

# **THE STATE OF PAKISTAN'S ECONOMY**

**Third Quarterly Report  
for the year 2008-2009 of the  
Central Board of State Bank of Pakistan**



**State Bank of Pakistan**

## **CENTRAL BOARD OF DIRECTORS**

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## LETTER OF TRANSMITTAL

State Bank of Pakistan  
Karachi.  
June 04, 2009

Dear Mr. Chairman,

In accordance with Section 9A(f) of the State Bank of Pakistan Act, 1956, I submit herewith the Third Quarterly Report for the year 2008-09 of the Central Board of Directors of the State Bank of Pakistan on the State of the Economy.

With best regards,

Yours sincerely,



(SYED SALIM RAZA)  
Governor

Mr. Farooq H. Naek  
Chairman  
Senate  
Islamabad

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June 04, 2009

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In accordance with Section 9A(f) of the State Bank of Pakistan Act, 1956, I submit herewith the Third Quarterly Report for the year 2008-09 of the Central Board of Directors of the State Bank of Pakistan on the State of the Economy.

With best regards,

Yours sincerely,



(SYED SALIM RAZA)  
Governor

Dr. Fehmida Mirza  
Speaker  
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<i>Contents</i>	<i>Page No.</i>
1. Overview	1
1.1 Economic Outlook	1
1.2 Executive Summary	6
2. Real Sector	13
2.1 Agriculture-sector Performance	13
2.2 Large Scale Manufacturing	28
2.3 Services	44
3. Prices	49
3.1 Global Inflation Scenario	49
3.2 Domestic Scenario	51
3.3 Consumer Price Index	53
3.4 Wholesale Price Index	59
3.5 Sensitive Price Indicator	61
4. Money & Banking	63
4.1 Monetary Policy	63
4.2 Developments in Monetary Aggregates	67
4.3 Credit to Private sector	72
4.4 Deposit Mobilization	85
5. Fiscal Developments	89
5.1 Overview	89
5.2 Domestic Budgetary Borrowings	90
5.3 FBR Tax Collection	91
5.4 Domestic Debt	92
6. External Sector	97
6.1 Overview	97
6.2 Current Account Balance	101
6.3 Financial Account	107
6.4 Foreign Exchange Reserves	114
6.5 Exchange Rate	116
6.6 Trade Account	119
Special Section 1: Waste Management: Recent Developments in Pakistan	141
Special Section 2: Regulating Pro-Actively: The Case of Minimum Capital Requirements (MCR)	149
Acronyms	155

# 1 Economic Outlook

## 1.1 Overview

As the year progressed, it became clearer that economic performance of the country would remain weak in FY09. A moderation in economic growth was expected and embedded in a lower growth target for FY09, but developments during the first four months of the fiscal year made it obvious that even this lower growth target would be difficult to achieve. These developments included stubbornly high inflation, massive deterioration in external accounts, and declining industrial output.

Nonetheless, by the end of Q2-FY09 some semblance of macroeconomic stability was beginning to emerge, as the government focused on restoring macroeconomic stability, and entered into a Stand By Arrangement (SBA) with the IMF in support of its reform program. This improvement continued in the third quarter of FY09, as these reforms took hold and the economy benefitted from a sharp decline in international commodity prices and other favorable developments.

Inflation began to decline, the current account deficit narrowed substantially with a corresponding stability in the exchange rate, and fiscal discipline was maintained with the fiscal deficit being reported to be 3.1 percent of GDP for July-March FY09. While this improvement in macroeconomic indicators is very encouraging, the economy is not out of the woods yet. Major macroeconomic indicators show underlying weaknesses which, if not addressed, could hamper economic recovery.

**Table 1.1: Selected Economic Indicators**

		FY07	FY08	FY09
<u><b>Growth rate (percent)</b></u>				
LSM	Jul-Mar	9.1	5.0	-7.7
Exports (fob)	Jul-Apr	2.9	9.9	-3.0
Imports (cif)	Jul-Apr	8.9	28.3	-9.8
Tax revenue (FBR)	Jul-Apr	20.0	16.3	17.7
CPI (12 month MA)	Apr	7.8	9.8	22.0
Private sector credit	Jul-Apr	13.0	15.0	1.7
Money supply (M2)	Jul-Apr	11.8	8.4	1.9
<u><b>billion US dollars</b></u>				
Total liquid reserves <sup>1</sup>	end-April	13.7	12.4	11.2
Home remittances	Jul-Apr	4.5	5.3	6.4
Net foreign investment	Jul-Apr	5.9	3.9	2.2
<u><b>percent of GDP<sup>2</sup></b></u>				
Fiscal deficit	Jul-Mar	3.1	4.7	3.1
Trade deficit	Jul-Mar	5.3	6.6	5.7
Current a/c deficit	Jul-Mar	4.3	5.7	4.6

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

<sup>2</sup> Based on full-year GDP in the denominator. For FY09 estimated full-year GDP.

The record wheat and rice harvests together with the likelihood of good production in minor crops and of fodder backs expectations that growth in the crops sub-sector of agriculture will exceed the FY09 annual target. A reasonable performance from the livestock sector, supporting all this, will help take the overall agri-sector growth close to, or over, the annual target. Also, notwithstanding a slowdown in the *trade*, and the *transportation & communication* sub-sectors, the services sector is also expected to perform well.

However, the substantial negative growth in large scale manufacturing (LSM) (see **Table 1.1**), remains a major drag on prospects of improving real GDP growth. While the decline in LSM growth is a reflection of weaker domestic and external demand, other domestic factors have a significant contribution as well. These include infrastructural bottlenecks (e.g. power and gas shortages), increasing risk averseness of banks (this has lowered access, and increased cost of credit, for both businesses and consumers), as well as persistent inflationary pressures.

In this context, the recent easing of inflationary pressures is indeed encouraging. The headline inflation - measured by consumer price index (CPI) - dropped to 17.2 percent on year-on-year (YoY) basis in April 2009 from its peak of 25.3 percent YoY in August 2008. In particular, a sharp downtrend in food inflation is a welcome development as this component of CPI affects low income groups the most. CPI food inflation fell from its peak of 34.1 percent YoY during August 2008 to 17.0 percent in April 2009.

The downtrend in inflation owes to both, favorable international and domestic developments, as well as a deceleration in domestic demand. The latter, in particular, reflects the monetary tightening by the central bank, as well as the complementary improvement in fiscal discipline, especially post November 2008. It is worth noting that the acceleration in the fall of inflation is becoming visible only after the monetization of the fiscal deficit was halted. The weakness in demand pressures amid fiscal prudence, lagged impact of relatively lower international commodity prices, bumper wheat and rice harvests as well as better supply management of key staples have augmented the gains of tight monetary policy.

While domestic demand had been visibly easing since November 2008, the pace of the improvement was initially unclear, and there were lingering risks on the external accounts as well as in the relative resilience in core inflation. These risks precluded an immediate easing of monetary policy, and accordingly the January 2009 monetary policy statement kept the policy rate unchanged.



Notwithstanding this, the measures introduced in the wake of the liquidity shock in October 2008 meant that KIBOR eased, particularly due to non-enforcement of the implicit interest rate corridor by SBP, which effectively diluted the impact of the policy stance on the already-stressed domestic economy. To support industry and particularly the export-oriented sectors, that were pressured by the impact of the global recession, measures were introduced such as; easing access to concessional financing schemes, and lengthening maturities. The central bank also injected appropriate liquidity to meet banking system's increased demands for commodity operations and settlement of circular debt. However, by April 2009, broad money (M2) growth was still quite weak, at 1.9 percent year-to-date, down sharply from 8.4 percent in the corresponding period last year, reflecting continued deceleration in domestic demand. As a result of this, SBP projections suggest that deceleration in inflation will be much sharper in the next few months. This is also evident from the successive fall in the core inflation during March and April 2009.

The projected improvement encouraged SBP to gradually shift its policy bias towards supporting growth in the economy. Thus, as other macroeconomic indicators improved further, this allowed the central bank a 100 bps reduction in the policy rate, bringing it to 14 percent effective from April 21, 2009.

It has been argued that the substantial improvement in macroeconomic indicators, should have allowed for a sharper reduction in the policy rate; particularly when the growth indicators show a substantial slowdown in the economy, and inflation is projected to fall sharply. Indeed, the market had already envisaged the possible cut in the policy rate, ahead of the April reduction, observing low inflationary pressures in the economy, the expectation is evident from the downtrend in the market rates since January 2009. Such a measure would have been possible, were it not for the risks attached to the current macroeconomic situation. These risks include anticipated shortfalls in fiscal receipts, the uncertain international environment which adds uncertainty to Pakistan's ability to finance even a narrower current account deficit, as well as the fact that the accelerated decline in inflation is, so far, more an expectation than a fact.

The fiscal deficit for July-Mar FY09 is reported at 3.1 percent of GDP, which is consistent with the annual target, but there are significant issues with both, the sustainability of this trend over the full year, and the quality of this reduction in the deficit.

- (1) The growth in tax collections has already slowed, and may decline further in Q4-FY09. Also, non-tax revenue receipts, which had hitherto supported overall revenue growth, are also expected to weaken in the same quarter

(e.g. rising international prices are expected to squeeze receipts of petroleum development levy).

- (2) The government's expenditure budget will also be stretched by the ongoing war on terror, the need to support an estimated more than a million internally displaced persons (IDPs) fleeing the conflict areas.
- (3) It is important to stress the "improvement" in the fiscal picture as a result of the sharp cut on development spending is neither sustainable nor desirable. Particularly in the context of the socioeconomic conditions that support the extremist militants, it is crucial that the government increase its spending on health, education, and strengthening social safety nets.

The anticipated weaker performance of revenues, and increase in expenditures both point to the risk of slippage in the fiscal deficit target, and a contingent increase in financing requirements. The pertinent point here is that the lower demand for private sector credit and increased risk averseness of banks during the year so far, allowed the government to increase borrowings from commercial banks without putting upward pressure on interest rates. However, recent developments suggest that this room is fast eroding, and significant additional government demand would increase the risk of crowding out the private sector.

Similarly, resurgence in international commodity prices poses risks to the assessment of a continued sharp deceleration in inflation in the months ahead. In particular, a rise in international oil prices would have adverse consequences for domestic inflation as well as the external account balance. In recent months, current account deficit witnessed improvement relative to the corresponding period, for the first time in five years. This is mainly attributed to a substantial fall in import growth, and sustained strong growth in remittances that continued during Dec-Apr FY09.<sup>1</sup>

However, flows under financial and capital accounts are relatively lower compared with the preceding years, causing a rise in overall external account deficit. A fall in financial inflows is the result of combined impact of both external and domestic factors. Financial flows towards emerging economies have generally significantly shrank amid financial turmoil and recession. On the domestic front, poor law & order and security situation, and political noise have led to net outflows of portfolio investment. While, Pakistan's ability to access

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<sup>1</sup> As per the exchange record data, imports recorded a YoY decline of 36.8 percent in Q3-FY09, export declined by 16.9 percent, while workers' remittances increased by a healthy 21.4 percent.

international financial market is constrained, any shortfall in external inflows would add to pressures on monetary policy.

In short, the limited gains in key macroeconomic indicators should not lead to complacency as the quality of these improvement and challenges to economy are some factors of disquiet. For example, a decline in fiscal deficit would have been a welcome development to the extent achieved through lower growth in current spending (see **Table 1.2**). The reduction in development expenditure is not desirable, as it would have detrimental impacts on country's human and physical infrastructure.

In the medium term, the only viable way to achieve sustainable improvements in fiscal accounts is to raise the tax-to-GDP ratio through increasing the tax net. This is because a substantial reduction in current expenditures is not possible without significant reduction in the size of government machinery, due to inflexible interest payments and expenses under defense and civil administration. Similarly, an increase in tax rate may probably encourage tax evasion.

Another area of concern is the gradual improvement in current account deficit, which is principally driven by a decline in import growth. It should be kept in mind that there exists quite uncertainty over the pace of growth in workers' remittances. In addition, country would also have higher debt servicing in coming years. These two factors reinforce the common view that sustainable improvement can be achieved only through increasing exports by product and market diversification with gains in productivity. These are not easy tasks. Increase in market diversification requires quality products with a good name of the country and congenial environment to buyers of Pakistani products to visit production venues and observe the processes. A large number of buyers required to do this to satisfy their developed countries clients about safety standards and

**Table 1.2: Projections of Major Economic Indicators**

		FY09	
	FY08	Annual plan targets	Projections
<i><b>growth rates in percent</b></i>			
GDP	5.8	5.5	2.0 - 3.0
Average CPI Inflation	12	11	20.5 - 21.5
Monetary assets (M2)	15.3	14	8.0 – 10.0
<i><b>billion US dollars</b></i>			
Workers’ remittances	6.5	7.7	7.5
Exports (fob-BoP data)	20.1	22.9	18.5 - 19.5
Imports (fob-BoP data)	35.4	37.2	30.5 - 31.5
<i><b>percent of GDP</b></i>			
Fiscal deficit	7.4	4.7	4.0 – 4.5
Current account deficit	8.4	7.2	5.0 – 5.5
Note: Targets of fiscal and current account deficit to GDP ratios are based on nominal GDP in the Budget document for FY09, while their projections are based on projected (higher) nominal GDP for the year.			

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environmental as well as social issues. Similarly, product diversification needs investment, expertise, spending in research and development.

Finally, a practical solution is to enhance productivity in the medium term. However, it cannot be achieved without providing basic education and health facilities to masses, as well as efficient physical infrastructure including credible low cost energy, transportation and postal systems. The country can achieve all these despite huge investment requirements. In fact, these areas indicate to implement second generation reforms to improve governance, strengthening institutions and reform legal as well as regulatory system.

## **1.2 Executive Summary**

### **1.2.1 Agriculture Sector**

Robust growth by major crops, despite lower water availability and decline in fertilizer off-take, is principally a reflection of anticipated higher prices, and good luck in terms of favorable weather. The good performance by major crops appears to be more impressive given a substantial decline in sugarcane harvest during FY09. Similarly, growth in production of some pulses, oilseeds and horticulture crops indicates a better performance by minor crops during FY09. More importantly, growth in livestock benefited from higher supply of fodder, following the extended monsoon and winter rains as well as absence of any major incident of diseases during FY09.

All these developments suggest that FY09 agriculture growth would be reasonably good and that could have been even better if sufficient inputs - irrigation water, fertilizers and certified seeds - could have been used.

Farmers' ability to increase investment in quality inputs may be reflected partially by slower than anticipated growth in agri-credit. The trends so far suggest that the annual target of Rs 250 billion would be missed, for the first time since FY05. This would be due to both demand and supply factors. However, for the next season, credit disbursement is expected to improve. For example, relatively stable fertilizer prices would help restore demand for agri-credit for inputs. Similarly, an ease in monetary policy and SBP measures to address liquidity shortages in the banking system would help improve supply of agri-credit in the months ahead.

### **1.2.2 Large-scale Manufacturing**

Growth in large scale manufacturing (LSM) has been negative for the tenth consecutive month in Mar 2009, the longest period in which production continued

to shrink. LSM growth dropped by 7.6 percent during July-Mar FY09 compared with a 5.0 percent rise in the corresponding period of FY08.

Weakness in domestic demand, worsening power shortages, structural problems and deterioration in law & order situation are some important factors responsible for the decline in LSM production. Similarly, decline in external demand and sharply lower fund flows amid global recession probably contributed to slowdown in domestic manufacturing activities.

Consumer durables industry witnessed drastic decline in production during July-Mar FY09. Domestic consumer durable industry largely produces for the local market and is relatively less competitive than the regional competitors. In particular, jeeps & cars sub-sector is the worst hit by the sluggish demand due to (1) continued increase in prices; (2) rise in cost of financing; as well as (3) lower availability of institutional financing given the risk averse behavior of banks amid increasing NPLs under consumer financing and liquidity problems.

Production decline in cooking oil & ghee industry is due to the combined impact of weaker domestic demand as well as uncertain international prices of key inputs. Similarly, textile industry suffered due to domestic as well as external shocks. Power outages, increase in utility charges and higher financial cost were some domestic factors responsible for a drag in textile sector, weak external demand amid global recession hurt production in this export driven sector. In contrast, drop in sugar production is entirely attributed to domestic factor i.e., lower sugarcane harvest during FY09.

### **1.2.3 Services**

A slowdown in economic activities as well as poor law & order situation also impacted the performance of services sector during FY09. In contrast with stellar growth in recent years, services sector is expected to record below target growth in FY09.<sup>2</sup> In relation to domestic economic slowdown, foreign inflows of funds in services have eased up in FY09. Overall domestic economic slowdown witnessed in FY09, depicted by decline in large scale manufacturing, decrease in domestic demand and decline in exports as well as imports are factors impeding growth prospects in services. Outlook for trading activities is on the down side as the two major components of value addition in trading i.e. manufacturing and imports exhibit slowdown in FY09.

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<sup>2</sup> Actual real growth in services has surpassed annual growth targets in three of the previous four fiscal years.

On the other hand, *finance & insurance* sub-sector also presents a mixed performance. The profits of commercial banks dropped substantially during the first three quarters of FY09. In contrast, SBP profits witnessed a substantial increase during this period. Moreover, other financial institutions; including, mutual funds, modarba companies and foreign exchange companies - whose earnings contain higher risk premia and are prone to fluctuation in rupee parity - were negatively impacted by capital market instability in H1-FY09 as well as high NSS returns. Transportation and communication are expected to benefit from relatively lower international oil prices and consolidation of revenues; in addition storage activities exhibit sharp increase in FY09.

#### **1.2.4 Prices**

The relative ease in inflationary pressures that began in Q2-FY09 continued into Q3-FY09 with all price indices exhibiting a declining trend. After reaching a record high in August 2008, CPI inflation (YoY) declined to 17.2 percent in April 2009. The recent downtrend in CPI inflation (YoY) was mainly attributed to declining domestic food inflation, principally a reflection of fall in international prices and smooth domestic supply of key staples. Signs of easing of inflationary pressures are also reflected by a decline in persistent component of inflation, which is measured by core inflation. The non-food non-energy (NFNE) and 20 percent trimmed mean, both the core inflation measures have shown signs of relative ease during April 2009.

Going forward CPI non-food inflation is also expected to ease as a result of lagged impact of tight monetary stance, declining international commodity prices, subdued inflationary expectations amid weaker domestic demand and absence of second-round effects due to a relative slowdown in food inflation. In line with CPI inflation (YoY) other price indices including WPI and SPI also witnessed a downtrend during Q3-FY09.

While, inflation is still high it is expected that the downtrend in inflation will gather pace in the next few months. Weak inflation expectations together with evident decline in domestic demand resulted in an ease in monetary policy in April 2009.

#### **1.2.5 Money and Banking**

SBP reduced the policy discount rate through a 100 bps to 14 percent effective from April 21, 2009. Though the demand pressures have been showing a downtrend since November 2008, the lowering of risks to external account position and a visible downtrend in stubbornly high core inflation allowed SBP to lower the policy rate.

While inflation has been quite stubborn over the last 6 months, this appears to be changing, as evident in the declining trend in the year-on-year figures for CPI inflation as well as both core inflation measures. Similarly, a sharp slowdown in country's import bill during Q3-FY09 helped substantially in narrowing the current account deficit to US\$ 396 million in the same period.<sup>3</sup> This together with financial flows from International Financial Institutions (IFIs) led to a significant increase in SBP's foreign exchange position to US\$ 7.8 billion at end-April 2009 from its low level of US\$ 3.5 billion by end-October 2008.

Moreover, the private sector credit growth continued to show deceleration as it recorded net retirement of Rs 127.1 billion in Jan-Mar FY09 compared with net lending of Rs 203.1 billion in H1-FY09.<sup>4</sup> While the credit demand is slowing down, banks were also reluctant to lend to private sector due to rising credit quality concerns. On the fiscal side, the demand stimulus has continued to ease as fiscal discipline improved, and government reliance on central bank borrowing has further declined by end-March 2009.

The domestic liquidity condition, as a result of slowdown in domestic credit requirements by the government and private sector and sharp fall in pace of depletion of NFA of the banking system have continued, so far, remained relatively easy.<sup>5</sup> The impact of improvement in demand pressures on rupee liquidity is quite visible from the softening of market interest rates since January 2009.

The YoY growth in broad money (M2) decelerated sharply to 8.4 percent as on April 25, FY09 compared to 15.3 percent in the corresponding period last year. This was despite a considerable fall in pace of depletion of Net Foreign Assets (NFA) of the banking system. The sharp deceleration in M2 growth came from reduced credit requirement by the government and private sector. Resultantly, as on April 25, 2009, the YoY growth in Net Domestic Assets (NDA) of the banking system dropped to 16.9 percent from 22.6 percent a year earlier.

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<sup>3</sup> During Q3-FY08, the current account deficit was US\$ 3.7 billion.

<sup>4</sup> The cumulative increase in private sector credit during Jul-25<sup>th</sup> April FY09 was only Rs 48.6 billion compared with Rs 371.3 billion in the corresponding period of the last year.

<sup>5</sup> While, in the month of October and November 2008 the continued decline in deposit growth exerted downward pressure on rupee liquidity, an abrupt and heavy withdrawal of deposits from the banking system further aggravated the situation. However, the SBP proactive liquidity management ensured the smooth functioning of inter-bank market.

The overall deposits mobilization by banks remained weak during July-Mar FY09 as overall deposits of the banking system witnessed a contraction of 0.6 percent on cumulative basis. This was despite a considerable ease in external current account pressures which was a significant source of erosion in deposit-base. Indeed, deceleration in private sector credit growth, higher competition from National Saving Scheme (NSS), and lower liquidity injections from SBP into banks following a lesser budgetary borrowings from the central bank limited the deposit growth in the period of analysis.

### **1.2.6 Fiscal Developments**

Recent update on fiscal developments by Ministry of Finance indicates that the budget deficit for July-Mar FY09, as a percentage of the estimated FY09 GDP, is likely to remain at 3.1 percent compared with 4.7 percent in the corresponding period of FY08. Though broadly consistent with the annual fiscal deficit target for FY09, the quality of this fiscal improvement can only be judged once consolidated fiscal accounts are released.

Indicators of tax performance suggest a likely shortfall in tax collection (budget) target for FY09. During July-Apr FY09, FBR tax receipts amounted to Rs 898.6 billion compared with Rs 763.6 billion in the same period last year, reflecting a YoY increase of 17.7 percent. Although the YoY growth in tax receipts during July-Apr FY09 is moderately higher than the 16.3 percent rise experienced in the corresponding period of FY08, monthly trend projects a deceleration in FBR tax revenues for the entire fiscal year 2008-09. Even if FBR is able to arrest the downtrend in the growth of tax collection during the remaining months of FY09, the current pace of increase in tax receipts falls short of the 24.1 percent YoY growth required to attain the Rs 1250 annual budget target for FY09.

As a percent of annual target, total tax collection stands at 71.9 percent by end April 2009. Importantly, 74.5 percent and 78.6 percent of the annual budget target were achieved in the same period of FY08 and FY07 respectively. It merits mentioning here that the FBR tax collections fell short by Rs 17.8 billion in FY08. To achieve FY09 target of Rs 1250 billion would require FBR to amass almost 28 percent of the target amount in the remaining two months; indicating that the revenue target for FY09 will be hard to achieve keeping in view the prevailing economic conditions in the country.

The aggregate government borrowing from domestic sources stood at Rs 353.0 billion during July-Mar FY09, which is significantly lower than the domestic budgetary requirements in the corresponding period of FY08. With apparent shortfall in external borrowing for budgetary support, the decline in budgetary



borrowing from domestic sources in July-Mar FY09 reflects improvement in fiscal balance.

### **1.2.7 Balance of Payments**

The improvement in Pakistan's overall external account, which emerged in November FY09, continued in the subsequent months as well. A large part of this improvement during July-Apr FY09 is on account of 23.5 percent contraction in current account deficit. This contraction mainly owed to fall in imports, on the back of weakening aggregate demand pressures and falling import prices, and strong remittances growth.

Unlike the improvement in current account, capital & financial account deteriorated sharply during July-Apr FY09. This deterioration was contributed by a fall in both investment and loan inflows. While loan inflows revived to large extent after IMF support for macroeconomic stabilization program, foreign investment inflows continued their declining trend in the wake of worsening global financial crises. While loan inflows could further strengthen if pledges (worth US\$ 5.28 billion) made in Friends of Democratic Pakistan (FODP) conference materialize, substantial recovery in foreign investment inflows is subject to the normalization of international financial market conditions and improvement of Pakistan's macroeconomic indicators.

The relative improvement in Pakistan's external accounts was reflected in foreign exchange reserves, which recorded sustained improvement Nov 08 onwards. Consequently by April 30 2009, foreign exchange reserves had climbed back to almost the end-June level of US\$ 11.4 billion after hitting a low of US\$ 6.8 billion in Oct 2008. This also alleviated pressures on the exchange rate, helping it to stabilize in the range of 78.8 and 80.8<sup>6</sup>

### **1.2.8 Trade Account**

Trade deficit recorded a break from rising trend of the past six years, declining by 15.9 percent YoY during July-Apr FY09. This was principally led by a 9.8 percent YoY fall in imports that more than offset a small 3.0 percent YoY fall in exports during this period. A larger share of the improvement in trade deficit was observed during Jan-Apr FY09; due to a sharp 35.1 percent YoY fall in imports that outpaced a yet large 19.2 percent YoY fall in exports in this period. The fall in imports, in turn, was contributed by a shrinking import demand which was complemented by a large YoY decline in import unit values from the beginning of Jan FY09.

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<sup>6</sup> Between Dec 1<sup>st</sup>, 2008 and Apr 30<sup>th</sup>, 2009.

Unfortunately exports, after recording a decent performance during July-Oct FY09, recorded an accelerated deterioration November 08 onwards. This deterioration in export performance was the result of multifarious issues faced by exports. For instance structural obstacles, domestic energy crisis, and worsening law and order situation were some of the major issues that constrained export performance. The impact of these domestic impediments was complimented by deepening international recession from Q4-CY08, which further squeezed external demand for country's major exports leading to a YoY fall in exports for July-Apr FY09.

Nevertheless, given the expectation that the decline in imports will be much larger than the fall in exports, the trade deficit is expected to continue to decline in the remaining months of FY09. Thus overall, the trade deficit for FY09 is likely to be much lower than that in FY08.

## 2 Real Sector

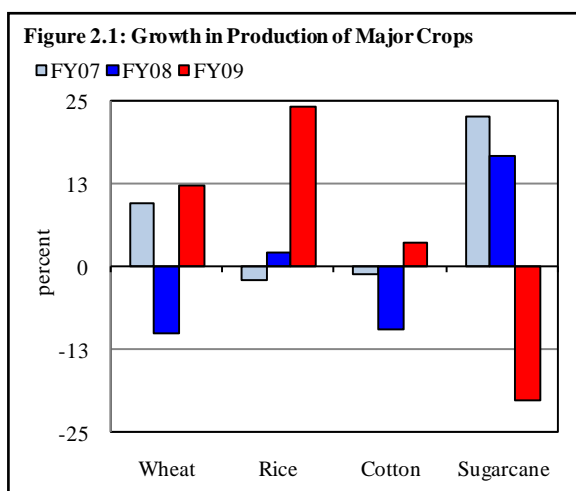
### 2.1 Agriculture Sector Performance

Robust growth in major crops, despite lower water availability and decline in fertilizer off-take, is principally a reflection of anticipated higher prices, and good luck in terms of favorable weather (see **Figure 2.1**). The good performance by major crops appears to be more impressive given a substantial decline in sugarcane harvest during FY09.

Similarly, growth in production of some pulses, oilseeds and horticulture crops indicates a better performance by minor crops during FY09. More importantly, growth in livestock benefited from higher supply of fodder, following the extended monsoon and winter rains as well as absence of any major incident of diseases during FY09.

All these developments suggest that agriculture growth would be reasonably good during FY09. And it could have been even better if sufficient inputs - irrigation water, fertilizers and certified seeds – would have been used. Less than required irrigation water, concerns over high prices and timely availability of fertilizers, as well as plantation of sub-standard seeds restricted possible gains. Further, the gains from high production in key crops in FY09 could not be fully transmitted to farmers as prices realized by the farmers were below their expectations. For example, following a drop in international rice prices and weaker exports, farmers did not get prices as high as anticipated earlier. In addition, farmers also faced late start of sugarcane crushing and delayed payments, despite domestic shortages of sugar.

Farmers' ability to increase investment in quality inputs may be reflected partially by slower than anticipated growth in agri-credit. The trends so far suggest that the annual target of Rs 250 billion would not be achieved, for the first time since FY05. This would be due to both demand and supply factors. However, for the



next season, credit disbursement is expected to improve. For example, relatively stable fertilizer prices would help restore demand for agri-credit for inputs. Similarly, an ease in monetary policy and SBP measures to address liquidity shortages in the banking system would help improve supply of agri-credit in the months ahead. A substantial increase in fertilizer off-take and agri-credit disbursement recorded during March 2009 would support prospects for continued improvement in agri-growth.

## Crops

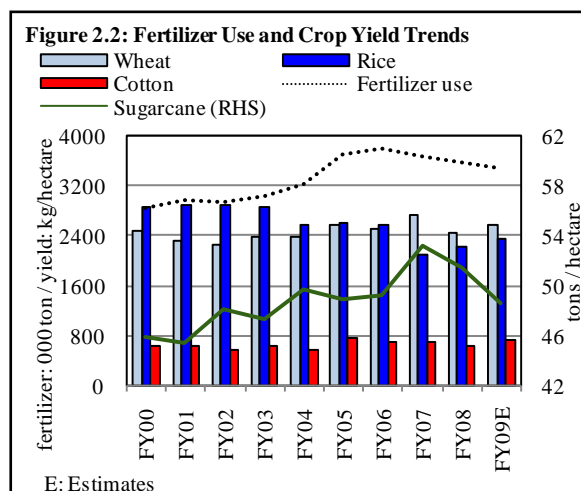
### Major crops

Growth in major crops saw recovery during FY09, owing to record production of wheat, rice and maize, despite decline in fertilizer off-take (see **Figure 2.2**). In addition, a substantial growth in gram and a moderate increase in cotton output (despite decline in area) more than offset the drag by relatively disappointing sugarcane crop. The decline in sugarcane harvest was not a surprise, as area under this crop fell during FY09 as the farmers could not realize the anticipated

prices besides disputes between farmers and sugar mills over payments. Growers substituted this area with wheat and rice crops owing to attractive prices for these crops. Despite less than required irrigation water, rice cultivation increased. The crop was supported by monsoon rains later on. Wheat sowing area increased mainly due to higher wheat support prices, announced before sowing time. Rains at sowing times also helped increase non-irrigated area under wheat during FY09.

### Wheat

Despite adversities such as lower fertilizer off-take, higher energy prices, decline in irrigation water availability, FY09 wheat harvest provisionally estimated to have reached record high of 23,302 thousand tons,<sup>1</sup> slightly higher than 23,295 thousand tons achieved in FY07. This increase seems more impressive given



<sup>1</sup> Likely to be revised upward.

losses at maturing stage due to rains and hailstorms in upper Punjab. An improvement in wheat output is largely attributed to timely announcement of support price for wheat at Rs 950/40kg with commitment of 6.5 million tons procurement, with effective campaign to grow more wheat. Moreover, front, provincial governments aggressive procurement operations help stabilize wheat prices in open market. In response of a bumper wheat crop and to supplement the government's efforts, SBP has also abolished the margin requirement on wheat financing.<sup>2</sup> In addition, despite slowdown in availability of necessary yield boosting inputs, wheat yield also improved due to supportive weather conditions during sowing and most of the growth period.

Wheat crop performance in FY09 may have improved further, if (1) recommended balanced use of fertilizers was followed, (2) more certified seeds were used, and (3) irrigation water for 4-5 spells were made possible from the canal system.

In recent years, despite substantial wheat harvests that were above domestic consumption, wheat shortages resulted in repeated crisis mainly due to illegal cross boarder movement of the grain or speculative hoarding. However, since domestic wheat prices are now significantly higher than the international prices, it is likely that both of these motives will be absent and wheat prices would remain stable. The only risk to this conclusion is misuse of wheat flour supplied at subsidized rates to provide cheaper bread (nan) to masses. While these types of schemes are necessary, they need strict monitoring. Ideally these should be carefully targeted to the poor.

### ***Rice***

Area under rice cultivation registered a healthy growth of 17.7 percent, mainly in response to high prices realized in FY08. Farmers' efficient use of inputs and supportive weather during growth phase resulted in 6.2 percent rise in yield during FY09. Consequently, rice harvest reached to a record 7.0 million tons, up by 25.0 percent over the preceding year.

However, benefits of this bumper crop did not translate into an equally strong rise in nominal income of farmers, as a fall in international rice prices led to the adoption of a cautious strategy by the domestic traders. Although, TCP buying operation helped domestic rice prices to stabilize and protect farmers, there were complains that TCP intervention was too little and too late. Encouragingly, despite some fall, FY09 prices have, so far, remained substantially higher than the preceding year. Moreover, recently some rice exporting countries

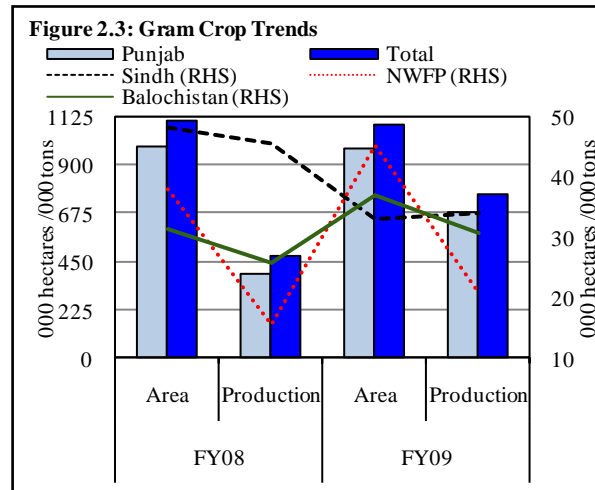
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<sup>2</sup> SMEFD Circular Letter No. 05 dated April 23, 2009.

imposed/extended restrictions on rice export, as a result rice prices started to inch up again. Nonetheless, despite some gains in prices, it seems difficult to achieve size of the FY09 rice harvest in FY10.

### Gram

Gram cultivation is largely concentrated in non-irrigated areas of Punjab (88.7 percent of total production) followed by Sindh, NWFP and Balochistan (see **Figure 2.3**). This crop is mostly planted on marginal lands; hence negligible inputs are being used. The production, of this weather sensitive crop, largely depends on flooding around major rivers in summer and winter rains, which usually contributes for increase in its cultivation. These factors resulted in volatile production performance of gram.

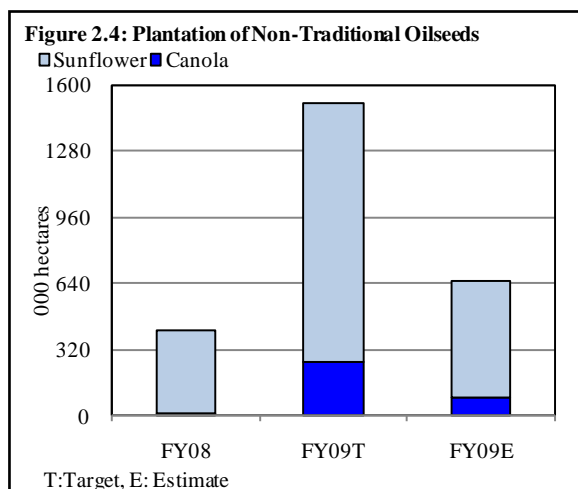


During FY09, following kind weather, gram production is estimated to have significantly increased by 60 percent, this was entirely due to a 62.2 percent rise in yield, as the area under gram cultivation dropped by 1.4 percent. This jump in yield is attributed to favorable weather in terms of timely winter rains. A sustained rise in gram yield is possible with better water management and modern farming techniques.

### Minor crops

Minor crops exhibited a mixed performance during FY09. While, a number of minor crops showed decline in production, some crops witnessed strong growth during the year under review. The aggregate performance of minor crops is expected to show a reasonable growth during FY09. This expectation is based on (1) stable prices of most of the minor crops during dominating period of the current fiscal year, as well as, (2) extended monsoon and winter rains. In particular, one of the positive sign regarding oilseed crops is the rise in cultivated area in recent years.

Canola and sunflower crops registered a strong 59.6 percent expansion in their combined planted area during FY09 over the preceding year, (see **Figure 2.4**) principally responding to prevailing higher prices. However, growth in canola output is more pronounced than sunflower. Cultivation of oilseeds needs policy support to meet growing domestic demand for edible oil. It would also help improve trade balance of the country. However, oilseed crops need heavy investment and crop failure may result in unbearable losses to farmers, therefore effective coverage of crop insurance scheme could incentivize risk averse farmers to cultivate these crops.



Similarly, crop failure is common in all other minor crops as they are sensitive to weather and disease incidents.

Importantly, market price signals largely influence the acreage of minor crops. Farmers' collective decision to sow a specific minor crop due to high prevailing prices leads to excess supply, consequently prices of this crop fall. Due to this disappointment, farmers avoid that crop in subsequent period, which results in supply shortages and higher prices. For example, a substantial decline in production of chillies and mung pulse during FY09 is a reflection of large variability (see **Table 2.1**). Small investment in food processing/packaging units may reduce variability in prices of most of the minor crops and may help ensure smooth supply.

**Table 2.1: Production of Minor Crops**

thousand tons

Crops	FY08	FY09 <sup>T</sup>	FY09 <sup>E</sup>
Potatoes	2,539.0	2,458.3	2,542.7
Onions	2,015.0	2,058.9	1,825.7
Chillies	116.0	104.5	104.6
Mung	177.7	140.4	148.0
Mash	17.3	16.9	16.0
Lentil (Masoor)	14.6	21.2	15.2
Canola	10.3	134.4	89.1
Sunflower	397.0	755.0	560.9

T: Targets, E: Estimates

Among minor crops, herbal crops have a great demand with strong potential to raise farmers' incomes. Traditionally Pakistan depends on imported herbs, thus

small investments in this area may yield favorable results for both, farmers and the national economy. MINFA has worked out a cost and income plan for some selected herbs and recommended commercial cultivation of these crops in potential parts of the country, especially Balochistan, South Punjab etc. Expansion in production will help to meet domestic requirements, reduces prices as well as provides exportable surplus. In addition, this will also create employment opportunities and develop value added products (see **Table 2.2**).

**Table 2.2: Estimated Economic Benefits of Herbal Crops**  
per acre

Herbs	Yield (Kg)	Income (Rs)	Production cost (Rs)	Net income (Rs)
Nigella sativa (kolangi)	350-400	21,000	2,040	18,960
Plantago ovata (Ispagol)	300-400	24,000	2,120	21,880
Matricaria chamomilla (Gul-e-banoona)	150-200	30,000	3,800	26,200
Lallementia royleana (Thkhan-e-Balangoo)	300-400	24,000	2,120	21,880
Carum copticum (Ajwain-desi)	350-450	14,000	1,960	12,040

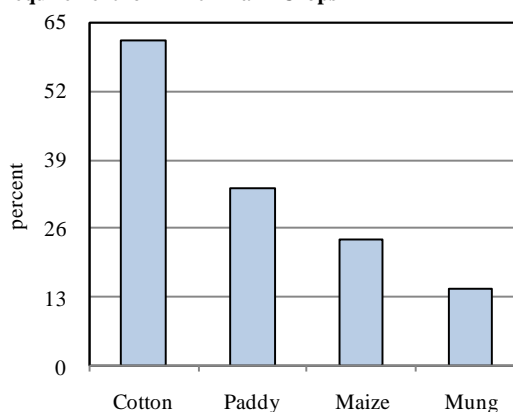
Source: MINFA

## Agriculture Inputs

### Improved Seeds

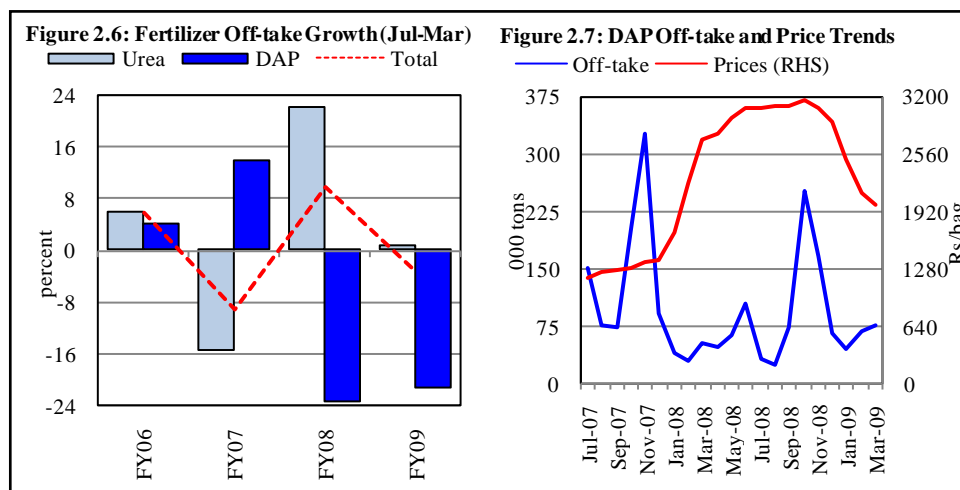
Crop seeds have vital role in crop cultivation and good quality seed plays a decisive role in yield maximization. Improved seeds help increasing production levels through maximizing yields and resistance against disease incidence. Current availability of improved seeds for almost all major and minor crops is inadequate to meet the requirements (see **Figure 2.5**). In particular, availability of improved seeds is low in case of minor crops, such as pulses.

**Figure 2.5: Improved Seed Availability as Percent of Requirement for FY10 Kharif Crops**





In addition, genetically modified seeds also reduce cost of production with higher yield. Encouragingly, cotton yield is likely to increase FY10 onwards due to larger cultivation of genetically modified variety (Bt Cotton).



## Fertilizer

In contrast to extended cultivation reflected in increased planted area of most of the crops, fertilizer off-take declined by 3.4 percent during Jul-Mar FY09<sup>3</sup> (see **Figure 2.6**) mainly due to non-availability of urea at controlled prices and uncertainty over DAP prices during *rabi* FY09 season (see **Figure 2.7**).

The decline in fertilizer off-take is also a reflection of delayed receipts of rice<sup>4</sup> and sugarcane crops. However, fertilizer off-take increased during Jan-Mar FY09, the crucial wheat growth period.

**Table 2.3: Fertilizer Off-take**  
million tons

	FY07	FY08	FY09
<b><u>Urea</u></b>			
Jul-Sep	1.14	1.37	1.33
Oct-Dec	1.50	1.51	1.46
Jan-Mar	0.87	1.40	1.54
Oct-Mar (Rabi)	2.37	2.85	3.00
<b><u>DAP</u></b>			
Jul-Sep	0.17	0.30	0.13
Oct-Dec	0.98	0.62	0.48
Jan-Mar	0.18	0.09	0.19
Oct-Mar (Rabi)	1.16	0.69	0.67
<b><u>Total (urea and DAP)</u></b>			
Jul-Mar	4.84	5.31	5.13
Oct-Mar (Rabi)	3.53	3.54	3.67

<sup>3</sup> Fertilizer off-take dropped initially by 10.1 percent in Jul-Jan FY09, then recovered somewhat Feb onwards.

<sup>4</sup> Rice prices realized by the farmers were below their expectations.

While, growth in urea off-take also decelerated, it was substantial decline in DAP consumption that principally contributed to a lower fertilizer off-take during Jul-Mar FY09. A decline of 23.3 percent in DAP off-take during Jul-Mar FY08 was attributed to its rising prices. Ironically, in FY09 sharp downward movement in the prices of DAP led farmers to postpone their purchases of the nutrient, in anticipation of even lower prices, which resulted in further decline in DAP off-take by 21.2 percent during the first nine months of FY09 (see **Table 2.3**).

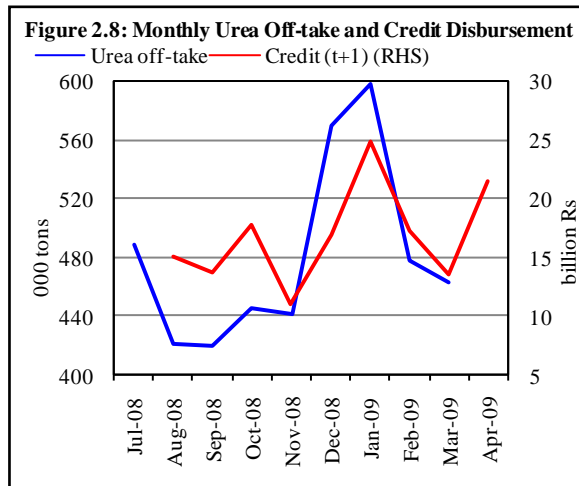
It is important to note that the surge in commodity prices in FY08 underscored the need to increase the production of agriculture commodities. Global demand for

**Table 2.4: Mid-term Global Fertilizer Supply Demand Projections FY13**

Items	Units	FY08			FY13		
		Supply	Demand	Balance	Supply	Demand	Balance
Nitrogen	Mt N	134.4	131.4	3.0	156.2	146.7	9.5
Phosphoric acid	Mt P <sub>2</sub> O <sub>5</sub>	38.7	38.1	0.6	46.4	43.4	3.0
Potash	Mt K <sub>2</sub> O	35.5	33.3	2.2	43.7	36.6	7.1

Source: IFA, June 2008, mid-term outlook FY13

fertilizer is therefore projected<sup>5</sup> to grow steadily by 3.1 percent annually up to FY13 (see **Table 2.4**), with dominating share in rising demand from Asian countries, including Pakistan. Pakistan may import large quantum of fertilizer due to inadequate domestic production. However, in medium term, country would be able to produce exportable surplus of urea as at least two urea plants are being installed.



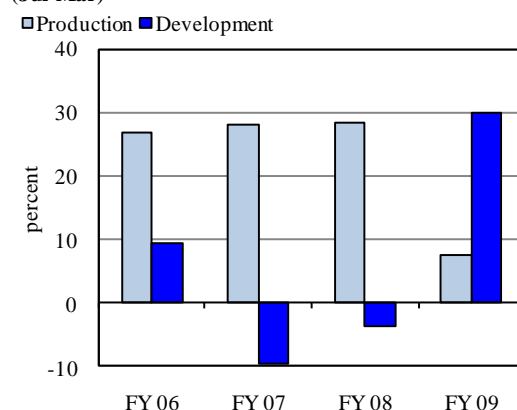
<sup>5</sup> Medium-term Outlook for Global Fertilizer Demand, Supply and Trade: 2008-2013 - International Fertilizer Association (IFA).

### Agriculture Credit Disbursement

Growth in agriculture credit disbursement slowed down to 9.6 percent during Jul-Mar FY09, 15.0 percentage points lower than in FY08 (see **Table 2.5**). This was mainly due to the combined impact of lower investment in farm inputs, as well as, risk averse behavior of the banks due to liquidity concerns. Nonetheless, the impact of the former seems more pronounced.

This view is also supported by a correlation between monthly urea off-take and preceding month's credit disbursement (see **Figure 2.8**).<sup>6</sup> This is also in conformity with the fact that disbursement for production related loans dropped and strong growth in development loans has been observed during this period (see **Figure 2.9**).

