

## The Team

### Team Leader

Mohammad Mansoor Ali [mansoor.ali@sbp.org.pk](mailto:mansoor.ali@sbp.org.pk)

### Editorial

Moinuddin

### Researchers

Moinuddin (Team Leader, Real Sector) [moinuddin@sbp.org.pk](mailto:moinuddin@sbp.org.pk)

Zafar Hayat (Agriculture) [zafar.hayat@sbp.org.pk](mailto:zafar.hayat@sbp.org.pk)

Imran Naveed Khan (Industry) [imran.naveed@sbp.org.pk](mailto:imran.naveed@sbp.org.pk)

Syed Sarfaraz Ali Shah (Prices) [syed.sarfaraz@sbp.org.pk](mailto:syed.sarfaraz@sbp.org.pk)

Mohib Kamal (Team Leader, Monetary Sector) [mohib.kamal@sbp.org.pk](mailto:mohib.kamal@sbp.org.pk)

Asma Khalid (Monetary Development) [asma.khalid@sbp.org.pk](mailto:asma.khalid@sbp.org.pk)

Syed Sajid Ali (Team Leader, External Sector) [sajid.ali@sbp.org.pk](mailto:sajid.ali@sbp.org.pk)

Sabina Khurram Jafri (Balance of Payments) [sabina.kazmi@sbp.org.pk](mailto:sabina.kazmi@sbp.org.pk)

Fayyaz Hussain (Trade) [fayyaz.hussain@sbp.org.pk](mailto:fayyaz.hussain@sbp.org.pk)

Abdul Jalil (Reserves) [abdul.jalil@sbp.org.pk](mailto:abdul.jalil@sbp.org.pk)

Dr Saeed Ahmed (Team Leader, Fiscal Sector) [Dr.Ahmed@sbp.org](mailto:Dr.Ahmed@sbp.org)

Safia Shabbir (Fiscal Developments) [safia.shabbir@sbp.org.pk](mailto:safia.shabbir@sbp.org.pk)

Muhammad Amin Khan Lodhi (Special Section) [amin.lodhi@sbp.org.pk](mailto:amin.lodhi@sbp.org.pk)

### Formatting

Zulfiqar Hyder (Team Leader) [zulfiqar.hyder@sbp.org.pk](mailto:zulfiqar.hyder@sbp.org.pk)

Safdar Ullah Khan [safdar.khan@sbp.org.pk](mailto:safdar.khan@sbp.org.pk)

Raza Naeem [raza.naeem@sbp.org.pk](mailto:raza.naeem@sbp.org.pk)

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## THE STATE OF PAKISTAN'S ECONOMY First Quarterly Report for FY06

### 1.1 Overview

Initial data on the commodity-producing sectors indicates that the performance of Pakistan's economy during FY06 will be weaker than in the preceding year; specifically, growth in large scale manufacturing has decelerated sharply, and the production in two of the four major *khariif* crops was significantly below target. Much of this slowdown is not unexpected, as is reflected in the 7.0 percent real GDP growth target set in the Annual Development Plan for the year, against the 8.4 percent growth achieved in FY05. While, the FY06 growth target is still *not* out of reach, achieving it might prove to be a challenge.

Specifically, in agriculture, while the value-addition by major crops is expected to fall well below the target, this may yet be compensated by an anticipated above target performance by the minor crops and livestock sub-sectors. Similarly, while industrial growth may remain a little below target, activity is expected to remain strong due to an expected recovery by LSM in succeeding quarters (as credit demand remains relatively strong), a buoyant construction sector, and improved electricity & gas distribution. Finally, growth in the services sector is also expected to turn in a strong performance.

In any event, while the contribution to FY06 growth by individual sub-sectors of the economy is likely to differ from earlier expectations, SBP estimates suggest that real GDP growth will range between 6.0-6.6 percent.

**Table 1.1: Selected Economic Indicators**

|                                    |         | FY04     | FY05     | FY06     |
|------------------------------------|---------|----------|----------|----------|
| <i>Growth rate (percent)</i>       |         |          |          |          |
| Large scale manufacturing          |         | 16.1     | 24.9     | 8.7      |
| Exports                            | Jul-Oct | 14.2     | 12.8     | 22.8     |
| Imports                            | Jul-Oct | 13.0     | 34.5     | 54.0     |
| Tax revenue (CBR)                  | Jul-Sep | 4.1      | 30.8     | 18.6     |
| CPI (12 m moving ave)              | Jul-Nov | 2.7      | 7.3      | 9.0      |
| Private sector credit              | Jul-Nov | 13.1     | 12.9     | 10.8     |
| Money supply (M2)                  | Jul-Nov | 7.9      | 5.5      | 3.0      |
| <i>million US Dollars</i>          |         |          |          |          |
| Total liquid reserves <sup>2</sup> | End Jun | 12,327.9 | 12,617.6 | 11,330.1 |
| Home remittances <sup>3</sup>      | Jul-Oct | 1,235.0  | 1,318.2  | 1,375.2  |
| Foreign private investment         | Jul-Oct | 106      | 270      | 657      |
| <i>percent of GDP<sup>4</sup></i>  |         |          |          |          |
| Fiscal deficit                     | Jul-Sep | 0.7      | 0.4      | 0.5      |
| Trade deficit                      | Jul-Oct | 0.33     | 1.16     | 2.65     |
| Current a/c balance                | Jul-Oct | 1.55     | -0.11    | -1.60    |

1. Based on 91 items

2. With SBP and commercial banks (end-November for FY06)

3. Excluding receipts on a/c of Kuwait war affectees and Hajj

4. Based on full-year GDP in the denominator.

The relative slowdown in economic activity, together with an improvement in food supply (stemming from better minor crop harvests and the government's supply-side interventions), is contributing to a relative weakening in domestic inflation. CPI inflation continued a trend decline throughout the first 5 months of FY06, consequently dropping from the peak of 11.1 percent YoY in April 2005 to reach 7.9 percent YoY by end-November 2005. This raises hopes that the eventual annual inflation will remain close to the 8.0 percent target for FY06. Two assumptions that underlie this expectation are: (1) that monetary policy will remain tight, and (2) fuel prices will not see a significant rise in the remaining months of the fiscal year.

Although monetary expansion has been contained to 3.0 percent during July-Nov FY06, as compared to the 5.0 percent increase seen in the corresponding period of FY05, demand for private sector credit remained strong, and most importantly despite a small dip in November 2005, core inflation persists at a relatively high 7.6 percent YoY. This suggests that inflationary pressures may still be persisting in the economy, and the SBP therefore has to be particularly vigilant, given that M2 growth may accelerate in the quarters ahead (reinvigorating inflation), pressed by both, high government borrowings for budgetary support and the realization of external assistance.

It is important to note here that much of the external assistance received for rehabilitation of the earthquake affected areas is likely to be excluded from budgetary financing, and the government borrowings may remain strong during FY06, adding to reserve money growth. The latter view is supported by expectation that the growth in government expenditures will remain strong (especially the encouraging rise in development spending), and an evident weakness in the structure of tax receipts – approximately 75 percent of the growth in tax receipts during Q1-FY06 stemmed from import-based taxes, led by a sharp rise in imports. Thus, tax receipts may be adversely impacted by any slowdown in imports in future quarters.

Imports have seen an extraordinary 54 percent YoY growth during July-October FY06, substantially higher than the robust 22.8 percent rise in exports during the same period. As a result, the trade deficit has widened to US\$ 3.37 billion, pushing the current account deficit to US\$ 2.04 billion (1.6 percent of estimated GDP). This will substantially raise the pressure for corrective action. However, it should be noted here that any adjustments are unlikely to be abrupt or add to market volatility, as Pakistan's external account receipts are expected to increase during FY06, and foreign currency reserves remain strong.

### Looking forward

The economic outlook for Pakistan present a mixed picture. On the one hand, real GDP growth is likely to remain well above the 6 percent long-term trajectory, and there is a strong expectation that CPI inflation will remain at the 8 percent level, in line with the annual target, by end-June 2006. However, potential emergence of large fiscal and external imbalances pose threats to the sustainability of these positive trends.

While inflation is falling, it needs to be reduced further even at the cost of sacrificing some growth in the short-term. This is essential, as a fall in inflation will allow for an easing of monetary policy, thereby supporting long-term growth and countering any cyclical downtrend. The elimination of emerging macroeconomic imbalances will also be essential to sustaining long term growth in the economy.

Similarly, while fiscal discipline is required, this cannot be at the expense of development expenditures, as this would lower the productive capacity of the economy, thereby contributing to even greater deficits in future. Therefore, improvements in the fiscal environment must necessarily stem from a widening of the tax base. In particular, the increasing dependance of overall revenues

**Table 1.2: Major Economic Indicators**

|                               | Provisional<br>FY05 | FY06                |                    |
|-------------------------------|---------------------|---------------------|--------------------|
|                               |                     | Original<br>targets | SBP<br>projections |
| <i>growth rates (percent)</i> |                     |                     |                    |
| GDP                           | 8.4                 | 7.0                 | 6.0-6.6            |
| Inflation                     | 9.3                 | 8.0                 | 7.5-8.5            |
| Monetary assets (M2)          | 19.3                | 12.8                | 13.1               |
| <i>billion US Dollars</i>     |                     |                     |                    |
| Exports fob                   |                     |                     | 16.7               |
| Imports cif                   |                     |                     | 27.1               |
| Workers' remittances          | 4.2                 | 4.0                 | 4.3                |
| <i>percent of GDP</i>         |                     |                     |                    |
| Budgetary balance             | -3.3                | -3.8                | -4.3               |
| Current account balance       | -1.4                | -2.1                | -4.4               |

on just a few sectors of the economy poses serious risks to fiscal stability (as shocks to these sectors can derail the fiscal discipline), and constraints the growth of the sectors which currently carry the tax burden of the whole economy.

Moreover, while recent increases in development spending bode well for the growth prospects of the economy, it is important to ensure that even within development spending there is a balance between the creation and maintenance of physical infrastructure, and raising the productivity of human capital through investment in health and education. This is true even for the earthquake affected areas, where initial focus may be greater on the re-creation of housing and infrastructure. It may be pointed out that a key risk to the country's growth potential is the lack of a substantial cadre of managers, skilled technicians, and

trainable general labor force.<sup>1</sup> The shortage of skilled labor is already particularly evident in the high growth, sunrise industries in Pakistan, including telecommunications, IT, high value-added textiles, telecast media, finance, etc. This is indeed a tragedy for Pakistan, where persistent skill-set mismatches, which despite employment opportunities, keep unemployment high, raise poverty and lower the country's growth potential.

Finally, containing the external imbalances will also be a challenging job, given the increasingly open economy and the need to sustain productive imports. In the short run, the country can sustain even the higher current account deficits, given the ample availability of foreign currency financing at relatively low costs, and strong foreign account reserves. However, the resort to these can only be a temporary phenomenon, and is not sustainable for extended periods, without engendering serious distortions in the economy. Moreover, even targeted fiscal interventions are unlikely to succeed in containing import growth and run the risk of introducing distortions in the economy. The required adjustments must therefore be borne by export oriented policies, rather than by containing imports.

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<sup>1</sup> Towards a prosperous Pakistan: A strategy for Rapid Industrial growth, MOI. GoP, January 2005.

## **1.2 Executive Summary**

### **Agriculture**

Provisional data on the major *kharif* crops suggests that value-added by these may not only fall below targets but even below the levels seen in FY05. Thus the overall FY06 agricultural growth target will depend on an exceptional *rabi* harvest, and above-target growth in the minor crops and livestock sectors.

Given the likelihood of adequate fertilizers availability, the timely announcement of support prices, ample agricultural credit and improved water availability the prospect of a good *rabi* harvest is very much likely. Also, indirect evidence, in the form of a fall in prices of many minor crop products, as well as some anecdotal evidence, raises hopes that production of many minor crops may exceed target. Similarly, increased focus of microfinance institutions on the livestock sector in recent years could lead to an above target outcome in this sector as well. Thus, all in all by the end of Q1-FY06, the prospects of the agriculture sector annual growth reach close to the target, are bright.

### **Industrial Production<sup>2</sup>**

The *Index of Industrial Production* (IIP<sup>3</sup>), indicates that industrial growth weakened during Q1-FY06, registering a single digit growth of 6.1 percent, in contrast to the 19.0 percent growth witnessed during Q1-FY05. This slowdown in IIP is mainly attributed to a distinct deceleration in large scale manufacturing growth. *LSM* grew by 8.7 percent in Q1-FY06, substantially lower than 24.9 percent YoY growth recorded during the corresponding period of FY05, and also below the 13 percent YoY annual growth target. The number of sub-sectors witnessing growth in excess of 10 percent has fallen from 11 in Q1-FY05 to 8 during Q1-FY06.

One of the stronger contributions to the deceleration in LSM growth is from the textile sub-sector with 7.2 percent YoY growth in Q1-FY06 as against 29.6 percent YoY growth in Q1-FY05. Similarly, growth in the automobile sector also fell sharply to 32.3 percent YoY during Q1-FY06, from the 40.2 percent YoY increase seen in Q1-FY05. The other industries that witnessed a notably slower growth during Q1-FY06 relative to Q1-FY05 include food, beverages & tobacco, cement, fertilizer and electronics. In contrast, leather, pharmaceutical, paper &

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<sup>2</sup> This analysis is based on the provisional data on *large scale manufacturing* (LSM) supplied by the Federal Bureau of Statistics.

<sup>3</sup> IIP is used as a proxy for industry to estimate the industrial production.

paper board and engineering industries saw a significant rise in growth during Q1-FY06.

### **Prices**

Inflationary pressures that started weakening by the last quarter of FY05, further weakened during the first five months of FY06. CPI and SPI inflation (YoY) witnessed obvious slowdown during FY06, on the back of a sharp deceleration in *food* inflation. In contrast, WPI inflation exhibited a steep rising trend until September 2005 due to the rising PoL prices. However, this too showed some signs of easing during Oct-Nov 2005 mainly on account of softening in *food* and *fuel & lighting* sub-group inflation.

Specifically, after rising from 8.7 percent in October 2004, marginal (YoY) CPI inflation peaked in April 2005, before dropping to 7.9 percent by November 2005. While the earlier rise was dominated by rising *food* inflation, during the first five months of FY06 inflationary pressures were being driven principally from the CPI *non-food* group since mid-April 2005. In fact, the impact of a gradual deceleration in food inflation is partially offset by a sharp rise in the prices of key fuels. The rise in oil prices also led to a significant rise in transportation costs, thus supporting inflationary pressures to sustain. On the positive side, a continued deceleration in house rent index (HRI)<sup>4</sup> augmented the ease in food inflation during Jul-Nov 2005.

### **Fiscal Developments**

The fiscal deficit widened marginally during Q1-FY06, rising to 0.5 percent of (estimated) GDP, as compared to approximately 0.4 percent of GDP in Q1-FY05. Fiscal accounts, however, presented a relatively stable position as the revenue balance remained unchanged at 0.2 percent of GDP and primary deficit declined to 0.1 percent of GDP in Q1-FY06 as compared to 0.4 percent in Q1-FY05. The deceleration in accounts is mainly because of development expenditure that presented a YoY growth of 58.6 percent; therefore, it is not a matter of great concern. However, given that fiscal performance post-Q1-FY06 is likely to deteriorate due to an expected rise in expenditures in the aftermath of the October 2005 earthquake, there is a need for greater vigilance in sustaining (and improving) revenue growth.

On the taxation side, CBR met its revenue targets for the quarter; however, the 21.0 percent growth in CBR revenues during the first quarter is mainly due to a

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<sup>4</sup> HRI inflation fell from a peak of 12.3 percent (YoY) in March to 10.8 percent during November 2005.

massive increase in international trade taxes (approximately 76.5 percent of the total increase in CBR tax collections during Q1-FY06). This would suggest that CBR will have to gear up its efforts to meet the annual target of Rs 690 billion and focus on tax compliance and expanding the tax net.

### **Money and Banking**

Q1-FY06 witnessed a monetary contraction, with M2 declining 0.3 percent in the period, in contrast to the 1.2 percent increase seen in Q1-FY05. This decline was dominated by a reduction in the NFA of the banking system, reflecting the increasing pressure on the country's external account, as NDA growth was relatively strong due to an increase in government borrowings for budgetary support and strong growth in private sector credit.

The lower growth in M2 together with the fall in CPI inflation from its 11.1 percent peak of April 2005 to 8.5 percent in September 2005, and the end of the steep uptrend in core inflation, together with the anticipated further lagged impact of earlier monetary tightening was instrumental in SBP's decision to hold the interest rates relatively unchanged through Q1-FY05. While benchmark rates did not change, SBP sought to support the transmission of the tight monetary posture by improving its inter-bank liquidity management.

However, the outlook of the monetary aggregates changed significantly from October 2005 onwards. In particular, private sector credit and government borrowing from the banking system both began rising strongly. As a result, during July-Nov FY06, the banking sector NDA registered a growth of 6.7 percent compared with the growth of 6.2 percent in the corresponding period of FY05. This growth was enough to offset the continuing decline in NFA, and therefore the money supply registered a sharp rise during Oct-Nov FY06, pushing the cumulative M2 growth during July-Nov FY06 to 3.0 percent as compared to the 5.5 percent rise in July-Nov FY05.

Given that the relatively subdued M2 growth in July-Nov FY06 is owed entirely to the sharp drawdown in the net foreign assets, the likelihood that this negative trend in NFA would halt or reverse in coming months (due to inflow of earthquake related foreign assistance), SBP would need to be extremely careful to ensure that money supply growth remains consistent with long-term non-inflationary growth.

### **Pakistan's External Sector**

The overall external balance of Pakistan recorded a deficit of US\$ 0.5 billion during Jul-Oct FY06 against a US\$ 1 billion deficit realized in Jul-Oct FY05.

This relative improvement was largely due to higher inflows in the financial account, which offset the sharp increase in the current account deficit.

The current account deficit deteriorated sharply to reach the level of US\$ 2 billion during Jul-Oct FY06 compared to a small deficit of US\$ 121 million during the corresponding period of FY05. This sharp deterioration was principally due to the 34 percent YoY rise in imports during Jul-Oct FY06, which overshadowed the healthy 14 percent YoY growth in exports.<sup>5</sup> Consequently, the trade deficit rose to US\$ 2.6 billion during Jul-Oct FY06, as compared to a deficit of US\$ 1.3 billion in the corresponding period of FY05.

In the case of imports, a significant contribution to the exceptionally strong growth during Jul-Oct FY06 was from international oil prices. In fact, petroleum group imports increased by YoY 73.2 percent to reach US\$ 2.1 billion during Jul-Oct FY06. This increase in imports of the petroleum group was driven almost entirely by higher prices (import volumes fell by 2.2 percent YoY).

However, even on excluding the oil bill, import growth remains exceptionally strong at 48.8 percent YoY. The machinery group imports portrayed a substantial growth of 62.2 percent YoY during Jul-Oct FY06 as against the 33.5 percent YoY growth witnessed during the corresponding period of the last year.

This suggests that even though Pakistan's oil import bill could shrink somewhat in the months ahead as international oil prices retreat from their peaks, this may be offset by the growth in non-oil imports (particularly machinery, raw material and imports to support relief efforts in areas affected by the October 2005 earthquake).

The substantial increase in trade volumes also contributed to a 44 percent YoY deterioration in the services account deficit during this period. Besides, current transfers also witnessed a marginal deterioration. This was largely due to a fall in net private current transfers on account of lower net inflows in the resident foreign currency accounts as well as sluggish growth in worker's remittances.

However, fortunately this deterioration in the current account was offset by a substantial improvement in the financial account, mainly emanating from higher net foreign investment. Further higher receipts of project loan from International Development Agency (IDA), supplier's credit inflows along with low payments of other liabilities also contributed in the financial account improvement.

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<sup>5</sup> Based on exchange record.

The net deficit in the overall external balance did not significantly pressure the exchange rate during this period, with the rupee-dollar parity remaining practically unchanged through Jul-Oct FY06. This relative stability was principally because SBP continued with its policy of meeting lumpy payments for import of key commodities, such as oil, wheat urea, etc. The SBP interventions, aimed at reducing market volatility, continued throughout Jul-Oct 2005, and led to a reduction in the SBP reserves.

The overall reserves fell by US\$ 1.29 billion during Jul-Nov FY06 to touch US\$ 11.3 billion by end-November 2005, down US\$ 1.7 billion from the peak level of US\$ 13.00 billion reached in April 2005. The decline is evident in both SBP and commercial bank reserves. SBP's reserves declined by US\$ 900.7 million during Jul-Nov 2005, despite some major inflows, including disbursement by the IDA and Asian Development Bank (ADB), receipt from logistic support, privatization proceeds as well as purchases from the inter-bank market. Similarly, the reserves held by the commercial banks fell by US\$ 387 million in the same period.

## 2 Real Sector

### 2.1 Agriculture

Encouraged by the strong FY05 agricultural performance, prospects of improved water supply, and the increased availability of institutional agri-credit the government set an ambitious growth target of 4.8 percent for FY06. This target was based principally on optimistic expectations that the strong FY06 performance by major crops would be sustained in the succeeding year.

Unfortunately, provisional data on major *kharif* crops already suggests that value-added by these crops may fall below even the levels seen in FY05, unless the wheat crop exceeds the already aggressive FY06 target by a substantial margin. In short, the achievement of the overall FY06 agricultural growth target will depend on an exceptional *rabi* harvest, as well as an above-target growth in the minor crops and livestock sectors. While direct data on minor crops is not yet available indirect evidence, in the form of a fall in prices of many minor crop products,<sup>1</sup> as well as some anecdotal evidence, raises hopes that production of many minor crops may exceed the targets. Similarly, it is possible that the increased focus of microfinance institutions on the livestock in recent years could lead to above target outcome in this sector as well.

#### Crops

The total cultivated area under the four major crops during *kharif* FY06 was 1.2 percent lower relative to that in *kharif* FY05. Most of this fall is attributed to the area under cotton and sugarcane; the area brought under cultivation for each crop during *kharif* FY06 has not only been below the annual target but also lower than the area under the crop in

**Table 2.1: Area Under Major Crops**  
thousand hectares

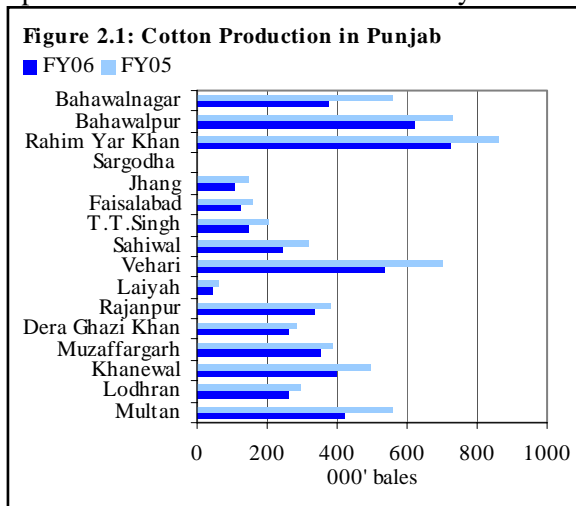
| Crop      | 2004-05 |        | 2005-06 |        |
|-----------|---------|--------|---------|--------|
|           | Targets | Actual | Targets | Actual |
| Cotton    | 3140    | 3229   | 3247    | 3120   |
| Sugarcane | 1000    | 967    | 955     | 900    |
| Rice      | 2586    | 2520   | 2533    | 2531   |
| Maize     | 939     | 946    | 971     | 1018   |
| Wheat     | 8290    | 8359   | 8415    | ..     |

Source: MINFAL

FY05. In fact, it was only a large jump in the area under maize, supported by a smaller (but below target) increase in area under rice, that pushed the aggregate cultivated area under major crops slightly over the FY06 target (see **Table 2.1**).

<sup>1</sup> An increase of 34 percent (YoY) in import of onion and potato also helped to ease pressures on their prices.

Provisional estimates place the FY06 cotton production at 12.5 million bales, down 14 percent YoY, against a 3 percent fall in cultivated area. Clearly productivity too has fallen, and this is reflected in the lower production in all cotton producing districts in the Punjab (see **Figure 2.1**). It appears that the cotton crop was adversely affected by delayed sowing, untimely rains and pest attacks. In addition, unusually high temperatures in August 2005 probably also badly affected the standing cotton crop.



As with cotton, the production of sugarcane is also estimated to be lower (by 2.8 percent YoY) during FY06 (see **Table 2.2**), despite an improvement in water availability. Unlike cotton however, the fall in the sugarcane crop is probably a reflection of the dispute between growers and sugar mills.<sup>2</sup> Productivity in the case of sugarcane crop has increased during FY06 and the lower production is largely a result of the price and payments-related issues that led growers to switch to oilseed and other crops.<sup>3</sup>

**Table 2.2: Production of Selected Major Crops**

| Crop                  | 2004-05 |        | 2005-06 |         |
|-----------------------|---------|--------|---------|---------|
|                       | Targets | Actual | Targets | Actual* |
| Cotton (mln bales)    | 10.72   | 14.6   | 15.0**  | 12.53   |
| Sugarcane (mln tones) | 50.9    | 47.2   | 50.1    | 45.9    |
| Rice (000 tones)      | 5114    | 5025   | 5000    | 5136    |
| Maize (000 tones)     | 2770    | 2774   | 2905    | 2983    |
| Wheat (mln tones)     | 20.2    | 21.6   | 22      | -       |

(\*) Initial estimates.  
(\*\*) The revised target is 12.5 million bales.  
Source: MINFAL

The other two major *kharif* crops, rice and maize, have performed quite well during FY06, with the production of both exceeding the annual targets.

<sup>2</sup> The offer of prices by sugar mills were lower than the government's announced prices for the last two years coupled with delayed payments have probably discouraged farmers.

<sup>3</sup> Unlike sugarcane which is essentially a tropical grass and best suited for tropical rainy climate, oilseed crops are well adapted for temperate regions and can tolerate high temperatures. In addition, growers do not have to wait extended periods for the payment of their crops, as is the case with sugarcane.

Interestingly, while the per *hectare* yield of maize did not see any change, rice yield rose by 1.8 percent during FY06, probably helped by the improved water availability relative to *Kharif* FY05, as well as an increase in the support prices.<sup>4</sup> However, the recent fall in the prices of rice would adversely affect the income of rice growers and may hurt the growth prospects of this crop in future.

### Fertilizers

The aggregate nutrient off-take witnessed a rise of 11.2 percent YoY during *kharif* FY06 (see **Table 2.3**), as compared to 8.5 percent YoY rise seen in *kharif* FY05.

Interestingly, while the urea off-take increased by 5.7 percent YoY during the period, the off-take of DAP increased at a much faster pace, jumping 21.9 percent YoY despite a sustained increase in prices (see **Figure 2.2**). It is likely that this robust increase was supported by the increased confidence of growers (due to increased water availability and good prices) as well as the ready access to agri-credit.

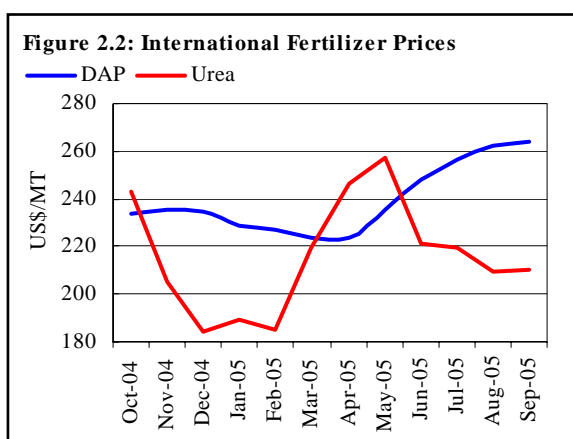
As the capacity utilization in the domestic fertilizer industry is already over 100 percent and demand remains strong, the import of fertilizers increased in FY06. This trend is expected to persist through rest of the year.

It is estimated that total imports of urea and DAP would be 388 thousand nutrient tons and 420 thousand nutrient tons respectively during *rabi* FY06. ECC has also

**Table 2.3: Cumulative Fertilizer Off-take during Kharif**

| 000' nutrient tones    |             |             |                |
|------------------------|-------------|-------------|----------------|
|                        | FY05        | FY06        | percent change |
| Nitrogen               | 1287        | 1385        | 7.6            |
| Phosphate              | 329         | 402         | 22.2           |
| Potash                 | 10          | 21          | 110.0          |
| <b>Total nutrients</b> | <b>1626</b> | <b>1808</b> | <b>11.2</b>    |
| Urea                   | 2404        | 2540        | 5.7            |
| DAP                    | 534         | 651         | 21.9           |

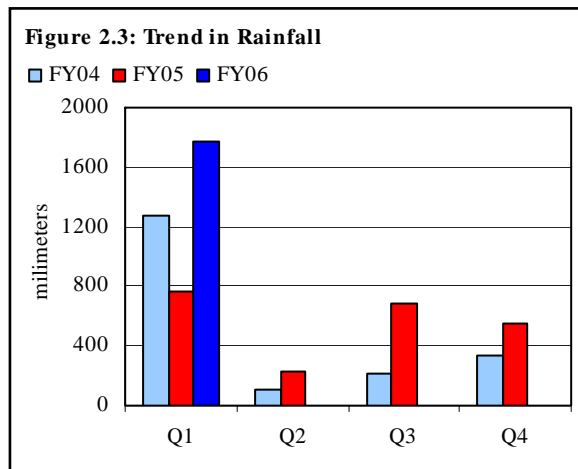
Source: National Fertilizer Development Centre (NFDC)



<sup>4</sup> Support prices for cotton has been raised from Rs 925 in 2004-05 to Rs. 975 for 2005-06, showing an increase of 5.0 percent. Similarly, the support prices for rice depicted an increase of 11.0 percent on average, which helped in accelerating the production of the crop.

