1 Overview and Executive Summary

1.1 Overview

The economy continued to accelerate for yet another year in FY05, with real GDP growth rising to a 20-year high of 8.4 percent, propelled by above-target contributions from all three major sectors, namely, agriculture, industry and services (see **Table 1.1**). The rise in agricultural output, despite the below target performance by both livestock and minor crops particularly serves to highlight the tremendous growth potential of the sector, given support through infrastructural investment, institutional development, appropriate pricing policies and a modicum of good fortune. Similarly, the robust growth of industry, despite capacity constraints in key industries and a high-base effect, speaks volumes of the impact of pro-business policies on generating domestic demand and maintaining the competitiveness of exports (particularly for textiles). In the same vein, the strong services sector growth in FY05, reflects not only the exceptional strength of the commodity producing sectors, but also the benign impact of deregulation, liberal investment policies, stability in macroeconomic indicators, and policy continuity. All of these probably also contributed to a significant increase in FDI into the sector.

At the broader level this performance is very welcome indeed, but a closer look at some of the macroeconomic variables and each of the commodity-producing sectors also reveals niggling issues that need to be addressed expeditiously if the long-term growth trajectory is to be sustained.

First and foremost, the persistently high domestic inflation, driven by demand pressures, supply-side issues and structural factors, is troubling; CPI inflation rose from 4.6 percent in FY04 to peak at 9.3 percent by end-June 2005. When the initial expectations of the fall in inflation due to the improvement in food supplies and stability in domestic fuel prices were not realized, SBP significantly tightened its monetary stance during H2-FY05, with the benchmark 6-month T-bill yields rising by 416 basis points during this period, as against the 166 basis point increase in H1-FY05, before pausing to gauge the impact of this rise. However, despite this rise in interest rates, monetary growth remained a robust 19.3 percent in FY05, only marginally lower than the 19.6 percent growth recorded in FY04. This monetary tightening was complemented by government measures such as allowing imports of food items from India, elimination of duty on import of wheat, and the subsidized sale of wheat flour and sugar through utility stores, as well as other administrative measures. While these measures did eventually lead to a weakening in core inflation as well as headline CPI inflation during Q1-FY06, structural rigidities, strong demand and rising international oil prices continue to pose a serious threat to price stability.

It has been argued that monetary policy needs to be tightened further in order to reduce inflationary pressures to more tolerable levels. However, the case for this is far from clear. Real interest rates are already hovering close to zero and, more importantly, preliminary data for Q1-FY06 suggests that the pace of private sector credit off-take is slowing. Thus, given the lags in the transmission of monetary signals, a significant additional tightening of monetary policy could run the risk of inducing recessionary pressures in the economy.

Secondly, the strong growth in both agriculture and industry this year is narrowly based relative to preceding years – much of the 7.5 percent YoY increase in agri-output stems solely from the extraordinary improvement in major crops, and the industrial production increase remains heavily dependent on a few LSM sub-sectors such as textiles. While this may simply be a transient phenomenon, reflecting the lags between investment and production in many sectors, it is nonetheless a point of some unease.

Table 1.1: Selected Macroeconomic Indicators

	FY01	FY02	FY03	FY04	FY05 Targets P	FY05 Actual	FY06 targets
				Growth rates (in percent)			
Real GDP (at factor cost)[1]	1.8	3.1	4.8	6.4	6.6	8.4	7.0
Agriculture	-2.2	0.1	4.1	2.2	4.0	7.5	4.8
Major crops	-9.9	-2.5	6.8	1.9	3.5	17.3	6.6
Manufacturing	9.3	4.5	6.9	14.1	10.2	12.5	11.0
Large-scale	11.0	3.5	7.2	18.2	12.0	15.6[5]	13.0
Services sector	3.1	4.8	5.2	6.0	6.2	7.9	6.8
Consumer price index (FY01 =100)	4.4	3.5	3.1	4.6	5.0	9.3	8.0
Sensitive price indicator (FY01 = 100)	4.8	3.4	3.6	6.8	-	11.6	-
Monetary assets (M2)	9.0	15.4	18.0	19.6	14.5	19.3	12.8
Domestic credit	3.7	1.9	0.6	23.7	17.3	22.4	15.7
Exports (f.o.b.)	7.4	-0.7	22.2	10.3	11.5	16.9	18.0
Imports (c.i.f.)	4.1	-3.6	18.2	27.6	8.7	32.3	--
Official liquid FE reserves[2] (million US$)	2,076	4,805	9,993	11,110	-	10,481	-
				As percent of GDP			
Total investment	17.2	16.8	16.9	17.3	18.8	16.8	18.1
National savings	16.5	18.6	20.8	18.7	19.1	15.1	15.9
Tax revenue	10.6	10.9	11.5	11.0	11.2	10.1	
Total revenue	13.3	14.2	14.9	14.3	13.7	13.7	
Budgetary expenditure	17.2	18.8	18.6	17.3	16.9	18.3	
Budgetary deficit[3]	4.3	4.3	3.7	3.0	3.2	3.3	
Current account balance (including official transfers)	0.5	4.0	4.9	1.9	-	-1.4	
Domestic debt	41.6	39.0	38.4	35.8	-	32.5	
Foreign debt	49.5	45.6	40.0	35.0	-	31.0	
Explicit liabilities[4]	2.3	1.4	0.9	0.6	-	0.4	
Total debt (including explicit liabilities)	93.3	85.9	79.3	71.4	-	63.9	

