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## THE STATE OF PAKISTAN'S ECONOMY

### Second Quarterly Report for FY08

#### 1.1 Economic Outlook

The country's economy continues to show resilience to domestic and international shocks. Although these have taken their toll, the economy is expected to turn in a reasonable growth performance during FY08, albeit substantially lower than target. So far, the principal drag on the year's growth has been the outcome of *kharif* harvests and the slowdown in LSM growth (particularly in December 2007). The services sector, on the other hand, seems set to show good performance for the sixth consecutive year.

However, growing macroeconomic imbalances, particularly the widening fiscal and current account deficits continued to create complications and add to inflationary pressures. On the other hand, Pakistan has so far largely been untouched by the continuing turmoil in the international credit markets.

**Table 1.1: Selected Economic Indicators**

		FY06	FY07	FY08
<i>Growth rate (percent)</i>				
LSM	Jul-Dec	8.7	8.3	4.5
Exports (fob)	Jul-Feb	18.8	3.4	7.9
Imports (fob)	Jul-Feb	46.3	9.9	21.9
Tax revenue (FBR)	Jul-Jan	21.8	25.1	10.6
CPI (12 month MA)	Jul-Feb	8.9	7.7	8.4
Private sector credit	Jul-1 <sup>st</sup> Mar	18.9	11.2	11.7
Money supply (M2)	Jul-1 <sup>st</sup> Mar	9.5	8.7	7.1
<i>billion US dollars</i>				
Total liquid reserves <sup>1</sup>	end-Feb	11.5	13.3	14.1
Home remittances	Jul-Jan	2.4	3.0	3.6
Net foreign investment	Jul-Jan	1.5	3.4	2.3
<i>percent of GDP<sup>2</sup></i>				
Fiscal deficit	Jul-Dec	1.8	1.9	3.6
Trade deficit	Jul-Feb	5.9	6.2	7.9
Current a/c deficit	Jul-Jan	2.7	3.6	4.8

<sup>1</sup> With SBP & commercial banks.

<sup>2</sup> Based on full-year GDP in the denominator. For FY08 estimated full-year GDP has been used.

The rise in the fiscal deficit during H1-FY08 has more troubling implications than the increase in the previous year. The modest increase in the fiscal deficit during the preceding two years had been relatively less troubling, as (1) revenue growth had remained strong, and (2) rise in spending essentially reflected the impact of post-earthquake relief and reconstruction (excluding this, the fiscal deficit remained below 4.0 percent of GDP); these substantive expenditures would fall sharply in a few years. In both years, the current expenditure during the first half of the fiscal year had remained below 7.0 percent of the full year GDP. In contrast, the fiscal deficit during the first half of FY08 is estimated to be roughly 3.6 percent of the estimated annual GDP - nearly twice the figures for the last two

years. This incorporates a decline in revenue growth, as well as rising current spending.

A part of the deceleration in revenue growth during H1-FY08 is likely to be reversed as substantial non-tax receipts are expected in the later half of the fiscal year. However, the annual growth in tax collections is likely to remain weak relative to the previous year. Another troubling aspect is that the fiscal deficit may be understated. Evidence suggests that at least a part of the subsidy on fuel prices during Jul-Feb FY08 was not financed from government account.<sup>1</sup>

Reducing the fiscal deficit in the remaining part of the fiscal year will thus be challenging, but is nonetheless essential. Support to aggregate demand due to fiscal deficit contributed directly to a rise in monetary aggregates, raising inflationary pressures, complicating monetary management, and stoking the growth of the current account deficit. International credit rating agencies have already cited the growth of the fiscal deficit as a key negative indicator for Pakistan's sovereign credit rating.

The combination of rising fiscal deficit and weak external receipts has pushed the government borrowings from SBP to a record Rs 359.3 billion during Jul-1<sup>st</sup> Mar FY08, compared to only Rs 25.6 billion in the corresponding period of last fiscal year. This has been instrumental in sustaining the growth in broad money (M2) for the period at 17.6 percent YoY, significantly offsetting the central bank's efforts to tighten monetary policy.

The government borrowings from the central bank are also the most inflationary form of financing the deficit. It seems likely that the exceptionally strong growth in these borrowings supported a rise in inflation. The impact of this was significantly augmented by the unanticipated strength of international commodity prices. Moreover, the rise in food prices was probably also aggravated by anti-competitive market structures and practices in the domestic market, as well as supply disruptions. The government has limited options to ease inflationary pressures. Efforts to reduce government subsidies on fuel will raise inflation in the short-run. Further, given limited fiscal space, any subsidies need to be carefully targeted and should be limited in scope.

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<sup>1</sup> Instead, in order to mitigate the financial difficulties of the various institutions (particularly the oil marketing companies) with unpaid price differential claims, the government provided guarantees against which these public and private sector institutions could borrow the amounts from financial institutions. Such a financing structure simply shifts most of the cost of the financing from the current fiscal year to the fiscal deficit in future years (when the principal amount is paid off).

Policy actions should not distort price signals, as these are essential to ensure investment and productivity increases needed to remove the shortages in future, as well as to modulate consumption. For example, the government's laudable desire to reduce current cost pressures in the domestic economy through a subsidy on key fuel prices, had the unintended consequence of supporting the widening of the current account deficit, as demand was not rationalized to reflect the higher international prices<sup>2</sup>.

The growth of the current account deficit indicates that the exceptional fiscal expansion supported aggregate demand in the economy. The impact of the strong domestic demand on the current account deficit was

**Table 1.2: Overall Import Growth of Textiles**

	CY06	CY07
EU*	8.3	4.7
USA**	6.4	1.3

\* Source: Eurostat (CY07 Data available for Jul-Oct)

\*\*Source: US CY07 Census Bureau (data available for Jul-Nov)

compounded by the weakness in demand for textile in key markets. During the Jul-Jan FY08, textile imports in both the US and the EU slowed significantly (see **Table 1.2**). Pakistan's textile exports also suffered in December 2007 due to extended business closures.<sup>3</sup>

The impact of the widening current account deficit, driven essentially by the trade deficit, on the country's overall balance was compounded by a decline in the financial & capital account balance in the same period. While FDI flows witnessed a year-on-year increase in Jul-Jan FY08. Portfolio investment observed a net outflow.

These developments highlight three points:

- (1) Sustained large current account deficits pose risks to the country's macroeconomic stability. Over the last few years, Pakistan was able to comfortably sustain current account deficit due to favorable domestic and international investment conditions that encouraged large non-debt creating financial inflows into the country. As a result, Pakistan was not only able to run large deficit but also added to its foreign exchange reserves. However, that will be an increasingly risky strategy, given the stresses on the domestic economy as well as the relatively less favorable dynamics in the international capital markets.

<sup>2</sup> It is instructive to note that approximately 21 percent of the rise in the imports during Jul-Jan FY08 is on account of the oil bill.

<sup>3</sup> The impact of extended holidays for the *Eid* festival was compounded by political disruptions, following the assassination of a former prime minister.

- (2) The volatility in portfolio investment points to the need to reduce dependence on these flows and the corresponding need to increase domestic savings. The latter, in particular would increase market depth and lower dependence on potentially volatile external flows.
- (3) Pakistan's need to improve its infrastructure and its dependence on imported inputs, reducing the current account deficit to sustainable levels must perforce target export growth. The most efficient measure here would be those targeting a reduction in inflation, and to reduce the cost of doing business in Pakistan.

Given domestic turbulence and external shocks, SBP estimates suggest that FY08 real GDP growth would be in the range of 6.0-6.5 percent (see **Table 1.3**). This below target growth nonetheless remains strong. An unanticipated strength in international commodity prices is mainly responsible for cost push driven inflationary pressures in the economy. These pressures further intensified due to strong aggregate demand amidst a continuing fiscal stimulus. As a result, it is likely that FY08 inflation would be in the range of 8.0-9.0 percent, significantly above the target of 6.5 percent for the year.

**Table 1.3: Major Economic Indicators**

	FY08		
	Provisional FY07	Original target	SBP projections
<i><b>Growth rates (percent)</b></i>			
GDP	7.0	7.2	6.0 – 6.5*
Inflation	7.8	6.5	8.0 – 9.0
Monetary assets (M2)	19.3	13.7**	15.5 – 17.5
<i><b>billion US dollars</b></i>			
Exports (fob-BoP data)	17.1	18.9	19.7
Imports (fob- BoP data)	27.0	29.6	32.1
Exports (fob-customs data)	17.0	19.2	19.2
Imports (cif-customs data)	30.5	32.3	35.1
Workers' remittances	5.5	5.8	6.0 - 6.5
<i><b>percent of GDP</b></i>			
Budgetary balance	-4.3	-4.0***	-5.2
Current account balance	-5.3	-5.0	-6.0
*Estimated range is based on the assumption of 12.7 million bales of cotton and 24.0 million tonnes of wheat crop.			
**Announced in MPS Jul-Dec FY08; ***Budget estimates.			

\*Estimated range is based on the assumption of 12.7 million bales of cotton and 24.0 million tonnes of wheat crop.

\*\*Announced in MPS Jul-Dec FY08; \*\*\*Budget estimates.

The impact of the higher international commodity prices and strong domestic demand is also reflected in the deteriorating external imbalances during FY08. The current account deficit is projected to be around 6.0 percent of GDP during FY08 reflecting the rising imports growth (led by rising commodity prices) and slow growth in textile exports.

## **1.2 Executive Summary**

### **1.2.1 Real Sector**

#### ***Agriculture***

Information available by mid-February 2008 suggests that agriculture sector is likely to record reasonable growth during the fiscal year. Prospects of achieving the targeted 4.8 percent growth for the year remain dim. The record sugarcane and maize harvests, anticipated good wheat harvest, and above-target growth in minor crops, are unlikely to overcome the drag from the disappointing performance of some major *kharif* crops (cotton and rice). Livestock sub-sector, hit by bird flu virus may see some slowdown in growth.

Relatively weak aggregate performance of the crops, in the face of strong international prices of most agri-commodities, indicate not only the sector's vulnerability to the vagaries of nature but also the urgent need to enact reforms targeting distortions in the incentive structure for farmers, and the substantial wastage due to inadequate infrastructure. Investment in farm-to-market roads, agri-storage facilities, and small processing units can significantly reduce wastage and increase value addition in agriculture.

Institutional credit disbursement to agri-sector increased significantly by Rs 23.8 billion to Rs 104.8 billion during Jul-Jan FY08. The growth in agri-credit disbursement was due to aggressive lending by commercial banks. A sharp jump in non-farm credit also contributed in agri-credit growth acceleration during Jul-Jan FY08. The substantial rise in commercial bank lending compensated for a contraction in lending by the specialized banks during Jul-Jan FY08.

The aggregate fertilizer off-take witnessed recovery during Jul-Jan FY08 in contrast to a decline during the corresponding period of FY07. This growth was entirely driven by significantly higher off-take of urea. Despite a significant subsidy on DAP fertilizer,<sup>4</sup> its off-take saw a sharp decline in Jul-Jan FY08 amid a much sharper increase in international prices.

#### ***Large Scale Manufacturing***

Pakistan's large scale manufacturing (LSM) has been encountering headwinds since the start of FY08. Domestic as well as external factors are responsible for the relatively slower growth in this sector compared to the stellar performance of

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<sup>4</sup> Subsidy of Rs 470 per 50 kg bag of DAP fertilizer was extended for the FY08 cropping seasons to encourage farmers to use a balanced mix of fertilizers.

preceding years. These factors include: the continued strong increases in the international commodity prices, domestic energy woes and dampened demand (particularly for textile exports). Economic losses in the aftermath of December 27, 2007 have further weakened the chances of meeting the annual target. Overall, the slowdown in LSM during H1-FY08 was broad based and was seen in 11 out of 15 industrial groups. Of these, paper & board, metals, fertilizer and electronics industries registered a decline in production. In contrast to these under-performers, pharmaceuticals, POL, cement, engineering and wood industries depict reasonably strong growth.

### ***Services***

Most of the indicators for the services sector suggest robust growth in this sector during the first half of FY08. Wholesale and retail trade seems likely to perform well given a significant increase in imports (which accounts for more than half of the value addition in this sub-sector). This sub-sector is also likely to benefit from expansion in the network of domestic and foreign chain stores.

In the transport & communication sub-sector, a relative weakness in transportation sub-sector could be offset by a strong growth in the electronic media and tele-communication sub-sectors on the back of government's liberal policy as well as large FDI in recent years. In particular, expansion in cellular services is impressive as cellular density has more than doubled during July 2006 to December 2007.

The combined impact of a likely improvement in the profitability of the overall banking sector, coupled with some improvement in value-addition by other financial institutions is expected to support the high growth momentum in finance & insurance sub-sector as well. In addition, growth in value addition by public administration & defense as well as community & social services (other services) is likely to be strong.

### **1.2.2 Prices**

Inflationary pressures in the domestic economy have continued to mount throughout Jul-Feb FY08, with particularly sharp increases in the later months of the period, despite the central bank's efforts to contain the growth in aggregate demand. The headline CPI inflation rose to 11.3 percent (YoY) in February 2008 from 7.0 percent in June 2007. This reflects not only the stimulus from the expansionary fiscal policy but also the unanticipated strength of international commodity prices. The impact for food commodity prices was probably also aggravated by anti-competitive market structures and practices in the domestic market, as well as supply disruptions.



CPI food inflation (YoY) started to strengthen since September 2007 and was recorded at 16.0 percent in February 2008 after reaching to a local peak of 18.2 percent during January 2008; the highest level seen since April 1995. The rise in the food inflation is now increasingly being supplemented by acceleration in non-food prices. The latter is driven partly by high energy prices, but there is also evidence that the sustained rise in food and energy prices is engendering broad second round effects on inflation. This view is supported by the sustained increase in both measures of core inflation, seen since June 2007. On a YoY basis, NFNE (non-food, non-energy) core inflation increased to 8.1 percent in February 2008 (the highest since November 2005) from 6.0 percent in February 2007.

The inflationary pressures in the economy stemmed from strong aggregate demand were further strengthened due to rising international commodity prices (both food and energy), supply disruptions, and market inefficiencies. The latter can clearly be tackled through fiscal and administrative measures. However, given evidence that these cost push inflationary pressures are generating second round inflationary cycle, continued monetary tightening was essential and guided the SBP decision to accentuate its monetary tightening. The monetary measures aimed at siphoning out the excess demand in the economy need to be supplemented by greater fiscal discipline, as well as administrative and policy measures to correct market distortions.

### **1.2.3 Money and Banking**

The sustained increase in food commodity prices and the impact of rising costs of oil products led to unexpected rise in inflationary pressures in the economy during the first half of FY08. At the same time, risks to macroeconomic stability increased considerably as the fiscal and current account deficits turned out to be considerably wider than envisaged in the monetary policy framework. These developments eroded the impact of monetary tightening measures undertaken in August 2007, and increased the risks of further surge in inflationary pressures.

The rising fiscal deficit and its financing posed severe complications for the Monetary Policy Framework for FY08. Besides adding to aggregate demand pressures in the economy, the impact of higher fiscal deficit was also evident in a sharp rise in budgetary borrowings from the central bank –the most inflationary in nature. The borrowings from SBP reached Rs 359.3 billion during Jul-1<sup>st</sup> Mar FY08, instead of the net retirement recommended in the Monetary Policy Statement for Jul-Dec FY08. The sharp rise in budgetary borrowings was the major driving force behind the high annualized M2 growth. YoY M2 growth of

17.6 percent as on 1<sup>st</sup> March 2008 is a source of concern for SBP as it has the potential to add to the excess demand pressures in the economy.

SBP responded aggressively by further raising its policy discount rate by 50 bps to 10.5 percent and the cash reserve requirement of the banking system by 100 bps on current deposits effective from 1<sup>st</sup> February 2008.

SBP believes that monetary policy can best contribute to long-run economic growth by creating an environment with a stable price level or a low and predictable rate of inflation. In the medium term stable prices also help in moderating the fluctuations in output. In this backdrop, addressing widening macroeconomic imbalances becomes essential as these imbalances not only add to inflationary pressures, but also harm economic growth prospects.

The importance of low and stable inflation in achieving high long run growth also provides a cornerstone for monetary and fiscal policy coordination. It is therefore essential that government improves its fiscal discipline and limits its borrowings from the central bank within the targets recommended in the monetary policy framework. Otherwise, the time path for achieving a stable and low inflation would be extended, raising the cost of adjustment for economic agents.

The available data suggests that private sector credit has grown by 11.7 percent during Jul-1<sup>st</sup> Mar FY08; slightly higher than that in the corresponding period of the preceding year. The demand for working capital is on the rise as (1) delays in the settlement of price differential claims led IPPs and OMCs to resort to financing from bank sources for their working capital requirements, and (2) a sharp surge in raw material prices, both in the domestic and global markets, had pushed up the credit demand from the corporate sector.

Although the demand for fixed investment loans moderated in a number of industries, this is more a reflection of the fact that some industries had already expanded their activities in recent years, whereas others are using foreign currency loans & investments and issuing debt in the domestic market.

#### **1.2.4 Fiscal Developments**

Deterioration in key fiscal indicators seen during Q1-FY08, accelerated sharply in the next quarter, as revenue growth stagnated, even when expenditures continued to rise. As a result, the cumulative fiscal deficit for H1-FY08 as a percent of (estimated) annual GDP was almost twice that seen in the previous two years, reaching a seven-year high for the period. Similarly, the revenue deficit and the

primary deficit ratios for H1-FY08 increased substantially relative to the preceding years.

The fiscal performance is expected to improve in the remaining two quarters of the financial year, with greater discipline in spending being complemented by an anticipated improvement in revenues.<sup>5</sup> Nonetheless, it is likely that the annual fiscal deficit will exceed 4.0 percent of GDP target. The fiscal concerns are also heightened by the substantial (Rs 54.6 billion) issuance of contingent liabilities of the government in the first six months of FY08.

### **1.2.5 External Sector**

#### ***Balance of Payments***

Pakistan could not sustain the modest improvement in the current account deficit seen during Q1-FY08, and it widened sharply in succeeding months. Consequently, the cumulative Jul-Jan FY08 current account deficit rose by 47.1 percent YoY, compared to the 51.0 percent YoY increase in the same period of the previous year. The dominant contribution to the post-Q1-FY08 deterioration in the current account was from an abrupt rise in the country's oil bill, large one-off aircraft import, the impact of political disturbance in December 2007 as well as delays in the receipt of coalition support funds, all of which overshadowed the sustained increase in remittances.

The impact of the widening current account deficit on the country's overall external balance was compounded by a decline in the financial and capital account surplus in the same period. In particular, while FDI flows improved slightly, there was a precipitous US\$ 1.4 billion drop in net foreign portfolio investment flows. The decline reflected the outflows partly from the equity markets due to perceptions of increased political risk, and partly due to the delays in the planned floatation of Global Depository Receipts (GDRs) in the face of global financial turmoil and a perceived increase in country risk.<sup>6</sup> Apart from the impact of the fall in portfolio investment was also lowered by a large rise in other investments, including FE-25 nostros, short-term loans, etc.

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<sup>5</sup> The incentive to accelerate development spending ahead of the elections will no longer hold. Indeed, media reports indicate that concerned by the ballooning fiscal deficit, the government has sharply curtailed expenditure growth in H2-FY08.

<sup>6</sup> The impact of a general increase in risk-averseness in the troubled global financial market was compounded by the increased risk perceptions on Pakistan due to the pre-election uncertainty, particularly following the assassination of a former prime minister. As a result, the sovereign spread rose from 140 bps at end-June 2007 to 620 bps at end-January 2008 on 5 year bond.

Given that the decline in the financial account surplus was quite moderate, it is clear that the decline in the country's foreign exchange reserves essentially reflects the sharp increase in the current account deficit. Overall foreign exchange reserves declined to US\$ 14.0 billion by end February of FY08 compared with US\$ 15.6 billion as at the end June FY07.

As a result of worsening of external account during Jul-Jan FY08, Pak Rupee could not hold its grounds against the US dollar and depreciated by 3.5 percent during Jul-Feb FY08.

### ***Foreign Trade***<sup>7</sup>

Rising international commodity prices coupled with domestic supply constraints of some key commodities resulted in a 21.9 percent YoY rise in imports growth during Jul-Feb FY08 that outpaced 7.9 percent growth in exports during this period. Resultantly, the trade deficit recorded a sharp US\$ 3.5 billion YoY increase during the period.

Almost half of the total increase in the import bill during Jul-Jan FY08 was contributed by rising international commodity prices: oil, fertilizers, palm oil, etc.<sup>8,9</sup> In addition, imports of wheat and cotton were necessitated due to domestic shortages. The import bill was further inflated due to a large one-off import in the category of *aircrafts, ships and boats*. In the absence of all these factors, import growth, and thus the trade deficit, would have been significantly lower than the current level.<sup>10</sup> The significant slowdown in the imports after adjusting for these factors represents a deceleration of the real demand for imports, which can, in part, be attributed to the tight monetary policy being pursued by SBP.

The growth in exports during Jul-Jan FY08 was entirely due to rise in the *non-textile* exports – mainly *other manufactures* and *petroleum group*; whereas *textile* exports recorded 3.4 percent YoY fall during this period. The decline in the textile exports was broad based with only the exports of synthetic textiles, ready-made garments and textile made-ups registering positive growth.

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<sup>7</sup> This analysis is based on the provisional data provided by Federal Bureau of Statistics, which is subject to revisions. This data may not tally with the exchange record numbers reported in the section on *Balance of Payments*.

<sup>8</sup> The price impact for the 50.2 percent imports for which price and quantum data was available was around 49 percent of the total rise in the import bill during Jul-Jan FY08.

<sup>9</sup> The broad analysis of trade deficit is based on Jul-Feb FY08 data. However the detailed exports and imports trends are discussed for the period Jul-Jan FY08, since detailed monthly data is not available for February FY08.

<sup>10</sup> In the absence of these two factors, the import growth for Jul-Jan FY08 would have been mere 4.6 percent, which implies a trade deficit of US\$ 7.9 billion for this period.

## 2 Real Sector

### 2.1 Agriculture Sector Performance

Information available by mid-February FY08 suggests that agriculture sector is likely to record reasonable growth during the fiscal year. Prospects of achieving the target of 4.8 percent growth for the year remain dim. The record sugarcane and maize harvests, anticipated good wheat harvest, and above-target growth in minor crops, are unlikely to overcome the drag from the disappointing performance of some major *kharif* crops (cotton and rice) (see **Table 2.1**). livestock sub-sector, hit by bird flu virus (see **Box 2.1**), may see some slowdown in growth.

**Table 2.1: Performance of Major Crops**

Area under cultivation (000 hectares)					% change	
Crops	FY06	FY07 <sup>T</sup>	FY07 <sup>P</sup>	FY08 <sup>T</sup>	FY08 <sup>E</sup>	FY08 <sup>E</sup> /FY07 <sup>P</sup>
Cotton	3,100	3,072	3,072	3,250	3,082	0.3
Sugarcane	907	1,005	1,029	1,040	1,155	12.2
Rice	2,621	2,575	2,581	2,594	2,512	-2.7
Wheat	8,448	8,459	8,578	8,578	-	-
Gram	1,029	1,051	1,074	1,120	-	-
Maize	1,042	1,001	1,038	1,001	1,055	1.6
Production (000 tonnes; cotton in 000 bales of 170.09 kg each)						
Cotton	13,019	13,820	12,856	14,140	12,775*	-0.6
Sugarcane	44,651	50,500	54,871	55,871	62,300	13.5
Rice	5,547	5,693	5,439	5,721	5,490	0.9
Wheat	21,277	22,000	23,295	24,045	-	-
Gram	536	707	848	707	-	-
Maize	3,110	3,279	2,907	3,221	3,248	11.7
Yield (kg/hectare)						
Cotton	714	724	720	740	705	-2.1
Sugarcane	49,229	50,249	53,325	53,722	53,939	1.2
Rice	2,116	2,211	2,107	2,205	2186	3.7
Wheat	2,519	2,601	2,716	2,803	-	-
Gram	521	673	790	631	-	-
Maize	2,985	3,276	2,801	3,218	3079	9.9

\*: The size of cotton crop for FY08 is likely to be revised downward.

P: Provisional, T: Target, E: Estimates.

Source: MINFAL

Relatively weak aggregate performance of the crops, in the face of strong international prices of most agri-commodities indicates not only the sector's vulnerability to the vagaries of nature but also the urgent need to enact reforms. It should target distortions in the incentive structure for farmers and the substantial wastage due to inadequate infrastructure.

For example, the disconnect between price signals to farmers and the prevailing international market prices is, in some measure, captured by the small decline in the acreage under wheat during the FY08 *rabi* season. Wheat prices, both international as well as domestic retail prices, surged through most of the FY07, but farmers did not

appear to be capitalizing on this opportunity. Some farmers preferred to delay sowing

Wheat (continuing with late picking of cotton) or switched to alternate crops (such as sunflower). One explanation to this could be the delayed announcement of the support price, leading to uncertainty on the eventual sale prices. But given the limited scope of government purchase program (it purchased only 4.4 million tonnes out of 23.3 million tonnes of the FY07 crop. It appears that farm-gate prices are not keeping pace with international market prices. This suggests that substantial improvements in yields (and welfare gains) may be possible through reforms to improve price-signal transmission to farmers, and other reforms. An active futures market for wheat could provide some benchmark price to the farmers to help them taking timely sowing decisions.

Future market for agri-produce is even stronger in the case of sugarcane. While government announces procurement prices, sugar mills offer lower prices than the

#### **Box 2.1: Impact of Bird Flu**

The bout of the bird flu incidence in domestic poultry industry during January 2008 in urban Sindh caused a decrease in the output of the poultry farms with no reported culling of the grandparent and parent resources by the one day old chick producers. The impact on the otherwise stable growth of the livestock sector was expected to be partially offset as the result of the two weeks long scare. However, fears that lesser production of one day old chicks during the two weeks was likely to cause price jump in April-May 2008 due to demand and supply imbalance; with lesser supplies caused by few one day old chicks as well as traditional weather cycle impact.

Traditionally, the one day chick production process is spread over 25 months starting from the grandparent flocks laying down eggs that produce parent flocks which in turn lay down eggs for the one day old chicks. It is the one day old chick that after 40 days gains weight up to 1.60 kg to be transferred to the retail sale outlets. Any letup in the demand causes lesser production cycles with extreme situations causing culling of the parent and grandparent stock. A situation faced in spring 2006 causing the re organization of the culled flocks. These refurbished flocks have been responsible for over production incidence in the upcountry poultry clusters forcing small players out of business.

announced benchmark prices and clear payments with significant lags. Delay in crushing season also goes against the farmers as weight of sugarcane gets reduced with each passing day due to evaporation of water content in sugarcane. In addition, farmers were unable to vacate fields for succeeding crops. However, effective implementation of regulations regarding beginning of crushing season, assurance of a minimum (rational) price to farmers that could also provide incentive to sugar mills to work at full capacity can resolve these issues. In this backdrop, delayed crushing amid price dispute between farmers and sugar mills during FY08 is likely to adversely impact FY09 sugarcane crop, which would lead to sugar shortage next year and hike in the domestic sugar prices. This reinforces the need for effective policy and regulations to resolve these issues on permanent basis.

According to a World Bank assessment, Pakistan is one of the most water-stressed countries on the globe.<sup>1</sup> The need to use water resources prudently has never been as demanding as today, when changing weather patterns make agriculture more uncertain and prone to the vagaries of nature. Timely investment in infrastructure is also required to upgrade water distribution system and to increase land productivity. In addition, efficient use of water resources should be promoted with (1) laser leveling of farms,<sup>2</sup> (2) reduction of 30-40 percent irrigation water losses between canal heads and farm gate with the improvement in water courses, (3) drip water irrigation system, and (4) evolving drought resistant seed varieties. According to World Bank report, Pakistan needs to invest US\$ 1 billion per annum for the next five years to improve its irrigation system.

Investment in farm-to-market roads, agri-storage facilities, and small processing units can also significantly reduce wastage and increase value addition in agriculture. The strong growth in dairy sector is a case in point; with support for small dairy farmers for storage units helping the milk processing industry which recorded strong growth, leading to increase investment across the value-added chain, and supporting income prospects for farmers (see **Box 2.2**).

### **2.1.1 Crops**

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<sup>1</sup> The World Bank Report on *Pakistan Infrastructure Implementation Capacity Assessment*, 2008 available at <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/SOUTHASIAEXT/0,,contentMDK:21642194~pagePK:146736~piPK:146830~theSitePK:223547,00.html>

<sup>2</sup> Along other benefits, this may increase 20 percent crop yield: Muhammad Rafiq Akhtar, *J. Agric. Res.*, 2006, 44(3).

In the wake of relatively disappointing FY08 *kharif* crop, hopes of achieving reasonable growth in the crops sub-sector during FY08 are centered mainly on a good wheat harvest.

**Box 2.2: World Development Report 2008: Agriculture for Development<sup>3</sup>**

The World Development Report (WDR) for 2008 identifies a number of policy options to reduce poverty through agricultural productivity growth and hence provides guidance to governments and international community on designing and implementing agriculture-for-development agendas that can make a huge dent in world poverty. Countries have been classified in the report as agriculture-based, transforming and urbanized based on the share of agriculture poverty in the rural areas (using US\$ 2 a day line). Pakistan falls among the transforming countries.

The report warns that agriculture suffers from slower growth and natural resources are under growing pressure from agriculture and non-agricultural sectors. While the combination of population pressure together with declining farm size and water scarcity further exacerbate the situation, especially in South Asia. As a result, arable and permanent cropland per capita of the agricultural population is falling on one hand; and increased competition over access to scarce land and water due to rising urban population, income and demand has adversely affected the agricultural output on the other. Consequently, farm income in transforming countries lag behind the fastest growing non-farm income and results into further increase in rural urban income divide. In the same way, lack of investment and public spending besides leadership and management crisis in R&D, led to a huge knowledge gap between industrial and developing countries.

The report states that access to water is a major determinant of land productivity and the stability of yields. For that reason, soil and water quality degradation, in case of Pakistan, have negated the productivity gains from improved varieties and technical progress by one third, even then the improved varieties of seeds contributed 53 percent of total factor productivity gains, particularly in Punjab, from 1971 to 1994.

Livestock contribution in agriculture output is about 50 percent in Pakistan but the report observed that the share of Pakistani household in livestock is below 40 percent as compared to 80 percent in Albania, Nepal and Vietnam. This shows that livestock holding in Pakistan is quite low. Livestock production plays a major role in intensifying agriculture growth by diversifying risk and exploring new diverse markets. Therefore, improved animal genetics combined with improved animal health and feeding can increase productivity and lead to greater agriculture output.

Agriculture production is vital for food security since it is a source of livelihood for majority of the rural poor. The report described agriculture as a source of growth for national economy and a provider of investment opportunities for the private sector. In addition, agricultural productivity growth acts as a prime driver for stimulating growth in other parts of the economy and determines the price of food, which in turn determines wage cost and competitiveness of the tradable sectors.

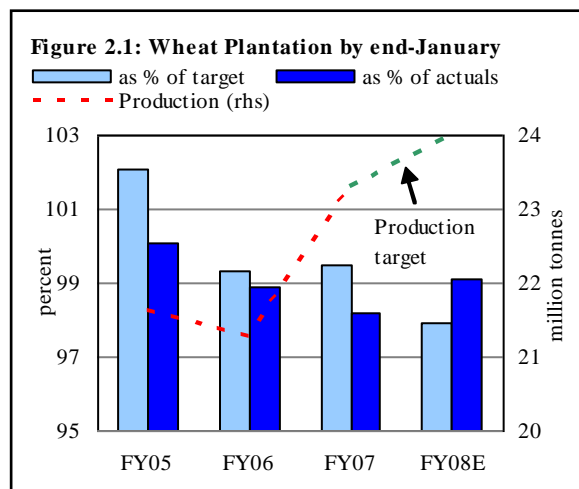
Report also asserts that increasing assets may also call for affirmative action to equalize chances for disadvantaged or excluded groups, such as women and ethnic minorities. Similarly, institutional development, such as enhancing the security of property rights and the quality of land administration, health, education, access to the market and diverting remittances to farm activity will pay back heavily.

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<sup>3</sup> World Development Report 2008: Agriculture for Development- prepared/published by the International Bank for Reconstruction and Development 2007, the World Bank.



The latest data on FY08 *rabi* crops indicates that area under wheat cultivation decreased by 0.2 percent (see **Figure 2.1**),<sup>4</sup> which is a consequence of delayed sugarcane crushing and extended cotton picking season. Other factors responsible for lower area under wheat cultivation are: (1) an anticipated reduction in availability of irrigation water during *rabi* FY08, (2) delay in announcement of wheat support price, (3) rising input cost particularly prices of fertilizers and (4) load shedding (that reduced water supply from tube-wells). It has been reported that growers (in Multan, Rahim Yar Khan and Khanewal) shifted planting area from wheat to sunflower and also to gram pulse.<sup>5</sup> As a result, achieving the wheat harvest target of 24.0 million tonnes for FY08 will be difficult.



However, impact of lower wheat plantation was somewhat offset by increase in water supply for irrigation purposes by recent rains and snowfall. In particular, winter rains would not only improve water supply to wheat fields but also provided sufficient low temperature levels. The low temperature would have significant effect on yield, especially at early growth stage, which has brightened the prospects of good wheat harvest. The main beneficiary of rain spell are the *barani* areas (un-irrigated land), where approximately 14.0 percent of total wheat is planted.

### Other Crops

Initial data on various minor crops suggests that in FY08, growth of minor crops will be substantially higher than previous years. Other crops like bajra, jawar, chili, moong, potatoes, etc., also performed well. Improved supply as a result of higher production is also mirrored in relatively lower prices of a number of

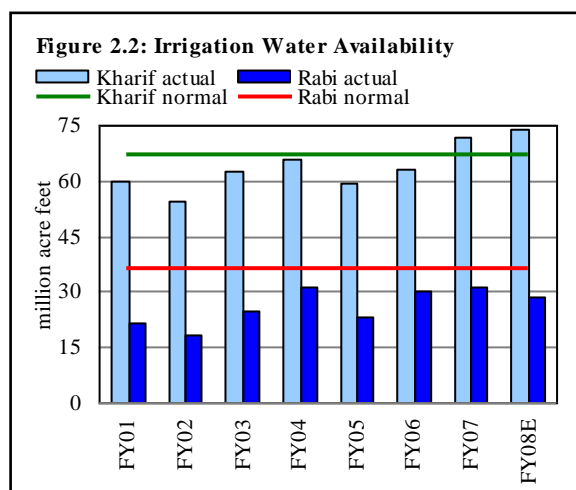
<sup>4</sup> Wheat planting area is provisionally estimated at 8400 thousand hectares by end-January 2008 compared to 8420 thousand hectares by end-January 2007.

<sup>5</sup> Print media, reported that increase in cost of wheat production (due to increase in DAP prices) growers have shifted soil to sunflower plantation; they are anticipating higher earnings, as compare to wheat.

vegetables and fresh fruits during FY08, particularly mangoes, citrus, onion and potatoes.

### 2.1.2 Irrigation Water

At the beginning of *rabi* FY08, water shortage was estimated to be around 22 percent lower than the 'normal' levels compared with a shortfall of 14.3 percent in *rabi* FY07 (see **Figure 2.2**). While the recent rains had helped allay some of these concerns, the expectations of water shortfall at the time of sowing have already hurt growth prospects.



For example, expectations of poor water availability probably contributed to the lower area under wheat, with farmers switching to sunflower and gram in some areas. Ironically, while the extended winter rains have probably helped the wheat crop, the sunflower and gram crops may have suffered some damage.

Unfortunately, the benefits of rains proved less effective and water shortage is likely to be intensified further during the remaining period of *rabi* FY08 as excessive release of water from reservoirs took place to meet the acute electricity shortages in January 2008. Therefore, prospects of water availability for *kharif* FY09 would crucially depend upon monsoon rains.

### 2.1.3 Credit to Agriculture Sector

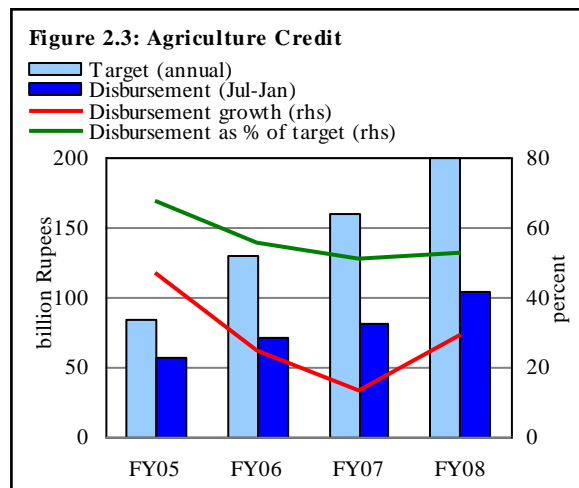
Institutional credit disbursement to agri-sector increased significantly by Rs 23.8 billion to Rs 104.8 billion during Jul-

**Table 2.2: Agri-Credit Disbursement (Jul-Jan)**

percent			
	FY06	FY07	FY08
<b>Growth</b>			
CBs	39.3	0.9	33.2
ZTBL	9.9	20.4	3.4
PPCBL	-29.0	22.1	-9.3
DPBs	54.0	44.3	89.7
<b>Total</b>	<b>24.7</b>	<b>13.0</b>	<b>29.4</b>
<b>Shares</b>			
CBs	52.4	46.8	48.2
ZTBL	31.5	33.6	26.8
PPCBL	4.6	5.0	3.5
DPBs	11.4	14.6	21.4

Jan FY08. The major impetus to this accelerated growth in agri-credit disbursement stemmed from aggressive lending by the commercial banks, catering to strong demand on account of rising prices of fertilizers (especially DAP), pesticides, energy, labor charges, and transportation.

A sharp jump in non-farm credit also contributed in agri-credit growth acceleration during Jul-Jan FY08. Substantial rise in commercial bank lending compensated for a contraction in lending by specialized banks during Jul-Jan FY08. As a result, the share of all commercial banks (five largest commercial banks and domestic private banks) rose to an all time high of 75.0 percent, at the expense of specialized banks (see **Table 2.2**). Credit disbursement as percent of annual target, also rose to 52.6 percent during Jul-Jan FY08 compared with 50.6 percent in Jul-Jan FY07, indicating the possibility of an above-target agri-credit disbursement for the 5<sup>th</sup> successive year (see **Figure 2.3**).



Increasing role of commercial banks in agri-credit is appreciable and points towards emergence of agri-credit market as a viable opportunity for commercial lending. Commercial banks also responded positively and have introduced new financial products for agri-credit with aggressive marketing. As a result, agri-credit disbursement by the five largest commercial banks increased significantly by 33.2 percent YoY during Jul-Jan FY08 against only 0.9 percent rise witnessed in the same period of the previous year.<sup>6</sup>

Similarly, strong performance has been shown by domestic private banks (DPBs) with 89.7 percent growth in agri-credit disbursement during Jul-Jan FY08 on top of 44.3 percent increase in the same period of FY07. Steady rise in the agri-credit market share of DPBs placed this group as one of the most important players

<sup>6</sup> A weaker growth of commercial banks lending during H1-FY07 was principally due to restructuring drive at HBL.

within few years. If continued, this group would become the second largest source of agri-credit in the country.

In contrast, weaker performance of agri-credit disbursement by the specialized banks during Jul-Jan FY08 is largely a reflection of restructuring and stress on revolving credit scheme by ZTBL. Providing the greater availability of infrastructure and skilled staff with specialized banks, slowdown in agri-credit disbursement is not a welcome development. Specialized banks must improve their agri-credit disbursement performance to maintain their market share. There is a need to restructure and revamp the operations of specialized banks on commercial basis.

It is also important to note that while agri-credit disbursement has been increasing, the number of borrowers has been declining in recent years. This trend also continued in Jul-Jan FY08. Good to see, while number of borrowers declined for production loans, number of borrowers increased for developmental and non-farm purposes. State Bank is aware of the problem that a large number of small farmers are unable to avail institutional credit. The major hindrance is non-availability of appropriate collateral for small farmers. SBP has therefore designed a financing scheme for small farmers to increase the outreach of the agri-credit (see **Box 2.3**). It is expected that this scheme would yield desired results and number of borrowers would increase in agriculture sector.

**Table 2.3: Number of Borrowers and Purpose-wise Agri-credit Disbursement (Jul-Dec)**

volume in million Rupees

Sectors	Number			% change		Volume		% growth	
	FY06	FY07	FY08	FY07	FY08	FY07	FY08	FY07	FY08
Farm sector	454,724	519,317	452,350	14.2	-12.9	61,345	66,191	15.7	7.9
Production*	434,558	506,576	436,098	16.6	-13.9	57,923	61,857	22.4	6.8
Development**	20,166	12,741	16,252	-36.8	27.6	3,422	4,334	-39.7	26.6
Corporate	3	14	2	366.7	-85.7	673	140	1.7	-79.1
Non-farm***	33,514	29,735	33,652	-11.3	13.2	9,674	23,946	9.2	147.5
Agri-sector	488,241	549,066	486,004	12.5	-11.5	71,691	90,277	14.7	25.9

\*: Include seeds, fertilizers, pesticides etc.

\*\*: Include land development, tractor, machinery etc.

\*\*\*: Livestock, poultry, forestry and fishing.

### **Purpose-wise Credit<sup>7</sup>**

While growth in farm related loans saw a slowdown during H1-FY08, agri-credit for non-farm purposes witnessed an impressive growth (see **Table 2.3**). The sharp

<sup>7</sup> Purpose-wise credit data is available up to Jul-Dec FY08.

jump in non-farm loans is a result of government's supportive policies and private sector's optimism in livestock sub-sector. Encouragingly, despite a deceleration in farm sector, development loans rose by a robust 26.6 percent, indicating farmers' enthusiasm about the prospects of this sector. However, a decline in corporate lending is disappointing, as growth in this segment is necessary to introduce modern techniques and best farm management. Introduction of best practices usually has positive spillover effects, which would likely to enhance productivity and reduce wastages.

### Agri-Credit Recovery

Since agri-credit disbursement is based on revolving credit formula, the performance of disbursements is also mirrored in the recoveries.