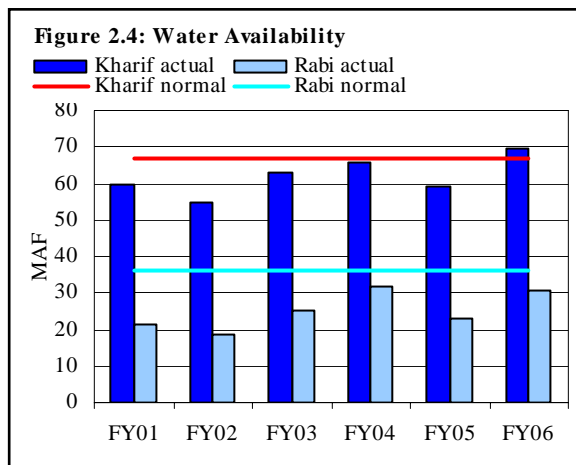
allowed an additional import of 200 thousand nutrient tons of urea during *rabi* FY06 to keep check on prices by ensuring smooth supply and to avoid speculative trade. A total of 312 thousand nutrient tons of fertilizer has already been imported by September 2005. As a result, total urea availability is likely to be 2820 thousand nutrient tones for *rabi* FY06, as against an estimated urea consumption of about 2760 thousand tones. However, timely imports would be crucial to avoid possible shortages in December and January FY06.

At face value, the total availability of DAP at 841 nutrient thousand tons<sup>5</sup> during *rabi* FY06 seems quite substantial. However, it is only 19.3 percent higher than the offtake during *rabi* FY05, and the trend demand growth in recent years continues, the industry may require additional imports for the FY06 *rabi* season.



**Water availability**

As a result of heavy rains and snowfall, water availability during *kharif* FY06 was not only 18.1 percent higher than in *kharif* FY05, it reached above normal levels for the first time in six years (see **Figure 2.3**).<sup>6</sup> However, the picture is not so positive for *rabi* FY06. Although the heavy rains in Q1-FY06 has raised the estimated water availability for *rabi* FY06 by



<sup>5</sup> The opening balance of DAP is estimated at 226 thousand nutrient tons for the *rabi* FY06 season, domestic production is likely to be 195 thousand nutrient tons. Moreover, DAP imports indicated by NFDC is about 420 thousand nutrient tons.

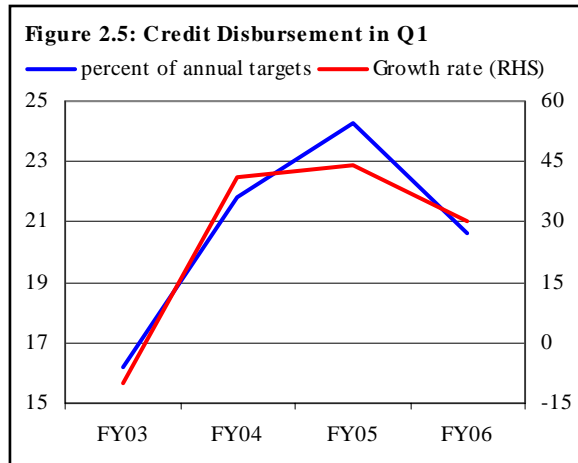
<sup>6</sup> Normal availability is the average water availability during 1996-2000 that is 103.5 MAF or the agreed availability of 103.6 MAF mentioned in the 1991 water accord.

32.8 percent YoY, it will nonetheless remain 15.8 percent lower than normal levels (see **Figure 2.4**).

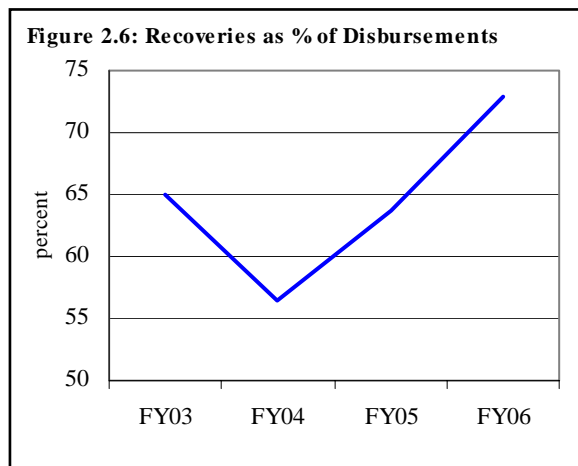
### Agriculture Credit

The above-target agri credit disbursement of Rs 108.6 billion during FY05 provided the base to set a record Rs 130 billion target for FY06.

However, the growth in agri-credit disbursement has slowed in FY06, pushing down the Q1-FY06 disbursement as percent of the annual target to 20.6 percent compared with a corresponding figure of 24.3 percent recorded in Q1-FY05, but it nonetheless remains a very robust 30.0 percent YoY (see **Figure 2.5**).



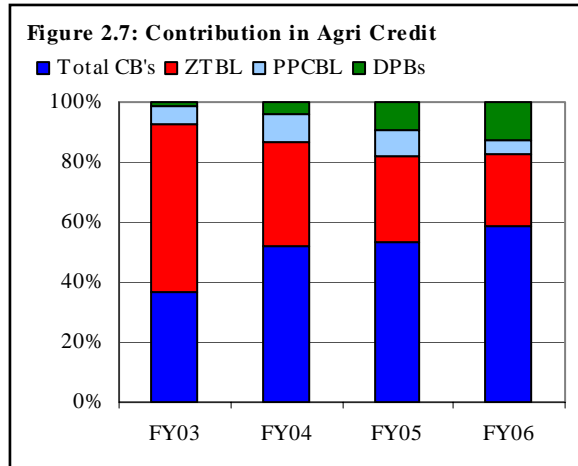
Also, quite encouragingly, the growth in recoveries is substantially higher than the growth in disbursements. As a result, the ratio of recovery-to-disbursement ratio rose sharply to 72.9 percent during Q1-FY06 compared with 63.7 percent in Q1-FY05 ( see **Figure 2.6**). This improvement in recovery is expected to encourage banks to increase their agri credit operations in years ahead.



A possible reason for the rise in the recovery ratio is the increase in the share of commercial banks in the agri-credit market. A glance at **Figure 2.7** shows that the share of big five commercial banks (B5) and Domestic Private banks (DPBs) is increasing whereas that of specialized institutions (ZTBL and PPCBL) is declining.

Within the B5, National Bank of Pakistan and Habib Bank Limited are the major contributors with an over two-third of the total agri-credit disbursement in Q1-

FY06. Interestingly, the share of HBL increased during Q1-FY06, whereas the share of other banks either declined or remained unchanged. Amongst the DPBs, the share of three banks (Bank of Punjab, Bank Al-Falah and Askari Bank) in agri credit disbursement is a dominant 81 percent. This is mainly due to their aggressive marketing and introduction of innovative products.



### Tractor Financing

The amount disbursed for tractor financing exhibited a rise of 15.3 percent YoY during Q1-FY06 compared with an 11.1 percent YoY rise in Q1-FY05. The B5 banks and ZTBL together accounted for approximately 89 percent of the total tractor financing during Q1-FY06.

### Outlook for Rabi FY06

The latest available estimates<sup>7</sup> indicate that, so far, wheat cultivation has been completed on an area of 6.2 million hectares, which represents 74 percent of the FY06 target, and is 0.9 percent lower than that achieved in the corresponding period of FY05 (see **Table 2.4**).

**Table 2.4: Area Under Cultivation**  
thousand hectares

|                | Punjab | Sindh | NWFP | Balochistan | Total |
|----------------|--------|-------|------|-------------|-------|
| FY04           | 6256   | 878   | 742  | 335         | 8210  |
| FY05           | 6379   | 887   | 767  | 326         | 8359  |
| FY06 T         | 6403   | 900   | 767  | 345         | 8415  |
| FY05 Dec.      | 5034   | 373   | 667  | 205         | 6279  |
| FY06 Dec.      | 4975   | 421   | 621  | 205         | 6222  |
| percent change | -1.2   | 12.9  | -6.9 | 0.0         | -0.9  |

T=Target.

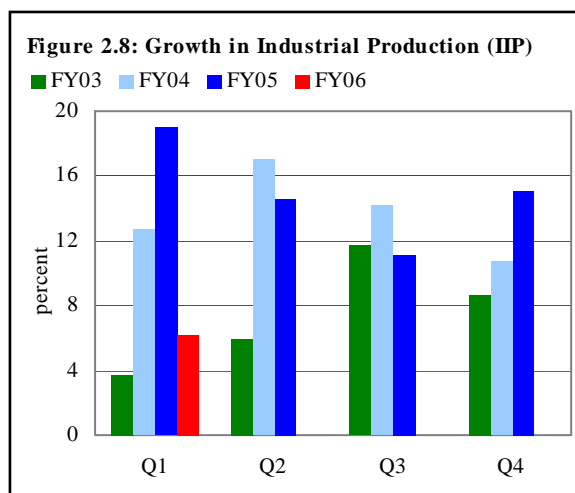
While Sindh recorded an increase of 12.9 percent in the area under wheat, this was offset by the Punjab and NWFP, which recorded declines of 1.2 and 6.9 percent YoY respectively. Late cotton picking, slow harvesting of rice and slow sugarcane lifting are the main reasons for the slowdown in wheat sowing in the Punjab. On the other hand, the shortfall in the NWFP may be attributed to the chaos caused by the earthquake that hit the region in October 2005. However, all in all, it is likely that the marginal decline in the areas under wheat may not threaten the prospects of the

<sup>7</sup> As of December 3, 2005.

wheat crop, given the likelihood of adequate fertilizer availability, the timely announcement of support prices, ample agricultural credit and improved water availability.

## 2.2 Industrial Production<sup>8</sup>

The *Index of Industrial Production (IIP)*<sup>9</sup>, indicates that industrial growth weakened during Q1-FY06, registering a single digit growth of 6.1 percent, in contrast to the 19.0 percent growth witnessed during Q1-FY05. In fact, the Q1-FY06 industrial growth indicated by the IIP is not only lower than the 9.6 percent target for the year, it is the lowest quarterly growth since Q2-FY03 (see **Figure 2.8**).



The slowdown in the Q1-FY06 individual growth rate was visible in all three sub-sectors of the IIP i.e. *LSM*, *electricity generation* and *mining & quarrying*, but the biggest contribution was from *LSM*. This was caused by a number of factors, including a high base effect, capacity constraints, etc. (for details see **Section on capacity utilization**).

Similarly, the deceleration in *mining & quarrying* was mainly the result of weak production of gas & coal as well as a reduction in crude oil production, which declined by 1.1 percent in the first quarter of FY06 as compared with a 5.0 percent growth during the same period of FY05. Finally, *electricity generation* sub-sector recorded a lower growth of 0.9 percent YoY in Q1-FY06 as against a 5.4 percent YoY growth during the first three months of FY05. The slowdown in electricity generation is, however, puzzling given that the overall *electricity generation* by WAPDA rose by 9.4 percent<sup>10</sup> YoY during the Q1-FY06 as compared to the

<sup>8</sup> This analysis is based on the provisional data on *large scale manufacturing (LSM)* supplied by the Federal Bureau of Statistics.

<sup>9</sup> IIP is used as a proxy for industry to estimate the industrial production.

<sup>10</sup> Though, data on electricity generation by KESC are not available, its sale figures indicate a rise of 9.9 percent during Q1-FY06.

corresponding period of previous year. While during Q1-FY06 the thermal generation decreased by 8.1 percent YoY, hydel generation witnessed a significant rise of 31.8 percent YoY, reflecting the improved water situation in the country.

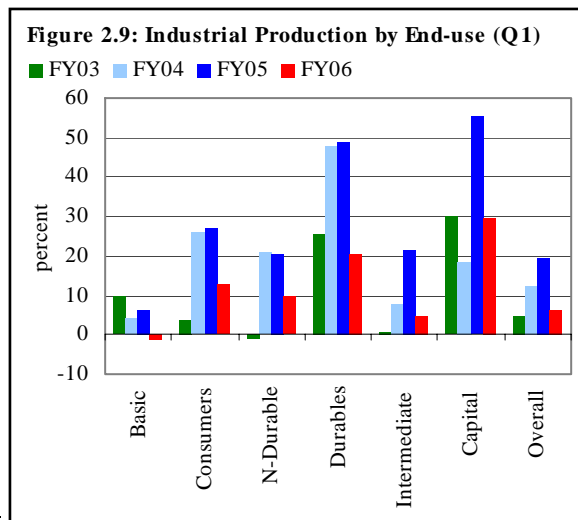
### Infrastructure Industries<sup>11</sup>

The Index of Infrastructure Industries output, a combination of seven industrial sub-sectors, registered a 0.9 percent fall during Q1-FY06 as against a rise of 9.8 percent during the corresponding period of the previous fiscal year (see **Table 2.5**). Though, all sub-sectors of infrastructure industries exhibited a lower growth in Q1-FY06, the trend reversal is mainly attributed to a sharp decline of 57 percent YoY in the basic metal industries.<sup>12</sup>

| Industries     | FY05       | FY06        |
|----------------|------------|-------------|
| Power          | 5.4        | 0.9         |
| Natural gas    | 20.7       | 2.7         |
| Crude oil      | 5.0        | -1.1        |
| Coal           | 17.3       | 4.5         |
| Basic metals   | -0.2       | -57.0       |
| Cement         | 17.2       | 14.6        |
| Petroleum      | 17.2       | 1.3         |
| <b>Overall</b> | <b>9.8</b> | <b>-0.9</b> |

### Analysis of Industries by End-Use (UBQI)<sup>13</sup>

During Q1-FY06, the User Based Quantum Index (UBQI) recorded a growth of 6.5 percent YoY growth, which is significantly lower than the 19.3 percent growth registered during Q1-FY05 (see **Figure 2.9**). The weakness in the various sub-indices of the UBQI reflects the trend seen in the *LSM* and *mining & quarrying* sub-sectors. While *consumer goods*, *intermediate*



<sup>11</sup> The infrastructure industries comprise of power, coal, gas, metal, cement, crude oil and petroleum industries. These industries are almost 26 percent of the total industrial sector in Pakistan. This index is a leading indicator.

<sup>12</sup> The decline in the production of Pakistan Steel was due to problems with the function of one of the blast furnaces and coke-oven batteries.

<sup>13</sup> The UBQI covers about 62 percent of the industrial sector, with basic goods, consumer goods (durable & non-durables) and the capital goods.

*goods* and *capital goods* sub-indices recorded a deceleration in growth, the *basic goods* recorded a fall in output. The major reasons for the decline in the production of basic goods industries were the slowdown in electricity generation and a fall in the production of crude oil and coke.

Within *consumer goods*, the growth in the production of *non-durables* decelerated to 9.6 percent YoY in Q1-FY06, compared to the 20.4 percent YoY growth in Q1-FY05. While production growth accelerated in a number of these industries such as *vegetable ghee*, *tea (blended)*, *beverages* and *pharmaceuticals*, the impact of this was offset by the significantly slower growth in the remaining industries (that account for 60 percent weight in *consumer non-durables*). While the growth in the production of *consumer durables* also fell sharply from the exceptional 48.8 percent in Q1-FY05, it nonetheless remained very strong at 20.6 percent YoY during Q1-FY06. The major drivers for the low growth in the production of *consumer durables* were deceleration in the production of *electronics & automobiles* sub-sectors (probably due to a high-base) and decline in the production of *rubber industry* during Q1-FY06 (in aggregate, these industries have an aggregate weight of approximately 86 percent in the *consumer durables* sub-index).

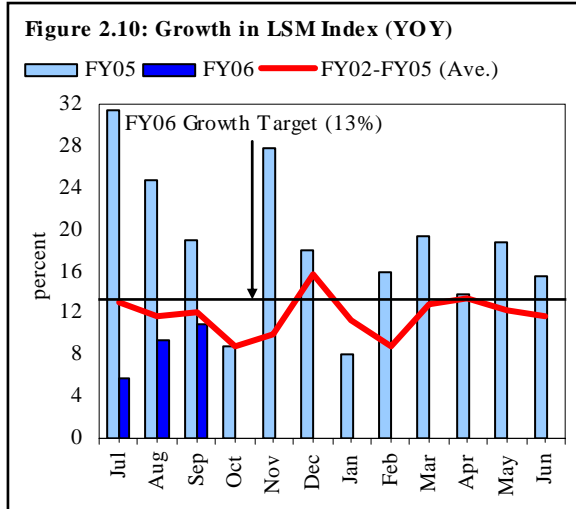
The *intermediate goods* industry recorded a modest growth of 4.8 percent during Q1-FY06 as compared with 21.2 percent YoY growth seen during the first quarter of FY05. The deceleration was mainly due to the fall in the production of *iron & steel* as well as slower production growth in *textiles*, *chemicals* and *fertilizers* (the latter industry faces capacity constraints in increasing the production of urea).

The *capital goods* production recorded a 29.7 percent YoY growth during Q1-FY06 mainly due to the continued demand for *trucks*, *electric meters*, *electric motors* and *engineering goods*. While this growth is substantially lower than the 55.6 percent recorded in Q1-FY05, it must be noted that the latter is higher only because of the low production base in FY04.

#### **Large Scale Manufacturing (LSM)**

During Q1-FY06 LSM grew by 8.7 percent, substantially lower than 24.9 percent YoY growth recorded during the corresponding period of FY05, and also well below the average for FY02-05 (see **Figure 2.10**). While the deceleration in LSM growth is not unexpected, given the high base set by the exceptional FY05 performance and capacity constraints faced by some industries, the Q1-FY06 is a source of some disquiet as it is far below the 13 percent YoY annual growth target. LSM performance will have to improve substantially in the succeeding quarters if this target is to be met.

As seen in **Table 2.6 & 2.7** the deceleration in LSM growth is quite broad-based. While a majority of sub-sectors (accounting for 54.0 percent of the LSM) had seen growth accelerate in Q1-FY05, growth in a majority of sub-sectors (with a dominant share of 83.8 percent) has decelerated in Q1-FY06. This picture is reinforced by the distribution of the growth rates as well. In particular, the number of sub-sectors witnessing growth in excess of 10 percent has fallen from 11 (with 84.8 percent share in LSM) in Q1-FY05 to 8 (with a 26.5 percent share in LSM) in Q1-FY06.



**Table 2.6: Growth Performance of Selected Industrial Groups (Q1)**

| FY06                   |                             |                    | FY05                   |                             |                   |
|------------------------|-----------------------------|--------------------|------------------------|-----------------------------|-------------------|
| Acceleration in growth | Deceleration in growth      | Decline in growth  | Acceleration in growth | Deceleration in growth      | Decline in growth |
| 1 Leather              | 1 Textile                   | 1 Tyres & tubes    | 1 Textile              | 1 Food, beverages & tobacco | 1 Leather         |
| 2 Paper & board        | 2 Food, beverages & tobacco | 2 Metal industries | 2 Petroleum            | 2 Pharmaceuticals           |                   |
| 3 Engineering          | 3 Petroleum                 |                    | 3 Fertilizers          | 3 Chemicals                 |                   |
| 4 Pharmaceuticals      | 4 Chemicals                 |                    | 4 Electronics          | 4 Automobile                |                   |
|                        | 5 Automobile                |                    | 5 Engineering          | 5 Metal industries          |                   |
|                        | 6 Fertilizers               |                    | 6 Tyres & tubes        | 6 Paper & board             |                   |
|                        | 7 Electronics               |                    | 7 Wood                 |                             |                   |
|                        | 8 Non metallic              |                    | 8 Non metallic         |                             |                   |
|                        | 9 Wood                      |                    |                        |                             |                   |

One of the stronger contributions to the deceleration in LSM growth is from the textile sector. During Q1-FY06, the textile sub-sector recorded 7.2 percent YoY growth as against 29.6 percent YoY growth in Q1-FY05. A part of this fall in the Q1-FY06 growth rate reflects a base effect of the exceptional Q1-FY05 growth, and this impact is compounded by the smaller FY06 cotton crop. This is particularly visible in the cotton ginning industry where growth slowed from a robust 45.3 percent YoY in Q1-FY05 to a mere 2.8 percent YoY in Q1-FY06 (see **Table 2.8**).

**Table 2.7: Distribution of Sectoral Growth Rates (Q1)**

| number | Distribution of Sectoral Growth Rates (Q1) |      |       |        |        |               |
|--------|--|------|-------|--------|--------|---------------|
|        | (-ve)                                      | 0-5% | 5-10% | 10-15% | 15-20% | 20% and above |
| FY02   | 3  | 5    | 2     | 1      | 1      | 3             |
| FY03   | 4  | 3    | 1     | 4      | 0      | 3             |
| FY04   | 1  | 1    | 2     | 2      | 3      | 6             |
| FY05   | 1  | 3    | 0     | 3      | 3      | 5             |
| FY06   | 2  | 1    | 4     | 2      | 4      | 2             |

**Table 2.8: Textile Production (Q1)**

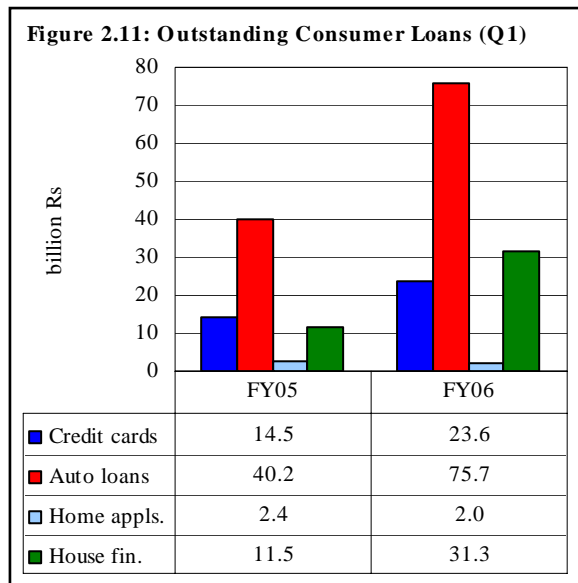
| Items                | Units        | Weights in LSM | FY04  | FY05  | FY06  | Growth rate |      |
|----------------------|--------------|----------------|-------|-------|-------|-------------|------|
| Cotton yarn          | 000' Tonnes  | 13.1           | 487.0 | 570.5 | 622.6 | 17.1        | 9.1  |
| Cotton cloth         | million Sq.m | 7.5            | 159.5 | 229.9 | 244.1 | 44.1        | 6.2  |
| Cotton (ginned)      | 000' Tonnes  | 3.4            | 427   | 621   | 638   | 45.3        | 2.8  |
| Woolen & carpet yarn | Tonnes       | 0.3            | 647   | 628   | 718   | -2.9        | 14.3 |
| Jute goods (total)   | 000' Tonnes  | 0.2            | 24.3  | 25.8  | 25.0  | 6.0         | -4.6 |
| Knitting wool        | Tonnes       | 0.0            | 899   | 843   | 850   | -6.2        | 0.8  |

Encouragingly however, textile exports continue to perform well, with strong increases in the quantum of exports compensating for lower prices to push up the value of textile exports during Q1-FY06 by 23.8 percent YoY against a modest 1.5 percent growth in the first quarter of FY05. It is particularly heartening to note that this growth has been achieved despite significant challenges faced by exporters, including rising financial costs, loss of preferential access, etc. Clearly, the domestic textile industry has benefited somewhat from the end of exports quotas in the post-MFA period (i.e. January 2005 onwards), raising hopes that the performance of the sector will improve in succeeding quarters.

As with textiles, the automobile sector also witnessed a deceleration in growth. During Q1-FY06, the sectoral growth fell to 32.3 percent YoY, down sharply from the 40.2 percent YoY increase seen in Q1-FY05. However, even this lower growth was amongst the strongest for any LSM sector in FY06.

The remarkable growth of automobile sub-sector is driven by both, rising demand and increased supply. The continuing demand is led by the availability of credit (particularly supporting car sales and tractors), and strength of the domestic economy (supporting the sales of trucks and buses), while rising supply mirror increased investment in the preceding years.

- Though, auto financing extended during Q1-FY06 at Rs 9.8 billion is considerably lower than Rs 12.4 billion in Q1-FY05, auto-financing continues to play a major role in the growth of automobile sub-sector (see **Figure 2.11**).
- Indeed, although auto manufacturers expand production capacity<sup>14</sup>, capacity utilization nonetheless rose by an impressive 16.1 percentage points in Q1-FY06.



Within the automobiles sector, the production of trucks saw a remarkable 165 percent YoY growth during Q1-FY06 as against a decline of 12.9 percent in the first quarter of the preceding year. The reason for this extraordinary growth of trucks was the initiative of the production line of Dong Feng trucks by Sindh Engineering (Pvt) Limited. Similarly, the production of light commercial vehicles (LCV) witnessed growth of more than 58 percent YoY in Q1-FY06, as compared with 84.9 percent YoY growth during Q1-FY05. The high growth rates in both years reflect the increasing production by two new entrants, capacity expansions by incumbent producers, as well as the availability of bank credit for purchases.

Similarly the growth in the output of *cars & jeeps*, though decelerated, was a robust 29.5 percent YoY in Q1-FY06 as compared with a growth of 36.4 percent YoY during the same period of FY05. Interestingly, during the last three years the

<sup>14</sup> During Q1-FY06, the industry attracted FDI of US\$ 8.1 million.

share of high engine capacity cars (1000cc and above) in total sales rose from 39 percent to 44 percent. The production of *motorcycle & auto rickshaw* industry was also strong, rising by 29.4 percent YoY in Q1-FY06 as against 51.6 percent YoY in the first quarter of the preceding year. The expansion in production capacity by one manufacturer of cars and one in motorcycle & auto rickshaw was the main contributing factors for these growths.<sup>15</sup>

As in the *automobiles* sector, consumer financing continued to play an important role in the demand for *electronics products*. Production registered an increase of 9.8 percent YoY during Q1-FY06 as against a significant 71.3 percent YoY increase in Q1-FY05. This lower growth is a function of high base effect, and possibly weaker demand following rising interest rates.

The leather products sub-sector witnessed a 17.9 percent remarkable growth rate during Q1-FY06 in contrast with a decline of 8.8 percent in first three months of last year. This performance was the outcome of the fulfillment of demand of the manufacturers-cum-exporters of leather products for the levy of a 20 percent export duty on the raw-hides and skins of web blue leather.<sup>16</sup> This levy increased availability of raw material at lower cost, and improved the export competitiveness of the industry. This is reflected in a 40.9 percent rise in leather exports during Q1-FY06 compared with 4.6 percent YoY growth in exports during the same period last year. The production of leather footwear, leather sole and upper leather registered a quick turnaround from a decline of 16.2 percent, 10.0 percent and 6.6 percent in Q1-FY05 to a growth of 18.6 percent, 11.1 percent and 19.9 percent YoY respectively during Q1-FY06.

The production of *food, beverages & tobacco* group, witnessed considerable growth on account of the acceleration in the production of *vegetable ghee, blended tea and beverages* sub-sectors, which have a 33.7 percent share in the *food* group. During Q1-FY06 food sub-sector recorded 10.0 percent YoY growth as compared with a 13.5 percent YoY in Q1-FY05. Within the *food group*, the *vegetable ghee* industry registered 12.2 percent growth in Q1-FY06 as against a modest growth of 5.8 percent in Q1-FY05. The main reason for the growth in the production of

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<sup>15</sup> Indus Motors Company Limited and Pakistan Cycle Industrial Cooperative Society Limited (Sohrab) made expansion in production capacity of cars and motorcycles by 16000 and 18000 units respectively.

<sup>16</sup> Government had provided many incentives to the *leather* industry, which would help exporters to export more leather & leather-made goods; (1) removal of sales tax on leather exports, (2) reduction in income tax from 6 percent to 1 percent, and (3) cut the customs duties on the import of 95 percent of the chemicals used as raw material by leather goods' manufacturers.

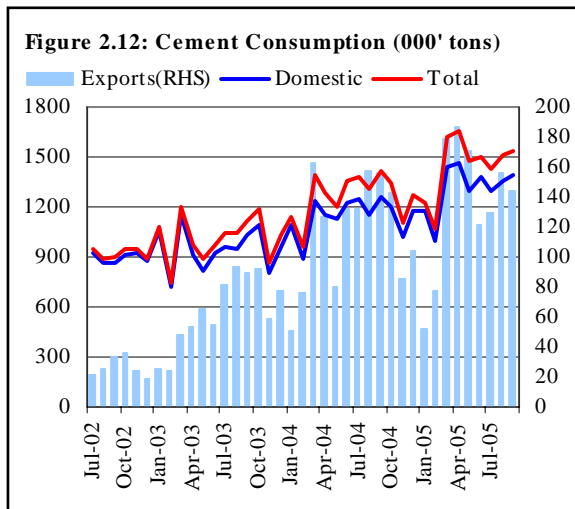
vegetable ghee was a rise in the exports to Afghanistan, which increased by 7.8 percent YoY during the first three months of FY06. Amongst the food sub-sector, the weakest growth was observed in cigarettes industry with 0.5 percent YoY growth during Q1-FY06 in contrast with 8.1 percent YoY growth in Q1-FY05, The deceleration in tobacco industry was largely attributed to decline in the external demand for *tobacco* and *cigarettes*, which fell by 65.6 percent YoY during the first quarter of current fiscal year.

**Table 2.9: Construction--Performance Indicators(Q1)**

|   | Unit           | FY02 | FY03 | FY04 | FY05 | FY06 |
|---|----------------|------|------|------|------|------|
| Cement production                         | 000' tons      | 2438 | 2607 | 3061 | 3587 | 4111 |
| Production of steel (Pakistan Steel)      | 000' tons      | 222  | 250  | 256  | 271  | 93   |
| Import of iron & steel                    | 000' MT        | 425  | 317  | 416  | 708  | 863  |
| Import of construction & mining machinery | billion Rupees | 2.3  | 1.5  | 1.7  | 2.1  | 2.0  |
| Private credit for construction           | billion Rupees | 27.4 | 12.9 | 15.0 | 20.8 | 34.4 |
| Public sector development programm        | billion Rupees | 10.7 | 14.6 | 24.9 | 32.0 | 50.7 |

Construction-related industries such as *cement*, *paints & varnishes*, *wood*, *iron & steel* etc. exhibited a mix picture during Q1-FY06, as can be seen from **Table 2.9**.

