

THE STATE OF PAKISTAN'S ECONOMY



Second Quarterly Report
for the year 2009-2010 of the
Central Board of State Bank of Pakistan



STATE BANK OF PAKISTAN

CENTRAL BOARD OF DIRECTORS

Syed Salim Raza	Governor & Chairman
Mr. Salman Siddique	Member
Mr. Kamran Y. Mirza	Member
Mr. Zaffar A. Khan	Member
Mr. Tariq Sayeed Saigol	Member
Mirza Qamar Beg	Member
Mr. Asad Umar	Member
Mr. Waqar A. Malik	Member
Mr. Aftab Mustafa Khan	Corporate Secretary

LETTER OF TRANSMITTAL

State Bank of Pakistan
Karachi.
March 29, 2010

Dear Mr. Chairman,

In accordance with Section 9A(f) of the State Bank of Pakistan Act, 1956, I submit herewith the Second Quarterly Report for the year 2009-2010 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

LETTER OF TRANSMITTAL

State Bank of Pakistan
Karachi.
March 29, 2010

Dear Madam Speaker,

In accordance with Section 9A(f) of the State Bank of Pakistan Act, 1956, I submit herewith the Second Quarterly Report for the year 2009-2010 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
National Assembly
Islamabad

The Team

Team Leader

Mohammad Mansoor Ali

mansoor.ali@sbp.org.pk

Researchers

Moinuddin (Team Leader, Real Sector)

moinuddin@sbp.org.pk

Muhammad Sharif Khawaja (Agriculture)

sharif.muhammad@sbp.org.pk

Muhammad Naqi Akbar (Agriculture)

naqi.akbar@sbp.org.pk

Naila Iram (Agriculture)

naila.iram@sbp.org.pk

Asma Khalid (Large Scale Manufacturing and Services)

asma.khalid@sbp.org.pk

Shabbir Ahmad (Large Scale Manufacturing)

shabbir.ahmad@sbp.org.pk

Tamkinat Rauf (Large Scale Manufacturing and Services)

tamkinat.rauf@sbp.org.pk

Saghir Pervaiz Ghauri (Prices)

saghir.pervaiz@sbp.org.pk

Waseem Fazal ur Rehman (Prices)

waseem.fazal@sbp.org.pk

Zahid Hussain (Prices)

zahid.hussain@sbp.org.pk

Sadia Bader (Team Leader, Money & Banking)

sadia.badar@sbp.org.pk

Sabahat (Monetary Survey)

sabahat@sbp.org.pk

Reeba Nasim (Deposit mobilization)

reeba.nasim@sbp.org.pk

Muhammad Zeb (NPLs, Revenues)

muhammad.zeb@sbp.org.pk

Muhammad Idrees (Fiscal developments)

muhammad.idrees22@sbp.org.pk

Mohib Kamal Azmi (Team Leader, External Sector)

mohib.kamal@sbp.org.pk

Imran Naveed Khan (External Debt)

imran.naveed@sbp.org.pk

Fayyaz Hussain (Balance of Payments)

fayyaz.hussain@sbp.org.pk

Syed Zulqernain Hussain (Trade)

zulqernain.hussain@sbp.org.pk

Farrukh Abbas Mirza (Trade in Services, Exchange Rate and Reserves)

farrukh.mirza@sbp.org.pk

Tosif Hussain (Balance of Payments)

tauseef.hussain@sbp.org.pk

Dr. Mian Farooq Haq (Team Leader, Special Section 1)

mian.farooq@sbp.org.pk

Bushra Shafique (Special Section 1)

bushra.shafique@sbp.org.pk

Editor

Umar Siddique

umar.siddique@sbp.org.pk

Formatting

Shabbir Ahmad

shabbir.ahmad2@sbp.org.pk

Farrukh Abbas Mirza

farrukh.mirza@sbp.org.pk

Sabahat

sabahat@sbp.org.pk

Waseem Fazal ur Rehman

waseem.fazal@sbp.org.pk

Research Assistance

Bilal Khan

bilal.khan@sbp.org.pk

<i>Contents</i>	<i>Page</i>
1. Economic Outlook	1
1.1 Overview	1
1.2 Looking Forward	4
1.3 Executive Summary	6
2. Real Sector	11
2.1 Agriculture Sector Performance	13
2.2 Large Scale Manufacturing	21
2.3 Services	25
3. Prices	27
3.1 Overview	27
3.2 Consumer Price Index	29
3.3 Wholesale Price Index	33
3.4 Sensitive Price Indicator	34
3.5 Global Scenario	35
4. Money & Banking	37
4.1 Monetary Policy	37
4.2 Developments in Monetary Aggregates	40
4.3 Credit to Private Sector	45
4.4 Deposit Mobilization	49
4.5 Non Performing Loans	52
5. Fiscal Developments	54
5.1 Overview	54
5.2 Fiscal Performance Indicators	55
5.3 Revenues	56
5.4 Expenditures	59
5.5 Financing	61
5.6 FBR Tax Collection	63
5.7 Provincial Fiscal Operations	64
5.8 Domestic Debt	65
6. External Sector	69
6.1 Overview	69
6.2 Current Account Balance	71
6.3 Financial Account	81
6.4 Services Trade	86
6.5 Foreign Exchange Reserves	89
6.6 Exchange Rate	93
6.7 Trade Account	96
6.8 External Debt	108
Special Section : SME Growth in Pakistan: Addressing Access to	115
Acronyms	127

1 Economic Outlook

1.1 Overview

Available provisional data by February 2010 shows that a moderate but fragile recovery is underway, aided by a gradual increase in aggregate demand following improvement in many key macroeconomic indicators. The most visible manifestation of this has been a recovery in manufacturing activity. Despite continuing energy shortages and rising production costs (especially of imported inputs and electricity),¹ large-scale manufacturing (LSM) activity gathered pace during H1-FY10 (see **Table 1.1**). The major impetus to this recovery is from strong domestic consumption demand (particularly for consumer durables).

The recovery in LSM has, in part, helped to compensate for the setbacks to major crops during Jul-Feb FY10 that have undermined hopes of reasonable growth in the agriculture sector during the full year. With the “major crops” sub-sector likely to record a decline in value-addition during the year - principally due to fall in the production of rice, sugarcane and an expected decline in wheat harvest - hopes of an overall positive contribution to growth by the agriculture sector now rest critically on a robust contribution by the ‘minor crops’ and ‘livestock’ sub-sectors. Encouragingly, there are some indications that the former, at least, is expected to do well in FY10.

Table 1.1: Selected Economic Indicators

		FY08	FY09	FY10
<i>Growth rate (percent)</i>				
LSM	Jul-Jan	5.6	-5.4	2.3
Exports (fob) ¹	Jul-Feb	7.4	3.5	2.7
Imports (cif) ¹	Jul-Feb	21.9	-1.5	-8.2
Tax revenue (FBR)	Jul-Dec	6.0	27.3	5.1
CPI (12 month ma)	Feb	8.4	21.7	12.6
Private sector credit	Jul- Feb	11.7	4.6	4.7
Money supply (M2)	Jul-Feb	7.4	2.0	5.7
<i>billion US dollars</i>				
Total liquid reserves ²	end-Feb	14.1	10.1	14.8
Home remittances	Jul-Feb	4.1	4.9	5.8
Net foreign investment	Jul-Feb	2.8	1.9	1.0
<i>percent of GDP³</i>				
Fiscal deficit	Jul-Dec	3.5	1.9	2.7
Trade deficit	Jul-Feb	8.2	8.1	6.3
Current A/c deficit	Jul-Feb	7.7	6.8	2.2

¹ Trade data compiled by FBS.

² With SBP & commercial banks.

³ Based on full-year GDP in the denominator. For FY10, estimated full year GDP has been used.

¹ Such as rising international commodity prices and reduction in domestic subsidy on power during recent months.

Indeed, ample domestic stocks of key staples and improved production of minor crops played an important role in bringing inflation down to 8.9 percent YoY by October 2009, 16.1 percentage points lower than a year ago, before it bounced back into double digits, reaching 13.0 by February 2010. The rigidity in inflation is principally due to: (a) rising international prices of many commodities amid supply shortages and a recovery in the global economy; (b) weakening of the rupee, particularly in December 2009 and January 2010, when SBP stopped providing forex liquidity support for oil imports; (c) a moderate recovery in the domestic economy, which also shows strength in aggregate demand; and, quite significantly (d) an upward adjustment in administered prices of power and key fuels.

At first glance, it appears that the inflationary pressures are concentrated in food and energy sub-groups of CPI. However, the fact that the “trimmed mean” core inflation measure continues to rise despite a decline in NFNE core inflation indicates that inflationary pressures are strengthening in the economy. It also points towards the possibility of strong second-round effects on prices of other goods and services due to increased cost of production and rise in cost of living.

The reversal of the earlier trend decline in inflation exemplifies the fragility of the improvements in the country's economic environment seen so far in FY10. Clearly, there is a need to vigilantly monitor the relative deterioration in macroeconomic indicators, and particularly those that had seen substantial improvement in the initial months of the year.

In fact, as indicated in the last monetary policy statement, it was precisely the potential (and emerging risks) to macroeconomic stability that had forced the SBP to move very cautiously in easing monetary policy, despite relative easing of inflation and weakness in aggregate demand towards the end of FY09 and the beginning of FY10. Thus, after reducing the policy rate by a cumulative 250 basis points during CY09, SBP kept its discount rate unchanged at 12.5 percent in succeeding months.

This conservative monetary stance continues to attract criticism from industry at large. This is quite understandable, since there are pressures on the domestic economy, due to the global economic slowdown, and energy costs have also increased. However, given the weakness in the country's fiscal outlook and risks to external flows, and rising inflation, policy options for Pakistan are quite limited.

The fiscal outlook appears especially challenging. Existing rigidities in current expenditures have been exacerbated in FY10 by the strong buildup in domestic and external debt, and rising military spending for anti-terrorist operations. Moreover, spending has also been boosted by efforts to address the growing energy sector circular debt logjam, as well as the less desirable policy to ensure higher-than-market price for farmers. Although development spending increased by 69.6 percent during H1-FY10, even this is below the levels implied in the original budgeted amount for FY10.

The impact of these developments, together with weak revenue generation and considerable lags in the receipts of coalition support funds, contributed to a rise in the fiscal deficit. It rose to approximately 2.7 percent of GDP in H1-FY10, in contrast to 1.9 percent of GDP in H1-FY09. More significantly, the original FY10 fiscal deficit target of 4.9 percent of GDP looks unachievable even after incorporating the proposed large reduction in development spending. The latter is certainly not a welcome development, with negative implication for the country's long-term growth potential. But it is worth noting here that the government's ability to protect development spending has been severely cramped by the non-availability of expected external aid flows from FoDP.

Lower than planned availability of external financing also significantly increased the government's reliance on financing from scheduled banks. This demand was compounded by higher demand for credit from PSEs and for commodity operations, thereby squeezing market liquidity and crowding out the private sector.

This forced SBP to aggressively inject liquidity, allowing banks to accommodate a small seasonal recovery in credit demand from the private sector during Q2-FY10. Thus, while M2 growth accelerated from an anemic 2.0 percent in Jul-Feb FY09 to a more robust 5.7 percent in the corresponding period of FY10, the larger part of this was contributed by government sector activities, including quasi-fiscal activities, e.g. the government's commodity operations, interventions to reduce the stock of energy sector subsidy arrears, etc.

Unlike the fiscal accounts, external account balances show significant year-on-year improvement during the aggregate Jul-Feb FY10 period. Specifically, the current account deficit dropped from 6.8 percent of GDP in Jul-Feb FY09 to 2.2 percent of GDP in Jul-Feb FY10, as a large drop in imports overshadowed a

smaller decline in exports², and remittances saw a 17.7 percent YoY rise in the same period. Consequently, the country's foreign exchange reserves rose to US\$ 14.8 billion by end-February 2010, from a low of US\$ 6.8 billion in October 2008.

The good news on the external sector ends here. A monthly disaggregation for the period shows that most of this improvement was concentrated in the first quarter of the fiscal year. Thereafter, the YoY trends have steadily deteriorated, with an uptrend in imports relative to exports, and slowdown in remittances inflows. The trends in the financial and capital accounts are also discouraging: of the US\$ 3.7 billion surplus for Jul-Feb FY10, approximately US\$ 2.8 billion was recorded in Q1-FY10. Moreover, practically all of the external sector financing was in the form of debt, significantly adding to the country's vulnerability to external shocks.

Similarly, even as continued inflows on account of the IMF Stand-By Arrangement pushed up the country's foreign exchange reserves, the rupee depreciated sharply between mid-December 2009 and mid-Feb 2010. The rupee weakened because SBP stopped providing liquidity support for oil payments in the inter-bank forex market in mid-December 2009, over a month ahead of schedule. The impact of additional demand for dollar was further compounded due to increase in demand for POL imports in recent months, as well as some (temporary) rumor-driven rise in the informal (kerb) exchange rate market.

1.2 Looking Forward

Despite an anticipated decline in value addition by major crops (having a share of about 38 percent in agriculture value addition), an above-target recovery in manufacturing, strong rebound by the construction sector and reasonable performance by the services sector are likely to sustain a modest revival in growth during FY10. SBP growth estimates remain unchanged from the previous quarter, with real GDP growth for the year projected to fall in the range of 2.5 – 3.5 percent (see **Table 1.2**).

Similarly, the resurgence in inflationary pressures due to revival in aggregate demand, exchange rate pass-through, etc. have so far, not exceeded levels already embedded in earlier SBP forecasts. The annual headline CPI inflation projection for FY10 also remains unchanged. An important risk to the inflation outlook, however, lies in the possibility of a revival in inflationary expectations if domestic demand picks up further or the pass through of rising international commodity prices increases.

² Exports and imports numbers are based on exchange record (SBP) data and will not tally with the export import data presented in table 1.1 which is based on FBS data.

Encouragingly, due to a better than expected performance by the exports in recent months and robust performance of remittances earlier in the year, the current account deficit has narrowed more than projected earlier. Thus, even incorporating relatively less positive trend in months ahead, it seems likely that the full year FY10 deficit will be lower than earlier SBP forecasts. Current projections suggest that the FY10 current account deficit is likely to fall in the range of 3.2 – 3.8 percent of GDP, which represents a 0.5 - 1.1 percent of GDP improvement from the earlier estimates. A key risk to this more positive assessment, however, lies in the possibility of a further large (US\$ 5 – 10 / barrel) increase in international oil prices.

Table 1.2: Projections of Major Macroeconomic Indicators

	FY09	FY10	
		Annual Plan Targets	SBP Projections
<i>growth rates in percent</i>			
GDP	2.0	3.3	2.5 - 3.5
Average CPI inflation	20.8	9.0	11.0 - 12.0
Monetary assets (M2)	9.6	-	14.5 – 15.5
<i>billion US dollars</i>			
Workers' remittances	7.8	7.0	8.0 - 8.5
Exports (fob-BoP data)	19.2	19.9	18.7 - 19.2
Imports (fob-BoP data)	31.7	28.7	30.5 - 31.0
<i>percent of GDP</i>			
Fiscal deficit	5.2	4.9	5.0 - 5.5
Current account deficit	5.3	5.3	3.2 – 3.8

Note: Targets of fiscal and current account deficit to GDP ratios are based on nominal GDP in the budget document for FY10, while their projections are based on projected (higher) nominal GDP for the year.

In contrast, FY10 fiscal deficit is estimated to be higher on account of extraordinary defense related spending and weakness in revenue collection. In recent consultations with IMF, need for a cut in PSDP and relaxation in fiscal deficit target was also recognized. Accordingly, the fiscal deficit is projected to lie in a range of 5.0 – 5.5 percent of GDP during FY10.

In brief, the economic outlook is mixed. While inflation decelerated significantly during FY10 compared with the preceding year, inflationary pressures have decisively remerged in recent months. Similarly, although, the current account deficit witnessed improvement, sustaining it at low levels will be challenging given rising import requirements of the economy, and evident weakness in the pace of growth in remittances. Prospects for real GDP growth are better relative to the preceding year. However, this level of growth is not adequate to generate required employment opportunities. It should be remembered that the growth in labor force is higher than the preceding years due to: (1) induction of new people into the job market, and (2) an encouraging increase in female participation in job market.

This situation reinforces the need for serious policy efforts to achieve sustained high growth. This needs both macroeconomic stability (low inflation, prudent fiscal stance, low current account deficit, high investment and savings), and political stability, including improvement in law & order and security conditions. Implementation of structural reforms focused on elimination of subsidies, reduced role of government in price setting, formulation of effective regulations to ensure optimum market-based outcome, are needed to sustain growth and enhance resilience of the economy. These must also be complemented with the introduction of second generation reforms centered on institution building and governance.

It is worth reiterating that while tax reforms are most readily legislated during times of economic stress, this is also the period where the revenue impact of reforms is most limited. In other words, revenue measures will gain most traction only when the economy recovers somewhat. This implies that, in the short run, there may be few options to contain the fiscal deficit. Nonetheless, aggressive fiscal reforms are key to achieving and retaining macroeconomic stability in the medium term. These need to focus on the entire range of options from increasing efficiency of public expenditures, reducing size of government, raising the tax-to-GDP ratio, etc.

There is little doubt that the government intervention cannot successfully stabilize the economy and simultaneously provide stimulus for growth. This means that fiscal policy must be carefully calibrated and prioritized by targeting either the provision of public goods or targeting market failures, and also create an enabling environment for provision of other services by the private sector. In this context, the government interventions in market pricing can be particularly distortionary. These can not only lead to inefficient production decisions, and entail very significant fiscal costs, the added political risk in market pricing can discourage private sector investments.

1.3 Executive Summary

Agriculture sector

Growth prospects for agriculture sector remain weak in contrast to the strong growth seen last year. Negative contribution by the two major crops of FY10 *kharif* (rice and sugarcane) and expected decline in wheat harvest are mainly responsible for this gloomy outlook. The major contributory factors for lower area under cultivation and relatively weak performance by these crops were: (a) water shortages; and (b) realization of lower prices in the preceding season for rice and sugarcane.

An overall decline in area under major crops, conservative lending by domestic private banks (DPBs) and weakness in demand for credit by the non-farm sector led to slowdown in agri-credit disbursement during Jul-Jan FY10. On the positive side, relatively lower prices of fertilizer and higher farm incomes in FY09 encouraged farmers to use fertilizers aggressively. Fertilizer off-take also increased due to government support in terms of maintaining a higher support price for FY10 wheat crop despite a substantial decline in international prices of the grain.

Large Scale Manufacturing

The pace of recovery in LSM subsector increased in Q2-FY10 largely in response to rising domestic demand. Most of the recovery emanated from the consumer durable industries as demand for automobiles & allied industries increased sharply despite the QoQ increase in prices. Furthermore, revival in construction activities in both public and private sector resulted in a sharp increase in demand for cement and steel during the quarter. Cement sector benefited also from recovery in external demand as exports to North African countries showed a steep rise. Resource based industries, however, presented a mixed picture. Where the low-value-added textile sector benefited from a good cotton crop and a simultaneous shortage of cotton globally, the local sugar industry suffered from lower sugarcane production.

Nonetheless, it will be extremely challenging to sustain the growth seen in Jul-Jan FY10 period given the prevalent energy shortages in the country. In addition to energy insufficiency, local manufacturers are also confronting the rising cost pressures, since electricity and gas tariffs have increased from January 2010. Furthermore, the rise in global commodity prices from Q2-FY10 has also put significant pressures on production costs. If manufacturers tend to shift the cost burdens on the consumers, demand may tumble as consumers' purchasing power has already been hit by rising food prices.

Prices

Inflationary pressures strengthened in the economy in recent months. Resurgence in inflation during recent months is mainly attributed to: (a) rise in the administered prices of energy³ and key fuels by the government, (b) depreciation of rupee, and (c) a temporary supply shock due to bad weather (fog) in Punjab.

³ An upward adjustment in electricity and gas tariff is part of the efforts to reduce subsidy, thus help reduce burden on fiscal budget.

Moreover, relatively higher international commodity prices of sugar, rice and crude oil also fueled inflationary pressures in the economy.

Specifically, headline CPI inflation fell to 13.0 percent YoY in Feb 2010 after bottomed out at 8.9 percent in October 2009. The surge in CPI inflation in recent months is principally contributed by rise in the prices of food items and administered prices of key fuels and electricity tariffs. This is also evident in a lower core inflation measured by excluding food and energy items (NFNE) from the CPI basket relative to core inflation measured by 20% trimmed mean. While NFNE inflation registered at 10.1 percent, 20% trimmed mean inflation recorded at 12.4 percent in Feb 2010. Relatively higher core inflation measured by trimmed mean also indicates that inflationary pressures are substantially broad based within food and energy sub-groups. This also points towards rigidity in inflationary pressures in the economy. More importantly, since inflationary pressures concentrated in food and energy sub-groups, this indicates possibility of strong second-round effects on the prices of other goods and services due to rising costs of production and increase in cost of living.

Money and Banking

SBP kept the policy rate unchanged at 12.5 percent in January 2010. This was because of rebounding inflationary pressures, lingering risks on external current account though reduced from last year level and persistent weakness in the fiscal account.

In terms of monetary aggregates, growth in Broad Money (M2) accelerated to 5.7 percent during Jul-Feb FY10 from 2.0 percent in the corresponding period of FY09. This improvement resulted entirely from an expansion in net domestic assets (NDA) of the banking system on the back of strong rise in private sector credit and increased recourse of government to finance its deficit from the banking system. On the other hand, trend improvement in the external account visible since December 2008, has started to reverse from October 2009 onwards. Resultantly, NFA of the banking system recorded a depletion of Rs 46.6 billion in Jul-Feb FY10; though much lower compared to last year's contraction. Deposit mobilization by banks shows some recovery since deposits recorded a growth of 4.6 percent during Jul-Feb FY10 in sharp contrast to the previous year when the deposit base contracted by 0.6 percent.

The trend decline in private sector credit, visible for twelve consecutive months, reversed from October 2009 as (1) the demand for seasonal finance (i.e. cotton, sugarcane and rice) picked-up, and (2) a mild recovery was seen in domestic demand. Consequently, cumulative credit to private sector grew by 4.7 percent

during Jul-Feb FY10; slightly lower than the growth seen in the corresponding period a year earlier.⁴

Fiscal Developments

Key fiscal indicators improved in Q2-FY10 over the previous quarter, bringing the cumulative fiscal deficit for H1-FY10 to 2.7 percent of annual estimated GDP. This figure is consistent with the SBP forecast of budget deficit for the year.

The improvement in revenue growth during Q2-FY10 is largely due to increased direct tax collection. This was to be expected given that the traditional first quarter receipts had been pushed into the second quarter following extension of the deadline for filing income tax returns. Moreover, tax collection was also helped by a revival in the economy and rise in rupee value of imports.

On the expenditure side, the government was able to contain growth in total outlays during Q2-FY10. However, given the rigidities in current expenditure on account of the need to address buildup of energy sector circular debt, security related expenditure etc, the government has little choice but to cut development spending if pledges by FoDP are not realized and lags in reimbursement of Coalition Support Fund continue.

Balance of Payments

Improvement in the overall external accounts recorded during Q1-FY10 could not be sustained in the ensuing months (Oct-Feb). Considerable YoY decline in financial inflows during the latter period and trend reversal with regard to the improvement in CA deficit witnessed earlier led to a noticeable deterioration in overall external account during this period. Nonetheless, overall external account recorded sizeable YoY improvement for the aggregate Jul-Feb FY10 period.

Deterioration in the current account deficit during Oct-Feb period was contributed by both an expansion in the trade deficit and a contraction in invisible account surplus. On the financing side, the decline was primarily due to fall in net foreign investment flows. Significant fall in foreign direct investment along with payment of Sukuk bond worth US\$ 600 million resulted in 61.2 percent decline in net foreign investment during the period under review. Furthermore, inflows from IFIs also remained subdued in the latter months of current fiscal year.

⁴ While the sharp rise in private sector credit during Q2-FY10 was entirely explained by a robust demand for incremental running finance; demand for fixed investment loans remained relatively lower.

The pressures on the country's reserves during Jul-Feb FY10 were visibly lower owing to improvement in the overall external account balance during this period. As a result the country's overall reserves climbed to US\$ 15.1 billion against US\$ 10.6 billion in the same period last year. The foreign exchange market also exhibited relative stability, and the exchange rate depreciated by only 4.3 percent during Jul-Feb FY10 compared to 14.5 percent in the corresponding period last year.

Trade Account

Pakistan's trade deficit contracted by 19.5 percent YoY during Jul-Feb FY10 as compared to a fall of 6.2 percent during the same period last year. This contraction was largely on account of a fall in the import bill which was supported by a marginal rise in exports.

The compression in imports was entirely due to price impact which outpaced the rising import quantum. However, with price impact also turning positive from December 2009 onwards, import growth has started to rebound. As far as exports are concerned, the recovery was observed both in textile as well as non-textile sectors particularly in Q2-FY10. Revival in external demand for textiles coupled with good production of cotton⁵ resulted in an increase in exports of low value added products.⁶ In non-textile sector, quantum growth for the fuel group in particular was remarkable during the period under review with major contribution coming from rice and fruits.

⁵ Production of cotton in FY10 is 12.7 million bales in contrast to production of 12.1 million bales during FY09.

⁶ Export growth of raw cotton and cotton yarn grew by 142.0 and 38.0 percent YoY respectively during Jul-Jan FY10.

2 Real Sector

Data for the initial months of FY10 reinforces the view that a moderate economic recovery is in progress aided by a recovery in external demand as well as strengthening domestic sales. Evident from gradually improving export growth, increase in external demand was probably helped by continued stimulus policies in US and European countries. The recovery in domestic demand was supported by a number of factors including relatively easy monetary policy higher fiscal spending and a rise in rural incomes on the back of improved prices for agri-commodities. The sustained demand recovery is also evident from increase in input requirements. Specifically, while Q1-FY10 saw a modest increase in demand for key inputs, Q2-FY10 was marked by a sharp rise in domestic energy requirements, import of raw-materials as well as bank loans (see **Table 2.1**).

Table 2.1: Indicators of Aggregate Demand

YoY growth in percent

	Q1		Q2			Q1		Q2	
	FY09	FY10	FY09	FY10		FY09	FY10	FY09	FY10
HSD sales ¹	1.8	-6.5	-12.1	9.3	Comm. auto sales ⁶	3.0	-3.9	3.7	24.8
FO sales to power ¹	-2.3	25.0	3.9	21.5	Steel sale ⁷	6.1	-34.9	-33.3	7.6
FO sales to industry ¹	-24.1	36.3	-21.0	13.4	FDI	-11.5	-57.8	16.3	-56.2
Gas sales to industry ²	-1.1	-7.4	-9.3	6.8	Non-food exports	9.3	-12.0	-6.5	11.6
Gas sales to power ²	-7.0	-2.9	-5.4	-6.6	Non-food imports	32.8	-29.1	-10.6	5.4
Hydel generation ³	-4.0	1.9	-4.6	3.9	Gov. expenses ⁸	4.0	4.3	4.3	4.4
Electricity sales to industry ⁴	-6.2	-8.1	-10.5	6.1	Fiscal deficit ⁸	1.0	1.5	0.9	1.2
Local cement sales ⁵	-14.6	11.1	-12.7	10.0	Pvt. sector credit	3.1	-2.6	3.8	7.0
Consumer auto sales ⁶	-19.9	24.6	-28.2	55.2	Disbursement FII	59.3	-29.8	-36.5	8.0

Source: ¹OCAC; ²SSGC & SNGPL; ³WAPDA; ⁴FBS (for Jul-Nov period); ⁵APCMA; ⁶PAMA; ⁷Pakistan Steel Mill; ⁸percent of GDP

This assessment of aggregate demand corresponds to a small recovery seen in industrial sector. In particular, the LSM sub-sector staged a strong rebound and grew by 2.3 percent in Jul-Jan FY10 compared with a decline of 5.4 percent in the same period last year. More importantly, the LSM growth of 4.0 percent seen in Q2-FY10 was the highest in the previous 7 quarters. Construction sector also seem to have recovered on the back of lower building material prices as well as higher fiscal spending. Mining activities however, could not recover due to unfavorable security situation as well as natural decline in key oil and gas fields.

The pace of industrial recovery, however, will be challenging to sustain in H2-FY10 as domestic energy imbalances are likely to inhibit production processes. In particular, a modest increase in power sector investments means that existing capacities may not be sufficient to support a stronger recovery. Furthermore, near-stagnant gas supplies in recent years have also resulted in frequent gas outages for industrial units. Similarly, due to circular debt problem, local production of petroleum products has declined sharply in H1-FY10 resulting in burgeoning import dependence.

Another challenge for local producers is the rising global commodity prices in recent months that have already transmitted to domestic prices of major energy items (electricity and gas), industrial metals and fertilizers. Resultantly, domestic inflation witnessed a trend reversal in November 2009 onwards and started inching up again. Furthermore, rise in import demand during Dec-Jan FY10 and transfer of oil payments from SBP to interbank market put significant pressures on exchange rate, which compounded the impact of rising international commodity prices.

The SBP concerns over rising inflation were one of the factors considered in MPC decision of keeping discount rate unchanged. Moreover, realizing the key challenges for the industrial revival, the SBP has maintained its earlier forecasts, indicating that FY10 real GDP growth is likely to be in the range of 2.5-3.5 percent. In addition to the industrial sector, the forecast also incorporates expected improvement in services sector in FY10, supported mainly by *finance & insurance* as well as *public administration & defense*. Improving manufacturing and import growth in Q2-FY10 is also likely to benefit *wholesale & retail trade* activities. The GDP estimates could have been higher if not for weakening seen in agriculture growth. Specifically, lower rice and sugarcane production and expected fall in wheat harvest will more than offset the gains from a higher cotton production in FY10.

2.1 Agriculture Sector Performance

Growth prospects for agriculture sector remain weak in contrast to the strong growth seen last year. Negative contribution by the two major crops of FY10 *kharif* (rice and sugarcane) and expected decline in wheat harvest are mainly responsible for this gloomy outlook.

Although cotton output rose by 5.3 percent in *kharif* FY10, its impact was more than offset by the decline in production of other major crops (see **Table 2.2**). The major contributory factors for lower area under cultivation and dismal performance by major crops were: (a) water shortages; and (b) realization of lower prices in the preceding season for rice and sugarcane.

An overall decline in area under major crops, conservative lending by domestic private banks (DPBs) and weakness in demand for credit by the non-farm sector led to slowdown in agri-credit disbursement during Jul-Jan FY10. On the positive side, relatively lower prices of fertilizer and impact of higher farm income in FY09 encouraged farmers to use fertilizers aggressively. Fertilizer off-take also increased due to government support in terms of maintaining a higher support price for FY10 wheat, despite a substantial decline in international prices of the grain.¹

Table 2.2: Performance of Major Crops

Area Under Cultivation (000 hectares)					% change
	FY08	FY09 ^P	FY10 ^T	FY10 ^E	FY10
Cotton	3,055	2,850	3,200	3,040	6.7
Sugarcane	1,241	1,029	1,106	952	-7.5
Rice	2,516	2,963	2,526	2,854	-3.7
Wheat	8,550	9,045	9,045	8,873	-1.9
Gram	1,107	1,092	1,022	-	-
Maize	1,037	1,062	1,039	971	-8.6
Production (000 tons; cotton 000 bales of 170.09 kg each)					
Cotton	11,655	12,060	13,360	12,700*	5.3
Sugarcane	63,920	50,045	56,527	48,622	-2.8
Rice	5,561	6,954	5,949	6,377	-8.3
Wheat	20,959	24,032	25,000	-	-
Gram	475	760	749	-	-
Maize	3,109	3,548	3,414	3,344	-5.7
Yield (Kg/hectare)					
Cotton	649	720	710	711	-1.3
Sugarcane	51,507	48,635	51,109	51,074	5.0
Rice	2,210	2,347	2,355	2,234	-4.8
Wheat	2,451	2,657	2,764	-	-
Gram	429	696	733	-	-
Maize	2,998	3,341	3,410	3,444	3.1
P: Provisional, T: Target, E: Estimates					Source: MINFA
*: Pakistan Central Cotton Committee					

¹ DAP prices down by 52.6 percent YoY and international wheat price dropped by 16.2 percent YoY in October 2009.

Crops sector

Cotton

Cotton harvest witnessed an increase for the second consecutive year in FY10. Initial lower estimates for FY10 cotton crop were based on the situation in Punjab; however, a strong growth of 50.0 percent in Sindh drove overall cotton harvest to 12.7 million bales (see **Table 2.3**).² Despite higher acreage (6.7 percent) in Punjab, cotton production decreased by 8.3 percent during FY10 mainly due to severe virus attack.

The extraordinary growth of cotton production in Sindh was achieved due to: (1) increase in cultivated area; (2) aggressive sowing of Bt cotton; (3) supportive weather - low rains and desired temperatures; (4) no major incidence of disease or insects strike (no attacks of mealy bug); and (5) extended picking season.

Table 2.3: Province-wise Cotton Harvest

thousand bales

	FY08	FY09	FY10
Punjab	9062	9160	8400
Sindh	2536	2800	4200
Balochistan	57	99	100
NWFP	0.5	1.0	0.5
Total	11655.5	12060.0	12700.5

In particular, disappointed growers of rice and sugarcane (due to lower realized prices last year) switched to cotton cultivation and area under cotton rose by 6.7 percent in FY10. Recovery in cotton production in FY10 crop is a welcome development, but despite the rise, the FY10 production is still lower than the record crop of 14.3 million bales registered in FY05. The cotton consumption in the country is estimated at about 16.0 million bales which suggest that Pakistan may need to import the deficit quantity.

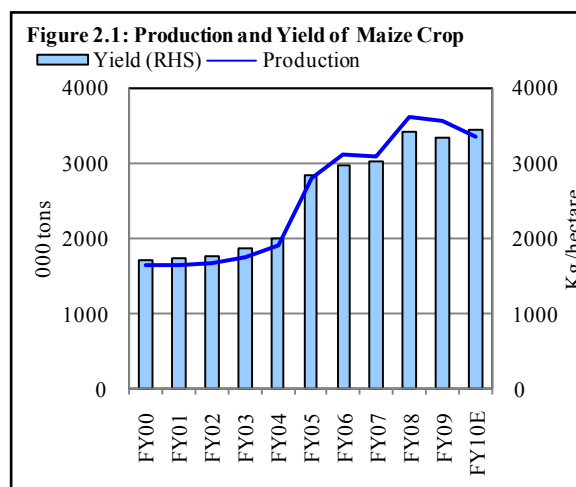
Rice

Rice production fell by 8.3 percent to 6.4 million tons in FY10 relative to FY09, but was still substantially higher than the target for FY10. A decline in area under rice (and harvest) was anticipated due to a sharp slide in rice prices during the preceding season. However, it appears that some support from the government in FY09 made rice crop attractive. Recent surge in international rice prices, due to supply shortages in India and Philippines, would also help motivate farmers to cultivate more rice in coming *kharif* season (Apr 2010).

² Due to extended picking season cotton output may increase further during FY10.

Maize

Maize harvest declined by 5.7 percent in FY10 entirely due to decline in the area under cultivation. However, it is notable that the country has seen substantial gains in maize harvest and yields in the last five years (see **Figure 2.1**). Maize is the third most important cereal after wheat and rice. It provides major portion of feedstock for livestock and poultry sector. In recent years, demand for maize has increased in the country.



Wheat

The impact of water shortages on the crop was further compounded due to lower rains during Nov-Dec 2009 – sowing period for wheat. As a result, area under wheat cultivation dropped by 1.9 percent YoY in FY10. In particular, acreage declined by 18.4 percent in non-irrigated³ (*barani*) areas during FY10 crop compared with a rise of 5.0 percent last year. However, wheat sowing in canal regions increased by 2.5 percent in FY10 mainly in response to better incentives. The prospects for wheat harvest improved somewhat with healthy fertilizer off-take in *rabi* FY10 and reasonable rainfall in February 2010. However, the impact of lower acreage and water shortages will take its toll and wheat harvest is likely to be significantly lower than the FY10 target of 25.0 million tons.

A spatial break-up reveals that area under wheat cultivation increased by 0.9 percent in Punjab during FY10 relative to the last year (see **Table 2.4**). In contrast, area under wheat declined by 1.0 percent in Sindh mainly due to lower availability of irrigation water. Similarly, poor winter rains are responsible for lower acreage in NWFP and Balochistan during FY10.

Table 2.4: Province-wise Wheat Cultivation

million hectares

Provinces	FY09	FY10 ^E	% change
Punjab	6.836	6.897	0.9
Sindh	1.031	1.021	-1.0
NWFP	0.769	0.665	-13.5
Balochistan	0.409	0.290	-29.1
Total	9.045	8.873	-1.9

^E estimated

³ Pertain to Punjab and Sindh as data for NWFP and Balochistan is not available.

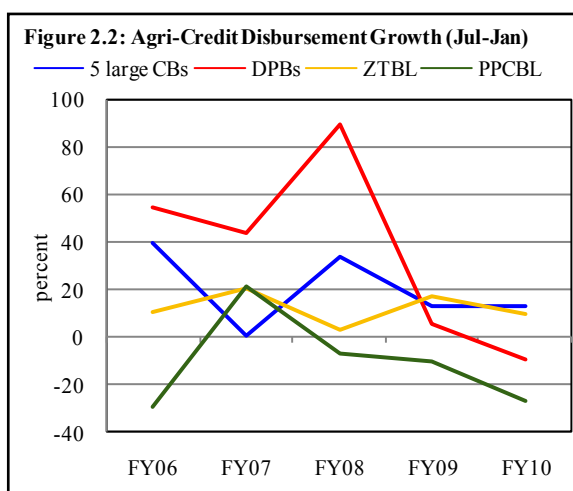
In addition, decline in wheat acreage was also caused by late harvesting of rice, delayed sugarcane crushing season and extended cotton picking on account of rising price.

Minor crops

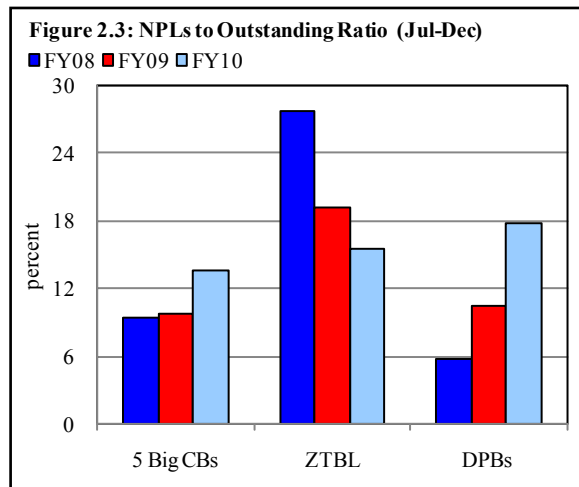
Driven by strong demand and higher prices, growers increased acreage and production of minor crops i.e., potato, tomato, onion, chilies etc. Warming weather helped early harvesting of most of the minor crops. Some of the minor crops, such as onion, also received the benefits of strong external demand, e.g. the Indian harvest was hit by a drought. Therefore, despite bumper crops, prices of most of the minor crops did not see a seasonal decline in FY10. One exception was tomatoes where a supply glut resulted in extremely low prices with some farmers were unable to cover costs. As a result area under the crop is expected to decline next year and consequent supply shortages will push its prices up. The intensity of this boom-bust cycle may be reduced with investment in cold storage, processing and packaging units in rural areas. It would not only help stabilize prices of minor crops, but will also generate most needed employment opportunities for the landless farmers in rural areas.

Agriculture credit

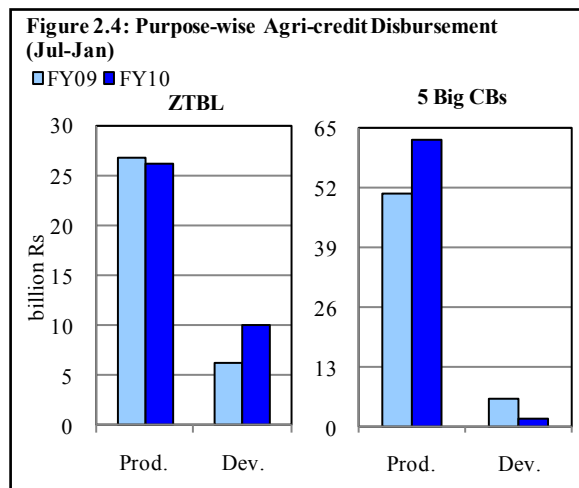
Growth in agri-credit disbursement slowed to 6.3 percent during Jul-Jan FY10 compared with 11.5 percent in the same period last year. This slowdown is largely attributed to a decline in the disbursements by the DPBs and PPCBL (see **Figure 2.2**). The main factors affecting the pace of growth in agri-credit are: (a) decline in both overall area under cultivation and number of borrowers; (b) rising NPLs in agri-credit, particularly for DPBs and five large commercial banks (CBs) (see **Figure 2.3**); as well as, (c) improvement in farm income on the back of bumper crops and better prices of most of the agri-produce in FY09.