P -Provisional; R -Revised

1 During FY05, sectoral shares in GDP were as follows: agriculture (23.1 percent), industry (24.5 percent) and services (52.4 percent).

2 Foreign exchange reserves include CRR/SLR on FE-25 deposits.

3 For FY02, if one-off expenditure of Rs 52 billion incurred on KESC recapitalization (Rs 32 billion) and CBR bonds (Rs 20 billion) is accounted for, the fiscal deficit will be 6.6 percent of GDP.

4 Explicit liabilities include Special US dollar Bonds, FEBCs, FCBCs and DBCs.

5 Growth in LSM is recorded at 15.6 percent based on production index data for July-June 2005.

Note: Targets are based on Annual Plan, Trade Policy, Credit Plan and Annual Budget Statement for FY06.

Third, in contrast to the preceding year, the FY05 growth is derived substantially from a sharp rise in real private consumption as much as continued robust growth in investment. It is important to note here that the rise in real private consumption is not necessarily a negative indicator for the economy – consumer led demand has proven to be a potent engine of growth in many economies and, more importantly, investment growth also remained strong in FY05. However, the fact that a sharp drop in savings parallels the rise in consumption raises a note of disquiet; in FY05 national savings have seen a decline, in *nominal* terms, for the first time in six years.

Fourth, this decline in national savings is mirrored also in the reversal of the current account balance, from a FY04 surplus to a large FY05 deficit. Fortunately, these imbalances are not yet great enough to be a serious concern. The combination of relatively slow growth in the stock of public debt due to fiscal discipline, the increasing reliance on concessional financing and retirement of expensive debt, the rise in FDI inflows and most importantly, the strong growth of the domestic economy, meant that the country's ability to service debt actually improved for the fourth successive year in FY05. In particular, the debt to GDP ratio continued to decline, falling from 93 percent in FY01, to 64 percent in FY05 – which is the lowest level for the last 20 years.

It is also important to remember that the greater contribution to the current account deficit is from the trade account. Since the rise in the trade deficit from US$ 3.3 billion in FY04 to a massive US$ 6.2 billion in FY05,[1] in turn, appears to be driven mainly by the exceptional growth in imports of machinery and inputs, and that growth in exports remained strong (particularly post-MFA), it can be argued that the trade imbalance could prove to be a temporary phenomenon. The assumption here is that the resulting increase in productive capacity would translate into further strengthening of exports in coming years, but the extent and the timing of this possible transformation remains in question. Indeed, this would depend crucially on the incentive structure available to exporters, including pro-export government policies and a supportive exchange rate environment.

Fifth, another potential vulnerability lies in the country's fiscal position. On first look, the performance of the CBR seems exceptionally good, with tax revenues exceeding target for yet another year; the FY05 tax receipts of Rs 591.1 billion are slightly higher than the Rs 590 billion revised target for the year. However, the tax buoyancy continues to decline, pushing down the tax-to-GDP ratio to 10.1 percent as compared to 11.0 percent in FY04. This suggests that the tax reforms have not yet led to an increasing propensity to collect taxes, and that the achievement of the tax targets may simply be due to the unexpectedly strong growth of the economy. Similarly, there is a need to ensure that current expenditure remains in check, particularly as rising interest rates, point to the risk of rising debt servicing costs in the years ahead. Weakening fiscal discipline, coupled with the risk of a slowdown in tax revenues (in case of any adverse shock) raises the specter of a frittering away of the hard won fiscal space achieved in recent years.