The cement industry recorded a 14.6 percent YoY growth in Q1-FY06, which was less than 17.2 percent YoY growth during Q1-FY05 (see **Figure 2.12**). The local cement dispatches reached at 4.5 million tons during Q1-FY06 indicating a growth of 10.8 percent YoY compared to a 23.7 percent YoY growth of Q1-FY05. In contrast, exports of cement fell to 0.43 million tons, down by 3.4 percent YoY, despite a rise in exports to Afghanistan.



The rise in the production of *iron & steel* sub-group derived from the activities in *construction* as well as from the *automobiles* sub-sector. In Q1-FY06, the demand was met by 21.9 percent YoY rise in imports of *iron & steel* followed by a decline

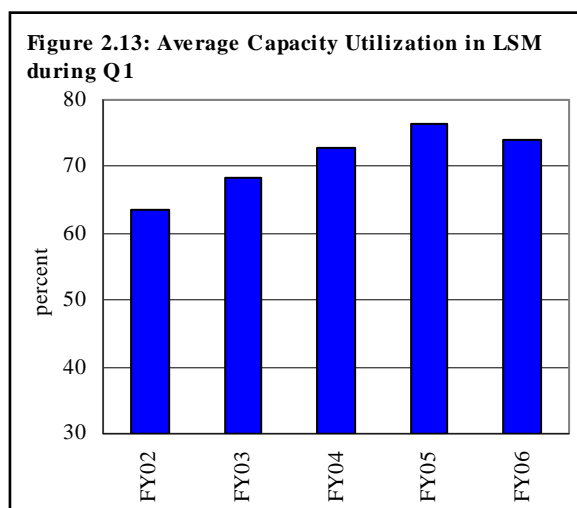
in domestic production of metal industry by 62.1 percent. In contrast, the *paints & varnishes* industry witnessed a growth of 38.7 percent during Q1-FY06, slightly higher than 34.2 percent growth in the same period of the preceding year.

The *engineering* sub-sector has shown consistent acceleration in growth during the first quarter of the last three years from 13.6 percent in Q1-FY04 to 35.4 percent in Q1-FY06. This remarkable growth was attributed to rise in the production of *capital goods* such as *diesel engines, sugarcane machines, sewing machines, shuttles & bobbins* and *wheat thrashers*, which contributed more than 63 percent production in the engineering group. Within the engineering sub-sector, production of *diesel engine* recorded the extraordinary 98.1 percent growth during the first quarter of the current fiscal year as compared to 41.8 percent rise in Q1-FY05, mainly due to higher income of farmers and easier access to agri credit. The growth in *sewing machines* (18.2 percent) and *shuttles & bobbins* (19.4 percent) was attributed to 23.6 percent rise in the exports of *textile* sector especially of *readymade garments* (with 113.8 percent growth in external demand).

*Pharmaceutical* is another sub-sector that witnessed 15.7 percent growth during Q1-FY06 as against a modest growth of 2.1 percent in Q1-FY05 and also significantly higher than the 5.4 percent average growth during Q1-FY02-Q1-FY05. The rise in *pharmaceuticals* group came from the acceleration in almost all of its components on the back of rise in exports of *pharmaceuticals & chemical*<sup>17</sup> products..

### Capacity Utilization in LSM

Apparently, the average capacity utilization in LSM declined by 2.3 percentage points during Q1-FY06 as compared with a rise of 3.6 percentage points during the same period of FY05 (see **Figure 2.13**). However, this fall is mainly due to a sharp decline in the capacity utilization by Pakistan Steel. In fact, average capacity utilization in LSM excluding Pakistan Steel witnessed a rise



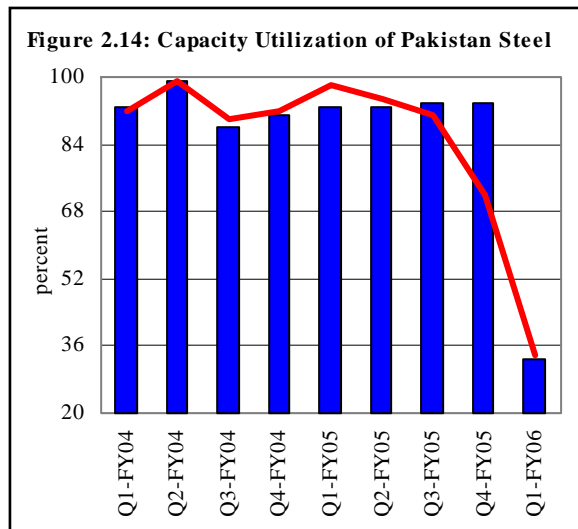
<sup>17</sup> Separate data on exports of these industries for Q1-FY06 is not yet available.

of 4.9 percentage points during Q1-FY06 compared with an increase of 3.0 percent in Q1-FY05. This seems even more impressive given that production capacity enhanced in various industries, reflecting increased investment in recent years (both domestic as well as foreign direct investment).

In particular, despite fresh additional capacity, a remarkable 16.1 percentage point expansion in capacity utilization was observed in the automobiles industry<sup>18</sup> especially in *cars, LCVs and motorcycles* which respectively saw year-on-year increases of 12.8, 32.2, and 13.8 percentage points during the quarter. Capacity utilization in the tractors industry also rose to almost 91 percent by the end of Q1-FY06, and this has attracted considerable attention from investors.<sup>19</sup>

Capacity utilization in the *electronics* industry stood at 26.8 percent during Q1-FY06, marginally higher than that seen in Q1-FY05. However, even this small increase is commendable given that a significant increase in the installed capacity took place during FY05.

During Q1-FY06 the capacity utilization in the *cement* industry fell by 4.5 percentage points to 73.7 percent relative to Q1-FY05. This drop in capacity utilization was due to the expansion in production capacity, on the back of strong domestic as well as external demand.<sup>20</sup>



<sup>18</sup> Indus Motors Company Limited, Pakistan Cycle Industrial Cooperative Society Limited (Sohrab) had made expansion in production capacity, while Adam motor limited and Master motor limited have commenced the production.

<sup>19</sup> With the assistance of investors from Romania and the United States, a local company Universal Tractor Pakistan (Pvt) Limited is setting up a new tractor manufacturing plant at Port Qasim. On completion, this will produce up to 8000 tractors per annum. The government has provided an incentive for new producers by allowing duty free imports of 2500 duty free tractors to new entrants. Three producers are expected to import 7,500 duty-free tractors under this scheme during FY06.

<sup>20</sup> Lucky Cement has begun the long-awaited commercial production of its third line of expansion project Pezu in Bannu Division of NWFP with the production capacity of 2,000 tons per day.

Similarly, *petroleum refinery* industry has also shown 3.5 percentage points decline in the capacity utilization during Q1-FY06 as compared with 7.8 percentage point's increase during the first quarter of previous year mainly due to expansion in production capacity<sup>21</sup> on the back of a 11.9 percent YoY rise in foreign direct investment.

In Q1-FY06, the capacity utilization in Pakistan Steel Mills fell to 34.0 percent, which is 64.6 percentage points less than the capacity utilization during the corresponding period of FY05 (see **Figure 2.14**). The lower capacity utilization was due to the technical problem and outstanding repairable work in operational units, especially in coke oven batteries of the plants. The repairs are expected to be completed soon, ensuring higher capacity utilization in the subsequent quarters.

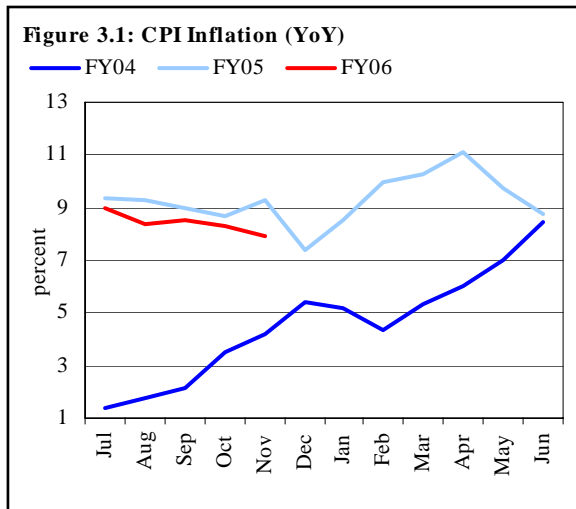
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<sup>21</sup> ENAR has started production in current year.

### 3 Prices

The decline in inflationary pressures that began in the last months of FY05 continued into the first five months of FY06, with CPI inflation (YoY) falling from a peak of 11.1 percent in April 2005 to 7.9 percent in November 2005 (see **Figure 3.1**). Also, while the core inflation,<sup>1</sup> defined as non-food non-energy inflation, did not decelerate, it too is holding steady around an average rate of 7.6 percent during the first five months of FY06.<sup>2</sup> Indeed the stagnancy in core inflation, which appears to incorporate a lagged effect of the monetary tightening initiated late in FY05, and a sharp fall in food inflation (aided by improved supply and supportive government policy) have contributed to the downtrend in CPI inflation.

Interestingly, while marginal CPI and SPI inflation have both decelerated during Jul-Nov FY06, marginal WPI inflation has exhibited a steep rising trend during the same period (see **Table 3.1**).



**Table 3.1: Inflation Trends - (end November)**

| percent    | Marginal inflation (YoY) <sup>1</sup> |             |             |            |
|------------|---------------------------------------|-------------|-------------|------------|
|            | Annualized inflation <sup>2</sup>     |             |             |            |
|            | FY05                                  | FY06        | FY05        | FY06       |
| <b>CPI</b> | <b>9.3</b>                            | <b>7.9</b>  | <b>7.3</b>  | <b>9.0</b> |
| Food       | 13.6                                  | 5.8         | 10.8        | 9.6        |
| Non-food   | 6.3                                   | 9.4         | 5.0         | 8.4        |
| H.rent     | 11.2                                  | 10.8        | 7.8         | 11.7       |
| <b>WPI</b> | <b>5.9</b>                            | <b>10.9</b> | <b>8.9</b>  | <b>8.2</b> |
| Food       | 10.6                                  | 6.4         | 9.9         | 9.3        |
| Non-food   | 2.6                                   | 14.3        | 8.2         | 7.3        |
| <b>SPI</b> | <b>11.1</b>                           | <b>5.4</b>  | <b>11.0</b> | <b>8.9</b> |

1: Change in November 05 over November 04.

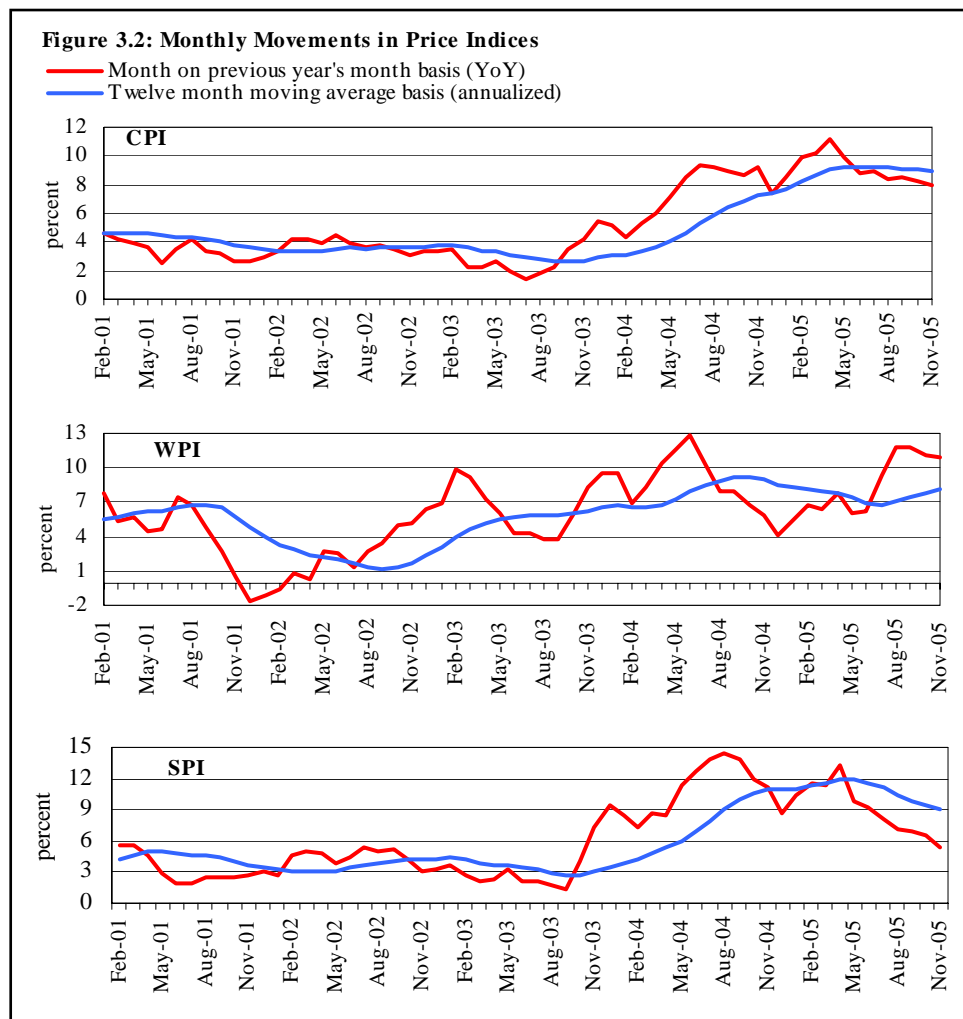
2: Change in 12-month moving averages of Nov. 05 over Nov. 04.

Source: Federal Bureau of Statistics

<sup>1</sup> Core inflation attempts to capture the permanent part of the headline inflation to determine the future course of inflationary pressures in the economy.

<sup>2</sup> See Inflation Monitor, October 2005 for trend in other measures of core inflation.

The divergence between WPI and CPI trends was primarily due to two factors: (1) food inflation, that has driven the rise in CPI inflation during FY05, witnessed a much stronger deceleration in CPI than in WPI during Jul-Nov FY06; and (2) the impact of the lower food inflation on WPI was offset by a sharp rise in the prices of POL (these have a much larger weight in WPI compared to the corresponding CPI weight).



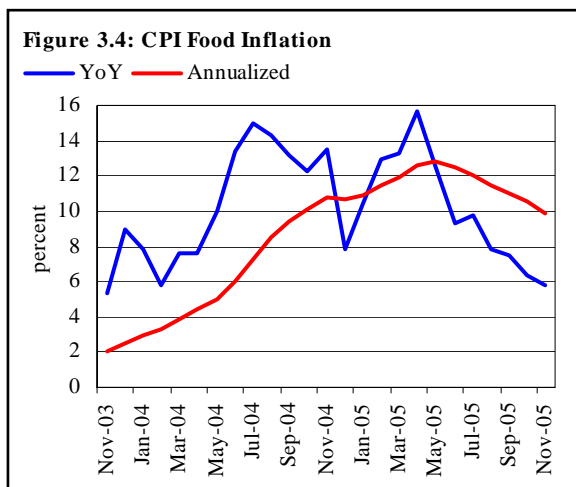
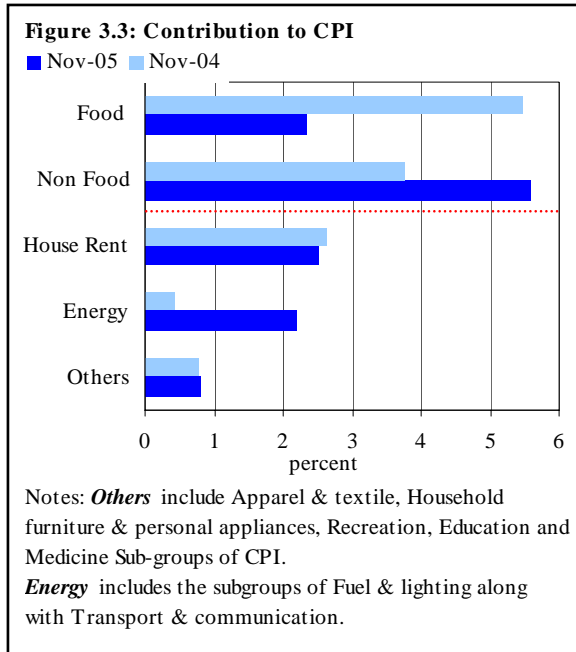
### 3.1 Consumer Price Index

After rising from 8.7 percent in October 2004, marginal (YoY) CPI inflation peaked in April 2005, before dropping to 7.9 percent by November 2005. While

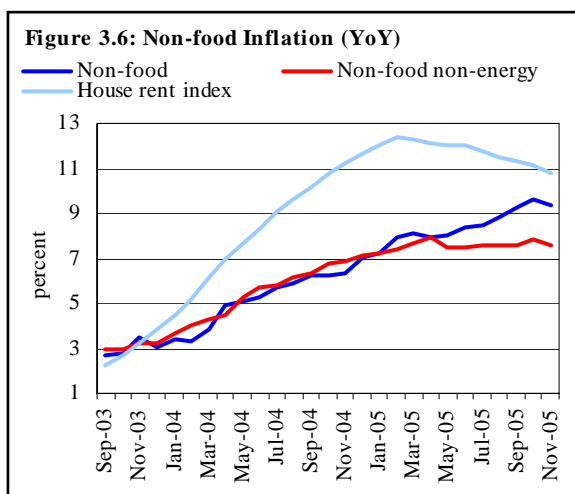
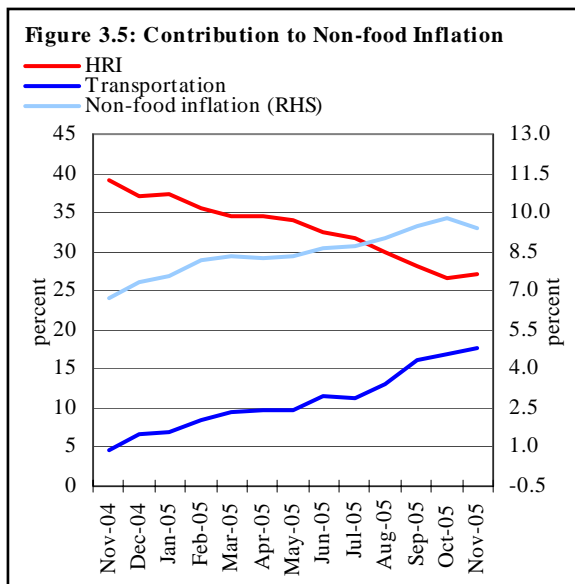
the earlier rise was dominated by rising food inflation, during the first five months of FY06 inflationary pressures were being driven principally from the CPI *non-food* group (see **Figure 3.3**), as food inflation decelerated sharply after mid-April 2005.

A major contribution to the fall in food inflation is from the downward correction in the prices of wheat and its products, alongwith the lower prices for some minor crops (see **Figure 3.4**). The fall in wheat prices reflected the improved supply on the back of the record FY05 wheat harvest compounded with other administrative measures taken by the government (including permission for duty free imports of wheat). The government also allowed imports of sugar and other essential food items, and provided sugar and wheat flour through utility stores at controlled prices.

Besides major crops, prices of the minor crops (fruits & vegetables) that were expected to show some temporary rise during the month of Ramadan, have also weakened during the Jul-Nov FY06 period, which could possibly reflecting effective price control measures by the government during Ramadan, alongwith the subdued demand in the aftermath of the October 2005 earthquake.



On the other hand, as seen throughout FY05, the CPI non-food group inflation also rose steadily during the first five months of FY06. The rise through most of FY05 was due to a persistent rise in HRI inflation. While HRI inflation has decelerated since March 2005, the impact of this has been more than offset by the sharp increases in transportation costs on the back of rising fuel prices (see **Figure 3.5** & **Figure 3.6**). Indeed, the latter has also supported increased inflationary pressures in other sub-groups<sup>3</sup> as well during November 2005. Conscious of this broad impact, the government initially made efforts to contain the rise in domestic fuel prices until December 2004, but the consequent budgetary impact eventually forced the government to pass on a large part of the higher international prices. Even this limited increase resulted in a 22.7 percent YoY inflation in the sub-group of *transportation and communication* during November 2005.



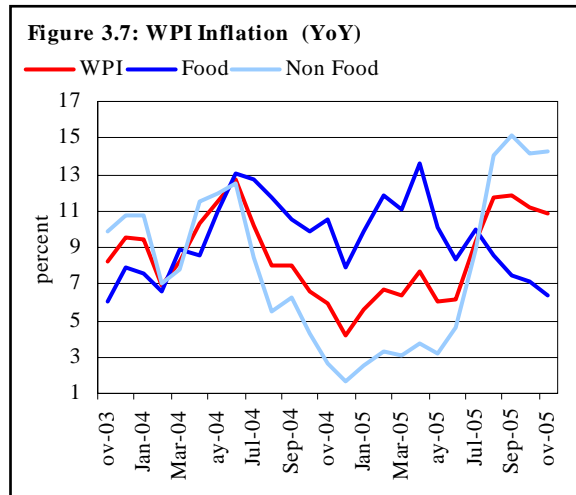
### 3.2 Wholesale Price Index

Despite a sharp deceleration in WPI *food* group inflation, the overall WPI YoY inflation recorded a steep rise but seems to have peaked off at 11.9 percent in

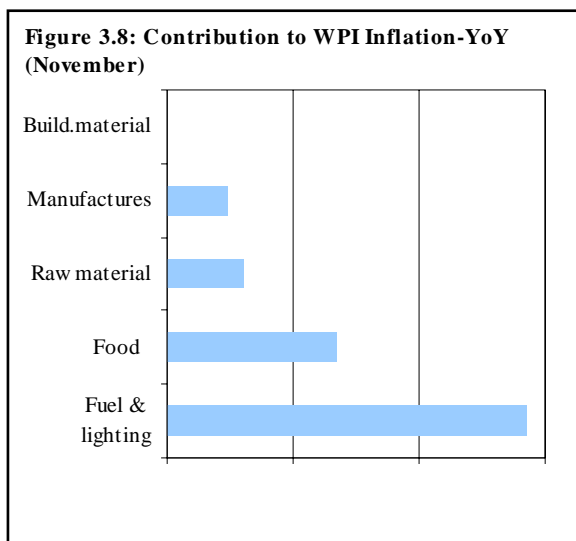
<sup>3</sup> For example, apparel textiles & footwear, fuel & lighting and education.

September 2005, declining in the subsequent two months. As a result, WPI inflation stood at 10.9 percent YoY during November 2005 compared to the 5.9 percent YoY recorded in the corresponding month of 2004 (see **Figure 3.7**).

Although WPI food inflation (YoY) was recorded at 6.4 percent during November 2005, its trend has been declining since April 2005 due to a fall in the prices of key staples such as wheat, pulses, sugar, tomato, onion and potato, resulting from improved supply situation. Prices of vegetable ghee and cooking oil also witnessed deceleration due to the declining price of palm oil in the international market.



In fact, **Figure 3.8** reveals that it was mainly a rise in fuel prices that drove the WPI inflation higher during the initial months of FY06. In particular, furnace oil prices increased by a massive 66.3 percent during Jul-Nov FY06 over the same period last year. Similarly prices of kerosene oil, diesel, and gas also witnessed significant increases during the same period. This resulted in sharp increase in *fuel & lighting* sub-group of WPI, leading WPI non-food inflation YoY to 14.3 percent in November 2005, against the 2.6 percent YoY inflation recorded during November 2004.



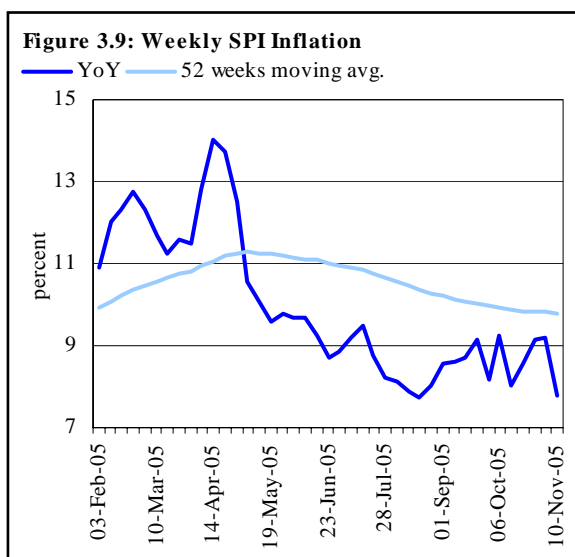
Another contribution to the rise in WPI *non-food* inflation was by the 15.1 percent YoY rise in the *raw material* index of WPI. This sharp rise in the *raw material*

index, on the one hand is due to a low-base effect<sup>4</sup> and on the other, it is attributable to the rise in price of cotton (amid reports that the FY06 crop is likely to be well below target). The latter also had a downstream impact, as the consequent rise on prices of yarn and readymade garments has reversed the downtrend in the WPI *manufactures* sub-index, June 2005 onwards.

Finally, the *building material* sub-index witnessed a moderate inflation of 0.3 percent YoY in November 2005 compared to a sharp increase of 22.7 percent YoY in the corresponding month of last year. This could largely be attributed to the persistent deceleration in sub-indices of iron bars & sheets since March 2005, reflecting the impact of reduced import duty on iron & steel as well as the fall in prices in international market.

### 3.3 Sensitive Price Indicator

The sensitive price indicator (SPI) records the changes in prices of basic essential commodities (mostly kitchen items and some non-food items e.g. petrol and diesel). During November 2005, weekly SPI inflation YoY decelerated further after recording abrupt fluctuations during the first quarter of FY06 (see **Figure 3.9**). Monthly SPI (YoY) witnessed 5.4 percent increase during November as compared to the 11.1 percent YoY rise recorded during the same month last year. The deceleration in SPI inflation could greatly be attributed to the downward correction in prices of wheat and its products in recent months. In addition, the prices of some of the important minor crops, including tomato and onions, also declined during the last few months.



<sup>4</sup> *Raw material* sub-index witnessed a fall of 24.8 percent during November 2004, thus suppress its base for November 2005.

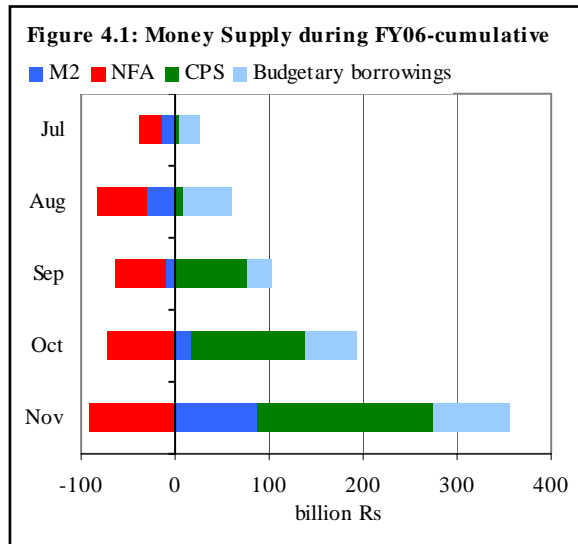
### **3.4 Income Group-wise Inflation**

As a result of the weakening inflationary pressures in the CPI *food* inflation, the higher income group has been recording relatively high inflation as compared to the other income groups during the initial four months of FY06. Year on year inflation for the higher income group (above Rs 12,000 per month) was witnessed at about 9 percent during November 2005, while the remaining income groups (below Rs 12,000 per month) recorded below 8 percent inflation during the same month.

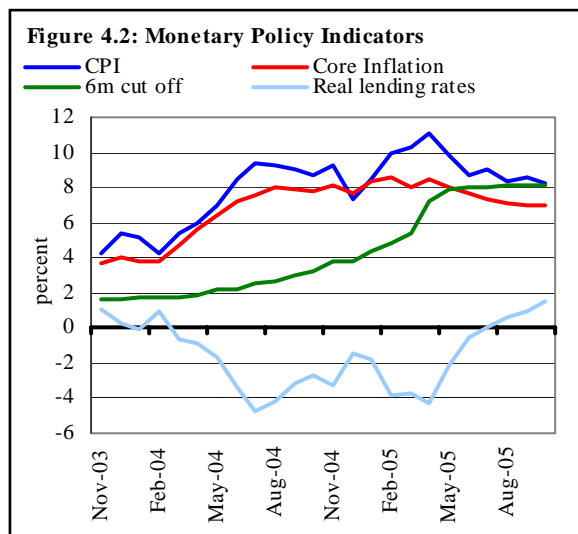
## 4 Money and Banking

### 4.1 Overview

Q1-FY06 witnessed a monetary contraction, with M2 declining 0.35 percent in the period, in contrast to the 1.2 percent increase seen in Q1-FY05 (see **Figure 4.1**). This decline was dominated by a reduction in the NFA of the banking system, reflecting the increasing pressure on the country's external account, as NDA growth was relatively strong due to an increase in government borrowings for budgetary support and strong growth in private sector credit.



The lower growth in M2 together with the fall in CPI inflation from its 11.1 percent peak of April 2005 to 8.5 percent in September 2005, and the end of the steep uptrend in core inflation, together with the anticipated further lagged impact of earlier monetary tightening, were instrumental in SBP's decision to hold interest rates relatively unchanged through Q1-FY06 (see **Figure 4.2**). While keeping benchmark rates unchanged however, the SBP continued with the tight monetary posture by improving its inter-bank liquidity management (see **Figure 4.3**).

