment in the country.

For all of this, a key policy element is a competitive exchange rate, but one that is also stable. This combination is not possible without a low inflation environment, and therefore this is a key priority for the central bank. This essential pre-requisite needs then to be complemented by other supportive measures to reduce the cost of doing business (reducing red-tape and eliminating unnecessary regulations, ending multiplicity of taxes and agencies, etc.), facilitate supply chain improvements and provide a flexible labor force.

Exports

The growth of exports continued to decelerate during Jul-Jan FY07 (see **Figure 6.12**). Consequently, the actual exports of US$ 9.63 billion fell short of the target by US$ 0.67 billion during the period under consideration.[12] The slowdown in exports, which became noticeable from January 2006, continued showing a

[11] The approval process is underway for ten oil-based projects with a cumulative capacity of 2,355 MW and an estimated cost of US$ 1,766 million (Source: http://www.ppib.gov.pk).
[12] The target mentioned in the Annual Development Plan documents.

decelerating trend in the ensuing months. Moreover, although the textiles sector (which constitutes around 60 percent of exports) was the leading contributor to the overall exports deceleration, the slowdown in exports is also visible in other main categories (see **Table 6.9**).

Primary Commodities

The primary commodities exports declined by 9.1 percent during Jul-Jan FY07 as compared to 18.9 percent growth in the corresponding period last year (see **Table 6.10**). The decline in the exports of primary commodities is mainly due to decrease in rice, raw cotton and fruits exports. The Basmati rice exports have shown a substantial growth of 24.4 percent whereas exports of other varieties of rice declined significantly by 22.7 percent. The fall in exports under other categories of rice occurred because of damaged rice crop owing to adverse weather. The rise in exports of Basmati rice, despite damages to the crop, came from last year's stock because the Basmati rice requires seasoning/processing (for period of up to one year) before it is exported for the best price. Raw cotton exports declined due to lower production and as well as increased domestic prices. Similarly, a fall in the citrus fruit production owing to unfavorable weather conditions was the primary reason behind fall in fruit exports.

Figure 6.12: Export Growth (YoY)

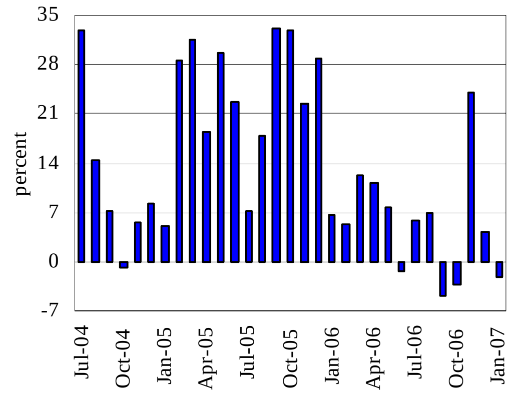


Table 6.9: Analysis of Exports (Jul-Jan)

percent

	FY06		FY07	
	Share	Growth	Share	Growth
Primary commodities	11.3	18.9	9.9	-9.1
Textile manufactures	61.2	24.2	61.3	4.1
Other manufactures	16.9	32.2	13.5	-17.1
Others	10.6	-5.0	15.3	50.2
Total exports		**20.9**		**3.9**

Textile Manufactures

There was a sharp deceleration in the exports of textiles manufactures during Jul-Jan FY07 as indicated by a marginal growth of 4.1 percent compared with an impressive growth of 24.2 percent in the corresponding period last year (see **Table 6.11**).