The lending behavior of different institutions also reveals their priority in an environment of rising NPLs. CBs extended higher financing for short-term production related loans and cautiously contracted their exposure in development lending, whereas ZTBL concentrated on medium to long-term developmental loans (see **Figure 2.4**). A sharp jump of 61.9 percent in developmental loans by the ZTBL was probably due to financing of Benazir Tractor Scheme.



Among purpose-wise lending, total production loans increased by 8.5 percent in Jul-Jan FY10 compared with 7.8 percent increase seen during the same period last year. This improvement is principally driven by CBs as production loans by these institutions grew by a strong 22.7 percent during Jul-Jan FY10 compared with a rise of 6.7 percent in the same period last year. The rise in production loans was



attributed to higher fertilizer off-take following lower prices and efforts of the farmers to increase yield of wheat. However, production related loans by ZTBL and DPBs declined in Jul-Jan FY10, mainly due to weaker recovery by these institutions than in the same period of the preceding year.

In contrast with the production loans, disbursements for developmental loans declined by 9.4 percent during July-Jan FY10, despite a healthy growth by ZTBL.

This was mainly caused by slower lending for developmental loans by CBs and DPBs.

The structure of agri credit market appears to have become stable in recent years after a distinct transformation during FY01-FY07.

The share of 5 large commercial banks is gradually increasing, improving their leading position in the market on the back of extensive branch network. The share of specialized banks seems

to be stabilized while the share of DPBs contracted somewhat (see **Figure 2.5**). Given bright prospects for investment in agriculture due to strong domestic and external demand as well as reasonable prices of agriculture commodities, the share of commercial banks (including DPBs) is likely to increase in coming years.

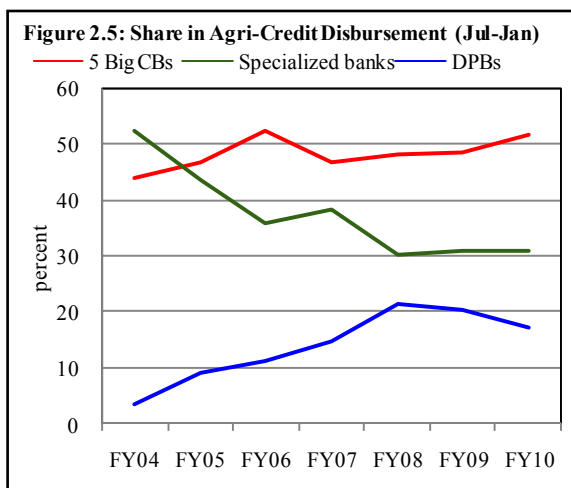


Table 2.5: Borrowers and Credit Disbursement (Jul-Jan)

Number of borrowers (000)

	FY08	FY09	FY10
Farm	595.2	850.2	567.3
Non-Farm	38.0	47.7	63.1
<i>Growth (percent)</i>			
Farm	31.6	42.8	-33.3
Non-Farm	12.9	25.5	32.4

Amount (billion Rs)

	FY08	FY09	FY10
Farm	77.2	80.7	86.1
Non-Farm	27.5	36.1	38.1
<i>Growth (percent)</i>			
Farm	16.3	4.6	6.7
Non-Farm	15.2	30.8	5.6

Sector-wise Disbursement

Agri-credit for farm sector increased by 6.7 percent during Jul-Jan FY10 compared with 4.6 percent rise seen in the same period last year. Improvement in farm credit was recorded by the economic and above economic holding groups. It appears that subsistence farmers (having a share of about 60.0 percent in total disbursements to farm sector) relied more on their own resources on the back of increased farm income in FY09 and growth in disbursement

slowed under this category.

Despite fall in number of borrowers in Jul-Jan FY10 in farm sector, growth in credit disbursement improved by 2.1 percentage points due to higher growth under economic farm holders and above economic (large) farm holders. On the other hand the number of borrowers improved by 6.9 percentage points in non-farm sector, however growth in disbursement slowed during Jul-Jan FY10, owing principally to a deceleration in disbursements to large borrowers, which in the past availed about 80.0 percent of the total loans to non-farm sector.

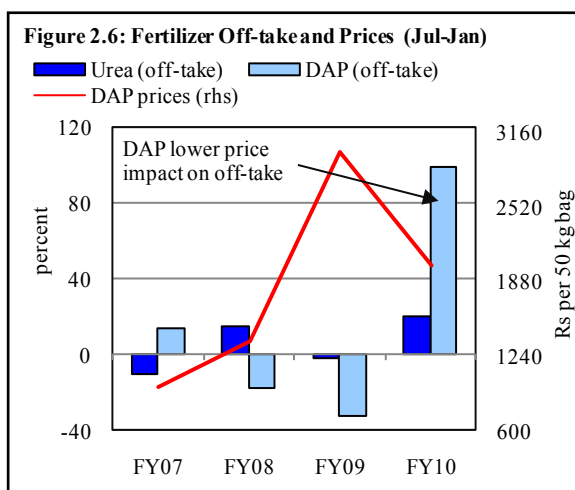
In contrast to farm sector, growth in disbursement to non-farm sector decelerated during Jul-Jan FY10 (see **Table 2.5**). A slowdown in disbursement to livestock and poultry sector is a source of concern as country needs heavy investment in these two sectors to improve domestic supply of dairy and poultry products as well as to increase exports.

Fertilizer off-take

Despite slowdown in irrigation water availability and less winter rains, fertilizer off-take registered a strong growth of 32.6 percent during Jul-Jan FY10 in contrast to a decline of 9.2 percent witnessed in the same period last year. This growth is attributed to: (1) lower prices of DAP and stable prices of urea; (2) better prices of most of the agri produce; and (3) farmers efforts to improve yield (on the face of good prices for produce) to offset the impact of water shortages.

In particular, DAP off-take substantially increased by 98.5 percent in Jul-Jan FY10 against a fall of 33.0 percent in the same period last year (see **Figure 2.6**). The record DAP off-take of 1.3 million tons is attributed to better inventories, timely imports and, more importantly, lower prices. Consequently, share of DAP in total fertilizer off-take rose by 8.1 percentage points during Jul-Jan FY10 compared with the same period last year.

Generally, growers prefer to purchase major share of DAP in the second quarter of financial year, however, as prices bottomed out in Q1-FY10, a large portion of



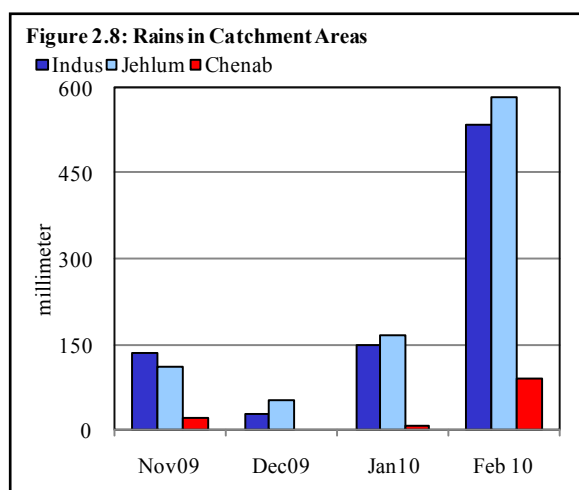
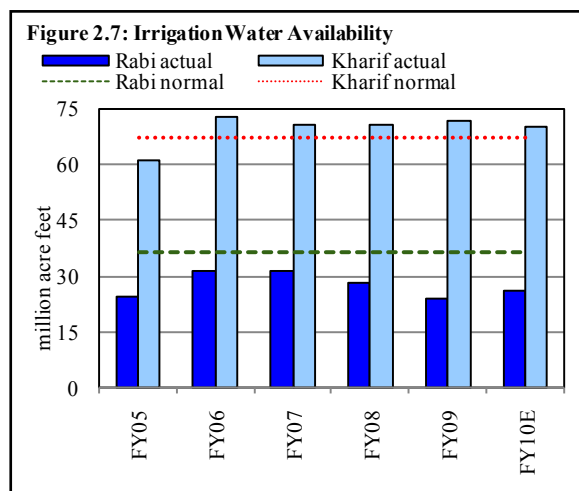
(51.0 percent) was lifted by the farmers as against only 21.0 percent in the same period last year. Similarly, urea off-take rose by 19.8 percent during Jul-Jan FY10 as against 2.4 percent fall seen in Jul-Jan FY09. An aggressive DAP off-take with substantial rise in urea is likely to impact FY10 wheat yield with a more balanced mix of the nutrients that would somewhat mitigate the impact of water shortages.

Irrigation Water

Canal water availability was initially estimated to increase by 7.7 percent YoY in *rabi* FY10 as against 13.7 percent decline in the corresponding season last year (see **Figure 2.7**). Inadequate water inflows in four major rivers, however, resulted in substantial decline in water availability for *rabi* FY10. The collective reservoir water availability dropped to 1.4 MAF by 30th Jan 2010 as against 2.6 MAF last year.

Availability at farm gate declined further due to poor water management. This adversely affected the area under wheat cultivation the most, which declined by 1.9 percent despite announcement of an attractive procurement price and lower fertilizer prices.

Lower winter rains also discouraged farmers to cultivate wheat in the non-irrigated areas. Rains in February 2010, however, provided much needed relief as the rains not only improved inflows in the reservoirs but also improved water availability in barani areas (see **Figure 2.8**).



Water shortages are likely to become more frequent and acute in years to come due to the combined impact of environmental changes and construction of new dams by India. This situation requires efficient management of water resources, as well as, improvement and construction of new dams on priority basis.

2.3 Large Scale Manufacturing

The LSM subsector continued its uptrend in Q2-FY10 largely in response to rising domestic demand. Production of consumer durables contributed most to the recovery as automobiles and allied industries increased production sharply despite the QoQ increase in prices (see **Table 2.6**). Furthermore, the demand for cement and steel increased sharply as local construction activities revived. Cement sector benefited also from rising global demand as exports to North African countries showed a considerable increase. Finally, the resource based industries presented a mixed picture. Textile sector (low value-added) benefited from a good cotton crop and a simultaneous shortage of cotton globally; whereas, local sugar industry suffered from lesser sugarcane production as well as increasing use of cane in gur manufacturing.

Major recovery was seen in consumer vehicle sector in Jul-Jan FY10. This recovery was despite the non-availability of consumer finance by banks; as a result, most of the transactions were cash-based. This was possible due to improvement in rural incomes (in case of motorcycles), as well as

Table 2.6: Performance of Selected Industries
percent growth

	FY09		FY10	
	Q1	Oct-Jan	Q1	Oct-Jan
Overall LSM	-5.9	-4.9	-1.0	4.8
Resource-based				
Cotton ginning (PCGA)	32.7	-3.8 ⁱ	24.6	10.3 ⁱ
Cotton yarn (TCO)	0.6	1.5 ⁱ	1.1	1.6 ⁱ
Cotton cloth (FBS)	-0.9	-0.1	-0.2	-0.1
Sugar	N.A.	-18.3	N.A.	-8.8
Edible oil & ghee	-9.1	-8.8	2.2	-0.1
Consumer durable				
Consumer autos (cars/M-cycles)	-43.7	-43.0	11.2	51.4
Consumer electronics	-15.6	-19.8	-9.6	17.4
Rubber	-2.3	-6.0	24.5	36.7
Construction based				
Cement	0.4	9.2	15.1	16.8
Steel (billets & coils only)	-35.8	-42.8	-24.0	10.2
Paints	27.8	9.5	-13.2	6.3
Other intermediate				
Commercial vehicles	15.6	-9.8	-18.4	10.4
POL	-5.4	-10.2	-11.0	-2.6
Fertilizers	8.0	36.2	2.4	14.8

ⁱ Oct-Feb ; ^j Oct-Jan

For details, please see FBS data on www.statpak.com

favorable price adjustments; first in April 2009 in response to depressed demand, and later in July 2009 following the removal of 5 percent FED in 2009-10 Budget (that was imposed last year). The demand for local cars was further strengthened by lesser availability of imported cars as customs duty on CBU imports was already increased by 10 percent in Budget 2009. On the supply side, two of the over 1000 cc cars were going through production phase-out process in FY09 which was the major factor in production decline in this category last year; in FY10, newly introduced models were received well by the near-captive customers.

Two features make the Oct-Jan FY10 growth more peculiar: (1) the demand for consumer vehicles remained strong in this period despite the quarter-on-quarter increase in prices;⁴ and (2) a strong recovery was seen in commercial vehicles category (as production and sales of consumer vehicles had already picked up in Q1-FY10). Tractors sales mainly reflected the generous agri-spending by Punjab government as well as increase in tractor financing by banks. On the other hand, the growth in sales of LCVs and trucks coincided with the growth in trade volume in Dec-Jan FY10 period. Moreover, larger transport of different POL products also increased the use of heavy vehicles.

The growth in textile manufacturing emanated mainly from, (1) good cotton crop; (2) export opportunities emanating from cotton and yarn shortages globally due to weaker crop in US and China; and (3) recovery in textiles related sales in advanced economies. However,

it appears that the growth in textile industry could have been higher if not for the shortages of raw-material in the country. Specifically, poor international crop and demand recovery in advanced economies put upward pressures on international cotton prices. Thanks to a better domestic crop, local ginners and spinners could offer cheaper prices in the region and thus fetched a large number of export orders mainly from China. The resultant increase in yarn exports appears to have caused a supply constraint for high value-added sector (see **Table 2.7**). At least partly as a result, local production of fabrics and exports of other high value-added items declined through most of Jul-Jan FY10. However, it must be noted that despite relatively higher yarn prices, China was able to increase its share in value-added

Table 2.7: Yarn Availability (Jul-Jan)
(000 tons)

	Production	Export	Available for local market
FY08	1,654	334.5	1,319
FY09	1,672	291.1	1,381
FY10	1,695	424.4	1,271

Source: Textile Commissioner's Organization

⁴ However, it must be noticed that although prices increased over the previous quarter; these still remained low compared with the peak seen in H2-FY09.

export to advanced economies. It must be noted that the exports of local high-value added categories has remained low in FY09 also due to structural weakness, removal of quotas in china recession etc. Nonetheless, the increase in China's share in exports to advanced economies in FY09 and FY10 appears to be driven by liberal export packages announced by the government. This was almost the reverse in case of Pakistan. Specifically, value added sector in Pakistan felt the burden of 100 bp increase in EFS rate and a rise in energy tariffs at a time when competitors were provided with liberal textile stimulus packages to circumvent stagnant export demand.⁵ The lower availability of electricity was also a key constraint for the value-added textile sector.

In sharp contrast to textile sector, sugar industry suffered heavily from raw material shortages for the second consecutive year. The shortage was an outcome of serious management problems in sugar sector whereby no proper mechanism is in place to ensure timely payments to the cane growers. Delayed payments in FY08 bumper crop year by the sugar mills discouraged sugarcane growers as they became extremely uncertain regarding future liquidity. As a result, farmers not only switched to other crops but also looked for other markets to sell their product. With better market mechanisms in place, gur making is now becoming an increasing attractive option for cane growers. The resultant decline in sugar production not only caused increased import of sugar in the country but has also hit other sugar-dependent industries like pharmaceuticals and beverages.

Going forward, the growth seen in Jul-Dec FY10 period will be challenging to sustain in the remaining months of FY10 given the inadequate energy balances in the country. For instance, the increase of 0.5 percent in gas exploration during Jul-Nov FY10 period does not seem sufficient to fuel a quick recovery. It must be noticed here that gas constitutes more than 50 percent of total energy consumption by industries. Similarly, scanty power investments in recent years allowed only a small increase in electricity generation capacity; which too often remains under-utilized due to water shortages or insufficient provision of gas and/or furnace oil. For instance, as winter rains remained low in FY10, the Hydel generation capability declined sharply in January 2010. Similarly, gas sales to power sector also declined during H1-FY10. Consequently, the use of furnace oil (FO) for thermal generation,⁶ increased.

⁵ Under the Stand-By Arrangement with IMF, the SBP is required to rationalize its refinancing schemes, and as a first step, the interest rate for both the EFS and LTFF schemes has been increased.

⁶ Unfortunately, due to circular debt problem, local refineries could not provide required FO quantity to power generation companies. As a result, import burden has increased significantly for FO provision.

Besides energy insufficiency, another challenge for local manufacturers is the continuing increase in cost, as prices of almost all energy items including electricity, gas increased January 2010 onwards. Moreover, the rise in global commodity prices Q2-FY10 onwards has already put significant pressures on production costs. Furthermore, the sharp increase in food inflation January 2010 onwards has weakened consumers' purchasing power. In this scenario, the demand for manufactured goods may tumble again if manufacturers tend to shift the cost burden to consumers by raising the retail prices. Realizing this, a number of firms are taking measures to circumvent cost pressures.

For instance, car and electronics assemblers at present are trying to indigenize the production process as much as possible to avoid vulnerability to import prices and adverse exchange rate movements. This was necessary as in previous quarter, rising input prices coupled with weakening rupee has already started translating in domestic prices of automobiles and electronics. So far, sale of automobiles has remained strong but given the non-availability of bank finance, so it is possible that demand for these items become more sensitive to prices. Anecdotal evidence also suggests that the sales of used cars have increased in recent months.

Similarly, a few cement firms have started looking for local and cheaper sources of energy for their production. For instance, where one of the top two companies has inked an accord for local provision of coal from Thar coal fields and the other has decided to use Municipal Solid Waste as Refused Drive Fuel (RDF) as an alternative to coal. This will not only reduce the rising cost of production but also will reduce volatility in input cost emanating from global price fluctuations. Besides, there is an additional possible positive for local cement industry in the months ahead. Metal prices are likely to remain stable (if not easing) in global and local market as China has become quite wary of the real estate boom and it appears that most of the possible tightening measures would be directed towards construction industry. Export prospects also seem steady as African and some middle-eastern countries, major export market for local cement, are expected to increase infrastructure spending in months ahead.

Fertilizer production is likely to remain strong in remaining months of FY10 with two new plants coming on line by the year-end. One of these plants was scheduled to commence commercial production by end-January 2010 but due to technical problems and gas shortages, timelines could not be met. Nonetheless, the technical problems have been resolved and it is expected that the plant will start operation by the start of March 2010. Gas pressure should also improve once the winter season is over.

2.3 Services Sector

On the back of recovery seen in manufacturing sub-sector, rebound in trade volumes Q2-FY10 onwards and a modest growth in agriculture sector, services sector appears well geared to achieve the annual target of 3.9 percent. In particular, wholesale & retail trade activities are likely to benefit from recovery seen in commodity producing sector as well rising imports (see **Table 2.9**). Transport sector also benefited from domestic and international trade of

Table 2.9: Indicators of Services Sector Performance in H1

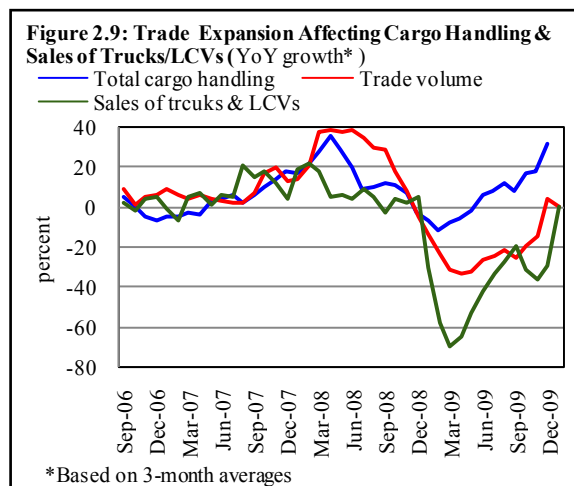
percent YoY growth unless mentioned otherwise

	FY09		FY10	
	Q1	Q2	Q1	Q2
Wholesale & retail trade (33.6)				
Credit to wholesale and commission trade	11.3	2.6	-16.0	-15.3
Credit to retail trade	45.4	32.5	1.8	5.0
FDI in trade	-11.2	0.4	-53.8	-53.4
Manufacturing growth	-5.9	-3.7	-1.0	3.8
Import growth	34.2	-6.7	-29.8	1.3
Transport (16.0)				
Cargo handling at ports	12.1	-3.0	8.7	32.5
Commercial vehicles sale	-10.6	-24.9	-1.4	37.2
Transport & communication price index	39.2	31.2	-5.8	1.6
PIA profit/loss after tax (Rs. bn.) Sep latest	547.8	..	-73.7	..
Communication (2.9)				
Telecomm imports	-29.3	-60.9	-60.0	-23.4
Communication services exports	-28.1	-45.7	138.6	277.7
Finance & insurance (10.6)				
Transfer of SBP profit to government (Rs. bn.)	28.0	16.0	70.0	65.0
Profits of commercial banks (YoY) Sep (Rs. bn.)	53.8	59.9	41.9	..
Percentage of advances at 12% or above - inc	86.9	78.2	81.4	85.8
Percentage of deposits held at 8% or above - inc	57.1	54.9	55.2	55.0
Interest Rate Spread - incremental	6.8	7.4	8.0	7.3
Gross NPLs to loans ratio	8.4	9.1	12.4	12.2
Government Services (11.5)				
Government borrowing	27.8	93.6	176.7	121.6

Values in parenthesis are 5-year average percentage shares in services value-addition.

commodities. Within the transport sub-sector, the burden of both passengers and freight has now largely shifted to road transport (89.4 percent average share in transport value-addition). It is also evident from pick up in commercial vehicles sales November 2009 onwards. Cargo handling also gained from increasing trade volumes Q2-FY10 onwards (see **Figure 2.9**). However, any major improvement

in air transport is unlikely as earnings of Pakistan International Airlines may be hurt by rising oil prices. Specifically, the first quarter result has shown a sharp decline in net losses from Rs 20.4 billion in Q1-FY09 to only Rs 5.4 billion in Q1-FY10. However, it appears that this improvement came entirely from lower oil prices in Q1-FY10 compared with Q1-FY09. Aside from that, the turnover of the company declined slightly, administrative expenses increased and financial costs remained high. Thus a rise in oil prices Q2-FY10 onwards is likely to constrain earnings of the company in remaining months of FY10.



Finance & insurance sub-sector is likely to rebound following the recovery in loan demand from private sector. Initial financial reports of few banks for H1-FY10 shows an improvement in earnings attributed to increase in volumetric expansions coupled with widening margins. However, a part of earnings growth will be offset by higher provisioning. Moreover, a sharp increase in transfer of SBP profits to government account in H1-FY10 also points towards positive financial sector earnings.

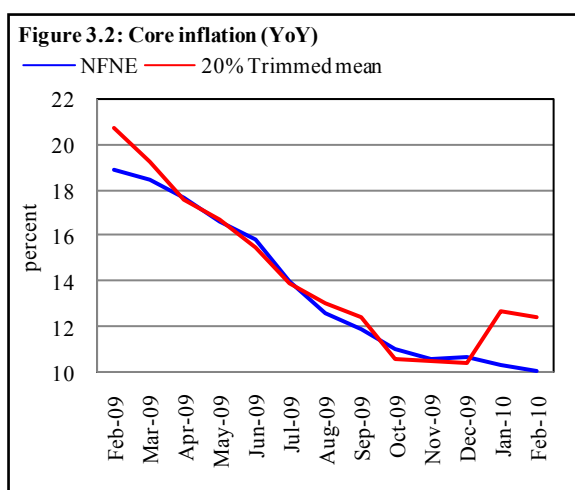
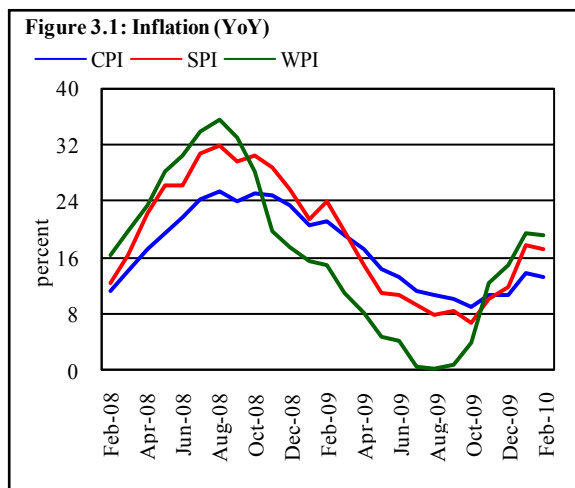
Telecom earnings are expected to gain from improved earnings of PTCL as well cellular companies. Specifically, the earnings of PTCL showed an increase of 1 percent in profit after tax compared with net decline in the previous year. The cellular companies, benefited mainly from, (a) increase in cellular subscribers H1-FY10 by 3.4 percent which resulted in higher turnover in H1-FY10; and (b) growth in telecom export services.

3 Prices

3.1 Overview

As anticipated, inflationary pressures strengthened in the economy in recent months. All price indices exhibited sharp rise since October 2009 (see **Figure 3.1**). Increase in domestic inflation is mainly attributed to: (a) rise in the administered prices of energy¹ and key fuels by the government; (b) exchange rate pass-through; and, (c) a temporary supply shock in January 2010 due to bad weather (fog) in the Punjab. Moreover, relatively higher international commodity prices of sugar, tea, pulses, rice, and crude oil also fueled inflationary pressures in the economy.²

Headline CPI inflation bottomed out at 8.9 percent in October 2009 before rising to 13.0 percent in February 2010. However, this remains lower than the 21.1 percent in February 2009, and 13.7 percent in the preceding month. A divergent trend of core inflation measured by 20% trimmed mean and core inflation measured by non-food non-energy (NFNE) indicates that



¹ An upward adjustment in electricity and gas tariff is part of the efforts to reduce subsidy, thus help reduce burden on fiscal budget.

² The impact of this is more evident in sharp surge in wholesale price index (WPI) during recent months.

inflationary pressures were more concentrated in food and energy sub-groups in recent months (see **Figure 3.2**). A higher 20% trimmed mean measure also implies that within food and energy sub-groups, inflationary pressures were substantially broad based. It also points towards the possibility of strong second-round effects on prices of other goods and services due to increased cost of production and rise in cost of living (see **Table 3.1**).

The fear of these renewed inflationary expectations, due to an inevitable reduction in subsidies on power and indications of strength in aggregate demand³, contributed to the central bank's monetary policy committee decision to keep the policy interest rate unchanged in January 2010. The decision was supported by the risk posed by continued expansionary fiscal stance due to war against terrorism, etc. However, it is also important to mention that as inflationary pressures eased earlier in 2009, SBP cut policy rate by a total of 250 basis points in CY2009. This probably helped the recovery in the growth during FY10. In particular, LSM growth witnessed strong recovery and registered 2.3 percent production growth during Jul-Jan FY10 as against a decline of 5.4 percent in the same period last year.

Table 3.1: Different Dimensions of Inflation (YoY)
percent

	Feb-09	Jan-10	Feb-10
Overall CPI	21.1	13.7	13.0
Food group	22.9	15.5	14.9
Non-food group	19.6	12.2	11.5
HRI	18.5	13.4	12.7
WPI	15.0	19.6	19.3
Food group	22.0	15.6	15.4
Non-food group	9.8	23.0	22.6
SPI	23.9	17.8	17.2
Core Inflation			
NFNE	18.9	12.6	10.1
NFNE excl. HRI	19.4	7.5	7.6
Trimmed	20.8	12.7	12.4
Trimmed excl. HRI	22.4	12.7	12.4

SBP forecasts indicate that inflationary pressures are likely to persist going forward. This view is endorsed by most commodity analysts, who believe that crude oil prices would average above US\$ 80 for the remaining 9 months of 2010. This would also impact domestic inflation in the months ahead. In view of these factors, SBP forecasts remain unchanged, indicating that annual CPI inflation would fall in the range of 11-12 percent in FY10.

³ A strong growth in sale of consumer durables, reduced but continued current account deficit and consensus on a moderate acceleration in real GDP growth, all these factors indicate continued strength in aggregate demand.

3.2 Consumer Price Index (CPI)

Although CPI inflation during recent months was still lower than the levels seen in the preceding fiscal year, upward pressures on inflation are evident (see **Figure 3.1**). Specifically, headline CPI inflation rose to 13.0 percent YoY in February 2010 compared to a local trough of 8.9 percent recorded in October 2009. The surge in CPI inflation during February 2010 is principally attributed to rise in the prices of food commodities, upward adjustment in administered prices of key fuels and electricity tariff relative to the corresponding period last year. Nonetheless, CPI inflation marginally declined during February 2010 relative to the preceding month as supply restored after improvement in weather as well as a slight downward revision in the prices of key fuels (see **Table 3.2**).

Acceleration in inflationary pressures in recent months is also evident from the significant increase in the number of items recording double digit price increases in CPI basket (see **Figure 3.3**). It is important to note that a large part of the current strength in inflationary pressures is stemming from imported inflation (see **Figure 3.4**). In particular, a rise in the international prices of sugar, cotton (thus apparel & textiles), rice, pulses, and tea coupled with weakness in rupee parity led to substantial rise in domestic prices of these commodities. In contrast, a decline in international wheat prices did not lead to lower local prices due to higher minimum procurement prices. Anecdotal evidence suggests that part of domestic wheat consumption is met by inward smuggling from some

Figure 3.3: Distribution of Price Changes (YoY)

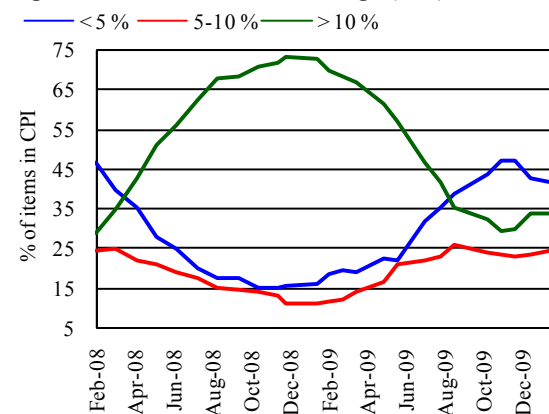
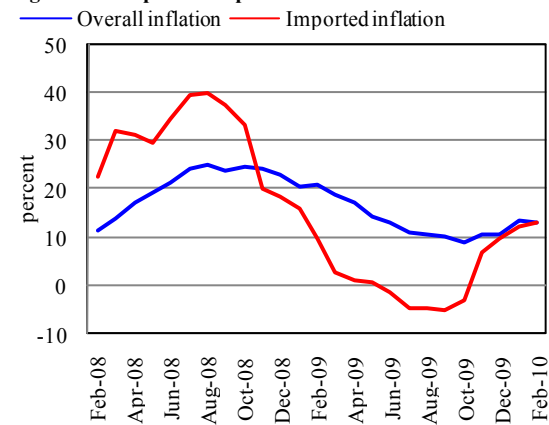


Figure 3.4: Impact of Imported Inflation



neighboring countries (Central Asian Republics, etc.). Though rise in wheat prices is subdued in FY10, its impact on overall inflation is strong since it is the key staple and a wage commodity in rural areas.

Table 3.2: Weighted Contribution to CPI Inflation (YoY)
percent

		Weights	Feb-08	Feb-09	Jul-09	Jan-10	Feb-10
1	House rent index	20.7	20.3	34.9	22.0	22.1	20.7
2	Milk fresh	11.2	13.2	7.9	7.3	9.6	11.2
3	Wheat flour	8.3	7.7	10.4	7.8	8.1	8.3
4	Sugar	-2.2	3.5	4.9	7.0	7.4	-2.2
5	Meat	2.1	2.8	4.9	4.8	5.5	2.1
6	Electricity	0.0	5.2	7.0	5.1	5.3	0.0
7	Vegetables	6.5	-1.5	4.0	3.6	4.5	6.5
8	Readymade food	2.6	3.6	0.8	5.2	4.0	2.6
9	Fresh fruits	1.8	-0.1	-7.2	3.0	2.9	1.8
10	Chicken farm	13.1	-1.1	-6.1	2.3	2.8	13.1

It is important to note that higher inflation in Pakistan relative to other regional countries has often been quoted as an anomaly. However, overall macroeconomic situation including large external and fiscal account imbalances, frequent changes in administered prices of fuel, energy⁴ and key food commodities, weak market structure, and frequent supply shocks are some reasons of higher inflation in Pakistan. In particular, a continued slide in Rs/US\$, which is in fact reflecting the position of Pakistan's external accounts, is also a major cause of higher inflation in the country. To have price stability in medium to long run, structural reforms, investment in agri sector focusing on enhancement of yields and productivity, sustained rise in exports, as well as, improvement in law & order situation (to attract forex inflows) are unavoidable.

3.2.1 CPI Food Inflation

CPI food inflation (YoY) resurged after bottoming out in October 2009. It rose from 7.5 percent in October 2009 to 14.9 percent in February 2010, though remained lower than the 22.9 percent recorded in February 2009 (see **Figure 3.5**). While overall domestic supply of essential food items is largely adequate in FY10, rise in the prices of imported commodities such as sugar, pulses and tea are the main source of acceleration in food commodity prices in recent months.

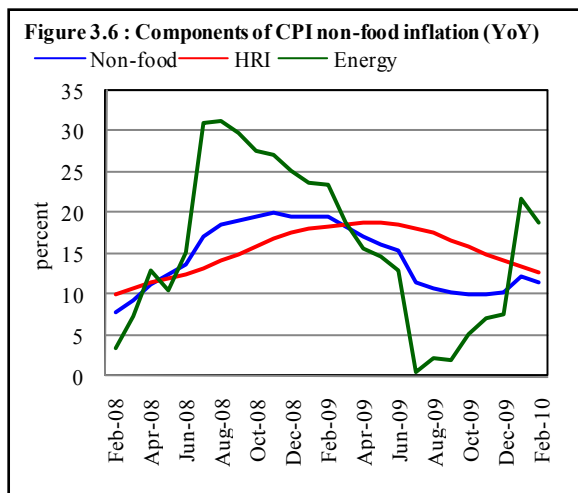
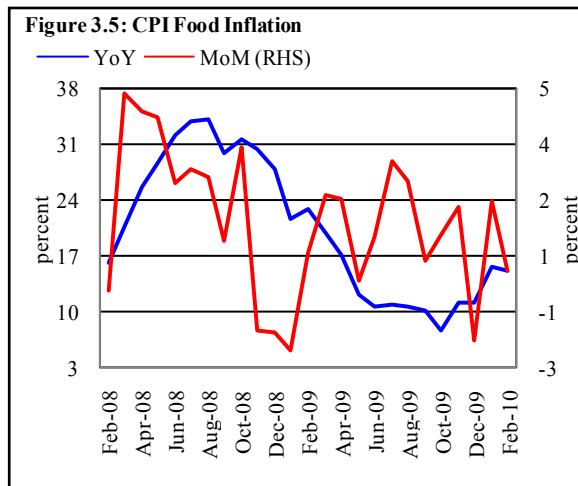
⁴ Government is reducing subsidies on these items. However, the impact on prices is disproportionate. A direct impact since these are part of the CPI basket. Also, these are key input in manufacturing process and transportation, therefore, carries a substantial indirect impact on prices of a large number of items.

Moreover, seasonal decline in the prices of food commodities in February was absent this year, probably reflecting increased transportation cost of these items.

In particular, domestic sugar prices witnessed an increase of 62.0 percent YoY during February 2010 on top of 63.6 percent in February 2009. Domestic sugar prices showed declining trend in recent weeks on the back of improved supply in the market and falling international sugar prices.⁵ However, decline in international prices is mainly a function of weak demand as major importers such as India, Pakistan, Egypt, Philippines, etc. deferred their purchases in response to very high prices in February 2010. In addition, an above 21.0 percent rise in Brazilian sugar output also improved supply. Nonetheless, there is a risk that whenever these countries will enter in the market, prices will resurge again. In this backdrop, it is important to timely import sugar to stabilize its prices in the country, as around 0.5 million tons of sugar is needed to import to meet the domestic consumption. A delay in imports may lead to shortages before the holy month of Ramadan, which may push up prices.

3.2.2 CPI Non-food Inflation

The impact of a continued moderation in HRI inflation coupled with a slight decline in key fuel prices in February 2010 relative to January 2010



⁵ FY10 sugar production dropped to around 3.0 million tons (due to sharp fall in sugarcane output), which is significantly lower than the domestic consumption requirements of about 4.2 million tons. Cost of imported sugar at Karachi port is estimated to be around Rs 48/kg on the basis of international prices as on March 18, 2010.

halted the rising trend in CPI non-food inflation; dropping to 11.5 percent YoY during February 2010 from 12.2 percent in the preceding month (see **Figure 3.6**).

Table 3.3: CPI Non-food Inflation (YoY) by Groups
percent

	Weights	MoM			YoY		
		Feb-09	Jan-10	Feb-10	Feb-09	Jan-10	Feb-10
Non-Food Group	59.7	1.2	2.8	0.6	19.6	12.2	11.5
Apparel, textile, etc.	6.1	0.3	0.5	0.7	15.4	5.2	5.6
House rent	23.4	1.3	0.8	0.8	18.5	13.4	12.7
Fuel & lighting	7.3	2.5	13.4	-0.1	29.8	20.2	17.2
Household furniture & equipment	3.3	0.7	0.6	0.7	14.7	5.6	5.5
Transport & communication	7.3	0.2	3.0	1.1	21.5	9.4	10.4
Recreation & entertainment	0.8	1.3	-0.3	3.5	14.0	2.1	4.3
Education	3.5	0.8	0.2	0.2	18.0	13.7	12.9
Cleaning, laundry, etc.	5.9	2.1	0.9	0.5	18.3	11.5	9.8
Medicare	2.1	0.4	2.7	0.4	14.2	5.9	5.9

Analysis of sub-groups of non- food reveals that out of nine sub-groups, five sub-groups showed a decline, three sub-groups an increase, and one saw no change, during February 2010 compared to the preceding month (see **Table 3.3**).

In particular inflation (YoY) in *transport & communication* sub-group has accelerated from 9.4 percent during January 2010 to 10.4 percent in February 2010 mainly due to indirect effect of increase in domestic fuel prices as transportation fares moved up. The acceleration in this sub-group is also attributed to upward rise in the prices of different vehicles and tyres and tubes amid strong domestic demand.

In contrast, a moderate deceleration in HRI is likely to continue during next few months of FY10 due to fall in the prices of cement and iron & bars. This would help contain CPI non-food inflation since HRI has about 45.9 percent weight in CPI non-food basket.

3.2.3 Incidence of Inflation

The incidence of inflation again shifted to low income groups with a sharp jump in food inflation (see **Table 3.4**). It is consistent with economic theory and the fact that a large part of income of this group is spent on food staples. However, it is notable that the incidence of non-food inflation is also higher for low income groups. This shows that a rise in power tariff and increase in the prices of key fuels – the major drivers of February 2010 inflation – also hurt low income groups. In fact, rise in administered prices of fuel leads to increase in transport

Table 3.4: Income Group-wise CPI Inflation (YoY)
percent

	Upto 3000			Rs. 3001-5000			Rs. 5000-12000			Above Rs. 12000		
	Feb-09	Jan-10	Feb-10	Feb-09	Jan-10	Feb-10	Feb-09	Jan-10	Feb-10	Feb-09	Jan-10	Feb-10
General	21.7	14.2	14.3	22.2	14.0	14.0	22.0	13.8	13.3	19.8	13.5	12.5
CPI Food	23.7	16.4	16.8	23.6	16.1	16.3	23.3	15.7	15.4	22.1	14.9	13.8
CPI Non-food	19.2	11.5	11.2	20.5	11.6	11.4	20.8	12.0	11.3	18.5	12.6	11.8

fares, which usually show downward rigidity. Similarly, consumption of electricity by low income groups is probably inelastic (at the lowest possible level), thus a rise in tariff severely hit their budget.

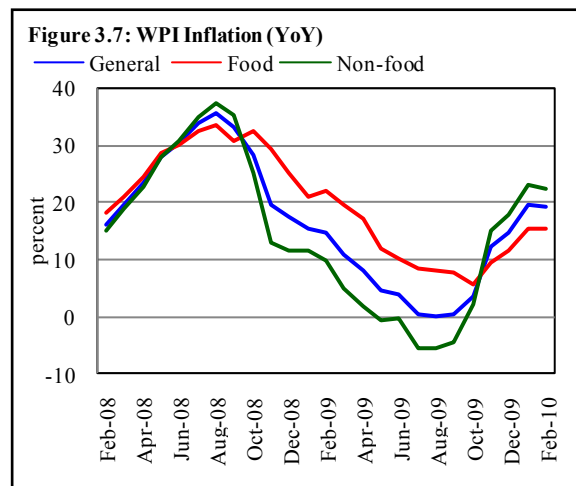
City-wise inflation data of the federal and provincial capitals shows that CPI inflation remained lower in all cities except Lahore compared to overall inflation in February 2010. Inflation in Lahore was slightly higher than overall inflation (see **Table 3.5**). This suggests that temporary supply disturbances did not severely hit major urban centers, rather inflationary pressures stemmed from smaller urban towns during February 2010.