Despite a slowdown in agri-credit recovery growth by the five largest commercial banks and DPBs, their performance remained buoyant during Jul-Jan FY08 (see **Table 2.4**). In contrast, the recovery performance of specialized banks is relatively lackluster. This reinforces the view that specialized institutions need to streamline their operations on a commercial basis.

**Table 2.4: Agri-Credit Recovery (Jul-Jan)**

percent				
Banks	FY05	FY06	FY07	FY08
CBs	153.1	-32.9	72.0	39.7
ZTBL	16.8	-3.0	14.1	0.5
PPCBL	4.4	6.0	-3.2	10.8
DPBs	662.8	-57.0	231.9	93.5
<b>Total</b>	<b>77.1</b>	<b>-22.5</b>	<b>49.6</b>	<b>31.7</b>

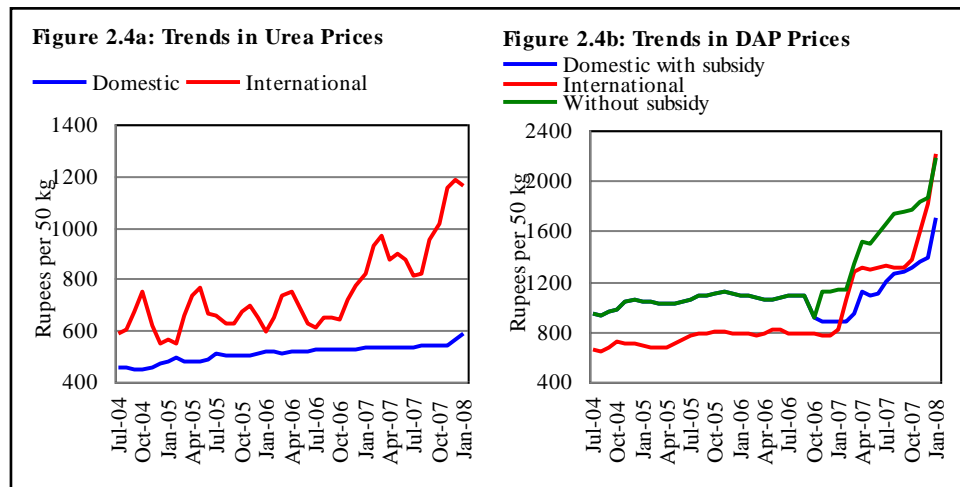
### 2.1.4 Fertilizer Off-take

Aggregate fertilizer off-take witnessed recovery during Jul-Jan FY08 in contrast to decline during the corresponding period of FY07 (see **Table 2.5**). This growth was entirely driven by significantly higher off-take of urea. Despite a significant subsidy on DAP fertilizer,<sup>8</sup> its off-take saw a sharp decline in Jul-Jan FY08 amidst continued increase in international prices.

**Table 2.5: Fertilizer Off-take (Jul-Jan)**

000 tonnes			
	FY06	FY07	FY08
Urea	3,380	3,011	3,468
DAP	1,056	1,202	961
<b>Total</b>	<b>4,435</b>	<b>4,213</b>	<b>4,429</b>
<b>Growth (%)</b>			
Urea	7.2	-10.9	15.2
DAP	-0.8	13.8	-20.0
<b>Total</b>	<b>5.2</b>	<b>-5.0</b>	<b>5.1</b>
<b>Market share (%)</b>			
Urea	76.2	71.5	78.3
DAP	23.8	28.5	21.7

<sup>8</sup> Subsidy of Rs 470 per 50 kg bag of DAP fertilizer was extended for the FY08 cropping seasons to encourage farmers to use a balanced mix of fertilizers.



The higher off-take of urea is also a result of lower domestic prices of urea compared to international prices (see **Figure 2.4a**). This difference is mainly attributed to availability of relatively cheaper natural gas which is an important input for the production of urea. In case of DAP, domestic prices have traditionally been higher than the international prices. However, subsidy on DAP resulted in relatively lower domestic prices of DAP than international prices. While, government increased the subsidy on DAP, it is unable to offset the increasing trend in international prices (see **Figure 2.4b**). A fall in DAP off-take suggests that the use of DAP is probably not feasible at this price. Low use of DAP will not only hurt the government's campaign for farmers to implement a balanced mix of the nutrients, it would also have negative impact on wheat yield.

#### Box 2.3: Small Farmers Financing Scheme-Guideline for Banks

In order to enhance the outreach of institutional credit to small farmers having no collateral, State Bank of Pakistan introduced "Financing Scheme for Small Farmers" (FSSF). This is an attempt to resolve the root cause of market failure in agriculture credit, i.e., non-availability of collateral. This scheme offers an opportunity to small farmers in mainstream institutional credit, which is likely to impact lives of thousands small farmers. This FSSF is based on small groups of farmers and cover all areas of agriculture including farming, livestock, dairy, poultry, fisheries, horticulture etc. The salient features of the scheme are given below:

##### Group dynamics

- Banks will form Small Farmers Group (SFG) with 5-15 members through NGOs and outlets of farm input services providers etc.
- Banks will determine the eligibility for loans by on-site verification of farming activities being financed and assessment of cash flows of individual members.
- Bank staff will maintain record and facilitate group meetings, relieve/replacement of member as per eligibility criteria.
- Each Group will nominate a group coordinator amongst themselves with the consent of the concerned bank.

- The selected coordinator will prepare a tentative schedule of meetings/proceedings. He will also maintain and retain group documents/files/registers. He will also inform bank in case of misuse of funds by a member.
- Members of the group ensure that the bank receives timely repayments from individual borrower/group members. In case of default/non repayment by a member, all members should come up with a strategy/timeline for setting off the due repayments.
- Each group will submit Personal Guarantee (PG) which would be a joint liability agreement/undertaking wherein each member of the group takes the responsibility of the outstanding debt of all group members. In case of any change in the composition of group members, a fresh PG would be signed by all members of the group.

#### **Eligibility of borrower**

- In crop sector, individual should be a holder/ tenant/lessee/allottee, farmer of land up to 12.5 acres.<sup>9</sup> Individuals having sufficient knowledge of the business /activity being carried out.
- In case of non-crop sector:
  - Individual farmer involved in small scale livestock activities like goat and sheep up to 40 animals, meat cattle up to 25 animals and milch animal up to 4 animals  
or
  - Poultry farming for broiler up to 1,500 birds, layers up to 500 birds and dessi up to 500 birds  
or
  - Inland fisheries with pounds up to 2 acres or marine fisheries with one boat not exceeding five gross ton capacity.
  - Should have computerized N.I.C.
  - Should be resident of same village/area at least for the last two years.
  - Bank account in the name of the intending borrower.
  - Not to be a defaulter of any bank.
  - Any other criteria as per policy of the bank(s).

#### **Financing facilities**

- Financing would not exceed Rs 200,000 per borrower to meet their financial requirement and based on individual's cash flows.
- Repayment schedule may be set as per production cycle of the crop/non-crop activities being financed or revolving credit facility for three years subject to mandatory clean up of entire liabilities (both principal and mark up) once in a year or cash flow of the borrower in case of non-crop activities.

#### **Type of Financing**

- **Working Capital:** (i) Small farm credit to be provided for purchase of inputs like: seeds, fertilizers, pesticides etc. for crops production. Production loans also include working capital finance to meet various expenses attributable to farming. (ii) Non-farm credit includes short-term financing for livestock, dairy, poultry and fisheries. These include financing for purchase of feeds, raising and veterinary expenses, working capital for milk collection, purchase of chicks, fish seed, running charges of tube wells etc.

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<sup>9</sup> In case of Sindh and Balochistan, this limit is up to 16 and 32 acres respectively.

- **Term Financing:** Banks can provide term loan facility to small farmers for making different types of improvements in the land, construction of sheds/ ponds, development of orchards/ nurseries, purchase of livestock, farm implements, machinery, tube wells, generators etc.
- **Documentation:** The banks/DFIs may use the following standardized documents.<sup>10</sup> However, they can obtain a separate set of documents or additional documents as per their policies in order to safeguard interest of the bank/borrower.
  - Group Formation Form (GFF)
  - Loan Application Form
  - Attested copies of CNIC
  - Personal Guarantee (PG)
  - Residence Certificate from Taluka Nazim (only in case of difference in permanent address on CNIC from the place of business)
  - For the verification/confirmation of cultivation by the borrower, khasra girdawari/ lease agreements or any other document as per policy of the bank.
  - An undertaking from the landowner that neither he has availed agri-finance against his land from any institution nor he will draw such loans in future without the approval of the bank until he remained a member of SFG.

#### Other important features

- Banks would ensure disbursement of working capital/short-term financing within seven days and for term loans within 15 days from the date of completion of formalities.
- Bank shall determine mark-up on the basis of KIBOR and their cost of funds in line with their credit policy.
- Banks shall not charge any penalty on early repayment/adjustment of loan.
- Banks to arrange insurance of loan disbursed for crop and non crop activities (wherever available) and life insurance of the borrower to safeguard the interest of the borrower and the bank, in case of losses due to natural calamity or event beyond the control of the borrower.
- It would be the joint responsibility of the group members to ensure timely repayment of principal and mark up of the members. Other terms and conditions will be as per Prudential Regulations for Agriculture Financing in this regard.
- In case of non settlement of default amount, bank has the right to stop renewal/disbursement/withdrawal of loan to all members of the group till the full settlement or rescheduling by the bank. Proper mechanism should be developed by bank for recovery/follow up of the loan accounts including recovery/follow up of skip and death cases.
- Banks/DFIs to ensure that loans have been utilized for the same purposes for which they were obtained. For this purpose, banks/DFIs may consider it's prudent to make payments directly to the suppliers wherever appropriate. However, this provision will not apply on farmers who are provided loans under Revolving Credit Scheme.

<sup>10</sup> Specimen of documents is available at [www.sbp.org.pk/acd/2008/Annex-C1.pdf](http://www.sbp.org.pk/acd/2008/Annex-C1.pdf).



## 2.2 Large Scale Manufacturing

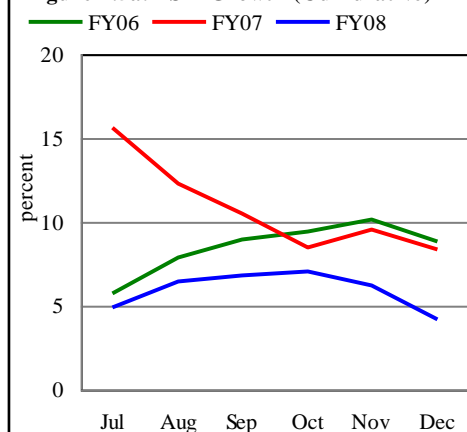
Pakistan's large scale manufacturing (LSM) has been encountering headwinds since the start of FY08. Domestic as well as external factors are responsible for the relatively slower growth in this sector compared to the stellar performance of preceding years (see **Table 2.6**). These factors include: the continued strong increases in the international commodity prices, domestic energy woes and dampened demand (particularly for textile exports). Economic losses in the aftermath of 27<sup>th</sup> December 2007 have further weakened the chances of meeting the annual target.

The impact of latter was complemented by intensifying energy shortages in December

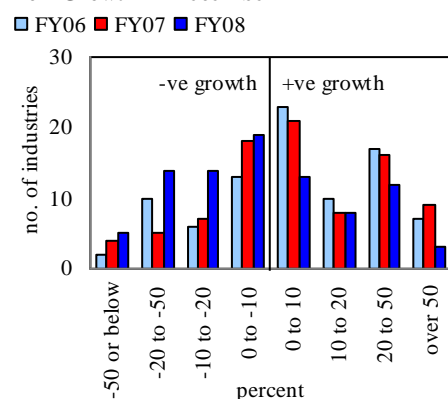
**Table 2.6: Sector wise LSM Performance (Jul-Dec)**

percent	FY07	FY08
<b>Sectors showing decline in production</b>		
Paper & board	2.0	-10.4
Fertilizers	-2.9	-3.2
Metal industries	13.1	-7.2
Electronics	9.8	-7.7
<b>Sectors showing deceleration</b>		
Textiles	11.3	2.1
Chemicals	15.0	3.09
Food, beverages and tobacco	4.8	4.4
Automobile	7.9	0.5
Leather and leather products	3.1	1.8
Tyres & tubes	18.4	8.4
Non metallic minerals	19.5	17.8
<b>Sectors showing acceleration</b>		
POL	-6.0	6.2
Pharmaceuticals	4.0	36.4
Wood products	1.4	31.1
Engineering products	17.5	19.1
<b>Overall LSM</b>	<b>8.4</b>	<b>4.2</b>

**Figure 2.5a: LSM Growth (Cumulative)**



**Figure 2.5b: Frequency Distribution of YoY Growth in December**



2007 leading to a substantial fall in the production of a large number of industries (see **Figure 2.5**). As a result, although the deceleration in December is a common factor in preceding three years, the decline in LSM growth during December 2007 was stronger.

Overall, the slowdown in LSM during H1-FY08 was broad based and was seen in 11 out of 15 industrial groups. Of these, paper & board, metals, fertilizer and electronics industries registered a decline in production.

Paper & board industry has done rather dismally as few plants in the sector were temporarily closed for expansion activities during the period. Similarly, the decline in fertilizer production during H1-FY08 was mainly due to the closure of a large DAP producing plant in the country for balancing, modernization and replacement (BMR) activities. As a result, the imports of non-urea fertilizer shot up during the period.

In contrast, the decline in electronics production was in response to the weakened demand. On one hand, rising inputs costs led to higher prices, while on the other, demand was also dampened by the rising cost of consumer loans (as banks priced-in the higher benchmark rates and perceptions of increased risk on these loans).

Decline in basic metals sub-sector was caused by operational bottlenecks. Specifically, the sector is facing acute energy shortages which are forcing manufacturers to operate the plants below potential and in some cases production activity has come to a halt. These energy supply constraints in local economy combined with increasing international prices have pushed up local prices and are diluting the demand for steel products from housing sector.

Liberal automobile import policy of the last two years has adversely affected local auto industry. Government in FY08 budget tightened the policy by only allowing imports of automobiles up to three years old. This measure has reduced the import of completely built

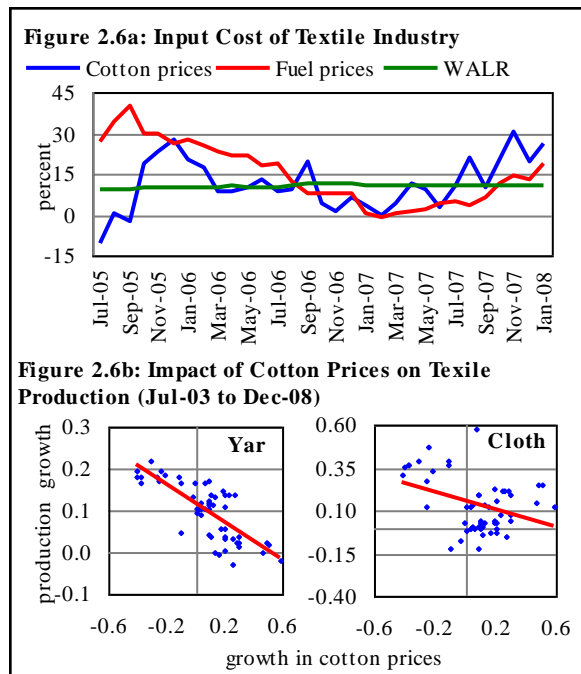
units (CBUs); but could not spur local production. The impact of this measure has been more than offset by stronger Yen and a 2.5 percent levy on car sales (see **Table 2.7**). Moreover, the relatively costlier auto loans in FY08 also dampened

**Table 2.7: Performance Indicators of Car Industry (Jul-Dec)**

	percent growth				
	Auto loans	Auto production	Auto sales	CBU imports	CKD imports
FY05	2.8	29.1	31.2	NA	NA
FY06	25.8	28.4	24.2	NA	NA
FY07	7.7	6.1	6.7	3.7	-27.7
FY08	7.2	-2.8	-7.7	-5.8	-19.1

the demand for automobiles.<sup>11</sup> As a result, car manufacturers cut production during H1-FY08. However, robust growth in completely knocked down (CKD) imports of 14.5 percent during Q2-FY08 suggests that car manufacturing may recover in the second half of the year, when 70 percent of annual production usually takes place.

Poor performance of textile sector is mainly a reflection of sharp slowdown in its exports. Ironically, the deceleration in textile exports is despite the substantially high subsidized financing for working capital, fixed investment, and concessional export finance in recent years, and appears to be driven by structural impediments in the industry<sup>12</sup> as well as recent slowdown in US demand for textiles (for details see **Section 6.6** on **Foreign Trade**). Besides this, supply and operational bottlenecks like decline in FY08 cotton harvest, electricity & gas shortages and deteriorating law and order situation in the country, further worsened the sector's weak performance during the period. Poor cotton harvest and the resultant growth in cotton prices; appears to be the most critical factor in deteriorating competitiveness of domestic textile (see **Figure 2.6**).



<sup>11</sup> On face value, though auto loans showed only marginal deceleration in H1-FY08; in the context of upward revision in car prices during the period, the slowdown is rather substantial.

<sup>12</sup> The structural impediments in the textile industry mainly include dearth of market research in designing of the products as well as quality issues (for instance, cotton contamination).

In contrast to these under-performers, pharmaceuticals, POL, cement, engineering and wood producing industries witnessed a reasonably strong growth.<sup>13</sup> While growth in cement production is mainly

due to export demand (see **Table 2.8**), growth in petroleum products is driven mainly by robust domestic consumption as well as productivity gains following the overhauling of plants in two refineries in the preceding year. Sugar and pharmaceutical industries managed to perform well due to ample availability of raw materials.

Pharmaceuticals recorded an unprecedented growth of 36.4 percent during H1-FY08 driven mainly by increase in the outreach of public sector health related activities in the year as well as reduction in duties on raw-material imports announced in federal budget for FY08.<sup>14</sup> Similarly, robust growth in sugar production is an outcome of record sugarcane crop during the year.<sup>15</sup> However, the food, beverages and tobacco sub-group decelerated slightly due to the decline in the production of edible oil/ghee.

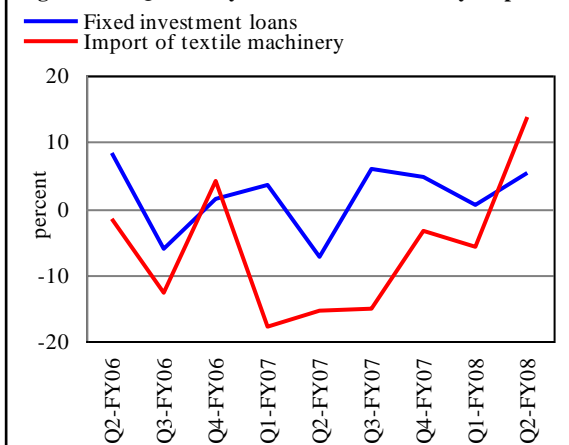
Thus, it appears that the manufacturing sector needs to consolidate its gains in coming months in order to improve the muddling performance so far. However, the prospects for improvement appear low, given:

1. Short-term performance of fertilizer sector will be affected as the only DAP production plant in the

**Table 2.8: Cement Dispatches (000 tonnes)**

	Jul-Dec		Exports as % of total
	Domestic	Export	
FY06	7981	775	8.9
FY07	9979	1203	10.8
FY08	10940	2996	21.5

**Figure 2.7: Quarterly Growth in Machinery Import**



<sup>13</sup> Cement production registered a robust growth of 18.2 percent in FY08, decelerated only marginally from 18.8 percent in the preceding year. However, production of other items in *non-metallic minerals* group declined sharply.

<sup>14</sup> The latter is evident from the 34.8 percent growth in import of medicinal products.

<sup>15</sup> However, this robust sugar production could have been even better had the cane crushing started on time.

- country will remain closed during Q3-FY08 for BMR expansion.
2. Yawning gap between energy demand and supply, and resultantly, the government instructing all the steel-melting and re-rolling steel units to close down operation for 15 days to conserve energy and also instructing textile mills to reduce operation during January 2008.
  3. Slowdown in the US economy following the financial turmoil may weaken exports to USA.

On the positive end, however, mild recoveries are expected in a few sectors as:

1. Sugar production is likely to remain robust in coming months. It is also expected that in order to stabilize the declining sugar prices in domestic market, surplus sugar will be exported. It is also important to note that the international prices of sugar witnessed a rise in recent months, which may be beneficial for the domestic sugar industry.
2. Price pressures in domestic cotton market may ease somewhat once the import of raw cotton from India is realized. Moreover, sharp growth in fixed investment loans and import of textile machinery in Q2-FY08 also hints at some recovery in textiles going forward (see **Figure 2.7**).
3. Similar recovery is expected in edible oil & ghee industry January 2008 onwards when the Free Trade Agreement (FTA) between Pakistan and Malaysia comes into force.<sup>16</sup> This is also evident from 52.6 percent YoY growth in *quantum* of palm oil imports during January 2008.
4. Refining activities will get a major spurt as the new pre-flash distillation system in one of the refining companies will be taken on line during February 2008, and
5. Government deferred withholding tax (levied in the start of FY08) on auto sales for two months February to April 2008. The said measure is expected to ease prices.

Finally, however, prospects of the LSM sector will largely depend much upon the nature of political scenario, law and order situation as well as the effectiveness of government measures to mitigate the energy crisis.

### **2.3 Services Sector**

The early availability of information on growth trends is important for the modulation of policy, particularly as the impact of changes in economic policies is transmitted with variable lags. While the services sector contributes over 50 percent in annual GDP for Pakistan, an assessment of growth in the sector is

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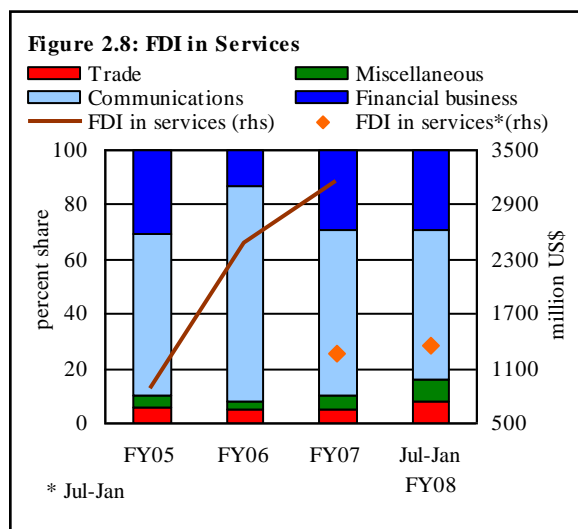
<sup>16</sup> Specifically, the agreement requires a 15 percent cut on import tariff on palm oil which currently is Rs 9200 per ton. However, the agreement is expected to have marginal effect on the industry as palm oil prices are not likely to show any respite.

available only on an annual basis. This is in contrast to the position for the commodity producing sectors (CPS), where partial data on crops and large-scale manufacturing allows for intra-year assessments of on-going growth trends.

In light of the above, this section attempts to assess broad direction of FY08 growth trends for the services sector, based on a number of variables that may be indicative to trends in the respective area (see **Table 2.9**). Most of these growth indicators for the services sector suggest robust growth for the first half of FY08.

Wholesale and retail trade<sup>17</sup> seems likely to perform well given a significant increase in imports (which accounts for more than half of the value addition in this sub-sector). This sub-sector is also likely to benefit from expansion in the network of domestic and foreign chain stores. In particular, multinational chain stores are operational at full swing in FY08. These stores contributed substantial FDI inflows of US\$ 319.2 million during FY05-FY07

compared with only US\$ 109 million during FY02-FY04. While trade activities adversely impacted due to weakness in the growth by major crops, significant rise in the production of minor crops and imports of wheat and cotton is expected to offset this drag. Similarly, a relative weakness in transportation sub-sector could be offset by a strong growth in the electronic media and telecommunication sub-sectors on the back of government's liberal policy as well as large FDI in this sub-sector in recent years (see **Figure 2.8**). In particular, expansion in cellular services is impressive as cellular density has turned more than double during July 2006 to December 2007.<sup>18</sup> Relatively weak growth in transportation sector is reflected in growth deceleration of credit, production of LCVs and import of petroleum.



<sup>17</sup> The share of manufacturing and wholesale and retail trade is 19.1 percent each in GDP during FY07.

<sup>18</sup> The overall teledensity increased by 7 percentage points in H1 FY08 (source PTA).

**Table 2.9: Services Sector Performance Indicators**

percent growth or mentioned otherwise

	FY06	FY07	H1-FY07	H1-FY08
<b>Wholesale &amp; retail trade</b>				
Credit to wholesale and retail trade	8.1	-62.8	15.5	10.7
FDI in trade	126.4	46.0	55.0	-0.4
Imports	38.8	6.9	9.1	13.8
Trade volume (imports & exports)	28.7	5.5	7.4	10.3
<b>Transport storage &amp; communication</b>				
Credit to transportation storage and communication	-50.9	48.3	25.9	4.6
Petroleum crude imports	76.6	-4.9	-1.8	3.6
Commercial vehicles production	16.1	7.9	4.2	1.6
Teledensity (percentage of population)	26.3	44.1	35.4 <sup>1</sup>	52.9 <sup>1</sup>
Cellular density (percentage of population)	22.2	39.9	31.1 <sup>1</sup>	48.6 <sup>1</sup>
FDI in transport storage & communication	267.8	-0.5	52.4	43.4
<b>Finance &amp; insurance</b>				
Profit of commercial banks	51.5 <sup>2</sup>	10.8 <sup>2</sup>	20.4 <sup>3</sup>	6.9 <sup>3</sup>
FDI in financial business	22.2	182.6	340.0	-32.7
<b>Ownership of dwellings</b>				
Cement	13.5	22.5	11.6 <sup>4</sup>	25.8 <sup>4</sup>
Metal production	5.3	10.7	12.8 <sup>c</sup>	-0.6 <sup>c</sup>
<b>Public administration &amp; defence</b>				
Fiscal spending on public admin. and defence	14.3	3.3	-18.5 <sup>3</sup>	26.3 <sup>3</sup>
<b>Community, social &amp; personal services</b>				
FDI in social and personal services	162.5	23.8	1.3	51.5
<b>Total FDI in services sector</b>	<b>181.5</b>	<b>27.4</b>	<b>111.7</b>	<b>7.2</b>

<sup>1</sup>: Data pertains to end-Dec. <sup>2</sup>: Data pertains to Jan-Sep.

<sup>3</sup>: Data pertains to Jul-Sep. <sup>4</sup>: Data pertains to Jul-Oct.

At glance, slower growth in profit for commercial banks and fall in FDI inflows could point to lower growth in value addition by the *finance & insurance* sub-sector. However, the impact of a likely improvement in the profitability of the central bank, coupled with some improvement in value-addition by non-bank financial institutions is expected to support the high growth momentum in this sector as well. In addition, growth in value addition by public administration & defence as well as community & social services (social services) is likely to be major contributing factors. Rise in value addition in these two sectors is principally driven by deployment of troops in various parts of the country; election related public and private spending as well as increase in social services, particularly government initiatives for health and education during the year.

## 3 Prices

### 3.1 Global Inflation Scenario

Inflationary pressures in the global economy remained strong during second quarter of FY08. Inflation in the US, UK, Euro area, Japan and China remained at a significantly higher level in January 2008 compared to January 2007. Inflationary pressures have also remained strong in the developing economies during the second quarter of FY08 (see **Table 3.1**).

This was driven by reasonably strong growth in the global economy, which fueled a broad commodity market boom, particularly from emerging markets (see **Figure 3.1**). However, the most significant impetus to global inflation arguably came from the rise in energy prices, amid strong demand and supply concerns. Crude oil prices showed strong upward movements.

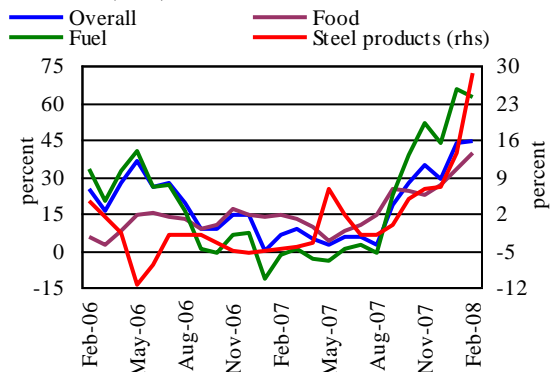
High energy prices also contributed indirectly to the rise in food prices, by spurring interest in bio-fuels, with attendant increase in the prices of key cereals. The impact of the latter was then compounded by production shocks to key crops, particularly for wheat and rice. Global inflationary pressures are likely to continue in months ahead. It is apparent from

**Table 3.1: Headline Inflation YoY**

percent			
	Jun-07	Sep-07	Jan-08
United States	2.7	2.8	4.3
Euro zone	1.9	2.1	3.2
UK	2.4	1.8	2.2
Japan	-0.2	-0.2	0.7
India	6.1	5.7	5.5
Bangladesh	9.2	9.6	11.4
Sri Lanka	13	17.3	21.6
China	2.9	4.6	7.1
Malaysia	1.4	1.8	2.3
Indonesia	5.8	7.0	7.4
Pakistan	7.0	8.4	11.9

Source: IFS and statistical agencies of various countries

**Figure 3.1: World Commodity Price Indices Inflation (YoY)**



Source: IMF and World Bank



the rising core inflation (CPI excluding food and energy) in most of the economies (see **Table 3.2**).

### 3.2 Domestic Scenario

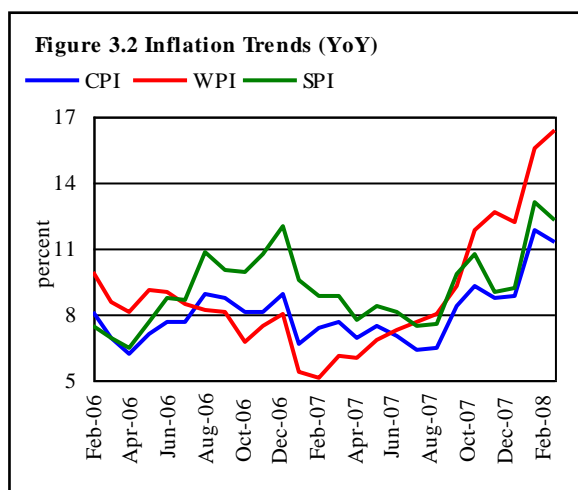
Inflationary pressures in domestic economy have continued to mount throughout Jul-Feb FY08, with particularly sharp increases in the later months of the period (see **Figure 3.2**). Increasing inflationary pressures have persisted despite the central bank's efforts to contain the growth in aggregate demand. This reflects not only the stimulus from the expansionary fiscal policy but also the unanticipated strength of international commodity prices. The impact of high international food commodity prices was probably also aggravated by anti-competitive market structures and practices in the domestic market, as well as supply disruptions (see **Figure 3.2**).

**Table 3.2: CPI excluding Food and Energy\* (YoY change)**

percent				
	Jun 06	Dec 06	Jun 07	Dec 07
Australia	1.8	2.3	2.5	2.8
Korea	2.0	2.2	2.5	2.6
United States	2.6	2.6	2.2	2.4
Czech Republic	1.8	1.6	2.7	4.1
United Kingdom	1.2	1.8	2.0	1.4
Philippines	5.8	4.6	2.5	2.6
Thailand	2.7	1.5	0.7	1.2
South Africa	n.a	3.8	5.7	7.8
Pakistan	6.5	5.7	5.7	7.2

\* end month values

Source: OECD, statistical agencies & websites of various countries and FBS.



The dominant contribution of food prices is evident in all three inflation indices; the consumer price index (CPI), the wholesale price index (WPI), and the sensitive price indicator (SPI) (see **Table 3.3**). Indeed, the CPI food inflation (YoY) at 16.0 percent in February 2008 is significantly higher than the 10.0 percent seen in February 2007, though it came down from a peak of 18.2 percent in January 2008. The rise in the food inflation is now increasingly being supplemented by an acceleration in non-food prices. The latter is driven partly by high energy prices, but there is also evidence that the sustained rise in food and energy prices is engendering broad second round effects.

This view is supported by the sustained increase in both measures of core inflation since June 2007. On a YoY basis, NFNE (non-food non-energy) core inflation increased to 8.1 percent in February 2008 (the highest since November 2005) from 6.0 percent in February 2007. This uptrend in core inflation is supported by a rising house rent index (HRI) inflation during the past few months. Similarly, core inflation based on 20 percent trimmed-mean also recorded a rise and gained 3.1 percentage points during FY08 (see **Figure 3.3**).

The strength of inflationary pressures is largely due to rising international commodity prices (both food & fuel); as well as supply disruptions and market inefficiencies which can clearly be tackled through fiscal and administrative measures. However, given the evidence that these cost push inflationary pressures could generate second round inflationary cycle, continued monetary tightening was essential and guided the SBP decision to accentuate its monetary tightening.<sup>1</sup>

**Table 3.3: Inflation Trends**

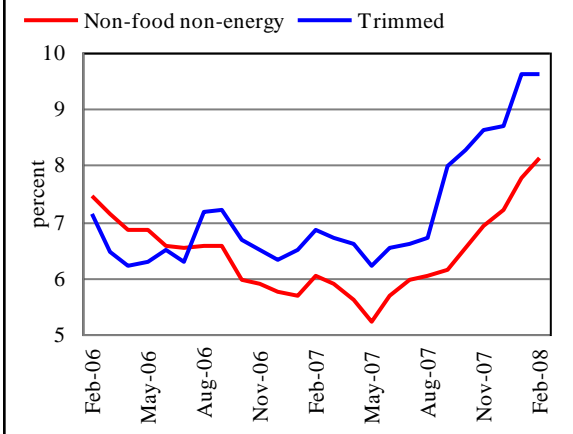
	percent			
	Year-on-Year <sup>1</sup>		12-month moving average <sup>2</sup>	
	Feb-07	Feb-08	Feb-07	Feb-08
<b>CPI</b>	7.4	11.3	7.7	8.4
Food	10.0	16.0	8.7	12.1
Non-food	5.6	7.8	6.9	5.7
<b>WPI</b>	5.1	16.4	7.6	10.0
Food	8.7	18.3	7.5	13.5
Non-food	2.6	15.0	7.7	7.6
<b>SPI</b>	8.8	12.3	9.2	9.4
<b>Core</b>				
NFNE <sup>3</sup>	6.0	8.1	6.4	6.4
Trimmed mean	6.8	9.6	6.6	8.2

<sup>1</sup>e.g., change in February 2008 over February 2007

<sup>2</sup>e.g., change in 12-month average of February 2008 over February 2007

<sup>3</sup>Non-food non-energy

Source: Federal Bureau of Statistics

**Figure 3.3: Core Inflation (YoY)**

<sup>1</sup> For details see Monetary Policy Statement for January to June 2008 at [http://www.sbp.org.pk/m\\_policy/MPS-JAN-JUNE-FY08-EN.pdf](http://www.sbp.org.pk/m_policy/MPS-JAN-JUNE-FY08-EN.pdf)

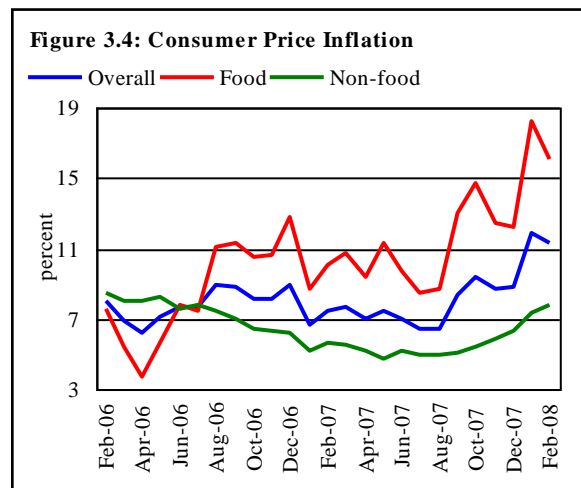
However, the monetary measures aimed at siphoning out the excess demand in the economy need to be supplemented by greater fiscal discipline, as well as administrative and policy measures to correct market distortions.

Ironically, the government has limited options to mitigate inflationary pressures through fiscal measures, given its shrinking fiscal space. Thus any subsidies need to be carefully targeted and should be limited in scope. Moreover, policy actions should not distort price signals, as these are essential to ensure investment and productivity increases needed to remove the shortages in future.

However, substantial gains can also be achieved through reforms aimed at reducing or eliminating anti-competitive practices and supporting investment in agricultural production, storage and transportation. The on-going boom in food commodity prices provides an incentive for investment on sustainable basis in the sector.

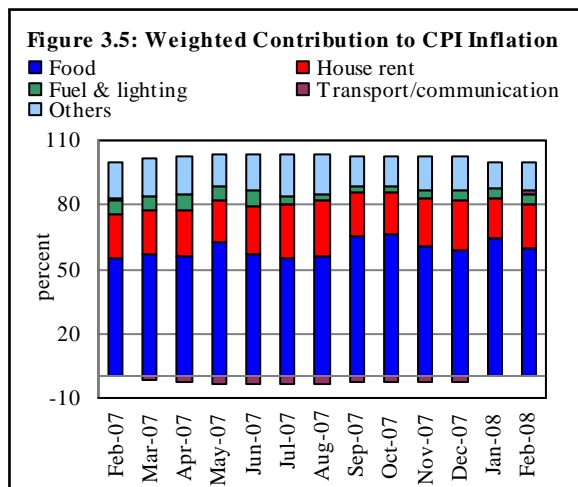
### 3.3 Consumer Price Index (CPI)

CPI inflation remained strong in the first eight months of FY08. CPI inflation (YoY) rose to 11.3 percent in February 2008 from 7.0 percent in June 2007. This upsurge was mainly due to a stubbornly high food inflation that has remained in double digits since September 2007. The pace of increase in non-food inflation has also accelerated in the past few months (see **Figure 3.4**).



Due to persistent high food inflation, the contribution of food group in overall inflation has increased from 55.4 percent in February 2007 to 59.9 percent in February 2008 (see **Figure 3.5**). The high food inflation implies that it is hurting low income groups disproportionately. Although government is providing essential food items at subsidized prices through utility stores, a large segment of deserving population cannot avail this subsidy due to limited outreach of utility stores. Since food prices are likely to remain high in the medium to long-term, the targeted food subsidy program for low income groups needs to be revamped to be more

effective. In addition, private sector's involvement is also necessary as it would be difficult for utility stores to cater all needy people. Moreover, there is an urgent need to increase the productivity of key food staples to ensure smooth domestic supply. It can be achieved through offering appropriate incentives to farming community, increase usage of fertilizer and certified seeds, as well as research and development to develop new high yield varieties.



It is also important to note that frequency distribution of YoY change in the prices of items included in the CPI basket exhibits that number of items on extreme ends, i.e., showing YoY decline or no change and double digit rise, has increased in February 2008 compared to February 2007 (see **Table 3.4**). This phenomenon is more pronounced in CPI food group compared to the non-food group.

**Table 3.4: Distribution of Price Changes of CPI Basket (YoY)**

number of items	Food group		Non-food group	
	Change in percent		Change in percent	
	Feb-07	Feb-08	Feb-07	Feb-08
0 or less	13 (5.2)	20 (8.8)	65 (8.2)	71 (10.9)
0 to 5	18 (8.0)	8 (1.6)	104 (12.6)	69 (8.4)
5 to 10	28 (4.1)	12 (4.8)	52 (28.8)	75 (35.1)
10 or above	49 (22.9)	68 (25.2)	29 (10.1)	35 (5.2)
<b>Total</b>	<b>108</b>	<b>108</b>	<b>250</b>	<b>250</b>

Note: Prices of 16 seasonal items were not reported during the months.

Values in parenthesis are weights.

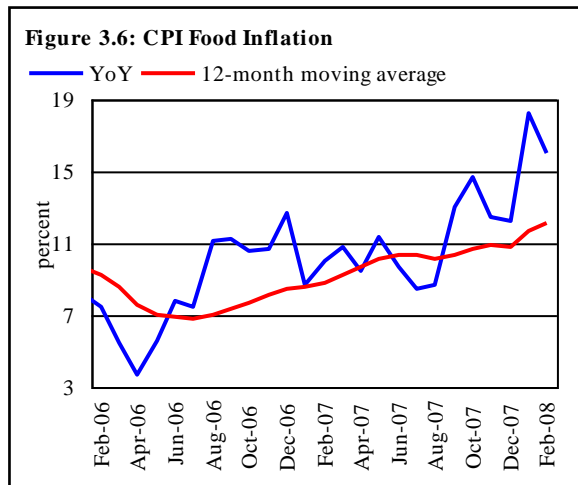
### 3.3.1 CPI Food Inflation

CPI food inflation (YoY) started to strengthen since September 2007 and recorded at 16.0 percent in February 2008 after reaching to a local peak of 18.2 percent during January 2008; the highest level seen since April 1995 (see **Figure 3.6**). This persistence in CPI food inflation reflects the dynamics of international markets as well as factors specific to the domestic economy.

In the domestic markets, the prices of key staples including wheat, rice and edible oil have seen an uptrend throughout FY08. The rise in domestic wheat prices is mainly attributed to speculative hoarding done on the insufficient stocks position of the government. The low level of stocks impaired government's ability to intervene in the market to stabilize the prices. Moreover, since

replenishment of government stocks needed import at substantially higher international prices, hoarders took advantage of the situation. As a result of supply shortages, domestic prices rose to record highs. It is also important to note that continued export of wheat flour to Afghanistan and illegal cross border movement of wheat further aggravated the supply shortages.