Table 6.10: Major Exports (Jul-Jan)

value: million US$; unit value: US$

			FY06		FY07p		Absolute change. in value	% change in Jul-Jan FY07/Jul-Jan FY06		
		Unit	Value	Unit value	Value	Unit value		Qty	Value	Unit value
A	**Primary commodities**		**1,051.2**		**955.8**		**-95.3**		**-9.1**	
1	Rice	MT	620.9	314.5	603.1	366.0	-17.8	-16.6	-2.9	16.4
2	Raw cotton	MT	40.0	1,073.3	31.5	1,066.6	-8.5	-20.7	-21.2	-0.6
3	Raw wool (excl wool tops)	MT	0.7	815.8	0.6	635.9	-0.2	0.0	-22.0	-22.0
4	Fish & fish preparations	MT	106.2	1,522.5	107.1	1,706.0	0.9	-10.0	0.9	12.0
5	Leather	SQM	163.7	16.9	136.0	16.8	-27.7	-16.4	-16.9	-0.7
6	Guar and guar products	MT	13.8	1,149.9	9.9	1,173.1	-4.0	-30.0	-28.6	2.0
7	Fruits	MT	71.8	301.8	34.3	201.7	-37.5	-28.5	-52.2	-33.2
8	Vegetables	MT	17.9	282.4	20.6	454.2	2.7	-28.4	15.2	60.8
9	Crude animal material	MT	9.9	3,365.9	4.1	2,847.7	-5.8	-51.1	-58.7	-15.4
10	Oil seeds & nuts etc.	MT	6.3	632.5	8.8	705.2	2.5	25.4	39.8	11.5
B	**Textile manufactures**		**5,671.0**		**5,901.2**		**230.3**		**4.1**	
1	Cotton yarn	MT	756.1	2,020.5	799.3	2,089.6	43.2	2.2	5.7	3.4
2	Cotton fabrics (woven)	SQM	1,217.4	0.8	1,089.3	0.8	-128.1	-17.8	-10.5	8.8
3	Hosiery (knitwear)	DOZ	1,021.7	21.9	1,191.2	22.8	169.5	12.0	16.6	4.1
4	Bedwear	MT	1,190.5	5,435.2	1,103.0	5,416.9	-87.5	-7.0	-7.4	-0.3
5	Towels	MT	330.4	3,740.5	337.4	3,772.3	6.9	1.2	2.1	0.8
6	Cotton bags and sacks	MT	8.2	4,117.3	3.0	3,050.6	-5.2	-50.4	-63.3	-25.9
7	Readymade garments	DOZ	766.4	34.7	809.7	37.3	43.3	-1.7	5.6	7.5
8	Tarpaulin & other canvas goods	MT	15.9	2,249.4	46.8	2,350.6	30.9	182.2	194.9	4.5
9	Tule, lace, embroidery etc.	(-)	5.2	-	1.2	-	-4.0	-	-76.8	-
10	Synthetic textiles	SQM	111.5	0.7	277.8	0.8	166.3	122.5	149.1	12.0
11	Other textile made up	(-)	240.4	-	239.2	-	-1.2	-	-0.5	-
12	Waste material of textile fibres/fabrics	MT	7.3	712.9	3.5	756.4	-3.8	-55.1	-52.3	6.1
C	**Other manufactures**		**1,571.0**		**1,302.8**		**-268.2**		**-17.1**	
1	Carpets, rugs & mats	SQM	153.4	60.7	132.0	64.0	-21.4	-18.5	-13.9	5.6
2	Petro and petro products	MT	436.3	505.4	429.1	705.4	-7.2	-29.5	-1.6	39.6
3	Sports goods	(-)	170.6	-	139.9	-	-30.7	-	-18.0	-
4	Leather manufactures	(-)	435.2	-	290.7	-	-144.5	-	-33.2	-
5	Surgical & medical instrument	NO	93.7	-	61.1	-	-32.6	-	-34.8	-
6	Cutlery	GR	19.7	22.9	19.3	57.9	-0.5	-61.5	-2.5	153.0
7	Onyx manufactured	MT	7.3	1,565.8	8.1	1,748.4	0.7	-1.4	10.1	11.7
8	Chemicals & pharmaceuticals	(-)	223.9	-	206.1	-	-17.8	-	-8.0	-
9	Molasses	MT	14.4	79.7	16.5	76.2	2.1	20.0	14.9	-4.3
10	Sugar	MT	16.4	404.4	0.0	--	-16.4	-	-	-
D	**Others**		**978.8**		**1,470.2**		**491.4**	**-**	**50.2**	
	Total		**9,271.9**		**9,630.0**		**358.1**		**3.9**	

Source: Federal Bureau of Statistics

p : Provisional

It may be pertinent to mention here that last year's remarkable textile exports growth was basically driven by increases in exports volumes that offset decline in unit prices. However, during the current year, the reduction occurred mostly because of the plunge in the quantum of fabrics and bedwear exports.