Table 3.5: City-wise Inflation (YoY) of Selected Cities
percent

	Feb-09	Dec-09	Jan-10	Feb-10
Overall CPI	21.1	10.5	13.7	13.0
Islamabad	18.4	9.2	12.1	11.0
Lahore	18.1	9.9	13.4	13.1
Karachi	22.2	9.7	13.0	12.2
Quetta	25.1	7.9	10.6	11.0
Peshawar	23.9	7.8	12.9	12.3

3.3 Wholesale Price Index

WPI inflation rose to 19.3 percent YoY during February 2010 compared with 15.0 in February 2009 and a low of 0.3 percent in August 2009 (see **Figure 3.7** and **Figure 3.8**). Acceleration in WPI inflation came from September 2009 due to supply side pressures in some of agriculture commodities led by sugar and pulses (mash, moong), weakening of rupee, and rise in international commodity prices (see **Table 3.6**).



In particular, the impact of international commodity prices as well as exchange

rate pass-through was relatively strong on WPI basket because most of these are imported items. Even the prices of a large number of POL items in this basket are not administered and determined on the basis of international prices and prevailing rupee exchange rate. While the rise in WPI food inflation is also equally shared by CPI food inflation, dynamics of non-food inflation

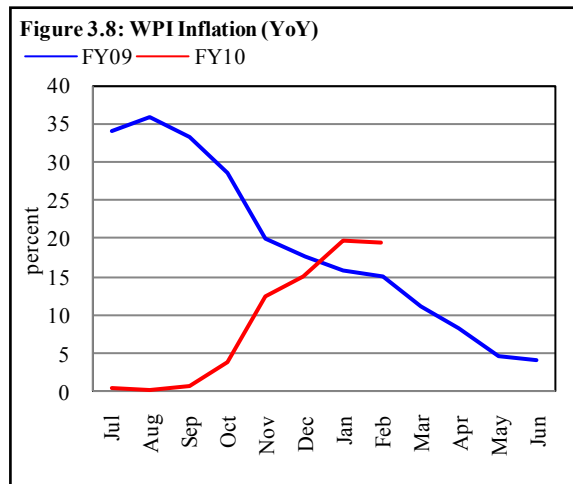


Table 3.6: Percentage Change in WPI Commodity Groups (YoY)

	General	Food	Raw materials	Fuel, lighting & lubricants	Manufactures	Building materials
Dec-08	17.6	25.3	10.2	10.2	9.7	30.6
Jan-09	15.7	21.0	16.4	11.7	7.5	20.3
Feb-09	15.0	22.0	19.9	7.1	6.9	20.1
Dec-09	15.0	11.5	33.7	25.5	11.0	-12.4
Jan-10	19.6	15.6	30.3	33.2	14.3	-3.7
Feb-10	19.3	15.4	34.7	30.8	15.1	-4.2

are largely different. For example, FY10 cotton harvest improved in Pakistan, however, its international prices rose to record levels due to global supply shortages. Impact of higher cotton prices is evident in both raw material as well as *manufactures* sub-groups due to rising prices of all types of yarn.

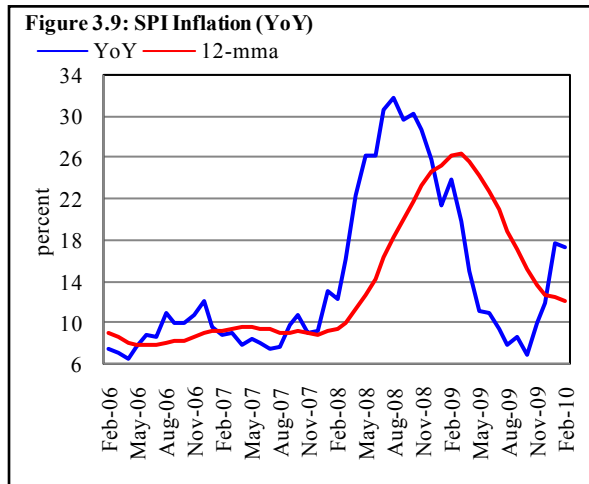
However, steep YoY rise in *fuel lighting and lubricants* is the combined impact of relatively higher administered prices of energy and fuel amid rising international prices and weakening of rupee. It is also important to note that the offsetting impact of building material sub-group on WPI inflation is reducing and likely to turn in positive in coming months. It is notable that while prices of cement and iron are declining, prices of almost all other construction material are trending upward.

3.4 Sensitive Price Indicator

Similar to CPI and WPI, inflation measured by sensitive price indicator (SPI) has also shown sharp increase in recent months after dipping to the lowest level since

April 2006 during October 2009 (see **Figure 3.9**). Weekly SPI inflation (YoY) also depicts a rising trend after reaching its 5-year low level in the second week of October 2009.

An analysis of SPI items on weekly basis suggests that SPI inflation was driven principally by rising prices of food commodities. Second large contribution came from the prices of petroleum products.



3.5 Global Inflation Scenario

There are mixed sentiments regarding the recovery in advanced economies. While the risk of deflation in advanced economies is low, a firm recovery remain elusive. Large fiscal stimulus provided some support to growth in advanced economies. At the same time, managing sustained economic growth with high unemployment will be challenging.

Table 3.7 : Inflation (YoY) and Key Policy Rates in Major Economies

Country	Inflation			Policy Rate		
	Feb-09	Sep-09	Feb-10	Current	Previous	Changed on
United States	0.2	-1.3	2.6*	0.25	1.00	Dec 16 2008
Japan	-0.1	-2.2	-1.3*	0.10	0.30	Dec 20 2008
Europe	1.2	-0.3	1.0*	1.00	1.25	May 07 2009
United Kingdom	3.2	1.1	3.5*	0.50	1.00	Mar 05 2009
China	-1.6	-0.8	2.7	5.31	5.58	Dec 22 2008
Sri Lanka	7.6	0.7	6.9	7.50	8.00	Nov 18 2009
Indonesia	8.6	2.8	3.8	6.50	6.75	Aug 05 2009
India	9.6	11.6	16.2*	4.75	5.00	Apr 21 2009
Pakistan	21.1	10.1	13.7*	12.50	13.00	Nov 24 2009
Thailand	-0.1	-1.0	3.7	1.25	1.50	Apr 08 2009
Philippines	7.3	0.7	4.2	4.00	4.25	Jul 09 2009
Vietnam	14.8	2.4	8.5	5.00	6.00	Apr 10 2009
Malaysia	3.7	-2.0	1.3*	2.00	2.50	Feb 24 2009

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

*data pertain to January 2010

Support from counter-cyclical monetary and fiscal policies also resulted in rising inflationary pressures particularly in advanced economies (see **Table 3.7**). Interest rates are at historically low levels in most of these economies, but maintaining policy rates at these levels with potential threat of inflationary pressures would be another challenge.

International commodity prices also recovered from their lows in mid 2009 mainly due to: (a) renewed interests of hedge funds in commodity markets; (b) OPEC cuts in oil production coupled with high cost of oil extraction in other parts of the world made low prices unsustainable; (c) bad harvests of sugarcane, cotton, rice, pulses, and tea in key producing countries; as well as (d) relative weakening of dollar and risks of inflation also boosted investors interest in commodities.

3.5.1 International Commodity Prices

International commodity prices have started increasing since August 2009 and trend has become more steep during the last three months (see **Figure 3.10**). Prices of all commodity groups rose during recent months. Strong demand from emerging economies and prospects of recovery in the developed economies dragged the metal and energy prices

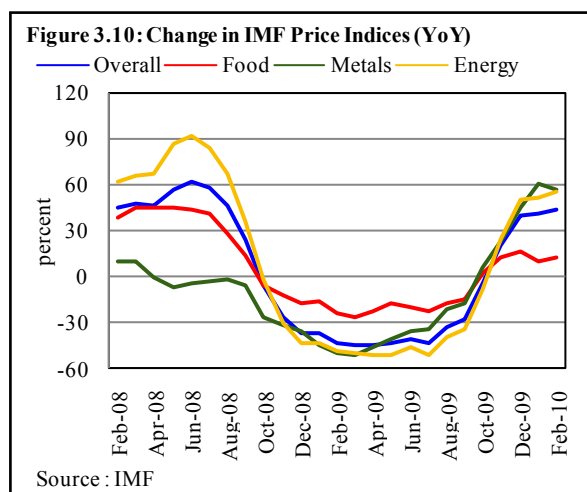


Table 3.8 : Prices Changes in Major Commodity Groups

Commodity group	Month on Month change				Year on Year change			
	Feb-09	Dec-09	Jan-10	Feb-10	Feb-09	Dec-09	Jan-10	Feb-10
Overall	-4.5	-0.5	4.2	-2.3	-43.7	40.5	41.1	44.4
Food	-2.6	1.8	1.1	-0.6	-24.7	16.6	10.2	12.5
Metals	-3.3	5.3	3.5	-5.6	-50.9	44.5	59.7	55.8
Energy	-5.8	-2.2	4.3	-2.9	-49.5	49.9	51.2	56.0

Source: IMF

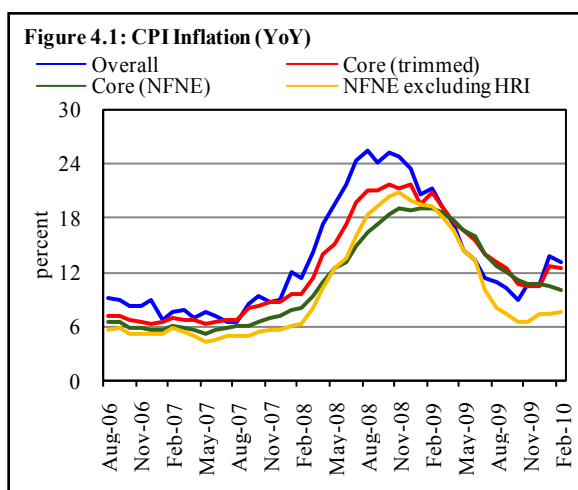
higher despite higher inventories. However, recent credit tightening measures by China had downward pressures on commodity prices. In addition, bright prospects of wheat, corn and edible oil would help ease international prices in the months ahead (see **Table 3.8**).

4 Money and Banking¹

4.1 Monetary Policy

Improved prospects of macroeconomic stability² in FY10 allowed SBP to maintain the accommodative monetary policy initiated in April 2009.³ SBP cut the policy rate twice in the first half of the fiscal year, representing a cumulative reduction of 150 basis points.⁴ However, the recovery in aggregate demand in the economy as evident from rebounding inflationary pressures, rising imports in recent months, and excessive fiscal spending held the central bank from a more aggressive easing. Therefore the SBP chose to keep the discount rate unchanged in January 2010 monetary policy announcement.

The major concern has been the trend decline in headline inflation that bottomed out in October 2009 and gradually rose from 8.9 percent YoY in October 2009 to 13.0 percent in February 2010 (see **Figure 4.1**). The inflationary pressures emanated mainly from, (1) adjustments in electricity tariff rates that have started to show up in CPI index⁵; (2) a sharp weakening of rupee value in December 2009 onwards; and (3) rise in international prices of key



¹ This section is based on the data available up to end February 2010.

² This was particularly noticeable in: (1) considerable decline in headline inflation; (2) sharp decline in imports that resulted contraction in current account deficit; and (3) recovery in LSM production growth.

³ In the current ease in monetary stance, SBP first decreased the policy rate by 100 basis points in April 2009.

⁴ Policy rate was cut by 100 basis points in August 2009 followed by another 50 basis points in November 2009.

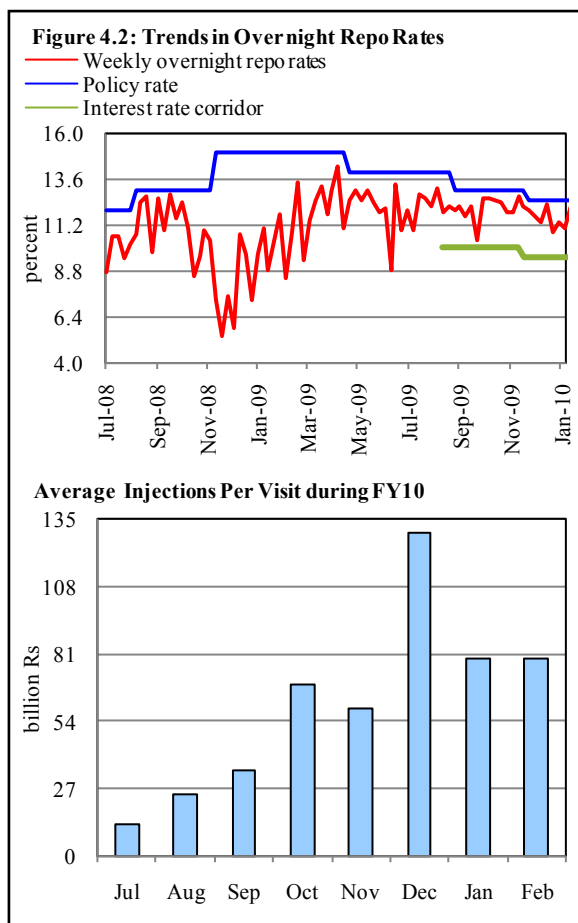
⁵ Rationalization of electricity and gas prices became inevitable given the efforts of the government to phase out power subsidy.

commodities such as oil, sugar and pulses. Most of these pressures are visible in CPI food prices.

Although current level of inflation is much lower when compared with February 2009 (21.1 percent), it has the potential to ignite inflationary expectations and offset the previous achievements of a tight monetary policy. More importantly, the rise in core inflation, measured by 20 percent trimmed mean, during February 2010 also indicates persistence in inflationary pressures. The SBP was also mindful of the strong second round effects of broad based inflationary pressures from food and energy.

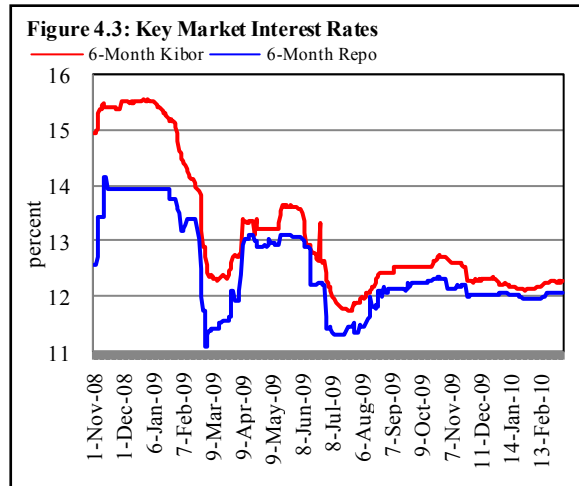
The concerns of inflation expectations were more pronounced given the rising fiscal deficit and subsequent government borrowings. In fact, fiscal deficit in Q2-FY10 was not only higher than Q2-FY09, IMF also allowed relaxation in the quarterly target for the fiscal deficit. While the increase in the fiscal deficit was unavoidable given the lingering payments of power related subsidies and war against terrorism; it led to high budgetary borrowings from the banking system.

In specific terms, lower external receipts in Q2-FY10 increased government reliance on the banking system for budgetary borrowings. Unlike Q1-FY10, however, the budgetary borrowings from the commercial banks were lower in Q2-FY10 as the government largely adhered to its pre-auction targets that were set lower for Q2-FY10 in anticipation of increased external inflows. Resultantly, reliance on SBP borrowings increased during Oct-Feb FY10. As a result, reserve money grew by 10.6 percent in Jul-Feb FY10 compared with a fall of 2.5 percent in Jul-Feb FY09.



Interestingly, hefty borrowings of PSEs and lower than expected retirement of commodity finance loans in Q2-FY10 led to a substantial drain of rupee liquidity from the interbank market October 2009 onwards. The liquidity strains became more severe as commercial banks have been investing heavily in government papers since the inception of IMF program in November 2008.⁶ All these factors complicated liquidity management by the SBP.

Therefore, to reduce volatility in inter-bank money market rates and avoid the transmission of high inter-bank rates to retail lending rates, the SBP conducted a number of OMOs throughout FY10 (see **Figure 4.2**). The frequent OMO injections reduced excess volatility in the overnight rates and other market rates in line with the reduction in policy rate (see **Figure 4.3**).



The timely SBP measures to counter liquidity concerns and reducing WA lending rates did indeed help commercial banks to lend to private sector. As a result, private sector credit grew by 7.5 percent in Oct-Feb FY10 compared with 1.4 percent in the preceding year. Although credit off-take is high, it appears that credit growth could have been even higher were it not for banks' cautiousness given the still-prevalent credit risk in the economy. Moreover, as a large part of banks' liquidity was stuck in PSEs and commodity finance related loans; banks' ability to lend to private sector was limited. Thus, during Jul-Feb FY10, the money multiplier reduced significantly compared with Jul-Feb FY09. As a result, money supply grew by 5.7 percent compared with 10.6 percent growth in reserve money during Jul-Feb FY10.⁷

Thus, although M2 growth has remained significantly lower than reserve money growth during Jul-Feb FY10, the continuation of government borrowing from the SBP poses a risk for generating inflationary pressures. Moreover, with the gradual

⁶ This is also evident from the fact that commercial banks' excess SLR ratio rose to 18.3 percent by end December 2009 as against 10.3 percent in the same month a year earlier.

⁷ During Jul-Feb FY09, growth in M2 recorded at 2.0 percent whereas reserve money fell by 2.5 percent.

recovery seen in the manufacturing sub-sector and improvements in the financial position of the corporate sector, credit risk is reducing gradually. Therefore, banks' willingness to lend to the private sector is expected to improve going forward. Furthermore, the government also appears keen on debt settlement in the commodity finance sector and circular-debt.

4.2 Developments in Monetary Aggregates⁸

The growth in broad monetary aggregate (M2) accelerated to 5.7 percent during Jul-Feb FY10 from 2.0 percent in the corresponding period of FY09 (see **Table 4.1**). However, these broad numbers do not capture the shift in composition of M2 growth after the first quarter of FY10. While the growth in M2 during Q1-FY10

Table 4.1: Monetary Aggregates (Jul-Feb)

flows in billion Rupees, growth in percent

	Flows				Growth	
	Jul-Feb		Oct-Feb		Jul-Feb	
	FY09	FY10	FY09	FY10	FY09	FY10
Broad money (M2)	91.6	291.5	106.9	252.9	2.0	5.7
NFA	-301.0	-46.6	-118.1	-80.7	-45.1	-9.0
SBP	-305.3	-25.2	-132.6	-68.4	-63.6	-7.8
Scheduled banks	4.3	-21.4	14.5	-12.2	2.3	-11.1
NDA	392.6	338.0	225.1	333.5	9.8	7.3
SBP	212.8	167.7	-40.7	96.7	27.5	19.1
Scheduled banks	179.7	170.3	265.8	236.8	5.5	4.6
of which						
Government borrowing	359.3	184.0	254.1	148.7	23.8	9.0
For budgetary support	348.0	237.5	226.7	199.4	25.5	14.1
SBP	299.6	61.0	72.8	145.6	29.0	5.2
Scheduled banks	48.4	176.5	153.9	53.8	14.6	34.2
Commodity operations	13.3	-52.1	28.0	-50.8	10.5	-15.5
Non government sector	193.8	226.7	40.0	236.8	6.4	7.1
Credit to private sector	131.9	137.7	41.6	212.2	4.6	4.7
Credit to PSEs	62.0	89.2	-1.5	24.8	54.6	33.5
Other items net	-160.5	-72.7	-69.0	-52.0	31.7	29.7

⁸ The discussion here onwards is based on NFA and NDA adjusted for SDR.

was driven largely by an improvement in NFA of the banking system, the sharp acceleration in M2 growth thereafter is explained largely by an uptrend in seasonal credit demand from the private sector mainly visible in Q2-FY10.

Moreover, during Oct-Feb FY10, the government borrowed more from the central bank to meet budgetary expenses compared to Q1-FY10 (though monetization remained within the quarterly target agreed with the IMF).

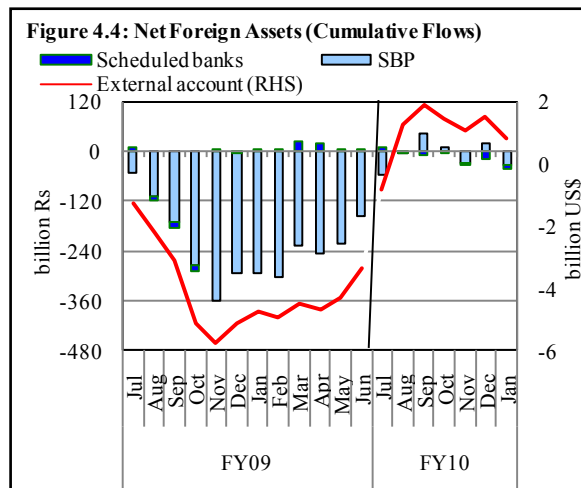
On the other hand, the improvement in NFA, visible since December 2008, has shown reversal October 2009 onwards.

Net Foreign Assets (NFA)

The trend improvement in NFA of the banking system, visible since December 2008, reversed as pressures on external account re-emerged October 2009 onwards (see **Figure 4.4**). As a result, the NFA of the banking system showed a depletion of Rs 80.7 billion in Oct-Feb FY10.

The depletion in the NFA of the banking system during Oct-Feb FY10 was mainly evident in the SBP NFA. The contraction in SBP NFA was despite the lower net intervention in the forex market as SBP completely shifted the financing of oil imports to the interbank market by mid December 2009. Indeed, the increased repayment of official loans, particularly Sukuk bond in January 2010, overshadowed the receipt of a second IMF tranche of US\$ 374 million for budgetary support in December 2009 as well as other official inflows.⁹

The NFA of scheduled banks witnessed a depletion of Rs 21.4 billion during Jul-Feb FY10 in contrast to a net expansion of Rs 4.3 billion in the corresponding period a year earlier. The high oil import payments, fall in foreign investments inflows, substantially lower net inflows under foreign private loans, and low retirement of foreign currency loans by traders were major factors responsible for



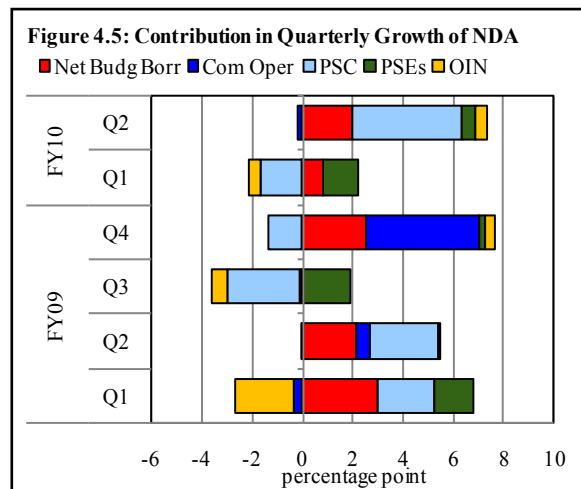
⁹ The first tranche of IMF budgetary finance of US\$ 745 million was received in August 2009.

this reversal in NFA of scheduled banks. These factors were strong enough to offset improvements arising from higher inflows under FE-25 deposits.

Net Domestic Assets (NDA)

The NDA growth changed dramatically after Q1-FY10. During Q1-FY10, NDA had a negative contribution to M2 growth. However thereafter, NDA experienced a sharp increase, mainly due to:

- (1) A strong rise in private sector credit, and
- (2) Increased recourse of the government to borrow from the banking system (see Figure 4.5).

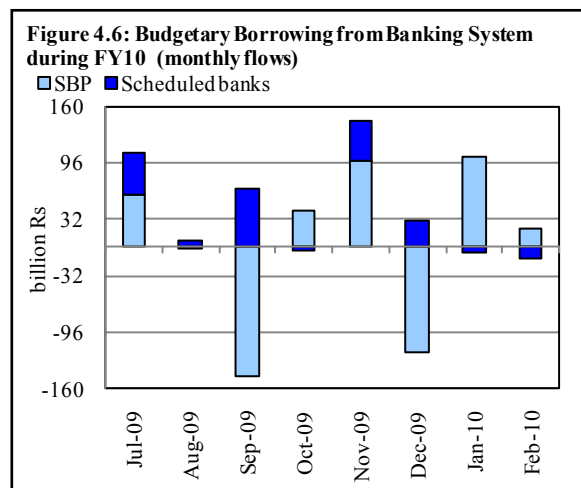


Government Budgetary Borrowings

Government budgetary borrowings from the banking system rose sharply October 2009 onwards (see Figure 4.6).

This is mainly explained by:

- (1) rising fiscal spending as Q2-FY10 fiscal deficit¹⁰ is higher compared with the same quarter last year¹¹, and (2) lower availability of external budgetary financing.¹² These factors overshadowed the higher inflows



¹⁰ It must be noted here that part of the rise in fiscal deficit in Q2-FY10 was inevitable in the wake of expenditure on power subsidies payments and war against terrorism.

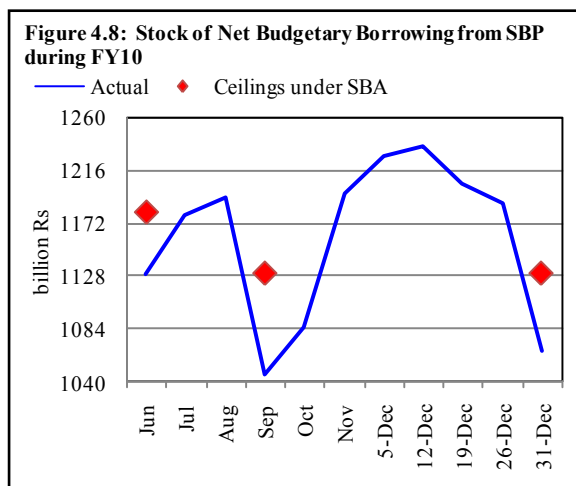
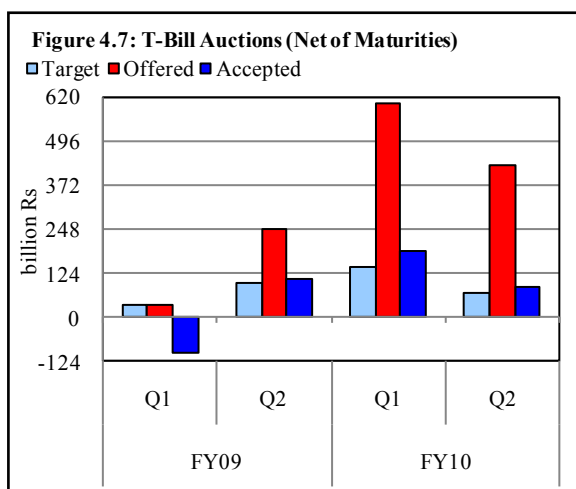
¹¹ IMF also provided relaxation in the target of fiscal deficit for Q2-FY10.

¹² Country received Rs 23 billion external budgetary inflows during Q2-FY10 compared with Rs 33 billion in the same quarter last year.

from non-bank sources as well as some availability of the second tranche of bridge finance from the IMF.¹³

Within the banking sector, borrowings from the commercial banks fell October 2009 onwards. This was because the government largely adhered to its pre-auction targets that were set lower for Q2-FY10 in anticipation of revenue receipts such as coalition support funds (see **Figure 4.7**). Resultantly, reliance on SBP borrowing increased during Oct-Feb FY10. Indeed, the government's increased recourse to SBP borrowing was made possible due to the available room for financing resulting from disciplined borrowing in the first quarter. However, in the absence of sufficient commercial bank borrowings, government borrowings from the central bank had exceeded its quarterly limits by the end of third week of December 2009 (see **Figure 4.8**). However, this possible breach of IMF target was avoided due to non tax-receipts in the final month of December 2009 (see **Box 4.1**).

More importantly, in the last few T-bill auctions, banks started to lock into shorter tenor government papers. This behaviour possibly reflects: (1) market anticipation



¹³ To facilitate orderly budget execution, the IMF is providing bridge financing until pledged donor support from FoDP is realized. In this regard, the first tranche of US\$ 745 was received in Sep 09, and the second tranche of US\$374 was received in Dec 09.

for an increase in interest rate in the wake of renewed inflationary pressures, and (2) liquidity constraints. Moreover, anecdotal evidence suggests that increased bidding by commercial banks, particularly for three month papers, also reflects high demand from money market funds (see **Figure 4.9**).¹⁴

Commodity Finance

Stock of commodity finance fell by Rs 52.1 billion during Jul-Feb FY10 compared to net increase of Rs 13.3 billion in the corresponding period last year.

The decline in the stock of commodity finance is mainly explained by retirement of loans availed for wheat procurement; stock of wheat finance declined to Rs 200.6 billion by end-February 2010 from its peak of Rs 276.8 billion in June 2009. Even at this level, the stock of wheat finance is considerably higher than the average of the past three years' end- February level of Rs 53.8 billion. Therefore, outstanding wheat financing must be retired well before March 2010 so that provincial governments can meet the procurement target for the 2010 wheat crop.

Box 4.1: Decline in Government borrowing from SBP in December 2009

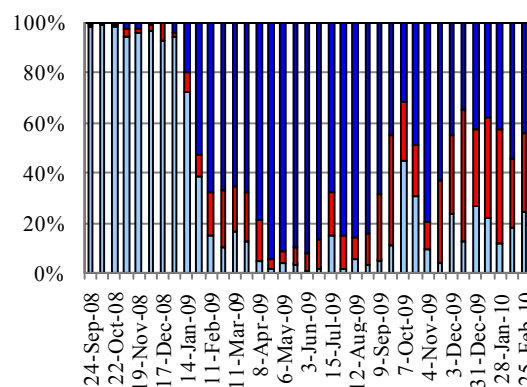
There was a sharp decline in government borrowing from SBP in the last week of December 2009. This fall was on account of a jump in government deposits with the central bank following the transfer of SBP's profit (Rs 65.0 billion) to GoP; a part of which also includes transfer from general reserves funds.^{1,2} These additional resources enabled GoP to retire Rs 37.1 billion of its debt with the central bank in January 2010. As a result, GoP deposits with SBP also declined in this month.

¹ SBP maintained its general reserve funds to mitigate the requirement for general risk management.

² It is interesting to note here that the cumulative transfer of SBP profit to the government reached Rs 135 billion in the first six months of FY10 compared with Rs 89.9 billion for the whole FY09.

Figure 4.9: Offered Amount in T-bill Auctions

■ 12-month ■ 6-month ■ 3-month



¹⁴ Indeed, increased interest of money market funds in short-term government papers was consequent to lower return offered by banks on their deposits.

At the same time, retirement under rice finance was also delayed, as PASSCO could not offload the stock of 2008 rice crop without incurring losses at the prevailing offered tender price of rice. The delays in loan retirement hampered the availability of bank finance for the procurement of 2010 rice crop.¹⁵

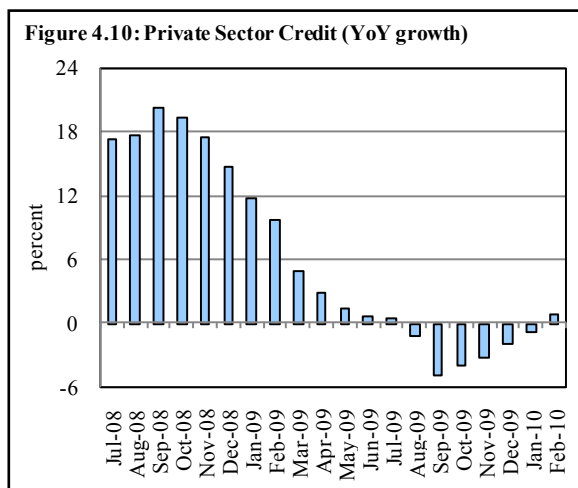
However, with recent recovery in tender price, PASSCO is in a position to offload a significant portion of 2008 rice crop in the domestic market. Retirement of bank loans in coming months is likely to accelerate as the government has also allowed the TCP and PASSCO to export surplus rice in the international market.¹⁶

4.3 Credit to Public Sector Enterprises

The public sector enterprises' (PSEs) borrowing from commercial banks increased by Rs 89.2 billion during Jul-Feb FY10 compared with Rs 62.0 in the corresponding period last year. This increase stemmed mainly from (1) high credit demand from a power holding company in September 2009¹⁷, (2) a few POL related PSEs have availed the cushion for fresh lending after settlement of part of their outstanding bank credit with the issuance of PPTFCs,¹⁸ and (3) borrowing requirement from a public sector steel mill to finance its unfunded LC imports of raw material.

Private Sector Credit (net)¹⁹

The trend decline in private



¹⁵ Consequently, PASSCO could not meet the procurement target for rice crop in FY10.

¹⁶ One of the agency claims that the differential in their storage and procurement cost and the issue price for rice in recent international tenders started to decline, whereas the other agency remained unable to attract buyers for procured rice at desired price.

¹⁷ The power holding company issued a government backed privately placed term finance certificates (PPTFCs), which was meant to settle significant part of inter corporate debt in the energy sector.

¹⁸ Within POL related PSEs, high borrowing from an oil refinery was to make payments to government on account of petroleum development levy in December 2009.

¹⁹ Private sector credit comprises of banks' investment and advances to the private sector. The data on private sector credit is based on monetary survey covering the period of Jul-Feb FY10.

sector credit, visible for twelve consecutive months, reversed from October 2009 onwards representing recovery in aggregate demand in the economy as well as increase in private sector participation in commodity finance (particularly for cotton, rice and sugarcane) (see **Figure 4.10**).

Consequently, cumulative credit to private sector grew by 4.7 percent during Jul-Feb FY10; slightly higher than the growth seen in the corresponding period a year earlier.²⁰ Most of the credit growth was seen in commerce and trade, cement, construction, power, fertilizer and agriculture machinery (see **Table 4.2**).

Table 4.2: Private Sector Credit

billion Rupees

	Jul-Jan		Jul-Sep		Oct-Dec		Jan	
	FY09	FY10	FY09	FY10	FY09	FY10	FY09	FY10
Private sector credit*	131.9	137.7	90.3	-74.6	112.8	199.2	-45.3	-12.2
Business sector advances	159.0	123.7	83.2	-65.6	110.9	190.2	-35.1	-1.0
Total working capital	36.1	75.6	49.2	-84.1	23.5	162.4	-36.5	-2.7
Seasonal finance	55.8	38.4	2.5	-38.7	47.5	63.4	5.8	13.7
Fixed investment	123.6	48.4	34.1	18.7	87.9	27.3	1.7	2.4

* pertains to Jul-Feb period

Procurement of crops explained part of the rise in credit demand

A look at the advances data suggests that procurement of crops such as rice, sugarcane and cotton mainly increased the seasonal credit demand from private sector in Q2-FY10; the major portion of which is visible in working capital loans (see **Table 4.3**). It appears that lower than targeted procurement of rice from PASSCO in FY10 resulted in a rise in procurement by private rice traders which in turn increased their running finance requirements. Moreover, a fall in rice production in India and Philippines resulted in higher imports of rice from Pakistan, which in turn increased the demand for trade related loans, most of which is mainly visible under export financing schemes (EFS).

²⁰ While the sharp rise in private sector credit during Q2-FY10 was entirely explained by a robust demand for incremental running finance; demand for fixed investment loans remained relatively low (see **Table 4.2**).

Table 4.3: Advances for Working Capital Loans (including trade loans)

billion Rupees

	Jul-Jan		Jul-Sep		Oct-Dec		Jan	
	FY09	FY10	FY09	FY10	FY09	FY10	FY09	FY10
Seasonal finance	55.8	38.4	2.5	-38.7	47.5	63.4	-0.7	13.7
Rice	17.9	19.6	-11.3	-7.7	26.3	24.8	8.8	2.5
Cotton	29.6	20.9	6.7	-11.5	20.2	34.1	-2.7	-1.7
Sugar	-1.8	-2.3	-7.7	-21.8	0.0	0.6	7.6	18.8
Fertilizer	10.2	0.2	14.8	2.3	1.0	3.8	-14.4	-5.9
Commerce & trade	-10.8	5.4	0.9	-10.9	-1.7	21.4	-27.9	-5.2
Exports of commodities	-0.7	3.4	8.9	-3.0	0.7	6.4	-6.5	0.0
Retail trade	3.0	8.5	-2.9	-2.4	1.3	12.8	-10.2	-2.0
Power	2.7	-2.4	10.0	-17.0	-3.4	18.9	-11.6	-4.3
Construction	-7.5	-3.0	-5.3	-4.2	0.2	2.2	-4.4	-1.0
Building related	-7.6	-0.1	-4.8	-1.2	-1.0	1.2	-3.7	-0.1
Cement	6.4	4.6	4.3	2.2	2.3	2.5	-2.1	-0.1
Overall	36.1	75.5	49.2	-84.1	23.5	162.4	-49.6	-2.7

Textile sector demand for advances picked up in Q2-FY10, mainly from spinners and ginners. This was due to a confluence of favorable domestic and external factors: (1) good domestic cotton crop, (2) fall in global production of raw cotton, - mainly in US and China, and (3) recovering demand for textile products in advanced economies. This environment provided an opportunity for Pakistani exporters to increase market share²¹ by capitalizing on better cotton crop and explains higher working capital requirements in Q2-FY10.

Growth in running finance advances to *fertilizer manufacturers* during Q2-FY10 was led by high import demand. The rise in import demand emanated mainly from (1) slowdown in domestic production, (2) inadequate existing stock of DAP to meet expected shortfall²² and (3) a few companies built up inventories to benefit from anticipated increase in international prices of phosphate rock since Dec 2009.

²¹ Market share of textile exports increased, particularly in China, from 29 percent in CY08 to 40 percent in CY09. These exports mainly comprised of low value added categories of cotton yarn and raw cotton.

²² A sharp off-take of DAP fertilizer March 2009 onwards depleted inventories and prompted a few companies to import DAP in Q2 FY10.

Besides running finance, long-term loans extended to fertilizer sector also remained strong during Jul-Jan FY10. In fact, delays in commencement of the projects had actually accelerated their cost overrun expenses in the initial months of FY10. However thereafter, long-term credit demand from the fertilizer sector fell sharply as one of the major fertilizer plants is expected to start its operations by March 2010.

Demand led recovery seen in few sectors

Mild recovery seen in commodity producing sectors and rising trade volume led to increased credit demand from the commerce and trade sector; this reflected in both working capital and trade related advances. Furthermore, revived construction activities domestically increased the working capital requirements of construction and allied industries. Finally, high tractor imports during Q2-FY10 under the Benazir Tractor Scheme partly explain credit demand for long-term loans under agriculture machinery in this period.

Banks' appetite for private sector credit October 2009 onwards

During the first three months of FY10, banks' lending to the private sector was constrained by weak credit demand as well as high government recourse to deficit financing.²³ However, October 2009 onwards a number of factors dramatically changed the credit outlook for banks. For instance: (1) seasonal demand for credit picked-up, (2) government borrowing target from commercial banks in Q2-FY10 fell sharply compared to the preceding quarter, and (3) pace of worsening in the asset quality of banks slowed down.²⁴ Consequently, bank finance to private sector recorded a strong rise in Q2-FY10.

This strong revival in banks' lending to the private sector was despite looming rupee liquidity concerns in the interbank market. This suggests that the lending to the corporate sector may have been higher if the rupee liquidity strains had not hit the interbank market.

In particular, continued strong credit demand from PSEs and low pace of retirement of outstanding commodity finance loans in FY10 exerted pressures on the market liquidity.²⁵

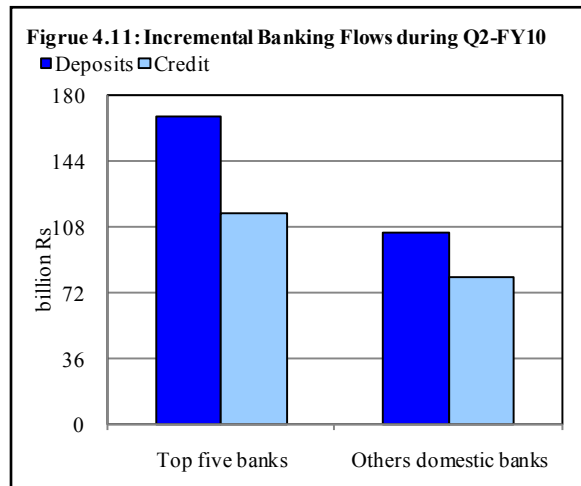
²³ During Q1-FY10, net accepted amount in T-bill auction was Rs 142.6 billion as against a net target of Rs 144.2 billion.

²⁴ The lower concerns regarding credit quality are evident from a sharp slowdown in NPLs growth during the same period. More specifically, growth in NPLs during H1-FY10 was limited to 8.6 percent compared with a strong growth of 30.0 percent in the same period last year.