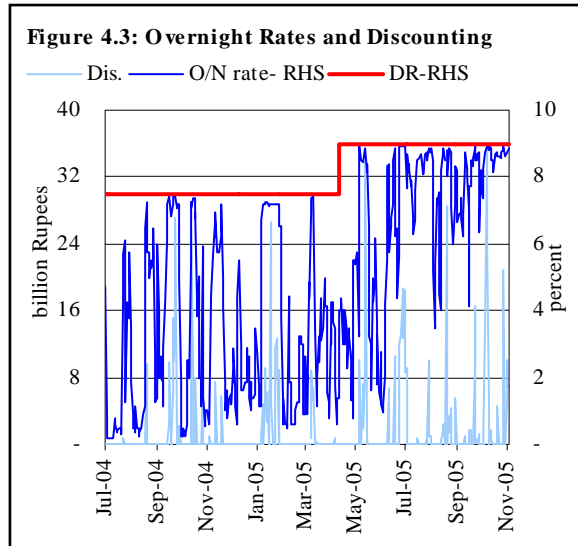


Specifically, despite the negative growth in banks' deposit base and the absorption of Rupee liquidity on account of the substantial SBP forex interventions, the central bank continued with OMO operations to mop up any excess liquidity created as a result of the maturities of government securities.

However, the outlook of the monetary aggregates changed significantly from October 2005 onwards. In particular, private sector credit and

government borrowing from the banking system both began rising strongly, with private sector credit expansion outpacing the monthly credit growth during the corresponding period of FY05<sup>1</sup>. As a result, during July-Nov FY06, the banking sector NDA registered a growth of 7.6 percent compared with the growth of 6.4 percent in the corresponding period of FY05. Indeed, the resulting increase in NDA offset the continuing decline in NFA, and therefore the money supply registered a sharp rise during Oct-Nov FY06, pushing the cumulative M2 growth during July-Nov FY06 to 3.0 percent as compared to the 5.5 percent rise in July-Nov FY05.

Given that the relatively subdued M2 growth in July-Nov FY06 is owed entirely to the sharp drawdown in the net foreign assets, (i.e. domestic demand has not slowed substantially), and the likelihood that this negative trend in NFA would halt or reverse in coming months (due to inflow of earthquake related foreign assistance), the SBP would need to be extremely careful to ensure that money supply growth remains consistent with long-term non-inflationary growth.



<sup>1</sup> During October and November 2005, private sector credit registered a growth of Rs 108.2 billion; compared with the growth of Rs 99.0 billion during October and November 2004.

#### 4.2 Monetary Survey

The money supply recorded a growth of 3.0 percent during Jul-Nov FY06 compared with a robust growth of 5.5 percent in the corresponding period of FY05. This slow growth emanated entirely from a sharp decline in the NFA of the banking system that partially offset the robust growth in NDA during the period.

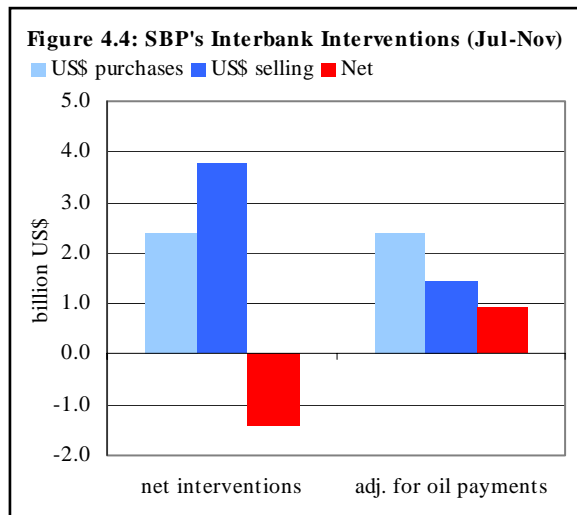
#### 4.3 Net Foreign Assets

Unlike July-Nov FY05, when only the NFA of SBP had declined, the fall in the NFA of the banking system during July-Nov FY06 was visible in both the NFA of the SBP as well as that of the scheduled banks (see **Table 4.1**).

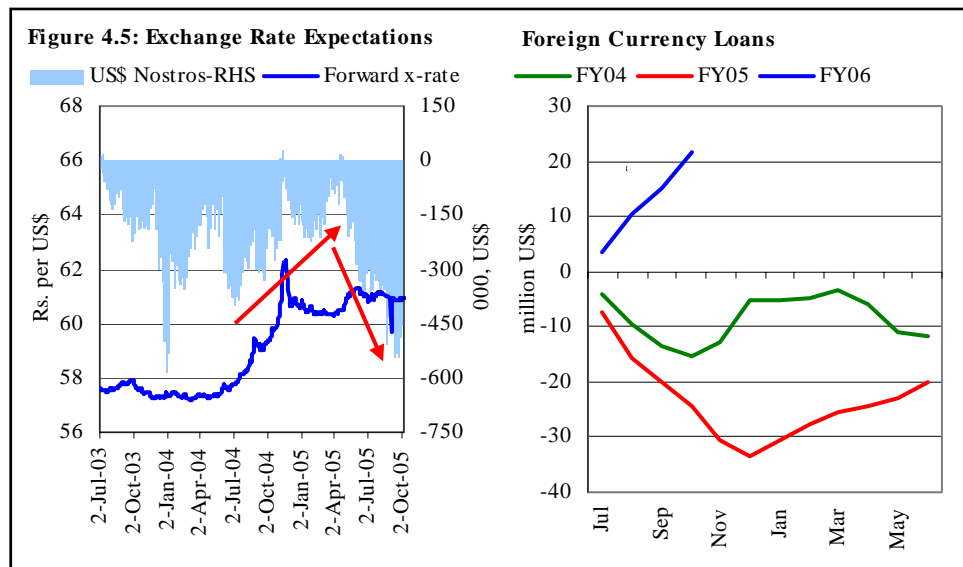
**Table 4.1: Monetary Survey (Flows)**  
in billion Rupees

|                                  | Credit<br>PlanFY06 | Jul-Nov      |              |
|----------------------------------|--------------------|--------------|--------------|
|                                  |                    | FY05         | FY06         |
| <b>Monetary assets</b>           | <b>380.0</b>       | <b>137.2</b> | <b>88.2</b>  |
| <b>Net Foreign Assets (NFA)</b>  | <b>15.0</b>        | <b>15.1</b>  | <b>-90.5</b> |
| SBP                              |                    | -62.6        | -57.0        |
| Scheduled Banks                  |                    | 77.7         | -33.5        |
| <b>Net Domestic Assets (NDA)</b> | <b>365.0</b>       | <b>122.0</b> | <b>178.7</b> |
| SBP                              |                    | 161.9        | 121.3        |
| Scheduled Banks                  |                    | -39.8        | 57.4         |
| <i>of which</i>                  |                    |              |              |
| <b>Government borrowing</b>      | <b>120.0</b>       | <b>45.7</b>  | <b>65.3</b>  |
| <b>budgetary support</b>         | <b>98.0</b>        | <b>42.8</b>  | <b>81.6</b>  |
| SBP                              |                    | 183.3        | 161.0        |
| Scheduled Banks                  |                    | -140.5       | -79.4        |
| <b>Commodity operations</b>      | <b>20.0</b>        | <b>1.3</b>   | <b>-15.5</b> |
| <b>Credit to non-govt sector</b> | <b>320.0</b>       | <b>146.7</b> | <b>182.6</b> |
| Private sector                   | 330.0              | 164.7        | 185.8        |
| PSEs                             | -10.0              | -13.4        | -1.6         |
| <b>Other Items (Net)</b>         | <b>-75.0</b>       | <b>-70.3</b> | <b>-69.2</b> |
| SBP                              |                    | -17.6        | -38.1        |
| Scheduled Banks                  |                    | -52.7        | -31.1        |

The decline in SBP NFA, in both periods, was mainly due to the continuation of the decision to provide foreign exchange to meet large outflows resulting from imports of some key commodities, so as to reduce market volatility. This can be seen from the fact that SBP sold US dollars worth Rs 141.4 billion in the inter bank market only for oil payments. Adjusting for these, it is seen that SBP has actually been a net purchaser of foreign exchange in the inter bank market (see **Figure 4.4**).



Ironically, the relatively stability of the exchange rate due to the SBP's interventions, may have contributed to the decline in the NFA of scheduled banks, by encouraging a sharp rise in foreign currency loans, even as continuing pressure of import payments led to a decline in banks' nostro balances (see **Figure 4.5**). In sharp contrast, during Jul-Nov FY05, the expectations of exchange rate appreciation had led to a rise in FE-25 deposits and had induced the retirement of foreign currency loans.



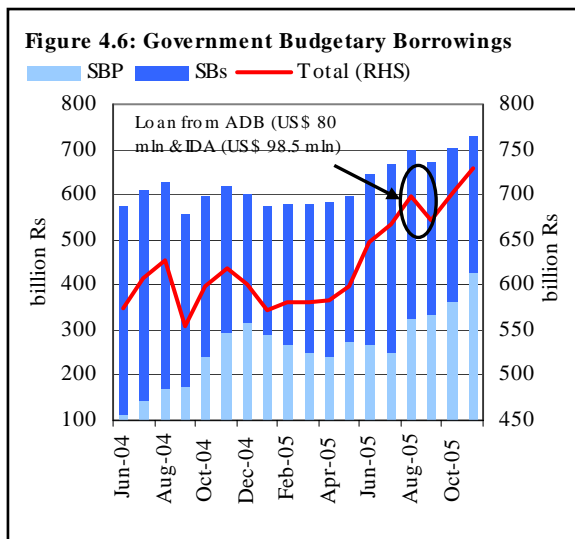
#### 4.4 Net domestic assets-NDA

The NDA of the banking system increased by Rs 178.7 billion during Jul-Nov FY06 compared with an increase of Rs 122.0 billion in the corresponding period of FY05. As in FY05, the July-Nov FY06 NDA increase was driven principally by the rise in SBP NDA. This was because, through the first 5 months of FY06, the SBP had been lending directly to the government for its budgetary requirements and let the commercial banks cater to the financing needs of the private sector only. In fact, the rise of Rs 57.4 billion in the NDA of commercial banks is entirely due to their lending to the private sector.

#### *Government sector borrowing*

Government sector borrowing from the banking system during Jul-Nov FY06 increased by Rs 65.3 billion, as compared to the increase of Rs 45.7 billion during Jul-Nov FY05. This rise was entirely due to higher budgetary borrowings in the former period as the loans for commodity operations registered a net retirement.

Specifically, budgetary borrowings from the banking system increased by Rs 81.6 billion during Jul-Nov FY06 compared with an increase of Rs 42.8 billion in the corresponding period of FY05 (see **Figure 4.6**). These higher borrowings were the outcome of: (1) the higher budget deficit during Jul-Sep FY06 compared with Jul-Sep FY05 and; (2) lower availability of budgetary financing from other sources to the government during Jul-Sep FY06 (see **Table 4.2**).



The composition of budgetary borrowings within the banking sector during Jul-Nov FY06 is similar to that of FY05. In both the periods, SBP solely funded the government budgetary requirements and commercial banks have registered net retirements.

Government loans for commodity operations declined by Rs 15.5 billion during Jul-Nov FY06 compared with an increase of Rs 1.3 billion in the corresponding period of FY05 (see **Figure 4.7**). Retirements were recorded in loans for cotton and fertilizer in addition to wheat. It should be noted that during Jul-Nov FY05, government increased its cotton procurement to stabilize the prevailing low domestic cotton prices arising out of a bumper crop. However, during Jul-Nov FY06, domestic cotton prices were already quite high and the TCP therefore continued retiring the loans borrowed in the previous season. The amount outstanding for commodity operations has declined substantially with the increase private sector role in commodity procurement, particularly for wheat.

**Table 4.2: Deficit Financing (July-September)<sup>1</sup>**

billion Rupees

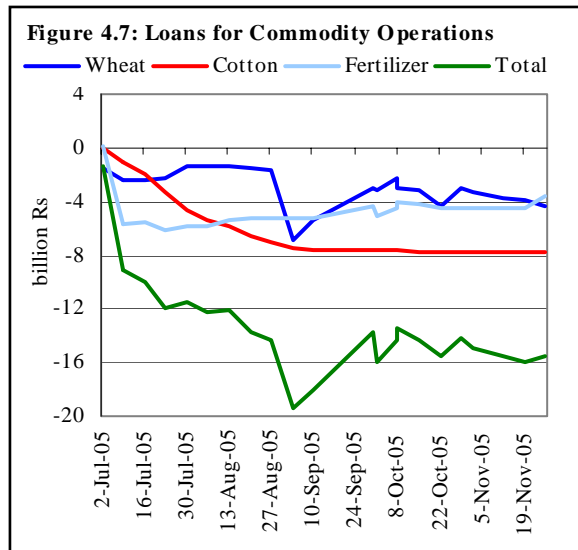
|                                    | FY05        | FY06        |
|------------------------------------|-------------|-------------|
| External                           | 19.6        | 5.0         |
| Non-bank                           | 19.1        | 14.3        |
| Privatization proceeds             | 6.1         | 3.5         |
| <b>Sub-total</b>                   | <b>44.8</b> | <b>22.8</b> |
| <b>Total financing requirement</b> | <b>24.9</b> | <b>37.7</b> |
| Banking system                     | -19.9       | 14.8        |

Source: Ministry of Finance (MoF), quarterly data.

<sup>1</sup> The MoF and SBP numbers differ due to differences in timings and definitions

#### 4.5 Other items (net)

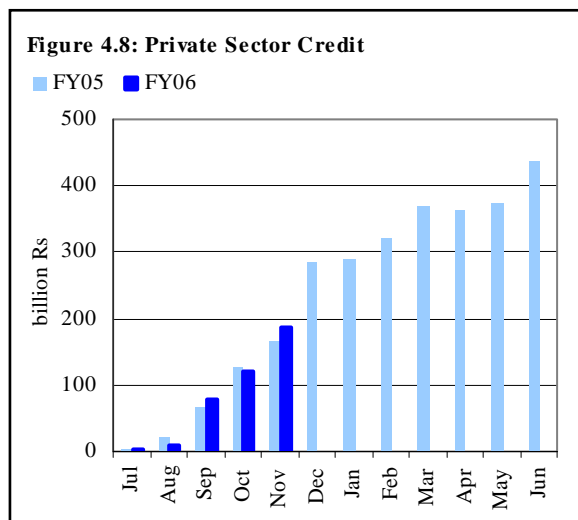
During Jul-Nov FY06, the accounting procedure for recording the OMO transactions has been changed and now these transactions will be reflected in the *other item net* (OIN) of the SBP and the scheduled banks. Specifically, prior to July 2005, the sale and purchase of government securities through OMOs used to result in the shift of claims on government between SBP and commercial banks.



However, this standard has been changed from July 2005 onwards; now banks and SBP record the value of OMO transaction in their respective *other assets* and *other liabilities*. Consequently every transaction has an equal and opposite impact on the OIN of SBP and commercial banks, with no net impact on the OIN of the banking sector. This is an international practice that has been adopted to avoid frequent changes in the budgetary borrowing position of the government from State Bank and scheduled banks emanating from the OMO transactions.

#### 4.6 Credit to private sector

Net credit to the private sector has increased by Rs 185.8 billion during Jul-Nov FY06 compared with the net growth of Rs 164.7 billion in the corresponding period of FY05 (see **Figure 4.8**). However, unlike the preceding three years, the credit to large scale manufacturing has seen a YoY decline, which appears to reflect a deceleration of growth in the sector in Q1-FY06.



The expansion in credit to the private sector is a source of concern for two reasons: (1) the pace of credit growth indicates that the monetary tightening so far has succeeded marginally in reducing the private sector credit growth to 10.8 percent during the first five months of FY06 from 12.9 percent during the same period of FY05; and (2) sector wise data shows that corporate, SME and commodity finance are the major areas where most of the slowdown has been registered. In other words, agriculture and consumer loans are the major sectors driving the credit growth (see **Table 4.3**) in July-Nov FY06.

#### 4.7 Reserve money

The reserve money growth during Jul-Nov FY06 is reflective of the SBP Rupee and dollar liquidity management in the inter bank

market. In particular, during Jul-Sep FY06, reserve money registered negative growth. This was mainly due to SBP's huge inter bank dollar selling during the period that led to a sharp decline in SBP NFA. On the other hand, absorptions on account of OMOs compensated the increase in the NDA (by increasing 'other items net', as explained earlier) arising from government borrowings (see **Figure 4.9**). As a result the reserve money showed negative growth during this period.

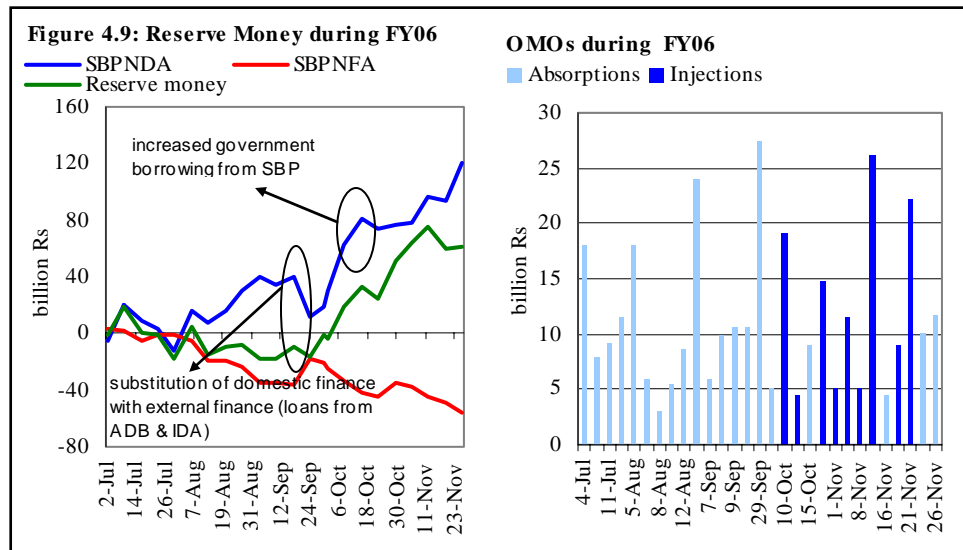
However, October onwards the inter bank market started facing severe liquidity shortages on account of (1) a robust growth in credit off take; and (2) net withdrawals in banks' deposit base on account of Ramadan and Eid. Therefore during October and November 2005, SBP had to make short-term liquidity injections in the inter bank market through OMOs. This along with a substantial increase in the government borrowings turned the hitherto negative growth in

**Table 4.3: Sectoral Distribution of Advances**  
billion Rupees

|                                    | Jul-Oct       |               |
|------------------------------------|---------------|---------------|
|                                    | FY05          | FY06          |
| <b>(I) Private sector business</b> | <b>87,112</b> | <b>78,317</b> |
| Agriculture                        | 7,119         | 10,327        |
| Mining and quarrying               | 2,143         | 140           |
| Manufacturing                      | 21,312        | 16,016        |
| <i>of which</i>                    |               |               |
| (1) Food products                  | (7,488)       | (14,477)      |
| <i>edible oil and ghee</i>         | 2,360         | (1,020)       |
| <i>sugar</i>                       | (3,693)       | (3,670)       |
| (2) Textiles                       | 24,335        | 26,655        |
| (3) Chemicals and products         | 6,326         | 4,724         |
| <i>fertilizer and nitrogen</i>     | 4,560         | 4,397         |
| (4) Cement                         | 346           | 4,994         |
| Construction                       | 3,735         | 4,419         |
| Commerce and trade                 | 12,630        | 30,396        |
| Transport and communications       | 9,075         | 2,509         |
| Services                           | 19,910        | 11,779        |
| Other private business             | 10,497        | 1,664         |
| <b>(II) Personal</b>               | <b>15,922</b> | <b>32,418</b> |
| <i>of which</i>                    |               |               |
| Consumer financing                 | 13,382        | 32,197        |
| <i>i. House building</i>           | 5,422         | 4,870         |
| <i>ii. Auto finance</i>            | 14,545        | 10,188        |
| <i>iii. Credit cards</i>           | 1,778         | 5,255         |
| <i>iv. Consumer durables</i>       | 656           | 588           |
| <i>v. Personal loans</i>           | (3,645)       | 11,471        |

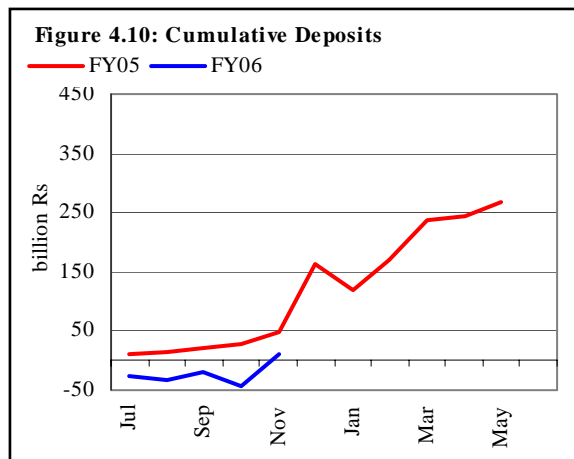
Source: Statistics Department, SBP

reserve money to positive. Although the reserve money growth increased sharply in Oct-Nov 2005 to record a Jul-Nov 06 cumulative growth of 6.8 percent, it remained substantially lower than the 13.5 percent increase recorded in the corresponding period of last year.



#### 4.8 Deposit mobilization

Deposit mobilization of the banks registered an increase of Rs 11.1 billion during Jul-Nov FY06 compared with an increase of Rs 47.1 billion in the corresponding period of FY05. Monthly data shows that during Jul-Oct FY06, there were net withdrawals from the banking system as a result of the net monetary contraction and the Ramadan effect. Subsequently, during November 2005, bank deposits registered an increase of Rs 54.5 billion (see **Figure 4.10**).



However, while analyzing the net withdrawals, the impact of changes in the format of data reporting by commercial banks to SBP cannot be ignored.

Specifically, in the older format, banks used to report some of the other liabilities in their respective deposit base; however the new format (adopted during July 2005) does not allow for such reporting and is hence a more accurate representation of the of volume of deposits. This change in the reporting mechanism caused a sharp decline of Rs 50 billion during July 2005 that had a cumulative impact on the overall deposit trend of Jul-Nov FY06.

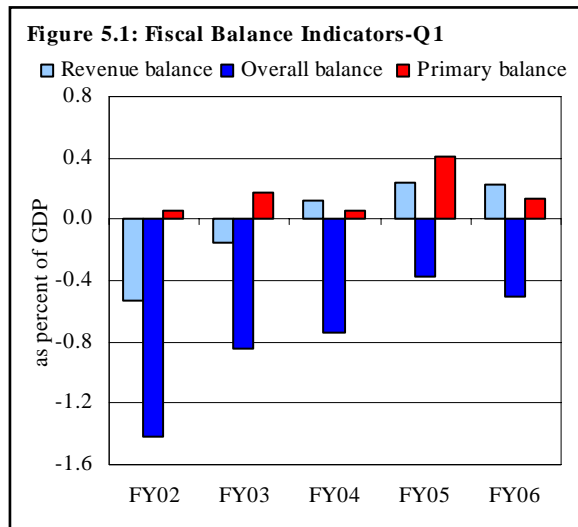
## 5 Fiscal Developments

### 5.1 Overview

The fiscal deficit widened marginally during Q1-FY06, rising to 0.5 percent of (estimated) GDP, as compared to approximately 0.4 percent of GDP in Q1-FY05. This rise is not a concern, as the increase is small, revenue growth appears reasonably strong, net lending to PSEs has remained negative,<sup>1</sup> and given that the higher growth in expenditure is driven primarily by a 58.6 percent YoY increase in development expenditure. This is clearly

evident in the fiscal balance indicators, where the revenue balance for Q1-FY06 is practically unchanged from the previous year. Similarly, the primary surplus has dropped 0.1 percent of GDP against the 0.4 percent of GDP in FY05 (see **Figure 5.1**). This too is not worrisome considering that interest payments have declined, and given that the remaining deterioration is principally caused by higher developmental expenditure; which have risen from 0.5 percent of GDP in Q1-FY05 to 0.7 percent of GDP in Q1-FY06.

However, given that fiscal performance post-Q1-FY06 is likely to deteriorate due to a possible rise in expenditures in the aftermath of the October 2005 earthquake, there is a need for greater vigilance in sustaining (and improving) revenue growth. Specifically, the appreciable 21.0 percent YoY growth in CBR revenues in the first quarter is mainly due to the unexpectedly large rise in international trade taxes; these taxes accounted approximately 76.5 percent of the total increase in CBR tax collections during the period. This suggests the need for the CBR to increase focus on tax compliance and expanding the tax net.



<sup>1</sup> This improved position was primarily attributable to Pakistan Steel, while the other PSEs did not perform well during the quarter.

## 5.2 Revenues

Revenue receipts increased to Rs 236.6 billion in Q1-FY06; this represents a growth of 17.0 percent YoY, which is sharply lower than the 22.2 percent YoY rise in Q1-FY05. In absolute terms however, the Rs 34.4 billion increase in Q1-FY06, is only a little lower than the Rs 36.7 billion increase recorded in Q1-FY05. Indeed, when seen as a percentage of GDP, revenues increased marginally from 3.1 percent in Q1-FY05 to 3.2 percent during Q1-FY06 (see **Table 5.1**).

**Table 5.1: Consolidated Federal and Provincial Government**  
billion Rupees

|                             |   | FY02  | FY03  | FY04  | FY05  | FY06  | YoY change |         |
|-----------------------------|---|-------|-------|-------|-------|-------|------------|---------|
|                             |   |       |       |       |       |       | abs.       | percent |
| 1                           | Revenue Receipts                        | 115.3 | 153.5 | 165.5 | 202.2 | 236.6 | 34.3       | 17.0    |
|                             | a) Tax Revenue                          | 94.4  | 115.6 | 119.7 | 142.5 | 164.9 | 22.3       | 15.7    |
|                             | b) Non-Tax Revenue                      | 20.9  | 38.0  | 45.8  | 59.7  | 71.7  | 12.0       | 20.1    |
| 2                           | Total Expenditures                      | 178.0 | 194.5 | 206.5 | 227.1 | 274.3 | 47.1       | 20.8    |
|                             | a) Current                              | 138.8 | 161.2 | 158.9 | 186.9 | 219.8 | 32.9       | 17.6    |
|                             | b) Developmental<br>Net Lending to PSEs | 13.5  | 21.7  | 24.9  | 32.0  | 50.7  | 18.8       | 58.6    |
|                             | c) etc.                                 | 5.7   | -0.6  | 8.3   | 1.5   | -0.1  | -1.6       | -110.0  |
|                             | d) Unidentified                         | 20.0  | 12.3  | 14.5  | 6.8   | 3.9   | -2.9       | -43.1   |
| 3                           | Revenue Balance (1-2.a)                 | -23.5 | -7.6  | 6.6   | 15.4  | 16.8  | 1.4        | 9.1     |
| 4                           | Overall Balance (1-2)                   | -62.7 | -41.0 | -41.0 | -24.9 | -37.7 | 12.8       | 51.5    |
| <b>As percentage of GDP</b> |   |       |       |       |       |       |            |         |
| 1                           | Revenue Receipts                        | 2.6   | 3.2   | 3.0   | 3.1   | 3.2   | 0.1        | 2.6     |
|                             | a) Tax Revenue                          | 2.1   | 2.4   | 2.2   | 2.2   | 2.2   | 0.0        | 1.5     |
|                             | b) Non-Tax Revenue                      | 0.5   | 0.8   | 0.8   | 0.9   | 1.0   | 0.0        | 5.3     |
| 2                           | Total Expenditures                      | 4.0   | 4.0   | 3.7   | 3.5   | 3.7   | 0.2        | 5.9     |
|                             | a) Current                              | 3.2   | 3.3   | 2.9   | 2.9   | 2.9   | 0.1        | 3.2     |
|                             | b) Developmental<br>Net Lending to PSEs | 0.3   | 0.4   | 0.5   | 0.5   | 0.7   | 0.2        | 39.2    |
|                             | c) etc.                                 | 0.1   | 0.0   | 0.2   | 0.0   | 0.0   | 0.0        | -108.8  |
|                             | d) Unidentified                         | 0.5   | 0.3   | 0.3   | 0.1   | 0.1   | -0.1       | -50.1   |
| 3                           | Revenue Balance (1-2.a)                 | -0.5  | -0.2  | 0.1   | 0.2   | 0.2   | 0.0        | -4.3    |
| 4                           | Overall Balance (1-2)                   | -1.4  | -0.8  | -0.7  | -0.4  | -0.5  | -0.1       | 32.9    |

Source: Ministry of Finance

In Q1-FY06, tax revenues stood at Rs164.9 billion, up 15.7 YoY, compared to a rise 19.1 percent YoY during Q1-FY05. The deceleration in the growth of tax

revenues owes to both, a relatively slower rise in CBR taxes,<sup>2</sup> as well as a drastic decline in Petroleum Development Levy<sup>3</sup> (that decreased from Rs 3.6 billion in Q1-FY05 to Rs 1.2 billion in Q1-FY06).

While non-tax revenues also saw growth decelerate from 30.4 percent YoY in Q1-FY05 to 20.1 percent in Q1-FY06, the growth was nonetheless high, pushing the receipts to Rs 71.7 billion. Key contributions to this included defence receipts (Rs 28.9 billion), profits from PTA (Rs 10.2 billion), and SBP profits (Rs 3.6 billion) and dividends (Rs 7.6 billion).

### 5.3 Expenditure

The consolidated expenditure during the first quarter of FY06 rose to Rs 274.3 billion, up 20.8 percent YoY, as compared to a rise of 10 percent YoY in Q1-FY05.

This acceleration in expenditure is principally due to a substantial increase in development spending.

The rise on current expenditure during Q1-FY06 was held steady at 17.6

percent YoY, and therefore current expenditure as a share of GDP remains at 2.9 percent of GDP (see **Table 5.1**). Encouragingly, interest payments declined by 6.7 percent during the quarter, although the impact of this was offset by a 21.4 percent YoY increase in defence expenditure (see **Table 5.2**). Nonetheless, the aggregate share of defence and interest payments in total current expenditure dropped from 52.2 percent in Q1-FY05 to 47.3 percent in Q1-FY06.