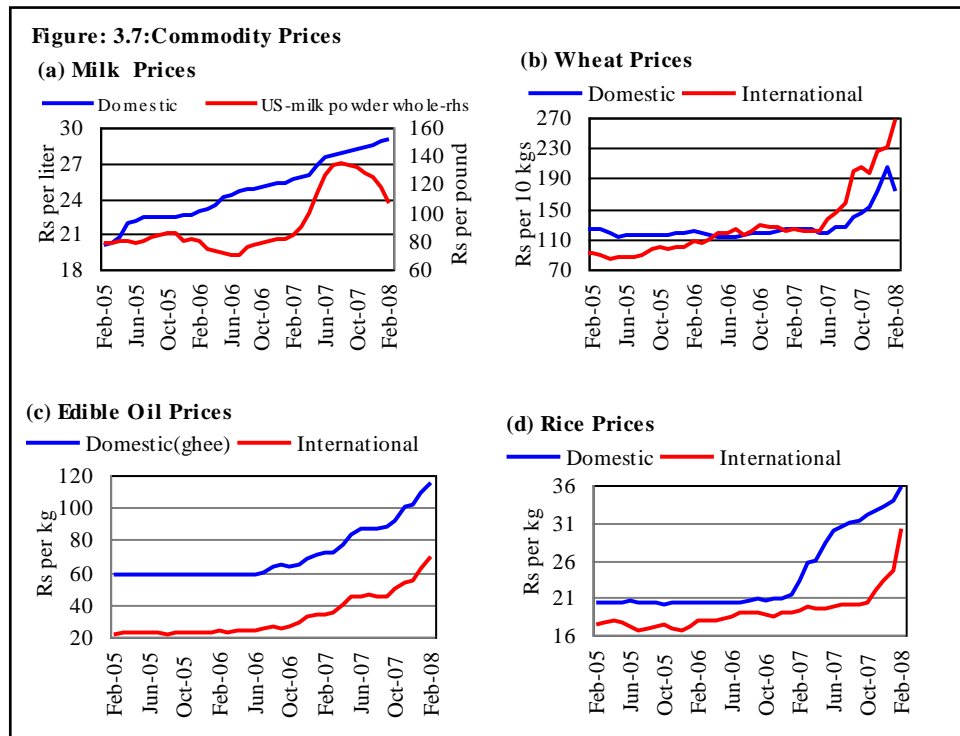
Also, a below-target FY08 rice harvest in Pakistan coupled with strong demand for Pakistani rice in the international market, has resulted in persistent pressure on domestic rice prices. Similarly, high international prices of edible oil has led to an increase in domestic vegetable ghee and oil prices as its production is based on imports from international market (see **Figure 3.7**). It is also important to note that while prices of wheat, edible oil and rice are following the trends of international prices, domestic milk prices are showing a secular uptrend despite a recent downtrend in international prices. This is



**Table 3.5: Top Ten Contribution to YoY CPI Inflation in February 2008 (Ranked by Weighted Contribution in percent)**

Items	YoY change		Weighted Contribution
	Feb-07	Feb-08	
1 House rent index	6.3	10.0	20.7
2 Vegetable ghee	17.1	51.6	13.1
3 Wheat flour	3.3	25.3	11.2
4 Milk fresh	12.3	13.0	8.3
5 Rice	14.8	56.2	6.7
6 Vegetables	-12.3	40.5	6.5
7 Tomatoes	-45.8	190.9	4.5
8 Readymade food	9.4	17.2	2.8
9 Natural gas	1.7	9.7	2.6
10 Cooking oil	11.1	40.9	2.5
<b>Total</b>			<b>78.8</b>

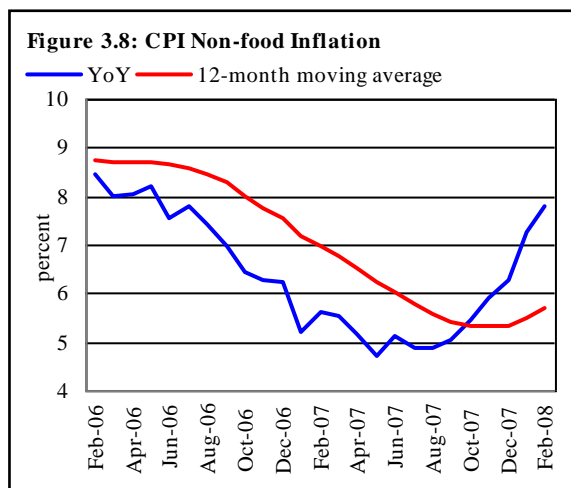
Note: Weighted contribution is estimated by multiplying the weights by the price change of an item; this is then reported as a share in YoY change in CPI, which is 11.3 percent in February 2008.



mainly a reflection of (1) strong domestic demand, (2) an imperfect market structure, (3) lack of storage capacity, as well as (4) limited marketing network due to transportation problems.

It is important to note that the contribution of individual food items in the overall CPI inflation (YoY) has been significant as four out of top five items contributing in overall inflation during February 2008 were from the food group (see **Table 3.5**).

These items which have a cumulative weight of 15.8 percent include wheat flour, vegetable ghee, fresh milk and rice. These food items



contributed half of the overall CPI inflation during February 2008.

### 3.3.2 CPI Non-Food Inflation

In comparison to CPI food inflation (YoY), CPI non-food inflation exhibited a relatively moderate increase in the first eight months of FY08. The YoY CPI non-food inflation rose to 7.8 percent in February 2008, bouncing back from 4.7 percent in May 2007 (see **Figure 3.8** and **Table 3.6**). The recent upsurge in non-food inflation is mainly due to an increase in non-food sub-groups including *house rent, fuel & lighting* and *household furniture & equipment*.

**Table 3.6: CPI Non-food Inflation by Groups (YoY in percent)**

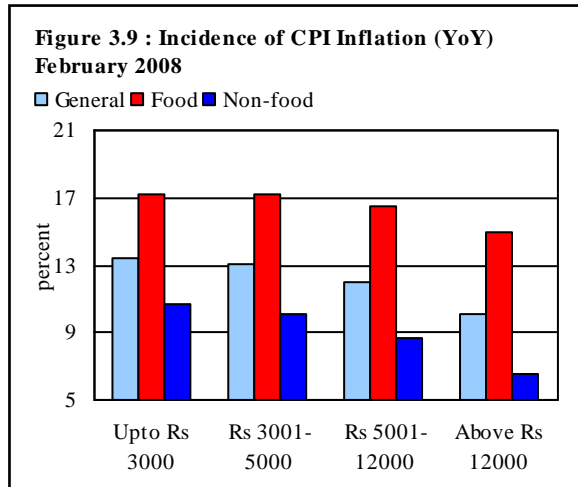
	Weights	Feb-07	Jul-07	Sep-07	Nov-07	Dec-07	Jan-08	Feb-08
<b>Non-food group</b>	<b>59.7</b>	<b>5.6</b>	<b>4.9</b>	<b>5.0</b>	<b>5.9</b>	<b>6.3</b>	<b>7.3</b>	<b>7.8</b>
Apparel, textile & footwear	6.1	6.2	7.4	7.6	8.7	8.7	8.6	6.7
House rent	23.4	6.3	6.9	7.5	8.3	8.8	9.5	10.0
Fuel & lighting	7.3	6.5	2.6	2.7	4.8	5.5	7.4	6.2
Household furniture	3.3	7.5	6.2	6.3	5.9	6.5	6.1	6.3
Transport & communication	7.3	0.9	-3.1	-3.1	-3.1	-3.0	-0.3	3.0
Recreation & entertainment.	0.8	-0.1	0.0	0.0	0.3	0.4	0.5	0.7
Education	3.5	8.3	6.2	4.8	4.3	4.4	4.3	3.4
Cleaning, laundry and others	5.9	4.5	5.0	6.5	8.8	8.9	10.1	13.0
Medicare	2.1	9.3	14.0	7.8	7.9	7.6	7.5	7.9
<b>Headline</b>	<b>100</b>	<b>7.4</b>	<b>6.4</b>	<b>8.4</b>	<b>8.7</b>	<b>8.8</b>	<b>11.9</b>	<b>11.3</b>

It is important to note that inflation recorded by the *house rent index* sub-group has maintained a rising trend throughout FY08 and reached 10.0 percent (YoY) in February 2008 compared to 6.3 percent in the same month last year. This is mainly because of higher prices of bricks (reflecting higher input costs and wage pressures), iron bars & sheets and wires & cables (a consequence of high global metal prices). Despite a substantial upsurge in international oil prices, the government had imposed a freeze on the prices of key POL products during the period under review. Nevertheless, the impact of high international prices has been witnessed in rising prices of furnace oil and various petroleum products, as their prices are directly linked with international prices. The recent upward adjustment in the prices of key fuels during March 2008 would also likely to strengthen the inflationary pressures in the economy.

### 3.3.3 Incidence of Inflation

The contribution of food inflation in overall CPI remained high in the first eight months of FY08, which resulted in a larger incidence of inflation on the low-

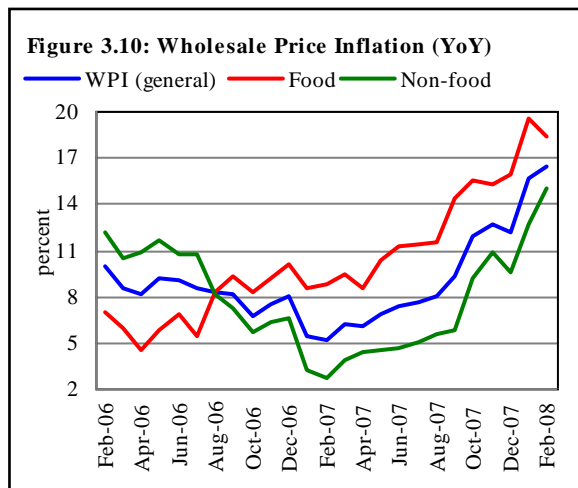
income groups where food staples typically account for a greater proportion of total expenditure (see **Figure 3.9**). Thus in February 2008, the lowest income group (income up to Rs 3000 per month) and middle income group (income Rs 3001 – 5000 per month) witnessed highest inflation of 13.4 and 13.0 percent respectively, followed by 12.0 percent in upper-middle income group (Rs 5001 – 12000) and 10.1 percent for the highest income group (with income above Rs 12000 per month). Food inflation for the lower-middle income group (Rs 3001 – 5000 per month) was the highest, showing that this group is more vulnerable given constraints to avail targeted subsidy through utility stores compared to low income group. This suggests that the government food subsidy program should also consider a part of this group with the lowest incomes with the people eligible under *bachat* card scheme (zakat recipients). Similarly, non-food inflation was higher than overall non-food inflation in lower and two middle income groups in February 2008.



### 3.4 Wholesale Price Index (WPI)

WPI inflation has remained in double digits since October 2007 principally driven by rising international commodity prices. Both, food and non food groups contributed to the rise in WPI inflation. In February 2008, WPI inflation (YoY) exhibited a steep rise and was recorded at 16.4 percent – the highest since February 1995. In particular, WPI food inflation exhibited a sharp

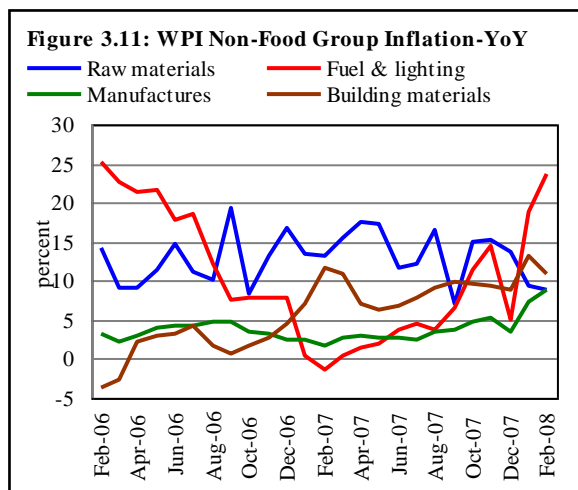
rise and was recorded at 18.3 percent in February 2008 mainly due to a continuous





increase in the prices of food items like rice, maize, vegetable ghee, wheat, fresh milk and cooking oil. Non-food WPI inflation also accelerated to 15.0 percent in February 2008 compared to only 2.6 percent during the same month last year (see **Figure 3.10**).

However, the contribution of food inflation came down to 47.3 percent in February 2008 as compared to 69.9 percent in the same month last year. Accordingly, the contribution of non-food group was recorded at 52.7 percent in February 2008 compared to 30.1 percent in the same month last year. The reason behind the decline in contribution of food group in WPI inflation is a relatively steeper rise in non-food inflation as well as higher weight of non-food in WPI basket (i.e., 57.9 percent). Therefore the impact of non-food WPI inflation is more pronounced in terms of weighted contribution. Within non-food group the weighted contribution of various sub-groups exhibited mixed trends. The weighted contributions of raw material, manufactures and building material sub-groups came down whereas the contribution of fuel, lighting and lubricant sub-group moved up in February 2008 (see **Table 3.7**).

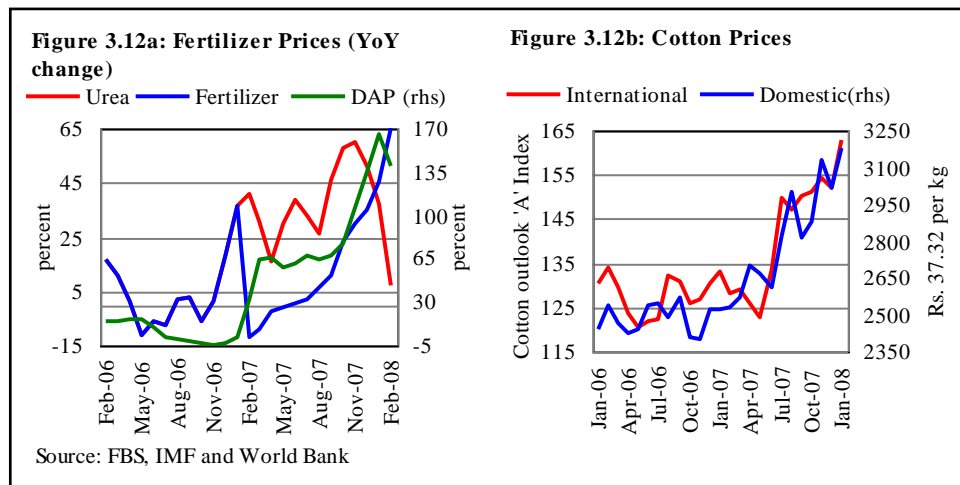


**Table 3.7: Contribution of Sub-indices to WPI Non-food Inflation (in percent)**

	Feb-07	Jun-07	Jan-08	Feb-08
Raw materials	62.3	31.4	10.0	8.1
Fuel, lighting & lubricants	-22.0	34.9	60.4	64.0
Manufactures	22.9	21.4	20.9	21.9
Building materials	36.5	12.1	8.7	6.4

In case of WPI non-food group, components of all sub groups showed uptrend during the first eight months of FY08 except *raw material* sub group (see **Figure 3.11**). The WPI inflation for *fuel, lighting & lubricants* sub-group witnessed a sharp increase and witnessed a rise of 23.5 percent in February 2008. Within this group, coke, mobil oil, furnace oil, fire wood and coal witnessed double digit (YoY) growth.

The wholesale prices of *manufactures* sub-group also displayed significant YoY growth during FY08 and reached at 8.8 percent in February 2008 compared to 1.6 percent during the same month last year. Fertilizers, chemicals, footwear, soaps, plastic products and sole leather experienced double digit YoY growth in their wholesale prices. The *building material* also reflected uptrend during the first eight months of FY08 and reached 10.9 percent in February 2008 mainly due to the historic high metal prices coupled with an increase in the labor wages and bricks prices. The average YoY WPI inflation under *raw material* sub-group decelerated and depicted a lower growth of 8.9 percent during February 2008 compared to 13.1 percent inflation during the same month of 2007.

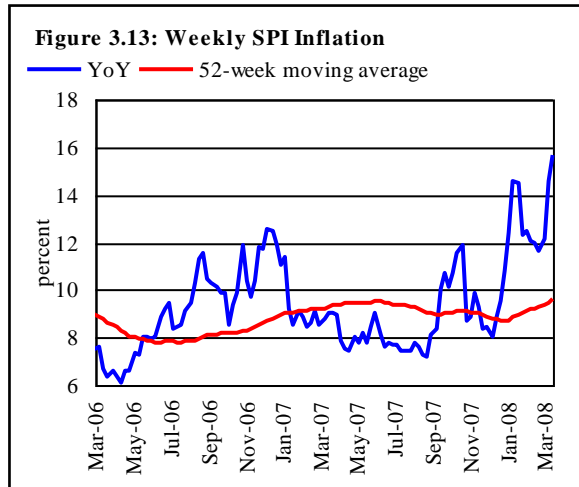


In non-food group, the upward movement in international prices of DAP, urea and cotton were also reflected in the domestic wholesale prices of these commodities (see **Figure 3.12**). During the past few months, DAP and urea prices have continuously been rising due to a strong demand and sharp increase in the cost of phosphate rock in the international market. Phosphate rock is a dominant raw material input for the production of phosphate fertilizers. Therefore, an increase in its price has led to high domestic fertilizer prices. Similarly, both domestic as well international cotton prices have also been on a rising trend mainly due to decline in FY08 harvest in major cotton producing countries.

### 3.5 Sensitive Price Indicator

The SPI covers prices of 53 essential items of daily use (mostly kitchen items and some energy items, e.g., petrol and diesel). The SPI inflation (YoY) accelerated to 12.3 percent in February 2008 as compared to 8.8 percent in February 2007. Similarly, the weekly SPI showed acceleration and was recorded at 15.7 percent in

the second week of March 2008 compared to 12.5 percent in the last week of January 2008. Increase in weekly SPI inflation is mainly due to an increase in the prices of essential items like wheat, rice, LPG, vegetable ghee.



## 4 Money and Banking

### 4.1 Overview

In the light of FY08 targets for inflation and GDP growth, and the risks identified in the Monetary Policy Statement for Jul-Dec 2007, SBP further tightened its monetary policy effective from 1<sup>st</sup> August 2007 (see **Box 4.1**). However, the impact of these policy measures was swiftly eroded by (1) sustained increase in food commodity prices, (2) impact of rising costs of oil products, and (3) a stimulus from expansionary fiscal policies. As a result, during the first half of FY08, inflationary pressures not only gained further strength, but the risks to macroeconomic stability also increased substantially. These risks were particularly evident from higher fiscal and external current account deficits, which turned out to be considerably higher than those envisaged in the monetary policy framework. The worsening of macroeconomic imbalance points to the continued and strong aggregate demand in the economy.

The sheer magnitude of the increase in commodity prices has been particularly unexpected and a disconcerting feature of inflationary pressures in FY08, particularly post-Q1-FY08. Prices of number of commodities (e.g., oil, copper, aluminum, wheat, palm oil, DAP) reached historic highs in FY08.

The impact on rising food inflation in particular has increased inflationary stresses throughout the economy, due to its large share in the consumption basket.

#### **Box 4.1: Key Risks to Monetary Policy in FY08 and SBP's Response**

In line with FY08 targets for GDP growth and inflation (i.e., 7.2 percent and 6.5 percent, respectively), the monetary policy framework envisaged the M2 growth of 13.7 percent for the year. In addition, the Monetary Policy Statement for Jul-Dec 2007 pointed out following key risks and challenges to the monetary policy:

- high and volatile domestic food inflation and its possible second round impact on the broader economy,
- continued strength in international oil prices and its likely pass through on the domestic inflation,
- possible monetization of fiscal deficit in case of delays in external financing receipts, and
- impact of an exceptional rise of 19.3 percent in M2 growth during FY07.

In response, SBP took several monetary and other measures, for example,

- raising the policy rate by 50 bps to 10 percent effective from August 1, 2007,
- recommending the government to retire borrowings from the SBP by Rs 62.3 billion during FY08, and
- capping the refinancing of concessional loans to exporters.

Similarly, the expected strength<sup>1</sup> in international oil prices significantly added to domestic inflation.<sup>2</sup>

Rise in food prices, due to supply problems and/or market inefficiencies, can clearly be better tackled through fiscal and administrative measures.

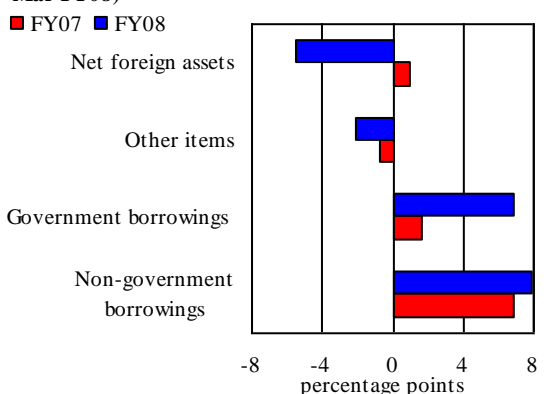
However, given evidence that the steep rise in food prices was driving a second round inflationary cycle, continued monetary tightening was essential. It is important to note that without the sustained monetary tightening, it is likely that headline inflation would be considerably higher.

The rising fiscal deficit and its financing also posed severe complications for the Monetary Policy Framework for FY08.<sup>3</sup> Besides adding to aggregate demand pressures in the economy, the increased financing of the fiscal deficit from domestic sources has led to a sharp rise in budgetary borrowings from the central bank—the most inflationary in nature. The borrowings from SBP reached Rs 359.3 billion

**Table 4.1: Deficit Financing (Jul-Dec)**

billion Rupees		
	FY07	FY08
Deficit	169.0	356.3
<b>Financing</b>		
External	96.2	68.0
Domestic	72.7	288.3
Non-bank	25.3	58.0
Bank	31.5	228.6
Privatization proceeds	15.9	1.7

**Figure 4.1: Contribution to M2 Growth (Jul-1st Mar FY08)**



<sup>1</sup> Although the monetary framework anticipated pressures on oil prices in the global markets, the extent of the rise in oil prices was far beyond expectations.

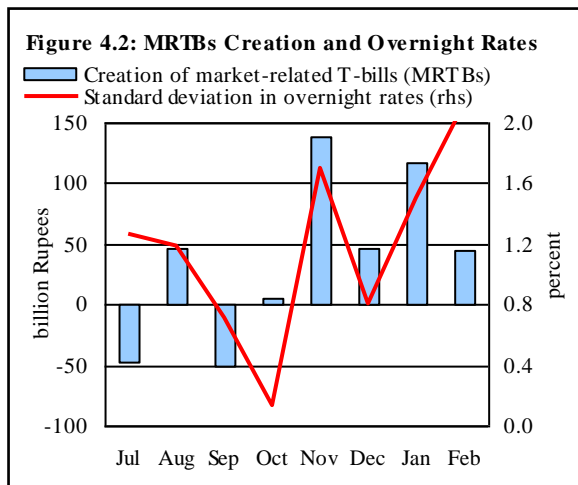
<sup>2</sup> While the government insulated the economy from a part of the rise in international oil prices, by freezing domestic prices of some products (diesel and petrol), the prices of most petroleum products and derivatives were unregulated.

<sup>3</sup> The fiscal deficit during Jul-Dec FY08 was significantly higher than that in the corresponding period of the preceding year (see **Table 4.1**), and if current trends continue, the full-year fiscal deficit would breach the target for FY08 (i.e., 4.0 percent of GDP).

during Jul-1<sup>st</sup> Mar FY08, instead of the net retirement of Rs 62.3 billion recommended in the Monetary Policy Statement for Jul-Dec FY08. The sharp rise in budgetary borrowings was major driving force behind the high annualized M2 growth of 17.6 percent YoY as on 1<sup>st</sup> Mar 2008 (see **Figure 4.1**). This is a source of concern for SBP as it has the potential to add to the demand pressures in the economy going forward.

One major reason for excessive government borrowings is the shortfall in external financing flows.<sup>4</sup> However, it is important to note that (a) the rise in budgetary borrowings from central bank was greater than the decline in external financing receipts, and therefore (b) even if the projected external financing is realized and the government uses these to retire its budgetary borrowings from the central bank, this would not reduce the monetary overhang created by monetization of the high budget deficit.<sup>5</sup> In other words, it is important for the government to reduce its fiscal deficit, if monetary growth is to be contained.

These excessive borrowings from the central bank also posed difficulty in liquidity management by SBP (as reflected in higher volatility of overnight rates (see **Figure 4.2**).<sup>6</sup> The liquidity injections from unpredictable government borrowings weakened the transmission of the rise in policy rate to the retail rates (as reflected in softening of KIBOR).<sup>7</sup> The widening fiscal deficit



<sup>4</sup> In particular, uncertainties due to domestic political noise and the adverse impact of sub-prime mortgage crisis on global financial markets led to delays in privatization (through GDRs etc.)

<sup>5</sup> In case, if the government retires central bank's borrowings using external finance receipts, this will simply result into a substitution of SBP's NDA with SBP's NFA, with no impact on the reserve money. Thus, the monetary impact of the budgetary financing from the central bank and from external sources is identical.

<sup>6</sup> Although the fall in effective CRR during Jul-Feb FY08 was also adding to the market liquidity, the excessive government borrowings from the central bank was the dominant factor that even offset the impact of (a) a deceleration in the non-government deposit growth, (b) liquidity absorption through export refinance, (c) net foreign exchange outflows reflecting rising current account deficit, (d) SBP's market support, and (e) strong private sector credit demand.

<sup>7</sup> During Aug-Dec FY08, 6-month KIBOR declined by 26 bps.

coincided with the growing current account gap.<sup>8</sup> This unexpected worsening of country's external account was challenging for SBP because the evidence of high aggregate demand pressures evident in the persistent rise in current account deficit and its financing raises questions on the macroeconomic sustainability. And if not responded adequately, these could adversely impact growth outlook of the economy.<sup>9</sup> The impact of external account deficit on exchange rate may even add to inflationary pressures and expectations in the economy.

The available evidences suggest that the external account stress is not likely to ease in the short-term,<sup>10</sup> and therefore a prompt policy response, aiming at reducing expenditures through a mix of monetary and fiscal policies, is essential.<sup>11</sup> But with expansionary fiscal policy being one of the sources for higher current account deficit,<sup>12</sup> responsibility of containing external account pressures falls disproportionately on the monetary policy.<sup>13</sup>

Rising macroeconomic imbalances clearly risked further stoking inflationary pressures in the economy (as seen in the steady increase in core inflation), raising a threat to Pakistan's economic growth prospects in medium to long-term. Thus, SBP responded aggressively by further raising its policy discount rate by 50 bps to

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<sup>8</sup> Current account deficit increased sharply by 47.1 percent during Jul-Jan FY08 on YoY basis. In terms of GDP, this stands at 4.8 percent during Jul-Jan FY08 period, significantly higher than 3.6 percent during the corresponding period of previous year.

<sup>9</sup> The balance of payments difficulties may even constrain long run economic growth. For example, as the rise in export growth is the major sustainable mean to finance higher import demand, unsustainable deficit in the balance of payments constrains economic growth through restraining import demand (resulting from expansion in domestic economic activity).

<sup>10</sup> While the imminent slowdown in the US economy and its spillover to other export markets as well as the impact of domestic power shortages will hold back growth in exports, the continued strength of commodity prices in the global markets would likely to keep the import bill inflated.

<sup>11</sup> Since the monetary and fiscal policies are significant determinants of the current account balance, (see **Box 7.2** in *SBP Annual Report for FY07*), the monetary tightening aimed at correcting current account deficit should be accompanied by improved fiscal discipline.

<sup>12</sup> The government's decision to prevent *direct* pass through of higher international oil prices to domestic consumers had two major implications: (1) domestic demand for petroleum products remained intact, thus making their imports relatively less responsive to rising prices in the international markets, and (2) the government's decision to prevent *direct* pass through of higher international oil prices to domestic consumers has made import demand of POL products relatively less responsive to rising prices in the international markets, thereby maintaining pressures on aggregate demand in the economy.

<sup>13</sup> It is expected that (a) the reduction in domestic demand pressures following the monetary tightening would help easing pressures on import demand, (b) moderation in inflationary pressures would improve international price competitiveness of exports, and (c) commitment for achieving macroeconomic stability would reduce perceived risks to the economy and improve credit worthiness, thus easing external financing constraints.

10.5 percent and the cash reserve requirement of the banking system by 100 bps on current deposits effective from 1<sup>st</sup> February 2008.

The monetary policy can best contribute to long run economic growth by creating an environment with a stable price level or a low and predictable rate of inflation (see **Box 4.2**).<sup>14</sup> In the medium-term, stable prices also help in moderating the fluctuations in output. Addressing widening macroeconomic imbalances becomes essential as these not only add to inflationary pressures, but also harm economic growth prospects.

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**Box 4.2: Price Stability and Economic Growth**

Price stability not only complements the GDP growth and employment generation in the long-run but also moderates the fluctuations in output and employment in the medium-run. This is because:

Firstly, low and stable price level provides the corporate sector with an environment where the economic agents can make their decisions without the fear of unexpected fluctuations in the purchasing power of the domestic currency. High and fluctuating price level distorts the market signals emitting out of the price mechanism by confusing both the producers and the consumers in differentiating between the changes in prices due to supply and demand conditions or due to changes in the general inflation. Thus, the increase in *noise* attached with the high levels of inflation oppresses the effectiveness of the market economy thereby making the incentive structures for the economic agents complicated where more resources are diverted towards hedging the risks associated with high levels of inflation.

Secondly, some recent empirical studies have concluded that low and stable level of general price level not only contributes to the economic growth and employment but also ensures greater stability in output and employment in the short to medium-run.<sup>15</sup> Moreover, price stability for a long period leads to low, stable and well anchored inflation expectations by the economic agents-granting freedom to the central bank to fix different disorders in the broader economy.

Thirdly, interest rate movements in an economy generally respond to the changes in inflation expectations because the lenders incorporate the costs associated with the loss in purchasing power of the principal amount in their lending decisions. When inflationary expectations are low, the rental cost of money will automatically go down due to low rate of purchasing power erosion-leading the real interest rates in the economy to go down. Moreover, with stable prices, not only the risks associated with holding long-term bonds and securities will be lower but will also reduce the premium on bearing that risk by the lender. It will lead to a declining interest rate scenario ensuring greater scope for the private sector to invest.

The importance of low and stable inflation in achieving high long-run growth also provides a cornerstone for monetary and fiscal policy coordination. It is therefore essential that government improves its fiscal discipline and retire its borrowings from the central bank as recommended in the monetary policy framework.

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<sup>14</sup> For example, the resulting strength of pricing signals contributes towards a better resource allocation in the economy.

<sup>15</sup> For further details, see Bernanke, B.S (2006) “Benefits of Price Stability” Center for economic policy studies, Princeton University, Princeton.



Otherwise, the time path for achieving a stable and low inflation would be extended, thus raising the cost of adjustment for other economic agents.

Limiting government borrowings is also important. Otherwise, more aggressive SBP's efforts to contain M2 growth to its indicative target of 13.7 percent for FY08 would crowd out the private sector credit. So far this has been avoided. Available data suggests that the private sector credit has grown by 11.7 percent during Jul-1<sup>st</sup> Mar FY08; slightly higher than the corresponding period last year. The demand for working capital is on the rise as (1) delays in the settlement of price differential claims led IPPs and OMCs to resort to financing from bank sources for their working capital requirements, and (2) a sharp surge in raw material prices, both in the domestic and global markets, had pushed up the credit demand from the corporate sector.

Although the demand for fixed investment loans moderated in a number of industries, this is more a reflection of the fact that some industries had already expanded their activities in recent years, whereas others are using foreign currency loans & investments and floatation of debt instruments in the domestic market.

## 4.2 Monetary Survey

Growth in broad monetary aggregate (M2) slowed to 7.1 percent during Jul-1<sup>st</sup> Mar FY08 compared to 8.7 percent during the corresponding period of FY07 (see **Table 4.2**). This M2 growth stemmed entirely from a sharp rise in Net Domestic Assets (NDA) of the banking system due to high government

borrowings. Net Foreign Assets (NFA) of the banking system registered a net contraction mainly reflecting weakness in country's external account.

**Table 4.2: Monetary Survey (Jul-1<sup>st</sup> Mar)**

billion Rupees				
	Absolute flows		Growth	
	FY07	FY08	FY07	FY08
<b>Government borrowing</b>	57.3	277.7	6.8	30.0
For budgetary support	94.0	296.6	13.1	36.6
SBP	25.6	359.3	6.4	104.2
Scheduled banks	68.4	-62.8	21.8	-13.5
Commodity operations	-36.5	-18.2	-33.9	-18.4
<b>Credit to non-govt sector</b>	232.3	320.5	10.6	12.4
Private sector	237.0	289.3	11.2	11.7
Credit to PSEs	-5.0	31.5	-8.3	39.1
<b>Other items (net)</b>	-25.2	-86.0	8.3	20.3
SBP	44.2	-21.0	-22.5	10.2
Scheduled banks	-69.4	-65.0	63.4	29.9
<b>NDA</b>	264.3	512.3	9.7	16.6
SBP	69.6	337.4	32.0	223.9
Scheduled banks	194.7	174.9	7.8	6.0
<b>NFA</b>	31.4	-223.4	4.6	-22.7
SBP	30.1	-142.4	5.3	-18.1
Scheduled banks	1.3	-81.1	1.1	-41.2
<b>M2</b>	295.8	288.8	8.7	7.1
<i>YoY M2 growth</i>			14.0	17.6

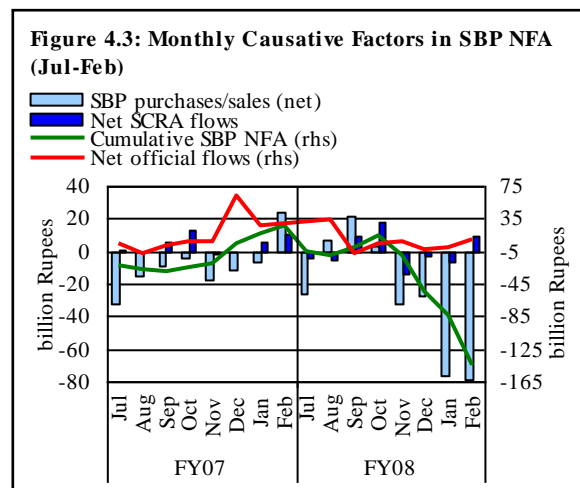
The YoY M2 growth as on 1<sup>st</sup> March 2008 however remained higher at 17.6 percent compared to 14.0 percent YoY growth as on 3<sup>rd</sup> March 2007. This suggests that meeting the indicative target of 13.7 percent for M2 during FY08 would be a major challenge for the central bank.

#### 4.2.1 Net Foreign Assets (NFA)

NFA of the banking system registered a net contraction of Rs 223.4 billion during Jul-1<sup>st</sup> Mar FY08 compared to an expansion of Rs 31.4 billion during the corresponding period previous year. This contraction in NFA is attributable to domestic political unrest, pressures on commodity prices in the international markets and the global implications of the sub-prime mortgage crisis in the US economy.<sup>16</sup>

Within the banking system, contraction in SBP's NFA was higher compared to the scheduled banks. Delays in issuance of GDRs, lower logistic support receipts and SBP's decision to provide foreign exchange to support a part of oil payments (even when the oil prices are at their historic high levels) explain the current decline in SBP's NFA (see **Figure 4.3**).<sup>17</sup>

Similarly, scheduled banks' NFA registered a net decline of Rs 81.1 billion during Jul-1<sup>st</sup> Mar FY08 compared to an expansion of Rs 1.3 billion during the corresponding period last year. Despite substantial rise in the workers' remittances,<sup>18</sup> decline in the net foreign



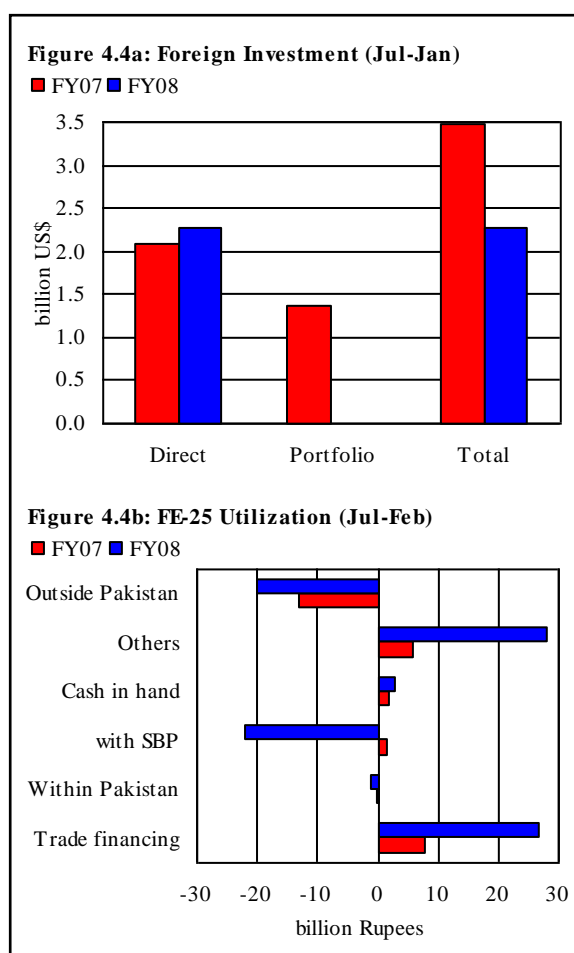
<sup>16</sup> The domestic political problems have led to a slowdown in exports, outflow of foreign assets from the country, and delays in the privatization. The liquidity problems in the international financial markets following sub-prime mortgage crisis in the US economy has made external financing more difficult. At the same time, the economic slowdown in key markets has reduced the demand for Pakistan's exports.

<sup>17</sup> The SBP NFA for Jul-Feb period of FY07 included US\$ 731 million mobilized through issuing OGDCLs GDRs.

<sup>18</sup> Workers' remittances increased by US\$ 4.1 billion during Jul-Feb FY08 compared to US\$ 3.4 billion during the same period FY07.

investment (see **Figure 4.4 (a)**) and slowdown in foreign private loans<sup>19</sup> are the major factors responsible for contraction in scheduled banks' NFA.<sup>20</sup>

Furthermore, the trade financing availed by importers due to a rising interest rate differential between the Rupee and foreign currency loans led to a sharp decline in the scheduled bank's NFA (see **Figure 4.4 (b)**). More specifically, during Jul-Feb FY08, trade sector availed Rs 26.7 billion worth foreign currency loans compared to Rs 7.9 billion during the Jul-Feb FY07. It is important to note that this decline in scheduled banks' NFA was despite an increase of Rs 25.3 billion in Resident Foreign Currency Deposits (RFCDs) during Jul-1<sup>st</sup> Mar FY08 against the increase of just Rs 1.7 billion during the same period last year. Had this increase in RFCDs not taken place, scheduled banks' NFA would have shown an even larger contraction.



#### 4.2.2 Net Domestic Assets (NDA)

Due to a phenomenal rise in government sector borrowings from the banking system, net domestic assets of the banking system registered a strong growth of

<sup>19</sup> Foreign private loans witnessed a sharp slowdown as economy received only US\$ 127 million during Jul-Jan FY08 in this category compared to US\$ 191 million during the same period last year.

<sup>20</sup> The scheduled banks NFA for Jul-Feb FY07 included the impact of GDR issued by one of the private banks as well of foreign currency bond issued by one of the corporates in the Telecom sector.

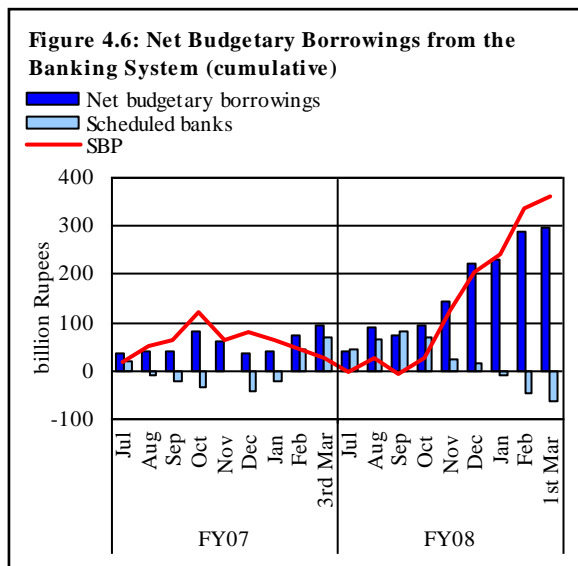
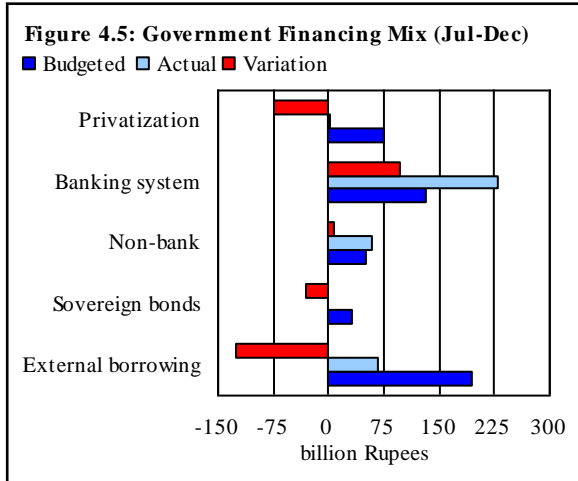
16.6 percent during Jul-1<sup>st</sup> Mar FY08 compared to the growth of 9.7 percent during corresponding period of FY07. Growth in private sector credit however remained at 11.7 percent during Jul-1<sup>st</sup> Mar FY08, only slightly higher than 11.2 percent growth during the corresponding period last year.

Credit to the public sector enterprises also contributed to the current rise in NDA by registering a growth of 39.1 percent during Jul-1<sup>st</sup> Mar FY08 in contrast to the negative growth of 8.3 percent during the corresponding period last year. This growth in the credit to the PSEs is attributable to delays in settlement of oil price differential<sup>21</sup> claims of one public sector oil marketing company (OMC), and the credit extension to the electricity distribution companies.

### **Government Budgetary Borrowings**

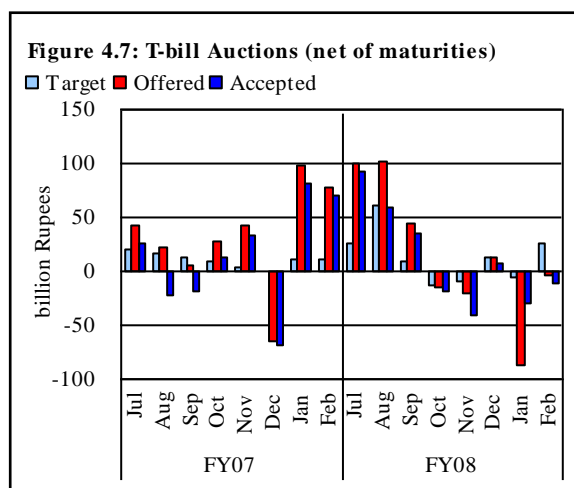
Government budgetary borrowings from the banking system rose sharply by Rs 296.6 billion during Jul-1<sup>st</sup> Mar FY08 against Rs 94.0 billion during the corresponding period last year. It indicates that during first eight months of the current fiscal year,

government has borrowed Rs 165.6 billion in excess of its full year banking sector borrowings target of Rs 131.0 billion.



