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THE STATE OF PAKISTAN'S ECONOMY Third Quarterly Report for FY06

1.1 Overview

Provisional estimates show that the country's long-term growth momentum remains intact, with real GDP growth exceeding 6 percent for the third successive year. While the 6.6 percent real GDP growth estimated for FY06 is relatively weaker than the 8.6 percent revised growth rate for FY05, this was not unexpected in light of historic trends and a high-base effect, as evident in the lower growth target (7 percent) for FY06. It must also be kept in mind that a substantial portion of the losses in agriculture simply reflected bad luck, e.g., even if *only* the cotton harvest had not been hit by inclement weather, it is possible that the FY06 growth target may have been exceeded.

Table 1.1: Major Macroeconomic Indicators

	Jul-to date		
	FY04	FY05	FY06
<i>growth rates (percent)</i>			
Large-scale manufacturing (Mar)	17.0	15.4	9.0
Exports-FBS (May)	11.8	16.2	16.7
Imports-FBS (May)	24.1	33.8	39.4
Tax revenues (CBR) (May)	12.4	13.6	22.0
CPI (12-m ma) (May)	4.0	9.3	8.0
PSC (CBs) (Jun 10)	29.6	29.7	19.5
Money supply (M2) (Jun 10)	17.1	16.2	13.3
<i>million US Dollars</i>			
Total liquid reserves ¹ (May)	12,438	12,359	12,990
Home remittances (May)	3,516.6	3,809.8	4,136.3
Foreign private investment (Apr)	629.1	1,027.0	3,376
<i>percent of GDP²</i>			
Fiscal deficit (full year)	2.9	3.3	4.2
Underlying (ex-earthquake)		3.4	3.7
Trade deficit (Apr)	2.1	4.4	7.5
Current a/c balance (Apr)	2.2	-0.8	-3.3

¹ With SBP & scheduled banks. End-May.

² Calculated by taking fiscal year GDP. Projected GDP for FY06 has been used.

The strength of aggregate demand in the economy is quite encouraging (see **Table 1.1**), particularly given the impact of the global rise in energy costs. However, given that the fiscal stimulus from the recently announced budget for FY07 will add to demand and the emerging macroeconomic imbalances, there is a clear need for corrective policy measures to protect long-term growth prospects of the economy. The risks include the possibility of an increase in inflationary pressures, the gradual weakness in fiscal indicators, and the widening of the current account deficit.

The first of these may not be of serious *immediate* concern. The tight monetary policy being followed by the SBP clearly appears to be bearing fruit, with M2 growth falling to 13.3 percent for Jul-Jun 10, FY06, down from 16.2 percent in the

corresponding period last year. This fall is led principally by a deceleration in private sector credit to 19.5 percent in Jul-Jun 10 FY06 from 29.7 percent in the corresponding period of FY05.

The resulting *relative* slowdown in aggregate demand, coupled with supply-side improvements through: (1) better harvests (for some crops, particularly wheat), and (2) administrative measures by the government (including the use of cheap imports to discouraging cartels, etc.) have helped significantly reduce inflationary pressures in the economy. CPI inflation has dropped from 11.1 percent YoY in April 2005 to 7.1 in May 2006, and it is expected that the FY06 average inflation will fall within the 8 percent target, despite the unexpectedly high oil prices that prevailed throughout the year.

The second issue (i.e. the fiscal deficit) is a concern more in terms of the trends and structural weaknesses (and therefore the probable future impacts). While the fiscal deficit has indeed widened in FY05 and FY06, in both years the underlying figures are low, at 3.3 percent and 3.4 percent of GDP respectively (the latter number jumps to 4.2 percent of GDP only due to the impact of the earthquake relief efforts). The concern stems from the fact that the tax net has seen little broadening in recent years, and continues to exclude (or under-tax) a substantial portion of the economy. It is therefore not surprising that the growth in the economy is not matched by a corresponding increase in tax revenues. To put this in perspective, if the tax-to-GDP ratio had been maintained even at the low FY01-05 average of 10.8 percent, the government would have had additional resources of Rs 27.4 billion in FY06 alone.

The lack of buoyancy in the tax receipts needs to be addressed while the economy is still strong, as the costs of the re-distribution of the tax base are more palatable as long as sectoral profitability of hitherto under-taxed areas remains strong. Such measures would also strengthen the competitiveness of other sectors of the economy by allowing the government to reduce the tax burden in these sectors that currently carry a disproportionate share of the tax burden.

The third macroeconomic risk, the re-emergence and widening of the current account deficits from a surplus of US\$ 1.8 billion in FY04 to a sizeable deficit of US\$ 5.7 billion (annual estimate) in FY06 poses a more immediate policy dilemma. This phenomenon is inextricably linked with the strength of the domestic economy (as seen from the very substantial share of industrial inputs and machinery in the total import bill), the impact of liberalization of the economy (as seen in the rising imports of media and telecom equipment, as well as the fall in the effective tariff rates) and a sharp rise in oil prices. The policy options are

correspondingly complex, particularly given that (1) exports continue to rise strongly, suggesting that the problems could ease with time, as import growth reverts to (lower) historical norms, and (2) given that a heavy-handed, knee-jerk response could easily add disruptive volatility to the financial markets. Accordingly, with the current account deficit still low, at 4.3 percent of GDP (estimated) in FY06, and given the availability of external financing, the SBP opted to keep monetary policy tight to contain excessive volatility in the exchange rate and inflation.

1.2 Looking Forward

Despite a relative slowdown, all evidence indicates that the growth momentum of the economy remains strong, although growth is now more narrowly-based compared to the previous year. It is in light of this evident strenght in the economy that the government has set the GDP growth target of 7 percent for FY07, which at first glance, does not seem unreasonable.

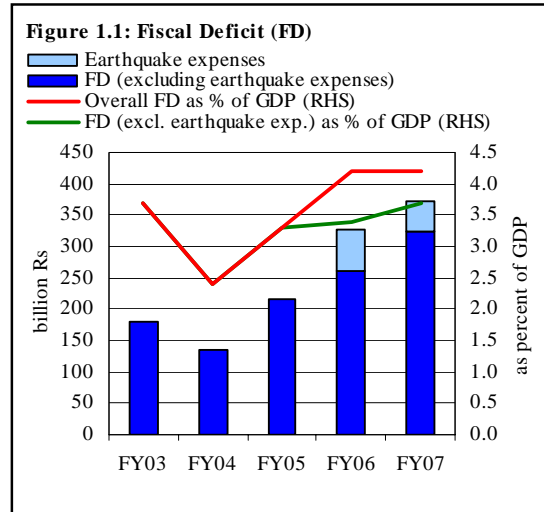
In particular, it is quite possible that FY07 will see a strong agri-growth given the low base provided by the relatively poor performance by major crops in FY06. This in turn, would support an improved performance in key industries such as textiles and sugar, thus supporting growth in the large-scale manufacturing. However, FY07 could also see the drag from high oil prices (though the government has signaled that it will keep domestic prices in check by eliminating substantial taxes on key fuels), and from a continued tight monetary policy. On the last, arguments have been made that inflation is now on a downtrend, and therefore monetary policy can be safely loosened. However, given that aggregate demand is still strong, and that the economy will benefit also from the expansionary fiscal stance, a loosening of the monetary posture is clearly not advisable.

Table 1.2: Major Economic Indicators

	FY05 Revised	FY06		FY07 Targets/ projections
		Original targets	Prov. estimates	
<i>growth rates (percent)</i>				
GDP	8.6	7.0	6.6	7.0
Inflation	9.3	8.0	7.9	6.5
Monetary Assets (M2)	19.3	12.8	14.8	13.5
<i>billion US\$</i>				
Exports (fob-Customs record)	14.4	-	16.8	19.5
Imports (cif-Customs record)	20.6	-	28.4	34.1
Workers' remittances	4.2	4.0	4.5	4.7
<i>percent of GDP</i>				
Budgetary balance	-3.3	-3.8	-4.2	-4.2
Current account balance (excluding official transfers)	-1.6	-2.1	-4.4	-5.7

Going forward, the impact of the credit slowdown on inflation may be substantially augmented by a continuing decline in food inflation following the implementation of the recently announced administrative measures and subsidies by the government. This suggests that the 6.5 percent average inflation targeted for FY07 may not be unachievable. However, there are some risks to this relatively benign picture. Oil prices are at historical highs, with attendant risks to price stability and growth. Moreover, the broadest inflation measure, the GDP deflator, is estimated at 10.3 percent for FY06, up sharply from 8.8 percent in the preceding year, suggesting that inflationary pressures still persist in the economy. The path of future monetary policy becomes further complicated by both, the proposed expansionary fiscal policy (see **Figure 1.1**) as well as the uncertainty on the degree of monetization of the fiscal deficit.

On the positive side, over half of the increase in government expenditure during FY07 is on account of development spending (which will add to the economy's future growth), and there is also a substantial one-off element (Rs 50 billion in earthquake related spending) to the proposed rise. However, it is troubling to note that even adjusting for the earthquake related spending, there is a gradual weakening in the underlying trend of the fiscal deficit (see **Figure 1.1**).



Although the CBR taxes have grown strongly in recent years, the tax-to-GDP ratio remains low, having declined from 11.5 in FY03 to 10.4 in FY06. It is in this backdrop that the government's intention of keeping the fiscal deficit at 4.2 percent of GDP has already drawn reproof from the rating agency Standard & Poors. The fiscal position would worsen if the 18.6 percent growth target for FY07 tax revenues is not achieved. However, this possibility seems remote. On the one hand, measures to expand the tax base will support strong growth in receipts, while on the other hand, the government will also have the possibility of raising revenues from the Petroleum Development Levy (PDL). The FY07 budget does not envisage any revenues from this source, in contrast to the Rs 20.2 billion collection (estimate) for FY06,

but the government has the option to revise this decision in case of serious revenue shortfalls.

The expansionary fiscal stance will add to aggregate demand, and therefore to inflationary pressures. The impact could be worsened if the government depends heavily on central bank borrowings to finance the deficit. The budget for FY07 envisages a receipt of Rs 35 billion from SBP profits,¹ which suggests that this may be the case, and therefore the burden of containing inflationary pressures will fall disproportionately on monetary policy.

This is amply clear also from the trends in the external account, where strong aggregate demand, together with rising oil prices, has led to a sharp 39.4 percent hike in imports during Jul-May FY06, substantially overshadowing the 16.7 percent rise in exports in the same period. While the exceptional growth in imports is certain to moderate in FY07 (despite an anticipated rise in the oil import bill, especially following an anticipated dip in hydroelectricity generation), it is important that the export growth momentum be sustained. Indeed, while data shows that the exceptional growth in imports may already be slowing considerably, export growth is also weakening, suggesting the need for greater support for exporters in the forthcoming trade policy, and that the projects to improve domestic logistics chain and infrastructure be expedited. This also requires that the central bank remain vigilant against inflation, as price stability will be a key competitive advantage for the country.

The current account deficit is envisaged at US\$ 6.3 billion or 4.3 percent of targeted GDP in the Annual Plan for FY07. While this deficit seems high, privatization receipts and strong aid inflows are anticipated to offset much of the impact during FY07. This, however, would primarily depend on the realization of the anticipated moderation in import growth, as foreseen in the annual plan, and continued strong export growth. If, as suggested by SBP projections, the current account deficit proves to be substantially higher, it would be extremely difficult to sustain without either substantially raising external debt, recourse to an undesirable drawdown in reserves, or strong measures to contain aggregate demand or a more focused policy of containing external demand.

¹ A substantial portion of the central bank's profitability is from the interest earned on its holdings of government securities (principally accrued through the financing of government fiscal deficits).

1.3 Executive Summary

Economic Growth

According to provisional estimates of national income accounts, real GDP remained at its long-term growth path in FY06 with a growth rate of 6.6 percent. While this growth is marginally lower than the 7.0 percent annual target, this is quite impressive given the aftermath of the earthquake, the relatively poor harvests of key crops, the impact of high oil prices and rising domestic interest rates. The greater contribution to this high growth rate is by the services sector, which exhibited a remarkable 8.8 percent growth during FY06 as compared to the 4.3 percent growth of the commodity-producing sector in the same period. Within the services sector, the highest growth was seen in *finance & insurance* (23.0 percent) followed by *wholesale & retail trade* (9.9 percent).

Agriculture

The disappointing performance of key *kharif* cash crops (cotton and sugarcane) coupled with below-target production of wheat and minor crops, dragged down the agricultural growth to 2.5 percent during FY06 from 6.7 percent last year. The value addition by crops showed a decline of 2.3 percent during the year compared to previous year mainly due to lower production of cotton, sugarcane and grams. However, the livestock sub-sector posted strong growth of 8.0 percent in FY06.

It is encouraging that the off-take of fertilizers increased sharply (by 12.1 percent) despite rise in prices. Both urea and DAP witnessed higher growth rates of 11.1 percent and 15.7 percent during Jul-Apr FY06 respectively compared with corresponding figures of 5.0 percent and 7.7 percent in FY05.

The growth in agriculture credit disbursement, on the other hand, decelerated to 25.7 percent YoY (Rs 116.96 billion) in Jul-May FY06 as against a robust growth of 50.4 percent YoY in the corresponding period of FY05 which probably reflects the rising interest rates in the economy. The growth in loan recoveries also decelerated, but this is smaller than that in disbursements and, as a result, recoveries as a percent of disbursements have increased during the year.

Large-scale Manufacturing

Provisional estimates indicate that LSM growth has fallen significantly from 15.6 percent in FY05 to 9.0 percent during the current fiscal year; and is lower than the FY06 target of 13.0 percent. Moreover, the data for Jul-Mar FY06 shows that the deceleration is quite broad based with most of the sub-groups showing growth below that in the previous year. The only sectors showing higher growth included food, leather, pharmaceutical, paper & board. The sector which has the largest

weight in LSM, i.e., textiles, saw growth slow to 4.0 percent during Jul-Mar FY06 as compared with a 28.7 percent growth seen in the same period of FY05. A substantial contribution to this slowdown was from a deceleration in the production growth of cotton yarn & cotton cloth and a decline in the production of ginned cotton.

A sharp deceleration was also seen in the *petroleum and lubricant* (POL) and *fertilizer* industries, which recorded growth rates of 2.3 percent and 9.8 percent respectively during Jul-Mar FY06 as compared corresponding FY05 figures of 11.7 percent and 37.2 percent respectively. While the growth in the *automobiles* industry also declined, it remained a robust 27.7 percent during Jul-Mar FY06, only a little lower than the 31.5 percent for Jul-Mar FY05.

Capacity utilization in LSM declined by 1.3 percentage points in Jul-Mar FY06 as compared with a *rise* of 0.5 percentage points during the same period of FY05. However, this was essentially due to Pak Steel Mills, where production has dropped steeply due to a major technical fault. Excluding the impact of the latter, LSM capacity utilization was 1.1 percentage points higher than in the corresponding period of last year, even after capacity additions in some industries.

Prices

Inflationary pressures generally weakened throughout the current fiscal year due to tight monetary stance since April 2005, and administrative measures to improve the supply of key commodities.

Inflation measured by the Consumer Price Index (CPI) increased to 7.1 percent YoY in May 2006, which is significantly lower than the 9.8 percent inflation in May 2005. The deceleration in CPI inflation stemmed essentially from decelerating CPI food inflation, which declined to 5.6 percent in May 2006 down from 12.5 percent in the corresponding month last year. CPI non-food inflation, on the other hand, weakened modestly, remaining above 8 percent during Jul-May FY06.

After declining steadily through most of Jul-Apr FY06, WPI inflation jumped back to 9.1 percent YoY in May 2006 up from 8.1 percent in the preceding month, and significantly higher than the 6.0 percent recorded in May 2005. This increase has been contributed both by food and non-food groups of WPI. SPI inflation also witnessed an increase of 7.7 percent during May 2006 which is significantly higher than the inflation of 6.4 percent seen in the preceding month.

Money and Banking

State Bank of Pakistan maintained a tight monetary policy throughout FY06 in order to contain inflationary pressures in the economy. The instrument used for containing monetary growth was predominantly open market operations through which the SBP drained excess liquidity from the inter-bank market without bringing any significant change in the benchmark 6-month T-bill rate. The discount rate was also kept unchanged during the period.

As a result of monetary tightening, monetary aggregates have been showing significant weakening by Jun 10 FY06 compared with the corresponding period of FY05. The growth in money supply (M2) decelerated to 13.3 percent during Jul-Jun 10 FY06 from 16.2 percent in the same period last year. This slowdown was driven primarily by the deceleration in the growth of both private sector credit and net foreign assets.

The downtrend in the NFA of the banking system during most of Jul-Jun 10 FY06 is driven by two apparently contradictory developments – the sharp widening of the country’s current account deficit, and the firming expectations of exchange rate stability. Although the receipts from the PTCL privatization and the Eurobond issues prevented a net decline in the NFA of the banking system during the period, the growth is still significantly below the levels of the previous year.

The NDA of the banking system showed a growth of 16.0 percent during Jul-Jun 10 FY06 compared with the growth of 19.6 percent during the same period of FY05. As in the previous year, the current increase in NDA was driven principally by the growth in credit to the non-government sector.

By end-February 2006, government borrowing for budgetary support from the banking sector had exceeded the Rs 98.0 billion FY06 annual target by 64 percent, principally due to substantial borrowings from SBP. However, the inflows under PTCL privatization and the issuance of Eurobonds during March 2006 allowed the government to retire a large part of these borrowings. As a result, the cumulative government borrowings from the banking sector dropped to Rs 120 billion during 1st Jul-10th June FY06, which remains higher than that in the corresponding period of FY05.

The growth in private sector credit during 1st Jul-10th June FY06 was a little higher than the annual credit plan estimates for the year, but was significantly lower than the increase during the same period of FY05. This slowdown is despite the larger increases in trade-related loans and the private sector commodity finance during

Jul-May FY06 compared with the preceding year. This slowdown in the credit market appears to be driven by both demand and supply side factors.

Fiscal Sector

Fiscal indicators weakened for the second successive year in FY06. Not only has the fiscal deficit widened, the revenue and primary balances have also declined, primarily due to the impact of the earthquake relief and rehabilitation expenditures. Adjusting for these, the fiscal picture improves somewhat, with the re-emergence of primary and revenue surpluses, but the fiscal deficit continues to show a marginal increase. However, to the extent that the higher fiscal deficit stems from rising developmental spending, the increase is less of a problem.

Total revenue is estimated to reach Rs 1095.6 billion during FY06, up 21.7 percent YoY as compared to the growth of 13.8 percent YoY in FY05. Growth in both tax and non-tax revenue contributed to this achievement. In terms of individual taxes, the direct taxes and sales-tax surpassed their targets, while the collections on account of Federal Excise Duty (FED) and Customs duty remained below the respective targets.

Total expenditure in FY06 is estimated at Rs 1423.0 billion, up 27.4 percent YoY. Almost 55 percent of the total expenditure was accounted for by interest payments, defense, current subsidies and general administration. However, encouragingly, the growth in both the interest payments and defense expenditures was lower than in the previous year. The development expenditure increased 43.5 percent YoY to Rs 326.7 billion, mainly to expand infrastructure and on social development.

The overall budgetary deficit for FY06 works out to be Rs 327.4 billion, which is financed by external resources to the extent of Rs 118.3 billion and the rest is financed from internal resources. Of the internal resources, the government is likely to meet the financing gap from the banking sector (Rs 96.7 billion), from the non-bank (Rs 22.4 billion), and privatization proceeds (Rs 90 billion; of which Rs 55.2 billion has already been realized by the end of the third quarter of FY06).

Balance of Payments

The pressure on the country's external account increased substantially during FY06, as the current account deficit swelled to a historic peak of US\$ 4.1 billion by end-Apr FY06, sharply higher than the US\$ 0.94 billion deficit recorded in the corresponding period of FY05. Even more significantly, as a percentage of GDP the annual current account deficit is estimated to rise from an innocuous 1.4 percent of GDP in FY05 to a more troubling 3.2 percent of GDP in FY06,

indicating that a continued weakening would raise grave risks to the hard-won macroeconomic stability achieved in recent years.

As in the previous year, the deterioration in the current account deficit during Jul-Apr FY06 emanates essentially from the trade deficit, wherein the gains from a robust 13.0 percent increase in exports have been eclipsed by the exceptionally strong 28.5 percent increase in imports. Within the current account, the trade deficit of US\$ 6.5 billion was accompanied by services account deficit of US\$ 3.5 billion, up 36 percent from last year (mainly due to higher transportation and other business charges associated with higher imports). The Income account also recorded a deficit of US\$ 2.1 billion. The rise in deficit in the trade, services and income account was partially offset by an increase in the current transfers, which rose from US\$ 7.1 billion in Jul-Apr 2005 to US\$ 8.1 billion in Jul-Apr 2006, largely on account of the worker remittances and increases in official grants.

Pakistan was however, successful in tapping the international markets to finance its deficit, attracting FDI (including for its privatization program) and in obtaining financing for developmental projects. All of these, together with rising portfolio investment, are reflected in the country's substantial US\$ 5.0 billion financial account surplus during Jul-Apr FY06, as compared to a surplus of only US\$ 24 million in the corresponding period of FY05. As a result, the overall balance witnessed a surplus of US\$ 1.4 billion during Jul-Apr FY06.

This also helped sustain the *relative* stability of the exchange rate – the rupee depreciated only 0.88 percent against the US dollar during Jul-May FY06 to Rs 60.22/US\$² - and sustaining SBP reserves around the US\$ 10.6 billion mark by end-May 2006.

Trade Account³

The steadily widening trade deficit touched US\$ 10.6 billion during Jul-May FY06, substantially higher than the US\$ 5.5 billion recorded in the same period last year. The driving force behind the exceptionally high trade deficit remained the persistent surge in the import growth. During the period, the extraordinary import growth of 39.4 percent outstripped the otherwise healthy export growth of 16.7 percent.

The major contributors to the growth in imports were soaring international oil prices and machinery imports. In fact, the POL imports contributed almost one-

² Average of buying and selling inter-bank floating rate.

³ The discussion in this section is based on FBS data.

third (32.2 percent) of the total import growth of 39.4 percent.⁴ Machinery imports contributed another 22.7 percent of the annual import growth.

However, there is a discernible slowdown in the import growth from February 2006 onwards. The detailed analysis of the data shows that the growth in major heads is much lower in Feb-May 2006 compared to that in Jul-Jan 2006. Furthermore, almost 80 percent of the growth in the Feb-May period is being contributed by just two broad categories; 'petroleum' and 'other imports'. The share of machinery in imports growth has gone down from 29 percent in Jul-Jan 2006 to 5 percent in Feb-May 2006.

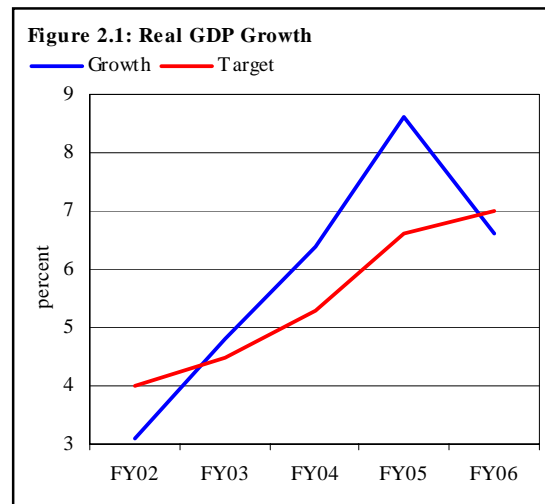
Export growth averaged a healthy 16.7 percent during Jul-May FY06, despite the increasing competition post-MFA (which has hit unit values in key export commodities), as well as punitive anti-dumping duties and loss of GSP benefits for textile exports to the EU region. However, a relative weakness in export growth in the latter half of FY06 is a matter of some concern, and it is hoped that with the recent reduction in antidumping duty by the European Union on Pakistan's bedwear exports (from 13.1 percent to 5.8 percent, effective May 7, 2006), and restoration of some GSP benefits (albeit at lower levels), export growth could revive in FY07.

⁴ Almost the entire rise was due to high prices.

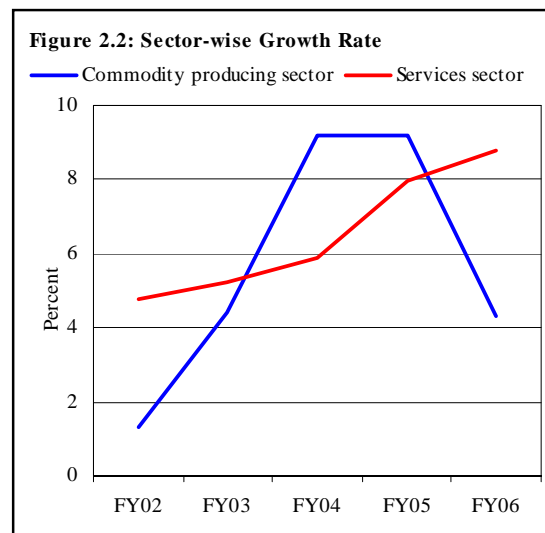
2 Real Sector

2.1 GDP

Provisional estimates show that the country's long-term growth momentum remains intact, with real GDP growth exceeding 6 percent for the third successive year (see **Figure 2.1**). While the 6.6 percent real GDP growth for FY06 is relatively weaker than the 8.6 percent growth rate for FY05 and falls marginally short of the 7.0 percent annual growth target, this achievement is impressive given the backdrop of relatively poor crop harvests, the losses due to the earthquake, the impact of high oil prices and rising domestic interest rates (**Box 2.1**).



While sustained high oil prices, rising interest rates and persistent inflationary pressures amidst capacity constraints in major industries put pressures on industrial growth, harvests of three major crops (cotton, sugarcane and wheat) witnessed shortfall against the respective targets, these adverse developments dragged down agricultural growth significantly below target. As a result, the commodity producing sector registered 4.3 percent growth during FY06 against the annual target of 7.2 percent, and considerably below the 9.2 percent growth



achieved in FY05 (see **Table 2.1**). In contrast, the services sector exhibited a remarkable 8.8 percent growth during FY06, higher than both, the target of 6.8 percent for the year as well as the 8.0 percent growth witnessed in the preceding year (see **Figure 2.2**).

Indeed, unlike FY05, when the economy experienced a broad based growth, a larger part of the FY06 GDP growth originates from the services sector. Nearly all the sub-sectors of commodity producing sector (except for *livestock* in agriculture and *small scale manufacturing* and *construction* sub-sectors in industry) have shown below the target performance. In contrast all the services sub-sectors showed acceleration and surpassed their respective growth targets, bringing overall share of the services sector in GDP to 52.3 percent in FY06, up from 51.3 percent in FY05.

Table 2.1: Gross Domestic Product
at constant prices of 1999-00; percent

Sectors	Growth rate		Contribution in GDP growth	
	FY05 R	FY06 P	FY05 R	FY06 P
Commodity producing sector	9.2	4.3	52.3	31.0
Agriculture	6.7	2.5	17.7	8.1
<i>Major crops</i>	17.8	-3.6	17.4	-4.2
Industry	11.4	5.9	34.9	23.1
<i>Manufacturing</i>	12.6	8.6	26.2	23.6
<i>LSM</i>	15.6	9.0	22.6	17.3
Services sector	8.0	8.8	47.8	69.7
GDP at Factor Cost	8.6	6.6		

P: Provisional, R: Revised

Source: Economic Survey 2005-06

Within the services sector, the highest growth of 23.0 percent was witnessed by *finance & insurance* sub-sector only a little lower than the strong 29.7 percent growth in FY05. *Wholesale & retail trade* registered 9.9 percent growth against 11.1 percent last year (mainly on the back of surge in imports). The *transport, storage & communication* sub-sector saw growth accelerate to 7.2 percent during FY06 against the annual target of 5.8 percent for the year and 3.6 percent growth in FY05. This sub-sector also witnessed US\$ 1.7 billion FDI inflow, of which US\$ 1.4 billion of FDI was due to the privatization proceeds of the telecommunication utility PTCL. *Community, social and personal services* sector also exhibited acceleration with growth rate moving up from 5.9 percent in FY05 to 6.5 percent during FY06.

On the demand side, private consumption expenditures remained the source of growth in GDP, as is evident in the continued strong growth in imports, even as the performance of the domestic commodity producing sector fell below target (see **Table 2.2**). The acceleration in public consumption is mainly attributed to increased earthquake relief spending during FY06.

Table 2.2: Expenditures on GDP
constant prices of FY00, percent

	Growth rates		Share in GDP (mp)	
	FY05	FY06	FY05	FY06
Consumption	11.9	7.8	83.8	85.0
Private	13.1	8.1	75.6	76.9
Public	1.7	4.8	8.2	8.0
Investment	9.3	10.3	13.9	14.4
Private	9.6	11.0	10.1	10.5
Public	8.5	8.5	3.8	3.9
Changes in stocks	9.3	6.0	1.7	1.7
Net exports	-83.2	-261.6	0.7	-1.1
Exports	9.6	12.9	18.1	19.2
Imports	40.5	23.9	17.4	20.3

Source: Economic Survey 2005-06

Also, while the growth in private sector investment expenditures witnessed an encouraging acceleration during FY06, the growth in public investment stagnated. While both consumption to GDP ratio and investment to GDP ratio increased during FY06, there was a decline in the share of net exports in GDP. Although the growth in exports accelerated relative to a deceleration in imports in real rupee terms, the share of imports in GDP increased at a faster rate than that of exports.

Box 2.1: MTFD 2005-10 and Current Status of Pakistan Economy

Maintaining an annual average growth rate of 7.6 percent is the key objective of MTFD 2005-10, to act as an impetus to poverty reduction in the economy. However, achieving it needs a high level of commitment at policy level keeping in view the performance of economy for FY06, especially the disappointing performance of agriculture as well as industrial sector, resulting in a huge deceleration in overall commodity producing sector. Following are some suggested measures to be applied in the sector, to ensure future compliance of MTFD growth target:

- Introducing reforms in agriculture sector with a focus on research and development, water management and easy credit availability to the sector. Further, information infrastructure is a must to create awareness regarding a broad based application of latest techniques in the sector.
- Enhancing the capacity of industrial units to ensure higher growth in manufacturing.
- Attracting domestic as well as foreign investment by improving policy framework as well as business environment in the economy, especially law and order situation. Secondly, transmitting the resources thus generated to priority sectors like manufacturing.

Although the Pakistan economy has accelerated strongly during the last three years, performance in FY06 suggests weaknesses in the structure of the economy which needs to be taken care of to keep the economy on the right track of higher growth rate, which would act as a first step towards a steady development path.

2.2 Agriculture

Following the disappointing performance of key *kharif* cash crops (cotton and sugarcane), the 4.8 percent agri-growth target for FY06 already looked optimistic, and hopes of nearing this growth rested firmly on the achievement of a substantially above-target wheat harvest as well as a significant improvement in value-added by the *minor* crops and the *livestock* sub-sectors. Although SBP forecasts of a substantial improvement in livestock proved correct, provisional data for the crops sub-sector indicates that the wheat harvest will likely fall short of target, and that the hoped-for-improvement in minor crops will also not materialize. As a result, agri-growth for FY06 is estimated at 2.5 percent, well below the 6.7 percent growth seen in the preceding year (see **Table 2.3**).