The sharp increase in total expenditure mainly came from an increase in the development expenditure that rose from 0.5 percent of GDP to 0.7 percent of GDP. It is noteworthy that of the development expenditure of Rs 50.7 billion, a net profit of Rs 146 million from public sector enterprises also helped contain fiscal balances in this regard.

**Table 5.2: Composition of Current Expenditure during Q1 billion Rupees**

|                      | FY05  | FY06  | YoY change |         |
|----------------------|-------|-------|------------|---------|
|                      |       |       | absolute   | percent |
| Current expenditures | 186.9 | 219.8 | 32.9       | 17.6    |
| <i>Of which</i>      |       |       |            |         |
| Interest payments    | 51.5  | 48.0  | -3.5       | -6.7    |
| Domestic             | 42.4  | 39.8  | -2.7       | -6.3    |
| Foreign              | 9.0   | 8.2   | -0.8       | -8.9    |
| Defense              | 46.1  | 55.9  | 9.9        | 21.4    |
| Provincial           | 52.7  | 67.0  | 14.3       | 27.1    |

Source: Ministry of Finance

<sup>2</sup> For details please see **Section 5.5**

<sup>3</sup> Petroleum development levy remained almost zero on major products during the comparable period.

Finally, net lending to PSEs was negative during the first quarter of FY06, as compared to the 1.5 billion lending in the comparable period last year. This is primarily because of high profits of Pak Steel.

#### 5.4 Financing

The budgetary financing requirements increased to Rs 37.7 billion in Q1-FY06 as compared to the Rs 24.9 billion during the corresponding period of FY05.

Unlike the previous year, the financing requirements were largely met though the domestic resources (86.7 per cent) (see **Table 5.3**).

**Table 5.3: Financing of Budget Deficit during Q1**  
billion Rupees

|                         | FY05  | FY06 | Percent share |       |
|-------------------------|-------|------|---------------|-------|
|                         |       |      | FY05          | FY06  |
| Financing through       | 24.9  | 37.7 | 100.0         | 100.0 |
| External resources(net) | 19.6  | 5.0  | 78.6          | 13.3  |
| Internal resources      | 5.3   | 32.7 | 21.4          | 86.7  |
| Domestic non-bank       | 19.1  | 14.3 | 76.8          | 38.0  |
| Banking system          | -19.9 | 14.9 | -79.9         | 39.4  |
| Privatization proceeds  | 6.1   | 3.5  | 24.5          | 9.3   |

Source: Ministry of Finance

To finance its budget, the Government raised Rs 14.9 billion through bank borrowing and Rs 14.3 billion from the non-bank. Of the non-bank borrowing, the major chunk came from the public debt, especially T-Bills auction, while Rs 3.2 billion were also raised from saving schemes. Moreover, privatisation proceeds of Rs 3.5 billion also helped in financing the fiscal deficit.

#### 5.5 CBR Tax Collection

CBR tax receipts surpassed the Rs 145.5 billion target for Q1-FY06 by 4.5 percent. Details of monthly tax collection reveal that CBR met all its monthly targets with an overall growth of 21 percent over the last year; however, progress during the month of August was exceptionally good as total revenue collection surpassed the target by 8.3 percent. This was mainly due to sales tax collection that exceeded the monthly target by 16.2 percent (see **Table 5.4**).

**Table 5.4: Monthly Tax Collections (Net)**  
billion Rupees

|           | FY04        | FY05         | FY06         | Growth rates |             |
|-----------|-------------|--------------|--------------|--------------|-------------|
|           |             |              |              | FY05         | FY06        |
| Jul       | 23.4        | 30.7         | 34.6         | 31.3         | 12.8        |
| Aug       | 30.1        | 34.2         | 44.9         | 13.5         | 31.4        |
| Sep       | 40.6        | 60.8         | 72.5         | 50.0         | 19.2        |
| <b>Q1</b> | <b>94.1</b> | <b>125.7</b> | <b>152.1</b> | <b>33.6</b>  | <b>21.0</b> |

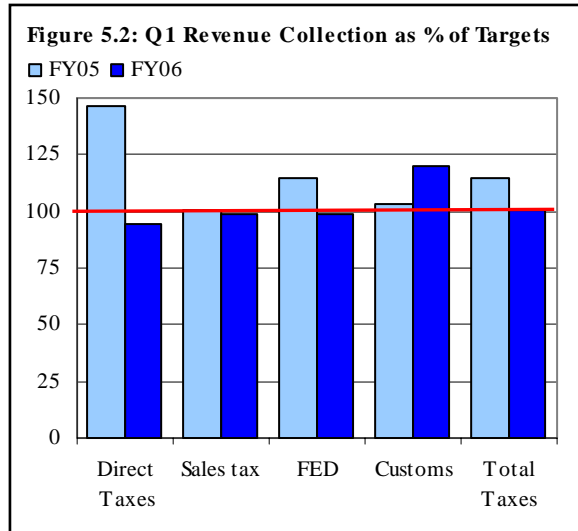
Source: Central Board of Revenue

Although the individual targets of all domestic taxes (income tax, sales tax - domestic and federal excise duty) could not be met during the quarter, it was mainly due to the ambitious targets set for the quarter. However, their YoY growth performance was not impressive relative to the last year (see **Figure 5.2**).

Looking to the performance of the first quarter, the CBR will have to gear up its efforts in the remaining months of the current year to meet its annual target of Rs 690 billion.

### 5.5.1 Refunds and Gross Collection

The 15 percent YoY growth in gross collection, (from Rs 148.3 billion in Q1 FY05 to Rs 170.3 billion in Q1 in FY06) and fall of YoY 19.4 percent in refunds (from Rs 22.6 billion to Rs 18.2 billion) made the achievement of tax revenue target possible during the quarter (see **Figure 5.3**).

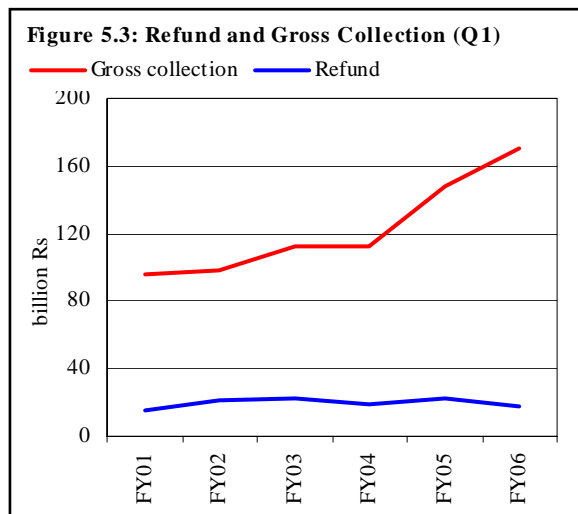


The decline in tax refunds is basically due to a fall in sales tax refunds, principally owing to zero tax rating on export-oriented products.

### 5.5.2 Analysis by Tax Components

#### Direct Taxes

Growth in direct tax collections decelerated to 15.5 percent YoY during Q1-FY06 from 63.2 percent in Q1-FY05. As a result, the collections totalled only Rs 48.2 billion, slightly lower than the Rs 48.8 billion target for the period (see **Table 5.5**).



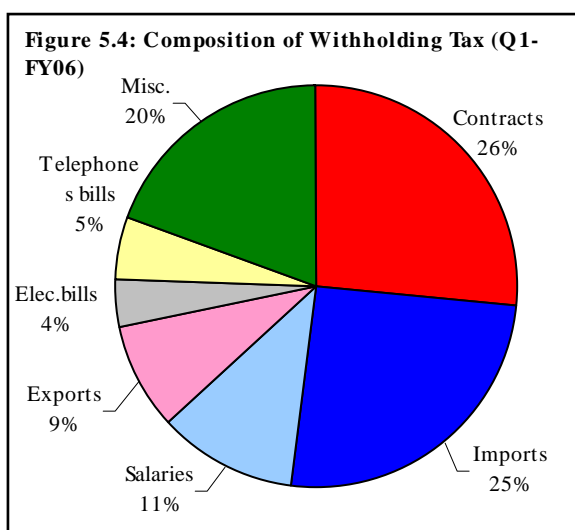
**Table 5.5: Tax Collection in Q1**

billion Rupees

|                    | Targets FY06 |              | Net Tax Collection |              |              | As % of target |              | YoY change  |             |
|--------------------|--------------|--------------|--------------------|--------------|--------------|----------------|--------------|-------------|-------------|
|                    | Annual       | Q1           | FY04               | FY05         | FY06         | Annual         | Q1           | Abs.        | Percent     |
| Direct Taxes       | 215.4        | 48.8         | 25.6               | 41.7         | 48.2         | 22.4           | 98.7         | 6.5         | 15.5        |
| Indirect Taxes     | 474.6        | 96.7         | 68.5               | 84.0         | 103.9        | 21.9           | 107.4        | 19.9        | 23.7        |
| Sales tax          | 294.0        | 57.1         | 41.6               | 50.4         | 63.0         | 21.4           | 110.3        | 12.6        | 25.1        |
| FED                | 59.4         | 12.7         | 9.0                | 11.2         | 12.2         | 20.6           | 96.4         | 1.0         | 9.0         |
| Customs            | 121.2        | 26.9         | 17.9               | 22.4         | 28.6         | 23.6           | 106.5        | 6.3         | 27.9        |
| <b>Total Taxes</b> | <b>690.0</b> | <b>145.5</b> | <b>94.1</b>        | <b>125.7</b> | <b>152.1</b> | <b>22.0</b>    | <b>104.5</b> | <b>26.3</b> | <b>21.0</b> |

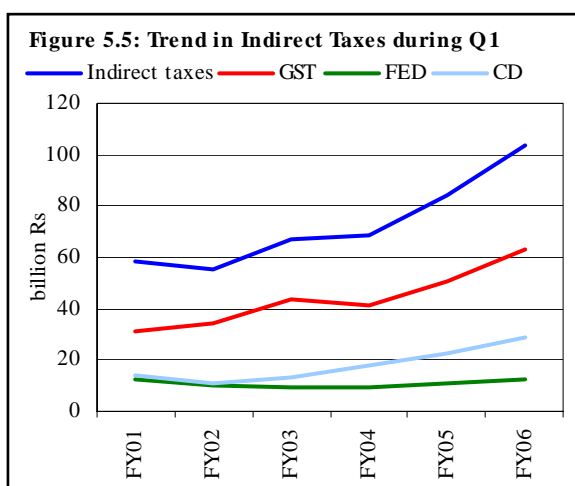
Source: Central Board of Revenue

A break-up of income tax collections does not exhibit any notable improvements in voluntary payments and collection on demand, and the main source of the growth in collections remains withholding taxes, which rose 18.2 percent YoY to Rs 26.6 billion, which is attributable to the increased economic activity in the country. The main sources of withholding tax receipts were contracts (Rs 7.1 billion), imports (Rs 6.7 billion) and salaries (Rs 3.0 billion) – (see **Figure 5.4**).



### Indirect Taxes

During Q1-FY06, indirect taxes amounted to Rs 103.9 billion, up 23.7 percent YoY compared to a 22.6 percent YoY rise in Q1-FY05 (see **Figure 5.5**). This strong rise in indirect tax receipts is entirely due to acceleration in both sales tax and customs duty receipts, due to the exceptional rise in the



country's import bill, and a fall in claims of refunds.

### Sales Tax

Sales tax receipts witnessed a robust increase 25.1 percent YoY during Q1-FY06, as compared to the 21.0 percent YoY during Q1-FY05 (see **Table 5.5**). In contrast to recent years, this was achieved principally due to an exceptional 39.5 percent YoY rise in receipts from domestic sources, which outstripped even the strong YoY rise of 17.6 percent in the sales tax on imports. The biggest contribution to this sharp rise was from the decline in sales tax refunds, following the zero rating of exports oriented industries. (see **Table 5.6**)

**Table 5.6: Major Revenue Spinners of GST (Domestic)**

| billion Rupees         |             |             |             |             |
|------------------------|-------------|-------------|-------------|-------------|
|                        | FY05        | FY06        | YoY change  |             |
|                        |             |             | absolute    | percent     |
| POL Products           | 5.9         | 5.4         | -0.5        | -8.2        |
| Services (telecom)     | 4.1         | 5.3         | 1.1         | 27.3        |
| Natural Gas            | 2.6         | 2.9         | 0.3         | 11.2        |
| Sugar                  | 1.7         | 2.0         | 0.3         | 16.3        |
| Cement                 | 0.9         | 1.2         | 0.2         | 23.6        |
| Sub total              | 15.3        | 16.8        | 1.4         | 9.4         |
| Others                 | 17.7        | 14.7        | -3.0        | -16.8       |
| <b>All Commodities</b> | <b>33.0</b> | <b>31.5</b> | <b>-1.5</b> | <b>-4.6</b> |
| Refund/ Rebate         | 15.2        | 7.5         | -7.6        | -50.3       |
| <b>GST Net</b>         | <b>17.9</b> | <b>24.0</b> | <b>6.1</b>  | <b>34.1</b> |

Source: Central Board of Revenue

### Federal Excise

Federal excise contributed around Rs 12.2 billion to the exchequer during Q1-FY06 showing an increase of 9 percent YoY, as compared to the 24.8 percent YoY rise in Q1-FY05.

The increase in FED receipts essentially mirrors the increasing production in key industries, particularly cigarettes, cement and beverages. However, it is surprising that despite a growth of 1.3 percent in POL products, the FED collection declined by 8.3 percent YoY in the first quarter of FY06 as compared to the same period of the preceding year. (see **Table 5.7**)

**Table 5.7: Gross Federal Excise Collection in Q1 (gross)**

| billion Rupees   |             |             |            |            |
|------------------|-------------|-------------|------------|------------|
|                  | FY05        | FY06        | YoY change |            |
|                  |             |             | absolute   | percent    |
| Cigarettes       | 4.0         | 4.5         | 0.6        | 14.6       |
| Cement           | 2.6         | 2.8         | 0.2        | 6.5        |
| POL              | 1.1         | 1.0         | -0.1       | -8.3       |
| Natural gas      | 1.3         | 1.3         | 0.0        | -3.0       |
| Beverages        | 1.1         | 1.4         | 0.3        | 23.7       |
| Sub total        | 10.2        | 11.1        | 0.9        | 8.7        |
| Others           | 1.0         | 1.1         | 0.1        | 11.8       |
| <b>Total FED</b> | <b>11.2</b> | <b>12.2</b> | <b>1.0</b> | <b>9.0</b> |

Source: Central Board of Revenue

### Customs Duty

Collection from customs duty amounted to Rs 28.6 billion, up 27.9 percent YoY as compared to the rise of 25.2 percent YoY during Q1-FY05. This rise simply reflects the increase in the country's import bill during the period.

A break-up of the collections shows that motor vehicles continued to remain a major revenue spinner, followed by edible oils, mechanical appliances, and electrical machinery. Unlike previous

years, however, the revenue from POL products has declined (see **Table 5.8**).

**Table 5.8: Major Revenue Spinners of customs duty (Q1)**  
billion Rupees

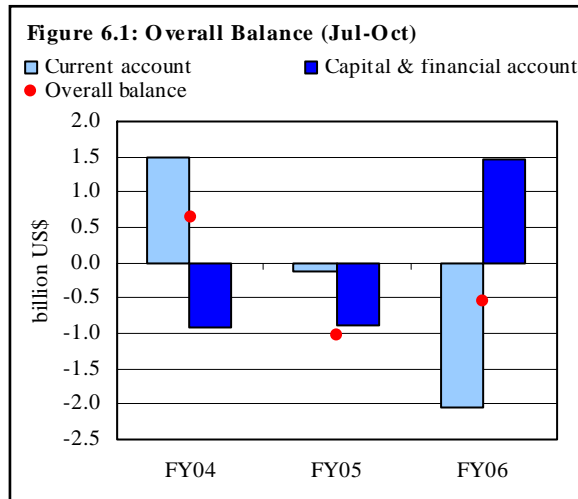
|                     | FY05 | FY06 | YoY change |         |
|---------------------|------|------|------------|---------|
|                     |      |      | absolute   | percent |
| Vehicles            | 4.6  | 7.1  | 2.5        | 55.2    |
| Edible Oil<br>Mech. | 3.6  | 4.1  | 0.4        | 12.0    |
| Appliances          | 2.0  | 2.4  | 0.3        | 16.0    |
| Elec. Machinery     | 1.5  | 1.7  | 0.2        | 13.5    |
| Iron and Steel      | 1.5  | 1.5  | 0.0        | 1.3     |
| POL                 | 1.7  | 1.1  | -0.6       | -34.0   |
| Sub total           | 14.9 | 17.8 | 2.9        | 19.6    |
| Others              | 11.7 | 16.1 | 4.5        | 38.3    |
| Gross collection    | 26.5 | 33.9 | 7.4        | 27.8    |
| Refunds/rebate      | 4.2  | 5.3  | 1.1        | 27.2    |
| Net Collection      | 22.4 | 28.6 | 6.2        | 27.9    |

Source: Central Board of Revenue

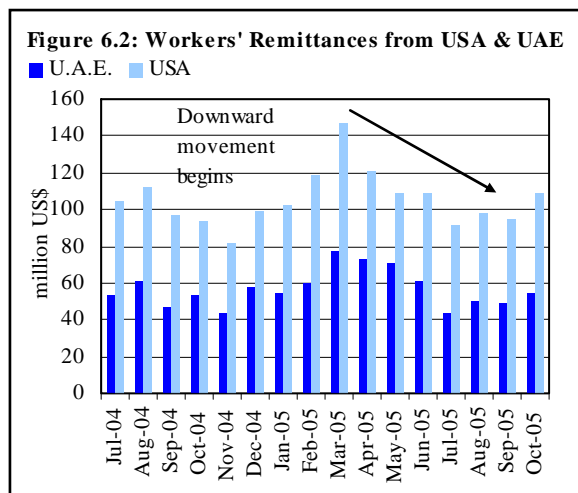
## 6 External Sector

### 6.1 Balance of Payments

The country's overall external balance witnessed a marginal improvement during Jul-Oct FY06 relative to Jul-Oct FY05, recording a deficit of US\$ 0.5 billion in the former period against a US\$ 1 billion deficit in the latter. The relative improvement was largely due to higher inflows in the financial account (see **Figure 6.1**), which offset the sharp increase in the current account deficit.



This deterioration in the current account was principally due to the 34 percent YoY rise in imports during Jul-Oct FY06, which overshadowed the healthy 14 percent YoY growth in exports,<sup>1</sup> pushing the trade deficit to US\$ 2.6 billion, as compared to a deficit of US\$ 1.3 billion in the corresponding period of FY05. The substantial increase in trade volumes also contributed to a 44 percent YoY



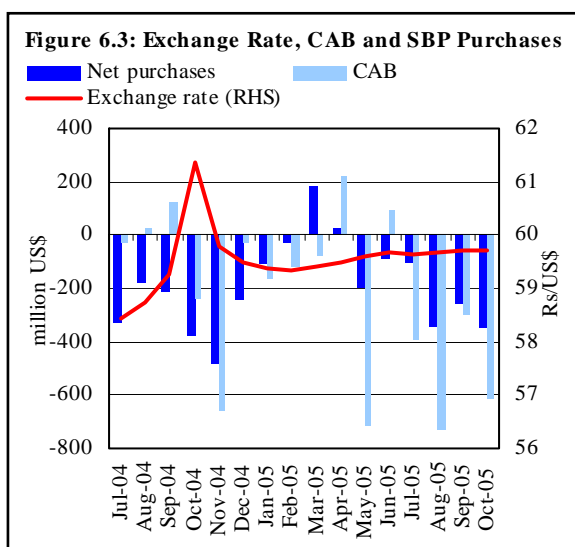
deterioration in the services account deficit during this period. Finally, unlike Jul-Oct FY05, current transfers witnessed a marginal deterioration during Jul-Oct FY06. This was largely due to a fall in net private current transfers on account of lower net inflows in the resident foreign currency accounts as well as sluggish growth in worker's remittances. The latter is a sign of concern, particularly given that flows from the USA and UAE declined (see **Figure 6.2**), although both

<sup>1</sup> The growth rates of exports and imports pertain to the exchange record data.

economies are performing well. While remittances from both countries improved in October 2005, this increase could simply be a consequence of the earthquake in Pakistan. Thus, it remains to be seen if the weakness in remittances is a short-term phenomenon or persists in future as well.

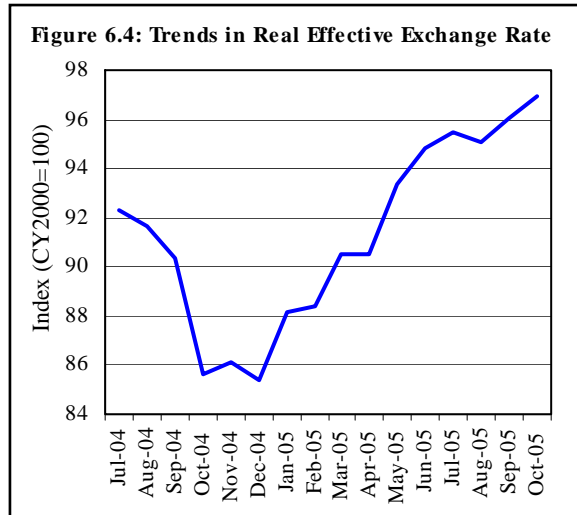
While the deterioration in the current account during Jul-Oct FY06 was offset by a substantial improvement in the financial account, it is important to examine the source of this improvement. A surplus caused by higher debt creating inflows can potentially lead to issues in debt sustainability in the long run, while the surplus caused by higher non-debt-creating flows (such as foreign direct investment), are obviously more welcome. Encouragingly, around one third of the surplus in the financial account during Jul-Oct FY06 is caused mainly by rising net foreign investment inflows, particularly FDI. If this trend sustains, the country's current account deficit would not cause significant strains on the economy.

The net deficit in the overall external balance did not significantly pressure the exchange rate during this period, with the rupee remaining practically unchanged through Jul-Oct FY06. This relative stability was principally because the SBP continued with its policy of meeting lumpy payments for key commodities imports, such as oil, wheat urea, etc. The SBP interventions, aimed at reducing market volatility, continued throughout Jul-Oct 2005 (see **Figure 6.3**), and led to a reduction in the SBP reserves.<sup>2</sup>



<sup>2</sup> It is important to note here that the need for SBP market interventions was reduced due to the additional liquidity injection into the inter-bank market through the rising volume of FE-25 foreign currency loans during Jul-Oct FY06. In fact these loans, together with the lower net inflows into resident FCAs caused a decline in commercial banks reserves also.

A part of the pressure on the SBP reserves may simply reflect the normal leads and lags in foreign currency flows in the inter-bank market. These would not be source of concern as the central bank would add liquidity in the inter-bank market to meet shortfalls and then re-purchase in times of surplus liquidity. The risk is that such interventions could lead to excessive exchange rate stability, distorting the price signals in the market. Indeed, trends in the real effective exchange rate (REER) show that rupee has strongly appreciated in real terms against the currencies of other trading partners, since February 2005 (see **Figure 6.4**). This may have adversely impacted the competitiveness of the country's exports and suggests the need to bring down the rate of inflation that has primarily caused the appreciation in REER.



On the whole, however, it seems likely that the weakness in the Pakistan's current account will persist through FY06, although the increase in the current account deficit October 2005 onward will not be as pronounced as in the initial four months of FY06.<sup>3</sup> In particular, the trade deficit is expected to rise further during FY06, with a commensurate increase in the services account deficit. However, it is hoped that this impact will be significantly offset by worker's remittances and the receipt of cash grants. Further, the capital and financial accounts are also expected to register large surpluses due to anticipated large inflows of project grants and non-food aid (see **Box 6.1**). This suggests that the overall balance could potentially record a surplus in FY06.

It should be noted that on the one hand, the timing of the receipts of aid and grant remains unclear, while on the other hand, earthquake-related imports have already gained momentum exerting further pressure on the trade account. This mismatch in the timings of flows and imports payments could potentially exert short-term

<sup>3</sup> The Jul-Oct FY06 current account deficit suffered in comparison to Jul-Oct FY05 due to a large one-off payment, as well as a base effect (in particular, the Jul-Oct FY06 figure incorporates the full impact of the sharp rise in international oil prices, which was not so evident in corresponding period last year).

pressures on the BoP position. Fortunately, this should be comfortably absorbed, given the country's substantial forex reserves.

**Box 6.1: Channels through which earthquake related flows may affect BoP**

*Trade and services account:* The first and the foremost area to be affected by this incident is the trade account, mainly through rising imports. The import of medicines, fuel, tents, tarpaulin & blankets, construction machinery and material is expected to rise as a result of the ongoing relief and future rehabilitation operations. Hence, the services account will also be affected by the accompanying rise in the shipment freight charges causing rise in the transportation inflows. Keeping in view the extent of losses due to the earth quake, it is certain that rehabilitation operations will continue over a number of years and so the inflow of the relevant imports. Further, the income account will also witness higher net interest payments on external debt, once the loan pledges so far made by the international community are realized.

*Current transfers:* This head is expected to see higher inflows in private and official transfers. For example, the workers' remittances for October 2005 were up 11.1 percent YoY, as compared to a very sluggish rise in earlier months of FY06. Similarly, the resident foreign currency accounts are also expected to receive higher inflows as the direct aid flows to NGOs are likely to be deposited in their resident FCAs. Official transfers are also expected to rise with the inflow of committed cash grants.

*Capital & Financial account:* Likewise the capital and financial account is also expected to see higher receipts of project grants and non-food aid, respectively. However, keeping in view the concessional nature of these loans, their servicing is not expected to have a material adverse impact on debt sustainability indicators.

On the whole, the pressures on the trade, services and income account are expected to be mitigated by the higher inflows of current transfers as well as higher grants and loans inflows.

**6.1.1 Current Account Balance**

The deterioration in the current account seen in FY05 accelerated during the initial months of FY06. The deficit for the period of Jul-Oct reached US\$ 2 billion as compared to a deficit of US\$ 0.12 billion in the corresponding period last year (see **Table 6.1 & Figure 6.5**). Not only did the trade and services account deficits continue to widen, this period also saw a 4 percent YoY reduction in the surplus under current transfers.

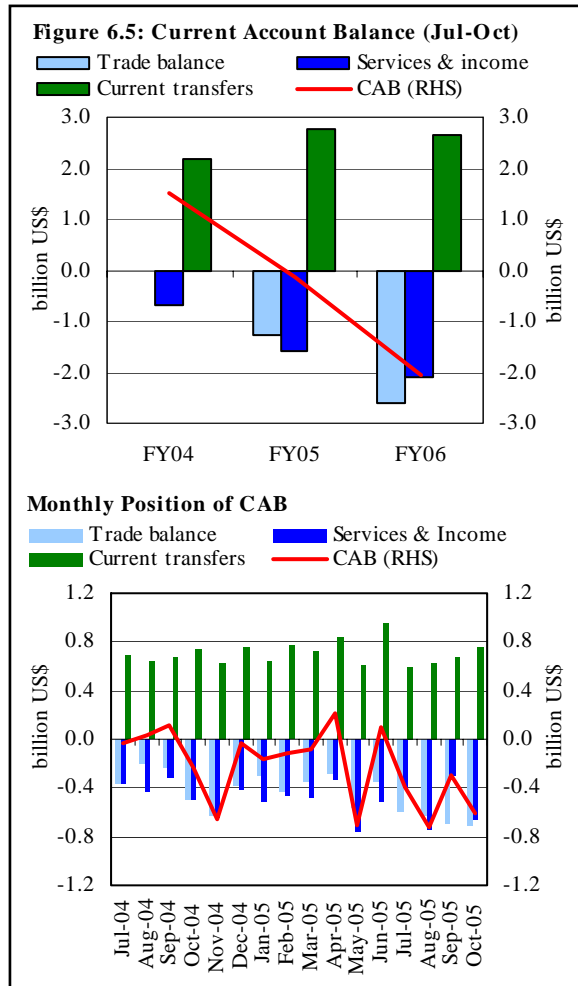
These adverse developments were compensated to a limited extent by higher growth in exports, accompanied by a rise in earnings on country's reserves and declining net interest payments on long-term external debt.

**Trade Balance**<sup>4</sup>

The trade deficit worsened during Jul-Oct FY06 by US\$ 1.3 billion to reach US\$ 2.6 billion. As mentioned earlier, this was due principally to an extraordinary rise in imports which more than offset a steady rise in exports (for details please see section on **Foreign Trade**). As customary, the growth in imports saw a strong contribution from the rise in imports of *petroleum group* (reflecting sharp rise in oil prices in the international market) as well as of *machinery group*.

**Services (Net)**

The services account deficit widened significantly during Jul-Oct FY05, reflecting increased coverage of foreign exchange transactions, as well as the impact of increased activity in the domestic economy (as reflected in rising imports). It is the same two factors that further widened the net services account deficit in Jul-Oct FY06 to US\$ 1.3 billion, as compared to the US\$ 0.9 billion deficit recorded in the corresponding period of FY05.



<sup>4</sup> 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 accrual basis (after the realization of actual receipts and payments), while trade section is based on custom basis (which include the receipts and payments on the basis of physical movement of goods).