The cotton fabrics and bedwear, which together constitute almost 37 percent of the group exports, were the major categories that contributed in slowdown of the textile exports growth. During Jul-Jan FY07, the exports of these two items declined by 10.5 percent and 7.4 percent respectively against the strong growths in the corresponding period of last year. The exports under this head declined despite the Research and Development (R&D) subsidy of 5 percent and 3 percent for bedwear and fabrics respectively which was initiated at the start of the current fiscal year. [13] The rise in the prices of Pima cotton[14] (a genetically modified version), which is imported form the USA and is a critical input for producing high quality bedwear and fabrics, has made these items less competitive compared to India. Further, the discriminatory anti-dumping duty of 5.8 percent on the bed linen exports to the EU also adversely affected Pakistan's competitiveness.

Table 6.11: Analysis of Textile Exports (Jul-Jan)

percent

	FY06		FY07	
	Share	**Growth**	**Share**	**Growth**
Cotton yarn	13.3	36.0	13.5	5.7
Cotton fabrics (woven)	21.5	22.6	18.5	-10.5
Hosiery (knitwear)	18.0	1.8	20.2	16.6
Bedwear	21.0	77.6	18.7	-7.4
Towels	5.8	17.2	5.7	2.1
Readymade garments	13.5	38.8	13.7	5.6
Others	6.8	-23.8	9.7	47.1
Total		**24.2**		**4.1**

The cotton yarn, knitwear and towels were the only categories which recorded visible increase in both the volumes and values (see **Table 6.12**). The cotton yarn exports were able to record 5.7 percent growth during Jul-Jan FY07, compared to 36.0 percent increase in the same period of last year. The relatively lower demand at home due to slowdown in the down stream industry and higher demand by China to feed its fast growing textile industry appears to have caused the exports growth of cotton yarn.

[13] As per S.R.O number 803 (1)/ (2006) dated August 04, 2006.

[14] According to anecdotal evidence the price of Pima Cotton has gone up by 30 to 40 percent in recent months.

However, 7.5 percent average increase in the average local cotton prices during Jul-Jan FY07 along with a relatively poor cotton quality, on account of cotton contamination issue, is adversely affecting the exports of spinning industry. Contrary to other categories, knitwear exports recorded a double-digit growth of 16.6 percent during Jul-Jan FY07, as compared to a nominal growth of 1.8 percent during the same period last year.

Table 6.12: Impact of Price and Volumes on the Major Textile Exports
million US$

	FY06			FY07		
	Total change	Due to		Total change	Due to	
		Quantum	Price		Quantum	Price
Cotton yarn	200.0	225.2	-25.3	43.2	16.7	26.4
Cotton fabrics (woven)	224.4	225.0	-0.6	-128.1	-216.2	88.1
Hosiery (knitwear)	18.0	148.4	-130.3	169.5	122.5	47.0
Bed wear	520.2	512.9	7.4	-87.5	-83.8	-3.7
Towels	48.5	47.5	1.1	6.9	4.1	2.8
Readymade garments	214.2	126.8	87.5	43.3	-13.4	56.7

The readymade garments recorded 5.6 percent growth during Jul-Jan FY07 as compared to 38.8 percent growth in the same period of last year despite reduced quantum of exports, which was more than offset by increase in unit prices. The continuation of R&D subsidy of 6 percent, and political turmoil in Bangladesh, seem to have provided support to the readymade garment exports.

Other Manufactures

The other manufactures exports declined by 17.1 percent during Jul-Jan FY07, as against 32.2 percent growth in the corresponding period of FY06 (see **Table 6.13**). Specifically, within the other manufactures, petroleum and petroleum products, sports goods, leather manufactures, chemical & pharmaceutical products, and carpets (which form around 90 percent of total other manufactures), were the main contributory items behind decline in the group's exports during the period under consideration. The sharp reversal in the exports of other manufactures is attributable to industry specific issues.