²⁵ It may be recalled that in the latter half of FY09, the rising NPLs of the corporate sector made banks more conservative in terms of taking incremental exposures on the corporates. At the same

Though deposits of the banking system witnessed robust growth in Q2-FY10, this was not sufficient to ease liquidity concerns in the interbank market. Therefore, to address liquidity concerns in the interbank market SBP conducted huge OMO injections throughout FY10 so far.

The analysis of group-wise incremental advances by banks suggests that the increase in private sector credit during Q2-FY10 remained broad based as most of the banks had increased their lending activity (see **Figure 4.11**).²⁶



4.4 Deposit Mobilization²⁷

Despite a considerable fall in incremental deposit returns, the banking industry recorded deposit growth of 4.6 percent during Jul-Feb FY10 in contrast to a contraction of 0.6 percent in the corresponding period last year (see **Figure 4.12**).²⁸

Monthly data shows an erratic trend in deposit growth September 2009 onwards.

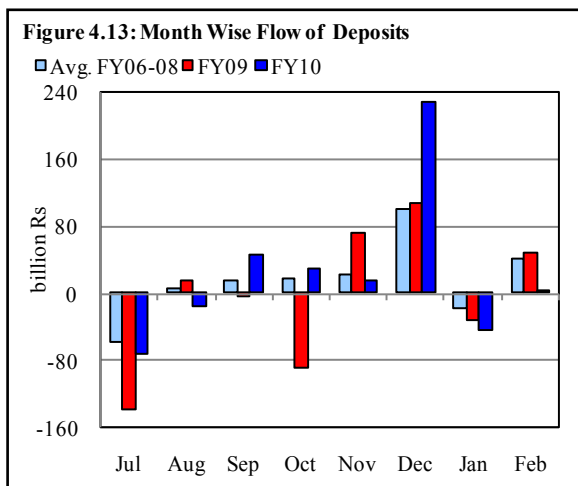
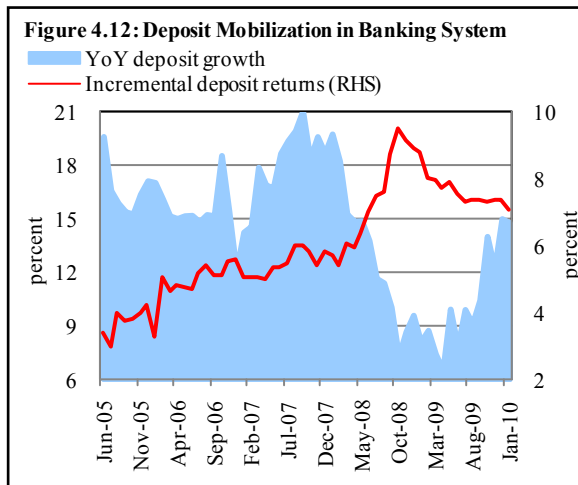
time, government preference to raise funds from banks after the inception of stabilization program in November 2008 provided a safe avenue for banks to put their funds in government papers. The impact of high government demand on banks finance was further compounded by a strong rise in credit demand from a few public sector enterprises to meet their financing gap which arose as the government has been consistently facing problems in releasing the subsidy payments to these institutions on time.

²⁶ Interestingly, one large public sector bank that experienced strong growth in government deposits also enjoyed considerable advances growth.

²⁷ The analysis is based on total deposits of the banking industry including government deposits.

²⁸ It may be noted that the increase in the deposit rate last year was primarily a reflection of banks' efforts to attract deposits at the height of the rumor driven withdrawal period in Oct-Nov 08. Deposit rates have since exhibited a downward trend; however, appear to have stabilized in recent months.

While deposits witnessed a sharp increase during Sep-Oct FY10 compared with net withdrawals in the same months of FY09²⁹; the pace of growth was much lower in November 2009 (see **Figure 4.13**).³⁰ The unusual development however was the exceptional increase in the month of December 2009. Although, the deposits of the banking system generally experience a sharp rise in the month of December each year followed by withdrawals in the subsequent month, the increase in the deposit base during December 2009 was stronger than the same month in the previous year, as well as the average for December FY06-08 (see **Figure 4.13**). Other factors that explain deposit growth during Oct-Feb FY10 include: (1) monetary expansion stimulated mainly by NDA - in particular private sector credit, and (2) a mild recovery in the domestic economy as evident from LSM growth.^{31,32}



²⁹ It may be noted that deposit inflows during Sep and Oct FY10 were also higher than the average for FY 06-08.

³⁰ However the higher growth in Nov 08 must be seen in context of sharp withdrawals of preceding month of Oct 08; whereas deposits witnessed an increase in Oct 09.

³¹ During Jul-Jan FY10 the large scale manufacturing index increased by 2.3 percent against a contraction of 5.4 percent in the same period last year.

³² The improved performance of the chemical, construction, commerce and trade sectors provided impetus to their deposits.

Further analysis suggests broad based deposit growth across banks during Oct-Feb FY10.³³ More importantly, in contrast to the previous quarter, **top 5 banks**³⁴ staged a recovery during the period under review (see **Table 4.4**).

Within the **top 5** category, *large privatized banks* – that experienced contraction in deposits during the previous quarter - recovered considerably during Oct-Feb FY10. Interestingly, *large privatized banks* increased their share of short to medium term deposits in efforts to support their interest income.³⁵ In

particular, one *large privatized bank* that experienced sharp withdrawals in its fixed deposits during the first two months of FY10 recovered in Q2-FY10 by mobilizing shorter tenure deposits from corporates and individuals.³⁶

Further, the *large public sector bank*³⁷ in the **top 5** category experienced strong deposit growth by mobilizing sizeable government agency deposits and benefitted from higher provincial government deposit inflows mainly in Dec-Jan FY10.

Other banks' deposit growth during Oct-Feb FY10 contributed 2.4 percentage points to total deposit growth during this period. This relatively lower contribution mainly reflects large withdrawals experienced by two *merged banks* during this quarter that contained deposit growth of the group. Excluding these banks, contribution of **other banks'** deposit growth to total deposit growth increased to 3.2 percentage points during Oct-Feb FY10.

Table 4.4: Contribution in Growth of Deposits
percentage points

	FY09	FY10	
	Jul-Feb	Jul-Feb	Oct-Feb
Top 5 banks	-0.8	1.3	3.3
Others	0.3	3.3	2.4
<i>of which</i>			
<i>Private domestic banks*</i>	-0.6	2.6	2.0
<i>Foreign banks</i>	0.3	0.1	-0.1
<i>Islamic banks</i>	0.5	0.7	0.5
All Banks	-0.6	4.6	5.7

*Excluding Top 5 and specialized banks

³³ All bank groups experienced deposit growth during Oct-Feb FY10 except the Merged and Foreign Bank categories.

³⁴ These banks are categorized on the basis of their asset size and branch network. This category includes five banks namely; NBP, MCB, ABL, HBL, UBL.

³⁵ Three large privatized banks increased their share of demand liabilities in total deposits from 68.4 percent in Feb FY09 to 75.1 percent in Feb FY10.

³⁶ In order to reduce the burden of interest expenses and support its earnings, this bank has reduced its efforts in mobilizing longer tenure deposits.

³⁷ This bank's deposit growth during Oct-Jan FY10 was 7.2 percent, of which contribution of government deposits was 5.2 percentage points.

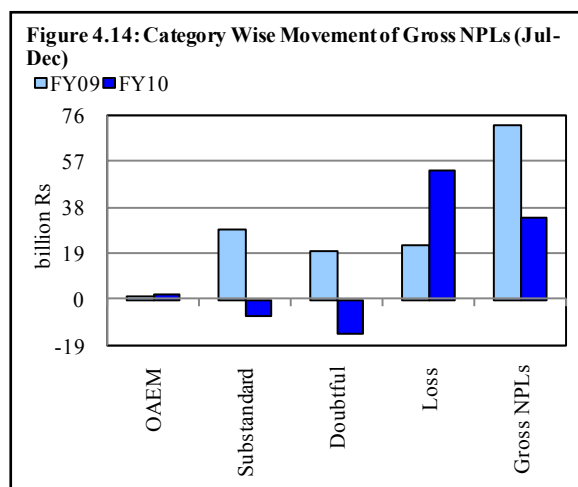
A recently merged bank³⁸ experienced considerable withdrawals in its deposit base despite a steep rise in its deposit returns; higher than the industry average.³⁹ This suggests that these withdrawals may relate to increased uncertainty among the bank's customers stemming from a subsequent and currently ongoing acquisition process.

4.5 Non Performing Loans

NPLs of the banking system witnessed a relatively lower rise of Rs 34.2 billion during H1-FY10 compared with a strong increase of Rs 72.4 billion in the corresponding period a year earlier. This slowdown was evident in corporate sector NPLs and mainly the result of a sharp deceleration in advances growth, and improved repayment capacity of borrowers due to: (a) relatively stable input prices, (b) falling interest rates, (c) a mild recovery in the domestic economy, and (d) high earning from arrival of better cotton crop.⁴⁰

Though the lower pace of NPLs growth in H1-FY10 released some pressures on asset quality of banks, the provisioning requirements for infected loans saw a marginal rise. More specifically, provisioning increased by Rs 27.5 billion in H1-FY10; slightly higher than the rise recorded in H1-FY09. This anomaly is perhaps due to a change in the composition of

incremental gross NPLs. In particular, the gross NPLs in the loss category increased sharply in H1-FY10 compared with H1-FY09 (see **Figure 4.14**).^{41,42}



³⁸ The category of merged banks includes those banks merged in the last five years.

³⁹ Merged banks registered incremental deposit returns of 7.7 percent for the Oct-Jan FY10 period, against an industry weighted average rate of 7.4 percent.

⁴⁰ A closer look at the recent data on movement in NPLs also supported this assertion as cash recovery increase by Rs 23.2 billion in H1-FY10 compared with Rs 18.8 billion in the corresponding period of FY09. On the other hand, new addition in NPLs during H1-FY10 was also limited to Rs 81.0 billion; much lower than a strong rise of Rs 115.3 billion in H1-FY09.

⁴¹ It is pertinent to note here that the increase in provisioning during H1-FY10 was despite the fact that SBP allowed banks to avail the benefit of 40 percent of Forced Sale Value (FSV) of collateral while calculating provisioning requirement w.e.f September 30, 2009.

⁴² In FY09, the benefit of Forced Sale value (FSV) of collateral was 30 percent.

A sectoral break-up of gross NPLs shows that the contribution from the corporate sector in gross NPLs growth remained at 5.8 percent during Jul-Dec FY10; this was much lower than the corresponding period FY09 (see **Table 4.5**). While, the distribution shows a large number of borrowers in the agricultural sector, the value of NPLs is concentrated in the corporate sector. As a result, the average size of corporate sector NPLs stood at Rs 78.3 billion by end Dec 2009 (see **Table 4.6**). This suggests that a small number of large borrowers has the potential to cause significant deterioration in asset quality of the banks.

Table 4.5: Break-up of Increase in Gross NPLs (Jul-Dec)

Segments	Increase (billion Rs)		Contribution in growth (percent)	
	FY09	FY10	FY09	FY10
Corporate	51.5	23.1	21.3	5.8
Agriculture	15.4	2.0	6.4	0.5
SME	-1.0	1.4	-0.4	0.4
Consumer	4.5	6.1	1.9	1.5
Others	2.0	1.6	0.8	0.4
Total increase	72.4	34.2	30.0	8.6

In the corporate sector, textile, sugar and cement are the main sectors contributing to the increase in gross NPLs during H1-FY10.⁴³ The rise in textile sector NPLs seems quite surprising given the recent increase in external demand coupled with better cotton crops. One of the possible explanations is the operational bottlenecks that the textile

Table 4.6: Average size of NPLs by end December 2009
number in thousands, average size in billion Rs

	No of borrowers	Avg. size of NPLs
Corporate	3.5	78.3
Agriculture	203.4	0.1
SME	58.0	1.4
Consumer	170.5	0.2
Commodity finance	0.6	7.5
Other	42.9	0.7

sector has been facing in last few years. These mainly include extended gas and power outages-and a recent sharp depreciation of rupee against US dollar which has made foreign currency borrowing more expensive for a few corporates. All these factors, hampered the repayment ability of a few borrowers in this sector.

⁴³ Of the total net increase in NPLs of the corporate sector (Rs 23.1 billion), textile sector accounted for Rs 14.6 billion.

5 Fiscal Developments

5.1 Overview

As anticipated, key fiscal indicators improved in Q2-FY10 over the previous quarter bringing the cumulative fiscal deficit for H1-FY10 to 2.7 percent of annual estimated GDP (see **Table 5.1**). This figure is consistent with the SBP forecast of budget deficit for the year.

The improvement in revenue growth during Q2-FY10 is largely due to increased direct taxes collection. This was to be expected given that the traditional first quarter receipts had been pushed into the second quarter following the extension of the deadline for filing income tax returns. Moreover, tax collection was also helped by a revival in the economy and rise in rupee value of imports.

On the expenditure side, the government was able to contain the growth in total outlays during Q2-FY10. However, given the rigidities in current expenditure on account of the need to address the buildup of energy sector circular debt, security related expenditure etc, the government had little choice but to cut the development spending if pledges by FoDP are not realized and lags in reimbursement of Coalition Support Fund continues.

This weakness in expected external receipts is also reflected in the financing mix of budget deficit which is skewed towards domestic sources. Going forward, a fiscal pressure is expected to mount if proceeds from Coalition Support Fund and FoDP pledges are not realized.

Another concern on fiscal front is the increased volume of contingent liabilities issued by the government to the Public Sector Enterprises. In addition to the guarantees already issued to many PSEs, government is now issuing guarantees on TCP and PASSCO commodity financing loans. Such activities not only understate

Table 5.1: Buildup of Fiscal Deficit

billion Rupees

	Jul-Sep		Oct-Dec	
	FY09	FY10	FY09	FY10
Total revenue	385.0	427.3	449.5	482.7
Tax revenue	278.7	298.8	328.2	360.4
Non-tax	106.3	128.5	121.3	122.3
Total expenditure	522.8	650.9	561.1	662.2
<i>of which</i>				
Current	456.1	521.0	463.1	537.6
Development & net lending	57.6	115.7	75.2	123.7
Budget deficit	137.9	223.7	111.6	179.6

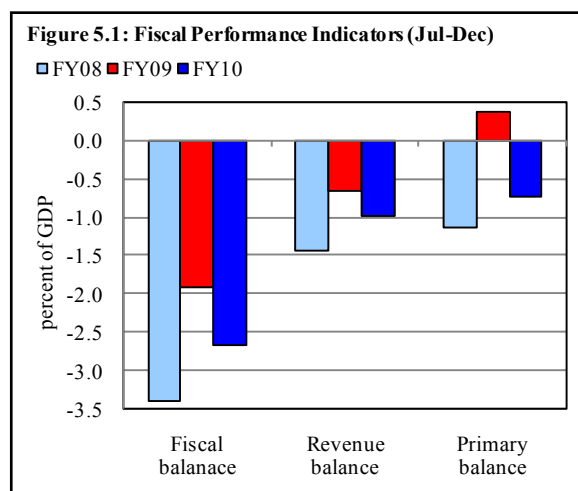
Source: MoF

Note: Totals may not tally due to separate rounding off.

the volume of the public debt stock and pose a risk of increasing future liabilities but also potentially crowded out private investment.

5.2 Fiscal Performance Indicators

Although the fiscal performance during second quarter of FY10 was better than that in the first quarter, the overall fiscal position in H1-FY10 stands poor when compared with same period of the last year (see **Figure 5.1**). The large fiscal slippage in H1-FY10 resulted mainly from substantial increase in total expenditure, particularly power sector subsidies and security related expenses.



The deficit in the revenue balance,¹ as percent of annual estimated GDP has increased to 1.0 percent during H1-FY10 from 0.6 percent in H1-FY09. This reflects the inability of the government to finance capital expenditure from existing resources, as evident from recent cuts in the development expenditure. High revenue deficit during H1-FY10 is also against the target of a surplus FY08 onwards set under the Fiscal Responsibility and Debt Limitation Act (FRDL) 2005.

Primary balance² as percent of GDP turned into deficit of 0.7 percent in H1-FY10 from a surplus of 0.4 percent during H1-FY09. This reflects the viability of non-interest expenditure compared to total government's resource envelope, which could potentially lead to further increase in total debt stock.

¹ Revenue balance measures the saving capacity of the government and is calculated as the difference between total revenues and current expenditures.

² Primary balance helps assess the sustainability of the fiscal deficit. It highlights the *current* discretionary budgetary stance by excluding the impact of interest payments (that are caused by past policies).

5.3 Revenue

Total revenue in H1-FY10 stood at Rs 909.9 billion; with a YoY increase of 9.0 percent compared to 33.4 percent rise in H1-FY09 (see **Table 5.2**). The deceleration in total revenue stemmed from lower growth both in tax revenue and non-tax revenue collection. A compositional analysis of the growth in total revenue shows that tax revenue contributed 6.3 percentage points with remaining being contributed by non-tax revenue collection.

Table 5.2: Summary of Consolidated Public Finance

billion Rupees

	Jul-Dec				YoY change (%)	
	FY07	FY08	FY09	FY10	FY09	FY10
Total revenue	614.8	625.6	834.5	909.9	33.4	9.0
Tax revenue ³	451.5	458.0	606.8	659.2	32.5	8.6
Non-tax revenue	163.3	167.5	227.6	250.7	35.9	10.1
Total expenditure	783.8	981.9	1083.9	1313.2	10.4	21.1
Current	581.4	775.1	919.2	1058.6	18.6	15.2
Development and net lending	147.9	225.8	132.8	239.4	-41.2	80.3
Unidentified expenditure	54.4	-18.9	31.9	15.1	-268.9	-52.7
Fiscal balance	-169.0	-356.3	-249.5	-403.3	-30.0	61.9
As percent of GDP⁴						
Total revenue	7.1	6.0	6.4	6.1		
Tax revenue	5.2	4.4	4.6	4.4		
Non-tax revenue	1.9	1.6	1.7	1.7		
Total expenditure	9.0	9.4	8.3	8.7		
Current	6.7	7.4	7.0	7.0		
Development and net lending	1.7	2.2	1.0	1.6		
Unidentified expenditure	0.6	-0.2	0.2	0.1		
Fiscal balance	-1.9	-3.4	-1.9	-2.7		
Primary balance	-0.2	-1.4	0.4	-0.7		
Revenue balance	0.4	-1.1	-0.6	-1.0		

Source: Ministry of Finance

Tax revenue during the period under review experienced deceleration largely due to weak growth in FBR tax collection compared to the previous year. Specifically, growth in tax revenue during H1-FY10 decelerated to 8.6 percent from 32.5

³ Surcharges on POL are added in tax revenues and subtracted from non-tax revenues from FY07 to FY09, to make figures comparable.

⁴ Revised nominal GDP is used for FY07 to FY09.

percent in the corresponding period a year earlier (see **Table 5.3**). As a percentage of the budgeted target, tax revenue reached only 43.5 percent during H1-FY10 compared to 51.0 percent a year earlier.

Table 5.3: Composition of Tax and Non-Tax Revenue

billion Rupees

	Jul-Sep		Oct-Dec		Jul-Dec		Difference (Jul-Dec)	
	FY09	FY10	FY09	FY10	FY09	FY10	FY09	FY10
Tax Revenue	278.7	298.8	328.2	360.4	606.8	659.2	148.8	52.4
Direct taxes	89.7	84.1	121.1	127.3	210.8	211.4	46.4	0.6
Taxes on property	1.8	1.7	0.7	1.2	2.5	2.8	0.5	0.3
Taxes on goods and services	136.6	146.1	136.0	155.1	272.6	301.2	65.4	28.6
Taxes on international trade	38.2	33.1	35.3	38.2	73.4	71.2	11.9	-2.2
Petroleum levy	1.8	24.1	27.0	27.8	28.8	51.9	21.5	23.0
Other taxes	10.5	9.9	8.1	10.8	18.7	20.7	3.0	2.0
Non-tax Revenue	106.3	128.5	121.3	122.3	227.6	250.7	60.1	23.1
Profit of PTA/PO	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Interest (PSE and others)	1.6	0.1	2.0	4.5	3.7	4.6	-11.2	1.0
Dividends	9.5	18.9	24.9	7.6	34.4	26.5	2.0	-7.8
SBP profits	28.0	70.0	43.9	65.0	71.9	135.0	24.6	63.1
Defence	29.2	1.9	1.0	1.3	30.2	3.2	27.9	-27.0
Development surcharges on gas	6.4	5.7	2.2	4.3	8.5	10.0	-3.6	1.5
Discount retained on crude oil	4.1	0.0	1.9	2.5	6.0	2.5	6.0	-3.5
Royalty on oil/gas	10.4	9.2	15.4	13.4	25.8	22.6	4.3	-3.2
Others	17.1	22.6	30.1	23.6	47.2	46.1	10.0	-1.0
Total revenue	385.0	427.3	449.5	482.7	834.5	909.9	208.9	75.5

Source: Ministry of Finance

Exceptional shortfall in direct tax collections and decline in the tax receipts from international trade during H1-FY10 largely translated into the deceleration in FBR taxes. The large deceleration in direct tax receipts is explained by decline in advance tax payments that highlight the fall in corporate earnings due to weak economic conditions. To increase the income tax collection, FBR allowed a 15 days relaxation in the last date of quarterly advance tax payment. The relaxation is valid till the third quarter of FY10. Also a greater number of tax payers failed to file the income tax statements till December 31, 2009; and the FBR had to announce an extension in the last date of filing income tax returns up to January 25, 2010. In the background of these measures taken by the FBR, an increase in

direct tax collection is expected in the second half of FY10. Yet the entire shortfall may be hard to cover in the remaining months.

A large decline in the rupee value of imports, particularly that of POL products, machinery and mechanical appliances, and electrical machinery, translated into a decrease in collection from taxes on international trade compared to last year.

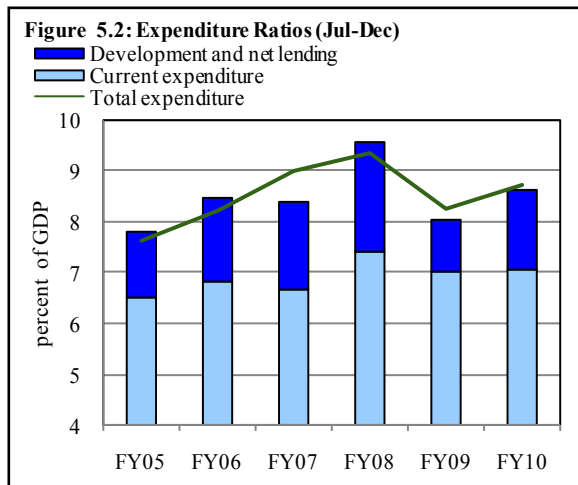
Although the tax collection from goods and services experienced a lower growth, it performed relatively better than other FBR tax heads during the period under review with an increase of Rs 28.6 billion in H1-FY10, up by 10.5 percent YoY compared to 31.6 percent YoY in H1-FY09. This growth is mainly attributed to: (a) increase in domestic sales tax collection under the heads of electrical energy, sugar, services, beverages and motor cars, (b) enhancement of rate of FED on cigarettes, advertisement, banking, insurance services and services provided by the stockbrokers during the budget FY10, and (c) increased tax collection from one percent special excise duty. A sharp increase in petroleum levy also helped raise revenue collection as it rose to Rs 51.9 billion during H1-FY10 compared with Rs 28.8 billion in H1-FY09 mainly due to increase in domestic consumption of high speed diesel (HSD), furnace oil and petrol in the period under review. It merits mentioning here that petroleum levy was imposed as fixed consumption tax from the start of the current fiscal year. Also, surcharges on POL have been replaced with petroleum levy and are now treated as part of tax revenue. Had petroleum levy not included in the tax revenue, net addition in tax revenue during H1-FY10 would stand at Rs 29.3 billion (5.1 percent YoY growth) instead of Rs 52.4 billion (8.6 percent YoY growth).

Non-tax revenue also decelerated by 10.1 percent during H1-FY10 compared to 35.9 percent growth during the corresponding period last year. The decline in revenue under the head of dividends and defense provided main reason for non-tax revenue to decelerate. The fall in dividends might be due to both lower earnings of public sector financial and non-financial institutions and a delay in dividend income receipts from these institutions. Decline in non-tax revenues under the head of defense largely reflect the holding back of reimbursements by the US for logistic support services provided by Pakistan to the coalition forces. The rise in transfer of SBP profits during H1-FY10, however, greatly helped the non-tax revenue to post a positive growth. Had the SBP contributed the same amount as it transferred to the government last year, the non-tax revenue would have declined by 17.6 percent YoY instead of increasing by 10.1 percent YoY.

5.4 Expenditure

Higher than expected security outlays and increase in the power sector subsidies⁵ has produced significant acceleration in the growth of public expenditure during the first six months of FY10. Specifically, consolidated public sector expenditure rose to Rs 1313.2 billion during H1- FY10, up by 21.1 percent compared to 10.4 percent increase in the corresponding period last year. A further

analysis shows that rise in total spending largely emanated from better growth in the development spending during H1-FY10. The strong growth in total spending has restored the increasing trend of total expenditure to GDP ratio, which saw a temporary reversal during FY09 (see **Figure 5.2**).



Current expenditure increased to Rs 1058.6 billion during H1-FY10, reflecting a rise of 15.2 percent compared to 18.6 percent in the same period last year (see **Table 5.4**). This deceleration was mainly caused by decline in interest payments and expenditure under the '*economic affairs and services*' head. However, this decrease was largely compensated by high current spending owing to grants, subsidies and defense expenditure. The three heads combined constituted nearly 34.7 percent of total current expenditure during H1-FY10.

The break-up of current government expenditure data reveals that defense spending recorded 12.3 percent growth reaching Rs 166.0 billion during H1-FY10. This increase was mainly on account of continued military campaign in some northern areas of Pakistan. Similarly, spending under *other general public service* reached Rs 85.6 billion, up by 35.2 percent compared to 33.0 percent last year. The large outlay under this head was chiefly attributed to subsidy provided by government to power sector to offset the rising cost of the electricity tariff. Additionally, grants (other than provinces) increased by impressive 232.0 percent during H1-FY10, compared to a decline of 11.0 percent in the same period last

⁵ These payments include partial settlements of tariff differential claims of the power sector build up in the previous years. It may be noted here that the government has increased the subsidy disbursement against the budgeted amount for FY10.

year. This increase was probably due to (a) non-receipts of the logistics support grants from the US; and (b) the grants extended to internally displaced persons (IDPs).

Table 5.4: Composition of Current Expenditure

billion Rupees

	Jul-Dec			YoY change (%)	
	FY08	FY09	FY10	FY09	FY10
Current expenditure	775.1	919.2	1058.6	18.6	15.2
<i>of which</i>					
Interest payments	237.7	299.7	294.2	26.1	-1.9
Domestic	208.8	265.8	262.0	27.3	-1.4
Foreign	28.9	33.9	32.2	17.2	-5.1
Grants (other than provinces)	45.2	40.3	133.7	-11.0	232.0
Other General Public Service	47.6	63.3	85.6	33.0	35.2
Defence	131.8	147.8	166.0	12.1	12.3
Economic affairs	50.9	74.5	21.8	46.2	-70.7
Health	2.7	2.3	2.8	-13.8	21.6
Education affairs and services	10.5	7.7	13.7	-26.9	78.0
Provincial	210.1	236.5	284.8	12.6	20.4

Source: Ministry of Finance

Given the rigidities in the current expenditure, especially defense, interest payments and the security related expenses, the government had to slash the development spending during H1-FY10. Although development spending increased by 69.6 percent during H1-FY10, this seems to be lagged behind the original budgeted amount for FY10. For instance, the total development spending incurred by the government during H1-FY10 constituted only 28.0 percent of the total development spending target set for FY10. Moreover, data on development spending suggest that cut in the development expenditure was largely undertaken by the federal government and the development spending by the provincial governments remained largely on track. Additionally, spending under *other development expenditure* head saw a large boost during H1-FY10. This increase was mainly driven by; (a) spending on support programs for poor initiated by the government; and (b) spending related to relief and rehabilitation of the IDPs.

5.5 Financing

With shortfall on account of budgeted external financing during H1-FY10, the government had to rely on additional financing from domestic sources to finance the budget deficit. Of the total financing requirement, approximately one-fourth was met through external resources compared to only 14.8 percent in H1-FY09

Table 5.5: Sources of Financing

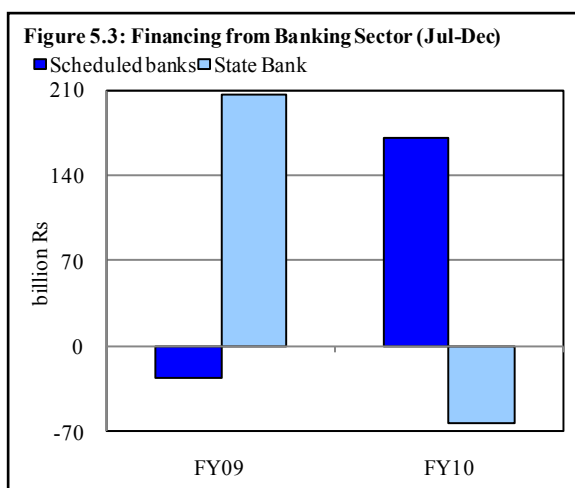
billion Rupees

	Jul-Dec			Growth (%)		Percent share ¹	
	FY08	FY09	FY10	FY09	FY10	FY09	FY10
Total financing of budget	356.3	249.5	403.3	-30.0	61.7	100.0	100.0
External resources (net)	68.0	37.0	110.3	-45.6	198.0	14.8	27.3
Internal resources (net)	288.3	212.5	293.0	-26.3	37.9	85.2	72.7
Banking system	228.6	181.0	107.2	-20.8	-40.8	(85.2)	(36.6)
Non-bank	58.0	30.2	185.8	-48.0	515.5	(14.2)	(63.4)
Privatization Proceeds	1.7	1.3		-21.8	-100.0	(0.6)	(0.0)

Source: Ministry of Finance

¹ Numbers in parenthesis represent share in internal source of financing.

(see **Table 5.5**). Despite this apparent improvement, the net external financing constitutes only 35.3 percent of the annual target for FY10. This shortfall came from delays in the realization of the Tokyo pledges. However, a part of commitments under Tokyo pledges was covered by bridge financing⁶ provided by the IMF, adding approximately Rs 93.2 billion in total gross external inflows. Furthermore, Rs 83.7 billion outflows on account of repayment of external debt left the net external financing to only Rs 110.3 billion during H1-FY10.

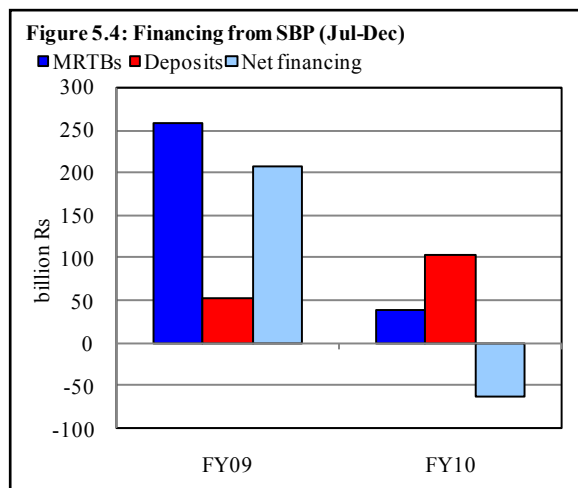


⁶ Bridge financing is temporary financing and is used as a bridge to maintain liquidity while waiting for expected cash inflow.

Financing from the banking sector⁷

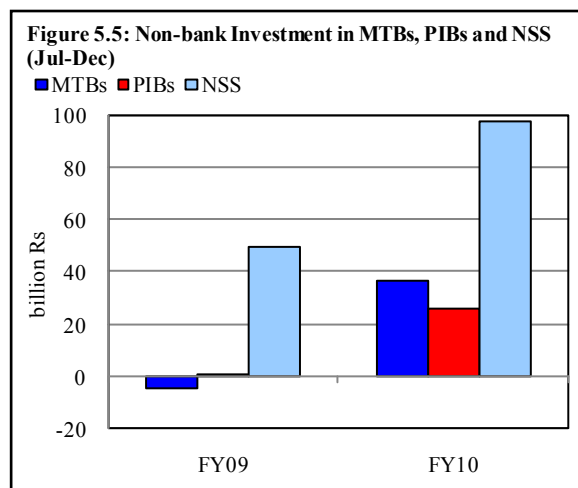
Budgetary financing availed from the banking sector declined by 40.8 percent YoY to Rs 107.2 billion in H1-FY10 (see **Figure 5.3**). Scheduled banks remained the major source of deficit financing which provided Rs 171.0 billion, in contrast to a net retirement of Rs 25.6 billion during H1-FY09. This reflects the renewed interest of commercial banks in T-bill auctions in the falling interest rate scenario.

On the other hand, the government continued to retire its debt with the central bank to meet the limit imposed by the IMF under Stand-By Arrangement. Disaggregation of data shows that the government deposits with SBP (including other deposits) increased significantly by Rs 103.6 billion in H1-FY10 which has dropped the borrowings of Rs 39.8 billion through fresh MRTBs to a net retirement of Rs 63.9 billion during H1-FY10 (see **Figure 5.4**).



Financing from the non-banks

Budgetary financing received from the non-banks increased to Rs 185.8 billion during H1-FY10 compared to only Rs 30.2 billion in the same period last year. NSS with Rs 98.8 billion was the largest contributor to the total non-bank financing (see **Figure 5.5**). Non-bank participation



⁷ Budgetary financing from the banking system is worked out on cash basis and hence, these will differ from government borrowing numbers reported in the section on Money and Credit where data is measured on accrual basis.

in the budgetary financing through government securities also increased significantly during H1-FY10. This was possibly due to reduced availability of alternative investment opportunities to the non-bank financial institutions. In H1-FY10, financing received from PIBs increased to Rs 26.2 billion, while T-bills added Rs 36.8 billion in total non-bank financing against a net retirement in the same period last year.

Table 5.6: FBR Tax Collection (net) during (Jul-Dec)

billion Rupees

	Tax collection (net)		Absolute difference		Annual target		% of annual target achieved	
	FY09	FY10	FY09	FY10	FY09	FY10	FY09	FY10
Direct taxes	210.3	211.4	45.7	1.1	498.9	565.6	42.2	37.4
Indirect taxes	343.5	370.8	73.0	27.3	751.1	751.1	45.7	49.4
Sales tax	217.2	242.9	47.9	25.7	469.9	499.4	46.2	48.6
FED	53.6	56.7	14.0	3.1	112.0	152.8	47.8	37.1
Customs	72.8	71.2	11.1	-1.5	169.2	162.2	43.0	43.9
Total collection	553.8	582.2	118.8	28.4	1,250.0	1,380.0	44.3	42.2

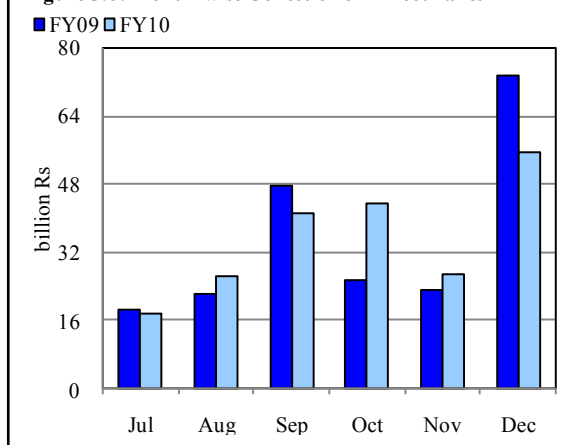
Source: Federal Board of Revenue

5.6 FBR Tax Collection

The FBR tax collections rose by 5.1 percent during H1-FY10 compared to 27.3 percent increase in the same period last year (see **Table 5.6**). The growth was restricted largely due to decline in imports and shortfall in direct tax collection (see **Figure 5.6**).

Out of the total growth of 5.1 percent, indirect tax collection accounted for 4.9 percentage points with the remaining being contributed by direct tax collection. The relatively better performance of indirect taxes is largely owed to the noticeable collection from the domestic source⁸ which partially offset the effect of the decline in the rupee value of imports. Also the collection of indirect taxes up to the first

Figure 5.6: Month-wise Collection of Direct Taxes



⁸ The domestic source of the indirect taxes comprises collection of sales tax and federal excise duty from the domestic source.

half of the current fiscal year looks strong when viewed as a percent of the annual target.

To achieve the target FBR has to collect Rs 133 billion per month on the average in the remaining six months of the year.

5.7 Provincial Fiscal Operations

Notwithstanding a substantial rise in the total revenue, provincial public finances exhibited deterioration in the overall balance during H1-FY10. The overall balance of the provinces decreased by 39.4 percent during H1-FY10 compared to the same period last year.

Total revenue receipts of all provinces stood at Rs 385.5 billion, registering a growth of 18.1 percent during H1-FY10 against 14.4 percent last year (see **Table 5.7**). The sizeable increase in the growth of revenue receipts is mainly due to increase in transfer of grants by the federal government to the provinces. On the other hand, growth in federal tax assignment to the provinces observed a deceleration as expansion in divisible pool was restricted following slowdown in the growth of FBR taxes.

Table 5.7: Summary of Consolidated Provincial Finance (Jul-Dec)

billion Rupees

	Jul-Dec		
	FY08	FY09	FY10
Total revenue	285.2	326.4	385.5
Provincial share in federal revenue	187.4	250.6	284.8
Provincial taxes	18.2	22.0	23.7
Property taxes	2.0	2.5	2.8
Excise duties	1.3	1.5	1.6
Stamp duties	5.3	5.0	5.0
Motor Vehicle tax	3.9	3.5	4.4
Other	5.8	9.4	9.7
Provincial non-tax	34.2	24.7	21.4
Interest	9.8	0.1	0.1
Profits from hydro electricity	3.3	0.0	4.8
Irrigation	1.0	1.2	0.8
Others	20.2	23.5	15.6
Federal loans and transfers/grants	45.4	29.2	55.7
Loans (net)	3.7	1.8	5.8
Grants	16.3	19.2	35.5
Grant for dev. expenditure	25.4	8.2	14.3
Total expenditure	322.4	294.4	366.1
Current expenditure	218.3	245.0	293.2
Development Expenditure	104.2	49.4	72.9
Overall balance	-37.2	32.1	19.4

Source: Ministry of Finance

Total expenditure of the provinces rose strongly during H1-FY10, to reach Rs 366.1 billion from Rs 294.4 billion last year. The sharp rise in total expenditure was mainly brought about by acceleration in the growth of development expenditure during H1-FY10. The

sudden increase in total expenditure resulted in a decline in overall balance of provinces to Rs 19.4 billion from Rs 32.1 billion in same period of FY09. Province wise details shows that while the other three provinces experienced surplus in their respective overall balance, Punjab recorded a deficit during H1-FY10 from surplus in the same period last year (see **Table 5.8**). The deficit in the overall balance of the Punjab government probably reflects spending on untargeted subsidy and aggressive commodity procurement operations. Despite significant increase in total expenditure of NWFP, the surplus in overall balance has deteriorated marginally during H1-FY10. This was mainly due to increase in the federal grants to NWFP for rehabilitation and relief of the IDPs during the period under discussion.