<sup>21</sup> Differential is between the international oil prices and the domestic consumer prices.

The above target government sector borrowings from the banking system are the result of multiple factors. These include, (1) slower growth in tax revenues, (2) a higher growth in government expenses, (3) less than expected external inflows for budgetary finance, and finally (4) the fall in the receipts of logistic support funds.<sup>22</sup> As a result, government borrowings rose substantially from both the bank and the non-bank sources (see **Figure 4.5**).



However, what is more worrying for the monetary policy is the fact that the government has relied heavily on borrowings from SBP. This, being the most inflationary, may further worsen inflationary expectations.

**Table 4.3: SBP Open Market Operations (Jul-Feb)**

	Injection	Absorption
FY07	47.0	658.4
FY08	68.4	718.4

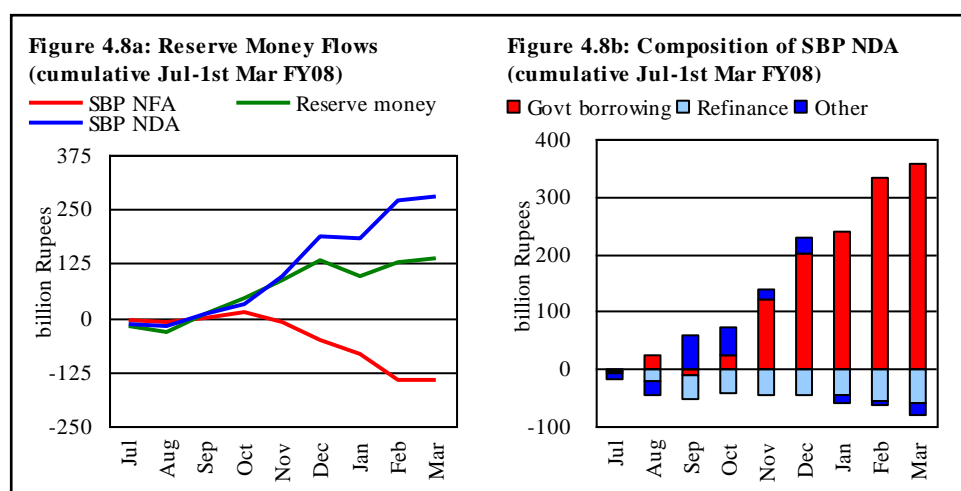
On the other hand, government has retired Rs 62.8 billion to commercial banks during Jul-1<sup>st</sup> Mar FY08 (see **Figure 4.6**).

It may be pointed out that the government had borrowed substantially from the scheduled banks during Q1-FY08. This trend however changed completely second quarter and onwards when scheduled banks showed little interest in the T-bill auctions.<sup>23</sup> This probably reflect strong seasonal demand for private sector credit (as well as attractive returns on private sector loans) and lower growth of non-government deposits. In addition, the expectations regarding changes in discount rate in the monetary policy statement for H2-FY08 also limited the

<sup>22</sup> Pakistan has received US\$ 281.7 million under logistic support during Jul-Feb FY08 compared to US\$ 722.0 million received during the corresponding period of FY07.

<sup>23</sup> SBP did not increase the cut-off rates significantly from September FY08 onwards because of the narrowing differential between T-bill cut off rates and the discount rate.

scheduled banks' participation in the auctions of the government securities (see **Figure 4.7**).<sup>24</sup>



As a result, scheduled banks did not choose even to rollover their investments in the T-bills during Q2-FY08.

Despite exceptional rise in government borrowings from the central bank, the reserve money growth fell 11.3 percent during Jul-1<sup>st</sup> Mar FY08, compared to the exorbitant 15.5 percent during the corresponding period of FY07 (see **Figure 4.8**). This was possible due to the net retirement under the refinance facility, a sharp decline in SBP NFA and net higher absorption by SBP in open market operations (see **Table 4.3**).

#### **Private Sector Credit (net)**<sup>25</sup>

Private sector credit growth remained slightly higher during Jul-1<sup>st</sup> Mar FY08

**Table 4.4: Growth in Private Sector Credit**

percent		
	FY07	FY08
Private sector credit	11.2	11.7
minus the impact of circular debt	11.2	11.2
Business sector advances*	13.0	13.7
Working capital	14.6	19.6
Fixed investment	6.7	0.5
Trade loans	19.9	21.0

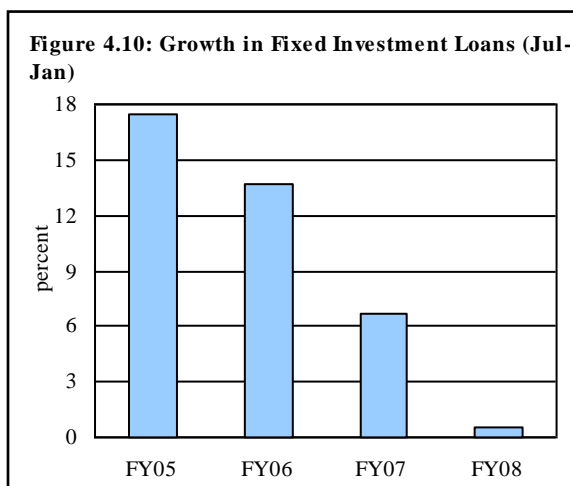
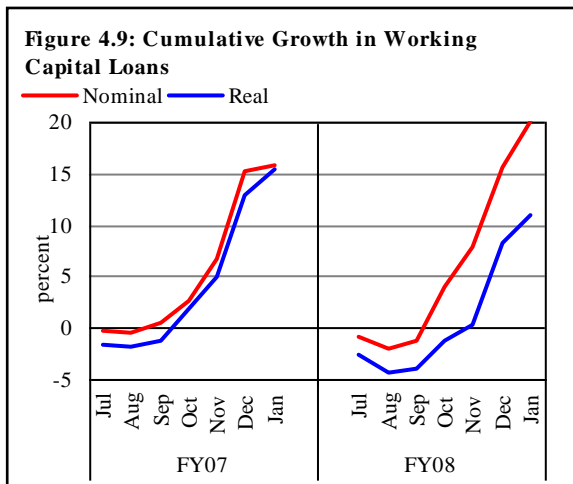
\*pertains to Jul-Jan period

<sup>24</sup> It is important to note that the government deposits with scheduled banks have reached Rs 26.2 billion by 1<sup>st</sup> March 2008. Since the budgetary borrowings from the banking system are reported in net terms, these deposits have actually depressed overall budgetary borrowings accordingly.

<sup>25</sup> Private sector credit comprises of banks' investments and advances to the corporate sector. The data on private sector credit is based on monetary survey covering the period of Jul-1<sup>st</sup> Mar FY08.

compared with corresponding period of the previous year (see **Table 4.4**). Although delays in settlement of price differential claims of OMCs<sup>26</sup> and IPPs<sup>27</sup> have somewhat inflated the demand for working capital. The adjusted credit off-take remains strong at 11.2 percent during Jul-1<sup>st</sup> Mar FY08.<sup>28</sup>

A look on advances to private sector suggests that a part of resilience in private sector credit is due to a sharp surge in raw material prices (both in the domestic and global markets) that has pushed up the credit demand from the corporate sector. This is evident from higher growth of working capital loans<sup>29</sup> during Jul-Jan FY08 in a number of industries (such as edible oil, cement, rice processing and construction) for Jul-Jan FY07 period. The impact of higher raw material



<sup>26</sup> The government has been providing the oil price differential (between the international oil prices and the domestic consumer prices) to OMCs. However, in recent months, following cash flow problems due to delays in settlement of price differential claims, OMCs had to borrow (against the government guarantee) from the banking system. Out of total amount disbursed to OMCs (i.e., Rs 33.0 billion), Rs 27.0 billion was disbursed to a public sector entity which is not included in the reported private sector credit data.

<sup>27</sup> In case of IPPs, delays in settlement of claims with WAPDA led to an increase in their demand for working capital.

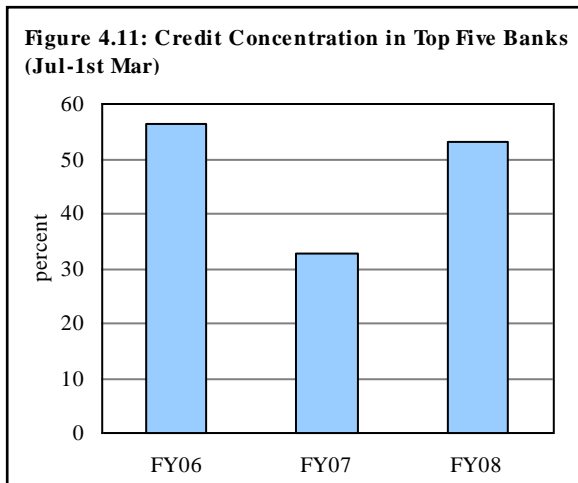
<sup>28</sup> Anecdotal evidence suggests that delays in settlement of claims with WAPDA also had subsequent effect on higher demand for credit by few refineries. However, this rise in working capital demand by refineries could not be adjusted due to data limitations.

<sup>29</sup> This includes trade financing and working capital loans.

prices on private sector credit demand is also captured in the large variance between real and nominal demand for working capital loans during Jul-Jan FY08 (see **Figure 4.9**).<sup>30</sup>

It appears that demand for fixed investment loans has moderated in a number of industries (see **Figure 4.10**). However, this does not necessarily suggest a slowdown in economic activities as (a) the moderation in fixed investment demand in *cement*, *construction* and *textile* is more of a reflection of the fact that these industries had already expanded their capacities in recent years; and (b) some of the industries are financing their expansion projects through other sources, such as foreign currency loans (e.g., telecom), foreign investments (telecom, chemical) and floatation of debt instruments (e.g., chemical, cement, real estate and ship yard) in the domestic market. Further, the demand for fixed investment is expected to grow substantially in the power and refinery sector.<sup>31</sup>

It is encouraging that the private sector is issuing more debt instruments (e.g., privately placed Sukuks and TFCs). Anecdotal evidence suggests that apart from supplementing the total credit availability to the private sector, the financing from NBFIs, in some of the cases, is substituting the bank loans. The latter has an offsetting impact on the overall credit from the banking system.



Another interesting observation is the higher concentration of lending activities within a few banks, as reflected in the rising share of large five banks in the incremental credit extended during Jul-1<sup>st</sup> Mar FY08 (see **Figure 4.11**).<sup>32</sup> This probably reflects the lower credit to deposit ratio, particularly of the large banks, that provided them room to extend more credit. On the other hand, some of the banks have become more vigilant while extending loans probably due to (1) rising

<sup>30</sup> The stock of working capital loans has been deflated by the WPI index for non-food group.

<sup>31</sup> It is expected that financial closure of more power projects would realize in the next fiscal year, and some of the refineries would raise funds from banking sector to undertake their expansion activities.

<sup>32</sup> Banks have been classified according to their asset size.



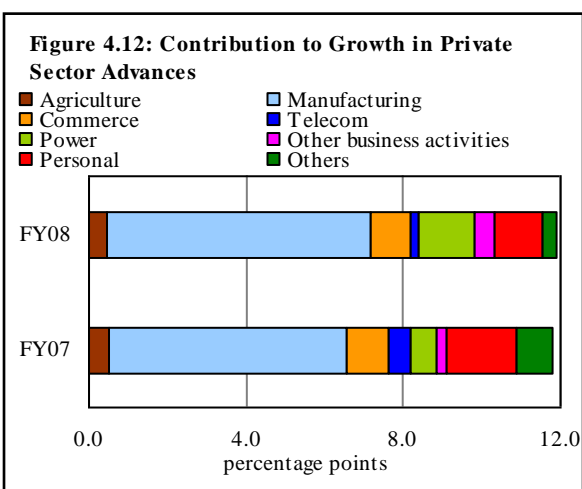
recovery issues as a result of bad debts and write-off, especially in consumer loans, and (2) limits on capital requirements (a few smaller banks have curtailed aggressive lending to remain within their capital adequacy limits).

**Private Sector Advances (net)**<sup>33</sup>  
Private sector advances witnessed a growth of 11.9 percent during Jul-Jan FY08, almost unchanged from the corresponding period last year (see **Table 4.5**). *Manufacturing, power and other private business* made major contribution in the net advances growth. In contrast, contribution from *telecom, construction, personal and others* was significantly lower during Jul-Jan FY08 compared to the corresponding period of FY07 (see **Figure 4.12**).<sup>34</sup>

In the *power sector*, the demand for advances (both for working capital and fixed investment) was significantly higher during Jul-Jan FY08.

**Table 4.5: Private Sector Advances (Jul-Jan)**

growth in percent		
	FY07	FY08
<b>1. Private sector businesses</b>	<b>13.0</b>	<b>13.7</b>
<b>A. Agriculture</b>	<b>7.2</b>	<b>6.9</b>
<b>B. Manufacturing</b>	<b>12.9</b>	<b>14.7</b>
Textiles	8.1	19.1
Paper and products	55.6	20.0
Fertilizer	20.8	-0.8
Cement	14.6	3.2
Edible oil	7.5	8.5
Basic iron & steel	56.7	26.0
Rice processing	26.4	74.9
<b>C. Electricity, gas and water supply</b>	<b>63.9</b>	<b>73.9</b>
<b>D. Construction</b>	<b>24.2</b>	<b>19.4</b>
<b>E. Commerce and trade</b>	<b>11.0</b>	<b>10.8</b>
<b>F. Transport, storage &amp; communications</b>	<b>17.3</b>	<b>5.7</b>
<b>G. Real estate, renting and business activities</b>	<b>6.6</b>	<b>11.8</b>
<b>F. Other private business n.e.c</b>	<b>15.5</b>	<b>-20.4</b>
<b>2. Personal</b>	<b>10.0</b>	<b>6.7</b>
Consumer financing	10.4	6.6
<b>Private sector advances</b>	<b>11.8</b>	<b>11.9</b>



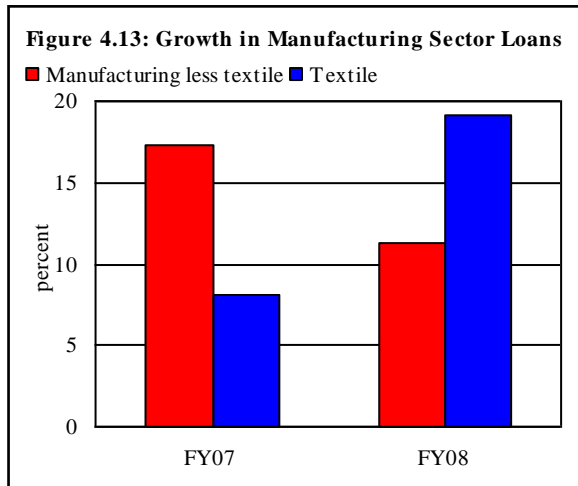
<sup>33</sup> This section is based on data on private sector loans as per the classification under International Standard Industrial Classification and is available up to January 2008. The said data will not tally with the credit data reported in monetary survey as the latter includes banks' investments in equities of private business sector as well.

<sup>34</sup> Other sectors mainly include business sector loans which are not specified elsewhere. As some of the loans included in the category were reclassified, this led to a sharp reduction during Jul-Jan FY08.

Indeed, the rise in working capital loans incorporated the impact of delays in payment from WAPDA to IPPs, whereas growth in fixed investment loans reflects the impact of capacity expansion in private sector power projects.

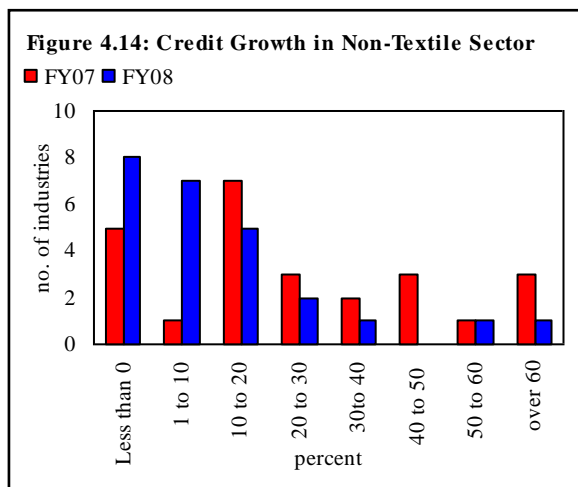
#### Manufacturing

Growth in advances to the manufacturing sector rose to 14.7 percent during Jul-Jan FY08 from 12.9 percent in Jul-Jan FY07. This higher growth was mainly driven by higher advances to the textile sector; excluding the textile industry, the growth in advances to manufacturing sector has decelerated (see **Figure 4.13**).



#### *Advances to non-textile sector*

Slowdown in advances to non-textile sub-sector is broad-based and mainly came from lower demand for fixed investment loans and for working capital loans (see **Figure 4.15**).<sup>35</sup> The growth in trade-related loans to non-textile sectors (particularly in *basic chemicals, cement and fertilizer sectors*) however accelerated during Jul-Jan FY08, reflecting increased trade activity during the period under review.

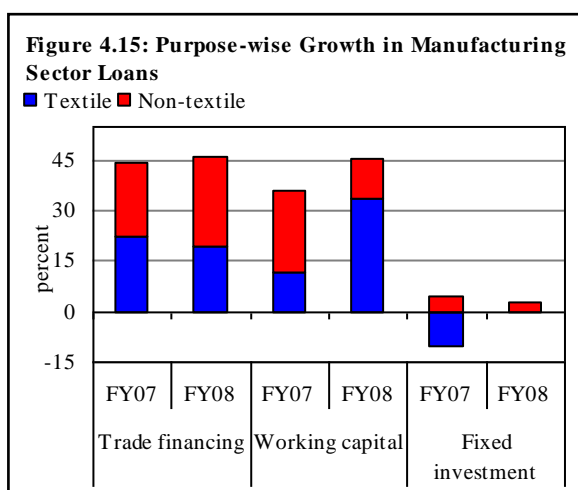


<sup>35</sup> The number of industries showing net retirement has increased in Jul-Jan FY08 (see **Figure 4.14**).

Slowdown in working capital loans in *edible oil*,<sup>36</sup> *basic iron and steel*, *machinery of domestic appliances* and *weaving apparel* reflects mainly the dismal industrial activities in these sectors during Jul-Jan FY08. In the fertilizer sector, the deceleration in the working capital loans was largely due to lower prices of natural gas.<sup>37</sup>

Growth in working capital advances to *refining petroleum products* also decelerated, but this still remains strong at 87.0 percent during Jul-Jan FY08, probably due to delays in settlement of claims with the OMCs. Demand for working capital loans however rose in a number of industries, for example *rice processing*, *medicinal and pharmaceutical products*, *electrical distribution and control apparatus*, *cement*, and *paper industry*. In the case of rice processing, the rising demand for working capital was mainly due to increased domestic prices of rice.<sup>38</sup> Higher demand from the pharmaceutical industries was primarily a reflection of increased production on account of measures taken by the government in form of duty slash on raw material imports.<sup>39</sup>

In case of fixed investment loans, deceleration in many industries partly reflects (1) large repayments in some sectors (e.g., following a substantial disbursement for capacity enhancement in past few years, net retirement in cement sector was to be expected) and (2) substitution of expensive bank loans with local bond issuances (e.g., a swap of banks' credit with a debt instrument by one of the large paper manufacturer).



<sup>36</sup> As Pakistan imports a substantial quantity of edible oil, the domestic industry is sensitive to international prices of edible oil.

<sup>37</sup> The gas prices during Jul-Jan FY08 fell by 9.3 percent compared to a rise of 24.2 percent last year.

<sup>38</sup> On average, retail rice prices increased within a range of 42-58 percent under different categories during Jul-Jan FY08.

<sup>39</sup> For details, see **section 2.2 on Large Scale Manufacturing**.

*Advances to textile sector*

Growth in advances during Jul-Jan FY08 was largely visible in working capital loans, mainly to the spinning industry.<sup>40</sup>

Specifically, the advances to the spinning industry (see **Figure 4.16**) registered a robust growth of 42.1 percent during Jul-Jan FY08 compared with 9.8 percent increase in Jul-Jan FY07, reflecting a rise in domestic raw cotton prices (see **Table 4.6**).

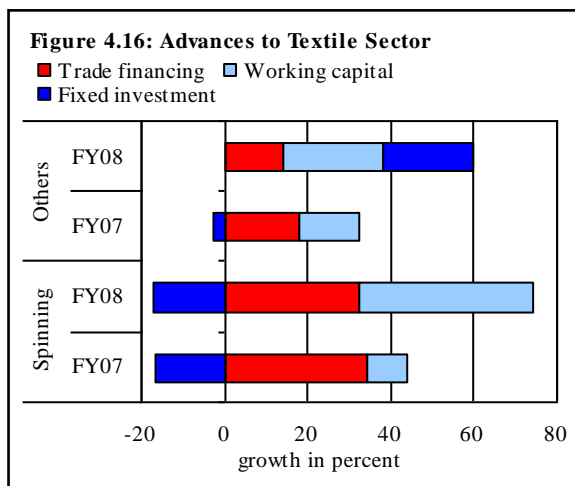
Fixed investment loans to the textile sector witnessed a retirement, probably of loans disbursed under the Textile Vision 2005. Monthly trends

however show a rise in demand for fixed investment loans during November and December 2007 that interestingly coincides with the rise in import demand for textile machinery during these months.

Growth in trade related loans to the textile sector decelerated to 19.3 percent during Jul-Jan FY08 compared with 22.4 percent rise in the corresponding period of FY07. In fact, it was the anemic advance growth in weaving industry that had caused the slowdown in overall demand for trade-related loans; excluding the weaving sub-sectors, credit for trade financing depicts a strong growth of 24.2 percent in Jul-Jan FY08 as against 15.7 percent growth during Jul-Jan FY07.

Construction

Growth in advances to *construction* sector decelerated to 19.4 percent during Jul-



**Table 4.6: Impact of Rise in Cotton Prices on Cotton Credit (Jul-Jan)**

amount in billion Rupees; production in billion bales

	% change in raw cotton prices	Production of raw cotton	Loans extended to spinning of cotton
FY07	4.3	13.0	7.3
FY08	26.1	12.8	33.4

<sup>40</sup> The increase was recorded despite the dismal performances of textile industry mainly driven by lower export demand.

Jan FY08 compared with 24.2 percent growth in the corresponding period last year. The issuance of privately placed Sukuks for financing new projects probably explains lower demand for fixed investment loans from this sector.

On the contrary, the working capital requirements depict robust growth of 32.4 percent in Jul-Jan FY08 compared with 20.5 percent rise during Jul-Jan FY07. Besides rising housing demand, the increase in domestic raw material prices for construction mainly explains the higher demand for working capital requirement in this sector during Jul-Jan FY08.

**Table 4.7: Growth in Consumer Loans (Jul-Jan)**

percent		
	FY07	FY08
Mortgage loans	15.5	17.6
Credit cards	19.2	6.9
Auto finance	8.0	6.0
Personal loans	7.9	3.0
<b>Consumer loans</b>	<b>10.4</b>	<b>6.6</b>

#### Consumer loans

Growth in consumer loans slowed to 6.6 percent during Jul-Jan FY08 from 10.4 percent in the preceding year (see **Table 4.7**). The deceleration in consumer loans is evident in all categories (except mortgage finance).<sup>41</sup> In particular, deceleration in the growth of auto finance was attributed to (1) lower demand for automobiles due to increase in prices of locally produced cars, and (2) risk aversions of banks following recovery issues (e.g., one of the banks has even suspended auto finance scheme). On the contrary, mortgage finance depicts a robust growth of 17.6 percent as compared to 15.5 percent rise in the corresponding period last year.

**Table 4.8: Issuances of Privately Placed Listed Sukuk (Jul-Jan FY08)**

million Rupees			
Sectors	Amount	Purpose	
		Repayment	Project Finance
Electronic	2,550	√	
Paper	3,500	√	
Sugar	500	√	
Chemical	9,500	√	√
Cement	10,500	√	√
Textile	650	√	
Real estate	3,000		√
Oil & gas	5,000	√	
WAPDA*	8,000		√
Shipping	4,000		√

Source: Banks and beneficiaries

#### Banks' Investments in Privately Placed Sukuk

In addition to providing advances, banks are also

<sup>41</sup> The mandatory use of Credit Information Bureau (CIB) data by banks is also cited as a major reason of slowdown in consumer loans.

investing in debt instruments issued by the private sector. As evident from **Table 4.8**, approximately Rs 47 billion of privately placed Sukuk have been issued from July 2007 onwards.<sup>42</sup> This suggests that while the overall demand for credit is still intact, there is now a lower dependence on banks' advances.

It must be noted here that though the substantial portion of investment in debt instruments came from banks, non-bank financial institutions are also investing in these papers.

**Table 4.9: Incremental Credit to Deposit ratio (Jul-1<sup>st</sup> Mar)**

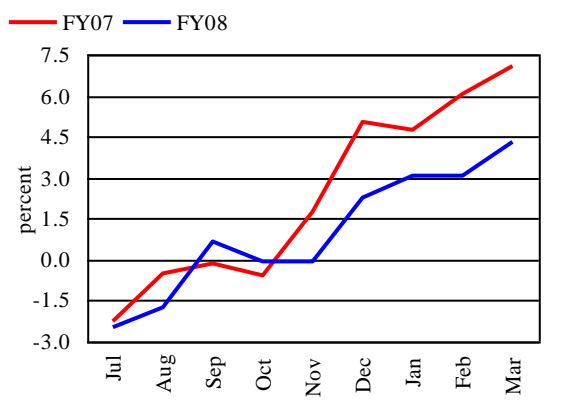
billion Rupees	Increase		
			Ratio (%)
	Credit	Deposits	
FY06	294.7	183.7	160.6
FY07	195.5	188.6	103.7
FY08	302.7	137.1	220.8

Furthermore, despite the attractiveness of Sukuk for Islamic banks (as these are Shariah-based instruments), the share of Islamic banks in the primary debt issuances is small compared with traditional banks.

#### Source of Credit Finance<sup>43</sup>

A quick look at the **Table 4.9** shows that the lower growth in deposit during Jul-1<sup>st</sup> Mar FY08 has led to a rise in the incremental credit-deposit ratio (see also **Figure 4.17**). Thus, in order to sustain strong credit growth, banks have used non-depositary sources.<sup>44</sup> In this regard, the fall in effective CRR during the period under review, and banks' unwillingness to

**Figure 4.17: Cumulative Deposit Growth (Jul-1<sup>st</sup> Mar)**



<sup>42</sup> This information set should be read with some caution due to its possible *partial* coverage. This is because: (a) privately placed Sukuks are currently not recorded by any regulatory institution, thus there is a chance that some of the issues are not covered; and (b) the information has been collected from banks who were acting as arrangers for these transactions, thus, a Sukuk arranged by any NBFIs, has not been captured in this dataset.

<sup>43</sup> This section is based on monetary survey deposits which excludes government deposits.

<sup>44</sup> Theoretically, banks' equity is the most common form of non-deposit resources. Besides this, banks can also liquidate their investment in government and private papers; and draw down excess reserves held with the central bank.

invest in government papers<sup>45</sup> explain funding sources for credit expansion.

#### Deposit Mobilization<sup>46</sup>

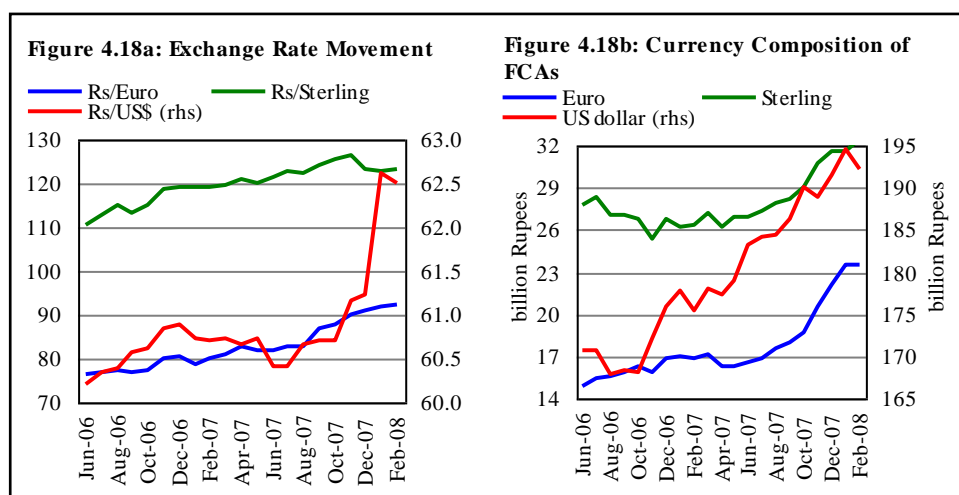
The overall deposit growth slowed from 6.4 percent during Jul-Feb FY07 to 4.2 percent in Jul-Feb FY08 (see **Table 4.10**).

It was the fall in growth of *other*<sup>47</sup> deposits that explains the slowdown in deposit mobilization.

**Table 4.10: Sector wise Deposit Growth (Jul-Feb)**

	FY07		FY08	
	Growth	Share*	Growth	Share*
Customer	4.4	4.2	4.1	3.8
NBFIs	50.6	0.4	18.6	0.3
Others	41.1	1.8	3.6	0.2
<b>Total</b>	<b>6.4</b>		<b>4.2</b>	

\*Contribution in growth in percentage points



The currency-wise break-up of the customers' deposits reflect that a sharp depreciation in the value of the Rupee against major currencies during Jul-Feb FY08, made foreign currency deposits more attractive to the customers (see **Figure 4.18**). Thus, within foreign currency deposits, Sterling, Euro and US-dollar denominated deposits registered a robust growth during Jul-Feb FY08 over Jul-Feb FY07.

<sup>45</sup> The consequent rise in government borrowings from central bank has added to available liquidity with banks.

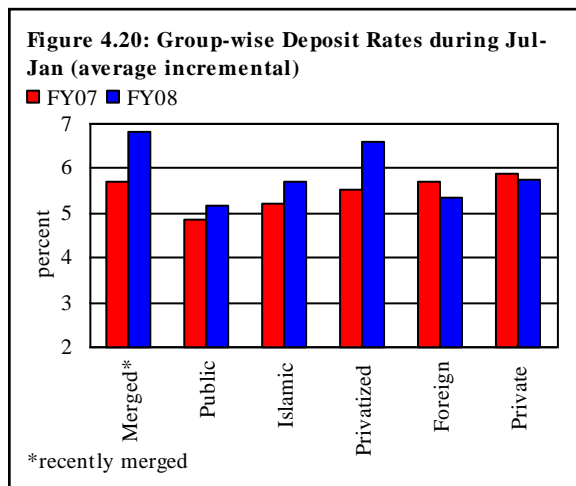
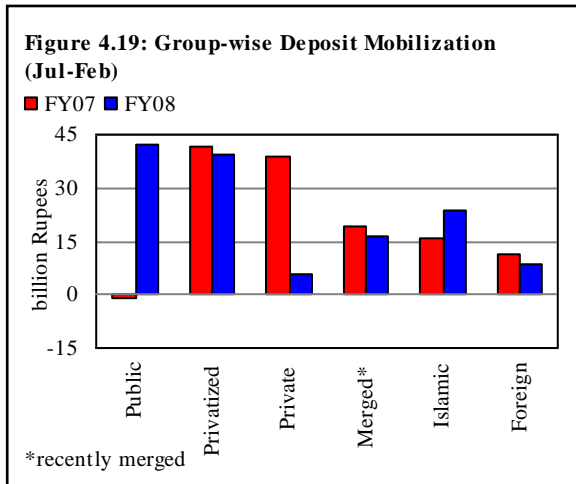
<sup>46</sup> The section includes all customer deposits including government deposits and thus will not tally with the deposits reported in the sub-section of "Source of Credit Finance".

<sup>47</sup> Others deposits mainly includes margin or LCs, margin on guarantees, unclaimed dividend/dividend payable, security deposit accounts and any other miscellaneous liabilities.

Further, a bank-wise deposit distribution shows that except public sector banks and Islamic banks, all other banking groups recorded a substantial decline in the deposit mobilization during Jul-Feb FY08 compared to the corresponding period of FY07 (see **Figure 4.19**).

This decline was recorded despite a rise in deposit rates by most of the banks (see **Figure 4.20**). Moreover, the slowdown in deposits of one of the domestic private banks (under the category of small domestic private banks), is mainly explained by the net withdrawals from the deposits of PSEs and corporate sector.

On the contrary, the sharp rise in deposits of public sector banks was on account of a sizeable increase in deposits of government and public sector enterprises (PSEs) in one large bank within this category.

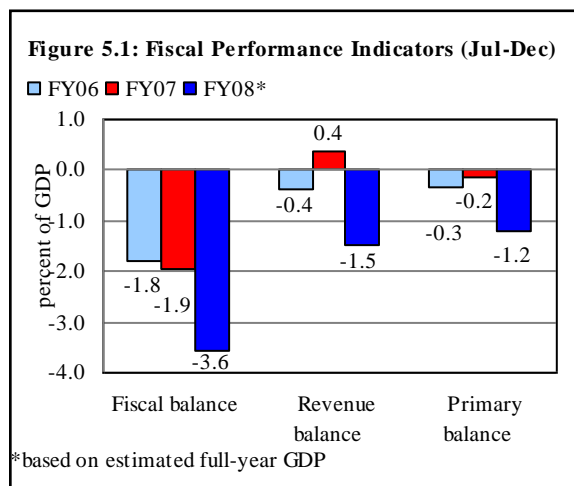




## 5 Fiscal Developments

### 5.1 Overview

The deterioration in key fiscal indicators seen during Q1-FY08, accelerated sharply in the next quarter as revenue growth stagnated, even as expenditures continued to rise. As a result, the cumulative fiscal deficit for H1-FY08 as a share of (estimated) annual GDP, was almost twice than seen in the previous two years, reaching a seven-year high for the period. Similarly, the revenue deficit and the primary deficit ratios for H1-FY08 increased substantially compared with the preceding years (see **Figure 5.1**).



A quarter-by-quarter analysis of the data reveals that nearly 55.6 percent of the Jul-Dec FY08 fiscal deficit was generated in the second quarter of FY08. The buildup of fiscal deficit during Q2-FY08 is largely associated with an unusual fall in total revenues, contributed by decline in both tax and non-tax sources. Growth in total expenditures during Q2-FY08 has been relatively moderate at 15.8 percent YoY compared to the abrupt 37.5 percent YoY surge in Q1-FY08 (see **Table 5.1**).

**Table 5.1: Buildup of Fiscal Balance**

billion Rupees				
	Jul-Sep		Oct-Dec	
	FY07	FY08	FY07	FY08
<b>Total revenue</b>	<b>255.7</b>	<b>312.6</b>	<b>359.1</b>	<b>313.0</b>
Tax revenue	191.6	215.6	241.8	235.1
Non-tax	64.1	97.0	117.3	77.9
<i>of which defence</i>	0.6	1.3	6.6	2.3
<b>Total expenditure</b>	<b>342.4</b>	<b>470.7</b>	<b>441.4</b>	<b>511.2</b>
<i>of which grants (other than provinces)</i>	9.7	7.7	16.6	37.5
<b>Budget Balance</b>	<b>-86.7</b>	<b>-158.1</b>	<b>-82.3</b>	<b>-198.3</b>

Source: Ministry of Finance, Islamabad

The weakness in Q2-FY08 fiscal revenues stemmed from a variety of factors. For example, direct taxes declined due to a fall in expected taxable profits of key

industries (e.g., banks, cement, etc.). Similarly, the weakness in non-tax revenues mainly reflected the delayed disbursement of logistic support grant (indicated by a fall in defence receipts), and low collections of surcharges on petroleum and gas. The fiscal performance is expected to improve in the remaining two quarters of the fiscal year, with greater discipline in spending<sup>1</sup> being complemented by a relative improvement in revenues. In particular, aggregate taxable profits of corporates (particularly for banks) are expected to improve somewhat in H2-FY08 even as non-tax revenues are bolstered by the realization of defence receipts, and an anticipated increase in dividends, etc.

**Table 5.2: Summary of Consolidated Public Finance**

billion Rupees

	Jul-Dec				YoY change (%)	
	FY05	FY06	FY07	FY08	FY07	FY08
Total revenue	423.8	497.8	614.8	625.6	23.5	1.8
Tax revenue	284.4	343.3	433.4	450.7	26.3	4.0
Non-tax revenue	139.4	154.6	181.3	174.9	17.3	-3.6
Total expenditure	503.3	634.5	783.8	981.9	23.5	25.3
Current	427.5	525.3	581.4	775.1	10.7	33.3
Development and net lending	86.3	127.8	147.9	225.8	15.7	52.6
Unidentified expenditure	-10.4	-18.6	54.4	-18.9	-391.9	-134.7
Budget balance	-79.6	-136.7	-169.0	-356.3	23.6	110.9
<b>As percent of GDP</b>						
Total revenue	6.6	6.6	7.1	6.3	--	--
Tax revenue	4.4	4.5	5.0	4.5	--	--
Non-tax revenue	2.2	2.0	2.1	1.8	--	--
Total expenditure	7.8	8.4	9.0	9.8	--	--
Current	6.6	6.9	6.7	7.8	--	--
Development and net lending	1.3	1.7	1.7	2.3	--	--
Unidentified expenditure	-0.2	-0.2	0.6	-0.2	--	--
Budget balance	-1.2	-1.8	-1.9	-3.6	--	--

Source: Ministry of Finance

But, notwithstanding this anticipated relative improvement, revenue growth for FY08 is likely to remain below target. Moreover, the fiscal concerns are also

<sup>1</sup> The incentive to accelerate development spending ahead of the elections will no longer hold. Indeed, media reports indicate that concerned by the ballooning fiscal deficit the government has sharply curtailed expenditure growth in H2-FY08.

heightened by the large Rs 54.6 billion issuance of contingent liabilities by the government in the first six months of FY08.

Furthermore, now that almost 90 percent of the annual fiscal deficit target of 4.0 percent of GDP has already been reached in the first six months of FY08 (see **Table 5.2**), the government needs to act swiftly in order to curtail the fiscal deficit within manageable limits. The government also needs to take corrective steps to avoid a breach of targets set in Fiscal Responsibility and Debt Limitation Act, 2005.

## 5.2 Revenues

Revenue growth in H1-FY08 decelerated to extremely low levels. Total revenues increased by 1.8 percent YoY in H1-FY08 as compared to 23.5 percent YoY in H1-FY07 and an average 18.6 percent YoY for the corresponding period in last six years. The dull growth in revenue receipts during H1-FY08 is contributed by a deceleration in tax revenues as well as an actual decline in non-tax receipts.

**Table 5.3: Composition of Tax and Non-tax Revenues**

billion Rupees					
	Jul-Dec			YoY change (%)	
	FY06	FY07	FY08	FY07	FY08
<b>Tax revenues</b>	<b>343.3</b>	<b>433.4</b>	<b>450.7</b>	<b>26.3</b>	<b>4.0</b>
Direct taxes	104.2	176.6	162.8	69.5	-7.8
Taxes on property	3.3	1.7	2.0	-46.7	15.6
Taxes on goods and services	158.4	178.0	207.2	12.4	16.4
Taxes on international trade	61.5	60.7	61.5	-1.4	1.4
Other taxes	16.0	16.5	17.3	3.0	4.8
<b>Non-tax revenues</b>	<b>154.6</b>	<b>181.3</b>	<b>174.9</b>	<b>17.3</b>	<b>-3.6</b>
Profits from PTA/post office department	10.5	0.1	0.0	-99.5	-70.0
Interest (PSE and others)	7.6	4.3	15.2	-44.2	257.5
Dividends	27.3	33.8	32.4	23.6	-4.2
SBP profits	3.9	39.2	47.3	905.1	20.7
Defence	46.5	27.2	2.3	-41.5	-91.7
Surcharges	19.2	33.8	19.5	75.9	-42.4
Petroleum	9.4	18.0	7.3	92.6	-59.3
Gas	9.9	15.8	12.2	60.1	-23.2
Royalty on oil/gas	10.2	14.1	21.5	37.8	52.1
Others	29.3	28.9	36.7	-1.4	27.2
<b>Total revenue</b>	<b>497.8</b>	<b>614.8</b>	<b>625.6</b>	<b>23.5</b>	<b>1.8</b>

Source: Ministry of Finance

A breakup analysis illustrates that the deceleration in tax receipts is largely on account of an exceptional fall in direct tax collections (see **Table 5.3**). As indicated earlier, this reflected a fall in expected profitability of the corporate sector (the largest contributor to direct tax receipts).

On the other hand, the decline in non-tax revenues in H1-FY08 was likely in the wake of non-receipt of logistic support grant from US. The resulting declines in defence and surcharge receipts more than offset the improvement in interest income, SBP profits and collection on account of royalty on oil and gas.

### 5.3 Expenditures

Though the increase in total expenditures has been relatively moderate in second quarter of FY08 (15.8 percent YoY in Q2-FY08 compared to 37.5 percent YoY in Q1-FY08), still the growth in total expenditures during H1-FY08 is greater than the increase recorded in H1-FY07. The strong growth in total expenditures during H1-FY08 was due to substantial rises in both current and development spending.

**Table 5.4: Composition of Current Expenditure**

billion Rupees

	Jul-Dec			YoY change (%)	
	FY06	FY07	FY08	FY07	FY08
<b>Current expenditures</b>	<b>525.3</b>	<b>581.4</b>	<b>775.1</b>	<b>10.7</b>	<b>33.3</b>
<i>of which</i>					
Interest payments	111.4	155.8	237.7	39.8	52.6
Domestic	89.8	131.3	208.8	46.2	59.1
Foreign	21.6	24.5	28.9	13.4	18.0
Defence	119.1	114.9	131.8	-3.4	14.7
Economic affairs	24.7	18.6	50.9	-24.5	173.3
Health	2.2	2.3	2.7	3.6	19.1
Education affairs and services	7.4	10.6	10.5	44.8	-1.0
Provincial	149.0	176.7	210.1	18.6	18.9

Source: Ministry of Finance

The upsurge in current expenditures witnessed in the first quarter of FY08 persisted during H1-FY08, and for almost the same reasons: (1) interest payments grew by 52.6 percent YoY during H1-FY08 to reach at 2.4 percent of GDP compared to 1.8 percent in H1-FY07, (2) though defence spending as a percent of GDP remained unchanged (1.3 percent) during H1-FY08, actual expenditures showed a sizeable growth in H1-FY08 compared to a decline in the corresponding period last year, and (3) spending under *economic affairs* reached Rs 50.9 billion

in H1-FY08, up by 173.3 percent YoY compared to a fall in H1-FY07 (see **Table 5.4**).

