THE STATE OF PAKISTAN'S ECONOMY

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

State Bank of Pakistan

CENTRAL BOARD OF DIRECTORS

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LETTER OF TRANSMITTAL

State Bank of Pakistan
Karachi.
June 01, 2010

Dear Mr. Chairman,

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

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State Bank of Pakistan
Karachi.
June 01, 2010

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With best regards,

Yours sincerely,

(SYED SALIM RAZA)
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1 Overview and Economic Outlook

1.1. Overview

Despite various economic and social challenges, with the passage of months, it can be said that the country's macroeconomic environment has improved. The April 2010 inflation of 13.3 percent YoY implies that average annual inflation for FY10 will be close to 12 percent; significantly lower than 20.8 percent for the previous year. The current account deficit has also fallen sharply (see **Table 1.1**) with foreign exchange reserves improving, and, although the fiscal deficit is expected to be above target, borrowings from the central bank have so far, been relatively low, relative to past years. The resulting improvement in business confidence, together with reasonable harvests, expansionary fiscal stance, and a small recovery in the global economy have fostered growth. in FY10. Real GDP growth for FY10 is estimated at 4.1 percent against the annual target for 3.3 percent.

Table 1.1: Selected Economic Indicators

		FY08	FY09	FY10
Growth rate (percent)				
LSM	Jul-Mar	5.1	-7.4	4.4
Exports (fob)	Jul-Apr	9.9	-3.4	8
Imports (cif)	Jul-Apr	28.3	-9.8	-2.8
Tax revenue (FBR)	Jul-Mar	13.9	19.9	11.6
CPI (12 mma)	Apr	9.8	22.0	11.8
Private sector credit	Jul-Apr	15.5	1.5	5.0
Money supply (M2)	Jul-Apr	9.3	2.4	8.1
billion US Dollars				
Total liquid reserves[1]	end-Apr	12.4	11.6	14.9
Home remittances	Jul-Apr	5.3	6.4	7.3
Net foreign investment	Jul-Apr	3.8	2.2	1.7
percent of GDP[2]				
Fiscal deficit	Jul-Dec	3.5	2.0	2.7
Trade deficit	Jul-Apr	10.0	8.7	6.9
Current a/c deficit	Jul-Apr	6.7	5.5	1.7

1. With SBP & commercial banks.
2. Based on full-year GDP in the denominator. For FY10, provisional estimates by FBS full year GDP has been used.

But these macroeconomic silver linings accompany clouds that carry considerable risks to the fragile recovery currently underway. Despite the deceleration in inflation it remains high, and there has been resurgence in inflation in recent months. Increases in international commodity prices (particularly oil) threaten to accelerate this rising trend, and raise the risk that the external account imbalances will also increase in months ahead. The latter risk is all the more worrying given that the country is already facing problems in financing a current account deficit that is substantially lower than in the previous year. Similarly, if the fiscal deficit continues to increase, the risks to macroeconomic stability will rise, particularly if there is higher recourse to budgetary borrowings from the central bank and if the

use of quasi-fiscal operations is not contained. It should be noted that although budgetary borrowings from the central bank have so far been contained in FY10 (relative to levels in preceding years), the resulting rise in government sector credit demands means that this has been at the risk of seriously crowding out private investment. Thus, as public sector investment has reportedly also been curtailed in H2-FY10, this raises questions about the medium-term sustainability of the economic recovery.

For example, although large scale manufacturing (LSM) sector witnessed a better than expected growth during the first eight months of FY10, this has been made possible by capacities built up by investments in yester years. Thus, as business confidence improved and aggregate demand increased, LSM was in a position to respond, *despite* continuing energy shortages, law & order issues as well as financial constraints. However, if aggregate demand further gathers pace, the slowdown in investments could potentially constrain future output growth, and add to pressures on the external account and inflation.

In other words, the increase in the fiscal deficit FY08 onwards poses risks to macroeconomic stability. This impact of the fiscal deficit is compounded by the substantial increase in quasi-fiscal activities in recent years that have not only contributed to the build-up of inter-locking debt chains (circular debt) in the energy and agri-commodity sectors, but also raised the financial costs for all borrowers in the economy, restricting output growth.