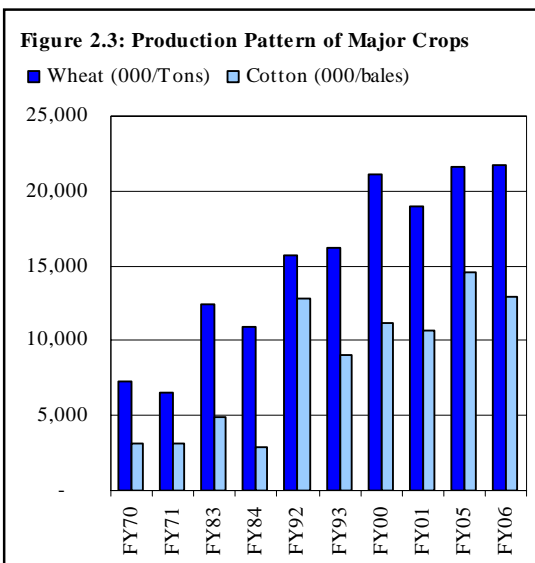
It is interesting to note that the cropping pattern of Pakistan shows that bumper crop harvests, based on higher yields, have never been repeated in the succeeding year. The sole exception to this trend has been the wheat harvest in 1992-93 (see **Figure 2.3**). Thus, the FY06 crop-sector performance is a repetition of historic trends.¹

Table 2.3: Agriculture Value added

percent growth			
	FY05	FY06 T	FY06 P
Agriculture	6.7	4.8	2.5
Major crops	17.8	6.6	-3.6
Minor crops	3.0	4.0	1.6
Livestock	2.3	3.5	8.0
Fishing	2.2	4.0	1.9
Forestry	-30.4	3.1	-9.7

T: Targets; P: Provisional

Source: Economic Survey 2005-06



¹ It was also argued in *SBP Third Quarterly Report for FY05*.

Crops

The provisional FY06 estimates indicate that the crops sub-sector will record a 2.3 percent decline in value-addition, largely due to below-target performance of the wheat harvest and aggregate minor crops, which failed to offset the impact of decline in the cotton and sugarcane harvests (see **Table 2.4**).

Table 2.4: Production Targets and Harvests of Important Crops

(million tons, cotton in million bales)

Crops	FY05		FY06		FY07	percent change in		
	Target	Actual	Target	Actual	Target	FY06 over FY05	FY06 Actual over Target	FY07 Target over FY06 Target
Cotton	10.70	14.60	15.00	13.00	13.82	-11.0	-13.3	-7.9
Rice	5.11	5.03	5.00	5.55	5.69	10.3	11.0	13.8
Sugarcane	50.90	47.22	50.10	44.32	50.50	-6.1	-11.5	0.8
Wheat	20.80	21.61	22.00	21.70	-	0.4	-1.4	-
Maize	2.20	2.80	2.90	3.56	3.28	27.1	22.8	13.1

In particular, other important crops witnessed a decline of 3.6 percent as the production of gram and *jowar* was also badly affected due to unfavorable weather and witnessed declines of 38.2 percent and 17.7 percent respectively during FY06.

In contrast, minor crops posted a positive growth of 1.6 percent during FY06, but this was lower than the 4.0 percent growth target for the year as well as the 3.0 percent rise in production during FY05. The latest available data for FY06 shows that the impact of increases in the production of *chillies* (33.3 percent) and *onion* (10.6 percent) (see

Table 2.5: Production of Selected Crops

(thousand tons)

Crops	FY04	FY05	FY06	% change in FY06 over FY05
Gram	611	868	536	-38.2
Bajra	274	193	221	14.5
Jowar	238	186	153	-17.7
Sesamum	25	30	34	13.3
Tobacco	86	101	120	18.8
Onion	1449	1853	2050	10.6
Chillies	96	90.4	121	33.3

Table 2.5) were partially offset by the fall in the output of pulses,² and potatoes (down 17.9 percent). In fact, the decline in the aggregate production of these crops is explainable either by vagaries of nature or lack of incentives (lower prevailing prices of crops). Specifically, the decline in the production of pulses during FY06 is a result of a fall in the area under cultivation due to the relatively

² Production of *masoor* pulse witnessed a decline of 13.5 percent, followed by *moong* (12.6 percent and *mash* (9.8 percent).

stagnant prices of pulses last year. The output of potatoes was damaged in the Punjab due to bad weather and in parts of NWFP because of the earthquake.

However, there are some encouraging developments within this disappointing performance by the crops sub-sector. Firstly, despite the under-performance on the annual target, the wheat harvest is a little higher than the 21.6 million tons record harvest of FY05. Moreover, this higher output was achieved despite a marginal decline in the area under wheat,³ i.e. the improvement was caused by a rise in the yield, which rose by 1.1 percent to 2614 kg/hectare during FY06. The improved FY06 wheat yield was due to: (1) improved irrigation water supply, at sowing and growth period, compared to *rabi* FY05, (2) higher institutional financing, and (3) better distribution of certified seed. Thus, given favorable weather and water supply,⁴ and adequate pricing, it seems likely that wheat production could be sustained at higher levels in future.⁵

Similarly, the drop in the sugarcane harvest owes mainly to the price disputes between farmers and sugar mills, rather than poor weather or inadequate inputs. Thus, if the price disputes were to be resolved, it is quite likely that production of this cash crop would bounce back in FY07. Indeed, following the sharp rise in sugar prices many farmers eventually received significant premiums over the sugarcane support price late in the crushing season, and this probably encouraged growers to enhance the planted area by 13.9 percent to approximately one million hectares for the FY07 crop (close to the target set for the year). The sowing was almost completed in time and moderate winter rains improved the crop prospects. If water availability in *kharif* FY07 is around the last year's level, then harvesting of 2.9 percent higher yield over FY06 would be sufficient to achieve the production target of 50.5 million tons for FY07.

Finally, although the cotton production was below target in FY06, it is important to note that harvests in FY05 and FY06 were significantly higher than the average

³ The decline of 0.7 percent in area was entirely due to delayed crushing of sugarcane.

⁴ The wheat yield restrained by lower than normal water supply at reproductive stage and quick day/night temperature fluctuations during Jan-Feb 2006, which lowered weight/size of grain.

⁵ While the first two of these factors are substantially subject to the vagaries of nature, government policy can significantly influence the prices received by farmers. While it is true that a market determined price is very important to ensure economic efficiency, it must also be recognized that underdevelopment of a competitive market can adversely distort the returns to farmers. For example, the availability of storage facilities and access to credit could help significantly improve the holding power of farmers allowing them to improve their terms of trade. Similarly, the development of an active commodity futures market can significantly remove the informational asymmetry between intermediaries and farmers, allowing the latter to negotiate better terms for produce.

of the preceding years, principally due to higher yields. However, while it is still too early to make an assessment of the prospects for the cotton crop, there is a risk that the FY07 cotton harvest target may prove optimistic, given that farmers may switch some land from the cultivation of cotton to sugarcane in the FY07 *khariif* season.

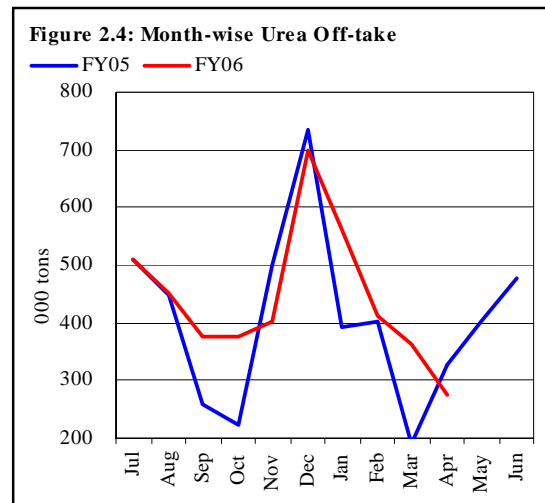
Livestock

The livestock sub-sector of agriculture posted a significant growth of 8.0 percent in FY06, which is not only higher than the moderate 2.3 percent seen in FY05, but also well above the average growth rates of the 1980s (5.3 percent) and 1990s, (6.3 percent). A substantial increase in the population of animals, probably a result of concerted private and public sector efforts aided this growth. This is particularly reflected in milk production, which increased by 6.3 percent in FY06 compared with a 2.8 percent rise last year.

In recent years, the livestock sector has been recognized as an important contributor to rural incomes. Increased access to institutional credit, availability of technical support from the government and private sector initiatives, all suggest that the contribution of the livestock sector would significantly increase in the years ahead.

Fertilizer Off-take

Fertilizer off-take increased strongly by 12.1 percent during FY06 compared to a moderate rise of 7.1 percent last year. The contribution of urea in total fertilizer off-take fell by 0.6 percentage points YoY in FY06, even though its off-take posted a higher growth of 11.1 percent to 4.4 million tons during Jul-Apr FY06 against a 7.7 percent rise in the same period last year (see **Figure 2.4**).



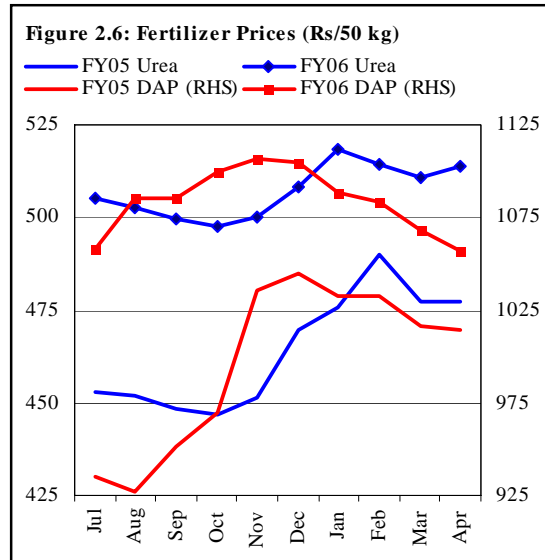
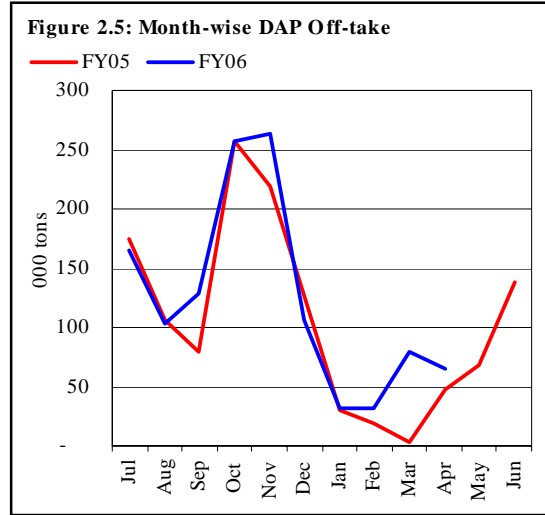
On the back of strong demand, the share of DAP in total off-take increased by 0.6 percentage points YoY during Jul-Apr FY06. Off-take recorded a healthy rise of 15.6 percent YoY to 1.2 million tons in Jul-Apr FY06. The DAP followed its usual seasonal pattern and witnessed strong off-take during July-December (*kharif* and *rabi* seasons) (see **Figure 2.5**).

It is encouraging that the off-take of fertilizers increased sharply, despite rise in prices. The prices of urea showed a continuous rising trend through FY06 cropping seasons while the rise in the prices of DAP slowed down somewhat since January 2006, due to both an ease in demand and a deceleration in international prices (see **Figure 2.6**).

Water Availability

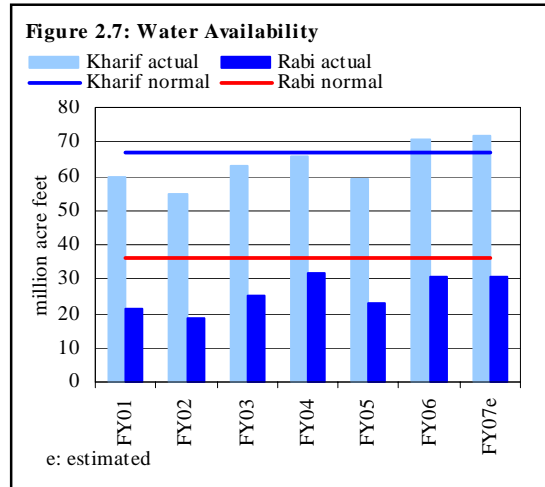
The winter rains during January 2006 improved the irrigation water availability at canal heads by 1.6 percent YoY to 71.86⁶ million acre feet (MAF) for *Kharif* FY07.

This improved water availability is estimated to be 4.8 MAF over and above the normal levels of 67.1 MAF, which significantly improves the growth prospects for the FY07 *Kharif* crops (see **Figure 2.7**).

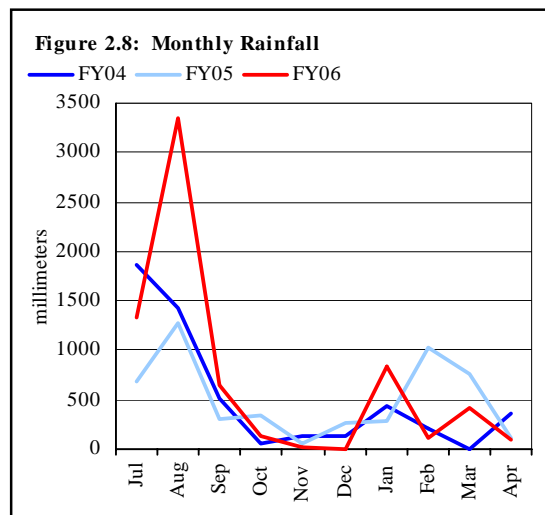


⁶ Estimated by IRSA.

Rainfall increased by 35.6 percent YoY during Jul-Apr FY06 against only a 0.1 percent increase in the same period last year, the impact of higher rainfall during Jul-Sep 2005 was particularly notable (see Figure 2.8). These higher rains coupled with the current hot spell across the country, which enhanced the snow melt in the mountains, led to a considerable increase of water inflow in the Indus, Kabul, Jhelum and Chenab rivers.

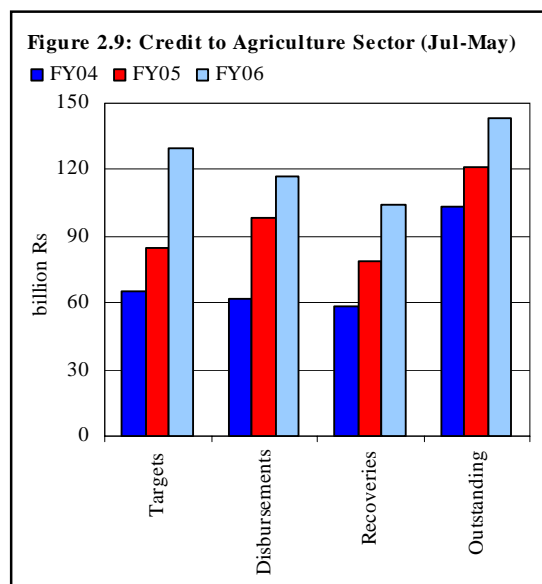


Unfortunately over the years the water storage capacity in the country has declined considerably. Specifically the storage capacity of the existing water reservoirs Tarbela, Mangla and Chashma had declined to 13.48 MAF by 2005 from their original capacity of 18.37 MAF. In this background and to meet the growing challenges in water management in Pakistan, the Diamer Basha Dam has been recently inaugurated. At completion this would add storage capacity of 6.4 MAF (see **Box 2.2**).



Credit Disbursement

The growth in agriculture credit disbursement slowed to 25.7 percent YoY (to Rs 116.96 billion) in Jul-May FY06 as against a robust growth of 50.4 percent YoY in the corresponding period of FY05. This slower growth was anticipated, as evident from the 19.6 percent growth target set for the year, following the high base set by the strong growth in the preceding two years (see **Figure 2.9**). The small underperformance till May 2006 relative to the target probably reflects the rising interest rates in the economy, but it is likely that the credit off-take for the full year will not be substantially below the target (see **Table 2.4**).



A break-up of the credit off-take for July-May FY06 reveals that the growth in disbursements slowed for almost all institutions relative to July-May FY05.

Moreover, the better performance of commercial banks (CBs) and domestic private banks (DPBs), meant that these institutions gained market share at the expense of specialized institutions (see **Table 2.6**). Specifically, the credit disbursement by ZTBL decelerated to 19.7 percent YoY in Jul-May FY06 compared to 27.5 percent YoY rise in the same period of FY05. The share in credit disbursement of PPCBL continued to decline, falling to 3.9 percent during Jul-May FY06 against 6.6 seen in Jul-May FY05.

Table 2.6: Share in Agri-credit - Jul-May in percent

	FY04	FY05	FY06
CBs-5	46.3	48.0	51.1
ZTBL	41.1	34.8	33.2
PPCBL	9.0	6.6	3.9
DPBs	3.6	10.6	11.8

Credit Recoveries

Reflecting the lower growth in loan off-take, the growth in loan recoveries also decelerated to 32.8 percent YoY during Jul-May FY06 compared with 34.8 percent YoY in the same period last year. The slowdown in recoveries, however is smaller than that in the disbursements and, as a result, recoveries as percent of disbursements have increased from 84.5 percent YoY in Jul-May FY05 to 89.3 percent YoY in Jul-May FY06 (see **Table 2.7**).

Although the recovery ratio dropped in case of three commercial banks during Jul-May FY06 relative to the preceding year, in aggregate, recoveries have been strong, which is an important indicator of the sustainability of the growth in agri-credit. Indeed, the DPBs, which

aggressively entered the agri-credit business market in recent years, have seen a strong improvement in their recovery ratio compared to the preceding years. The recovery ratio of the specialized banks has been particularly good (see **Table 2.7**).

Table 2.7: Recovery as Percent of Disbursement – Jul-May
percent

	FY04	FY05	FY06
Total CB's	75.9	79.7	84.2
Specialized banks	113.8	102.4	99.5
DPBs	60.2	50.6	79.5
Total	94.3	84.5	89.3

Credit for Tractors

A notable development in agri-credit is the significant fall in tractor financing during Jul-Mar FY06, even as the domestic tractor production jumped by over 16 percent in the same period last year. The decline in tractor financing was probably attributable to a significant rise in interest rates. The break-up of loans by category of institutions reveals that the decline was evident in specialized banks and DPBs, while CBs increased tractor financing by 10.5 percent YoY during Jul-Mar FY06 (see **Table 2.8**).

Table 2.8: Tractors Financed by Banks (Jul-Mar)

	million Rupees			
	FY05		FY06	
	Tractors finance (Nos)	Amount disbursed	Tractors finance (Nos)	Amount disbursed
CBs*	6,396	2,031.6	6,526	2,245.7
ZTBL	7,414	1,888.6	6,122	1,665.9
PPCBL	1,338	580.3	322	122.7
DPBs	1,821	617.8	825	289.8
Total	16,969	5,118.3	13,795	4,324.1

* ABL, HBL, MCB, NBP and UBL

Box 2.2: Water Management Issues in Pakistan

Pakistan built dams in the sixties and seventies, which today are incapable of meeting the rising demands in the agriculture and energy sector. The Tarbela reservoir which was built in 1976 with an original storage capacity of 11.62 MAF has lost its storage capacity by 3.05 MAF. Mangla dam was constructed in 1967 with a storage capacity of 5.88 MAF. It, too, has lost 1.41 MAF and this loss would further extend to 1.51 MAF by 2010. The Chashma reservoir was completed in 1971 with a storage capacity of 0.87 MAF. Its capacity has squeezed to 0.44 MAF and it will further shrink in the years to come. The government has planned a number of large reservoirs which will increase the supply of water, manage river inflows and control floods.

Accordingly, the first reservoir under construction is the Diamer Basha Dam. It was inaugurated on 27 April 2006 and, on completion is expected to increase the irrigation water reservoir capacity, enhance water availability at farms, get and generate hydel power. It is located on the Indus River, 315 km upstream from Tarbela Dam, 163 km and 40 km downstream from Gilgit and Chilas. The dam would have maximum height would be 281 meters and be 990 meters long. Its estimated cost is \$6.5 billion in FY05. The dam is expected to be completed in a minimum period of 10-12 years. At the completion of the project it will increase the surface water availability by about 6.4 MAF annually to supplement irrigation supplies to the agriculture sector during shortages and also provide 4500MW of electricity. It would also help to control floods and manage river inflows.

Table B1: Irrigation Water Facts

million acre feet

Water availability in Indus River System	142
Supply of water through canals	104
Losses	42
Supply of water at farm gate through canals	62
Water supply by underground water resources	44
Total supply of water at farm gate	106
Total water requirement for agriculture sector	115
Shortages of water	9
Flow of water in sea annually	35
River flow in Kharif	85%
River flow in Rabi	15%
Water requirement in Kharif	60%
Water requirement in Rabi	40%

2.3 Industry

Provisional government estimates suggest that the overall value addition by industry witnessed a rise of 5.9 percent in FY06, significantly lower than both, the 9.5 percent target for the year and the 11.4 percent growth in FY05. This deceleration in industrial growth was contributed by all sub-sectors other than *small scale manufacturing* and *slaughtering* (see **Table 2.9**); while growth in the former accelerated⁷ in FY06, growth in the latter was kept unchanged at 2.4 percent.

Table 2.9: Industrial Growth and Sectoral Share
percent

	FY05 ^R	FY06 ^P	FY05 ^R	FY06 ^P
	Growth Rates		Share	
Industry	11.4	5.9	100.0	100.0
Manufacturing	12.6	8.6	68.3	70.0
Large-scale	15.6	9.0	47.5	48.9
Small-scale	7.5	9.3	15.8	16.4
Slaughtering	2.4	2.4	4.9	4.8
Mining and quarrying	9.6	3.8	10.2	10.0
Construction	18.6	9.2	8.2	8.4
Electricity & gas distribution	3.5	-8.4	13.4	11.6

Source: Economic Survey 2005-06

P: Provisional R: Revised

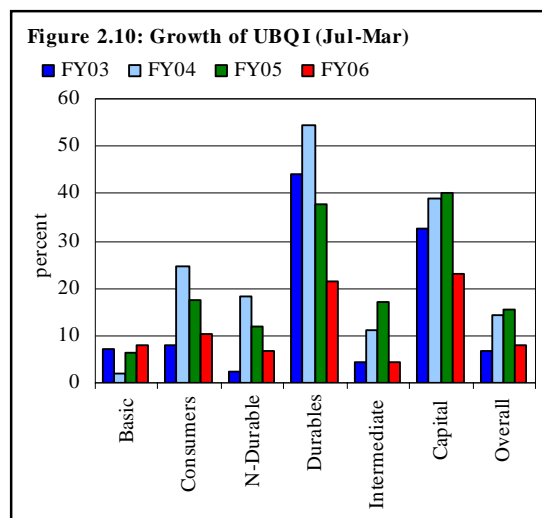
Within industry, the highest growth of 9.2 percent was observed by the construction sub-sector during FY06. While this growth is higher than the annual target of 7.5 percent, it is nonetheless significantly lower than the robust 18.6 percent growth witnessed in the preceding year.

In contrast, *electricity & gas distribution* is the only sub-group of industry to register a fall in value addition during FY06. The value addition by *electricity & gas distribution* declined by 8.4 percent in FY06 in contrast to the 3.5 percent growth recorded in the preceding year. As in the previous year, the negative growth in this sub-sector mainly reflects the higher costs of inputs such as oil and gas.

⁷ According to Small and Household Manufacturing Industries (SHMI) surveys, the share of cotton products manufacturing in small scale manufacturing is about 14 percent. This portion of small scale sector has been raised at the growth of non-mill cotton products (20 percent) provided by the Textile Commissioner. The overall growth rate of this sector has changed from 7.5 percent to 9.3 percent.

Analysis of Industries by End-Use (UBQI)⁸

During the first three quarters of FY06, the *User based Quantum Index (UBQI)* registered a growth of 8.0 percent, which is significantly lower than the 15.4 percent growth witnessed in the corresponding period of last year (see **Figure 2.10**). The slowdown in all sub-indices (except of *basic* sub-group) of UBQI imitates the development seen in the *LSM* and *mining & quarrying* sub-sector. The *basic goods* recorded the acceleration in output in Jul-Mar FY06, mainly due to acceleration in *electricity generation* and some industries of *mining & quarrying*, while the *consumer goods*, *intermediate goods* and *capital goods* industries witnessed a deceleration in growth compared to the corresponding period last year.



The biggest slowdown of 16.9 percentage points was observed in the capital goods industries during Jul-Mar FY06 over the same period of the previous year. The major contribution in the slowdown of *capital goods* stemmed from the decline in the production of *buses*, *power looms* and *electric motors* as well as deceleration in the production of *tractors*, *LCVs*, *electric transformers* and *wheat thrashers* during the first three quarters of FY06.

Similar to *capital goods*, a deceleration was recorded in the growth of *intermediate goods* in Jul-Mar FY06. Most of the slowdown in the growth of output of *intermediate goods* came from the lower production of *textile products*, *basic metal industry*, *petroleum products*, *fertilizers products*, etc.

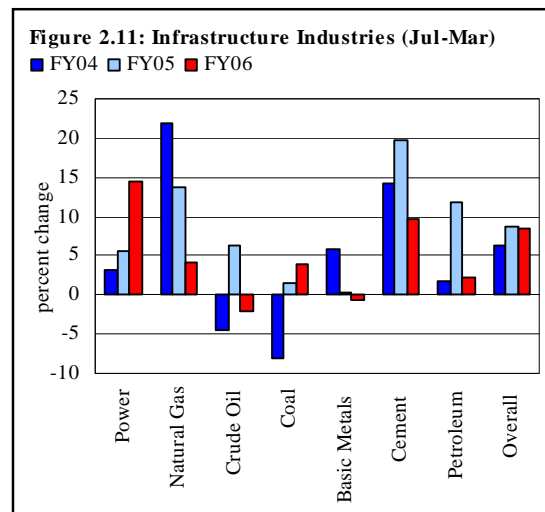
Consumer goods group grew at a rate of 10.5 percent in Jul-Mar FY06 as against a growth of 17.6 percent during the corresponding period of the preceding year. This slow growth is attributed to both *durable* as well as *non-durable* sub-groups.

⁸ Due to data constraint on *mining & electricity*, estimated production figures extrapolated using the available data (for Jul-Feb FY06,) were used for the month of March 2006.

The decline in the production of *sugar, vegetable ghee & cooking oil*, and in some items of the *chemical* group are the main reasons for the deceleration in the *consumer non-durables* group. Similarly, the deceleration in *electronics* products and *rubber* industry output slowed down the growth of *consumer durables goods* in Jul-Mar FY06.

Infrastructure Industries Index (III)

The overall performance of *infrastructure industries* measured by the composite index of seven infrastructure industries⁹ slightly weakened during the first nine months of FY06. The III registered an increase of 8.5 percent in Jul-Mar FY06 marginally less than 8.8 percent growth during the corresponding quarters of the previous year (see **Figure 2.11**). This deceleration is mainly attributed to a fall in the production of *basic metal* and *crude oil* during Jul-Mar FY06, which was partially offset by positive contributions by *electricity generation, coal, natural gas, cement* and *petroleum* products.



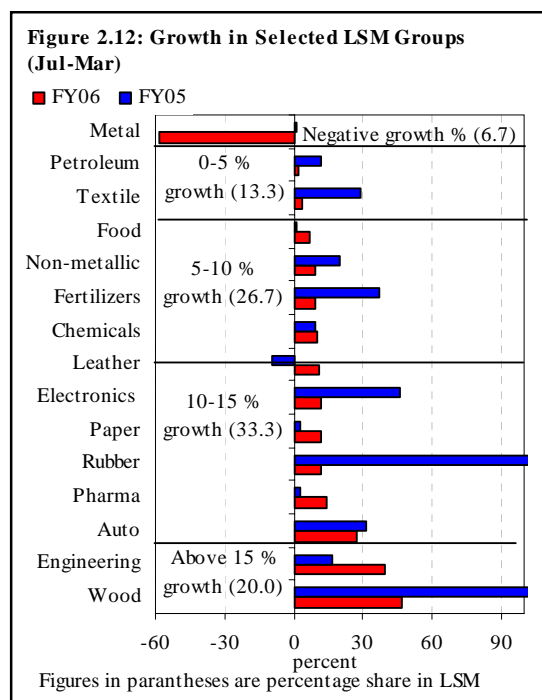
Large-scale Manufacturing (LSM)

The FY06 annual growth target for LSM was set at 13 percent, a little below the 15.6 percent growth recorded in FY05. However, provisional estimates indicate that *LSM* growth slowdown has been substantially greater than anticipated, with growth falling to approximately 9 percent. Moreover, the provisional data for July-March FY06 indicates that the deceleration is quite broad based (see **Figure 2.12 & Table 2.10**), with only six LSM sub-groups (that have an aggregate weight of 36.6 percent in LSM) witnessing growth higher than that in the corresponding period of the previous year.

⁹ These industries are electricity generation, natural gas, basic metals, petroleum products, crude oil, cement and coal.

Of these, the most significant is the *food* group (that has second highest weight in LSM), which witnessed a 7.0 percent growth during Jul-Mar FY06 as against 1.5 percent growth in the same period of FY05. This acceleration was contributed by the substantial increase in the production of *beverages* and *tea (blended)*, which was partially offset by the drag of a small slowdown in the production of *vegetable ghee & cooking oil* as well as a sharp decline in sugar production.

The output of *beverages* increased by 42.1 percent in Jul-Mar FY06 as compared with a growth of 17.4 percent in the corresponding period of the preceding year. On the other hand, the production of *vegetable ghee & cooking oil* grew at 13.2 and 17.6 percent in Jul-Mar FY06 respectively as against 14.3 and 28.6 percent growth for Jul-Mar FY05. One driver of the sustained strong growth in the production of these two products was a significant rise in exports to Afghanistan.¹⁰ The government has taken some measures to bring the Federally Administered Tribal Area (FATA) and Provincially Administered Tribal Area (PATA) into the tax net (see **Box 2.1**), shifting duty on *ghee* and *cooking oil* from production to import stage. This would eliminate tax evasion from the *ghee*, thus putting an end to the shortcomings/disadvantages faced by *ghee* manufacturing units in settled areas.



¹⁰ During Jul-Dec FY06 the export of ghee reached to US\$ 53.7 million, up by a substantial 358.8 percent over the same period of last year based on the latest commodity wise data of trade is available for Jul-Dec FY06.

Similarly, the cigarettes industry saw a drop to 4.7 percent growth in Jul-Mar FY06 in contrast to the 10.5 percent growth during the first three quarters of the preceding year. This deceleration is largely explainable by the substantial 64.8 percent decline of cigarettes export volumes during the period.

In contrast to the other food industries, sugar production actually declined for the second successive year.¹¹ According to the FBS data, output fell by 2.4 percent during Jul-Mar FY06 as against a fall of 21.0 percent during the corresponding period of the previous year. This reflects the smaller sugarcane harvest, and unnecessary delays in the crushing season and farmers' increased preference to making "gur" (dehydrated sugar), following continuing disputes between farmers and sugar mills owners over the pricing of sugarcane. It is interesting to note that despite low *sugar* production and *sugar* shortage in the economy, the manufacturers have been building their inventories.