The larger contribution to the widening deficit was from higher outflows for *other business services*, mainly due to extended coverage of the foreign exchange transactions routed through foreign exchange companies (FECs).<sup>5</sup>

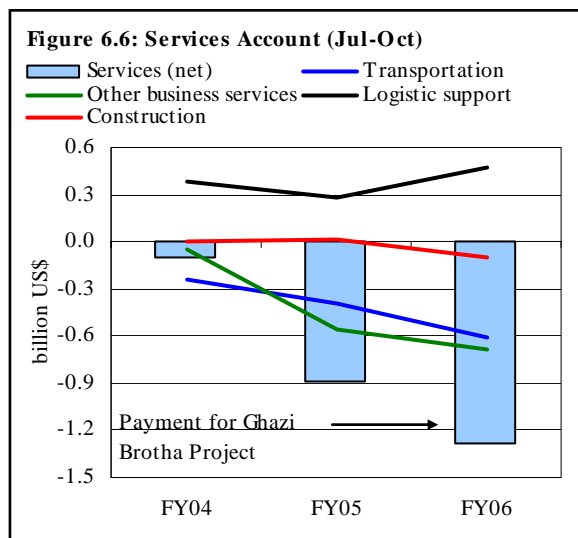
|  | <b>FY05</b>  | <b>FY06</b>    | <b>Difference<br/>FY06 over<br/>FY05</b> |
|--|--------------|----------------|--|
| 1. Trade balance                             | -1,275       | -2,611         | -1,336                                   |
| Exports                                      | 4,516        | 5,129          | 613                                      |
| Imports                                      | 5,791        | 7,740          | 1,949                                    |
| 2. Services ( net )                          | -886         | -1,278         | -392                                     |
| Transportation                               | -395         | -613           | -218                                     |
| Travel                                       | -329         | -326           | 3  |
| Communication services                       | 94           | 46             | -48                                      |
| Other business services                      | -557         | -691           | -134                                     |
| Government services                          | 365          | 532            | 167                                      |
| Of which logistic support                    | 280          | 474            | 194                                      |
| Other  | -64          | -226           | -162                                     |
| 3. Income ( net )                            | -709         | -801           | -92                                      |
| Investment income( net )                     | -710         | -801           | -91                                      |
| Direct investment                            | -518         | -652           | -134                                     |
| Of which: Profit & dividend                  | -147         | -167           | -20                                      |
| Purchase of crude oil & minerals             | -273         | -313           | -40                                      |
| Portfolio investment                         | -29          | -43            | -14                                      |
| Of which: Profit & dividend                  | -10          | -23            | -13                                      |
| IMF charges & interest on off. external debt | -164         | -146           | 18                                       |
| Interest on private external debt            | -27          | -32            | -5                                       |
| Others                                       | 28           | 72             | 44                                       |
| 4. Current transfers ( net )                 | 2,749        | 2,647          | -102                                     |
| Private transfers                            | 2,735        | 2,618          | -117                                     |
| Workers remittance                           | 1,318        | 1,375          | 57                                       |
| FCA – residents                              | 264          | 53             | -211                                     |
| Others                                       | 1,153        | 1,190          | 37                                       |
| Official transfers                           | 14           | 29             | 15                                       |
| Saudi oil facility                           | 0            | 0              | 0  |
| Cash grants                                  | 3            | 17             | 14                                       |
| <b>Current account balance</b>               | <b>(121)</b> | <b>(2,043)</b> | <b>-1,922</b>                            |

<sup>5</sup> Following the transformation of moneychangers into foreign exchange companies (FECs), the foreign exchange transactions which were previously undertaken by moneychangers are now being channelized through FECs. As explained in earlier reports (see *SBP Annual Report FY05*), the outflows under FECs have no impact on the overall current account balance as these are offset by a contra entry in the other private transfers.

Further, higher import growth caused the shipment freight charges to rise, leading to higher outflows for *transportation services*.

Moreover, apart from these routine developments, the abnormal rise in the outflows for *construction services* also contributed in the expansion of services account deficit in Jul-Oct FY06 (see **Figure 6.6**). During this period, construction services recorded a net outflow of US\$ 100 million as compared to the US\$ 13 million inflows in the corresponding period of the last year. This was due to the deferred payments for the Ghazi Brotha Dam.

Fortunately, the impact of this outflow was more than offset by receipts for logistic support; the Jul-Oct FY06 receipts totaled US\$ 474 million, up 69 percent (US\$ 194 million) from those received during the corresponding period of FY05.



**Income (Net)**

Investment income outflows recorded a 13 percent YoY rise during Jul-Oct FY06 to reach US\$ 801 million, with the increase largely reflecting a large jump in *direct investment* outflows.

As seen in **Table 6.2**, the outflows for direct investment recorded a rise of US\$ 131 million during this period. The decline in the repatriation of profits as well as rising repatriation of *dividends* and *reinvested earnings*, probably reflects both, increased holdings by foreigners of Pakistani assets as well as expectation of continued growth in corporate profitability.

**Table 6.2: Returns on Direct Investment (Jul-Oct)**  
million US\$

|                       | FY05 | FY06 | Change |
|-----------------------|------|------|--------|
| FDI                   | 525  | 656  | 131    |
| Profits               | 53   | 10   | -43    |
| Dividend              | 94   | 157  | 63     |
| Purchase of oil & gas | 273  | 313  | 40     |
| Reinvested earnings   | 103  | 178  | 75     |

Source: SBP

The outflows on account of *purchase of oil & gas* also rose substantially due to the increased production and higher prices. In particular, the purchase of gas rose from approximately US\$ 110 million during Q1-FY05 to US\$ 129 million during Q1-FY06.

However a large part of the increase in direct investment outflows was offset by a decline in interest payments on external debt and higher earnings on Pakistan's foreign exchange reserves (see **Table 6.3**).

Specifically, the interest payments to Paris club creditors registered a significant fall during Jul-Oct FY06 compared to Jul-Oct FY05. This was because the latter figure included a one-off US\$ 65.4 million payment of accrued interest on a restructured long term official loan to JBIC.<sup>6</sup> In the absence of such payments, the interest payment remained lower in FY06.

**Table 6.3: Details of Interest Payments and Receipts**  
million US\$

|                                | Jul-Oct     |             |            |
|--------------------------------|-------------|-------------|------------|
|                                | FY05        | FY06        | Saving     |
| <b>Payments (I+II)</b>         | <b>246</b>  | <b>288</b>  | <b>-42</b> |
| I <u>Total external debt</u>   | <u>208</u>  | <u>225</u>  | <u>-17</u> |
| Public & publicly guaranteed   | 177         | 190         | -13        |
| Long-term                      | 147         | 128         | 19         |
| Military                       | 11          | 8           | 3          |
| Euro bonds                     | 17          | 47          | -30        |
| Commercial loans/credits       | 2           | 2           | 0          |
| IDB                            | 0           | 5           | -5         |
| Private loans/credits          | 27          | 32          | -5         |
| IMF                            | 4           | 3           | 1          |
| II <u>External liabilities</u> | <u>38</u>   | <u>63</u>   | <u>-25</u> |
| Foreign currency deposits      | 5           | 5           | 0          |
| Special US\$ bonds             | 10          | 9           | 1          |
| Central bank deposits          | 7           | 18          | -11        |
| Others                         | 16          | 31          | -15        |
| <b>Receipts</b>                | <b>55</b>   | <b>122</b>  | <b>67</b>  |
| Interest on reserves           | 36          | 81          | 45         |
| Others                         | 19          | 41          | 22         |
| <b>Net Payments</b>            | <b>-191</b> | <b>-166</b> | <b>25</b>  |

Source: State Bank of Pakistan

On the other hand, the interest payments on Eurobonds witnessed a significant rise of US\$ 30 million during this period. Although the payments for the Eurobonds are expected to remain high in future (see **Box 6.2**), this is expected to be compensated by the fall in the interest payments on long term debt as a result of the re-profiling of Paris club bilateral debt, the substantial write off of the US bilateral debt stock and the prepayment to ADB and private external creditors.

The interest payments on external liabilities also remained high especially due to the payments representing the interest on foreign currency loans extended to

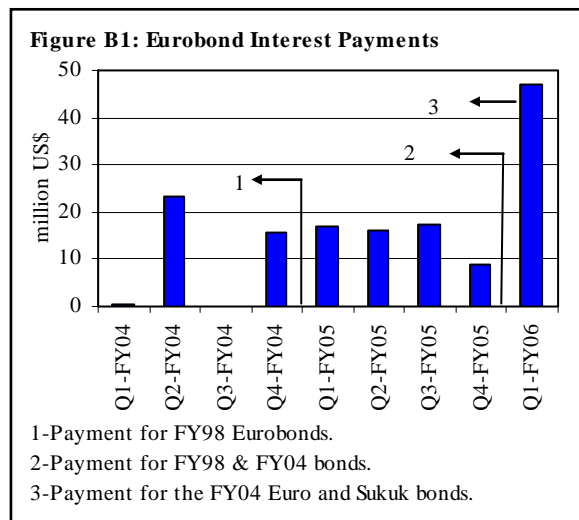
<sup>6</sup> During Q1-FY05, Pakistan paid 80 percent of interest in respect of bilateral agreement signed between JBIC and Government of Pakistan. Under bilateral rescheduling agreement in December 2001, all interest payments falling between 30<sup>th</sup> November 2001 and 30<sup>th</sup> June 2002, and 20 percent of annual interest payments accrued on restructured debt for FY03 and FY04 were deferred.

Pakistani traders,<sup>7</sup> and (2) higher interest payments made by the foreign companies for the working capital requirement. However these higher outflows were more than offset by the higher interest payments on reserves, leading to a net saving of US\$ 25 million during Jul-Oct FY06.

**Box 6.2: Interest Payments on Eurobonds**

The interest payments on the Eurobonds largely comprise of payments for three types of bonds: (1) Eurobonds of US\$ 603 million that were launched during FY98; (2) The US\$ 500 million euro bond launched in Q3-FY04; and finally (3) the US\$ 600 million *sukuk* launched in Q3-FY05.

The payments for the first category fell due in FY00, however following an agreement with the quasi-London Club creditors; this was restructured and the three issues of this market debt were converted to the realized value of US\$ 620 million. Further according to the terms of the restructured bond 10 percent rate of interest was payable semi-annually, with a final maturity of 6 years, ending in December 2005.<sup>8</sup>



Therefore, till Q4-FY04 the interest payment was solely for the restructured bonds worth US\$ 620 million. However from Q1-FY05 the semi annual interest payments for the Euro bond launched in Q3-FY04 also contributed to a US\$ 20 million rise in the total interest payments for Eurobonds in FY05 over FY04. Further during Jul-Oct FY06 the interest payments for the Sukuk launched during Q3-FY05 also added US\$ 30 million to the interest payments during this period as compared to Jul-Oct FY05 (see **Figure B1**). This rise in the interest payments was to moderate Q3-FY06 onwards after the maturity of FY98 bonds, since the government has planned to issue one such bond annually the decline may not materialize.

**Current Transfers**

Current transfers witnessed a US\$ 102 million fall during Jul-Oct FY06 compared to Jul-Oct FY05. This is largely due to lower inflows into resident FCAs, and very weak rise in worker remittance receipts.

<sup>7</sup> The notional outflow of interest on these loans (*other external liabilities*) is offset by an equal inflow in '*other receipts*'.

<sup>8</sup> The first three years entailed no principal payments (grace period); and the total principal payments ending in December 2005 in four installments. The first principal repayment was due on 13<sup>th</sup> December 2002.

*Worker Remittances*

Workers' remittances (cash) recorded 3.9 percent YoY increase, reaching US\$ 1,368.1 million during Jul-Oct FY06 as compared to the YoY 8.6 percent in Jul-Oct FY05 (see **Table 6.4**). But even this weak rise emerged due to a 10 percent YoY increase in remittance receipts during October 2005, in the aftermath of the devastating earthquake in Pakistan early in the month.<sup>9</sup> To put this in perspective, Jul-Sep FY06 remittances recorded a marginal growth of 1.5 percent, in contrast to the 10.3 percent growth seen during Jul-Sep FY05.

Inflows from UK recorded a significant rise of US\$ 32.5 million during Q1-FY06. This rise was however concentrated in the months of Aug & Sep FY06 possibly due to the July FY06 bombings in London that caused Pakistani residents there to repatriate some capital to Pakistan. On the other hand, aggregate remittances from UAE and USA recorded a fall of US\$ 34 million during this period. The drop in remittances from USA suggests that the environment of strict financial checks and controls in USA imposed after Sep 11 has started to relax now.

The fall in remittances from UAE may partly be attributable to huge investments by the expatriate Pakistanis in the real estate there. In addition, the sharp rise in international gold prices might also have negatively impacted the remittances.

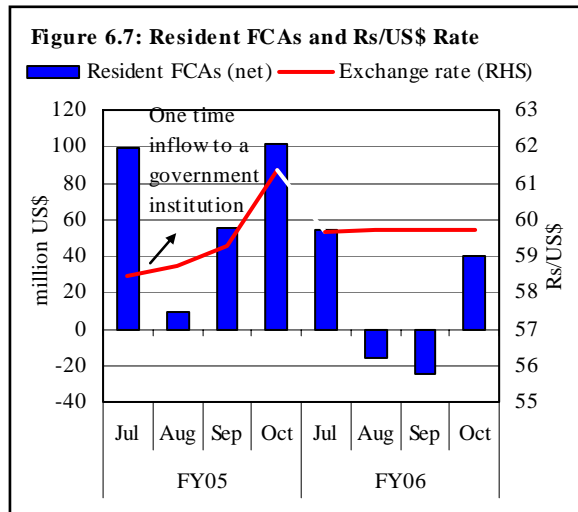
**Table 6.4: Workers' Remittances**  
million US\$

|  | Jul-Oct       |               | Growth rate  |
|--|---------------|---------------|--------------|
|  | FY05          | FY06          |              |
| <b>I. Gulf region</b>                  | <b>585.8</b>  | <b>610.1</b>  | <b>4.2</b>   |
| Bahrain                                | 32.3          | 31.4          | -2.8         |
| Kuwait                                 | 66.0          | 72.6          | 10.1         |
| Qatar                                  | 32.9          | 35.3          | 7.3          |
| Saudi Arabia                           | 205.6         | 232.6         | 13.1         |
| Sultanat-e-Oman                        | 35.1          | 42.0          | 19.7         |
| U.A.E.                                 | 214.0         | 196.3         | -8.3         |
| <b>II. U.S.A.</b>                      | <b>407.4</b>  | <b>391.8</b>  | <b>-3.8</b>  |
| <b>III. Other than Gulf &amp; US</b>   | <b>323.6</b>  | <b>366.2</b>  | <b>13.2</b>  |
| Canada                                 | 12.8          | 26.8          | 110.1        |
| Germany                                | 17.6          | 19.9          | 13.1         |
| Japan                                  | 2.7           | 2.2           | -17.0        |
| Norway                                 | 4.7           | 5.5           | 16.6         |
| U.K.                                   | 116.2         | 148.7         | 28.0         |
| Other                                  | 169.7         | 163.1         | -3.9         |
| <b>Total</b>                           | <b>1316.8</b> | <b>1368.1</b> | <b>3.9</b>   |
| <b>of which: Exchange Companies</b>    | <b>96.6</b>   | <b>220.6</b>  | <b>128.5</b> |
| <b>Encashment of FEBCs &amp; FCBCs</b> | <b>2.0</b>    | <b>7.1</b>    | <b>247.5</b> |
| <b>Grand total</b>                     | <b>1318.8</b> | <b>1375.2</b> | <b>4.3</b>   |

<sup>9</sup> Inflows from the USA and Saudi Arabia alone increased by US\$ 26 million in October 2005

*Resident FCAs*

The net inflows into resident FCAs recorded a fall of US\$ 211 million during Jul-Oct FY06 compared to the same period in FY05. The change in FCAs inflows is generally driven by the expectations regarding strength of US dollar versus the rupee.<sup>10</sup> Moreover, the one time movement of funds, such as privatization proceeds and FDI related flows, also contributed to the outflows from FCAs.



During Jul-Oct FY05 due to the one-time inflows in the deposits of a government institution and the expectations regarding appreciation in the value of dollar caused increased inflows into FCAs. By contrast, Jul-Oct FY06 saw relative stability in the value of US dollar, and a one-off outflow of funds<sup>11</sup> (see **Figure 6.7**).

**6.1.2 Financial Account**

The improvement in the financial account evident during H2-FY05 continued into the succeeding year, with Jul-Oct FY06 witnessing a net surplus of US\$ 1.4 billion as compared to the US\$ 1.4 billion deficit in Jul-Oct FY05 (see **Table 6.5**). To put the latter in perspective however, it should be noted that the high Jul-Oct FY05 figure included one-off payments.<sup>12</sup> Adjusting for these non-recurring flows, the Jul-Oct FY05 financial account deficit falls to US\$ 811 million, but even then the Jul-Oct FY06 figure reflects a US\$ 2.2 billion improvement.

Encouragingly, a large share of this (adjusted) improvement in the financial account came from higher net foreign investment. Further higher receipts of project loan from IDA, supplier’s credit inflows along with low payments of other liabilities also contributed in the financial account improvement.

<sup>10</sup> Around 80 percent of total FCAs are denominated in US\$.  
<sup>11</sup> Indeed if this US\$ 63.4 million outflow from the account of a private firm is excluded, the net flows into FCA during the Jul-Oct FY06 turn positive.  
<sup>12</sup> Non-recurring flows during Q1-FY05 include US\$ 495 million of US debt write-off, and US\$ 100 million of settlement of foreign currency loans of commercial banks to repay PARCO loans.

**Table 6.5: Financial Account**

million US\$

| Items  | Jul-Oct      |             | Abs. Change |
|--|--------------|-------------|-------------|
|  | FY05         | FY06        |             |
| <b>Financial Account (1 through 4)</b>       | <b>-1406</b> | <b>1430</b> | <b>2836</b> |
| <b>1. Direct investment abroad</b>           | <b>-22</b>   | <b>-14</b>  | <b>8</b>    |
| <b>2. Direct investment in Pakistan</b>      | <b>275</b>   | <b>466</b>  | <b>191</b>  |
| <i>of which: Equity capital</i>              | 172          | 288         | 116         |
| Reinvested earning                           | 103          | 178         | 75          |
| <b>3. Portfolio investment</b>               | <b>-5</b>    | <b>191</b>  | <b>196</b>  |
| <i>of which: (Stock markets)</i>             | 25           | 216         | 191         |
| <i>Special US Dollar bonds</i>               | -30          | -27         | 3           |
| <i>Euro bonds</i>                            | -2           | 0           | 2           |
| Net foreign investment                       | 248          | 643         | 395         |
| <b>4. Other investment (I+II)</b>            | <b>-1654</b> | <b>787</b>  | <b>2441</b> |
| I. Assets                                    | -699         | 343         | 1042        |
| i. Outstanding exports bills (Exporters)     | -47          | -126        | -79         |
| ii. Outstanding exports bills (DMBs)         | 20           | 62          | 42          |
| iii. Currency & deposits                     | -672         | 407         | 1079        |
| <i>of which: Bank</i>                        | -664         | 367         | 1031        |
| II. Liabilities                              | -955         | 444         | 1399        |
| i. Foreign Long-term loans / credits ( net ) | -265         | 303         | 568         |
| <i>of which: Project assistance</i>          | 199          | 212         | 13          |
| Food aid                                     | 0            | 0           | 0           |
| Non-food aid                                 | 341          | 446         | 105         |
| Amortization                                 | 805          | 355         | -450        |
| ii. Private loans                            | -126         | 42          | 168         |
| <i>of which: Suppliers credits/MNCs</i>      | 12           | 167         | 155         |
| Supplier credits repayments                  | 138          | 125         | -13         |
| iii. Short term capital, (official)          | -3           | -33         | -30         |
| <i>of which: Commercial banks (net)</i>      | -100         | -100        | 0           |
| IDB (net)                                    | 97           | 67          | -30         |
| iv. Currency & deposits                      | -348         | 154         | 502         |
| <i>of which: Trade financing</i>             | -444         | 364         | 808         |
| v. Other liabilities                         | -213         | -22         | 191         |

Source: Statistics Department, SBP

Note= LT: Long-term, DMBs: Deposit Money Banks, ST: Short-term.

**Net Foreign Investment**

The net foreign investment recorded a substantial YoY rise of US\$ 395 million during Jul-Oct FY06 due to rising foreign direct investment as well as foreign portfolio investment.

Pakistan saw a US\$ 196 million increase in foreign direct investment during Jul-Oct FY06 as compared to Jul-Oct FY05 largely in the sectors of *telecommunication, financial business and oil & gas exploration*. In particular, investments in the *telecommunication* sector alone recorded US\$ 83 million rise in this period, mainly reflecting the entry of two new companies in the cellular phone market. Further, investors from USA made substantial investments in the sector of *oil and gas exploration*.

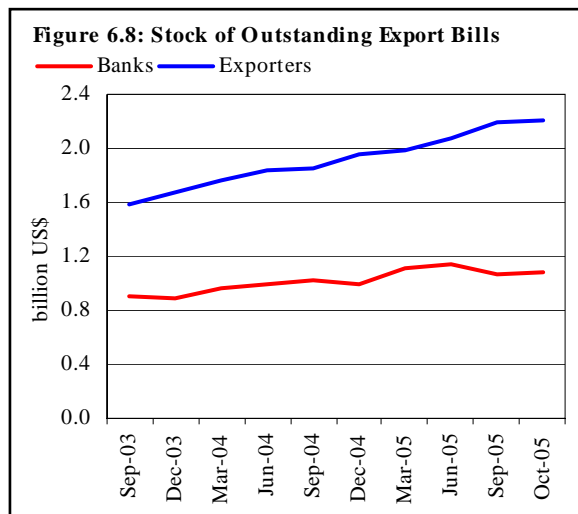
Portfolio investment also recorded a remarkable improvement; moving from a net outflow of US\$ 5 million in Jul-Oct FY05 to a net inflow of US\$ 191 million during Jul-Oct FY06. A larger share of this rise was contributed by the investors from USA and the UK.

**Outstanding Export Bills (OEBs)**

The stock of outstanding export bills recorded a US\$ 64 million rise during Jul-Oct FY06 as compared to the US\$ 27 million rise during Jul-Oct FY05. Detailed analysis shows that the OEBs held by exporters witnessed an increase in this period, whereas the OEBs with deposit money banks (DMBs) recorded a significant decline (see **Figure 6.8**).

OEBs held by exporters witnessed US\$ 126 million rise as compared to the US\$ 47 million rise during Jul-Oct FY05. This is probably owing to higher exports during this period.

On the other hand, OEBs of banks witnessed a significant decline of US\$ 62 million as compared to the decline of US\$ 20 million in Jul-Oct FY05. This is due to higher realization of export proceeds to banks that might have outweighed



the discounting of OEBs by exporters, leading to a fall in the OEBs stock of DMBs.

### **Currency and Deposits**

In contrast to the US\$ 672 million increase seen in Jul-Oct FY05, *currency and deposits* assets recorded a US\$ 407 million fall during Jul-Oct FY06.<sup>13</sup> The latter was largely caused by a decline in banks' FE-25 Nostro holdings by US\$ 367 million, mainly because of (1) a fall in foreign currency deposits, and (2) increased lending in the trade financing by US\$ 364 million (as compared to net retirement of US\$ 444 million during Jul-Oct FY05).

### **Foreign Long-term Loans**

The long-term official loans registered a net inflow of US\$ 303 million during Jul-Oct FY06 as compared to the US\$ 265 million net outflow during Jul-Oct FY05. Moreover, it should be noted that the latter

| million US\$ |         |         |
|--------------|---------|---------|
|              | Q1-FY05 | Q1-FY06 |
| Receipts     | 540     | 658     |
| Amortization | 310     | 355     |
| Net flows    | 230     | 303     |

figure includes the notional outflow of US\$ 495 million representing the debt relief provided by the US; however the net inflows during Jul-Oct FY06 remain higher even after making this adjustment (see **Table 6.6**). The rise in the net flows during Jul-Oct FY06 is attributable to the receipt of around US\$ 200 million concessional loan from IDA during Oct FY06.

### **Private/Short-term Loans**

Private loans witnessed a net inflow of US\$ 42 million during Jul-Oct FY06 as compared to the net outflow of US\$ 126 million in Jul-Oct FY05 largely due to higher inflows in the *transport, storage and communication* sector.

Short term loans contain commercial loans along with the IDB financing for oil imports. This head witnessed a higher net outflow of US\$ 33 million during Jul-Oct FY06 as compared to the US\$ 3 million outflow during Jul-Oct FY05. Analysis reveals that during the period of Jul-Oct FY06, although higher inflows from IDB worth US\$ 163 million were received, however due to repayment of US\$ 96 million, the net inflows remained lower during Jul-Oct FY06. On the other hand the US\$ 100 million outflows in the commercial loans reflect the rolled-over amount.

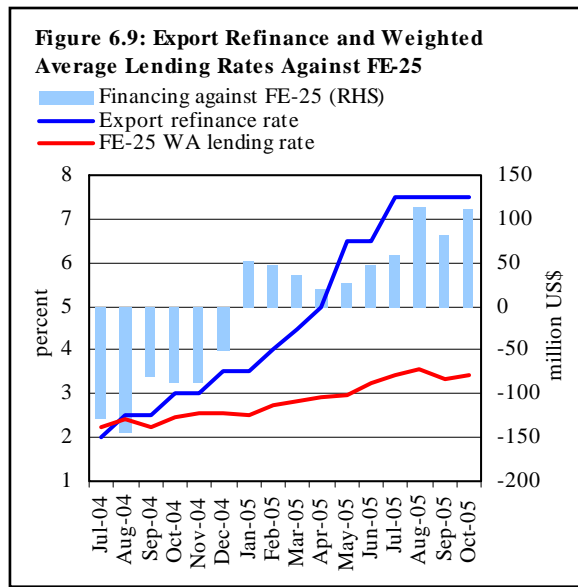
<sup>13</sup> This head comprises of currency and deposits held by monetary authorities, general government, commercial banks and other sectors.

**FE-25 Related Trade Financing and Other Liabilities**

Trade financing against FE-25 deposits recorded a US\$ 364 million rise during Jul-Oct FY06 opposed to the US\$ 444 million net retirement during Jul-Oct FY05.

This trend largely resulted from a change in the lending rates of export finance scheme (EFS) as compared to the weighted average lending rate for trade financing against FE-25 deposits. The sharp rise in the EFS rates since July FY04 has made borrowing against FE-25 more attractive for exporters (see **Figure 6.9**).

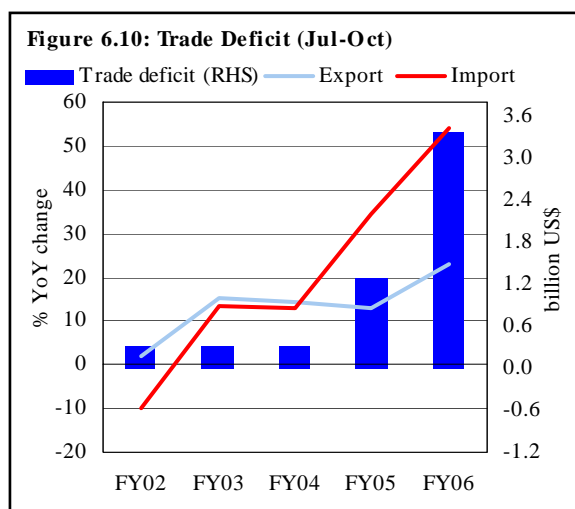
However keeping in view the change announced by SBP in the method of calculation of EFS rates since June FY05, the widening difference between these two rates might narrow in future. This can possibly result in a reversal of the Jul-Oct FY06 trend by lowering trade financing extended to exporters against FE-25 deposits. Further the strong growth of imports also might have raised the need of trade financing for importers.



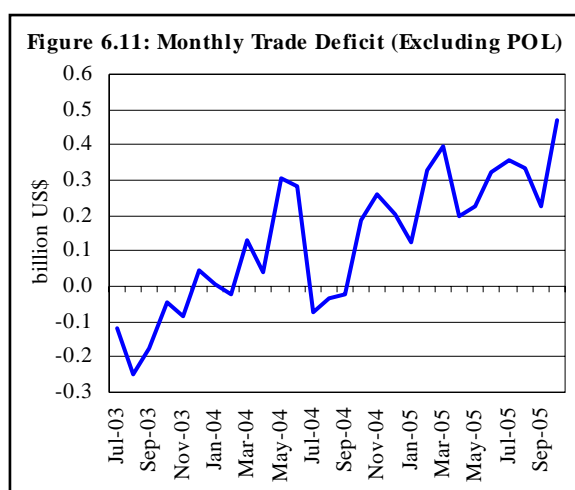
Outflows under *other liabilities* also witnessed a considerable fall of US\$ 22 million as compared to the outflow of US\$ 213 million in the corresponding period of the last year. However, the sharp increase in net outflows of *other liabilities* during Jul-Oct FY05 however, reflects the settlement of foreign currency loans (US\$ 100 million) arranged by the commercial banks in Q4-FY04 to repay PARCO loans. In the absence of this one off effect, outflows remained lower in FY06.

## 6.2 Foreign Trade<sup>14</sup>

Although Jul-Oct FY06 exports rose by a very robust 22.8 percent YoY, imports increased at a much faster pace (54.0 percent YoY), thereby sharply widening the trade deficit for the period (see **Figure 6.10**). Indeed, this US\$ 3.4 billion trade deficit for Jul-Oct FY06 was more than double the US\$ 1.3 billion deficit recorded during the corresponding period previous year.