Increased risk averseness of banks played an important role in slower expansion of credit to the private sectors during FY09. However, banks' ability to sustain this trend into FY10 was probably assisted by the ever-rising demand from the government sector for bank borrowings. A look at the pattern of the growth in broad money (M2) during the two years clearly testifies this argument. A substantial part of the growth in broad money during FY10, in particular, is principally due to borrowings by the government sector (see **Table 1.2**).

Table 1.2: Contribution of Government Sector to M2 growth (Jul-Apr)
flows in billion Rupees, growth in percent

	Flows		Growth	
	FY09	**FY10**	**FY09**	**FY10**
Broad money (M2)	114.1	414.0	2.4	8.1
of which				
Government borrowing	315.2	325.0	20.9	16.0
Credit to private sector	43.4	144.3	1.5	5.0

The existing fiscal rigidities meant that an increase in the full year fiscal deficit was probably unavoidable in FY10 given the additional need for army operations against militants, and to help the resulting internally displaced population. However, even after excluding defense services, the growth in current spending

for H1-FY10 is high at 15.7 percent YoY. Moreover, the impact of the high fiscal deficit was compounded by shortfall in external receipts. The latter contributed to lower liquidity in the banking system and problems in financing the current account deficit.

The central bank continued to inject liquidity in the banking system during most of the year to mitigate part of the impact of the pressures from fiscal and quasi-fiscal operations, but overnight rates have remained close to the ceiling during most of the fiscal year. Similarly, despite a sharp decline in the current account deficit, the overall external account position remains vulnerable, since financing receipts have also plummeted (see **Table 1.3**). It should be remembered that the sustainability of the current account depends on a country's ability to finance it (preferably from the non-debt creating inflows).

Table 1.3: External Accounts
billion US Dollar

	Jul-Apr		FY10		
	FY09	**FY10**	**Q1**	**Q2**	**Jan-Apr**
A-Current account balance	-9.0	-3.1	-0.6	-1.5	-0.9
B-Financial/capital balance	4.5	3.9	2.8	0.5	0.7

Indeed, the risks to macroeconomic stability from the fiscal and external deficits, as well as resurgence in CPI inflation were key parameters in the SBP inability to further ease its monetary stance. Ironically, it was the government's decision to lower fiscal imbalances and reduce allocational inefficiencies that proved to be a key contributor to this revival of inflation. The reduction in subsidy on power and upward adjustment in the domestic prices of key fuels following rising international prices was immediately felt in the domestic economy.

In particular, the impact of rising fuel prices on transportation was immediately seen in higher prices of food commodities. Consequently, headline inflation rose to 13.3 percent in April 2010. While sharply lower than the 17.2 percent seen in the same month of the preceding year, it was nonetheless high. Moreover, the impact was greatest on the purchasing power of low-income groups due to persistent high food inflation. The significant role of essential energy and food prices in the current CPI inflation uptrend also raises the risk of higher second round inflationary impacts.

The latter could be further compounded if imported inflation becomes a greater concern. Fortunately the substantial assistance from the IMF has supported an increase in the country's foreign exchange reserves, and underpinned the relative stability of the exchange rate. Pakistan has to move aggressively to attract fresh

investment by implementing additional reforms to increase economic efficiency and improve the business environment.

Steps to increase investment must also be accompanied by measures to foster savings. In this regard, SBP is looking to increase the access of people to the financial system, and also introducing projects to improve the transmission of policy rates to savers. The greater impact is likely to be through improving institutional savings, for which there is an urgent need to reform the institutional structure of pension and provident funds in the country, to foster the expansion of the pool of long-term savings.

1.2 Looking Forward

Initial provisional estimates by FBS are in conformity with the earlier SBP assessment of a rebound in real GDP growth; it is estimated at 4.1 percent for FY10 from an anemic 1.2 percent in the preceding year. The recovery was contributed mainly by above target growth in the livestock and LSM sub-sectors as well as the services sector.