During the first three quarters of FY06, producers have sold only 43.1 percent of sugar produced, which is far less than the 99.7 percent of production sold in the same period of the previous fiscal year (see **Figure 2.13**).

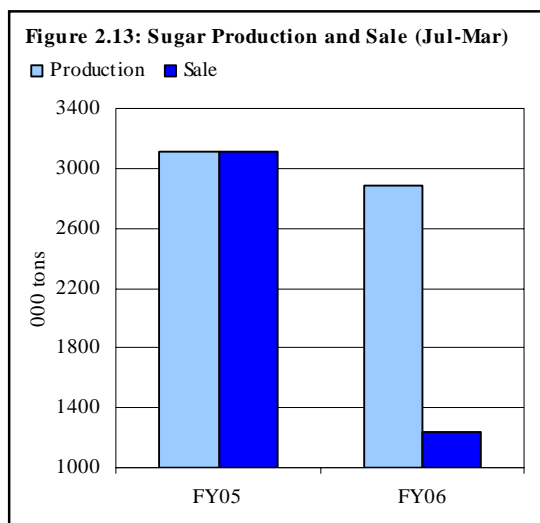
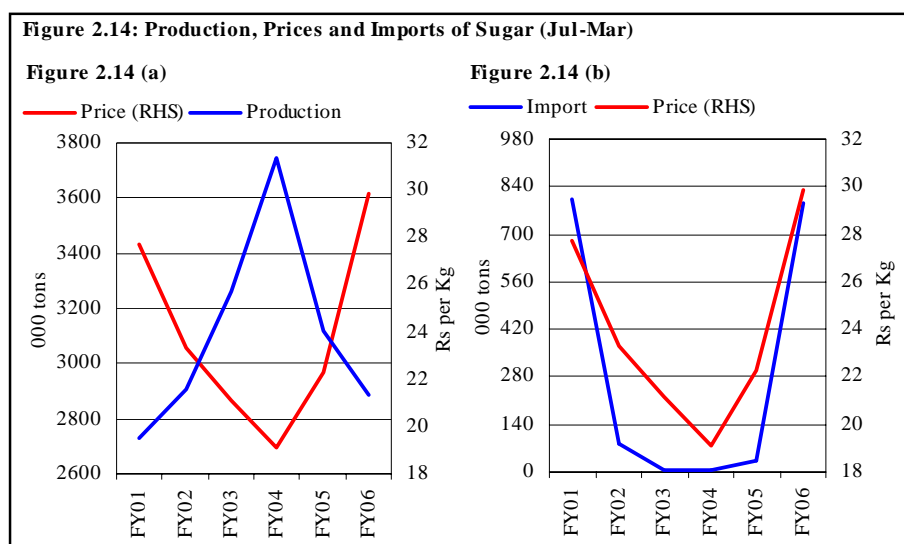


Table 2.10: Distribution of Sub-sector Growth Rates (Jul-Mar)

numbers	FY06	FY05
Negative growth	1	1
0-5 % growth	2	4
5-10 % growth	4	1
10-15 % growth	5	1
Above 15 % growth	3	8

¹¹ Pakistan Sugar Mills Association reported 7.3 percent decline during Jul-Mar FY06 as compared with 16.7 percent fall in output during the same period of last year.

The decline in sugar production as well as lower sale of sugar by manufacturers pushed up the sugar prices by 33.9 percent in the domestic market during Jul-Mar FY06 as compared with 16.6 percent increase in the same period of last year¹² (see **Figure 2.14 a**). To keep the sugar prices at reasonable level or to control the sugar price crisis in the economy, the government has encouraged sugar imports. In Jul-Mar FY01, the quantity of sugar imported was 803.3 thousand tons, the highest import of sugar in the corresponding periods of the last six years. Although the government has imported a significant amount of 789.5 thousand tons of sugar during Jul-Mar FY06, contrary to the FY01 trend, ease in the prices of sugar is yet not evident (see **Figure 2.14 b**).



As with the food group industries, the leather industry observed remarkable acceleration in output during Jul-Mar FY06, with output rising to 10.8 percent as compared with 9.5 percent decline in production in the same period of FY05. This acceleration was contributed by all three components of the leather industry, which recovered very well from negative growth in Jul-Mar FY05 to positive growth in Jul-Mar FY06. The government has taken many measures (*see First Quarterly Report 2005-06 for details*) for the betterment of the leather industry. As a result, 44.0 percent rise of leather products export was observed during the

¹² The government has exempted the 10 percent sugar mills' stocks from sales tax that they will provide to the Utility Store Corporation (USC) for selling at its outlets at subsidized rates of Rs 29.50 per kg. At present there is about 10 percent sales tax on sugar sales. The mills were selling stocks at around Rs 36 per kg which included Rs 4 to 5 per kg sales tax.

first nine months of the current fiscal year as against a 20.6 percent rise in export in the corresponding period of last year.

The *pharmaceutical* sub-sector also saw accelerated growth. During the first three quarters of the current fiscal year, this industry witnessed 14.2 percent growth as compared with a low growth of 2.5 percent during the same period of the previous year. The high local demand (earthquake affected areas), increase in external demand, entry of new companies¹³ and expansion in production capacity by existing units are the main factors for the growth of the *pharmaceutical* industry. All sub-sector of *pharmaceutical* except for *capsules and tinctures/spirits* witnessed acceleration in output for the period. Within *pharmaceutical*, the maximum growth of 29.9 percent was registered in *injections* production during the Jul-Mar FY06 as against 2.1 percent small growth in the first nine months of the previous year. Production of *chemicals*, which is a sign of industrial activities, grew at the rate of 9.9 percent in Jul-Mar FY06 compared to a slight low of 9.3 percent in the same period last year. The growth in *chemicals* was mainly contributed by *soap & detergents* and *toilets soap* which are the bi-products of *vegetable ghee and cooking oil*. While *textiles-related chemicals* such as *caustic soda, sulphuric acid and hydrochloric acid* had shown a deceleration trend as seen in the *textiles* sector.

In the same way, the *paper & board* sub-group also witnessed acceleration with 11.9 percent growth in output in Jul-Mar FY06 in contrast to 3.2 percent growth during the corresponding period of FY05. The increased growth in *paper & board* output during the current fiscal year was mainly due to an expansion in production capacity by some manufacturers. However, strong domestic demand was met by an increase of 15.1 percent in imports of *paper & board* products in Jul-Mar FY06 as against a 12.0 percent YoY rise in imports during the same period of the previous fiscal year.

Unlike the *papers & board* sub-sector, despite deceleration, the *automobiles* industry observed another year of robust growth. Production grew at 27.7 percent rate during Jul-Mar FY06 considerably lower than 31.5 percent growth in the same period of the preceding year.¹⁴ Credit availability and rising incomes were the main causes for the remarkable performance of the *automobiles* industry.

¹³ 10 new pharmaceutical companies have been set up in Karachi, 45 in Punjab and 10 in the NWFP in recent times.

¹⁴ PAMA reported 27.8 percent growth up to Jul-Mar FY06 as compared with 24.3 percent rise in output during the same period of last year; the difference may be due to reporting of unit. PAMA reports only members' production while FBS reports members as well as non members' production.

Except for *jeeps & vans* and *buses*, all automobiles sub-groups recorded positive growth in output during the first nine months of FY06 (see **Table 2.11**).

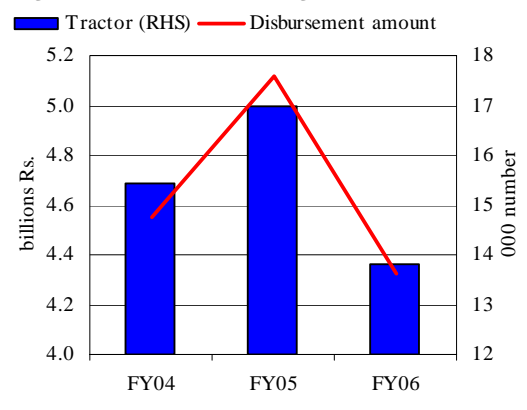
Within the *automobiles* industry, the *cars* and *trucks* sub-sectors saw acceleration in production during Jul-Mar FY06. During the first nine months of FY06, *cars* industry recorded 29.9 percent growth YoY compared with 26.1 percent YoY rise in Jul-Mar FY05 on the back of significant increase in the production capacity.¹⁵ This acceleration is the result of a continued growth momentum in high capacity engine cars (up by 36.4 percent) and a turn around in the production of low capacity engine cars (which rose by 25.4 percent during Jul-Mar FY06, in contrast to a fall of 1.3 percent in Jul-Mar FY05).

On the other hand, the production of *tractors* grew at a low pace during the first three quarters of the current fiscal year. This group recorded 16.3 percent growth in output during Jul-Mar FY06 as compared with 24.5 percent growth during Jul-Mar FY05. This slowdown was attributed to a rise in interest rates and

Table 2.11: Automobile Industry During Jul-March

Numbers	Production		
	FY04	FY05	FY06
Cars 1300cc and above	27,477	36,799	49,518
Cars less than 1300cc	50,977	50,290	62,960
Jeeps & vans	4,005	10,271	9,098
LCVs	5,839	11,294	20,564
Trucks	1,411	2,138	3,268
Buses	1026	2,282	518
Tractors	25,382	31,335	36,383
Motorcycles	213,778	302,063	381,341

Figure 2.15: Tractor Financing (Jul-Mar)



¹⁵ The Land Utilization Department has issued Provisional Allotment Letter of 400 acres of land to Prime Transport Limited (PTL) to establish a car assembly/manufacturing plant at Dhabeji, which will produce the famous Black Cabs of UK in Pakistan with rated capacity of 6000 units per annum on single shift basis. The vehicles will be operated by PTL as Satellite Controlled Taxi Service in all major cities of Pakistan and would be exported to African, Asian and Middle Eastern countries from Pakistan. This car manufacturing plant would be established in the proposed industrial estate comprising of an area of 13,000 acres at Dhabeji. Mercedes Benz is also establishing their plant of assembling/manufacturing buses, trucks and cars at Karachi.

subsequently a decline in tractor financing both in terms of amount as well as numbers by the banks (see **Figure 2.15**).

The *automobiles* industry performed very well during the last three years but has been unable to meet the rising demand of *automobiles* in the economy. To fill this gap, the government has taken many budgetary measures in the recent years, which has changed the market scenario in favor of consumers with the availability of a variety of imported second-hand cars, jeeps, LCVs, pickups, vans, etc. The leasing and bank financing companies, who have boosted the buying confidence for locally assembled cars, are now also targeting used and new imported cars.

However, there is a dilemma here. Liberal import of cars adds to the pressure on the trade balance, but on the other hand, if domestic industry is protected for an extended period, the absence of competition could lower efficiency gains and reduce the consumer surplus. The one probable solution of these problems is imposition of substantial domestic taxes to discourage consumption. While this policy would add to revenues, lower addition of vehicle will lessen the problems of traffic jams and pollution as well. However, any such policy is strongly conditional upon the significant improvement in the urban transportation system.

A sharp deceleration was seen in the *petroleum* and *lubricant* products (*POL*), which recorded only 2.3 percent growth during Jul-Mar FY06 as compared to 11.7 percent rise in the same period of the last fiscal year. The high *POL* prices (which are up by approximately 38.8 percent in Jul-Mar FY06 over Jul-Mar FY05)¹⁶ are the main factors behind this slowdown. During the first three quarters of the current fiscal year, the imports of *POL* products declined by 5.5 percent as against 14.5 percent rise during the same period of the previous fiscal year.

Table 2.12 shows that within *POL* sector, *furnace oil* (*FO*) imports recorded an acceleration with 7.4 percent growth in Jul-Mar FY06 as against 6.7 growth in output in Jul-Mar FY05, generally because of higher consumption by electricity producers. *Jet fuel* recorded the highest 14.2 percent growth in Jul-Mar FY06 as compared with 17.1 growth during the same period of last year. The rise in the production of *jet fuel* is mainly due to increasing domestic consumption on the back of the expansion in activities of domestic airlines as well as exports to Afghanistan. Contrary to *jet fuel*, *high speed diesel* which has the largest contribution in *petroleum* products registered 2.8 percent fall in the production during Jul-Mar FY06 in contrast with 19.4 percent growth during Jul-Mar FY05,

¹⁶ It may be noted that even when domestic prices of key fuels are fixed, most of the industrial inputs (oils and lubricants) witnesses increases with international prices.

mainly due to 40.3 percent upward revision in the domestic prices during Jul-Mar FY06.

Similar to the petroleum industry, a slowdown was also seen in the *textiles* sub-sector, which has the largest weight in LSM. During Jul-Mar FY06, the sector saw production rise by 4.0 percent, significantly lower than the 28.7 percent growth

seen in the same period of last year. A substantial contribution to this slowdown was from a deceleration in the production growth of cotton yarn & cotton cloth and a decline in the production of ginned cotton. Specifically, the production of these textile items grew by 11.2 percent, 0.1 percent and -10.9 percent in Jul-Mar FY06, compared to the robust 18.3 percent, 39.6 percent and 45.3 percent growth respectively recorded during Jul-Mar FY05.

The deceleration in *textiles* mainly owes to low cotton harvest, high prices and disruption in gas supply during Dec-Feb FY06 by Sui Northern Gas Pipelines Limited (SNGPL) to about 40-42 captive power plants (CPP) in the areas of Sheikhpura, Faisalabad and Gujranwala where various textiles and chemical units are located. However, it is interesting to note that despite a slowdown in the production growth of *textiles*, the exports of textiles manufacturing increased by 18.2 percent during the first nine months of the current fiscal year as compared with a moderate 4.2 percent rise in the same period last year. The jump in exports may be a reflection of (1) aggressive marketing by the exporters in post-MFA regimes by utilization of inventories and (2) significant growth in the export related production of small-scale textiles units.

The *fertilizer* industry also saw deceleration as growth fell sharply to 9.8 percent during Jul-Mar FY06, lower than 37.2 percent growth witnessed in Jul-Mar FY05. The main contributor for this slowdown was *phosphatic fertilizer*, which grew by 12.0 percent during the first nine months of current fiscal year as against 59.7 percent growth in Jul-Mar FY05. The slowdown in *fertilizer* was mainly due to capacity constraints: the capacity utilization for urea is already over 100 percent, and rising domestic demand is increasingly being met through imports. *Fertilizer* imports rose to 1.7 million metric tons during Jul-Mar FY06, which is 49.5

Table 2.12: Production of POL Products During Jul-Mar
million tons

	FY05	FY06
Jet fuel	847593	968228
Kerosene	142953	160831
Motor spirits	1013410	902817
High speed diesel	2574228	2503001
Light speed diesel (n.o.s.)	135708	94907
Furnace oil	2370051	2546107
Lubricant oil	154073	152371
Jute batching oil	4622	2864
Solvent naphtha	547295	660456
Petroleum products (n.o.s.)	502438	494040

percent higher than in July-March FY05. In the next few years, a significant rise in the production of *fertilizer* is expected after the completion of additional plants of fertilizers,¹⁷ which will reduce the dependency on imported fertilizer.

Construction activities have impacted both directly on employment generation and indirectly on allied industries such as non-metal industry, iron & steel, paint & varnishes, etc. The performance of the construction industry can be judged on the basis of its performance indicators (see **Table 2.13**), which shows that all indicators positively contributed in construction activity but it was less than last year's contribution. In other words we can say there is slowdown in the economic activities of construction sector. Construction auxiliary industries, especially non-metal industry, recorded deceleration in output with 9.5 percent growth during Jul-Mar FY06 as compared with 19.7 percent growth during the same period of last year. The immensity of this slowdown replicated from a deceleration in growth of the cement industry, where output growth declined to 9.8 percent in Jul-Mar FY06, compared to a robust 19.8 percent growth during the same period of FY05 (see **Figure 2.16**).

Table 2.13: Construction: Performance Indicators (Jul-Mar)

		FY04	FY05	FY06
Domestic Cement dispatches	000 tons	9009.7	10640.9	12192.8
Private credit for construction (flow)	million rupees	-757.0	9000.0	9015.0
Public sector development expenditure	billion rupees	85.0	137.9	204.2
Foreign direct investment *	million US\$	32.2	22.0	93.0
Production of steel (Pakistan Steel)	000 tons	777.129	782.078	445.108
Import of iron & steel	000 tons	1299.6	2122.1	2938.1
Import of construction & mining machinery	million rupees	4201.5	6365.8	8447.5
Change in cement price		-1.8	2.9	13.5

* It includes the FDI in construction, cement, metal and basic metal group.

The local cement dispatch attained 12.2 million tons during the first nine months of FY06, from 10.6 million tons in Jul-Mar FY05, mainly due to high domestic price and expansion in production capacity. Similarly, external demand reached 1.2 million tons during Jul-Mar FY06, marginally higher than 1.1 million tons during the first three quarters of the last fiscal year. To reduce the price in the domestic market, the government has announced some measures, such as: withdrawal of sales tax on cement export, temporary ban on cement export,

¹⁷ The Fatima Fertilizer Complex (FFCL), a US\$ 475 million project being built at Machi Goth, is to have a capacity of producing 1.580 million tons of urea, calcium, ammonium nitrate and phosphatic fertilizers like NP and NPK (substitute of DAP).

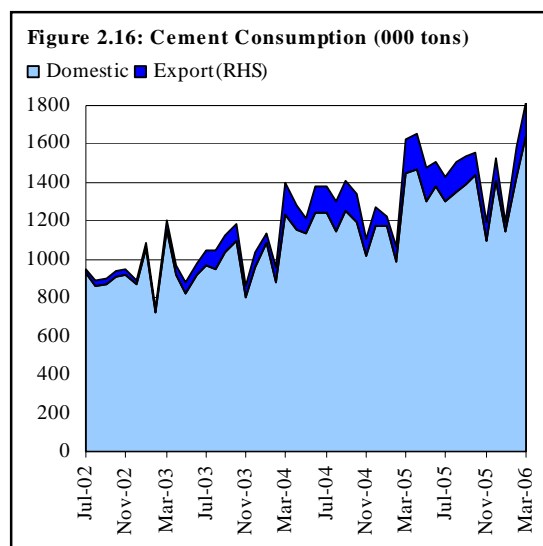
subsidy on cement import, allowed import from India, etc. (for details see **Box 2.3**).

As with the *cement* industry, the *tyres & tubes* industries also witnessed a slowdown in output with 12.2 percent growth during Jul-Mar FY06 as compared with 14.9 percent YoY growth seen in the first nine months of FY05. The major impetus to this deceleration came from a fall in the production of *motor tubes* by 42.6 percent during Jul-Mar FY06 in contrast with 20.2 percent decline during the corresponding period of the preceding year. The rising demand of *tubeless tyres* in *automobiles* is the major reason for this decline in *motor tubes* industry during Jul-Mar FY06. The continuously extraordinary performance of *automobiles* industry generates the strong domestic demand of *tyres & tubes* which was met by 11.0 percent rise in the import of rubber *tyres & tubes* in Jul-Mar FY06 as against 25.2 percent rise in imports during Jul-Mar FY05.

The production of *metal* industries witnessed a fall of 58.6 percent in the first nine months of the current fiscal year as compared with a minor increase of 1.5 percent in production in the same period of the preceding year (see **Figure 2.17**). The fall in the production of *iron & steel* sector was mainly caused by the technical problems in Pakistan Steel.^{18, 19} The rising demand of *iron & steel* was met through imports, which saw an increase of 41.5 percent in Jul-Mar FY06.

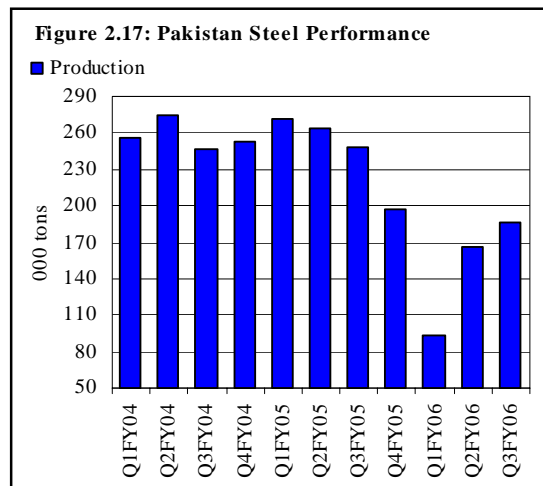
¹⁸ Two coke oven batteries of Pakistan Steel (PS) are out of order since April 2005. The PS has given tender for their repairing work in the first week of January 2006, in which 18 months are mentioned for the completion of task. This means that PS will start working at full capacity by the end of 2007.

¹⁹ Al-Tawairiqi Group of Companies is building a steel mill at Bin Qasim in two phases. In the first phase, direct reduced iron (DRI) plant with a capacity of 1 million tons will be completed in the next 18 to 24 months costing around US\$ 130 million. In phase two, with an additional investment of US\$ 170 million, the plant will start making steel billets, wire rods, heavy structures, seamless pipes and other construction material. The Tawairiqi Steel Mill project will cost US\$ 300 million with production capacity of up to 1.5 million tons of iron products annually.

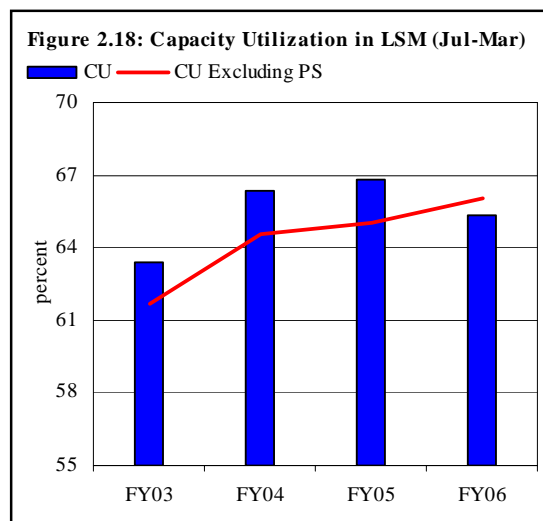


Capacity Utilization in LSM

The overall capacity utilization in LSM declined by 1.3 percentage points in Jul-Mar FY06 as compared with a rise of 0.5 percentage points during the same period of FY05. The major contributor to this was Pak Steel Mills, where production has dropped steeply due to a major technical fault. Excluding the Pakistan Steel Mills' production, the overall capacity utilization in LSM reached 66.2 percent in Jul-Mar FY06, which is 1.1 percentage points higher than the corresponding period of last year (see **Figure 2.18**).



In the first nine months of FY06, the capacity utilization in Pakistan Steel Mills fell to 54.0 percent, which is 40.8 percentage points less than the capacity utilization during the corresponding period of preceding year (see **Figure 2.19**). Technical problem and outstanding repairable work in operational units, especially in coke oven batteries of the plants was the main reason for this lower capacity utilization, which are expected to be overcome by the end of 2006.



The rise in capacity utilization in LSM excluding Pakistan Steel is impressive given capacity additions seen in major industries during FY06 as a result of increase in investment (both domestic as well as foreign direct investment). The highest increase of 13.7 percentage points was recorded by automobiles, as the capacity utilization in all components of the automobile industry increased

substantially during Jul-Mar FY06. Capacity utilization in the tractors industry also rose to 98.2 percent by the end of the first three quarters of FY06, which has attracted considerable attention from investors (local as well as foreign investors).²⁰

Capacity utilization in *edible oil & ghee* industry increased by 6.4 percentage points and reaching to 52.0 percent during the first three quarters of the current fiscal year. The strong domestic as well as external demand, largely from Afghanistan, was the main reason for this rise in capacity utilization.

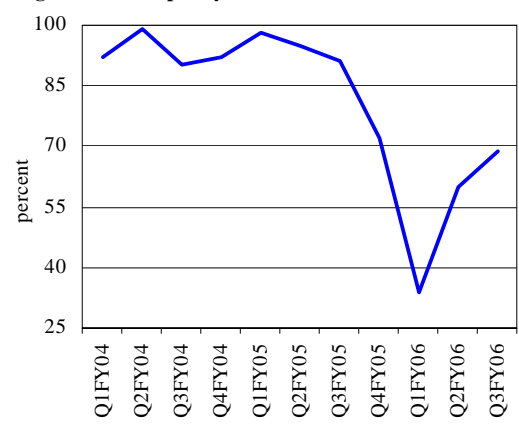
Capacity utilization in the *electronics* industry stood at 13.3 percent during Jul-Mar FY06, marginally higher than 12.3 percent. A probable reason for this under utilization is that cheap Chinese electric items gained popularity in the domestic market, rendering some local products uncompetitive.²¹

Table 2.14: Capacity Utilization in Selected Industries (Jul-Mar)

percent		
Industry	FY05	FY06
Textiles	58.7	59.1
Edible oil & ghee	45.6	52.0
Sugar	65.7	59.7
Automobiles	74.6	88.3
Electronics	12.3	13.3
Cement	81.0	73.1
Steel (Pak Steel)	94.8	54.0
Industrial chemicals	89.0	94.7
Fertilizer	105.2	110.9
Petroleum refining	86.1	85.6
Paper & paper board	100.3	108.7
Overall capacity utilization	66.8	65.4
Overall capacity utilization *	65.0	66.2

* Excluding Pak Steel production

Figure 2.19: Capacity Utilization in Pakistan Steel



²⁰ With the assistance of foreign investors, a local company is setting up a new tractor manufacturing plant at Port Qasim with the production capacity of 8000 tractors per annum.

²¹ According to market sources, more than 75 percent sales of electrical and electronic items are Chinese and only 25 per cent are locally-assembled products. Even the 25 percent of locally assembled items are dependent on the import of parts and material arriving from China.

During Jul-Mar FY06 the capacity utilization in the *cement* industry fell by 7.9 percentage points to 73.1 percent relative to 81.0 percent in Jul-Mar 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.

Box 2.3: Government's Supportive Measures for Construction Industry

The Government of Pakistan has announced a number of measures to generate economic activities in the construction sector, which are as follows:

- Ministry of Commerce has included cement in the positive list of importable items from India through an amendment in the Import Policy Order 2005.
- GOP has allowed duty and tax free import of cement and clinker from India through rail, road and sea routes with immediate effect. The cement import from India is now permissible to private and public sector entities including Earthquake Rehabilitation and Reconstruction Authority (ERRA) for reconstruction needs in Azad Kashmir and the NWFP.
- Rupees 60 per bag discount on freight rates from India to Pakistan.
- 30 per cent reduction in railway freight for cement import.
- Withdrawal of rebate of Federal Excise Duty (FED) and refund/adjustment of sales tax on the export of cement via land, air or sea routes.
- Import of iron sheets from India has been allowed, up to September this year, via land route as well, for exclusive use in the reconstruction of earthquake-affected areas.
- The government has banned cement exports for 25 days from April 2006 to control domestic prices of cement in the economy.

Government Measures for Ghee & Cooking Oil Industry

The Government of Pakistan has announced a number of measures for vegetable ghee & cooking oil industries, which are as follows:

- Introduction of uniform duty formula for ghee and cooking oil industries.
- Imposition of Rs 1,000 per ton excise duty at import stage of edible oil and vegetable ghee, including cooking oil.
- Levy of vegetable ghee to pay 15 percent general sales tax (GST) on the by-products, including carbon dioxide gas, oxygen gas, soap and oil dirt.
- If a manufacturer of vegetable ghee is producing hydrogen gas within his premises for use in the manufacture of final product, i.e. vegetable ghee, its consumption within the same premises is exempted from the sales tax.
- This exemption will not apply to such hydrogen gas, which is not manufactured within industries' own premises or is either purchased/supplied by the manufacturer of vegetable ghee.

3 Prices

The retention of a tight monetary stance since April 2005, supplemented by administrative measures to improve supply of key commodities, contributed to a significant decline in the volatility of inflation during July-May FY06¹ (relative to FY05); it also helped to keep the average inflation within the stipulated target of 8 percent during the period.

Inflationary pressures generally weakened throughout the current fiscal year, but this decline is a little unstable, as seen in the up tick in inflation measured by the Consumer Price Index (CPI) in May 2006 (see **Figure 3.1**). This uptick is primarily due to a sharp rise in food inflation due to increases in the prices of key food staples, particularly the unseasonal increase in the prices of pulses and a reversal of the downtrend in wheat prices. This said, SBP assessment indicates that food inflation would resume its downtrend June 2006 onwards as a result of the recent budgetary measures. In contrast to food inflation, CPI non-food inflation remained

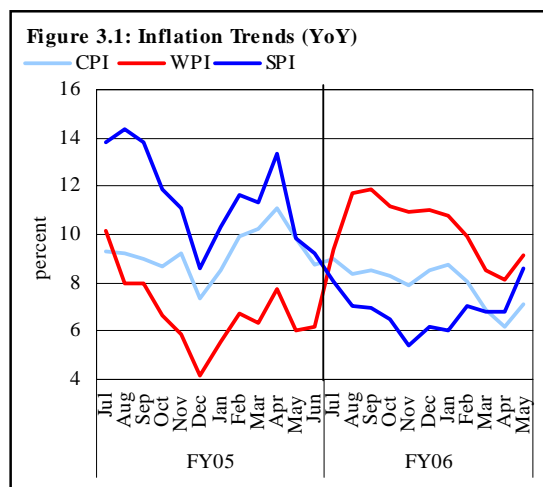


Table 3.1: Inflation Trends - (end May)
percent

	Year-on-year (YoY) ¹		12-month moving average ²	
	FY05	FY06	FY05	FY06
CPI	9.8	7.1	9.3	8.0
Food	12.5	5.6	12.8	7.0
Non-food	8.0	8.2	6.9	8.7
H. Rent	12.0	8.3	11.0	10.3
WPI	6.0	9.1	7.3	9.9
Food	10.1	5.7	11.1	7.1
Non-food	3.2	11.6	4.7	11.9
SPI	9.9	8.6	11.8	7.0
Core inflation				
NFNE ³	7.5	6.6	6.8	7.2
Trimmed mean ⁴	8.0	6.0	8.8	6.8

¹ Change in May 2006 over May 2005.

² Change in average of Jun 2005-May 2006 over the average of Jun 2004-May 2005.

³ Non-food, Non-energy inflation

⁴ By trimming 20 percent of CPI items showing extreme changes

Source: Federal Bureau of Statistics

¹ This was true for all three price indices, the CPI, WPI and the SPI.

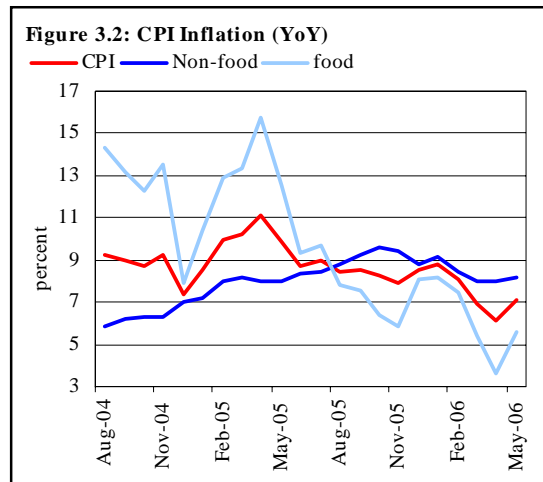
stable around 8.0 percent as the increases under energy, education and medicare sub-groups were partially offset by declines witnessed by house *rent index* (HRI) and *apparel, textiles & footwear* sub-groups.