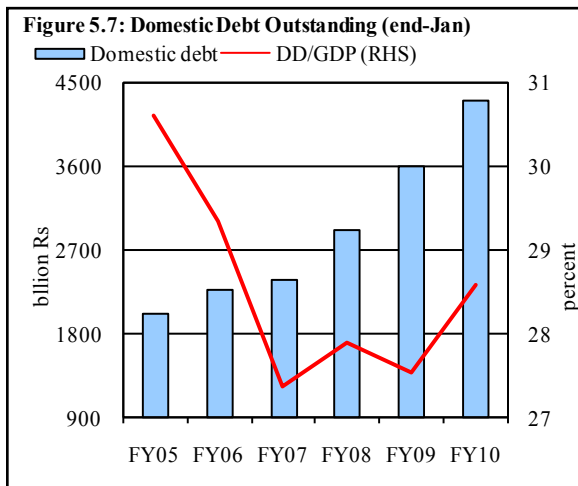
Table 5.8: Provincial Finance during Jul-Dec
billion Rs

	Punjab		Sindh		NWFP		Balochistan	
	FY09	FY10	FY09	FY10	FY09	FY10	FY09	FY10
Total revenue	159.8	162.5	89.9	107.9	43.3	75.2	32.8	39.8
Provincial share in Federal revenue	124.0	143.0	76.7	86.6	31.4	34.7	18.5	20.5
Provincial taxes	10.2	12.1	10.4	10.0	1.1	1.2	0.3	0.4
Provincial non-tax	19.7	7.4	1.8	3.3	2.3	10.0	1.0	0.6
Federal loans and transfers/grants	6.0	0.0	1.0	8.1	8.6	29.3	13.9	18.3
Total expenditure	148.2	188.0	94.0	103.2	29.1	62.1	22.3	25.3
Current expenditure	120.2	141.7	83.1	90.6	23.5	50.4	18.2	23.0
Development Expenditure	28.0	46.3	11.0	12.6	5.6	11.7	4.1	2.3
Overall balance	11.5	-25.5	-4.1	4.7	14.2	13.0	10.5	14.5

Source: Ministry of Finance

5.8 Domestic Debt

Country's outstanding stock of domestic debt amounted to Rs 4.3 trillion at end-January 2010, up by 11.4 percent YoY compared to 10.4 percent in the same period last year, and an average growth of 6.4 percent during FY04-09 period. A sharp rise in domestic debt and a relative slowdown in nominal GDP

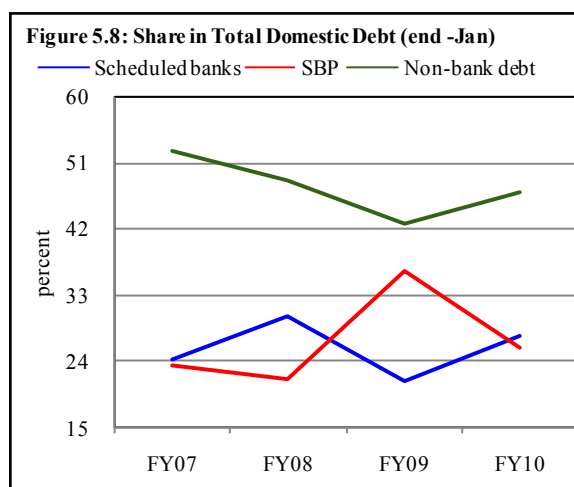


growth, resulted in rise in the domestic debt to GDP ratio to 28.5 percent by end-Jan FY10, which showed some recovery during FY09 (see **Figure 5.7**).

The rise in domestic debt is mainly attributed to net external financing due to (a) lower than expected disbursements of the pledged foreign financing (b) increase in the external debt repayments on maturing stocks of the foreign currency bonds.

Composition of Domestic Debt

A slightly higher than the projected fiscal deficit and the virtual halt with the budgeted external financing during H1-FY10 put pressure on the domestic source of financing to finance the budget deficit. Consequently, the structure of domestic debt changed significantly with increasing share of scheduled banks and non-bank debt in total domestic debt. Financing through non-bank sources, mainly comprising NSS remained almost in tandem with its budgetary estimates for FY10. With the cap on the borrowing from central bank agreed with IMF under SBA, the proportion of domestic debt held by scheduled banks increased significantly during the period under discussion. Even so, with the rise in the borrowings from scheduled banks during H1-FY10, the debt held by non-bank still constitutes a major share in the total domestic debt as on end-January 2010 (see **Figure 5.8**).



The outstanding stock of permanent debt went up by 10.2 percent during Jul-Jan FY10 compared to a rise of 0.1 percent a year earlier. Despite this acceleration, the share of the permanent debt in total domestic debt as on end January 2010 only recorded a marginal increase compared to the same period of last year.

Within the permanent debt, a major development was the introduction of first ever tradable National Saving Bond (NSB) in January 2010. The government was able to attract Rs 3.7 billion through NSB during January 2010. On the other hand, PIB retained its dominant share in outstanding stock of permanent debt by adding Rs 32.7 billion during Jul-Jan FY10 against a net retirement of Rs 12.5 billion in

the same period last year (see **Table 5.9**). Additionally, mobilization through prize bonds also saw significant improvements during Jul-Jan FY10.

Floating debt rose by 13.7 percent during Jul-Jan FY10, compared to 16.3 percent in the corresponding period last year. The deceleration in the rise of floating debt is largely stemmed from heavy retirement of the government debt held by the central bank. In contrast, commercial banks' holding of T-bills increased by 32.4 percent in Jul-Jan FY10

compared to 12.2 percent increase during Jul-Jan FY09.

Despite this increase during Jul-Jan FY10, government may have difficulty in mobilizing funds through commercial banks in the coming months, as the monthly flows through T-bills observed declining trend.

Gradual fall in the net mobilization through T-bills was mainly due: (a) increase in demand for credit from private sector during Q2-FY10; and (b) slowdown in accumulation of Non-performing Loans (NPLs).

Unfunded debt showed an increase of 8.7 percent in Jul-Jan FY10 to reach Rs 110.0 billion from Rs 72.9 billion last year. The outstanding stock against major NSS instruments recorded positive growth except for DSCs which recorded a net retirements of Rs 32.4 billion during Jul-Jan FY10 (see **Table 5.10**).

Table 5.9: Profile of Permanent Debt (Jul-Jan)

billion Rupees

	FY09		FY10	
	Net receipts	Debt (end Jan)	Net receipts	Debt (end Jan)
PIBs	-12.5	399.1	32.7	473.7
Ijara Sukuk	12.5	12.5	14.4	42.2
Prize bonds	0.7	183.5	19.2	216.7
NSB	--	--	3.7	3.7
Others	-0.1	13.9	-1.0	10.8
Total	0.6	609.0	69.0	747.1

Source: SBP

Table 5.10: Gross & Net Receipts of Major NSS Debt Instruments (Jul-Jan)

billion Rupees

	FY09		FY10	
	Gross	Net	Gross	Net
DSCs	45.2	-3.6	28.4	-32.2
SSCs	128.1	20.1	79.4	44.5
RICs	44.6	13.4	38.0	27.1
BSCs	257.4	38.4	55.6	35.1
SSAs	36.9	5.0	39.0	27.0
others	174.9	-0.3	105.6	8.6
Total	687.0	72.9	346.1	110.0

Source: Central Directorate of National Savings (CDNS)

Gross mobilization through NSS stood at Rs 346.1 billion during Jul-Jan FY10, almost half compared with the mobilization in Jul-Jan FY09. In fact, huge rise in the gross flows through NSS during Jul-Jan FY09 was based on the investor's efforts to lock in their funds at higher profit rates before any downward revision in

the profit rates in the second half of the last fiscal year. Also the massive encashment to jump toward the higher profit rates further boosted the gross receipts and lowered the net receipts during Jul-Jan FY09.

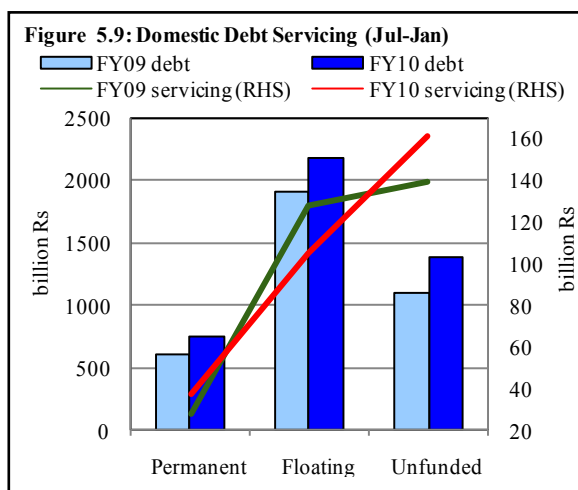
Interest Payments on Domestic Debt

In Jul-Jan FY10 period, interest payments on domestic debt increased by 2.7 percent compared with a rise of 15.7 percent in the same period last year. The relative deceleration in the growth of interest payments on domestic debt is attributable to decline in the interest payments on the floating debt.

The breakup of domestic debt servicing data reveals that interest payments on the permanent debt increased significantly during Jul-Jan FY10 compared to same period last year. This increase was largely due to interest payments on 10- year PIBs, in line with its increasing share in the total outstanding stock of PIBs. On the other hand, interest payment on floating debt fell down by 18.2 percent to reach Rs 104.7 billion

during Jul-Jan FY10 (see **Figure 5.9**). Interest payment on the outstanding stock of MRTBS remained almost consistent with Jul-Jan FY09 level. However, fall in the interest payments on T-bills (auction) brought down the overall interest payment on floating debt compared to H1-FY09. This was mainly on account of increased participation of commercial banks in 12-months and lesser maturities of T-bills during Jul-Jan FY10, as the banks were reluctant to participate in the 12 months T-bills during the Jul-Jan FY09.

Debt servicing cost being incurred against matured stock of DSCs stood at Rs 97.7 billion during Jul-Jan FY10, which constitutes almost 60.4 percent of the total debt servicing cost on the unfunded debt. However it is pertinent to note here that the outflow in the form of interest payments on DSC is declining overtime. Also the debt servicing cost of Behbood Saving Certificates (BSC) and Special Saving Certificates (SSC) increased significantly in the period under discussion, as the major amount raised against these certificates was issued at significantly higher interest rates during FY09.



6 External Sector

6.1 Overview

The improvement in the overall external accounts recorded during Q1-FY10 could not be sustained in the ensuing months (Oct-Feb). Considerable YoY fall in financial inflows in the latter period together with moderation in YoY contraction in current account deficit led to a noticeable deterioration in overall external account during this period (see **Table 6.1**). Nonetheless, overall external account recorded sizeable YoY improvement for the aggregate Jul-Feb FY10 period.

Close to half of YoY contraction in current account deficit during Jul-Feb FY10 was attributed to lower imports and related freight costs.

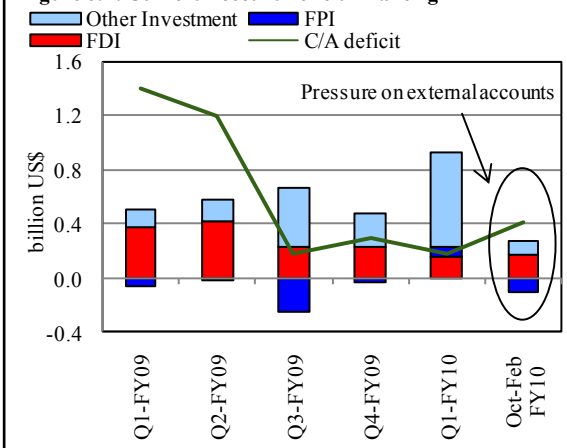
Fall in foreign exchange companies outflows, lower repatriation of dividends and strong rise in workers' remittances also contributed to the improvement in current account balance.

Fall in exports amid energy crises and subdued external demand offset a part of the above mentioned gains. Specifically, exports declined by 3.0 percent during Jul-Feb

Table 6.1: Summary of External Accounts (Jul-Feb)

billion US dollar	FY10			
	FY09	FY10	Jul-Sep	Oct-Feb
A-Current A/C balance	-8.0	-2.6	-0.5	-2.0
<i>i) Trade balance</i>	-9.5	-7.4	-2.8	-4.6
<i>Exports</i>	12.9	12.5	4.6	7.9
<i>YoY growth (%)</i>	2.1	-3.0	-19.1	10.1
<i>Imports</i>	22.3	19.9	7.4	12.5
<i>YoY growth (%)</i>	2.8	-10.8	-27.4	3.5
<i>ii) Invisible balance</i>	1.5	4.9	2.3	2.6
<i>Remittances</i>	4.9	5.8	2.3	3.5
B-Financial/Capital A/C balance	3.4	3.9	2.9	1.0
<i>i) FDI</i>	2.8	1.3	0.5	0.8
<i>ii) FPI</i>	-0.9	-0.3	0.2	-0.5
<i>iii) Other Investment</i>	1.4	2.6	2.1	0.5
C-Errors & omissions	0.0	-0.4	-0.4	0.1
D-Overall balance	-4.5	0.9	1.9	-1.0

Figure 6.1: Current Account Deficit Financing



FY10 against 2.1 percent increase in the corresponding period last year.

Most of the surplus in the financial account was also concentrated in the first quarter of FY10 (see **Figure 6.1**). Specifically of the US\$ 3.7 billion surplus during Jul-Feb FY10, US\$ 2.8 was accumulated in Q1-FY10, which included non-recurring US\$ 1.2 billion equivalent SDRs allocation by International Monetary Fund. In the later period (Oct-Feb) financial inflows fell considerably and accumulation was limited to only US\$ 0.8 billion.

Potential Risks

Oct-Feb FY10 developments in the external accounts indicate that while current account deficit has gone down compared to the same period last year, financing even this lower current account deficit is becoming difficult. The situation could become more serious in the months ahead as current account deficit has recorded month on month increase during Oct-Feb FY10.

While some part of this monthly deterioration owed to seasonal or one off factors, anticipated increase in imports led by domestic demand and high average import prices is likely to further weaken current account balance in the months ahead (see **Table 6.2**). Moreover, there is a risk that remittance inflows may further lose momentum as already evident from MoM decline.

Table 6.2: Potential Risks to External Outlook

Imports				
Commodity average prices ¹	H1-FY09	H2-FY09	H1-FY10	Jan-Feb FY10
Crude oil (US\$/barrel)	85.8	51.7	63.4	76.0
Palm oil (\$/MT)	640.8	627.5	660.6	748.2
Soybean oil (\$/MT)	966.1	769.2	804.8	839.4
DAP (\$/MT)	908.4	332.9	313.2	459.0
IMF metal price index (2005=100)	146.4	106.0	137.3	150.3
Workers' remittances				
	2007	2008	2009	FY10 ²
Kerb premium (Rupees)	0.6	0.4	0.1	0.7
	FY07	FY08	FY09	FY10 ³
Domestic GDP growth	6.8	4.1	2.0	3.3
International capital flows				
Pakistan's Euro bond yield ³	Dec-08	Jun-09	Dec-09	Feb-10
10-year bond (end period)	23.0	15.0	9.8	10.1
30-year bond (end period)	20.1	15.3	10.9	11.9

1: International Monetary Fund, 2: End Feb, 2010,

3: Bloomberg, p: projections

Table 6.3: Positive Factors for Exports Recovery

	2007	2008	2009	2010 ^p
Real GDP growth¹				
World	5.2	3.0	-0.8	3.9
Advanced economies	2.7	0.5	-3.2	2.1
United States	2.1	-0.4	-2.5	2.7
Euro Area	2.7	0.6	-3.9	1.0
Emerging & developing economies	8.3	6.1	2.1	6.0
China	13.0	9.6	8.7	10.0
Middle East	6.2	5.3	2.2	4.5
Cotton production (million bales) ²	12.9	11.7	12.1	12.7
REER (app(+)/dep(-)) ³	0.0	-0.7	-3.6	-
Average prices				
	H1FY09	H2FY09	H1FY10	Jan-Feb FY10
Cotton outlook 'A' index	147.6	126.6	149.8	173.4
Rice (\$/MT)	666.0	590.2	588.6	591.4

1: World Economic Outlook Update (January, 2010), 2: Fiscal year, 3: State Bank of Pakistan, p: projected

Current account balance is however, expected to benefit from the likely recovery in exports on account of some favorable developments (see **Table 6.3**).

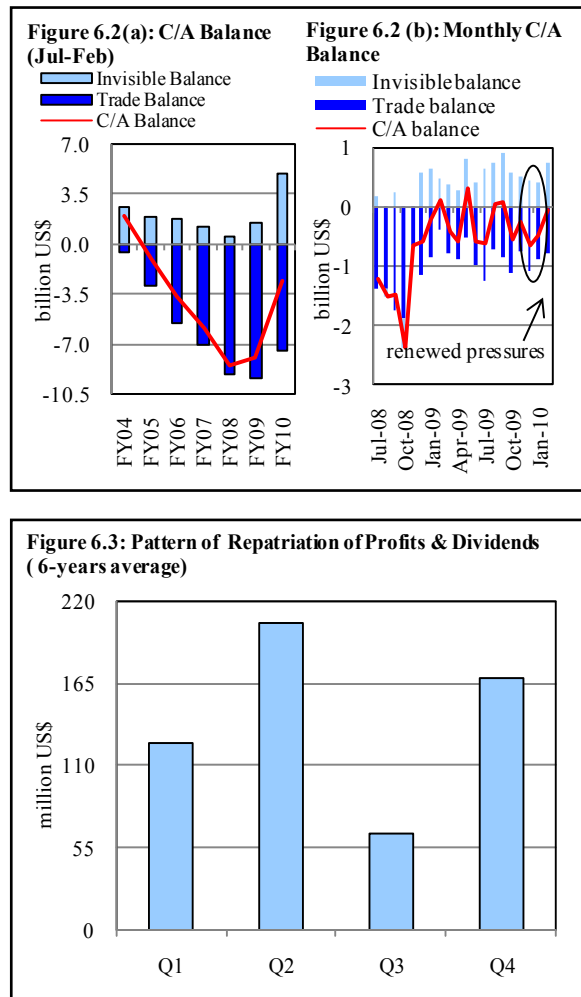
On the financing side, investment inflows are expected to remain weak amid impaired ability to tap international capital and uncertainty about realization of Tokyo pledges.

6.2 Current Account Balance

After widening continuously in the last five years, current account deficit recorded substantial YoY contraction (67.8 percent) during Jul-Feb FY10 (see **Figure 6.2a**). This improvement was largely driven by a considerable fall in imports and impressive increase in workers' remittances.

A bulk of this improvement in current account deficit was concentrated in Q1-FY10. In the subsequent months (Oct-Feb), pace of YoY improvement in current account deficit has noticeably slowed down, while month over month position is showing deterioration (see **Figure 6.2b**). Indeed, during December FY10 current account deficit reached the highest level in the last fourteen months.

While a large part of increase in monthly current account deficit is attributed to fall in invisible surplus, increase in imports also contributed. Fall in invisible surplus, in turn, was the result of both higher payments and lower receipts. The



former, mainly reflected increase in freight cost and seasonal payments of Hajj, dividends (see **Figure 6.3**)¹ and debt servicing whereas the latter largely owed to slowdown in remittances growth.

Further, the future path of imports and remittance also pose risk to current account outlook.

6.2.1 Trade Account²

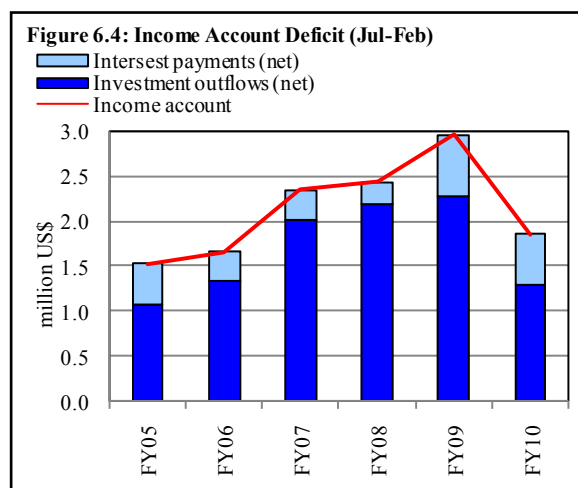
During Jul-Feb FY10, substantial fall in imports more than offset the decline in exports. As a result, trade deficit contracted by 21.3 percent during Jul-Feb FY10 against 3.7 percent expansion in the same period last year.

Lower import prices and weak economic activity were the key factors behind fall in imports during the period under review. Better cotton production and exchange rate depreciation also reduced demand for imports.

Although exports have recorded a YoY decline of 3.0 percent during Jul-Feb FY10, they have staged a comeback in October, 2009 onward. This recovery may be attributed to better cotton production amid poor international cotton crop, nascent recovery in major export markets and depreciation in real effective exchange rate. However, imports are likely to grow faster than exports in the remaining months of FY10, thus keeping trade deficit under pressure.

6.2.2 Services (net)

Services account deficit contracted by 37.4 percent during Jul-Feb FY10 compared with the same period last year. This contraction mainly reflected lower payments on account of



¹ Most of the foreign companies repatriate their profit and dividends on annual basis. As audit and other procedures take approximately three to four months, thus a major part of repatriation takes place in either second or fourth quarter depending on the financial years of the companies.

² This section is based on exchange record compiled by SBP that does not tally with more detailed custom data used in **sub-section 6.2**.

freight costs, travel expenses and other business services imports. This fall in freight costs followed a remarkable contraction in country's merchandise imports, whereas restrictions on foreign exchange companies' outflows largely explains lower payments of travel and other business services. Some of the improvement, however, was offset by seasonal increase in hajj related expenses (for details see **section on services**).

6.2.3 Income Account

Income account deficit declined by 37.3 percent during Jul-Feb FY10 against 21.6 percent expansion in the same period last year. While a larger part (88.8 percent) of this contraction emanated from fall in investment outflow (net), lower net interest payments also contributed to this decline (see **Figure 6.4**).

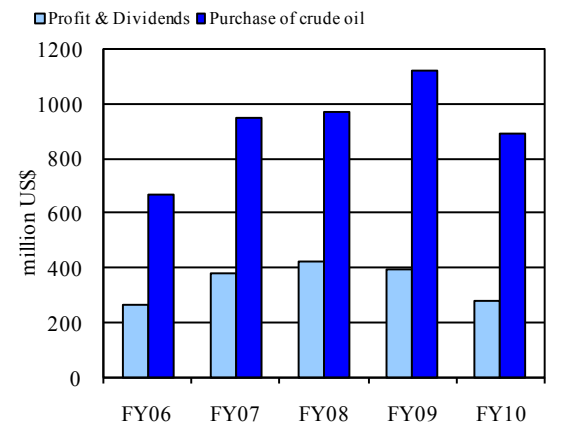
Table 6.4: Sector-wise Repatriation of Profits and Dividends (Jul-Feb)
million US dollar

	FY09			FY10		
	FDI	FPI	Total	FDI	FPI	Total
Petroleum refining	58.5	12.8	71.3	17.5	2.5	20.0
Oil & gas	20.8	39.3	60.1	6.6	19.1	25.6
Power	93.1	5.9	99.0	32.3	9.8	42.1
Trade	41.4	3.6	45.0	40.9	0.2	41.1
Communication	25.3	2.9	28.2	47.0	4.6	51.7
Financial business	16.5	16.5	32.9	7.7	10.1	17.8
Others	115.3	23.5	138.8	142.2	19.9	162.1
Total	370.9	104.4	475.3	294.3	66.2	360.5

Although a number of factors explains the fall in investment related outflows during the period under review, but most important among these are the circular debt and low average prices of oil and gas. For instance, circular debt hampered companies' operations by affecting their cash flows while low average oil and gas prices led to inventory and revenue losses.

The impact of these factors is more pronounced on purchase of crude oil and mineral (which is a function of oil & gas extraction and their prices), and dividends payments of oil and gas, petroleum refining and power sectors (see **Table 6.4**). Oil & gas extraction was also adversely affected by poor law & order situation and aging impact of oil fields. As a result, not only purchase of crude oil & minerals (which constitutes around 50 percent of overall investment related outflows) has fallen considerably

Figure 6.5: Investment Income Outflows (Jul-Feb)



(see **Figure 6.5**), but repatriation of profit and dividend of oil & gas sector has also reduced substantially.

Falling profitability of financial business amid weak economic growth is another factor behind lower repatriation of profit & dividends during the period. Moreover, nominal fall in foreign investment stock in equity markets may also have lowered repatriation of profit and dividends (see **Figure 6.6**).

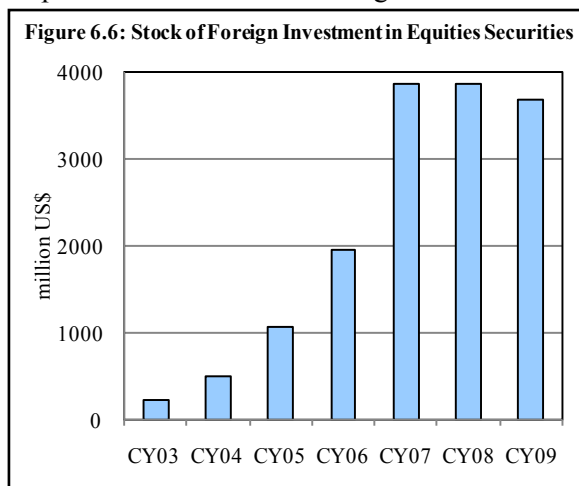


Table 6.5: Details of Interest Payments and Receipts (Jul-Feb)

million US dollar

	FY09	FY10	Q1	FY10 Q2	Jan-Feb
Payments (I+II)	807	642	213	331	98
I. Total external debt	635	559	181	296	82
Public & publicly guaranteed	527	436	144	239	53
Long-term	373	334	100	199	35
Military	2	0	0	0	0
Euro bonds	122	78	42	26	10
Commercial loans/credits	6	11	1	2	8
IDB	24	13	1	12	0
Private loans/credits	77	39	14	19	6
IMF	31	84	23	38	23
II. External liabilities	172	83	32	35	16
Foreign currency deposits	62	45	14	26	5
Special US\$ bonds	3	0	0	0	0
Central bank deposits	16	7	4	0	3
Others	91	31	14	9	8
Receipts	171	56	21	18	17
Interest on reserves	73	10	4	3	3
Others	98	46	17	15	14
Net	-636	-586	-192	-313	-81

Source: State Bank of Pakistan

The only exception to this fall in repatriation of profit & dividends was telecommunication sector which recorded an increase in repatriation of profit during Jul-Feb FY10.³

³ PTCL repatriated profit in Jul-FY10, after successful completion of its VSS scheme last year.

The decline in net interest payments, on the other hand, was entirely explained by fall in gross interest payments during Jul-Feb FY10 (see **Table 6.5**). Apart from the impact of a relatively lower international interest rate on the floating debt payments, fall in debt stock of relatively expensive IDB debt, Euro bond and private debt largely explains lower gross interest payments during the period.

Moreover, interest payments on foreign currency deposits also declined during the period under review.

However, a part of these gains was offset by increase in interest payments on IMF loan and decline in interest earnings on foreign exchange reserves.

6.2.4 Current Transfers

Led by remarkable increase in workers' remittances and higher inflows in Resident Foreign Currency Accounts (RFCAs), current transfer recorded a YoY growth of 17.8 percent during Jul-Feb FY10, compared with the decline of 2.2 percent in the same period last year (see **Figure 6.7**).

Workers' Remittances

Continuing last four years trend, workers' remittances recorded impressive growth in Jul-Feb

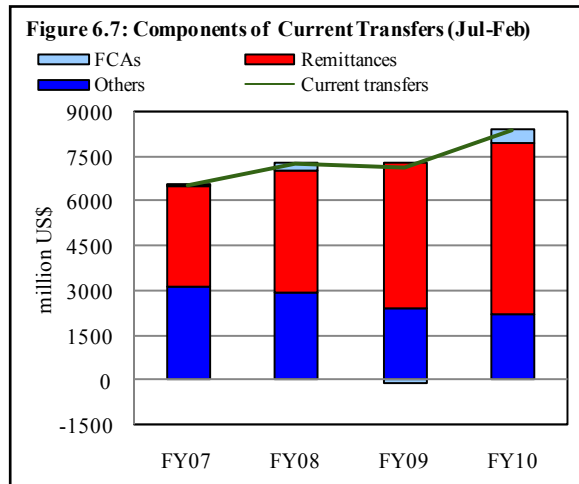


Table 6.6: Country-wise Workers' Remittances (Jul-Feb)
million US dollars

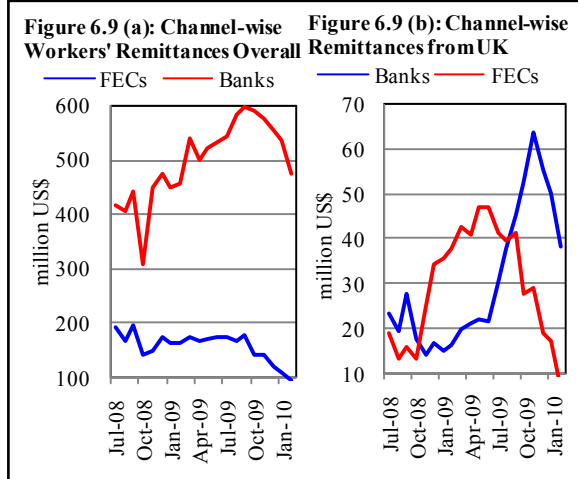
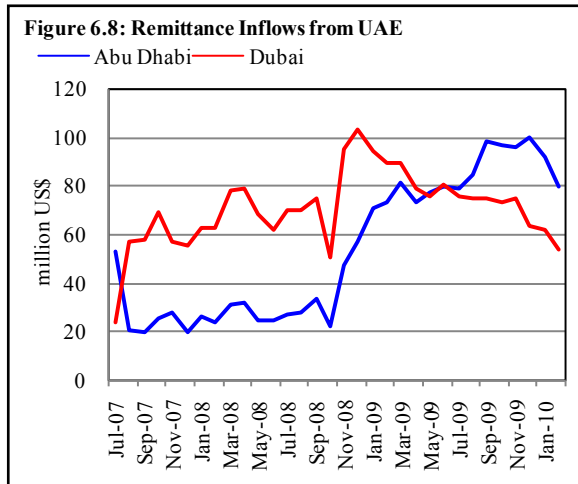
Countries	FY09	FY10	Share (%)	Contribution in growth (%age points)
Gulf region:	2781.2	3293.0	56.9	10.4
<i>Bahrain</i>	<i>99.6</i>	<i>101.0</i>	<i>1.7</i>	<i>0.0</i>
<i>Kuwait</i>	<i>287.9</i>	<i>297.1</i>	<i>5.1</i>	<i>0.2</i>
<i>Qatar</i>	<i>212.7</i>	<i>243.3</i>	<i>4.2</i>	<i>0.6</i>
<i>Saudi Arabia</i>	<i>962.3</i>	<i>1148.9</i>	<i>19.9</i>	<i>3.8</i>
<i>Oman</i>	<i>183.1</i>	<i>185.5</i>	<i>3.2</i>	<i>0.0</i>
<i>U.A.E.</i>	<i>1035.6</i>	<i>1317.2</i>	<i>22.8</i>	<i>5.7</i>
U.S.A.	1156.5	1173.4	20.3	0.3
U.K	344.1	596.3	10.3	5.1
Canada	51.6	71.6	1.2	0.4
Germany	57.5	61.8	1.1	0.1
Japan	4.3	3.0	0.1	0.0
Norway	24.8	15.8	0.3	-0.2
Others	498.6	572.2	9.9	1.5
Total	4918.6	5786.9	100.0	17.7

FY10. Specifically workers remittance increased by 17.7 percent during Jul-Feb

FY10 on the top of 17.3 percent average growth during the corresponding period of last four years.

Although a large impetus to this growth came from the gulf region and United Kingdom, USA and Canada also contributed positively (see **Table 6.6**). Within Gulf region, 55 percent of the increase was sourced from UAE and 36.5 percent came from Saudi Arabia.

Market sources suggest that Dubai (which depends on trade finance and real estate rather than oil & gas) was hard hit by recent global financial crises. As a result, the income of Pakistani migrants was squeezed amid cuts in their salaries and job losses. Thus some of the migrants facing job losses shifted to Pakistan while others sent their families back home.⁴ In the first case, migrants brought their savings with them while in the latter case the funds which were spent in Dubai are now remitted home to support their families. Some of such migrants have been successful in finding jobs in Abu Dhabi as is depicted by strong increase in remittance inflow from this state (see **Figure 6.8**). Increasing use of official channels in the wake of FIA actions against illegal fund transfer and various measures under Pakistan Remittance Initiative



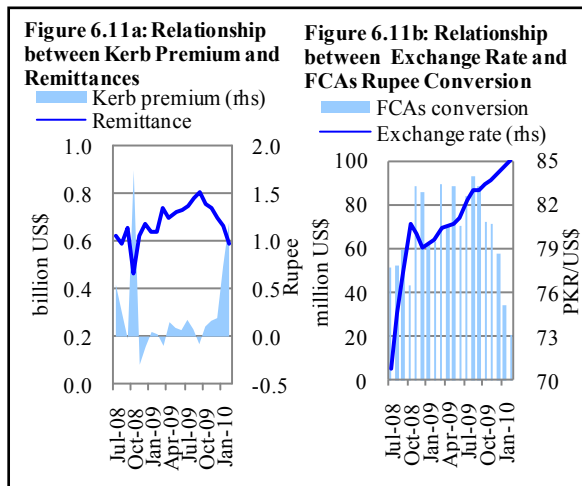
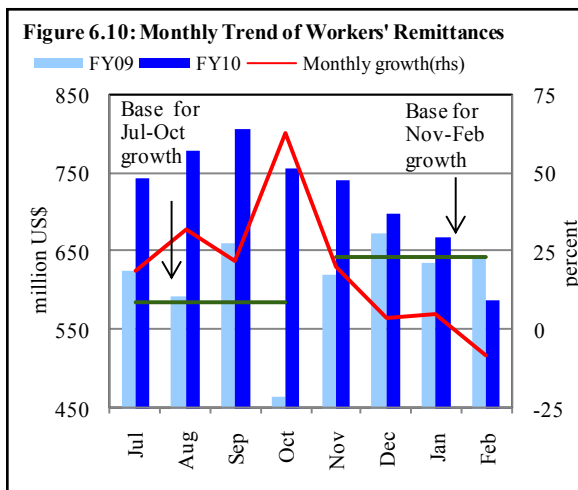
⁴ Migrants in UAE have contract based visas, so they become illegal as soon as they lose jobs. Such illegal migrants, who do not return home, face the risk of being apprehended and deported with no chance of recovering their possessions or savings. As a result, these workers send back all their income as fast as possible.

seem to be other probable reasons for surge in remittance inflows from UAE during the period under review.

Channel-wise data suggests that almost an entire increase in remittance during Jul-Feb FY10 was sourced from banking channel as remittance routed through foreign exchange companies recorded YoY fall during the period under review (see **Figure 6.9 (a)**). Higher remittances inflow through banking channel mainly reflects PRI's efforts to attract remittance through this channel. This effect is more pronounced in UK, where a large number of tie-ups are signed between banks and foreign entities (see **Figure 6.9 (b)**).

Recent Slowdown in Remittance

Monthly data shows that a large part of remittance growth was concentrated in Jul-Oct FY10, as ensuing months recorded considerable slowdown in remittance growth (see **Figure 6.10**). A combination of factors is responsible for this slowdown. On the one hand, high base set last year affected growth, and on the other hand expectations of exchange rate depreciation have slowed down remittances inflow during the period. The latter has impacted remittance in two ways: (a) it reduced FCAs rupee conversion (which is a part of workers' remittance) and (b) it led to increase in kerb market premium (see **Box 6.2**) thereby encouraging remittance inflow through informal channels (see **Figure 6.11**). Moreover, lack of processing in the last week of December 2009 on account of Ashura leaves followed by strikes against bomb blast also impacted remittances inflow

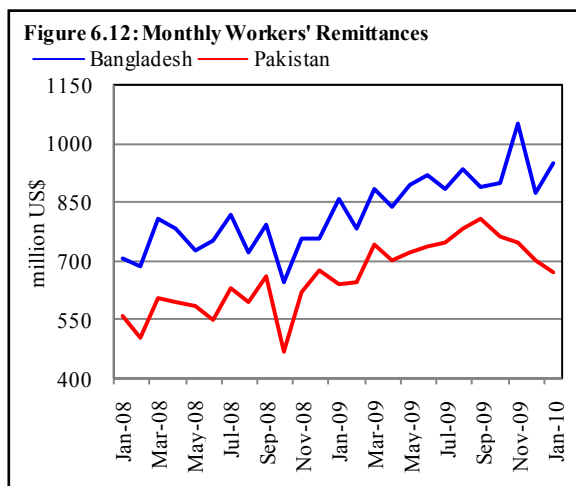


adversely.

Data analysis suggests that although slowdown in remittance growth during Nov-Feb FY10 was broad based, a large part of this slowdown emanated from fall in inflows through foreign exchange companies. Moreover, lower FCAs conversion of commercial banks (probably on account of expectations of exchange rate depreciation) and fall in remittance inflows through post offices also contributed to slow down in remittance growth during Nov-Feb FY10 period (see **Table 6.7**).

Table 6.7: Channel-wise Contribution in Remittance (YoY)			
Growth (percentage points)			
	FY10		
	Jul-Sep	Oct	Nov-Feb
Banks	24.9	60.8	12.3
<i>of which</i>			
Family maintenance	19.4	54.6	16.8
FCAs conversions	5.5	6.2	-4.5
FECs	-1.8	-0.2	-7.0
Post Offices	1.1	2.1	-0.3
Total	24.2	62.7	5.0

It may be pointed out that a part of remittance slowdown which was attributed to fall in FCAs rupee conversion is less worrisome as it has no impact on current account balance. In fact, fall in FCAs rupee conversion means increase in FCAs, which are also part of current account. However, considerable fall in remittance inflow through foreign exchange companies during Nov-Feb FY10 is worrisome as this may lead to increase in kerb market premium.



Still there is risk of downturn

Despite the fact that a considerable part of recent slowdown in remittance growth could be attributed to temporary factors, prospects of long slowdown in remittance are still there. This assessment mainly originates from possible lag response in remittance flow to slowdown in economic activities in the gulf (particularly

Dubai). This view gets some support from the fact that remittance in Bangladesh⁵ has also slowed down after strong surge in the crises period (see **Figure 6.12**).

On the positive side, with substantial recovery in oil prices in CY09, investment in huge infrastructure projects in Abu Dhabi and other oil rich gulf Emirates is expected to go on. Thus migrants losing jobs in Dubai would have an opportunity to move to these neighboring countries. This, in turn, may lower the risk of fall in remittance on account of construction slowdown in Dubai. Likewise, various measures under Pakistan Remittance Initiative (PRI) are also expected to have positive impact on remittance inflows (see **Box 6.1**).

Box 6.1: Pakistan Remittance Initiative's Strategic Alliance with Pakistan International Airlines

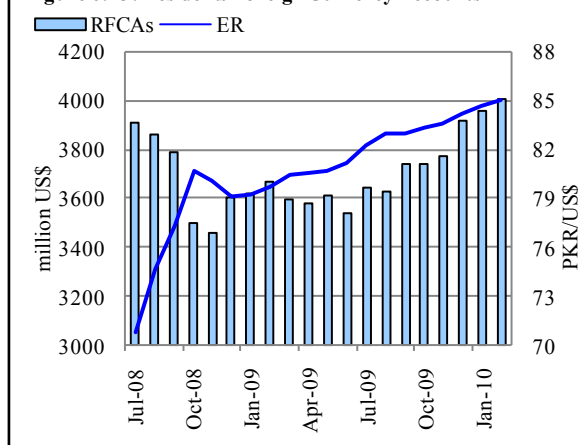
Under Pakistan Remittance Initiative, various measures are being taken to encourage and facilitate workers remittance flows through official channel. For instance, introduction of Real Time Gross Settlement (RTGS) in the major banks to enable them to transfer interbank transactions into the beneficiary account same day and increasing banks outreach by arranging their tie-ups with foreign entities had already been taken. As a part of these efforts, Pakistan's Remittance Initiative (PRI) has signed a Memorandum of Understanding (MoU) with Pakistan International Airlines (PIA) on December 29, 2009.

This strategic alliance will work in different phases. In the first phase, overseas Pakistanis will be given 100 free return air tickets through lucky draws. In the second phase, a frequent flyer card and miles program linked with the remittance transaction will be introduced. The card holders will be entitled to a number of privileges such as reserve seats and special gifts in the flights and business class services at check in counters, business class lounges and excess baggage allowance. Importantly, a small movie will also be shown in all the PIA flights to educate workers about the use and importance of remitting their earnings through official channel.

Resident FCAs

Resident Foreign Currency Accounts posted a sharp reversal during Jul-Feb FY10, from an outflow of US\$ 142 million during Jul-Feb FY09 to an inflow of US\$ 465 million during the period under review. The fall in FY09 was panic driven withdrawals following the

Figure 6.13: Residents Foreign Currency Accounts



⁵ Remittances flow to Pakistan is compared with that of Bangladesh as both have not only low profile migrants, but main source of remittance is also the same i.e. Gulf region

rumors that FCAs may be frozen in the country.

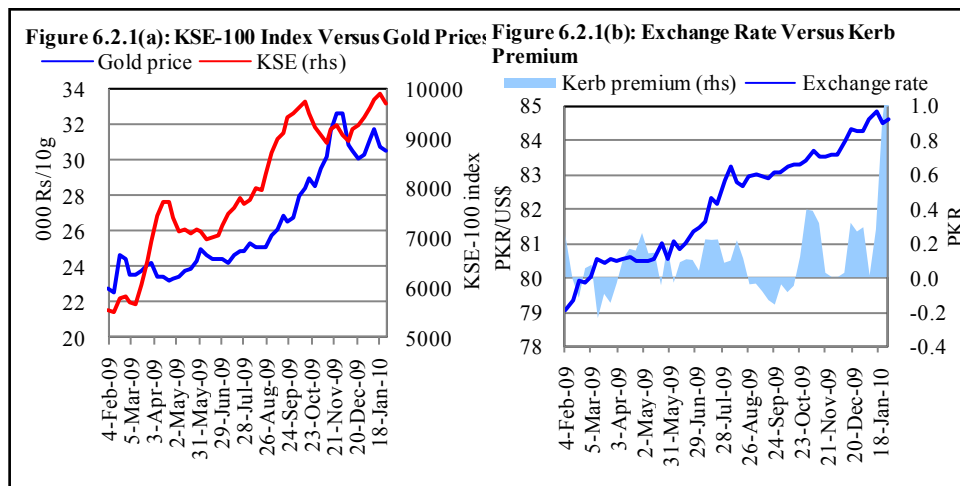
The recovery in RFCAs during Jul-Feb FY10, on the other hand, mainly reflects expectations of exchange rate depreciation and subsequent fall in rupee conversion of these accounts (see **Figure 6.13**). It may be pointed out that shifting of oil payments to interbank markets increased the exchange rate volatility; thereby some speculation. The major enterprises recording increase in their FCAs during the period include OGDC, KESC and UN mission..