**Figure 2.9: Purpose-wise Agri-Credit Disbursement Growth (Jul-Mar)**



**Table 2.5: Agriculture Credit Trends (Jul-Mar)**

billion Rupees

Banks	Disbursement			Recoveries			Net credit			Outstanding		
	FY07	FY08	FY09	FY07	FY08	FY09	FY07	FY08	FY09	FY07	FY08	FY09
All CBs	65.0	95.1	102.9	59.7	90.7	104.4	5.3	4.4	-1.5	68.3	77.7	84.3
5- large CBs	49.0	65.1	74.4	46.9	65.8	74.8	2.1	-0.7	-0.5	52.1	54.1	58.8
DBPs	16.1	30.0	28.6	12.8	24.8	29.6	3.3	5.1	-1.0	16.2	23.6	25.5
Specialized banks	46.2	43.5	48.9	39.4	40.0	45.9	6.8	3.4	3.0	74.7	81.1	90.6
ZTBL	40.9	39.6	45.4	35.3	35.9	41.4	5.6	3.6	4.0	66.2	72.5	80.8
PPCBL	5.3	3.9	3.5	4.1	4.1	4.6	1.1	-0.2	-1.0	8.4	8.6	9.8
<b>Total</b>	<b>111.2</b>	<b>138.6</b>	<b>151.9</b>	<b>99.1</b>	<b>130.7</b>	<b>150.4</b>	<b>12.1</b>	<b>7.9</b>	<b>1.5</b>	<b>142.9</b>	<b>158.8</b>	<b>174.9</b>

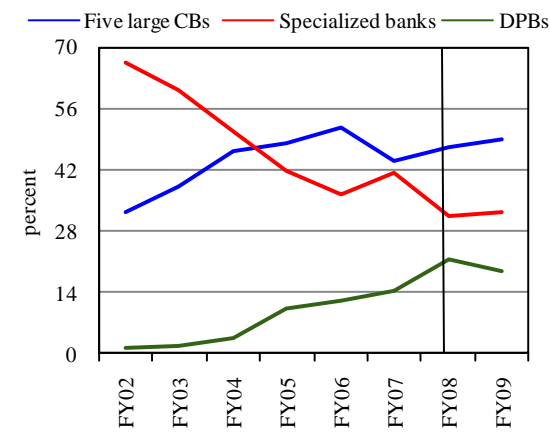
The rise in development loans is a positive sign as the impact of these disbursements would materialize in future. More importantly, not only these disbursements were made for conventional tractor financing, but also new areas

<sup>6</sup> Accordingly, a substantial increase in credit disbursement in March-09 indicates a rise in urea off-take in April-09.

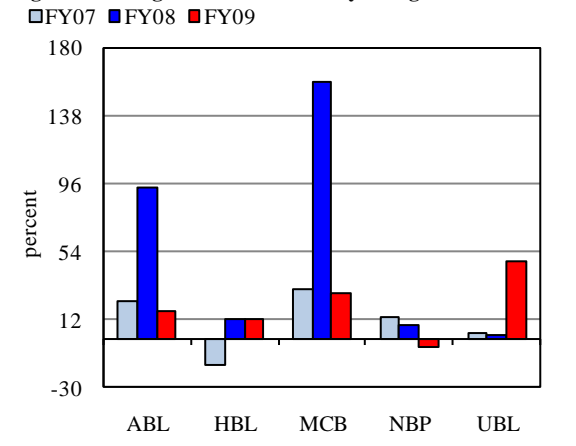
such as orchard farming, storage facilities, seed processing, as well as, development of infrastructure for livestock and poultry.

Institution-wise break up suggests that the growth in development loans extended by the commercial banks (CBs) improved from negative 17.7 percent in Jul-Mar FY08 to 35.2 percent during Jul-Mar FY09.<sup>7</sup> Among specialized banks, disbursement for development purposes by ZTBL also increased by 33.1 percent during July-March FY09. Domestic private banks (DPBs) had rapidly increased their share in agri-credit market since their entry in FY02. However, their share declined during Jul-Mar FY09 for the first time in seven years, probably due to severe liquidity crunch as well as rising NPLs, which restricted DPBs to maintain their rapid growth in agri-credit. Consequently, agri-credit disbursement by DPBs exhibited a fall of 4.7 percent in Jul-Mar FY09, as against a healthy rise of 86.3 percent in the same period last year (see **Figure 2.10**).

**Figure 2.10: Share in Agri-Credit Disbusment (Jul-Mar)**



**Figure 2.11: Agri -Credit Growth by 5-large CBs**



Similarly, agri-credit growth by five large CBs<sup>8</sup> decelerated to 14.2 percent during Jul-Mar FY09 from 32.9 percent in the corresponding period of FY08. Agri-credit

<sup>7</sup> In particular, MCB and Faysal Bank made aggressive lending.

<sup>8</sup> ABL, HBL, MCB, NBP, and UBL.

disbursement decelerated for all these banks, except for UBL which registered a 47.3 percent increase (see **Figure 2.11**).

The major drag was from a decline in the disbursement by NBP, which recorded a fall of 5.4 percent in agri-credit disbursement during Jul-Mar FY09 despite relatively better liquidity position and large branch network. This decline is probably due to delay in disbursement amid introduction of new policies. Encouragingly, credit extended by ZTBL witnessed a sharp increase in this period, which more than offset the impact of lower disbursement by PPCBL and helped improve share of specialized banks in agri-credit market.

### Sector-wise Disbursement

Farm sector credit disbursement increased by 4.5 percent to Rs 106.3 billion during Jul-Mar FY09. While, small and medium farmers availed higher agri-credit during Jul-Mar FY09, disbursement to large farmers dropped (see **Table 2.6**). This trend suggests that probably large farmers were more aware about falling input prices during FY09 and deferred purchases. Though, a substantial growth was seen in disbursement to corporate farmers, limited amount was disbursed to a few corporate clients. There is a need to encourage corporate farming in the country given its positive externalities.

**Table 2.6: Holding-wise Agri-Credit Disbursement (Jul-Mar)**  
billion Rupees

Category	FY08	FY09	Growth in FY09
<b>Farm</b>	<b>101.7</b>	<b>106.3</b>	<b>4.5</b>
<u><b>Economic classification</b></u>			
Subsistence	60.6	67.1	10.7
Economic	23.2	25.0	7.8
Above economic	17.8	14.2	-20.2
Corporate	0.2	2.0	900.0
<b>Non-farm</b>	<b>36.9</b>	<b>45.6</b>	<b>23.6</b>
Small	6.5	8.8	35.4
Large	30.4	36.7	20.7

Note: Growth rates may not tally due to separate rounding off.

**Table 2.7: Non-Farm Credit Disbursement (Jul-Mar)**

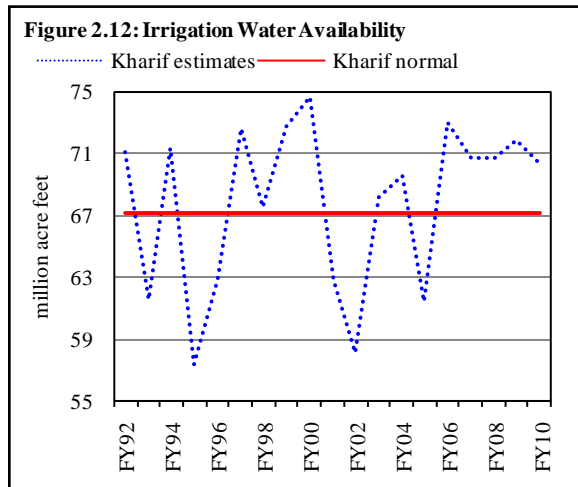
Purpose	FY08	FY09	Growth in FY09
<u><b>Number of borrowers</b></u>			
Livestock, dairy & meat	47,508	54,553	14.8
Poultry	1,156	1,436	24.2
<u><b>Credit disbursement (billion Rupees)</b></u>			
Livestock, dairy & meat	11.1	15.9	43.2
Poultry	23.4	28.3	20.9

**Table 2.8: Province-wise Agri-Credit Disbursement (Jul-Mar)**  
billion Rupees

Province	FY07	FY08	FY09	Growth in FY09
Punjab	92.8	116.7	127.0	8.8
Sindh	11.7	15.0	18.2	21.3
NWFP	6.1	6.1	5.8	-4.9
Balochistan	0.3	0.3	0.3	0.0
Azad Kashmir	0.2	0.3	0.4	33.3
Northern Areas	0.1	0.2	0.2	0.0
<b>All Pakistan</b>	<b>111.2</b>	<b>138.6</b>	<b>151.9</b>	<b>9.6</b>

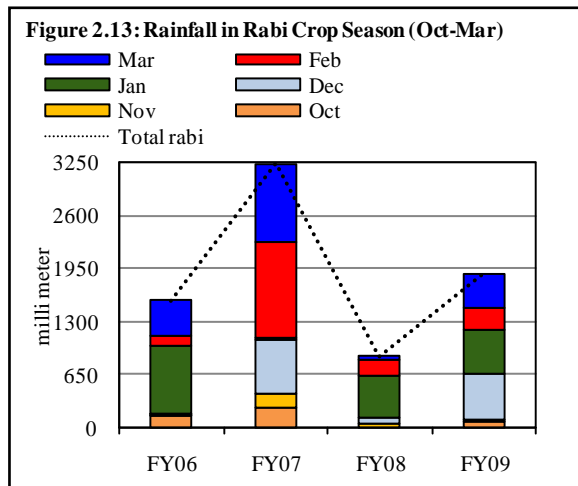
Note: Growth rates may not tally due to separate rounding off

Similarly, growth in disbursement to small borrowers is stronger in the non-farm sector (see **Table 2.7**). Further break-up reveals that major impetus to this strong growth came from credit to livestock, dairy & meat sub-sectors with a substantial increase in number of borrowers during Jul-Mar FY09. Investment in livestock sub-sector is a welcome development as it would not only help improve supply of dairy products, it would also help lower poverty amongst landless farmers.



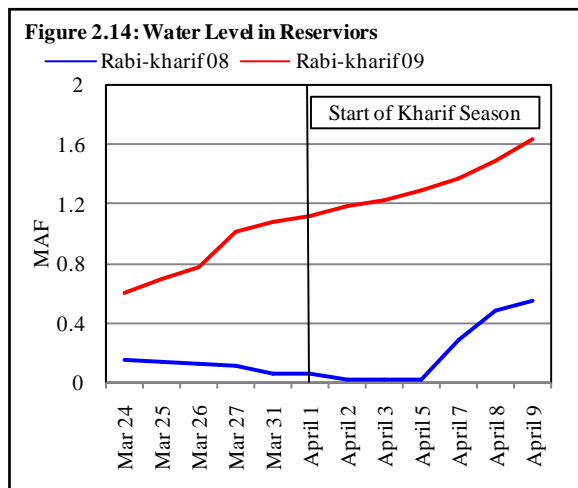
#### Province wise Disbursement

The slowdown in agri-credit disbursement is seen in all provinces (see **Table 2.8**). The impact of deceleration in agri-credit is, however, more pronounced in NWFP and Punjab. As a result, their respective shares in agri-credit disbursement dropped during Jul-Mar FY09 compared with the same period last year. It is important to note that there is a huge potential of expansion in agri-credit market in small provinces. Provincial governments have to address the problem of non-availability of passbooks, a basic document for collateral. Inability to access institutional credit leads farmers to seek assistance from informal sector. Informal credit is not only expensive, most of the time stringent conditions (e.g., to sell produce to money lender at specific price) are also attached with it. Therefore, it appears that access to institutional credit could increase returns to farmers and help increase productivity.



### Agri-credit Recovery

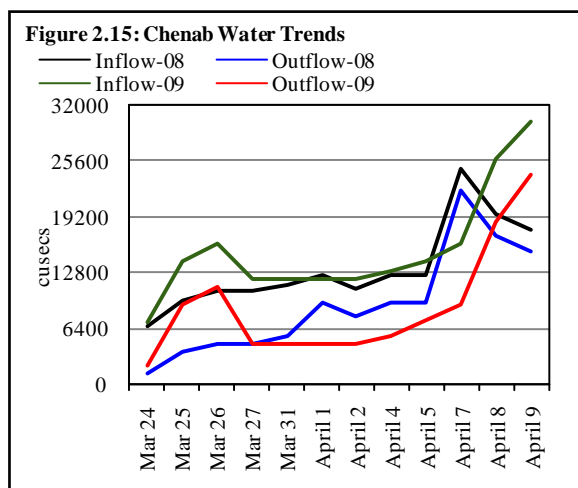
A significant improvement was witnessed in recovery ratios (recovery as percent of disbursement) during July-Mar FY09 compared with the corresponding period of FY08. This is primarily attributed to the increased focus of the banks on recoveries. Under a portfolio clean-up drive, banks recruited additional staff to accelerate recovery process. In particular, lending operations of ZTBL are entirely based on recoveries due to absence of fresh credit lines. In addition, improved cash flow of farmers amid strong growth in crops also helped increase recovery ratio during FY09.



### Irrigation Water Availability

Initially, the canal head water shortages were projected at up to 39.0 percent for *rabi* FY09 season. Actual shortfall during *rabi* FY09 season was lower at 33.8 percent, with a decline of 13.7 percent from the corresponding season of FY08. Area under wheat cultivation was low during initial wheat sowing period due to water shortages; however, timely arrival of westerly rain bearing systems encouraged farmers and aggregate area under wheat cultivation thereafter increased by 6.0 percent (see **Figure 2.12**).

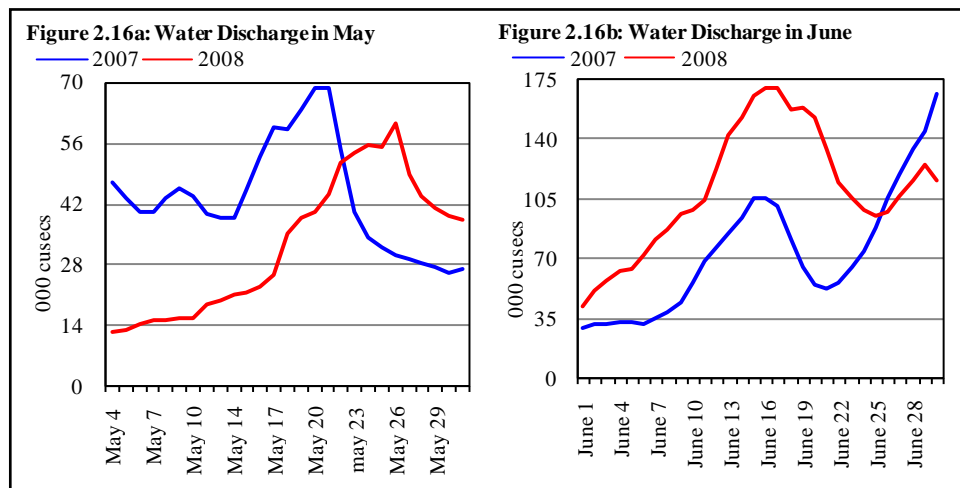
In contrast to preceding year, with extended winter rains (see **Figure 2.13**) and heavy snowfall in the northern areas, water availability for the upcoming sowing of cotton and rice is expected to be good. In particular, during *rabi* (Oct-Mar) FY09 season rainfall significantly increased by 116.0 percent over the same



period last year. Consequently, reservoir situation in the current *kharif* season (see **Figure 2.14**) reflects a carry forward of 1.12 million acre feet (MAF) of water from the concluding *rabi* FY09 season as against less than one MAF collective reservoir water availability in the corresponding period in FY08.

A similar situation is reported in Chenab where the inflows have improved (see **Figure 2.15**) thus putting less pressure on Mangla reservoir for supplementing Chenab and Ravi river operations. Accordingly, IRSA forecasts of average 70 MAF for the current *kharif* is close to last year's estimate of 70-71 MAF, which makes short-term scenario positive for the key cotton and rice crops. However, realization of this expectation will largely be depending on weather conditions during May and June; especially in the glacial belt zones. In case the temperatures remain steady; the water inflows from the melt would be consistent; otherwise in case of premature monsoon and early cloud cover in the two months melting can be slow (see **Figure 2.16a**). Relevant data shows that in case of early monsoon cloud cover in June 2007 (*kharif* FY08), the glacial water resources fell with temperatures (see **Figure 2.16b**).

It is also important to mention here that agriculture sector will benefit from increased capacity of Mangla dam by one MAF during FY10. The additional





capacity appears more important, given forecast of low monsoon rains.<sup>9</sup> A

moderate-high monsoon is crucial for agri-sector, which not only adds up in running canals, also helps to fill up the reservoirs for future use. In addition, it also leaves sufficient moisture for raising fodder (livestock feed) as well as improving underground water resources. The country may face acute water shortages in future given rising demand for irrigation water, construction of new dams by India and climate changes. Thus, it is inevitable to build new reservoirs urgently in the country. Further, effective resources management (land leveling, drip irrigation, reduce water losses between canal head to farm gate etc.) is needed for efficient use of water.

**Table 2.9: Area and Production of Major Crops**

	FY08 <sup>P</sup>	FY09 <sup>E</sup>	FY10 <sup>T</sup>
<b>Area Under Cultivation</b> (000 hectares)			
Cotton	3,055	2,850	3,200
Sugarcane	1,241	1,029	1,105
Rice	2,516	2,962	2,678
Maize	1,037	1,078	1,062
<b>Production</b> (000 tons cotton in 000 bales of 170.09 kg each)			
Cotton	11,655	12,060	13,360
Sugarcane	63,920	50,045	56,527
Rice	5,561	6,954	5,949
Maize	3,109	3,579	3,414

P: provisional; E: Estimate T: Target

Source: MINFA

### Outlook for *Kharif* (April-September) FY10

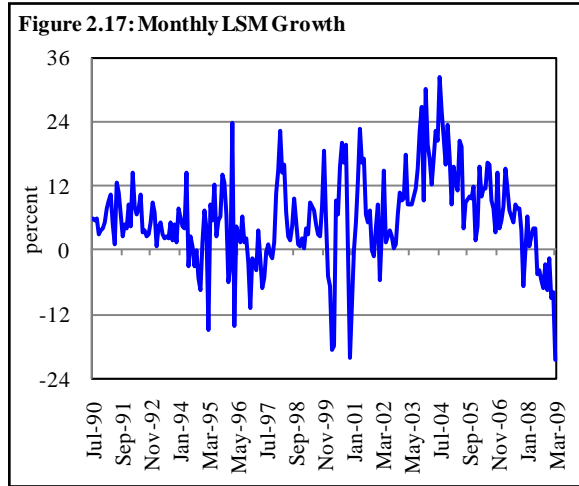
The overall prospects for *kharif* FY10 are positive, as prevailing higher prices of sugarcane will encourage farmers to increase area under sugarcane, which is likely to have a strong recovery in production during FY10. FY10 targets by MINFA also reflect this optimism regarding sugarcane crop. Similarly, cotton production is likely to benefit from (1) better prevailing prices, (2) supportive weather so far, as well as, (3) increasing use of Bt cotton variety, which may also help boost cotton yield, contrary to MINFA forecast of a decline in yield (see **Table 2.9**).

Similarly, a better than MINFA projected maize harvest is expected in FY10 by on the back of substantial gains in yields in recent years as well as farmers' enthusiasm due to better prices. In contrast, it will be difficult to maintain rice harvest at FY09 level, principally due to farmers' disappointment after a sharp unanticipated fall in rice prices at the time of harvest. This would lead farmers to substitute land from rice to sugarcane.

<sup>9</sup> A recent climate modeling study found that monsoon - critical to agriculture in Bangladesh, India, Nepal and Pakistan - could be weakened and delayed due to rising temperatures in the future, climate change could influence monsoon dynamics and cause less summer precipitation, a delay in the start of monsoon season and longer breaks between the rainy periods-Study by Purdue University research group, Indiana, USA. (<http://www.sciencedaily.com/releases/2009/02/090227112307.htm>).

## 2.2 Large Scale Manufacturing

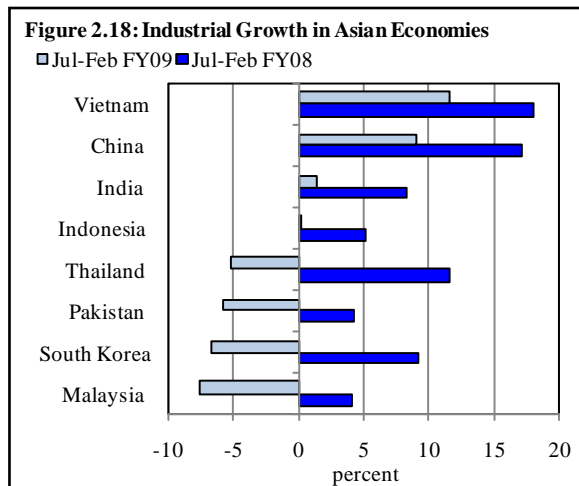
Large Scale Manufacturing (LSM) registered negative growth for the tenth consecutive month in March 2009, the longest period in which production continued to shrink.<sup>10</sup> Moreover, 20.7 percent YoY decline in the month of March 2009 (see **Figure 2.17**) is the highest ever fall in LSM production. Resultantly, LSM growth dropped to 7.7 percent during Jul-Mar FY09 compared with a 5.0 percent rise in the corresponding period of FY08.



The persistent disappointing performance is a reflection of various adverse domestic and external developments. While, industrial growth slowed in most of the other regional economies primarily due to global recession, domestic factors had dominant impact on Pakistan's manufacturing sector growth in FY09.

In particular, weakness in domestic demand, worsening power shortages, structural problems (see **Box 2.3 & 2.4**) and deterioration in law & order situation are some important factors responsible for the decline in LSM production. Similarly, decline in external demand and lower fund flows towards emerging economies amidst global recession probably contributed to slowdown in domestic manufacturing activities.

Despite all these problems, it is noteworthy that almost all of the



<sup>10</sup> Since Jul-1990, LSM production showed a declining trend for the five consecutive months only during Oct-Feb FY97.

negative growth is attributable to industries catering to domestic consumer demand (see **Figure 2.18**). Excluding consumer durables and sugar, LSM production during Jul-Mar FY09 remained flat relative to the previous year (see **Table 2.10**). In particular, automobiles

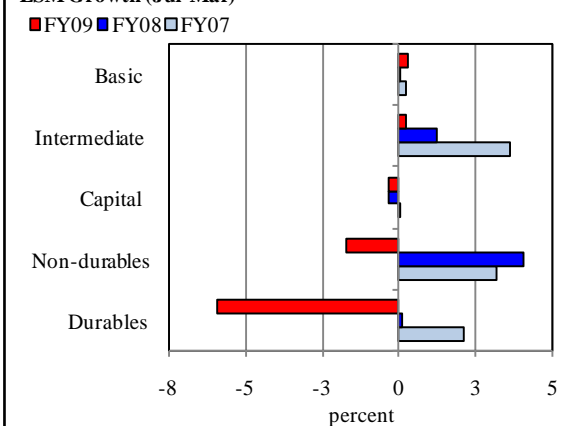
industry witnessed sharp slide mainly due to high cost of consumer financing continued upward prices of cars, tight liquidity position of the banks as well as risk averse behavior after facing substantial NPLs in consumer finance. Further, slow income growth and high inflation impaired consumers' ability to spare funds for purchasing durables. While higher cost of consumer financing was an important reason for softer demand for household electronics, weaker demand for transformers and electric meters by the power distribution companies resulted in a poor performance by this industry.

**Table 2.10: LSM Growth with Selected Exclusions**

percent		
	Weight in LSM	Growth
LSM		-7.7
Excl. consumer durables	6.1	-1.80
Excl. consumer durables & sugar	11.6	0.16
Excl. durable, sugar & ghee	17.3	0.70

On policy front, realizing the need to contain inflation (as it effects aggregate demand and consequently production (see **Figure 2.19**), SBP raised its policy discount rate four times during CY2008. The tight monetary policy was necessary to offset the inflationary pressures of expansionary fiscal policy and monetization of fiscal deficit during this period. Unfortunately, this policy scenario coincided with the on-going global recession and has hurt the domestic industry. In this backdrop and an expected ease in inflation from Q4-FY09 onwards, the central bank lowered its policy rate by 100 bps in April 2009. However even if monetary policy eases substantially, it should be kept in mind that commercial banks willingness to extend aggressive lending for consumer financing in the face of substantial NPLs, will be a major determinant of growth in the consumer durable industries.

**Figure 2.19: Contribution of Different Commodity Groups in LSM Growth (Jul-Mar)**

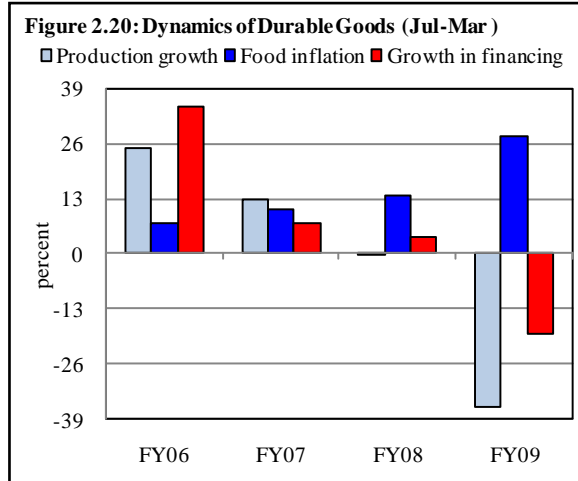


### Consumer Durable Industry

Consumer durables industry witnessed decline in production during Jul-Mar FY09.

Domestic consumer industry largely produces for the local market and is relatively less competitive than the regional competitors. Therefore, in a shallow market with elastic demand, the industry is sensitive to a number of factors such as income growth, availability of institutional financing, inflation and trade restrictions etc. (see **Figure 2.20**).

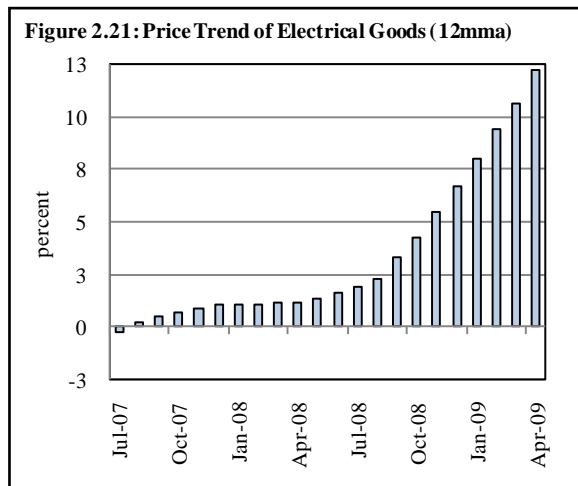
The impact of these was further compounded by a substantial rise in the domestic prices of consumer durables. The increase in the prices was partly justified due to increase in input cost during FY08, depreciation of rupee in most of 2008 and upward wage pressures. A similar downward adjustment in the prices of these items in tandem with the plunge in international prices of input (which is not visible so far) may support demand for these items going forward.



### Electronics

Electronics sector is not only going through weak demand created by financing gap and increased prices of products (see **Figure 2.21**), but also due to frequent power outages. People are forced to spend on alternate power supply equipment (UPS and generators) to streamline electricity supply, which do not support a number of household electronic appliances.

Moreover, anecdotal evidence suggests that this industry also faces stiff competition from continued influx of cheaper and better quality products from abroad both through legal and illegal means.



### Automobile Industry

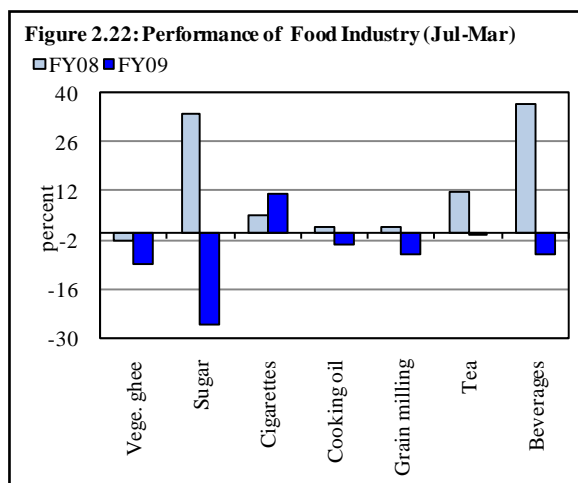
Similarly automobiles industry is facing significant contraction in demand (except for tractors where domestic production is low). In particular, jeeps & cars sub-sector is the worst hit by the sluggish demand due to (1) continued increase in prices, (2) rise in cost of financing, as well as (3) lower availability of institutional financing given risk averse policy of banking sector amid increasing NPLs and liquidity problems with the banks. On the other hand, motorcycle industry suffered from increased prices of petrol (in early months of FY09) and less than expected prices of major crops dampened the demand for two wheelers in rural areas. Demand for motorcycles is likely to recover following a bumper wheat harvest and substantially higher prices of the crop. Whereas overall contraction of economy and slack government buying led to decline in the demand for LCVs, busses and trucks during Jul-Mar FY09.

### Consumer Non-durable Industry

Non-durable consumer goods producing industry is also going through a difficult phase as production in food sub-sector declined by 10.5 percent during Jul-Mar FY09 as against a healthy growth of 11.5 percent last year.

#### Food industry

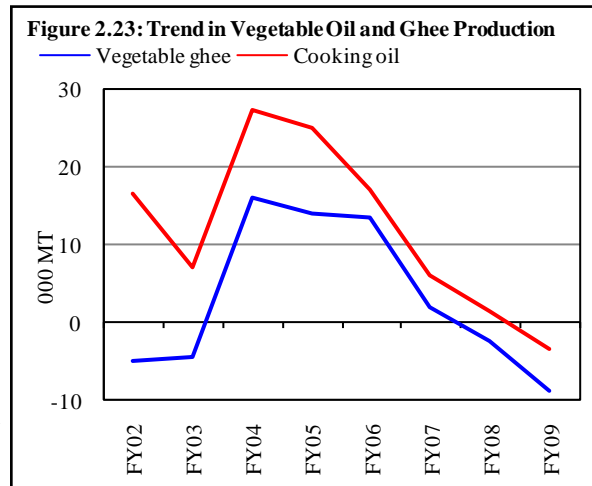
The decline in production of food industry is attributed to domestic market structure issues, uncertain prices of key inputs as well as shortages of inputs due to crop failure during FY09. While the former reasons impacted growth in ghee & cooking oil industry, the latter was responsible for a drag in sugar production (see **Figure 2.22**).



Production in cooking oil & ghee manufacturing – together having the largest weight in food – declined by 8.2 percent and 3.5 percent respectively during Jul-Mar FY09 (see **Figure 2.23**). On face value, decline in ghee & cooking oil production appears to be surprising as input cost has dropped significantly during FY09. The anomaly is probably due to the fact that while informal cooking oil and ghee manufacturers substantially declined prices of their products in response to reduced input cost, price adjustment in the formal sector is rather slow. As a result, it becomes difficult for

the formal manufacturers that figure in LSM statistics to compete, at least in the domestic market, without compromising on profit margins.

Similarly, sugar production declined by 26.3 percent in July-Mar FY09 compared with 34 percent rise in the same period of FY08, mainly due to a 20.3 percent fall in sugarcane harvest in the current season. It is important to note that the boom-bust cycle in sugarcane harvest was due to a continued dispute between growers and sugar mills; thus impacting the domestic sugar industry. In the current season, there was huge demand for sugarcane and



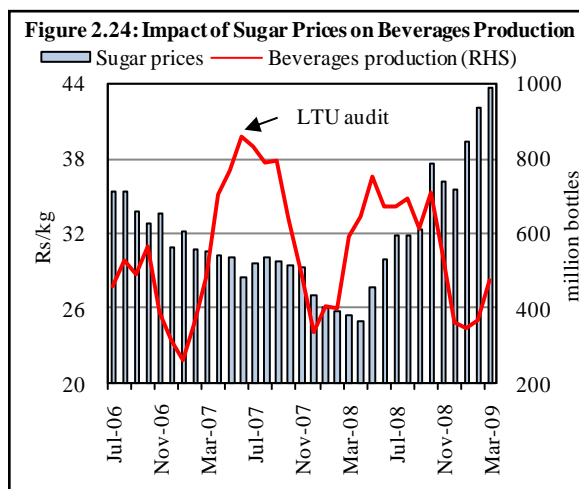
there were no significant problems reported by farmers for prices and payments. In response to higher prevailing prices, initial reports suggest that area under sugarcane is likely to increase for the FY10 cropping season. In case of a substantial rise in the size of sugarcane crop, delay in crushing season, lower sugarcane prices and delayed payments to farmers by the mills will again set a pace for the shortfall in FY11 crop.

In the short-term, this problem may be resolved by effective regulations and their implementation. For example, the Punjab government raised sugarcane purchase price floor to Rs.100 per 40kg, a 25 percent increase over the last crushing season to protect sugarcane growers and to encourage next season's crop. However, there is a need to ensure that farmers will get this price in time, which would keep them motivated for the next seasons as well.

However, an efficient and long-term solution can be provided only by the market. Establishment of effective futures market with appropriate infrastructure (contract enforcement, crop insurance, etc.) may help to maximize returns to farmers, sugar mills and consumers. In FY09 sugarcane shortages badly hit sugar mills and production temporarily came to a halt in many factories. The resulting supply shortages of sugar translated into higher prices, which are adversely impacting consumers.

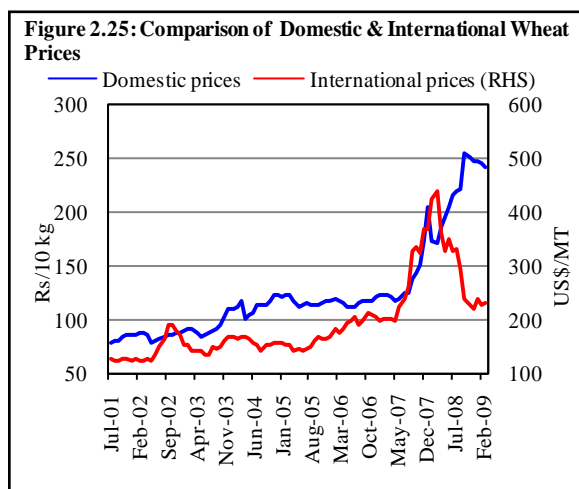
Importantly, higher sugar prices are also hitting consumers and other industries as well. Beverage production dropped by 3.7 percent in July-Mar FY09 as the prices of sugar, one of the key inputs in beverages, sharply rose in recent months (see **Figure 2.24**).

Consequently, prices of beverages were revised upward and demand declined. The impact of this was also augmented as a major bottle manufacturing plant, remained closed for BMR during mid-FY09.



At glance, despite a substantial improvement in domestic supply of wheat (domestic harvest and continued import), decline in wheat & grain milling activity during July-Mar FY09 also seems puzzling. In fact, part of this movement can be attributed to surge in smuggling of wheat to Afghanistan in the last few years as international wheat prices were either in line with or higher than the domestic prices (see **Figure 2.25**).

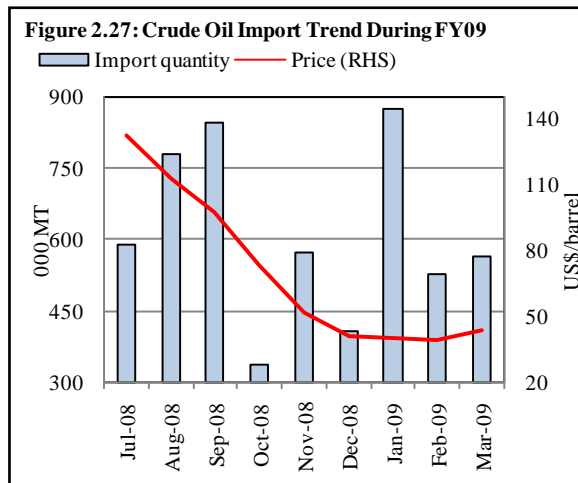
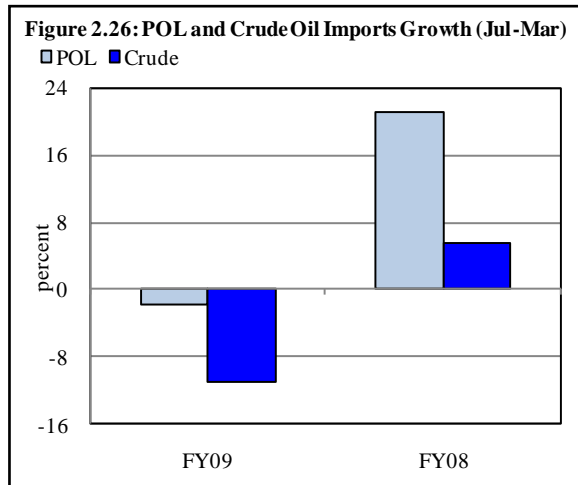
However, international wheat prices have been declining since July 2008, while domestic prices remained high. This price differential served as a disincentive for smuggling, and consequently, output declined in this sector. In addition, frequent load-shedding also affected milling activity to some extent.



### Petroleum Industry

POL with production decline of 9.2 percent during the Jul-Mar FY09 was the third largest contributor to lackluster performance of LSM. According to OCAC data,

POL production decline may primarily be attributed to weak demand due to sluggish economic activities. This is also visible from lower quantum of imports for POL during Jul-Mar FY09 (see **Figure 2.26**) in comparison to last year. However, it is important to mention here that a number of developments also adversely affected the POL production including (1) a reduction in deemed duty from 10 percent to 7.5 percent in July 2008 led to lower margins and sales revenues,<sup>11</sup> (2) import of crude oil postponed due to declining international prices, particularly in Q2-FY09 (see **Figure 2.27**), (3) below capacity operation of IPPs due to circular debt problem resulted in lower demand for furnace oil, as well as, (4) liquidity crunch and circular debt issue led to create obstacles in confirmation of LCs for the import of crude oil during FY09. After the partial resolution of circular debt issue and resumption of production by Attock Refinery, POL production is expected to improve going forward. Moreover, recently announced Petroleum Policy (see **Box 2.1**) offers incentives that would probably attract more investment and help sustained growth in this sector.



<sup>11</sup> Government is considering various proposals including increase in deemed duty.



### Box 2.1: Petroleum Exploration and Production Policy 2009

The government of Pakistan has announced a comprehensive policy to promote exploration and production (E&P) in the petroleum sector. The policy adopts an integrated approach towards exploitation of domestic petroleum reservoirs while ensuring environmental sustainability.

Pakistan's current crude oil production meets only 18 percent of its demand, while the remaining requirement is met through imports, adding to the trade deficit and, in turn, has adverse consequences for forex reserves and exchange rate. Under this consideration, the government introduced the first national petroleum policy in 1991. This was followed by subsequent policies in 1993, 1994, 1997, 2001, and 2007. Petroleum policies need frequent revisions as technology, legal practices, tax laws, price-setting and environmental standards continue to evolve around the globe. The 2009 policy redefines the previous policies to accommodate new market conditions, particularly the steep rise in international energy prices.

The 2009 policy provides procedural and price incentives for exploitation of natural petroleum resources. It envisions the development of local firms and human resource augmented with increased foreign investment. The policy proposes competitive terms-of-investment for foreign firms and incentives to encourage participation of local oil and gas companies.

For both, on-shore and off-shore operations, royalty will be payable to the federal government. However, royalty will be waived for the first two years of off-shore production. Companies incorporated in Pakistan can have 100 percent ownership of on-shore exploration sites. For off-shore sites, the government will enter into a sliding-scale production sharing agreement. Corporate income tax will be payable according to the Income Tax Ordinance 2001.

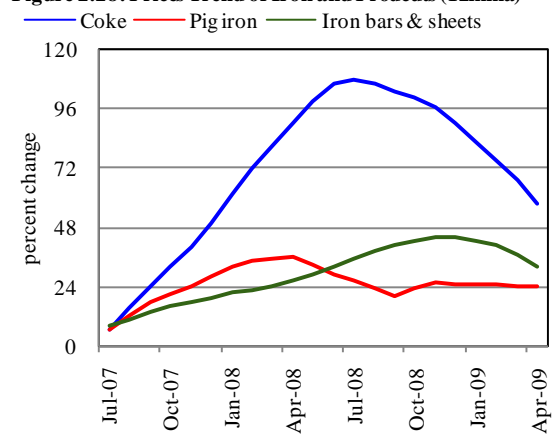
To secure domestic supply, E&P firms will be subject to 'domestic supply obligations', whereby the export volumes will be monitored. Moreover, a levy will be applicable on all export licenses. Once these requirements are met, foreign firms will be allowed to export their share of production and to retain sale proceeds abroad.

The program will provide employment opportunities and an extensive training program is proposed for capacity building of local professionals. The policy also focuses on sound regulations and proactive resource-management. Social-welfare funds will be pledged by all companies benefiting from the policy. To keep an eye on environment, operational, geological and geophysical information will be provided to the Directorate General of Petroleum Concessions on a regular basis.

### Metal Industry

As with POL, metals industry witnessed decrease in production in the beginning of FY09 due to surge in international metal price, which

Figure 2.28: Prices Trend of Iron and Prodcuts (12mma)



resulted in accumulation of inventories with Pakistan Steel. Therefore, a reduction in production was necessary to clear inventories. However, later, with the decline in international prices, a comeback in production was hindered by a sharp cut in both PSDP and private construction activities.

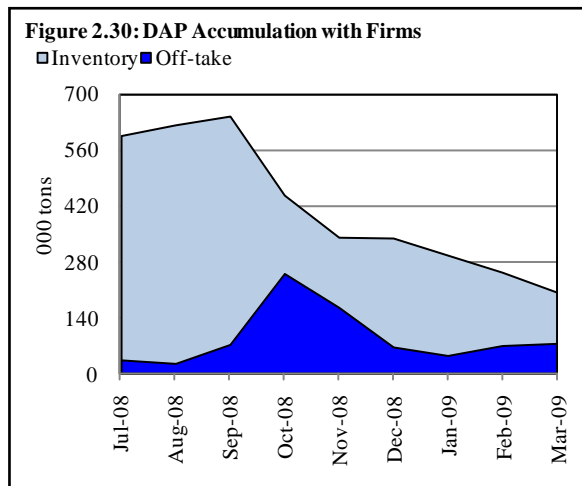
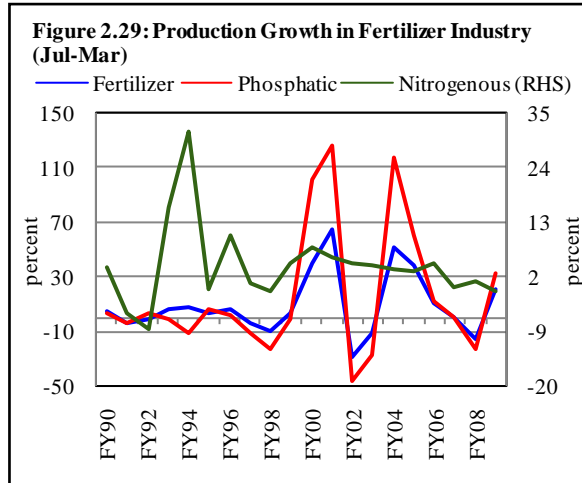
However, as domestic prices of iron and its products have eased in recent months (see **Figure 2.28**), demand is expected to strengthen.

### Fertilizer Industry

In contrast to a declining trend in overall manufacturing activity, fertilizer production posted a significant growth of 20.7 percent in Jul-Mar FY09 after a dismal performance during the preceding two years. This reversal in production conforms to the historical trend that since FY85 production declines in fertilizer have not generally been more than two years longer (see **Figure 2.29**).

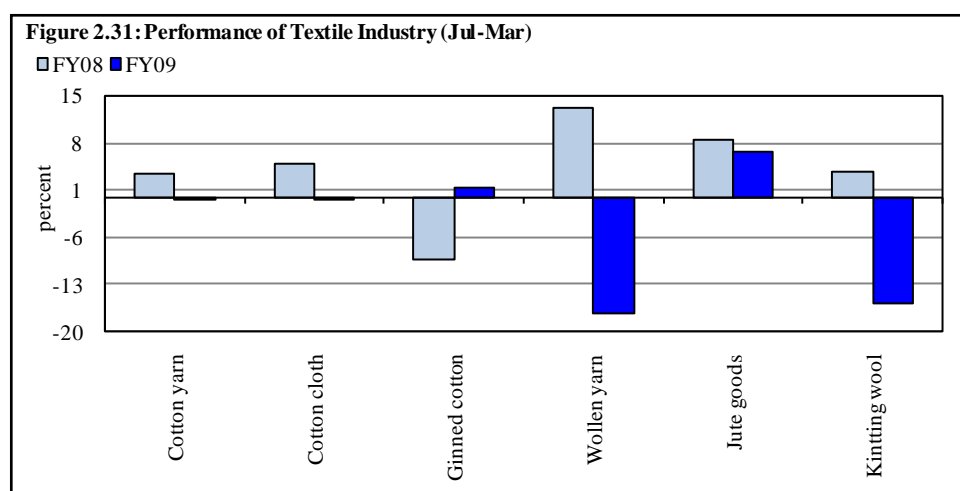
Production increase in FY09 is partially due to base effect as Pakistan's only phosphatic fertilizer plant remained close for BMR during last year. This year production was halted in January due to accumulation of high inventories of costly DAP

(see **Figure 2.30**). In addition, a slower pace of decline in international prices of phosphatic rock (major input for DAP) squeezed the margins of the firm. While, current production of both phosphatic and nitrogenous fertilizer are insufficient to meet local demand, with the completion of plants by Fatima Fertilizer and Engro, shortage of urea is expected to turn into a surplus during FY11. However, DAP shortage will continue due to lack of raw material in the country and large investment required to setup a new plant.



### Textile Industry

The impact of global recession on domestic LSM is most visible in the textile industry. Growth in textile industry fell by 0.1 percent in July-Mar FY09 over the same period last year. Textile sector was badly hit by power shortages and weak external demand. Both cotton yarn and cloth industries, which have the largest shares in the textile sector, posted negative growth of 0.27 percent and 0.33 percent respectively during Jul-Mar FY09 (see **Figure 2.31**).



However, on the back of relatively better FY09 cotton crop, ginning showed slight improvement of 3.4 percent in this period compared to a decline in the last three consecutive years. In contrast, among the smaller sub-sectors of textile industry, jute goods industry showed a reasonable 6.6 percent growth during July-Mar FY09, well supported by strong demand emanated from record rice and wheat harvests this year. It is also important to note that while a large number of textile units, particularly operating in small or informal sector, are facing problems, H1-FY09 results of some listed textile units are encouraging (see **Box 2.2**).

As global textile demand declined, quantum of yarn exports shrank by 7.8 percent in July-Mar FY09 over the same period last year, and the average export unit value of yarn fell by 8.7 percent. Similarly, export unit value of cotton fabric dropped by 1.0 percent in this period. The combined impacts of domestic and external factors has resulted in closure of about 20 percent spinning mills in the country.<sup>12</sup> Reports also suggest that the US - importer of over 30 percent of

<sup>12</sup> Pakistan Textile Journal, Feb. 2009.

Pakistani textile exports - is expected to cut back its cotton textile imports further in 2009 for the third consecutive year.<sup>13</sup>

#### Box 2.2: Profitability of Textiles in First Half FY09

Textile sector net profits posted a vigorous 23 percent growth in the first half of FY09 over the same period last fiscal year. Demand for textiles is apparently regaining ground as textile composite and weaving sector registered 26 percent increase in net sales while spinning sector sales were up by 13 percent.

Independent power supply arrangements by almost all large textile firms are resulting in efficient cost management during countrywide power supply shortages. Out of the country's five largest textile companies, Nishat Mills and Azgard Nine Limited earned 10 percent return on equity (ROE) in Oct-Dec 2008, while Gul Ahmed Textiles and Colony Mills, earned two and four percent ROE respectively. Only Kohinoor Mills' were doing badly in this period, with all their spinning, weaving, and composite units registering losses, despite having an independent power plant facility.

The earnings before interest and tax (EBIT) margin of the textile sector in H1-FY09 was 13.0 percent compared to 9.5 percent in H1-FY08, indicating higher earnings per unit of sale. On this scale, textile composite sector was the best performer with 15.6 percent EBIT margin while weaving and spinning reported a margin of around 7.8 percent.

These results seem more impressive given a 100 percent rise in financial costs during H1-FY09 over the same period last year. While textile composite and weaving sectors have managed to still come up with 61 and 43 percent increase in net profits, respectively, the spinning sector has taken a blow, with the losses of 31 spinning mills amounting to Rs 783 million against Rs 343 million profits earned last year.

It may be noted here that this data is only representative of large registered companies. While big companies have apparently found ways to get through the power crisis and are now dealing with their financial costs, the problems of small textile mills, which constitute a significant part of textile industry, are entirely different.

Production in small industries is still vulnerable to power outages and tariff hikes, and these units continue to bear losses on this account or are forced to closure. However, SBP provided support to spinning units for restructuring their loans and by reducing mark-up on export refinance scheme. Similarly, government is also taking steps to resolve problems of textile industry.