The decline in the petroleum and petroleum products exports is attributable partly to the increase in the international oil prices and partly to the refineries' inability to market the product mix domestically, which is necessary for their profitable operations.[15]

The decline in sports goods exports was primarily on account of lower exports of footballs which constitute more than 60 percent of the total sports goods exports. In FY06, Pakistan received large exports order for hand stitched footballs for the World cup tournament; in the absence of these large orders FY07 exports have recorded a sharp decline.

Table 6.13: Analysis of Other Manufactures Exports (Jul-Jan)
percent

	FY07	
	Share	**Growth**
Carpets, carpeting rugs & mats	10.1	-13.9
Petroleum & petroleum products	32.9	-1.6
Sports goods	10.7	-18.0
Of which: Football	6.6	-20.7
Leather manufactures	22.3	-33.2
Of which: Leather garments	16.0	-32.3
Surgical and medical Instruments	4.7	-34.8
Cutlery	1.5	-2.5
Onyx manufactured	0.6	10.1
Chemicals and pharmaceuticals	15.8	-8.0
Of which: Plastic material	4.7	-24.8
Other Chemicals	7.8	4.8
Molasses	1.3	14.9
Total other manufactures (with **13 %** share in exports)		**-17.1**

The Pakistan Sports Goods Manufacturing & Exports Association (PSMEA) also claims that tough competition from relatively cheaper machine-made football manufactured in the EU area as compared with Pakistan's hand-stitched footballs and a rise in the domestic cost of production, have also contributed to lower exports. Moreover, decision by Nike (a major buyer) to pull out of Pakistan on the issue of child labor may also affect the exports of sports goods in the coming months.[16]

The lower leather manufacture exports were attributed to (1) increased cost of key production inputs such as hike in fuel prices and utility charges; (2) competitive pressures from China and India; (3) relatively lesser demand from US and EU.

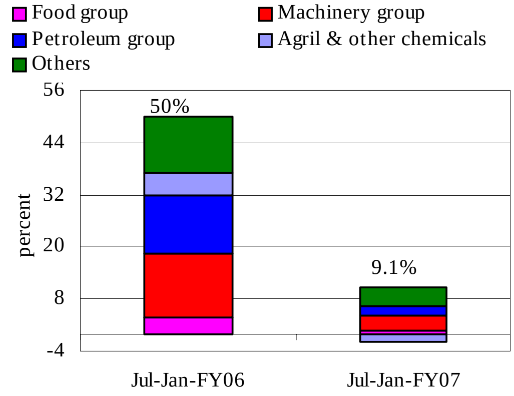
[15] Specifically, domestic demand for the furnace oil and diesel has increased while that for petrol and kerosene has gone down; however, refining produces each in fixed amounts, leaving domestic refineries with stock of products with low demand which they cannot sell profitably. Refineries have responded by reducing capacity utilization and importing refined products. Also, prices of petroleum products exports are lower.

[16] According to anecdotal evidence, Nike has asked the Saga sports to complete its market orders until March-07.

Imports

Import growth decelerated significantly during Jul-Jan FY07, primarily on account of lower oil prices, slowdown in consumer credit, improved domestic production of some food items and slowdown in the imports of machinery compared with last year's phenomenal growth. Specifically, the imports growth dropped to 9.1 percent during Jul-Jan FY07 compared with 50.0 percent growth in the corresponding period last year (see **Figure 6.13)**.