In this backdrop, therefore, overall CPI inflation is also likely to continue declining in months ahead. Given CPI inflation is at 8.0 percent year-to-date (YTD) in May 2006, and an expected ease in June 2006, overall average CPI inflation for FY06 is likely to be marginally lower than the 8.0 percent target.

3.1 Consumer Price Inflation

Consumer price inflation fell from 9.8 percent YoY in May 2005 to 7.1 percent YoY during May 2006, but was nonetheless higher than 6.2 percent in April 2006.

However, it is still below the average of the first eleven months of the current fiscal year as well as the average annual target for FY06.² The deceleration in CPI inflation stemmed essentially from decelerating food inflation; while CPI non-food inflation has dropped from a FY06 peak of 9.6 percent YoY in October 2005, it did not fall below the 8 percent levels since February 2005 (see **Figure 3.2**).



The CPI food group witnessed an inflation of 5.6 percent during May 2006 that is significantly lower than the 12.5 percent YoY during May 2005. The deceleration in CPI food inflation has mainly been driven by a decline in the prices of poultry, ghee & cooking oil, and some vegetables & fruits, as well as relatively smaller increases in the prices of wheat, milk, beef and rice.

Unlike food inflation, volatility in non-food inflation remained low during the year. During May 2006, non-food inflation increased slightly to 8.2 percent from 8.0 percent. Increase in non-food inflation during the month under review was contributed by higher inflation in *fuel & lighting, household furniture &*

² See Inflation Monitor, May 2006, for more on different dimensions of inflation.

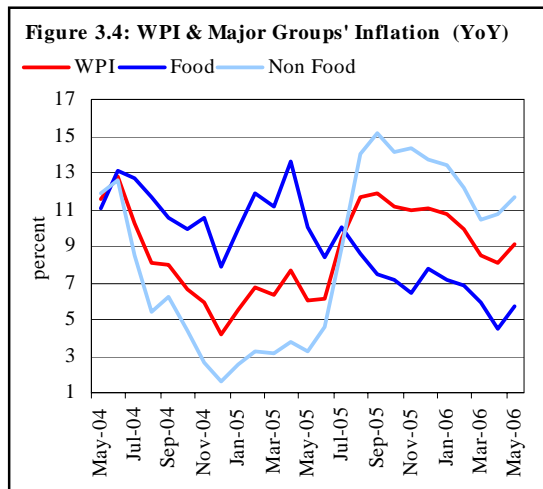
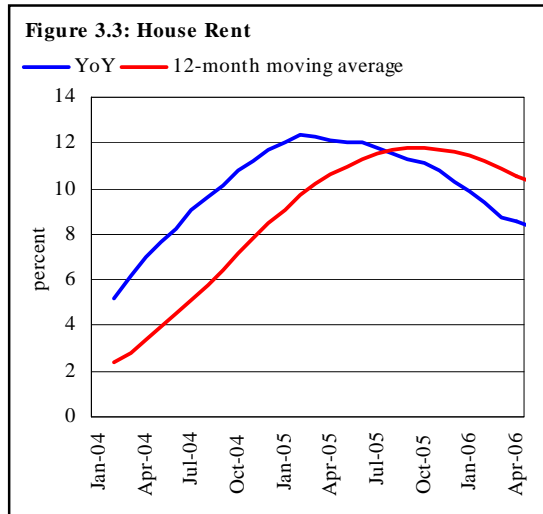
equipments, cleaning, laundry & personal appearance and education. Inflation in other two groups including HRI and apparel, textiles & footwear declined during the month; however, their impact has been overshadowed by sub-groups showing accelerated inflation.

Interestingly, more than one-fourth of the deceleration in CPI inflation is explained by a declining trend of HRI inflation (see **Figure 3.3**).

3.2 Wholesale Price Inflation (WPI)

After declining steadily through most of Jul-Apr FY06, WPI inflation jumped back to 9.1 percent YoY in May 2006 up from 8.1 percent in the preceding month, and significantly higher than the 6.0 percent recorded in May 2005. This increase has been contributed both by *food* and *non-food* groups of WPI (see **Figure 3.4**).

The annual rate of growth in *food* sub-index increased from 4.5 percent in April 2006 to 5.7 percent in May 2006, which is mainly attributable to the sharp increase in the wholesale prices of pulses, particularly gram split and *besan* along with sugar, milk and meat. In particular, the prices of almost all pulses showed YoY increase in the range of 30 to 87 percent during the month, and further rise was contained only through improved supply



through imports.³ Moreover, the prices of wheat and vegetables, which have seen a declining trend during the last few months, also witnessed an increase in May 2006 over the previous month.

Within the *non-food* group all sub-groups except *fuel, lighting & lubricants*, showed higher inflation in May 2006 as compared with that in April 2006 (see **Table 3.2**). In particular, the index of *building material*, which had been witnessing a deflation during Dec-Mar FY06, has finally recorded an inflation of 2.2 percent and 2.9 percent YoY in April and May 2006 respectively. This probably reflects that impact of a sharp rise of more than 25 percent (YoY) in cement prices during each of these months, as well as that of a significant increase in the prices of *wires & cables*, and *other building materials*. It nonetheless is still below 5 to 6 percent rise in *building material* index seen in the corresponding period of FY05. The relatively low increases witnessed in *building material* is a reflection of a continued decline in the prices of *iron and steel* on the back of lower international prices as the global steel production increased significantly to meet the strong demand from China and other Asian economies.

Table 3.2: WPI Group-wise Inflation (YoY)

	Food	Raw materials	Fuel, lighting & lubricants	Manufacture	Building materials
May-05	10.1	-19.4	18.6	-1.5	6.1
Jun-05	8.4	-20.0	23.9	-1.5	3.7
Jul-05	10.0	-3.1	26.7	0.1	2.0
Aug-05	8.6	3.8	34.4	3.1	3.2
Sep-05	7.5	0.1	40.1	1.5	2.7
Oct-05	7.2	15.2	29.8	3.0	0.8
Nov-05	6.4	15.1	29.6	3.7	0.3
Dec-05	7.8	19.1	26.1	4.1	-3.1
Jan-06	7.2	17.4	27.4	3.4	-4.2
Feb-06	6.9	14.2	25.2	3.1	-3.7
Mar-06	5.9	8.9	22.7	2.1	-2.7
Apr-06	4.5	9.0	21.4	2.9	2.2
May-06	5.7	11.3	21.4	4.1	2.9

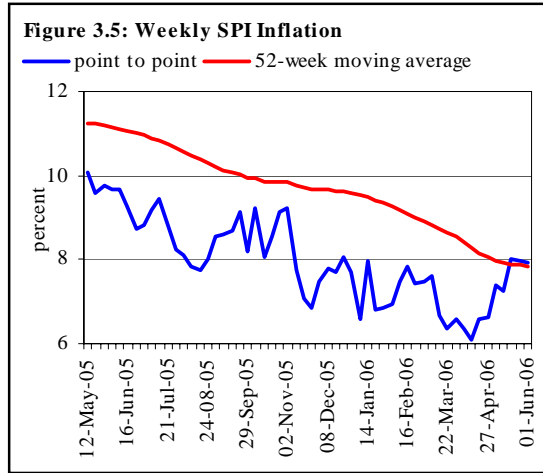
Source: Federal Bureau of Statistics

In contrast, *raw material* index saw a rise of 11.3 percent YoY in May 2006, substantially higher than the deflation of 19.4 percent in the corresponding month last year. The rise in *raw material* index during May 2006 is mainly attributed to noteworthy increases in the sub-indices of *tobacco, wool, sugarcane* and cotton.

³ Import of pulses increased by 19.7 percent during Jul-Apr FY06 compared to the corresponding period last year.

Sensitive Price Indicator (SPI)

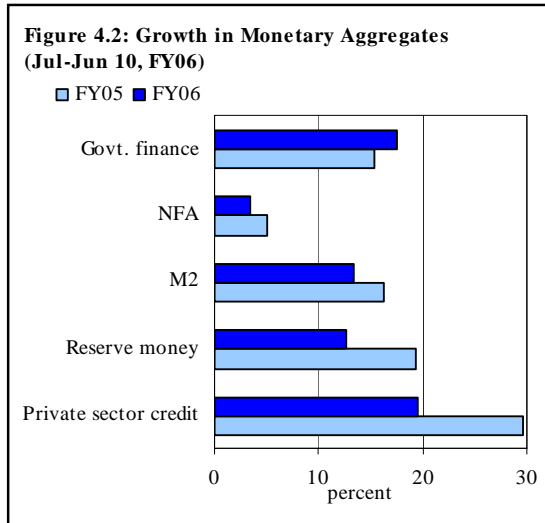
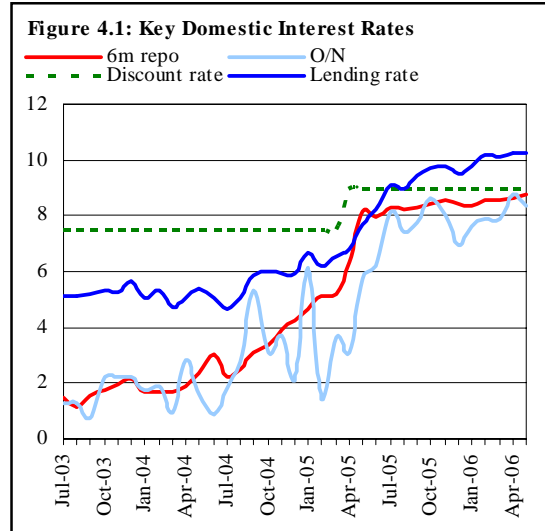
Like CPI, the impact of weak base of corresponding month last year was also reflected in SPI inflation during May 2006. Average inflation in weekly SPI was 7.7 percent in May 2006 which is significantly higher than the inflation of 6.4 percent seen in the preceding month (see **Figure 3.5**). The contributing factors are increased prices of fuel, sugar, milk, potatoes, and pulses.



4 Money and Banking

4.1 Overview

As in the case of many regional economies (see **Box 1**), Pakistan's central bank has maintained a tight monetary policy throughout FY06 in order to contain inflationary pressures in the economy. However, in a departure from most Asian central banks (and SBP's own past) practices, the monetary tightening in Pakistan was not achieved through raising the policy rate; the discount rate remained unchanged through FY06, and even the auction yields on the benchmark 6-month T-bill rate was almost unchanged, witnessing a rise of only 50 basis points during the period. Instead, the SBP focused on draining excess liquidity from the inter-bank market through very frequent OMOs'. As a result, the short-term inter bank interest rates remained fairly close to the discount rate and contributed to an increase of 202 basis points in weighted average lending rates during Jul-May FY06 (see **Figure 4.1**).



The rise in interest rates had a visible impact on credit growth. Consequently, by June 10 FY06, the major monetary aggregates have been showing significant weakening compared with FY05. The growth in money supply-M2 decelerated to 13.3 percent during July-June 10 FY06 compared with the 16.2 percent in the same period of FY05 (see **Figure 4.2**).

Box 4.1: Monetary tightening in Asian Economies Jul-Apr FY06

The inflationary concerns arising out of higher energy prices and a continuous increase in asset prices during 2004 have deepened further during 2005 through most of the Asian region (see **Table B.1**). As a response, many central banks have been pursuing a tight monetary posture by revising upwards the policy rates during 2005 and 2006.

Table B.1: CPI Inflation in Major Asian Economies (calendar year averages)

	2004	2005	2006*	Apr-06**
India	3.8	4.2	4.8	4.9
Indonesia	6.1	10.5	14.2	15.4
Korea	3.6	2.7	2.5	2.0
Malaysia	1.4	3.0	3.1	4.5
Pakistan	7.4	9.1	8.4	6.2
Philippines	6.0	7.6	7.4	7.1
Thailand	2.8	4.5	3.6	6.0

Source: World Economic Outlook Apr 2006; *2006 estimated
**YoY growth; Source: International Financial Statistics-IFS

For instance, Bank of Thailand that executes its monetary stance by influencing the short-term money market rates through changes in its policy rate the 14 day repurchase rate; has made seven upward revisions in its policy rate taking it from 2.5 at end June 2005 to 4.75 at end April 2006 (a cumulative increase of 225 basis points during the period Jul-Apr FY06). The Central Bank of Philippines has made three revisions during Jul-Apr FY06 in its policy rate (the overnight repurchase rate) raising it from 9.25 percent to 9.75 percent at end April 2006. The Bank Negara Malaysia influences the money market rates through changes in its overnight policy rate (OPR). During Jul-Apr FY06, BNM made three revisions in OPR to bring in a cumulative increase of 80 basis points. In Indonesia, the BI rate is used as a policy rate by Bank Indonesia and is a reference rate to conduct open market operations. During Jul-Apr FY06, the BI rate has been revised in five occasions bringing in a cumulative increase of 425 basis points. Finally, the Reserve Bank of India has increased its policy rate by 75 basis points during Jul-Apr FY06.

This slowdown was driven primarily by the deceleration in private sector credit. While the growth in private sector credit during July-June 10 FY06 was slightly higher than the estimate in the Annual Credit Plan for the year, it was markedly lower than that in the corresponding period of FY05. As shown in **Table**

4.1, while the aggregate contribution of government sector borrowings and the NFA to M2 growth during Jul-June 10 FY06 saw a little change from that in the

Table 4.1: Contribution to M2 growth
in percentage points

	Jul-Feb		1 Jul-10 Jun	
	FY05	FY06	FY05	FY06
Credit to non-govt sector	12.3	10.5	14.3	11.3
Government borrowing	0.1	3.9	4.1	4.4
NFA	1.7	-2.7	1.2	0.8
Sub total	1.9	1.2	5.3	5.2
OIN	-3.2	-3.1	-3.4	-2.9
M2	10.9	8.6	16.2	13.3

preceding year, the lower contribution by non-government credit continued to dominate the slowdown in overall M2 growth during Jul-Jun 10 FY06.

Clearly, monetary tightening has started generating some dividends and the implied fall in aggregate demand has begun to ease inflationary pressures. May 2006 data shows significant improvement, with headline CPI inflation decelerating to 7.1 percent YoY compared with 9.8 percent YoY during May 2005. However, besides the tight monetary posture pursued since H2-FY05, improved domestic food supplies, and a decline in major international commodity prices played a significant role in bringing the headline inflation down. While core inflation also decelerated, it still remained high throughout the period. Thus, from SBP's perspective, a discontinuation of tightening remained far from consideration. Moreover, continuity of monetary tightening is also vital to achieve the moderate inflation target of 6.5 percent in FY07, especially given the need to reduce aggregate demand in the economy in the face of an expansionary stance of the FY07 budget, and the projected widening of the current account deficit.

4.2 Monetary survey

The growth in the broad money supply slowed to 13.3 percent during Jul-Jun 10 FY06 compared with the 16.2 percent during the corresponding period of FY05. As a result monetary growth may be very close to the rise in nominal GDP for the first time in four years. This deceleration in M2 growth was contributed by both, Net Domestic Assets (NDA) as well as the Net Foreign Assets (NFA), of the banking system (see **Table 4.2**). While the former was attributable to weakening growth in private sector credit; the slower growth in the latter is explained by deterioration in the country's balance of payments during the period.

Table 4.2: Monetary Survey – Flows (July-June 10 FY06)
in billion Rupees

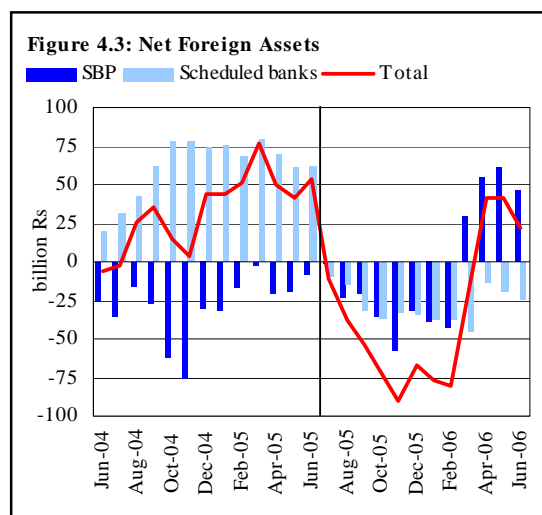
	Credit Plan		
	FY06	FY05	FY06
M2	380.0	402.4	395.5
<i>growth in percent</i>		16.2	13.3
Reserve money		149.7	114.5
<i>growth in percent</i>		19.4	12.6
NFA	15.0	30.0	22.4
SBP		-30.3	46.7
Scheduled Banks		60.3	-24.3
NDA	365.0	372.4	373.1
SBP		162.7	58.4
Scheduled Banks		209.7	314.7
Government borrowing	120.0	101.1	131.9
for budgetary support	98.0	77.2	120.4
SBP		188.1	112.3
Scheduled Banks		-110.9	8.1
Commodity operations	20.0	22.1	11.4
Credit to non-govt sector	320.0	355.5	335.1
Private sector	330.0	378.0	333.7
PSEs	-10.0	-16.4	2.7
OIN	-75.0	-84.2	-93.9
SBP		-19.9	-53.1
Scheduled Banks		-64.4	-40.7

Net foreign assets-NFA

The decline in the NFA of the banking system during most of Jul-Jun 10 FY06 derived from two apparently contradictory developments – the sharp widening of the country's current account deficit, and the firming expectations of exchange rate stability.

In the preceding year, the re-emergence (and widening) of a current account deficit after a gap of three years had raised the risk of large exchange rate adjustment. This had led to a rise in FE-25 deposits as well as the retirement of FE-25 loans, both of which improved scheduled banks' NFA. However, the SBP NFA had deteriorated, reflecting mainly the SBP decision to provide foreign exchange for imports of some key commodities (mainly oil).

This support continued into FY06, and the SBP NFA therefore continued to decline, through most of the period (see **Figure 4.3**). However, the expectations of relative stability in the rupee due to this SBP liquidity support, led to slower growth in banks' forex deposits and, together with rising rupee interest rates, led to a rise in forex loans. These two developments meant that banks' NFA also declined in FY06, in contrast to the FY05 picture.



However after having declined by Rs 80.8 billion during Jul-Feb FY06, NFA of the banking sector took a sharp (but an expected) upturn during March 2006 mainly on the back of (1) long waited receipts of privatization proceeds of PTCL and (2) receipts against the issuance of Euro bond. These flows propped up the SBP NFA by Rs 71.8 billion during the month and also offset the continued weakness in NFA of commercial banks. As a result, the NFA of the banking system witnessed a net increase of Rs 22.4 billion during July-June 10 FY06.

Net Domestic Assets (NDA)

The NDA of the banking system increased by Rs 373.1 billion (growth of 16.0 percent) during Jul-Jun 10 FY06 compared with the increase of Rs 372.4 billion

(or 19.6 percent) during the same period of FY05. As in the previous year, the Jul-Jun 10 FY06 increase in NDA was driven principally by the growth in credit to the non-government sector.

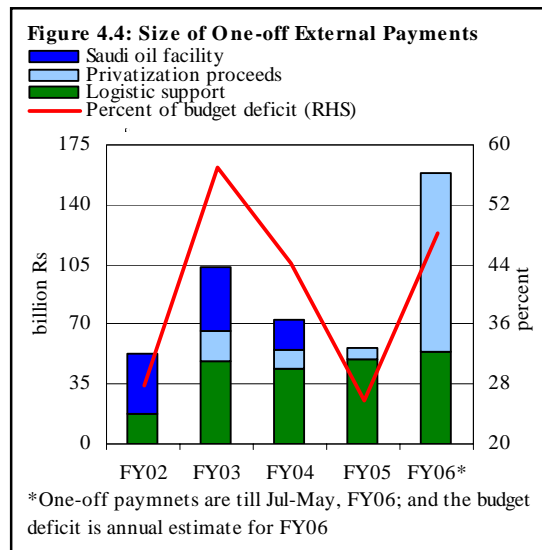
Government Budgetary Borrowings

By end-February 2006, government borrowing for budgetary support from the banking sector had exceeded the Rs 98.0 billion FY06 annual target by over 50 percent principally due to substantial borrowings from SBP.

However, the inflows under PTCL privatization and the issuance of Euro bonds during March 2006 allowed the government to retire a large part of these borrowings. As a result, the cumulative government borrowings from the banking sector dropped to Rs 120 billion during Jul-June10 FY06.

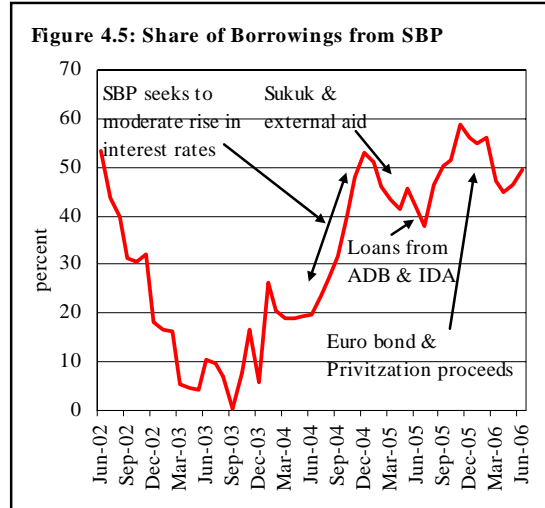
As shown in **Figure 4.4**, the volume of one-off flows during Jul-May FY06 is the largest in last five years and the share of these has reached over 48 percent of the budget deficit. Since such inflows effectively provide 'costless financing' to the government; their increased volume is a source of disquiet as this might undermine the need for the government to adhere strictly to the fiscal discipline.¹

Stepping back, the composition of bank borrowings during Jul-Jun 10 FY06 was similar to the preceding year as SBP continued to finance a significant part of government requirements. Commercial banks, on the other hand, provided only 6.7 percent of the total budgetary finance. However, the share of borrowings



¹ In addition, such one-off inflows increase the non-structural supply of foreign exchange in the economy thereby masking the possible needs for exchange rate adjustments.

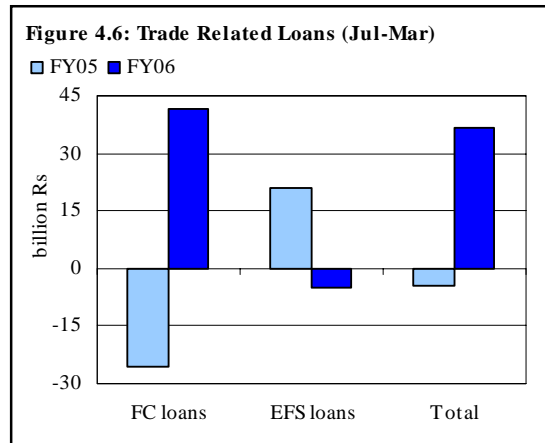
from SBP in total budgetary bank borrowings receded sharply during April 2006 after touching a 46-month peak during Q2-FY06 (see **Figure 4.5**) as the government retired a large proportion of SBP debt using the external receipts though privatization proceeds and Eurobond issue. Had these receipts not been realized, government borrowing for budgetary support from SBP would have stood at Rs 222.1 billion during Jul-June 10, FY06.



Credit to Private Sector

The increase of Rs 333.7 billion in private sector credit during Jul-Jun 10 FY06 was a little higher than the annual (credit plan) estimate for FY06, but was significantly lower than the increase during the same period of FY05. This slowdown is despite the larger increases in trade related loans and the private sector commodity finance during Jul-May FY06 compared with the preceding year.

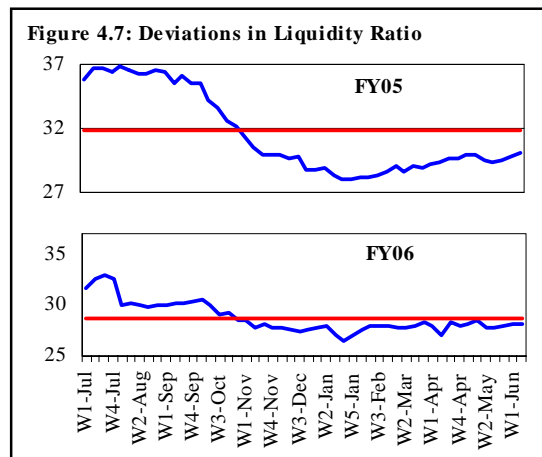
Specifically, the trade related loans (including both FE-25 loans and the loans under export finance scheme) during Jul-Mar FY06 increased by Rs 36.5 billion compared with the net retirements registered in the preceding year (see **Figure 4.6**).² This said, the slowdown in activities in the credit market appears to be driven by both demand and supply side factors.



² The data for EFS volume is reported on quarterly basis.

From the demand side, major factors causing the credit slowdown were; (1) a rise in real lending rates that not only slowed down the demand for productive loans but have also lessened the arbitrage opportunities prevailing as a result of negative real lending rates; and (2) a slowdown in credit off take by domestic synthetic textile and telecommunication industries.³

From the supply side, tighter liquidity conditions in the inter bank market as a result of the SBP tightening measures probably contributed to the slowdown in private sector credit. During the Jul-Jun 10 FY06, not only the average liquidity ratio⁴ was slightly lower than that in the same period of FY05, the deviations from average were also thin (see **Figure 4.7**).



A sectoral distribution of credit shows that the retirements in agriculture sector⁵ loans and a slowdown in credit off-take by textiles and telecommunications sectors contributed most to the weakening credit growth during Jul-May FY06 (see **Table 4.3**). While the slowdown in textile credit is attributed mainly to the rising import of synthetic textiles and the slowdown in fixed investment loans in the

Table 4.3: Private sector advances (Jul-Apr)
in billion Rupees

	FY05	FY06
Agriculture	16.2	-0.5
Manufacturing	146.8	131.1
sugar	4.7	15.8
textiles	94.7	68.8
non-metallic minerals	15.1	16.4
Construction	9.6	9.4
Commerce and trade	36.9	49.8
Transport and communications	21.4	8.4
Consumer finance	66.0	70.7
Total (business + personal)	332.4	303.7

Source: Statistics Department

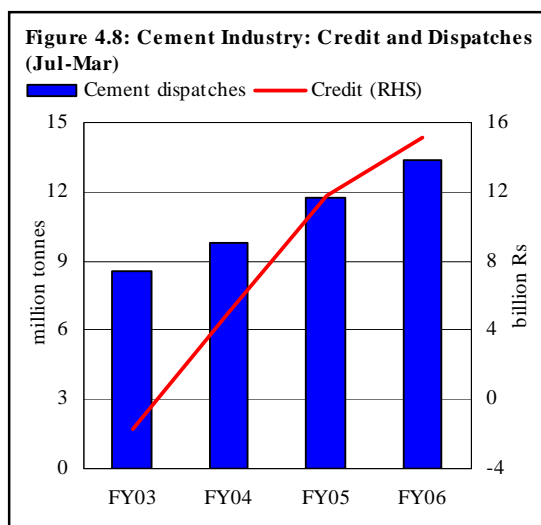
³ For details, please see *SBP's Second Quarterly Report for FY06*.

⁴ Liquidity ratio is defined as required reserves (CRR and SLR) plus excess reserves as percent of demand and time liabilities of banks net of inter bank time and demand liabilities and FE-25 deposits.

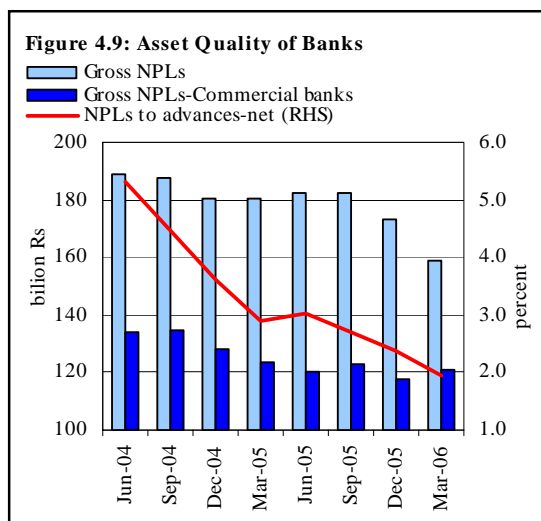
⁵ The net retirements are shown mainly because the ZTBL wrote-off loans worth over Rs 13 billion during the period.

sector;⁶ the slowdown in telecommunication credit reflects only the absence of fixed investment loans during Jul-Apr FY06.⁷

Credit to the cement sector registered higher increases during Jul-Apr FY06 mainly on the back of continued public as well as private sector construction activities (see **Figure 4.8**). Similarly, the credit for *commerce and trade* sector also registered higher increase during Jul-Apr FY06 mainly due to a sharp rise in trade related loans (in foreign currency). Finally, the increase in consumer credit during Jul-Apr FY06 was only slightly higher compared with Jul-Apr FY05. Within consumer finance, credit card financing increased with a growth of 177 percent over Jul-Apr FY05; whereas auto loans, housing finance and personal loans registered slowdown.



From the financial stability perspective, however, there were two interesting developments during FY06. First, it is important to see that the 50 percent of the total *increase* in outstanding advances during Jul-Dec FY06 was extended against real estate as collateral. A continuation of this trend would not be a welcome development as a high level of concentration in collaterals



⁶ The import of textile machinery registered a negative growth of 5 percent.

⁷ For details, please see *SBP' Second Quarterly Report for FY06*.

could prove detrimental for banks' soundness at the time of financial distress (see **Box 4.2**).

Second, it should be noted that the gross non-performing loans (domestic operations) of the banking industry though declined significantly by Rs 23.3 billion during Jul-Mar FY06; however this decline was attributed entirely to the decline in the NPLs of ZTBL. In fact, gross NPLs of commercial banks have registered a slight increase of Rs 1 billion during Jul-Mar FY06 compared with a decline of Rs 13.9 billion during Jul-Mar FY05 (see **Figure 4.9**). This again is not yet a source of concern, mainly reflecting (1) the low fresh NPLs, and (2) the fact that banks probably done with the loan write-off that had led to decline in their NPL in previous years. It may also be noted that NPLs as percent of net advances are at very low level.

It should be noted that NPLs of most of the domestic private banks (other than large five banks) have increased during the period; whereas NPLs of all the large five banks have registered a net decline.

Box 4.2: Exposure in Real Estate: Risks to the Banking Sector & the Countries' Experiences

The exposure of banking sector to real estate can take any form including,¹ (1) holdings of real estate assets in banks' portfolios; (2) lending to customers for real estate purchases; (3) financing of real estate developers and construction companies; (4) lending to NBFIs especially housing finance companies; (5) relying on real estate to collateralize other kind of lending. In any case, risks to the banking sector is clear; if the property price falls, the value of collateral starts declining and the risk of banks increases. This decline in prices forbids banks to finance real estate purchases which further reduce the demand and thus price of real estate. Hence, higher the exposure of banks in real estate worse the impact of any price falls.