**Table 2.11: Textile Exports Value and Production Growth (Jul-Mar)**

	FY07	FY08	FY09
Exports value (million US Dollar)	8,017	7,784	7,194
Growth (percent)	6.9	-2.9	-7.6
Exports value (million Rupees)	499,840	477,399	485,995
Growth (percent)	4.7	-1.8	8.4
Growth in production (percent)	9.81	2.90	-0.11

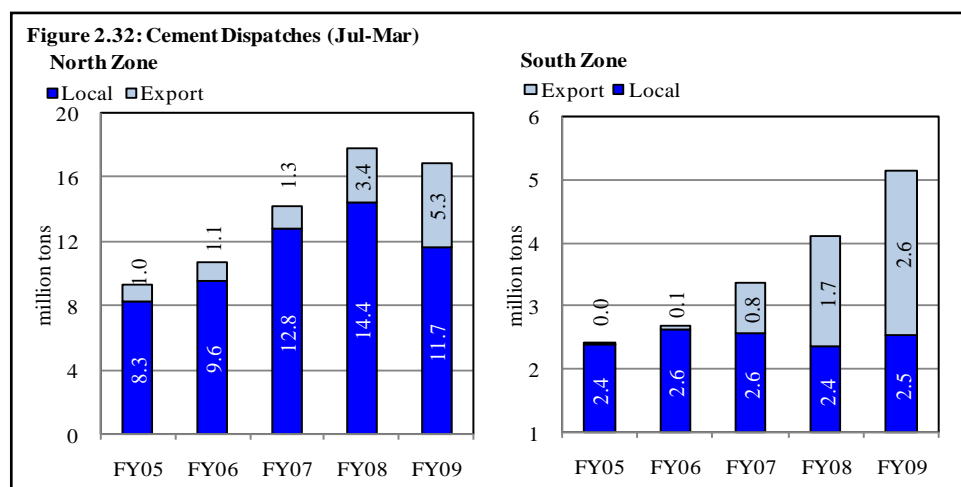
While, a sharp recovery in textiles will be challenging, a bullish trend in domestic cotton market during April 2009 indicates some improvement in textile output in the months ahead. One driving factor is probably lifting the anti-dumping duty by

<sup>13</sup> National Cotton Council of America: <http://www.cotton.org/econ/reports/outlook.cfm>

EU on bed linen imports from Pakistan that has been in effect since March 2004. This bodes well for textile production as Pakistani exporters will seek to re-capture the EU market. Adding to the profitability of textile industries is the depreciation of rupee against the greenback: textile exports earned 16.8 percent more revenue in Jul-Mar this year, over the same period last year, even though dollar earnings were low (see **Table 2.11**).

### Cement Industry

Growth in cement production though helped contain free fall of LSM growth, weakened in recent months. Cement production rose by 4.7 percent during Jul-Mar FY09,<sup>14</sup> the lowest growth in the last six years. A sustained double digit growth in cement production was achieved by addition in production capacity and exploitation of export markets.



It was the reason that the north zone, with higher capacities, started with greater volume of exports than the south zone. However, due to close proximity of ports, south zone is now producing almost equal amounts for local and export markets. North zone is mainly catering to the needs of domestic market with advantage of exports to Afghanistan and Central Asia as well (see **Figure 2.32**). Cement production are expected to improve further with increased production capacity and improvement in margins with decline in prices of coal. Prices of cement have already started to decline in domestic market which will likely bolster demand in

<sup>14</sup> Cement production declined by 6.5 percent YoY during March 2009.

the months ahead. In addition, complimentary effect of lower metal prices would also help increase domestic cement demand.

**Box 2.3: Relative Ease of Doing Business in Pakistan (2009)**

Measured specifically, pertaining to the regulations and red tape issues<sup>15</sup> in running businesses, relative ease of doing business ranking of Pakistan (among 181 countries ranked by World Bank) goes three places down to 77 in 2009 from 74<sup>16</sup> in 2008. Similarly, among Asian economies this ranking slipped down by three places to 20 from 17 as Central Asian states of Azerbaijan, Kyrgyz Republic and Kazakhstan outpaced Pakistan in reforming their business regulations. A detailed analysis of data reveals that this down grading is mainly due to improvement in business governing regulations of other economies as these regulations remained unchanged in case of Pakistan (see **Table 2.3.1**).

**Table 2.3.1: Ranking of Asian Competitors and their Reforms during 2008/09**

	Thailand	Malaysia	Pakistan	China	Vietnam	Sri Lanka	Bangladesh	India	Indonesia	Philippines
<b>Rankings</b>										
2008	13	20	77	83	92	102	110	122	129	140
2009	19	25	74	90	87	103	104	120	127	136
<b>Indicators</b>										
Starting a business		↑					↑		↓	
Dealing with construction permits										
Employing workers				↓						
Registering property	↑						↑			
Getting credit				↑	↑	↑			↑	
Protecting investors	↑									
Paying taxes	↑	↑		↑						
Trading across borders	↑							↑		↑
Enforcing contracts				↑						
Closing a business										
↑ reforms making it easier to do business; ↓ reforms making it more difficult to do business										

Performance on ten indicators used to reach at overall rankings (see **Table 2.3.2**) reveals that Pakistan's ranking improved on three of them (getting credit, paying taxes and trading across borders) due to improvement in at least one of the sub-indicators. The rankings remained same for two indicators (dealing with construction permits and enforcing contracts) irrespective of the fact that at least one of sub-indicators worsened or improved (implying that both movements were not relatively significant enough). On the contrary rankings on five indicators (starting a business,

<sup>15</sup> It does not, for example, measure security, macroeconomic stability, corruption, and the labor skills of the population, the underlying strength of institutions or the quality of infrastructure.

<sup>16</sup> After inclusion of three new economies in the sample as of 2008 ranking was 76.

**Table 2.3.2: Pakistan's Performance on Different Measures of Ease in Doing Business**

	2009	2008		2009	2008
<b>Starting a business (rank)</b>	<b>77</b>	<b>59</b>	<b>Protecting investors</b>	<b>24</b>	<b>19</b>
Procedures (number)	11	11	Extent of disclosure index (0-10)	6	6
Time (days)	24	24	Extent of director liability index (0-10)	6	6
Cost (% of income per capita)	12.6	14	Ease of shareholder suits index (0-10)	7	7
Minimum capital (% of income per capita)	0	0	Strength of investor protection index (0-10)	6.3	6.3
<b>Dealing with construction permits (rank)</b>	<b>93</b>	<b>93</b>	<b>Paying taxes</b>	<b>124</b>	<b>146</b>
Procedures (number)	12	12	Payment (number per year)	47	47
Time (days)	223	223	Time (hours per year)	560	560
Cost (% of income per capita)	734	869.5	total tax rate (% of profit)	28.9	40.7
<b>Employing workers (rank)</b>	<b>136</b>	<b>132</b>	<b>Trading across borders (rank)</b>	<b>71</b>	<b>94</b>
Difficulty of hiring index (0-100)	78	78	Documents to export (number)	9	9
Rigidity of hours index (0-100)	20	20	Time to export (days)	24	24
Difficulty of firing index (0-100)	30	30	Cost to export (US Dollar per container)	611	515
Rigidity of employment index (0-100)	43	43	Documents to import (number)	8	8
Firing cost weeks of salary	90	90	Time to import (days)	18	19
<b>Registering property (rank)</b>	<b>97</b>	<b>88</b>	Cost to import (US Dollar per container)	680	1336
Procedures (number)	6	6	<b>Enforcing contracts</b>	<b>154</b>	<b>154</b>
Time (days)	50	50	Procedures (number)	47	47
Cost (% of property value)	5.3	5.3	Time (days)	976	880
<b>Getting credit (rank)</b>	<b>59</b>	<b>68</b>	Cost (% of claim)	23.8	23.8
Strength of legal rights index (0-10)	6	4	<b>Closing a business</b>	<b>53</b>	<b>51</b>
Depth of credit information index (0-6)	4	4	Time (years)	2.8	2.8
Public registry coverage (% of adults)	4.9	4.6	Cost (% of estate)	4	4
Private bureau coverage (% of adults)	1.5	1.4	Recovery rate (cents on the Dollar)	39.2	39.1

employing workers, registering property, protecting investors and closing business) worsened that resulted in overall slide of ranking. The decline in ranking here is mainly due to improvement of other economies in these areas.

However, the slide in ranking by only three points should not be taken lightly because,

- (1) These rankings do not cover all aspects of business environment there are other indicators like political uncertainty, law & order situation and country perception which weigh much more and where we are lacking.
- (2) This slide highlights the fact that reforms are a continuous process and we have to keep an eye on our competitors to keep existing businesses viable and for attracting more investment.
- (3) Competition is increasing with the passage of time so we are required to spend on not only chalking out state of the art industrial and trade policies to improve business environment but also on R&D in technical expertise for increasing manufacturing value addition.

**Box 2.4: Lessons for Developing Economies from Industrial Development Report 2009<sup>17</sup>**

- Industrialization is essential for growth and development of a country as the direction of change runs from manufacturing growth to economy wide growth and not the other way round.
- UNIDO's research shows that difference in level of development among countries is principally determined by total factor productivity (efficient utilization of resources).
- Labor intensive industrialization in developing countries will help alleviate poverty and promote gender equality as labor intensive manufacturing is usually found to be gender neutral. Environmental issues do not necessarily mean slackening on industrialization it may actually make it inevitable.
- Alternatives to development other than manufacturing development like agriculture<sup>18</sup> and natural resource extraction have limited scope or even problematic in latter's case as it has the potential of undermining rest of the economic activity.
- New evidence confirms that diversifying and moving up the ladder of sophistication are important drivers of development because diversification creates more opportunities in international markets and it helps to create more productive firms through freer entry and exit in industry.
- A new concept of task based specialization among countries for manufacturing the same product is found effective as it does not contribute to greater specialization by poor countries in less sophisticated goods.
- Reliance on natural resource richness hinders overall productivity of economies due to problems like Dutch disease, construction boom which pushes up the price level and actual achievement like kilometers of road built decreases and full standardization of extractive production processes is not possible.
- Location of manufacturing activity matters as geographical concentration of one type of manufacturing activity creates positive externalities and it is important for developing economies as well but concentration of all industrial activity in some geographical location is questionable.

<sup>17</sup> Industrial Development Report is a publication of United Nations Industrial Development Organization (UNIDO).

<sup>18</sup> For a country like Pakistan agriculture sector cannot be looked over to achieve manufacturing growth as more than 60 percent of manufacturing value addition is based on agriculture sector.



- Fast growth requires more sophistication in exports with the condition that production and export structures move in the same direction.
- New entrants to export market are required to compete with OECD countries as well as China and fast growing middle income countries which enjoys economies of scale. But developing economies can benefit from concentration of industrial activity, trade in tasks and supportive policies from developed economies as well as China.
- Business climate though necessary for attracting investment is not sufficient for dynamic industrial growth. What matters a lot are infrastructure facilities, traded logistics for export, efficient public institutions and competence and competition of firms and special economic zones (SEZ) can help to cater the last of these.
- Infrastructure development needs change in public spending pattern towards infrastructure investment, improving the quality of investment and convincing development partners about the relevance of this all for growth and poverty reduction. On the other hand industrial cluster development should be facilitated through investing heavily in generating industry relevant knowledge and putting in place liberalized regulatory framework for entry and exit of firms.

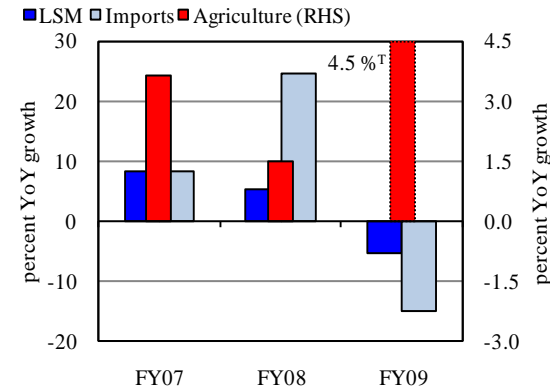
### 2.3 Services

Key indicators of the services sector presents a mixed performance of the sector, with a below target growth during FY09. However, growth outlook of the services sector remains better than the commodity producing sector. The indication of below target growth in services sector comes from the overall economic slowdown, which is suggested by a decline in LSM output, lower imports and shortfall in tax receipts during the year.

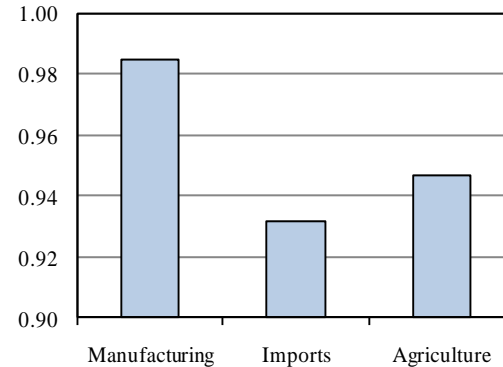
On the other hand, a notable (expected) growth in agriculture would also provide some support to trade and *transportation & communication* sub-sectors. In addition, *public administration & defense* is also likely to contribute reasonable growth in services sector during FY09.

*Wholesale & retail trade* sub-sector is the largest component of value addition in services sector.<sup>19</sup> Recent data illustrates a strong positive correlation of value addition among trading activities, domestic commodity production and imports (see **Figure 2.33a** and **2.33b**). Positive growth by major crops in FY09 indicates increased value addition in trading, while decline in other constituents i.e. LSM and imports may drag growth in trade. Positive outlook for gram harvest, relatively better wheat production as well as import and prospects of increased trading in sugar and rice in Q4-FY09 bode well for trading in FY09. However, slowdown in manufacturing, imminent as a consequence of decline in LSM in FY09, may significantly drag value addition in trading activities.

**Figure 2.33a: Trading Activities in FY09 are Mired by Decline in Both LSM and Imports (Jul-Mar)**



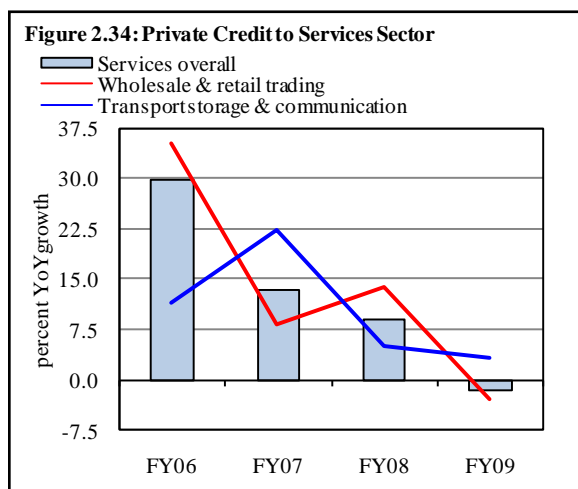
**Figure 2.33b: High Degree of Correlation Exists Among Growth in Trading activities and Manufacturing, Agriculture and Imports (FY00-08)**



<sup>19</sup> Wholesale and retail trade constituted 32.1 percent of total value addition in services in FY08.

Also relevant is the sharp decline in domestic demand in the form of declining imports (see **Table 2.12**). Slowdown in trading can also be gauged by a decline in credit, as well as fall in FDI in trading (see **Figure 2.34**). As a consequence, FY09 growth in trading activities is anticipated to be lackluster and achieving annual growth target of 5.4 percent seems difficult.

*Finance & insurance* sub-sector also presents a mixed performance. In fact, commercial banks constitute about 90 percent of total assets of the financial sector; weaker growth in banks impacts the overall growth of *finance & insurance* sub-sector. The profits of commercial banks dropped substantially during the first three quarters of FY09. In contrast, SBP profits witnessed a substantial increase during this period.



Other financial institutions; including, mutual funds, modarba companies and foreign exchange companies - whose earnings contain higher risk premia and are prone to fluctuation in rupee parity - were negatively impacted by capital market instability in H1-FY09 as well as high NSS returns. Financial statements of banks and DFIs, particularly those of modarbas, mutual funds and insurance companies indicated decline in gross earnings due to losses in capital market investment. Relative stability in capital market and decline in NSS rates in Q3-FY09 are expected to positively impact value addition from these financial intermediaries in H2-FY09.

Impetus to growth in transportation in FY09 stems from the decline in global petroleum prices, the impact of decreased input cost is expected to be shared amongst air, land and water transportation in FY09. In air transportation, annual financial statements of the national flag carrier i.e. PIA<sup>20</sup> for CY08 indicate that although the corporation posted loss for the CY08 owing to unprecedented hike in oil prices, total revenue of PIA increased (see **Table 2.11**). A relative stability in

<sup>20</sup> Pakistan International Airlines (PIA) accounts for almost 50 percent of domestic passenger traffic (source: PIA Annual Report 2008).

rupee value<sup>21</sup> as well as reduction in fuel cost going forward are factors that may improve value addition in Air transportation in particular and transportation in general. Growth in private credit off take and overall easing of petroleum prices, resultantly road transportation, like air transportation, is expected to grow reasonably well in FY09.<sup>22</sup> Prospect of improvement in value addition from road transportation is expected to benefit overall value addition in transportation in FY09; as road transportation constitutes about 75 percent of VA in transportation.

**Table 2.11: Selected Performance Indicators of PIA**  
percent growth (YoY) or mentioned otherwise

	CY08			
	Q1	Q2	Q3	Q4
Operating revenue	0.8	14.7	33.0	56.3
Operating cost	5.6	18.2	45.5	167.9
Fuel cost (million Rs)	8,649	10,976	13,991	12,239
Fuel cost as percent of operating cost	43.7	48.8	51.4	44.9
Profit/Loss (billion Rs)	-5.5	-12.6	-20.4	2.6
Fuel price (Rs/US gallon)	174.5	241.2	274.0	216.0
Growth jet fuel price	52.7	92.9	103.7	34.3

Source: PIA Annual and Quarterly reports

Composition of VA in communication is centered on cellular, land lines, wireless local loop (WLL) services and broadband internet. Communication sub-sector shows signs of consolidation during FY09. For instance, WLL subscriber base grew by only 7.6 percent in Jul-Mar FY09 as against 27.3 percent in the comparable period last year. Beyond FY09, decline in FDI and slowdown in telecom imports may impede expansion going forward. Positive growth outlook in storage is supported by a bumper wheat, rice and gram harvests during FY09. In addition, inventory and stock buildup of fertilizer, iron and steel, rice and sugar<sup>23</sup> in FY09 so far, is also expected to contribute towards increase in value addition in storage this year. *Transport storage & communications* sector thus depicts positive overall outlook for FY09.

Public expenditure on administration and defense has exhibited sharp increase in FY09 on account of military campaign in the northern areas. In addition, expenditure on public safety nets and economic affairs increase by 17.5 and 46.2 percent respectively in H1-FY09. *Public administration & defense* sub-sector is, therefore, expected to outperform target annual growth of 4 percent in FY09.

Services sector performance though mired by drop in domestic commodity production and imminent decrease in demand is still expected to remain

<sup>21</sup> Rupee instability and exposure to foreign exchange risk constituted 67.5 percent of total loss of PIA in CY08.

<sup>22</sup> Domestic petroleum prices were eased in Nov-2008.

<sup>23</sup> Total stock of sugar stood at 2,547,566 tons as on 31-03-2009, Pakistan Sugar Mills Association.

reasonable in FY09. Factors supporting growth in *transport storage & communication*, *financial* sector and *public administration* point towards resilience of services sector in FY09.

**Table 2.12: Services Sector Performance Indicators**  
percent growth or mentioned otherwise

	FY06	FY07	FY08	Jul-Mar		
				FY07	FY08	FY09
<b>Wholesale &amp; retail trade</b>	<b>-2.4</b>	<b>5.4</b>	<b>6.4</b>			
Credit to wholesale and retail trade	31.8	9.0	20.1	8.3	13.7	-3.0
FDI in trade	126.4	46.0	1.3	56.9	15.1	-5.2
Imports	38.8	6.9	30.9	8.4	24.7	-6.5
Trade volume (imports & exports)	28.7	5.5	24.2	6.4	18.9	-4.2
<b>Transport storage &amp; communication</b>	<b>4.0</b>	<b>6.5</b>	<b>4.4</b>			
Credit to transportation storage and comm.	23.5	28.3	17.0	22.2	5.0	3.1
Petroleum crude imports	76.6	-4.9	44.8	-6.8	32.2	-7.9
Commercial vehicles production	13.5	7.9	2.0	-3.7 <sup>a</sup>	-1.3 <sup>a</sup>	5.7 <sup>a</sup>
Tele density (percentage of population)	26.3	44.1	59.7	-	56.7	60.3
Cellular density (percentage of population)	22.2	39.9	54.7	-	52.2	56.5
Telecomm imports	-	15.2	4.0	19.4	0.8	-52.2
Total cargo handling at KPT	11.9	-5.6	22.4	-9.4	21.9	0.1
Transport group imports	-	9.2	-6.4	15.4	-16.2	-40.0
FDI in transport storage & comm.	267.8	-0.5	-11.0	35.0	-29.3	-15.5
<b>Finance &amp; insurance</b>	<b>42.9</b>	<b>15.0</b>	<b>17.0</b>			
Home remittances	10.5	19.7	17.4	22.3	20.1	19.7
SBP profit	119.6	59.5	51.6	905.1 <sup>c</sup>	20.7 <sup>c</sup>	52.0 <sup>c</sup>
Profit of commercial banks	-	-	-	24.0 <sup>b</sup>	-1.8 <sup>b</sup>	-23.4 <sup>b</sup>
FDI in financial business	22.2	182.6	72.4	162.2	-2.1	-1.3
<b>Ownership of dwellings</b>	<b>3.5</b>	<b>3.5</b>	<b>3.5</b>			
Credit to construction	33.9	30.9	45.0	24.6	27.3	-8.6
Cement production	13.5	22.5	17.6	21.1	17.7	-8.7
Metal production	5.3	10.7	-12.7	12.0	-11.7	-33.1
<b>Public administration &amp; defense</b>	<b>10.1</b>	<b>9.1</b>	<b>10.9</b>			
Defense expenditure	14.3	3.3	14.1	-3.4 <sup>c</sup>	14.7 <sup>c</sup>	12.1 <sup>c</sup>
Public order and safety services	32.8	8.8	17.8	18.4 <sup>c</sup>	8.7 <sup>c</sup>	17.5 <sup>c</sup>
Economic affairs expenditure	-7.7	46.9	226.1	-24.5 <sup>c</sup>	173.3 <sup>c</sup>	46.2 <sup>c</sup>
<b>Community, social &amp; personal services</b>	<b>9.9</b>	<b>8.8</b>	<b>9.4</b>			
FDI in social and personal services	162.5	23.8	16.3	39.1	12.2	0.6
<b>Total FDI in services sector</b>	<b>181.5</b>	<b>27.4</b>	<b>13.5</b>	<b>59.5</b>	<b>-19.0</b>	<b>-7.5</b>

a: Including light commercial vehicles, buses, trucks and tractors. Growth rates computed by using relative weights in LSM.

b: data pertains to calendar year.

c: data pertains to H1 of fiscal year.

## 3 Prices

### 3.1 Global Inflation Scenario

The turmoil in international credit markets, that hit consumer demand around the world, resulted in low inflation in developing economies and created deflationary threats for developed countries. In the USA, YoY inflation turned negative in March 2009 – the first annual decline in consumer prices since 1955. The CPI inflation is falling in Japan and is close to zero in the Euro area. In the UK, though consumer price inflation was 2.9 percent in March 2009, prices measured by Retail Price Index (RPI) have declined (-0.4 percent) for the first time in nearly five decades (see **Table 3.1**). The state of deflation might turn precarious as consumers expect further fall in prices and defer purchases. This would cause further fall in profits, job losses, and weaker demand.

This situation has created challenges for central banks as deflation makes monetary policy less effective. In this scenario, central banks can inject money into the economy by purchasing long term assets to stimulate the economy.

**Table 3.1: Inflation and Policy Rates in Major Economies**

percent

	YoY inflation			Policy rates		
	Jul-08	Dec-08	Apr-09	Current	Previous	Changed on
United States*	5.6	0.1	-0.4	zero to 0.25	1.0	Dec 16 2008
United Kingdom *	4.4	3.0	2.9	0.5	1.0	Mar 05 2009
Euro Area	3.8	1.6	0.6	1.0	1.3	May 07 2009
Japan*	2.3	0.4	-0.3	0.1	0.3	Dec 20 2008
Australia@	5	3.7	2.5	3.0	3.3	Apr 08 2009
China*	6.3	1.2	-1.2	5.3	5.6	Dec 22 2008
India #	8.3	9.7	9.6	4.8	5.0	Apr 21 2009
Malaysia*	8.5	4.4	3.5	2.0	2.5	Feb 24 2009
Indonesia	11.9	11.1	7.3	7.5	7.8	Apr 03 2009
Sri Lanka	26.6	14.4	2.9	10.3	10.5	Feb 11 2009
Pakistan	24.3	23.3	17.2	14.0	15.0	Apr 21 2009

Sources: Bloomberg, IMF, World Bank, OECD, The Economist, and Central Banks' websites.

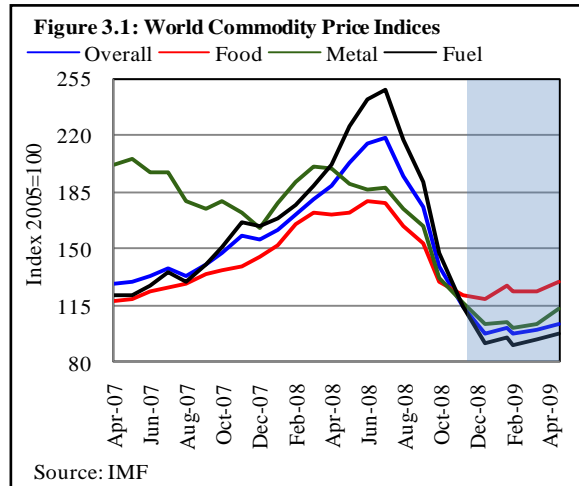
# Inflation data pertains to February 2009.

\* Inflation data pertains to March 2009.

@ Quarter 1, 2009.

Impact of weak global demand on the back of ongoing economic recession continued to affect commodity prices in the international markets. Commodity prices have declined from their peak levels in international markets (see **Figure 3.1** and **Table 3.2**). Though prices of all major commodities have slumped from all time highs, the impact of global economic slowdown is more pronounced in the case of oil.

On the one hand, food prices witnessed relatively lesser decline due to their less elastic demand, while on the other hand, prices of manufacturing goods, durables and construction were affected the most, alongwith a decline in fuel and metals prices.



Upto April 2009, the IMF food, fuel and metal price indices had declined sharply, by 26.7 percent, 61.1 percent and 40 percent respectively, since July 2008. The fall in commodity prices can be attributed to a number of factors, including a decline in global oil demand, particularly for power and steel production, on the back of sufficient available stocks in the world.<sup>1</sup>

**Table 3.2: Global Commodity Prices**

Items	Unit	Jul-08	Dec-08	Apr-09
Crude oil	US\$/barrel	132.5	41.5	50.3
Rice	US\$/MT	799.0	550.8	577.3
Wheat	US\$/MT	328.2	220.1	233.5
Sugar	US cents/pound	13.2	11.3	13.5
Palm oil	US\$/MT	1,026.2	440.4	693.2
Soybean oil	US\$/MT	1,372.3	681.0	787.3
Corn	US\$/MT	266.9	158.2	168.7
Copper	US\$/MT	8,407.0	3,105.1	4,436.9
Zinc	US\$/MT	1,856.4	1,112.9	1,388.1
Gold	US\$/Ounce	939.8	822.0	889.5
Lead	US\$/MT	1,960.0	968.2	1,393.9

Source: IMF and [www.gold.org](http://www.gold.org)

Among non-fuel commodities, prices of major grains eased as a result of improved supply conditions as farmers around the world increased area under cultivation as compared to the previous year in response to earlier high commodity prices. In addition, demand for food

<sup>1</sup> According to IMF's World Economic Outlook, April 2009, global oil demand fell by 0.4 million barrel per day in 2008.

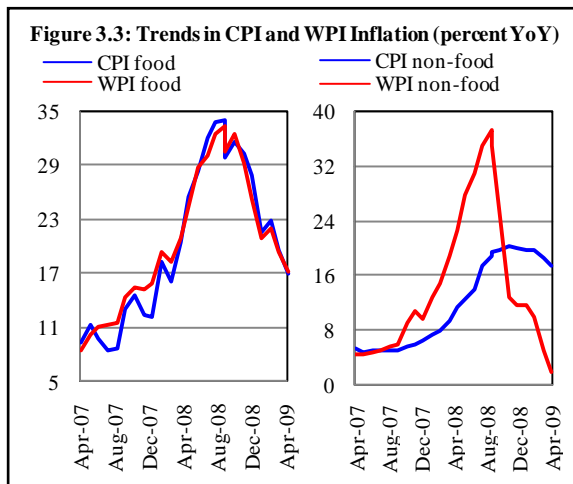
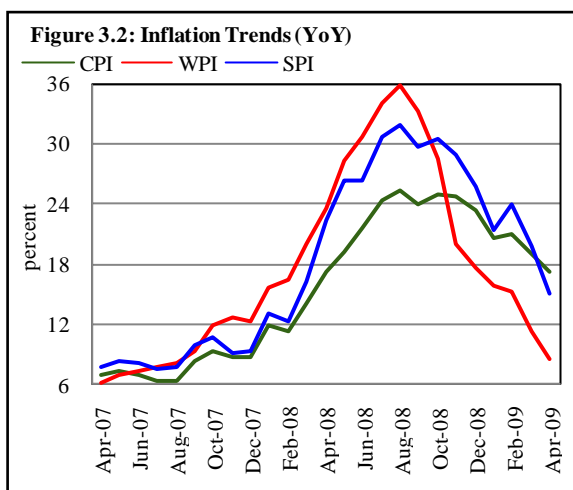
commodities also eased since their use becomes less attractive as a substitute of oil (bio-fuel) due to decline in oil prices amid global recession.

Going forward, in the wake of sluggish global economic recovery, commodity prices are expected to remain subdued in coming months. However there are risks to this assertion, in particular, food prices may experience upward pressure as any disruption in the supply of key staples may force countries to adopt protectionist food policies due to their experience of food crisis in past years.<sup>2</sup>

### 3.2 Domestic Scenario

The relative ease in inflationary pressures that began in Q2-FY09 has continued into Q3-FY09 with all price indices exhibiting a declining trend (see **Figure 3.2**).

While both food and non-food inflation show deceleration, the impact of the former was more pronounced in CPI. However, the impact of latter dominated in a sharp deceleration in WPI inflation (see **Figure 3.3**).<sup>3</sup> The sharper downtrend in WPI non-



<sup>2</sup> Recently, Vietnam – world's second largest rice exporter – announced a four-month ban on overseas rice sales. Egypt extended the ban on rice exports upto October 2009, (this ban was originally planned to be lifted by April 2009). Similarly, India has also announced a ban on export of non-basmati rice. In Argentina, speculation has mounted that the government could set up a Grains and Oilseeds Trading Board and grant it greater control over a key revenue-earning sector of the economy.

<sup>3</sup> For detailed analysis of reasons behind the difference in the trends of the two inflation indices see *Second Quarterly Report* for FY09 on the State of Pakistan's Economy.



**Table 3.3: Inflation Trends**

percent

	Year-on-Year <sup>1</sup>				12-month moving average <sup>2</sup>	
	Apr-08	Peak value	Peak month	Apr-09	Apr-08	Apr-09
<b>CPI</b>	17.2	25.3	Aug-08	17.2	9.8	22.0
Food	25.5	34.1	Aug-08	17.0	14.3	27.2
Non-food	11.2	20.2	Nov-08	17.3	6.5	18.1
<b>WPI</b>	23.5	35.7	Aug-08	8.3	12.6	22.7
Food	24.6	33.5	Aug-08	17.2	15.8	26.6
Non-food	22.7	37.4	Aug-08	1.8	10.4	19.7
<b>SPI</b>	22.3	31.8	Aug-08	15.0	11.2	25.6
<b>Core</b>						
NFNE <sup>3</sup>	10.8	18.9	Feb-09	17.7	7.2	17.0
Trimmed mean	14.1	21.7	Oct-08	17.6	8.9	19.4

<sup>1</sup>e.g. change in Apr 2009 over Apr 2008<sup>2</sup>e.g. change in 12-month average of Apr 2009 over Apr 2008<sup>3</sup>Non-food non-energy

Source: Federal Bureau of Statistics

food inflation probably indicates the immediate impact of lower import unit values of key manufacturing inputs including oil, metal, lubricants etc. Also as a leading indicator, this points toward a sharp fall in CPI non-food inflation in next few months.

Signs of easing inflationary pressures are also evident in the decline in persistent component of inflation, which is measured by core inflation. The Non-Food Non-Energy (NFNE), and 20 percent trimmed mean, core inflation measures have both shown signs of relative ease since March 2009 (see **Table 3.3**).

A major contributory factor to this was the tight monetary posture of the central bank throughout 2008. SBP raised its policy discount rate four times during 2008, for a cumulative increase of 500 basis points, taking the discount rate to 15 percent. Indeed the need to tighten monetary policy was accentuated by expansionary fiscal policy. The subsequent improvement in fiscal discipline, and plunge in international commodity prices paved the way for containing excess demand and inflationary expectations. Accordingly, SBP reduced its policy discount rate by 100 basis points to 14 percent on April 20, 2009.

In case of month-on-month (MoM) inflation, all inflation measures have also declined from their peak levels. The MoM inflation peaked out in July 2008

except for CPI food and core inflation, measured by trimmed mean. For example, CPI inflation (MoM) was recorded at 1.4 percent in April 2009 compared to 3.0 percent in April 2008 (see **Table 3.4**).

While, inflation is still high, SBP projection firmly indicates that the downtrend in inflation will gather pace in the next few months. The expectation, together with evident decline in domestic demand, led the SBP to initiate a loosening monetary policy.

**Table 3.4: Inflation Trends (MoM)<sup>1</sup>**

percent	Apr-08	Jul-08	Apr-09
<b>CPI</b>	3.0	3.3	1.4
Food	4.3	2.8	2.0
Non-food	2.0	3.8	0.9
<b>WPI</b>	4.3	4.4	1.7
Food	3.7	3.5	1.7
Non-food	4.8	5.0	1.7
<b>SPI</b>	5.4	4.6	1.2
<b>Core</b>			
NFNE <sup>2</sup>	1.8	2.3	1.1
Trimmed mean	2.0	1.8	1.2

<sup>1</sup>Change in Apr-09 over Mar-09

<sup>2</sup>Non-food non-energy

Source: Federal Bureau of Statistics

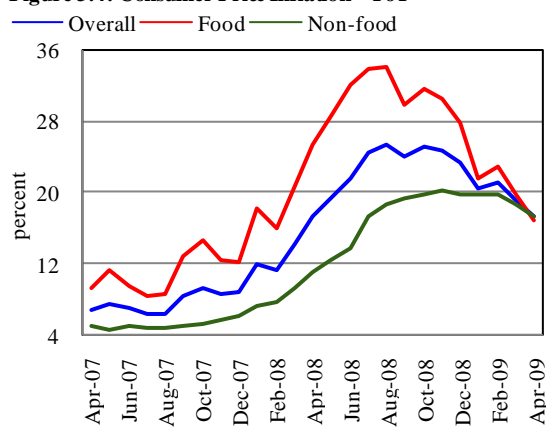
Inflationary pressures are likely to continue easing in Q4-FY09. While the annual inflation for FY09 is expected to be well above its annual target of 11 percent, given that inflation measured by 12 month moving average for April 2009 is still 22 percent.

### 3.3 Consumer Price Index (CPI)

After peaking in August 2008, headline inflation (YoY) declined to 17.2 percent in April 2009. The recent downtrend in CPI inflation (YoY) was mainly attributed to declining domestic food inflation, principally a reflection of fall in international prices, and smooth domestic supply of key staples.

The extent of the ease in CPI food inflation can be gauged from the fact that it has come down by 17.1 percentage points by April 2009 from its peak level in August 2008 (see **Figure 3.4**).

**Figure 3.4: Consumer Price Inflation - YoY**

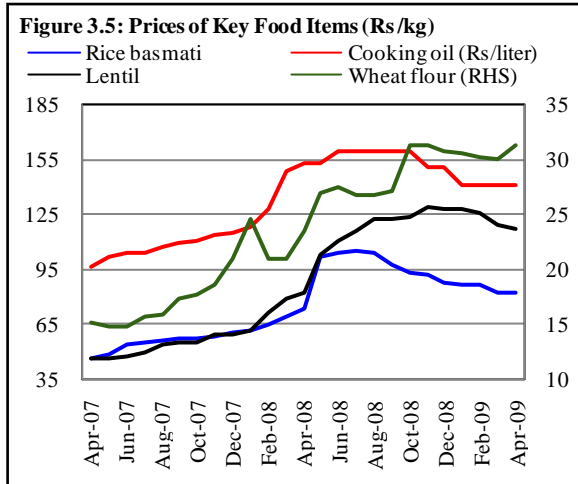


Encouragingly, CPI non-food group has also shown signs of relative easing during H2-FY09; however, this decline is not as prominent as in CPI food group. Going forward, CPI non-food inflation is expected to ease further as lagged impact of tight monetary stance, declining international commodity prices, subdued inflationary expectations amidst weaker domestic demand, and the absence of second-round effects due to a relative slowdown in food inflation.

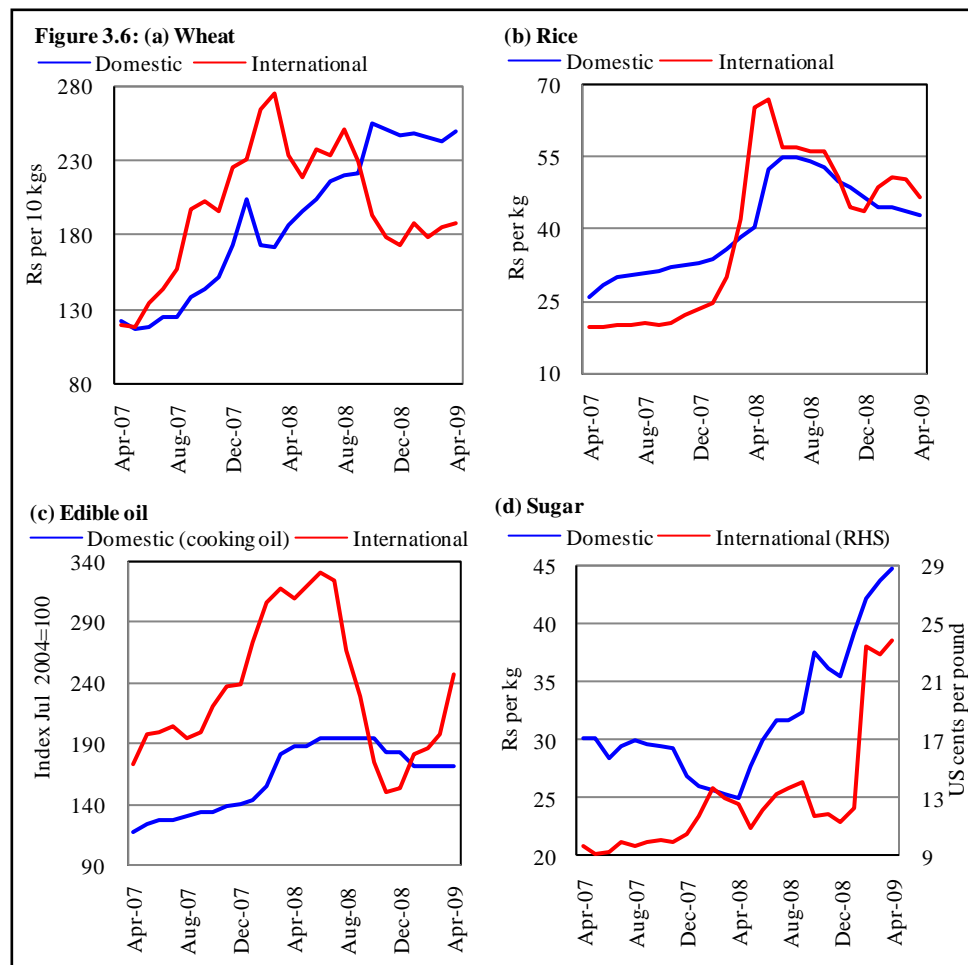
### 3.3.1 CPI Food Inflation

After peaking at 34.1 percent in August 2008, CPI food inflation has retreated to reach 17.0 percent YoY in April 2009. This was mainly due to better supply management, as well as a gloomy global scenario for growth and commodity prices.

In particular, substantial and timely import of wheat eroded the possibilities for speculative hoarding. Similarly, a bumper rice crop and lower international rice prices helped contain the domestic prices of the grain (see **Figure 3.5 and 3.6**).



Also, international wheat prices, which were above the domestic prices during its upward rally, dropped below domestic prices in recent months. In fact, if domestic wheat prices declined in tandem with international prices, domestic food inflation would have come down much earlier. The main reason of the current divergence between domestic and international prices was the government's decision to increase wheat procurement prices by 52 percent to Rs 950/40kg for FY09 crop. This decision resulted in a bumper wheat crop, despite water and urea shortages and some losses due to rains before harvesting in Punjab. Moreover, not only incentives for illegal cross border movement of the grain have been eroded, it also helped improve food security albeit at a higher cost. In recent months, domestic wheat prices have declined mainly due to expectations of a bumper wheat crop and lower demand from neighboring countries. However, wheat prices are expected to slightly move upward in May 2009 mainly due to an alignment of issue price with the government support price of Rs. 950 per 40 kg in Punjab province.



It is imperative to note that rice prices in the domestic economy witnessed a downtrend in Q3-FY09. The prices of domestic basmati declined mainly due to shrinking export of basmati rice from November 2008 onwards, amidst competition from India. However, price of rice irri-6 is expected to rise in the near future due to mismatch between demand and supply as recently many countries, including India, Egypt and Vietnam, have reintroduced restrictions on exports of irri-6 and similar varieties.

On the other hand, domestic price of sugar remained on an uptrend throughout FY09, mainly due to lower domestic production.<sup>4</sup> While the government's

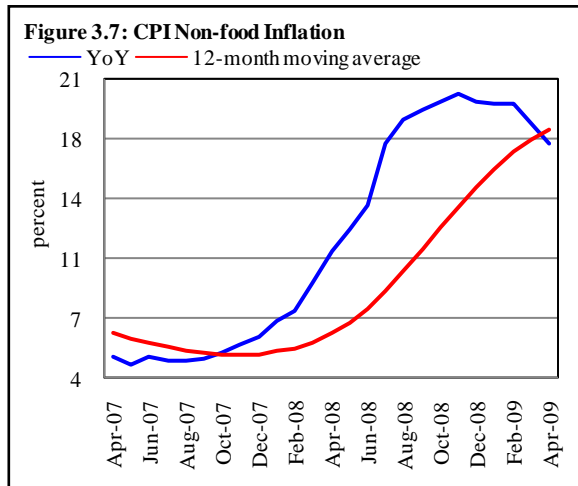
<sup>4</sup> Total sugar production remained at 3.2 million tonnes against last year's record production of 4.35 million tonnes according to Pakistan Sugar Mills Association (PSMA).

decision to allow import of sugar is likely to improve domestic supply, sugar prices are expected to remain high as international prices are also strong, principally reflecting high demand from India.

### 3.3.2 CPI Non-food Inflation

The uptrend in CPI non-food inflation that started during H1-FY08 witnessed a reversal during FY09 as YoY inflation of the sub-group reached 17.3 percent during April 2009 against a local peak of 20.2 percent reached during November 2008 (see **Figure 3.7**).

All sub-indices in the non- food group, except *house rent index*, have witnessed relative ease in YoY inflation during Q3-FY09 (see **Table 3.5**). In particular, the *transport & communication* sub-index has declined at a higher pace as compared to other sub-indices mainly reflecting the impact of downward adjustment in fuel



**Table 3.5: CPI Inflation (YoY) by Groups**

	Weight	Aug-08	Dec-08	Mar-09	Apr-09
<b>Non-Food Group</b>	<b>59.7</b>	<b>18.7</b>	<b>19.8</b>	<b>18.5</b>	<b>17.3</b>
Apparel, textile & footwear	6.1	14.9	15.7	13.6	12.3
House rent	23.4	14.2	17.6	18.7	18.9
Fuel & lighting	7.3	21.0	29.5	26.7	26.7
Household furniture	3.3	12.0	14.6	14.2	12.6
Transport & communication	7.3	40.5	25.7	17.8	8.6
Recreation & entertainment	0.8	11.7	12.6	13.9	13.9
Education	3.5	15.4	17.0	18.4	23.0
Cleaning, laundry	5.9	19.6	19.8	16.4	16.0
Medicare	2.1	9.9	12.7	14.2	13.4
<b>Overall CPI</b>	<b>100</b>	<b>25.3</b>	<b>23.3</b>	<b>19.1</b>	<b>17.2</b>

prices and transportation charges, partially responding to the larger decline in international fuel prices. A slower pace of decline in *fuel & lighting* sub-group is

attributed to sharp upward adjustment in gas and electricity charges during the year.

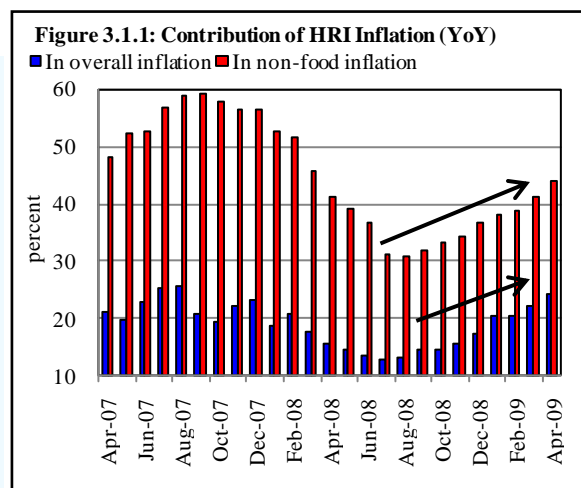
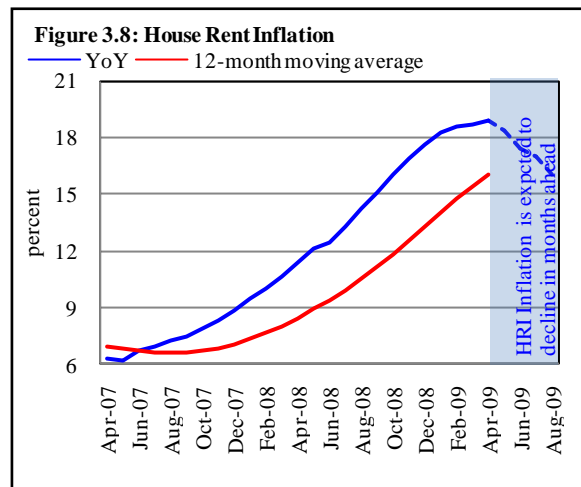
Visible resilience in *education, cleaning & laundry, medicare* and *HRI* sub-groups of CPI represents the second-round effects of persistent high food inflation in the economy as all these sub-groups have a substantial component of wages and salaries. However, while tight monetary policy restricted the possible increase in these sub-indices in response to a surge in food inflation, an expected sharp slowdown in food inflation months ahead is likely to help contain rise in service oriented sub-indices of non-food group as well. And the combined impact of a slowdown in food and non-food inflation would be a sharp deceleration in overall CPI inflation.

Moreover, in case of *house rent index*, YoY inflation seems peaking off and is expected to witness a reversal in coming months, given a significant decline in metal and other construction material prices (see **Figure 3.8**). Expected decline in HRI inflation will lead to ease-off overall CPI and CPI non-food inflation given that HRI has 23.4 percent weight in overall CPI basket and 39.3 percent weight in non-food group (see **Box 3.1**).

#### Box 3.1: Role of HRI in CPI Inflation

House Rent Index is the highest individual item in terms of weight in the CPI basket, having a 23.4 percent weight in overall CPI basket and 39.3 percent weight in non-food group.

The Federal Bureau of Statistics compiles this index using an indirect method by incorporating construction costs prevailing in 35 urban centers of the country. Both labor and material costs are taken into consideration; labor costs constitute 40 percent while remaining is accounted for the material



cost. The construction index is then compiled for individual urban centers by taking a 24-month moving geometric mean of labor and material costs. After this the weights for house rent of individual cities (obtained through family budget survey) are applied to compute the overall HRI.