Table 1.4: Projections of Major Macroeconomic Indicators

	FY09	FY10	
		Annual plan targets	SBP projections
growth rates in percent			
GDP*	1.2[R]	3.3	4.1
Average CPI inflation	20.8	9.0	11.5 - 12.5
Monetary assets (M2)	9.6	-	13.5 – 14.5
billion US Dollars			
Workers' remittances	7.8	7.0	8.5 – 9.0
Exports (fob-BoP data)	19.1	19.9	19.5 – 20.0
Imports (fob-BoP data)	31.7	28.7	31.0 - 31.5
percent of GDP			
Fiscal deficit	5.3	4.9	5.1 - 5.6
Current account deficit	5.7	5.3	2.2 – 2.8

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 provisional estimates of nominal GDP for the year by FBS.
[R]: Revised; (*): Show provisional estimates by FBS; retrieved on May 21, 2010 from http://www.statpak.gov.pk/depts/fbs/statistics/national_accounts/national_accounts.html

As far as inflation is concerned, resurgence in inflationary pressures during H2-FY10 was anticipated. However, the impact of adjustment in power tariff was further fueled by sharp rise in international prices of oil, cotton, and metals. In contrast, benefits of a fall in international prices of wheat were not passed on to the consumers, ironically, as a result of government interventions in market mechanisms. In view of these, SBP forecasts suggest that annual average headline CPI inflation will be slightly higher than estimated earlier, falling in the range of 11.5 – 12.5 percent during FY10 (see **Table 1.4**). The upward revision in the forecast range indicates that inflationary pressures strengthened in the economy.

Encouragingly, projections for current account deficit indicate an improved picture, with the deficit now expected to fall even lower, in the range of 2.2 - 2.8

percent of GDP during FY10, substantially lower from earlier forecasts of 3.2-3.8 percent of GDP and actual deficit of 5.7 percent of GDP seen in FY09. This improvement is mainly due to an impressive performance of exports and workers' remittances.

However, the fiscal performance remained lackluster. SBP estimates for fiscal deficit have been revised upwards to 5.1 - 5.6 percent of GDP. Although the main factor for pressures on fiscal accounts is rising current expenditure, a low tax to GDP ratio is also a source of concern. Implementation of value added tax (VAT) could be an appropriate remedy if supported by appropriate systems to curtail misuse of VAT refunds. Even though tax collection is likely to drop during the initial phase of implementation, tax collection and documentation in the economy will improve in later years.

Equally critical is the efficient use of taxpayers' money. Government has to reduce quasi fiscal activities and aggressively privatize loss making public sector commercial entities. Improvement in governance, institution building and effective enforcement of investor friendly laws are prerequisites for sustainable growth. Both good governance and effective legislation could attract substantial investment, which is needed to exploit the potential of the economy and accelerate employment generation. Such a structural transformation is needed to accelerate employment generation in the economy.

For example, progress is needed towards protecting intellectual property rights (IPRs) and enforcing contracts, in order to encourage innovation. While recognition and enforcement of intellectual property rights is a concern globally (particularly in emerging markets), Pakistan lags behind many countries. Similarly, the domestic construction industry could be encouraged, if tenancy laws could be reformed such that these are neither biased towards tenants nor distinctly in favor of landlords. Adoption of best international practices regarding tenancy laws may attract massive investment in housing sector and help bridge the gap between demand and supply.

Finally, the provision of basic utilities and infrastructure is equally important. While LSM has grown despite energy shortages, it is quite likely that the impact on small & medium manufacturers and traders has been quite severe, with consequent loss of output and employment. The impact of power outages on SMEs was compounded with the rising prices of key fuels and non-availability of gas. The roots of energy shortages lie, in part, in inappropriate pricing and an inefficient distribution system. The continued provision of untargeted subsidies generated a cobweb of debt in the energy sector, with negative repercussions for

output growth. For example, as a conseuqunce of a debt build-up domestic refineries and IPPs are working below capacity. On a broader note there is a need for lower direct government intervention in market prices, with market structure problems being handled by independent regulatory authorities such as the Competition Commission of Pakistan.