In this regard, East Asian crisis (1997) gives a clear indication of banks' exposure to the real estate sector resulting in severe financial crisis once the property prices start declining. **Table B1** shows the magnitude and duration of the price falls in selected countries. On average, prices of the residential property declined by 35 percent and those of commercial property fell by 45 percent. In most countries, property prices peaked on average 2-3 years while the price fall was a gradual process taking 3 to 8 years on average.

Table B1: Length & Magnitude of Real Estate Price Falls

	Price Fall		Length of bust period	
	RRE	CRE	RRE	CRE
	percent		years	
Canada	-21	-30	3	5
Finland	-47	-53	4	4
Ireland	-28	NA	7	NA
Japan	-33	-72	8	8
Malaysia	-15	-5	2 (on gog)	1
Mexico 1	-81	NA	6	NA
Mexico 2	-10	NA	1	NA
Netherlands	-48	NA	7	NA
Spain	-32	NA	4	NA
Sweden	-26	-42	3	3
Thailand	-45	-69	6	8
Average	-35	-45	4.6	4.8

RRE: Residential Real Estate CRE: Commercial Real Estate
Source: IMF Working Paper WP/01/129 (full citation in references)

In Thailand, during 1994-96, credit from finance companies to real estate and construction sector reached to 30 percent of total loans. Banks' exposure to real estate sector reached to 30 to 40 percent of the total assets. Therefore, with the burst in asset price bubble there, non-performing loans surged to 25 percent of total assets of the banking sector (see **Table B2**).

In Sweden and Finland, real estate prices increased significantly during 1980s as a result of growth in real income and credit. This price boom ended abruptly during 1990 with the beginning of worldwide economic slowdown and rising housing units, finance companies experienced major losses and they borrowed heavily from banks to remain sound. A systemic financial crisis occurred in both the countries in 1991-92.

The Japanese banking crisis was also caused by banks' heavy exposure in the real estate. The direct exposure of banks in real estate even reached to 18 percent of the outstanding loans during 1991. During 1991-92, property prices began to fall and this was accompanied by a sharp contraction in private sector credit.

Table 2: Exposure of East Asian Countries' Banking Sector to Real Estate

in percent of assets at end 1997				
	Property Exposure	Collateral Valuation	Non-performing loans	
in percent of assets at end 1997				
	1997		1997	1998
Korea	15-25	80-100	16	22.5
Indonesia	25-30	80-100	11	20
Malaysia	30-40	80-100	7.5	15
Philippines	15-20	70-80	5.5	7
Thailand	30-40	80-100	15	25
Hong Kong	40-55	50-70	1.5	3
Singapore	30-40	70-80	2	3.5

Source: IMF Working Paper WP/02/20 (full citation in *references*)

Contrary, there are some cases where the asset price bubble and bust appeared but no banking crisis occurred. In case of Singapore, real estate prices more than doubled during 1994-97 and the banks' exposure in the real estate and construction was even more than 35 percent of outstanding loans during 1990s. During 1996-97, property prices began to fall and the non-performing loans to total loans reached to 12 percent at end 1999 from 3 percent a year earlier. Although profitability of banks hampered significantly but their capital adequacy remained well above the minimum target. This shows that with well supervised and well capitalized banks, swings in the real estate market might not cause any severe financial distress in the economy.

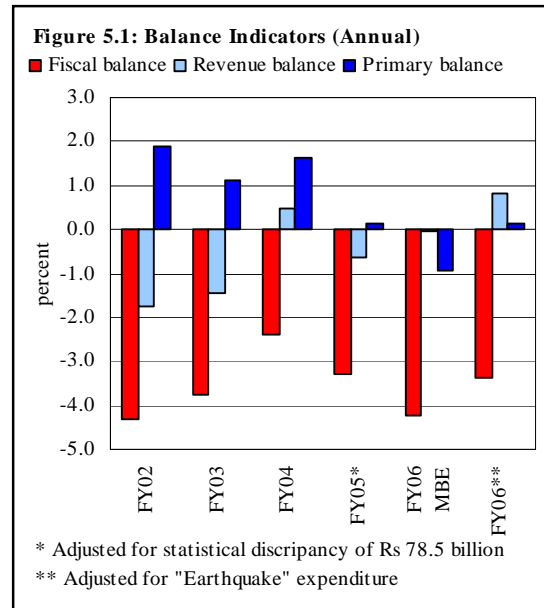
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1. Real estate market developments and financial soundness indicators, Paul Hilbers, Qin Lei and Lisbeth Zacho: No. WP/O1/129, September 2001.
2. Lending Booms, Real estate bubbles and the Asian crisis, Charles Collyns and Abdelhak Senhadji: No WP/02/20, January 2002.

5 Fiscal developments

5.1 Overview

Fiscal indicators computed using the Revised budgetary Estimates (MBE) depict a weakening for the second successive year in FY06; not only has the fiscal deficit widened, the revenue and primary balances have also declined visibly. However, a significant part of the FY06 deterioration in fiscal indicators reflects the impact of the earthquake relief and rehabilitation expenditures. Adjusting for these, the fiscal picture improves somewhat, with the re-emergence of primary and revenue surpluses, but the fiscal deficit continues to show a marginal weakening (see **Figure 5.1**). Moreover, it is encouraging to note that the increase in deficit stemmed substantially from a strong growth in development spending rather than a surge in current expenditure.



The FY06 tax data also reveals continued structural weaknesses in the tax regime, as evident in the continued low tax-to-GDP ratio, the heavy reliance on import-related taxes and potentially volatile non-tax revenues, and inability to broaden the tax base. The risk to the country's fiscal profile from these weaknesses is compounded by the gradual weakening, evident in expenditure management.

The FY07 attempts to address some of the weaknesses, with measures to expand the tax net and thereby the dismal tax-to-GDP ratio. The CBR has been given a target of Rs 835 billion for FY07, which is Rs 131 billion (or 18.6 percent) higher than the revised target of Rs 704 billion for FY06. Moreover, the government appears to be seeking to lower its reliance petroleum surcharges (and cushion the domestic economy partially from a rise in international oil prices). Unfortunately, the continued requirements for earthquake rehabilitation expenditure, and the massive increase in PSDP mean that the budgetary deficit will remain high at 4.2 percent of GDP in FY07.

In this context, it is also important that the government lays before the National Assembly the fiscal policy statement in compliance with section 6 of the Fiscal Responsibility and Debt Limitation Act, 2005. Such statements would have helped explaining the government's position on how emerging fiscal indicators accord with the principles of sound fiscal and debt management.

5.2 Revenues

Total revenue is estimated to reach at Rs 1095.6 billion during FY06, up 21.7 percent YoY as compared to the growth of 13.8 percent YoY in FY05. The major contribution in this relatively high revenue growth was equally strong from both tax revenues and non-tax revenues (see **Table 5.1**).

Table 5.1: Summary of Public Finance

billion Rupees

		FY02	FY03	FY04	FY05	FY06	YoY Change	
							R.E	MBE	FY05	FY06
1	Revenue Receipts (a+b)	624.1	720.8	791.1	900.0	1095.6	13.8	21.7
	a) Tax Revenue	478.1	555.8	608.4	659.4	805.6	8.4	22.2
	b) Non-Tax Receipts	146.0	165.0	182.7	240.7	290.0	31.7	20.5
2	Total Expenditure (a+b+c)	826.3	898.2	955.8	1117.0	1423.0	16.9	27.4
	a) Current	700.2	791.7	774.9	864.6	1097.9	11.6	27.0
	b) Development	126.3	129.2	160.5	227.7	326.7	41.9	43.5
	c) Net Lending to PSEs etc.	-0.2	-22.7	20.4	24.8	-1.6	21.4	-106.5
	d) Statistical discrepancy	-11.7	3.2		78.5			-100.0
3	Surplus/Deficit (1-2.a)	-76.1	-70.9	16.2	35.4	-2.3	118.8	-106.5
4	Overall Deficit (1-2)	-190.5	-180.6	-164.7	-217.0	-327.4	31.8	50.8
As per cent of GDP (mp)								
1	Revenue Receipts (a+b)	14.2	14.9	14.0	13.7	14.2	...	...
	a) Tax Revenue	10.9	11.5	10.8	10.0	10.4	...	...
	b) Non-Tax Receipts	3.3	3.4	3.2	3.7	3.8	...	...
2	Total Expenditure (a+b)	18.8	18.6	16.9	17.0	18.4	...	...
	a) Current	15.9	16.4	13.7	13.1	14.2	...	...
	b) Development	2.9	2.7	2.8	3.5	4.2	...	...
	c) Net Lending to PSEc etc.	0.0	-0.5	0.4	0.4	0.0	...	...
3	Surplus/Deficit (1-2.a)	-1.7	-1.5	0.3	0.5	0.0	...	...
4	Overall Deficit (1-2)	-4.3	-3.7	-2.9	-3.3	-4.2	...	...

Source: Up to FY04 Economic Survey 2004-05, for FY05 and FY06 Economic Survey 2005-06 due to inconsistent data series

* Adjusted the statistical discrepancy of Rs 78.5 billion for the purpose of analysis

The 22.2 percent rise in tax revenues is primarily realized through the taxes on goods and services (sales tax, excise, and surcharges) that rose to Rs 391 billion from Rs 323.5 billion in FY05. Though excise duty (FED) collection grew slowly (1.5 percent), the high growth in sales tax (up 26.0 percent) and surcharges (up 19.9 percent) contributed to the sharp rise in tax revenues. It is notable, that revenue from surcharges is likely to be higher than the modified budget estimates of Rs 32.6 billion, because of exceptionally high revenue generation from PDL in the third quarter as the Government achieved its PDL revenue target of Rs 15.9 billion full year FY06 by the third quarter, while the gas development surcharge provided Rs 15.7 billion accounting for 94.5 percent of the annual modified budgetary target.

Non-tax revenue is also estimated at Rs 290 billion, of which Rs. 247.2 billion is from federal resources while the rest from the provincial resources. The analysis in this respected is limited due to data constraints, but quarterly data indicates that the significant contributor to the 31.7 percent rise in the non-tax revenues are logistic supports payments, SBP profits and dividend receipts.

5.3 Expenditure

Total expenditure in FY06 is estimated at Rs 1423.0 billion, up 27.4 percent YoY (see **Table 5.1**), led mainly by a 43.5 growth in development expenditure.

Almost 55 percent of the total expenditure was accounted for by interest payments (19.2 percent), defense, (16.9 percent), current subsidies and general administration (17.6 percent) (see **Table 5.2**). However, encouragingly, the growth in both the interest payments and defense expenditures was visibly lower than in the previous year (the spending has not increased, in

real terms). The deceleration in the growth of interest payments was essentially due to declines in foreign debt payments and provincial interest payments.

Table 5.2: Composition of Current Expenditure
billion Rupees

	FY05	FY06	Growth	
			FY05	FY06
Current Expenditures	943.1	1097.9	21.7	16.4
<i>Of which</i>				
Interest Payments	257.2	273.1	11.8	6.2
Federal	222.7	241.2	13.5	8.3
Domestic	180.1	200.6	16.3	11.4
Foreign	42.6	40.6	2.9	-4.7
Provincial	34.6	31.9	1.9	-7.7
Defense	211.7	241.1	17.4	13.9
General				
Administration	130.5	157.4	8.8	20.5
Current Subsidies	66.7	92.7	-1.8	39.0
Development and Net				
Lending	252.5	325.1	39.6	28.8
PSDP	227.7	326.7	41.9	43.5
Net Lending	24.8	-1.6	21.4	-106.5

Source: Economic Survey 2005-06

However, substantial growth is visible in current subsidies and general administration.

Development expenditure increased to Rs 326.7 billion with a YoY increase of 43.5 percent. Of the total PSDP outlay, the federal government expenditure is estimated at Rs 92.9 billion on infrastructure development while 85.3 billion is on social development. On the other hand, quite surprisingly, the net lending to PSE is estimated to be -1.6 billion, which appears inconsistent with the fiscal data for July-Mar FY06, in which all the PSEs except Pak Steel, declared losses for the period.

5.4 Financing

The overall budgetary deficit of Rs 327.4 billion during FY06 is estimated to be financed by Rs 118.3 billion from external resources while the rest is estimated to be financed from the internal resources (see **Table 5.3**).

Of the internal resources, the government is likely to meet the financing gap of Rs 96.7 billion from the banking sector, Rs 22.4 billion from the non-bank, while the Rs 90 billion from the privatization proceeds of which Rs 55.2 billion has already been realized by end Q3-FY06.

Table 5.3: Financing of Budget Deficit

billion Rupees		
	FY05	FY06
Total financing	217	327.4
External resources (net)	120.4	118.3
Internal resources	96.6	209.1
Banking system	60.2	96.7
Domestic non-bank	8.1	22.4
Privatization proceeds	28.3	90.0

Source: Ministry of Finance

5.5 CBR Tax Collection

Aided by strong growth in economic activities and an exceptional rise in imports, the CBR tax collections have been substantially above the original targets for FY06. The growth in the CBR net tax receipts July-May FY06 have averaged 22 percent YoY, and are likely to comfortably exceed the original Rs 690 billion annual target. The growth in CBR revenues is quite encouraging, as it is significantly higher than the 13.6 percent growth in the same period of FY05, and given that the ratio of CBR taxes to GDP has improved in FY06.

If this trend persists in FY07 onwards, it will be a good omen for the public finances as it would help increase the country's dismal tax-to-GDP ratio and reverse the decline in the elasticity estimates witnessed in FY05.

The analysis of monthly tax collections show that except for the months of Nov, Jan, Feb and Apr, CBR met all its monthly targets set for the year (see **Figure 5.2**). In terms of individual taxes, the direct taxes and sales-tax surpassed their targets, while the collection on account of Federal Excise Duty (FED) and Customs remained quite below the target (see **Table 5.4**). Further, customs and federal excise duty lagged behind their targets in seven months up to May in the current fiscal year.

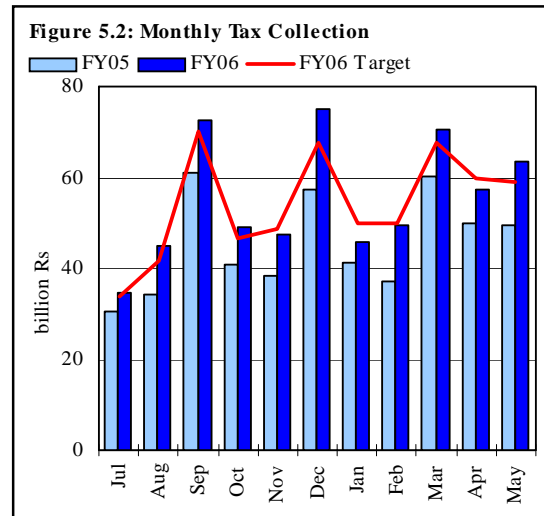


Table 5.4: Tax Collection up till May

billion Rupees

Head	Target		Net tax collection up to May		Percent of target		Growth	
	FY06	May	FY05	FY06	Annual	May	FY05	FY06
Direct taxes	214.0	169.8	146.4	181.9	85.0	107.2	9.8	24.3
Indirect taxes	476.0	425.4	354.1	428.6	90.0	100.8	15.3	21.0
Sales tax	276.5	248.0	207.8	259.1	93.7	104.5	8.9	24.7
Federal excise duty	59.5	53.2	47.1	51.5	86.6	96.9	18.7	9.5
Customs	140.0	124.2	99.3	118.0	84.3	95.0	29.3	18.8
Total	690.0	595.2	500.5	610.6	88.5	102.6	13.6	22.0

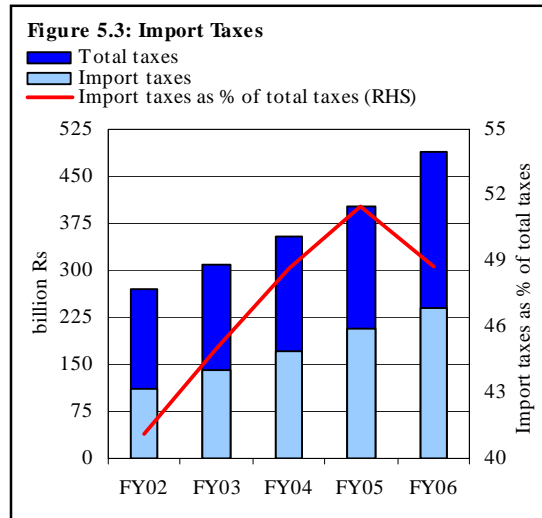
Source: Central Board of Revenue

Structural analysis reflects that the share of import-related taxes in total tax collection has continuously grown in the last five years. These taxes contributed Rs 238.7 billion in the revenue up to Q3-FY06, accounting for almost 48.7 percent of total CBR taxes. The trend shows that although overall share of the import-based taxes in total taxes has slightly fallen in Q3-FY06 yet it remains of considerable size, suggesting the vulnerability of tax receipts if the import growth falls back to the relatively low historical norms (see **Figure 5.3**).

Refund and Gross Collection

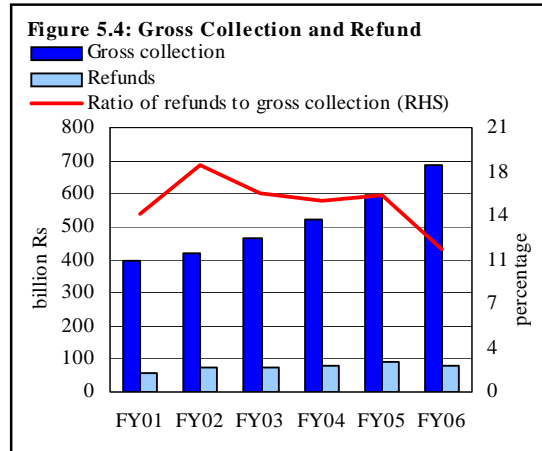
Trends in gross collection depict consistent growth over the last six years. Up to May FY06 gross collection increased by 16 percent as compared to 14.1 percent during the same period last year (see **Figure 5.4**).

Refunds, however, sharply declined by 16.3 percent as compared to 16.5 percent increase in the corresponding period last year, reflecting the impact of various policy measures, principally the zero rating of sales tax on key export-oriented products and universal self-assessment scheme.



Direct Taxes

During July to May FY06, direct tax collection stood at Rs 181.9 billion against the period target of Rs 169.8 billion with a YoY growth of 24.3 percent (see **Table 5.4**). A break-up of direct taxes, which is available only for the Jul-Mar period, shows that around 95 percent of total direct taxes were contributed by income tax.



Within the income tax, withholding taxes contributed 55 percent of receipts while the share of voluntary payments was 39.5 percent, as both the components also registered strong growth (see **Table 5.5**). It is, however, interesting to note that the share of various components of income tax has not shown any significant structural change over the last five years (see **Figure 5.5**) suggesting that the tax reforms of recent years have yet to contribute significantly to improving the tax collection profile.

Table 5.5: Major Components of Income Tax during Q3

billion Rupees

	FY02	FY03	FY04	FY05	FY06	Growth	
						FY05	FY06
Voluntary payments	36.9	25.2	40.4	52.4	67.2	29.8	28.2
Collection on demand	7.7	5.4	9.0	8.3	9.3	-8.2	13.0
Withholding taxes	53.6	44.0	62.7	73.3	93.5	16.9	27.5
Others	0.1	0.7	0.4	0.5	0.1	42.9	-84.6
Gross total	98.3	75.3	112.5	134.5	170.1	19.6	26.5
Refund	8.3	5.4	11.7	19.8	24.3	69.1	22.5
Total Net	90.0	69.8	100.7	114.7	145.8	13.9	27.1

Source: Central Board of Revenue

A break-up of the income tax, up to March FY06, shows that almost half of the collection on demand comprises of arrears (Rs 4.4 billion) while the current demand contributed Rs 4.9 billion. Of the withholding taxes, major revenue heads were contracts (Rs 29.4 billion), imports (Rs 19.5 billion), salaries (Rs 10.2 billion), and exports (Rs 7.5 billion).

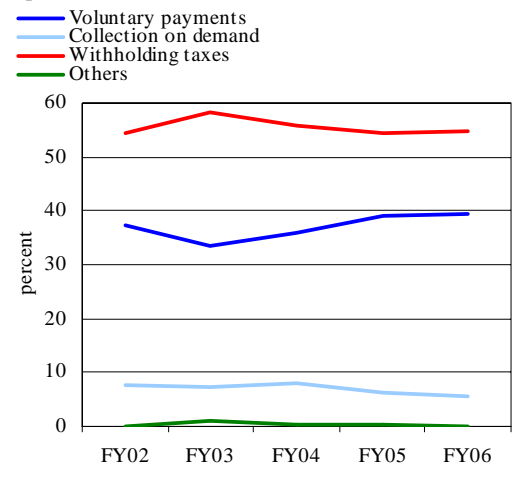
Indirect Taxes

Collection from indirect taxes rose 19.6 percent YoY to Rs 337.1 billion by end Q3-FY06.

Approximately 60 percent of the indirect taxes were accounted for by sales tax collection with federal excise duty (12 percent) and the customs (28 percent) contributing the remainder.

Sales Tax

With a net collection of Rs 202.4 billion during first three quarters of FY06, sales tax surpassed period target of Rs 196.6 billion registering a YoY growth of 22.4 percent.

Figure 5.5: Share of the Components of Income Tax upto Q3

Sales tax on imports contributed around Rs 121.1 billion, approximately 59.8 percent, that portrays high dependence on consumption of imported commodities. Major revenue came from POL (Rs 17.1 billion), vehicles other than railway/tramway (Rs 13.6 billion), vegetable oil (Rs 4.7 billion), and electrical machinery (Rs 4.2 billion). On the other hand, domestic sales tax provided Rs 81.3 billion, of which major revenue spinners were POL (Rs.36.8 billion), services (Rs 21.4 billion) and sugar & sugar confectionery (Rs 6.0 billion).

Customs Duty

During July-March FY06, collection from customs stood at Rs 95.1 billion with a YoY increase of 18.7 percent. The growth in customs duty, however, does not seem to be compatible with the 43.2 percent growth in imports during Q3-FY06.

Major revenue sources were vehicles, vegetable oil, POL, mechanical appliances and electrical machinery.

Federal Excise Duty (FED)

With a shift to VAT- mode sales tax, federal excise duty is considered as a dying tax, but it continues to remain an important source of revenue. During Q3-FY06, the FED collection remains below the target in five months and also lags behind its overall target of Rs 41.3 billion with a collection of Rs 39.6 billion.

Major revenue spinners of the FED remained the same as in the past, that is, beverages, beverages concentrates, cigarettes & tobacco, cement, natural gas and POL products, constituting around 96.5 percent of the revenue generated from the locally produced goods. It is

noteworthy that there is a 10 percent YoY decline in the revenues from the POL products and a further 9.4 percent decline in revenues from beverages concentrates (see **Table 5.6**), while industrial growth depicts a YoY increase of 2.3 percent

Table 5.6: FED Collection up to Q3

billion Rupees					
Major commodities	FY04	FY05	FY06	Growth	
				FY05	FY06
Beverages	1.6	1.7	2.6	4.9	53.6
Beverages concentrate	0.8	1.1	1.0	42.4	-9.4
Cigarettes & tobacco	12.1	14.6	16.4	20.9	12.0
Cement	6.7	7.9	9.1	17.4	14.6
Natural gases	3.6	4.1	4.0	12.2	-1.0
POL products	2.5	2.9	2.6	14.1	-10.0
<i>Sub-total</i>	<i>27.4</i>	<i>32.3</i>	<i>35.7</i>	<i>17.9</i>	<i>10.5</i>
Others	2.2	2.0	1.3	-7.0	-36.6
<i>Local goods (gross)</i>	<i>29.6</i>	<i>34.4</i>	<i>37.0</i>	<i>16.1</i>	<i>7.7</i>
<i>Imported goods (gross)</i>	<i>0.9</i>	<i>2.0</i>	<i>2.9</i>	<i>129.2</i>	<i>42.7</i>
<i>Total (gross)</i>	<i>30.5</i>	<i>36.4</i>	<i>39.9</i>	<i>19.3</i>	<i>9.6</i>
<i>Refund & rebates</i>	<i>0.1</i>	<i>0.0</i>	<i>0.2</i>	<i>-42.3</i>	<i>490.6</i>
Total (net)	30.4	36.4	39.6	5.9	19.5

Source: Central Board of Revenue

growth in POL production, 4.7 percent in Cigarette, 9.8 percent in Cement, and 2.3 percent in POL.

5.6 Federal Budget FY07

The budgetary measures announced in the Federal Budget 2006-07 broadly focus on providing a conducive environment for economic activity in the country. In addition, the Government's policy of increasing revenues through broadening the tax base is implemented through various budgetary measures.

The Government has announced a substantial increase in development spending in subsidies on essential foodstuffs. From the budgetary outlay of more than Rs 1.5 trillion, Rs 435 billion have been allotted to public sector development; a 60 percent increase from the Rs 272 billion allocated in FY06 and 38.7 percent higher than the revised (Rs 325.1 billion) (see **Table 5.7**). About Rs 8 billion have been allocated for subsidizing household essentials, particularly foodstuffs, in state-run utility stores, up from Rs 2 billion currently, to ease the impact of inflation, currently at around 8 percent.

Table 5.7: Summary of Public Finance

Rs. in billion

	FY05	FY06	FY07
Total revenue receipts	900.0	1095.6	1188.0
Tax revenue	659.4	805.6	954.0
Non-tax revenue	240.7	290.0	233.0
Total expenditure	1117.0	1423.0	1561.5
Current	943.1	1097.9	1152.0
Development and Net Lending	252.5	325.1	435.0
Statistical discrepancy	78.5	-	25.5
Overall fiscal deficit	217.0	327.4	373.5
<i>Without earthquake spending</i>	-	262.4	323.5
Financing of fiscal deficit	217.0	327.4	373.4
External (net)	120.4	118.3	171.7
Domestic	96.6	209.1	201.7
Non-bank financing	8.1	22.4	6.7
Bank financing	60.2	96.7	120.0
Privatization proceeds	28.3	90.0	75.0
(as percent of GDP)			
Total revenue	13.7	14.2	13.5
Tax revenue	10.0	10.4	10.8
Total expenditure	17.0	18.4	17.7
Current expenditure	14.3	14.2	13.1
Development expenditure	3.8	4.2	4.9
Overall fiscal deficit	3.3	4.2	4.2
Fiscal Deficit (without earthquake)		3.4	3.7

The budget is pro-poor and is aimed at sustaining growth. Over the period from 2001 to 2005 regardless of the fact that poverty has declined, the income distribution has worsened in the country. The ratio of the highest to the lowest quintile which measures the gap between the rich and the poor also widened to some extent from 3.76 in 2001 to 4.15 in 2005. At regional level, the gap between

the rich and poor in urban areas has widened relatively at higher pace – increase from 10.40 to 12.02. In contrast, the gap between the rich and poor in rural area remained more or less unchanged, that is, from 2.22 to 2.19. In this backdrop, the budget aims to address the issue of growing rich-poor gap by taxing the richer segments of the society and by providing relief and concession to the poor amounting to Rs 109 billion. The grant of subsidies in various sectors is to attain the objective of pro-poor growth.

The Budget may be regarded as ‘industry-neutral’ as it places little emphasis on industry and trade. However, it is ultimately going to benefit the businesses as the budget focuses more on the sustained growth of the economy.

On the expenditure side, defence spending has been increased to Rs 250 billion (3 percent of the GDP), up Rs 27 billion from the Rs 223.5 billion in FY06. The Federal budget on education and health shows YoY net increase of Rs 2.1 billion and Rs 0.3 billion, respectively; but in terms of GDP there is no improvement. However, we should recognize that the overall impact of the government spending on education, health, and population welfare sectors would be available after the provincial budgets come out.

With a budgeted revenue of Rs 1083 billion, the overall budget deficit (Rs 373.5) is estimated to be 4.2 percent of the GDP (including earthquake rehabilitation expenditure), mainly due to the increase in PSDP. This is consistent with the Fiscal Responsibility and Debt Limitation Act, 2005.

CBR has been assigned a target of Rs 835 billion for FY07, which is Rs 131 billion (or 18.6 percent) higher than the revised target of Rs 704 billion for FY06. This will increase the tax-GDP ratio of CBR taxes from the current 9.1 percent to 9.5 percent. This is a very positive development.

The tax system in Pakistan is characterized by narrow tax base, disproportionate tax burden on different sectors and low tax buoyancy, contributing to the low tax-to-GDP ratio. It may be recognized; however, that the Federal Government and CBR have limited ability to increase the tax/GDP ratio for the reason that the taxability of two important sectors of the economy offering enormous revenue potential (agriculture income tax and sales tax on services) are provincial subjects. Unfortunately, the receipts from these provincial taxes are not reflective of the share of these sectors in the total economy. Tax/GDP ratio for the federal government is 9.9 percent, whereas it is only 0.6 percent for provincial governments.

It is instructive to note that sales tax is the most prolific tax in terms of revenue generation in Pakistan. Its widespread acceptability has increased its share in federal tax receipts from 23.4 percent in FY99 to 40.0 percent in FY06. The ratio of sales tax to GDP has also increased from 2.45 percent in FY99 to 3.7 percent in FY06. However, the services sector, which contributed 52.3 percent in the GDP in FY06, mostly remains outside the scope of sales tax and the collection of sales tax/federal excise duty from this sector is very low. During FY05, the sales tax/CED collection on services amounted to Rs 27.9 billion only. The main portion of Rs 20.4 billion was generated through telecommunication services. Other services contributed Rs 3.6 billion to the total sales tax collection of Rs 240 billion. The contribution of retail and wholesale trade to the sales tax collection was very dismal (Rs3.3 billion), representing 0.26 percent of its value added in the GDP (mp) which amounted to Rs 1251 billion.

To meet the growing challenge of higher revenue collection, the Budget FY07 has introduced some new taxation measures which are aimed at improving resource mobilization and broadening of tax base in the country.

A welcome development has been the move to bring some of the services (financial services, franchise services, services provided by foreign exchange and money changer) into the excise regime. Such taxation measures would broaden the tax base, mobilize resources, and make the tax system more equitable. It would be desirable to bring *all* other services with significant revenue potential into the tax net, so as to increase the tax-GDP ratio and make the tax system more equitable.

Another Wealth-tax Act, 1963 was suspended (held in abeyance) from July 1, 2001. Prior to its suspension, wealth tax contributed nearly Rs 4.0 billion (in FY00) to the exchequer. In the absence of wealth tax and given the fact that enormous capital gains (on sale of property, land, shares, etc.) are made by the rich segment of society, it may be prudent to impose and implement capital gains tax seriously. This will improve income distribution in the economy as the rich will pay more taxes. This year, the Government has increased the rate of CVT on shares from 0.01 to 0.02 percent but this will hardly generate significant additional revenues. The CVT collected from stock exchanges in Pakistan in FY05 amounted to Rs 2.068 billion, and in FY06 Rs 0.922 billion have been collected up to March. We can roughly estimate that this raise in tax rate would fetch additional Rs 1.5 billion in FY07.