Box 6.2: Short Investor's Behavior and Kerb Market Premium

Short investors in Pakistan usually invest in stock market, forex market or commodity market. As short investor behavior is also important for kerb market premium, it will be pertinent to analyze this behavior.

To study short investor behavior in three different markets, weekly average prices of US dollar, gold and KSE-100 index are plotted against kerb market premium. The data is used from Feb-2009 to Jan-2010.

The trend analysis suggests that the premium increases when increase in US dollar price is relatively higher than that of gold and stock index. Thus the magnitude of short investors influence on the premium mainly depends on price differential between US dollar and gold & stock market performance. For instance, kerb premium has increased considerably in December 2009 and January 2010 amid rising dollar price and either stagnant or declining gold price or KSE-100 index (see **Figure 6.2.1**).



This is in line with economic intuition. As when dollar price increases against other asset prices, short investor invests in dollar, thereby increasing its demand and premium. However, when price of US dollar increases less than that of gold and KSE-100 index, only a small number of short investors appears to invest in dollar, having little impact on kerb premium.

6.3 Financial Account Balance⁶

Financial account surplus recorded 10.1 percent increase during Jul-Feb FY10 compared to 40.0 percent decline in the same period last year.

During Jul-Feb FY10, financial inflows underwent a compositional change compared to the same period last year. While foreign direct investment constituted a major part of financial inflows (net) during the last year, financial inflows (net) in the current year mainly comprised of other investment (see **Figure 6.14**). Higher inflows in other investment, in turn, largely owed to one off SDRs allocation worth US\$ 1.2 billion, IMF bridge financing of US\$ 1.1 billion and realization of Tokyo pledges worth US\$ 0.2 billion.

Monthly breakup shows that financial inflows were mainly concentrated in Q1-FY10. In the subsequent months (Oct-Feb), Sukuk payments worth US\$ 600 million and IDB payment of US\$ 267 million kept the financial inflows under stress.

Net Foreign Investment (NFI)

Sharp fall in foreign direct investment along with payments of public sector sukuk bond led to a substantial decline in Net Foreign Investment (NFI) during Jul-Feb FY10. Specifically, NFI recorded 45.9 percent YoY fall during Jul-Feb FY10 compared to 33.5 percent fall in the same period last year (See **Table 6.8**).

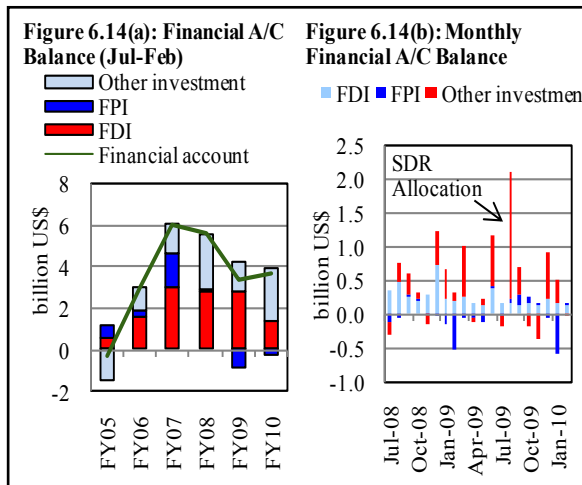


Table 6.8: Net Inflow of Foreign Investment in Pakistan (Jul-Feb)

million US dollar

	FY09	FY10	Growth (%)
Foreign investment	1,892.4	1,024.1	-45.9
I. Private investment	2,427.7	1,662.8	-31.5
Foreign direct investment	2,794.7	1,319.3	-52.8
Portfolio investment	-367.0	343.5	193.6
Equity securities	-367.0	343.5	193.6
Debt securities	0	0	0
II. Public investment	-535.3	-638.7	-19.3
of which: Debt securities*	-535.3	-638.7	-19.3

* Net sale/purchase of Special US dollar bonds, Eurobonds, FEBC, DBC, T bills and PIBs

⁶ It does not include use of IMF credit and loans (except bridge financing).

Foreign Direct Investment

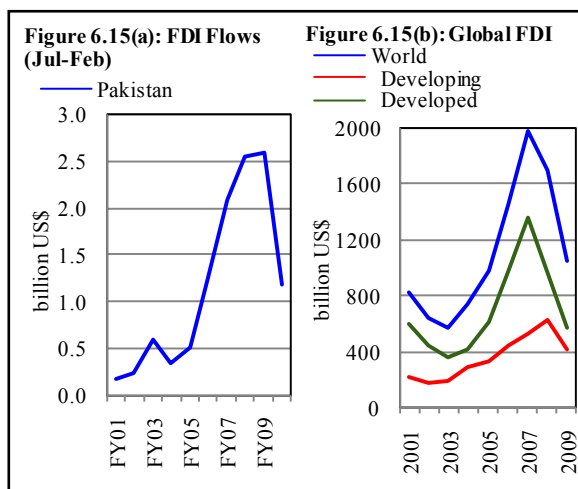
In line with global trends, Pakistan is witnessing substantive decline in foreign direct investment (see **Figure 6.15**). Globally, many companies are postponing their investments as a result of market uncertainty, contraction in their profitability and difficulty in obtaining credit.⁷ The impact of these developments on foreign direct investment flow to Pakistan was further

aggravated by hostile domestic factors such as energy crises, increasing security risk and weak economic activity. As a result, foreign direct investment recorded an extraordinary YoY decline of 52.8 percent during Jul-Feb FY10 compared to a nominal increase of 0.2 percent in the comparable period last year.

Close to one fourth of this decline was attributed to fall in reinvested earnings, which largely reflects either a fall in profitability or increase in losses. Moreover, considerable fall in merger & acquisition and decline in green field projects together contributed three fourth of the drop in overall FDI during the period.

Sector wise data shows that a large part (74.0 percent) of fall in overall FDI during Jul-Feb FY10 was driven by sharp fall in investment inflows to financial business and telecommunication. As a result, share of aforementioned sectors in overall FDI was reduced to 22.1 percent during Jul-Feb FY10 from 49.5 percent a year earlier. Apart from impact of negative reinvested earnings on account of companies' losses or lower profits, lower investment in equity in communication sectors owed to stiff competition and market saturation while investment in financial business was negatively affected by lack of mergers& acquisitions and repayment of intra-company loans.

Moreover, fall in investment in oil & gas exploration contributed around 4.9 percent of the overall fall in FDI during the period. Lower foreign investment in this sector is largely attributed to deteriorating law & order situation and circular



⁷ UNCTAD estimates show that global inflow of foreign direct investment fell by 39.0 percent during 2009.

debt issue which constrained the companies' operations. Likewise, circular debt issue also appears to be the dominant reason behind lower foreign investment in petroleum refining during the period (see **Table 6.9**).

Table 6.9: Sector -wise Foreign Direct Investment (Jul-Feb)
million US dollar

Sectors	FY09			FY10		
	Cash	Re-invested earnings	Total	Cash	Re-invested earnings	Total
Chemicals	2.4	38.6	41.0	43.5	33.7	77.2
Petroleum refining	20.5	53.5	74.0	11.0	25.4	36.4
Oil & gas explorations	321.5	149.5	471.1	315.5	83.8	399.3
Cement	9.0	21.9	30.9	0.1	6.2	6.2
Power	82.4	-8.0	74.3	93.8	22.0	115.8
Construction	45.6	-2.7	42.8	75.7	-3.6	72.1
Trade	90.3	31.2	121.5	39.3	9.6	48.9
Telecommunications	735.8	1.1	736.9	267.3	-61.9	205.4
Financial business	473.1	174.4	647.5	87.5	-1.1	86.5
Personal services	60.4	3.2	63.6	31.5	2.8	34.2
Others	364.3	126.8	491.1	207.4	30.0	237.3
Total	2205.2	589.5	2794.7	1172.5	146.8	1319.3

Sectors attracting higher FDI

Power, construction and chemical sectors, on the other hand, recorded YoY increase in foreign direct investment during Jul-Feb FY10. Higher investment in power sector was mainly routed to KESC project at Port Qasim and Uch power project, while higher investment in chemical largely channeled to a large FMCG multinational company. Likewise, higher investment in construction sector mainly channeled to road and bridges and one of the major construction companies in Karachi.

Country-wise FDI

While FDI from almost all the major sources declined during Jul-Feb FY10 compared with the same period last year, bulk of this decline (72.5 percent) was recorded from Mauritius, Malaysia, Singapore, United States and Switzerland.

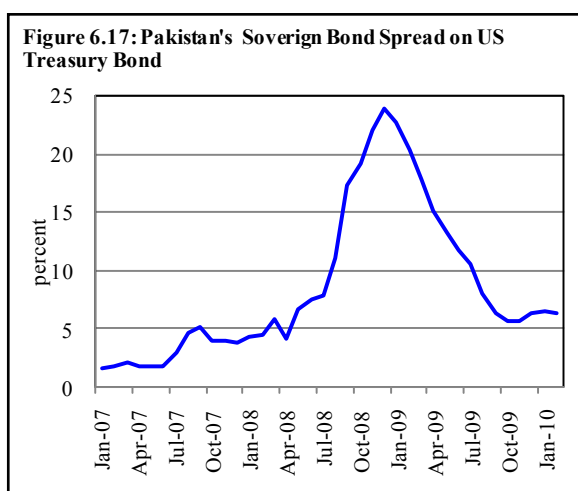
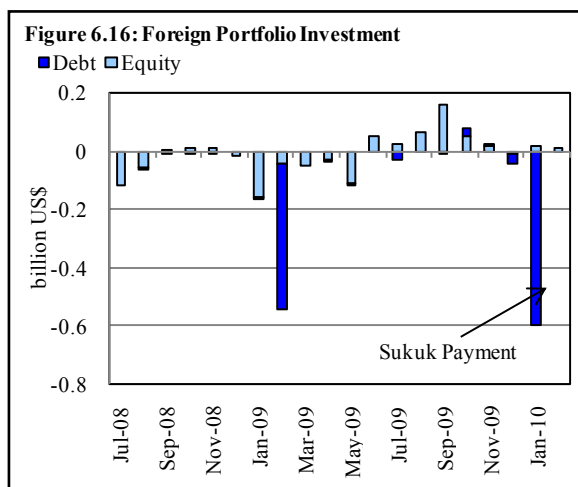
Foreign Portfolio Investment

Foreign portfolio investment recorded a net outflow of US\$ 295 million during Jul-Feb FY10 compared to net outflow of US\$ 902 million in the corresponding period last year. Although investment in equity market showed some revival, this

was more than offset by Sukuk bond payment worth US\$ 600 million during the period (see **Figure 6.16**).

It may be pointed out that revival of investment in equity market was largely concentrated in Jul-Oct FY10, when Pakistan's credit rating was improved by international credit rating agencies following its re-entry into MSCI frontier market index and considerable increase in its reserves mainly on account of SDRs allocation.

However, it slowed down considerably in the subsequent months probably on the back of lower return on stock market investment, relatively higher exchange rate fluctuation and rising security concerns. Moreover, yield spread on Pakistan's sovereign bond has also witnessed an uptick in the latter period (Nov-Feb) (see **Figure 6.17**).



Other Investment

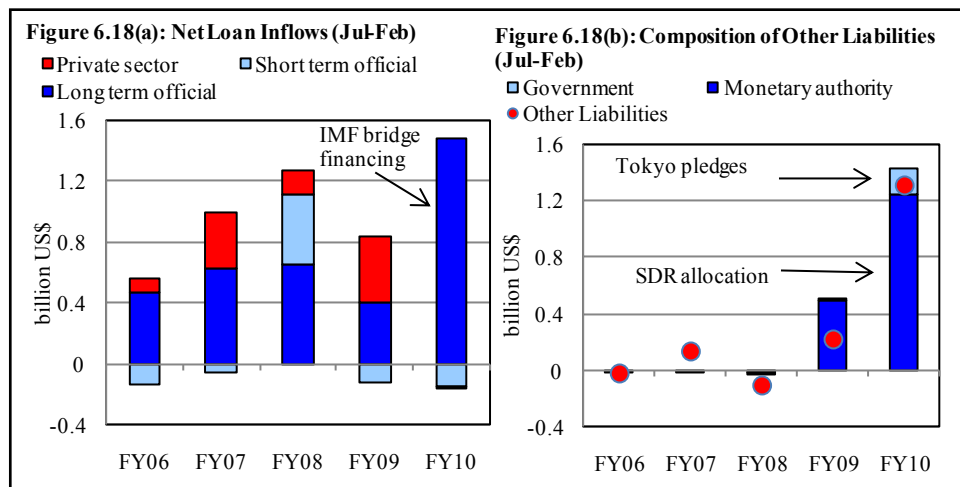
Net inflow in other investment almost doubled to US\$ 2.6 billion during Jul-Feb FY10 compared with the same period last year. Almost the entire increase was attributed to substantive increase in liabilities, while asset side⁸ had negative impact on the other investment.

Other investment assets increased by US\$ 44 million during Jul-Feb FY10 compared with US\$ 544 million decline in the comparable period last year.

⁸ Increase in assets abroad is recorded as dollar outflow and vice versa.

Relatively higher decline last year was mainly attributed to considerable fall in outstanding exports bills in the wake of weak exports. During Jul-Feb FY10, however, outstanding exports bills have increased following respectable recovery in exports. However, a large part of this increase was offset by considerable fall in commercial bank trade nostros. It may be pointed out that shifting of oil payments to interbank market is putting enormous pressure on commercial bank trade nostros.

Increase in other investment liabilities, during Jul-Feb FY10, was chiefly explained by higher net inflows of long term official loans and other liabilities (see **Figure 6.18**). The former was largely attributed to IMF bridge financing loan while latter was the result of IMF SDRs allocation (US\$ 1.1 billion) and realization of Tokyo pledges (US\$ 200 million) from Saudi Arabia.



However, net payments of short term official loan and private loans⁹ offset a part of the higher long term official net loan inflows during the period. It may be mentioned here that net payments of official short loans would have been even higher, had it not been for the rollover of IDB loan repayment (US\$ 323 million) due in December, 2009.¹⁰

⁹ Major payments Packages limited (US\$ 30 million), Pakistan mobile communication (US\$ 23 million), Pak refinery limited (US\$ 18.5 million).

¹⁰ The loan is rollover for six months.

6.4 Services Trade

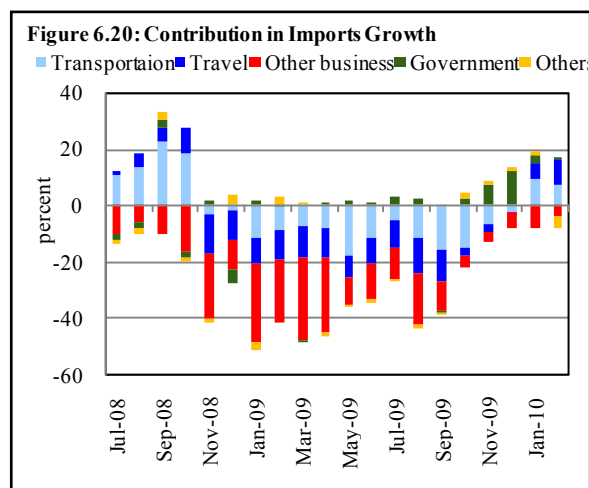
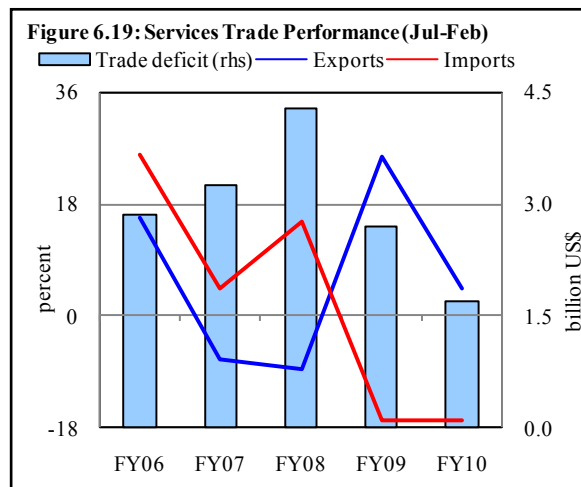
Pakistan's services trade deficit shrunk by 37.4 percent during Jul-Feb FY10 as compared to 37.3 percent contraction recorded in the same period last year. The fall in services trade deficit was due to 16.4 percent YoY fall in services imports bill and 4.4 percent YoY increase in services exports (see **Figure 6.19**).

The contraction in services imports was a result of combination of fall in transportation services which declined due to lower merchandise imports & lower passage payments to foreign airlines and outflows restrictions on foreign exchange companies (see **Figure 6.20**).

In services exports, apart from transportation, travel, computer & information services groups, all other major sub-groups including communication, financial, other business and government services recorded increase during the period under consideration.

Services Exports

Pakistan's services exports witnessed a mild increase of 4.4 percent during Jul-Feb FY10 as compared with a significant rise of 25.6 percent in the same period last year. While telecommunication, financial and government services exports recorded strong growth, the overall rise in invisible receipts was limited due to the poor export performance witnessed by the transportation and travel services sub-groups. During Jul-Feb FY09, the overall services exports grew on account of



high passage earnings of national airline, increased expenses of foreign transport companies domestically and higher travel services exports (see **Table 6.10**).

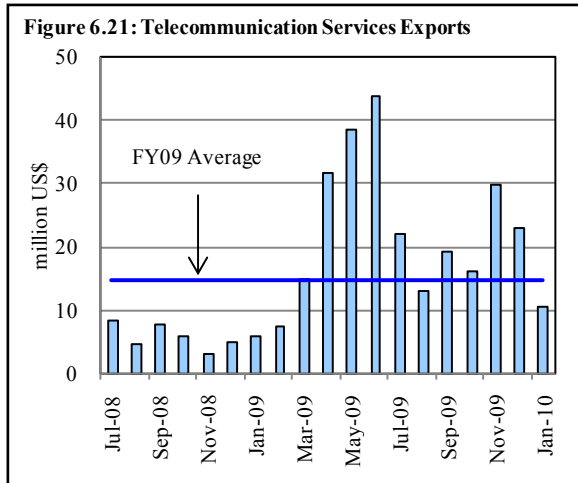
Table 6.10: Major Services Exports (Jul-Feb)
million US dollars

	Absolute value		Growth (%)		Share (%)	
	FY09	FY10	FY09	FY10	FY09	FY10
Transportation	931	759	37.1	-18.5	35.5	27.7
Travel	227	191	27.5	-15.9	8.7	7.0
Other business	334	339	18.2	1.5	12.7	12.4
Communication	62	160	-28.2	158.1	2.4	5.8
Computer & info.	127	126	34.9	-0.8	4.8	4.6
Financial	45	77	52.8	71.1	1.7	2.8
Government	823	1038	25.1	26.1	31.4	37.9
Total	2621	2737	25.6	4.4		

Transportation services exports fell by 18.5 percent during Jul-Feb FY10 against an impressive growth of 37.1 percent in the same period last year. The fall in exports of this category was on account of lower passage and freight earnings and reduced local operations of foreign transport companies. However, some recovery in transportation services exports is evident in the last couple of months.

Communication services exports posted remarkable increase of 158.1 percent during Jul-Feb FY10 as against 28.2 percent decline in the corresponding period of last year. The growth in the groups' exports was an outcome of Pakistan Telecom Authority (PTA) efforts to eliminate illegal traffic (grey telephony) in the country.¹¹

PTA has taken number of steps both regulatory and technical with the coordination of LDI stakeholders curb illegal traffic, which has led to increase in country's exports (see **Figure 6.21**).



Other business services

exports witnessed decline of 1.5 percent during Jul-Feb FY10 as compared to the

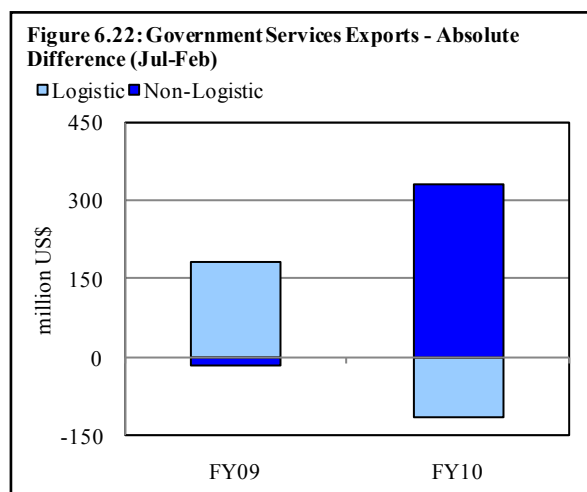
¹¹ Grey telephony is a term referred to the illegal telecom traffic in which calls from foreign countries are brought in the country as local calls while using illegal means.

strong growth of 18.2 percent in the same period of last year. This decline is attributable to the fall in *agency commission, architect & technical services* and *miscellaneous items*.

Government services exports increased by 26.1 percent owing to the remarkable performance of non-logistic sector during the period under analysis.

Logistic support declined to US\$ 349 million during Jul-Feb FY10 as compared to the US\$ 465 million in the same period last year. The entire inflow under this head was recorded in February 2010.

On the contrary, non-logistic support recorded healthy increase (see **Figure 6.22**). Among the non-logistic support, *remittances received by foreign missions in Pakistan* increased by 36.3 percent during Jul-Jan FY10 as compared to the decline of 16.5 percent in the same period last year. Foreign missions had curtailed their activities last year due to worsening of law & order situation. During Jul-Jan FY10, a part of the rise could be attributed to increase in the diplomatic operations of the US. Reportedly US has stepped up its operations in Pakistan for which it has been spending on securing its embassies and consulates.



Services Imports

Falling transportation services imports coupled with SBP's stringent check on foreign exchange companies' outflows led to 16.8 percent contraction in the invisible import bill during Jul-Feb FY10, compared with the fall of 16.7 percent in the corresponding period of last year (see **Table 6.11**).

Fall in the foreign exchange companies' outflows was particularly pronounced and contributed 73.1 percent to the fall in the overall services import bill during Jul-Jan FY10. Lower merchandise imports and reduced passage earnings of foreign airlines also contributed 40 percent to the fall in overall services imports.

Table 6.11: Major Services Imports (Jul-Feb)

million US dollar

	Absolute Value		Growth (%)		Share (%)	
	FY09	FY10	FY09	FY10	FY09	FY10
Transportation	2608	2234	10.8	-14.4	49.0	50.5
Travel	827	580	-21.2	-29.9	15.5	13.1
Other business	1165	708	-47.4	-39.2	21.9	16.0
Government	230	413	-16.4	79.6	4.3	9.3
All others	489	493	-1.3	0.8	9.2	11.1
Total	5319	4427	-16.7	-16.8		

Among the **transportation services**, the largest decline was recorded in freight payments on merchandise imports, which contracted by US\$ 204 million followed by the US\$ 116 million fall in passage earnings of foreign airlines during Jul-Jan FY10.

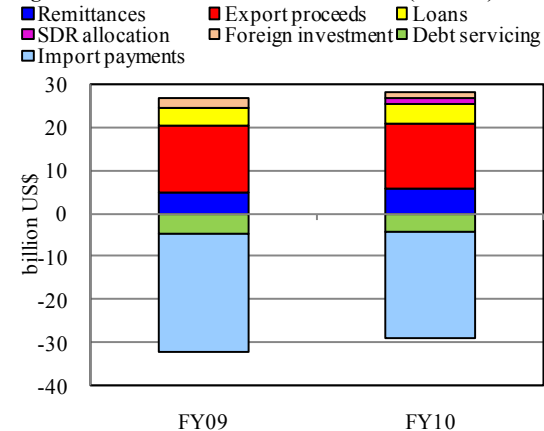
Likewise, **travel services payments** and **other business services payments** declined on account of outflows restriction on foreign exchange companies during Jul-Feb FY10. The fall in the travel services payments was also due to lower Hajj payments (under the head religious travel) which fell by 16.0 percent during Jul-Jan FY10 as compared to an increase of 10.4 percent during the same period last year. This was attributed to decline in the number of pilgrims by 5000 compared to the year before.

Monthly data reveals that the pace of decline in invisible imports has slowed down, which suggests that services imports are likely to pick up in the remaining months of FY10 on account of recovery in merchandise imports.

6.5 Foreign Exchange

Reserves

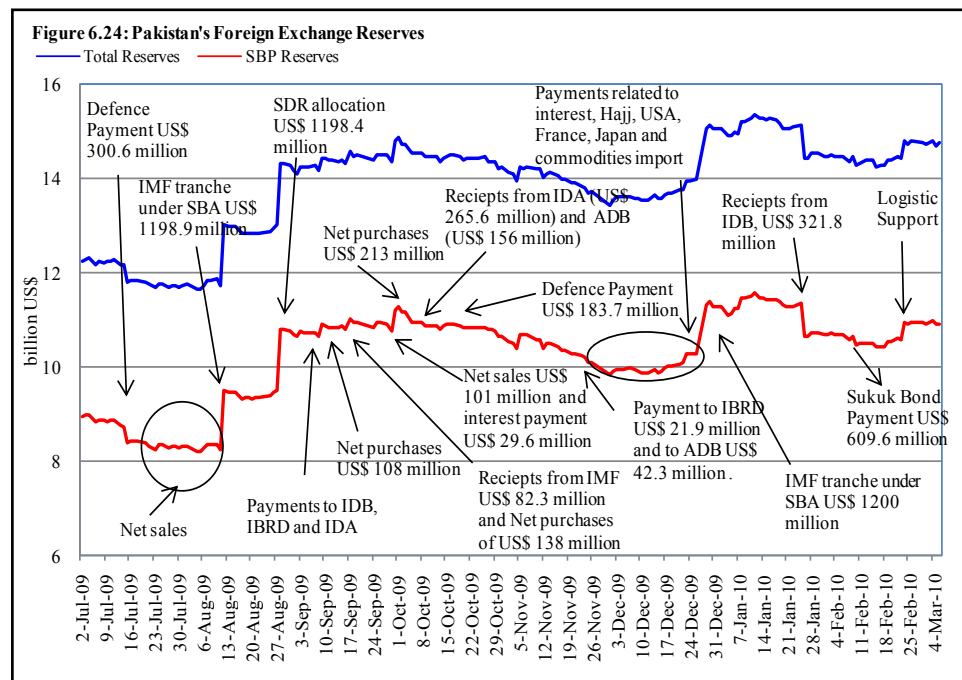
Pakistan's foreign exchange reserves improved significantly during Jul-Feb FY10, reaching US\$ 15.1 billion against US\$ 10.6 billion in the same period last year. With current account deficit declining considerably compared to the last year, the pressure on the country's reserves was visibly lower. Thus despite lower loan inflows and FDI, Pakistan was

Figure 6.23: Reserves Inflows and Outflows (Jul-Feb)

able to add US\$ 2.3 billion to its reserves during Jul-Feb FY10 (see **Figure 6.23**). A part of the rise in reserves was however, due to enhancement of SDR allocation equivalent to US\$ 1.2 billion by the IMF.

Of the US\$ 2.3 billion increase in the overall reserves, SBP reserves increased by US\$ 1.7 billion, while that of the scheduled banks increased by US\$ 525 million.¹²

Major inflows to SBP reserves during Jul-Feb FY10 came from IMF disbursements under Stand-By Arrangement and one-off SDR allocation. Shifting of oil related payments to interbank market also contributed to accumulation of reserves. **Figure 6.24** illustrates impact of major inflows and outflows on SBP reserves.

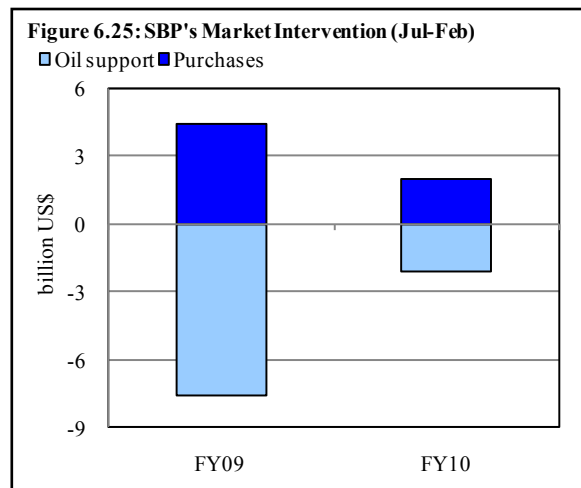


It may be recalled that in Nov-2004 to curtail speculative pressures on the domestic currency SBP had committed to provide foreign exchange to interbank market for oil related payments. Following this decision Pakistan recorded healthy buildup of forex reserves. This measure was continued as it ensured stability in exchange rate. However, starting Q2 FY08, the forex inflows started

¹² The methodology of calculating SBP reserves has changed on the recommendation of IMF. Claims on RBI are now excluded and cash foreign currency is included.

to dry up, putting domestic currency and SBP reserves under severe stress. Political pressures however, restrained SBP from rolling back what was essentially a temporary arrangement. Consequently, SBP reserves depleted sharply; over US\$ 10 billion of SBP's reserves depleted between Oct 07 and Oct 08.

Finally, as a part of the structural adjustment program in Nov-2008, SBP was allowed to gradually withdraw from its market support arrangement. The phased withdrawal was completed in December 2009 ahead of the schedule. This has had two fold benefits: (1) it allowed the exchange rate to become more responsive to market conditions and (2) it has stopped the drain of SBP reserves (see **Figure 6.25**).¹³



The commercial banks' foreign exchange reserves principally comprise of their foreign currency deposits after adjusting for outstanding FE-25 loans. During Jul-Feb FY10, commercial banks' reserves recorded US\$ 525 million rise as compared to the rise of US\$ 599 million during the same period of FY09.

This rise in the reserves of the commercial banks during Jul-Feb FY10 was largely on account of: (1) increase in foreign currency deposits; and (2) retirements of foreign currency loans.

Foreign currency deposits of the commercial banks largely reflect the rise in the deposits of OGDC, KESC, Pak Arab Refinery, BP Pak Explorations, UN Missions etc. This increase in foreign currency deposits was due to the lower US\$ conversions into Pak Rupee probably in anticipation of exchange rate depreciation. This argument is further strengthened by the overdrawn nostro accounts of commercial banks despite the 17.7 percent increase in workers' remittances. Both the workers' remittances and foreign currency deposits

¹³ SBP has shifted oil payments to interbank market vide three circulars in 2009 e.g. FE circular No.2 dated January 15, 2009, FE circular No.3 dated July 15, 2009 and FE circular No. 9 dated December 05, 2009.

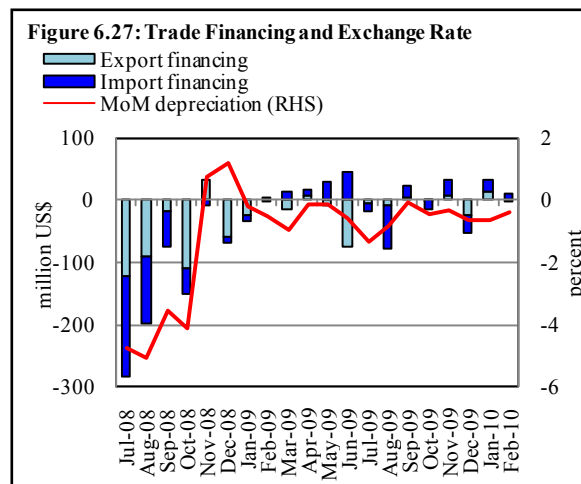
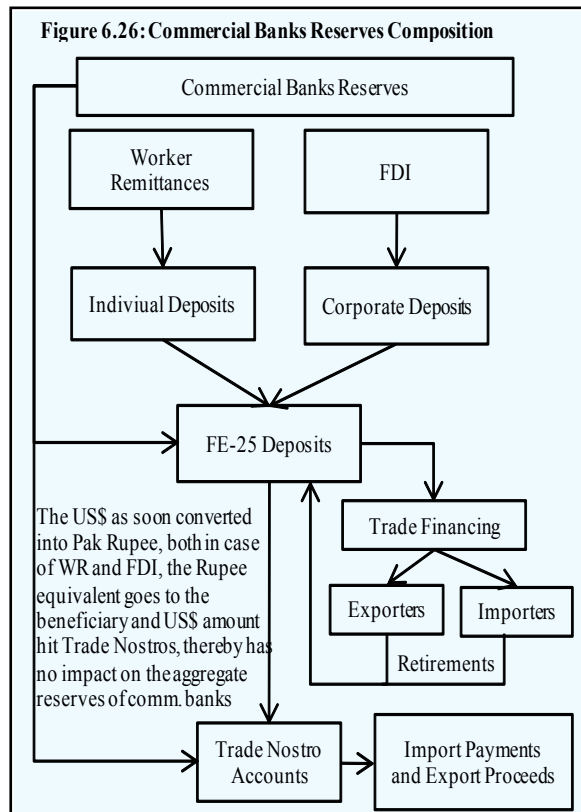
ultimately hit the trade nostro accounts of scheduled banks at conversion to local currency (see **Figure 6.26**).

Another factor which contributed in the increase of commercial banks' reserves was the retirement of foreign currency loans availed by the traders during Jul-Feb FY10. The pressures on the exchange rate first in July 2010 and later in December 2010 proved to be a disincentive for availing foreign currency loans (see **Figure 6.27**). Both importers and exporters opted to retire FC loans. This is also reflected in the rise in EFS disbursements during Jul-Jan FY10.¹⁴

Adequacy of Reserves

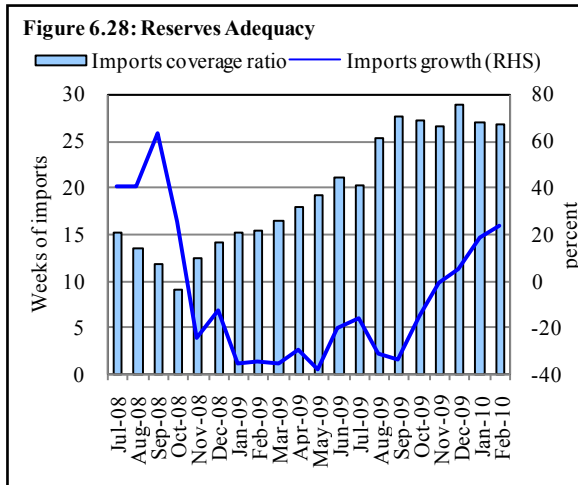
The adequacy of reserves in terms of weeks of imports increased considerably from 9 weeks at end Oct-2008 to 26.7 weeks at end-Feb 2010 (see **Figure 6.28**).

A combination of the rise in reserves and fall in the import bill led to this rise in the import coverage ratio. Interestingly, imports started to decline from November 2008, the same month when



¹⁴ EFS disbursements in Q2-FY10 have increased for commodities like rice, bedwear, readymade garments, towels, cement etc.

Pakistan entered into Stand-By Arrangement with IMF and received the first tranche of US\$ 3.0 billion. With imports declining continuously improvement in the import coverage ratio was quite significant, however Oct-09 onwards the imports have started to rise again whereas the built up of reserves has also slowed down. As a result the import coverage ratio has more or less stabilized at around 27 weeks.



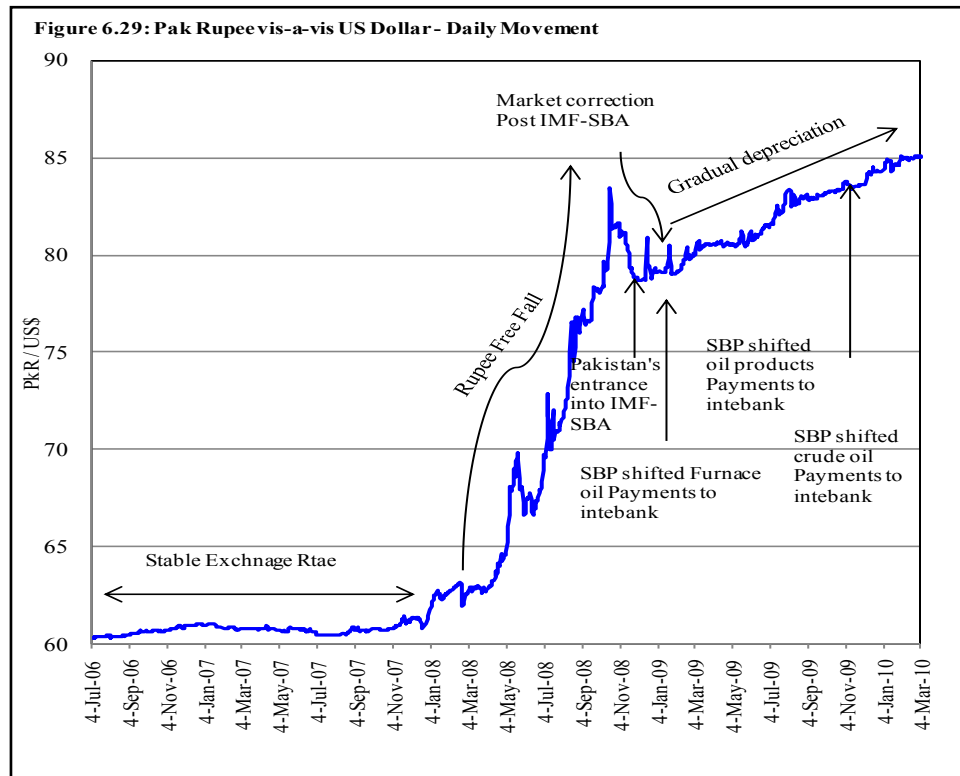
6.6 Exchange Rate

Flexible exchange rate plays an important role in correcting the external imbalances, however, excess volatility in the exchange rate is undesirable as it inhibits investment decisions and gives rise to speculative activities.

Notwithstanding the benefits of a flexible exchange rate regime, the general public perception regarding depreciation of domestic currency is almost always negative. As such the decision to let the currency freely float is politically difficult and governments usually tends to avoid such moves especially when its impact on the external accounts is also ambiguous.

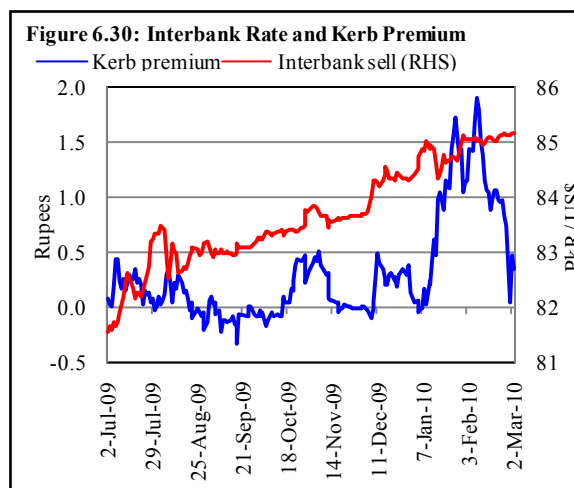
Exchange rate is a sensitive issue in Pakistan also, as it is perceived to be an indicator of performance of the government and its economic managers. Thus even as Pakistan's external position started to deteriorate rapidly from Nov 2007 onwards; necessary adjustments in the exchange rate required to correct external imbalances were avoided. However, by Jan 2008 market pressures were able to dictate the value of exchange rate causing exchange rate to depreciate rapidly.

Market conditions and Pakistan's entry into structural adjustment program paved the way for adaptation of a more flexible exchange rate regime. The gradual depreciation of Pak rupee post November 2008 is essentially a reflection of shift in the exchange rate regime (see **Figure 6.29**).



Relatively lower depreciation of 4.3 percent during Jul-Feb FY10 as compared to 14.5 percent depreciation last year was a function of lower trade deficit and robust workers' remittances.

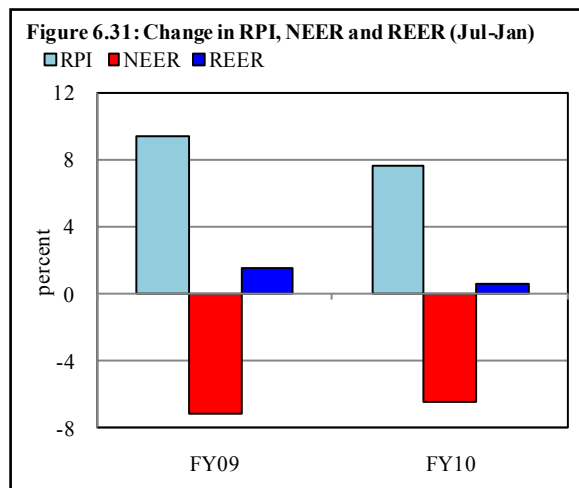
Although in overall terms the depreciation of Pak rupee during Jul-Feb FY10 was gradual, market did react to shifting of oil payments (see **Figure 6.29**). Speculative pressures were evident as reflected by the rise in kerb premium prior to preannouncement shifting date. Perhaps this prompted SBP to shift the remaining oil payments in December ahead of the scheduled date in February.