It must be kept in mind that the fiscal space will be sorely tested in the aftermath of the recent earthquake that severely damaged the public infrastructure in the affected areas. As it is, development spending in Pakistan, though rising, is still low. Now additional resources would be required to meet the challenge of building new towns over the ruins, providing healthcare for the injured, restoring the social & economic infrastructure, and providing seed capital for businesses. This is not an easy task and, moreover, is one that will have to be sustained over a number of years.

1.2 Future Outlook

In setting a 7 percent growth target, the Annual Development Plan for FY06 implicitly accepted that that the exceptional 8.4 percent growth recorded in FY05 was unlikely to be repeated in the succeeding year. However, it also indicated that the growth in real GDP would remain substantially higher than the long-term growth trajectory of 6.0 percent. This expectation is based principally on hopes of a continued strong growth in the manufacturing and services sectors, together with a reasonable performance by agriculture.

Expectations of the achievement of the growth target for large scale manufacturing in FY06 are underpinned by hopes of an easing of capacity constraints in some industries (especially *cement*, *automobiles*, *paper & paper board*, etc.) due to capacity expansions and establishment of new units, and the continuation of strong demand. Indeed, domestic demand could receive a significant boost as from the rebuilding efforts after the destruction caused by the earthquake, while the external demand would help the textiles industry to perform reasonably well in the post-MFA environment following the heavy investments in recent years and the supportive measures taken by the government. The

[1] This is based on FBS data from customs record.

FY06 LSM performance is also likely to be boosted by a resurgence in sugar production. All in all however, a high base and the impact of the monetary tightening initiated in FY05 means that the FY06 growth will probably remain below the robust FY05 levels, but SBP estimates hold out the possibility that the LSM growth could slightly exceed the 13.0 percent FY06 target.

Similarly, the optimism on the services sector growth seems well grounded. The heavy investments in *transport and telecommunications* in FY05 have raised hopes that the growth here would accelerate substantially in FY06. At the same time, the strength of the commodity-producing sectors and the evident increase in merchandize trade indicate that the *wholesale & retail level* sub-sector too will do well. Similarly, the performance of the financial sector is expected to go from strength to strength on the back of the continued strong performance of the economy and widening net margins of banks.

On the other hand, the agricultural growth target may prove to be optimistic. While government estimates continue to hold out the possibility of achieving a cotton harvest of 15 million bales, market sources indicate that the crop could be below 14.6 million bales achieved in FY05. The below target cotton crop and the high base set by the FY05 production of major crops suggests that the FY06 value-addition by major crops is likely to fall short of target. This risk would be raised further if the water shortages envisaged by IRSA for *rabi* FY06 materialize. Fortunately, a significant part of this weakness is likely to be covered by the minor crops and livestock sub-sectors, which are expected to post significantly above-target growth rates. The expectations regarding the former are based on better water availability and substantially higher prices, while the latter is anticipated as a result of favorable developments such as increased availability of fodder, and increased access to non-farm credit.

Table 1.2: Major Economic Indicators

	FY05	FY06	
growth rates (percent)		Original targets	SBP Projections
GDP	8.4	7.0	6.3 - 6.8
Inflation	9.3	8.0	7.7 - 8.3
Monetary assets (M2)	19.3	12.8	12.0 - 13.0
Private sector credit incl. PSCEs	*32.6*	*19.2*	17.0 - 18.0
Exports	16.9	18.0	18.0-18.2
Imports	32.3	--	18.8-19.0
billion US Dollars			
Workers' remittances	4.2	4.0	4.2 - 4.3
percent of GDP			
Fiscal deficit	3.3	3.8	3.8 - 4.0
Current account deficit	1.4	2.2	2.9 - 3.2
Private investment	10.9	11.3	11.1 - 11.3

In view of the above, real GDP growth is estimated to be in the range of 6.3 – 6.8 percent during FY06 as against the 7.0 percent growth target for the year (see **Table 1.2**).

A relative decline in aggregate demand (implicit in the above lower growth estimate), a high base effect for FY06 prices and an anticipated improvement in food supplies, all contribute to the expectations of a decline in inflationary pressures. Indeed, SBP estimates indicate that the FY06 inflation will likely remain close to the 8 percent inflation target set in the Annual Development Plan (ADP). However, this expectation is conditional on domestic oil prices remaining unchanged, particularly during the winter of FY06.

The demand slowdown is also likely to be reflected in a relative deceleration in import growth during FY06. SBP estimates suggest that imports during the year could witness a rise of at least 11.4 percent, as compared to the staggering 32.2 percent increase seen during FY05.[2] While exports are likely to maintain the robust growth of FY05, the smaller base relative to imports means that in absolute terms the trade deficit may widen during FY06, putting further pressure on the current

[2] This conservative estimate however, does not incorporate the impact of additional imports that may be required in the aftermath of the earthquake disaster.

account (which may rise to 3.1 percent of GDP). However, heavy FDI flows on account of PTCL privatization and other capital inflows may turn the overall BOP position into a surplus of about US$ 1 billion.