Overall CPI inflation (YoY) has witnessed a clear downtrend since September 2008. However, CPI non-food group has not witnessed a similar downtrend. This is primarily due to the persistence shown by HRI which has continued to rise. Due to the high weight of HRI in non-food group (39.3 percent) CPI non-food inflation has remained stubbornly high. This can clearly be observed as non-food inflation excluding HRI has decelerated more rapidly (see **Table 3.1.1**).

The persistence in non-food inflation due to HRI is also evident from its weighted contribution.

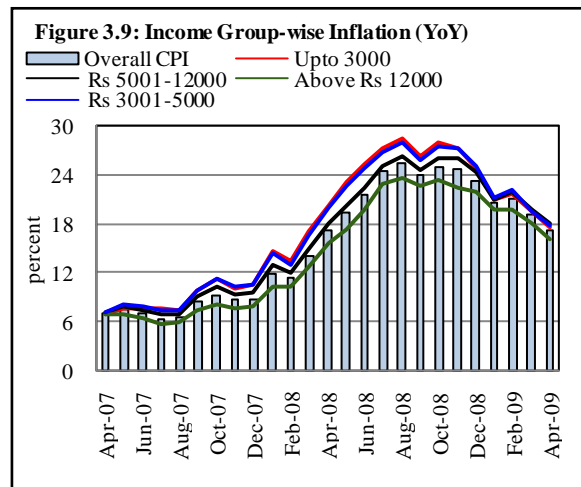
**Table 3.1.1 Trends (YoY: Inflation in percent)**

	General	Non-Food Group	House Rent	NFNE	NFNE excl HRI	Overall excl HRI	Non-food excl HRI
Apr-08	17.2	11.2	11.4	10.8	10.4	19.0	11.1
May-08	19.3	12.5	12.0	12.3	12.6	21.5	12.7
Jun-08	21.5	13.8	12.4	13.0	13.6	24.3	14.8
Jul-08	24.3	17.3	13.3	14.7	16.1	27.7	20.1
Aug-08	25.3	18.7	14.2	16.4	18.4	28.7	21.9
Sep-08	23.9	19.2	15.0	17.3	19.4	26.6	22.2
Oct-08	25.0	19.7	16.0	18.3	20.5	27.7	22.4
Nov-08	24.7	20.2	16.8	18.9	20.8	27.1	22.6
Dec-08	23.3	19.8	17.6	18.8	19.9	25.1	21.3
Jan-09	20.5	19.7	18.2	18.9	19.6	21.2	20.7
Feb-09	21.1	19.6	18.5	18.9	19.4	21.8	20.4
Mar-09	19.1	18.5	18.7	18.5	18.3	19.2	18.4
Apr-09	17.2	17.3	18.9	17.7	16.6	16.7	16.3

**Figure 3.1.1** shows that the contribution of HRI in non-food inflation has consistently increased since September 2008 resulting in continuously high non-food inflation. Moreover core inflation measured by non-food non-energy (NFNE) has also remained persistently high mainly due to HRI, as HRI has 46 percent weight in NFNE group. However, going forward HRI inflation is expected to witness a reversal in its trend given a significant decline in metal and other construction material prices and the fall in HRI is expected to bring a sharp downtrend in CPI non-food and core inflation measured by NFNE.

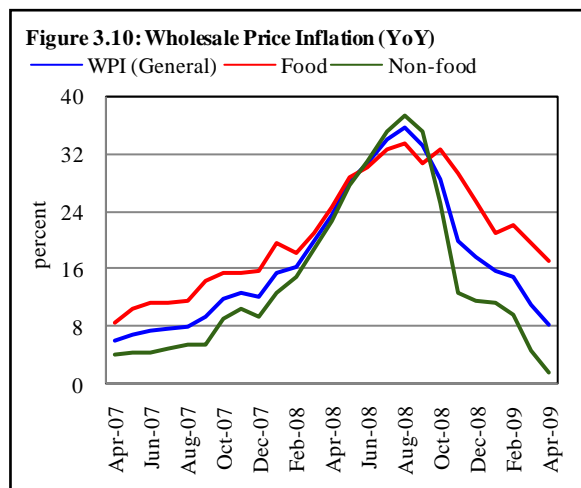
### 3.3.3 Incidence of Inflation

Income group-wise inflation during FY09 shows that the highest incidence of inflation has shifted from lower income groups to the middle income groups since November 2008. The relative ease in inflationary pressures for the lowest income group can be attributed to declining food inflation, given that staple food accounts for a greater proportion of their total expenditure. Income group-wise inflation data further reveals that all income groups, except the highest income group (with earnings above Rs 12,000), recorded higher inflation incidence than the overall CPI inflation throughout FY09 (see **Figure 3.9**).



### 3.4 Wholesale Price Index

Wholesale Price Index (WPI) inflation, that started declining in September 2008, continued its downtrend in FY09. The WPI inflation was recorded at 8.3 percent in April 2009 compared to 23.5 percent during the same month last year. The deceleration in non-food group inflation was more pronounced compare to food group (see **Figure 3.10**).



Within non-food group all sub-indices except raw material sub-index saw inflation decrease significantly during FY09. The weighted contribution of non-food group to overall WPI inflation also declined significantly from 56.1 percent in April 2008 to 12.3 percent in April 2009. Within WPI non-food group, fuel lighting & lubricant sub-index contribution dropped most



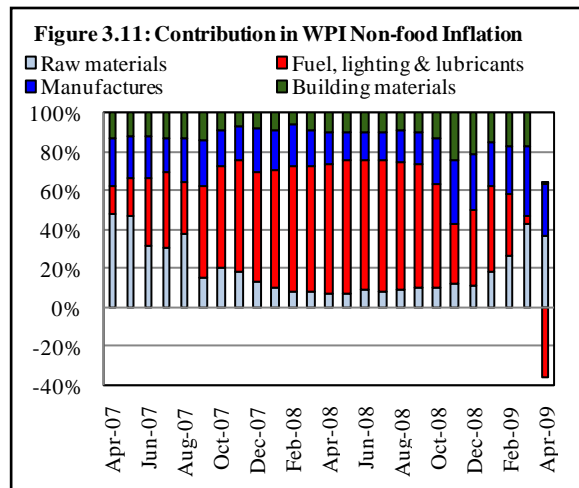
significantly, from 37.5 percent in April 2008 to (-) 15.1 percent during April

**Table 3.6: Percentage Change (YoY) of Selected WPI Non-food Commodities**

	Mar-08	Jun-08	Sep-08	Dec-08	Mar-09	Apr-09
Iron bars & sheets	34.2	53.9	53.9	28.8	-0.1	-9.8
Chemicals	36.6	44.9	31.6	8.9	-18.7	-21.1
Mustard/rapeseeds	48.3	64.1	70.9	32.0	7.2	5.8
Furnace oil	68.2	93.0	55.5	-41.2	-41.7	-40.0
Fertilizers	84.6	93.8	87.2	74.7	14.4	11.8
Coke	111.1	118.2	81.8	50.0	18.4	7.1

2009 (see **Figure 3.11**).

WPI food inflation (YoY) was 17.2 percent during April 2009 compared to 24.6 percent in the same month last year. The relatively low pace of decline in WPI food group inflation as compared to non-food group was primarily due to an increase in the prices of some food commodities such as onion (211.1 percent), sugar (85.7 percent), gur (84.6 percent), condiments (53.6 percent), pulse masoor (41.7 percent) and wheat flour (41.9 percent). Out of the 43 commodities in WPI food group, 28 registered price change above 10 percent during April 2009 (25 items in April 2009).



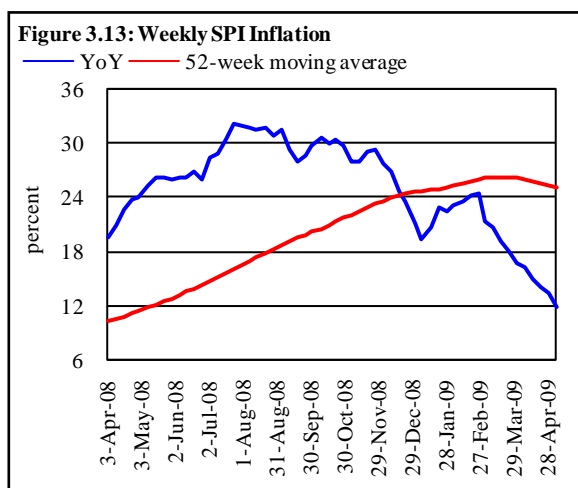
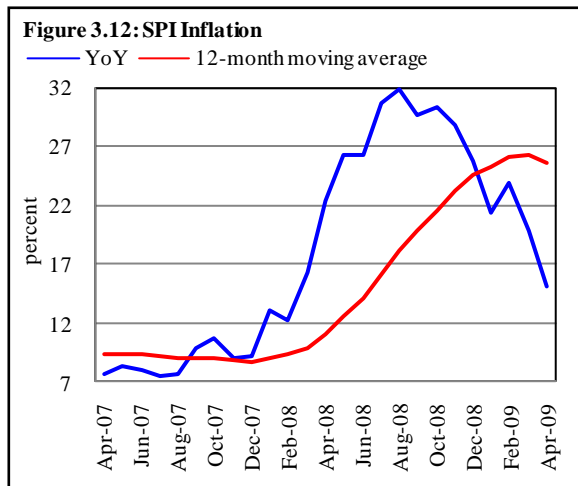
The sharp deceleration in WPI non-food inflation (YoY) was due to the impact of ongoing global economic recession on commodity prices. This can be seen from the decline of selected WPI non-food commodities (see **Table 3.6**).

However, given strong demand for cotton in the country and expected lower global production in FY10, domestic cotton prices are likely to increase in months ahead. Going forward, high cotton prices might weaken the pace of deceleration in WPI non-food group inflation.

### 3.5 Sensitive Price Indicator (SPI)

Inflation (YoY) measured by the sensitive price indicator (SPI) was 15.0 percent during April 2009, compared to 22.3 percent in the same month last year. The long run trend, measured by 12-month moving average, showed that an upward trend peaked out during March 2009 and decelerated to 25.6 percent during April 2009 (see **Figure 3.12**).

The decline in weekly SPI, which started from the first week of March 2009, continued till the first week of May 2009. Weekly SPI inflation (YoY) in first week of March 2009 was recorded at 21.4 percent and during the first week of May 2009 was at 11.8 percent. The long run trend in weekly SPI, measured by 52-week moving average, began to decline from first week of March 2009 (see **Figure 3.13**). A sharp downtrend in weekly SPI inflation reflects that CPI food inflation is likely to exhibit substantial deceleration in the months ahead.<sup>5</sup>



<sup>5</sup> 64 percent items included in the SPI basket are also included in *CPI food basket*. As discussed in *Second Quarterly Report* for FY09 on the State of the Pakistan's Economy, both CPI and SPI generally move in the same direction.

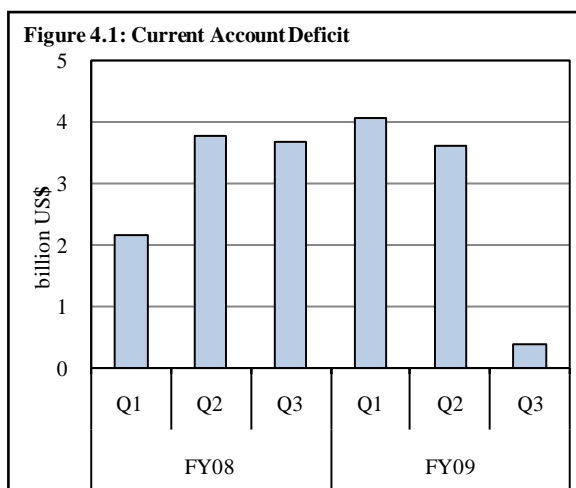
## 4 Money and Banking<sup>1</sup>

### 4.1 Monetary Policy

Domestic demand has been visibly declining since November 2008. This was particularly noticeable in: (1) a downtrend in the country's imports that, over time, helped substantially narrow the current account deficit; (2) a deceleration in private sector credit growth; as well as (3) the moderation of demand stimulus as fiscal discipline improved, and incremental monetization of the fiscal deficit was constrained. The *pace* of the improvement, however, was initially unclear, and there were lingering risks on the external account as well as in the relative resilience in core inflation. These risks precluded an immediate definitive easing of monetary policy, and accordingly the January 2009 Monetary Policy Statement (MPS) kept the policy rate unchanged.

Notwithstanding this, the measures introduced in the wake of the liquidity shock in October 2008 meant that KIBOR eased, particularly in the wake of the non-enforcement of implicit interest rate corridor by SBP, which effectively diluted the impact of the policy stance on the already stressed domestic economy. Further, in order to support industry, and particularly the export-oriented sectors, that were pressured by the impact of the global recession, by easing access to concessional financing schemes, and lengthening maturities.

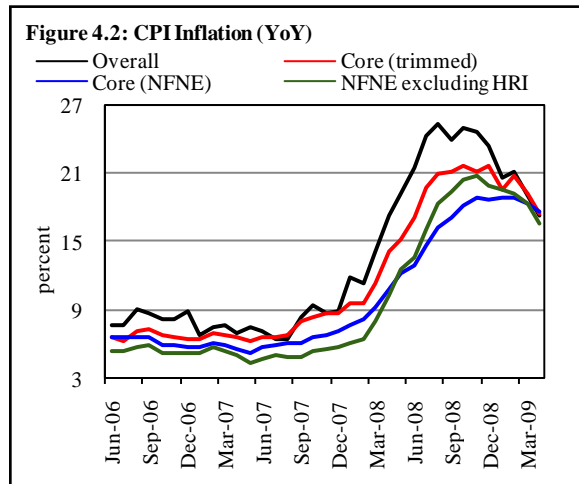
By April 2009, the trend improvement had accelerated, allowing the central bank to signal a definitive easing of monetary policy through a 100 bps reduction of the policy rate, bringing it to 14 percent effective from April 21, 2009. The risks emanating from the external account and stubbornly high core inflation have both lessened substantially. The current account deficit has fallen very sharply (see **Figure**



<sup>1</sup> This section covers data till last week of April 2009.

4.1), and the CPI inflation has also declined.

While inflation has been quite persistent over the last 6 months, this appears to be changing, as evident in the declining trend in the year-on-year figures for CPI inflation as well as both core inflation measures (see **Figure 4.2**).<sup>2</sup> SBP forecasts indicate that disinflationary trends will accelerate in months ahead, with the emerging steep downtrend in CPI inflation being followed by a sharp decline in core inflation. A leading indication of the expected decline in core inflation is seen in the behavior of NFNE core measure excluding HRI, which has dipped sharply in recent months.



Similarly, recent available information on the external account indicates a strengthening of the country's balance of payments position. The incremental rise in the current account deficit during Q3-FY09 was only US\$ 396 million, substantially lower than the deficit of US\$ 3.7 billion during the corresponding period of FY08 (see **Figure 4.1**). Indeed, the current account posted a surplus of US\$ 128 million in February 2009. This improvement in external current account, together with foreign exchange inflows from International Financial Institutions (IFIs) led to a significant increase in SBP's foreign exchange reserves, which rose to US\$ 7.8 billion at end-April 2009 from its low level of US\$ 3.5 billion by end-October 2008. Recognizing lowering of risk to external sector position, SBP has revised downward its FY09 forecast for the external current account deficit.<sup>3</sup>

Meanwhile, the recent pronounced weakening of excess demand pressures continued in Q3-FY09 as well. In particular, the YoY growth in imports further dropped to 36.4 percent in Q3-FY09 due to both sharp YoY fall in import prices

<sup>2</sup> The YoY headline CPI dropped to 17.2 percent in April 2009 compared with its peak of 25.3 percent recorded in August 2008. Likewise, core inflation (20 percent weighted trimmed measures) reached to 17.6 percent in April 2009 compared with 21.7 percent in October 2008.

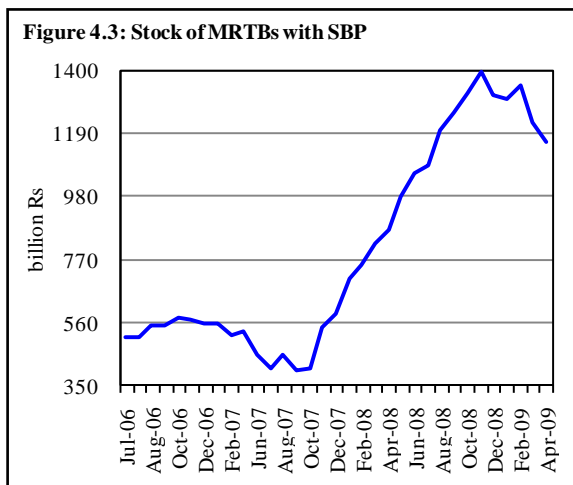
<sup>3</sup> It may be noted here that SBP has lowered its projection of current account deficit as percent of GDP which was in the range of 5.8-6.2 to 5.2-5.6 for FY09.

and quantum.<sup>4</sup> Moreover, the private sector credit growth continued to show deceleration as it recorded net retirement of Rs 127.1 billion in Jan-Mar FY09 compared with net lending of Rs 203.1 billion in H1-FY09.<sup>5</sup> The deceleration in credit growth was a reflection of both lower demand and banks' reluctance to lend to private sector in wake of deteriorating credit quality.

Likewise, on the fiscal side the government's reliance on central bank borrowing has further declined by end March 2009. Specifically, the government has retired Rs 218.1 billion to SBP in March 2009 to meet the quantitative ceilings on borrowing from SBP envisaged in the Stand By Arrangement (SBA).<sup>6</sup> Resultantly, the cumulative government budgetary borrowing from SBP reduced to Rs 81.5 billion during Jul-Apr FY09; significantly lower than Rs 404.8 billion in the corresponding period last year.

The domestic liquidity condition, as a result of slowdown in domestic credit requirements by the government and private sector and sharp fall in pace of depletion of Net Foreign Assets (NFA) of the banking system have continued, so far, remained relatively easy.<sup>7</sup> The impact of improvement in demand pressures on rupee liquidity is quite visible from the softening of market interest rates since January 2009 (see **Figure 4.4**).

It has been argued that the substantial improvement in macroeconomic indicators, should have allowed for a sharper reduction in the policy rate, particularly the



<sup>4</sup> For detail please see chapter on **Trade Account**.

<sup>5</sup> The cumulative increase in private sector credit during Jul-25<sup>th</sup> April FY09 was only Rs 48.6 billion compared with Rs 371.3 billion in the corresponding period of the last year.

<sup>6</sup> The stock of Market Related Treasury Bills (MRTBs) has lowered to Rs 1158.2 billion by end April, 2009 from a peak of Rs 1429.5 billion on December 3<sup>rd</sup>, 2008 (see **Figure 4.3**).

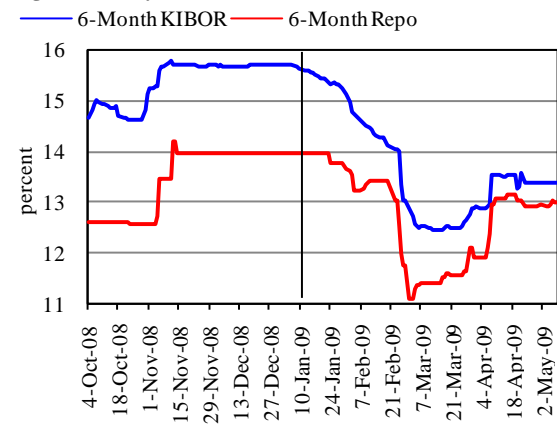
<sup>7</sup> While, in the month of October and November 2008 the continued decline in deposit growth exerted downward pressures on rupee liquidity, an abrupt and heavy withdrawal of deposits from the banking system further aggravated the situation. However, the SBP proactive liquidity management ensured the smooth functioning of inter-bank market.

growth indicators show a substantial slowdown in the economy, and inflation is projected to fall sharply. Indeed, the market had already envisaged the possible cut in the policy rate, ahead of the April 2009, in wake of lower inflationary pressures in the economy, as evident from the downtrend in the market rates since January 2009.

Such a measure would indeed be possible were it not for the risks attached to the current macroeconomic situation, including anticipated shortfalls in fiscal receipts, the uncertain international environment which adds uncertainty to Pakistan's ability to finance even a narrower current account deficit, as well as the fact that the accelerated decline in inflation is, so far, more an expectation than a fact.

Ironically, risks to monetary easing may emerge from a much-desired revival of credit demand from the private sector; if the government's financing demands on the banking system remain at current levels. It must be kept in mind that the government's success in financing its fiscal deficits post-November 2008 from commercial banks, without sparking upward pressure on

**Figure 4.4: Key Market Interest Rates**



**Table 4.1: Monetary Aggregates (Jul-Apr)**

flows in billion Rupees and growth in percent

	Absolute flows since end-June		Growth	
	FY08	FY09	FY08	FY09
<b>Broad money (M2)</b>	<b>341.2</b>	<b>88.4</b>	<b>8.4</b>	<b>1.9</b>
<i>YoY growth</i>			15.3	8.4
<b>NFA</b>	<b>-297.7</b>	<b>-236.9</b>	<b>-30.2</b>	<b>-35.5</b>
<i>YoY growth</i>			-12.9	-37.3
SBP	-219.9	-237.3	-27.9	-49.4
Scheduled banks	-77.8	0.4	-39.5	0.2
<b>NDA</b>	<b>638.9</b>	<b>325.3</b>	<b>20.7</b>	<b>8.1</b>
<i>YoY growth</i>			22.6	16.9
SBP	407.2	114.7	270.2	14.8
Scheduled banks	231.7	210.5	7.9	6.5
<i>of which</i>				
<b>Govt sector borrowing</b>	<b>360.0</b>	<b>303.2</b>	<b>38.9</b>	<b>20.1</b>
Net budgetary support	333.2	259.9	41.1	19.0
SBP	484.9	105.3	140.6	10.2
Scheduled banks	-151.7	154.5	-32.6	46.7
<b>Credit to PSEs</b>	<b>41.7</b>	<b>142.1</b>	<b>51.7</b>	<b>125.0</b>
<b>Credit to private sector</b>	<b>371.3</b>	<b>48.6</b>	<b>15.0</b>	<b>1.7</b>
<b>Other items (net)</b>	<b>-134.3</b>	<b>-168.5</b>	<b>31.8</b>	<b>33.3</b>
<i>Memorandum item</i>				
Total domestic credit <sup>1</sup>	754.1	464.5	22.1	10.9
<b>Reserve money</b>	<b>133.5</b>	<b>-50.6</b>	<b>11.0</b>	<b>-3.4</b>

<sup>1</sup> Sum of government and non-government credit.

market rates was because of weak private sector demand, as much as bank's increase risk averseness in the face of rising NPLs. A hint of this is already evident in April 2009 uptrend in the market rates that was possibly an indication of short-term liquidity stress arising mainly in wake of advance taxation payments.

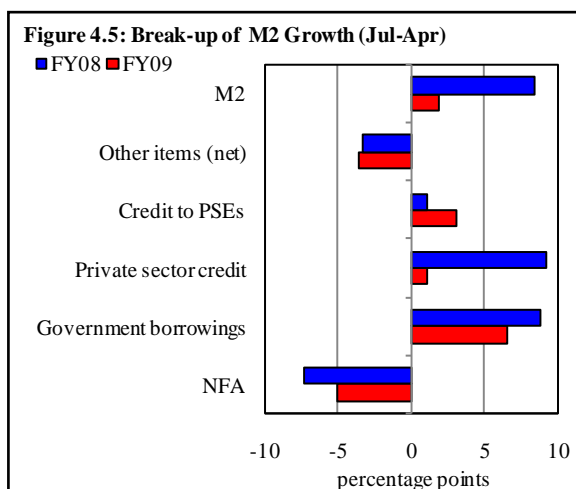
<sup>8</sup> Notably, the rise in T-bills cut-off rates in the auction held on April 08, 2009, was not mirrored in the last Pakistan Investment Bond (PIB) auction held on April 15, 2009. As a matter of fact, in this auction banks' not only offered higher amount i.e. Rs 49.3 billion against a target of Rs 20 billion but the yield had also declined markedly, reflecting that the market continued to anticipate lower long term inflation (and therefore lower benchmark rates).

It is this balance of risks that held back a sharper adjustment in the policy rate in April 2009; the reduction was thus a pro-active measure taken ahead of the *projected* sharp decline in inflation, as the SBP strove to strike a balance between its twin objects of containing inflation, while supporting growth in the economy.

#### 4.2 Developments in Monetary Aggregates

Growth in broad money (M2) decelerated sharply during Jul-Apr FY09 even as the depletion in net foreign assets (NFA) of the banking system was checked following the improvement in overall balance of payments account since November 2008. The YoY growth in M2 as on April 25, 2009 dropped to 8.4 percent from 15.3 percent a year earlier (see **Table 4.1**).

A look at the causative factors of M2 growth during Jul-Apr FY09 reveals that the sharp deceleration resulted from declines in the contribution to the stock of broad money by government borrowings and credit to private sector (see **Figure 4.5**). While the contraction in the stock of NFA lessened and credit to public sector enterprises (PSEs) expanded significantly, these were not large enough to arrest the deceleration in M2 growth.



<sup>8</sup> SBP responded to ease the liquidity pressures by injecting Rs 276.8 billion in the month of April 2009.

Given reduced credit requirements by the government as well as the private sector, and the fact that the improvement in NFA owes partially to weaker import demand, the slowdown in the growth of M2 points to a possible weakening of domestic aggregate demand.

This is also indicated by a deceleration in the growth of total domestic credit.

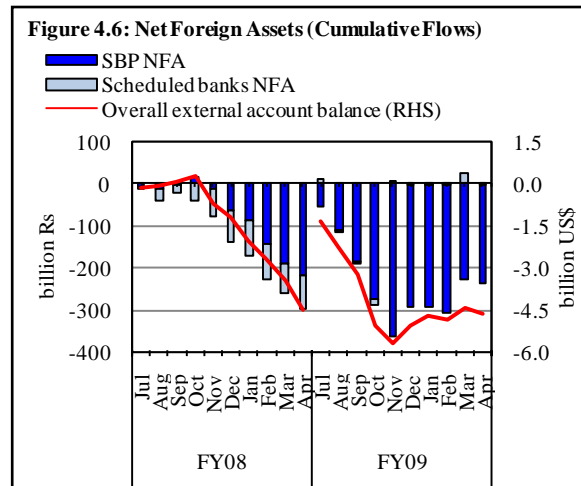
#### Net Foreign Assets (NFA)

Following the upturn in country's external account, contraction in NFA of the banking system has eased gradually since December 2008 (see **Figure 4.6**). Even so, the cumulative contraction in NFA of the banking system stood at Rs 236.9 billion as on April 25, 2009. The improvement in

external account and hence the NFA of the banking system owed to: (1) decline in current account deficit as trade balance improved and workers' remittances remained strong; (2) external financial inflows strengthened from multilateral and bilateral sources; and (3) substantial retirement of foreign currency loans to commercial banks.

Within the banking system, the extraordinary strong contraction in SBP NFA seen in the initial months of FY09 eased out as major trends in balance of payments reversed in the subsequent months. First, the SBA helped the government in acquiring external budgetary financing inflows from other multilateral and bilateral sources. Specifically, the government received US\$ 500 million each from the World Bank and the Government of China and another US\$ 100 million in logistic support during the third quarter of the current fiscal year. The resulting build-up of foreign exchange reserves and the decision to partially meet foreign exchange requirement for payments of oil import from the interbank market explain the current position of SBP intervention in foreign exchange market (see **Figure 4.7**). Second, imports witnessed a large contraction during Jul-Apr FY09 resulting in quantitative improvement in trade balance, despite a complete standstill in export growth.

NFA of the scheduled banks registered a net expansion of Rs 0.4 billion during Jul-25<sup>th</sup> Apr FY09 compared to a contraction of Rs 77.8 billion during the





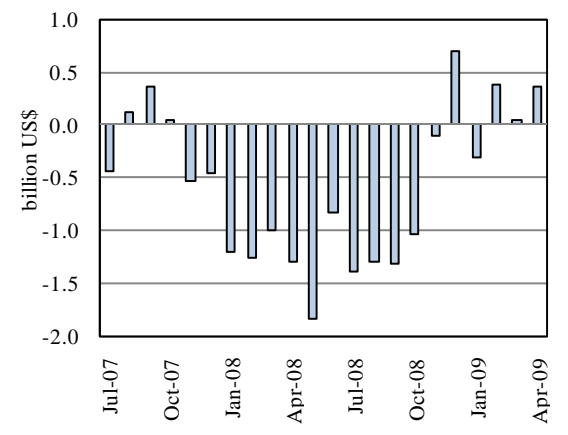
corresponding period last year. This reversal is mainly explained by strong rise in workers' remittances and substantial retirement of foreign currency loans by the business sector following large depreciation of rupee against major currencies (see **Figure 4.8**).

#### Net Domestic Assets (NDA)

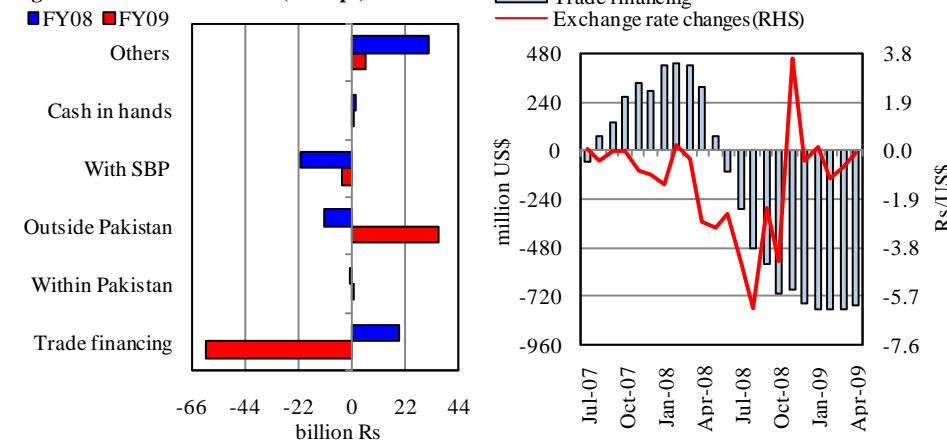
NDA of the banking system registered a YoY growth of 16.9 percent during Jul-25<sup>th</sup> Apr FY09 compared to the YoY growth of 22.6 percent in the corresponding period of FY08. The sharp deceleration in NDA growth of the banking system was contributed by declines in government borrowings as well

as credit to non-government sector during Jul-Apr FY09. As a result, the growth

**Figure 4.7: SBP Forex Market Support (Net)**



**Figure 4.8: FE-25 Utilization (Jul-Apr)**



in NDA of both the SBP and of the scheduled banks experienced significant slowdown.

While the decline in the growth of SBP NDA is a direct result of quantitative ceilings on budgetary borrowings from SBP under SBA, the deceleration in the growth of scheduled banks' NDA reflects the financial and economic risks faced by the country. With weak deposit growth and rising non-performing loans, banks

have gradually shied away from extending credit to the private sector. On its part, the credit demand from the private sector also shrank owing to (1) slowdown in economic activity exacerbated by power shortages, decline in external demand due to global recession, and (2) aggressive monetary tightening by SBP over the last 12 months. Thus, credit to private sector fell to merely Rs 48.6 billion during Jul-25<sup>th</sup> Apr FY09 compared to Rs 371.3 billion in the corresponding period last year.

However, the impact of decline in credit to private sector was partially offset by the increase in banks' investment in risk-free government securities and loans to the public sector enterprises.

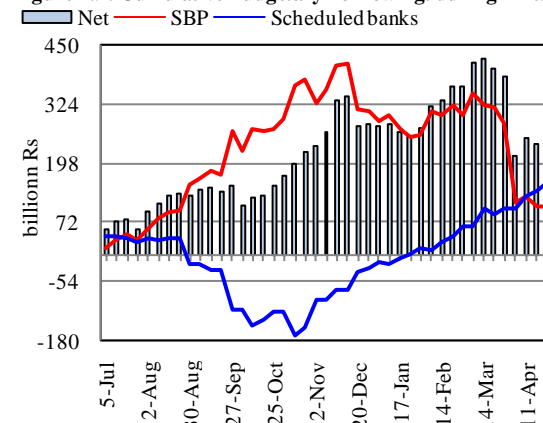
#### 4.2.1 Government Budgetary Borrowings

The increase in government's budgetary borrowing from the banking system fell off sharply towards the end of March 2009. On cumulative basis, government's budgetary borrowing from the banking system rose by Rs 259.9 billion during Jul-25<sup>th</sup> Apr FY09, which is significantly lower than Rs 333.2 billion rise in the corresponding period of FY08.

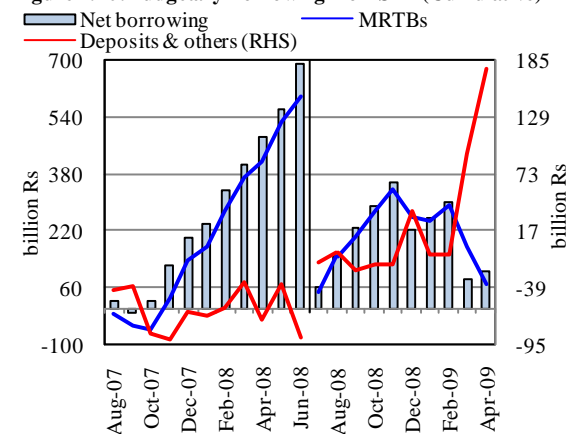
The commitment to contain the fiscal deficit to Rs 562.0 billion for FY09 under SBA and considerable external budgetary inflows in the third quarter of the current fiscal year have resulted in reduced reliance of the government on banking sector financing.

What is more important for the monetary policy is the welcome shift in the composition of government budgetary

**Figure 4.9: Cumulative Budgetary Borrowings during FY09**



**Figure 4.10: Budgetary Borrowing from SBP (Cumulative)**



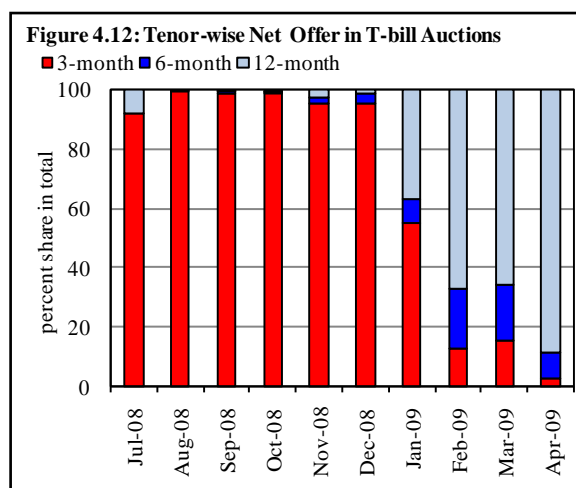
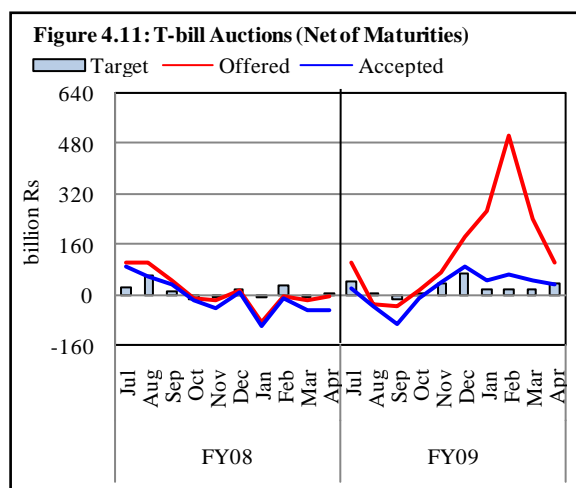
borrowing from the banking sector. The government has retired some of its debt to the SBP and financed its additional borrowing needs from the scheduled banks. As a matter of fact, scheduled banks now finance major portion of government's budgetary requirements (see **Figure 4.9**).

Even though the government retired a portion of MRTBs held by SBP, the sharp decline in budgetary borrowing from SBP towards the end of March 2009 mainly reflects build up of government deposits at SBP (see **Figure 4.10**). Major reasons for this rise in government deposits at SBP include (1) receipts of US\$ 500 million from World Bank, and (2) transfer of Rs 63.3 billion SBP profits to the government. It is interesting to note that the cumulative transfer of SBP profits to the government reached Rs 135.3 billion for the first nine months of FY09, against Rs 87.3 billion for the whole FY08.

Scheduled banks, on the other hand, showed renewed interest in extending budgetary financing to the government (see **Figure 4.11**).

Consequently, the government was able to raise Rs 137.2 billion during Jul-Apr FY09 from the scheduled banks against net retirement of Rs 100.4 billion in the corresponding period of FY08.

Banks' greater interest in government paper was due to a number of factors, including (1) demand for bank credit from private sector declined due to domestic and external shocks to the economy; (2) increased risk averseness of the banks consequent to the rise in non-performing loans; and (3) banks' expectations that interest



rates have peaked out, as reflected in shift to more offering in 12-month tenor in T-bills auctions (see **Figure 4.12**). The fact that banks started locking into longer tenor since January 2009 reflects that the market anticipated a cut in SBP policy rate and incorporated it into their bid decisions for T-bill auctions well before the announcement of Monetary Policy Statement by the SBP.

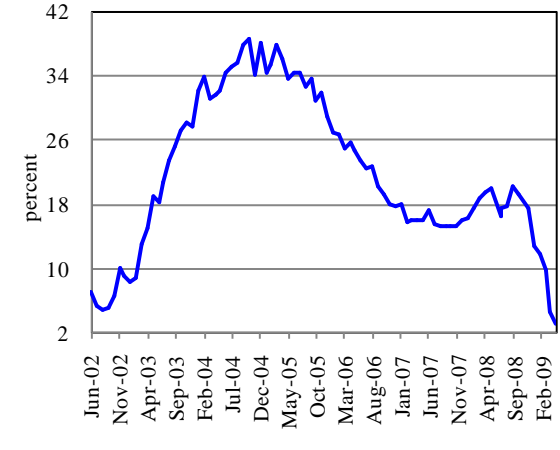
#### 4.3 Private Sector Credit (net)<sup>9</sup>

The slowdown in private sector credit which started in October 2008, due to temporary liquidity crunch with banks, persisted in the following months of FY09 as well.

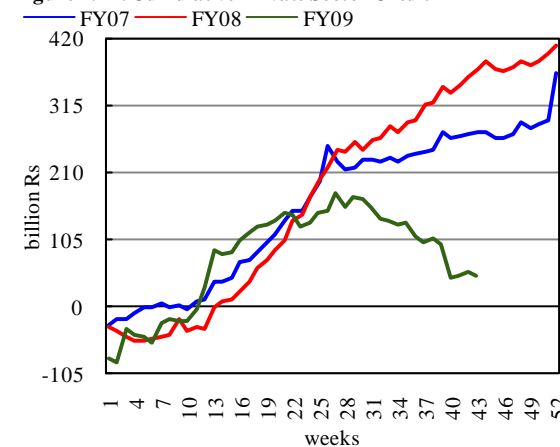
Resultantly, the YoY growth in private sector credit reached to a six-year low of 3.0 percent by end April 2009 (see **Figure 4.13**). In absolute terms, the increase in private sector credit was only Rs 48.6 billion in Jul-Apr FY09 compared with

remarkable surge of Rs 371.3 billion in the corresponding period of the previous year. The deceleration in credit growth was a little exaggerated as a few Independent Power Projects (IPPs) settled some of their loans obligations with banks (see **Figure 4.14**).<sup>10</sup> Nonetheless, even after adjusting for this one-off

**Figure 4.13: YoY Growth in Private Sector Credit**



**Figure 4.14: Cumulative Private Sector Credit**



<sup>9</sup> The reported credit numbers comprise banks' investments and advances to the private sector. This data is based on monetary survey. The sector-wise advances discussion covers the period of Jul-Mar FY09.

<sup>10</sup> Some of the corporates used banks' funding to smooth out their cash flows due to buildup of inter-corporate debt. To resolve part of circular debt issue, government has recently issued Term Finance Certificate (TFC) of worth Rs 80 billion. It may be noted here that banks' investment in this TFC

impact for bank finance, the credit off-take for Jul-Mar FY09 period remained significantly low at Rs 105.8 billion compared with Rs 332.0 billion in the same period of the previous year.

The slowdown in private sector credit was mainly explained by exceptionally low demand for working capital. This reflects a number of developments, such as (1) slowdown in domestic economic activities on account of acute power shortages, (2) a sharp fall in raw material prices in the international and domestic markets, (3) rising interest cost and (4) contraction in trade volume partly due to the global recession etc.

The demand for fixed investment loans in contrast remained quite resilient. The growth in long-term loans was because a few industries such as power, fertilizer and construction, utilized their credit lines committed with banks in the last two years. This reliance is likely to persist as the commencement of new private sector projects particularly in cement, fertilizer, power and sugar industries would continue to sustain the demand for long-term loans in the coming months.

### ***Lending Behavior of Banks***

During the initial months of FY09, not only the demand for private sector was strong, banks were also willing to extend credit to the private sector (see **Table 4.2**). Thereafter, a number of inter-related developments completely changed the credit environment for banks. For example, (1) with continued decline in deposit growth, rupee liquidity in the inter-bank market started drying up – this was also reflected in falling banks' excess reserve with SBP, (2) liquidity conditions worsened further following an abrupt and heavy withdrawal of deposits from the banking system and (3) concerns on quality of credit began to surface.

**Table 4.2: Banks' Lending Business**

billion Rupees

	Jul-Apr		FY09	
	FY08	FY09	Jul-Sep	Oct-Apr
Private sector	371.3	48.6	90.3	-41.7
PSE	41.7	142.1	63.5	78.6
Investment in GoP papers*	-30.7	268.5	-96.4	364.9

\*PIBs & T-bills (net accepted)

will have an offsetting impact on short-term banks' advances extended to the private sector (particularly the power sector) and a few public sector enterprises.

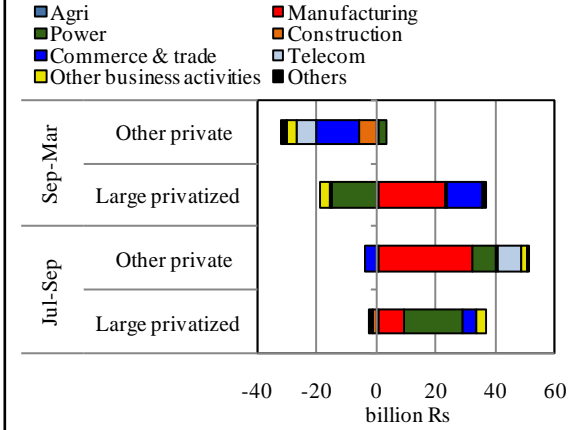
While the liquidity concerns were addressed to an extent by the SBP's timely measures in November 2008, the apprehensions on credit quality continued with banks limiting their exposure on the private sector. Resultantly, banks' credit to the private sector dropped drastically September 2008 onwards.

The resulting availability of loanable funds with banks permitted the government to sharply increase its financing of the deficit through scheduled banks. Thus, banks' investment in government papers has expanded by Rs 375.5 billion since November 2008.<sup>11</sup> Besides this, a few banks have also invested in recently issued government TFCs of worth Rs 80 billion for settlement of a part of inter-corporate debt which had emerged in the previous year. This has an offsetting impact on short-term banks' advances extended to the private sector (particularly the power sector) and a few public sector enterprises.

**Table 4.3: Bank-wise Advances Supply in FY09**

billion Rupees			
	Jul-Sep	Oct-Mar	Jul-Mar
Domestic private banks	80.9	-10.5	70.4
Large privatized	34.2	18.2	52.5
Other private	46.7	-28.7	17.9
Public banks	2.4	20.1	22.5
Foreign banks	5.9	1.8	7.8

**Figure 4.15: Sectoral Break-up of Loans Extended from Domestic Private Banks**



**Table 4.4: NPLs to Loan Ratio in Textile Sector**

percent		
	Dec-08	Dec-09
Large privatized	10.9	12.7
Other private	6.0	11.3
Public	23.2	28.0
Foreign	2.2	5.5

The group-wise analysis of incremental advances by banks suggests that the slowdown in private sector credit since September 2008 remained broad based as most of the banks had limited their lending activity.<sup>12</sup> Although, the advances

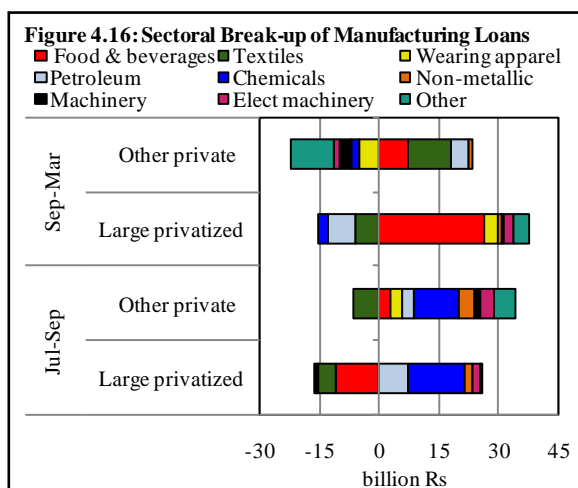
<sup>11</sup> During Jul-Sep FY09, government retired Rs 99.6 billion to scheduled banks.

<sup>12</sup> Advances to the private sector explain more than 85 percent of total private sector credit.

from the public banks in the same period increased significantly, this was essentially due to one of *large public banks* in this group (see **Table 4.3**).

Within domestic private banks, the fall in advances of large privatized banks<sup>13</sup> in March 2009 is partly explained by retirement of loans by a few IPPs (see **Figure 4.15**).

Excluding this impact, the lending activity of large privatized banks showed improvement in Sep-Mar FY09. Notably, this improvement was concentrated in two of *large privatized banks*, and was visible in manufacturing and commerce & trade sectors (see **Figure 4.15**). Within manufacturing sector food & beverages sub-sector was the major recipient of advances (see **Figure 4.16**).



Further, except for a few small banks, most of the banks seem to be unwilling to extend funds to the textile sector during Jul-Mar FY09.<sup>14</sup> Besides lower credit demand, deteriorating credit quality in this sector partly explains banks' reluctance to extend credit. The concern on textile sector's ability to repay loans was highlighted due to a sharp increase in NPLs to Loans ratio of this sector during the year 2008 (see **Table 4.4**).

Recognizing the credit quality concerns, most of the banks have acted cautiously, to prevent their balance sheets from further worsening, by implementing more stringent lending criteria. In this regard, banks are now gauging the debt servicing ability of corporates by focusing on their current income streams or liquidity position. Indeed, in recent past, banks used to assess collateral value more, which includes inventories and fixed assets, and less importance was given to the cash flows of corporates.

<sup>13</sup> This category includes four banks namely; MCB, ABL, HBL, UBL.

<sup>14</sup> Traditionally textile sector has the largest share in total private sector advances.

### Trends in Sectoral Advances

Growth in the private sector advances during Jul-Mar FY09 was limited to only 1.0 percent compared with robust growth of 15.1 percent in the corresponding period last year. While growth in consumer finance has been decelerating since FY07, recent marked deceleration in business sector advances stifled the growth in private sector advances.

The slowdown in business sector advances stemmed essentially from the fall in working and trade related loans (see **Figure 4.17**). Indeed, the extent of deceleration in total working capital loans was strong enough to offset the high growth in fixed investment loans. A disaggregated analysis reveals that the slowdown in the business sector advances was visible in various sectors including manufacturing, construction, telecom, commerce and trade sectors and other business services (see **Table 4.5**).