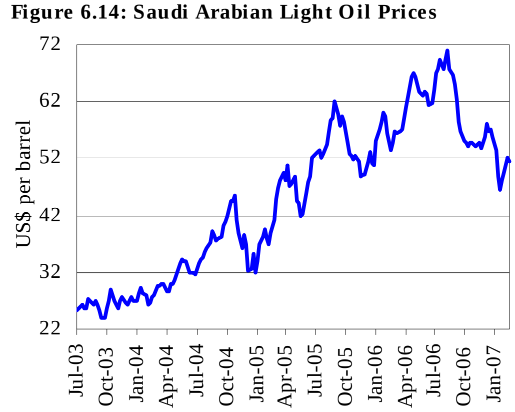
Figure 6.13: Contribution in Import Growth



In fact, the rise in the price of imported oil contributed to US$ 0.14 billion to the import bill during Jul-Jan FY07 as compared to US$ 1.34 billion in the same period last year (see **Table 6.15**). [17]

Specifically, the unit price of *petroleum group* increased by only 4.3 percent during Jul-Jan FY07 as compared to 61.0 percent increase in the same period of last year (see **Figure 6.14**).

Figure 6.14: Saudi Arabian Light Oil Prices



Food Group

The improved supply conditions of food items, particularly of sugar, led the food group to register a low growth of 8.8 percent during Jul-Jan FY07 as compared

[17] The increase in Saudi Arabian light oil prices decelerated to 7.6 percent during Jul-Jan FY07 from 45 percent in the same period last year.

with 57.0 percent growth in the corresponding period last year. [18] The sugar imports growth of 15.8 percent was due to 50.5 percent quantum fall which was partially offset by over 133.7 percent rise in unit price. The imports of the pulses increase substantially by 62.4 percent during Jul-Jan FY07, mainly due to short falls in production for the second consecutive year.

Machinery Group

The growth in machinery group imports dropped to 13.8 percent during Jul-Jan FY07 compared with a 55.4 percent increase during the corresponding period of last year. The decline in imports of road motor vehicles and textile machinery along with slowdown in the telecom group imports (which together constitute around 50 percent of the overall machinery imports), were the driving forces behind the deceleration in the overall machinery imports.

The imports of power generating machinery showed a growth of 52.0 percent and are expected to grow further as Pakistan needs to urgently add power generating capacity.[19] The telecom imports with a share of about 25.9 percent continued growing fast with much of the imports arising due to the strong demand for mobile phones. The aircraft import was due to the purchase of new aero plane by a domestic airline. Similarly, imports in the category of ships & boats and electrical machinery and apparatus rose considerably during the period under consideration.

Road Motor Vehicles

During Jul-Jan FY07, the imports of road motor vehicles declined by 9.3 percent as compared with a substantial growth of 70 percent in the same period of last year. Almost all the decrease can be explained by 8.25 percent fall in the imports of Completely Knocked-Down System (CKDs/SKDs), as the completely built up units (CBUs) recorded marginally positive growth. The fall under this category was principally because of 14.7 percent decline in the CKDS/SKDs of motor cars, which constitutes almost 73.0 percent of the total CKDs/SKDs imports. Regarding CBUs imports, the 7.3 percent increase in motor cars and 17.2 percent increase in motorcycles were partially offset by 14.3 decline in the imports of buses, trucks and heavy vehicles.

[18] During Jul-Dec FY07, sugar production increased by 15.6 percent as compared to 40.5 percent decline in the corresponding period last year. The wheat production during the current year is estimated to grow by 3.6 percent.

[19] A large number of cases are under process with the Private Power and Infrastructure Board (PPIB) for setting up of power projects with a cumulative capacity of 13,399 MW and an estimated cost outlay of US$ 12.85 billion. Source: http://www.ppib.gov.pk/list.htm

Textile Machinery
A substantial 34.1 percent YoY fall in the imports of textile machinery, probably reflects a base effect following the surge in imports in the past years as the industry prepared for the increased competition post-MFA.

Telecom Group
After showing extraordinary growth since last couple of years following the opening up of telecommunication sector, the group imports moderated to 23.3 percent during Jul-Jan FY07 against 154.7 percent in the corresponding period last year. The relatively modest growth in the group imports was contributed by both the cellular phones and other telecommunication apparatus. This suggests that the economic agents might have absorbed the impact of the policy changes in the sector to a large extent and imports would now continue at moderate levels (see **Table 6.14**).