On the positive side, the substantial rise in imports as well as the continued growth momentum is likely to help support growth in tax receipts, particularly if the CBR focuses more closely on improving tax compliance with tax measures. While the recent efforts to improve the tax culture by limiting contact between the taxpayers and officials, and the introduction of a universal self-assessment scheme are important and necessary steps, it is equally important to deter tax evasion through a meaningful audit. Similarly, it is now more important than ever to ensure vigilance on expenditures, given the likely increased demand on the exchequer stemming from the growing need for investment in development as well as the urgent requirements of the earthquake struck regions. Indeed, even the conservative SBP estimates indicate that the overall budgetary deficit could be significantly above-target in FY06.

All of the above developments suggest that FY06 will present a very challenging environment for the conduct of monetary policy. On the one hand, it seems prudent to carefully wean the economy off the monetary overhang generated in the preceding years (when SBP was seeking to stimulate the economy), by keeping the monetary growth below than that of nominal GDP. On the other hand, the risk of a slowdown in the economy, as suggested by SBP studies,[3] militates against too tight a monetary posture. This brew is further complicated by the possibility of increased resort by the government to deficit financing from the banking sector and the resulting conflict between allowing the crowding out of private sector credit and accommodating the rise in monetary aggregates.

In short, the economy is now delicately poised – on the one hand, the continuation of fiscal discipline, prudent monetary policy and focused attention to bettering infrastructure, and social sector indicators clearly indicate the possibility that the economy can maintain its long-term growth trajectory. On the other hand, if the weakness in key indicators such as the lack of buoyancy in taxes, growth in current expenditure, and external sector imbalances are not addressed, the economy could begin to suffer deviations from the growth path so diligently restored in the last four years.

1.3 Executive Summary

1.3.1 Economic Growth, Savings and Investment

The real GDP growth of 8.4 percent in FY05 not only surpassed the 6.6 percent target by a wide margin for the third consecutive year, but is also the highest during the last two decades. The acceleration in domestic economic growth looks even more impressive since it was achieved despite an evident slowdown in major economies around the globe, a sustained rise in international oil prices and a gradual monetary tightening in efforts to contain inflationary pressures. In fact, this exceptional growth was due to a combination of (1) strong domestic demand, (2) good luck in terms of timely winter rains, (3) continuity of policies, and (4) a robust financial sector.

The soaring private consumption expenditure in FY05 in particular provided impetus to strong domestic demand for the second year in a row. The rise in consumption expenditure was probably due to rising consumer confidence as a result of huge capital gains in the equity and real estate markets, and increased remittances from abroad. Moreover, the growth in consumer credit also facilitated the rise in private consumption, which is more evident in the demand for consumer durables.

[3] Arby, Farooq (2001), "Long-Run Trend, Business Cycles and Short-Run Shocks in Real GDP", SBP Working Paper #1, available at www.sbp.org.pk/publications/wpapers/index.htm.

Agriculture

The agriculture sector staged a strong performance by recording 7.5 percent growth during FY05, which not only surpassed the annual target of 4.0 percent but is also well above the 2.2 percent growth recorded in FY04. All sub-sectors (except livestock, which saw a deceleration in growth) contributed toward this improved performance. The record production of cotton (14.6 million bales) and a bumper harvest of wheat (21.1 million tons) during FY05, pushed up the share of major crops in agricultural value addition to 37.1 percent in FY05 from 34.0 percent during the previous year. A host of factors were responsible for this improved showing, including good fortune (in the form of favorable conditions and timely rainfall), and the sharp rise in the availability of institutional agri-credit that encouraged use of improved seeds, pesticides and fertilizers. The record level of production of cotton, wheat, and strong maize and rice harvest probably led to rise in farm incomes during FY05, helping spur economic activity in the rural areas, reduce rural poverty.

Industry

Provisional estimates place the FY05 industrial growth at 10.2 percent YoY, down from the 12.0 percent YoY recorded during the preceding year. *Large-scale manufacturing* (LSM) recorded a growth of 15.6 percent in FY05 as compared to 18.2 percent growth in FY04. The strongest contribution to *LSM* growth during FY05 came from the *textile* sector that witnessed a remarkable YoY growth of 24.7 percent compared to 6.5 percent in the preceding year. Other LSM sectors that made significant contribution in value addition include *automobiles* (particularly *trucks*, *motorcycles & auto rickshaw*) and *electronics*, mainly driven by the availability of consumer financing. Furthermore, local cement dispatches also showed a growth of 18.2 percent over 14.2 percent growth of FY04 owing to higher domestic demand (reflecting expansion in the construction industry) as well as external demand (exports to Afghanistan and Iraq).