The rise in the kerb premium in January 2010 was therefore surprising as there were no apparent market pressures (see **Figure 6.30**).

While the nominal depreciation of the Pak rupee during Jul-Jan FY10 was lower than the corresponding period last year, the relatively lower inflation translated into higher gains in real terms.

Specifically, Pakistan's relative prices increased by 7.6 percent during Jul-Jan FY10, against 9.4 percent rise during the same period last year. This rise was little higher than the nominal depreciation of 6.5 percent thus causing the real exchange rate to appreciate by 0.6 percent (see **Figure 6.31**). The real appreciation of the domestic country could have adverse impact on the country's exports.



The value of Pak rupee against the major currencies i.e., Euro, Pound and Yen is determined indirectly after conversion of these currencies in US dollars. Thus their rates against Pak currency depends on the performance of these currencies against the US\$ and the parity of Pak rupee against the US\$.

The recovery of US dollar against Euro and Pound (in Jan-Feb 2010) and relatively lower depreciation of Pak rupee against the dollar caused the domestic currency to appreciate against Pound and depreciate only slightly against Euro (see **Table 6.12**). Euro has lost its value vis-à-vis US dollar due to sovereign debt problems surrounding Greece and other peripheral euro zone economies.

Table 6.12: Dep(-)/App(+) Against Major Currencies
percent

	Jul-Jan FY09	Jul-Jan FY10	Jul-Feb FY10
US Dollar vis-à-vis			
Yen	-15.8	-6.4	-4.2
Pound	39.3	2.6	7.6
Euro	23.0	1.2	4.5
Pak Rupee vis-à-vis			
Yen	-26.7	-9.8	-8.5
Pound	18.6	-0.2	3.1
Euro	6.4	-2.3	-0.5

However as dollar remained relatively weak against yen because lower US dollar interest rates have kept the dollar unattractive, the depreciation of Pak currency against yen was significant.

6.7 Trade Account¹⁵

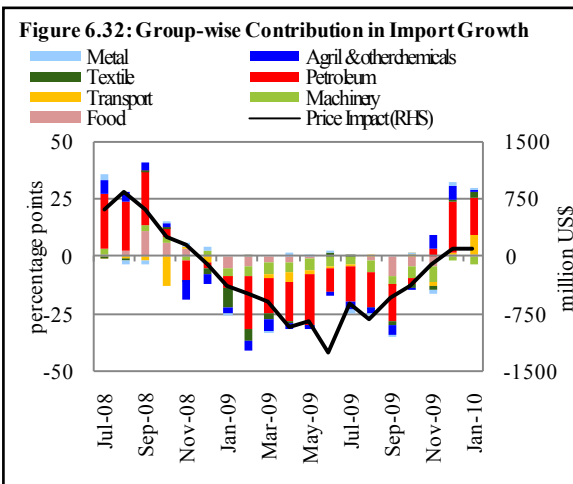
Pakistan's trade deficit contracted by 19.5 percent YoY during Jul-Feb FY10 as compared with the decline of 6.2 percent YoY in Jul-Feb FY09. The main contributor in contraction of trade deficit was the 8.2 percent YoY fall in import growth which was complemented by a small improvement in exports during the period under review.

The compression in import bill is attributed to a decline in both POL as well as non-POL imports (see **Table 6.13**). Group-wise contribution in import growth shows that fall was broad-based (see **Figure 6.32**) through most of the period under review owing to a significant negative price impact which overshadowed the impact of rising import quantum.¹⁶

Recovery in exports was observed both in textile as well as non-textile sectors

Table 6.13: An Anatomy of Trade Deficit (Jul-Jan)

changes in million US dollars;			
	FY08	FY09	FY10
Trade deficit (bln US\$)	10.3	10.8	8.5
Exports (bln US\$)	10.1	10.8	10.8
Imports (bln US\$)	20.4	21.6	19.3
Change in exports	539.4	697.7	50.7
of which change in			
<i>Textiles exports</i>	-185.9	-242.8	131.9
<i>Non-Textile exports</i>	725.2	940.4	-81.2
Change in imports	3255.8	1165.5	-2330.3
of which change in			
<i>POL imports</i>	782.3	1468.1	-828.7
<i>Non-POL imports</i>	2473.5	-302.6	-1501.6



¹⁵ The analysis is based on provisional data provided by the Federal Bureau of Statistics, which is subject to revisions. This data may not tally with the exchange record numbers posted in the section on *Balance of Payment*.

¹⁶ During Jul-Jan FY10, the price impact was US\$ -2340.7 million, whereas quantum impact was 721.9 million US\$. Price and quantum impact encompass 54 percent of the total imports as quantum data for the rest of import items is not published.

particularly in Q2-FY10 (see **Figure 6.33**). Revival in textile's external demand coupled with good production of cotton¹⁷ resulted in high exports of low value added products.¹⁸ In the non-textile sector, food group quantum growth in particular was remarkable during the period under review with major contribution coming from rice and fruits.

Improved external demand,¹⁹ recovery in industrial production and depreciation of domestic currency bode well for exports. However structural issues like power shortages and tough competition from regional economies, particularly in textile sector, may impede export growth. On the other hand, import growth seems to have rebounded from Q2-FY10. Recovery in international commodity prices coupled with revival in domestic demand is likely to increase the import bill during the remaining months of FY10.

Exports

Exports posted modest growth of 2.7 percent YoY during Jul-Feb FY10 in contrast to a slightly higher growth rate of 3.5 percent during the corresponding

Figure 6.33: Contribution in Export Growth

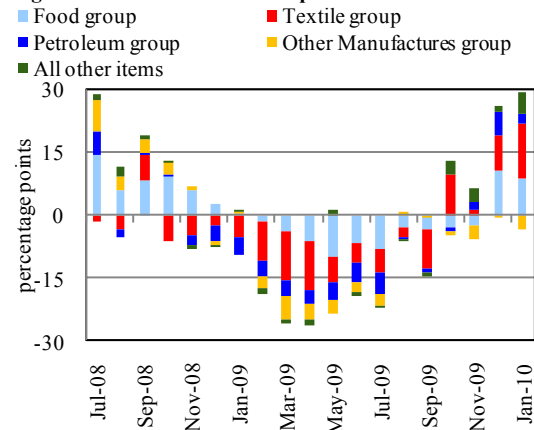
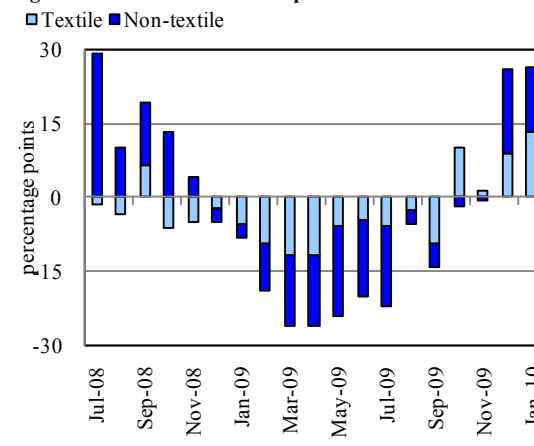


Figure 6.34: Contribution in Exports Growth



¹⁷ Production of cotton in FY10 is estimated at 12.7 million bales in contrast to production of 12.1 million bales during FY09.

¹⁸ Export growth of raw cotton and cotton yarn grew by 142.0 and 38.0 percent YoY during Jul-Jan FY10.

¹⁹ GDP growth of US and EU improved from -2.3 to 0.1 and -4.1 to -2.1 percent in Q2-FY10.

period last year. The gradual improvement observed from the start of Q2-FY10 is attributed to a rise in export quantum of rice, fruits and raw cotton. Revival in global demand, especially for textile products²⁰, also kept textile's contribution in exports growth positive (see **Figure 6.34**)

Non Textile Exports

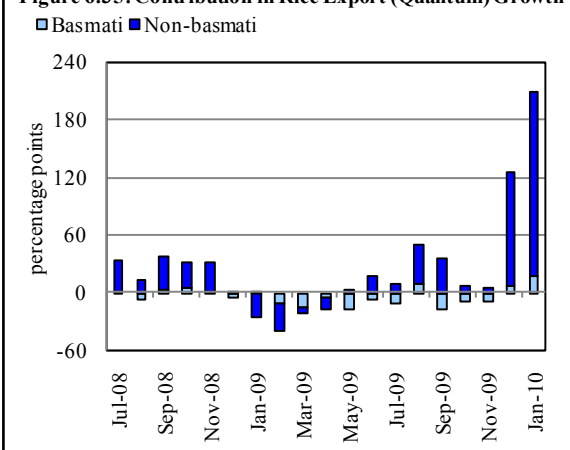
Food group export growth during Jul-Jan FY10 fell by 11.6 percent YoY despite quantum growth in most of the categories of food group (see **Table 6.14**). *Rice* exports rose in terms of quantum amid better-than-targeted production²¹ and demand from major importers. The contribution in rice export is primarily coming from non-basmati rice (see **Figure 6.35**).

In terms of market share, positive development was the rising share of Pakistani non-basmati rice exports to African countries (see **Figure 6.36(b)**).²² Kenya being a major importer of Pakistani Irri-6 rice extended the preferential duty for Pakistani

Table 6.14: Food Group Exports (Jul-Jan)

	Abs Δ (million US\$)	Growth in value (%)	Growth in quantity (%)
Rice	-104.29	-8.25	50.93
<i>of which</i>			
Basmati	-241.30	-34.94	-7.40
Non-basmati	137.01	23.91	83.70
Fruits	59.28	65.34	52.37
Vegetables	24.58	88.92	81.64
Fish	-12.92	-10.01	-5.96
Tobacco raw	-1.77	-29.46	-14.48
Spices	3.65	21.09	19.64
Oilseeds	-2.49	-14.22	-24.08
Meat and meat preparation	14.80	36.21	43.22
Total	-75.20	-4.00	N.A

Figure 6.35: Contribution in Rice Export (Quantum) Growth



²⁰ Due to low production of cotton in China, exports of raw cotton and cotton yarn increased.

²¹ The target of rice production for FY10 was 5.9 million tons, while the estimated production is 6.3 million tons, last year production was 6.9 million tons.

²² African countries imported 9.6 million tons of rice from the world, accounting for 32 percent of global trade. Suspension of the import duty on rice estimated to have facilitated a 37 percent increase in imports. Source: FAO Rice Market Monitor – December 2009

rice in June 2009 for one year.²³ As a result, the share of non-basmati rice exports to Kenya rose further in FY10 (see **Figure 6.36(b)**). Demand from Iran and Saudi Arabia also proved beneficial for rice exporters as these countries have a major share in overall rice exports of Pakistan.

The record export of fruits was primarily led by higher exports of mangoes, dates, edible nuts and kinos.²⁴ Improved market access to Iran, establishment of food irradiation plant for fruit in FY09, better harvest, coupled with improved marketing strategies led to an impressive growth of fruit exports.

Other manufacturers' group export declined by 6.7 percent YoY during Jul-Jan FY10 compared with a positive growth of 13.0 percent during Jul-Jan FY09. Decline in other manufacturers' group was broad based (see **Table 6.15**).

Garments, having the largest share in the leather group, saw exports drop by 15.8 percent YoY during the period under review. Weak global demand led to subdued exports of this group. *Cement* exports declined on account of

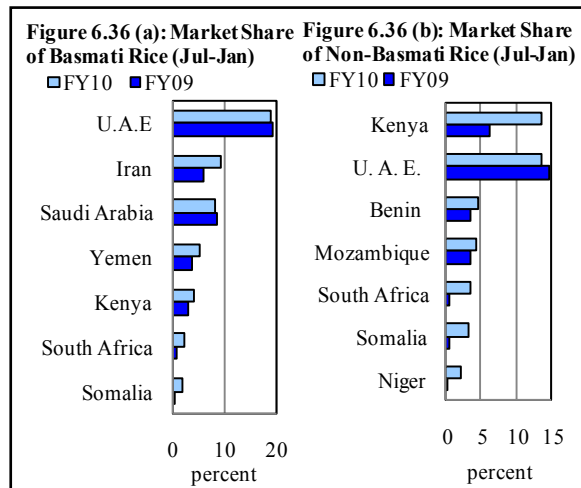


Table 6.15: Other Manufactures Exports (Jul-Jan)

	Abs Δ (million US\$)	Growth (%)	Share in other manuf. (%)
Carpets, rugs & mats	-12.7	-13.5	4.2
Sports goods excl. toys	-18.5	-11.3	6.8
Leather exc. reptile leather	-28.0	-14.8	7.6
Leather manufactures	-95.6	-25.9	13.3
Foot wear	-11.9	-17.2	2.8
Medical & surgical instruments	-14.2	-9.6	6.4
Chemicals and pharmaceuticals	2.2	0.6	18.2
Engineering goods	-10.8	-6.8	7.2
Molasses	-41.5	-68.4	0.9
Cement	-49.9	-14.9	14.1
Total	-143.7	-6.7	100.0

²³ Pakistani rice exports are being charged 35 percent import duty while others are charged 70 percent.

²⁴ Mangoes, dates, edible nuts and fresh kino exports posted growth of 34.0, 29.0, 450.0 and 28.0 percent respectively.

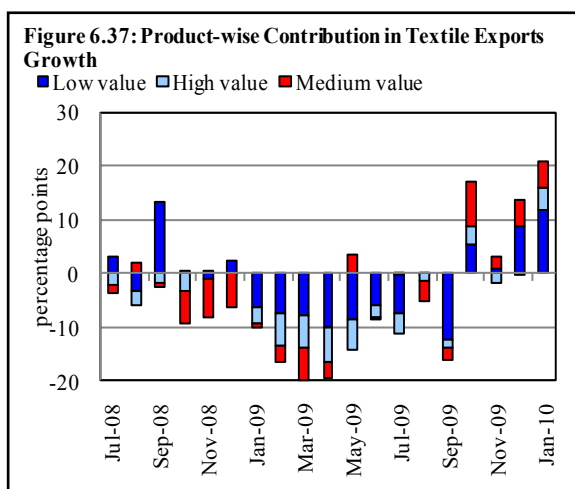
declining export quantum²⁵ due to low demand from major importers i.e. Afghanistan and India. Export orders from countries like U.A.E, Oman, and Qatar have also dropped owing to lower construction activities.²⁶ Moreover, Pakistan can lose its share in markets of Middle East and African countries, as Saudi Arabia has lifted ban on its cement exports.

Although cumulative export proceeds from engineering goods declined, the export growth of *electric fans* was remarkable i.e. 51.7 percent YoY growth during the period under review amid high demand from markets like Africa, Middle East, and South Asia.

Export of *molasses* was already declining since the government imposed 15 percent duty on this category in a bid to support ethanol production. Since molasses is a by- product of sugar, low production of sugar has severely impacted the exports of molasses.²⁷

Textile export is showing signs of recovery on account of better cotton crop and revival in global demand.²⁸

As a result, textile exports posted a modest growth of 2.3 percent YoY in Jul-Jan FY10 compared to a 4.0 percent decline in Jul-Jan FY09. Monthly data reveals that textile export growth after remaining in the negative territory during FY09 and initial months of FY10 is now posting positive figures. Product-wise contribution analysis indicates that low value products have remained the dominant contributors in



²⁵ The data of APCMA (All Pakistan Cement Manufacturers Association) data shows an increase of 14.0 percent YoY during Jul-Jan FY10.

²⁶ Share of Qatar in Pakistan exports declined from 22 to 14 percent, while share of Oman and UAE declined from 10 to 6 and 15 to 4 percent, respectively, during the period under review.

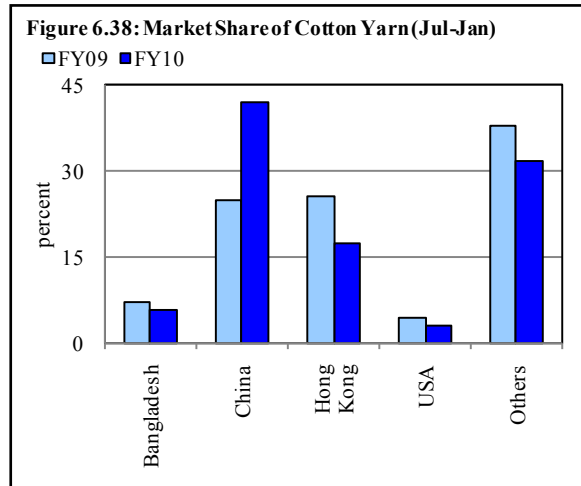
²⁷ Production of sugarcane is estimated to be 48,622,000 MT during FY10 against the official target 56,527,000 MT.

²⁸ Revival in global demand is estimated by US imports of textile and apparel products. Since the data of EU is available till October 2009, the analysis of EU market has not been incorporated.

overall textile exports growth (see **Figure 6.37**).

Raw Cotton and *cotton yarn* exports increased by 142.0 and 38.1 percent YoY during the period under review amid early arrival of crops and better production. Revival of demand²⁹ from major importers of raw cotton and yarn was an encouraging sign for exporters of these items. In case of cotton yarn, export quantum rose by 45.9 percent

YoY during Jul-Dec FY10. In terms of market share, China has emerged as the major importer of cotton yarn during the period under review. Low cotton production in China resulted in high imports of cotton yarn from Pakistan. The share of other markets subsequently declined during the period under review (see **Figure 6.38**).



However, the government's decision to cap cotton yarn export³⁰ is likely to have mix effects on the textile industry. For instance, on one hand, it would stabilize yarn prices, which is good for downstream industry. While on the other hand, the government action is likely to hit the spinning sector as the increased export demand provided much needed-relief after the industry suffered serious losses during FY09 on account of low international prices, liquidity constraints and energy shortages. It may also be pointed out that unlike the value added sector, spinning sector is not provided any subsidized credit facility.

Although exports of bed wear and towel rose in terms of quantum, probably reflecting improvement in the external demand but due to lower unit values, the value of exports during Jul-Jan FY10 was less than the last year earnings (see **Table 6.16**).

²⁹ China's total cotton yarn imports grew by 74.0 percent YoY during CY09, while imports from Pakistan grew by 136.0 percent YoY. Production of cotton in China declined by 14.0 percent YoY during Jul-Nov FY10, however consumption rose by 6.0 percent during the same period.

³⁰ S.R.O 26 (I)/2010, dated 14 January 2010, Ministry of Commerce

Table 6.16 : Major Textile Exports Price & Quantum Impact (Jul-Jan)

million US\$

	FY09			FY10		
	Total Change	Due to		Total Change	Due to	
		Quantum	Price		Quantum	Price
Textile Group	-242.8			131.9		
<i>Of which</i>						
Raw cotton	49.1	49.6	-0.5	102.2	83.8	18.4
Cotton yarn	-113.9	-100.3	-13.7	202.8	302.1	-99.3
Cotton fabrics	158.5	177.6	-19.1	-249.4	-290.0	40.6
Knitwear	-5.4	166.1	-171.5	-64.8	-106.6	41.8
Bedwear	-96.2	-11.8	-84.4	-50.8	7.0	-57.7
Towels	49.0	84.3	-35.3	-4.7	60.0	-64.7
Readymade garments	-102.0	-156.6	54.6	23.3	-78.8	102.1
Art silk and synthetic textiles	-0.1	-0.1	0.0	116.3	79.1	37.2

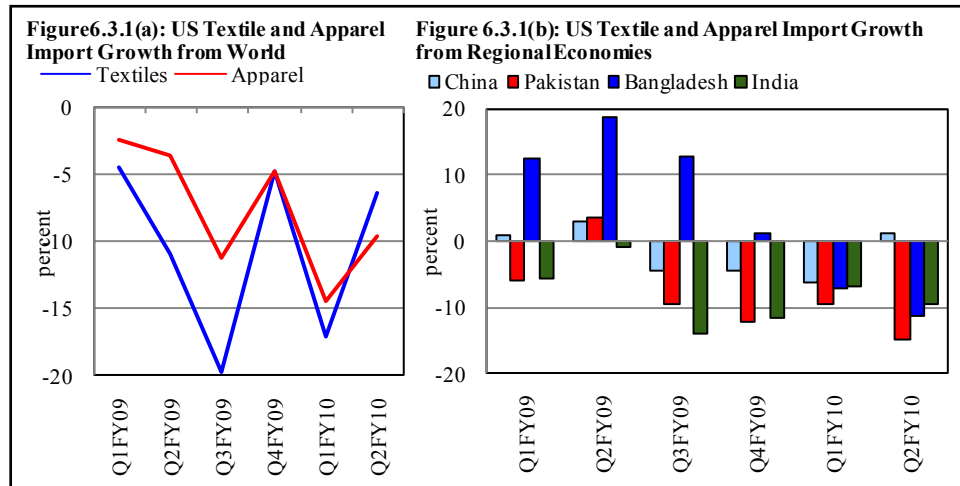
On the other hand, quantum impact of readymade garments and knitwear declined in FY10. Initially, low external demand and domestic issues were hampering the exports, but lately tough competition from regional countries like China and Bangladesh is taking its toll on the local exporters (see **Box 6.3**).

Box 6.3 Comparison of Regional Competitors Amid Revival in US Textile Market³¹

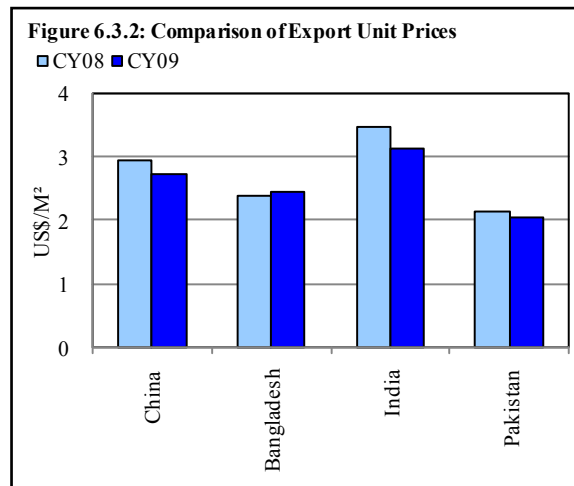
The impact of global recession was quite visible in the declining textile imports of the developed countries, which resulted into falling textile exports of Pakistan and its regional competitors. However, as the global economy is on the path of recovery³², the demand for apparel and textile products has also rebounded in the US. The regional textile exporters are now eyeing this recovery in order to capture major share in US apparel and textile market. However, comparison of regional economies indicates that textile and apparel exports performance of Bangladesh, India and Pakistan is lagging behind China (see **Figure 6.3.1(b)**).

³¹ US is the largest importer of textile and apparel products with 18 percent share in overall textile imports of the world

³² World Economic Outlook, 2009



It is interesting that despite higher unit prices than Bangladesh and Pakistan, (see **Figure 6.3.2**) China managed to capture lion's share in the US apparel market. The share of China in US apparel market in particular has almost doubled in some of the categories since the removal of quota in US market.³³ Economy of scale, labor efficiency, good quality, production of market specific products, availability of latest textile machinery³⁴, established infrastructure and technological readiness are positive contributors to China's progress.³⁵ In addition, increase in the tax refund rate for exported textile and clothing to 17 percent from 16 percent coupled with the introduction of a comprehensive 3-year Textile Plan to aid the textile and clothing industry also facilitated the exporters.



The textile sector of Bangladesh was relatively less affected by the global recession owing to lower unit values, incentives and duty free exports access to countries like US and

³³ Share of China rose from 15 to 30 percent in US imports of cotton knit shirts, whereas China's share increased from 13 to 26 percent in case of cotton trousers during CY09

³⁴ China is the largest producer of textile machinery.

³⁵ According to GCI 2009-10, China is ranked at 29th position compared to Pakistan at 101 and Bangladesh at 106th place.

EU.^{36,37} India's apparel exports remained subdued due to high export prices and tough competition from Bangladesh. Anecdotal evidence suggests that Indian textile firms are setting up their units in Bangladesh in order to gain the benefits of duty free access.

On the other hand, Pakistan textile sector was confronted with issues like power shortages, low investment, lack of latest technology and liquidity problems that hampered the textile exports during CY09. However, with the aim to foster textile exports, a Textile Investment Support Fund has been proposed by the government for modernization of machinery, infrastructure development, skill development, marketing and use of technology. However this proposal has not been implemented yet.

Imports

Import growth contracted by 8.2 percent during Jul-Feb FY10 as compared with 1.5 percent YoY fall during the same period last year.

However, monthly analysis of imports show that after posting negative growth for 13 consecutive months, imports moved into positive territory from December 2009 (see **Figure 6.39**).

During most of FY10, the price impact had offset the rise in quantum, however with price impact also turning positive, imports recorded positive growth in December and January (see **Figure 6.40**).

Figure 6.39: Monthly Analysis of Imports YoY Growth

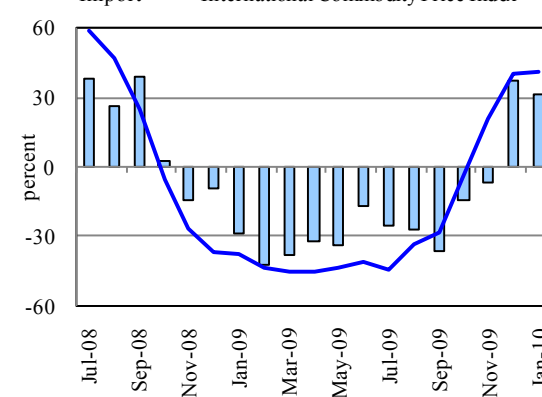
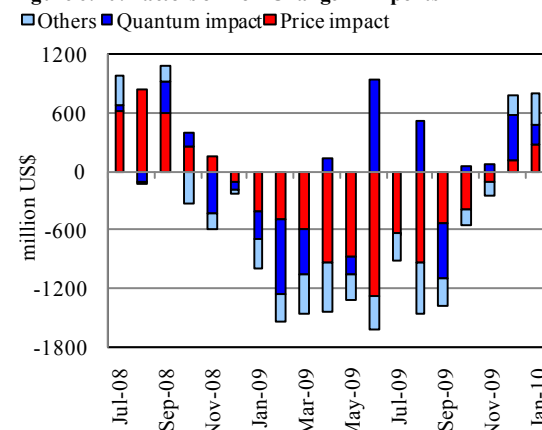


Figure 6.40: Factors of YoY Change in Imports



³⁶ The government of Bangladesh initiated a 150 million US dollar Export Development Fund facility based on revolving funds. This measure will provide liquidity to scheduled banks for financing the exporters' raw material imports.

³⁷ Bangladesh enjoys the Most Favored Nation status in the US import market and it also gets benefits from the Generalized System of Preferences in the US and EU.

Cumulative data reveals that fall in import growth is broad-based except for road motor vehicles and fertilizer (see **Table 6.17**). However, a large number of categories are showing a gradual revival as reflected by positive quantum impact.

Table 6.17: Major Categories of Imports (Jul-Jan)

million US dollars, growth and share in percent

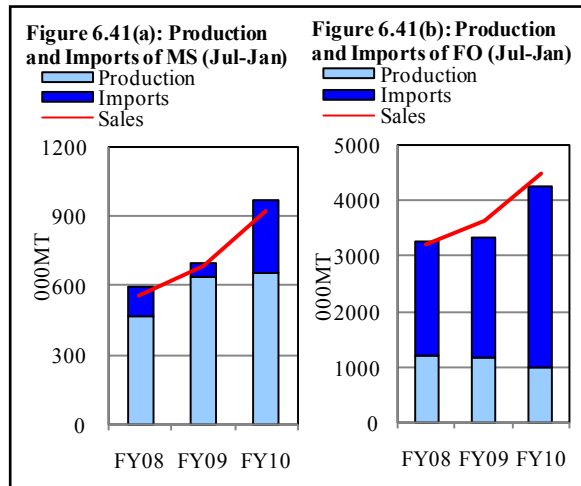
Commodity	Import bill	Absolute change	Quantum impact	Price impact	Growth	Share
Petroleum products	3620.1	1.0	1328.7	-1327.7	0.0	18.7
Petroleum crude	2014.4	-829.6	-145.1	-684.5	-29.2	10.4
Power generating Machinery	871.8	-112.0	N.A	N.A	-11.4	4.5
Palm oil	673.1	-142.0	27.3	-169.3	-17.4	3.5
Iron and steel	681.8	-82.2	-96.1	13.9	-10.8	3.5
Fertilizer manufactured	486.9	77.7	108.0	-30.3	19.0	2.5
Telecom	395.3	-273.2	N.A	N.A	-40.9	2.0
Road motor vehicles (CKD)	322.4	101.1	N.A	N.A	45.7	1.7
Total	9065.7*	-1259.2	721.9	-2340.7	-10.8	N.A

* import of all these items had 47 percent share in total imports

Petroleum Group

Petroleum group imports, having the largest share (30 percent) in the import bill, contracted by 12.8 percent YoY during Jul-Jan FY10 in contrast to a healthy growth of 29.4 percent YoY during the same period last year. The compression in POL import bill is entirely attributed to falling import prices.³⁸

Within petroleum group, petroleum products import quantum increased

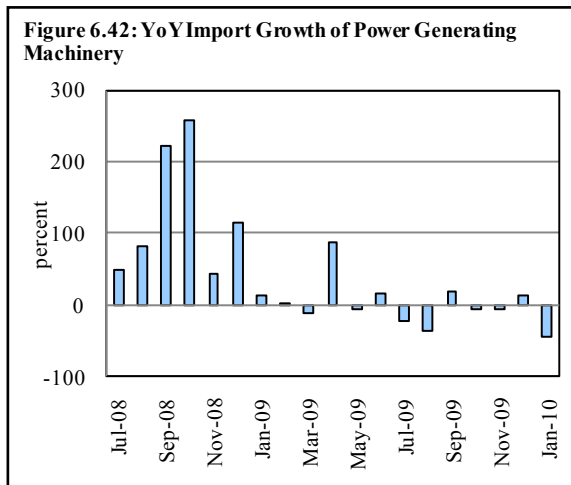


³⁸ Price impact of petroleum group imports for the period Jul-Jan FY10 is US\$ (-) 1978.7 million, compared to positive price impact of US\$ 6463.0 million during Jul-Jan FY09.

substantially as operations of the refineries were hampered by ongoing circular debt issue. Low crude imports resulted in high imports of refined products in order to meet the rising domestic demand (see **Figure 6.41(a & b)**).

Power generating machinery

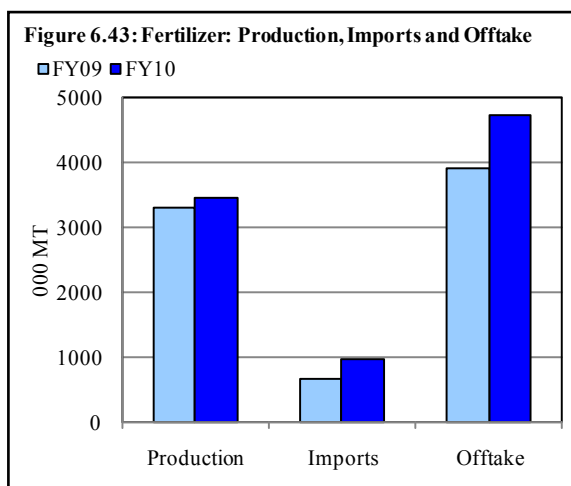
having the largest share in machinery group posted negative growth of 11.4 percent during the period under review (see **Figure 6.42**). Anecdotal evidence suggests that keeping in view the prolonged energy crisis, a large quantum of generators were imported during FY08 and FY09. However, the domestic demand for generators was not as strong as anticipated and sale of second-hand generators resulted into accumulation of large inventories.



Demand-Led Recovery in Some Categories

Fertilizer Manufactured imports recorded a growth of 19.0 percent YoY amid high demand. Fertilizer imports rose by US\$ 108 million due to quantum impact. Aggressive off take of fertilizers by the farmers resulted in high production and imports during the period under review. Analysis of Jul-Jan period show that production, imports and off take increased during FY10 in contrast to the same period last year (see **Figure 6.43**).

Road Motor Vehicles imports after posting negative growth for three consecutive years, increased by 10.8 percent YoY during the first seven months of FY10 (see **Figure 6.44**). The trend reversal in imports of road motor vehicles is attributed to demand led



recovery.³⁹ The imports of CBUs and in particular CKDs increased during the period under review (see **Figure 6.44**).

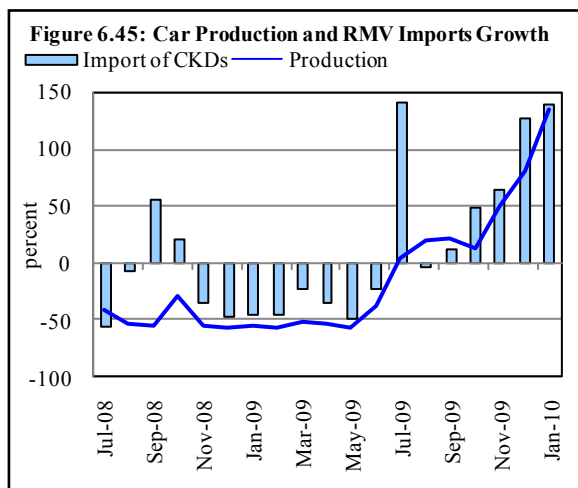
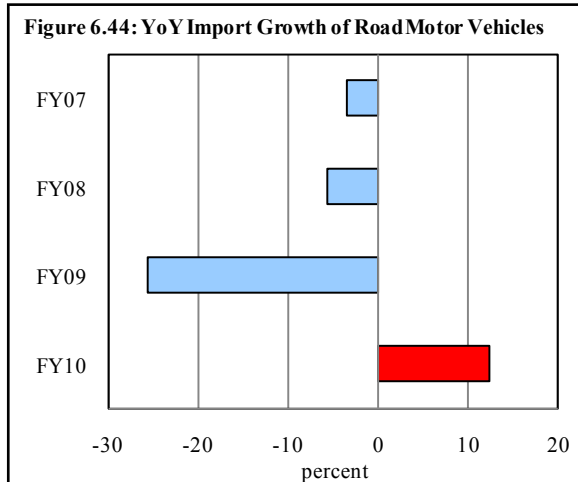
Monthly analysis of car production shows that production process started picking up since the start of FY10 leading to rising imports of CKDs (see **Figure 6.45**). Improved production and sales of road motor vehicles also led to demand for *rubbers tyres* and *tubes*. As a result, the imports of this category increased by 14.9 percent YoY during the period under review.

Agriculture Machinery

imports recorded a growth of 74.8 percent YoY during Jul-Jan FY10. The impressive growth is attributed to high imports of tractors and parts of tractors. Sixty six percent of total agriculture machinery imports originated from

tractors and its parts.⁴⁰ Projects like Benazir Tractor Scheme and Green Tractor Scheme resulted in high demand, imports and sales of tractors.

Sugar imports increased during the period under review amid acute shortage of sugar in the country. Although the surge in sugar import bill is attributed to quantum and price impact, the contribution of the former is much stronger.⁴¹



³⁹ Sales of cars and motor cycles increased by 63.0 and 66.0 percent respectively, during Jul-Jan FY10. Sales are being made on cash and 75 percent demand is originating from individuals according to anecdotal evidence.

⁴⁰ Parts includes CKDs/SKD's which are used in production process.

6.8 External Debt

The acceleration in the accumulation of external debt and liabilities (EDL) witnessed during the last two years continued in H1-FY10 as US\$ 4.7 billion were further added to the stock of EDL. As a result, the stock of EDL reached US\$ 55.8 billion by the end of H1-FY10 (see **Table 6.18**).

Table 6.18: Pakistan's External Debt and Liabilities (Jul-Dec)

value and absolute change in million US dollars

ITEM	FY08	FY09	FY10	Absolute change		Percentage change	
				FY09	FY10	FY09	FY10
1. Public and publically guaranteed debt	37,836	41,626	43,295	3,790	1,669	10.0	4.0
<u>A. Medium and long term(>1 year)</u>	37,235	40,963	42,973	3,728	2,010	10.0	4.9
Paris club	13,430	14,523	14,330	1,093	(193)	8.1	-1.3
Multilateral	19,912	22,207	23,791	2,295	1,584	11.5	7.1
Other bilateral	1,063	1,410	2,453	347	1,043	32.6	74.0
Euro bonds/saindak bonds	2,653	2,650	2,150	(3)	(500)	-0.1	-18.9
<u>B. Short Term (<1 year)</u>	601	663	322	62	(341)	10.3	-51.4
IDB	601	663	322	62	(341)	10.3	-51.4
2. Private nonguaranteed debts (M&LT:>1 yr)	2,122	3,234	3,266	1,112	32	52.4	1.0
3. Private non-guaranteed bonds	250	276	137	26	(139)	10.4	-50.4
4. IMF	1,332	4,352	7,494	3,020	3,142	226.7	72.2
Total external debt (1-4)	41,540	49,488	54,388	7,948	4,900	19.1	9.9
5. Foreign exchange liabilities	1,196	1,574	1,422	378	(152)	31.6	-9.7
Foreign Currency Bonds (NHA / NC)	66	44	22	(22)	(22)	-33.0	-50.0
Central Bank Deposits	700	1,200	1,200	500	-	71.4	0.0
NBP/BOC Deposits	400	300	200	(100)	(100)	-25.0	-33.3
Total external debt and liabilities (1-5)	42,736	51,062	55,810	8,326	4,748	19.5	9.3

It may be pointed out that Pakistan's stock of EDL had remained almost stagnant at around US \$37.0 billion from FY00-FY06, in contrast, it has grown on average by more than 12 percent during the last three and a half years. This rise in EDL owes to sharp deterioration in both the current account deficit and fiscal deficit FY07 onwards (see **Figure 6.46**). The rapid rise in the stock of EDL and falling output has raised serious concerns over the debt sustainability. The debt sustainability (measured as debt to GDP ratio) worsened further in the first six months of the current fiscal year. IMF in its recent country report has carried out a

⁴¹ Sugar imports surged by US\$127 million, out of which quantum impact is US\$ 101 million and the rest US\$ 26 million is price impact.

debt sustainability exercise which indicates that Pakistan's debt sustainability indicators can deteriorate significantly in case of exogenous shocks (see **Box 6.4**)

While the inability of the country to generate resources to finance its expenditures remained the main cause of rise in the EDL, the currency composition of its stock of EDL has also contributed to rise in its debt stock.

The major part (75 percent) of Pakistan's external debt is denominated in currencies other than US dollar. Thus, as the debt is reported in US dollar terms, the weakness of dollar against other currencies (see **Figure 6.47**) results in a significant increase in the debt stock on account of valuation change. In H1-FY10, almost 25 percent of the net increase in the EDL (see **Figure 6.48**) owed to the depreciation of US dollar against major currencies.

Figure 6.46: Average Current A/c Balance and Fiscal Balance

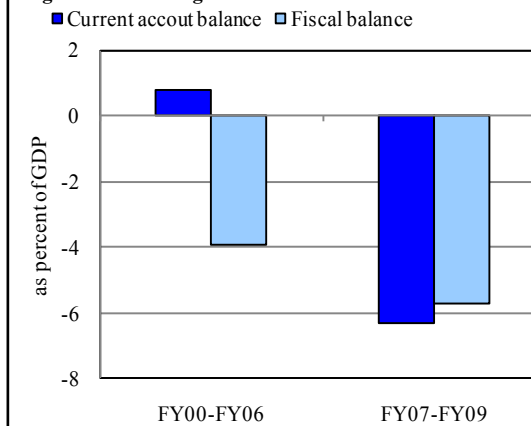
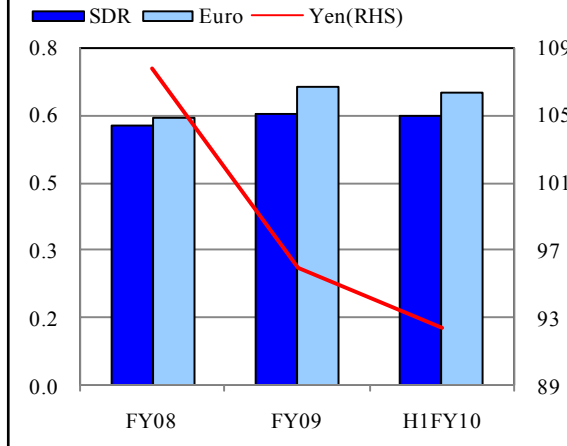


Figure 6.47: Exchange Rate vis-a-vis US Dollar



The increase in the stock of outstanding debt was on account of loans contracted from the IMF under the Stand-By Arrangement (SBA). As a result, the share of IMF loan in total debt of Pakistan increased significantly during H1-FY10.