Power Generating Machinery
As a result of the 52.0 percent increase in the imports of power generating machinery during Jul-Jan FY07 on the top of 39.4 percent increase in the same period of last year, the group's share in the overall machinery imports has increased from 6.6 percent during Jul-Jan FY06 to 8.9 percent during Jul-Jan FY07. The foreign direct investment in power generating sector was the dominant

Table 6.14: Analysis of Machinery Imports (Jul-Jan)
Percent

	FY06		FY07	
	Share	**Growth**	**Share**	**Growth**
Machinery group		**55.4**		**13.8**
Power generating machinery	6.7	39.4	8.9	52.0
Office machinery	3.6	9.7	3.6	12.0
Textile machinery	11.2	-9.2	6.5	-34.1
Construction & mining machinery	2.1	3.3	2.1	10.0
Electrical machinery & apparatus	6.3	58.8	7.2	30.6
Telecom	23.9	154.7	25.9	23.3
a) Mobile phones	8.5	247.0	10.0	33.6
b) Other apparatus	15.4	122.1	15.9	17.6
Railway vehicles	1.2	36.6	0.1	-86.9
Road motor vehicles	19.6	69.6	15.6	-9.3
Aircraft, ships and boats	1.7	106.1	7.3	385.1
Agricultural machinery & implements	2.1	267.7	2.1	16.1
Other machinery	21.6	47.2	20.6	8.6

contributor behind this substantial imports growth.

Petroleum Group

The growth in the aggregate imports of petroleum products during the first seven months of FY07 fell sharply to 18.4 percent, substantially lower than 66 percent rise in the corresponding period of FY06. Unlike Jul-Jan FY06 period when the growth was mostly price driven (95 percent), the growth during the current fiscal year is mainly driven by increase in volumes (79 percent). Within the group, all the increase was driven by refined petroleum products (furnace oil & diesel), whereas the imports of petroleum crude declined by 3.2 percent during the period under review mainly because of lower demand by oil refineries (see **Table 6.15).** The oil refineries are operating below capacity as they are not able to market their product mix, which is necessary for their profitable operations. As a result, the increased demand for furnace oil (for the oil based power generation) and diesel is being met through imports which caused 59.8 percent rise in the quantum of petroleum products.

Table 6.15: Impact of Price and Volumes on Petroleum Group Imports (Jul-Jan)

million US$

	FY06			FY07		
	Total change	Due to		Total change	Due to	
		Quantum	Price		Quantum	Price
Petroleum group	**1,406.2**	**67.9**	**1,338.4**	**651.9**	**512.7**	**139.2**
Petroleum product	489.2	-63.8	553.0	720.3	830.0	-109.7
Petroleum crude	917.1	127.9	789.2	-68.3	-261.6	193.3

Metal Group

The metal group imports declined by 14.6 percent during Jul-Jan FY07 as against a 75.6 percent increase in the corresponding period of last year (see **Table 6.16**). Iron & steel and iron & steel scraps were major items that led to a decline in the group's imports. The contributory factors behind this decline were substantial increases in the metal prices in international market, improvement in domestic steel production as Pakistan Steel Mills resumed production and large imports in the preceding year in anticipation of the jump in demand emanating from the construction activity in the earthquake affected areas.

Table 6.16: Major Imports during Jul-Jan (value in million US$, unit value US$)