Finally, capacity utilization[4] during FY05 fell marginally by 0.8 percentage points, compared to an increase of 9.4 percentage points in FY04. This drop is mainly attributed to the enhanced capacity, contributed equally by domestic (private) as well as foreign direct investments in LSM.

As with *LSM*, growth in *mining & quarrying* saw a modest dip, falling to 11.5 percent in FY05 as against the 12.8 percent growth witnessed during FY04. The *electricity generation* sector recorded a slowdown, witnessing a growth of 4.9 percent in FY05 as compared to 6.8 percent in FY04; this was mainly due to disruptions in gas distribution during the year.

Services

The services sector also kept pace with the higher growth realized in the commodity producing sectors. The growth rate of 7.9 percent during FY05 is significantly above the 6.2 percent target as well as the 6.0 percent actual growth witnessed in FY04. The major contributions came from the *finance & insurance*, *wholesale & retail trade*, and *transport, storage & communication* sub-sectors.

The value addition in *finance & insurance* was mainly on account of a sharp increase in SBP's profits during FY05 as well as higher volume and efficiency gains realized by the banks and non-bank financial institutions. This increase was well supported by the growth in the insurance business. Moreover, the *wholesale & retail trade* sub-sector (with a share of 36.5 percent in total services sector) registered a strong growth of 12 percent during FY05 on top of the 8.1 percent rise in FY04. This reflects the robust performance of the industry, agriculture and foreign trade sectors of the economy.

[4] This represents the average of capacity utilization in vegetable ghee & cooking oil, cement, automobiles, petroleum refining, industrial chemicals, fertilizer, paper & paper board and electronics sub-sector.

Moderate growth has been witnessed in the *transport, storage and communication* sector, largely on account of developments in the telecom sector, and foreign direct investment flows in this sector. However, the *transport* segment is adversely affected by the sharp rise in oil prices during FY05.

Saving and Investment

The national savings deteriorated for the second successive year, recording a 4.5 percent *fall* in FY05, after witnessing a deceleration in growth to 3.2 percent in FY04. The FY04 deceleration in national savings was contributed by the decline in private savings, which was more than offset by an exceptionally large jump in public savings. Unfortunately, during FY05 not only have private savings continued to decline (albeit at a lesser pace), public savings have also declined. As a result, national savings dropped from the FY03 peak of 20.8 percent of GDP to 15.1 percent of GDP in FY05.

Nominal investment grew strongly during FY05, remaining well above the 5-year average of 10.6 percent, on the back of robust macroeconomic fundamentals, increased availability of credit and significant rise in foreign direct investment (FDI). It may be noted that despite the rise in nominal investment during the preceding three years, the investment to GDP ratio has continued to hover around 15.5 percent in the last three years.

As far as foreign direct investment is concerned, it reached US$ 1.5 billion during FY05, registering a healthy growth of 60.5 percent. Disaggregated data reveals that the FDI is concentrated in a few sectors, such as telecommunication, finance & insurance and oil & gas exploration.

1.3.2 Prices

Inflationary pressures that were visible in the economy since H2-FY04, strengthened significantly during FY05, with the annualized CPI inflation remaining high throughout the year.

During H1-FY05, CPI inflation was principally driven by domestic factors, e.g., as evident in the level of the *food* and *house rent index* (HRI), and was largely insulated from the high international oil prices.[5] In H2-FY05 however, the influence of these factors was compounded somewhat by the impact of the hike in domestic prices of petroleum, oil and lubricant (POL) as well as the associated rise in inflationary expectations.[6] As a result, *annualized* average CPI inflation rose to 9.3 percent by end-June 2005 – the highest level since 1997.

However, it may be noted that the marginal YoY CPI inflation peaked off in April 2005 and showed visible weakening in the subsequent months. The evident slowdown in inflation is probably a combined result of a more aggressive monetary tightening as well as measures taken by the government to ensure the better availability of major food items.[7]

1.3.3 Public Finance and Fiscal Policy

The Central Board of Revenue (CBR) achieved its revenue targets for the third successive year in FY05, helping to raise the aggregate revenues slightly above the Rs 590 billion revised target. However, expenditure exceeded the target substantially, pushing the overall budgetary deficit to 3.3 percent of GDP, which was slightly above the target of 3.2 percent of GDP, and higher than the deficit of 3.0 percent of GDP realized in FY04.