Additionally, expenditure under *superannuation allowance and pension* increased by Rs 10.1 billion in H1-FY08 to reach Rs 22.8 billion compared to a fall of Rs 5.3 billion in H1-FY07. Furthermore, *grants (other than provinces)* jumped to Rs 45.2 billion in H1-FY08, up by 71.5 percent, probably on account of non-receipt of logistic support grant from the US.

Development expenditures also increased significantly during H1-FY08 (48.2 percent YoY during Jul-Dec FY08 compared to 16.4 percent during Jul-Dec FY07). However, while the revised data for Q1-FY08 suggest that provinces undertook almost 54.7 percent of the development expenditures in that period, the numbers for H1-FY08 reveal federal government taking a lead in development spending (52.9 percent for federal government to 47.1 percent for provinces) in H1-FY08.

#### 5.4 Budgetary Financing<sup>2</sup>

The increase in fiscal deficit during H1-FY08 was coincided with a sharp decline in external financing inflows. This forced the government to substantially increase reliance on domestic sources for budgetary financing (see **Table 5.5**).

**Table 5.5: Sources of Financing**

(billion Rupees)

	Jul-Dec			Growth (%)		Percent share <sup>1</sup>	
	FY06	FY07	FY08	FY07	FY08	FY07	FY08
<b>Total financing of budget</b>	<b>136.7</b>	<b>168.9</b>	<b>356.3</b>	<b>23.6</b>	<b>110.9</b>	<b>100.0</b>	<b>100.0</b>
External resources (net)	39.8	96.2	68.0	141.7	-29.3	57.0	19.1
Domestic resources (net)	96.9	72.7	288.3	-25.0	296.5	43.0	80.9
Banking system	84.9	31.5	228.6	-62.9	625.7	(43.3)	(79.3)
Non-bank	-6.7	25.3	58.0	-477.6	129.2	(34.8)	(20.1)
Privatization proceeds	18.7	15.9	1.7	-15.0	-89.6	(21.9)	(0.6)

Source: Ministry of Finance

<sup>1</sup> Numbers in parenthesis represent share in domestic source of financing

<sup>2</sup> The budgetary financing numbers do consider the impact of government deposits with the banking system whereas the debt numbers do not.

### 5.4.1 Financing from the Banking Sector<sup>3</sup>

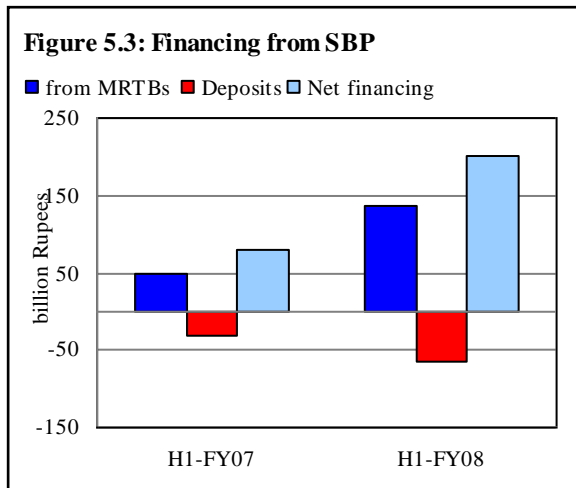
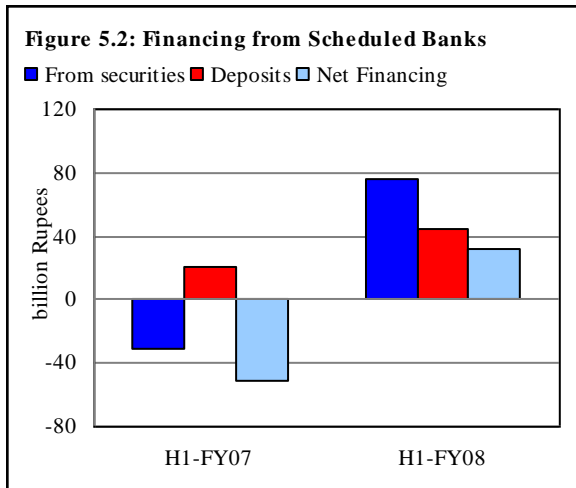
Budgetary financing availed from the banking sector increased by 625.7 percent to Rs 228.6 billion in H1-FY08 compared to Rs 31.5 billion in H1-FY07. SBP remained the major source for this deficit financing which provided Rs 200.6 billion, 153 percent more compared to H1-FY07.

Commercial banks also supplied Rs 31.8 billion in H1-FY08 for budgetary support to the government in contrast to H1-FY07, where it had net retirement of Rs 51.0 billion (see **Figure 5.2**).

It is important to note that the quoted budgetary financing figure is net of government deposits. Hence, some discussion about deposits is necessary to understand the dynamics of this banking sector financing.

Disaggregated data shows that the government deposits with SBP (including other deposits) decreased by Rs 63.6 billion in H1-FY08 which has magnified the borrowings of Rs 137.0 billion to Rs 200.6 billion in freshly created MRTBs from SBP (see **Figure 5.3**).

On the other hand, the deposits with the scheduled banks increased by Rs 44.4 billion which diluted the impact of



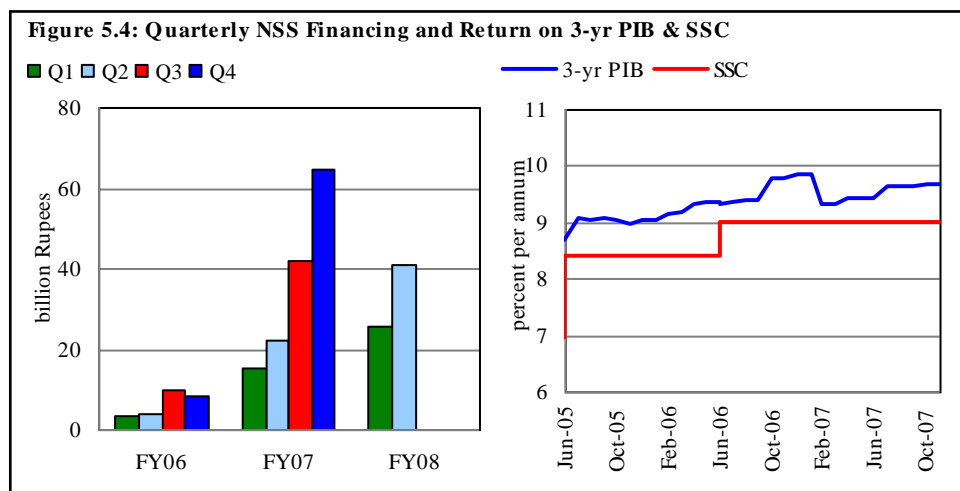
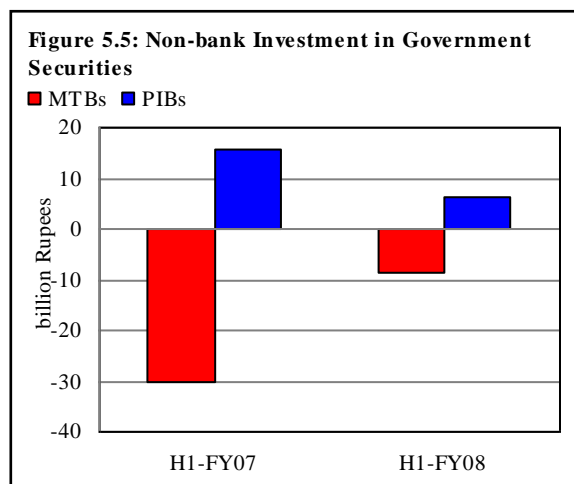
<sup>3</sup> The separate figures for SBP and scheduled bank financing are based on SBP data and might deviate marginally from Ministry data.

actual financing of Rs 76.2 billion received in terms of government securities, taking the net financing to Rs 31.8 billion.

#### 5.4.2 Non-Bank Financing<sup>4</sup>

Budgetary financing received from the non-banks increased by 129.2 percent in H1-FY08 compared to financing received in the same period of H1-FY07. NSS with Rs 40.7 billion was the larger contributor to the total financing of Rs 58.0 billion received from non-banks in H1-FY08.

It is worth noting that the performance of the NSS instruments is improving persistently over time despite a trivial upward revision in return on these instruments after FY05 (see **Figure 5.4**). The improved performance of the NSS



instruments is due to slowdown in the retirements of the SSCs and DSCs as

<sup>4</sup> The separate figures for NSS, PIBs and MTBs financing are based on SBP data.

indicated by the persistent gross receipt in both the NSS instruments.<sup>5</sup>

Non-bank participation in the budgetary financing through government securities remained low possibly due to availability of alternative investment opportunities such as mutual funds. In H1-FY08, financing received from PIBs declined to Rs 6.2 billion compared to Rs 15.8 billion in H1-FY07 while the retirement of T-bills continued (see **Figure 5.5**).

### 5.5 FBR Tax Collection

Although data on monthly targets is not available, all indicators hint at Federal Board of Revenue (FBR) having troubles in meeting its revenue targets since December 2007. Net tax collection till January 2008 lags behind the FY08 annual target by a wide margin; nearly 55.4 percent of the FY07 annual target had been achieved by January 2007 while in FY08 Jul-Jan tax collections amount to about 49.9 percent of FY08 annual target (see **Table 5.6**). To still achieve FY08 target of Rs 1025.0 billion would require FBR to amass 51.1 percent of the target amount in remaining five months; indicating that the revenue target of Rs 1025.0 billion for FY08 will be hard to achieve.

**Table 5.6: FBR Tax Collection (Jul-Jan)**

billion Rupees					
	Net tax collection			YoY change (%)	
	FY06	FY07	FY08	FY07	FY08
Direct taxes	114.4	185.2	190.7	61.9	3.0
Indirect taxes	255.4	277.5	320.9	8.6	15.6
Sales tax	154.9	171.0	199.2	10.4	16.5
FED	29.5	36.2	46.3	22.6	27.9
Customs	71.0	70.3	75.4	-1.0	7.2
<b>Total taxes</b>	<b>369.8</b>	<b>462.7</b>	<b>511.6</b>	25.1	10.6
<b>Memorandum item:</b>					
Targets (annual)	690.0	835.0	1025.0		
Tax collection (annual)	713.4	847.2	1025.0*		
<i>Jul-Jan collection as % of</i>					
Annual target	53.6	55.4	49.9		
Actual annual collection	51.8	54.6	49.9		

Source: Federal Board of Revenue, Islamabad

\* assumed for calculations.

<sup>5</sup> In FY03, deposits through SSCs increased by Rs 85.0 billion due to substantial price differential existed at that time. The average return on the PIBs in FY03 was 3.71 percent while average return on SSC was 10.4 percent.



**Table 5.7: Major Components of Income Tax**

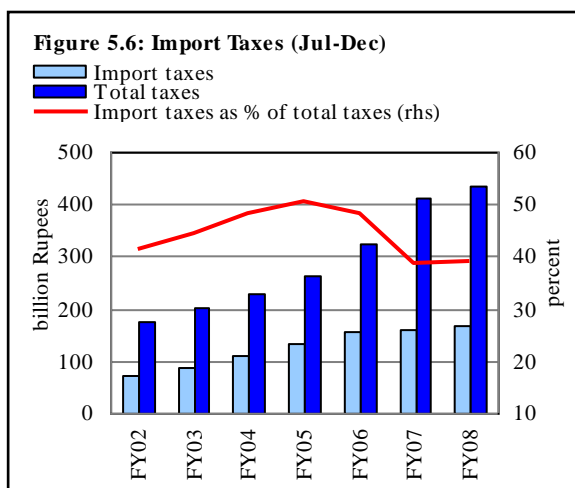
billion Rupees	Jul-Dec				YoY % change	
	FY05	FY06	FY07	FY08		
					FY07	FY08
Voluntary payments	35.9	48.8	105.1	66.9	115.3	-36.3
Collection on demand	3.7	5.6	4.5	11.3	-20.3	152.8
Withholding taxes	46.8	60.3	77.0	91.7	27.7	19.2
Others	0.4	0.1	0.1	0.1	-19.4	2.5
<b>Gross collection</b>	<b>86.9</b>	<b>114.7</b>	<b>186.6</b>	<b>170.1</b>	<b>62.7</b>	<b>-8.9</b>
Refund/rebate	10.5	15.3	19.6	13.4	27.9	-31.4
<b>Total net</b>	<b>76.4</b>	<b>99.5</b>	<b>167.0</b>	<b>156.6</b>	<b>67.9</b>	<b>-6.2</b>

Source: Federal Board of Revenue

Growth in net tax collections during Jul-Jan FY08 slowed considerably compared to the same period last year, mainly due to a sharp decline in growth of direct taxes. The collection from direct taxes rose only 3.0 percent YoY in Jul-Jan FY08 to Rs 190.7 billion compared to a spectacular 61.9 percent increase during the corresponding period last year.

A break up of the direct tax collection, available for H1-FY08, reveals that despite a significant decline in refunds, net income tax had actually dropped by 6.2 percent during the period (see **Table 5.7**). The decline in net income tax collection is entirely attributable to 36.3 percent fall in voluntary payments.

Worryingly, voluntary payments with return witnessed a fall of 86.7 percent while voluntary payments on account of advance tax recorded an increase of 1.6 percent over the previous period. The substantial decline in voluntary payments with returns caused its share in total voluntary payments to fall to just 9.0 percent in H1-FY08 against 42.9 percent in H1-FY07.



Encouragingly, collection on demand witnessed an increase of 152.8 percent in H1-FY08, reflecting an improvement in recovery drive of the FBR. Receipts under arrear demand increased to Rs 4.7 billion, up by 136.7 percent in H1-FY08 while receipts under current demand rose by 166.0 percent to reach Rs 6.5 billion in H1-FY08. However, FBR needs to further strengthen its recovery drive as Rs 22.4 billion still stand pending on account of arrear demand.

Withholding tax receipts grew by a respectable 19.2 percent in H1-FY08 against 27.7 percent in H1-FY07.

Major heads contributing to withholding tax receipts were imports (Rs 12.7 billion, down 4 percent), salaries (Rs 8.7 billion, up 18.3 percent), and contracts (Rs 31.6 billion, up 31.1 percent).

**Table 5.8: Summary of Consolidated Provincial Finance**

billion Rupees				
	Jul-Dec			
	FY06	FY07	FY08	
<b>Total revenue</b>	<b>192.8</b>	<b>215.7</b>	<b>285.2</b>	
Provincial share in Federal revenue	126.2	170.2	187.4	
Provincial taxes	17.2	17.0	18.2	
Property taxes	3.3	1.7	2.0	
<i>of which: agriculture tax</i>	0.3	0.3	0.2	
Excise duties	1.0	1.0	1.3	
Stamp duties	4.6	4.7	5.3	
Motor vehicle tax	3.4	3.9	3.9	
Other	5.1	5.8	5.8	
Provincial non-tax	18.0	18.3	34.2	
Interest	0.2	0.1	10.2	
Profits from hydro electricity	1.5	1.5	3.3	
Irrigation	0.9	0.9	1.0	
Others	15.4	15.8	19.8	
Federal loans and transfers/grants	31.4	10.3	45.4	
Loans (net)	1.5	-4.4	3.7	
Grants	29.9	14.7	16.3	
Grant for development expenditure	0.0	0.0	25.4	
<b>Total expenditure</b>	<b>204.9</b>	<b>242.7</b>	<b>322.4</b>	
Current expenditure	160.2	187.2	218.3	

On the other hand, indirect taxes grew by 15.6 percent during Jul-Jan FY08 as compared to 8.6 percent in the same period last year. Encouragingly, this increase is driven by sizeable

Interest payments to federal govt	11.2	10.5	8.2
Other current expenditure	149.0	176.7	210.1
Development expenditure	44.7	55.4	104.2
<b>Overall balance</b>	<b>-12.1</b>	<b>-26.9</b>	<b>-37.2</b>

Source: Ministry of Finance

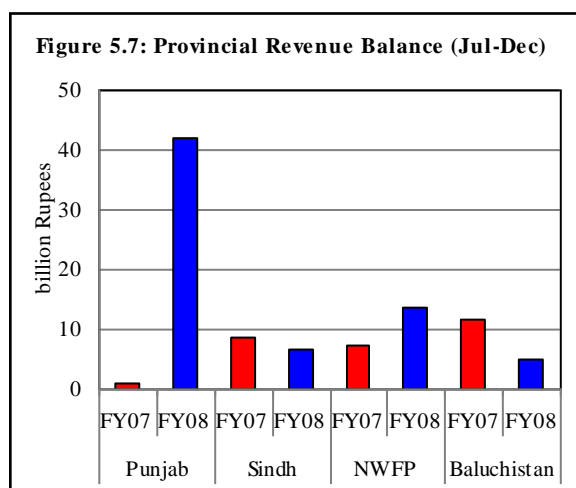
growth in all the categories (see **Table 5.6**). As growth in direct taxes faltered, its share in total taxes declined to 37.0 percent during Jul-Jan FY08 from 40.0 percent in the corresponding period last year. Finally, import taxes grew by 6.4 percent in Jul-Dec FY08 compared to a mere 2.0 percent in the same period last year. However, the apparent acceleration in growth is misleading as the average growth recorded for the corresponding periods of FY02-FY06 turns out to be 21.2 percent. As import taxes and total taxes grew at roughly the same rates (total taxes grew by 6.0 percent in Jul-Dec FY08), the share of import taxes in total taxes remained effectively unchanged (see **Figure 5.6**).

## 5.6 Provincial Fiscal Operations

Notwithstanding a substantial rise in total expenditures, provincial public finance exhibited a deceleration in the fall of overall balance; thanks largely to Rs 25.4 billion federal grant for development spending (see **Table 5.8**). Province-wise analysis shows that while all the four provinces experienced revenue surpluses, Punjab and NWFP exhibited substantial

improvements in their respective revenue balances during H1-FY08 (see **Figure 5.7**). With slight increases in current expenditures, the sharp rise in revenue balance of both these provinces was directly associated with a substantial revenue inflow on account of provincial share in federal revenue and provincial non-tax receipts (see **Table 5.9**).

The fall in revenue balance for Sindh in H1-FY08, however, results from strong growth of current expenditures under head *other than interest payments to federal government*.



**Table 5.9: Provincial Finance during Jul-Dec**

billion Rupees

	Punjab		Sindh		NWFP		Balochistan	
	FY07	FY08	FY07	FY08	FY07	FY08	FY07	FY08
<b>Total revenue</b>	<b>101.1</b>	<b>144.1</b>	<b>64.4</b>	<b>78.4</b>	<b>29.9</b>	<b>39.3</b>	<b>20.3</b>	<b>23.4</b>
Provincial share in Federal revenue	80.4	94.2	56.1	56.8	19.2	23.0	14.5	13.4
Provincial taxes	8.7	9.8	6.9	7.0	1.1	1.0	0.4	0.4
Provincial non-tax	11.5	22.8	1.7	3.9	4.1	6.8	1.0	0.7
Federal loans and transfers/grants	0.6	17.3	-0.3	10.6	5.6	8.6	4.4	8.9
<b>Total expenditure</b>	<b>134.1</b>	<b>173.9</b>	<b>65.3</b>	<b>86.1</b>	<b>30.8</b>	<b>38.6</b>	<b>12.5</b>	<b>23.9</b>
Current expenditure	100.3	102.3	55.8	71.9	22.6	25.6	8.6	18.5
Development expenditure	33.9	71.6	9.5	14.2	8.2	12.9	3.9	5.4
<b>Overall balance</b>	<b>-33.0</b>	<b>-29.8</b>	<b>-0.9</b>	<b>-7.7</b>	<b>-0.9</b>	<b>0.8</b>	<b>7.9</b>	<b>-0.5</b>

Source: Ministry of Finance

Finally, development expenditures saw a massive 87.9 percent growth, to reach at Rs 104.2 billion in H1-FY08 compared to 24.0 percent in the corresponding period last year.

### 5.7 Domestic Debt

Growth in outstanding stock of domestic debt accelerated sharply (10.6 percent) in H1-FY08 (see **Table 5.10**) reflecting an increase in the fiscal deficit, as well as weaker than expected external financing.

**Table 5.10 : Key Developments of Domestic Debt**

	Jul-Dec	
	FY07	FY08
Growth in domestic debt (percent)	2.8	10.6
Contribution of LT debt (billion Rs)	39	74
Contribution of ST debt holding (billion Rs)	25	206.5
Domestic debt (billion Rs)	2363.5	2877.8

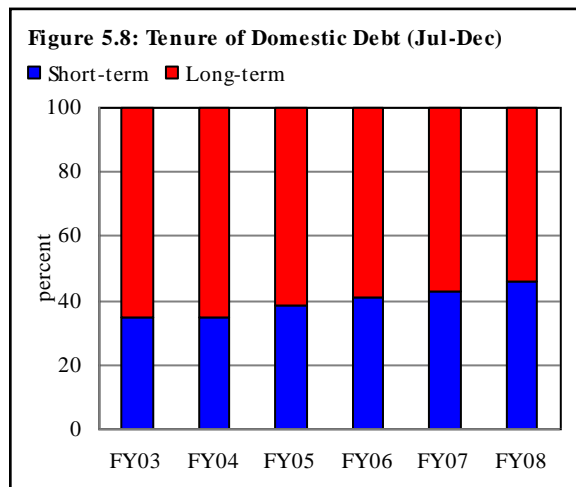
**Table 5.11: Gross Sales & Net Receipts of NSS Instruments (Jul-Dec)**

billion Rupees

	FY07		FY08	
	Gross sales	Net receipts	Gross sales	Net receipts
DSC	9.0	-3.8	35.0	1.8
SSC	56.4	0.0	34.8	8.3
BSC	52.2	27.1	47.4	22.3
SA	25.7	-2.4	60.1	-7.0
PBA	16.6	6.3	16.4	5.4

Source: CDNS

Greater reliance on borrowings from the central bank led to a rise in short-term debt. Consequently, the share of short-term debt reached to 45.7 percent in total debt during H1-FY08 compared to 40.8 percent during H1-FY07 (see **Figure 5.8**). Though the government also borrowed a substantial amount from long-term debt instruments during H1-FY08, its share in total debt retained the declining trend seen since FY04.



### 5.7.1 Components of Domestic Debt

The most striking development in domestic debt during H1-FY08 has been the oversized contribution of *floating debt* to the rise in domestic debt. Floating debt rose by 18.6 percent in H1-FY08 as compared to a modest increase of 2.7 percent in H1-FY07, reflecting government's dependence on central bank to finance the budget deficit.

Outstanding stock of *permanent debt* went up by 7.1 percent in H1-FY08. A break up of the permanent debt instruments data reveals that this rise stemmed largely from PIBs and the prize bonds. The government fetched (net) Rs 41.2 billion through five successful PIB auctions in H1-FY08 and (net) Rs 4.48 billion from Prize Bonds.

*Unfunded debt* showed an increase of 3.7 percent in H1-FY08 to reach at Rs 34.9 billion from Rs 21.6 billion in H1-FY07. Despite significant repayments, NSS showed a net increase of Rs 31.7 billion. Gross sales of major NSS instruments, i.e., defence saving certificates (DSCs), saving accounts (SA) and pensioners benefit account (PBA) went up during the period (see **Table 5.11**).

Domestic debt servicing cost declined to 1.0 percent of GDP in H1-FY08 from 1.5 percent of GDP in H1-FY07. However with sustained rise in the stock of domestic debt coupled with hikes in interest rate, the debt servicing cost is expected to rise substantially in the future. In particular, debt servicing on short-

term instruments will probably swell considerably given that short-term debt comprises 45.1 percent of the total stock of domestic debt.

Increasing reliance on bank borrowings to finance government deficits under tight monetary policy stance caused the share of debt servicing on floating instruments to reach 64.4 percent during H1-FY08, outstripping both the permanent and unfunded categories. Permanent debt instruments claimed nearly 10.0 percent in domestic debt servicing while unfunded debt contributed about 25.6 percent. The highest

expenditure on unfunded debt servicing is on the bullet maturities of DSCs sold in 1996-97. This reflects that part of the government's additional expenditure on domestic debt servicing is due to past financing commitments and not excessive spending in H1-FY08. Other major repayments were made on SAs, Special Saving Accounts, and Bahbood Saving Certificates (see **Figure 5.9**).

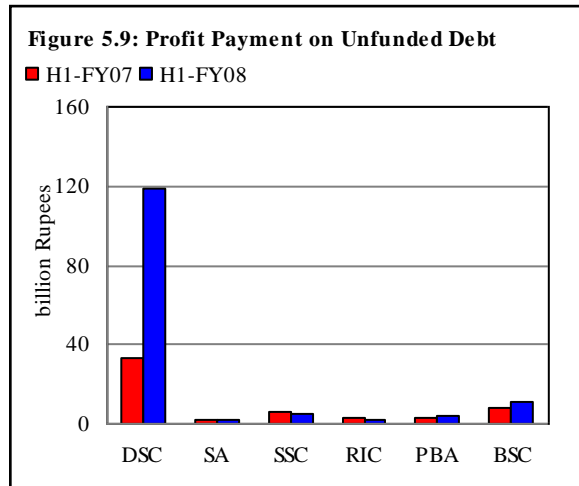


Table 5.12: Guarantees Issued by the Government

### 5.8 Contingent Liabilities and Government Guaranteed Loans

Contingent liabilities are the obligation triggered by an event that may or may not occur in future. A common example of the contingent liabilities are the government guaranteed loan. These guarantees are not directly associated with any existing budgetary program so these are not recognized as the direct liabilities. The government often issues guarantees to cover part or all of the risk that a borrower fails to repay a loan. However, the probability of the contingency occurring and its magnitude depends on some exogenous conditions (natural disaster or banking crises) or some endogenous conditions (contracts of state guarantees and enforcement of regulation and supervision). These contingent forms of government support can create moral hazard in the markets and can potentially raise the risks of fiscal instability. The government must have capacity to deal with such fiscal risks.

**Table 5.12** shows that the guarantees issued by the government during first six months of FY08 were Rs 54.6 billion, almost 80.0 percent of the total guarantees issued in FY07. The share of guarantees issued in domestic currency is about 55.7 percent while guarantees issued in foreign currencies constitute about 44.3 percent of the total guarantees. The major recipients among the guarantees issued in foreign currencies are MINFAL/TCP (15.2 percent), PIA (14.8 percent) and WAPDA (14.0 percent). However, the MoF is still of the view that the government will remain within the limits set by fiscal responsibility and debt limitation (FRDL) Act 2005.

billion Rupees		
	<b>FY07</b>	<b>H1-FY08</b>
PIA	45.0	8.1
WAPDA	6.5	7.8
PNSC	0.4	0.0
MINFAL/TCP	0.0	8.3
Local currency	17.0	30.4
<b>Total</b>	<b>69.0</b>	<b>54.6</b>
<i>as percent of GDP</i>	0.8	0.55

Source: Debt Policy Statement 2008

**Box 5.1: Summary of Fiscal Policy Statement 2007-08**

The Fiscal Policy Statement 2007-08 was issued by the Debt Policy Coordination Office (DPCO), Ministry of Finance on 31<sup>st</sup> January 2008 as required by section 6 of the Fiscal Responsibility and Debt Limitation (FRDL) Act 2005. This Act requires from the federal government to explain the compliance of main fiscal indicators with the principles of sound fiscal and debt management. This Act also requires the setting of strategic priorities by the federal government for the financial year in the fiscal area.

The Statement rightly argues that the effectiveness and credibility of government policies depends crucially on the availability of timely and accurate financial and management information supplemented by a framework of financial and accounting principles designed according to internationally accepted standards. Moreover, a system of public accountability, that includes a strong and independent legislative audit function, ensures fiscal discipline by the government. The Statement claims that the government has made considerable progress in the efforts to separate its accounting and audit functions. Strengthened financial management practices are expected to increase the effectiveness of development programs and related external assistance.

The New Accounting Model (NAM) has been used for federal budget since FY05. However, except for NWFP, NAM is being used in parallel with existing model in other provinces. Its implementation in the remaining provinces will take some time due to certain capacity constraints. Pakistan is moving to develop a medium-term budgetary-framework (MTBF). In this regard, reforms of fiscal reporting and expenditure management have been put to fast track to increase the efficiency of public expenditures.

As a percent of GDP, the fiscal deficit remained around 4 percent in last two years which was nearly 7.0 percent in 1990s. The report maintains that the decline was mainly on account of a decrease in expenditures rather than the increase in revenues. The Statement affirms the intention of the government to undertake tax reforms to help improve tax-to-GDP ratio. In this context, more emphasis will be given on tax revenue potential of the provincial governments.

The government has succeeded in reducing the debt burden by following the strategy suggested by the Debt committee in 2000. As a result the debt-to-GDP ratio decreased much more than what is envisaged in FRDL. The resulting fiscal gap enabled the government to increase the size of PSDP, poverty and social sector related expenditures.

Looking forward, the government needs to take important decisions in order to avoid a breach of targets envisaged in FRDL Act. Given that as a percent of GDP, the revenue balance has already reached -1.5 percent in H1-FY08, the government is likely to breach the FY08 zero percent revenue balance requirement provided in FRDL Act. The government has to search for ways to enhance the tax-to-GDP ratio and bring discipline in the expenditures in order to return back solidly on the path to fiscal sustainability.



**Box 5.2: Summary of Debt Policy Statement 2007-08**

The Debt Policy Statement 2007-08 was issued by Debt Policy Coordination Office (DPCO), Ministry of Finance on 31<sup>st</sup> January 2008 in order to fulfill the requirement in section 7 of the Fiscal Responsibility and Debt Limitation (FRDL) Act 2005. The purpose of the Debt Policy Statement is to allow the assessment of the federal government's debt policies against the principles of sound fiscal and debt management and debt reduction path.

The Statement asserts that the capacity of Pakistan to carry more debt has increased as: (1) GDP grew at much faster pace than that of public debt in last 6 years; and (2) as the real cost of borrowing reduced, the resources available to service the debt have grown considerably since FY01. In particular, the real cost of public debt declined to 4.4 percent during FY00-04 and further to -1.3 percent during FY04-08. In addition, after reaching a high of 589 percent of total revenue in FY00, public debt declined substantially to 371 percent by FY07 and further to 338 percent in Q1-FY08.

The public debt to GDP ratio dropped from 83.8 percent in FY01 to 55.2 percent in FY07, below the 60 percent limit envisaged for 2013 in the FRDL Act. However, the public debt to GDP ratio reduced by 2 percentage point in FY07 which is less than the 2.5 percentage point decline in the ratio fixed in FRDL Act 2005. On the other hand, the sum of new guarantees issued by the government was 0.8 percent of GDP in FY07, which is much smaller than the room (of 2 percent) provided in FRDL Act 2005.

The Statement also reveals government's intention to put in place several measures in order to meet the twin objectives of borrowing at minimum cost while keeping risk in check and of developing an efficient local currency sovereign debt market. These include:

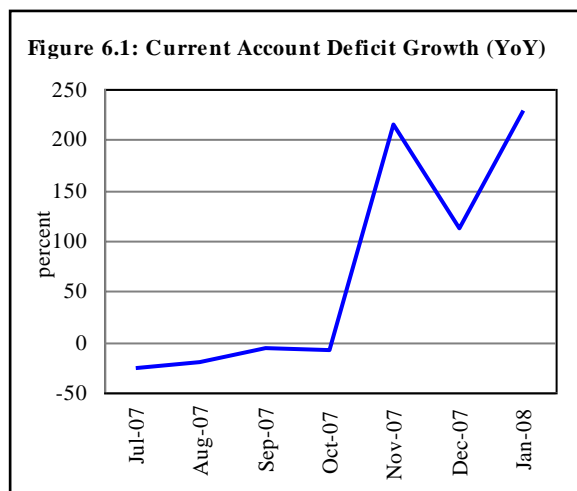
- The DPCO will publish an analytical report on debt on a quarterly basis.
- The government will continuously provide the supply of long-term securities in order to establish an efficient government yield curve.
- The investor base will be diverse by encouraging different sectors like insurance and pension.
- Work with the SBP to reconsider the held-to-maturity (HTM) category for sovereign bonds.
- The government will work on its long-term funding resource (NSS) to make them market based instruments.
- Debt capital market will be developed to have alternative sources of financing rather than just to rely on banking system.
- Provision of electronic media can expedite the financial processes.
- The government will follow the external debt strategy to ensure the sustainability of debt.
- The government will ensure that its guarantees are in limit imposed by FRDL Act, 2005.

## 6 External Sector

### 6.1 Overview

As feared, Pakistan was unable to sustain the modest improvement in the current account deficit seen during Q1-FY08, and the deficit widened sharply in succeeding months (see **Figure 6.1**).

Consequently, the cumulative Jul-Jan FY08 current account deficit rose by 47.1 percent YoY, compared to the 51.0 percent YoY increase in the same period of the previous year (see **Table 6.1**). Dominant contribution to the post-Q1-FY08 deterioration in the current account was from an abrupt rise in the country's oil bill, large one-off aircraft import, the impact of political disturbance in December 2007 as well as delays in the receipt of coalition support funds; all of which overshadowed the sustained increase in remittances.



**Table 6.1: Summary of External Account (Jul-Jan)**

billion US\$	FY06	FY07	FY08
A-Current account balance	-3.4	-5.1	-7.5
<i>Trade balance</i>	-4.9	-6.2	-7.8
<i>Invisible balance</i>	1.5	1.1	0.3
B-Financial/Capital balance	2.6	4.8	4.6
<i>FDI</i>	1.2	2.1	2.3
<i>FPI</i>	0.3	1.4	0.0
<i>Other investment</i>	0.8	1.1	2.2
C-Errors & omissions	0.2	0.4	0.4
<b>D-Overall balance</b>	<b>-0.6</b>	<b>0.0</b>	<b>-2.5</b>

Impact of the widening current account deficit on the country's overall balance was compounded by a decline in the financial & capital account balance in the same period. In particular, while FDI flows improved slightly, there was a precipitous US\$ 1.4 billion drop in net foreign portfolio investment.<sup>1</sup> The decline reflected partly the outflows from the

<sup>1</sup> In portfolio investment, the gross inflows declined to US\$ 0.5 billion during Jul-Jan FY08 from US\$ 1.4 billion in the same period of last year while gross outflows increased to US\$ 0.5 during Jul-Jan FY08 from meager outflow of US\$ 0.006 billion in the comparable period of last year.

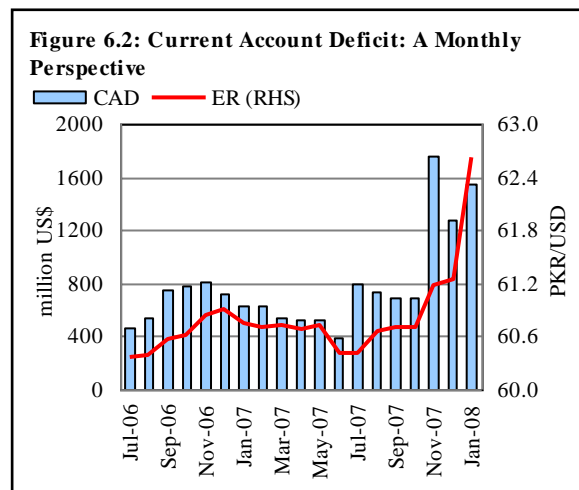
equity markets due to perception of increased political risk, and partly due to the delays in the planned floatation of Global Depository Receipts (GDRs) in the face of global financial turmoil and perceived increase in country risk.<sup>2</sup> A part of the impact of the fall in portfolio investment was mitigated by a large rise in other investments, including FE-25 nostros, short-term loans, etc.<sup>3</sup>

Given that the decline in the financial account surplus was quite moderate, it is clear that the depletion in the country's forex reserves essentially reflects the sharp increase in the current account deficit. Overall foreign exchange reserves declined to US\$ 14.8 billion at the end of January FY08 compared with US\$ 15.6 billion at the end of June FY07.

Moreover, as a result of worsening of external account during Jul-Jan FY08, Pak Rupee could not hold its grounds against the US dollar (see **Figure 6.2**). In particular, Pak Rupee depreciated by 3.5 percent during Jul-Feb FY08, highest depreciation since H1-FY05, as compared to nominal depreciation of 0.8 percent in the same period last year. It may also be noted, the depreciation was more

pronounced during Nov-Jan FY08 reflecting partly rising pressures on the external account and partly speculative activity following the political disturbance in the country. However, the exchange rate recovered part of the losses, following FDI inflows and easing of political tensions after peaceful elections.

The Jul-Jan FY08 developments thus serve to highlight the fact that sustained large current account deficits pose risks to the country's macroeconomic stability. Over the last few years, Pakistan was able to comfortably sustain current account

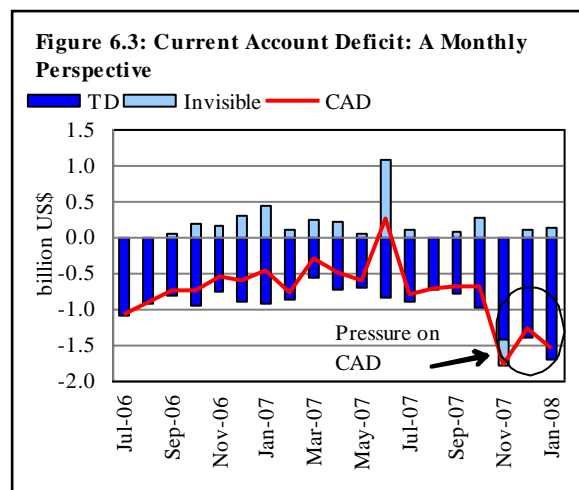


<sup>2</sup> The impact of a general increase in risk-averseness in the troubled global financial market was compounded by the increased risk perception on Pakistan due to the pre-election uncertainty, particularly following the assassination of a former prime minister.

<sup>3</sup> FE-25 nostros constitute the placement by domestic commercial banks with their foreign counterparts out of FE-25 deposits mobilized by these banks. The decline in these placements is regarded as inflows in the other investments.

deficit due to favorable domestic and international investment conditions that encouraged large non-debt creating financial inflows into the country. As a result Pakistan was not only able to run large deficit but also added to its foreign exchange reserves. However, that will be increasingly risky strategy, given the stresses on the domestic economy as well as the relatively less favorable dynamics in the international capital markets.

It may also be pointed out that current account deficit, during Jul-Jan FY08, largely followed the trend in trade deficit as the strong current transfers' inflows (mainly remittances driven) almost entirely offset the deficit in services and income accounts (see **Figure 6.3**). Thus a small improvement in the trade deficit in the initial four months of FY08 was well reflected in the modest improvement in current account deficit. Thereafter (Nov-Jan FY08), the worsening of trade deficit on the back of increased wheat and petroleum group imports and low export growth led to significant deterioration in current account deficit. The aforementioned trend implies that soaring trade deficit is the major underlying weakness of the external sector



Clearly, correction in external imbalance lies either in import compression or export promotion; or a combination of the two. The policy options for import compression include imposition of tariff, tight monetary policy and exchange rate depreciation. The former option is exercisable only in limited cases where the MFN rates are significantly lower than those required under WTO obligation. Regarding the latter two options, Pakistan has already tightened its monetary policy to reduce the aggregate demand and Pak Rupee depreciated considerably against the US dollar in the recent months.

As a result, the real import growth (adjusted for price effect) has slowed down significantly<sup>4</sup>. Unfortunately, this slow down has been offset by the rise in oil and

<sup>4</sup> For details, see section 6.6 on Foreign Trade.

commodity prices in the international market and not too benign fiscal expansion at home. Moreover, the potential for further import compression is limited due to (a) Pakistan needs to invest heavily in building up infrastructure, (b) rise in oil import bill on the back of high global oil prices and increased domestic consumption, (c) price effect of rising commodity prices on import bill and (d) anticipated increase in import of power generating machinery.

Boosting export growth, on the other hand, will be challenging against the power shortages, increased competition in textile exports, declining growth in the demand for textile (Pakistan's major exports) in key markets and relatively high domestic logistic costs (see **Box 6.1**). In this regard, more strenuous efforts are required to promote exports such as to move from low value added to high value added exports, to diversify exports market by capturing the fast growing emerging markets, to address the issues like infrastructural bottlenecks, power shortages and low productivity.

Beside these challenges, raising funds from the international market to finance the current account deficit is another challenge. In particular, raising funds from the international capital market has become expensive in the wake of global financial turmoil and political uncertainty at home (see **Box 6.2**). However, the expected post election stability may help in attracting the foreign inflows mainly because (a) Pakistan's stock market is still relatively safe from global financial turmoil,<sup>5</sup> and (b) Pakistan's stock market is trading at discount as compared to other regional markets. Moreover, persistent flows of foreign direct investment combined with expected proceeds of NBP and HBL's floatation of GDRs and issuance of euro bond in the later half of the year would help in financing the current account deficit.

Going forward, the current account deficit is likely to remain under pressure mainly due to (a) adverse effect of increased cotton prices compounded with frequent power shortages on the export growth, (b) slowdown in Pakistan's major export markets (see **Box 6.3**), (c) lack of compliance with international standards, and (d) infrastructural bottlenecks. However, the consistent flows of remittances and favorable impact of Pak Rupee's considerable depreciation (Nominal Effective Exchange Rate Index depreciated by 7.3 percent during Jul-Jan FY08) against trading partners' currencies on the export proceeds are likely to provide some relief to the widening current account deficit.