The trade related loans exhibited a fall of 0.3 percent during Jul-Mar FY09 compared with strong growth of 24.7 percent in the corresponding period last year. The slowdown was contributed by both the import finance and export loans other than scheme (mainly

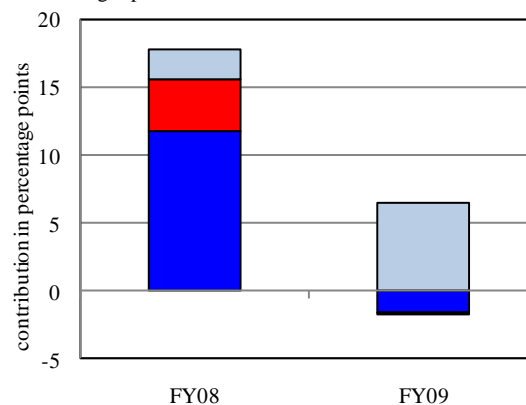
**Table 4.5: Growth in Private Sector Advances (Jul-Mar)**

	Change			
	percent		billion Rupees	
	FY08	FY09	FY08	FY09
1. Business sector	17.7	4.8	304.7	100.5
A. Agriculture & forestry	8.2	5.4	12.1	8.5
B. Manufacturing	19.2	7.3	193.1	88.4
a. Manufacture of food products	13.8	17.5	23.4	33.5
<i>Rice processing</i>	68.7	34.6	19.8	13.7
<i>Sugar</i>	6.4	26.2	4.0	17.2
b. Manufacture of textiles	21.5	0.3	94.2	1.4
<i>Spinning of fibers</i>	20.3	0.5	71.8	2.0
c. Manufacture of basic metals	13.8	-9.0	3.8	-3.3
d. Manufacture of domestic appliances	27.2	4.2	3.0	0.6
e. Manufacture of refined petroleum	152.0	28.9	15.6	5.5
f. Fertilizers and nitrogen compounds	25.0	45.3	7.1	22.2
g. Cement	2.8	10.1	2.3	8.1
C. Power	88.0	20.0	37.3	22.7
D. Construction	27.3	-8.6	15.0	-6.8
E. Transportation & telecommunication	5.0	2.6	4.0	2.4
<i>Telecommunication</i>	0.6	3.7	0.4	2.6
F. Commerce & trade	13.7	-3.0	28.5	-7.5
G. Other business activities*	11.7	-3.1	8.1	-2.7
2. Personal loans	5.3	-11.2	21.2	-47.1

\*Mainly includes loans extended to stock brokers/trade under CFS

**Figure 4.17: Advances to Business Sector (Jul-Mar)**

■ Working capital ■ Trade loans □ Fixed investment





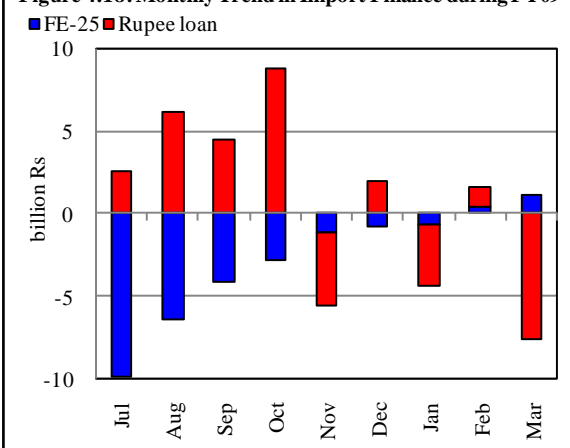
against FE-25). Only the contribution from Export Finance Scheme (EFS) in total trade loans remained robust (see **Table 4.6**). The drop in export loans other than EFS was partly due to sharp fall in rupee value against US dollar in the initial few months. Resultantly, most of the exporters had substituted their FE-25 outstanding stock with EFS. Furthermore, fall in country's exports has also exerted downward pressure on overall demand for export loans.

On the other hand, the monthly trend in import finance suggests that the stability in rupee value against US dollar since December 2008 has somewhat eased the downward pressure on import finance against FE-25 loans.

**Table 4.6: Contribution in Growth of Trade Finance**  
percentage points

	Import finance	EFS	Other than scheme
FY08	19.0	3.7	2.0
FY09	-4.6	10.0	-5.6

**Figure 4.18: Monthly Trend in Import Finance during FY09**



However, the continued deceleration in country's import bills November 2008 onwards, partly due to fall in international oil prices and slowdown in economic activity explains the overall fall in demand for loans extended to the importers (see **Figure 4.18**).

### Manufacturing Sector

Advances growth to the manufacturing sector decelerated drastically to 7.3 percent during Jul-Mar FY09 compared with robust growth of 19.2 percent in the same period last year (see **Table 4.5**). Monthly trend depicts that after recording strong growth in the initial few months of FY09, there was an unusual drop in advances demand November 2008 onwards, even during Jan-Mar FY09 a number of sectors had seen net retirement which is unlike to previous years.<sup>15</sup> A closer

<sup>15</sup> Although deceleration in credit growth during Jan-Mar period is a common factor in preceding few years-reflecting credit cycles; the decline in credit growth during Q3-FY09 was stronger.

look at the manufacturing sector suggests that this deceleration mainly came from lower running finance requirements (see **Table 4.7**). In general, the growing severity of energy shortages and continued slump in economic activity has adversely affected the production activity in a number of industries which in turn lowered the demand for working capital loans. Furthermore, fall in prices of raw materials in a few sectors has also lowered the additional demand for running finance in Jul-Mar FY09.

**Table 4.7: Growth in Manufacturing Sector Loans (Jul-Mar)**

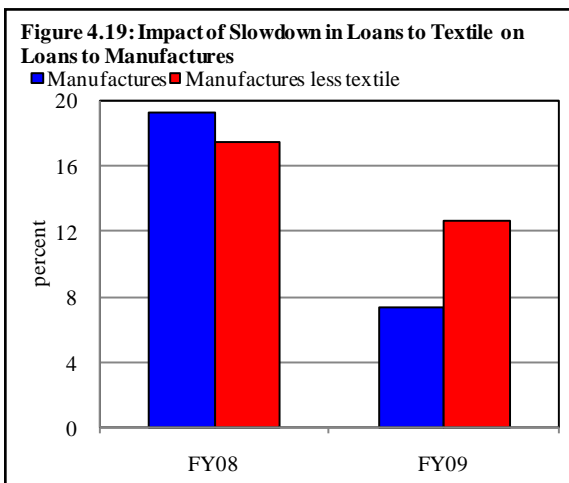
percent	FY08	FY09
Trade finance	26.9	-0.3
Working capital	22.6	5.1
Fixed investment	9.3	17.2

The demand for fixed investment loans, however, remained strong in the same period. A part of the increase in fixed investment loans is probably a reflection of the earlier commitment in some industries.

Within manufacturing sector, the major deceleration in the period of analysis came from the textile sector (see **Figure 4.19**). Excluding this, the growth in manufacturing sector increased to 12.6 percent in Jul-

Mar FY09, though still lower than the same period of the previous year. Besides textile, refinery, basic metal and domestic appliance also dragged down the demand for bank loans in the manufacturing sector.

The slowdown in *textile sub-sector* was visible in both working capital loans and fixed investment loans, only advances extended under EFS registered a significant growth.<sup>16</sup> However, the strong impact of EFS was more than diluted by a sharp drop in import finance and other than EFS loans to textile sector.



<sup>16</sup> During Jul-Mar FY09 EFS loans to textile sector recorded 21.0 percent growth compared with 3.0 percent rise in the corresponding period of the last year.

**Table 4.8: Advances for Working Capital Loans**

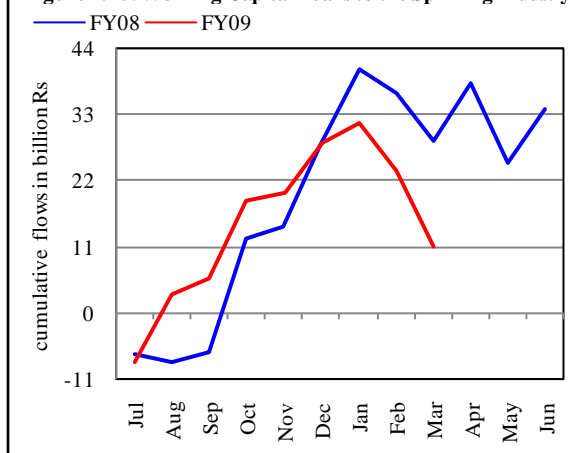
growth in percent

	Jan-Mar		Jul-Mar	
	FY08	FY09	FY08	FY09
Manufacturing	7.4	-7.5	22.6	5.1
a. Manufacture of food products	13.6	7.6	10.7	18.6
<i>Rice processing</i>	0.2	-9.6	86.2	41.7
<i>Sugar</i>	54.3	60.1	4.6	32.1
b. Manufacture of textiles	3.3	-11.5	27.4	1.0
<i>Spinning of fibers</i>	0.6	-11.2	29.6	8.3
c. Manufacture of basic metals	-16.5	-22.5	-18.4	-21.0
d. Manufacture of domestic appliances	-7.8	-6.4	27.1	-8.7
e. Manufacture of refined petroleum	18.2	-6.9	119.4	6.1
f. Fertilizers and nitrogen compounds	69.0	-22.9	10.2	28.9

Within *textile sector*, most of the slowdown in running finance requirements emanates from the *spinning sector* (see **Table 4.8**). Monthly trend reveals that the credit-off take in this sector was strong in the initial few months of FY09; partly a reflection of commodity financing for cotton availed by the private sector (see **Figure 4.20**).<sup>17</sup> However, in the following months of FY09, the loans to the spinning industry could not maintain the growth momentum and dropped drastically.<sup>18</sup>

Though a part of the fall in textile loans was anticipated, in view of continued global slowdown and the resulting

**Figure 4.20: Working Capital Loans to the Spinning Industry**



<sup>17</sup> It may be noted here that the private sector availed Rs 13.7 billion during Jul-Dec FY09 for procurement of cotton compared with net retirement of Rs 0.6 billion in the corresponding period last year.

<sup>18</sup> Decline in net advances in the second half of the fiscal year had been a traditional feature of credit cycle in past few years, however, FY08 was an exception probably on account of higher cotton prices.

drop in exports, the huge stock of inventories on account of delays in export order settlement further aggravated the situation. Furthermore, a few spinning industries have closed down their production operations in the recent months on account of acute power shortages, structural impediments in the industry and rising inability to service bank obligations. All these factors have led to lower the additional demand for running finance in this sector in the period of analysis.

Loans to the *refinery industry* registered a growth of 28.9 percent in Jul-Mar FY09 compared with triple digit growth during Jul-Mar FY08. Most of the deceleration was evident in running finance requirement mainly on account of lower crude oil imports due to financial constraints in some refineries.

Loans extended to the *basic metal industry* fell by 9.0 percent during Jul-Mar FY09 in contrast with a robust growth of 13.8 percent in the corresponding period last year. This was due to inventory accumulation and downward rigidity in steel import prices that lowered the country's import, thus decreasing the trade finance requirements of the sector.<sup>19</sup>

Finally, advances to the *machinery and equipment* dropped by 3.9 percent during Jul-Mar FY09 compared with a strong growth of 20.3 percent in the same period preceding year. This mainly stemmed from the domestic appliances industry. Indeed, persistent inflation in the economy has curbed the purchasing power of households which led to fall in demand for the domestic appliances. This impact was further compounded by the fact that the industrial activity in this sector has also declined partly due to lower demand, power shortages and piling up of inventories. All these factors probably led to lower the running finance requirement from this sector.

This said, a few sectors mainly food & beverages, cement and fertilizer saw *high growth* in advances.

Loans to the *food & beverages* sub-sector registered a rise of 17.5 percent during Jul-Mar FY09 compared with 13.8 percent growth in Jul-Mar FY08. This was mainly visible in rice processing and sugar industries (see **Table 4.5**). The advances to former came from working capital loans in wake of bumper crop and significant increase in rice exports. The advances to sugar sector stemmed from running finance requirement for procurement of sugarcane.<sup>20</sup> Moreover, sugar

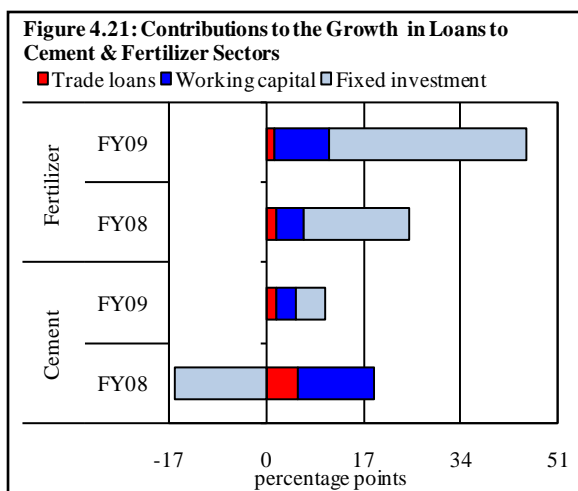
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<sup>19</sup> Please see chapter on **Trade Account** for detail.

<sup>20</sup> In FY08 manufactures had delayed sugarcane crushing, primarily due to carry over stocks which led to subdued demand for working capital loans.

sector may see higher demand for fixed investment loans in the months ahead as the government has recently allowed a few industrialists to setup new sugar mills.

Growth in advances extended to the *cement sub-sector* came mainly from the fixed investment loans due to a few ongoing capacity augmentation projects in this industry (see **Figure 4.21**).<sup>21</sup> Moreover, a few cement industries are also focusing on initiating power generation projects through waste heat recovery process.<sup>22</sup> This indicates that the demand for fixed investment loans in this sector is likely to continue in the upcoming months as well. In contrast, the demand for working capital loans decelerated sharply to 11.0 percent during Jul-Mar FY09 compared with strong growth of 78.0 percent in the corresponding period last year.



Indeed, the cement industry has expanded its installed capacity significantly in the recent past in expectation of higher domestic demand in wake of government spending on construction of dams and other developmental projects. Unfortunately, the current domestic consumption of cement has reduced partly due to reduction in developmental expenditures and private construction activities. Moreover, though the global economic recession has also adversely affected the cement demand in UAE, the export demand is still strong in the Africa, India and Middle East. Resultantly, cement export though decelerated, exhibited a strong growth of 59.8 percent in Jul-Mar FY09. Furthermore, one of the major cement producers has issued right shares to repay part of their expensive bank loans. All these factors therefore aptly explain the lower demand for working capital loans in the cement industry during the period of analysis. This said, the monthly trend of local cement

<sup>21</sup> During FY08 a few corporates of cement sector issued TFCs to finance expansions and in some cases to retire their long term bank obligations.

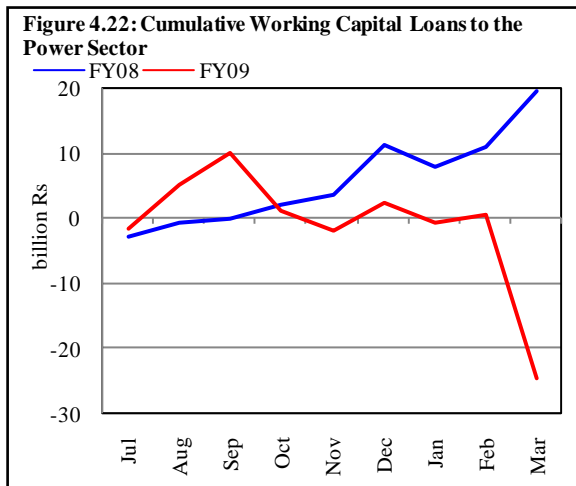
<sup>22</sup> A few cement industries are focusing on recycling the steam generated during cement production to produce power for the industry.

dispatches suggests some sign of recovery in the recent months which in turn may slightly increase the working capital demand, going forward.<sup>23</sup>

*Fertilizer* was another sub-sector where the high demand for bank advances during Jul-Mar FY09 was mainly driven by a few large capacity expansion projects (see **Figure 4.21**). The higher demand for working capital loans in the initial few months of FY09 was partly due to short-term bridge finance by a few companies in this sector to meet the financing gap arising due to delays in settlement of DAP subsidy claims from the government.<sup>24</sup> This exceptionally high borrowing, however, fell in the following months of FY09 as one of the major companies had retired its bank loan on account of settlement of subsidy claims.

### Power

Growth in advances to the power sector remained robust at 20.0 percent during Jul-Mar FY09, although it decelerated sharply from a strong growth of 88.0 percent in the corresponding period last year (see **Table 4.5**). It must, however, be noted that FY08 strong growth, mainly under working capital loans, was partly attributed to high borrowing by some IPPs to fill the financing gap due to delays in settlement of circular debt claims. Though, the credit demand from those IPPs was still strong in Jul-Sep FY09, it however, decelerated in the following months of FY09. This was initially due to retirement of bank loans by some of the IPPs to avoid the rising financial cost. This was further compounded by a sharp fall seen in March 2009 in wake of partial settlement of circular debt claims (see **Figure 4.22**). Resultantly, the cumulative growth in working capital loans dropped sharply. In case of fixed investment loans, increase in advances was anticipated on account of expansions in power generating and distribution



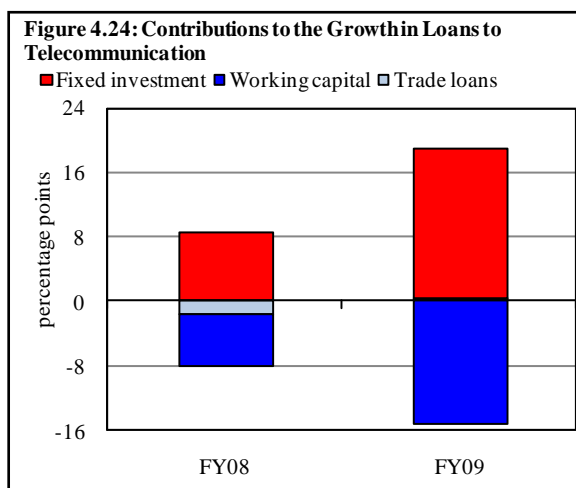
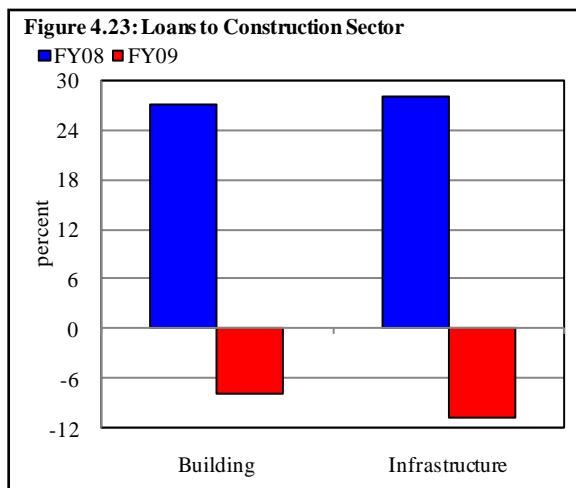
<sup>23</sup> Given the fact that a significant portion of raw material such as coal and fuel in the cement production is imported internationally, the recent fall in the price of coal and fuel in the international market would offset some of the impact of additional demand for working capital.

<sup>24</sup> For detail see Q2-FY09.

companies. Furthermore, the credit demand is likely to increase further in months ahead as a few banks are expecting more financial closures in this industry.

### Construction

Loans extended to the construction sector fell drastically to 8.6 percent in Jul-Mar FY09 compared with exceptional growth of 27.3 percent during Jul-Mar FY08. This was caused by both lower financing requirements for building and infrastructure related construction activities (see **Figure 4.23**). This was partly due to fall in steel bar prices since October 2008 and slowdown in construction activities both in public and private sector. Indeed, the latter factor not only lowered the credit demand in this sector but has also impacted adversely the credit demand in other related industries such as cement and basic iron & steels industries in the period of analysis.



### Telecommunication

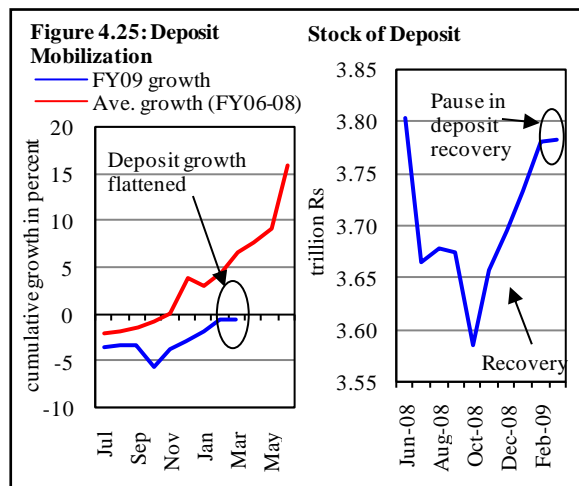
Growth in advances to the telecommunication sector witnessed strong growth of 3.7 percent during Jul-Mar FY09 compared with 0.6 percent rise in the corresponding period of previous year. While the growth in working capital loans dropped sharply, the higher demand for long-term finance largely explains the growth in this sector (see **Figure 4.24**). The former was probably a reflection of slowdown in business activity in this sector on account of lower consumer demand

due to increased taxes and saturation of the urban markets.<sup>25</sup> The lower consumer demand is also visible from fall in imports of mobile sets in Jul-Mar FY09 compared with Jul-Mar FY08.<sup>26</sup>

The demand for fixed investment loans was mainly for expansions in some telecom companies to increase the coverage of network in remote areas and also to provide the wireless internet facility.

Given the fact, that the cellular mobile subscribers has already crossed 88 million mark indicating that the market is on saturated stage, the demand for fixed investment loans from this sector probably may not increase significantly in the upcoming months.<sup>27</sup> Nevertheless, mobile banking<sup>28</sup> can be an attractive unexplored area for the telecom industry. In this regards, one of the major telecom industry has already taken step to initiate such projects.

Advances growth in *commerce and trade* exhibited a fall of 3.0 percent during Jul-Mar FY09 compared with strong growth of 13.7 percent in Jul-Mar FY08. The main contribution came from lower running finance requirements primarily in the wake of deceleration in trade volume. Lastly, though freeze on the stock market activity has been removed in December 2008, advances demand from the stock broker/agents did not pick up. This probably indicates banks' reluctance to take additional exposure in



<sup>25</sup> In the current budget of FY09, the rate of GST on telecom sector rose from 15 percent to 16 percent along with the imposition of custom duty of Rs 500 per mobile set. Source PTA.

<sup>26</sup> During Jul-Mar FY09 mobile phone imports witnessed a significant fall of 76 percent compared with a dropped of 12 percent in Jul-Mar FY08.

<sup>27</sup> For detail see PTA annual report 2007-08.

<sup>28</sup> Mobile banking is a phenomenon used for performing balance checks, account transactions and payments etc. via a mobile device such as a mobile phone. The first phase of mobile banking brings with it services of bank account maintenance which will lead to the second phase of facilities such as paper/plastic-free money transactions, money transfer, mobile sales, auctions, and brokerage etc.



stock market activity. Thus, the advances growth under this head fell by 3.1 percent during Jul-Mar FY09 compared with impressive growth of 11.7 percent in the same period last year.

#### 4.4 Deposit Mobilization<sup>29</sup>

The overall deposit growth of the banking system continued to remain low (see **Figure 4.25**). This was despite a considerable ease in external current account pressures which was a significant source of erosion in deposit-base.<sup>30</sup>

Although banks have well withstood the severe withdrawal pressures of October 2008, there are other developments which have acted to hold back deposit

growth. These include (1) the slowdown in economic activities as evident from deceleration in private sector credit growth; (2) lower liquidity injections from SBP into banks following lower budgetary borrowings from the central bank; (3) increased competition from National Saving Scheme (NSS) – see **Table 4.9**; and (4) decline in weighted average return on deposits. Thus, on cumulative basis, deposits of the banking system recorded contraction of 0.6 percent in Jul-Mar FY09.

The slowdown in deposit growth during March 2009 should, however, be interpreted carefully, as it was the net withdrawal in government deposits with banks and in foreign currency deposits largely on account of import payments by a few corporates that offset the effect of a rise in personal and business deposits during the month.

**Table 4.9: Factors Impeding Deposit Growth**  
percent

	Jul-Mar	
	FY08	FY09
Reserve money	10.4	-2.1
Private sector credit	13.9	3.4
Receipts under national saving schemes	7.1	17.2

**Table 4.10: Deposit Growth by Banks' Category (Jul-Mar)**

	Change in FY08		Change in FY09	
	Abs Δ billion Rupees	Cont. to growth in %	Abs Δ billion Rupees	Cont. to growth in %
Public banks	22.0	0.66	-6.6	-0.17
Privatized banks	68.1	2.04	-43.3	-1.14
Merged banks <sup>1</sup>	31.8	0.95	-1.7	-0.05
Private banks	9.7	0.29	-3.2	-0.08
Foreign banks	16.9	0.51	12.3	0.32
Islamic banks	30.7	0.92	23.8	0.63
<b>All banks</b>	<b>179.1</b>	<b>5.36</b>	<b>-21.5</b>	<b>-0.57</b>

<sup>1</sup>Includes banks which have merged during the previous 5 years

Note: Specialized banks are included in all banks

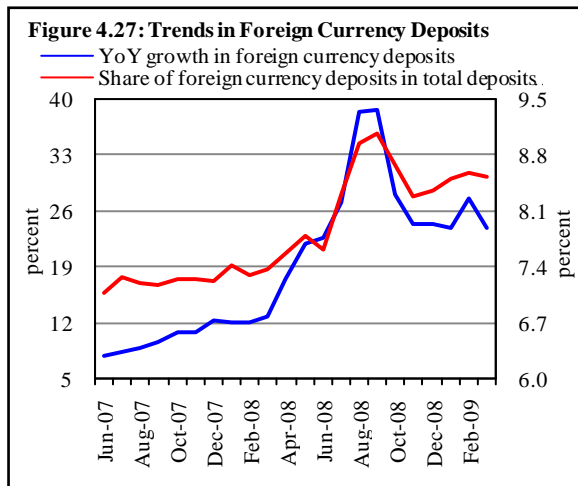
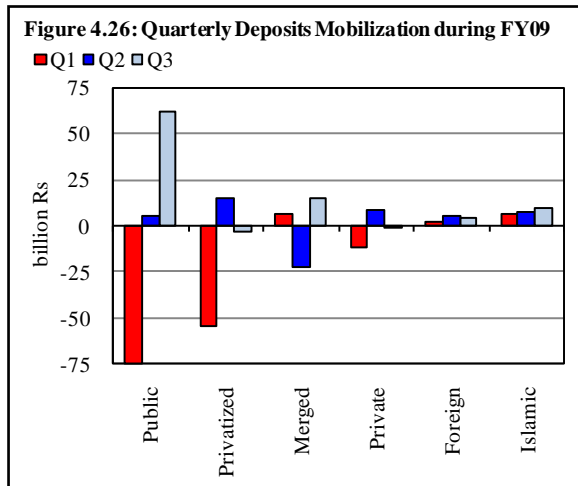
<sup>29</sup> The discussion on deposits is based on total deposits of the banking system including government deposits.

<sup>30</sup> The foreign exchange remittance inflows, which are an important contributor to deposit growth, have shown a rise of 19.7 percent during Jul-Mar FY09.

The deceleration in deposit growth affected almost all banks. The YoY growth in deposits of top five banks<sup>31</sup> (in terms of deposit base) has declined from 16.4 percent in June 2008 to 8.2 percent in March 2009.

A group-wise analysis shows that deposits in both public and private sector banks are yet to regain their end-June 2008 level. The privatized banks in particular are experiencing relatively large erosion in their deposit base (see **Table 4.10**). The public sector banks experienced a notable recovery during the third quarter of FY09 (see **Figure 4.26**).

Islamic banks and foreign banks are showing rather decent performance as there is a net increase in their deposit-base over June 2008; but the deposit growth is still lower compared to the previous year.

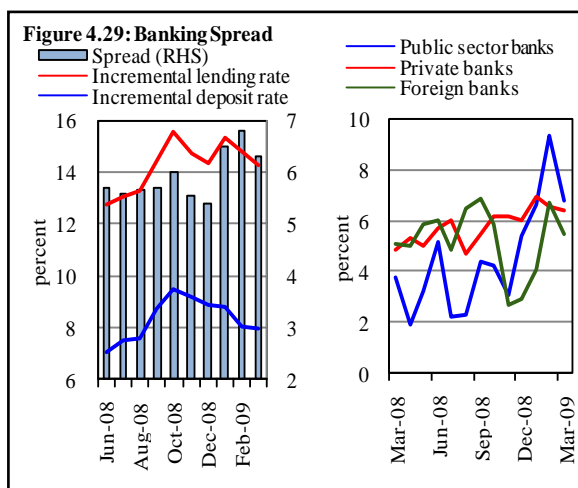
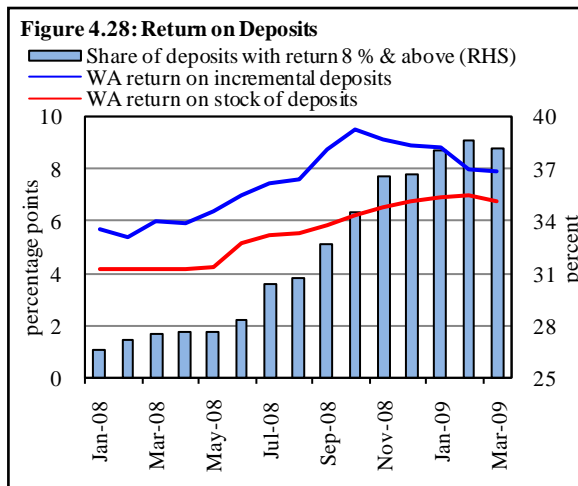


In terms of currency composition, the post-October 2008 gradual rise in the share of foreign currency deposits seem to have peaked out as YoY growth of foreign currency deposits decelerated in March 2009 (see **Figure 4.27**). The net withdrawal of US\$ 86 million in foreign currency deposits of the banking system during March 2009 was in US dollar and Euro denominated deposits.

<sup>31</sup> These banks contribute 51.8 percent of the total deposits of the banking system.

The slowdown in overall deposit growth is associated with a decline in average return on deposits. In particular, the maximum weighted average return on deposits has fallen from a near peak of 9.5 percent in October 2008 to 8.0 percent in March 2009. This was probably due to (1) perverse impact of SBP liquidity support and (2) market expectations that interest rate have peaked out. In former case, the massive liquidity support by SBP, to ensure stability of domestic banking system, during October 2008 and onwards probably eased the compulsion on banks to increase their deposit base. At the same time, growth in private sector credit decelerated. Thus, it was not surprising that the share of high yielding deposits in the total deposits has also started to decline in recent months (see **Figure 4.28**).

Despite recent softening of the deposit rates, the banking spread showed marginal contraction in March 2009 because of relatively large decline in lending rates (see **Figure 4.29**). Nonetheless, compared to June 2008, the banking spread shows an increase of 60 bps. This increase was mainly contributed by public sector and foreign banks.



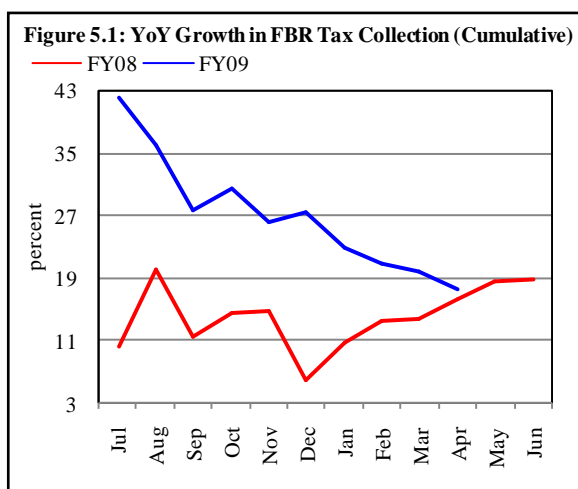
## 5 Fiscal Developments

### 5.1 Overview

Recent update on fiscal developments by Ministry of Finance<sup>1</sup> indicates that the budget deficit for Jul-Mar FY09, as a percentage of the estimated FY09 GDP, is likely to remain at 3.1 percent compared with 4.7 percent in the corresponding period of FY08. Though broadly consistent with the annual fiscal deficit target for FY09, the quality of this fiscal improvement can only be judged once consolidated fiscal accounts are released.

Even with limited information on fiscal operations during Jul-Mar FY09, a few observations warrant attention. First, in order to attain Rs 1.25 trillion tax collection (budget) target for FY09, FBR tax receipts will need to record a YoY growth of 24.1 percent by end-June 2009. Given the downtrend in growth of tax receipts (see **Figure 5.1**), achievement of tax revenue target for FY09 will be challenging. Second, government revenues during Jul-Mar FY09 are expected to

have sustained the robust growth seen during H1-FY09 despite shortfall in FBR tax receipts. This is due to large inflows in non-tax revenues recorded in Q3-FY09. Specifically: (1) the government received Rs 63.3 billion in March 2009 under transfer of SBP surplus profit, making SBP profit transfer to the government a cumulative Rs 135.3 billion during Jul-Mar FY09; (2) the ongoing large differential in international and domestic oil prices provided further relief to the government; and (3) US\$ 100 million were received on account of logistic support reimbursement during Q3-FY09.



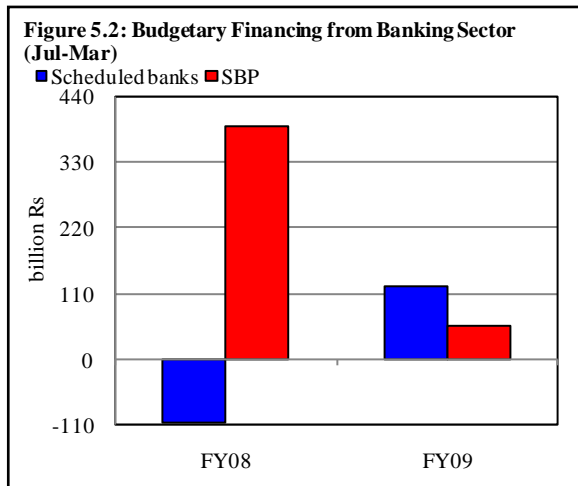
<sup>1</sup> Review of Economic Situation (July-March 2008-09); released on MoF website ([www.finance.gov.pk](http://www.finance.gov.pk)).

## 5.2 Domestic Budgetary Borrowings<sup>2</sup>

The aggregate government borrowing from domestic sources stood at Rs 353.0 billion during Jul-Mar FY09, which is significantly lower than the domestic budgetary requirements in the corresponding period of FY08. With apparent shortfall in external borrowing for budgetary support, the decline in budgetary borrowing from domestic sources in Jul-Mar FY09 reflects improvement in fiscal balance.

### *Financing from the Banking System*

Net budgetary borrowing from the banking system was Rs 176.2 billion during Jul-Mar FY09 compared to Rs 283.1 billion in the same period last year. Moreover, the structure of budgetary financing from the banking system improved during Jul-Mar FY09 as reliance on borrowing from SBP was reduced substantially (see **Figure 5.2**).



In particular, SBP provided Rs 55.7 billion for budgetary financing during Jul-Mar FY09 compared to Rs 390.9 billion during the same period of FY08. Analysis of government borrowing from SBP during the period under review shows that while Rs 174.7 billion were provided through issuance of new T-bills, large buildup of government deposits with the SBP reduced net financing from SBP.

### *Financing from the Non Banks*

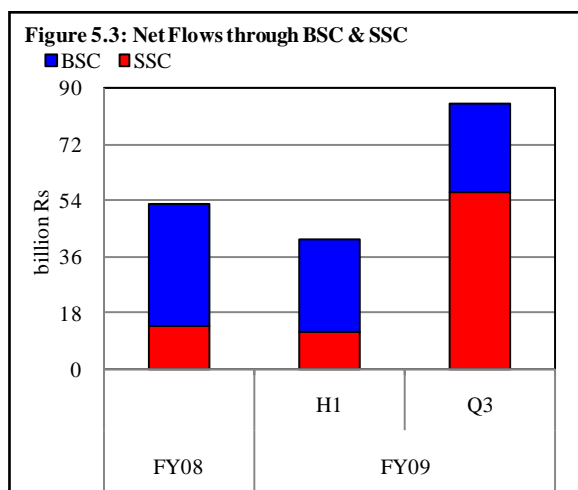
Non bank borrowing (net) rose by Rs 176.8 billion in Jul-Mar FY09, compared to moderate increase of Rs 109.4 billion in the corresponding period of the previous year. With sharp decline in bank financing during Jul-Mar FY09, non banks' share in domestic sources of budgetary financing saw a large boost.

Disaggregation of nonbank financing shows that the government mobilized Rs 163.6 billion through NSS instruments during Jul-Mar FY09, which is

<sup>2</sup> Based on SBP calculation, the government borrowing numbers do consider the impact of government deposits with the banking system whereas the debt numbers do not. The government borrowing numbers reported here also exclude the impact of deposits and reserve fund under the non-bank financing.

substantially higher than Rs 67.4 billion borrowed during the corresponding period last year.

Interestingly, higher mobilization through NSS during Jul-Mar FY09 resulted from extraordinarily strong inflows in Q3-FY09. In particular, net investment in Behbood Saving Certificates (BSC) and Special Saving Certificates (SSC) increased by Rs 85.1 billion in Q3-FY09, which is even larger than the entire FY08 investment in these instruments (see **Figure 5.3**). While higher inflows in BSC during Q3-FY09 followed upward revision in its rate of return, the surprising rise in mobilization through SSC towards the end of March 2009 probably reflects institutional investment by one public sector organization on the expectation of immediate cut in the rate of return.



### 5.3 FBR Tax Collection

Indicators of tax performance suggest a likely shortfall in tax collection (budget target for FY09). During Jul-Apr FY09, FBR tax receipts amounted to Rs 898.6 billion compared with Rs 763.6 billion in the same period last year, reflecting a YoY increase of 17.7 percent (see **Table 5.1**). Although the YoY growth in tax receipts during Jul-Apr FY09 is moderately higher than the 16.3 percent rise

**Table 5.1: FBR Tax Collection (Jul-Apr)**

billion Rupees

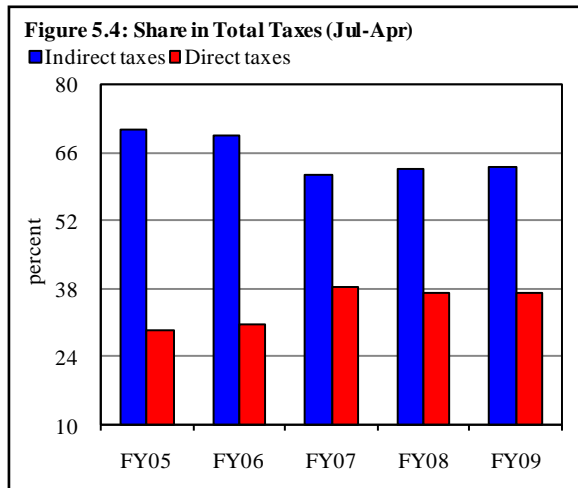
	Net collection			YoY change (%)		Percent of annual target		
	FY07	FY08	FY09	FY08	FY09	FY07	FY08	FY09
Direct taxes	25.9	284.6	332.5	12.5	16.9	95.5	70.3	66.6
Indirect taxes	403.6	479	566.1	18.7	18.2	70.8	77.3	75.4
Sales tax	245.8	293.7	358.9	19.5	22.2	71.5	78.3	76.4
FED	54.7	70.6	90.0	28.9	27.6	79.3	77.5	80.4
Customs	103.1	114.8	117.2	11.4	2.1	65.4	74.6	69.3
<b>Total</b>	<b>656.5</b>	<b>763.6</b>	<b>898.6</b>	<b>16.3</b>	<b>17.7</b>	<b>78.6</b>	<b>74.5</b>	<b>71.9</b>

Source: Federal Board of Revenue

experienced in the corresponding period of FY08, monthly trend projects a deceleration in FBR tax collections for the entire fiscal year 2008-09 (see **Figure 5.1**). Even if FBR is able to arrest the downtrend in the growth of tax collection during the remaining months of FY09, the current pace of increase in tax receipts falls short of the 24.1 percent YoY growth required to attain Rs 1250 billion annual budget target for FY09.

As a percent of annual target, total tax collection stood at 71.9 percent by end April 2009. Importantly, 74.5 percent and 78.6 percent of the annual budget targets were achieved in the same period of FY08 and FY07 respectively. It merits mentioning here that the FBR tax collections fell short by Rs 17.8 billion in FY08. To still achieve FY09 target of Rs 1250 billion would require FBR to amass almost 28 percent of the target amount in the remaining two months; indicating that the revenue target for FY09 will be hard to achieve keeping in view the prevailing economic conditions in the country.

Direct tax collection increased by 16.9 percent YoY to reach Rs 332.5 billion during Jul-Apr FY09 against the FY09 annual budget target of Rs 499.0 billion. On the other hand, indirect taxes registered a growth of 18.2 percent during Jul-Apr FY09 compared to 18.7 percent in the same period last year. As a result, the rise in the share of indirect taxes in total tax receipts continued for the second consecutive year (see **Figure 5.4**).



**Figure 5.4).**

#### 5.4 Domestic Debt

The stock of domestic debt rose by Rs 484.4 billion during Jul-Mar FY09 compared to Rs 433.0 billion in the corresponding period last year (see **Table 5.2**). The increase in absolute flows of domestic debt in Jul-Mar FY09 is despite a fall in government

**Table 5.2 : Key Developments of Domestic Debt**

billion Rupees

	Jul-Mar	
	FY08	FY09
Growth in domestic debt (percent)	16.7	14.8
Absolute	433.0	484.4
Of which		
Long term	111.5	198.3
Short term	321.6	286.1
Domestic debt stock (end-Mar)	3,033.7	3,750.5

budgetary borrowing from domestic sources during this period. The apparent disconnect is explained by strong buildup of government deposits due to large inflows from domestic as well as external sources.

### Composition of Domestic Debt

With a net addition of Rs 44.0 billion, the outstanding stock of permanent debt went up by 7.2 percent in Jul-Mar FY09. The breakup analysis reveals that this rise stemmed largely from receipts from Ijara Sukuk bond (see **Table 5.3**). The government fetched Rs 27.8 billion through three successful auction of Ijara Sukuk Bond during Jul-Mar

FY09. Although the government received Rs 25.9 billion through three PIB auctions during Jul-Mar FY09, huge repayments to the commercial banks on the matured stock of PIBs reduced net receipts to only Rs 9.7 billion.

Floating debt recorded a growth of 17.5 percent during Jul-Mar FY09 compared to 29.0 percent in the corresponding period last year. Deceleration in the growth of floating debt reflects the government's reduced reliance on the central bank for budgetary financing.

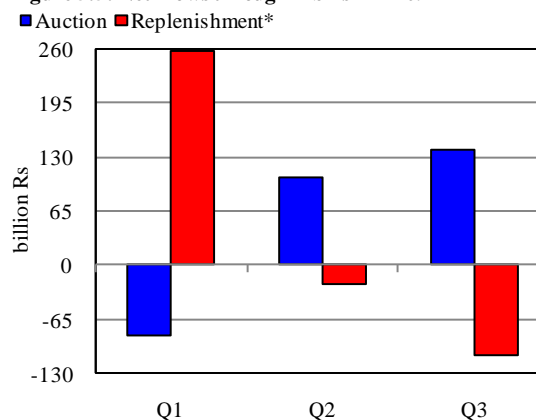
A notable development in floating debt is the shift in the ownership profile of the T-bills. The outstanding stock of T-bills (auction) increased by 29.6 percent in Jul-Mar FY09, as commercial banks' interest in government paper revitalized (see **Figure 5.5**). This preference for T-bills developed as increase in credit quality risks coupled with reduced demand for bank credit from the private sector produced a large decline in credit extended to the private sector. On the other hand, the stock of T-bills for replenishment went up by 11.5

**Table 5.3: Gross & Net Receipts of Major Permanent Debt Instruments (Jul-Mar)**

billion Rupees

	FY08		FY09	
	Gross	Net	Gross	Net
PIB	68.8	57.5	25.9	9.7
Ijara sukuk	-	-	27.8	27.8
Prize bonds	78.5	8.7	75.8	7.0
Others	0.0	-11.9	0.0	-0.5
Total	147.4	54.3	129.5	44.0

**Figure 5.5: Net Flows through T-bills in FY09**

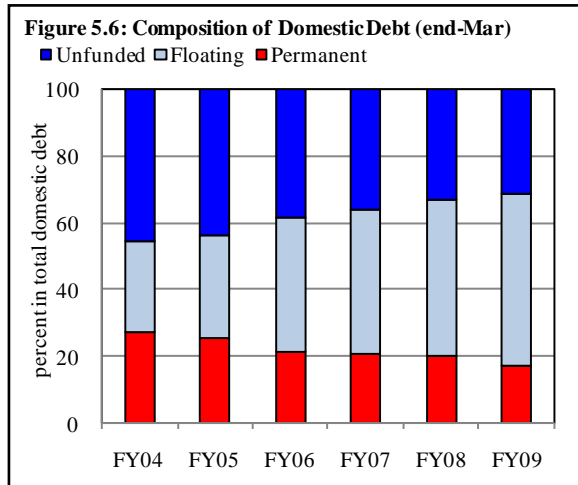


\*Inclusive of outright sale of MTBs to commercial banks



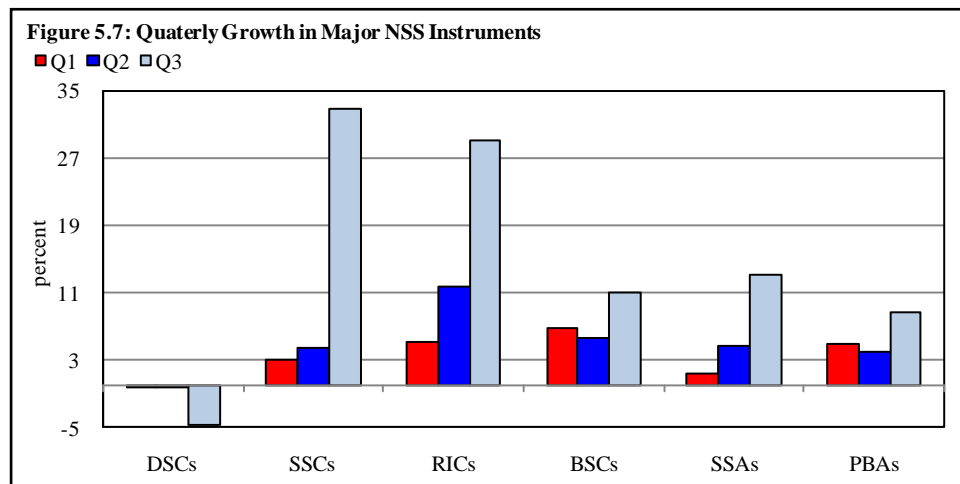
percent in Jul-Mar FY09, compared to a rise of 87.1 percent in the same period of FY08.

Even with a 11.5 percentage point decline in its growth, floating debt still represents the largest component in the stock of domestic debt as on March 31<sup>st</sup> 2009. Irregular and sparse issuance at the longer tenor has resulted in a persistent decline in the share of permanent debt, in total domestic debt, since FY04. Notably, the share of permanent debt declined to 17.4 percent as on end March 2009 compared to 20.0 percent a year earlier. Similarly, the share of unfunded debt in total domestic



debt decreased by 1.6 percentage points, despite a sizeable growth of 15.1 percent during Jul-Mar FY09. Consequently, the share of floating debt in total domestic debt increased by 4.2 percentage points during Jul-Mar FY09 (see **Figure 5.6**).

Quarterly growth in major NSS instruments reveal significant improvement in all but DSC since Q2-FY09 (see **Figure 5.7**). Although gross sale of BSC was substantially higher in Jul-Mar FY09, huge repayments pushed back net



investment from this instrument to a lower level. Net inflows through SSC remained unusually high in Q3-FY09 with net addition of Rs 39.6 billion in March 2009 alone. This exceptional increase probably reflects institutional investment by one public sector organization on the expectation of immediate cut in the rate of return.