[5] Earlier the impact of rising oil price in the international market was mitigated by fiscal measures, till mid-December 2004; however, government removed the fiscal shock absorbers after realizing the permanency of the oil price hike.

[6] The prices of oil has a strong indirect impact on transportations costs (fares & tariff), utilities (electricity & gas), and food items (since transportations costs rise), thus raising inflationary expectations in the economy.

[7] For example, while higher financial costs would discourage speculators from piling up unnecessary stocks of the essential food items, imports of these items from India, bulk import of sugar and release of TCP sugar stocks improved the supply situation.

However, at the same time, the cause of concern is the weakness in tax effort and overall revenue mobilization despite the collection of Rs 900 billion in FY05. The weak buoyancy is reflected in the continuing fall in the tax-to-GDP ratio. Admittedly, the weak FY05 growth in tax receipts is in part due to the loss of the PDL revenues, following the government's decision to buffer the economy from at least a part of the rise in international oil prices. However, it is instructive to note that the FY05 tax-to-GDP figure shows a decline even when adding back the full budgeted PDL revenue for the year. Moreover, the lack of effective audit, enforcement and penal actions to check non-compliance, tax avoidance and evasion have weakened the tax buoyancy.

Another area of concern is the structure of the government revenues. More than half of the increase in government revenues during FY05 over the preceding year is from a swift rise in non-tax revenues. Also, within non-tax revenues, a significant contribution is from non-recurring items. Given that these flows are uncertain and unlikely to repeat themselves in the future to the same extent, the concerns over the trend of the overall budgetary deficit in the years ahead are quite legitimate. A related weakness in the revenue structure is an almost total dependence of all tiers of government on Federal taxes.

The fiscal developments in FY05 have exposed weaknesses in our tax systems that need to be addressed if the improvement in fiscal indicators is to be sustained. In particular, the importance of raising revenues from sectors that have traditionally remained under-taxed cannot be overemphasized. The taxation of agricultural income has already received considerable attention at the policy level, but the tax yields remain low. Surprisingly, however, there has been a little debate on the poor growth in the services sector taxes.

Sustainable growth will depend heavily on tapping resources from all economic activities equitably, and the efficient usage of these resources. However, the responsibility for this cannot lie solely with the CBR or, indeed the Federal government. Provinces enjoy the constitutional authority in respect of agriculture income tax and sales tax on services – these two sectors contribute over 75 percent of GDP, but their share in total revenues remains negligible. The provinces will have to significantly enhance their tax collecting capacity to meet their financing requirements. Such efforts will greatly improve the tax-GDP ratios, as also meet the objective of fiscal decentralization.

Finally, while it is encouraging to note that a strong contribution to the FY05 expenditure growth is through a large rise in development spending, the apparent sharp (21.7 percent YoY) increase in the FY05 current expenditure needs to be contained.

1.3.4 Money and Banking

Monetary policy witnessed an important transition during FY05, switching from a broadly accommodative stance (that had continued from recent years) to an aggressive tightening in the second half of the fiscal year. It should be noted that SBP had begun to raise the benchmark interest rates early in FY04, but this increase was very gradual until January FY05. The moderate rise was driven by the fact that inflation, while increasing, was still quite low, and therefore the central bank was more concerned about derailing the momentum of the economy, which had only just started gathering pace after an extended period of weak growth. This consideration guided the monetary policy throughout H1-FY05.

SBP's reluctance to tighten monetary policy aggressively during H1-FY05, was supported by a number of considerations, including:

(1) The significant contribution of supply-side and structural components to inflationary pressures. These are typically less responsive to monetary policy, and are therefore better tackled through administrative and fiscal measures. Moreover, SBP forecasts had suggested that the

supply-side inflation would decelerate by Q3-FY05[8] and CPI inflation was indeed weakening (though very gradually) early in H1-FY05. All of this militated against an aggressive hike in interest rates.

(2) More importantly, this stance was supported by the fact that monetary research with regard to the trade-off between growth and inflation indicates that inflation in excess of an 8-12 percent (threshold level)[9] hurts growth in the long run. However research findings are inconclusive for the impact on growth of the inflation rates lower than the threshold level of 8-12 percent. This suggests that SBP could actually defer an aggressive monetary tightening for some time before negative growth implications would be visible.