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<sup>5</sup> [www.economist.com](http://www.economist.com)

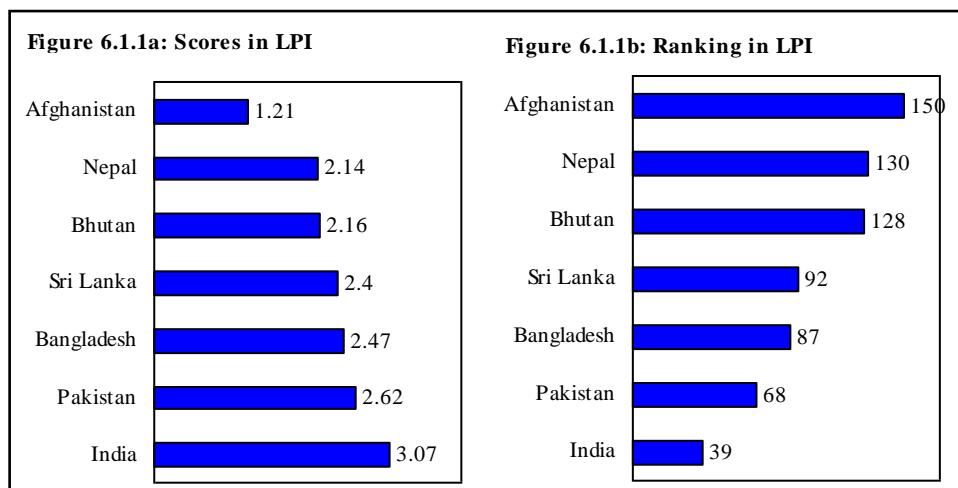
### Box 6.1: Logistic Performance Index

The Logistic Performance Index (LPI) is an interactive benchmarking instrument to help countries identify the challenges and opportunities they face in their performance on trade logistics and what they can do to improve their performance. Introduced by the World Bank in 2007, the LPI covers an assortment of actions, from transportation, consolidation of cargo, warehousing, and border clearance to in-country distribution and payment systems. Like the World Bank group's Doing Business report and the World Economic Forum's Global Competitiveness Index, the LPI provides a set of indicators to gauge international competitiveness. The LPI and its indicators are based on a survey of multinational freight forwarders of the world's largest logistics providers, which cover 150 countries. The performance of each country was evaluated by using a one to five point scale (one being the worst performance for the given dimension). The LPI was aggregated as a weighted average of the seven areas of performance, which are:

1. Efficiency of clearance process by customs and other border agencies.
2. Quality of transport and information technology infrastructure for logistics.
3. Ease and affordability of arranging international shipments.
4. Competence of the local logistics industry.
5. Ability to track and trace international shipments.
6. Domestic logistics costs.
7. Timeliness of shipments in reaching destination.

Pakistan's ranking in the 2007 logistics performance index is 68<sup>th</sup> among the 150 countries with 2.62 overall score (see **Figure 6.1.1** and **Table 6.1.1**). Amongst the South Asian countries, Pakistan is ranked at number two. As far as the indicators-wise ranking is concerned, Pakistan has better standing in area of competence of the local logistic industry (with 63<sup>rd</sup> position) as compared to worst place in the area of domestic logistic cost (with 90<sup>th</sup> ranking).

The LPI also classifies countries according to income<sup>6</sup> groups. Economies are divided according to 2006 gross national income (GNI) per capita, calculated using the World Bank Atlas method. The

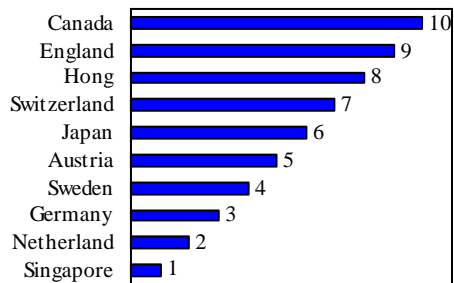
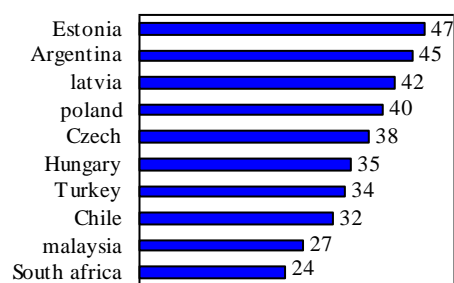
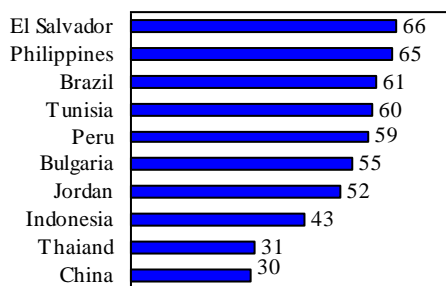
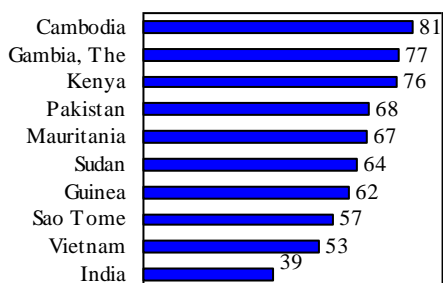


<sup>6</sup> Income classifications are set each year on 1<sup>st</sup> July. These official analytical classifications are fixed during the World Bank's fiscal year (ending on 30<sup>th</sup> June), thus countries remain in the categories in which they are classified irrespective of any revision to their per capita income data.

**Table 6.1.1: Logistics Performance Index of South Asian Countries for 2007**

	Pakistan		India		Bangladesh		Sri Lanka		Nepal	
	Rank	Score	Rank	Score	Rank	Score	Rank	Score	Rank	Score
<b>Logistic performance index</b>	<b>68</b>	<b>2.62</b>	<b>39</b>	<b>3.07</b>	<b>87</b>	<b>2.47</b>	<b>92</b>	<b>2.40</b>	<b>130</b>	<b>2.14</b>
Customs	69	2.41	47	2.69	125	2.00	91	2.25	141	1.83
Infrastructure	71	2.37	42	2.90	82	2.29	106	2.13	144	1.77
International shipments	65	2.72	39	3.08	96	2.46	112	2.31	131	2.09
Logistics competence	63	2.71	31	3.27	103	2.33	85	2.45	124	2.08
Tracking & tracing	76	2.57	42	3.03	88	2.46	75	2.58	102	2.33
Domestic logistics costs	90	2.86	46	3.08	50	3.08	47	3.08	8	3.43
Timeliness	88	2.93	47	3.47	54	3.33	113	2.69	122	2.63

groups are: low income group, US\$905 or less (with 52 countries); lower-middle income group, US\$906-US\$3595 (with 41 economies); upper-middle income group, US\$3596-US\$11115 (having 24 nations); and higher income group, US\$11116 or more (with 33 states **Figure 6.1.2**, Pakistan is classified in lower income group having 7<sup>th</sup> position in top ten countries.

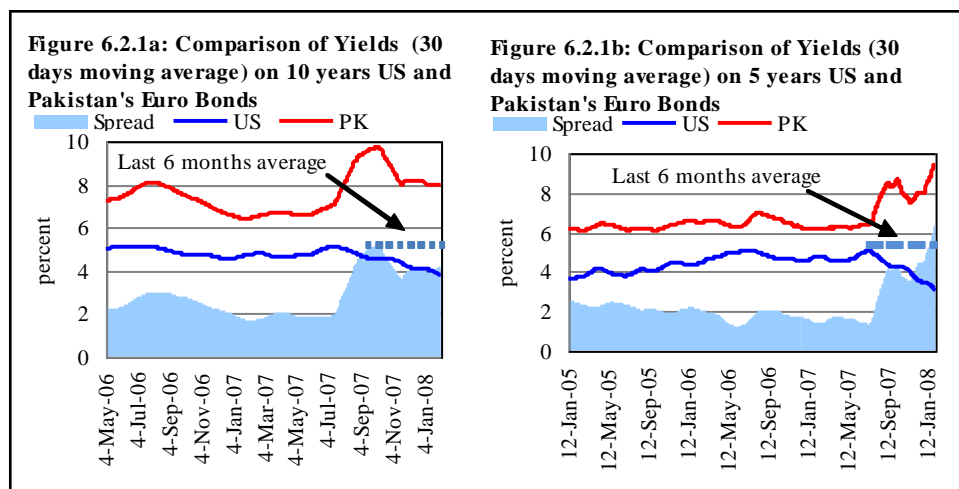
**Figure 6.1.2a: Top 10 Countries Higher Income****Figure 6.1.2b: Top 10 Countries Upper Middle Income****Figure 6.1.2c: Top 10 Countries Lower Middle Income****Figure 6.1.2d: Top 10 Countries Lower Income**

As mentioned above, Pakistan has worst position (ranked 90) in the field of domestic logistic cost that include: port charges, domestic transport agent fees, warehousing service charges, rail transport rates, less than full truck load services rates and full truck load rates. In Pakistan, the typical charges

for a 40-foot export container/import container are US\$ 382/444, while in Bangladesh and Sri Lanka these charges are US\$ 211/397 and US\$ 245/263 respectively. Similarly, Pakistan's ranking (88) in timeliness captured by both, the time to import and export and predictability of this time is also very low. It is evident that countries with higher logistic costs are more likely to miss the benefits of globalization. Thus there is a need to tackle issues that impede Pakistan's performance on LPI now that a benchmark has become available for evaluation.

#### Box 6.2: Global Financial Turmoil and External Bond Issuance

The recent turmoil in financial markets have significant implications for borrowing in the international debt market. The tighter global lending conditions and investors lack of confidence in credit evaluation has made the issuance of external bonds costlier. Even borrowing in the securities and bonds backed by government debt, typically thought to be free of credit risk, were affected by the turmoil in credit markets. As a result, the issuance of the external bonds slowed down in the third and fourth quarter of 2007. The IMF global financial stability report update (29<sup>th</sup> January 2008) shows that like developed economies, emerging markets also witnessed pronounced decline in the issuance of bonds during the aforementioned period (see **Figure 6.2.2**).



Pakistan, being one of the emerging economies, has also not issued euro bonds in the latter half of 2007. In this backdrop, it would be interesting to explore the costs of new issues in the international market in the face of financial turmoil at the external front and political uncertainty at the domestic front. One way to address this question is to analyze the yields of the already issued bonds of different tenors in the secondary markets. It can be observed from the **Table 6.2.1** that average yield on all the bonds issued has increased in the second half of 2007. Moreover, as depicted by the coefficient of variation, the risk on these bonds has also increased in the aforementioned period. Thus the preliminary data analysis suggests that Pakistan will have to pay more to attract the foreign investors. For instance, the spread between Pakistan's 5 years euro bonds over US bonds of the same tenor widened to 620 basis points at end January 2008 from 140 basis points at end June 2007.



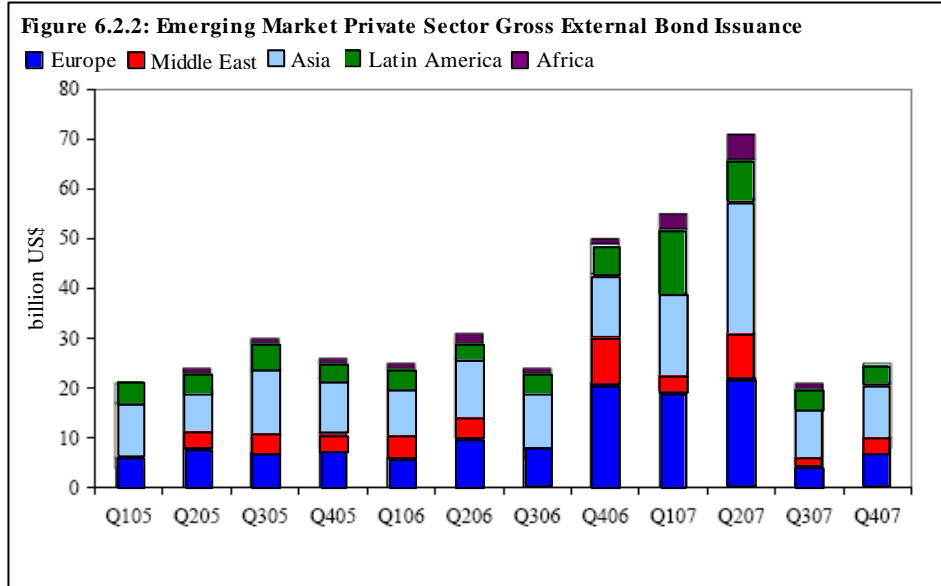
To support the economic activity in the face of financial turmoil and partly to increase country risk at home and resultant downward revision (from stable to negative) by Standard & Poor's of Pakistan outlook on the long-term foreign and local currency sovereign credit rating.

However, even if the yields on US bonds had followed the previous six months average assuming no reduction in federal fund rate, the risk premium on the Pakistan's euro bonds would have increased on account of increased political uncertainty at home (see **Figure 6.2.1**). Moreover, risk premium on the medium term bonds witnessed sharp increase as compared to the long-term bonds. The above analysis implies that Pakistan would have to pay more to raise capital from the international market owing to increased risk premium.

**Table 6.2.1: Pakistan's Euro bonds Price and Yield in the Secondary Market**

<b>10 years Bond</b>				
Mar27,2006-Jun 30, 2007		Jul 1,2007-Feb 2, 2008		
	Price	Yield	Price	Yield
Mean	100.3	7.1	91.7	8.5
CV	3.6	7.6	5.1	9.8
<b>5 years Bond</b>				
Feb 12,2004-Jun 30, 2007		Jul 1,2007-Feb 2, 2008		
	Price	Yield	Price	Yield
Mean	101.1	6.3	98.5	8.0
CV	0.7	3.8	1.3	14.0
<b>Sukuk</b>				
Jan 11,2006-Jun 30, 2007		Jul 1,2007-Feb 2, 2008		
	Price	Yield	Price	Yield
Mean	102.9	6.5	99.6	7.5
CV	0.1	1.0	1.4	8.2

Source: Bloomberg



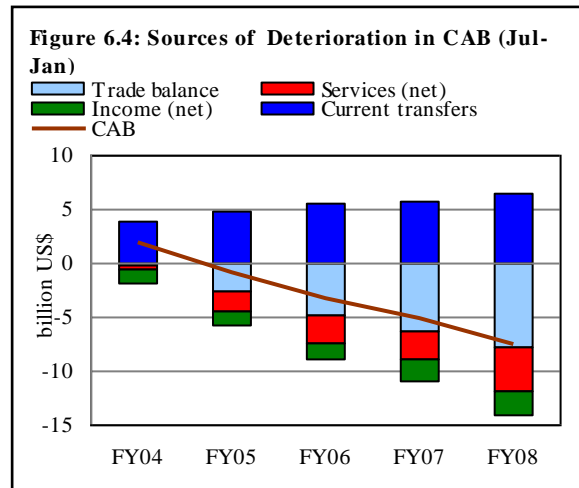
#### References

Bank for International Settlement Quarterly Review (December 2007)  
IMF Global Financial Stability Report Market Update (January 2008)

## 6.2 Current Account Balance

Current account deficit continued to widen for the fourth year in a row touching US\$ 7.5 billion in Jul-Jan FY08 compared with US\$ 5.1 billion in the same period last year (see **Figure 6.4**).

Deterioration in current account deficit is primarily driven by the widening trade deficit, delay in logistic support receipts and higher direct investment income outflows (see **Table 6.2**). All of these overshadowed the impact of strong growth in workers' remittances and higher earnings on foreign exchange reserves.



### 6.2.1 Trade Account<sup>7</sup>

As was feared, the modest decline in trade deficit in the initial four months of the current fiscal year, compared with the same period last year, could not be sustained in the ensuing months. In the subsequent months (Nov-Jan FY08) sharp increase in import growth and low export growth translated into higher trade deficit. As a result, the trade deficit reached US\$ 7.8 billion during Jul-Jan FY08 against US\$ 6.2 billion in the same period last year.

The higher import growth was chiefly attributed to inflated petroleum group imports on the back of high global oil prices and increased domestic demand, import of wheat in the wake of flour crises and rise in fertilizers imports. The low export growth, on the other hand, was mainly attributed to severe power shortages, increased political unrest and stiff regional competition in textile exports.<sup>8</sup>

<sup>7</sup> This section is based on exchange record data compiled by SBP that does not tally with the custom data compiled by FBS.

<sup>8</sup> For detail, see **section 6.6** on **Foreign Trade**.

**Table 6.2: Current Account Balance**

million US\$

	Jul-Jan			YoY Change	
	FY06	FY07*	FY08*	FY07	FY08
<b>1. Trade balance</b>	<b>-4903</b>	<b>-6228</b>	<b>-7844</b>	<b>-1325</b>	<b>-1616</b>
Exports	9166	9578	10985	412	1407
Imports	14069	15806	18829	1737	3023
<b>2. Services ( net )</b>	<b>-2452</b>	<b>-2631</b>	<b>-3968</b>	<b>-179</b>	<b>-1337</b>
Transportation	-1066	-1227	-1404	-161	-177
Travel	-731	-844	-784	-113	60
Communication services	48	24	26	-24	2
Construction services	-118	-18	-10	100	8
Insurance services	-67	-74	-86	-7	-12
Financial services	-47	-53	-76	-6	-23
Computer & information services	15	7	1	-8	-6
Royalties and license fees	-57	-48	-44	9	4
Other business services	-1307	-1173	-1710	134	-537
Personal & cultural & recreational services	-3	1	0	4	-1
Government services	881	774	119	-107	-655
<i>Of which logistic support</i>	756	723	0	-33	-723
<b>3. Income ( net )</b>	<b>-1497</b>	<b>-2050</b>	<b>-2176</b>	<b>-553</b>	<b>-126</b>
Investment income( net )	-1500	-2053	-2180	-553	-127
Direct investment	-1135	-1679	-1819	-544	-140
<i>of which: profit &amp; dividends</i>	-254	-355	-398	-101	-43
<i>purchase of crude oil and minerals</i>	-577	-830	-853	-253	-23
Portfolio investment	-86	-118	-118	-32	0
<i>Of which : profit &amp; dividend</i>	-46	-111	-130	-65	-19
IMF charges & interest on off. external long-term debt	-347	-376	-384	-29	-8
Interest on private external debt	-47	-70	-98	-23	-28
Others (net)	118	193	243	75	50
<b>4. Current transfers ( net )</b>	<b>5471</b>	<b>5803</b>	<b>6468</b>	<b>332</b>	<b>665</b>
Private transfers	5242	5574	6433	332	859
<i>Workers' remittance</i>	2444	2959	3619	515	660
<i>FCA - residents</i>	295	51	294	-244	243
<i>Others</i>	2542	2594	2574	52	-20
<i>of which exchange companies</i>	1586	1462	1353	-124	-109
Official transfers	229	229	35	0	-194
<b>Current account balance</b>	<b>-3381</b>	<b>-5106</b>	<b>-7520</b>	<b>-1725</b>	<b>-2414</b>

\* provisional

**Box: 6.3 Pakistan's Exports Are Less Vulnerable to a US Recession**

More than one quarter of Pakistan's total exports were destined to US market in 2006. In this situation, it is important to analyze the relationship between US economic activity and Pakistan's exports to US.

The breakup of Pakistan's overall exports to US market suggests that more than 90 percent of Pakistan's overall exports to US market consist of textile exports. Therefore textile exports to US have been used as the close proxy of the total exports to US market. The following analysis is based on two data sets: (a) UN comtrade data base and (b) US Office of Textile and Apparel (OTEXA).

Detailed data reveals that more than one third of Pakistan's total textile exports are directed to US market. Within textile group, US accounts for more than one quarter of Pakistan's low value added textile, yarn & fabrics exports and close to one half of the high value added clothing and accessories exports. With almost half of the total high value added being destined for the US market, it is likely that these exports would be more vulnerable to slow down in US economy than the low value added textile exports which are relatively more diversified.

Before analyzing the impact of US economic growth on textile imports from Pakistan, it would be relevant to know whether slow down in US economy is correlated with its overall textile imports from the world. The trend analysis (1990-2006) suggests that US economic growth and its textile imports growth are positively correlated (see **Table 6.3.2** and **Figure 6.3.1**). However, this relationship is stronger in case of high value added apparel imports than the low value added non-apparel imports (see **Table 6.3.2**).

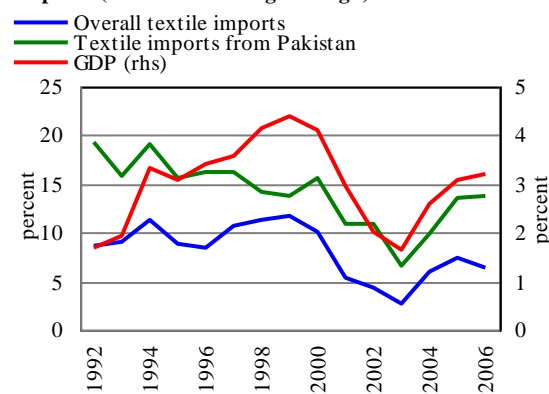
In case of Pakistan, though the US economic growth and textile imports growth from Pakistan are positively correlated but the magnitude of the correlation is very low (see **Table 6.3.2a** and **Figure**

**Table 6.3.1: Share (%) of Pakistan's Exports to US to its Total Exports**

	Total	Textile, yarn & fabrics	Clothing and accessories	Textile (total)
2001	22.6	23.1	46.3	30.5
2002	24.4	25.2	44.0	31.2
2003	23.1	24.0	42.4	29.8
2004	23.3	25.6	42.4	31.2
2005	24.8	29.6	45.4	34.9
2006	25.7	29.7	47.2	35.7

Source: UN comtrade

**Figure 6.3.1: Growth in US GDP and Textile Imports (3-month moving average)**



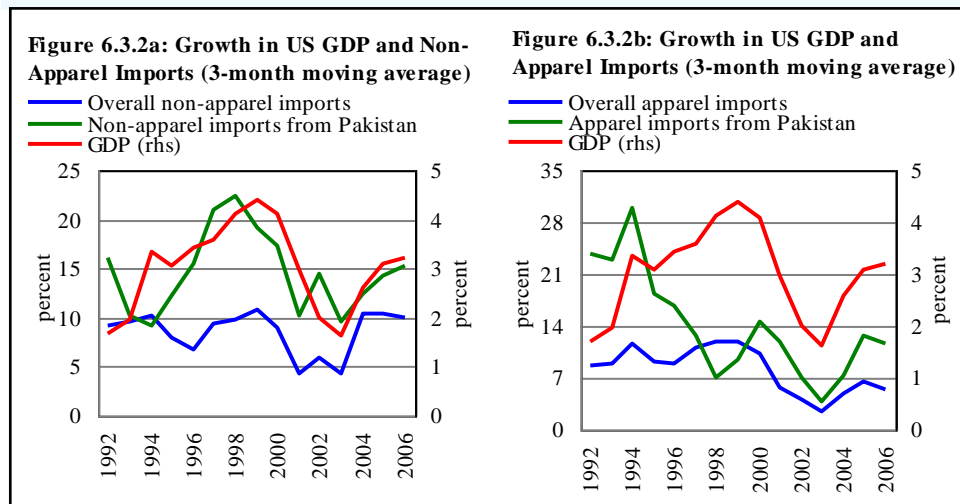
**Table 6.3.2: Correlation with US GDP Growth (1990-2006)**

	World	Pakistan
Total textile imports growth	0.64	0.33
Apparel imports growth	0.64	0.32
Non-apparel imports growth	0.48	0.18

Source: OTEXA

6.3.2b). With the fall in income, the possible shifting of US buyers to relatively low priced textile products from Pakistan may be the probable reason behind this low correlation. Moreover, the correlation is even weaker in case of low value added textile imports from Pakistan.

Thus, it may be argued that, (a) effect of US economy slow down is likely to be limited on Pakistan's overall textile exports to US and (b) the adverse effect is expected to be even lower in low value added textile exports (which constitute around 68.0 percent of Pakistan's total textile exports) relative to high value added textile exports.



### 6.2.2 Services (net)

Continuing four years trend, the services account deficit widened further in Jul-Jan FY08 (see **Table 6.3**). However, unlike the previous years, the largest contribution was not reflective of the rising imports. Rather, the dominant contribution to the year-on-year deterioration was from the delays in the receipts of logistic support. This accounted for approximately 54.1 percent of the rise in the overall services deficit during Jul-Jan FY08.

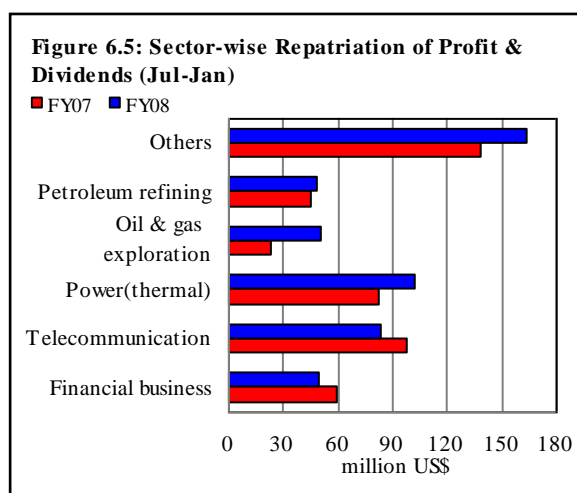
**Table 6.3: Services Account Balance**

million US\$			
	Jul-Jan		
	FY07	FY08	Change
1. Transportation	-1227.0	-1404.0	-177.0
<i>of which freight</i>	-1224.0	-1476.0	-252.0
2. Other business services	-1173.0	-1710.0	-537.0
<i>a) Architect, eng, technical</i>	-7.2	-37.3	-30.1
<i>b) Technical fees to foreigners</i>	-158.3	-291.4	-133.1
3. Government services	774.0	119.0	-655.0
<i>Of which logistic support</i>	723.0	0.0	-723.0
4. Others	-1005.0	-974.0	31.0
<b>Services (net)</b>	<b>-2631.0</b>	<b>-3968.0</b>	<b>-1337.0</b>

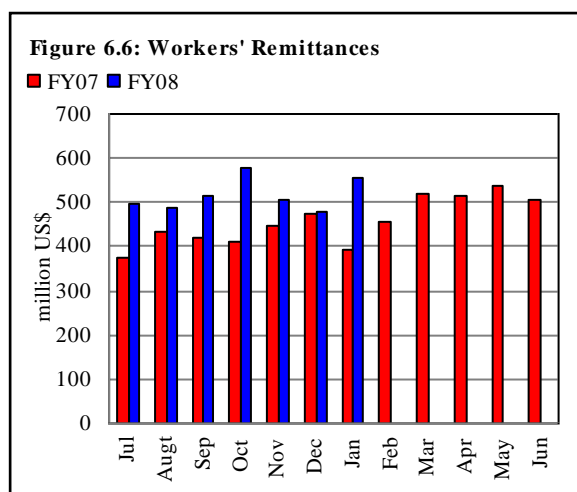
Followed by delay in logistic support, the outflows from other business services, mainly reflecting the increased coverage of foreign transaction routed through exchange companies.<sup>9</sup> Increase in payments of import related freight charges on the back of higher import growth also contributed significantly in the overall rise in services account deficit during the period under review.

### 6.2.3 Income (net)

Income account deficit deteriorated further during Jul-Jan FY08, by 6.0 percent. This is in sharp contrast to the 37.0 percent deterioration in the same period last year on the back of higher purchases of crude oil and minerals (see **Table 6.2**). This deterioration is mainly explained by the higher investment income outflows as the interest income payments (net) were lower during Jul-Jan FY08 compared with the same period last year.



Increase in investment income outflows, in turn, was mainly driven by the higher repatriation of profit & dividends on Foreign Direct Investment (FDI). The major contribution in repatriation of profit and dividend came from the fast growing sectors, i.e., thermal power (20.0 percent), telecommunication (16.1 percent), oil and gas exploration (10.0 percent) and financial business (10.0 percent) (see **Figure 6.5**).



<sup>9</sup> As mentioned in the earlier reports, these outflows have no impact on the overall current account balance as these outflows are matched by the receipts of foreign exchange companies.

**Table 6.4: Details of Interest Payments and Receipts**

million US\$

	Jul-Jan			Change	
	FY06	FY07	FY08	FY07	FY08
<b>Payments (I+II)</b>	<b>575</b>	<b>660</b>	<b>734</b>	<b>-85</b>	<b>-74</b>
<b>I.Total external debt</b>	<b>479</b>	<b>559</b>	<b>563</b>	<b>-80</b>	<b>-4</b>
Public & publicly guaranteed	422	475	462	-53	13
Long-term	330	355	377	-25	-22
Military	7	7	3	0	4
Euro bonds/Sukuk	74	98	62	-24	36
Commercial loans/credits	5	7	18	-2	-11
IDB	6	8	2	-2	6
Private loans/credits	47	70	98	-23	-28
IMF	10	14	3	-4	11
<b>II. External liabilities</b>	<b>96</b>	<b>101</b>	<b>171</b>	<b>-5</b>	<b>-70</b>
Foreign currency deposits	10	17	65	-7	-48
Special US\$ bonds	19	6	4	13	2
Central bank deposits	21	16	23	5	-7
Others	46	62	79	-16	-17
<b>Receipts</b>	<b>198</b>	<b>299</b>	<b>423</b>	<b>101</b>	<b>124</b>
Interest on reserves	132	228	335	96	107
Others	66	71	88	5	17
<b>Total payment (net)</b>	<b>377</b>	<b>361</b>	<b>311</b>	<b>16</b>	<b>50</b>

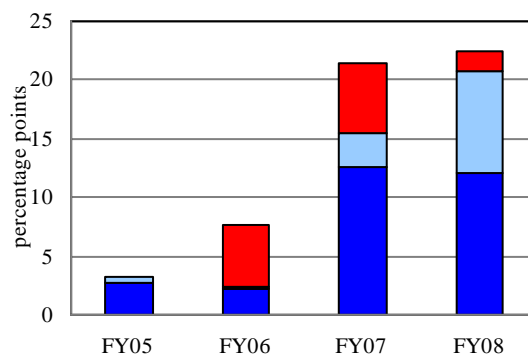
On the other hand, the lower interest payments (net) entirely emanated from higher earnings on the foreign exchange reserves (see **Table 6.4**). However, the interest payments on the external liabilities increased on account of higher payments on the foreign currency deposits.

#### 6.2.4 Current Transfers

The 11.5 percent rise in the current transfers during Jul-Jan FY08 on the top of 6.1 percent growth in the same period last year mainly

**Figure 6.7: Contribution in Remittances Growth (Jul-Jan)**

■ Gulf ■ USA ■ Others



reflects the strong growth in private transfers. Within private transfers, robust growth in remittances was the major contributor followed by higher inflows in the resident foreign currency accounts (FCAs).

### Workers' Remittances

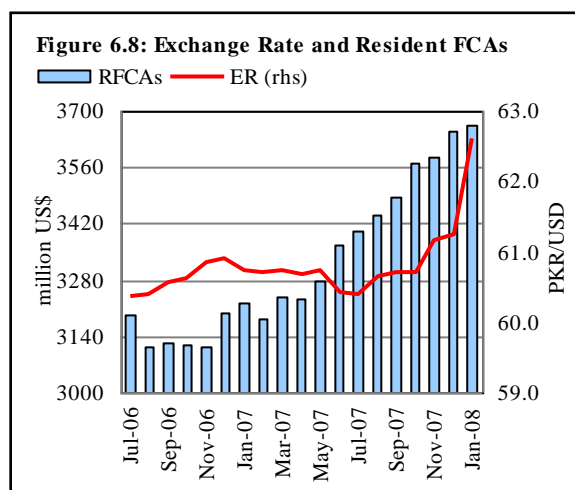
Workers' remittances continued to grow strongly for the second successive year. Remittances growth accelerated to 22.4 percent during Jul-Jan FY08 from strong growth of 21.1 percent in the same period last year. More encouragingly, the remittances remained higher than the corresponding months of FY07 through the entire Jul-Jan period of FY08 (see **Figure 6.6**).

As in the previous years (FY05-07), the remittances flows routed through Foreign Exchange Companies (FECs) registered extraordinary growth of 67.8 percent during Jul-Jan FY08. As a result, the share of remittances routed through FECs in overall remittances increased to 23.2 percent during Jul-Jan FY08 from 17.0 percent in the same period last year. The network expansion (establishment of payments booths and arrangements with western union) of Zarco and Wall Street exchange companies, which together constitutes more than 50 percent of total remittances routed through FECs, was the most probable factor behind this strong growth in remittances flows through FECs.

During the current year, the main contribution in remittances growth came from Gulf States and US (see **Figure 6.7**). As mentioned in the First Quarterly Report for FY08, the higher contribution of Gulf States probably reflects the higher oil prices and consequential prosperity there. The increasing share of remittances from the US (see **Box 6.4**), on the other hand, may reflect the fact that Pakistani migrants to US do not want to hold their savings there.

### Resident FCAs

Inflow in the resident FCAs increased to US\$ 294 million during Jul-Jan FY08 as compared to the nominal inflow of US\$ 51 million in



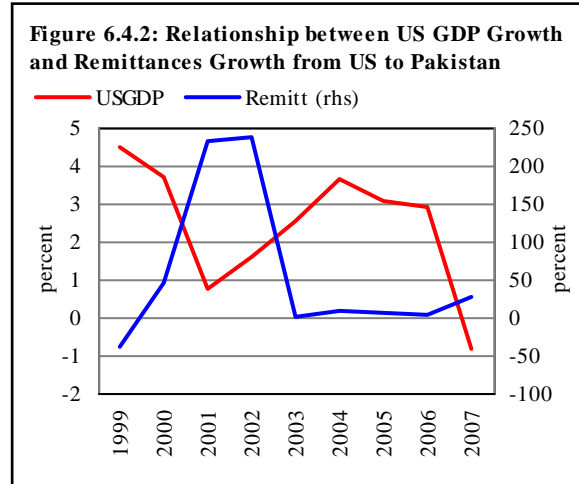
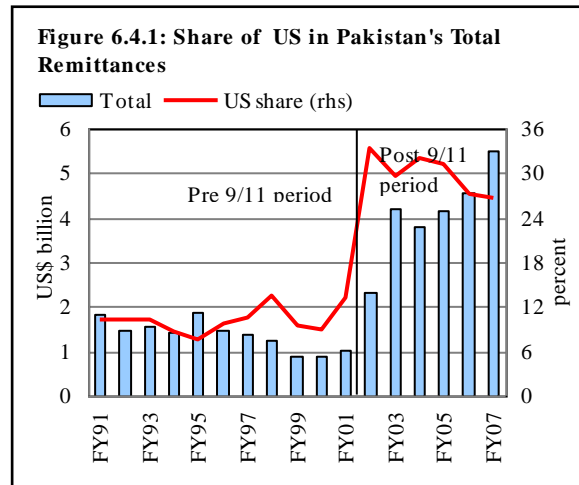


the same period last year. A part of this increase may be attributed to Rupee depreciation against US dollar which makes these deposits attractive (see **Figure**

**Box 6.4: US Economic Growth and Remittances to Pakistan**

Workers' remittances to Pakistan have grown rapidly in the recent years particularly in the post 9/11 period (see **Figure 6.4.1**). In the aforementioned period US emerged as one of the major sources of remittances flows to Pakistan. Specifically, US share in Pakistan's overall remittances has increased from 10.1 percent (average during FY91-FY01) to around 30.0 percent (average during FY02-FY07). The shifting trend has increased the importance of US economic conditions for maintaining stable remittances flows to Pakistan.

With the recession in the US economy it may be pertinent to analyze the influence of US economic growth on remittances flows to Pakistan. The trend analysis suggests that US GDP growth and growth in remittances flows to Pakistan seems to have very weak relationship (see **Figure 6.4.2**). This relationship is not surprising as similar results are found in empirical work of Lianos (1997) on remittances flows to Greece, Sayan (2004) on remittances flows to Turkey and Shaun K. Roache & Ewa Gradzka (2007) on remittances flows to Latin America.



The literature on the remittances provides hosts of factors for the missing or weak link between the remittances and host country economic activity. For instance, like consumption, the migrant workers may smooth their remittances flows thereby making remittances flows less volatile than the income fluctuations. Secondly, the low profile migrant workers attach more weight to being employed than to wage received and are therefore less likely to be unemployed.<sup>10</sup> Thirdly, the diversion of remittances flows from informal to formal channels may have increased the remittances flows

<sup>10</sup> In case of Pakistan, the anecdotal evidence suggests that around 40 percent of Pakistanis in US possess low profile jobs.

despite the fluctuations in the income of host country.<sup>11</sup> Besides these factors, home country income, socio-demographic profile of migrants, relationship of the emigrants to the household members, numbers of the years the migrant spend in the host country and the stock of migrants also influence the remittances flows.

#### References

Lianos, Theodore P. (1997), "Factors Determining Migrant Remittances: The Case of Greece," *International Migration Review*, Vol 31, No.1. (Spring, 1997), pp.72-87

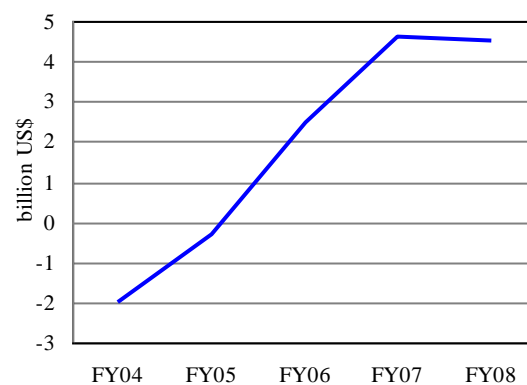
6.8). Moreover, depreciation of US dollar against major currencies may also have increased the US dollar value of resident FCAs during the period under review.

### 6.3 Financial Account

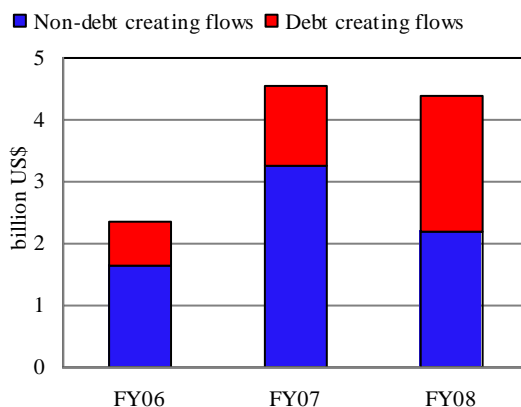
After recording sharp increase in Jul-Jan period of last two years, the financial account surplus witnessed modest decline during Jul-Jan FY08 (see **Figure 6.9**). This nominal fall in the financial account surplus is entirely explained by the substantial fall in the portfolio investment. In contrast, the FDI and other investment continued to grow at a reasonable pace during Jul-Jan FY08 (see **Table 6.5**).

Composition of net financial inflows has also changed significantly in FY08 compared to the previous two years. Unlike the previous years, when capital flows mainly emanated from equity securities and concessional debt, the capital flows during

**Figure 6.9: Financial Account Balance (Jul-Jan)**



**Figure 6.10: Sources of Financing CAD (Jul-Jan)**



<sup>11</sup> For example, the breakdown of *hundi* channel, followed by 9/11 incident, diverted the remittances flows by expatriate Pakistanis from informal to formal channel.

FY08 were mainly in the form of debt creating flows (see **Figure 6.10**). For instance, the government borrowed short-term debt worth US\$ 508 million from Islamic Development Bank (relatively expensive source) during Jul-Jan FY08

**Table 6.5: Financial Account**

million US\$

	Jul-Jan			YoY change	
	FY06	FY07	FY08*	FY07	FY08
<b>Financial account (net )</b>	<b>2456</b>	<b>4597</b>	<b>4502</b>	<b>2141</b>	<b>-95</b>
Direct investment abroad	<b>-19</b>	<b>-49</b>	<b>-35</b>	<b>-30</b>	<b>14</b>
Direct investment in Pakistan	<b>1244</b>	<b>2096</b>	<b>2298</b>	<b>852</b>	<b>202</b>
Equity capital	931	1585	1719	654	134
Reinvested earnings	313	508	579	195	71
<b>Portfolio investment</b>	<b>311</b>	<b>1370</b>	<b>-2</b>	<b>1059</b>	<b>-1372</b>
Equity securities	414	1227	-24	813	-1251
Debt securities	-103	143	22.0	246	-121
<b>Net foreign investment</b>	<b>1536</b>	<b>3417</b>	<b>2261</b>	<b>1881</b>	<b>-1156</b>
<b>Other investment</b>	<b>822</b>	<b>1119</b>	<b>2136</b>	<b>297</b>	<b>1017</b>
Assets	373	30	527	-343	497
1-Outstanding export bills (exporters)	-173	-144	-225	29	-81
2-Outstanding export bills (DMBs))	62	113	138	51	25
3-Currency and deposits	483	60	614	-423	554
of which banks	454	-23	529	-477	552
Liabilities	449	1089	1609	640	520
1-Foreign long-term government loans / credits ( net )	332	657	793	325	136
Project loans	340	496	602	156	106
Non- project loans	591	692	776	101	84
Amortization	600	531	585	-69	54
2-Private loans	-28	191	127	219	-64
of which supplier credits	166	401	282	235	-119
suppliers credit repayments	194	210	155	16	-55
3-Short-term capital (official)	-61	-58	467	3	525
of which IDB (net)	55	58	467	3	409
4-Currency and deposits	315	183	328	-132	145
Other liabilities	-11	177	-1	188	-178

\* provisional

as against cumulative amount of US\$ 394 million in the same period of last two years. The continuous increase in current account deficit and the emerging trend

in the composition of net financial inflows is a source of concern, particularly the increased reliance on the short-term debt.

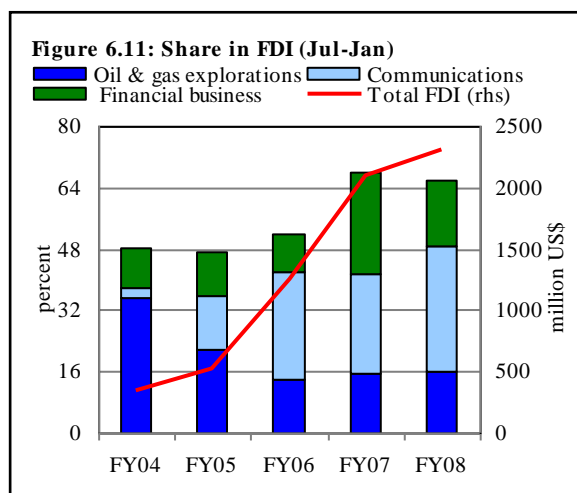
### 6.3.1 Net Foreign Investment

Overall net foreign investment declined by 33.8 percent during Jul-Jan FY08 as compared to exceptional growth of 122.4 percent in the same period last year. This was mainly because of lower inflows in both the private and public sector portfolio investment (see **Table 6.6**).