A significant contribution to the exceptionally strong imports growth during the Jul-Oct FY06 was from international oil prices. Petroleum group imports for the period totaled US\$ 2.1 billion for Jul-Oct FY06, up 73.2 percent YoY, with the increase being driven almost entirely by higher prices (import volumes fell by 2.2 percent YoY). In fact, the higher prices have led to an increase of US\$ 924 million in import bill during Jul-Oct

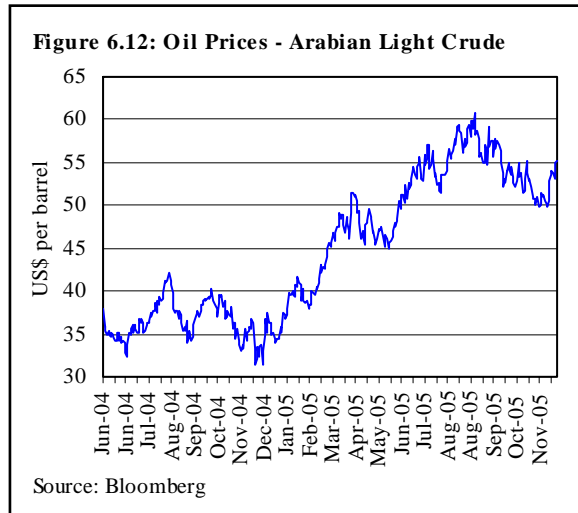


FY06. However, even on excluding the oil bill, the import growth remains an exceptionally strong 48.8 percent. Indeed, a look at **Figure 6.11** shows that the monthly trade deficit ex-oil imports continues to expand. Thus, even though Pakistan's oil import bill could shrink somewhat in the months ahead as international oil prices retreat from their peaks (see **Figure 6.12**), this may be

<sup>14</sup> 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*.

offset by the growth in non-oil imports (particularly machinery, raw material and imports to support relief efforts in areas affected by October 2005 earthquake). This suggests that even efforts to reduce domestic oil consumption through higher prices may still not help substantially, even while fueling inflation.

As shown by a number of studies, Pakistan's imports have proved to be highly income elastic in the short run, and this tendency would probably have been strengthened by the liberalization of the external sector in recent years.<sup>15</sup> This suggests that short of substantially compressing aggregate demand, and thereby GDP growth, the rise in imports is unlikely to be contained in the short run.<sup>16</sup> However, the same studies also show that in the long run, the import and export elasticities are likely to converge.



The key challenges for policy makers therefore are how to: (1) encourage and accelerate this long-run convergence in export and import elasticities; and, (2) to finance the trade deficit in the interim period.

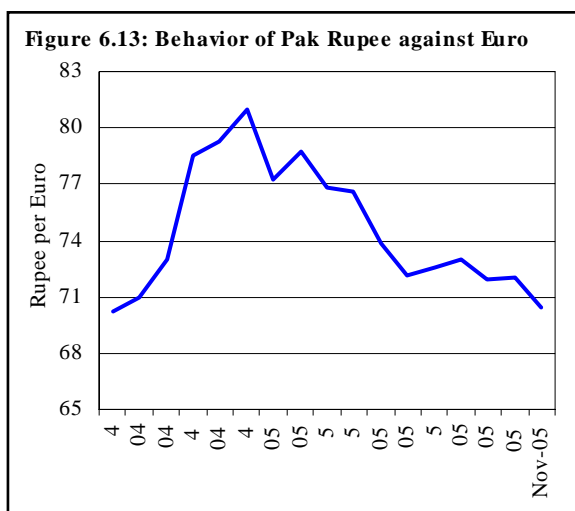
Historical evidence suggests that fiscal measures to contain imports are unlikely to be very effective. In particular, custom tariffs would be capped by WTO commitments, and would create other distortions in the economy, e.g. possibly reinvigorating the demand for foreign exchange in the kerb market to finance import demand in the parallel economy. This suggests a greater role for exchange rate policy in containing import demand in the short run (incidentally, this would also boost exports in the short run). However, it must be recognized here that such policies carry significant risks (and are effective primarily in the short run), and

<sup>15</sup> In fact, deregulation of other sectors of the economy such as telecommunication also has contributed to higher import growth in recent years.

<sup>16</sup> This expectation is further supported by the need for imports to support the relief and rebuilding efforts for the regions devastated by the October 2005 earthquake in Pakistan.

cannot correct the imbalances at their own. Moreover, it must be noted that a significant portion of the imports are also essential for generating exports.

Perforce, policy attention must therefore shift increasingly to fostering exports. Here, Pakistan is already enjoying some success, with Jul-Oct FY06 registering export growth well in excess of the 19.5 percent target for the period. Moreover, this good performance was seen despite a number of shocks, including: (1) antidumping duty imposed on bed linen by the European Union (EU); (2) a substantial decline in the prices of textile and clothing in the international market; (3) the relatively disadvantageous position of Pakistan after losing preferential access in EU market under Generalized System of Preference (GSP), while competitors such as Bangladesh and Sri Lanka etc continue to enjoy duty-free access to EU market under GSP plus;<sup>17</sup> and (4) the appreciation of the Rupee against the Euro (see **Figure 6.13**) and rising domestic interest rates.



The emphasis on export growth would require more focus on competitiveness. It may be pointed out that appropriate exchange rate policy is only one element of the overall competitive challenges faced by Pakistani exporters. What is more important for them is to respond to increasingly demanding markets through efficient and innovative practices. Under the new trading system, diversification, reliability, delivery time lines and quick adjustment to the changes in international market have become important sources of competitiveness. The role of the government would be to provide trade support infrastructure and strive for market access through regional preferential or free trade arrangements.<sup>18</sup>

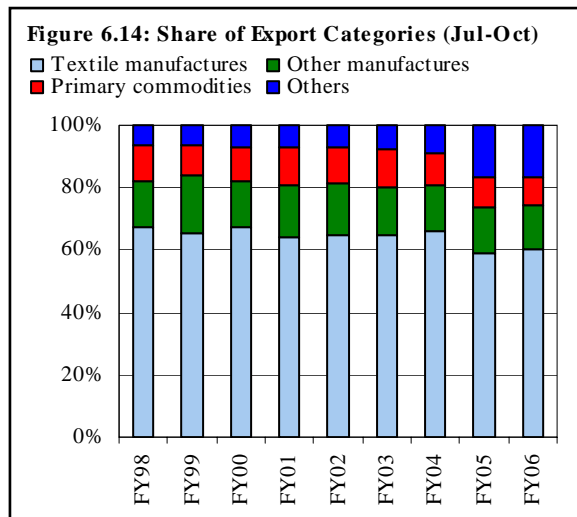
<sup>17</sup> While duty free access is provided under *GSP plus* to least developing countries by the EU, the *GSP general* entails market access with some duty concessions as compared to the duty on the imports of other countries into the EU market.

<sup>18</sup> The government is making efforts to improve market access in various countries (e.g., China, Sri Lanka, Malaysia, USA, Thailand, Turkey, Bangladesh etc.) through various trade arrangements.

### 6.2.1 Exports

The overall export depicted an impressive growth of 22.8 percent during Jul-Oct FY06 which was higher than the 19.5 percent target<sup>19</sup> for period as well as the growth of 12.8 percent during the corresponding period of FY05. This performance is encouraging given the decline in the prices of textile and clothing as a result of intensified price competition in the international market, imposition of antidumping duty on bed linen exports to EU together with end of the special Generalized System of Preference (GSP) incentive by EU, and appreciation of Pak Rupee against Euro (see **Figure 6.13**).

The export growth was mainly driven by the textile sector, the share of which in total exports has increased to 60.3 percent during Jul-Oct FY06 against 58.8 percent during the corresponding period of last year. However, from the perspective of the need to diversity exports, it is heartening to note that the share of the traditional textile exports nonetheless remained below the 64-67 percent range seen in years prior to FY05 (see **Figure 6.14**).



Of greater importance however, is the performance of exports after the complete phase out of the MFA, i.e. January 2005 onwards. In order to assess this performance during January-October 2005, the monthly growth of total exports and textile exports during the period is compared with the monthly averages growth of total exports and textile exports during the

**Table 6.7: Textile Export Growth during Post MFA**  
percent

|     | 5Years averages |      |      |      |
|-----|-----------------|------|------|------|
|     | T               | Te   | T    | Te   |
| Jan | 1               | 20.2 | 5.0  | -3.4 |
| Feb | 8.2             | 10.5 | 28.7 | 18.9 |
| Mar | 8.8             | 10.3 | 31.5 | 12.8 |
| Apr | 12.5            | 1    | 18.4 | -5.0 |
| May | 1               | 9.6  | 29.6 | 17.0 |
| Jun | 9.7             | 9.8  | 2    | 1    |
| Jul | 15.0            | 1    | 7.5  | 3.4  |
| Aug | 1               | 9.0  | 18.6 | 21.1 |
| Sep | 9.8             | 5.8  | 34.7 | 51.3 |
| Oct | 8.3             | 7.2  | 33.2 | 33.1 |

<sup>19</sup> The target is set by Pakistan's export promotion bureau (EPB).

preceding five years. Heartening, on average, the total exports as well as textile exports performance improved in the post-MFA regime (see **Table 6.7**).

**Table 6.8: Major Exports (Jul-Oct)**

Value: million US\$; Unit value: US\$

|   | Unit  | FY05           |               | FY06           |               | Abs<br>chg. in<br>value | % change in Jul-Oct<br>FY06/Jul-Oct FY05 |             |               |
|---|-------|----------------|---------------|----------------|---------------|-------------------------|--|-------------|---------------|
|   |       | Value          | Unit<br>value | Value          | Unit<br>value |                         | Qty                                      | Value       | Unit<br>value |
|   |       |                |               |                |               |                         |  |             |               |
| <b>A. Primary commodities</b>                         |       | <b>449.9</b>   |               | <b>524.4</b>   |               | <b>74.5</b>             |  | <b>16.6</b> |               |
| 1 Rice  | MT    | 214.5          | 360.4         | 299.2          | 394.3         | 84.7                    | 27.5                                     | 39.5        | 9.4           |
| 2 Raw cotton  | MT    | 17.8           | 1043.2        | 21.5           | 1012.1        | 3.7                     | 24.7                                     | 21.0        | -3.0          |
| 3 Raw wool (excl wool tops)                           | MT    | 0.1            | 1569.4        | 0.0            | 521.7         | -0.1                    | 0.0                                      | -66.8       | -66.8         |
| 4 Fish & fish preparations                            | MT    | 48.3           | 1841.0        | 61.8           | 1510.2        | 13.5                    | 56.0                                     | 27.9        | -18.0         |
| 5 Leather   | SQM   | 101.2          | 16.5          | 80.7           | 16.8          | -20.5                   | -21.8                                    | -20.3       | 1.9           |
| 6 Guar and guar Products                              | MT    | 8.2            | 1270.4        | 2.1            | 1153.7        | -6.1                    | -71.8                                    | -74.4       | -9.2          |
| 7 Fruits  | MT    | 39.0           | 335.0         | 37.5           | 372.3         | -1.5                    | -13.4                                    | -3.8        | 11.1          |
| 8 Vegetables  | MT    | 10.4           | 361.6         | 7.0            | 346.4         | -3.3                    | -29.1                                    | -32.1       | -4.2          |
| 9 Crude animal material                               | MT    | 6.1            | 3765.7        | 10.0           | 16771.9       | 3.9                     | -63.4                                    | 63.2        | 345.4         |
| 10 Oil seeds & nuts etc.                              | MT    | 4.1            | 811.4         | 4.4            | 683.5         | 0.3                     | 27.0                                     | 7.0         | -15.8         |
| <b>B. Textile manufactures</b>                        |       | <b>2,637.5</b> |               | <b>3,322.4</b> |               | <b>684.9</b>            |  | <b>26.0</b> |               |
| 1 Cotton yarn   | MT    | 291.6          | 2129.5        | 434.3          | 2030.5        | 142.6                   | 56.2                                     | 48.9        | -4.7          |
| 2 Cotton fabrics ( woven )                            | SQM   | 563.9          | 0.7           | 751.0          | 0.8           | 187.1                   | 21.9                                     | 33.2        | 9.3           |
| 3 Hosiery (knitwear)                                  | DOZ   | 683.6          | 24.5          | 613.9          | 22.9          | -69.7                   | -3.9                                     | -10.2       | -6.5          |
| 4 Bedware   | MT    | 371.7          | 5468.1        | 670.9          | 5445.0        | 299.2                   | 81.3                                     | 80.5        | -0.4          |
| 5 Towels  | MT    | 157.2          | 3839.4        | 202.9          | 3743.9        | 45.7                    | 32.4                                     | 29.1        | -2.5          |
| 6 Cotton bags and sacks                               | MT    | 4.3            | 3980.2        | 1.1            | 4075.2        | -3.3                    | -75.7                                    | -75.1       | 2.4           |
| 7 Readymade garments<br>Tarpaulin & other canvas      | DOZ   | 258.2          | 33.3          | 461.7          | 34.5          | 203.6                   | 73.0                                     | 78.8        | 3.3           |
| 8 goods   | MT    | 16.0           | 2554.9        | 11.8           | 2346.0        | -4.2                    | -19.5                                    | -26.1       | -8.2          |
| 9 Tule, lace, embroidery etc.                         | ( - ) | 3.7            | ---           | 1.0            | ---           | -2.7                    | ---                                      | -73.0       | ---           |
| 10 Synthetic textiles                                 | SQM   | 116.3          | 0.7           | 23.5           | 0.7           | -92.8                   | -78.9                                    | -79.8       | -4.3          |
| 11 Other textile made up<br>Waste material of textile | ( - ) | 169.2          | ---           | 149.5          | ---           | -19.7                   | ---                                      | -11.6       | ---           |
| 12 fibres/fabrics                                     | MT    | 1.9            | 551.2         | 0.9            | 826.3         | -1.0                    | -69.0                                    | -53.6       | 49.9          |
| <b>C. Other manufactures</b>                          |       | <b>661.5</b>   |               | <b>758.7</b>   |               | <b>97.1</b>             |  | <b>14.7</b> |               |
| 1 Carpets, rugs & mats                                | SQM   | 75.4           | 58.5          | 75.2           | 56.1          | -0.1                    | 4.2                                      | -0.2        | -4.2          |
| 2 Petro and petro products                            | MT    | 118.2          | 334.2         | 195.3          | 475.1         | 77.1                    | 16.2                                     | 65.3        | 42.2          |
| 3 Sports goods  | ( - ) | 92.0           | ---           | 89.7           | ---           | -2.3                    | ---                                      | -2.5        | ---           |
| 4 Leather manufactures                                | ( - ) | 163.5          | ---           | 225.1          | ---           | 61.7                    | ---                                      | 37.7        | ---           |
| 5 Surgical & medical instru                           | NO    | 58.8           | ---           | 44.2           | ---           | -14.6                   | ---                                      | -24.9       | ---           |
| 6 Cutlery   | GR    | 10.4           | 24.4          | 11.3           | -             | 0.9                     | -77.6                                    | 8.5         | ---           |
| 7 Onyx manufactured                                   | MT    | 3.2            | 1651.3        | 4.4            | 1621.3        | 1.3                     | 43.3                                     | 40.7        | -1.8          |
| 8 Chemicals & pharmaceuticals                         | ( - ) | 105.0          | ---           | 105.6          | ---           | 0.7                     | ---                                      | 0.7         | ---           |
| 9 Molasses  | MT    | 29.8           | 52.6          | 6.4            | 85.1          | -23.5                   | -86.8                                    | -78.6       | 61.8          |
| 10 Sugar  | MT    | 5.3            | 248.9         | 1.3            | -             | -4.0                    | -84.7                                    | -75.7       | ---           |
| <b>D. Others</b>                                      |       | <b>733.6</b>   | ---           | <b>900.7</b>   | ---           | <b>167.1</b>            | ---                                      | <b>22.8</b> | ---           |
| <b>Total</b>  |       | <b>4,482.6</b> |               | <b>5,506.2</b> |               | <b>1,023.6</b>          |  | <b>22.8</b> |               |

Source: Federal Bureau of Statistics

### **Primary Commodities**

The primary commodities depicted YoY growth of 16.6 percent during the Jul-Oct period of current fiscal year against 8.2 percent growth during the corresponding period last year. Despite this impressive growth, the contribution of this export category in total export growth is just 7.3 percent. As a result, the group share in total exports has declined to 9.5 percent during Jul-Oct FY06 which is lowest as compared to average share of the group for Jul-Oct period during the past several years (see **Figure 6.14**). The items which showed reasonable export growth includes *rice* and *fish & fish preparation* (see **Table 6.8**).

Rice exports recorded substantial YoY growth of 39.5 percent during Jul-Oct FY06 as against 4.6 percent during the same period last year. This was contributed by increases in export values as well as higher unit values. The higher export volumes may be the result of the increase in rice production as the timely rains benefited the crop to record production of 5.0 million ton during the current year surpassing the production of 4.8 million tons realized last year. Thus export of rice is likely to pick up further in the remaining period of FY06. However, rice exports to Kenya might be affected adversely due to the introduction of a pre-shipment inspection requirement, which adds to the cost of exporters.

Despite falling unit values, the fish and fish preparation exports observed 27.9 percent YoY growth during Jul-Oct FY06 as compared to the YoY *decline* of 23.1 during the corresponding period last year.

The raw cotton exports witnessed 21.0 percent YoY growth during Jul-Oct FY06 even over the substantial growth of 57.6 percent during the same period last year. However, the share of raw cotton exports in total exports of primary commodities is still very low. Interestingly, the unit vales of raw cotton fell during Jul-Oct FY06. However, it is expected that with the low cotton production in major producer countries (such as USA, China, Pakistan, Brazil, Australia etc.) together with the projected increase in global demand, unit prices of raw cotton would rise in 2005-2006 season;<sup>20</sup> this in turn may impact the unit values of export of textile manufactures.

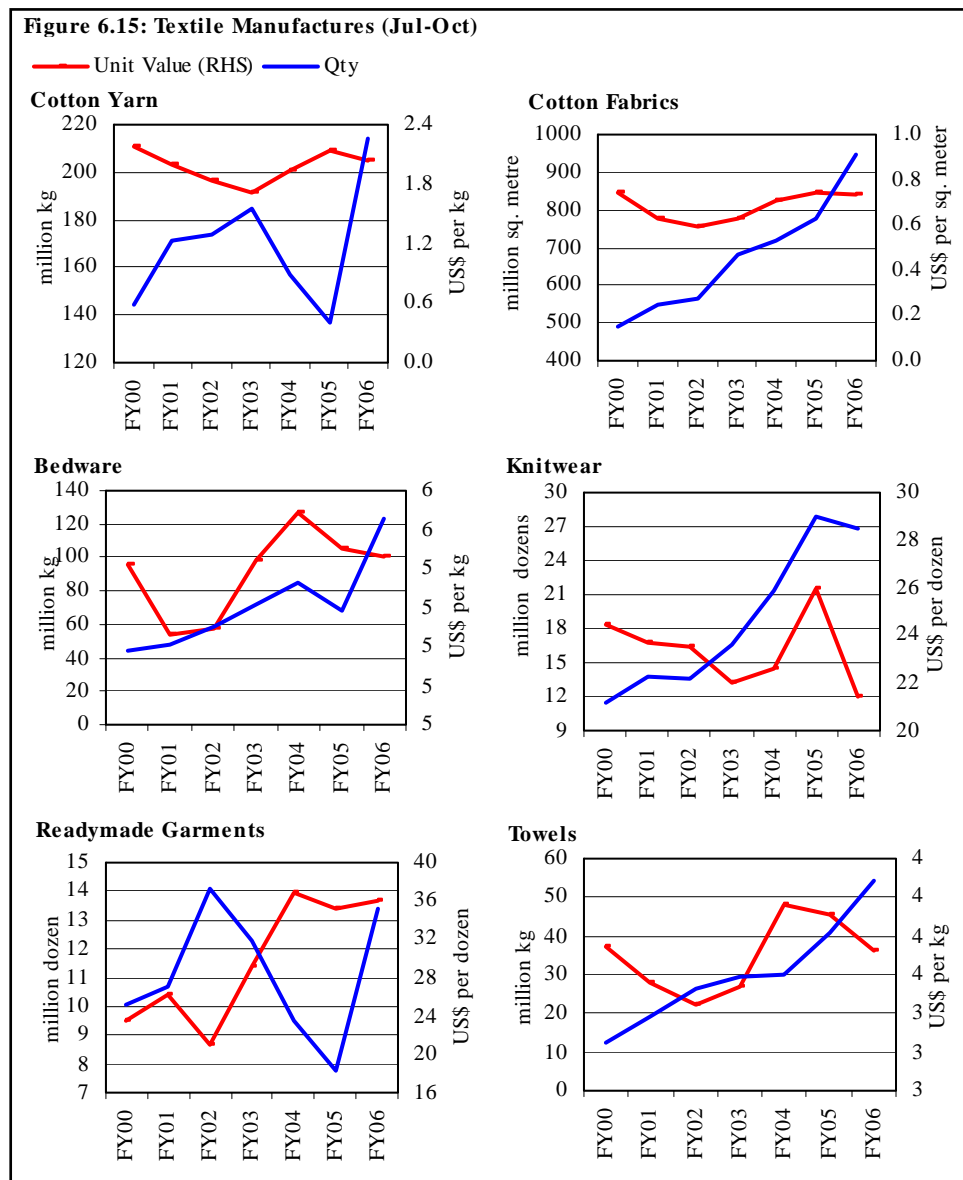
### **Textile Manufacture**

The textile manufacture exports witnessed substantial YoY growth of 26.0 percent during Jul-Oct FY06 as compared to a nominal YoY growth of 0.5 percent during

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<sup>20</sup> While the cotton production in China (Mainland) is expected to decline by 9 percent, the consumption forecasts are up by 10 percent. The resulting higher import demand by China is likely to raise international cotton prices (Source: International Cotton Advisory Committee, Press Release, December 1, 2005).

the corresponding period of FY05, despite the substantial constraints discussed earlier, as well as lower prices (see **Figure 6.15** and **Table 6.9**). The major contributors to the textile manufacture exports were *bedware, ready made garments, cotton fabrics, cotton yarn* and *towels*. On the other hand, exports of *synthetic textiles, other textile made up* and *knitwear* declined.



An important development is the Sino-US textile trade agreement whereby the growth of China's textile exports under selected categories to the US market have been capped during 2006, 2007 and 2008 to 10 percent, 12.5 percent and 16 percent respectively. While the safeguard measures by US on textile exports from China are unfortunate, this provides Pakistani textile exporters some room to revisit their business strategies accordingly.

**Table 6.9** shows that the unit values of all the major textile manufactures increased in the pre-MFA period (Jan-Oct 2004), thereby increasing major textile exports by US\$ 303 million. However, the unit values declined after the complete quota phase-out period (Jan-Oct 2005) as a result of intensified price

**Table 6.9: Impact of Unit Value Changes**

| million US\$            |              |              |
|-------------------------|--------------|--------------|
|                         | Jan-Oct CY04 | Jan-Oct CY05 |
| Cotton yarn             | 170          | -128         |
| Cotton fabrics (woven ) | 36           | 156          |
| Hosiery (knitwear)      | 44           | -35          |
| Bedware                 | -1           | -33          |
| Towels                  | 5            | -27          |
| Readymade garments      | 48           | -52          |
| <b>Total impact</b>     | <b>303</b>   | <b>-119</b>  |

competition to gain share in the international market, consequently having adverse impact worth US\$ 119 million on the major textile exports. Interestingly the impact on unit values varies inversely with the degree of value addition.

Despite the impact of anti-dumping duty imposed by the EU and fall in its unit values, the *bedware* exports were able to record impressive YoY growth of 80.5 percent during the Jul-Oct FY06 in contrast to negative growth of 23.0 percent in the corresponding period of the previous year. This suggests the low base effect as the dominant factor behind this substantial growth. Furthermore, the high growth in the presence of anti dumping duty in EU market indicates that *bedware* exporters are diversifying their export market outside the EU region.

Similarly, the exports of *ready made garments* depicted 78.8 percent YoY growth during Jul-Oct FY06 as compared to the negative growth of 26.2 percent YoY during Jul-Oct FY05. However, it is encouraging to note that the unit values of *ready made garments* exports have also increased during this period.

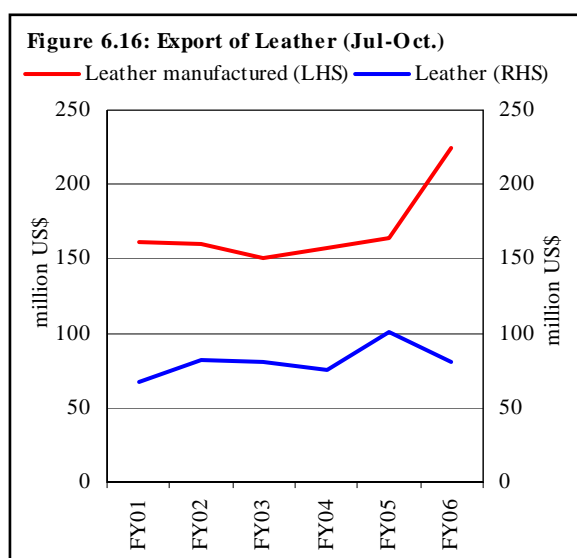
The increase in unit values is more pronounced in *cotton fabric* exports. This, together with rise in export quantity enabled the *cotton fabrics* to record YoY growth of 33.2 percent during Jul-Oct FY06 in comparison with the YoY growth of 10.8 percent during the corresponding period last year.

Towel exports recorded 29.1 percent YoY growth during Jul-Oct FY06 on the top of YoY growth of 31.2 percent during Jul-Oct FY05. The growth performance is remarkable given the high base impact and fall in unit values during the period.

The knitwear exports however recorded YoY decline of 10.2 percent during Jul-Oct FY06 as compared to 41.8 percent YoY growth during the corresponding period last year. The decline in export quantum was reinforced by falling unit values.

### Other Manufactures

The export of *other manufactures* posted a YoY growth of 14.7 percent during Jul-Oct FY06 on the top of 14.3 percent YoY growth during the corresponding period of FY05. Within this group the *petroleum & petroleum products* and *leather manufactures* were the major contributor registering 65.3 percent and 37.7 percent YoY growth rate respectively during the period under review. Moreover, it is encouraging to note that the exports of *leather manufacture* are substituting the raw leather exports (see **Figure 9.16**).

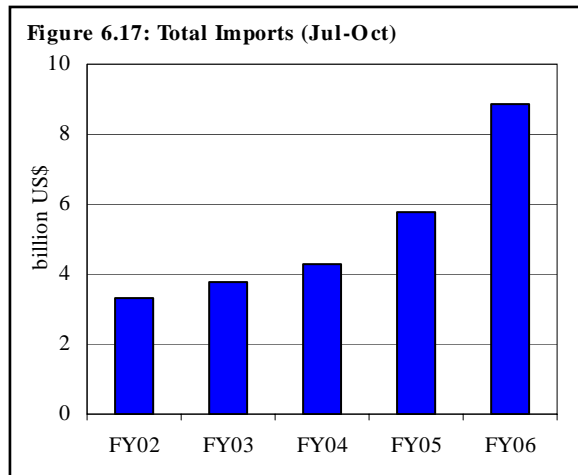


### Imports

The unusually high oil prices in the international market and persistent rise in the demand for machinery stemming from increased economic activity, contributed the bulk of the exceptionally strong 54.0 percent YoY rise in imports during Jul-Oct FY06. As seen in **Figure 9.17**, the US\$ 8.9 billion imports bill for this period marks the continuation of a secular rise in the imports bill in recent years, and this trend is unlikely to subside in the near term.

In particular, since Pakistan's import demand is relatively highly elastic with respect to domestic income in the short run as well as in the long run (as evident from empirical research work on Pakistan Trade elasticities), the higher demand for import of machinery and raw material was expected to persist to support the

domestic economic activity.<sup>21</sup> The extraordinary 77.2 percent YoY increase in unit prices of petroleum group imports during Jul-Oct FY06 as compared to almost 36 percent increase during the corresponding period last year inflated the petroleum group import bill, contributing substantially in the total import surge during the period. Unlike the corresponding period of FY05 whereby the increase in the import of



petroleum group was contributed by both, the quantum impact (39.2 percent) and price impact (60.8 percent), the recent surge in petroleum import during Jul-Oct FY06 is entirely contributed by the price impact (103.1 percent) as the import volume fell by 3.1 percent. Although the international oil prices have receded from their peak level in recent months, their impact on overall import bill is not yet evident due to sharp rise in non-oil imports.

Furthermore, the efforts of the government to contain domestic food inflation by ensuring enough supply of sugar through imports led to an increase the food group imports. In addition, the real appreciation of Pak Rupee against the trading partner's currencies might have increased the demand for imported goods.

*Food Group.*

The import of sugar as a part of the government efforts to contain rising domestic inflation led the food group imports to register 42.3 YoY growth during Jul-Oct FY06 on the top of 24.6 percent increase in the corresponding period last year (see **Table 6.10**). However, the share of food imports in total growth in imports has increased marginally from 5.4 percent during Jul-Oct FY05 to 5.5 percent during Jul-Oct FY06.

<sup>21</sup> For reference to relevant empirical work see the trade section in *SBP's Annual Report* for FY05.

Since the domestic production of sugar and wheat fell short of the domestic demand, their imports are likely to increase in the remaining period of the current fiscal year. Moreover, the attempt to set up vegetable oil refineries in Pakistan with the assistance of Malaysia to increase the vegetable oil refining capacity would lead to import substitution of refined palm oil with the import of relatively cheaper crude palm oil.