Commodities	Units	Jul-Jan FY06 Value	Jul-Jan FY06 Unit value	Jul-Jan FY07P Value	Jul-Jan FY07P Unit value	YoY change in Absolute value	YoY change in percent Qty	YoY change in percent Value	YoY change in percent Unit value
A. Food group		**1,075.0**		**1,169.9**		**94.8**		**8.8**	**-**
1. Milk & cream incl. milk food	MT	30.3	1,738.2	43.0	2,549.9	12.7	-3.3	41.9	46.7
2. Wheat un milled	MT	86.4	162.4	32.6	254.0	-53.8	-75.9	-62.2	56.4
3. Dry fruits	MT	32.0	553.6	34.4	456.4	2.4	30.5	7.6	-17.6
4. Tea	MT	130.2	1,660.4	129.8	1,915.9	-0.4	-13.6	-0.3	15.4
5. Spices	MT	30.9	633.3	31.9	701.4	1.1	-6.6	3.4	10.7
6. Edible oil	MT	455.6	434.3	494.4	460.2	38.8	2.4	8.5	6.0
Soya bean	MT	9.7	681.2	*20.6*	*806.8*	10.9	79.8	112.9	18.4
Palm oil	MT	445.9	430.9	*473.8*	*451.8*	27.9	1.3	6.2	4.8
7. Sugar	MT	212.8	339.2	246.4	792.9	33.6	-50.5	15.8	133.7
8. Pulses	MT	96.9	367.4	157.3	502.0	60.5	18.9	62.4	36.6
B. Machinery group		**4,318.5**		**4,912.6**		**594.1**		**13.8**	
1. Power generating machinery		287.4		436.9		149.5		52.0	
2. Office machinery		156.8		175.6		18.9		12.0	
3. Textile machinery		484.3		319.2		-165.1		-34.1	
4. Construction & mining machinery		92.1		101.4		9.2		10.0	
5. Electrical machinery & apparatus		270.9		353.8		82.9		30.6	
6. Railway vehicles		50.7		6.6		-44.0		-86.9	
7. Road motor vehicles		846.1		767.0		-79.1		-9.3	
8. Aircraft, ships and boats		74.4		360.8		286.4		385.1	
9. Agricultural machinery & implement		90.8		105.3		14.6		16.1	
10. Other machinery		1,965.0		2,285.8		320.8		16.3	
C. Petroleum group	**MT**	**3,533.6**	431.1	**4,185.5**	445.9	**651.9**	14.5	**18.4**	3.4
1. Petroleum products	MT	1,386.8	456.5	2,107.0	433.9	720.3	59.8	51.9	-4.9
2. Petroleum crude	MT	2,146.9	416.2	2,078.5	458.8	-68.3	-12.2	-3.2	10.3
D. Textile group	**MT**	**324.2**		**301.1**		**-23.1**		**-7.1**	
1. Synthetic fiber	MT	148.1	1,594.0	132.9	1,847.0	-15.3	-22.6	-10.3	15.9
2. Synthetic & artificial silk yarn	MT	148.2	1,617.9	136.6	2,150.1	-11.7	-30.7	-7.9	32.9
3. Worn clothing	MT	27.8	332.9	31.7	335.0	3.8	13.1	13.8	0.6
E. Agricultural and other chemicals group	**MT**	**2,627.6**		**2,359.3**		**-268.3**		**-10.2**	
1. Fertilizer	MT	508.4	279.0	249.7	304.6	-258.7	-55.0	-50.9	9.2
2. Insecticides	MT	79.4	3,585.8	58.7	3,583.2	-20.7	-26.0	-26.1	-0.1
3. Plastic materials	MT	604.1	1,211.3	649.9	1,381.1	45.8	-5.7	7.6	14.0
4. Medicinal products	MT	191.0	30,961.4	226.4	34,583.0	35.4	6.1	18.5	11.7
5. Others	-	1,244.7	-	1,174.7	-	-70.0		-5.6	
F. Metal group	**MT**	**1,084.3**	**-**	**926.5**	-	**-157.8**		**-14.6**	
1. Iron and steel scrap	MT	212.3	255.8	154.8	277.8	-57.5	-32.9	-27.1	8.6
2. Iron and steel	MT	805.2	486.6	671.9	618.1	-133.3	-34.3	-16.6	27.0
3. Aluminum wrought & worked	-	66.8	-	99.8		33.1		49.6	
G. Miscellaneous group		**339.3**	**-**	**369.1**	-	**29.8**		**8.8**	-
1. Rubber crude	MT	62.1	1,213.8	63.8	1,289.9	1.8	-3.2	2.9	6.3
2. Rubber tyres & tubes	No.	94.7	21.0	91.4	23.5	-3.3	-13.8	-3.4	12.0
3. Wood & cork	-	20.5		22.2		1.7		8.3	
4. Jute	MT	24.4	348.0	26.1	407.0	1.6	-8.7	6.7	16.9
5. Paper, paper board & manufacture	MT	137.7	709.5	165.5	722.0	27.9	18.2	20.3	1.8
H. Others		**2,492.6**		**3,312.9**		**820.3**		**32.9**	
Total imports		**15,795.3**		**17,225.4**		**1,430.1**		**9.1**	