1.3 Executive Summary

Real Sector

Agriculture

Despite water shortages and unfavorable weather conditions during FY10, agriculture sector is expected to achieve a reasonable growth of 3.0 percent; close to the average growth of the last 10 years. Contrary to expectations that growth by minor crops would be strong due to switch over of area from major to minor crops, recent information suggests that most of the minor crops also suffered from lower winter rains during FY10.

One positive was that adequate fertilizer and agri-credit was available to undertake agri-activities during FY10. Another positive development during FY10 was a significant contribution of agriculture in exports. This resulted in relatively higher domestic prices of most surplus agri-produce, and would encourage farmers to invest to increase output.

Large-Scale Manufacturing (LSM)

After posting a modest recovery in H1-FY10, LSM growth gathered further pace in Q3-FY10. Re-entry of commercial banks in consumer financing helped strengthen the demand for consumer durables, especially automobiles, despite rising cost pressures. Moreover, export-based industries, particularly value-added textile, finally picked-up in response to improved global demand as well as domestic policies.

The rising demand was absorbed by the available capacities in LSM sector without entailing any significant pressure on prices. The trend in capacity utilization in Jul-Feb FY10, however, was mixed; it increased in case of automobiles, electronics and cement sectors, and declined in petroleum and steel mainly due to liquidity constraints. Nonetheless, it appears that despite the available capacities in many sectors, sustaining a decent growth in LSM, going forward, could be constrained due to energy insufficiency in the country.

In specific terms, supply of energy will be a major determinant of capacity utilization going forward. Particularly, industrial energy mix is progressively

shifting towards natural gas, a fuel that is also being increasingly demanded by CNG, household, and power sectors. The insignificant gas exploration activity in the country during the last few years means that the demand-supply gap has widened in recent years, which is restricting capacity utilization in many industries, especially in the small-scale sector. In the short run, there seems little hope of improvement, though rigorous gas and electricity conservation measures may offer some respite. However, in the longer-run, the construction of dams and utilization of untapped domestic coal and gas resources will be crucial to ensure sustainable industrial growth.

Prices

Headline CPI inflation (YoY) rose to 13.3 percent by April 2010, slightly higher than the 12.9 percent in the preceding month, but significantly higher than the short-term low of 8.9 percent in October 2009. Core inflation measured by 20% trimmed mean remained unchanged during April 2010. However, core inflation measured by non-food non-energy (NFNE) increased to 10.6 percent during April 2010 compared with 9.9 percent in March 2010, showing that inflationary pressures were relatively broad-based in April 2010.

The increase in inflation in recent months is attributed to a number of factors, such as: (a) higher international commodity prices, particularly crude oil, metals, pulses and cotton; (b) upward adjustment in electricity tariffs and administered domestic fuel prices; (c) relatively weak harvests amid water shortages coupled with strong growth in exports of vegetables, fruits, livestock, etc., (d) expansionary fiscal stance; and (e) recovery in domestic economy.

Money and Banking

The SBP kept its policy rate unchanged at 12.5 percent in the last two consecutive monetary policy decisions; in January and March 2010.[1] A cautious approach to easing the policy rate was adopted to strike a balance between supporting the recovery in aggregate demand while guarding against the re-emergence of macroeconomic imbalances, including a resurgence of inflation.

The recent build-up in inflationary momentum largely reflecting the power tariff rationalization drive was compounded by global commodity price pressures. The situation was exacerbated by considerable deficit monetization as the government turned to the banking system to finance the rising deficit due to higher

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[1] The policy rate was cut by a cumulative 150 bps in H1-FY10; by 100 bps in August and 50 bps cut in November 2010.

expenditures amid elusive pledged foreign inflows. Resultantly, the government breached the IMF's March 2010 quarterly ceiling for deficit monetization.