#### Foreign Direct Investment

FDI registered double digit growth for the fourth successive year. However, the growth of 9.6 percent during Jul-Jan FY08 was substantially lower than the extraordinary growth of 68.5 percent in the same period of the previous year.

It may be pointed out that FDI inflows which were traditionally concentrated in oil producing sectors have now been diversified to some extent.<sup>12</sup> The liberalization of telecommunication and financial sectors has played important role in attracting the foreign inflows in the preceding five years. Specifically, the share of the former sector in the total FDI has increased from 3.0 percent during Jul-Jan FY04 to 32.6 percent during Jul-Jan FY08, while the share of latter in total FDI has increased from 10.1 percent during Jul-Jan FY04 to 17.2 percent during Jul-Jan FY08 (see **Figure 6.11**).



FDI in these two sectors created competitive environment for the benefit of consumers in the form of variety of products and lower prices. Moreover, FDI driven strong growth in the aforementioned sectors also contributed significantly in the overall GDP growth through expansion of services.

<sup>12</sup> During Jul-Dec FY02-Jul-Dec FY04, the average share of oil and gas exploration sector in total FDI was around 31 percent which is reduced to 16.0 percent during Jul-Dec FY08.

Cash and reinvested earning breakup of the FDI suggests that both the segments contributed positively in the overall FDI growth (see **Table 6.7**). Major sectors which recorded increase in reinvested earnings include *Telecommunication, financial business, oil & gas exploration, trade and cement*. The higher reinvested earning reflects the profitability of these sectors. Moreover, the rising reinvestment by the foreigners may also be considered as a proxy for the foreign investors' positive outlook for the domestic economy in the long run.

**Table 6.6: Net Flows of Foreign Investment in Pakistan**

million US\$			
Jul-Jan			
	FY06	FY07	FY08
<b>Foreign private investment</b>	<b>1658</b>	<b>2493</b>	<b>2192</b>
<b>Foreign direct investment</b>	<b>1244</b>	<b>2096</b>	<b>2298</b>
<i>of which privatization proceeds</i>	255	133.2	133.2
<b>Portfolio investment (net)</b>	<b>414</b>	<b>687</b>	<b>-24</b>
Equity securities	414	489	-24
<i>of which GDRs</i>	0	150	90.5
Debt securities	0	198	0
<b>Foreign public investment</b>	<b>-103</b>	<b>683</b>	<b>22</b>
<b>Portfolio investment</b>	<b>-103</b>	<b>683</b>	<b>22</b>
Equity securities	0	738	0
<i>of which GDRs of OGDC</i>	0	738	0
Debt securities *	-103	-55	22
<b>Total net foreign investment</b>	<b>1536</b>	<b>3417</b>	<b>2261</b>

\* Net sale/purchase of Special US\$ bonds, FEBC, DBC, T-bills and PIBs

### Portfolio Investment

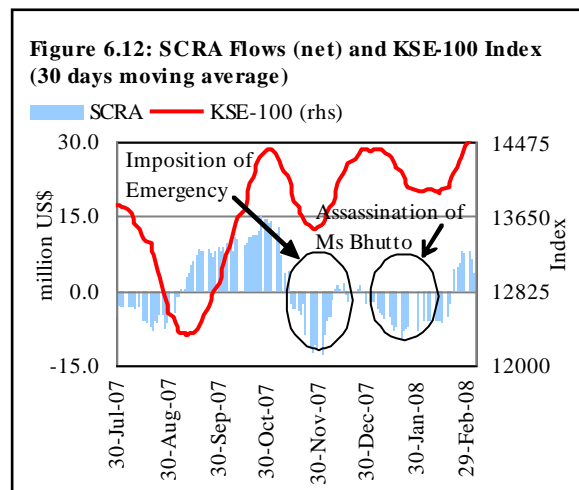
In sharp contrast to last year's robust performance, the portfolio investment recorded net outflows during Jul-Jan FY08 (see **Table 6.6**). This poor performance is attributed to delay in floatation of GDRs, lower floatation of debt securities and outflow from the equity and fixed income market. This dismal

**Table 6.7: Sector wise Foreign Direct Investment (Jul-Dec)**

million US\$						
	FY07			FY08		
	Cash	Reinvested earnings	Total	Cash	Reinvested earnings	Total
Chemicals	-10.1	28.6	18.6	27.4	25.5	52.9
Petroleum refining	9.2	57.4	66.6	9.8	39.4	49.1
Oil & gas explorations	255.5	74.5	329.9	245.1	122.5	367.6
Cement	1.1	12.5	13.7	58.3	24.6	82.9
Trade	94.5	11.6	106.1	83.5	27.9	111.4
Telecommunications	472.0	40.2	512.3	614.9	51.0	665.8
Financial business	420.2	133.4	553.6	239.3	187.9	427.3
Personal services	50.9	1.5	52.4	59.6	2.5	62.1
Others	292.0	150.9	442.9	380.9	98.2	479.2
<b>Total</b>	<b>1585.3</b>	<b>510.7</b>	<b>2096.0</b>	<b>1718.8</b>	<b>579.5</b>	<b>2298.3</b>

performance is attributable largely to global financial turmoil and domestic political unrest. On the one hand, this made it costlier to raise funds from the international capital market and on the other hand, led to capital flight from the equity market. As a result, during Jul-Jan FY08, Pakistan received only US\$ 90.5 million of United Bank Limited's GDRs as compared to receipts of Oil and Gas Development Company Limited (OGDCL) GDR worth US\$ 738 million and MCB bank GDR worth US\$ 150 million in the same period last year.<sup>13</sup> Likewise, debt securities witnessed lower inflow of US\$ 22.0 million (in T-bills and PIBs) during Jul-Jan FY08 compared with investment in Mobilink's Term Finance Certificate (TFC) worth US\$ 50 million and international bond issuance worth US\$ 250 million during the same period of the preceding year.<sup>14</sup>

Outflows from the equity market are reflected in the Special Convertible Rupee Account (SCRA) position (see **Figure 6.12**). The net outflow from the SCRA is more pronounced in the time of political uncertainty, e.g., imposition of emergency and assassination of Ms Bhutto. Encouragingly, the SCRA position improved during February 2008 (as is evident from net inflow of US\$ 154.8 million during the month).



Moreover, peaceful and transparent election is likely to restore the foreign investor confidence to some extent. Karachi Stock Exchange Index has responded positively to this development. Moreover, given Pakistan's equity market relative stability in the recent turmoil, foreign investors seeking to diversify their risk may want to invest in Pakistan's equities (if new government focused on macro stability).

<sup>13</sup> UBL floated GDRs worth US \$ 650 million during June FY07. However, part of the proceeds (US\$ 90.5 million) was realized in July FY08.

<sup>14</sup> Out of US\$ 250 million private bonds, US\$ 101 million was utilized in loan repayment of the company.

### **6.3.2 Outstanding Export Bills (OEBs)**

Aggregate stock of outstanding export bills held by exporters and commercial banks increased by US\$ 87 million during Jul-Jan FY08 as compared to increase of US\$ 31 million in the same period of FY07. As in the previous year, almost all increase in the total stock of OEBs during Jul-Jan FY08 stemmed from increase in OEBs held by exporters as the OEBs held by the commercial banks declined during the period. Interestingly, more than three-fourth (US\$ 180 million) of the total increase (US\$ 225 million) in OEBs held by the exporters was witnessed in the last two months (Nov-Jan FY08) probably reflecting the exporters' expectation of exchange rate depreciation.

The OEBs held by the commercial banks, on the other hand, declined by US\$ 138 million during Jul-Jan FY08 as compared to US\$ 113 million decline in the same period of the previous year.

### **6.3.3 Currency & Deposits**

During Jul-Jan FY08, the banks' FE-25 nostros declined by US\$ 529 million as against US\$ 23 million increase in the comparable period of FY07. The decline in the FE-25 nostros mainly reflects the increased FE-25 lending during the period.

### **6.3.4 Official Long-term Loans**

The net inflows in the official long-term loans reached US\$ 793 million during Jul-Jan FY08 against US\$ 657 million in the comparable period of FY07. This increase in inflows stemmed from US\$ 133 IBRD loans receipts during the period under review.

### **6.3.5 Official Short-term Loans**

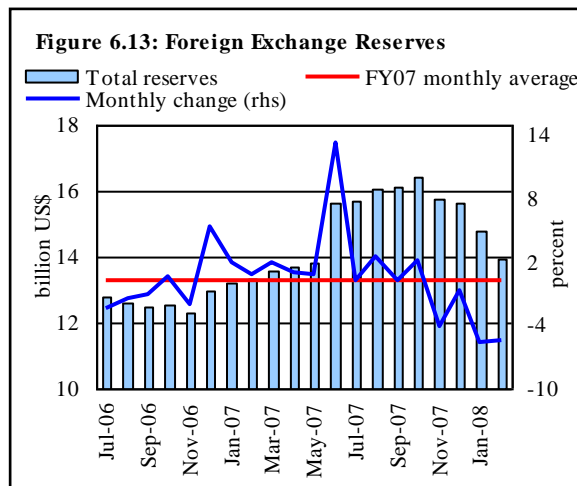
The net inflows under short-term official loans increased sharply by US\$ 467million during Jul-Jan FY08 as compared to net retirement of US\$ 58 million in the same period of the preceding year. This increase in net inflows was entirely contributed by Islamic Development Bank loans amounting to US\$ 467 million during the period.

## **6.4 Foreign Exchange Reserves**

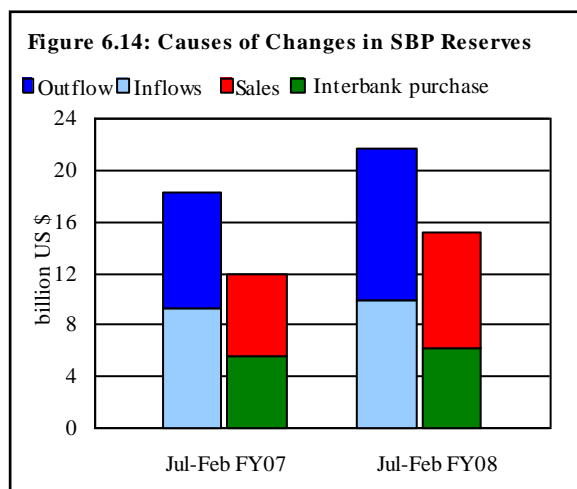
Changes in Pakistan's foreign exchange reserve position during Jul-Feb FY08 largely mirrored the developments in the country's current account. Pakistan's foreign exchange reserves declined from US\$ 15.6 billion as at the end of June 2007 to US\$ 14.1 billion by end of February 2008. The decline in the reserves was, however not consistent during this period. In the initial months (Jul-Oct) due to relatively benign current account deficit and substantial disbursement of program loans, Pakistan's foreign exchange reserves reached historical peak of

US\$ 16.5 billion. However, adverse developments in the subsequent months coupled with sharp rise in the trade deficit led to steep fall in reserves.

While the country's foreign exchange reserves have fallen quite steeply from November onwards, at US\$ 14.1 billion, these are still higher than the average level of foreign exchange reserves in FY07 (see **Figure 6.13**).



On disaggregated basis, reduction in both the SBP and commercial bank reserves added to the decline in overall reserves during Jul-Feb FY08. Major factors for decline in the level of reserves during last three months are mounting current account deficit, which is mainly a result of rise in trade deficit, outflows from portfolio investment through SCRA accounts following 3<sup>rd</sup> November 2007 events and increase in FE lending to importers as well as exporters.

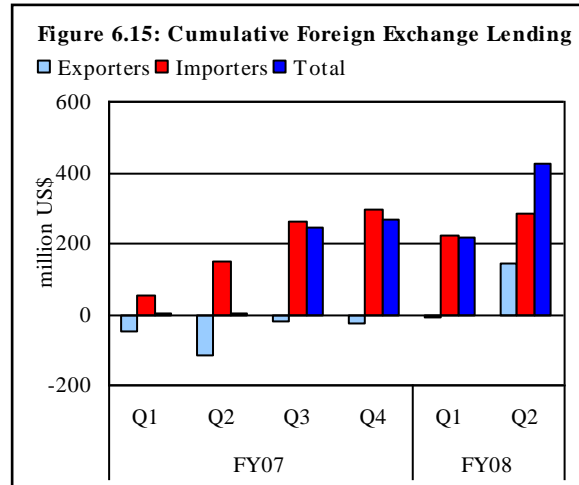


SBP liquid reserves<sup>15</sup> moved concurrent to overall reserves, rising during Jul-Oct FY08 period by US\$ 0.9 billion and falling subsequently by US\$ 2.3 billion during Nov-Feb FY08. Although, the inflows remained strong on the back of program loans and inter-bank purchases, 16.3 percent depletion in SBP reserves

<sup>15</sup> Excluding CRR.

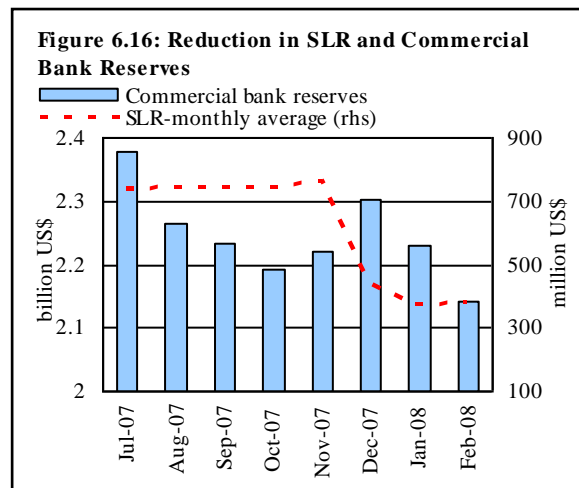


during this period owed to heavy outflows on account of oil support<sup>16</sup> as well as direct market intervention to reduce excess market volatility (see **Figure 6.14**). Besides, intervening in the market SBP also eased Special Cash Reserve Requirement (SCRR) on foreign currency deposits from 15.0 percent to 5.0 percent in order to provide liquidity comfort to forex market.<sup>17</sup>



Commercial bank reserves also registered a decline during Jul-Feb FY08 period, falling by US\$ 144.2 million to US\$ 2.2 billion as at the end of February 2008 down from US\$ 2.3 billion at end June 2007. Initially, during Jul-Oct FY08 commercial banks' forex reserves witnessed an outflow of US\$ 100.0 million, primarily due to outflows of portfolio investment during the month of August.<sup>18</sup> Surge in FE lending to

importers also put pressure on commercial bank reserves during this period. Afterwards, during Nov-Feb FY08, reserves held by commercial banks depleted but at a slower pace than pre-November period falling by US\$ 44.2 million, despite pressure emanating from outflows from portfolio investment, soaring current account deficit, and higher FE lending to both, importers and exporters during Nov-Jan



<sup>16</sup> Despite SBP withdrawal of oil support for furnace oil imports, the amount of oil support remained almost at the same level, although slightly lower, mainly due to rise in international oil prices, as imports of petroleum products has gone down by 0.4 percent during Jul-Dec 2007.

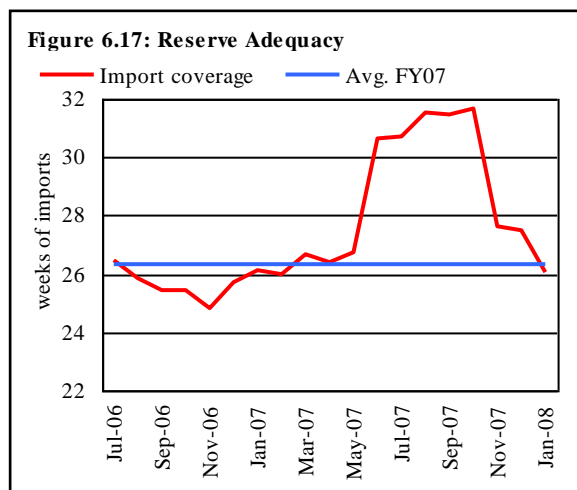
<sup>17</sup> As per BSD Circular No.09 of 2007, this is a temporary arrangement to provide liquidity to the market.

<sup>18</sup> During August, commercial banks' reserves fell by US\$ 112.0 million.

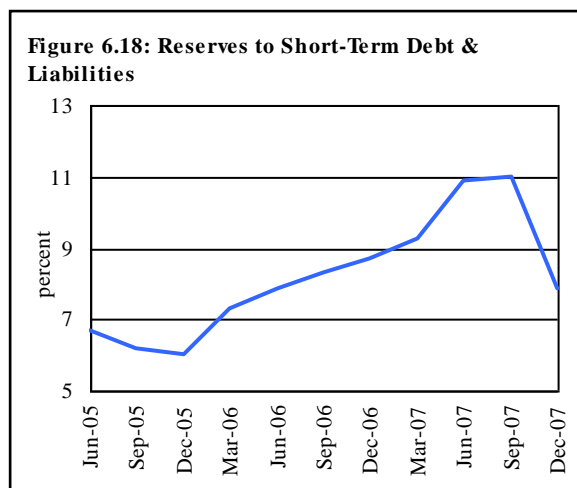
FY08 (see **Figure 6.15**). Decline in commercial bank reserves was contained due to higher SBP forex market interventions and easing of SCRR (see **Figure 6.16**).

#### 6.4.1 Reserve Adequacy

Adequate level of foreign exchange reserves is necessary but not a sufficient condition for external sector sustainability of a country as it is an indicator of economy's ability to meet its external obligations. Most widely used measures of gauging the adequacy of reserves are (1) import week coverage ratio and (2) reserves to short-term debt and liabilities ratio. On account of recent depletion in Pakistan's foreign exchange reserves coupled with surge in imports, Pakistan's reserve adequacy in terms of import week coverage has eroded to 24.8 weeks as in February 2008<sup>19</sup>, against its recent peak of 31.7 weeks witnessed in October 2007. Due to this sharp decline, the ratio has even slid down its average level in FY07 (see **Figure 6.17**).



Other measure of external sector vulnerability in terms of reserve adequacy, ratio of reserves to short-term debt and liabilities also decreased during Jul-Dec FY08 (see **Figure 6.18**), mainly on account of rise in short-term debt obligations during last two quarters coupled with depletion of foreign exchange reserves.<sup>20</sup>



<sup>19</sup> Ratio is calculated by using sum of 12-month moving imports.

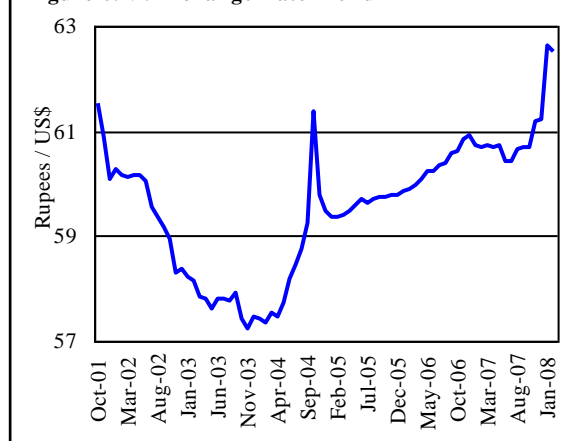
<sup>20</sup> Data on external debt is available only on quarterly basis. Latest data is available up to December 2007.

### 6.5 Exchange Rate

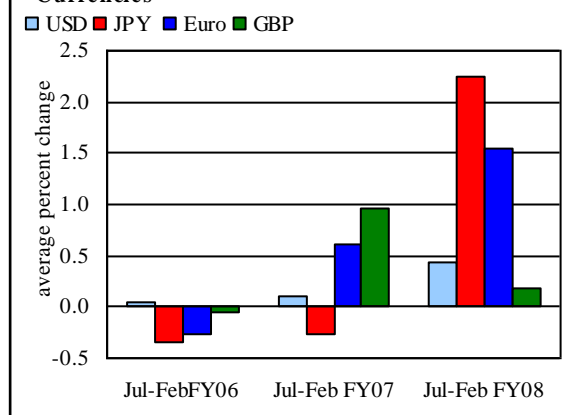
Pak Rupee suffered significant losses against the US dollar during Jul-Feb FY08, depreciating by 3.5 percent during the period. Movements in the Rupee/US\$ exchange rate largely followed the same pattern as the reserves. During the first four months of the current fiscal year Pak Rupee remained more or less stable and depreciation in the value of Rupee against the US dollar was only nominal. In contrast, Nov-Feb FY08 period saw steep decline in the value of Rupee, mirroring pressures in the foreign exchange market which arose October, 2007 onwards (see **Figure 6.19**). Besides, the steep depreciation to the extent of 3.0 percent on end period basis, during Nov-Feb FY08, the exchange rate also remained much more volatile, particularly mid December 2007 onwards.<sup>21</sup> This prompted SBP to intervene in the market aggressively, helping reduce the day to day volatility in the exchange rate. However, these interventions were not aimed at arresting the fall in the value of Pak Rupee against the US dollar.

While deteriorating economic and political environment may have been responsible in large part for the steep fall in the value of Rupee, a portion of the decline seems to be driven by speculative activity in the forex market. This is evident from the rising FC deposits and export bills outstanding in the second quarter of FY08.

**Figure 6.19: Exchange Rate Trend**



**Figure 6.20: Rupee Movement against Major Currencies**



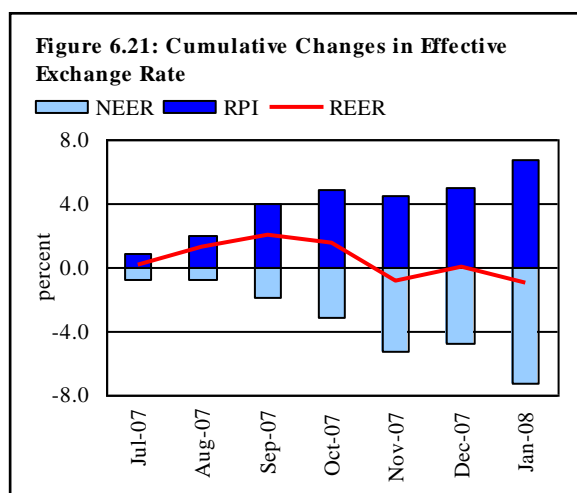
<sup>21</sup> Monthly standard deviations of Rupee-dollar exchange rate were 21.7 percent and 22 percent, during December 2007 and January 2008, respectively.

Furthermore, strengthening of the Pak Rupee following peaceful elections also lends credence to the argument that speculators were attacking the currency to make quick gains. In fact SBP had to intervene in the market to arrest steep appreciation immediately following the elections on 19<sup>th</sup> February 2008. Apparently strong reserves coupled with SBP's prompt actions to maintain calm in the forex market has been successful in arresting even steeper fall in the value of Rupee.

The situation in the forex market is likely to improve with expected inflows of FDI in the coming months<sup>22</sup>, besides proceeds from issuance of eurobonds and GDRs<sup>23</sup> during the current fiscal year. All these factors would help in stabilizing the exchange rate. This would in turn discourage the exporter and others to hold repatriation and importers from buying forward.

Due to the steep depreciation of Pak Rupee against US dollar, coupled with dollar depreciation in international markets, Rupee lost its value against major currencies as well. During Jul-Feb FY08, monthly Rupee depreciation against JPY averaged to 2.3 percent. Against Euro and Pound sterling, Rupee depreciated by 1.5 percent and 0.2 percent on average (see **Figure 6.20**).

While the recent surge in exchange rate has negative implications in terms of appreciation in the value of liabilities of the economy, it can have positive impact on the trade front by improving the country's competitiveness especially given the depreciation of dollar in international markets. This seems further eminent if the appreciation in currencies of Pakistan's major competitors is viewed (see **Box 6.5**).



<sup>22</sup> These expected FDI inflows include inflows worth US\$ 193 million from Omantel (Oman Telecommunication Co.) for purchase of Worldcall Telecom.

<sup>23</sup> During current fiscal year, flotation of NBP, HBL and KAPCO GDRs worth US\$ 1.3 billion are planned.

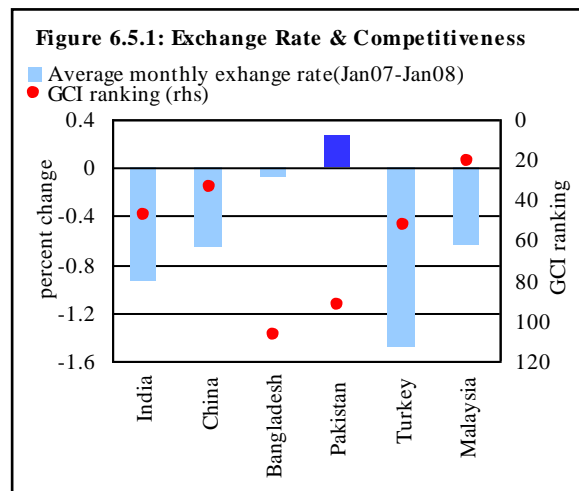
During Jul-Jan FY08, the Real Effective Exchange Rate (REER) of Pak Rupee depreciated by 1.0 percent against a basket of currencies, pointing towards an improvement in competitiveness of the economy against its major trading partners. This depreciation in REER is clear reflection of steep depreciation of Pak Rupee against the basket of currencies in nominal terms, which is also evident in depreciation in Nominal Effective Exchange Rate<sup>24</sup> (NEER) by 7.3 percent during Jul-Jan FY08. Resultantly, despite 6.7 percent rise in Relative Price Index (RPI), REER depreciated (see **Figure 6.20**).

**Box 6.5: Recent exchange rate movements and competitiveness of Pakistan:**

Global competitiveness of an economy is a major factor impacting the level of its exports. It is a relative phenomenon and any country's competitiveness is based on its position against other trading economies, especially its direct competitors. Exchange rate movements are a very important component of country's competitiveness as these have a direct bearing on the relative price of the country's exports against others. Depreciation in the country's currency has a favorable impact on the competitiveness of a country.

Pakistan ranked 92 among 131 countries on Global competitiveness index<sup>25</sup> for 2007-08, down one rank from last year. Besides, the country's ranking is lower against its major competitors, save only for Bangladesh. In this context, the recent Rupee depreciation coupled with dollar depreciation against other currencies could act as a source of improvement in country's competitiveness ranking, since the GCI also takes into account the impact of country's REER. The improvement in exchange rate competitiveness against major competitors especially in the area of textile exports, e.g., China, India, and Bangladesh among others can

have a positive impact on the trade balance of the country. As could be seen from the **Figure 6.5.1**, currencies of all these countries have appreciated against dollar during the last year. Although this bodes well for the comparative position of country against its rivals, it is not a sufficient factor for improvement in the exports of country, which depends on a host of other factors as well. With reference to Pakistan these include improving the allocative as well as productive efficiency of the country by lowering costs of production, skill enhancement, improving the governance and overcoming the infrastructural bottlenecks. Besides, inflationary tendencies need to be curbed as these can erode the relative prices, resulting in negative repercussions on the competitiveness of the



<sup>24</sup> Depreciation in NEER as well as REER remained more prominent in November 2007.

<sup>25</sup> Global competitiveness index is published by World Economic Forum on annual basis.

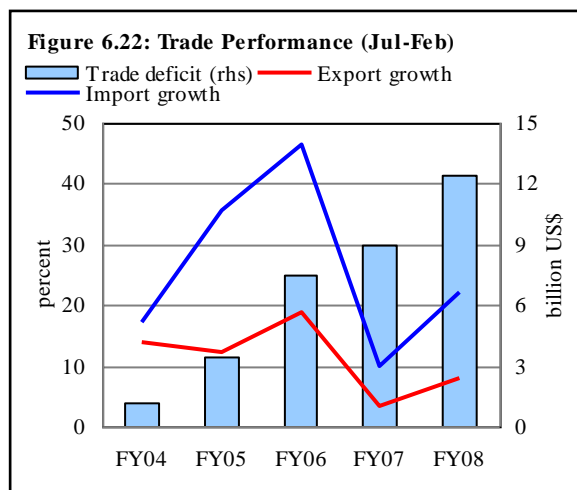
country, which is also evident in steep rise in relative price index for Pakistan during Jul-Jan FY08, by 6.7 percent.

Data Source: Bloomberg and World Economic Forum website.

## 6.6 Foreign Trade<sup>26,27</sup>

Rising international commodity prices coupled with domestic supply constraints of some key commodities resulted in 21.9 percent YoY rise in imports growth during Jul-Feb FY08 that outpaced 7.9 percent growth in exports during this period. Resultantly, the trade deficit recorded a sharp US\$ 3.5 billion YoY increase during the period (see **Figure 6.22**). With this expansion, the ratio of trade deficit to GDP worsened from 6.2 percent in Jul-Feb FY07 to 7.9 percent in Jul-Feb FY08.

In contrast to FY05 and FY06, the sharp surge in import growth during Jul-Jan FY08, was not due to any structural shift in demand as around half of the total increase in the import bill was contributed by rising international commodity prices: oil, fertilizers, palm oil,



**Table 6.8 :An Anatomy of Trade Deficit (Jul-Jan)**

abs changes in billion US\$; shares in percent

	FY05	FY06	FY07	FY08
<b>Trade deficit (bln US\$)</b>	<b>2.9</b>	<b>6.5</b>	<b>7.6</b>	<b>10.3</b>
<b>Abs. Δ in exports</b>	<b>0.7</b>	<b>1.6</b>	<b>0.3</b>	<b>0.6</b>
<i>Shares in exports absolute Δ</i>				
Textiles exports	8.7	76.3	120.5	-37.6
Non-textiles exports	91.3	23.7	-20.5	137.6
<b>Abs. change in imports</b>	<b>2.6</b>	<b>5.3</b>	<b>1.4</b>	<b>3.3</b>
<i>Shares in imports absolute Δ</i>				
<i>Of which</i>				
Price impact				
Oil price impact	14.0	25.4	11.7	21.7
Non-oil price impact	13.3	4.8	17.0	27.6
Wheat & raw cotton imports	2.1	1.2	0.4	18.5

<sup>26</sup> This analysis is based on the provisional data provided by Federal Bureau of Statistics, which is subject to revisions. This data may not tally with the exchange record numbers reported in the section on *Balance of Payments*.

<sup>27</sup> The broad analysis of trade deficit is based on Jul-Feb FY08 data. However the detail exports and imports trends are discussed for the period Jul-Jan FY08, since detail monthly data is not available for February 2008.

etc (see **Table 6.8**).<sup>28</sup> In addition, imports of wheat and cotton were necessitated due to supply shortages. The import bill was further inflated due a large one-off import in the category of *aircrafts, ships and boats*. In the absence of all these factors import growth and thus the trade deficit would have been significantly lower than the current level.<sup>29</sup> The significant slowdown in the imports after adjusting for these factors represents a deceleration of the real demand for imports, which can in part be attributed to the tight monetary policy being pursued by the SBP.

The composition of export growth on the other hand does represent a structural shift. The growth in exports during Jul-Jan FY08 was on account of a rise in *non-textile* exports – mainly *other manufactures* and *petroleum group*; whereas *textile* exports recorded 3.4 percent YoY fall during this period. The decline in the textile exports was broad based with only the exports of synthetic textiles, ready-made garments and textile made-ups registering growth.

Fall in the textile exports can be attributed to both supply and demand factors. On the supply side, textile exports were adversely affected by the rising cost of production due to increase in domestic cotton prices and tariff rates, as well as by the frequent power shortages and political unrest. On the demand side, textile and apparel products exports appear to have suffered from the slowdown in the US economy.<sup>30</sup> In this scenario, the growth in the non-textile exports is all the more encouraging.

Going forward, textile exports are expected to recover, once political environment in the country improves and importers become confident with regard to timely fulfillment of export orders. Having said this, the recovery may not be sharp due to acute power shortages and rising domestic cost of production. The overall export growth is nevertheless, likely to pick up on the back of rising non-textile exports.

Imports, on the other hand, are expected to continue to rise, as the current trend of rising international commodity prices is unlikely to reverse in the short-term. Apart from the price impact, the import bill is also likely to increase on account of rising demand. Particularly, the import of wheat, agriculture & chemicals group,

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<sup>28</sup> The price impact for the 50.2 percent imports for which price and quantum data was available was around 49 percent of the total rise in the import bill during Jul-Jan FY08.

<sup>29</sup> In the absence of these factors, the import growth for Jul-Jan FY08 would have been mere 4.6 percent, which implies a trade deficit of US\$ 7.9 billion for this period.

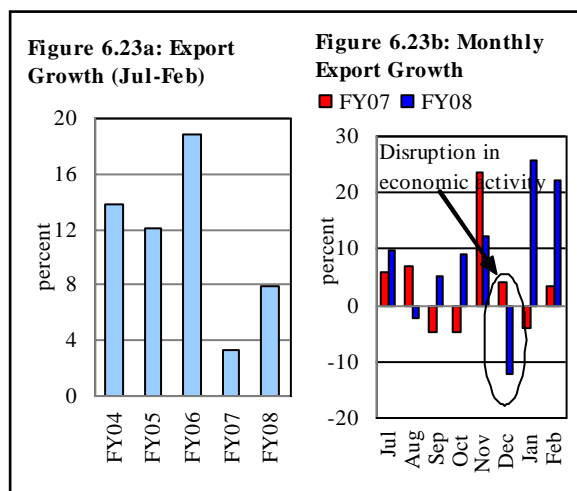
<sup>30</sup> Around one-third of country's total textile and apparel exports were directed to the US market during FY07.

raw cotton and metal group along with power generation machinery is likely to increase. This implies a substantial widening of the trade deficit through the remaining FY08.

### 6.6.1 Exports

Pakistan's exports stood at US\$ 11.7 billion during Jul-Feb FY08 period. Though slightly better than last year, the 7.9 percent YoY export growth was significantly lower than 11.6 percent target envisaged for Jul-Feb FY08 (see **Figure 6.23a**). Analysis of monthly data reveals that export growth recorded a significant fall on account of large-scale disruption in economic activity in the month of December FY08.<sup>31</sup>

In the absence of this abnormal decline, export growth for Jul-Jan FY08 could have been higher than the current recorded level (see **Figure 6.23b**).



The modest increase in exports during Jul-Jan FY08 was recorded on the back of *non-textile* exports, whereas *textile* exports growth recorded a fall during this period (see **Table 6.9 & 6.10**). Among the non-textile group, the major impetus to growth came from rising *other manufactures* exports that included cement, chemicals & pharmaceuticals, jewelry and leather. In addition, export of *all other items* also recorded large increase during this period.

**Table 6.9: Category-wise Growth in Exports (Jul-Jan)**

percent	FY07		FY08	
	Shares Growth		Shares Growth	
Food group	11.3	-3.1	11.1	4.8
Textile manufacturers	65.1	6.4	59.4	-3.4
Petroleum group	4.7	3.3	6.0	34.0
Other manufactures	15.1	-8.1	18.2	27.7
Others	3.8	30.4	5.3	49.4
<b>Total exports</b>	<b>3.6</b>		<b>5.9</b>	

<sup>31</sup> In the month of December 2007, economic activity remained largely subdued firstly on account of Eid-ul-Azha holidays and later due to political turmoil in the country.



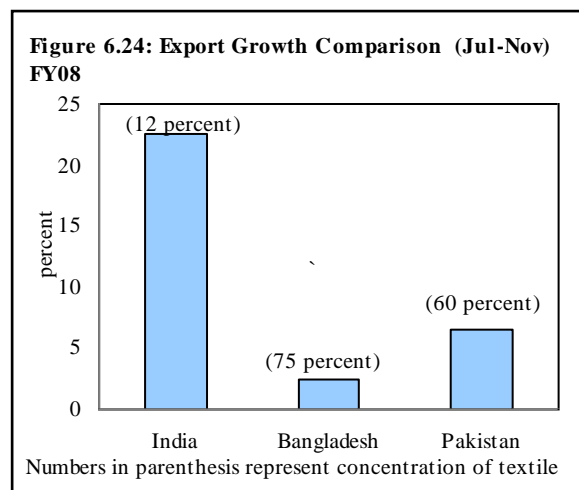
**Table 6.10: Major Exports (Jul-Jan)**

million US\$

		FY07		FY08(P)		Abs.Δ		% YoY Δ		
		Value	Unit value	Value	Unit value	value	Qty	Value	Unit Value	
<b>A Food group</b>		<b>1,079.9</b>		<b>1,131.6</b>		<b>51.7</b>		<b>4.8</b>		
<i>Of which</i>										
Rice	MT	622.4	344.7	628.7	481.8	6.3	-27.7	1.0	39.8	
Fish and fish preparations	MT	107.1	1611.6	105.8	1666.7	-1.3	-4.5	-1.2	3.4	
Fruits	MT	71.5	324.0	83.9	423.4	12.4	-10.2	17.4	30.7	
Vegetables incl. roots and tubers	MT	19.8	383.5	29.1	409.2	9.3	37.6	46.8	6.7	
Oil Seeds & nuts etc.	MT	8.8	719.6	23.0	822.5	14.2	129.1	161.9	14.3	
Meat and meat preparations	MT	22.8	2666.5	29.0	2891.3	6.2	17.3	27.2	8.4	
<b>B Textile group</b>		<b>6,242.6</b>		<b>6,028.2</b>		<b>-214.4</b>		<b>-3.4</b>		
<i>Of which</i>										
Cotton yarn	MT	813.0	2135.0	764.1	2195.7	-48.9	-8.6	-6.0	2.8	
Cotton fabrics	SQM	1148.3	875.1	1053.5	1001.8	-94.8	-19.9	-8.3	14.5	
Hosiery (knitwear)	DOZ	1180.1	20.9	1047.9	21.8	-132.1	-15.1	-11.2	4.6	
Bed wear	MT	1158.3	5361.0	1086.3	5518.1	-72.0	-8.9	-6.2	2.9	
Towels	MT	352.0	3907.4	328.4	3918.3	-23.6	-7.0	-6.7	0.3	
Readymade garments	DOZ	809.8	32.6	868.1	37.8	58.3	-7.5	7.2	15.8	
Art silk and synthetic textiles	SQM	241.3	0.7	302.0	0.9	60.8	5.6	25.2	18.5	
<b>C Petroleum group</b>		<b>452.7</b>		<b>606.6</b>		<b>153.9</b>		<b>34.0</b>		
<b>D Other manufactures</b>		<b>1,447.2</b>		<b>1,847.7</b>		<b>400.5</b>		<b>27.7</b>		
<i>Of which</i>										
Sports goods excl. toys	---	154.4	---	162.5	---	8.1	---	5.2	---	
Leather excl. reptile leather	SQM	167.8	16.7	230.7	17.5	62.9	31.1	37.5	4.9	
Leather manufactures	---	325.6	---	371.2	---	45.6	---	14.0	---	
Foot wear	PAIR	64.9	7.5	63.4	18.2	-1.5	-59.7	-2.4	142.0	
Chemicals and pharmaceuticals	---	218.6	---	318.3	---	99.7	---	45.6	---	
Engineering goods	---	121.2	---	109.5	---	-11.7	---	-9.7	---	
Jewelry	---	13.6	---	99.1	---	85.5	---	628.2	---	
Cement and cement products	MT	73.5	54.2	174.0	56.3	100.4	127.8	136.6	3.8	
<b>E All other items</b>		<b>360.6</b>		<b>538.7</b>		<b>178.1</b>		<b>49.4</b>		
<b>Total exports</b>		<b>9,583.0</b>		<b>10,152.8</b>		<b>569.8</b>		<b>5.9</b>		

As far as *textile* exports are concerned, this group largely recorded a broad-based decline during Jul-Jan FY08. Dismal performance of the textile sector is attributable to rising domestic cost of production that is hampering country's competitiveness vis-à-vis its competitors. In addition, the slowdown in the US economy (see **Table 6.5**) and political unrest in Pakistan also affected the export performance of this sector.

Since Pakistan's total exports have a large (around 60 percent in Jul-Jan FY08) concentration of textile items, the fall in textile export growth suppressed the overall export growth during Jul-Jan FY08. This effect is also visible in other regional economies. For instance, Bangladesh that had a higher concentration of textile exports as compared to Pakistan witnessed even lower growth of total exports during the period under review, largely due to falling textile exports. On the other hand India, which has a lower concentration of textile products, recorded a substantial export growth during Jul-Nov FY08 despite a deceleration in textile exports growth (see **Figure 6.24**).<sup>32</sup>



In order to improve country's exports and reduce export market and products concentration, a number of steps have been taken in the last few years. These include provision of freight subsidies for the exploration of new export markets as well as exporting new products.<sup>33</sup> These measures have helped improve export performance to some extent. Another step in this direction is the conclusion of preferential trade agreements with a number of countries namely China, SAARC countries, Sri Lanka, Iran, Mauritius and Malaysia (see **Box 6.6**). These agreements are concluded with the aim to increase trade flows between countries. However care should be taken at the time of concluding such agreements, since the desired objective of exports increase can only be achieved if the country has

<sup>32</sup> India's textile exports recorded a marginal 1.3 percent growth in the period of Apr-Nov 07 as compared to the 11.6 percent growth in the same period last year.

<sup>33</sup> Trade policies for FY00 to FY08.

the export potential for the goods for which preferential access is acquired from these countries.

**Box 6.6: Preferential trade agreements and trade performance Agreements**

In an effort to diversify export markets and get improved market access Pakistan has entered into preferential trade agreements with a number of countries in the last few years (see **Table 6.6.1**).

In terms of volume of trade the FTAs signed with China and the SAARC countries are the most important. Pakistan's overall trade volume with China has increased from US\$ 2.2 billion in FY05 before the start of any preferential arrangements to US\$ 4.1 billion in FY07. Similarly among the SAARC countries Pakistan's trade volume with India rose from US\$ 0.8 billion in FY05 to US\$ 1.6 billion in FY07 (**Table 6.6.2**).

In fact countries from around the world are entering into such preferential arrangements as a prelude to the start of free trade world envisioned by the WTO. The major theoretical support for such arrangements comes from the possibility of an increase in trade flows between countries after entering into such preferential arrangements.