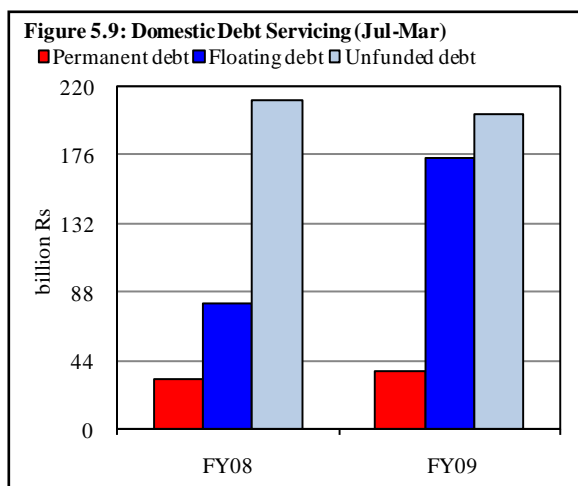
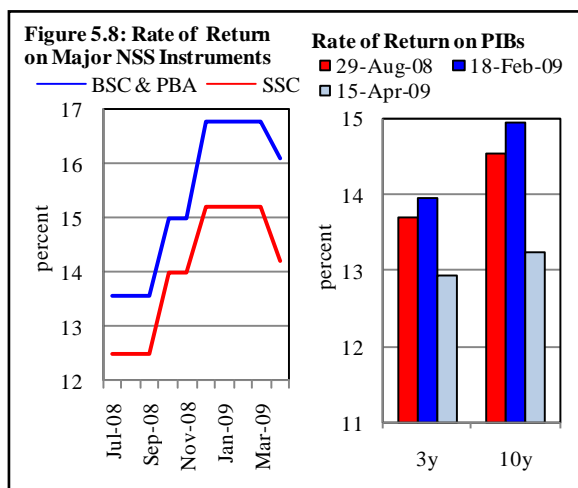
Banks' increased willingness to finance government budgetary requirements coupled with the recent fall in

interest rates on long term government paper has made possible for the federal government to cutback the profit rates on major NSS instruments by 70-140 basis points with effect from 1<sup>st</sup> April 2009 (see **Figure 5.8**).<sup>3</sup>

#### Domestic Debt Servicing

During Jul-Mar FY09, debt servicing cost of the domestic debt increased by 27.2 percent YoY to reach Rs 412.2 billion. A break up of domestic debt servicing data shows that the servicing cost of the permanent debt has moved in tandem with its outstanding balance. The cost of unfunded debt still constitutes the single largest component in total domestic debt servicing (see **Figure 5.9**), even though its share has declined to 49 percent in Jul-Mar FY09 from 65.2 percent in the same period of FY08.

In contrast, the share of floating debt servicing in total domestic debt servicing jumped to 42.1 percent in Jul-Mar FY09 from 24.8 percent in the



<sup>3</sup> The tenor of BSC and PBA is ten year, while that of SSC is three year.

same period last year. This seems to be consistent with the rise in the stock of floating debt since FY08 coupled with the hikes in interest rates.

## 6 External Sector

### 6.1 Overview

The improvement in Pakistan's overall external account, which emerged in November FY09, continued in the subsequent months as well. A large part of this improvement during Nov-Apr FY09 is attributed to continued contraction in current account deficit, as revival in financial inflows remained limited mainly on account of global financial crises (see **Table 6.1**). For the aggregate July-Apr FY09, however, overall external account deficit showed sizeable deterioration, as surplus generated in Nov-Apr FY09 could offset only a small part of the deficit incurred in the initial four months.

**Table 6.1: Summary of External Accounts**

billion US Dollar

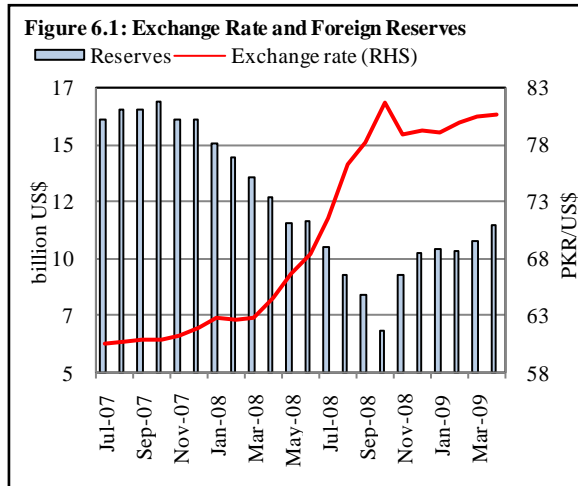
	Jul-Apr		Nov-Apr	
	FY08	FY09	FY08	FY09
A- C/A balance	-11.2	-8.55	-8.2	-2.5
i) Trade balance	-12.3	-10.8	-9.0	-4.9
Exports	16.4	16.0	10.2	8.8
YoY growth (%)	16.9	-2.6	16.3	-13.2
Imports	28.7	26.8	19.2	13.8
YoY growth (%)	28.5	-6.8	43.2	-28.2
ii) Invisible balance	1.1	2.2	0.8	2.4
Remittances	5.3	6.4	3.2	4.0
B- Financial/capital balance	6.3	3.6	2.5	2.7
i) FDI	3.7	3.2	2.1	1.9
ii) FPI	0.1	-1.0	-0.2	-0.8
iii) Other investment	2.4	1.3	0.5	1.6
C- Errors & omissions	0.4	0.3	1.0	0.2
D- Overall balance	-4.5	-4.6	-4.8	0.4

Contraction in current account deficit during July-Apr FY09 largely reflects fall in imports and strong rise in remittances. Fall in imports, in turn, mainly owes to both fall in aggregate demand as a result of monetary tightening and exchange rate depreciation as well as the impact of lower import prices. In particular, imports declined by 6.8 percent during July-Apr FY09 against the strong increase of 28.5 percent during the corresponding period last year.

Nonetheless, fall in exports amid deepening global recession and intensifying domestic power shortages together with substantial fall in earnings on foreign exchange reserves adversely impacted the contraction in current account deficit during the period under review.

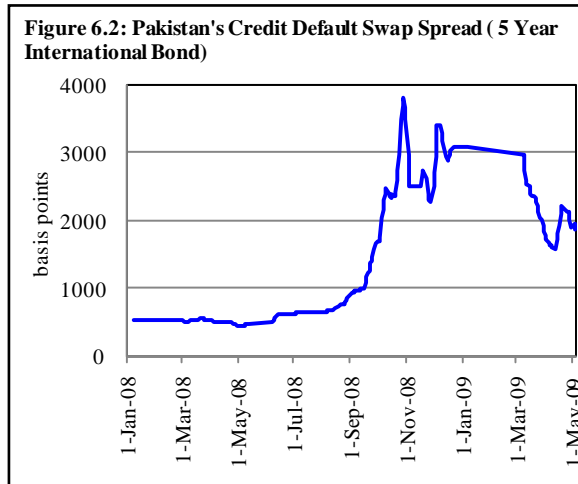
Unlike the improvement in current account, capital & financial account deteriorated sharply during July-Apr FY09. This deterioration was contributed by a fall in both investment and loan inflows. While loan inflows revived to large

extent after IMF support for macroeconomic stabilization program, foreign investment inflows continued their declining trend in the wake of worsening global financial crises. Indeed, even the improvement in financial flows principally reflects higher bilateral and multilateral receipts in contrast to significant share of private investment inflows in the previous two years.



The revival of loan inflows together with contraction in current account deficit in the post-IMF support period allowed an increase in foreign exchange reserves and stabilized exchange rate (see **Figure 6.1**). Consequently, credit default swap spread on Pakistan's five year bond also dropped (see **Figure 6.2**). However, the spread is still well above historical norms.

Notwithstanding these improvements, there are some emerging trends which are worrisome. While pressures emanating from commodity price shock have subsided, the falling growth in Pakistan's major export markets (US & EU) is hurting Pakistan's exports (see **Figure 6.3**). Likewise, the ongoing financial crisis has reduced foreign investment inflows to Pakistan (see **Box 6.1**). Moreover, job losses in source countries also poses downside risks to hitherto strong workers' remittances inflows.



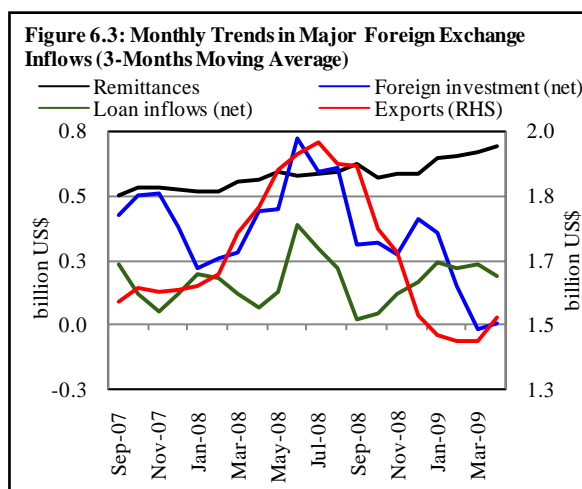
Besides fall in foreign inflows monthly trends also show compositional change in these inflows. With the fall in investment inflows, Pakistan's reliance on loan to finance current account deficit has increased (see **Figure 6.3**). The rising share of

debt creating flows in overall capital flows does not bode well for external account sustainability in the medium to long term.

It may be pointed out that external debt have increased rapidly in the last two years. In particular, Pakistan's external debt and liabilities has increased to around US\$ 50.1 billion by end Mar FY09 from US\$ 40.5 billion at end FY07.

With the anticipation of a more severe and longer global recession (see **Box 6.2**), chances of notable recovery in foreign inflows (exports and investment) remain dim in the months ahead. In this backdrop, there is need to devise a comprehensive strategy to mitigate the adverse impacts of ongoing external shocks.

In particular, after significant curtailment of import demand by macroeconomic policy tools, there is need to address the underlying causes of weakness in external accounts. For example, investment in infrastructure like power sector, manpower is critical for not only promoting exports but also attracting foreign investment. Similarly, efforts to diversify exports from advanced countries to emerging economies may also moderate the falling exports. In the same way, exports can also be promoted by channeling foreign investment inflows in the export oriented industries. Restoring law and order situation is another area which would help in attracting both the foreign buyers and investors.



#### Box-6.1: Recession in Developed Countries and Its Impact on Emerging and Developing Economies

The global financial turmoil and deepening recession in the developed countries is affecting the emerging economies through two major channels i.e. trade channel and capital inflows channel. In the former, falling prices and demand for emerging economies' exports is hampering their export growth while in the latter capital flows to emerging economies have fallen considerably.

Besides falling prices and demand, reduced trade financing has also adversely impacted exports of most of the emerging economies. Obtaining trade financing has become difficult as trade insurers,

like monolines, have cut back on their activities in the wake of excessive amount of troubled assets on their balance sheets.

As a result, export growth from emerging economies have considerably slowed down in 2008 (see **Figure 6.1.1**). With the expectations of further deepening recession in advanced economies, IMF in its recent World Economic Outlook has projected exports from emerging and developing economies to fall by more than 7.0 percent during 2009.

In addition to trade channel, global financial crunch have substantially reduced private capital flows to these economies. Specifically, while foreign direct investment is showing resilience, portfolio and other capital flows are witnessing reversal (see **Figure 6.1.2**).

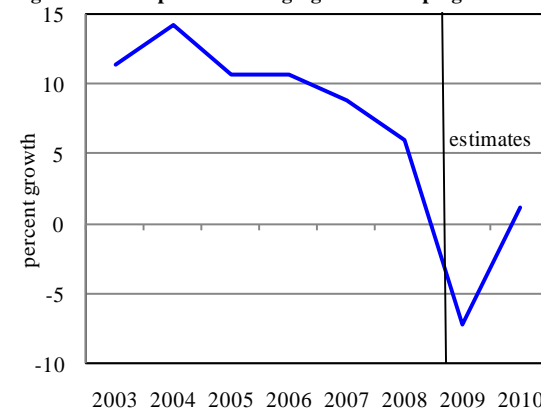
Outflow of other capital mainly reflects outflows from banks in the face of sudden stop in cross border lending and parent bank curtailed financing to emerging market subsidiaries.

IMF Global Financial Stability Report projects that falling trend in capital flows to emerging economies is expected to further strengthen in 2009. The reports further says that foreign direct investment to these economies is set to decline owing to a) diminished appetite of private equity firms, b) lack of credit available to finance acquisitions, and c) declining cyclical growth prospects in emerging economies. Likewise, outflows from portfolio and other investment are also likely to strengthen given the acute degree of stress in mature markets.

In line with the international trend, Pakistan is also impacted by the ongoing recession in the developed countries through these two channels. Specifically, a significant part of the sharp slowdown in Pakistan's exports can be attributed to the current recession in its major export markets.

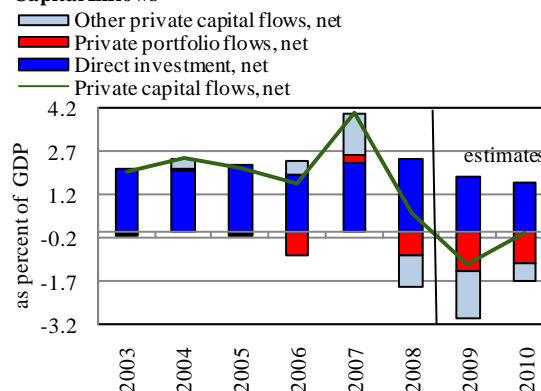
Similarly, global financial crunch has drastically reduced private capital flows to Pakistan. Composition of capital flows to Pakistan suggest that portfolio and other investment inflows are the worst hit. However, composition of other investment flows is different in Pakistan compared with most of other emerging economies. While other capital outflows in many emerging economies are

**Figure 6.1.1: Export of Emerging and Developing Economies**



Source: World Economic Outlook Data Base

**Figure 6.1.2: Emerging and Developing Economies' Private Capital Inflows**



Source: World Economic Outlook Database

driven by sudden stops in bank borrowing from abroad, Pakistan's banks have limited exposure to borrowing from abroad. Thus, fall in other investment inflows in Pakistan is mainly explained by lower public and private sector loan inflows.

#### **References**

*IMF Global Financial Stability Report, April 2009*

#### **Box-6.2: Global Recession is Likely to Deepen in 2009**

Intensified global financial crises and low confidence in financial markets has pushed the global economy to the deepest recession in the post-Great Depression period. While the US economy suffered from financial strains and continued fall in housing sector, the Western Europe and advanced Asia has mainly been hit by fall in global trade. The emerging economies, on the other hand, suffered badly through both trade and financial channels.

The uncertainty over losses on the bad assets and low confidence in the financial markets suggests the financial strains to last longer than previously envisaged. For instance, IMF in its Global Financial Stability Report (April 2009) has further increased the estimate of write downs on US originated assets by all financial institutions over 2007-10 from US\$ 2.2 trillion in January 2009 to US\$ 2.7 trillion in April 2009.

As a result, IMF in its World Economic Outlook (April 2009) has revised downward its initial projections (January, 2009) for the global economy. With across the board contraction in advanced economies, global economy is now projected to contract by 1.3 percent during 2009. Likewise, emerging economies are projected to sharply slowdown to 1.6 percent in 2009 from 6.1 percent in 2008.

The severity and duration of the ongoing recession is in line with the findings of literature on the subject. The empirical work on the recessions suggests that recessions associated with financial crises tend to be unusually severe and their recoveries are typically slow. For instance, Claessens, Stijn, M. Ayhan Kose, and Macro Terrones, (2008) comprehensively analyzed the behavior of key macroeconomic and financial variables around recessions, credit crunches and asset price busts for 122 recessions in 21 OECD countries over the 1960-2007 period. Their research shows that recessions which are associated with credit crunches and house price busts are deeper and longer than other recessions. Specifically, output losses are two to three times greater than the recessions without financial crunches.

#### **References**

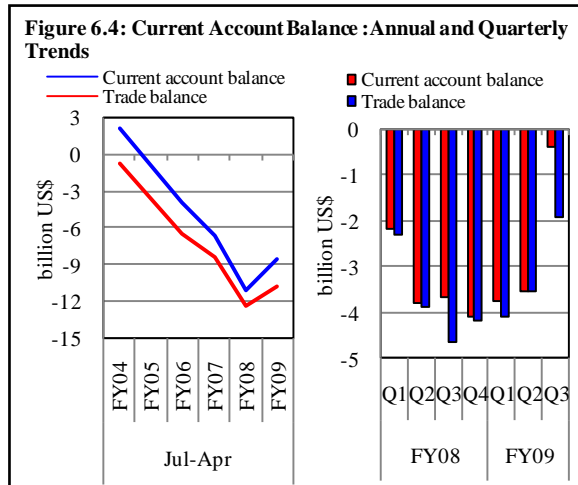
1. Claessens, Stijn, M. Ayhan Kose, and Macro Terrones, 2008, "What Happens During Recessions, Crunches, and Busts? IMF Working Paper 08/274.
2. IMF World Economic Outlook, April 2009

### **6.2 Current Account Balance**

Contraction in current account deficit which started in the second quarter of FY09 gained momentum in the following quarter (see **Figure 6.4**). Consequently, current account deficit in Q3-FY09 was the lowest in the last fourteen quarters. In particular, current account deficit for July-Apr FY09 contracted by 23.5 percent against the substantial expansion of 68.6 percent in the comparable period last year.



In line with the past trend, contraction in current account deficit during July-Apr FY09 was mainly driven by a fall in trade deficit (see **Figure 6.4**). Specifically, close to 58 percent of the contraction in current account deficit was contributed by fall in trade deficit while the remaining was contributed by increase in invisible surplus. Reduction in trade deficit was entirely driven by a fall in imports while increase in invisible surplus was largely contributed by strong increase in remittances and higher logistic support receipts.



With lower import prices and falling demand pressures along with resilience of remittance inflows and expectations of more logistic support receipts, contraction in current account deficit is likely to continue in the remaining months of FY09. However, further weakening in export growth amid deepening global recession may hamper improvement in current account deficit, to some extent, in the months ahead. Consequently, current SBP forecasts indicate that current account deficit to GDP ratio will decline to 5.0 to 5.5 percent in FY09, compared to 8.4 percent in the previous year.

### 6.2.1 Trade Account<sup>1</sup>

In sharp contrast to the 48.2 percent expansion in July-Apr FY08, the trade deficit contracted by 12.3 percent in July-Apr FY09. With the fall in exports, all of reduction in trade deficit was contributed by fall in imports.

Exports declined by 2.6 percent during July-Apr FY09 as against 16.9 percent increase in the corresponding period last year. Declining export prices and lower demand from recession hit export markets, domestic power shortages and poor law and order situation were the major contributory factors behind this dismal

<sup>1</sup> This section is based on exchange record data compiled by SBP that does not tally with the Custom data compiled by FBS due to inclusion of freight and insurance costs in the latter imports, difference in coverage, time and leads & lags involved in recording time etc.

export performance. On the other hand, 6.8 percent fall in the import bill during July-Apr FY09, largely reflected a fall in import prices and falling domestic demand pressures in the wake of a tight monetary policy and exchange rate depreciation.

### 6.2.2 Services (net)

Deficit in services trade declined by 41.3 percent during Jul-Apr FY09 against considerable expansion of 42.0 percent in the comparable period last year. Close to 90.0 percent of this reduction was contributed by fall in services imports while remaining 10.0 percent emanated from increase in services exports during the period.

Growth in services exports during the period largely reflected higher logistics support receipts and increase in foreign earnings of Pakistan's air companies (see **Table 6.2**).

Fall in services imports, on the other hand, was mainly caused by lower outflows from foreign exchange companies. As mentioned in the previous reports, outflows from foreign exchange companies have declined drastically after their outward remittances were restricted to 75 percent of their remittances mobilization during the preceding month.<sup>2</sup>

**Table 6.2: Detail of Services Trade (Jul-Apr)**

million US Dollar

<b>Major sources of increase in services exports</b>		
	<b>FY08</b>	<b>FY09*</b>
Transportation	858.0	1,002.0
Other business services	354.0	386.0
Government services	864.0	927.0
<i>of which: Logistic support</i>	282.0	465.0
<b>Total</b>	<b>2,672.0</b>	<b>2,914.0</b>
<b>Major sources of decrease in services imports</b>		
	<b>FY08</b>	<b>FY09</b>
Travel	1,340.0	907.0
<i>of which: Payments through exchange cos.</i>	1,074.0	632.0
Other business services	2,975.0	1,367.0
<i>of which: Payments through exchange cos.</i>	2,220.0	506.0
<b>Total</b>	<b>8,165.0</b>	<b>6,137.0</b>
* Provisional		

<sup>2</sup> For detail see FE circular No. 04 of 2008, dated May 09, 2008.

**Table 6.3: Current Account Balance**

million US Dollar

	FY08		FY09*	
	Jul-Apr	Nov-Apr	Jul-Apr	Nov-Apr
<b>1. Trade balance</b>	<b>-12,313.0</b>	<b>-8,995.0</b>	<b>-10,794.1</b>	<b>-4,931.0</b>
Exports	16,402.0	10,168.0	15,980.5	8,825.0
Imports	28,715.0	19,163.0	26,774.6	13,756.0
<b>2. Services ( net )</b>	<b>-5,493.0</b>	<b>-3,383.0</b>	<b>-3,223.0</b>	<b>-1,497.0</b>
Transportation	-2,056.0	-1,351.0	-1,953.0	-966.0
Travel	-1,113.0	-743.0	-721.0	-183.0
Communication services	12.0	-11.0	-5.0	1.0
Construction services	-13.0	-11.0	-34.0	-29.0
Insurance services	-90.0	-37.0	-63.0	-47.0
Financial services	-110.0	-92.0	-93.0	-59.0
Computer & information services	8.0	14.0	52.0	22.0
Royalties and license fees	-63.0	-25.0	-70.0	-53.0
Other business services	-2,621.0	-1,660.0	-981.0	-392.0
Personal & cultural & recreational services	2.0	2.0	2.0	2.0
Government services	551.0	531.0	643.0	207.0
of which: Logistic support	282.0	282.0	465.0	100.0
<b>3. Income ( net )</b>	<b>-3,090.0</b>	<b>-1,863.0</b>	<b>-3,612.0</b>	<b>-2,157.0</b>
Investment income( net )	-3,097.0	-1,869.0	-3,624.0	-2,165.0
Direct investment	-2,587.0	-1,522.0	-2,697.0	-1,573.0
of which: Profit & dividends	-546.0	-284.0	-501.0	-278.0
Purchase of crude oil and minerals	-1,226.0	-740.0	-1,403.0	-846.0
Portfolio investment	-204.0	-116.0	-362.0	-208.0
of which: Dividends	-189.0	-149.0	-155.0	-106.0
IMF charges & interest on official external debt	-532.0	-390.0	-525.0	-377.0
Interest on private external debt	-169.0	-114.0	-93.0	-45.0
Others (net)	402	279	65	46
<b>4. Current transfers ( net )</b>	<b>9,723.0</b>	<b>6,011.0</b>	<b>9,082.0</b>	<b>6,041.0</b>
Private transfers	9,296.0	5,603.0	8,936.0	5,990.0
Workers' remittances	5,317.0	3,238.0	6,356.0	4,011.0
FCA - residents	351.0	148.0	-230.0	85.0
Others	3,628.0	2,217.0	2,810.0	1,894.0
of which: Exchange companies	2,040.0	1,296.0	247.0	72.0
Official transfers	427.0	408.0	146.0	51.0
<b>Current account balance</b>	<b>-11,173.0</b>	<b>-8,230.0</b>	<b>-8,547.1</b>	<b>-2,544.0</b>
<b>Monthly average</b>	<b>-1,396.6</b>	<b>-2,057.5</b>	<b>-1,068.4</b>	<b>-636.0</b>

\* provisional

### 6.2.3 Income (net)

Deficit in net income increased by 16.9 percent during July-Apr FY09 compared to a nominal increase of 6.6 percent in the same period last year (see **Table 6.3**). While a large part (71.1 percent) of this deterioration was contributed by a fall in earnings on foreign exchange reserves, higher payments on account of purchase of crude oil and minerals also contributed considerably (33.9 percent). Fall in earnings on foreign exchange reserves is mainly the function of the lower foreign exchange reserves, while increase in purchase of crude oil and minerals probably reflects higher extraction.<sup>3</sup>

Compared with the same period last year, repatriation of profit and dividends on foreign investment remained lower during July-Apr FY09 (see **Table 6.4**). This fall largely reflected lower profitability of financial business and communication. Lower profitability of the former mainly owed to fall in bank profits in the wake of slowdown in the economy and rising non-performing loans while fall in the latter was mainly because of sharp fall in PTCL's profit owing to its Voluntary Separation Scheme.

**Table 6.4: Sector-wise Repatriation of Profit and Dividends (Jul-Mar)<sup>1</sup>**  
million US Dollar

	FY08			FY09 <sup>2</sup>		
	FDI	FPI	Total	FDI	FPI	Total
Petroleum refining	47.9	7.0	54.9	58.5	12.8	71.3
Oil & gas explorations	26.5	34.0	60.5	20.8	42.9	63.8
Power	110.8	15.7	126.5	133.7	7.4	141
Trade	10.7	7.1	17.8	56.5	3.6	60.1
Communications	78.9	9.2	88.1	39.5	5.2	44.7
Financial business	39.3	17.1	56.4	27.1	16.5	43.5
Others	140.6	42.5	183.1	115.8	24.8	140.7
<b>Total</b>	<b>454.8</b>	<b>132.4</b>	<b>587.2</b>	<b>452.0</b>	<b>113.1</b>	<b>565.1</b>

<sup>1</sup> Jul-Apr FY09 data is not available.

<sup>2</sup> provisional

### 6.2.4 Current Transfers

In sharp contrast to 15.1 percent growth in the first ten months of last year, current transfers declined by 6.6 percent during July-Apr FY09. With 19.5 percent YoY rise in workers' remittances, fall in current transfers was mainly the result of lower other private transfers and outflow from Resident Foreign Currency Accounts (RFCAs). Lower other private transfers, in turn, entirely emanated from fall in foreign exchange companies inflows.<sup>4</sup>

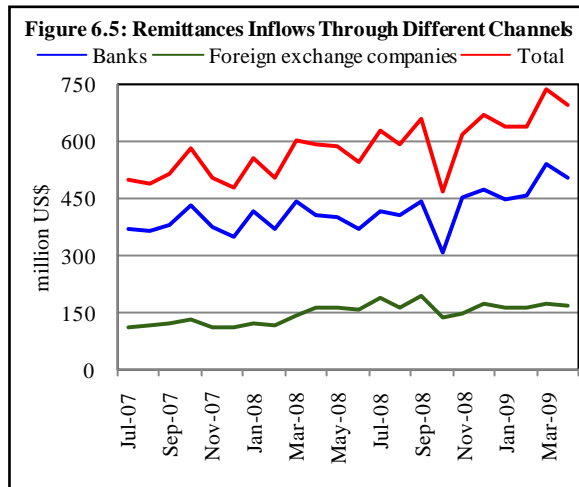
<sup>3</sup> Anecdotal evidence suggests that increased payments on account of purchase of crude oil and minerals, despite the fall in crude oil prices, mainly reflects a) higher share of gas in total purchases and b) increase extraction of oil and gas.

<sup>4</sup> As these inflows are contra entry of foreign exchange companies outflows (recorded in services account), they have no impact on current account balance.

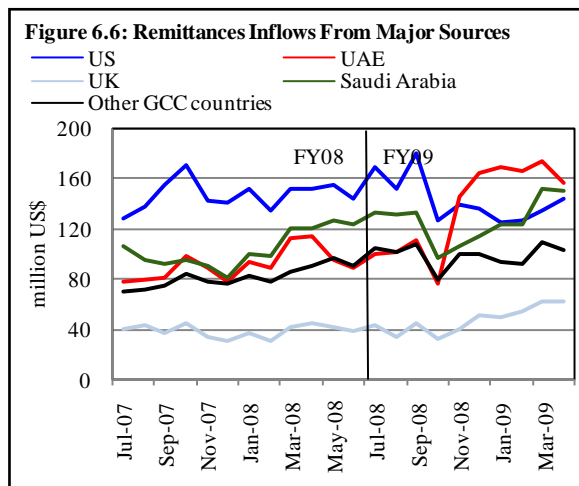
### Workers' Remittances

Remittances flows continued rising for the fifth successive year. In particular, remittances recorded YoY growth of 19.5 percent during July-Apr FY09 on the top of 19.5 percent growth in the corresponding period last year. However, the composition and sources of remittances flows in the current year were slightly different from that of the previous years. For instance, increase in remittances during July-Apr

FY09 largely owed to higher inflows through banking channel in contrast to higher inflows through exchange companies during the same period last year. Likewise, remittances growth in the first ten months of current fiscal year is largely contributed by Gulf region (88.8 percent) while almost all the regions contributed to remittances growth in the comparable period last year.



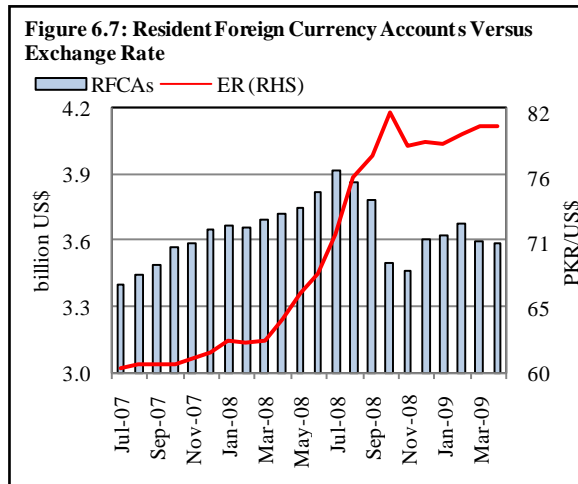
This change is more pronounced in the monthly trends. For example, after October FY09 remittances flows through banking channel increased considerably, while remittances flows routed through exchange companies remained stagnant (see **Figure 6.5**). As mentioned in the earlier report,<sup>5</sup> this change coincided with the action against undocumented fund transfers. Thus it may be argued that this action might have diverted some of the funds to banking channels which were earlier being transferred through undocumented channel.



<sup>5</sup> For detail, see SBP Second Quarterly Report for 2008-09.

Similarly, country-wise monthly data shows that after October FY09, remittances flow sourced from Gulf region (in particular United Arab Emirate) increased rapidly, while it declined from United States (see **Figure 6.6**).

A part of this sharp rise in remittances from UAE may be attributed to possible diversion of funds transfer from undocumented channel to documented channel and a part to the possible reverse capital flight to Pakistan. Decline in remittances flows from US, on the other hand, may be attributed to (a) economic recession and subsequent job losses and (b) some of the migrants might have withheld funds for the time being owing to the possibility of further crackdown against other exchange companies.

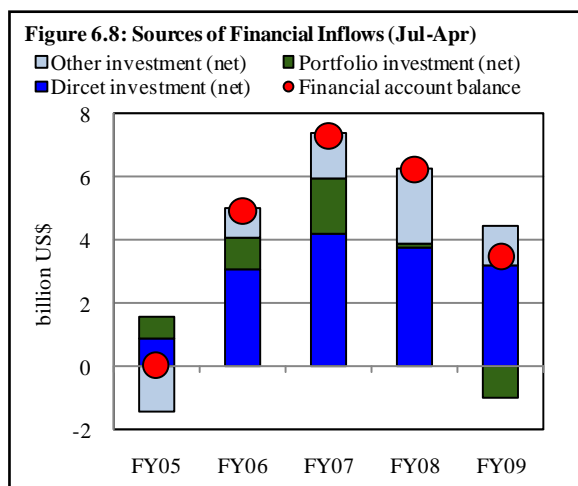


### Resident FCAs

Resident foreign currency accounts recorded net outflow of US\$ 230 million during July-Apr FY09 in contrast to net inflow of US\$ 351 million in the same period last year. Monthly trend suggests that a major chunk of this net outflow took place during October FY09 in the wake of substantial depreciation of exchange rate and rumors of possible freezing of currency accounts. However, with the stability in exchange rate in the subsequent months, resident foreign currency accounts recovered considerably (see **Figure 6.7**).

### 6.3 Financial Account

After sharp rise in FY06 and FY07, financial account surplus declined considerably from



FY08 onwards (see **Figure 6.8**). In particular financial account surplus declined by 44.1 percent during July-Apr FY09, compared to 14.8 percent fall a year earlier. Part of this deterioration is attributed to risk averse behavior of foreign investors in the face of global financial crisis and a part to domestic factors such as poor law and order situation, weakening domestic growth prospects, large economic imbalances and weak performance of stock market.

Nonetheless, IMF support for macroeconomic stabilization program has helped in reviving some of the financial inflows (net). For instance, this support has not only significantly decelerated retirement against FE-25 loans, a function of exchange rate stability, but also helped in increasing loan inflows from other sources. However, investment inflows continued falling even after this support, probably because of the deepening global financial crisis.

Looking ahead, while ongoing financial crisis is likely to maintain its downward pressure on investment inflows, loan inflows could further strengthen if pledges (worth US\$ 5.28 billion) made in Friends of Democratic Pakistan (FODP) conference materialize.

### 6.3.1 Net Foreign Investment

As in the previous year, net foreign investment declined sharply during the current year. Specifically, foreign investment inflows fell by 42.7 percent during July-Apr FY09 on the top of 35.0 percent fall recorded in the corresponding period last year. Like previous year, both the lower inflows in foreign direct investment and net outflows from portfolio investment, contributed to this decline (see **Table 6.5**). As mentioned earlier, substantial recovery in foreign investment inflows is subject to the normalization of international financial market conditions and improvement in Pakistan's macroeconomic indicators.

**Table 6.5: Net Inflow of Foreign Investment in Pakistan (Jul-Apr)**  
million US Dollar

	FY08	FY09	Growth (%)
<b>Foreign investment</b>	<b>3,862.5</b>	<b>2,212.9</b>	<b>-42.7</b>
<b>I. Private investment</b>	<b>3,818.0</b>	<b>2,753.9</b>	<b>-27.9</b>
Foreign direct investment	3,719.1	3,205.4	-13.8
<i>of which: Privatization proceeds</i>	<i>133.2</i>	<i>0</i>	<i>-</i>
Portfolio investment	98.9	-451.5	-556.5
Equity securities	98.9	-451.5	-556.5
Debt securities	0	0	0.0
<b>II. Public investment</b>	<b>44.5</b>	<b>-541</b>	<b>-1,315.7</b>
<i>of which: Debt securities*</i>	<i>44.5</i>	<i>-541</i>	<i>-1,315.7</i>

\* Net sale/purchase of Special US Dollar Bonds, Eurobonds, FEBC, DBC, T bills and PIBs

### Foreign Direct Investment

Foreign direct investment declined by 13.8 percent during July-Apr FY09 against 11.0 percent decline in the comparable period last year.

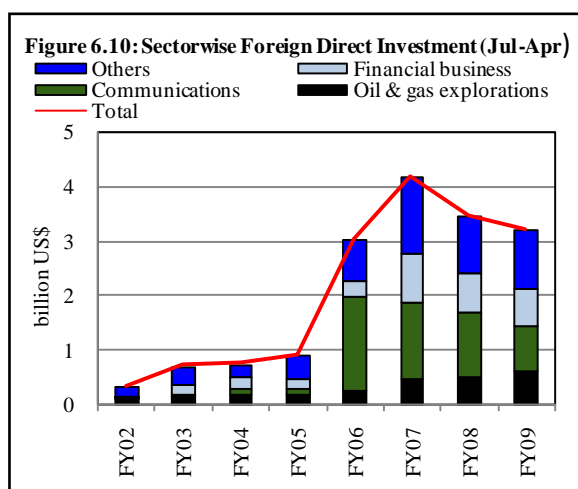
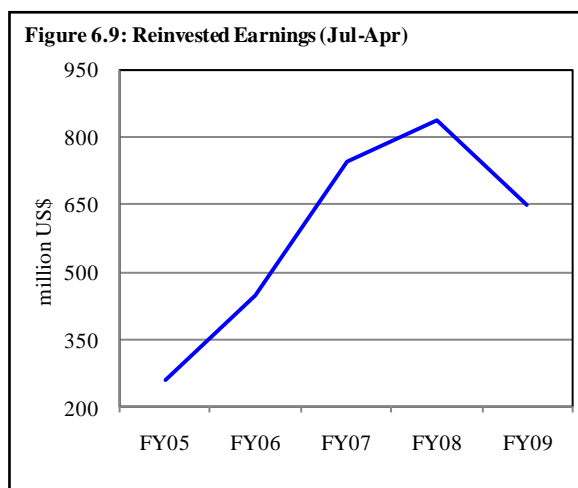
This decline may be attributed to a combination of factors such as worsening law and order situation, absence of privatization proceeds, fall in reinvested earnings in the face of lower profitability and continued global liquidity constraints.

Specifically, around 36.6 percent of the decline in foreign direct investment was driven by fall in reinvested earnings

during the period. It may be pointed out that reinvested earnings fell first time in July-Apr FY09 after rising continuously in the last five years (see **Figure 6.9**). Fall in reinvested earning, in turn, was contributed by lower profits and higher losses. For example, reinvested earnings of financial business fell on account of lower profits of banks while that of power sector witnessed net outflow mainly due to losses of KESC.

Absence of privatization proceeds, on the other hand, accounted for 25.9 percent of the fall in foreign direct investment during the period under review.

Sector wise data shows that a large part of the decline in foreign direct investment during July-Apr FY09 period emanated from financial business and communication sectors. It may be mentioned here that these two sectors along with





traditional oil & gas exploration sector accounted for a major chunk of investment inflows during the boom period (FY05-FY07). Thus with the absence of a congenial international and domestic environment, these sectors witnessed large decline in foreign investment (see **Figure 6.10**). Nonetheless, investment in oil & gas exploration continued its rising trend in July-Apr FY09 as well.

Other major sectors, which witnessed decline in foreign investment during July-Apr FY09, included cement, transport equipments (automobiles) and tourism. On the other hand, power, food packaging and petroleum refining were the major sectors which attracted higher investment inflows during the period.

#### **Foreign Portfolio Investment**

Foreign portfolio investment recorded net outflow of US\$ 1.0 billion during July-Apr FY09, against net inflow of US\$ 142 million in the corresponding period last year. This largely reflects outflows from stock market on account of risk averse behavior of foreign investors and maturing Eurobond worth US\$ 500 million.

Country-wise data suggests that close to 70 percent of the outflow from stock market during the period originated from USA, which is worst hit by ongoing financial crises (see **Table 6.6**).

**Table 6.6: Country-wise Investment in Stock Market (Jul-15 May)**

million US Dollar

	Inflow	Outflow	Net
Australia	9.9	22.9	-13.0
Chile	20.9	9.9	11.0
Hong Kong	60.1	84.3	-24.2
Luxembourg	30.1	19.4	10.7
Mauritius	1.2	0.0	1.2
Singapore	9.6	47.2	-37.6
Switzerland	44.9	91.0	-46.1
UAE	24.0	10.5	13.5
UK	66.9	169.0	-102.0
USA	275.7	673.3	-397.5
Others	23.3	15.2	8.1
<b>Total</b>	<b>566.7</b>	<b>1,142.7</b>	<b>-576.0</b>

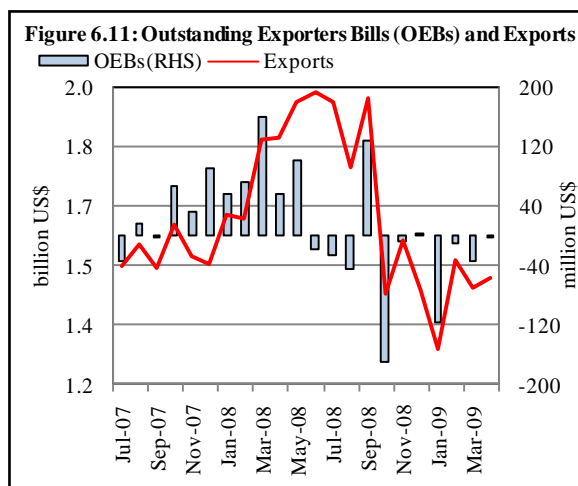
#### **6.3.2 Outstanding Export Bills**

Against increase of US\$ 432 million in the same period last year, aggregate stock of outstanding export bills declined by US\$ 532 million in July-Apr FY09. This decline largely owed to weak export growth (see **Figure 6.11**). Moreover, exchange rate stability post SBA and the central bank tight monitoring of overdue outstanding export bills might also have discouraged the deferral of export proceeds.

### 6.3.3 Currency and Deposits (Assets)

Currency and deposits declined by US\$ 64 million during July-Apr FY09 compared with the decline of US\$ 1375 million in the corresponding period last year. This was mainly because of a fall in banks assets.

It may be pointed out that under new methodology<sup>6</sup> bank assets also include trade Nostros along with FE-25 Nostros. While FE-25 Nostros increased on account of retirement of FE-25 loans, fall in trade Nostros more than offset the increase in the former during July-Apr FY09.



### 6.3.4 Official Long Term Loans

Despite higher amortization, long term loans net inflow worth US\$ 718 million during July-Apr FY09 was considerably higher than that of US\$ 664 million in comparable period last year. Higher loan inflows mainly reflect US\$ 485 million from World Bank and US\$ 693 million from Asian Development Bank. Relatively higher amortization, on the other hand, mainly stemmed from payments of World Bank, Asian Development Bank and Islamic Development Bank.

### 6.3.5 Official Short Term Loans

Official short term loans recorded net repayment of US\$ 45 million during July-Apr FY09 against net withdrawals of US\$ 559.0 million in the comparable period last year. Major repayments during the period included US\$ 590 million of Islamic Development Bank and US\$ 150 million of other commercial loans. However, in Nov-Apr FY09, short term loans recorded net withdrawal of US\$ 292 million which are entirely sourced from Islamic Development Bank.

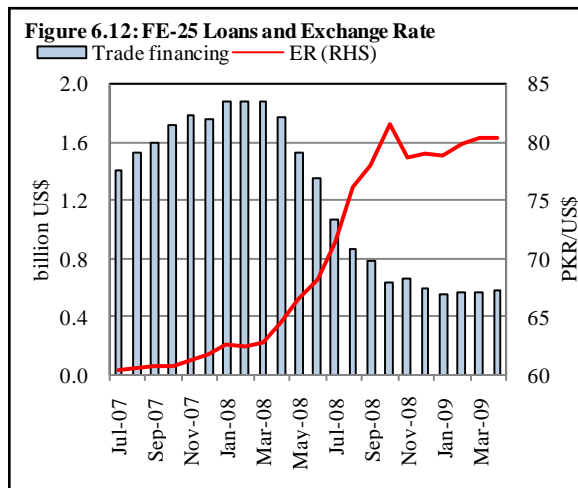
<sup>6</sup> Under the revised methodology, trade nostros are excluded from the claims of reserve assets of SBP and included in the bank assets.

### 6.3.6 Private Loans

Net inflow in private loan increased to US\$ 529 million during July-Apr FY09 from US\$ 262 million in the same period last year. More than 90 percent of this net inflow was witnessed after macroeconomic stabilization program at end October FY09 (see **Table 6.7**). Main contributors to the higher loan inflows during the period were Engro chemical, Warid Telecom, Mobilink and KESC.

### 6.3.7 Currencies and Deposits (liabilities)

Currency and deposits recorded net outflow of US\$ 440 million during July-Apr FY09 against the net inflow of US\$ 233 million in the same period last year. This net outflow largely reflects retirement of FE-25 loans by importers and exporters. A large part of this retirement took place during July-Oct FY09 amid sharp depreciation in exchange rate. However, with the macroeconomic stabilization program and stability in exchange rate, retirement of FE-25 loans have decelerated significantly in the subsequent months (Nov-Apr FY09) ( see **Figure 6.12**).



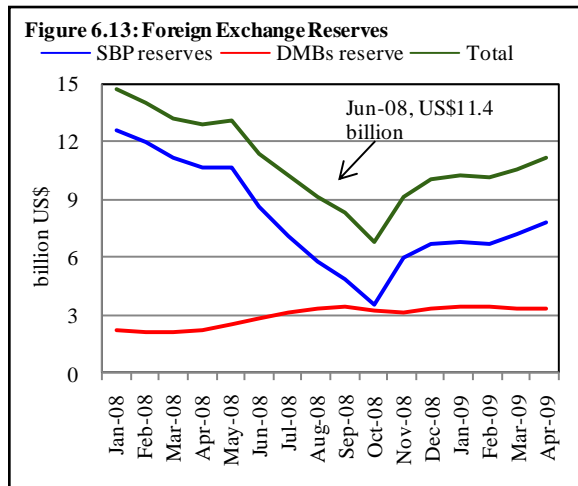
**Table 6.7: Financial Account**

million US Dollar

	<b>FY08</b>		<b>FY09*</b>	
	<b>Jul-Apr</b>	<b>Nov-Apr</b>	<b>Jul-Apr</b>	<b>Nov-Apr</b>
<b>Financial account (net )</b>	<b>6,224.0</b>	<b>2,434.0</b>	<b>3,476.4</b>	<b>2,657.4</b>
<b>Direct investment abroad</b>	<b>-41.0</b>	<b>-32.0</b>	<b>14.0</b>	<b>14.0</b>
<b>Direct investment in Pakistan</b>	<b>3,719.0</b>	<b>2,143.0</b>	<b>3,206.0</b>	<b>1,876.0</b>
Equity capital	2,882.0	1,627.0	2,557.0	1,571.0
of which: Privatization receipts	133.0	133.0	0.0	0.0
Reinvested earnings	837.0	516.0	649.0	305.0
<b>Portfolio investment</b>	<b>142.0</b>	<b>-169.0</b>	<b>-1,002.0</b>	<b>-821.0</b>
Equity securities	98.0	-244.0	-461.0	-296.0
Debt securities	44.0	75.0	-541.0	-525.0
<b>Net foreign investment</b>	<b>3,820.0</b>	<b>1,942.0</b>	<b>2,218.0</b>	<b>1,069.0</b>
<b>Other investment</b>	<b>2,404.0</b>	<b>492.0</b>	<b>1,258.0</b>	<b>1,588.0</b>
Assets	943.0	130.0	596.0	-41.0
1-Outstanding export bills (exporters)	-512.0	-467.0	286.0	170.0
2-Outstanding export bills (DMBs))	80.0	54.0	246.0	21.0
3-Currency and deposits	1,375.0	543.0	64.0	-232.0
of which: banks	1,269.0	505.0	-66.0	-333.0
Liabilities	1,461.0	362.0	662.4	1,629.4
1-Foreign long-term govt loans / credits ( net )	664.0	216.0	718.4	475.4
Project loans	929.0	484.0	638.4	378.4
Non- project loans	643.0	296.0	1,301.0	736.0
Amortization	908.0	564.0	1,221.0	639.0
2-Private loans	262.0	159.0	529.0	491.0
of which: Supplier credits	525.0	362.0	870.0	692.0
Suppliers credit repayments	263.0	203.0	341.0	201.0
3-Short term capital (official)	559.0	394.0	-45.0	292.0
of which: IDB (net)	675.0	410.0	55.0	292.0
4-Currency and deposits	233.0	2.0	-440.0	-16.0
5-Other liabilities	-307.0	-409.0	-100.0	387.0
* provisional				

## 6.4 Foreign Exchange Reserves

The relative improvement in Pakistan's external accounts was reflected in foreign exchange reserves, which recorded sustained improvement Nov 2008 onwards. Consequently by April 30 2009, foreign exchange reserves had climbed back to almost the end-June level of US\$ 11.4 billion after hitting a low of US\$ 6.8 billion in Oct 2008 (see **Figure 6.13**).



Both inflows and outflows in forex reserves of the country increased substantially during Jul-Apr FY09 compared to the same period last year (see **Table 6.8**).

The bulk of the outflow was as usual on account of forward swap maturities, SBP sales for oil and market support. During July-Apr FY09, however, the debt related payments and other miscellaneous payments were significantly higher than in corresponding period of the previous year.