It is important that taxes fall proportionately on all the sectors. The risk of deterioration in fiscal performance also needs to be guarded against. Some key risks include: (1) heavy dependence on import-related taxes, accounting for nearly

half of the share in collections (receipts could therefore slowdown if, as expected, import growth falls back to historical norms); and (2) dependence on potentially volatile non-tax revenues. Thus, there remains a clear need for further tax effort to raise the tax-GDP ratio substantially over the next few years. In this context, the estimated increase in the tax-GDP ratio in the next year needs to be monitored, and particular attention needs to be given to the broad-basing of the tax net and improving collections from under-taxed areas of the economy such as agriculture, the services sector.

6 External Sector

6.1 Balance of Payments

The pressure on the country's external account increased substantially during FY06, as the current account deficit swelled to a historic peak of US\$ 4.1 billion by end-April FY06, sharply higher than the US\$ 0.9 billion deficit recorded in the corresponding period of FY06. Even more significantly, as a percentage of GDP the annual current account deficit is estimated to rise from an innocuous 1.4 percent of GDP in FY05 to a more troubling 3.2 percent of GDP in FY06, indicating that a continued weakening could raise grave risks to the hard-won macroeconomic stability achieved in recent years.

As in the previous year, the deterioration in the current account deficit during Jul-Apr FY06 emanates essentially from the trade deficit, wherein the gains from a robust 13.0 percent increase in exports have been eclipsed by the exceptionally strong 28.5 percent increase in imports. Within the current account, trade deficit of US \$ 6.5 billion was accompanied by services account deficit of US\$ 3.5 billion, up 36 percent from last year; mainly due to higher transportation and other business charges associated with higher imports. Income account also recorded a deficit of US\$ 2.1 billion. The rise in deficit in the trade, services and income account was partially offset by increase in the current transfers, which increased from US\$7.1 billion in Jul-Apr 2005 to US\$ 8.1 billion in Jul-Apr 2006, largely on account of the worker remittances and increase in official grants.

The strong rise in exports has been widely welcomed, and the public debate on correcting the trade imbalances have largely revolved around the need to contain import growth, and particularly those imports that contribute, either directly or indirectly to domestic consumption. Unfortunately, the problems, and therefore the policy options, are more complex.

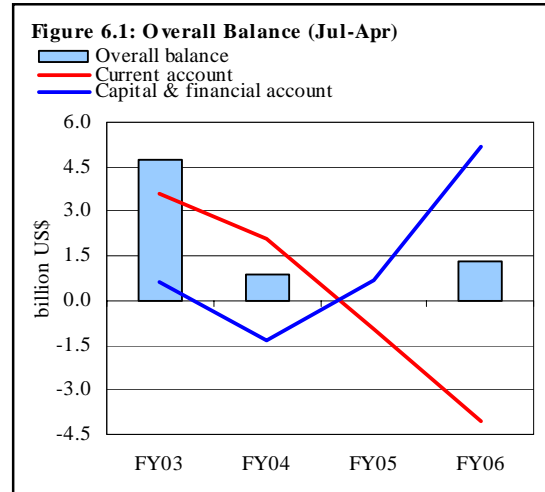
While practically all imports sub-groups have seen a significant increase during FY06, the larger contribution to the rise in aggregate imports has been by machinery, industrial raw materials, and particularly the rise in the oil import bill. Moreover, given that consumer durables have a small share in the imports growth, and results of empirical studies showing that imports of capital goods are more elastic to exchange rate movements, it seems measures to contain aggregate imports through large exchange rate adjustments, required for any meaningful reduction in the external deficit, would have significant negative growth

implications.¹ The problem is compounded by the fact the more targeted interventions (through taxes on specific imports) are unlikely to succeed, as evident from the past history – anecdotal evidence points to high tariffs leading to increased smuggling of goods.

Policy options in the short run, therefore revolve around the need to concentrate on supporting exports and securing the financing of the trade deficit through non-debt creating inflows such as remittances, FDI, portfolio investment, etc., or concessional debt flows. In the longer run, policy must focus more on ensuring that strong export growth is sustained, and on courting FDI flows. The government is already making efforts to provide a better

enabling environment to facilitate exports, broaden the exports base, and reduce the cost of business, but these efforts are likely to yield results only in the medium to long-run time frame. Pakistan also had some success in tapping the international markets to finance its deficit, attracting FDI (including for its privatization program) and has obtained financing for development. All of these together with rising portfolio investments, are reflected in the country's substantial US\$ 5.0 billion financial account surplus during Jul-Apr FY06 (see **Figure 6.1**), as compared to a surplus of only US\$ 24 million in the corresponding period of FY05. As a result, the overall balance witnessed a surplus of US\$ 1.3 billion during Jul-Apr FY06.

This also helped sustain the *relative* stability of the exchange rate - the rupee depreciated only 0.88 percent against the US\$ during Jul-May FY06 to Rs 60.22/US\$² - and sustaining SBP reserves around the US\$ 10 billion mark. The foreign currency reserves of both, the central bank, as well of commercial banks



¹ It may also be remembered that an exchange rate adjustment would not be without a fiscal cost, through increasing foreign debt liabilities in rupee term. Furthermore, a one-time adjustment could also potentially trigger a cycle of self-fulfilling expectations of exchange depreciation, putting extra pressure on country's limited reserves to maintain the exchange rate stability.

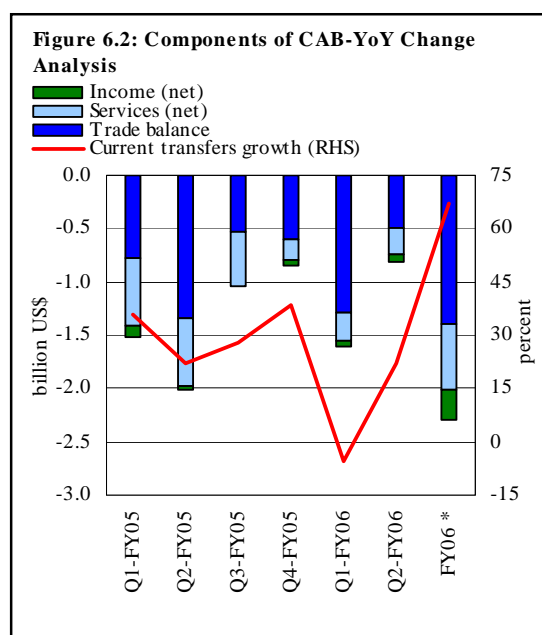
² Average of buying and selling inter-bank floating rate.

initially steadily declined during Jul-Jan 2006; more specifically, in this period overall reserves dropped from US\$ 12.6 billion to US\$ 11.5 billion while that of the SBP dropped from US\$ 9.8 billion to US\$ 9 billion. Thereafter, however, SBP's liquid reserves, witnessed a substantial increase of US\$ 1.6 billion on account of various inflows particularly in the month of March 2006. Interestingly almost two-third of the total 0.88 percent depreciation in the rupee value during Jul-May 2006 was witnessed in Feb-May 2006 period, after the substantial rise in the SBP reserves.

6.1.1 Current Account

The continued expansion in the country's trade deficit drew the current account deficit to a record high level of US\$ 4.1 billion during the period of Jul-Apr FY06 (see **Table 6.1**). This US\$ 3.1 billion YoY rise also caused the current account deficit-to-GDP ratio to soar to 3.2 percent from the level of 0.8 percent for Jul-Apr FY05. The trade deficit has witnessed a substantial rise in the last two years due to a sharp rise in imports. During Jul-Apr FY06 imports recorded a substantial YoY growth of 28.5 percent that outpaced the yet significant 13.0 percent rise in exports during this period. In addition to this the increase in imports also caused expansion in the services account deficit due to higher payments of transportation charges.

However, this rise was partly compensated by greater inflows of logistic support payments as well as a large increase in current transfers during this period. Particularly the rebound in current transfers since Q1-FY06 which is reflected in a substantial expansion in the current transfers during Sep-Apr FY06 substantially contained the further expansion in the current account deficit during this period (see **Figure 6.2**).



Items	H1		Jan-Mar		Jul-Apr		Change FY06 over FY05
	FY05	FY06	FY05	FY06	FY05	FY06	
I. Trade Balance	-2,276	-4,088	-1,050	-2,155	-3,610	-6,534	-2,924
Exports	6,946	7,912	3,751	4,092	11,921	13,420	1,499
Imports	9,222	12,000	4,801	6,247	15,531	19,954	4,423
II. Services (net)	-1,441	-1,953	-976	-1,374	-2,612	-3,548	-936
Transportation	-613	-918	-331	-430	-1,038	-1,484	-446
Travel	-512	-611	-254	-280	-842	-989	-147
Communication services	128	56	84	3	251	72	-179
Other business services	-927	-1,074	-666	-732	-1,853	-1,996	-143
Government services	573	864	223	105	1,010	1,163	153
Of which: logistic support	448	756	202	0	831	923	92
Others	-90	-270	-32	-40	-140	-314	-174
III. Income (net)	-1,219	-1,348	-470	-543	-1,820	-2,103	-283
Direct investment	-775	-1,006	-381	-463	-1,296	-1,635	-339
Of which: Profit & Dividend	-207	-246	-45	-54	-290	-325	-35
Purchase of crude oil & minerals	-421	-500	-258	-284	-761	-882	-121
Portfolio investment	-86	-71	-10	-22	-91	-118	-27
Of which: Profit & Dividend	-48	-38	-14	-14	-69	-76	-7
IMF charges & interest on official ext. debt	-356	-343	-81	-111	-449	-468	-19
Interest on private ext. debt	-59	-42	-29	-19	-96	-71	25
Others	56	112	31	69	111	183	72
IV. Current Transfers (net)	4,131	4,530	2,140	2,646	7,107	8,106	999
Private transfers	4,097	4,315	2,137	2,513	7,069	7,764	695
Workers remittance	1,946	2,055	1,104	1,173	3,451	3,629	178
FCA - residents	410	219	16	-21	466	268	-198
Others	1,741	2,041	1,017	1,361	3,152	3,867	715
Official transfers	34	215	3	133	38	342	304
Cash grants	17	117	0	27	17	145	128
Current Account Balance (I+II+III+IV)	-805	-2,859	-356	-1,426	-935	-4,079	-3,144

Source: Statistics Department, State Bank of Pakistan

Trade Balance

Country's trade deficit witnessed a sharp deterioration during Jul-Apr FY06 reaching US\$ 6.5 billion during this period i.e. US\$ 2.9 billion expansion as compared to the level of Jul-Apr FY05. This was due to a very substantial 28.5 percent rise in imports witnessed during this period. A major share of this rise came from sharply rising oil import bill due to high oil prices,³ and from large machinery imports. Hence, this large increase in imports outpaced the substantial 13.0 percent growth in exports witnessed during this period, thus causing the trade deficit to rise to a historic high level.⁴

Services (Net)

Services account deficit reached US\$ 3.5 billion during Jul-Apr FY06 showing 35.8 percent increase against the level of Jul-Apr FY05. This increase was largely attributable to rising transportation outflows caused by a sharp growth in imports as well as higher outflows under business services. In addition to this travel services also recorded higher outflows; whereas communication services recorded a fall in inflows during this period.

Further, the outflows under the head of *other services* also recorded a considerable expansion; this was mainly due to the deferred payments for the construction of Ghazi Brotha Dam during August FY06. However, these large outflows were substantially compensated by US\$ 92 million increase in the logistic support inflows during Jul-Apr FY06.

Income account

The income account deficit witnessed a 15.5 percent YoY increase during Jul-Apr FY06 to reach US\$ 2.1 billion. This rise was caused by higher direct investment income outflows. However, a significant share of this outflow was offset by higher earnings on country's international reserves (see **Table 6.2**).

The repatriation of returns on FDI increased by US\$ 339 million during Jul-Apr FY06 mainly due to higher payments of dividends along with higher purchase of crude oil and gas (see **Figure 6.3**). Further, the reinvested earnings also witnessed a large increase during this period.

³ According to the FBS trade data, around 93 percent rise in the oil import bill was due to rising oil prices.

⁴ For details, see section on *Trade*.

Besides, the interest payment on country's external debt also witnessed a marginal rise during Jul-Apr FY06.

The detail analysis of the components of external debt reveals that payments on public and publicly guaranteed debt witnessed a US\$ 43 million rise in this period. However, this increase was largely offset by lower interest payments on private loans and IMF credit, thus causing the interest payments on external debt to rise only marginally.

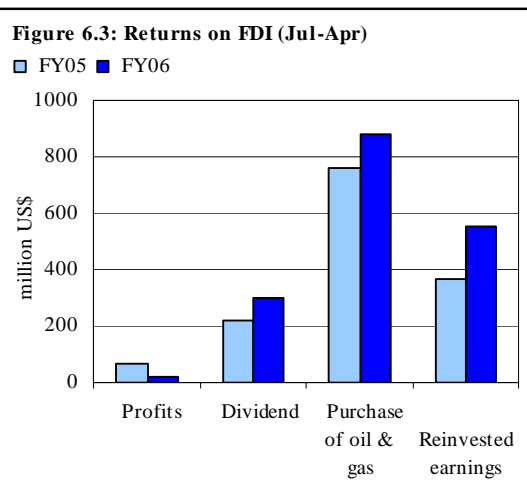
The rise in the interest payments on public and publicly guaranteed debt was contributed by rising payments for Eurobonds as well as for IDB loans. However keeping in view the issuance of Eurobonds on an annual basis since FY04 besides the surge in IDB loans (for financing oil as well as fertilizer imports), the increase in these two components was expected.

In addition, the interest payments for external liabilities also remained higher during Jul-Apr FY06 largely due to a rise in foreign currency loans extended to traders by commercial banks

Table 6.2: Details of Interest Payments and Receipts
million US\$

	Jul-Apr		
	FY05	FY06	Saving
Payments (I+II)	690	755	-65
I. <u>Total external debt</u>	<u>598</u>	<u>611</u>	<u>-13</u>
Public & publicly guaranteed	486	529	-43
Long-term	416	430	-14
Military	11	8	3
Euro bonds	53	72	-19
Commercial loans/credits	6	6	0
IDB	0	13	-13
Private loans/credits	96	71	25
IMF	16	11	5
II. <u>External liabilities</u>	<u>92</u>	<u>144</u>	<u>-52</u>
Foreign currency deposits	12	20	-8
Special US\$ bonds	26	22	4
Central bank deposits	18	28	-10
Others	36	74	-38
Receipts	170	298	128
Interest on reserves	115	204	89
Others	55	94	39
Net Payments	-520	-457	63

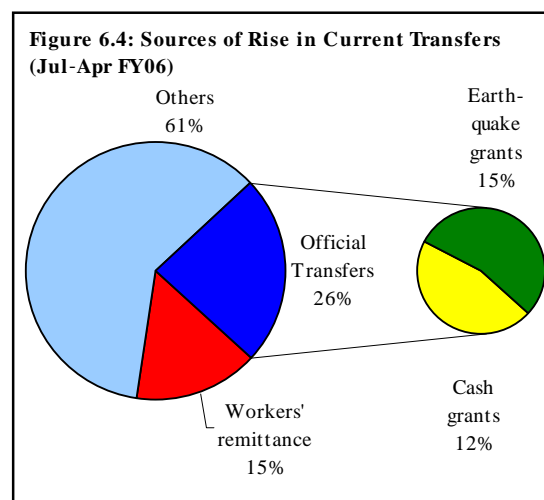
Source: Statistics Department, State Bank of Pakistan



during this period⁵ as well as the interest payments made by the foreign companies for the working capital requirement. These outflows, however, were compensated by higher interest receipts on country's international reserves during Jul-Apr FY06, resulting in net savings of US\$ 63 million during the period.

Current Transfers

Current transfers recorded a pronounced increase during Jul-Apr FY06 reaching US\$ 8.1 billion in this period as compared to US\$ 7.1 billion recorded during Jul-Apr FY05. The average monthly level of current transfers rose from US\$ 710 million witnessed during Jul-Apr FY05 to US\$ 810 million during Jul-Apr FY06. The analysis of the sources of this increase reflects that apart from the usual rise in remittances and other transfers, official transfers also had a significant contribution in this increase during Jul-Apr FY06 (see **Figure 6.4**).



Worker remittances⁶

Worker remittances (cash) reached US\$ 4.1 billion during Jul-May FY06 recording 8.7 percent rise as compared to the same period last year. Rising remittances from Saudi Arabia were the largest source of this increase; however, this increase was to an extent offset by falling inflow of remittances from the US (see **Table 6.3**).

Apart from the USA, remittances from the UAE, particularly Dubai, also declined in this period. Anecdotal evidence suggests that this fall is partly attributable to rising investment opportunities in the real estate in Dubai. In addition to this, the rising cost of living⁷ in UAE is also narrowing the margin of remittances from this region.

⁵ Outflows under this head are equally off set by the inflows in the *other receipts*.

⁶ The discussion on Workers' remittances is based on data up to end-May 2006.

⁷ <http://www.ameinfo.com/74538.html>

However, encouragingly the impact of this fall in remittances from the traditional source countries was mitigated by rising remittances from some non-traditional sources, especially Canada. In fact remittances from Canada have nearly doubled in each of the last two years. Their absolute level is although still very low; however, the pattern of remittance growth from this region points to the potential for substantial growth in future.

Apart from this, remittances from UK have also been witnessing a steady increase since FY02. The average monthly level of remittances from this region has risen from a mere US\$ 13 million during FY02 to US\$ 36.4 million in the current year. These positive factors have helped sustain the growth of remittances witnessed since last year. Apparently, remittances' growth seems to have generally stabilized in the range of 5-7 percent (see **Figure 6.5**).

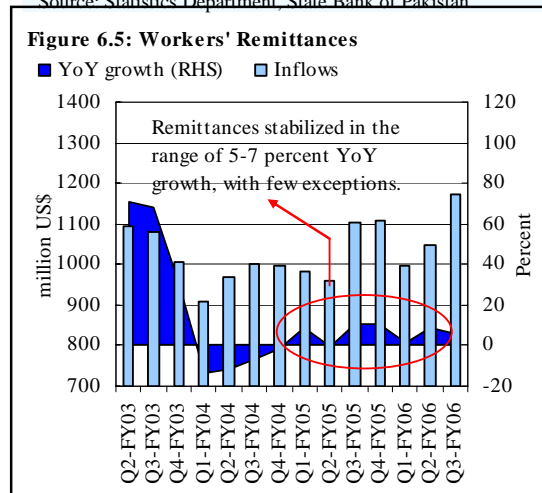
Resident FCAs

FCAs (resident) recorded a lower inflow of US\$ 268 million in Jul-Apr FY06 as compared to US\$ 466 million inflow during Jul-Apr FY05. In fact the higher level of inflows last year was due

Table 6.3: Workers' Remittances (July-May)

	FY05	FY06	FY06	
			Change	Share in Change
I. Gulf region	1,692	1,844	104.7	58.6
Bahrain	84	91	3.6	2.0
Kuwait	200	223	19.0	10.6
Qatar	79	105	21.5	12.0
Saudi Arabia	568	671	78.4	43.9
Oman	109	118	7.3	4.1
U.A.E.	652	636	-25.0	-14.0
II. U.S.A.	1,185	1,119	-81.4	-45.5
III. Other than Gulf & US	933	1,173	155.5	87.0
Canada	43	74	27.0	15.1
Germany	50	54	2.1	1.2
Japan	6	6	-0.3	-0.2
Norway	17	15	-2.8	-1.5
U.K.	338	400	36.1	20.2
Other	478.6	624.5	93.4	52.2
Total	3,795	4,125	104.7	58.6
Encashment of FEBCs/ FCBCs	15	11	-4	
Grand total	3,810	4,136	326	

Source: Statistics Department, State Bank of Pakistan



to some one-off inflows and in the absence of these, the level of inflows declined during Jul-Apr FY06. The month of December FY06 was however an exception, as some one-off inflows were received in this period.

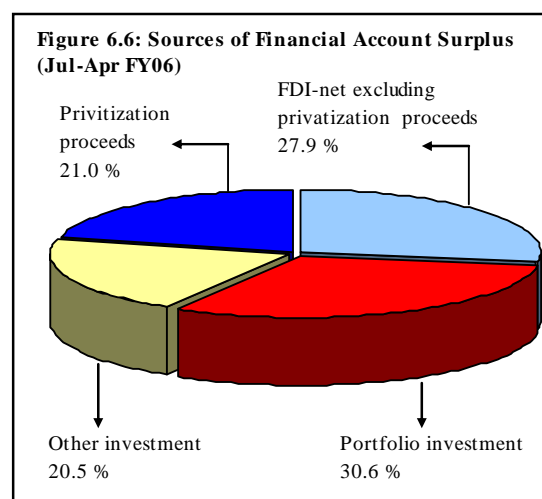
Official Transfers

Official transfers recorded a substantial rise of US\$ 304.0 million during Jul-Apr FY06 reaching US\$ 342.0 million as compared to a mere US\$ 38.0 million during the same period last year. This was largely due to the availability of higher grants during this period: country received US\$ 145 million as cash grant for budgetary support during Jul-Apr FY06 and US\$ 152 million received on account of earthquake assistance against US\$ 2.5 billion pledged by the international community.⁸

6.1.2 Financial Account

The financial account balance witnessed a sizeable surplus of US\$ 5 billion during Jul-Apr FY06 compared to the US\$ 24 million *surplus* recorded during Jul-Apr FY05 (see **Table 6.4**).⁹

The components of the financial account surplus reveals that the improvement in the financial account balance was broad based, contributed almost equally by FDI (excluding privatization proceeds), portfolio investment, other investment and privatization proceeds (see **Figure 6.6**).



Net Foreign Investment (NFI)

The net foreign investment recorded a robust YoY increase of US\$ 2.5 billion during Jul-Apr FY06 reaching US\$ 4.0 billion. A large share of this increase was contributed by rising FDI flows. In addition to this portfolio, investment also witnessed a substantial rise during the period.

⁸ Source: http://www.pakistan.gov.pk/donor/pledges_grant.jsp

⁹ Financial outflows during Jul-Apr FY05 included non-structural outflows such as (1) notional outflows as a result of debt write off, and (2) repayment of PARCO loans. After excluding these outflows, net financial account shows a surplus of US\$ 600 million during Jul- Apr FY05.

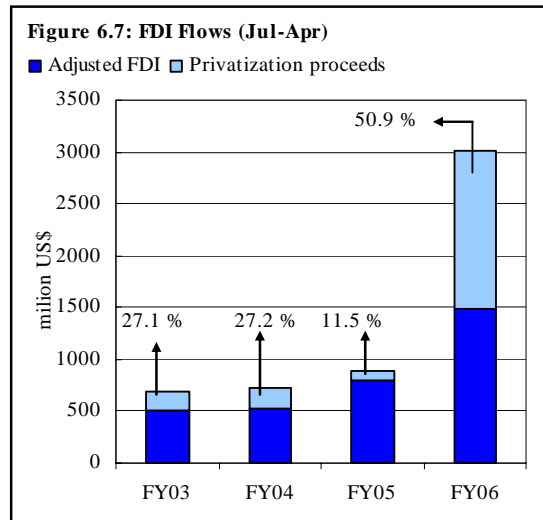
Table 6.4: Financial Account							
million US\$							
Items	H1		Jan-Mar		Jul-Apr		Abs. Change (Jul-Apr)
	FY05	FY06	FY05	FY06	FY05	FY06	
Financial Account (1 through 4)	1276	2393	1226	2162	24	5027	5003
1. Direct investment abroad	-34	-12	1	-66	-51	-78	-27
2. Direct investment in Pakistan	445	1103	348	1121	892	3019	2127
<i>of which: Equity Capital</i>	289	835	269	987	631	2572	1941
Reinvested earning	156	268	79	134	261	447	186
3. Portfolio investment	7	311	621	782	643	1031	388
<i>of which: (Stock Markets)</i>	59	359	48	47	134	355	221
<i>Special US Dollar Bonds</i>	-53	-53	-27	-68	-90	-133	-43
<i>Euro bonds</i>	-2	0	598	798	596	798	202
<i>Net Foreign Investment</i>	418	1402	970	1837	1484	3972	2488
4. Other investment	1694	991	256	325	1460	1055	2515
Assets	1122	376	7	62	1108	223	1331
<i>i. Outstanding Exports Bills (Exporters)</i>	-128	-181	-28	-48	-149	-241	-92
<i>ii. Outstanding Exports Bills (DMBs)</i>	-5	47	-104	-24	-105	-28	77
<i>iii. Currency & deposits</i>	-989	510	139	134	-854	492	1346
<i>of which: Bank</i>	-942	464	148	103	-792	403	1195
Liabilities	-572	615	249	263	-352	832	1184
<i>i. Foreign Long-term loans/credits (net)</i>	234	338	190	200	421	544	123
<i>of which: Project Assistance</i>	347	321	81	196	482	574	92
Food Aid	0	0	0	0	0	0	0
Non-Food Aid	862	591	300	221	1162	812	-350
Amortization	975	574	191	217	1223	842	-381
<i>ii. Private loans</i>	-160	0	-103	259	-300	237	537
<i>of which: Suppliers Credits/MNCs</i>	12	167	8	336	20	503	483
Supplier Credits Repayments	172	167	111	77	320	266	-54
<i>iii. ST Capital, (official)</i>	-27	-44	137	-136	122	-194	-316
<i>of which: Commercial Banks (net)</i>	-116	-116	0	0	-116	-116	0
IDB (net)	89	72	137	-136	238	-78	-316
<i>iv. Currency & deposits</i>	-409	286	31	23	-361	295	656
<i>of which: Trade financing</i>	-583	627	135	65	-430	610	1040
<i>v. Other liabilities</i>	-210	35	-6	-83	-234	-50	184

Source: Statistics Department, SBP

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

Foreign Direct Investment

The combination of rising foreign investment in the equity capital and significant increase in the privatization proceeds caused US\$ 2.1 billion YoY expansion in the FDI flows during Jul-Apr FY06 (see **Figure 6.7**). Even after adjusting for privatization proceeds, the FDI flows demonstrated a substantial rise of US\$ 692 million as compared to the same period last year. The highest increase was seen in the sectors of telecommunication, power, financial businesses, and oil & gas exploration.



The importance of FDI in the development process of any country can hardly be over-emphasized. However, in case of Pakistan it has become all the more important, not only for bringing in new technology and market access but also as a major source of financing the current account deficit. As discussed earlier, substantial current account deficit is likely to persist in the short run, and FDI would have to rise to support the financing gap. Therefore, the government needs to redouble its efforts to remove all the impediments to FDI.

While removing some of the impediments like infrastructure bottlenecks may take some time, others like bureaucratic hurdles, gross law and order situation, etc. can be tackled in relatively shorter period with a resolve.

Some concerns have also been raised on the composition of the FDI, as around 51 percent of the Jul-Apr FY06 FDI consists of the privatization proceeds. While the inclusion of the privatization proceeds in the overall FDI is technically correct, it does have different implications for the economy than the other FDI flows (see **Box 6.1**).

Portfolio Investment

Portfolio investment recorded a substantial YoY rise of US\$ 388 million reaching US\$ 1 billion during Jul-Apr FY06. A large share of this rise came from rising

Box 6.1: Foreign Direct Investment: Importance and Issues

The role of Foreign Direct Investment (FDI) in the developmental process is well established. Numbers of studies have been carried out (see, Chen 1992) to show that FDI produces a positive effect on economic growth in host countries. FDI brings with it not only capital but also technology, management techniques, and market access. FDI tends to be directed at those sectors that enjoy actual and potential comparative advantage creating economies of scale and linkage effects and raise productivity. Another benefit of FDI is a confidence building effect. While the local economic environment determines the overall degree of investment confidence in a country, inflows of FDI could reinforce the confidence, contributing to the creation of a virtuous cycle that affects not only local and foreign investment but also foreign trade and production

Therefore, it is heartening to see the rise of FDI in Pakistan; however, some issues have been raised, including the concerns over inclusion of the privatization proceeds in FDI and its utilization. It would be therefore pertinent to address some of these issues. The Data on FDI is compiled by the Statistics Department of the SBP according to the international standards of FDI compilation. FDI is a financial investment in a domestic enterprise by which foreign (non-resident) investors gain equity stake of 10 percent or more in the firm. Therefore, when a domestic asset is sold to a non-resident, privatization proceeds are counted as FDI. Thus, there is no foul play in inclusion of privatization proceeds in FDI.

However, FDI arising from privatization could have different implications for the economy than the normal FDI. Since, FDI is considered to contribute to growth by bringing in new technology and market access, the extent to which it is through privatization proceed, its positive impact on growth is likely to be relatively less. Further, FDI from privatization proceeds essentially represents switching of domestic asset to foreign asset against pure FDI which represents gross capital formation.

Another issue is in this regard is the utilization of the privatization proceeds which have been obtained from the selling of domestic assets. Recently the government has retired its central bank debt through these proceeds, since government expenditures are fungible it is hard to make out how much of these were developmental in nature. Thus, there is a possibility that privatization proceeds may have been used to finance non-developmental expenditures.

There is also a genuine concern that since public assets available for privatization are limited, current account can be financed through these inflows for only a limited period. Thus, in the long run there is a need to focus on non-privatization FDI.

foreign investment in the country's stock market, especially from USA, that was followed by yet a substantial rise in the inflows caused by the issuance of two new Eurobonds.

Although the size of portfolio investment in Pakistan is not significant, yet the volatile nature of these inflows does raise some concern (see **Box 6.2**). A cursory look at the movements in the KSE index in the recent months highlights these concerns. KSE index witnessed significant volatility in the month of March with the index witnessing a sharp fall in the mid of this month. Interestingly this fall

during March FY06 coincided with a sudden reversal in the pattern of foreign portfolio investment in the stock market. The month of March witnessed a substantial outflow of US\$ 64 million in contrast to the average monthly inflow of US\$ 59 million in the period of Jul-Feb FY06. This coincidence points towards the presence of a positive correlation between the movement of the KSE index and the level of portfolio investment. The presence of this relative weak positive correlation implies that movements in the KSE index might partly be impacted by foreign portfolio investment flows in the stock market.

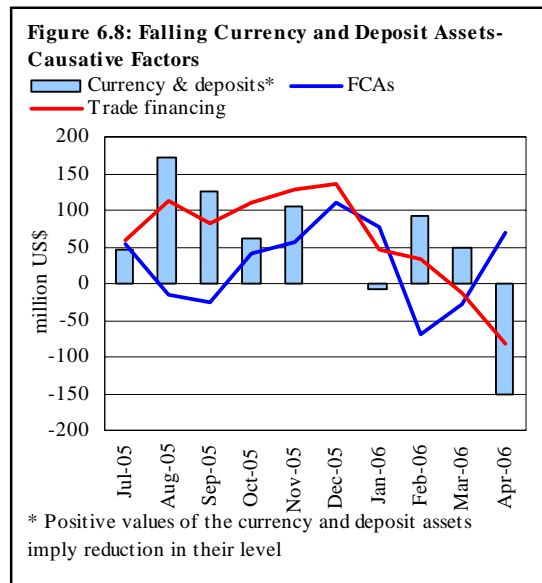
Eurobonds

The country successfully issued two new Eurobonds worth US\$ 800 million during the month of March FY06. With the issue of these bonds, the country witnessed a US\$ 202 million rise in the inflows in this head as compared to the same period last year. These bonds included a 10-year US\$ 500 million bond maturing in 2016 and a 30-year US\$ 300 million bond maturing in 2036. The coupon rate fixed on these bonds was 7.125 percent and 7.875 percent respectively to be paid semi-annually.