**Table 6.6.1: Status of Trade Agreements**

	Effective from	Full implementation
<b>FTAs</b>		
China	July 2007	2012
Sri Lanka	June 2005	Fully implemented
Malaysia	January 2008	2012
SAFTA	January 2006	2016
<b>PTAs</b>		
Iran	September 2006	Fully implemented
Mauritius	November 2007	Fully implemented
<b>Early harvest programmes</b>		
China	January 2006	Fully implemented
Malaysia	January 2006	Fully implemented

**Table 6.6.2: Trade Performance after Trade Agreements**

million US\$, growth: percent

	FY05			FY07			Growth		
	Exports	Imports	Trade balance	Exports	Imports	Trade balance	Exports	Imports	Trade balance
China	354.1	1846.0	-1491.9	575.9	3532.4	-2956.5	62.6	91.3	98.2
Sri Lanka	155.8	44.9	110.9	200.6	63.4	137.2	28.7	41.2	23.7
Iran	147.1	242.8	-95.7	167.5	405.8	-238.2	13.9	67.1	149.0
<b>SAARC countries</b>									
<i>of which</i>									
India	288.1	548.1	-260.0	342.9	1235.9	-893.0	19.0	125.5	243.5
Bangladesh	205.8	61.2	144.6	261.9	58.3	203.6	27.3	-4.7	40.8
Maldives	2.6	3.4	-0.9	3.6	0.0	3.6	42.4	-99.0	-507.1
Nepal	2.7	3.8	-1.0	1.6	3.2	-1.5	-40.6	-15.9	50.1
Bhutan	0.1	0.5	-0.4	0.0	0.1	0.0	-68.4	-88.2	-93.5

**Theoretical underpinnings:** The expected increase in the trade flows comes both from trade creation – the flow of trade that would not have existed between countries in the absence of preferential trade arrangements – and trade diversion – the flow of trade from a trading partner outside the FTA to a trading partner within the FTA. On the whole, net welfare from such trading

arrangements is expected to rise if the gains from trade creation are greater than the (possible) losses from trade diversion.<sup>34</sup> In this theoretical perspective, the impact of the preferential trading arrangements concluded with China and India, given their importance as reflected in the volume of trade with these countries, is discussed below.

**Trade performance:** The trade pattern with these countries after the implementation of trade agreements highlights a significant rise in the volume of bilateral trade. Specifically, exports to China have undergone large expansion over the period of two years. On the other hand, imports from both China and India have also increased substantially leading to large expansion in trade deficits with these countries.

Analysis of the expansion in exports to these countries (see **Table 6.6.3**) reveals that increase in exports is largely a result of creation of new trade opportunities. For example Pakistan's chromium ore export averaged at US\$ 28 million in FY05 and FY06. However, after obtaining preferential treatment from China, the export of this category reached US\$ 57.7 million mainly due to a US\$ 32.7 million rise in chromium ore export to China. While, in case of synthetic cotton yarn the rise in export to China and a fall in overall export of this category does give some evidence of trade

**Table 6.6.3: Analysis of Increase in Trade from PTA Partner Countries**

million US\$, unit value 000 Rs/unit

		Abs. change in FY07			Unit values FY07	
		Country wise	Largest alternate destination	Total	Country wise	Largest alternate destination
Exports						
China						
Chromium ores	Mt	32.7	-0.5	32.2	12.9	16.4
Synthetic cotton yarn	Kg	12.6	1.6	-0.8	0.1	0.1
Cotton yarn	Kg	12.4	-1.2	39.9	0.1	0.1
India						
Petroleum naphtha	Mt	61.5	321.1	118.3	32.3	34.4
Wheat	Mt	15.7	21.0	97.0	13.1	12.9
Unrefined led and alloys	Kg	7.6	0.8	8.8	0.1	0.1
Imports						
China						
Cell phones	No	148.2	-128.0	104.6	3.2	4.4
Coke of coal	Mt	50.3	17.7	80.1	10.2	10.8
Other transmission app.	No	108.0	98.6	339.9	21.7	32.0
India						
Para-Xylene	Kg	135.4	-7.4	105.5	0.07	0.06
Polypropylene	Kg	44.5	7.4	43.1	0.07	0.08
Oil cake	Kg	27.6	0.1	27.2	0.0	0.0

<sup>34</sup> Source: <http://internationalecon.com/Trade/Tch110/T110-2A.php>

diversion. Comparison of the unit values with the other largest partner shows that this diversion was not inefficient in terms of price obtained from China.

Similarly, the rise in cotton yarn export to China was less than the total increase in export of this commodity, implying creation of new trade opportunities. Since the increase in export of these three commodities constitutes more than half of the YoY increase in exports to China during FY07, these results can be extended for the total export growth to this market during this period. Similarly, the export of the top three commodities to India in FY07, also presents evidence of trade creation. Since the rise in export of these categories to India was accompanied by a general rise in their export as well.

In case of imports from China the import of cell phones presents clear evidence of trade diversion. However this diversion is efficient since the unit values offered by China are significantly below the unit values offered by the alternate supplier of this category. Further, the imports of the other two major categories are also less costly from China as compared to the alternate sources. Imports from India also show some signs of trade diversion; however this diversion is not inefficient in terms of unit values.

**Conclusion:** This analysis shows that the rise in trade as a result of these trading agreements is largely efficient both in case of exports and imports. The provision of improved preferential access in different countries is likely to help in diversifying country's export markets. The ability to take benefit from this opportunity, however, depends on the available exportable surplus. Currently the trade performance reveals increasing lack of competitiveness in the textile sector on account of rising costs. Also the elimination of quota regime has made it difficult for the country to face the competition from China, India and Bangladesh in the major export markets.

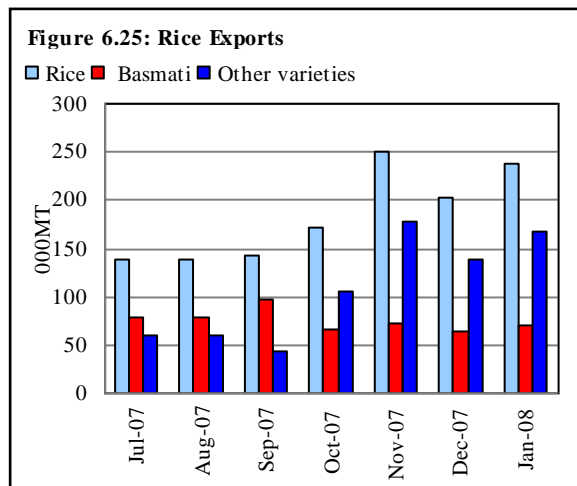
In this scenario provision of duty free access in other markets might help in slowing the current trend of deceleration witnessed in the textile exports. The availability of preferential access can provide incentives for increasing exports of other non-textile products as well. Therefore, government should focus on obtaining duty free access for both textile and non-textile goods. This can act as an incentive for diversifying country's overall export base. As regards imports, as a result of these trading arrangements imports are expected to divert to suppliers within the preferential arrangements. Apparently as the analysis reveals this diversion is expected to be efficient. Especially China is known as a low cost producer of goods in the world, therefore the diversion of imports from other suppliers to China is likely to help in improving country's trade balance.

The preferential trading agreements with large countries are thought to be more welfare enhancing as they provide less opportunities for inefficient trade diversion because the relative prices in large countries are more in line with the world prices. Secondly, preferential arrangements with natural trading partners – neighboring countries – are also more beneficial. This is because, these countries provide more opportunities for trade creation on account of reduced transportation cost and similar economic needs and potentials.

### ***Food Group***

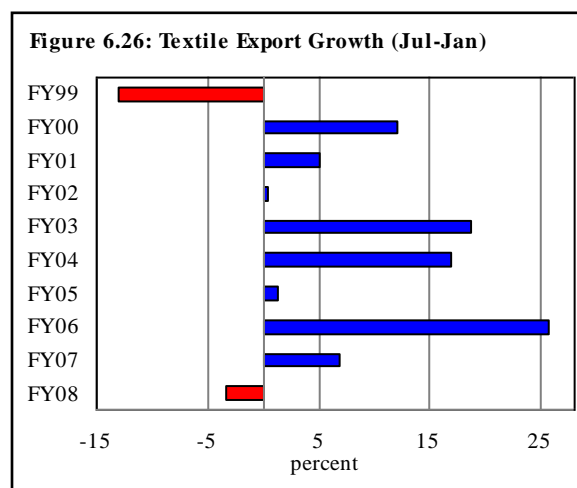
The small 4.8 percent YoY expansion in the food group exports during Jul-Jan FY08 is encouraging when seen against 3.1 percent fall registered in this group in the corresponding period of FY07. Importantly, the rise in the exports of this group was achieved despite a fall in the major categories of *other varieties of rice* and *fish* exports. In fact with the exception of these two commodities almost all

other categories in this group recorded reasonable growth during Jul-Jan FY08. Most notable of these are increasing *oilseeds, fruits, vegetables* and *meat & its preparations* exports. The increase in the exports of these categories is attributable to rise in production, higher international prices and various incentives given by the government for the growth of these non-traditional sectors



The marginal increase in the *rice* exports was recorded on account of increasing basmati rice exports, whereas *other varieties of rice* recorded a large fall during Jul-Jan FY08. However, from October FY08 the export of other varieties of rice has started to increase with the marketing of the FY08 crop (see **Figure 6.25**). Also the production of other varieties of rice was higher during FY08 as compared to the same period last year.<sup>35</sup> This fact points towards availability of higher exportable surplus during this year and thus a possibility of increase in export of this variety, going forward.

Rice exports are however faced with certain issues in Iran which captured around 18 percent share in total rice exports during FY07. Anecdotal evidence suggests that on account of political issues in the region and also reported shortage of dollars in this market some of the local banks are not accepting the letters of credit from Iranian importers. However this issue is likely to be resolved, as



<sup>35</sup> The production of other varieties of rice recorded a 10 percent YoY rise during FY08.

reportedly, the Iranian importers have opted for trading in Euro, which could revive rice exports to this market.

### **Textile group**

For the second time in last ten years, textile exports recorded a fall during the Jul-Jan period (see **Figure 6.26**). This fall mainly represents the impact of disruption in the economic activity in December FY08. Excluding this month the YoY textile exports growth for Jul-Jan FY08 stands at 0.6 percent.

Fall in the textile exports was largely broad based and exports of all textile categories except readymade garments, synthetic textiles and other textile made-ups witnessed decline during this period (see **Table 6.11**).

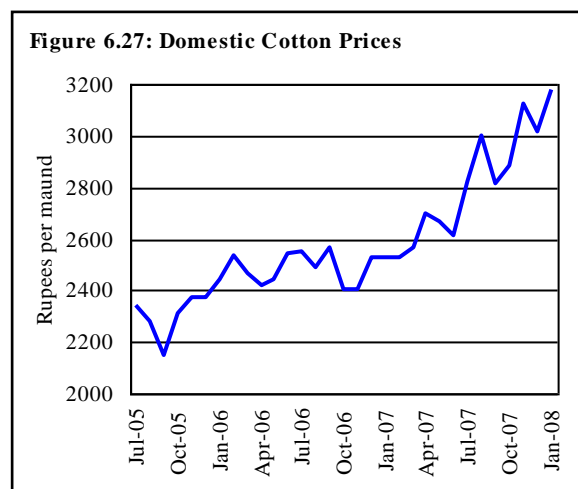
**Table 6.11: Major Textile Exports Price & Quantum Impact (Jul-Jan)**

million US\$						
	FY07			FY08		
	Absolute change	Due to		Absolute change	Due to	
		Qty	Price		Qty	Price
<b>Textile Group</b>	<b>374.9</b>			<b>-214.4</b>		
<i>Of which</i>						
Raw cotton	-13.1	-13.5	0.4	-3.5	-5.1	1.6
Cotton yarn	56.9	13.3	43.6	-48.9	-70	21.1
Cotton fabrics	-69	-198	129	-94.8	-228.1	133.2
Knitwear	158.3	214.3	-55.9	-132.1	-178.1	46
Bed wear	-32.3	-16.2	-16	-72	-102.9	30.9
Towels	21.6	6.6	15	-23.6	-24.6	0.9
Readymade garments	43.4	94.7	-51.3	58.3	-60.4	118.7
Art silk and synthetic textiles	129.8	109.1	20.7	60.8	13.6	47.2
Other textile made-ups (excl. towels & bed wear)	5.0			49.6		

Largest decline was observed in the category of knitwear exports followed by cotton fabrics. Synthetic textile was the only category that witnessed growth both in terms of quantum and unit values during Jul-Jan FY08. Unit values of all the categories recorded increase with the exception of carded or combed cotton during Jul-Jan FY08. Yet on account of large quantum decline their overall exports recorded fall.

This lackluster performance of the textile sector is attributable to the loss of country's competitive strength, which is also reflected by the rising unit values of

almost all textile exports. Apparently rising cost of production due to increase in domestic cotton prices,<sup>36</sup> (see **Figure 6.27**) higher electricity tariffs as well as rising power shortages in the country kept exporters from quoting lower prices. This is reflected in the falling export quantum. In addition to this, political uncertainty in the country also led to the diversion of export orders to other suppliers.



While the government's decision to allow imports of short staple cotton from India through land route would help in controlling rising cost of production to an extent,<sup>37</sup> other problems faced by this sector are essentially structural in nature. Especially the issues of high power tariffs and power shortages are affecting the overall industrial growth and need formulation of effective strategies to avert a long-term slowdown in this sector. On the other hand, textile sector has displayed its inability to translate huge support given to it in the form of R&D subsidies, into productivity gains.

#### Market Analysis<sup>38</sup>

Broader market analysis reveals that Pakistan's textile exports faced tough competition in the US market during Jul-Nov FY08. On the other hand country's apparel exports fared relatively better in this market, nevertheless growth recorded in this category during Jul-Nov FY08 was lower than the past three years' average growth. In the EU market the situation was reverse, and apparel exports recorded a slight fall during Jul-Oct FY08, whereas textile exports to this region recorded a reasonable rise (see **Table 6.12**).

<sup>36</sup> The size of cotton crop during FY08 was recorded at 12.775 million bales as compared to the 12.856 million bales recorded during FY07.

<sup>37</sup> India harvested a largest ever crop of 21 million bales during FY07. According to the Agricultural Outlook Forum 2007, during the current year (2007-08) also India's cotton production is expected to surpass the previous level with India becoming the 2<sup>nd</sup> largest cotton producer.

<sup>38</sup> The analysis is based on US Census Bureau and Eurostat data that is available up to November and October respectively.



Textile apparel exports:

Pakistan faces tough competition from China, Bangladesh, Turkey and India in the EU market for textile apparel. Especially Bangladesh, which is a large garments' exporter, enjoys preferential access to this market not available to it in the US market so far. Turkey is also at an advantageous position because of its close proximity to the EU that reduces the lead time involved for fulfilling the orders, which is an important factor in case of apparel exports. All these factors reduce Pakistan's competitiveness in apparel exports segment to EU.

In the US market Pakistan is still able to compete as is shown by a small growth in

Pakistan's apparel exports during Jul-Nov FY08. However with the end of the textile safeguard measures against China in the EU market from January 2008 and in the US market from January 2009 Pakistan's textile apparel exports are likely to come under further pressure.

Textile fabrics exports

In case of textile exports especially bed wear, Pakistan seems to be inherently in a stronger competitive position in the EU market, which is a factor that has led to the repetitive imposition of anti-dumping duty on this category in this market. Pakistan's bed wear exports to this region recorded 15.5 percent YoY rise during Jul-Oct FY08.<sup>39</sup> Bed wear exports to EU are rising after the reduction of antidumping duty on this category from the previous level of 13.1 percent to 5.8 percent from May 2006.

**Table 6.12: Textile and Apparel Export Growth to the Major Markets**

percent				
US Market*				
	Textile		Apparel	
	Avg. CY03-CY06	Jul-Nov CY07	Avg. CY03-CY06	Jul-Nov CY07
<b>World</b>	9.6	5.5	5.5	0.3
<b>B.desh</b>	-1.9	7.9	11.9	-2.4
<b>China</b>	28.1	11.4	25.3	10.0
<b>India</b>	14.1	6.0	13.0	2.3
<b>Pakistan</b>	13.9	-6.6	11.2	0.7
<b>Vietnam</b>	70.8	25.5	47.9	41.1
EU Market (Jul-Oct)**				
	Textile		Apparel	
	CY06	CY07	CY06	CY07
<b>World</b>	8.7	6.4	8.2	4.2
<b>B.desh</b>	35.0	15.1	28.3	-6.5
<b>China</b>	10.4	18.9	7.8	10.0
<b>India</b>	10.3	6.7	2.3	3.5
<b>Turkey</b>	10.6	2.2	-0.5	4.9
<b>Pakistan</b>	12.4	6.4	4.7	-1.9

\* Source: US Census Bureau

\*\* Eurostat

<sup>39</sup> Source: Eurostat

In the US market, this category faces tough competition in terms of prices especially from China. During Jul-Nov CY07, this category recorded a substantial 44.8 percent YoY decline in the US market, in terms of quantum.<sup>40</sup> Hence despite the increase observed in the EU market, the overall bed wear exports registered a decline during Jul-Jan FY08.<sup>41</sup> Bed wear export performance is expected to improve further in the EU market from next calendar year with the complete elimination of anti-dumping duty from March FY09.

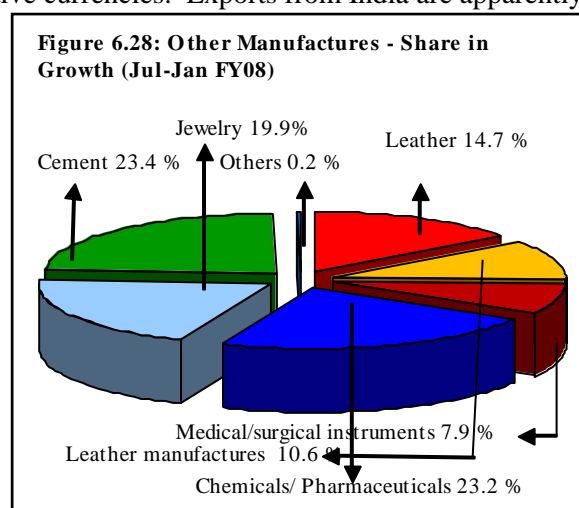
#### Competitors' position

The export performance of other regional competitors shows that there has been a general deceleration in the textile and apparel exports growth to these two major markets in the period under review. After the end of quota regime from January 2005, textile exports were expected to stabilize, in general, after undergoing an immediate expansion. In the US, this is also partly attributable to falling demand resulting from economic slowdown in this large market.

Apart from the demand side factors, the analysis of the individual performance of some of the competitors also highlights weaknesses in their respective competitive strengths. Bangladesh performed weakly in the category of textile apparel in both the US and the EU markets. This might be a result of the political turmoil in the country as well as natural calamities during this period. Similarly India and China face appreciation of their respective currencies. Exports from India are apparently under pressure in both these markets on account of this factor.

#### **Other Manufacturers**

Rising cement, chemicals & pharmaceuticals, jewelry and raw leather exports led the *other manufactures* sub-sector to record a remarkable growth during Jul-Jan FY08 (see **Figure 6.28**) against an 8.1 percent YoY decline recorded during the comparable period of last year.



<sup>40</sup> The data is obtained from the website of US Office of Textile and Apparel which provides quantum data for preliminary analysis.

<sup>41</sup> US occupied 47.2 percent share in Pakistan's bedwear exports during FY07, as compared to 38.7 percent share occupied in the EU market in the same period.

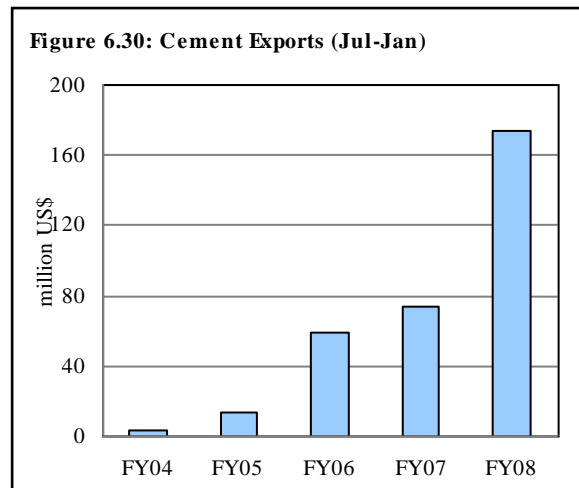
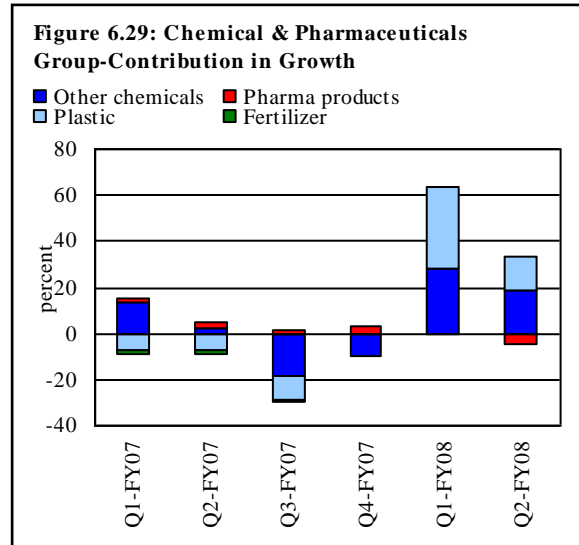
The expansion in the *chemicals and pharmaceuticals* group exports was recorded on account of rising plastic materials exports followed by other chemicals (see **Figure 6.29**).

Plastic materials exports are exhibiting rising trend since last fiscal year mainly due to rising exports of Polyethylene terephthalate (PET) resin (48 percent to EU) and plastic kitchen ware articles (largely to Afghanistan).

Manufacturing and export activity in this sector is increasing on the back of rising demand. While the rising export of kitchen-ware articles is a positive development, this sector should attempt to produce and export higher value added items.

For example, PET is the basic raw material used in the manufacturing of bottles, jars, etc. There is a need to expand the production activity by attempting to export manufactured products that can earn more value.

The largest share in the increase of other chemicals exports came from ethanol exports. The growth in ethanol exports is attributable to higher sugar production during FY08<sup>42</sup>. Further, the reported increase in the production capacity for



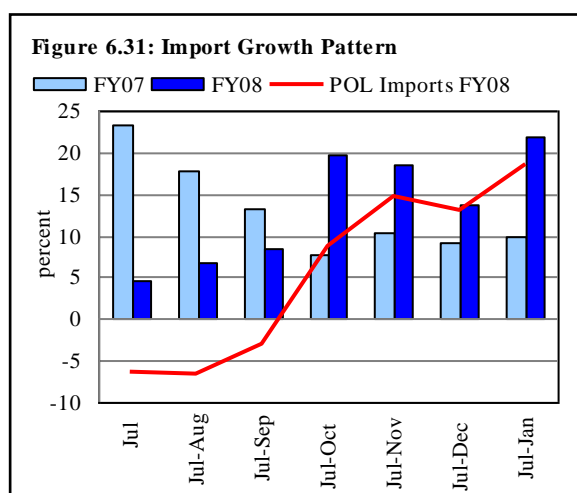
<sup>42</sup> Sugar cane production reached 62.33 million tonnes during FY08 as compared to 54.9 million tonnes during FY07.

ethanol over the last few years also represents improved potential for exports in this sector.

*Cement and cement products exports* reached the highest ever level, recording US\$ 100 million YoY increase during Jul-Jan FY08 (see **Figure 6.30**). Detailed data for Q1-FY08 show Afghanistan as Pakistan's largest cement export market. The prospects for cement exports seem bright in the medium term due to supportive supply and demand side factors. Rising domestic as well as regional cement demand has led the cement sector to increase the operating production capacity over the last few years (especially in FY07). Further, Pakistan also achieved improved access to India after the complete removal of the 12.5 percent custom duty on Portland cement imports in this country from January 2007. The current growing pace of the Indian economy coupled with cement shortages suggest this measure to last at least in the medium-term, which implies improved export opportunities for Pakistan.

### 6.6.2 Imports

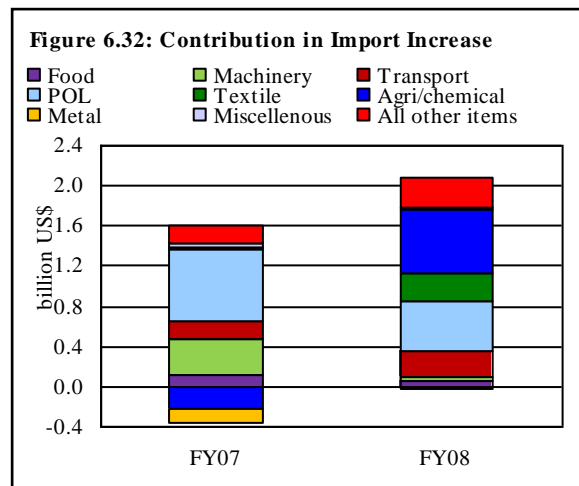
After experiencing a deceleration in FY07, import growth recorded a large 21.9 percent YoY expansion during Jul-Feb FY08. This rise however, was more an outcome of international supply constraints than a shift in demand. The international supply constraints resulted in rising international commodity prices – particularly of oil. This is evident from the import growth pattern that started to soar from October FY08 with the increase in international oil prices (see **Figure 6.31**).



Apart from the oil prices, the international DAP fertilizer and palm oil prices also witnessed a sharp surge during CY07. In overall terms, around 49.3 percent of the

total increase in the import bill during Jul-Jan FY08 was caused by increase in international commodity prices.<sup>43</sup>

In addition to the dominant role played by prices, the rising demand for raw cotton, chemicals, and iron and steel scrap also contributed in import growth. Further, the transport group also recorded a large one off *ship* import in the month of October FY08. All these factors led to a significant broad based hike in the import bill during Jul-Jan FY08 (see **Figure 6.32**).



The import bill is likely to maintain the current trend of expansion through FY08 on account of both, rising tendency in the international commodity prices as well as domestic shortages of some key commodities. Especially the food import bill is likely to undergo considerable jump due to the forthcoming wheat imports.

### Food Group

Food group imports experienced a small increase during Jul-Jan FY08. Thanks to a substantial fall in the *sugar* imports that helped in offsetting the impact of sharply increasing *palm oil* and *wheat* imports during this period (see **Table 6.13**). Fall in the *sugar* imports was brought about by increased production during FY08.<sup>44</sup>

Surge in the *palm oil* import bill was completely a consequence of rising prices, since the import quantum registered fall during the period under review. The international palm oil prices are witnessing a rising trend since CY07 due to increased international demand.<sup>45,46</sup>

<sup>43</sup> The price impact for the 51 percent imports for which price and quantum data was available was 49.3 percent of the total rise in the import bill during Jul-Jan FY08.

<sup>44</sup> Sugar production recorded 13.6 percent YoY rise during FY08.

<sup>45</sup> A part of the rising demand came from China which has abolished palm oil import quota from CY06.

<sup>46</sup> International palm oil prices averaged at US\$ 804 per MT as compared to the level of US\$ 447.1 per MT.

**Table 6.13: Major Food Imports (Jul-Jan)**

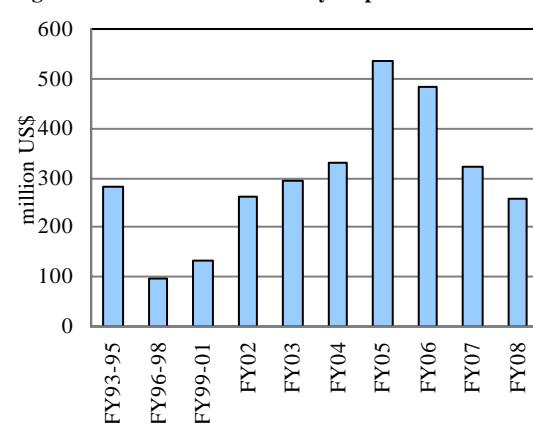
value: million US\$, growth: percent

		Value		Δ in	% Δ FY08 over FY07		Unit Value
		FY07	FY08	Value	Quantity	Value	
<b>Food group</b>		<b>1,731.9</b>	<b>2,046.2</b>	<b>314.3</b>		<b>18.1</b>	
<i>Of which</i>							
Palm oil	MT	437.4	671.0	233.6	-6.8	53.4	64.7
Pulses	MT	133.9	88.8	-45.0	-52.6	-33.6	40.1
Tea	MT	110.5	95.0	-15.5	-6.4	-14.0	-8.2
Sugar	MT	248.7	9.7	-239.0	-95.8	-96.1	-7.5
Wheat un-milled	MT	32.6	57.0	24.3	27.7	74.7	36.8

Besides, during H1-CY07 Malaysia's palm oil production also witnessed (8.0 percent YoY) fall, which<sup>47</sup> might also have added to pressures on the international palm oil prices. This trend is expected to continue to inflate country's palm oil import bill in the remaining FY08.

In addition to that *wheat* imports are also likely to undergo a major expansion going forward. The Trading Corporation of Pakistan has floated tenders for around 1.25 million tones of wheat, slightly more than one-third of which was imported till end of Jul-Jan FY08. This is worth mentioning that the international wheat prices are also witnessing a rising trend since H2-CY07 on account of lower world wheat stocks, implying a higher price impact in this category as well.<sup>48,49</sup>

**Figure 6.33: Textile Machinery Imports**



<sup>47</sup> Source: <http://www.palmoilprices.net/news/?p=280>

<sup>48</sup> The average international wheat prices recorded 52.6 percent rise during H1-FY08 as compared to the same period last year.

<sup>49</sup> According to the Food and Agriculture Organization of the United States, world stock to utilization ratio of wheat fell to 22.6 percent for 2007/08 as compared to 25.4 percent in 2006/07.

### Machinery Group

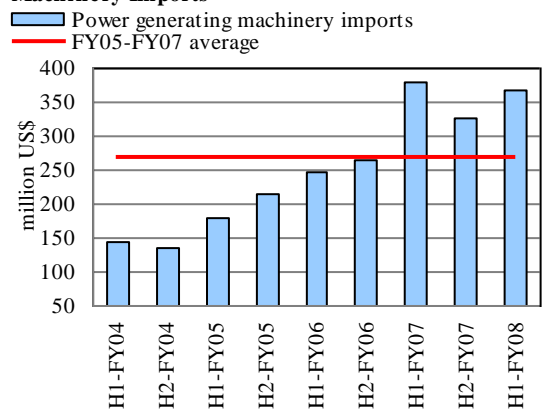
Falling *textile machinery* and *cellular mobile phones* imports caused suppression in the machinery import growth during the period under review as compared to the 12 percent growth in Jul-Jan FY07 (see **Table 6.14**). *Textile* machinery import is representing a mean reverting situation, where after remaining significantly higher for BMR activities in the past few years the import level is reverting back to the historic average level (see **Figure 6.33**). The underlying cause might be the overall slowdown in the textile exports.

**Table 6.14: Machinery Group Imports (Jul-Jan)**

million US\$				
	FY07	FY08	Abs Δ	% YoY Δ
<b>Machinery group</b>	<b>3749.3</b>	<b>3897.5</b>	<b>148.2</b>	4.0
Power generating machinery	428.6	517.7	89.1	20.8
Office machinery	182.2	176.0	-6.2	-3.4
Textile machinery	323.8	259.4	-64.4	-19.9
Construction and mining machinery	101.6	108.2	6.7	6.6
Electrical machinery and apparatus	373.7	394.5	20.8	5.6
Telecom	1241.8	1282.4	40.5	3.3
a. Mobile phone	480.2	441.0	-39.2	-8.2
b. Other apparatus	761.6	841.4	79.8	10.5
Agricultural machinery	86.7	86.9	0.1	0.2
Other machinery	1010.6	1072.5	62.0	6.1

*Power generating machinery* on the other hand continued the rising trend. This category is experiencing a gradual rise since FY05 due to ongoing work on various power projects in the country. During Jul-Jan FY08, the import in this head was substantially higher than the FY05-FY07 Jul-Jan average import level (see **Figure 6.34**). Going forward, the power generating machinery import is likely to further increase given that some eight

**Figure 6.34: Trends in Power Generating Machinery Imports**



Independent Power Projects have reached financial closures during the current fiscal year while agreements for further six have been signed.

### Transport Group

The hefty increase in the transport group was a result of a one-off rise in the *aircrafts, ships and boats* category during Jul-Jan FY08. In the absence of this one-off element transport group would have recorded a 17 percent YoY fall during this period. This is due to falling *road motor vehicle* imports (see **Table 6.15**). Demand for new cars has witnessed some decline during the current fiscal year due to rising cost of borrowing in the country. This is also evident from the deceleration in automobiles manufacturing during H1-FY08.<sup>50,51</sup>

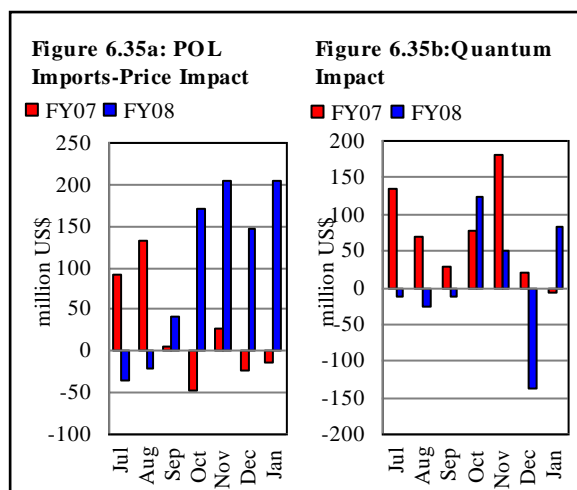
**Table 6.15: Price and Quantum Impact of Petroleum Group Imports (Jul-Jan)**

million US\$	FY07			FY08		
	Change in value due to			Change in value due to		
	Abs Δ	Quantity	Price	Abs Δ	Quantity	Price
<b>Petroleum group</b>	679.2	1153.3	-474.1	779.5	73.0	706.5
Petroleum products	747.5	1193.2	-445.7	837.3	342.7	494.7
Petroleum crude	-68.4	39.2	-107.6	-57.8	-277.7	219.9

### Petroleum Group

Given the record increase in oil prices, the petroleum group import bill witnessed a substantial expansion during Jul-Jan FY08.<sup>52</sup> This is evident from the rising price impact on the POL import bill from the month of October FY08 (see **Figure 6.35**).

The increase mainly came from petroleum products imports, whereas crude



<sup>50</sup> The average weighted average lending rates during H1-FY08 witnessed 7.5 percent rise over the level in Jun FY06.

<sup>51</sup> Automobiles production decelerated from the level of 11.4 percent in H1-FY07 to 5.1 percent in H1-FY08.

<sup>52</sup> The average oil prices during H1-FY08 reached US\$ 78.2 per barrel as compared to the level of US\$ 60.3 per barrel during H1-FY07.



imports witnessed decline in quantum. In terms of import quantum however; there is a visible deceleration in the products imports also (see **Table 6.15**).

**Table 6.16: Domestic Consumption of Petroleum Products**

volume: 000MT, growth: percent

	Volume			Growth	
	FY06	FY07	FY08	FY07	FY08
Furnace oil	1937.1	3440.5	3662.7	77.6	6.5
HSD	3706.3	3588.8	3929.5	-3.2	9.5
Motor gasoline	607.4	577.7	740.2	-4.9	28.1

This slow down in the products' import quantum was caused by falling furnace oil consumption<sup>53</sup> (see **Table 6.16**).<sup>54</sup> It may be recalled that during Jul-Jan FY07 a large quantity of furnace oil was imported for thermal power generation to supplement hydel generation that had declined due to water shortages.<sup>55</sup> These thermal units have been running on operational capacity due to acute power shortages, however, since no new thermal power generation units have been added, the growth in the furnace oil has not shown any substantial increase. As against furnace oil, both HSD and motor gasoline consumption recorded increase during H1-FY08 compared to the same period last year.

Increase in the motor gasoline consumption is particularly interesting given the falling demand of automobiles and their conversion to CNG. Apparently the rise in the domestic consumption of motor gasoline is the result of curtailment of large scale smuggling of this product from Iran.<sup>56</sup> The impact of this restriction can be seen in the form of higher domestic sales of this commodity during H1-FY08. Going forward the motor gasoline imports are likely to increase in order to fulfill the gap created by the elimination of smuggling possibilities. Crude oil imports, however, declined firstly on account of a temporary closure a large refinery during November FY08. Secondly refineries were also working below operating capacities from December FY08 due to their inability to market the product mix presently available with them.

<sup>53</sup> Consumption includes both imports and domestic production.

<sup>54</sup> According to H1-FY08 data, domestic production of petroleum products constituted 45.9 percent, 44.8 percent and 89.3 percent of the total domestic consumption of furnace oil, HSD and motor gasoline respectively.

<sup>55</sup> Thermal power generation was 13.2 percent higher during Jul-Mar FY07 as compared to the same period in the preceding year, whereas hydel power generation recorded a small 1.2 percent fall during the previous year.

<sup>56</sup> The Iranian government imposed restrictions on the sale of petrol in the border areas by starting a system of consumption permits from July 2007 for elimination of smuggling possibilities.

### Textile Group

A sharp surge in *raw cotton* imports resulted in a wide expansion in the textile group imports (see **Table 6.17**). Cotton imports were necessitated due to a fall in the domestic cotton production during FY08.<sup>57</sup> Going forward, the import of raw cotton is likely to rise since the government has allowed the import of short staple cotton through land route from India from December FY08.

**Table 6.17: Textile Group Imports (Jul-Jan)**

value: million US\$, growth: percent

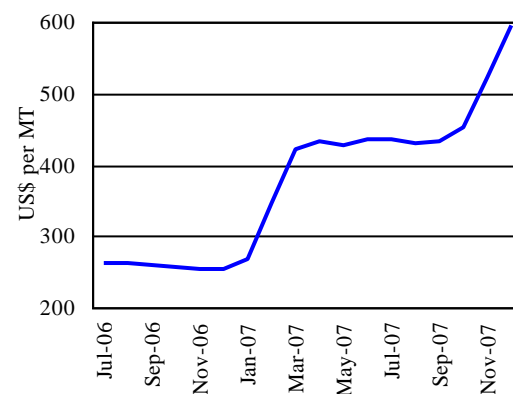
		Value		Δ in	% Δ FY08 over FY07		
		FY07	FY08	Val.	Qty.	Value	Unit Value
<b>Textile group</b>		<b>824.6</b>	<b>1337.8</b>	<b>513.2</b>		<b>62.2</b>	
Raw cotton	MT	298.4	726.6	428.3	122.9	143.5	9.3
Synthetic fiber	MT	136.3	164.7	28.4	6.3	20.8	13.7
Synthetic and artificial silk yarn	MT	136.7	172.2	35.5	13.4	26.0	11.1
Worn clothing	MT	31.8	37.2	5.5	13.5	17.2	3.2
Other textile items		221.3	237.0	15.8	---	7.1	---

### Agricultural and other chemicals group

Agriculture and other chemicals imports increase and had the highest (around 24 percent) share in the total imports increase during Jul-Jan FY08. Higher *fertilizers* and *other chemicals* imports were chiefly responsible for inflating import bill in this group.

The large increase in *fertilizer* imports was resulted both by rising quantum and prices, with the impact of the latter

**Figure 6.36: DAP Fertilizer International Price**



Source: World Bank

<sup>57</sup> Cotton production during FY08 was recorded at 12.8 million bales as compared to the 12.8 million bales recorded during FY07.

being greater. The international fertilizer prices are witnessing an expansion since CY07 on account of lower supplies from Russian, African and Lithuanian markets, which are major DAP suppliers to Pakistan (see **Figure 6.36**).<sup>58</sup>

As far import quantum, the rise was seen despite a 20 percent YoY fall in the domestic DAP off-take during Jul-JanY08. This is because, around 70 percent of the domestic DAP requirements are met through imports. Therefore, the impact of decline in the use of DAP did not translate into a fall in import quantum. Besides, domestic production of DAP also suffered from December FY08 due to closure of the single largest DAP fertilizer plant near Karachi which had to be supplemented through imports.<sup>59</sup>

*Other chemicals* imports increased to cater the needs of textile and plastic sectors. The imports in the agriculture and other chemicals group could expand further on account of the rising activity in plastics and other industries. However, the fertilizer import might possibly go down after the capacity improvements which are currently underway in the DAP fertilizer plant.

#### ***Metal Group***

Rise in metal group imports was mainly contributed by *iron and steel scrap* imports (see **Table 6.18**). Import in this category recorded a large increase due to higher iron and steel demand in the country originating from construction sector. This increased demand has led to the revival of the ship breaking industry, which at one time used to be second largest in the world.<sup>60</sup>

A substantial share of the increase in iron and steel scrap imports was offset by the falling gold imports. This fall which resulted from lower import quantum is attributable to record high level of gold prices.

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<sup>58</sup> Source: <http://mercermilling.com/>

<sup>59</sup> The DAP production fell from the level of 202.6 thousand tonnes in Jul-Nov FY07 to 197.7 thousand tonnes in Jul-Nov FY08.

<sup>60</sup> According to the Association of Ship Breakers, during Jul-Jan FY08 various private concerns have imported 25 vessels weighing 213.8 thousand light displacement tonnage (LDT) as compared to the 19 vessels weighing only 34.5 thousand LDT in the same period last year.

**Table 6.18: Agricultural & Other Chemical Group and Metal Group Imports (Jul-Jan)**

value: million US\$, growth: percent

		Value		Δ in Value	% Δ FY08 over FY07		Unit Value
		FY07	FY08		Quantity	Value	
<b>Agricultural &amp; other chemical group</b>		<b>2442.0</b>	<b>3224.5</b>	<b>782.5</b>		<b>32.0</b>	<b>2442.0</b>
Fertilizer manufactured	MT	248.4	588.8	340.3	50.1	137.0	57.9
Insecticides	MT	59.9	57.7	-2.2	-20.7	-3.7	21.5
Plastic material	MT	655.3	726.4	71.2	4.8	10.9	5.8
Medicinal products	MT	224.2	296.1	71.9	21.5	32.1	8.7
Other chemicals		1253.9	1555.6	301.6		24.1	1253.9
<b>Metal group</b>		<b>1458.3</b>	<b>1519.1</b>	<b>60.8</b>		<b>4.2</b>	
Gold	KG	151.2	10.5	-140.7	-93.1	-93.0	1.7
Iron and steel scrap	MT	181.3	381.2	199.9	76.9	110.2	18.9
Iron and steel	MT	676.7	705.0	28.4	2.1	4.2	2.1
Aluminum wrought & worked		100.8	83.1	-17.7		-17.5	
All other metals articles		348.0	339.2	-8.8		-2.5	

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