Moreover, while outflows were particularly strong in the initial month of FY09, the inflows were concentrated mainly in the middle of the July-Apr period (see **Figure 6.14**). This mismatch in the inflows and outflows, along with expansion in the current account deficit during the period, resulted in sharp depletion of reserves and pressure on the exchange rate till Oct 2008. In later months, capital inflows from IMF and other donor agencies

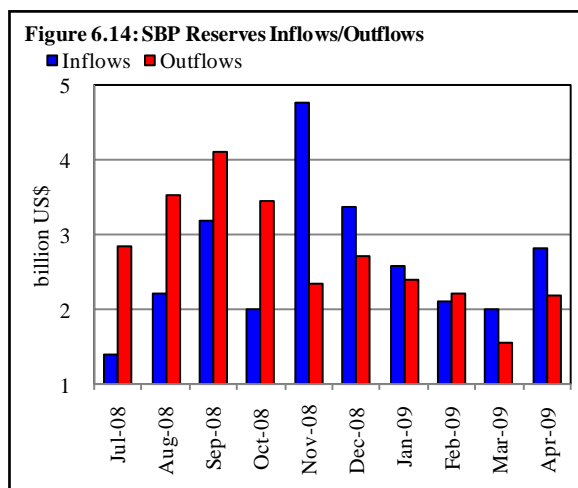
**Table 6.8: Major Inflows/Outflows from SBP Reserves**  
million US Dollar

	Jul-Apr	
	FY08	FY09
<b>Inflows</b>	<b>12,157.6</b>	<b>26,458.7</b>
Loans	1,975.4	5,984.8
Logistic support	281.7	465.5
Privatization proceeds	643.5	0.0
Miscellaneous receipts	161.4	1,309.1
<b>Outflows</b>	<b>15,777.5</b>	<b>27,296.7</b>
Debt servicing	1,015.1	1,822.0
Eurobonds	169.2	609.4
Wheat L/C - TCP	808.9	866.8
Miscellaneous payments	214.3	741.7

Source: DMMD

enabled SBP to build up reserves. This also alleviated pressures on the exchange rate, helping it to stabilize in the range of 78.8 and 80.8.<sup>7</sup>

While commercial banks' reserves also increased by US\$ 0.5 billion during July-Apr FY09, the increase in the overall foreign exchange reserves largely stemmed from the improvement in SBP reserves. These rose by almost 121.1 percent during Nov-Apr FY09, reaching US\$ 7.8 billion by end-Apr 2009, up from US\$ 3.5 billion at end October 2008 (see **Table 6.9**).



Major factors that contributed to SBP reserves accumulation

were long-term loans from donor agencies and the receipts under the logistic supports during July-Apr FY09. While the 79.5 percent YoY growth in debt servicing and payment for euro bond exerted downward pressure on the central bank reserves during the period under review (see **Table 6.8**).

The rise of US\$ 0.5 billion in the commercial banks' reserves owes largely to the retirement of foreign currency loans by traders that replenished the pool of foreign exchange reserves with commercial banks. During July-Mar FY09, trade financing decline to US\$ 0.6 billion against US\$ 1.3 billion as of end-June 08.

**Table 6.9: Foreign Exchange Reserves**  
million US Dollar

	Jun-08	Oct-08	Apr-09
<b>SBP</b>	8,577.0	3,529.7	7,805.2
<b>Commercial banks</b>	2,822.0	3,231.9	3,366.7
<b>Total</b>	11,399.0	6,761.6	11,171.9

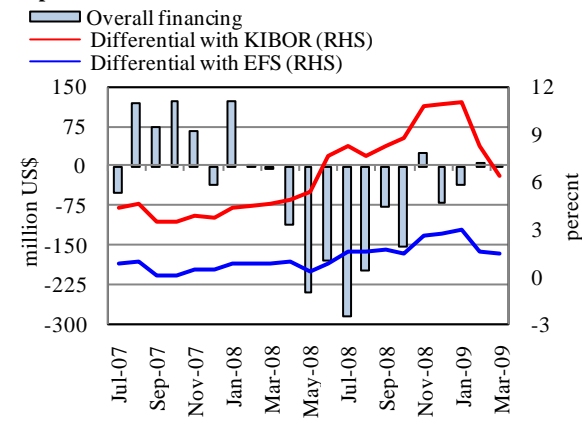
In the initial months of FY09, despite increased differential in WAFC (weighted average foreign currency) and local currency lending rates (both EFS and KIBOR) retirement of forex loans appears to stem from the expectations of the Rupee depreciation against US dollar, as retirement of these loans subsided with the stability in exchange rate Nov 2008 onwards (see **Figure 6.15**).

<sup>7</sup> Between Dec 1<sup>st</sup>, 2008 and Apr 30<sup>th</sup>, 2009.

### Reserve Adequacy

The import coverage ratio, one of the measures of reserve adequacy also recovered to 17.1 weeks of imports by end-Apr 2009. It may be recalled that reserves adequacy had dropped to mere 9.1 weeks in Oct 2008. Although this level is still lower than the average level of 25.6 weeks of imports recorded in FY08, it is nevertheless significant improvement over Oct 2008 position. This recovery in import coverage ratio owes to both, improvements in foreign exchange reserves as well as decline in import bill in the later months of July-Apr FY09 (see **Figure 6.16**).

**Figure 6.15: Trend in Overall Financing Through FE-25 Deposits**



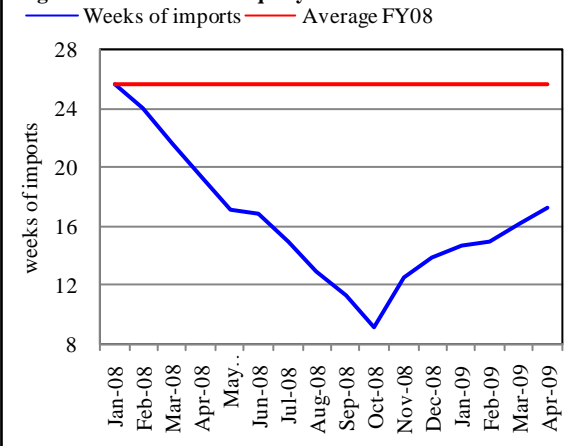
### 6.5 Exchange Rate

After depreciating by 13.3 percent during July-Nov FY09, rupee exhibited relative stability against US dollar during Dec-Apr FY09. As against the July-Nov period, rupee depreciation was limited to 2.2 percent in Dec-Apr period.

The post October 08 relative stability of the Pak rupee against US dollar mainly stemmed from (1)

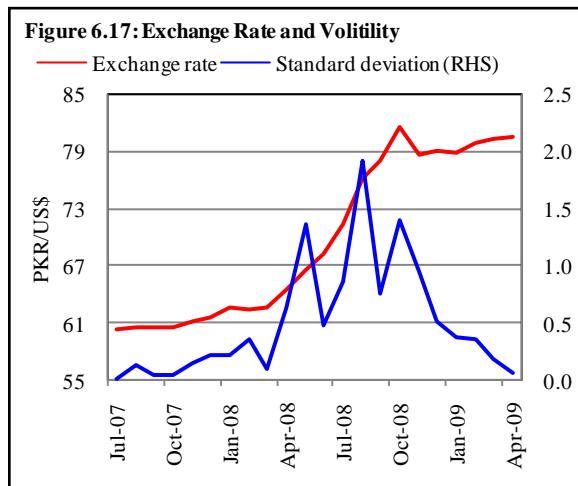
improvement in overall external balance, (2) consistent capital inflows, (3) crackdown on exchange companies involved in cross border smuggling of US dollar, and (4) SBP's interventions in the inter-bank market to reduce the volatility in the foreign exchange market. Furthermore, pledges from friends of Pakistan, and signals from the US of increase in the non-military aid have further calmed the foreign exchange market.

**Figure 6.16: Reserve Adequacy**



Consequently volatility (as measured by the deviations from the mean) in the exchange rate also declined significantly during the Nov-Apr period. Standard deviation dropped from 3.87 in July-Oct 2008 to 0.74 in the post Oct period (see **Figure 6.17**).

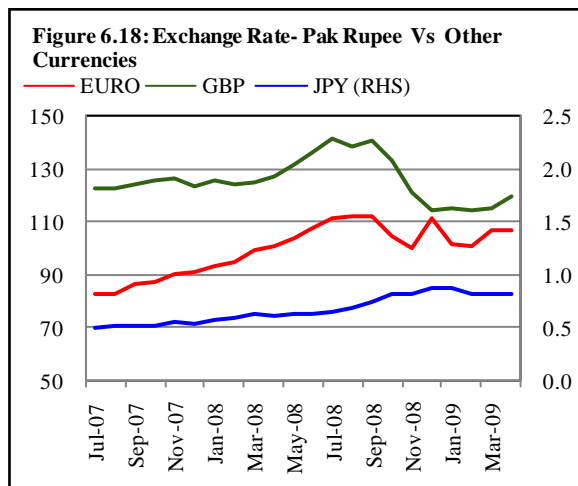
As against weak performance of the Pak rupee against the US dollar, Pak rupee showed relatively better performance against Euro and Pound. While against Japanese yen, Pak rupee depreciated significantly. During July-Apr FY09, Pak rupee appreciated by 0.6 percent and 14.2 percent against euro and pound respectively. On the other hand, Pak rupee depreciated by 22.1 percent against the Japanese yen (see **Figure 6.18**).



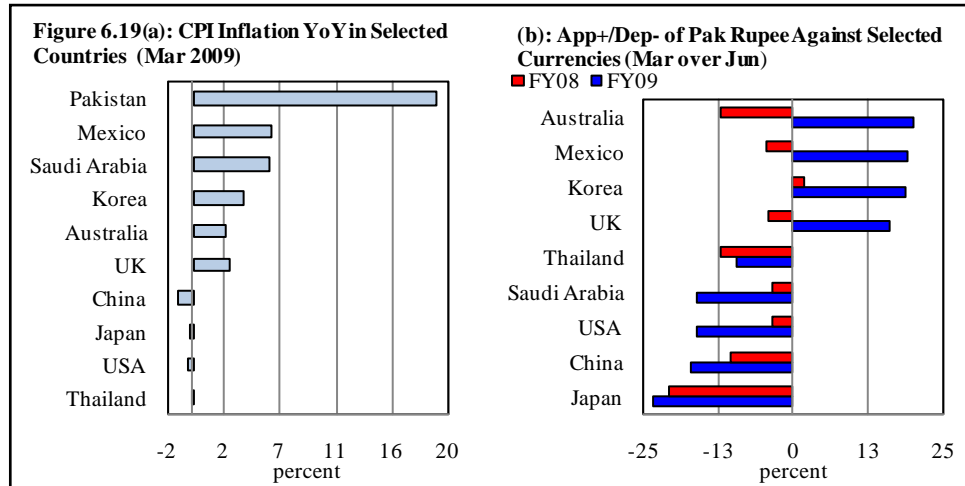
### Real Effective Exchange Rates

During July-Mar FY09, Nominal Effective Exchange Rate (NEER) depreciated by 6.4 percent as compared to 10.3 percent depreciation in the corresponding period of previous year. Since NEER is the weighted average exchange rate of basket of currencies, its overall value depends on the performance of the Pak rupee against the currencies of trading partner countries.

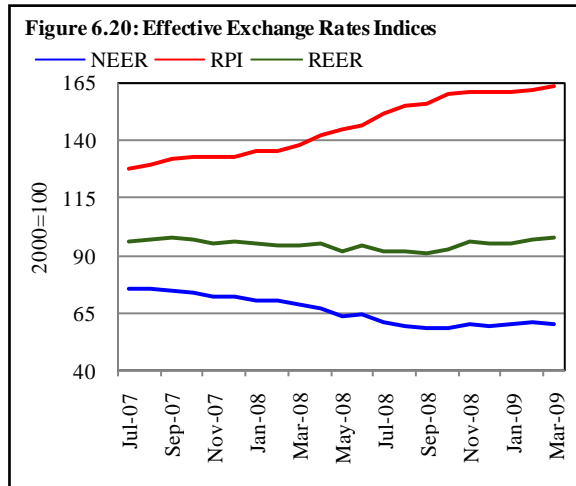
Pak rupee depreciated against more than half of the currencies in the basket of trading partners. Although rupee appreciated against some of its trading partner currencies but this was offset due to depreciation of Pak rupee against its major trading partners having relatively greater trade weights.





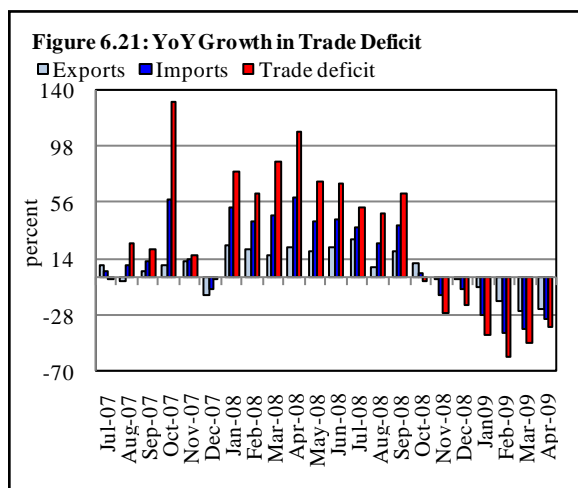


Movements in the Real Effective Exchange Rate (REER) are reflective of the cumulative movements in the NEER and Relative Price Index (RPI). The continuous rise in the domestic inflation compared to its trading partners resulted in the appreciation of the REER. Despite a sharp deceleration, domestic CPI inflation remained high as compared to CPI inflation in the major trading partners in recent months (see **Figure 6.19**). Therefore, due to 11.2 percent growth in RPI, REER appreciated by 4.1 percent by end-Mar 2009 relative to end-Jun 2008 (see **Figure 6.20**).

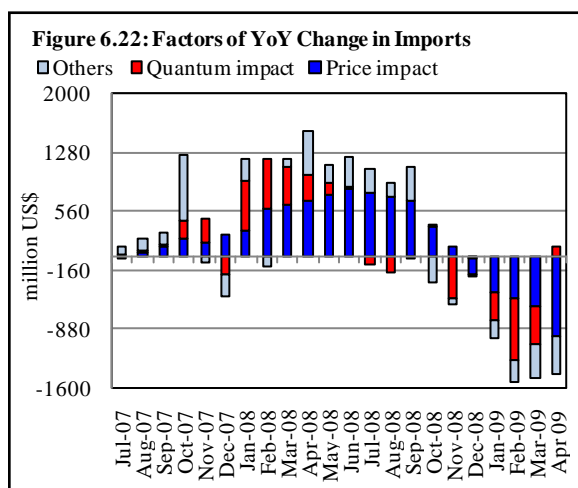


## 6.6 Trade Account

Pakistan's cumulative trade deficit recorded a significant 15.9 percent YoY fall, reaching US\$ 14.1 billion during July-Apr FY09 – the first time in seven years that trade deficit recorded a decline in the ten months period. This improvement was contributed by a 9.8 percent YoY fall in imports that more than offset 3.0 percent YoY fall in exports during this period. In fact country's trade account is witnessing a continuous improvement since October 2008; but, a larger share of this contraction was observed during the last four months, due to a sharp dip in imports (see **Figure 6.21**).



Contractionary fiscal and monetary policies, better domestic supply situation of some major import categories<sup>8</sup>, a large depreciation in the value of rupee and a general slowdown in economic activity all contributed to significantly squeeze import demand during July-Mar FY09. The effect of contracting demand was complemented by YoY fall in the import unit values from December 2008 (see **Figure 6.22**). The fall in import unit values, which became more pronounced in Q3-FY09, reflected the lagged impact of the sharp decline in international commodity prices from the start of FY09 (see **Table 6.10**). As the fall in import prices and quantum is likely to persist in the



<sup>8</sup> For instance raw cotton and fertilizer manufactured.

remaining months of FY09, the annual import bill is likely to record a significant YoY fall in FY09.

**Table 6.10: Average International Commodity Prices**

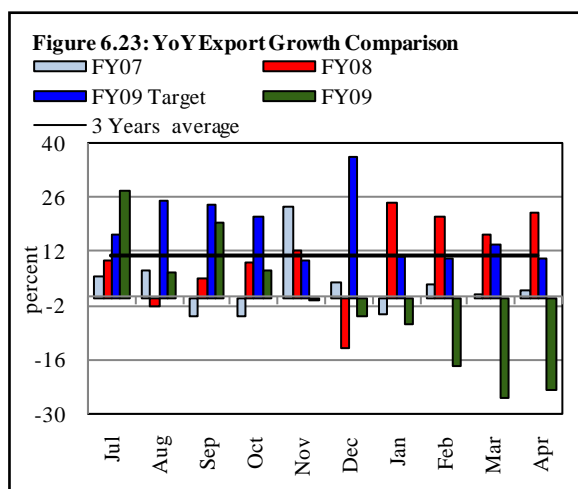
	Unit	FY08				FY09		
		Q1	Q2	Q3	Q4	Q1	Q2	Q3
Arabian light oil	US\$/barrel	71.3	85.2	93.7	117.2	113.8	54.9	38.8
Palm oil	US\$/MT	746.4	861.6	1,081.1	1,088.9	828.4	453.3	536.3
DAP	US\$/MT	432.5	522.1	860.2	1,191.6	1,153.7	663.3	362.2
Wheat	US\$/MT	274.9	341.9	411.4	346.5	317.7	228.1	231.7

In the case of exports, slackening external demand and various domestic issues, particularly the energy crisis, resulted in an accelerated YoY downturn in export growth since November 2008 (see **Figure 6.21**). In fact with the exception of rice and cement all major export categories recorded YoY decline during July-Mar FY09. These issues are likely to continue to hamper the YoY export growth during Q4-FY09 as well, leading to a moderate fall in exports for the whole of FY09.

On the whole, given the expectation that the decline in imports will be much larger than the fall in exports, the trade deficit is expected to continue to decline in the remaining months of FY09. Thus the overall, trade deficit for FY09 is likely to be much lower than that in FY08.

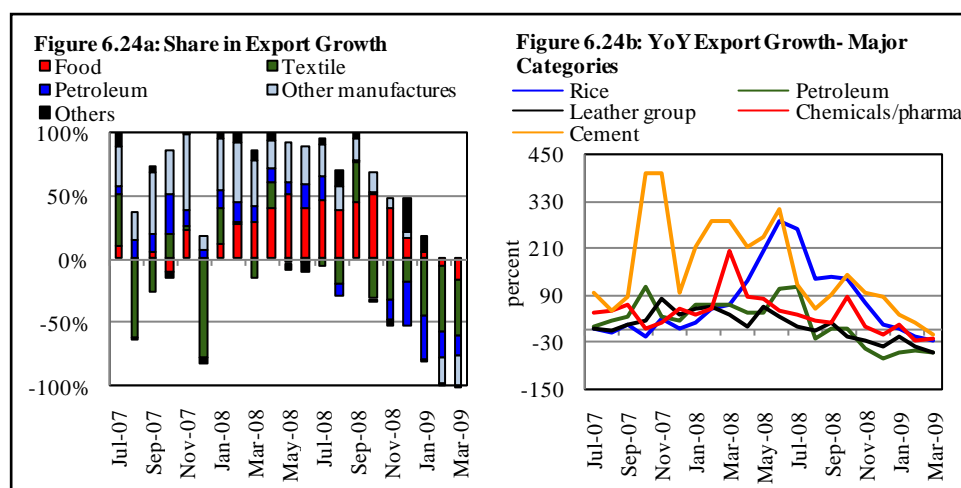
## Exports

A confluence of domestic and external factors suppressed YoY export growth to negative 3.0 percent during Jul-Apr FY09 as compared to a healthy 8.5 percent growth recorded during the same period last year. In terms of monthly performance, an accelerated deterioration started to emerge in export growth from November 2008, with growth in April 2009 being the lowest-ever since June 1997. In addition, exports remained



below the target level during Aug-Apr FY09 (see **Figure 6.23**). A comparison of Pakistan's export growth with that of some other regional countries, however, shows that country fared relatively better than some of other competitors, at least during H1-FY09. But from the start of CY09 with growing intensity of the various impediments faced by this sector the situation has started to worsen for Pakistan as well (see **Box 6.3**).

Analysis of export performance of the major categories reveals that domestic energy crisis, circular debt issue, worsening law and order situation, and government intervention in the rice trade were some of the major setbacks to the export sector. In addition, the political issues in the country that disrupted transportation of export goods further worsened YoY export growth in the month of April 09. The impact of these domestic impediments was complimented by deepening international recession from Q4-CY08, which further squeezed external demand for country's major exports.



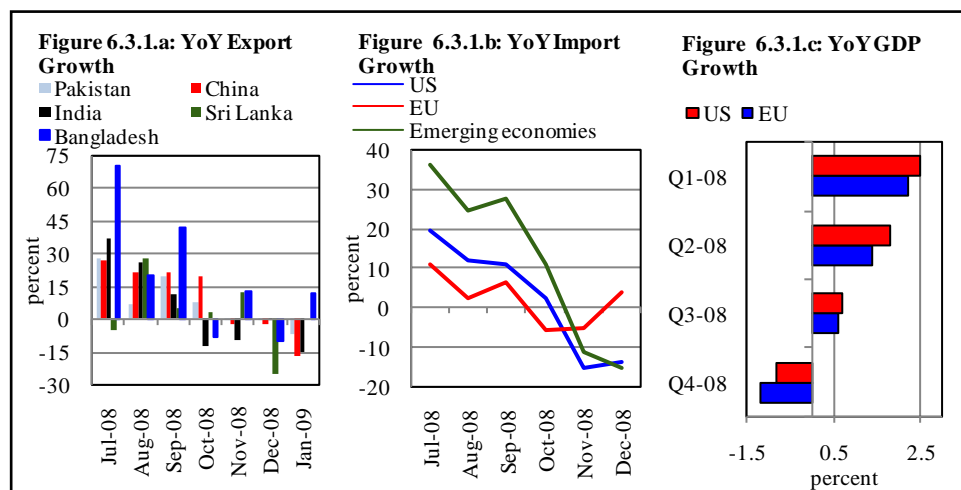
These factors resulted not only in worsening of textile export performance during July-Apr FY09, but they also moderated or even reversed the growth observed in some strong performing non- textile categories e.g., rice, petroleum products, leather, etc (see **Figure 6.24 b**). In overall terms, the largest declines were observed in the categories of textile and petroleum group, which overshadowed the growth recorded in food group and some categories of other manufactures (see **Figure 6.24a & Table 6.11**). The growth observed in the food group was also almost solely contributed by price impact in the rice export, as the quantum of rice exports has declined during Jul-Apr FY09.

**Box 6.3: Pakistan's Export Performance in Regional Perspective**

After displaying a decent performance during July-Oct FY09 Pakistan's exports are recording continued deterioration since Nov08. The average monthly YoY export growth that was as high as 15.4 percent in July-Oct FY09, fell to the level of -10.4 percent during Nov-Mar FY09. This lackluster export performance reflects the effect of both 1) falling external demand and 2) - worsening domestic issues, particularly the energy crisis.

However, a comparison of Pakistan's export performance with that of some other regional countries shows that Pakistan's exports are performing relatively better than some of its regional competitors. Global recession started taking its toll on developing countries exports from the last quarter of CY08. Resultantly, with a fall in developed countries GDP and imports from the last quarter of CY08, exports of most of the Asian economies witnessed YoY decline during this period (see **Figure 6.3.1a, b & c**).<sup>9</sup> This belief is also strengthened by a study of the Asian Development Bank (2009) which shows a strong positive correlation between developing Asia's exports and G3<sup>10</sup> non-oil imports.

In terms of the extent of the impact of weakening external demand, exports from China and India were more severely hit till January 2009<sup>11</sup> as compared to Pakistan, whereas Sri Lanka and Bangladesh were at relatively comfortable positions. This is evident from a steeper average 7.5 and 8.8 percent fall in China and India's exports during Nov-Jan 09 as compared to 2.9 percent fall recorded in Pakistan's exports during this period. The explanation to this fact lies in the analysis of composition of exports, which reflects that slowdown in exports is broad based with consumer durables and heavy manufacturing items, being the most severely hit categories (see **Figure 6.3.2.a**)<sup>12</sup>. This at least partially explains a greater fall in China and India's exports, as they have stronger market presence in these products.



<sup>9</sup> In view of Pakistan's export concentration in textile, this analysis includes those countries which are Pakistan's competitor in this category.

<sup>10</sup> G3 includes US, EU and Japan.

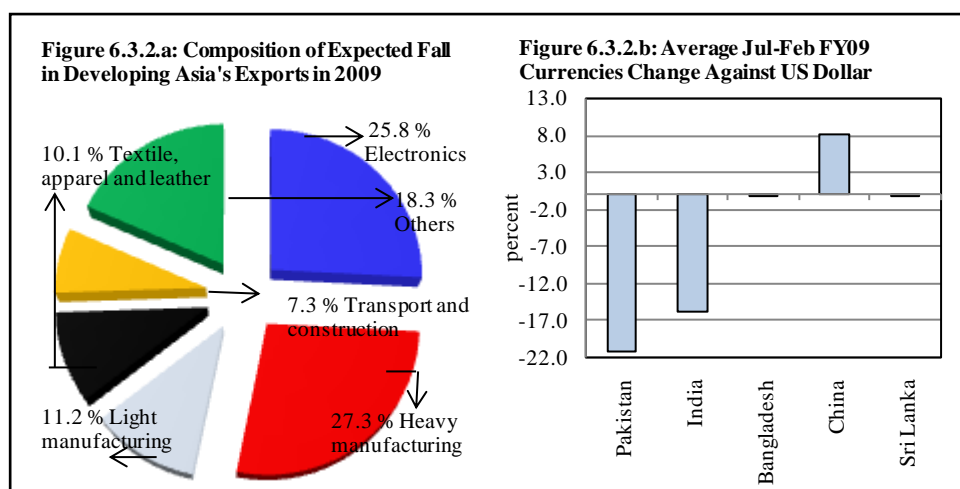
<sup>11</sup> Comparable data for India, China, Pakistan and Bangladesh is available till Jan 2009, while for Sri Lanka till Dec 2008.

<sup>12</sup> Source: Asian Development Outlook 2009: Rebalancing Asia's Growth.

In this scenario Pakistan's relatively comfortable position, emerged from a large depreciation of rupee against US dollar during July-Feb FY09, which bolstered country's export growth during this period (see **Figure 6.3.2.b**). However, from February 2009 Pakistan's exports have also started to record sharp YoY fall largely on the back of sharply falling textile exports. This implies that growing intensity of domestic issues have started to weaken textile sector's ability to face international competition. Further, reportedly textile and clothing demand has also started to undergo sharp contraction since the start of CY09. In the absence of data of other countries' comparative position cannot be analyzed for this period.

The global recession is likely to continue to squeeze export demand during 2009, as ADB (2009) forecasts major Industrial countries' GDP to undergo a 2.6 percent contraction during 2009. In this situation Pakistan seems to be at a weaker position due to a variety of domestic issues which are complementing the adverse impact of weakening external demand.

The current international recession has highlighted the risks attached to over dependence on developed countries as export markets have brought home the importance of greater export market



diversification. For Pakistan, this can be achieved by entering into FTAs and PTAs with other regional countries. In view of greater concentration of country's exports in textiles, country should attempt to acquire more access for its textile and clothing exports through these preferential arrangements. For the region as a whole this can be done by entering into some preferential regional arrangement aiming at increasing trade flow among Asian countries.

**Table 6.11: Major Exports (July-Apr)**

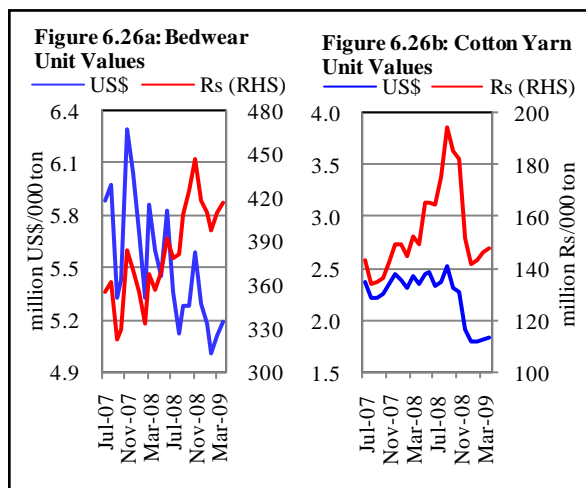
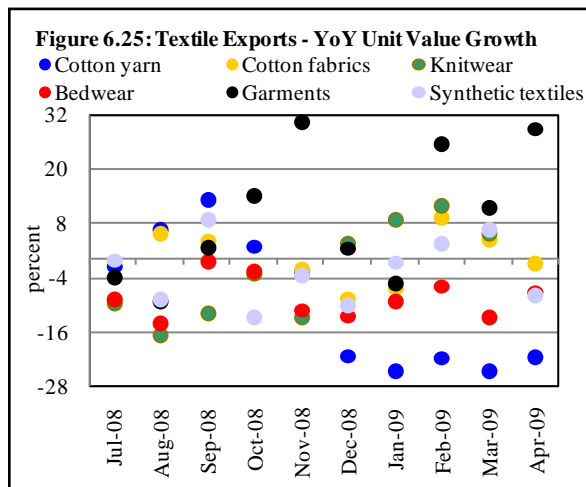
million US Dollar

	Units	FY08		FY09(P)		% YoY Δ			
		Value	Unit value	Value	Unit value	Abs.Δ value	Qty	Value	Unit value
<b>Food group</b>		<b>2,050.0</b>		<b>2,560.3</b>		<b>510.3</b>		<b>24.9</b>	
of which:									
Rice	MT	1,237.0	546.2	1,680.3	810.5	443.3	-8.5	35.8	48.4
<b>Textile group</b>		<b>8,706.4</b>		<b>7,898.9</b>		<b>-807.5</b>		<b>-9.3</b>	
of which:									
Cotton yarn	MT	1,082.9	2,324.7	909.9	2,120.1	-173.1	-7.9	-16.0	-8.8
Cotton fabrics	SQM	1,626.3	1,004.8	1,638.5	1,002.1	12.3	1.0	0.8	-0.3
Knitwear	DOZ	1,529.1	18.5	1,427.1	16.8	-102.6	3.2	-6.7	-9.6
Bed wear	MT	1,583.9	5,736.2	1,390.8	5,282.9	-193.1	-4.7	-12.2	-7.9
Towels	MT	500.7	4,074.0	517.0	3,674.1	16.3	14.5	3.3	-9.8
Readymade garments	DOZ	1,183.6	37.1	1,010.2	41.6	-173.4	-23.8	-14.7	12.0
Synthetic textiles	SQM	363.5	0.9	241.2	0.9	-122.3	-30.2	-33.6	-5.0
Other textile made-up		436.0	---	408.7	---	-27.3	---	-6.3	---
Other textile material		226.2	---	191.3	---	-34.9	---	-15.4	---
<b>Petroleum group</b>		<b>974.0</b>		<b>702.4</b>		<b>-271.6</b>		<b>-27.9</b>	
<b>Other manufactures group</b>		<b>2,926.2</b>		<b>2,938.8</b>		<b>12.6</b>		<b>0.4</b>	
of which:									
Chemicals and pharmaceuticals		499.9	---	509.7	---	9.8	---	2.0	---
Molasses	MT	37.5	64.1	85.5	102.0	48.0	43.3	127.9	59.1
Cement	MT	308.1	53.8	470.1	58.2	162.0	41.0	52.6	8.2
<b>Others</b>		<b>566.3</b>		<b>661.7</b>		<b>95.4</b>		<b>16.9</b>	
<b>Total exports</b>		<b>15,222.9</b>		<b>14,762.9</b>		<b>-460.7</b>		<b>-3.0</b>	

**Textile** exports have seen a steady YoY decline since October 2008 and recorded a large 9.3 percent YoY fall during July-Apr FY09. This weakness resulted from both, supply and demand side factors, as mentioned before. In addition to these factors liquidity constraints faced by this sector are also hampering its performance. This issue is originating from two channels. 1) - with the deepening global recession, international buyers are either opting for default or are increasingly demanding extension in payment periods; 2)- due to rising NPLs

banks have become more cautious in extending loans to textile companies. Composition of the fall: In terms of composition, this fall was recorded due to both falling quantum and unit values in almost all major categories, with the fall in the latter being greater. The unit values of most of the textile export categories recorded a decline almost throughout July-Apr FY09 (see **Figure 6.25**). This effect probably reflects the impact of falling external demand, to offset which exporters are lowering their export unit values.

In fact a large 15.2 percent depreciation in the value of rupee against US dollar during July-Apr FY09 has provided exporters some room for maneuvering. To retain their market shares they are sharing the depreciation gains with importers, by lowering their US dollar export unit values. While their rupee export unit values either remained at their last year's level or recorded increases (see **Figure 6.26a** & **Figure 26b**). Unlike some other competitors, this has so far enabled Pakistan's textile exports to resist a large fall in the major markets of US and the EU (see **Table 6.12**) in the face of weakening demand. Thus despite, a fall in the US Dollar unit values, rupee depreciation has supported rupee earnings of this sector.<sup>13</sup>



<sup>13</sup> In rupee terms textile sector recorded 14.7 percent YoY growth during July-Mar FY09.



Category-wise analysis: In terms of categories, during July-Apr FY09 the largest declines were recorded in *bed wear*, *cotton yarn* and *ready-made garments*. The decline in *bed wear* exports resulted from a sharp fall in demand in EU and the US markets. The bed wear imports of both of these destinations recorded large declines during CY08. Specifically, Pakistan is losing share to China in both of these markets (see **Table 6.13**), while, India is improving its market share in the *printed sheets* market segment of the US market by moving into higher value chain. Since January 2009, for Pakistan the competition has further increased in US market, because of the removal of safeguard restrictions imposed on China.

**Table 6.12: Textile & Apparel Export Performance - International Comparison**  
percent

	Textile		Apparel	
	FY08	FY09	FY08	FY09
<b>USA (Jul-Jan)</b>				
World	4.8	-8.9	-1.2	-3.4
Bangladesh	9.5	4.3	-0.8	15.4
China	10.3	-4.5	4.0	3.6
India	3.2	-2.4	-0.7	-4.8
Mexico	3.0	-18.2	-14.9	-10.7
Pakistan	-7.3	-3.3	-0.9	-1.4
Sri Lanka	5.5	-19.6	-11.2	-3.0
Turkey	12.3	-19.6	-29.5	-28.2
<b>EU (Jul-Dec)</b>				
World	4.4	-5.8	4.0	3.6
Bangladesh	13.0	5.7	-2.4	6.8
China	14.1	3.8	9.9	18.1
India	6.2	-8.8	3.4	3.1
Pakistan	9.0	-3.6	3.3	3.5
Turkey	1.1	-12.1	7.7	-14.8
Vietnam	8.7	-8.6	35.8	6.1

Source: US Census Bureau & Euro Stat

**Table 6.13: Bed Wear Exports Analysis**

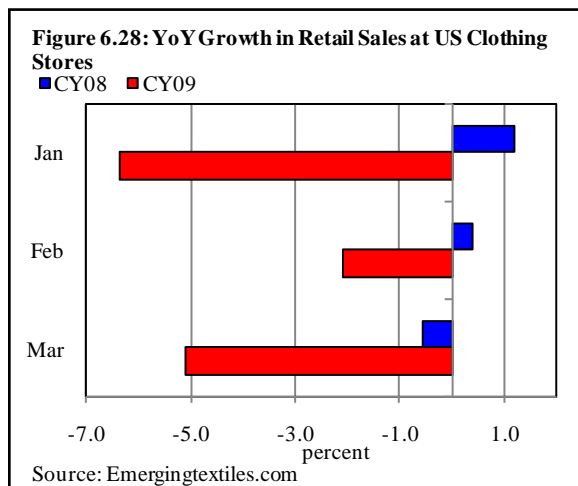
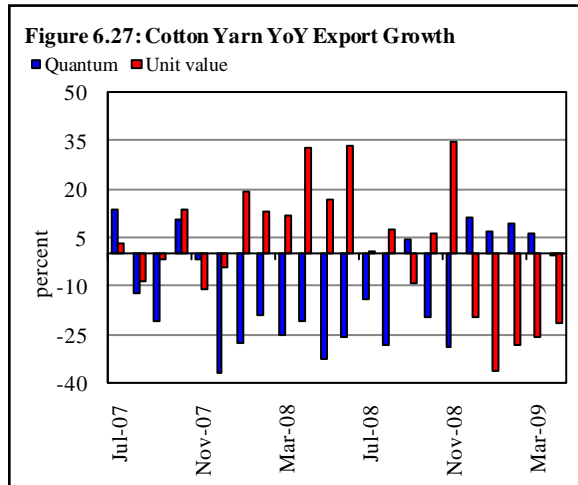
percent

	US market						EU market	
	Volume shares		Volume growth		Unit value growth		Value growth	
	CY05	CY08	CY07	CY08	CY07	CY08	CY07	CY08
<b>Printed sheets</b>								
World	100.0	100.0	9.9	-17.5	-5.4	3.2	17.7	2.7
Pakistan	48.9	45.9	1.1	-26.1	-1.5	-0.5	21.4	-0.5
China	15.0	28.0	19.7	7.5	-13.7	-1.1	77.0	41.8
India	9.0	6.6	57.0	-25.8	-8.1	22.3	-1.9	4.0
<b>Non-printed sheets</b>								
World	100.0	100.0	-28.0	-7.0	17.2	-4.9	17.9	-3.0
Pakistan	37.5	16.6	-56.6	-45.3	10.0	-15.8	55.0	7.1
China	27.4	46.3	-27.0	31.1	1.6	-14.1	24.5	12.2
India	4.7	10.0	67.0	-13.0	7.0	24.6	1.6	18.8

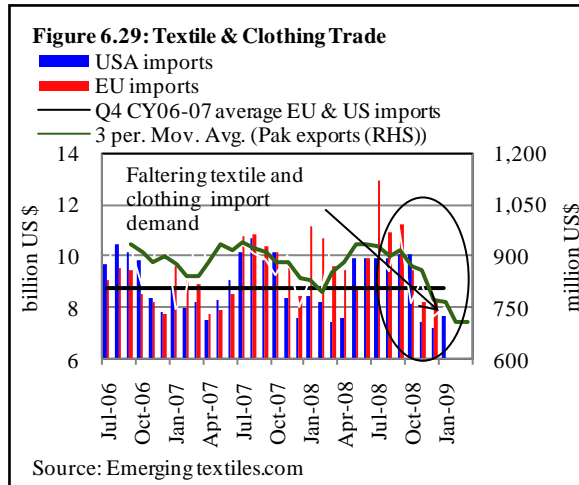
In the EU market, however, the situation is likely to improve after the removal of antidumping duty on Pakistan's bed wear exports in March 2009.

The fall in *cotton yarn* exports is attributable to lower demand both from the developed markets and the far eastern countries. In fact cotton yarn exports are recording quantum decline since FY08. This is due to falling demand for cotton products internationally. However, a small revival of demand has been witnessed since December 2008, which coincides with the fall in export unit values of this category (see **Figure 6.27**).

*Readymade garments* exports have been recording a decline in quantum since the start of FY09. This is attributable to intensifying domestic issues faced by exporters that led to reported switching of orders to other suppliers like China and India. In addition, the effect of domestic issues is being complimented by contracting external demand. A large (40 percent) share of country's garments exports is directed to the US market. With the deepening international recession, clothing demand is being worst hit in the US. This is confirmed from the available data for US clothing sales during Q3-FY09 (see **Figure 6.28**). This has probably led to further shrinking demand for country's garments exports resulting into a large fall in the export of this category.



Going forward, the competition faced by this sector is likely to stiffen further due to a steep fall in external demand. This belief is based on the analysis of monthly import trend of EU and US, which are Pakistan's major textile export markets. The textile and clothing imports of these countries undergo a seasonal contraction during the last quarter of each CY and bounce back in the first quarter of the subsequent year. In the period under review, however, the contraction observed during the last quarter of CY08 was steeper than the average of last two years, whereas the expected recovery was also not observed in January 2009<sup>14</sup> (see **Figure 6.29**). Thus the steep fall observed in Pakistan's textile export growth from October 08 is likely to continue.



On its part SBP has been taking various measures from time to time, to address the issues faced by textile sector.<sup>15</sup> However, in the absence of strong demand and persistence of structural issues, textile exports are likely to remain subdued for most part of CY09.

#### **Non-textile exports**

*Rice* is the most important non-textile export of the country. During July-Apr FY09 rice exports recorded an impressive 35.8 percent YoY rise mainly on account of higher export unit values. Though international rice prices are witnessing a downward slide since May 2008, on average these are still at a higher level than the FY08 average (see **Figure 6.30**). This difference materialized into US\$ 581.7 million price impact during July-Apr FY09.

<sup>14</sup> CY09 data is not available for EU, whereas for US this data is only available for Jan 09.

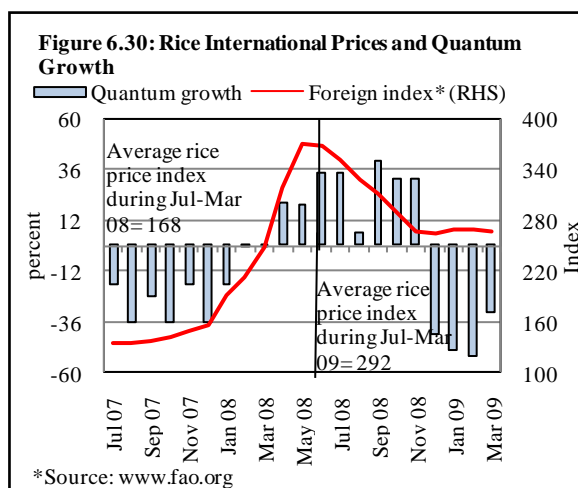
<sup>15</sup> These include one year extension in mark-up subsidy for spinning sector (SMEFD Circular No. 05, 2009, SBP), provision of 100 percent financing to banks against export finance provided to exporters (SMEFD Circular No. 03 of 2008, SBP), provision of one year moratorium on loans availed under the Long Term Financing Facility (SMEFD Circular No. 01, 2009, SBP), extension in the period of refinancing under EFS (SMEFD Circular No. 04, 2009, SBP), and provision of EFS to some categories of cotton fabrics (SMEFD Circular Letter No. 04, 2009, SBP) and provision of LTFF to various spinning sectors (SMEFD Circular No. 08, 2009, SBP).

Ironically, despite harvesting a bumper rice crop during 2008, country's rice exports are recording a YoY quantum decline since December 2008. This is due to various factors: 1) - The

government procurement of rice by Pakistan Agricultural Services and Supply Corporation (PASSCO) prevented an expected large fall in the domestic prices of this commodity, thus hampering its export competitiveness.

Reportedly Thai rice exporters are also facing the same issue as the Thai government has also announced a rice intervention scheme to support farmers.<sup>16</sup> 2) – The 2008 paddy season

recorded bumper crops in some of the world's major rice importing countries e.g., Bangladesh, Indonesia, the Philippines, Africa and Turkey<sup>17</sup>, resulting into lowering rice demand.



Cement exports recorded a significant 52.6 percent YoY rise during July-Apr FY09, largely on account of rising export quantum. In view of the 12 percent duty imposed by India on these exports, which is a large market occupying 10-12 percent share in country's total cement exports, this is an encouraging development.

An analysis of monthly export performance of this category reveals that cement export unit values have been declining from January 2009, after the imposition of duty from India (see **Figure 6.31**). In fact during July-Apr FY09 international coal prices have undergone a large reduction.<sup>18</sup> Since coal is the most important cost component of cement production, a fall in its prices provided cement exporters a margin to reduce their export unit prices. This has also helped them in maintaining their share in the Indian market despite the imposition of duty. Apart from that, a reported fall in domestic cement sales also increased the exportable surplus of this category.

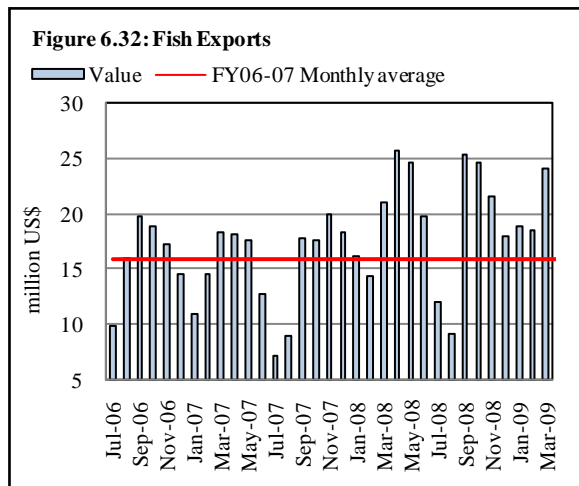
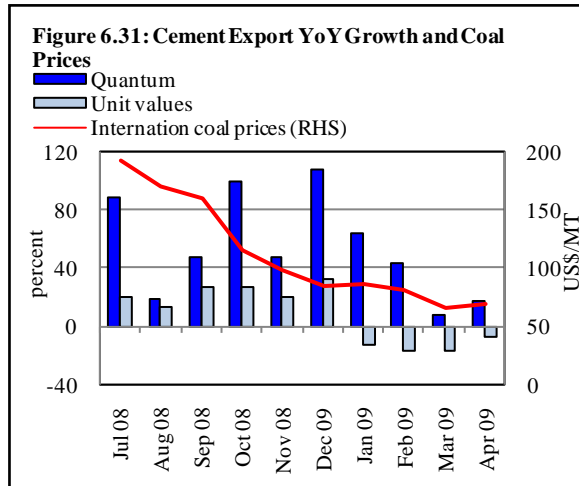
<sup>16</sup> <http://oryza.com/news/Asia-Pacific/Thailand-Market/9648.html>

<sup>17</sup> [http://www.fao.org/es/ESC/en/15/70/highlight\\_71.html](http://www.fao.org/es/ESC/en/15/70/highlight_71.html)

<sup>18</sup> The international coal prices in Mar 09 recorded 66 percent fall as compared to their July 08 levels.

*Petroleum products* exports continued with the declining trend witnessed since November 2008 mainly due to falling naphtha exports. Naphtha production recorded 19 percent YoY decline during July-Mar FY09. This is due to lower crude import by refineries due to the financial problems. However, the easing of financial constraints in recent months could translate into higher production and hence export of naphtha going forward.

*Fish & fish preparations* export recorded an impressive 17.3 percent YoY growth during July-Apr FY09. Encouragingly, this growth was observed both in terms of quantum and value. Country's fish exports are facing restrictions from the EU market since 2007 due to non-compliance with Sanitary and Phyto Sanitary Standards (SPSS) of WTO. However, after remaining subdued during FY07 and some part of FY08, export of this category rebounded during July-Mar FY09 (see **Figure 6.32**). This improvement came from two sources: 1) – establishment of fish processing units along the Baluchistan coastal highway in 2008, which led to improved fish catch and export; 2) – greater focus on other fish



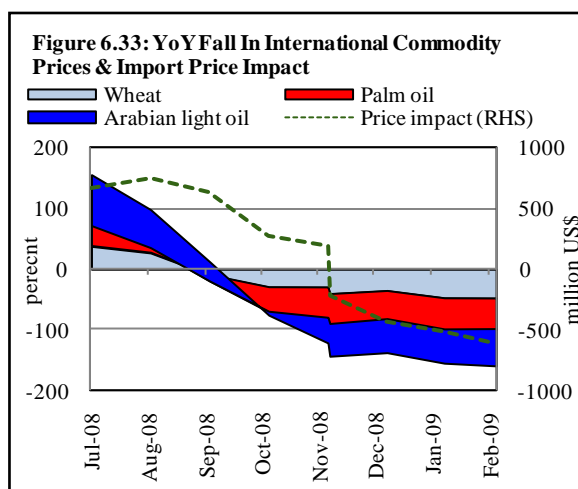
markets as Malaysia, Indonesia, UAE and Thailand which provide better prices.<sup>19</sup> In addition depreciation in the value of rupee has also increased the bargaining power of exporters to attract more demand.

*Molasses* export recorded a sharp 127.9 percent YoY rise during July-Apr FY09 due to both rising quantum and unit values. However, since molasses is a raw material for ethanol which is a high value added product, government has recently imposed 15 percent duty on the export of this category in a bid to support ethanol production. To facilitate *ethanol* exports SBP has also provided Long Term Financing Facility (LTFF) to this sector from January 2008.<sup>20</sup>

In overall terms country's export sector is passing through testing times. On the one hand there is a demand crunch internationally, while on the other hand domestic issues are also constraining growth in most of the export categories. Although, some of the developmental categories are still performing well this is not sufficient to offset the adverse performance of the categories occupying large shares in total exports. Going forward, due to the fall in external demand which is hampering export of a large number of commodities, the overall export growth is likely to be subdued in remaining part of FY09.