Currency and Deposits

A decline in the nostro accounts of banks caused a US\$ 492 million net drop in the currency and deposit assets during Jul-Apr FY06, in contrast to a US\$ 854 million rise observed during Jul-Apr FY05.

The fall in the nostro holdings was in turn observed due to a deceleration in the growth of FCA deposits as well as a large expansion in trade financing during this period, both developments probably reflect the relative stability of the rupee in the period (see **Figure 6.8**).

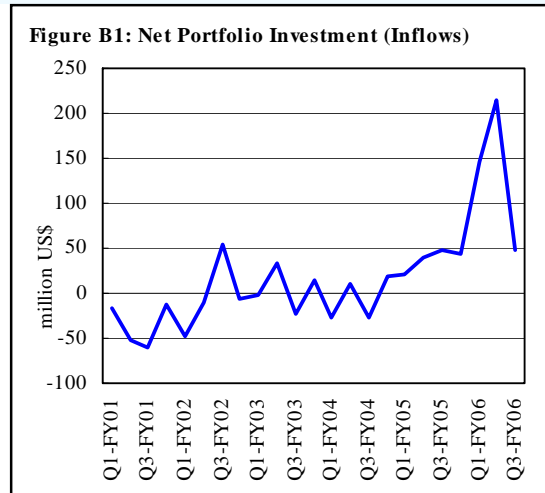


Box 6.2: Is a Rising Portfolio Investment a Source of Concern?

The surge in portfolio investment is always seen with a concern due to the high degree of volatility attached with these flows since its sudden withdrawal depresses the stock prices. Besides, it also reduces the recipient countries' central bank's ability to maintain the value of the currency of the respective country. The depreciation of the currency might in turn cause the debt crisis due to rising cost of the hard currency based foreign obligations.

In fact these volatile flows were one of the root causes of the East Asian crisis. These countries witnessed a dramatic increase in portfolio flows in the early 1990s. The net inflows into the emerging market economies totaled US\$ 800 million in 1987 that soared to US\$ 47 billion in 1996 - one year preceding the East Asian crisis. In this year Indonesia, Malaysia and Thailand received the third, fourth and sixth largest shares of foreign capital flows in the world - the ratio of foreign capital inflows reached 10 percent of GDP in Thailand and 6 percent of GDP in Korea and Indonesia in 1996.

From these countries' experiences it can be seen that portfolio inflows might not directly induce a crisis, however their sudden withdrawal raises the vulnerability of an economy. Secondly these concerns are related to large volume of net inflows. In case of Pakistan, however, the country has started witnessing surge in the portfolio investment only recently (see **Figure B1**) which is also reflected in the marginal share of net portfolio inflows in the GDP, i.e. 0.28 percent in Jul-Apr FY06. However keeping in view the experience of East Asian countries, Pakistan has the option of introducing various measures to encourage longer-term inflows, and limit volatile short-term inflows in case of sharp surges in these flows. These measures include direct or administrative measures and indirect or market based controls.



- Administrative controls directly affect the volume of the cross-border capital transactions. They seek to restrict capital transactions and transfers of funds through outright prohibitions, explicit quantitative limits, or approval procedures. However, the imposition of direct controls would be in conflict with the process of liberalization of the foreign exchange regime underway in the country.
- Indirect or market-based controls may affect only the price or both, price and volume of a given transaction. They tend to discourage capital movements and the associated transactions by increasing their cost. These measures include adopting multiple exchange rates, explicit or implicit taxation of cross-border financial flows, besides other predominantly price-based measures.
- Explicit taxation of cross-border flows involves imposition of taxes or levies on external financial transactions or on income resulting from the holding by non-residents of domestic

financial assets, thus discouraging such investments by reducing their rate of return or raising their cost. Further tax rates can also be differentiated to discourage certain types of transaction and maturities.

- Indirect taxation of cross-border flows takes the form of non-interest-bearing compulsory reserve/deposit requirements with the central bank of the recipient country. This is one of the most frequently used market-based controls adopted by countries.

Hence, in case of substantial rise in these broadly short-term flows the country has the option of adopting the indirect controls in order to reduce vulnerability of country's external account.

References: Jhonston J. Michael, Wilamoski. Peter, "From Rich to Poor: A Plan for Stabilizing Investment Markets in Developing Countries". <http://www.helleniccomserve.com/richtopoor1.html> Grabel Ilene (1998), "Portfolio Investment". *Foreign Policy in Focus*. Vol 3: No.13.

Outstanding Export Bills (OEBs)

Outstanding export bills held by exporters increased by US\$ 241 million during Jul-Apr FY06 as compared to the US\$ 149 million rise witnessed during Jul-Apr FY05. This rise is attributable to high volume of exports during this period. On the other hand the OEBs held by banks recorded a fall of US\$ 28 million during this period due to higher realization.

Foreign Long-term Loans

Net official long-term loans witnessed a marginal rise in inflows during Jul-Apr FY06 (see **Table 6.4** main financial account table). However, when these net inflows are adjusted for the US\$ 495 million debt relief given by the US during Jul-Apr FY05 the net foreign long term loans show lower inflows during Jul-Apr FY06 (see **Table 6.5**).

Table 6.5: Adjusted Official Long Term Loans (Jul-Apr)
million US\$

	FY05	FY06
Receipts	1644	1386
Amortization	728	842
Net inflows	916	544

Source: Statistics Department, State Bank of Pakistan

The fall in these inflows was due to lower inflows from World Bank and ADB. However, these loans also included US\$ 506 million in earthquake assistance from the ADB (US\$ 119 million), the IDA (US\$ 200 million) and Japan (US\$ 95 million).

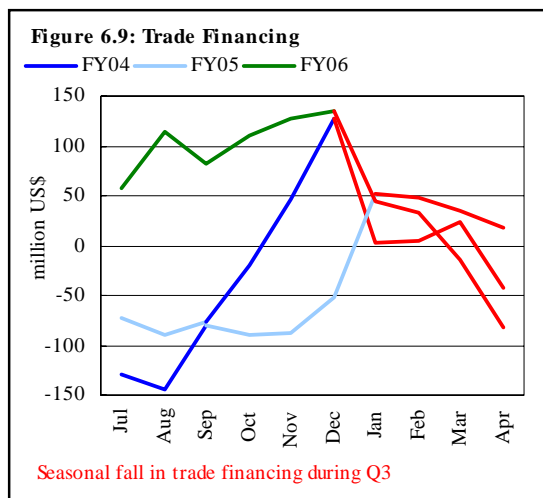
Private/Short-term Loans

Pakistan witnessed a 179.0 percent jump in net inflows of private loans during Jul-Apr FY06 as compared to 62.6 percent rise the same period last year. A large share of this rise was directed to the communication sector. Further the private loans proceeds also include US\$ 329.0 million of loan taken by PIA to finance the purchase of two new aircrafts. The short-term loans inflows on the other hand

witnessed a net retirement during this period.

FE-25 Related Trade Financing

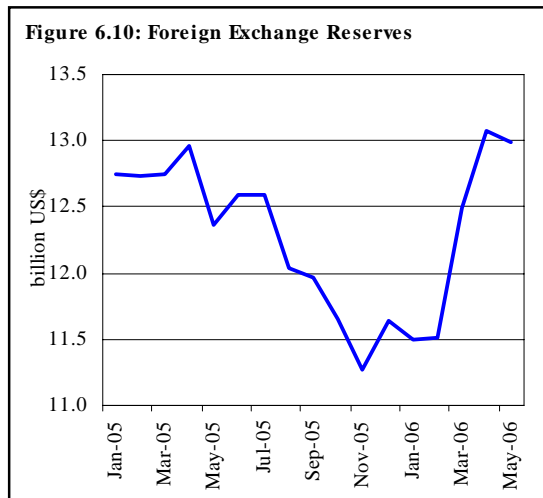
In overall terms trade financing against FE-25 deposits recorded a substantial rise of US\$ 610 million during Jul-Apr FY06 against the net retirement of US\$ 430 million in the same period last year. The substantial rise in disbursement of these loans during Jul-Apr FY06 is attributable to a wide difference between EFS and FE-25 weighted average lending rates as well as a stable exchange rate during this period.



Further the analysis of the monthly data reveals that disbursement of these loans remained higher during H1-FY06; but Q3-FY06 witnessed a seasonal fall in the disbursement of these loans (see **Figure 6.9**).

Foreign Exchange Reserves

The foreign exchange reserves of Pakistan reached US \$ 13.0 billion by the end of May 2006 (see **Figure 6.10**). The total increase in the total foreign exchange reserves is US \$ 372.1 million during the period of July-May FY06. Furthermore, the reserves of SBP increased by US \$ 811.6 million, while the reserves held by the commercial bank decreased by US\$ 439.5 million. The increase in the reserves held by SBP is



notable as it was despite its continuous intervention in the forex market, particularly for the support of oil payments.

Indeed, the increase in the reserves of SBP was mainly based on the non-structural inflows. The issuance of Eurobond and PTCL privatization proceeds were the main sources, which added to the foreign exchange reserves. Furthermore, the receipts from logistic support, cash grants, president's earthquake relief fund, interest income on placement and purchase from the inter-bank market further added to the level of foreign exchange reserves.

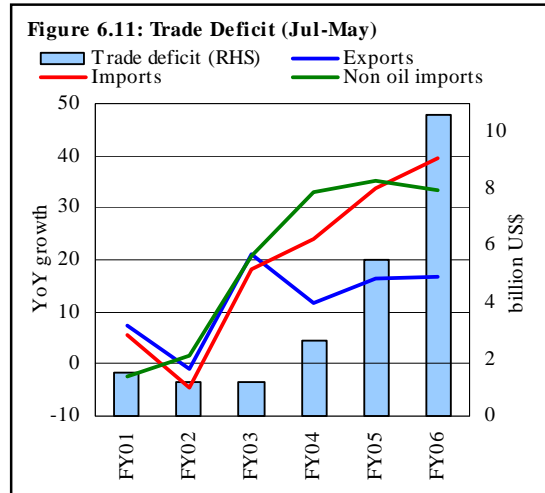
The inflows from donor agencies, logistic support and privatization totaled US \$ 5.8 billion during the period of Jul-May FY06. Importantly, more than 77.0 percent of these inflows are non-debt creating in nature. Such inflows include US\$ 0.9 billion from logistic support, US \$ 0.8 billion from the launching of Eurobond and US \$ 1.7 billion from the privatization proceeds.

In the inter-bank market, SBP continued its support to induce stability in the exchange rate primarily by providing hard currency for lumpy oil payments and some other commodities. During the Jul-May FY06, SBP injected US \$ 8.0 billion out of which US \$ 5.3 billion was for the support of oil payments. However, SBP was also able to purchase foreign currency from the market. The SBP purchases totaled US\$ 5.8 billion during the period Jul-May FY06.

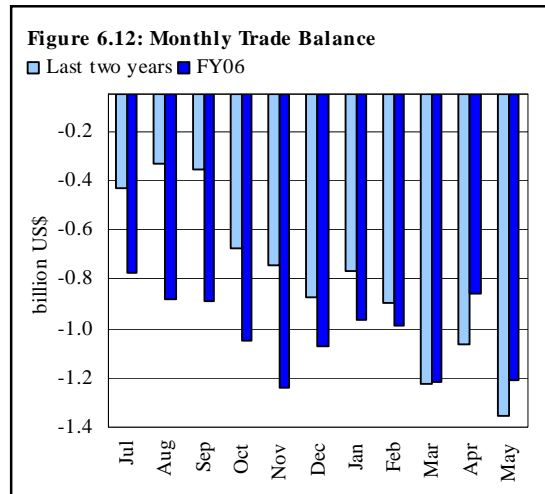
The drawdown in the reserves of commercial banks was mainly due to increased demand for foreign currency loans. The foreign exchange loans became attractive on the back of relative stable exchange rate and rising interest rate on Pak rupee loans. The incremental forex loans extended by commercial banks to local traders rose by US \$ 0.6 billion. However, the foreign exchange reserves of commercial banks were scaled down by relatively lower amount of US \$ 0.4 billion, due to US\$ 0.2 billion fresh mobilization of FE-25 deposit.

6.2 Trade Account¹⁰

The steadily widening trade deficit touched US\$ 10.6 billion during Jul-May FY06, substantially higher than the US\$ 5.5 billion recorded in the same period last year (see **Figure 6.11**). The driving force behind the exceptionally high trade deficit remained the persistent surge in the import growth. During the period, the extraordinary import growth of 39.4 percent outstripped the otherwise healthy export growth of 16.7 percent. Indeed, the trade deficit in almost each month of FY06 has been greater than the corresponding aggregate figure for the preceding two years (see **Figure 6.12**).



The major contributor in the trade deficit were soaring international oil prices and machinery imports. In fact, the POL imports contributed almost one-third (32.2 percent) of the total import growth of 39.4 percent (see **Box 6.3**).¹¹ Machinery group contribution to imports growth was 22.7 percent.



The trade deficit is likely to remain under pressure from increase in the oil imports as a decrease in the oil import bill is unlikely unless oil prices drop sharply (see **Box 6.1**). Indeed the oil bill could

¹⁰ The discussion in this section is based on provisional data provided by the Federal Bureau of Statistics (FBS). The data is subject to revision.

¹¹ More than 90 percent of growth in POL imports was contributed by the rising oil prices.

actually increase, as higher imports of furnace oil may be required in FY07 if (as feared) hydroelectricity generation drops due to water shortages in dams. Similarly, any policies at curtailing machinery imports could undermine efforts to overcome capacity constraints and develop infrastructure. Thus, as a sharp compression of imports does not seem achievable without a corresponding great drop in the economic activities, the focus of policy must perforce turn to encouraging exports, in hopes that sustained growth here, together with a reversion of import growth to historic norms will eventually reduce the external deficits to manageable levels. Encouragingly there is some evidence that a significant slowdown in import growth is underway; as evident from **Table 6.6**.

Exports growth averaged a healthy growth 16.7 percent, during July-May FY06, despite the stiff competition post-MFA (which has hit unit values in key export commodities), as well as punitive anti-dumping duties and loss of GSP benefits for textile exports to the EU region.¹² However, a relative weakness in export growth in the later half of FY06 is a matter of some concern, and it is hoped that with the recent reduction in anti-dumping duty by the European Union on Pakistan bed-linen exports (from 13.1 percent to 5.8 percent, effective May 7, 2006), and restoration of some GSP benefits (albeit at lower levels) exports growth could revive in FY07.¹³

	FY05		FY06	
	Jul-Jan	Feb-May	Jul-Jan	Feb-May
Food group	13	55	56	16
Machinery group	121	215	220	25
Petroleum group	75	65	201	231
Textile group	5	1	19	19
Agricultural and other chemicals group	74	52	85	11
Metal group	33	65	67	19
Miscellaneous group	7	9	12	7
Others	40	52	94	163
Total imports:	368	515	752	491

Over the longer term, there is a clear need to ensure that the macroeconomic environment remains supportive of exporters, and that appropriate investments are made towards the requisite infrastructural requirements. The exporters need to focus on improving competitiveness by product diversification and market diversification, speedy adjustment to the changes in the international market, meeting delivery time lines and improving the quality of their products.

¹² In 1968, the United Nations Conference on Trade and Development (UNCTAD) recommended the creation of a 'Generalized System of Tariff Preferences' under which industrialized countries would grant trade preferences to all developing countries.

¹³ With the normal duty of 9.6 percent the total duty on bed-linen exports to EU would be 15.4 percent from 25.1 percent.

At the same time policy-makers need to support exports by providing an enabling environment for the private sector, through improvements in the infrastructure, negotiating improved access to markets, and macroeconomic stability. In this regard it is heartening to note that the present government has laid renewed emphasis on improving the infrastructure, with special focus on improving modes of transportation. Further measures are also expected in the forthcoming Trade Policy for FY07.

Exports

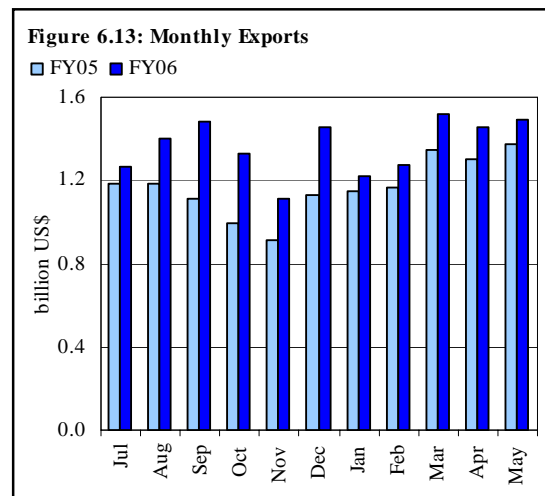
The exports recorded a healthy growth of 16.7 percent during Jul-May FY06 on the top of 16.2 percent growth in the corresponding period of last year (see **Figure 6.13**). However, this growth fell short of the 18.1 percent target for the period.

The strong export growth is commendable, particularly given headwinds from the withdrawal of the preferential access to Pakistan under the

Generalized System of Tariff Preferences (GSP) and the anti-dumping duty on Pakistani bed linen exports by the EU. Further, the appreciation of Pak rupee against Euro up to Jan 2006, and relatively higher domestic inflation throughout FY06 probably also had an adverse affect on the export growth.

Also encouraging is the rise in the share of manufactured products in the total exports compared to primary and semi-manufactured goods (see **Figure 6.14**). Specifically, the share of manufactured products in the total exports has increased to 78 percent during Jul-Jan FY 06 from 72 percent in the same period of FY01. However, relative weakening of dollar against Euro Feb onward and consequently that of Rupee and reduction of anti- dumping duty from 13.1 percent to 5.8 percent May 2006 onwards is likely to give boost to exports in the EU region in the months ahead.

On the flip side, sustaining the high FY06 export growth is not likely to be easy. A closer look at the monthly growth profile reveals two distinct trends; a very



strong growth of 20.9 percent during July-Jan FY06, followed by a considerable slowdown to an average monthly growth of 10.5 percent in the Feb-May FY06 period. The differences in exports performance in the two periods appear to lie essentially in the basis of the growth comparison. In the first half of the previous fiscal year, export growth had been constrained by the MFA quotas, and as exports in the comparable period of FY06 were not restricted by quotas, the growth rate appears that much stronger. The growth recorded for the Feb-May FY06 period however, is based on post-MFA performance in both years. The lower growth rate in the latter period, therefore, provides a better basis for estimating future export growth.

Primary Commodities

The primary commodities YoY growth slowed down to 10.2 percent during Jul-May FY06 from 33.3 percent in the same period of the last fiscal year.

As a result the group share in total exports has scaled down to 11.2 percent during the current year from 11.9 percent in the corresponding period of previous year. *Rice* was the major contributor in the group followed by *fish and fish*

preparation. The *rice* export posted YoY increase of 21.2 percent during the period as compared to the substantial growth of 50.1 percent during the same period of last year. The increase was contributed by price as the quantum impact was negative (see **Table 6.7**).

Likewise, the fish and fish preparation witnessed 43.4 percent YoY growth during the period on the back of increase in its quantum and unit values. However, the considerable increase in the aforementioned categories was partially offset by decline in the export of raw cotton and leather.

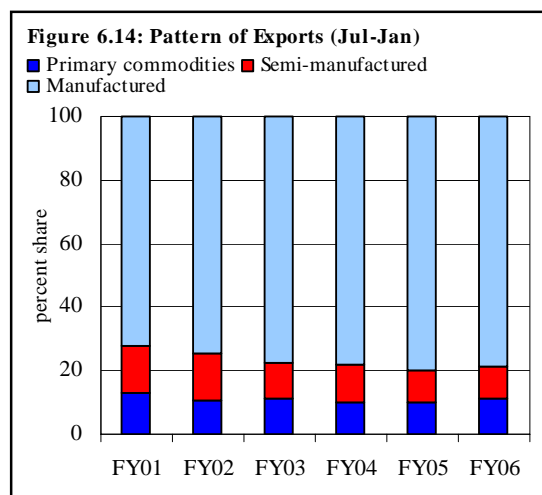


Table 6.7: Major Exports (Jul-May)

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

	Unit	FY05		FY06		Abs chg. In value	% change in Jul-May FY06/ Jul-May FY05		
		Value	Unit value	Value	Unit value		Qty	Value	Unit value
A. Primary commodities		1530.8		1686.6		155.8		10.2	
1 Rice	MT	850.6	320.7	1031.2	333.4	180.6	16.6	21.2	3.9
2 Raw cotton	MT	106.6	937.2	64.6	1045.9	-41.9	-45.6	-39.3	11.6
3 Raw wool (excluding wool tops)	MT	0.9	1147.6	0.7	913.7	-0.2	0.0	-20.4	-20.4
4 Fish & fish preparations	MT	124.9	5.5	179.1	8.3	54.2	-5.3	43.4	51.4
5 Leather	SQM	273.9	16.4	246.3	16.8	-27.6	-11.9	-10.1	2.1
6 Guar and guar products	MT	24.1	1179.7	13.8	1149.9	-10.2	-41.1	-42.6	-2.5
7 Fruits	MT	84.8	311.3	105.2	318.4	20.4	21.2	24.0	2.3
8 Vegetables	MT	28.7	313.8	25.6	299.2	-3.1	-6.5	-10.9	-4.7
9 Crude animal material	MT	15.1	3690.8	9.9	3365.9	-5.3	-28.5	-34.8	-8.8
10 Oil seeds & nuts etc.	MT	21.2	776.8	10.2	670.8	-11.0	-44.2	-51.8	-13.7
B. Textile manufactures		7575.1		8972.3		1397.2		18.4	
11 Cotton yarn	MT	954.4	2096.9	1290.0	2036.2	335.7	39.2	35.2	-2.9
12 Cotton fabrics (woven)	SQM	1681.3	0.8	1942.4	0.8	261.1	11.3	15.5	3.8
13 Hosiery (knitwear)	DOZ	1473.0	23.1	1563.9	22.7	90.9	7.9	6.2	-1.6
14 Bed ware	MT	1253.8	5480.8	1836.3	5488.3	582.5	46.3	46.5	0.1
15 Towels	MT	471.1	3741.0	531.7	3705.2	60.6	14.0	12.9	-1.0
16 Cotton bags and sacks	MT	12.6	4095.9	8.2	4117.3	-4.4	-35.6	-35.2	0.5
17 Readymade garments	DOZ	955.2	31.8	1213.5	35.5	258.3	13.8	27.0	11.6
18 Tarpaulin & other canvas goods	MT	61.8	2530.1	15.9	2249.4	-46.0	-71.1	-74.3	-11.1
19 Tule, lace, embroidery etc.	(-)	11.5	---	5.2	---	-6.4	---	-55.2	---
20 Synthetic textiles	SQM	268.6	0.8	182.4	1.1	-86.2	-53.6	-32.1	46.4
21 Other textile made up	(-)	422.4	---	375.6	---	-46.9	---	-11.1	---
22 Waste material of textile fibers/ fabrics	MT	9.4	626.4	7.3	838.6	-2.1	-41.7	-22.0	33.9
C. Other manufactures		2057.5		2462.8		405.3		19.7	
23 Carpets, carpeting rugs & mats	SQM	250.7	56.6	231.9	60.8	-18.8	-13.9	-7.5	7.5
24 Petroleum and products	MT	412.9	393.6	659.2	491.5	246.3	27.9	59.7	24.9
25 Sports goods	(-)	275.3	---	313.9	---	38.6	---	14.0	---
26 Leather manufactures	(-)	458.7	---	629.7	---	171.0	---	37.3	---
27 Surgical & medical instruments	NO	165.0	---	143.4	---	-21.6	---	-13.1	---
28 Cutlery	GR	29.4	19.4	29.7	34.5	0.4	-43.0	1.2	77.6
29 Onyx manufactured	MT	7.8	1704.3	11.7	1637.3	3.9	55.9	49.8	-3.9
30 Chemicals and pharmaceuticals	(-)	376.7	---	385.0	---	8.3	---	2.2	---
31 Molasses	MT	65.5	61.4	41.9	60.3	-23.6	-34.8	-36.0	-1.9
32 Sugar	MT	15.6	307.7	16.4	404.4	0.8	-20.1	5.0	31.4
Others		1695.4	---	1886.0	---	190.5	---	11.2	
Total exports		12858.		15007.6		2148.8		16.7	

Source: Federal Bureau of Statistics

Textile Manufactures

The textile manufacture export performance was remarkable, rising by 18.4 percent during Jul-May FY06, against nominal growth of 4.4 percent realized during the same period last year. Both the low value-added and high value-added products contributed in this impressive textile export growth.

The increase in the textile exports in the post Multi Fiber Agreement (MFA) period is a good omen for the economy, which remains heavily dependent on textiles exports. In FY05 textile exports suffered due to uncertainties surrounding the end of MFA in the mid of FY05. Although the growth in the post MFA period in FY05 was 9.3 percent, the growth prior to it was just 1.2 percent; as a result, FY05 growth was restrained to 4.9 percent.

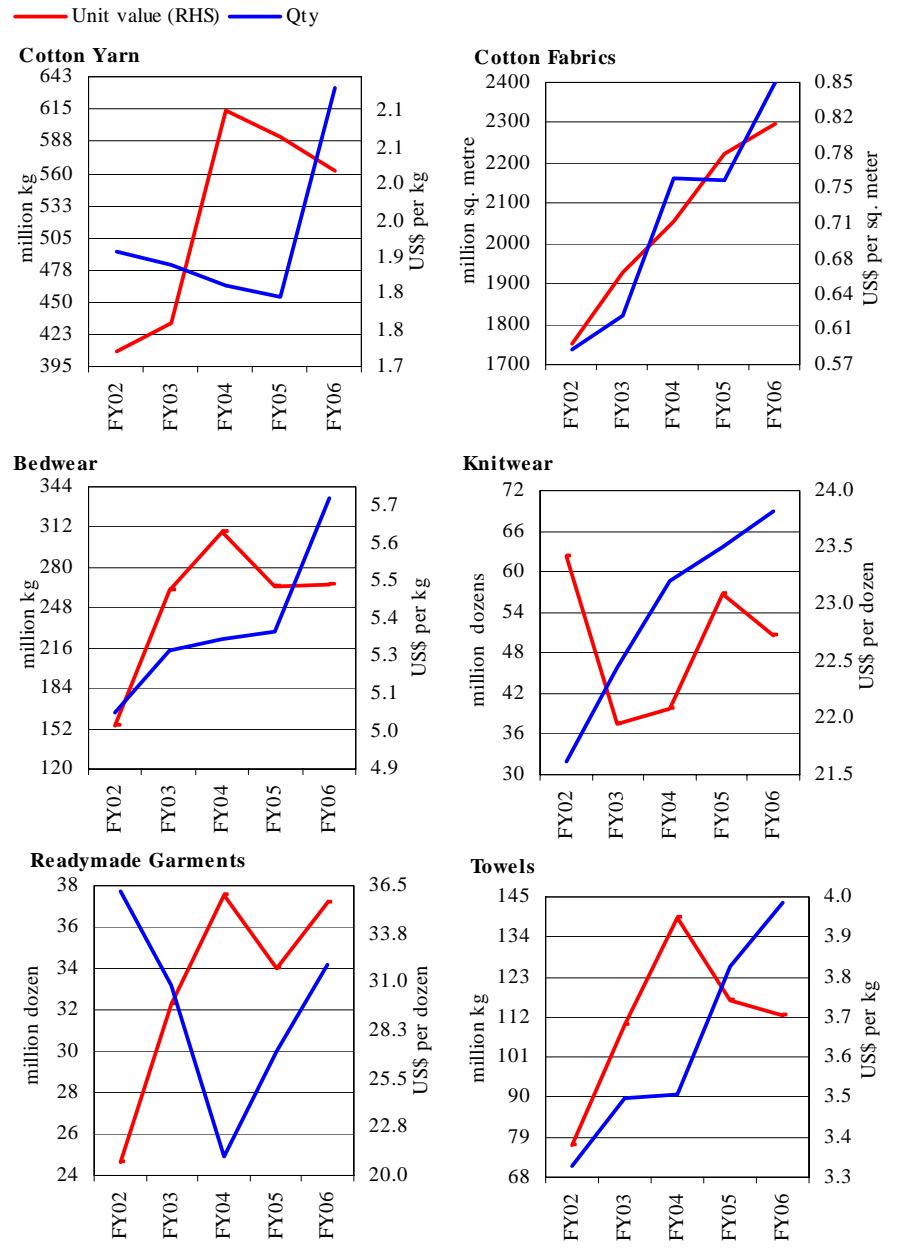
Within the low value-added group, cotton yarn and cotton fabrics showed 35.2 percent and 15.5 percent growth during the period, as against *minus* 4 percent and 9.3 percent growth in the same period of last year. Along with increase in quantum, the low base effect explains the growth in the group (see **Figure 6.15**).

With regard to high value added products, bed-wear and readymade garments were the major contributors, registering 46.5 and 27 percent growth during the period under review, against growth of *minus* 0.3 percent and 6.7 percent in the same period of last year. Almost the entire increase in bed-wear was explained by the quantum impact, while increase in readymade garments was also caused by high unit values. It is hoped that the reduction in the EU antidumping duty from 13.1 percent to 5.8 percent with effect from May 7, 2006 will have favorable impact on the export growth of bed-wear in the forthcoming months.¹⁴

However, fall in the unit values of knitwear and towels together with high base, affected the growth in these commodities adversely. The knitwear showed nominal growth of 6.2 percent during the period under review as compared to growth of 13.7 percent during the corresponding period of last year. However, despite the fall in unit values the export of towels witnessed a robust 12.9 percent growth, though this was sharply lower than the 31.2 percent rise seen during the corresponding period of FY05 (see **Figure 6.15**)

¹⁴ Pakistan would be in a better position as compared to its major competitor India facing 6.6 percent anti-dumping duty on its bed-wear exports.

Figure 6.15: Textile Manufactures- Export Quantums and Unit Prices (Jul-May)



The exports of synthetic textiles, other textile made ups and tarpaulin & other canvas goods exports declined during the period.

Other Manufactures

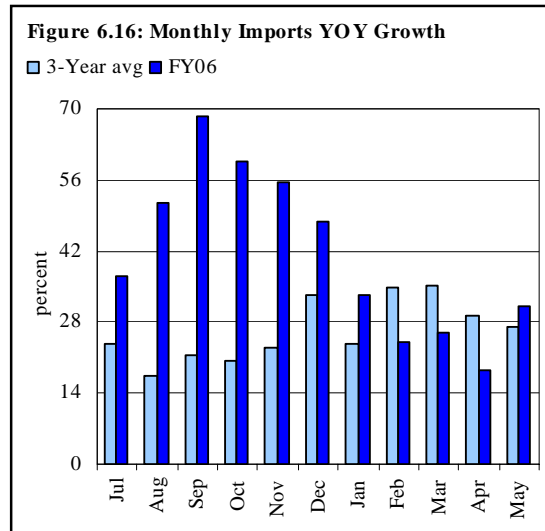
The strong growth in petroleum products and leather manufactures enabled the other manufactures to record noticeable growth of 19.7 percent during the period under consideration as compared to the substantial growth of 31.3 percent during the same period last year. The petroleum products showed impressive growth of 59.7 percent during the period on the top of 56 percent growth in the same period last year. Leather manufactures on the other hand, posted 37.3 percent growth during the period on the top of 23.2 percent growth in the same period last year. The increase of US\$ 171 million in the export of manufactured leather was partially offset by a decline of US\$ 27.6 million in the exports of crude leather.