**Table 6.10: Contribution in Growth (Jul-Oct)**

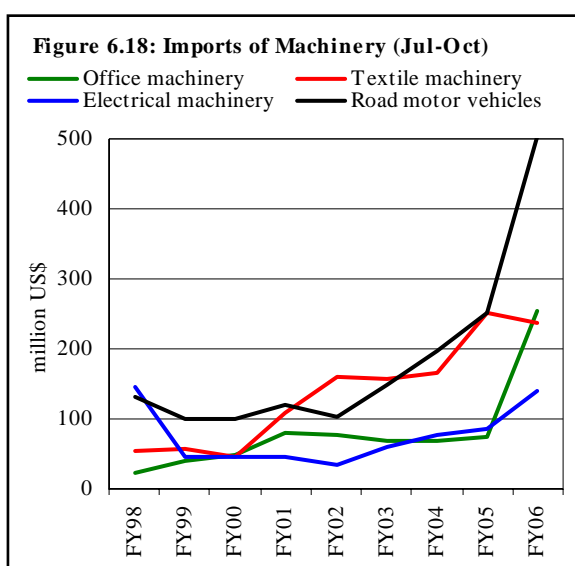
| Groups                 | percent     |                 |             |                 |
|------------------------|-------------|-----------------|-------------|-----------------|
|                        | FY-05       |                 | FY-06       |                 |
|                        | Growth      | Share in growth | Growth      | Share in growth |
| Food                   | 24.6        | 5.4             | 42.3        | 5.5             |
| Machinery              | 33.5        | 23.7            | 62.2        | 27.8            |
| Petroleum              | 35.7        | 21.8            | 73.2        | 28.8            |
| Textile                | 28.7        | 1.7             | 69.8        | 2.5             |
| Agri & other chemicals | 35.0        | 21.1            | 11.3        | 4.4             |
| Metal                  | 60.0        | 8.2             | 64.5        | 6.7             |
| Miscellaneous          | 21.1        | 1.8             | 22.1        | 1.1             |
| Others                 | 59.2        | 24.0            | 75.8        | 23.3            |
| <b>Total Imports:</b>  | <b>34.5</b> | <b>100</b>      | <b>54.0</b> | <b>100</b>      |

*Machinery Group.*

The machinery group imports portrayed a substantial growth of 62.2 percent YoY during Jul-Oct FY06 over 33.5 percent YoY growth witnessed during the corresponding period of the last year. Also, the share of machinery imports in total imports during Jul-Oct FY06 was 25.5 percent, marginally up from 24.2 percent share during Jul-Oct FY05.

The road motor vehicles depicted 99.7 percent YoY growth during Jul-Oct FY06 as

compared to 28.0 percent growth in the corresponding period of last year (see **Figure 6.18** and **Table 6.11**). Consequently, the share of road motor vehicles in total machinery imports has increased to 22.3 percent during Jul-Oct FY06 from its share of 18.1 percent during Jul-Oct FY05 (see **Table 6.12**).



Another significant contribution in import growth of *machinery group* came from *office machinery*. The *office machinery* increased by YoY US\$ 180.4 million

Table 6.11: Major Imports (Jul-Oct)

Value: US\$ million; unit value US\$

| Commodities                                      | Units     | Jul-Oct FY05   |                | Jul-Oct FY06   |                | Abs<br>chg. In<br>value | % chg in Jul-Oct<br>FY06/Jul-Oct FY05 |             |               |
|--|-----------|----------------|----------------|----------------|----------------|-------------------------|---------------------------------------|-------------|---------------|
|  |           | Unit<br>Value  | Value          | Unit<br>Value  | Value          |                         | Qty                                   | Value       | Unit<br>value |
|  |           |                |                |                |                |                         |                                       |             |               |
| <b>A. Food group</b>                             |           | <b>407.6</b>   | ---            | <b>580.2</b>   | ---            | <b>172.6</b>            | ---                                   | <b>42.3</b> | ---           |
| 1.Milk & cream incl. milk food for infants       | MT        | 7.0            | 1,951.6        | 14.4           | 3,444.8        | 7.4                     | 16.7                                  | 106.0       | 76.5          |
| 2.Wheat un milled                                | MT        | -              | -              | 0.4            | -              | -                       | -                                     | -           | -             |
| 3.Dry fruits                                     | MT        | 9.9            | 616.0          | 17.4           | 527.9          | 7.5                     | 105.4                                 | 76.0        | -14.3         |
| 4.Tea  | MT        | 72.8           | 1,673.4        | 68.9           | 1,659.1        | -3.9                    | -4.5                                  | -5.4        | -0.9          |
| 5.Spices   | MT        | 18.4           | 825.4          | 16.0           | 636.3          | -2.4                    | 12.6                                  | -13.2       | -22.9         |
| 6.Edible Oil                                     | MT        | 263.8          | 502.2          | 251.2          | 536.9          | -12.5                   | -10.9                                 | -4.8        | 6.9           |
| <i>Soyabean</i>                                  | MT        | 19.3           | 1,057.1        | 5.4            | 758.2          | -13.9                   | -60.9                                 | -71.9       | -28.3         |
| <i>Palm Oil</i>                                  | MT        | 244.5          | 482.2          | 245.8          | 533.4          | 1.3                     | -9.1                                  | 0.5         | 10.6          |
| 7.Sugar  | MT        | 0.9            | 288.9          | 159.8          | 326.1          | 158.9                   | ---                                   | ---         | 12.9          |
| 8.Pulses   | MT        | 34.8           | 301.1          | 52.1           | 418.9          | 17.3                    | 7.5                                   | 49.6        | 39.1          |
| <b>B. Machinery group</b>                        |           | ---            | <b>1,394.6</b> | ---            | <b>2,261.8</b> | ---                     | <b>867.1</b>                          | ---         | <b>62.2</b>   |
| 1.Power generating machinery                     | ---       | 107.0          | ---            | 128.5          | ---            | 21.4                    | ---                                   | 20.0        | ---           |
| 2.Office machinery                               | ---       | 75.0           | ---            | 255.5          | ---            | 180.4                   | ---                                   | 240.5       | ---           |
| 3.Textile machinery                              | ---       | 250.2          | ---            | 237.5          | ---            | (12.7)                  | ---                                   | (5.1)       | ---           |
| 4.Construction & mining machinery                | ---       | 51.5           | ---            | 46.5           | ---            | (5.0)                   | ---                                   | (9.7)       | ---           |
| 5.Electrical machinery & apparatus               | ---       | 85.2           | ---            | 139.2          | ---            | 54.0                    | ---                                   | 63.4        | ---           |
| 6.Railway vehicles                               | ---       | 11.1           | ---            | 15.5           | ---            | 4.4                     | ---                                   | 39.6        | ---           |
| 7.Road Motor vehicles                            | ---       | 252.2          | ---            | 503.7          | ---            | 251.5                   | ---                                   | 99.7        | ---           |
| 8.Aircraft, ships and boats                      | ---       | 27.4           | ---            | 31.5           | ---            | 4.1                     | ---                                   | 15.2        | ---           |
| 9.Agricultural machinery & Implements            | ---       | 12.1           | ---            | 39.4           | ---            | 27.3                    | ---                                   | 225.5       | ---           |
| 10.Other machinery                               | ---       | 522.9          | ---            | 864.5          | ---            | 341.6                   | ---                                   | 65.3        | ---           |
| <b>C. Petroleum group</b>                        | <b>MT</b> | <b>1,224.0</b> | <b>252.5</b>   | <b>2,120.6</b> | <b>447.5</b>   | <b>896.6</b>            | <b>-2.2</b>                           | <b>73.2</b> | <b>77.2</b>   |
| 1.Petroleum products                             | MT        | 506.6          | 271.5          | 837.6          | 495.6          | 331.0                   | -9.4                                  | 65.3        | 82.5          |
| 2.Petroleum crude                                | MT        | 717.4          | 240.6          | 1,283.0        | 420.9          | 565.5                   | 2.2                                   | 78.8        | 74.9          |
| <b>D. Textile group</b>                          | <b>MT</b> | <b>109.9</b>   | ---            | <b>186.6</b>   | ---            | <b>76.7</b>             | ---                                   | <b>69.8</b> | ---           |
| 1.Synthetic fibre                                | MT        | 50.0           | 1788.9         | 74.3           | 1725.1         | 24.3                    | 54.0                                  | 48.5        | -3.6          |
| 2.Synthetic & artificial silk yarn               | MT        | 46.7           | 1783.2         | 97.9           | 2,023.9        | 51.2                    | 84.9                                  | 109.8       | 13.5          |
| 3.Worn clothing                                  | MT        | 13.2           | 328.9          | 14.4           | 325.9          | 1.2                     | 10.1                                  | 9.1         | -0.9          |
| <b>E. Agricultural and other chemicals group</b> | <b>MT</b> | <b>1,203.1</b> | ---            | <b>1,338.7</b> | ---            | <b>135.6</b>            | ---                                   | <b>11.3</b> | ---           |
| 1.Fertilizer                                     | MT        | 129.4          | 253.5          | 182.0          | 274.5          | 52.7                    | 29.9                                  | 40.7        | 8.3           |
| 2.Insecticides                                   | MT        | 76.9           | 3377.3         | 66.8           | 3217.4         | -10.2                   | -8.9                                  | -13.2       | -4.7          |
| 3.Plastic materials                              | MT        | 254.2          | 1057.4         | 331.3          | 1,204.5        | 77.0                    | 14.4                                  | 30.3        | 13.9          |
| 4.Medicinal products                             | MT        | 82.7           | 21929.7        | 100.2          | 32,077.5       | 17.4                    | -17.2                                 | 21.1        | 46.3          |
| 5.Others   | ---       | 659.8          | ---            | 658.5          | ---            | (1.4)                   | ---                                   | (0.2)       | ---           |
| <b>F. Metal group</b>                            | <b>MT</b> | <b>322.7</b>   | ---            | <b>530.9</b>   | ---            | <b>208.3</b>            | ---                                   | <b>64.5</b> | ---           |
| 1.Iron and steel scrap                           | MT        | 57.9           | 181.3          | 106.3          | 252.9          | 48.4                    | 31.5                                  | 83.5        | 39.5          |
| 2.Iron and steel                                 | MT        | 237.6          | 417.4          | 391.5          | 569.5          | 153.9                   | 20.8                                  | 64.8        | 36.4          |
| 3.Aluminum wrought & worked                      | ---       | 27.1           | ---            | 33.2           | ---            | 6.0                     | ---                                   | 22.3        | ---           |
| <b>G. Miscellaneous Group</b>                    |           | <b>149.3</b>   | ---            | <b>182.3</b>   | ---            | <b>33.0</b>             | ---                                   | <b>22.1</b> | ---           |
| 1.Rubber crude                                   | MT        | 30.4           | 1056.4         | 34.8           | 1044.3         | 4.4                     | 16.0                                  | 14.6        | -1.1          |
| 2.Rubber tyres & tubes                           | No.       | 42.6           | 25.0           | 54.9           | 23.9           | 12.3                    | 34.8                                  | 29.0        | -4.3          |
| 3.Wood & cork                                    | ---       | 10.1           | ---            | 11.5           | ---            | 1.4                     | ---                                   | 14.3        | ---           |
| 4.Jute   | MT        | 7.4            | 282.8          | 8.1            | 359.6          | 0.8                     | -13.4                                 | 10.1        | 27.2          |
| 5.Paper, paper board & manufacture               | MT        | 58.9           | 608.1          | 72.9           | 704.2          | 14.1                    | 7.0                                   | 23.9        | 15.8          |
| <b>H. Others</b>                                 |           | <b>955.7</b>   |                | <b>1679.7</b>  |                | <b>724.0</b>            | ---                                   | <b>75.8</b> | ---           |
| <b>Total imports</b>                             |           | <b>5,766.9</b> |                | <b>8,880.9</b> |                | <b>3,113.9</b>          |                                       | <b>54.0</b> |               |

Source: Federal Bureau of Statistics

during Jul-Oct FY06, increasing its share in total machinery imports to 11.3 percent during the period under review compared to 5.4 percent witnessed during Jul-Oct FY05. However, excluding *office machinery*, total machinery imports still posted a YoY increase of 52.0 percent during Jul-Oct FY06.

**Table 6.12: Analysis of Machinery Imports (Jul-Oct)**  
percent

|                                     | FY05                             |             | FY06                             |             |
|-------------------------------------|----------------------------------|-------------|----------------------------------|-------------|
|                                     | Share in total machinery imports | Growth      | Share in total machinery imports | Growth      |
| Power generating machinery          | 7.7                              | -0.4        | 5.7                              | 20.0        |
| Office machinery                    | 5.4                              | 7.2         | 11.3                             | 240.5       |
| Textile machinery                   | 17.9                             | 50.0        | 10.5                             | -5.1        |
| Construction & mining machinery     | 3.7                              | 43.4        | 2.1                              | -9.7        |
| Electrical machinery & apparatus    | 6.1                              | 11.7        | 6.2                              | 63.4        |
| Railway Vehicles                    | 0.8                              | -68.5       | 0.7                              | 39.6        |
| Road motor vehicles                 | 18.1                             | 28.0        | 22.3                             | 99.7        |
| Aircraft, ships and boats           | 2.0                              | -50.0       | 1.4                              | 15.2        |
| Agricultural machinery & implements | 0.9                              | 77.9        | 1.7                              | 225.5       |
| Other machinery                     | 37.5                             | 77.4        | 38.2                             | 65.3        |
| <b>Total machinery</b>              | <b>100.0</b>                     | <b>33.5</b> | <b>100.0</b>                     | <b>62.2</b> |

The import of textile machinery showed a YoY decline of 5.1 percent during Jul-Oct FY06. This decline was expected as the textile manufactures in their efforts to prepare for the post-MFA regime had already imported textile machinery in the second quarter of the last fiscal year.

#### *Petroleum Group*

The substantial YoY increase of almost 77.2 percent in international oil prices during Jul-Oct FY06 led the *petroleum group* to record 73.2 percent YoY growth during the first four months of the current fiscal year.

**Table 6.13: Petroleum Group Imports (Jul-Oct)**  
million US\$

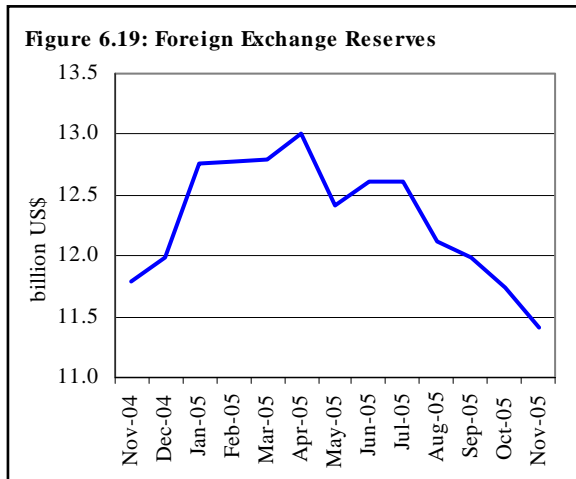
|                        | FY05         |              | FY06         |              |
|------------------------|--------------|--------------|--------------|--------------|
|                        | Quantum      | Price        | Quantum      | Price        |
| <b>Petroleum group</b> | <b>126.0</b> | <b>195.8</b> | <b>-27.5</b> | <b>924.0</b> |
| Petroleum products     | 35.1         | 86.5         | -47.7        | 378.7        |
| Petroleum crude        | 89.0         | 111.0        | 16.1         | 549.4        |

The entire increase in the petroleum bill was caused by the external oil price shock (103.1 percent) in the period under consideration as compared to relatively lower effect (60.8 percent) of the international oil prices in the corresponding period of last year (see **Table 6.13**). With the oil prices in the international market receding

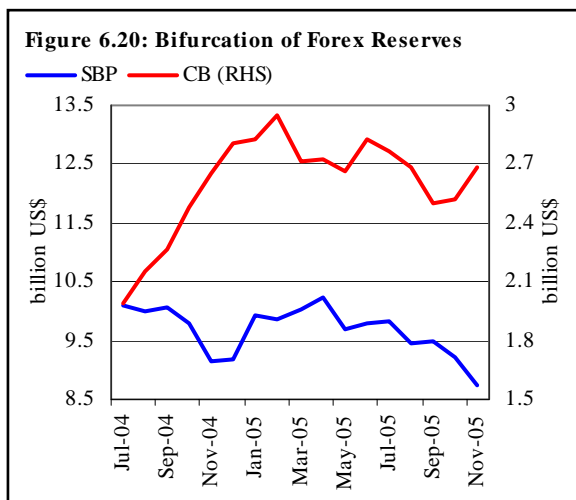
from their peak levels in recent months, it is expected that the pace of the rise in petroleum product imports would slow.

### 6.3 Foreign Exchange Reserves

The increasing pressure on Pakistan's external account led to a steady decline in the country's liquid foreign exchange reserves during July-Nov FY06. The reserves fell US\$ 1.3 billion during the period to touch US\$ 11.3 billion by end-November 2005, down US\$ 1.7 billion from the peak level US\$ 13.0 billion reached in April 2005 (see **Figure 6.19**).



The decline is evident in both SBP and commercial bank reserves. As evident from **Figure 6.20**, SBP's reserves declined by US \$ 900.7 million during Jul-Nov FY06, despite some major inflows, including disbursement by the IDA and Asian Development Bank (ADB), receipt from logistic support, privatization proceeds as well as the purchase from the inter-bank market. Similarly, the reserves held by the commercial banks fell by US \$ 386.8 million in the same period.



During July-November of 2005, SBP sold US\$ 3,793 million in the inter-bank market. At the same time, SBP received US \$ 4,226.1 million during the period of Jul-Nov FY06, including, SBP purchases from the inter-bank of US\$ 2,371 million. Inflow of US\$ 1,854.4 million from donor agencies, logistic support and privatization proceed, during Jul-Nov FY06, provided some additional resources.

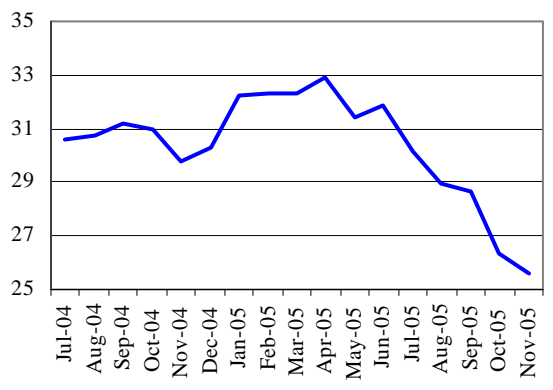
Importantly, most of the total inflows are non-debt creating in nature. The major share of inflows comprised from the US logistic receipts (US\$ 474.7 million) and privatization proceeds (US\$ 455.0 million)

The fall in the reserves held by commercial banks, however, mainly reflects the increased demand for foreign currency loans during the period. The rising demand for these loans reflects both the rising rupee interest rates and the stability of the exchange rate. Indeed, forex loans extended by domestic banks to local traders rose by US\$ 453.3 million during July-Nov FY06, but the corresponding decline in reserves of commercial banks was offset by a US\$ 67.0 million increase in their FE-25 deposits in the same period.

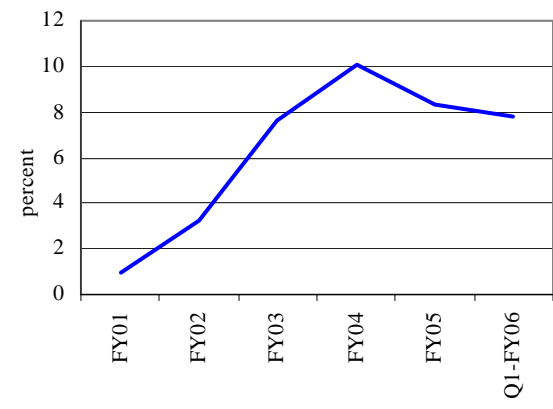
**Reserve Adequacy**

Measure of reserves adequacy indicate that Pakistan's ability to meet the external payment has weakened in Q1-FY06 (see **Figure 6.21**). The import coverage ratio, the measure of import financing, has fallen to 25.4 weeks in November 2005

**Figure 6.21: Reserve Adequacy (equivalent to weeks of Imports)**



**Figure 6.22: STDL to Foreign Exchange Reserves**



from 33 weeks in April 2005. Significantly, the deterioration in the indicator owes less to the decline in reserves and more to the sharp increase in imports. STDL to foreign exchange reserves has also decreased due to the inflows of US\$ 337 million from IDB (see **Figure 6.22**). However this ratio shows that the reserves of Pakistan are still in comfortable position.

## **Special Section**

### **Impact Analysis of Punjab Education Sector Reforms**

#### **Introduction**

It is generally believed that a good quality education plays a key role in the economic and social development of a country by improving the quality of human capital. Unfortunately, Pakistan's educational indicators do not portray a satisfactory picture.<sup>1</sup> The illiteracy rate is high; gross and net enrolment rates, at all level of education, are low; there are wide gender and regional disparities in opportunities to acquire education; dropout rates from schools are high; and quality of educational services is poor.<sup>2</sup>

As discussed in detail in the SBP Annual Report for FY04, the poor state of the education sector and, in particular, the low primary and secondary enrolment rates, are mainly attributed to: (1) the high cost of education - both direct and opportunity costs; (2) parental disapproval, especially in case of females, due to social and cultural norms; (3) the low quality of education, which incorporates shortages of trained and qualified teachers, and lack of proper physical infrastructure.

This said, during the last two years, efforts have been made by the government to address these areas. An interesting feature of this recent approach towards the education sector is the increasing role of provincial governments. Specifically, Punjab has initiated a Punjab Education Sector Reforms Program (PESRP) since 2003, which was followed by a similar reform process by Sindh governments. The thrust of these measures is to achieve universal primary education and adult literacy by addressing the major issues impeding the progress in education sector.

An attempt is made here to undertake an impact analysis of the educational reforms in Punjab. The recent data available from the Pakistan Social and Living Standards Measurement (PSLM) survey for the period 2004-05 provide an excellent opportunity to contrast the performance of Punjab in the area of education during the reform period with respect to pre-reform period, as well as to the trends in the remaining three provinces of the country. The analysis suggests that the educational reform process at the provincial level has been successful in bringing a significantly larger improvement in the Punjab.

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<sup>1</sup> In the year 2000, the Gross Primary Enrolment Rate (GPER) was above 100 percent in all the SAARC members, except Pakistan. Even the current GPER at 86 percent is well below the 100 percent mark.

<sup>2</sup> For details see SBP Annual Reports for FY04 and FY05.

### **Salient Features of Punjab Education Sector Reforms**

The Punjab Education Sector Reform Program (PESRP), which began in 2003, has three strategic pillars: (1) public finance reforms to ensure increased public spending for education; (2) devolution of public sector management reform; and, (3) improvement in access, quality and governance of education.

As in other provinces, issues pertaining to education in the Punjab included the high cost of education; lack of proper infrastructure facilities; high gender and regional gap; lack of trained teachers; and poor quality of education. The Punjab government has taken various steps to solve these issues and for the improvement of access to education in the province. Some of the initiatives taken are as follows.

- To boost enrolment and bring children into schools, the Punjab government has not only waived the fee at the public sector schools but has also provided free textbooks. In 2004, the Punjab government provided free textbooks to all the students (7.25 million students) from grade one to five on a timely basis. This facility will extend up to grade eight in 2005 while by the next academic year, the PESRP will be extended to all the students up to grade ten (the matriculation level).
- Basic infrastructure is one reason for low attendance at schools. Missing infrastructure facilities mainly include the shelter less schools, buildings and schools without boundary walls and drinking water etc. The PESRP has moved to incrementally provide the missing infrastructure facilities to schools in Punjab. Total number of missing facilities given in the district profile of all 34 districts was 118,274. Total missing facilities prioritized by the districts for the first year were 36,911 which are nearing completion. In this regard in FY04, Rs 150 million have been given to each of the 34 districts for the provision of basic facilities in primary schools.
- In order to promote female participation, Punjab government introduced a monthly stipend of Rs 200 for female students in 15 low literacy districts across the province. About 200,000 girl students of grade 6-8 with 80 percent and above school attendance have been regularly receiving stipend in targeted districts.
- To improve the quality of education, authorities in Punjab have also been taking steps to ensure the availability of teachers and to improve the quality of existing teaching staff. In this regard, 13,000 new teachers (on contract) have been recruited on school specific assignments. As a result, fifty percent

of closed or non functional schools (due to unavailability of teachers) reopened in 2004. To improve the quality of teaching staff, the provincial government has launched refresher courses for 90,000 teachers against the target of 150,000 teachers in 2004.

### Impact analysis of Punjab Education Sector Reforms

In order to do an unbiased impact analysis of the reforms and to draw meaningful conclusion it is important to consider two important dimensions. First, did the target group (Punjab in our case) see a significantly greater improvement in the reform period compared with the pre-reform period; and second, did the target group perform relatively better than the non-target group (the remaining three provinces)? Combining the two dimensions involve a difference and difference (D-D) approach; which process is generally being recommended in doing such impact analysis. Mathematically this can be written as:

$$D-D \text{ indicator} = (Punjab \text{ Progress} - other \text{ province progress})_{reform \text{ period}} - (Punjab \text{ Progress} - other \text{ province progress})_{pre-reform \text{ period}}$$

As shown in **Table 1**, Punjab saw a significantly larger improvement in gross as well as net primary enrolment rates during the reform period compared with the other provinces, which was not the case in the pre-reform period. This can also be seen by the positive values of D-D indicator for all the three provinces. The better progress by Punjab in the reform period was true for both male and female groups and also shared by the rural and urban regions (see **Table 2**).

| Table 1: Indicators of Education Performance |         |         |         |                   |               |               |
|--|---------|---------|---------|-------------------|---------------|---------------|
| percent                                      |         |         |         |                   |               |               |
|  | 1998-99 | 2001-02 | 2004-05 | Change during     |               | D-D indicator |
|  |         |         |         | Pre-reform period | Reform period |               |
| <b>Gross Primary Enrolment Rate</b>          |         |         |         |                   |               |               |
| Punjab                                       | 75      | 76      | 95      | 1                 | 19            | -             |
| Sindh  | 64      | 63      | 75      | -1                | 12            | 5             |
| NWFP   | 70      | 77      | 80      | 7                 | 3             | 22            |
| Balochistan                                  | 64      | 62      | 67      | -2                | 5             | 11            |
| <b>Net Primary Enrolment Rate</b>            |         |         |         |                   |               |               |
| Punjab                                       | 44      | 45      | 58      | 1                 | 13            | -             |
| Sindh  | 41      | 40      | 48      | -1                | 8             | 3             |
| NWFP   | 39      | 41      | 47      | 2                 | 6             | 8             |
| Balochistan                                  | 36      | 32      | 37      | -4                | 5             | 3             |

Source: PSLM Survey 2004-05

**Table 2.2 Change in Gross Primary Enrolment Rate**  
percentage points

|             | Male       |               | Female     |               | Urban      |               | Rural      |               |
|-------------|------------|---------------|------------|---------------|------------|---------------|------------|---------------|
|             | Pre-reform | During reform | Pre-reform | During reform | Pre-reform | During reform | Pre-reform | During reform |
| Punjab      | 2          | 16            | 1          | 20            | 0          | 16            | 1          | 19            |
| Sindh       | 1          | 8             | -3         | 14            | -10        | 15            | 6          | 5             |
| NWFP        | 13         | -4            | 2          | 9             | 3          | -1            | 8          | 4             |
| Balochistan | -2         | 6             | -2         | 5             | 0          | 6             | -4         | 4             |

Source: PSLM Survey 2004-05

### **Conclusion**

The analysis based on PSLM data suggest that Punjab Education Sector Reform Program has contributed significantly in improving the gross and net enrolment rates in the province, which was a major and immediate focus of these reforms. The lessons learnt from this program indicate that if the financial constraints can be eased, appropriate physical infrastructure facilities can be provided, and committed quality teachers are employed then progress can be accelerated towards substantially improving the educational access and outcomes in Pakistan.

## Acronyms

|       |   |
|-------|---|
| ADB   | Asian Development Bank                  |
| bftd  | billion cubic feet per day              |
| BoP   | Balance of Payments                     |
| CBR   | Central Board of Revenue                |
| CPI   | Consumer Price Index                    |
| DAP   | Di-Ammonium Phosphate                   |
| D-D   | difference and difference               |
| DMBs  | Deposit Money Banks                     |
| DPBs  | Domestic Private Banks                  |
| EFS   | Export Finance Scheme                   |
| ECC   | Economic Co-ordination Council          |
| EU    | European Union                          |
| FCAs  | Foreign Currency Accounts               |
| FDI   | Foreign Direct Investment               |
| FECs  | Foreign Exchange Companies              |
| FE-25 | Foreign Exchange Cir.No.25              |
| FY    | Fiscal Year                             |
| GDP   | Gross Domestic Product                  |
| GSP   | Generalized System of Preferences       |
| HRI   | House rent Index                        |
| HBL   | Habib Bank Limited                      |
| IDA   | International Development Agency        |
| IDB   | Islamic Development Bank                |
| IIP   | Index of Industrial Production          |
| IMF   | International Monetary Fund             |
| IT    | Information Technology                  |
| LCVs  | Light Commercial Vehicles               |
| LSM   | Large Scale Manufacturing               |
| MNCs  | Multi National Corporations             |
| MoM   | Month on Month                          |
| NDA   | Net Domestic Asset                      |
| NFA   | Net Foreign Asset                       |
| NFI   | Net Foreign Investment                  |
| OEBs  | Outstanding Export Bills                |
| OIN   | Other Items Net                         |
| OMOs  | Open Market Operations                  |
| PARCO | Pak-Arab Oil Refinery Company           |
| PESRP | Punjab Education Sector Reforms Program |
| POL   | Petroleum, Oil and Lubricants           |

|       |   |
|-------|---|
| PPBCL | Punjab Provincial Cooperative Banks limited |
| PSEs  | Public Sector Enterprises                   |
| PSLM  | Pakistan Social and Living Standards        |
| PTA   | Pakistan Telecommunication Authority        |
| Pvt.  | Private                                     |
| REER  | Real Effective Exchange Rate                |
| rhs   | right hand side                             |
| SBP   | State Bank of Pakistan                      |
| SMEs  | Small and Medium Enterprises                |
| SPI   | Sensitive Price Index                       |
| STARR | Sales Tax Automated Refund Repository       |
| TCP   | Trading Corporation of Pakistan             |
| UAE   | United Arab Emirates                        |
| UBQI  | User Based Quantum Index                    |
| USA   | United States of America                    |
| WAPDA | Water and Power Development Authority       |
| WPI   | Whole Price Index                           |
| YoY   | Year on Year                                |
| YTD   | Year to Date                                |
| ZTBL  | Zarai Taraqiati Bank Limited                |