### Imports

A combination of contracting domestic demand and falling international commodity prices caused import bill to record a 9.8 percent YoY decline in July-Apr FY09. Though imports had started to record decline since Q2-FY09, a large share of the total fall was concentrated in Q3-FY09. This was due to a large fall in both price as well as quantum impact during this period. In fact the international commodity prices



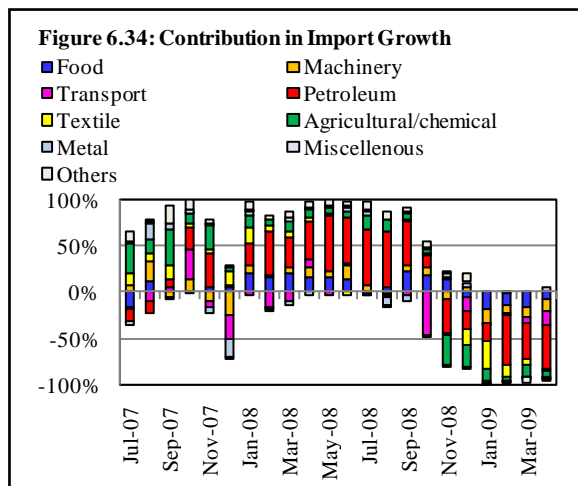
<sup>19</sup> At the time of imposition of ban by EU fish export unit was 2.31-3.31\$/kg in this market. As compared to this price exporters obtained 1.7\$/kg in Malaysia, 1.4\$/kg in Thailand, 3\$/kg in Indonesia and 3.2\$/kg in UAE in Jul-Nov FY09.

<sup>20</sup> SMEFD Circular No. 02 of 2009, SBP.

had started to soften since the start of FY09, however, their lagged translation in overall YoY fall in import price impact started from December 2008 (see **Figure 6.33**).

As regards, the YoY fall in import quantum, this has resulted from import demand compression of a large number of categories during July-Apr FY09. This can be attributed to: 1) – conscious policy efforts – tight monetary policy by SBP until the recent easing announced in April 2009 and increase in import duties and sales tax on luxury goods ; 2) – some sector specific matters as financial crunch faced to the POL sector that reduced its capability to import and improved domestic availability of cotton that reduced its import needs; 3) – a large depreciation in the value of rupee that increased the rupee cost of imports and 4) – a general economic slowdown in the country.

In terms of categories, the fall recorded in imports was broad based and with the exception of wheat, petroleum products and power generating machinery almost all major categories recorded YoY declines during July-Apr FY09. Specifically, transport and textile had the largest shares in the overall import decrease during the period under review (see **Figure 6.34 & Table 6.14**). The fall observed in the transport group during July-Apr FY09, however, also reflects the absence of a large one-off payment in the category of aircrafts, ships and boats that occurred during the same period last year.



The sharp 40.4 percent YoY fall in *fertilizer manufactured* imports during July-Apr FY09 was witnessed due to falling import quantum (see **Figure 6.35**). The import in this category contains a large share of DAP fertilizer, while urea imports also occur to complement its domestic supply whenever there are shortages. The fall in import quantum recorded during July-Apr FY09 is attributable to large

piled up domestic inventories of DAP during this period.<sup>21</sup>

**Table 6.14: Major Imports (Jul-Apr)**

million US Dollar

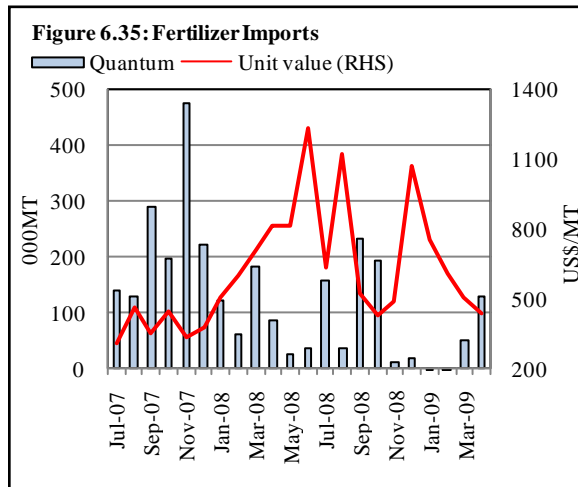
		FY08		FY09(P)			% YoY Δ			
	Units	Value	Unit value	Value	Unit value	Abs .Δ value	Qty	Value	Unit value	
<b>Food group</b>		<b>3,527.4</b>		<b>3,419.6</b>		<b>-107.9</b>		<b>-3.1</b>		
of which:										
Wheat	MT	819.8	471.6	946.2	466.3	126.4	174.2	15.4	-1.1	
Palm oil	MT	1,218.9	856.5	1,125.6	819.2	-93.3	-9.5	-7.7	-4.4	
<b>Machinery group</b>		<b>5,902.1</b>		<b>5,503.9</b>		<b>-398.2</b>		<b>-6.7</b>		
of which:										
Power generating machinery		857.2		1,427.3		570.1		66.5		
Telecom		1,897.4		857.1		-1,040.3		-54.8		
<b>Transport group</b>		<b>1,958.3</b>		<b>1,044.7</b>		<b>-913.6</b>		<b>-46.7</b>		
of which:										
Road motor vehicles		1,083.1		754.6		-328.5		-30.3		
Aircrafts, ships and boats		851.0		283.0		-568.0		-66.7		
<b>Petroleum group</b>		<b>8,670.4</b>		<b>8,012.7</b>		<b>-657.6</b>		<b>-7.6</b>		
Petroleum products	MT	4,650.7	569.5	4,608.1	540.1	-42.6	0.7	-0.9	-5.2	
Petroleum crude	MT	4,019.7	572.2	3,404.6	541.2	-615.0	-8.6	-15.3	-5.4	
<b>Textile group</b>		<b>2,031.9</b>		<b>1,300.7</b>		<b>-731.1</b>		<b>-36.0</b>		
of which:										
Raw cotton	MT	1,166.6	1,430.2	477.2	1,621.6	-689.4	-63.3	-59.1	13.4	
<b>Agricultural and other chemical group</b>		<b>4,756.4</b>		<b>4,391.9</b>		<b>-364.6</b>		<b>-7.7</b>		
of which:										
Fertilizer manufactured	MT	823.9	425.7	491.2	494.5	-332.6	-61.1	-40.4	16.2	
Other chemicals		2,356.3		2,429.4		73.1		3.1		
<b>Metal group</b>		<b>2,167.1</b>		<b>2,169.7</b>		<b>2.6</b>		<b>0.1</b>		
of which:										
Iron and steel scrap	MT	524.0	280.9	515.4	307.9	-8.6	-24.3	-1.7	9.6	
<b>Miscellaneous group</b>		<b>607.5</b>		<b>542.2</b>		<b>-65.2</b>		<b>-10.7</b>		
<b>All other items</b>		<b>2,438.3</b>		<b>2,536.9</b>		<b>98.6</b>		<b>4.0</b>		
<b>Total imports</b>		<b>32,059.4</b>		<b>28,922.4</b>		<b>-3,137.0</b>		<b>-9.8</b>		

<sup>21</sup> During FY08 a large quantum of DAP fertilizer was imported in the wake of closure of the single DAP manufacturing plant in the country for BMR purposes. This, however, resulted in the piling up of huge domestic inventories, since as a result of a sharp increase in international DAP prices its domestic off take remained very low. Whereas, the government also did not implement its decision of providing Rs.1000/bag subsidy as announced in FY09 budget. The huge inventories have eliminated the need of further DAP imports during July-Apr FY09.



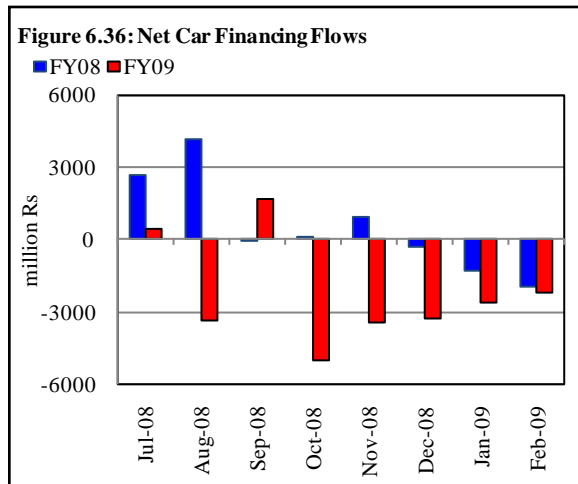
The off take of DAP fertilizer, however, has picked up in Q3-FY09<sup>22</sup>, which will lead to depletion of inventories. Hence, the need for further import is likely to arise for the sowing season in the next rabi crop. Further, government has also started the import of Urea during July-Apr FY09. This is because of its inadequate domestic production during this period, which is not sufficient to fulfill domestic demand.

<sup>23</sup> According to National Fertilizer Development Centre (NFDC) outlook for Kharif 2009, around 500 thousand tonnes of urea is likely to be imported during Q4-FY09 to avoid domestic shortage of this nutrient.



The 30.3 percent YoY fall in the import of *road motor vehicles* mainly reflects slowdown in demand on account of falling real purchasing power, rising domestic automobiles prices and higher costs of borrowing for car financing. Consumer financing for automobiles plunged during July-Mar FY09 as compared to the same period last year (see **Figure 6.36**).

Retrenchment in auto financing by commercial banks was witnessed due to large number of non-performing loans, besides, high interest rate and falling real incomes also played a pivotal role in curtailing the demand for consumer loans. <sup>24</sup> As regards falling automobiles demand, according to the latest PAMA release, auto sales (car,



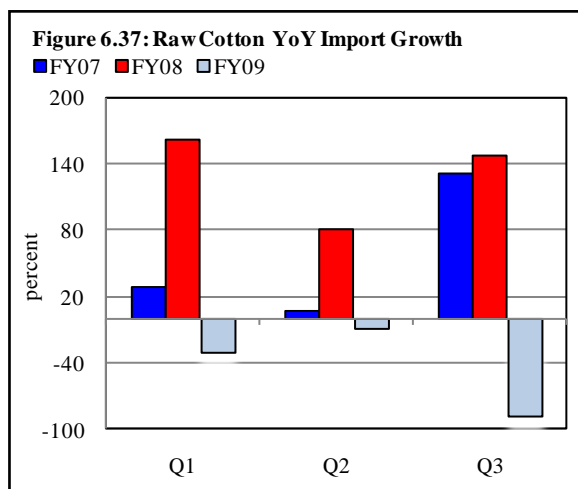
<sup>22</sup> DAP offtake recorded a sharp 104 percent YoY rise during Q3-FY09.

<sup>23</sup> NFDC, Fertilizer Situation: Mid April 2009, Rabi 2008-09 and Outlook for Kharif 2009.

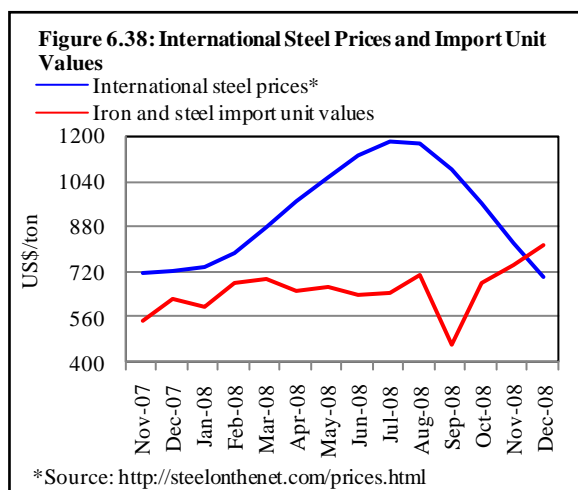
<sup>24</sup> PAMA.

LCV & pickup) during July-Mar FY09 plunged by 46 percent YoY.<sup>25</sup> In terms of import categories CBU units recorded a steeper fall during July-Mar FY09 as compared to the same period last year.

**Raw Cotton** imports declined steeply by 59.1 percent YoY during July-Mar FY09 with a greater share of the fall observed during Q3-FY09 (see **Fig 6.37**). The decline in raw cotton imports is attributable to better domestic cotton crop during 2008.<sup>26</sup> Further falling international demand for the textile and clothing sector also partly explains falling import quantum of this category. During July-Apr FY09 export of a large number of textile categories recorded quantum declines which might have resulted in lower demand for raw cotton during this period.



Import of **iron and steel** recorded a small YoY increase during July-Apr FY09. This was solely on account of rising import unit values, as in terms of quantum, this category recorded a large 13.2 percent YoY decline. The demand for steel has dropped sharply in the country; as the major consuming sectors i.e., infrastructure, housing, construction and automobiles failed to record an impressive performance. Along with the



<sup>25</sup> Car sales plunged by 49 percent YoY, and LCV pickup segment declined 22 percent YoY during July-Mar FY09.

<sup>26</sup> During FY09 cotton production recorded 3.5 percent YoY rise reaching 14.1 million bales during this period.

dull performance of industries, the row between Customs and steel importers over reduction in ITP (import trade price) of steel products also partly contributed to falling import quantum of this category. According to importers, the international steel prices are on a decline since September 2008; however, this decline was not being translated into reduction in ITP by customs authorities (see **Figure 6.38**). Customs authorities, however, announced a reduction in ITP of various steel products in March 2009, which might lead to some revival in import of this category going forward.

In overall terms **petroleum group** recorded 7.6 percent YoY fall during July-Apr FY09 due to falling petroleum crude imports (see **Table 6.14**). Detailed analysis of the data reveals that a sharp expected YoY fall in petroleum group import unit

**Table 6.15: Petroleum Group Imports - Quantum and Price Impact**

million US Dollar

	FY08				FY09		
	Q1	Q2	Q3	Q4	Q1	Q2	Jan-Apr
<b>Quantum impact</b>							
<b>Petroleum group</b>	<b>-43.4</b>	<b>180.4</b>	<b>558.2</b>	<b>195.7</b>	<b>201.6</b>	<b>-361.4</b>	<b>-236.6</b>
Petroleum products	-136.9	344.2	337.9	236.2	145.8	-201.3	106.3
Petroleum crude	93.4	-163.8	220.3	-40.5	55.9	-160.1	-343.0
<b>Price impact</b>							
<b>Petroleum group</b>	<b>-20.9</b>	<b>380</b>	<b>1,084.80</b>	<b>1,788.30</b>	<b>1,654.80</b>	<b>141.7</b>	<b>-2,085.5</b>
Petroleum products	20.9	201.3	536.5	967.4	836.9	165.7	-1,123.9
Petroleum crude	-41.8	178.7	548.3	820.9	817.9	-24.1	-961.7

values during Q3-FY09 was largely responsible for curtailing import bill during July-Apr FY09 (see **Table 6.15**). In addition, falling quantum of petroleum crude also partly contributed in the YoY fall observed in this category during the period under review. This was due to the financial crunch faced by refineries and OMCs, especially during H1-FY09 that disrupted PoL group imports during this period. The situation has improved from the last few months and petroleum products imports recorded 2.9 percent YoY rise during Q3-FY09.

Due to lower crude imports, refineries were working at lower capacity utilization rates during July-Apr FY09, which resulted in reduced production of major POL products namely HSD, furnace oil and motor spirit on a YoY basis during this

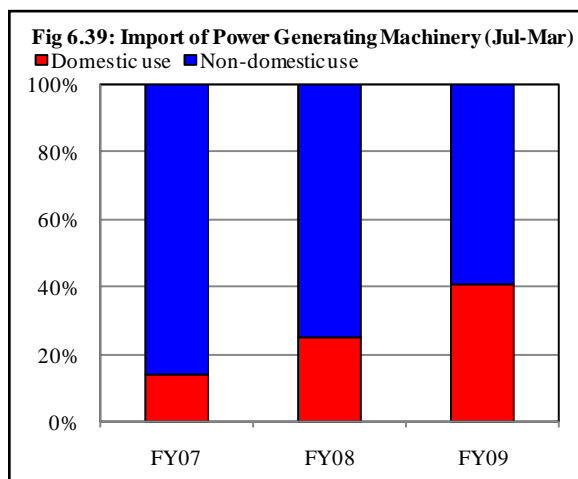
period. This fact created domestic shortages of these products, necessitating a YoY increase in their import during July-Apr FY09.<sup>27</sup>

Going forward there are certain upward pressures on the import quantum of petroleum products. Import of motor spirit is likely to rise as its domestic demand is soaring due to narrowing of the price gap between CNG and petrol. Further, the intensifying energy crisis in major parts of the country has resulted in an increased use of generators, which has created additional demand for motor spirit and diesel in the country.

The demand for furnace oil is also likely to increase from the power generating sector.<sup>28</sup> OCAC (Oil Companies Advisory Committee) in its recent annual report projected an average increase of 7 percent in demand for Furnace oil during the next five years. Looking at the sharp erosion in furnace oil price, declining gas supplies to power sector and commissioning of new power plants, FO is likely to remain a priority product for power generation in the coming period. To meet the shortage, imports of petroleum product is likely to continue. In the short term, however, a part of the rising quantum impact in this group is likely to be offset by falling price impact due to the falling international oil prices.

**Power Generating Machinery** imports grew at a rapid pace, recording 66.5 percent YoY rise during July-Apr FY09 as compared to the same period last year. The domestic power generation sector has so far failed to meet the country's energy needs. Shortage of energy and immense power generation crises are primary factors of the soaring power generating machinery imports figure.

The shortfall of electricity has increased the demand for generators, turbines, batteries and UPS units. Pakistan is



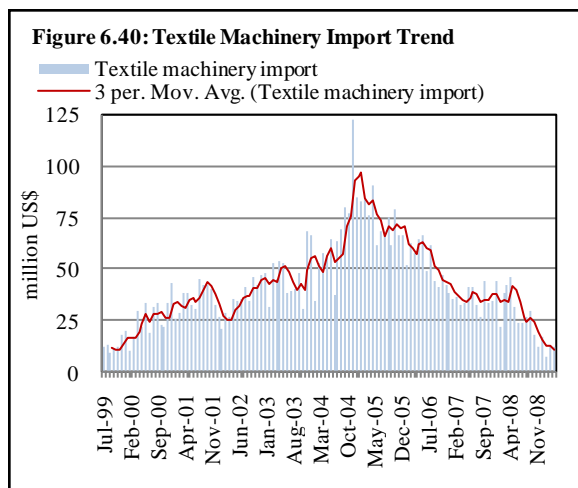
<sup>27</sup> During July-Mar FY09 domestic production of motor spirit, furnace oil and HSD recorded 3.1, 5.1 and 8.8 percent YoY decline.

<sup>28</sup> OCAC 2008 Oil report.

importing this machinery from China, USA and EU. This demand is originating from the household sector, IPPs, industries, office buildings, hospitals, etc. According to the SBP trade data the demand for generators from the household sector is increasing since the last few years (see **Figure 6.39**).

However, according to the power generating machinery importers, the recent recession in the domestic economic activity has curbed power generating machinery demand from the industrial sector during July-Apr FY09 resulting into piling up of inventories with them in this period. These importers had placed large orders for import of this machinery in anticipation of the continuation of the growth trend witnessed in this sector in the past few years. This fact points towards the possibility of a slowdown in power generating machinery imports going forward.

**Textile Machinery** imports continued the falling trend witnessed during the last few years and recorded a sharp 49.0 percent YoY fall during Jul-Apr FY09 (see **Figure 6.40**). In fact textile machinery recorded a sharp increase in period between FY02-FY05 under the BMR programme. Since then country's import of textile machinery are recording almost a continuous decline, which represents reduced demand for further modernization in this sector. Having said this, the sharp fall during July-Apr FY09 also represents the the impact of current global recession that has depressed textile products demand from country's major export markets.



**Telecom machinery** imports recorded a sharp 54.8 percent YoY fall during July-Apr FY09. In terms of individual categories this head had the highest (33.2 percent) share in the total YoY fall observed in import bill during July-Apr FY09. This fall was contributed by both falling cell phones and telecommunication machinery imports. This might be attributable to saturation in the market,

declining purchasing power, as well as higher custom and regulatory duties on mobile sets.<sup>29</sup>

**Wheat** imports recorded a large 15.4 percent YoY rise during July-Apr FY09. In terms of monthly analysis, this rise was concentrated during Jul-Nov FY09. The government had decided to import 2.5 million tones wheat during FY09. However, the news of better crop during 2009 eliminated the need of import of such large quantity of wheat, leading to withering wheat imports during Q3-FY09.

In overall terms in the remaining months of FY09 overall imports are likely to contract further; 1) – due to a more strong negative price impact; and 2) – absence of strong demand from most of the sectors. Hence imports are expected to record a sharp YoY decline during FY09.

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<sup>29</sup> In the FY08 budget the Federal Government imposed Rs 500 duty per set and later imposed Rs 250 regulatory duty in August 2008.

## **Special Section 1: Waste Management: Recent Developments in Pakistan**

### **1. Waste Management**

Waste, also referred to as garbage or rubbish, is unwanted material that is discarded. Heaps of litter is taken to dumpsites in developed countries. However, in developing countries, waste mostly ends up on road sides and empty plots. Untreated waste bears an economic cost for residents of the area and is also an environmental hazard. Increasing pollution leading to environmental changes and economic cost related to waste in terms of health hazards and negative impact on infrastructure have changed the way authorities view it. Though waste management is a relatively new phenomenon, it has caught the attention of governments all over the globe. Today the term waste management covers collecting, sorting, processing, recycling and reusing materials that would otherwise be considered as useless. It has moved from just being an environmental protection strategy to be an industry contributing to the economy.

Recyclable material markets are developing around the globe. With revenue generation capacity of \$160 billion annually, more than 1.5 million people worldwide are employed in this industry. Japan's waste market stood at \$67 billion in 2000 and United States at \$47 billion in 2003.<sup>1</sup> Waste is mostly exported by developed countries to developing countries where it is used in secondary and recycling industries. Major part of Asia consists of developing countries, which are the potential markets for secondary and recycled material. Some of the Asian countries like China and India are becoming recycling workshops for the West. Similarly, Pakistan's ship breaking provides jobs for tens of thousands of people, as well as cheap raw material for the industry.

This special section discusses the global practices of waste management and its contribution to the economy while providing as insight into developments related to the industry in Pakistan.

### **2. Global Practices in Waste Management**

Each year the world is producing approximately 4 billion tons of waste out of which 1.2 billion tons is municipal waste. According to an estimate only 1 billion ton is used. Out of this 600 million tons of waste is recycled to make 170 million tons of paper, 405 million tons of ferrous scrap, 25 million tons of non-ferrous scrap, and 5 million tons of plastics. Around 200 million tons of waste is used for

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<sup>1</sup> Source: Bureau of International Recycling.

energy production, which produces 220 million barrels of oil/600,000 barrels per day of oil.<sup>2</sup>

Waste is treated in various ways; such as, recycling, burning, and burying. In global practices the goal is either to generate power from waste, to produce fertilizer from it, or recycle it for re-use. Currently Europe<sup>3</sup> is recycling 41 percent of its municipal waste and US 32 percent. China is investing US\$ 6.3 billion to achieve its target of recycling 30 percent of its waste by 2030.<sup>4</sup> Incineration is a technique which is very popular worldwide and is used to convert waste into energy. At present there are more than 800 incineration plants worldwide of which, around 400 are in Europe, and 236 are in Japan alone.<sup>5</sup>

Waste-to-energy incineration plants are producing more power than all world's wind turbines and solar panels projects. Incineration plants in Europe provide 27 million inhabitants with electricity. Japan's incinerating plants produce energy equivalent to a nuclear power plant. Alexandria, Egypt, has a recycling plant where 120,000 tons of fertilizer is being produced annually. Europe plans to achieve an objective of 12 percent of domestic energy consumption and 22 percent of electricity from waste by 2010. Similarly USA aims to produce 5 percent of its power, 20 percent of its transport fuel, and 25 percent of its chemicals from biomass from farm, forest and municipal waste.<sup>6</sup>

Developing countries though late starters, have also started focusing on waste management and its economic value. International organizations, like United Nation Environment Program (UNEP) are working closely with the developing countries to help them in their capacity building to deal with issues related to handling of waste.

### **3. Waste Generation in Pakistan**

While Pakistan's population has increased to more than 160 million, lack of adequate infrastructure is creating environmental hazards. In Pakistan, sources of waste include households, commercial areas, institutions, construction and demolition sites, industrial areas and agricultural disposals. Factors that affect waste generation in the country are size and type of the community and level of

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<sup>2</sup> From Waste to Resource: An abstract of "2006 World Waste Survey" by Veolia Environmental Services, and Cyclopes.

<sup>3</sup> It includes 15 countries: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden and the United Kingdom.

<sup>4</sup> "The Economist" February 21st-28th 2009.

<sup>5</sup> The Worldwide Market for Waste Incineration Plants, by ECOPROG, March 2008.

<sup>6</sup> Source: Same as 4.



communities' income. Solid waste generated mostly ends up in empty plots, place of generation, in drains causing blockages in sewage system or on road sides. Composition of solid waste generally comprises of plastic and rubber, metal, paper and cardboard, textile waste, glass, food waste, animal waste, leaves, grass, straws, fodder, bones, wood and stones. Apart from this, substantial amount of hospital waste is also produced in the country.

Around 250,000 tons of medical waste is annually produced from all sorts of health care facilities. Some hospitals and municipalities burn their waste, which results in the production of large amount of highly toxic gases.<sup>7</sup> Open dumps of waste serve as breeding grounds for flies and mosquitoes creating health hazards. In addition, bio-nondegradable solid wastes including hospital and industrial wastes are found lying in heaps.<sup>8</sup> In Pakistan currently there are three primary ways of disposing waste - landfill, size reduction and screening.

According to various studies conducted on waste management in the country, about 54,888 tons of solid waste is generated daily in urban areas of Pakistan and 60 percent of it is collected by the municipal authorities. However, according to official estimates, 30 percent to 50 percent of the solid waste generated within most cities is not collected.

The Ministry of Environment undertook a study during 1996 on "Data Collection for Preparation of National Study on Privatization of Solid Waste Management in Eight Selected Cities of Pakistan". The study revealed that the rate of waste generation on average from all type of municipal controlled areas varies from 0.283 kg/capita/day to 0.613 kg/capita/day or from 1.896 kg/house/day to 4.29 kg/house/day in all selected cities. The projected population of the country for the year 2014 is 197.77 million on the basis of current annual growth rate of 2.6 percent resulting in an estimated projection of solid waste of 71,018 tons per day/ 25.921 m tons per year.

Solid waste generation in major cities of Pakistan on the basis of population in 2004 is given in **Table SS 1.1**:

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<sup>7</sup> Hospital Waste Management in Pakistan, Case Study Report Special Waste Fractions: Hospital Waste, Rehan Ahmed, August 1997.

<sup>8</sup> Solid Waste Management in Pakistan by Engr. Muhammad Humayun Khan, 24th WEDC Conference, 1998.

**Table SS1.1: Waste Profile of Major Cities in Pakistan**

	Population (million) 1998 Census	Population (million) 2004 Census	Solid waste generation rate (kg/C/Day)	Waste generated (tons/day)	Tons/year
Karachi	9.269	10.818	0.613	6,632	2,420,680
Faisalabad	1.977	2.307	0.391	902	329,230
Hyderabad	1.151	1.343	0.563	756	275,940
Gujranwala	1.124	1.312	0.469	615	224,475
Lahore	5.143	6.4	-	5,000	-
Peshawar	0.988	1.153	0.489	564	205,860
Quetta	0.560	0.654	0.378	247	90,155
Bannu	0.046	0.054	0.439	24	8,760
Sibi	0.082	0.095	0.283	27	9,855
Remaining Urban Areas	27.261	31.818	0.453	14,414	5,261,110
Total of Urban Areas	42.458	49.554	4.078	24,181	8,826,065
Rural Areas	88.121	102.853	0.283	29,108	10,624,420
Sub-Total	130.579	152.407	4.361	53,289	19,450,485
Add 3 percent for hazardous waste				1,599	583,635
<b>Grand Total</b>				<b>54,888</b>	<b>20,034,120</b>

Source: (Draft) Guideline for Solid Waste management Jun 2005, Pakistan Environment Protection Agency.

#### **4. Legal and institutional framework regarding Solid Waste Management in Pakistan:**

As in most developing countries, policies and regulations regarding solid waste management in Pakistan are enacted and made in huge data and information vacuum. Despite that there is no dearth of legal framework on solid waste management in the country. Presently the legal rules and institutional framework dealing with solid waste management in the country include:

- Pakistan Environmental Protection Act (PEPA) 1997.
- Section 11 of the Pakistan Environmental Protection Act prohibits discharge of waste in an amount or concentration that violates the National Environmental Quality Standards (NEQS).
- Hazardous Substances Rules of 1999.
- Guidelines for Hospital Waste Management since 1998 prepared by the Environmental Health Unit of the Ministry of Health, Government of Pakistan.
- Hospital Waste Management Rules 2005.

- Hazardous Substances Rules 2003.
- National Environment Quality Standards Rules.
- Islamabad Capital Territory Bye Laws, 1968 by Capital Development Authority Islamabad.
- Section 132 of the Cantonment Act 1924 deals with Deposits and disposal of rubbish etc.
- There is also Prime Minister's committee on Climate Change which was established to ensure that Pakistan fulfills requirements of Clean Development Mechanism (CDM) under the Kyoto Protocol. This committee has a sub-divisional level technical committee on Waste Management.
- In 1994 Pakistan joined Basel Convention on the Control of Trans-boundary Movements of Hazardous Waste and Their Disposal. The Convention aims at enabling the member countries to initiate "environmentally-sound management" (ESM), the purpose of which is to protect human health and the environment by minimizing hazardous waste production.
- The Pakistan Environmental Protection Act 1997 Section 12 directs that an Initial Environmental Examination (IEE), and wherever the project is likely to cause an adverse environmental effect, an environmental impact assessment be filed with the Environmental Protection Agency (EPA) for review and approval before the initiation of construction at site.
- Currently the World Bank is supporting the Urban Unit of Government of Punjab responsible for reforming the solid waste management practices in the Province.

## **5. Waste Management in Pakistan**

Before promulgation of the local government in 2001, the provincial Public Health Engineering Department (PHED) was responsible for the development and maintenance of water and sanitation services including solid waste management. Under the recently prevailing system of local government, it is the responsibility of Town/Tehsil Municipal Administration (TMAs); however the sighting of disposal facilities is primarily the function of Zila Council. Paid sanitary workers are employed by TMAs to sweep the streets and collect the trash at a specified place from where it is taken to the dumping site by the municipal carrier.

In addition to these there are some private entrepreneurs who have entered the field. Private sector is involved in waste management activities in the country may be divided into formal and informal categories. The formal sector consists of organizations and non-government organizations (NGOs). The informal sector is

significant in size as it consists of thousands of itinerant traders (called *kabarias* or *kabari-wallas*) spread throughout the cities who are engaged in collection of waste material of different kinds.

Private sector firms have initiated projects based on organic and in-organic waste management. Organic waste is used to produce organic fertilizer. Inorganic waste is first sorted into paper, plastic, tin, etc, and it is then sold to respective industries where it is recycled to make products such as; Plastic Wood and Tetra Sheets. Unplanned urbanization, poor sanitation and drainage system, inadequate human and capital resources for collecting waste, unavailability of official dumping sites, absence of weigh bridges for exact measurement of waste coming at sites, and almost negligible presence of recycling processes have negatively impacted waste management in the country.

In Pakistan there is immense potential to convert waste into resource for the economy. In this regard, some NGOs<sup>9</sup> and private firms<sup>10</sup> have already stepped into the industry. These organizations collect waste and reprocess it to produce fertilizer, plastic bottles, and tetra packs. A private firm has established a recycling facility in Lahore where it is engaged to produce a refuse-derived fuel (RDF) based on the concept of waste-to-energy. Similarly an NGO in Karachi encourages people to sell their waste to them and prepares soil-conditioning fertilizer. Another NGO is engaged in collecting urban waste in major cities of the country. It squeezes waste in order to dry it and finally produces waste pellets from it. The extracted liquid from organic waste is sold in market as liquid plant nutrient.

However operations of these organizations are limited in size and scope. Although there has been commitment on part the government to create opportunities of converting waste in to energy and other useful purposes. Lack of adequate infrastructure is inhibiting the industry to grow. The government of Pakistan is aware of the role of waste management industry. However there is a need for a more pro-active approach, likely to be based on public private partnership to help this industry provide a cleaner environment while adding value to the economy.

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<sup>9</sup> Gul Bahao and Pakistan Environment Welfare and Waste Recycling Trust (PEWWRPT).

<sup>10</sup> Farooq Compost Fertilizer Corporation and Shanghai Shun Gong Environmental Protection Limited.

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## Special Section 2: Regulating Pro-Actively: The Case of Minimum Capital Requirements (MCR)<sup>1</sup>

To strengthen solvency of individual banks, the State Bank of Pakistan (SBP) announced increases in the Minimum Capital Requirements (MCR) for banks and DFIs in September 2008. Banks were required to gradually increase in phases, their minimum paid up capital (net of losses) to Rs 23.0 billion by end-December 2013 (see **Table SS2.1**). The Capital Adequacy Ratio (CAR) was also revised upward from earlier 8 percent to 10 percent. All banks and DFIs were advised to achieve this new level of CAR by end-December 2008. Besides these measures, the SBP also introduced variable CAR for banks and DFIs based on their CAMELS-S Rating assigned by the SBP.

These changes in MCR were followed by two key developments: (1) persisting turmoil in global financial system evolved to full-fledged solvency crises as a number of age-old investment banks collapsed; and (2) domestic economy started signaling visible slowdown from initial months of the FY09. The sharp deterioration in domestic macroeconomic environment

forced the government to enter into a Stand-By Arrangements with the IMF by November 2008 to implement a macroeconomic stabilization program. Slowdown in economic activities is visible from the projected GDP growth of 2.0-3.0 percent for the year FY09 as against 5.8 percent for the year FY08.

Although banking sector of Pakistan remained largely immune to the direct impact of adverse developments in global financial system, the indirect impact stemming from trade linkages and difficulties in accessing international financial markets entail negative implications for the overall performance of the banking system. These international developments along with heightened uncertainty in the domestic capital markets on account of ‘war on terror’ and slowdown in economic activities highlight difficulties in accessing domestic capital markets.

**Table SS2.1: Minimum Capital Requirements**  
billion Rupees

Dead line	Minimum Paid up Capital (net of losses)	
	Previous*	Revised**
31-12-2008	5.0	5.0
31-12-2009	6.0	6.0
31-12-2010	10.0	7.0
31-12-2011	15.0	8.0
31-12-2012	19.0	9.0
31-12-2013	23.0	10.0

\* BSD Circular No. 19 dated September 2008.

\*\* BSD Circular No. 07 dated April 2009.

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<sup>1</sup> The ownership of this section is with the Research Department.

In such an environment, economic managers have to make an educated judgment on the MCRs. Such judgments are especially relevant in the context of emerging market, such as Pakistan, where financial markets are, and remain, incomplete, and the risk of large corporations exploiting this incompleteness is high. One such judgmental call by the SBP is the revision of the recently announced increase in future Minimum Paid up Capital (free of losses) requirements for banks (see **Table SS2.1**). Specifically, the SBP moved to create: (1) an operating environment where banks can focus on their core business activities; (2) level playing field for all players in the banking sector; and (3) competitive environment by strengthening competition. In this backdrop, we attempt to analyze this decision from all three angles.

### ***Focus on Banking Business***

Given the current economic climate, the SBP wants banks to strengthen their business activities so that significant progress made in recent years is consolidated. Specifically, key financial soundness indicators registered significant improvement over the last five years. Slight deterioration in asset quality indicators (NPLs to loan ratio and provisions to NPLs ratio) during CY08 is a reflection of weak economic environment (see **Table SS2.2**). Despite increase in net NPLs to capital ratio during CY08, the banking sector is well positioned to absorb these losses as net NPLs to capital ratio is still 13.6 percent only. Strong capital adequacy along with profitability indicators show, that banking sector is well positioned to withstand losses stemming from of weak economic environment. Improvement in economic indicators in the recent months due to implementation of macroeconomic stabilization with the help of IMF is a welcome development.

**Table SS2.2: Financial Soundness Indicators**  
percent

	CY00	CY01	CY02	CY03	CY04	CY05	CY06	CY07	CY08*
CAR**	9.7	8.8	8.8	8.5	10.5	11.3	12.5	13.2	12.2
Tier 1 Capital to RWA	8.3	7.3	6.2	6.5	7.6	8.3	9.9	10.5	10.2
NPLs to Loan Ratio	23.5	23.4	21.8	17.0	11.6	8.3	6.9	7.2	9.1
Provisions to NPLs	55.0	54.7	60.6	63.9	70.4	76.8	77.9	85.1	74.7
Net NPLs to Capital Ratio	131.3	150.5	85.5	54.4	29.2	14.1	9.7	5.6	13.6
ROA(after tax)	-0.2	-0.5	0.1	1.0	1.2	1.8	2.1	1.5	1.2
ROE (after tax)	-3.5	-12.6	3.2	20.0	20.3	25.0	24.2	15.5	11.3

\* Based on Quarterly data for end December 2008.

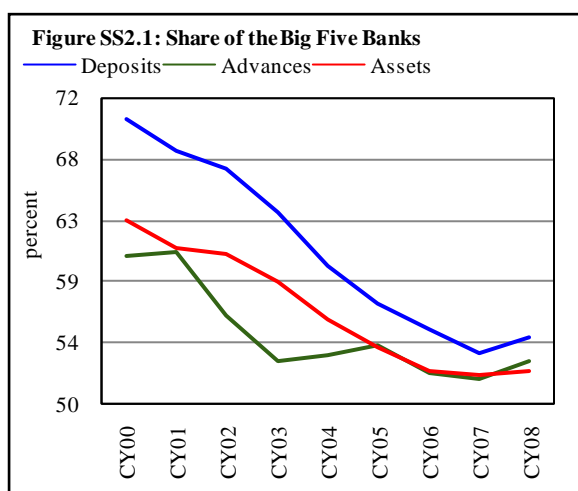
\*\* CAR for CY08 is based on BSEL II framework.

In this backdrop, the regulator has decided to cushion the banking sector achieved progress by revising downwards future MCR-targets so that banks can focus on consolidating their current balance-sheets and worry less about steep rise in future minimum capital requirements. Cyclical increase in NPLs of the banking sector requires close attention of the bank management.

### **Strengthening Competition in Banking Sector**

The SBP has been actively pursuing policies to instill competition in the banking system. Conscious efforts were made to facilitate (1) the emergence of normal size banks (capable to provide meaningful competition to big 5 banks) through mergers and acquisitions; (2) allowing the entry of strong foreign banks; and (3) establishing Islamic Banks parallel to conventional banks are some of the key steps to promote competition and inclusive finance. These initiatives have played an important role in lessening concentration in the banking industry<sup>2</sup> as various measures of concentration have witnessed significant improvement in recent years.

The share of the big five banks in total assets of the banking sector has dropped by 10.8 percentage points since CY00 to 52.4 percent by end CY08 (see **Figure SS2.1**). This loss of market share by these big banks simply reflects the increasing business activities of other banks in the system. The same is also visible from decreasing Herfindahl-Hirschman Index (HHI) and coefficient of variation (see **Table SS2.3**). However, this momentum has somewhat lost its pace since 2005 and the economic downturn of 2008 have further worsened this situation. The decision of downward revision in MCR is likely to bring improvement in the banking competition. Small banks will have an opportunity to create their market niche and provide competition to big banks.



<sup>2</sup> For detail discussion on this issues, please see “Chapter 4: Concentration and Competition in the Banking System” in Financial Stability Review 2007-08.



**Table SS2.3: Measures of Concentration**

	CY00	CY01	CY02	CY03	CY04	CY05	CY06	CY07	CY08
<b>Herfandahl-Hirschman Index</b>									
Deposits	1,238	1,185	1,130	1,032	946	833	810	785	794
Advances	942	965	852	777	764	772	746	732	742
Assets	1,023	993	973	912	850	762	745	741	736
<b>Coefficient of Variation</b>									
Deposits	2.10	2.05	1.90	1.79	1.63	1.52	1.49	1.45	1.47
Advances	1.77	1.80	1.57	1.47	1.40	1.44	1.40	1.38	1.39
Assets	1.87	1.83	1.72	1.65	1.51	1.42	1.40	1.39	1.39

Source: SBP calculations

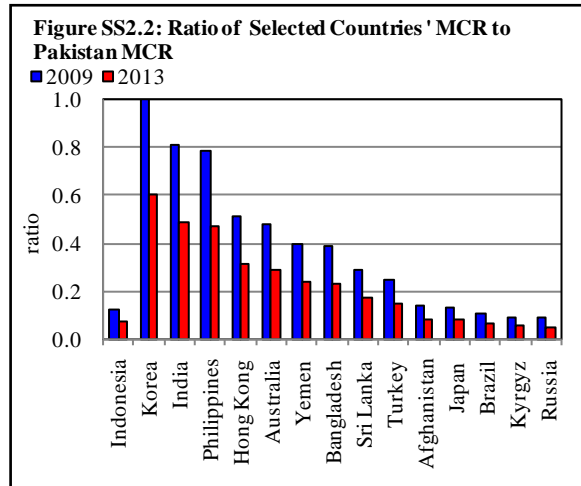
***Creating a Level Playing Field***

The on-going global financial crises and sharp deterioration in domestic macroeconomic environment during second half of CY08 have significantly changed the incidence of minimum capital requirements for small-medium size banks. Capital accumulation for banks except big five banks has become extremely difficult, especially for small size banks in the wake of losses stemming from cyclical downturn in economic activities, reduced profitability and persisting liquidity strains in international and domestic financial markets. At the same time, capital accumulation needs of the big banks are almost negligible as the net assets of these banks ranges from Rs 22.1 billion to Rs 110.9 billion (end-December 2008 position). It shows that big five banks are well placed to meet current and future MCR targets. In this scenario, the desire and ability of the larger players to acquire smaller ones is high. Anticipating this potential predatory behavior, the SBP has reduced MCR requirements. This decision is expected to reduce excessive burden of capital accumulation for small/medium banks without compromising on capital adequacy of the banks.

The small/medium size banks are in expansion phase as data on number of branches for CY08 indicate that 83.3 percent of new branches were opened by other than big 5 banks. Moreover, the share of the big 5 banks in total no of employees in banking sector has witnessed massive decline of 24.4 percentage points from CY00 to 48.8 percent by end CY08. In other words, the small and medium size banks have attracted larger number of personnel in line with their expanding business activities. The revision in MCR is likely to help small/medium banks to fully bear the fruit by creating level playing field for all players in the banking sector.

### Comparing internationally

Finally, the increased minimum capital requirements were likely to put banking sector of Pakistan at disadvantage against the significantly changing regulatory structure of banks around the globe. International comparison of MCR shows that the ratio of selected countries MCR to the MCR for banks in Pakistan is less than one; indicating high capital requirements in Pakistan (see **Figure SS2.2**). The revised MCR are likely to address this problem and provide relatively equal opportunities to domestic banks vis-a-vis other countries. This will further help in mitigating regulatory arbitrage activities in the banking system.



In sum, considering the current economic climate while taking into account the good progress of the banking system over the last seven years, and foreseeing the market behavior during downturns, the SBP's timely decision to reduce minimum capital requirements will help in further expansion in banking activities in Pakistan.

## Acronyms

ADB	Asian Development Bank
ARPU	Average Revenue per User
BMR	Balancing Modernization and Restructuring
BoP	Balance of Payments
BSC	Behbood Saving Certificate
CAR	Capital Adequacy Ratio
CBU	Completely Built Unit
CELSS	Controlled Ecological Life Support System
CLCV	Cotton Leaf Curl Virus
CNG	Compressed Natural Gas
CPI	Consumer Price Index
CRR	Cash Reserve Requirement
CY	Calendar Year
DAP	Di-Ammonium Phosphate
DMBs	Deposit Money Banks
DMMD	Domestic Market and Monetary Management Department
DPBs	Domestic Private Banks
DSC	Defense Saving Certificate
EBIT	Earning Before Interest and Taxes
EFS	Export Finance Scheme
EPD	Exchange Policy Department
ER	Exchange Rate
EU	European Union
FAO	Food and Agriculture Organization
FBR	Federal Board of Revenue
FBS	Federal Bureau of Statistics
FCAs	Foreign Currency Accounts
FCBCs	Foreign Currency Bearer Certificates
FDI	Foreign Direct Investment
FEBCs	Foreign Exchange Bearer Certificates
FED	Federal Excise Duty
FE-25	Foreign Exchange Cir.No.25
FO	Furnace Oil
FODP	Friends of Democratic Pakistan
FPI	Foreign Portfolio Investment
FSV	Forced Sal value
FTA	Free Trade Agreement
FY	Fiscal Year
GCC	Gulf Cooperation Council

GDP	Gross Domestic Product
GDR	Global Depository Receipts
GFSR	Global Financial Stability Report
GST	General Sales Tax
HHI	Herfindahl-Hirschman Index
HRI	House Rent Index
HSD	High Speed Diesel Oil
IBRD	International Bank for Reconstruction and Development
IDB	Islamic Development Bank
IFIs	International Financial Institutions
IMF	International Monetary Fund
IPPs	Independent Power Projects
IRSA	Indus River System Authority
ITP	Import Trade Price
KAPCO	Kot Addu Power Company Limited
KESC	Karachi Electric Supply Corporation
Kg	Kilogram
KIBOR	Karachi Inter Bank Offer Rate
KYC	Know Your Customer
LIBOR	London Inter Bank Offer Rate
L/C	Letter of Credit
LCV	Light Commercial Vehicle
LSM	Large Scale Manufacturing
LT	Long Term
LTFF	Long Term Financing Facility
MCR	Minimum Capital Requirement
MINFAL	Ministry of Food, Agriculture and Live Stock
MNCs	Multi National Corporations
MoM	Month-on-Month
12MMA	12 Months Moving Average
MPS	Monetary Policy Statement
MRTB	Market Related Treasury Bills
MT	Metric Ton
NDA	Net Domestic Asset
NASA	National Aeronautics and Space Administration
NEER	Nominal Effective Exchange Rate
NFA	Net Foreign Asset
NFDC	National Fertilizer Development Centre
NFNE	Non Food Non Energy
NPLs	Non Performing Loans
NSS	National Saving Schemes

NWFP	North-West Frontier Province
OCAC	Oil Companies Advisory committee
OECD	Organization for Economic Cooperation and Development
OGRA	Oil and Gas Regulatory Authority
OICCI	Overseas Investors' Chamber of Commerce & Industry
OMCs	Oil Marketing Companies
OMOs	Open Market Operations
OPEC	Organization of the Petroleum Exporting Countries
PAMA	Pakistan Automotive Manufactures Association
PASSCO	Pakistan Agriculture Storage and Supply Corporation
PBA	Pensioners Benefit Account
PIA	Pakistan International Airlines
PIBs	Pakistan Investment Bonds
POL	Petroleum, Oil and Lubricants
PPCBL	Punjab Provincial Cooperative Banks limited
PSDP	Public Sector Development Program
PSEs	Public Sector Enterprises
PTCL	Pakistan Telecommunication Company Limited
PTA	Pakistan Telecommunication Authority
PTA	Preferential Trade Agreement
REER	Real Effective Exchange Rate
RFCAs	Residents Foreign Currency Accounts
RHS	Right Hand Side
RIC	Regular Income Certificate
ROA	Return on Assets
ROE	Return on Equity
RPI	Relative Price Index
RPI	Retail Price Index
Rs	Rupees
RWA	Risk Weighted Assets
S&P	Standard & Poor's
SA	Saving Account
SBA	Stand-By Arrangement
SBP	State Bank of Pakistan
SECP	Securities and Exchange Commission of Pakistan
SMEFD	Small and Medium Enterprises Finance Department
SPI	Sensitive Price Index
SPSS	Sanitary and Phyto Sanitary Standards
SQM	Square Meter
ST	Short Term
SSA	Special Saving Account

SSC	Special Saving certificate
T-bills	Treasury Bills
TCP	Trading Corporation of Pakistan
TFCs	Term Finance Certificates
UAE	United Arab Emirates
UK	United Kingdom
UPS	Uninterrupted Power Supply
USA	United States of America
WAPDA	Water and Power Development Authority
WEO	World Economic Outlook
WPI	Wholesale Price Index
WTO	World Trade Organization
YoY	Year on Year
ZTBL	Zarai Taraqati Bank Limited