SBP therefore opted to raise interest rates moderately throughout the period, but kept the benchmark rates well below the inflation. Moreover, this gradual rise in the benchmark interest rates had no significant impact on the lending rates, consequently, net credit rose by a record Rs 428.8 billion. As a result, industrial production registered an impressive growth and the capacity utilization in a number of industries increased, especially in electronics and automobiles, where the increased activities are mainly credit driven. Together with higher government borrowings during FY05, private sector credit growth resulted in acceleration in the monetary expansion.

Although this monetary expansion led to increased industrial activity, it also fed a gradual and continuous rise in core inflation which raised the pressure for a significant rise in interest rates. The inflationary expectations hardened further as the increase in oil prices turned out to be a permanent rather than a transient phenomenon, and increased pressure on the government's fiscal resources forced the government to retract on its commitment to keep a cap on the oil prices. As a consequence of government's decision to pass on the impact of oil prices to the consumers, food prices also bounced back despite improved supplies, mainly due to a rise in transportation cost and hoarding.

In response to the signs that the economy may overheat in the absence of corrective measures as well as to curb cost push inflation, SBP raised the discount rate (for the first time after June 2001) in April 2005, by 150 basis points. This rise in interest rates was supported by high liquidity absorptions through OMOs and a slow down in reserve money growth. This, coupled with a higher acceptance ratio in T-bill auctions during these months compared with the initial nine months of the fiscal year further drained the inter bank liquidity. As a result, the transmission of monetary signal was far more effective during H2-FY05.

The performance of the banking sector also shows continued improvement during FY05. A disaggregation of the credit data by type of bank reveals that all major banking groups contributed to the tremendous FY05 credit, although the largest share was accounted for by domestic private banks. The major performance indicators till recent have shown an improvement in the financial health of banking institutions. For instance, banks' earnings have improved due to the large credit expansion especially given the rise in interest rates and the trend in diversified deployment of credit across sectors. In particular, SME and consumer finance are relatively riskier financing products and thus yield higher returns compared with corporate finance.[10]

[8] This was based on the assumption that improvements in supplies would reduce food prices, while an anticipated decline in the international oil prices would allow the government to keep its pledge of holding domestic oil prices unchanged.
[9] Khan S. Mohsin and Abdelhak S. Senhadji, Threshold effects in the relationship between inflation and growth, IMF Working Paper No WW/00/110, June 2000.
[10] This should be noted that SME finance and consumer finance constituted 18.0 percent and 22.7 percent respectively in total credit *flow* during FY05.

1.3.5 Domestic and External Debt

Although the country's total debt and liabilities (TDL) witnessed a small increase of 5.9 percent during FY05, this growth was comfortably outpaced by the nominal growth rate of 18.3 percent recorded by the economy. As a result, the country's debt bearing capacity improved during FY05, for the fourth successive year. In fact, by the end of FY05, the TDL as a percentage of GDP fell to its lowest level for the last 20 years, i.e. to 64 percent in FY05 from 71 percent a year ago and 93 percent in FY01. Furthermore other key indicators (such as the public debt servicing to GDP ratio, public debt servicing to tax revenue ratio) have also improved over the last five years, enhancing the country's capacity to carry debt and reducing its vulnerability to external shocks.

As in the preceding year, the major contribution to the FY05 growth in TDL came from domestic debt, raising its share in the country's TDL to 50.9 percent in FY05, up marginally from 50.1 percent in the preceding year. However, the average maturity of Pakistan's TDL shortened a little during FY05 as over 156.9 percent of the increase in domestic debt during the year constituted short-term issues.[11] Indeed, since FY05 also saw substantial maturities of long tenor debt, the stock of long-term debt instruments declined. A direct consequence of the shortening of the average maturity profile of the domestic debt is that the vulnerability of debt servicing cost to interest rates shocks increased somewhat in FY05.

In terms of the external debt and liabilities (EDL), its stock witnessed a marginal rise of US$ 576 million (1.6 percent YoY) during FY05, reversing the steady downtrend visible since FY99. This rise was realized despite a fall of US$ 154 million in external liabilities as well as the US$ 495 million debt relief provided by the USA during the year, and had only a negligible contribution from exchange rate fluctuations. The major factors contributing to the rise taking place in FY05 were fresh inflows from multilateral creditors and IDB; and the issuance of an Islamic bond – *sukuk* in the international capital market.

1.3.6 Balance of Payments[12]

The major highlight of Pakistan's external sector is the record high trade deficit of US$ 4.5 billion during FY05 compared to a deficit of US$ 1.3 billion during the preceding year. The sharp jump in trade deficit is clearly caused by the strong growth in import payments together with a rise in shipment freight charges during FY05.