Source: Federal Bureau of Statistics P: provisional

Acronyms

ABL	Allied Bank Limited
ADB	Asian Development Bank
AIDP	Auto Industry Development Program
BoP	Balance of Payments
CBs	Commercial Banks
CBR	Central Board of Revenue
CBU	Completely Built Units
CDL	Cash Development Loan
CKD	Completely Knock Down
CNG	Compressed Natural Gas
CPI	Consumer Price Index
DAP	Di-Ammonium Phosphate
DFIs	Development Finance Institutions
DMBs	Deposit Money Banks
DPBs	Domestic Private Banks
DPCO	Debt Policy Coordination Office
DPS	Debt Policy Statement
DSCs	Defence Saving Certificates
EFS	Export Finance Scheme
EOBI	Employees Old Age Benefit Institutions
EU	European Union
FBS	Federal Bureau of Statistics
FCAs	Foreign Currency Accounts
FCBCs	Foreign Currency Bearer Certificates
FDI	Foreign Direct Investment
FE-25	Foreign Exchange Cir.No.25
FEBCs	Foreign Exchange Bearer Certificates
FRDL	Fiscal Responsibility and Debt Limitation
FY	Fiscal Year
GDP	Gross Domestic Product
GDR	Global Depository Receipts
GSP	Generalized System of Preferences
GST	General Sales Tax
HBL	Habib Bank Limited
IDB	Islamic Development Bank
KESC	Karachi Electric Supply Corporation
KIBOR	Karachi Inter Bank Offer Rate
LIBOR	London Inter Bank Offer Rate
LCVs	Light Commercial Vehicles

LPG	Liquefied Petroleum Gas
LSM	Large Scale Manufacturing
LTF-EOP	Long Term Finance-Export Oriented Project
MAF	Million Acre Feet
MDGs	Millennium Development Goals
MFA	Multi Fiber Agreement
MoF	Ministry of Finance
MRTB	Market Treasury Bills (for Replenishment)
MTB	Market Treasury Bills
MTBF	Medium Term Budgetary Framework
NAM	New Accounting Model
NBP	National Bank of Pakistan
NDA	Net Domestic Asset
NEER	Nominal Effective Exchange Rate
NFA	Net Foreign Asset
NFC	National Finance Commission
NFI	Net Foreign Investment
NFNE	Non Food Non Energy
NSS	National Savings Scheme
OCAC	Oil Companies Advisory Committee
OGDC	Oil and Gas Development Company
OIN	Other Items Net
OMOs	Open Market Operations
PAMA	Pakistan Automotive Manufacturers Association
PCT	Pakistan Customs Tariff
PDs	Primary Dealers
PIBs	Pakistan Investment Bonds
POL	Petroleum, Oil and Lubricants
PPCBL	Punjab Provincial Cooperative Banks limited
PPIB	Private Power and Infrastructure Board
PSDP	Public Sector Development Program
PSEs	Public Sector Enterprises
PSMA	Pakistan Sugar Mills Association
PSMEA	Pakistan Sports Manufacturers and Exporters Association
PTA	Pakistan Telecommunication Authority
PTCL	Pakistan Telecommunications Company Limited
Pvt.	Private
REER	Real Effective Exchange Rate
RPI	Relative Price Index
SBP	State Bank of Pakistan
SECP	Securities and Exchange Commission of Pakistan

SKD	Semi Knock Down
SMED	Small and Medium Enterprises Department
SPI	Sensitive Price Index
SSAs	Special Saving Accounts
SSCs	Special Saving Certificates
TFCs	Term Finance Certificates
UAE	United Arab Emirates
UBL	United Bank Limited
UK	United Kingdom
USA	United States of America
WPI	Whole Price Index
YoY	Year on Year
ZTBL	Zarai Taraqiati Bank Limited

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