Imports

Soaring international oil prices in the international market together with persistently increased demand for the import of raw material and machinery led the imports to record a 39.4 percent growth during Jul-May FY06 despite the high base set by the 33.8 percent growth realized during the corresponding period of the previous year.

A substantial increase of around 54.6 percent in the unit prices of petroleum group on the top of 22.1 percent

increase in the same period of last year contributed significantly in inflating the total imports bill. Specifically, the exceptionally high oil prices contributed more than 90 percent in the total oil imports growth. However, the non-POL imports registered relatively lower growth of 33.2 percent as compared to the overall import growth of 33.8 percent in the corresponding period of last year.



In fact, there is a discernible slowdown in the imports growth February 2006 onwards (see **Figure 6.16**). The detailed analysis of the data shows that the growth in major heads is much lower in Feb-May 2006 compared to that in Jul-Jan 2006 (see **Table 6.8**). Furthermore, almost 80 percent of the growth is being contributed by just two broad items; 'petroleum' and 'other imports'. The share of machinery in imports growth has gone down from 29 percent in Jul-Jan 2006 to 7 percent in Feb-May 2006 (see **Table 6.8**).

Table: 6.8: Growth (YoY) and % Share of Major Groups in Total Import Growth

	YoY Growth		Percentage Share in import growth	
	Jul-Jan	Feb-May	Jul-Jan	Feb-May
	Food group	57.0	10.8	7	3
Machinery group	55.4	4.2	29	5
Petroleum group	66.1	61.5	27	47
Textile group	69.5	90.1	3	4
Agricultural and other chemicals group	28.9	3.8	11	2
Metal group	75.6	16.2	9	4
Miscellaneous group	31.1	17.3	2	1
Others	36.2	44.4	13	33
Total imports:	50.0	25.0	100	100

Food Group

Driven by increased imports of sugar and wheat, the food group imports depicted 35.9 percent YoY growth during Jul-May FY06, as compared to 32.4 percent growth in the same period of last year (see **Table 6.9**). In fact, the sugar imports contributed 82.3 percent in the food group imports growth. However, the healthy wheat crop is likely to reduce the wheat import bill substantially in the near future.

Machinery Group

The growth of the machinery group imports decelerated to 31.5 percent during Jul-May FY06 from 49 percent in the same period of the last year (see **Figure 6.17**). The slow down in the import growth of machinery was partially explained by the high base effect and partially by the decline in the imports of textile machinery, aircrafts, ships & boats. Moreover, deceleration in the imports of other machinery might be another

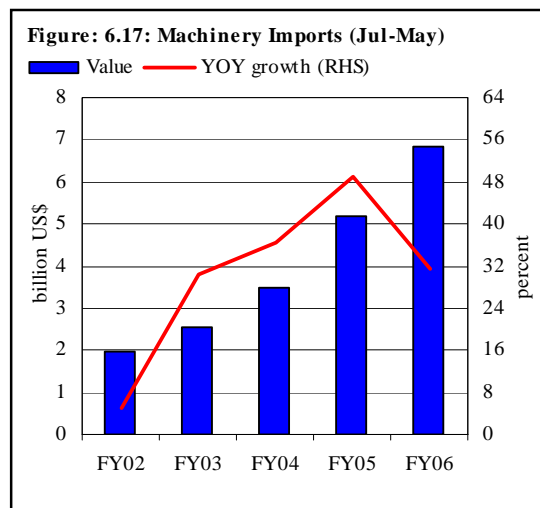


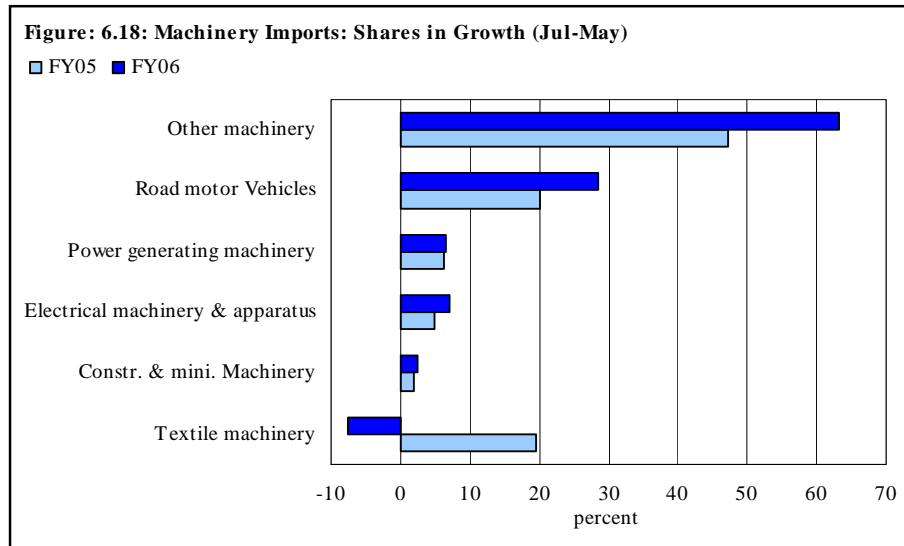
Table 6.9: Major Imports (Jul-May)

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

Commodities	Units	FY05		FY06		Abs chg. In value	% chg in Jul-May FY06/Jul-May FY05		
		Unit		Unit			Qty	Unit	
		Value	Value	Value	Value			Value	Value
A. Food group		1262.5	---	1,715.1	--	452.7	---	35.9	---
1. Milk & Cream		1262.5	---	1,715.1	--	452.7	---	35.9	---
2. Wheat Unmilled	MT	29.6	1,994.1	51.0	2,329.6	21.5	47.7	72.6	16.8
3. Dry Fruits	MT	93.0	217.9	119.9	163.0	26.9	72.4	29.0	-25.2
4. Tea	MT	39.4	587.0	50.6	526.0	11.2	43.2	28.3	-10.4
5. Spices	MT	204.3	1,664.5	202.2	1,660.4	(2.1)	-0.8	-1.0	-0.2
6. Edible Oil	MT	44.4	767.6	47.3	676.5	2.9	21.0	6.6	-11.9
<i>Soya bean</i>	MT	684.7	475.2	663.6	467.5	(21.1)	-1.5	-3.1	-1.6
<i>Palm Oil</i>	MT	51.8	749.3	19.8	704.3	(32.0)	-59.4	-61.8	-6.0
7. Sugar	MT	632.9	461.4	643.8	462.7	10.9	1.4	1.7	0.3
8. Pulses	MT	61.5	340.0	433.9	355.3	372.4	575.2	605.6	4.5
B. Machinery group		---	5203.4	---	6844.4	---	1641.0	---	31.5
1. Power generating	---	356.3	---	463.0	---	106.6	---	29.9	---
2. Office machinery	---	244.4	---	253.0	---	8.6	---	3.5	---
3. Textile	---	866.6	---	741.7	---	(124.9)	---	(14.4)	---
4. Construction & mining	---	129.9	---	169.8	---	39.9	---	30.7	---
5. Electrical machinery & apparatus	---	312.4	---	429.2	---	116.8	---	37.4	---
6. Railway vehicles	---	40.5	---	50.7	---	10.2	---	25.3	---
7. Road motor vehicles	---	940.0	---	1,406.1	---	466.1	---	49.6	---
8. Aircraft, ships and boats	---	146.3	---	121.5	---	(24.9)	---	(17.0)	---
9. Agricul machinery & implements	---	61.4	---	123.5	---	62.1	---	101.2	---
10. Other	---	2105.7	---	3,086.0	---	980.3	---	46.6	---
C. Petroleum group	MT	3626.2	287.5	5954.9	444.4	2328.7	6.2	64.2	54.6
1. Petroleum products	MT	1636.9	312.0	2547.6	466.3	910.7	4.1	55.6	49.5
2. Petroleum crude	MT	1989.3	270.0	3,407.3	429.4	1,418.0	7.7	71.3	59.0
D. Textile group	MT	277.8	-----	488.6	---	210.8	---	75.9	---
1. Synthetic fiber	MT	127.2	1818.2	230.4	1717.8	103.3	91.8	81.2	-5.5
2. Synthetic & artificial silk yarn	MT	114.8	1831.7	214.9	1,893.0	100.1	81.1	87.2	3.3
3. Worn clothing	MT	35.8	327.3	43.2	342.1	7.5	15.7	20.9	4.5
E. Agri and other chemicals	MT	3206.2	---	3842.0	---	635.8	---	19.8	---
1. Fertilizer	MT	311.9	243.6	581.2	280.7	269.3	61.7	86.3	15.2
2. Insecticides	MT	124.0	3328.7	103.4	3476.5	-20.7	-20.2	-16.7	4.4
3. Plastic materials	MT	707.0	1155.7	904.7	1,260.0	197.7	17.4	28.0	9.0
4. Medicinal products	MT	262.7	27217.7	296.6	31,752.0	33.9	-3.2	12.9	16.7
5. Others	---	1800.5	---	1,956.1	---	155.6	---	8.6	---
F. Metal group	MT	1081.5	---	1623.6	---	542.0	---	50.1	---
1. Iron and Steel Scrap	MT	200.0	223.1	300.7	267.4	100.6	25.4	50.3	19.9
2. Iron and Steel	MT	784.3	469.1	1,213.0	530.6	428.7	36.7	54.7	13.1
3. Aluminum wrought & Worked	--	97.2	---	109.8	---	12.7	---	13.0	---
G. Miscellaneous group		422.9	---	531.7	---	108.8	---	25.7	---
1. Rubber crude	MT	78.0	1073.6	96.6	1211.3	18.6	9.7	23.8	12.8
2. Rubber tyres & tubes	No.	118.6	25.0	142.2	24.1	23.7	24.8	20.0	-3.9
3. Wood & cork	---	26.2	---	32.0	---	5.8	---	22.0	---
4. Jute	MT	34.6	296.2	37.7	356.6	3.0	-9.7	8.7	20.4
5. Paper/ paper board & manufac	MT	165.4	644.9	223.2	723.5	57.8	20.3	35.0	12.2
H. Others		3288.0	---	4598.1	---	1310.1	---	39.8	---
Total imports:		18368		25598.3		7229.9		39.4	

Source: Federal Bureau of Statistics

factor for the recent slow down in the machinery import. The road motor vehicles, other machinery, electrical machinery & apparatus and power generating machinery mainly contributed in the growth of machinery group (see **Figure 6.18**).



Road Motor Vehicles

The YoY import growth of road motor vehicles was 49.6 percent during Jul-May FY06 on the top of 58.1 percent growth realized in the same period of last year. Importantly, the share of tractors in the total road motor vehicles imports has increased from 3.4 percent during Jul-Jan FY05 to 6.7 percent during Jul-Jan FY06.¹⁵ However, the share of seemingly unproductive or indirectly productive motor cars has also increased to 52.3 percent during Jul-Jan FY06 from 51 percent in the same period of last year. The dominant factors behind the surge in road motor vehicles import were auto leasing finance facility and wide choice of imported vehicles available for domestic consumers which hitherto had a limited pool to select from.

Electrical Machinery and Apparatus

As a result of 37.4 percent YoY growth during Jul-May FY06, the group share in the increase in total machinery import has increased to 6.3 percent during the

¹⁵ The analysis is limited up to January as the detailed data of Feb-May FY06 is still awaited from FBS.

period from 6 percent in the same period of the last fiscal year. The major imports in the group include dish washing machines, clean fill bottle and electronic integrated circuit, electric transformer, convertors, inductor, refrigerator freezer, other equipments and electrical apparatus for switching/protect etc.

Power Generating Machinery

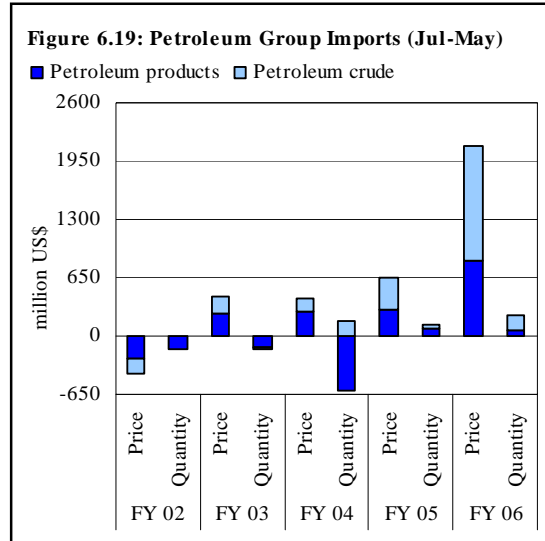
The power generating machinery recorded 29.9 percent growth during Jul-May FY06 on top of 42.3 percent growth recorded in the same period last year. The import of air craft engine together with other generator set in/combustion pistil engine contributed substantially in the import growth of the group.

Other Machinery

During the period under review, the other machinery imports growth decelerated to 46.6 percent from 94.7 percent during the same period of the previous year. Even in value term, the rise of US\$ 980.3 million in Jul-May FY06 is lower than the rise of US\$ 1024.2 million in the corresponding period of last year. During Jul-Jan FY06, the major contribution in the other machinery import growth came from transmission apparatus and cellular mobile phones.¹⁶

Petroleum Group

As mentioned earlier, the petroleum group recorded an extraordinary increase of 64.2 percent during the period under review on the top of 27.7 percent growth recorded in the same period last year. The increase in the petroleum prices was the dominant factor behind this substantial growth (see **Figure 6.19**). The price impact was relatively higher in case of petroleum product (93 percent) as compared to 89 percent in case of petroleum crude. Interestingly, increase in exports of petroleum product offset some of the increase in petroleum product imports.



¹⁶ The detail data from FBS is available only up to January FY06.

Other Imports

Against 17.4 percent YoY growth during Jul-May FY06, other imports registered a substantial growth of 39.8 percent during the period under consideration. The major contributors were Gold (monetary & non monetary), Oil Seeds & Oleaginous Fruits, Synthetic and Regenerated Fiber, and Coke & Briquettes etc.

Box 6.3: Future of Oil Prices

The international oil prices have been under pressure since the last couple of years. The crude oil prices touched US\$73 per barrel on May 11, 2006 from USD56/barrel on June 30, 2005. Growing demand with limited supply was the dominant factor behind this price hike besides adverse geo-political developments.

The strong global economic growth particularly in the China, US and India increased the demand for oil, while slowdown in the Russian production together with United States low production caused by hurricane damages led to supply side constraints. Moreover, disruption in Nigeria and Iraq, and stronger political rhetoric from Iran led to put additional pressure on the international oil prices.

There are growing concerns about the persistently rising oil prices. The factors important for the future outlook of the prices includes: a) the global trend in the oil demand growth, b) the non-OPEC production trends, c) the OPEC production capacity expansion, d) the surplus supply capacity in the global oil market, and e) the possibilities for supply disruptions and market destabilization.

The global oil demand is projected to increase by 1.25 mb/d during CY06 from 1.05 mb/day during Calendar year 2005. The major chunk of oil demand growth is likely to be contributed by the China and US. Thus oil demand is expected to rise steadily in the near future. However, the continuously high oil prices may put some restraints on the growing oil demand.

While supply of oil is likely to remain stretched, there are some who believe in easing of pressure. Cambridge Energy Research Associates (CERA) report suggests that the Non-OPEC Capacity is expected to expand by 7.6 million barrel per day (mbd) to reach 55.8 mbd by 2010. The contribution to new capacity is likely to come from Russia, the Caspian, Brazil, Angola, and Canada.

Similarly, the report also indicates that OPEC productive capacity is expected to rise to 45.6 mbd by 2010. In this group the major increase is expected from Nigeria, Iran and Iraq. The unconventional liquids like Condensates, natural gas liquids, extra heavy oils and ultra deep water oils are thought to be the major sources for the expected production capacity expansion.

Assuming no major political issues and possible disruptions, the report concludes that supply is expected to outpace the demand growth in the coming years. This in turn could result in the decline or deceleration in the international oil prices around 2007-08. However, the report is uncertain about the productive capacity expansion in the post-2010 period.

References:

International Agency Oil Market Report of 12th May 2006.
Cambridge Energy Research Associates (CERA) report, "Oil & Liquids Capacity to outstrip Demand until At Least 2010"

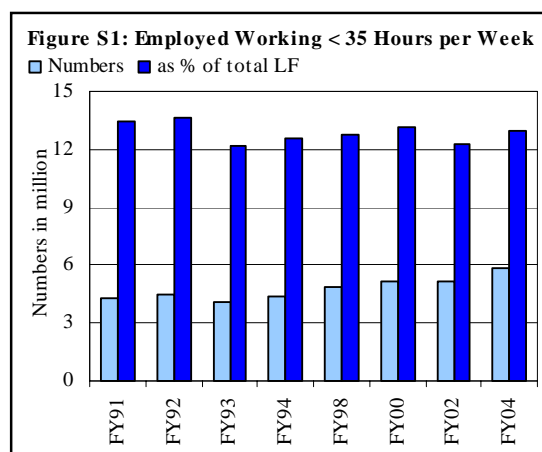
Special Section:

Underemployment in Pakistan

Introduction¹

In Pakistan, a large proportion of the employed labor force works less than 35 hours (see **Figure S1**) and may, therefore, be considered as being underemployed; without knowing how many were doing it voluntarily or involuntarily basis. This distinction is essential to compute the exact level of underemployment in the country. As defined in the Pakistan Labor Force Survey (LFS), employed persons

working less than 35 hours are considered to be underemployed, but only if they are willing and available for additional work (for details see **Box S1**). However, data constraint in the LFS does not allow a clear computation of the underemployment rates directly, but some supporting LFS data does provide some insights. Based on available information, it appears that the underemployment has increased from 13.4 percent to 14.0 percent during FY02-04.²



¹ The unemployment rate is one of the most important and widely used indicators of economic progress of any economy. However, the unemployment rate does not account for employed workers working below the desired capacity, whether in terms of number of working hours, compensation, level of skills, experience, etc. Such employed workers if willing and also looking for higher capacity jobs are termed as “underemployed”. While it is important to look at various dimensions of underemployment to supplement the analysis of trends in unemployment, only the work-hour- based concept of underemployment is being discussed here due to data constraints.

² According to latest government estimates the unemployment rate has further declined to 6.9 percent.

Box S1: Underemployment: Definition and Data Limitations in Pakistan

Time related underemployment has a variety of national definitions,¹ but the majority tends to cluster around the following three: (1) Persons in employment who reported that they were working part-time or whose hours of work (actual or usual) were below a certain cut-off point, and who also reported involuntary reasons for working fewer than full-time hours - these are also known as "involuntary part-time workers". (2) Persons in employment whose hours of work (actual or usual) were below a certain cut-off point and who wanted to work additional hours. (3) Persons in employment whose hours of work (actual or usual) were below a certain cut-off point and who sought to work additional hours.

In Pakistan, underemployment is defined as "... all employed persons who during the reference period satisfied the following three conditions: first, working less than 35 hrs per week; second, doing so on involuntary basis; and third seeking or being available for additional work."

Unfortunately, the data on the exact definition of underemployment rate is not available from LFS.² Specifically, while data on employed working less than 35 hours per week is available from LFS, proportion of employed doing this on involuntary basis and available for additional work is not given. Similarly in another table, data on employed available for additional worked are given, but here the time wise distribution of employed in this category is not available. It is likely that a certain proportion employed available for additional work are those people who are already working for more than 35 hours a week, thus should be considered as underemployed as per the definition of underemployment in Pakistan.

¹ KILM "Time Related Underemployment" by ILO.

² Including both in published data tables and one those are available on request

Features of Employed Working less than 35 Hours

According to the latest available LFS (for FY04), around 5.8 million or 14.0 percent of the total employed were working less than 35 hours a week. Considering all employed working below 35 hours per week as underemployed, the underemployment rate³ in FY04 works out at 12.9 percent (see **Table S1**). However, the actual underemployment rate probably much lower. Specifically, the proportion of total employed available for additional work,⁴ including both working below and above 35 hours in a week, was 8.6 percent (or 8.0 percent of labor force) in FY04. This suggests that underemployment in FY04 was either at 8.0 percent or lower.

³ Underemployment rate is defined here as underemployed as percentage of total labor force.

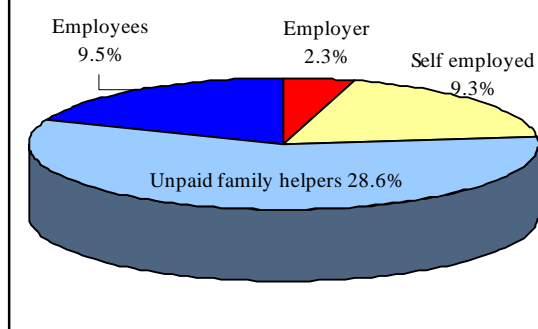
⁴ This data is not being published in LFS, however, available on request from FBS.

Table S1: Work Hours based Profile of Employed Labor Force in FY04

Percent	Both sexes		Male		Female	
	As % of employed	As % of LF	As % of employed	As % of LF	As % of employed	As % of LF
	Working < 35 hours a week	14.0	12.9	7.8	7.3	44.4	38.7
Working < 24 hours a week	5.5	5.1	2.9	2.7	18.1	15.7
Working < 15 hours a week	1.3	1.2	0.6	0.6	4.6	4.0
Available for more work	8.6	8.0	8.4	7.8	10.0	8.8

Source: Pakistan Labor Force Survey, 2003-04

Gender-wise break-up of the data provides some further insights. As shown in **Table S1**, while a very large proportion (almost 45) of the employed female was working less than 35 hours per week; just 10 percent were available for additional work. It is important to mention that female participation rate in labor force is also very low in Pakistan. In FY04, crude and refined activity rates for females were only 11.2 percent and 15.9 percent, respectively.⁵ This suggests that in Pakistan females participate less in the labor force, and those who do are willing to work for less than the normal working hours. As females comprise of almost half of the total work-age population, it is imperative to encourage higher female labor force participation as well as their availability to work up to normal working hours.⁶

Figure S2: Employment Status-wise Distribution of Employed Working < 35 Hours a Week

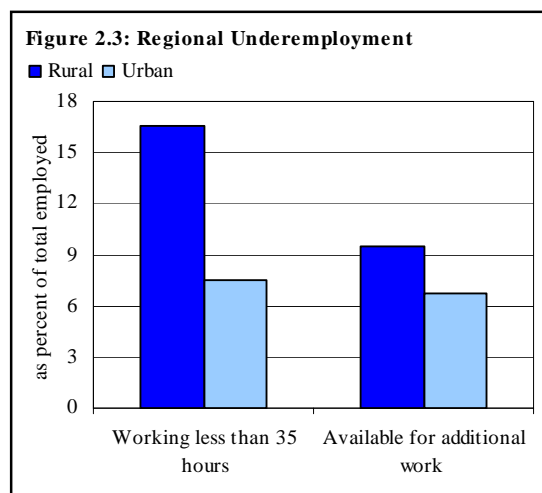
The proportion of employed males working for less than 35 hours a week was significantly lower at 7.8 percent (or 7.3 percent of LF) in FY04. Interestingly, in sharp contrast from the female group, the proportion of employed male available for additional work was higher than the proportion of male employed working for below 35 hours a week. This implies that for the male group, the latter proportion

⁵ Crude activity rate is the percentage of persons in labor force to the total population; while refined activity rate is the percentage of person in labor force to work-age population (10 years and above in Pakistan case).

⁶ For details see Box 8.1 in SBP Annual Report for FY05.

provides the maximum possible level of underemployment rate during FY04 (see **Table S1**). Thus, the underemployment in the male group was either at 7.3 percent or below during FY04.

Looking at the economic status-wise data, the proportions of the employed working less than the normal work hours were at the highest in *unpaid family helpers* and at the lowest in *employers* (see **Figure S2**). Considering the region-wise data, both indicators, i.e. employed working less than 35 hours a week and those available for additional work, suggest that the underemployment is more prevalent in the rural sector (see **Figure S3**).



Underemployment during FY02-FY04

Trends in both the indicators (i.e. employed working less than normal hours and employed available for additional work) suggest that the underemployment rate has increased during FY02-FY04 period (see **Table S2**).

Table S2: Gender-wise Indicators of Underemployment Rate

percent	Both Sexes		Male		Female	
	FY02	FY04	FY02	FY04	FY02	FY04
<i>As percent of total employed</i>						
Working < 35 hours per week	13.4	14.0	8.8	7.8	40.0	44.4
Working < 24 hours per week	5.5	5.5	3.4	2.9	17.8	18.1
Working < 15 hours per week	1.6	1.3	0.9	0.6	5.6	4.6
Available for additional work	7.4	8.6	7.5	8.4	6.8	10.0
<i>As percent of labor force</i>						
Working < 35 hours per week	12.3	12.9	8.2	7.3	33.4	38.7
Working < 24 hours per week	5.0	5.1	3.2	2.7	14.8	15.7
Working < 15 hours per week	1.4	1.2	0.8	0.6	4.6	4.0
Available for additional work	6.8	8.0	7.0	7.8	5.6	8.8

Source: Pakistan Labor Force Survey, 2003-04

However, this increase in the former is only attributed to the female group (see **Table S3**).

The proportion of employed people available for additional work has increased for both male and female group, but the latter group saw a larger increase. Specifically, the proportion of employed females available for additional work has jumped from 6.8 percent in FY02 to 10.0 percent in FY04. This increase of female interest in working for a greater number of hours is a welcome development.

Table S3: Employed Working < 35 Hours -- by Reasons

As percent of total employed working < 35 hours a week

	FY02	FY04
Due to low economic activity	13.69	10.18
Off season, bad weather	6.33	3.43
Shortage of raw material or fuel	1.15	0.45
Lockout, lay-off	0.20	0.11
Mechanical or electrical breakdown	0.16	0.01
Strike	0.02	0.02
Other involuntary reasons (law & order)	1.27	2.47
Others (slowdown in economic activity)	4.56	3.69
Due to personal reasons	86.11	89.82
Normally work the same no. of hours	75.50	80.97
Illness or injury	3.46	3.25
Holiday, ramzan, leave of absence	4.69	2.73
Education and training leave	0.32	0.77
Maternity and parental leave	0.78	0.80
Other voluntary or personal reasons	1.36	1.30

Source: Pakistan Labor Force Survey

Looking at the reasons (mentioned by employed⁷) for working less than normal hours suggests that increase in proportion of such employed (during FY02-04 period) was not because of lower economic activity in FY04 (see **Table S3**). In other words, it appears that strengthening economy is contributing to a fall in underemployment in Pakistan.

Conclusion

Following here are the key points of this sections:

- While, in Pakistan a substantially large proportion of labor force is working below normal working hours, a majority is doing it on voluntary basis. This is particularly true in case of the female labor force. As female comprises almost half of the total as well as work-age population in Pakistan, it is vital to increase their participation in economic activities.
- It is encouraging to note that during FY02-04, proportion of employed females available for additional work has increased from 6.8 percent to 10.0 percent. However, this is still considerably low.

⁷ This includes those who are working less than 35 hours a week.

- During FY02-04 period, available indicators suggest that underemployment has increased in Pakistan. However, two points are important in this regard: first, it was mainly because of the increased participation by female group; and second, it was not due to a slowdown in economic activity.

Acronyms

ADB	Asian Development Bank
bctd	billion cubic feet per day
BoP	Balance of Payments
CAB	Current Account Balance
CBR	Central Board of Revenue
CERA	Cambridge Energy Research Institute
CPI	Consumer Price Index (2000-01=100)
CVT	Capital Value Tax
CY	Calendar Year; from January 1 to December 31
DAP	Di-Ammonium Phosphate
DMBs	Deposit Money Banks
DPBs	Domestic Private Banks
DRI	Direct Reduced Iron
EFS	Export Finance Scheme
ERRA	Earthquake Rehabilitation and Reconstruction Authority
EU	European Union
FATA	Federal Administered Tribal Area
FBS	Federal Bureau of Statistics
FCAs	Foreign Currency Accounts
FDI	Foreign Direct Investment
FCBCs	Foreign Currency Bearer Certificates
FEBCs	Foreign Exchange Bearer Certificates
FED	Federal Excise Duty
FE-25	Foreign Exchange Circular No.25
FO	Furnace Oil
FY	Fiscal Year (from July 1 to June 30)
GDP	Gross Domestic Product
GSP	Generalized System of Preferences
GST	General Sales Tax
HRI	House Rent Index
IDA	International Development Agency
IDA	International Development Association
IDB	Islamic Development Bank
III	Infrastructure Industries Index
IIP	Index of Industrial Production
IMF	International Monetary Fund
IRSA	Indus River System Authority
LCVs	Light Commercial Vehicles
LF	Labor Force

LFS	Labor Force Survey
LSM	Large Scale Manufacturing
MAF	Million Acre Feet
mbd	million barrel per day
MBE	Modified Budgetary Estimates
MFA	Multi Fiber Arrangement
MT	Metric Ton
NDA	Net Domestic Asset
NFA	Net Foreign Asset
NFI	Net Foreign Investment
NFNE	Non-food, Non-energy
NPLs	Non Performing Loans
OEBs	Outstanding Export Bills
OIN	Other Items Net
OMOs	Open Market Operations
OPEC	Organization of the Petroleum Exporting Countries
PATA	Provincially Administered Tribal Area
PIA	Pakistan International Airlines
POL	Petroleum, Oil and Lubricants
POL	Pakistan Oilfields Limited
PS	Pakistan Steel
PSDP	Public Sector Development Program
PSEs	Public Sector Enterprises
PTCL	Pakistan Telecommunication Corporation Limited
PTL	Prime Transport Limited
Pvt.	Private
RHS	Right Hand Side
SBP	State Bank of Pakistan
SHMI	Small and Household Manufacturing Industries Survey
SPI	Sensitive Price Indicator
SQM	Square Meter
UAE	United Arab Emirates
UBQI	User Based Quantum Index
UNCTAD	United Nation Conference on Trade and Development
USA	United States of America
USC	Utility Store Corporation
US\$	United States Dollar
WPI	Wholesale Price Index
YoY	Year on Year
YTD	Year to Date
ZTBL	Zarai Taraqiati Bank Limited

Non-English Words

Rabi crops	Winter crops with sowing season starting from October to December, and harvesting season starting from April to May
Kharif crops	Summer crops with sowing season starting from April to June and harvesting season starting from October to December
Jowar	Sorghum, one of the major crops in Pakistan
Mash	A kind of pulses
Moong	A kind of pulses
Bt cotton	Baccillus thuringiensis cotton: Genetically enhanced and disease resistant variety of cotton which carries a special gene derived from soil born bacterium "Baccillus thuringiensis"