In fact the extraordinary 38 percent growth in imports overshadowed the impact of the 16 percent jump in exports during FY05. In fact, Pakistan's exports performed fairly well during FY05 despite the rising global competitive challenges in the post MFA regime, which were compounded by (1) loss of duty free access to the EU since January 2005; (2) the imposition of antidumping duty by the EU on its bed wear imports from Pakistan; and (3) relatively higher inflation compared to the trading partners and competitors.

Encouragingly, data shows that the trade deficit during FY05 was primarily caused by higher imports of machinery, raw material (which may be helpful in improving the capacity use as well as in expanding the productive capacity of the economy, thereby leading to a broad-based increase in economic activities) and petroleum products (reflecting the impact of persistently higher oil prices in the international market and rising consumption in the growing economy).

The strong growth in remittances from expatriates and gains from the lower interest payment on external debt & liabilities partially offset the impact of the large trade gap. As a result, the substantial

[11] The issue of long-term rupee debt was held to a mere Rs 0.8 billion during FY05, as against the Rs 107.7 billion issued in FY04.
[12] This discussion is based on exchange record data compiled by SBP.

deterioration in trade balance did not completely translate into the current account deficit of US$ 1.6 billion in FY05 as compared to a surplus of US$ 1.8 billion during FY04.

However, the deficit in the current account balance to some extent was offset by the significant capital flows in the financial account. These capital flows mainly include (1) one-off inflows (such as US$ 364 million through privatizations, and US$ 600 million through sovereign debt issued internationally) and (2) a jump in concessional long-term loans from the World Bank & ADB. Thus, the financial account registered a surplus of US$ 568 million during FY05 in contrast to a deficit of US$ 1,335 million in the previous year. Hence, despite the unprecedented YoY deterioration in trade account in FY05, the overall balance recorded a deficit of only US$ 0.41 billion during the period compared to a surplus of US$ 0.78 billion in FY04.

Pakistan's overall foreign exchange reserves during FY05 increased by US$ 289 million. Importantly, the reserves reached a historic high of US$ 13 billion in mid-April 2005 before closing the year at US$ 12.6 billion. A notable change is witnessed in the composition of overall reserves. SBP reserves scaled down by US$ 0.76 billion, while commercial banks' reserves increased by US$ 1.05 billion. SBP reserves fell mainly on the back of payments for loans and oil imports. On the other hand, commercial banks' reserves increased due to both fresh inflows in FE-25 deposits as well as net retirement of forex loan.

Given the deterioration in the external account, the pressure on the rupee during the initial months of FY05 was not surprising. However, this gradual slide of the rupee against the US dollar led to a generalized market panic. In fact, the rupee quickly weakened by 5.2 percent by end-October 2005, even through the SBP had been quietly injecting foreign exchange into the system. The magnitude of the pressure on the rupee solely due to expectations became evident only when SBP made a public (and quantifiable) commitment to smooth (the lumpy) oil payments. This immediately led to a rally by the rupee, wiping out much of its losses during the initial months. The significant point here was that SBP quickly became a net buyer in the market by December 2004, even as the currency appreciated. This suggested that at least a part of the August-October 2005 pressure on the rupee was due to the demand generated by the expectations of the rupee deprecation alone.

1.3.7 Socio Sector Development

Macroeconomic stability and strong economic growth during the last few years enabled the country to show some progress in social sector development as well. In particular, the rising trend of the rate of unemployment since FY93 has been reversed during FY02-04, despite a faster growth in the labor force. Similarly, the improvement in the fiscal position, through sustained efforts in recent years, has allowed the government to substantially increase spending in health, education and other social sector areas. As a result, the positive trends in most of the social indicators have gathered pace during FY02-05 compared to the FY99-02 period.

However, the social indicators still do not show a satisfactory picture. Unemployment, despite declining to 7.7 percent by FY04, is still very high and, moreover, even the decline was not broad based. The mortality rates in Pakistan for infants and children under 5 year of age, are the worst amongst SAARC members. Similarly, education indicators are also not very encouraging and a majority of the population still does not have access to basic facilities such as sanitation and safe drinking water, etc. Moreover, most of the social indicators show high regional and gender disparity.

Thus, it is important to speed up the progress on human development in Pakistan, and the acceleration has to continue consistently to catch up with the backlog and meet the needs of new entrants. In this regard, the sustainability of macroeconomic stability and maintaining the current growth momentum remain essential. Moreover, the government should significantly augment development spending, increase efficiency of expenditures, and foster better partnerships with the private sector to improve delivery of services. The government's efforts could be complemented by the increased access to financial services of the populace (as especially to the hitherto neglected SME and microfinance sectors).