Structure of External Debt and Liabilities

Public and publically guaranteed debt increased by US\$ 1.7 billion during H1-FY10 compared to US\$ 3.8 billion in corresponding period last year. The lower increase in H1-FY10 was on account of US\$ 1.0 billion repayments of euro bonds, paris club and short term debt.

Within public and publically guaranteed debt, multilateral debt increased by US\$ 1.6 billion during H1-FY10 compared to US\$ 2.3 billion in the corresponding period last year. These loans were provided mainly by IDA and ADB. Most of the additional loans were in the form of project loans (see **Table 6.19**).

The debt stock of bilateral donors (both Paris club and

Figure 6.48: Valuation Losses/Gains

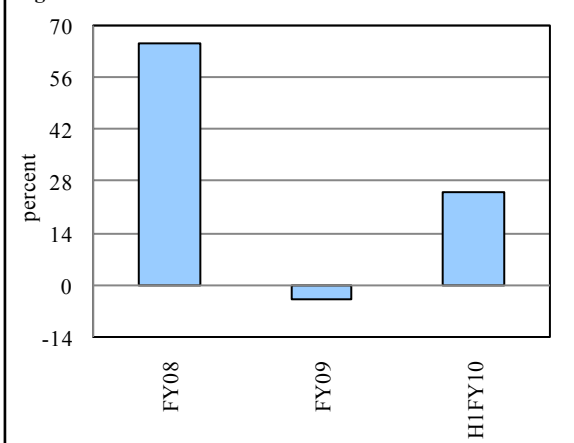


Table 6.19: Disbursement of External Resources during H1-FY10

million US dollar

Serial No.	Donors	Particulars/purpose	Amount
1	ADB	Earthquake emergency assistant	339.7
		Improvement in government efficiency program	
		Baluchistan road development	
		NWFP road development	
		National highway sector development	
		Power system transmission enhancement	
2	IDA	Higher education commission-DPL	407.4
		Social protection/safety program	
		Poverty alleviation fund	
		Highway rehabilitation	
		Public sector capacity building	
3	Saudi Arabia	Partnership for polio	200.0
		Friend of Democratic Pakistan under Tokyo Conference	
4	China	Rural infrastructure development package-I AJK	104.6
		Rural infrastructure development package-II AJK	
		Improvement of Karakorum Highway	
5	USA	Chashma Nuclear Power Plant-II	82.8
		SOGA governance III-IV	
		SOGA economic growth	
6	UK	NWFP police elite force	48.4
		Budget support for poverty reduction	

other bilateral) rose by US\$ 0.9 billion during H1-FY10 compared to an increase of US\$ 1.4 billion in the same period of the preceding year which was largely contributed by Japan, Saudi Arabia and China.

Lower inflows from the multilateral sources coupled with higher inflows from IMF resulted in the decline in the share of public and public guaranteed debt in total debt from 83.3 percent at end-June 2009 to 79.7 percent as of end December 2009 (see **Figure 6.49**).

It may be mentioned that around 75 percent of Pakistan's public and publically guaranteed loans are on fixed rates, and as such, Pakistan could not benefit much from the prevailing low interest rate environment. However, contracting loans at fixed rates is beneficial to the extent that it not only eliminates the risk of higher payments if the interest rates were to rise, but it also brings certainty in budgeting.

The outstanding stock of IMF loan increased by US\$ 3142 million in H1-FY10 on

account of third and fourth tranches under the SBA. Pakistan received US\$ 1198.9 million in August 2009 of which, about 62 percent was allocated for budgetary support as bridge financing following delays in the realization of flows from FoDP. Similarly, 31 percent of the fourth tranche of US\$ 1200 million received in Dec 2009 was for budget financing. The additional debt from IMF increased the share of IMF loan in Pakistan total debt from 10.1 percent in FY09 to 13.2 percent at end December 2009 (see **Figure 6.50**).

Figure 6.49: Public & Public Guaranteed Debt in Total Debt

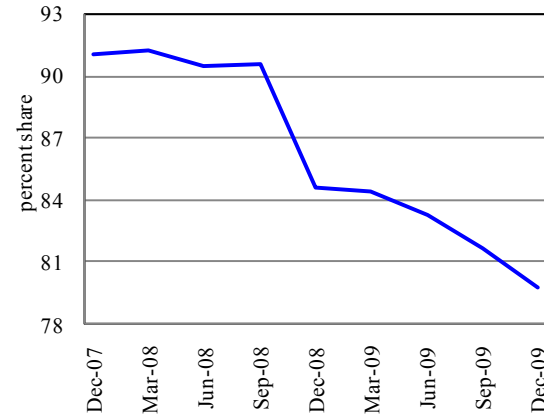
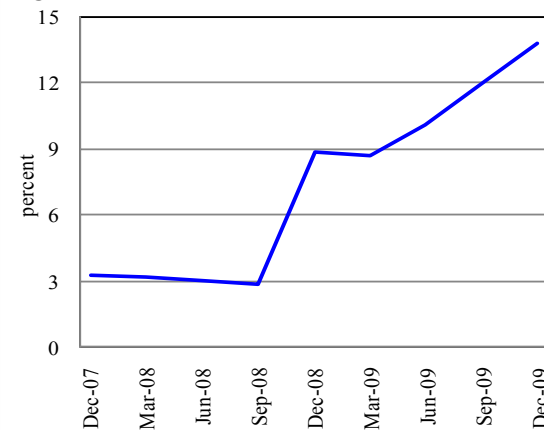


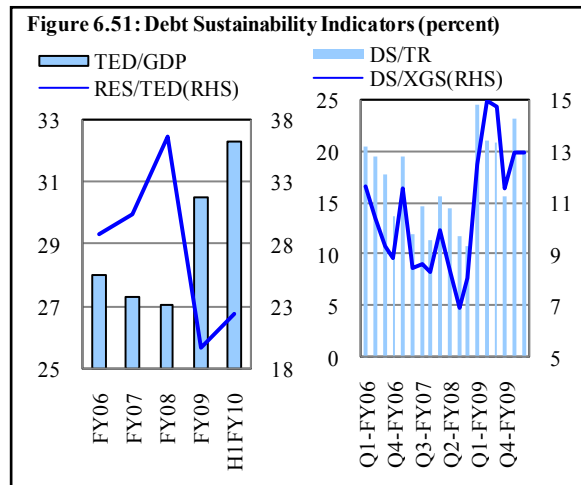
Figure 6.50: IMF Share in Total Debt



Debt Sustainability Indicators

The steady rise in the stock of EDL coupled with stagnant foreign exchange earnings and slowdown in economic growth led to further deterioration in most of the debt sustainability indicators of Pakistan in H1-FY10. Both, total external debt as a percent of GDP (TED/GDP), and debt servicing to exports earnings ratio (DS/XGS) deteriorated during H1-FY10. The

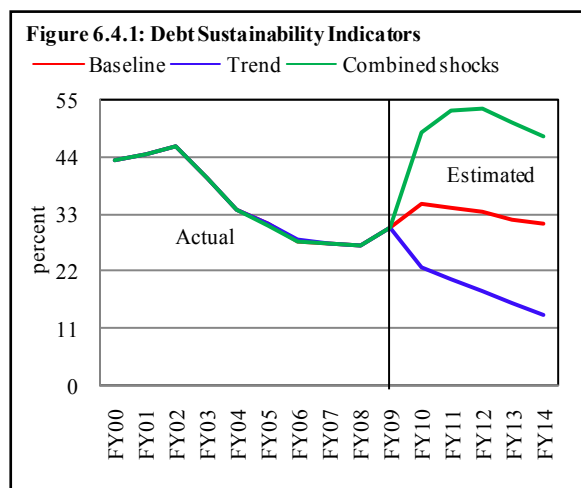
increase in TED/GDP ratio is a continuation of trend seen since FY08 (see **Figure 6.51**). The RES/ TED ratio, DS/TR and DS/XGS ratios however, after showing some improvement have again come under stress in Q2FY10.



Box 6.4: Debt Sustainability in Pakistan

IMF external debt sustainability analysis⁴² shows that debt to GDP ratio would increase from 30.5 percent in FY09 to 34.3 percent in FY12, after which it would start to decline during next two years and drop to 31.0 percent in FY14 mainly on the basis of reasonable growth of 5-5.5 percent and no change in other factors. Similarly, the debt services to exports of goods and services is estimated to rise from 13.2 percent in FY09 to 20 percent in FY14 period largely on account of repayments of IMF loans. This future outlook is based on the assumption of higher noninterest current account deficit, slower growth, larger depreciation, higher interest rate and lower FDI inflows.

In this country report, IMF also analysed the combined impact of different shocks on the debt sustainability of Pakistan. These comprises⁴³ shocks to growth, current



⁴² A complete country report about Pakistan can be seen on the following address:

<http://www.imf.org/external/pubs/cat/longres.cfm?sk=23517.0>

⁴³ The assumptions for combined shocks are; (1) current account deficit higher than baseline scenario by half of ten year standard deviation, (2) net flows of direct investment are fifty percent lower than

account, foreign direct investment and real depreciation. The combined impact of these shock would increase the debt stock to GDP ratio to 49 percent at the end of current fiscal year (see **Figure 6.4.1**).

External Debt and Liabilities Servicing

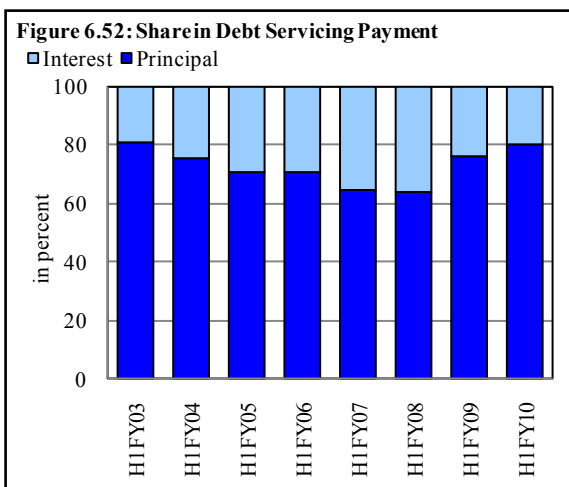
Pakistan's external debt servicing reached US\$ 2648 million at the end of H1-FY10, which is 9.7 percent higher than debt servicing of corresponding period of the preceding year (see **Table 6.20**). This increase in debt servicing is due to repayment to bilateral creditors, multilateral donors (IMF and IDB) and private non-guaranteed debt. Similarly, the increase in servicing of foreign liabilities was on account of the repayments of Bank of China deposit and NHA bonds. In debt servicing payment, the share of principal payment significantly increased to 79.7 percent in H1-FY10 (see **Figure 6.52**).

Table 6.20: Pakistan's External Debt and Liabilities Servicing
million US dollar

	H1-FY8	H1-FY9	H1-FY10	H1-FY8	H1-FY9	H1-FY10
	Actual Paid			Rescheduling/rollover		
1. Public and Publicly guaranteed	1,022.6	1,844.0	1,490.5	100.0	100.0	323.0
Principal	599.3	1,400.0	1,087.9	100.0	100.0	323.0
Interest	423.3	444.0	402.6	-	-	-
2. Private non-guaranteed	255.0	301.0	264.9	-	-	-
Principal	170.2	215.0	220.9	-	-	-
Interest	84.8	86.0	44.0	-	-	-
3. IMF	86.6	115.0	171.1	-	-	-
Principal	83.2	93.0	109.0	-	-	-
Interest	3.4	22.0	62.1	-	-	-
4. Total debt servicing (1+2+3)	1,364.2	2,260.0	2,472.9	100.0	100.0	323.0
Principal	852.8	1,708.0	1,957.4	100.0	100.0	323.0
Interest	511.4	552.0	515.5	-	-	-
5. Foreign liabilities	181.9	155.0	175.2	550.0	750.0	-
Principal	132.9	122.0	151.9	550.0	750.0	-
Interest	49.0	33.0	23.3	-	-	-
6. TOTAL (4+5)	1,546.1	2,415.0	2,648.1	650.0	850.0	323.0
Principal	985.7	1,830.0	2,109.3	650.0	850.0	323.0
Interest	560.4	585.0	538.8	-	-	-

in the baseline scenario, (3) one time real depreciation of thirty percent occurs in FY10 and (4) slowdown in growth

Given that repayment of IMF loans received in FY09 would start in FY11, the share of principal payment would increase further next year. As far as the debt servicing indicators such as debt servicing to XGS ratio and debt servicing to TR are concerned, deterioration was seen in both indicators, particularly in debt servicing to TR ratio during H1-FY10 (see **Figure 6.51**) on the back of deceleration in tax revenues.



Special Section 1

SME Growth in Pakistan: Addressing Access to Finance Issue

Small and medium enterprises (SMEs) are a major contributor to inclusive economic growth and poverty reduction (see **Box SS1.1**). There might be difference in SMEs'

contribution to relative economies, however its significance is globally agreed upon. Pakistan is no exception to this having SME sector constituting 90 percent of all economic establishments. The SME in Pakistan contributes substantially to both; the GDP growth and export earnings¹. The sector's significance towards resource distribution can be gauged from its absorption of 78 percent of non-agriculture labour force². While there is global consensus on the key role of SMEs, all stakeholders believe that lack of access to finance is a major obstacle in the sector's growth. SMEs in Pakistan are confronted with a similar challenge as indicated by the small share of SMEs' loan in total loan portfolio of the banking industry³. This special section focuses on strategies that can be opted on both demand and supply side

Box SS1.1: Importance of SME

Contribution of SME towards economic development of any country can be broadly categorized into three main areas;

1. **As an engine of growth:** SMEs have great potential for employment creation and are also a major source of innovation due to their distinct flexibility characteristic
2. **Essential for a Competitive & Efficient Market:** SMEs have got greater flexibility and high turnover with an easy entry and exit characteristic leading to larger number of SMEs in an economy. Consequently the chances of greater efficiency become higher through competition among large number of enterprises. SMEs not only complete the supply chain but also work as nursery for larger firms. Moreover these enterprises as sub-contractors of large firms play a critical role in the efficient working of large firms
3. **Poverty Reduction & Equitable Income Distribution:** SMEs are considered relatively more labour intensive and their employment creation characteristic make them critical for poverty reduction and equitable distribution of resources. These enterprises are considered an important source of employment for young, unskilled and women and therefore can contribute significantly towards the inclusive growth of any economy

Sources: Promoting SMEs for Sustainable Development, *World Business Council for Sustainable Development (2004)*

F. Qimiao (2003). Importance of SMEs and the Role of Public Support in promoting SME Development, *A Policy Dialogue Workshop at Russia*, World Bank

¹ *SME Financial Review; Second quarter 2007, Small and Medium Enterprises Department, State Bank of Pakistan*

² *ibid*

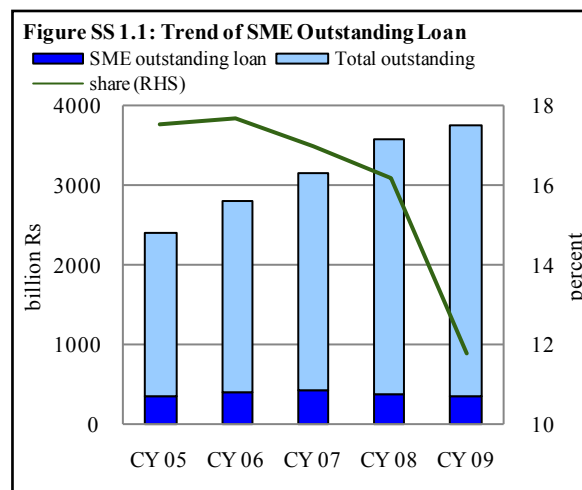
³ The share of SME loan in overall loan portfolio is 11.8 percent while SME loan portfolio constitutes only 7 percent of GDP

to overcome the challenge of constrained financing for SMEs. For supply side, this section covers only the banking industry.

Like other developing countries, inadequate financing of SMEs in Pakistan is a result of disequilibrium in the SME credit market. This implies that demand and supply of SME financing do not clear each other due to mismatch of issues of both sides. On supply side, banks shy away from lending to SMEs due to; (i) highly risky sector because of its greater sensitivity to economic fluctuations; (ii) lack of collateral; (iii) lack of credible data on market size; (iv) creditors' high search cost⁴; (v) high processing cost, etc. On demand side, SME industry cannot address concerns of banks due to; (i) smaller size; (ii) limited management capabilities; (vii) limited resources in keeping business account with banking requirements, etc. These concerns of both sides show that banks are risk averse and are reluctant to extend credit to SMEs while SMEs cannot afford meeting banking requirements. In the recent slowdown of the economy, the mismatch between demand and supply of credit market of SME may worsen further signifying the need for intervention.

During the current economic downturn in the country, financial indicators depict a declining trend in SME financing. On the basis of SME potential, institutional capability and historical trend, the State Bank of Pakistan signaled in 2007 that the banking credit for the sector needed to be increased up to Rs 1000 billion in 2012 to be consistent with the projected macro-economic targets of growth and employment⁵.

However, the negative growth rate in outstanding loan amount of the sector and its falling share in overall loan portfolio over the last two years have made the target difficult to be achieved. The outstanding loan amount has declined from Rs 361 billion in 2005 to Rs 348



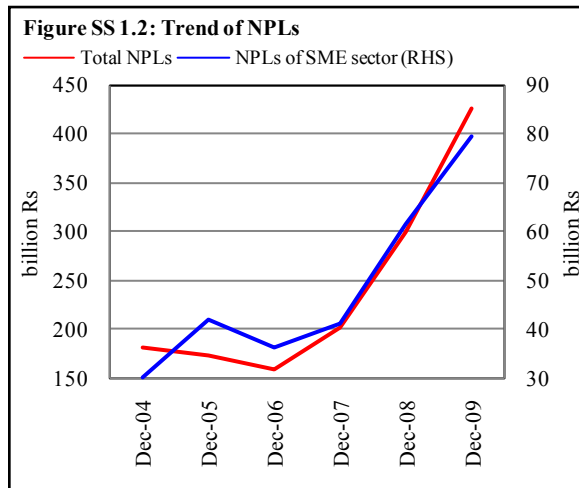
⁴ Term taken from H. Ishrat (2003) speech on : SME financing: Issues & Strategies

⁵ *SME Financial Review; Second quarter 2007, Small and Medium Enterprises Department, State Bank of Pakistan*

billion in 2009 while the SME share in overall loan portfolio has dropped from 17.5 percent to 10.2 percent during the same period (see **Figure SS1.1**).

This situation is further complicated by a rise in NPLs following the overall rising trend in NPLs of banking industry. Absolute amount of SME NPLs has jumped from Rs 30 billion in 2004 to Rs 79.2 billion in 2009 while its share in overall NPLs of banking industry has increased from 16.7 percent to above 18 percent over the said period(see **Figure SS 1.2**).

This is concerning as banks are generally reluctant in extending credit to SMEs can be discouraged further in the face of rising NPLs. Though the importance of SMEs



during the period of economic slowdown has increased due to their distinct characteristics of reducing income inequality and poverty reduction, banking sector has become more cautious in extending credit to the sector. The importance of SMEs in promoting inclusive economic growth in the backdrop of economic slowdown, calls for policy intervention to remove the impediment of constraint financing. Economic literature⁶ has got evidence in favour of intervention for the growth of the industry. (See **Box SS1.2** for cross country SME policy comparison)

Case for Intervention to Improve Access to Finance for SMEs in Pakistan

As a result of economic slowdown and limited financing avenues, major challenges faced by SMEs in obtaining finance have been amplified. Considering the earlier discussed factors that inhibit the finance expansion for SMEs, alternative options are being introduced on both demand and supply side to minimize the mismatch of issues between the two sides.

⁶ Sources (1)) D.Asli & B. Thorsten (2006). *Small and Medium-size Enterprises: Access to Finance as Growth Constraint*. (2) *Promoting SMEs for Sustainable Development*, World Business Council for Sustainable Development(2003)

A. Supply Side Policies

- 1. Credit Information Bureau (CIB):** Centralised data base like CIB can remove one of the major concerns of high search cost of creditors for banks. State Bank of Pakistan has established the CIB as a support service for banks helping them in minimizing their risk while extending credits. This may improve access to finance for SMEs by enabling banks to introduce customized products like cash flow based lending while making an assessment of a client on basis of his credit history. Banks can get greater support in this regard if the information of CIB is complemented with the information of credit rating agency for SMEs. Realising this, SBP is encouraging current rating agencies like PACRA and JCR-VIS to extend their expertise in this sector. Moreover, to develop skills of commercial bankers for risk management of this sector, SBP has conducted a credit scoring training program, and is also planning to implement credit scoring techniques for SMEs in banks.
- 2. Credit Guarantees Schemes (CGS):** These are used to assist under developed industries like SME to overcome the problem of constrained financing. Credit guarantee schemes helps in buffering funding difficulties⁷ as;
 - (i) Higher risk premium makes lending too expensive for SME borrowers to utilize the option.
 - (ii) Lack of sufficient collateral disqualify some SME borrowers from availing credit.

Lack of collateral has been recognized as a central issue in having the challenge of constrained financing for SME industry. Lending data for SMEs depicts that the share of collateral based lending for small and medium enterprises in the country is more than 90 percent of the total loan outstanding amount of the sector⁸. This implies that banks are secured against the high risk of the sector through collateral and do not appear inclined towards clean lending (without collateral). This signifies that small enterprises especially start-ups are facing more problems in having access to finance as they do not have enough assets to offer as collateral. Therefore the sector is in need of schemes like CGS for its smooth growth. SBP is currently working on CGS and will introduce the scheme in near future. However, this scheme needs to be implemented with cautious planning and effective monitoring. This is due to the fact that these kind of schemes;

⁷ Chapter 2; *Banking and Credit, The SME Financing Gap (Vol.1): Theory and Evidence*

⁸ *Development finance Quarterly Review*, September 2009, State Bank of Pakistan

- May affect efficiency of the banking sector especially in terms of development of new customized products.
- May lead to adverse selection problem.
- May also suppress efforts of the industry to become sustainable or efficient enough to generate its own resources.

The CGS may be introduced with a clear and strict phasing out plan that acts as buffer and avoids negative consequence of subsidy.

To encourage financing for SME sector SBP has introduced refinance initiatives like Agricultural Loans Refinancing & Guarantee Scheme, Refinance Schemes for BMR in SME Clusters-Ginning, Rice Husking and Alternate Energy up to 10 MW and has also extended scope of long term financing facility(LTFF) by including SME clusters.

3. Specialized Financial Institutions: Considering the distinctive nature of SMEs, the government has already established a specialized SME bank for the sector. Since SME bank is responsible for extending subsidized credit, therefore it focuses more on small enterprises compared to medium enterprises. This is because of the realization that small enterprises have got greater difficulty in securing finance compared to medium sized firms.

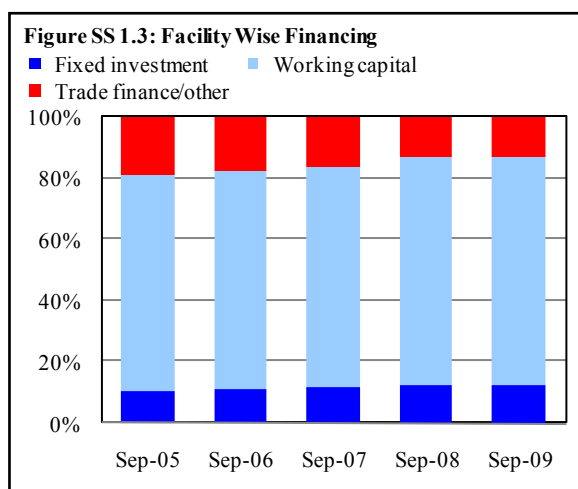
SME bank has been given the target of developing customised lending products, procedures and monitoring mechanisms, etc. so that they can be adopted by commercial banks. However, the impact of specialized banks has remained limited; specialized banks⁹ contribution towards the overall lending of the SME sector is less than 3 percent of the total lending to the sector¹⁰. To encourage banks to contribute more towards the growth of the sector, SBP has introduced customised regulations for SME financing (see **Annexure SS1.1**) and is also encouraging banks to introduce innovative products and financing techniques to create a level playing field for SMEs. SME Finance Grass Root Cluster Training Program is a significant example in this regard where commercial bankers have been trained in areas like cash flow based lending; program based lending, credit scoring, SME risk management and prudential regulations, etc. Moreover work is under progress to allow upscaling of micro finance banks to advance loans to SMEs.

⁹ These banks include SME bank, Zari Tarqati Bank Limited (ZTBL), Punjab Provincial Corporative bank Limited (PPCBL) and Industrial Bank limited (IDBP).

¹⁰ Borrowers of specialized banks are only 18 percent of total borrowers of the sector.

4. Venture Capital (VC):

Facility wise financing for SMEs depict that working capital constitutes the major share; above 70 percent, of total financing of SME (see **Figure SS1.3**). This implies that start-up projects are facing greater problem of having access to capital as compared to on-going firms. VC can be an effective option for start-up businesses. Venture capital by definition is an equity type financing that is targeted towards start-up industries to support their growth and development. Since this funding is similar to share rather than loan, therefore it does not incur extra cost for businesses. This implies that return on funds invested through VC in any business depends upon the profitability of that business.



Government is aware of the utility of this option and efforts are being made to develop VC market. However, to establish this market some significant steps are required to encourage domestic and foreign investors for the establishment of Fund Management Company (FMC). These steps may include the reduction in the capital requirement for the establishment of FMC from US \$ 4,200,000 to international standard of US \$ 100,000; issuance of contract for longer term and establishment of secondary markets, etc. The government has provided tax exemption till 2014 and Security Exchange Commission of Pakistan (SECP) has also issued regulations for private equity and venture capital fund. However, effective governance and monitoring may ensure the effectiveness of VC.

B. Demand Side Policies

1. **Sub-Contracting of large firms with small firms:** This can help in fostering the growth and sustainability of small and medium enterprises. This option can work through the following two channels:
 - (i) Large firms may act as guarantor for small and medium enterprises for having an easy access to formal financing avenues. These large firms may also advance credit to small and medium enterprises.

- (ii) Large firms can also assist in the growth of small and medium enterprises by providing them certainty in their business growth.

This mechanism is popular in countries like Taiwan, Korea China, and Japan where SME growth is a success. In Pakistan, the successful example of sub-contracting can be observed in automobile industry where automobile manufacturers have sub-contracted with small and medium enterprises of the sector¹¹. However, this option is dependent upon the willingness of large firms and capability of small and medium enterprises in utilizing this financing opportunity. For the said condition to be fulfilled, following strategies can play a facilitating role:

- a) **Awareness Raising Programs:** Awareness programs about available opportunities for SME financing and sector's critical role in the overall industrial growth of the country (see **Box SS1.1** for details) can act as convincing factors for both large and small firms to exercise the option of sub-contracting. Government can intervene by arranging these awareness programmes in consultation with SME association in the country. SBP is also in the process to undertake financial literacy program for building awareness of SMEs about banks and their targeted products.
- b) **Business Development Support for SMEs:** This mainly refers to advisory services for SMEs for developing their skills and enhancing capabilities to capitalize on all available financing options in the market. Realizing this requirement, the government has established Small and Medium Enterprise Development Authority (SMEDA) in 1998 and recently has also established Pakistan Enterprises Competitiveness Support Fund (CSF) with the help of USAID and Business Support Fund (BSF). Government can enhance the effectiveness of these advisory services by encouraging private sectors to enter in this area. With more service providers in the market, not only more establishments under the umbrella of SMEs will be able to have advisory services but competition among these service providers will also help in improving the efficiency of these service providers.
To improve access to finance for SMEs, SBP is currently working on the implementation of Secure Transaction Framework that will enable SMEs to offer their moveable assets as collateral. This initiative is likely to

¹¹ H.Ishart (2003) SME Financing-Issues and Prospects, Key Note address at the SMEDA-IBP seminar, Lahore

expand financing avenues for the sector by allowing SMEs to access collateral based lending.

Conclusion: All stakeholders recognize the importance of SME sector for economic development and consider constrained financing as major hurdle for the development of the industry. The negative impact of constraints on demand and supply side seems amplified during the period of economic slowdown. This scenario demands an effective and proactive intervention on both demand and supply sides. Intervention can produce desired impact when e implementation is complemented with a conducive regulatory environment and adequate infrastructure development. Moreover coordination among stakeholders and consistency in policies will play a leading role in bringing positive impact the growth of the industry.

Box 2: Cross Country Comparison				
Countries	SME Definition	SME Contribution	Intervention Programs	Features
India	The Small Scale Industries are industrial enterprises in which the investment in fixed assets does not exceed Rs 10 million.	SMEs constitute 80 percent of the country's industrial enterprises and contributes 35 percent of exports and employs 70 percent of the labour force (2008)	Priority Sector Lending Facility	Under this facility, 40 percent of net bank credit of public and private sector banks is earmarked for priority sectors including SME
	The category of 'Small Scale Services' include enterprises where investment in fixed assets excluding land and building does not exceed Rs one million'		Credit Guarantee Fund Scheme for Micro and Small Enterprises	32 percent of net bank credit of foreign banks is earmarked under this scheme for priority sectors of which 10 percent is allocated to SMEs
Pakistan	Small and Medium Enterprise (SME) means an entity which employs up to 250 persons in case of manufacturing or service concern and 50 persons in case of trading concern while its net sale sales assets does not exceed Rs 300 million. However the criterion in terms of assets is their cost value up to Rs 50 million (excluding land and building) for trading and service concern and up to Rs 100 million for manufacturing concern.	SME constitutes 90 percent of the economic establishments and contributes 30 percent of GDP and 25 percent of export earnings and also employs 78 percent of non-agriculture labor force	SME Bank	The bank provides subsidized loans to the sector
			Small and Medium enterprise Development Authority(SMEDA)	The public-private partnership in the name of SMEDA has got objective of providing consultancy services to small and medium enterprises as well as to create a conducive policy environment for SME growth in the country.
Indonesia	SMEs are enterprises that have less than 100 employees	Small enterprises contribute 41 percent of GDP and 89 percent of the total employment while medium size enterprises account for 16 percent of GDP and 10.55 percent of the employment (2000)	Credit For people's Business	This scheme allows credit of up to Rp 500 million per borrower at a maximum interest rate of 16 percent per annum return
China	SMEs are companies that have sales of RMB30 million to RMB400 million with a workforce ranging from 400 to	SMEs contribute 58.5 percent of GDP, 62.3 percent of export in value	Innovation Fund (1999) and SME Development (2004) and (2008)	This fund provides direct loans to SMEs

	3,000 employees*.	terms, 46.2 percent of tax revenue and 40 percent of the total employment (2008)	Technological Innovation Fund	This fund provides monetary support to SMEs for technology up gradation
Singapore	SMEs are enterprises that have less than 100 employees In manufacturing sector; enterprises that have an investment of less than S \$ 12 million in fixed assets are considered SMEs.	SMEs constitute 90 percent of the enterprises and contribute 42 percent of GDP and employ more than half of the labour force (2007)	Start-up Enterprise Development Scheme	According to the scheme, SPRING** will invest a matching dollar for every dollar an investor puts into the country's based start-up businesses, up to a maximum of \$ 300,000
			Micro Loan Programme	Under this program loans up to \$ 50,000 are extended to fund daily business operations for businesses having less than 10 employees
			Enterprise Investment Incentive Scheme	Under this scheme investors can deduct up to \$ 3 million worth of losses against their taxable income if investment is made in new venture
Malaysia	SMEs are enterprises that have less than 75 employees and assets valuing not more than RM 2.5 million	SMEs contribute 32 percent of GDP, 19 percent of exports and employs more than 50 percent of the labour force (2005)	Small and Medium Industries Development Corporation Matching Grants	Under this scheme the grant is provided for <ul style="list-style-type: none"> · business start-ups, · improvement in products and processes · certification and quality management system · development and promotion of halal products etc
Thailand	SMEs are enterprises that have less than 200 employees for labour intensive ventures and have investment of less than 100m Baht for capital intensive projects	SMEs contribute 37.8 percent of GDP and employ 75 percent of the labor force (2005)	Financial Promotion Programs	The program supports operations of the Small and Medium Enterprise Development Bank of Thailand and the Small Business Credit Guarantee Scheme (2000)
			Capacity Building Fund	The fund provides financing for consulting services, expansion in export market and application for intellectual property rights

			Various Loans Programmes of SME Bank	The bank extends loans including Food Safety Loans, one Tambon One Product Loans and other fast track loans etc
<p>Sources:(i) Enterprises in Asia: Fostering Dynamism in SMEs; Asian Development Bank Report 2009</p> <p>(ii) Towards the Recovery: Challenges and Opportunities facing Asia's SMEs, Economist Intelligent Unit 2010</p> <p>(iii) M. Thamrong (2007);" Opportunities for SMEs in Thailand", Thailand Board Of Investment, Japan.</p> <p>(iv) APEC and SME Policy: Suggestion for an Action Agenda (www.apec.org.au/docs/iss1.htm)(accessed on)(20th Feb'2010)</p> <p>(v) The Small and Medium Enterprise(SME) Annual Report 2008 (www.smidec.gov.my/node/4920/0)(accessed on)(20th Feb'2010)</p> <p>(vi) S.G. Aruna (2003);"Small and Medium Enterprise Development in Sri-Lanka: A Review"</p> <p>* H.Lauren (2009); SMEs in China";Industry Outlook</p> <p>* * SPRING Singapore is the enterprise development agency for growing innovative companies and fostering a competitive SME sector.</p> <p>† Rs. In the box refers to Indian rupee</p>				

Annexure SS1.1: Comparison Between Commercial Banking Regulation and SME Regulation			
Areas	Regulations		
	Corporate Sector	SME	
Limit on Clean Facilities	Banks/DFIs shall not provide clean financing facility in any form of a sum exceeding Rs 500,000 to any one person	Banks/DFIs are allowed to take clean exposure up to Rs 3 million provided that funded exposure should not exceed Rs 2 million	
Aggregate Exposure of a Bank/DFI	The aggregate exposure of a bank/DFI against all their clean lending shall not at any point in time exceed the amount of their equity(Unsecured TFCs and subordinate loans are exempted)	Classified SME Advances /Total portfolio of SME Advances (%)	Max. Limit
		< 5%	No limit
		< 10 %	3 x equity
		< 15%	2 x equity
		>= 15 %	Upto the equity
Margin Requirement	Banks/ DFIs are free to determine the margin requirements on facilities provided by them to their clients taking into account the risk profile of the borrowers in order to secure their interests. However this relaxation shall not apply in case of items imports of which are banned by government. Banks/DFIs will continue to observe margin restriction on shares/TFCs as per instructions under prudential regulation (R-6) along with the cash margin requirement of 100 percent on caustic soda for opening Import Letter of Credit	Same as Corporate Sector Regulation	
Cash Flow Backed Lending	Banks/ DFIs shall specifically identify the sources of repayment and assess the repayment of the borrower on the basis of assets conversion cycle and expected future cash flows. In order to add value, the banks/DFI are encouraged to assess conditions prevailing in the particular sector/industry they are lending to and its future prospects. The rationale and parameters used to project the future cash flows shall be documented and annexed with the cash flow undertaken by the bank/DFI.	Same as Corporate Sector Regulation. However, recognising the inability of SMEs' in preparing future cash flows it is expected that in such cases banks/DFIs shall assist borrowers in obtaining information and no SME shall be declined access to credit merely on this ground.	

Acronyms

A/C	Account
ABL	Allied Bank Limited
ADB	Asian Development Bank
APCMA	All Pakistan Cement Manufacturers Association
bn	billion
BoP	Balance of Payments
BP	British Petroleum
BSC	Behbood Saving Certificate
BSF	Business Support Fund
CA	Current Account
CBs	Commercial Banks
CBU	Completely Built Unit
CGS	Credit Guarantee Schemes
CIB	Credit Information Bureau
c.i.f	Cost of Insurance and Freight
CKD	Completely Knockdown Unit
CPI	Consumer Price Index
CSF	Competitiveness Support Fund
CY	Calendar Year
DAP	Di-Ammonium Phosphate
DBC's	Dollar bearer certificates
DD	Domestic Debt
DPBs	Domestic Private Banks
DS	Debt Servicing
DSC	Defense Saving Certificate
EDL	External Debt & Liabilities
EFS	Export Finance Scheme
ER	Exchange Rate
EU	European Union
FAO	Food and Agriculture Organization
FBR	Federal Board of Revenue
FBS	Federal Bureau of Statistics
FC	Foreign Currency
FCAs	Foreign Currency Accounts
FDI	Foreign Direct Investment
FE	Foreign Exchange
FEBCs	Foreign Exchange Bearer Certificates
FED	Federal Excise Duty
FE-25	Foreign Exchange Cir.No.25

FIA	Federal Investigation Agency
FMCG	Fast Moving Consumer Goods
FMC	Fund Management Company
FO	Furnace Oil
f.o.b	Free on Board
FoDP	Friends of Democratic Pakistan
FOREX	Foreign Exchange
FPI	Foreign Portfolio Investment
FRDL	Fiscal Responsibility and Debt Limitation
FSV	Forced Sale value
FY	Fiscal Year
GCI	Global Competitiveness Index
GDP	Gross Domestic Product
GoP	Government of Pakistan
H	Half
HLB	Habib Bank Limited
HRI	House Rent Index
HSD	High Speed Diesel
IDA	International Development Association
IDB	Islamic Development Bank
IDBP	Industrial Development Bank of Pakistan
IDPs	Internally Displaced Persons
IFIs	International Financial Institutions
IMF	International Monetary Fund
KESC	Karachi Electric Supply Corporation
KIBOR	Karachi Inter Bank Offer Rate
KSE	Karachi Stock Exchange
LCVs	Light Commercial Vehicles
LC	Letter of Credit
LDI	Long Distance & International
LSM	Large Scale Manufacturing
LTFF	Long Term Financing Facility
MAF	Million Acre Feet
MFN	Most Favored Nation
MoM	Month-on-Month
MoU	Memorandum of Understanding
MRTB	Market Related Treasury Bills
MS	Motor Spirit
MSCI	Morgan Stanley Capital International
MT	Metric Ton
NBP	National Bank of Pakistan

NDA	Net Domestic Asset
NEER	Nominal Effective Exchange Rate
NFA	Net Foreign Asset
NFI	Net Foreign Investment
NFNE	Non Food Non Energy
NHA	National Highway Authority
NPLs	Non Performing Loans
NSS	National Savings Scheme
NSB	National Saving Bond
NWFP	North-West Frontier Province
OAEM	Other Items Especially Mention
OCAC	Oil Companies Advisory Committee
OGDC	Oil and Gas Development Corporation
OIN	Other Items Net
OMOs	Open Market Operations
OPEC	Organization of the Petroleum Exporting Countries
PASSCO	Pakistan Agriculture Storage & Services Corporation
PCGA	Pakistan Cotton Ginners' Association
PIA	Pakistan International Airlines
PIBs	Pakistan Investment Bonds
PO	Post Office
POL	Petroleum, Oil and Lubricants
PPCBL	Punjab Provincial Cooperative Banks limited
PPTFC	Privately placed Term Finance Certificates
PRI	Pakistan Remittance Initiative
PSC	Private Sector Credit
PSDP	Public Sector Development Program
PSEs	Public Sector Enterprises
PTA	Pakistan Telecommunication Authority
PTCL	Pakistan Telecommunication Company Limited
Q	Quarter
QoQ	Quarter on Quarter
RBI	Reserve Bank of India
RDF	Refused Drive Fuel
REER	Real Effective Exchange Rate
RES	Reserves
RFCAs	Residents Foreign Currency Accounts
RHS	Right Hand Side
RPI	Relative Price Index
Rs	Rupees
RTGS	Real Time Gross Settlements

SBA	Stand-By Arrangement
SBP	State Bank of Pakistan
SDRs	Special Drawing Rights
SECP	Securities and Exchange Commission of Pakistan
SLR	Statutory Liquidity Requirements
SMEs	Small and Medium Enterprises
SMEDA	Small and Medium Enterprise Development Authority
SNGPL	Sui Northern Gas Pipelines Limited
SPI	Sensitive Price Index
SRO	Statutory Regulatory Order
SSC	Special saving certificate
SSGC	Sui Southern Gas Company
T-bills	Treasury Bills
TCO	Textile Commissioner's Organization
TCP	Trading Corporation of Pakistan
TED	Total External Debt
TR	Total Revenue
UAE	United Arab Emirates
UBL	United Bank Limited
UK	United Kingdom
UN	United Nation
UNCTAD	United Nations Conference on Trade and Development
USA	United States of America
USAID	United States Agency for International Development
VC	Venture Capital
VSS	Voluntarily Separation Scheme
WA	Weighted Average
WAPDA	Water and Power Development Authority
WEO	World Economic Outlook
WPI	Wholesale Price Index
XGS	Exports of Goods & Services
YoY	Year on Year
ZTBL	Zarai Taraqiati Bank Limited