In terms of monetary aggregate, M2 registered growth of 8.1 percent for Jul-Apr FY10 compared with 2.4 percent in the corresponding period last year. The improvement in M2 resulted from a robust growth in net domestic assets (NDA) which grew by 9.8 percent during Jul-Apr FY10 against 8.3 percent growth in the same period last year. On the other hand, net foreign assets (NFA) of the banking system witnessed a moderate decline; contracting by 7.2 percent during Jul-Apr FY10 compared with steep fall of 33.6 percent in the same period last year. In line with monetary expansion, deposits of the banking industry staged a recovery. They registered robust growth of 8.6 percent during Jul-Apr FY10, in stark contrast to a contraction of 0.2 percent in the same period last year.

Fiscal Developments

The budgetary data for Q3-FY10 is not yet available, but some preliminary information suggests that the fiscal sector remained under stress and the government is likely to miss its budget deficit target. Although the FBR has regained its revenue path in the third quarter of the year and non-tax revenue also propped up by appropriation of SBP profit in a considerable amount and realization of coalition support fund of US$ 349 million, the budget deficit is expected to be higher than the target. This primarily because of higher than budgeted public expenditures.

FBR improved its performance in the 3rd quarter of the year with 26 percent growth in the tax receipts. However, going forward, tax revenue target for FY10 will remain challenging as it would require a YoY growth of 37.6 percent during Q4-FY10 in order to attain Rs 1.38 trillion tax collection (budget) target for the year; compared with 5-year average tax revenue growth in the last quarter at 15.7 percent.

The aggregate government borrowing from domestic sources stood at Rs 535.3 billion during July-Mar FY10, which is significantly higher than the domestic budgetary requirements in the corresponding period of FY09. With shortfall in external borrowing for budgetary support, the widening budgetary imbalance was predominantly financed from banking system during Jul-Mar FY10 raising risks of crowding out of private investment.

External Sector

Balance of Payments

Aided by lower imports and sustained inflow of remittances, the current account deficit during Jul-Apr FY10 remained significantly lower than in the corresponding period last year. The impact of this improvement on overall external balance was, however, limited due to considerable fall in capital and financial account surplus during the period.

Apart from lower imports (accompanied with lower freight costs) and strong increase in current transfers, YoY contraction in current account deficit during Jul-Apr FY10 was also attributed to lower payments on account of repatriation of dividends and interest on debt. Likewise, lower outflows from foreign exchange companies and nominal increase in exports also contributed to this improvement in current account deficit.

On the financing side, however, surplus in financial account declined noticeably during Jul-Apr FY10 compared with the same period last year. This deterioration was on account of both, fall in equity and loan inflows. As a result, overall external account for Jul-Apr FY10 period recorded only a nominal surplus.

Country's reserves, nevertheless, improved by US$ 2.2 billion owing largely to one off SDR allocation by the IMF. Moreover, exchange rate also exhibited relative stability; depreciating by 3.9 percent during Jul-Apr FY10 as compared to 16.2 percent in the same period last year.

Trade Account

Trade deficit contracted by 13.9 percent during Jul-Apr FY10 against 15.6 percent decline recorded in the same period last year. This contraction in the trade deficit was the result of a 2.8 percent YoY fall in the imports, which was complimented by an encouraging 8.0 percent YoY rise in the exports.

The contraction in import bill was due to lower input prices that reduced the import bill in the first five months of FY10. This negative price impact more than offset the rise in quantum of imports during almost the entire Jul-Apr period. The recovery in exports was broadly led by food and textile group. In case of food group, exports increased on account of rise in quantum of rice, fruits and vegetables. Textile exports on the other hand, benefited from rise in the low value added categories exports, that is, raw cotton and cotton yarn.

2 Real Sector

The economic recovery seen in H1-FY10 gathered pace in the third quarter as rising domestic and external demand encouraged higher production. Most of the recovery was evident in LSM production but small and medium sized manufacturing units complained of productivity losses due to prevailing energy shortages. Although production in LSM sector has increased over the previous year; it nonetheless remained low compared with the peak levels seen in FY08. Even so, the increase in capacity utilization in the LSM sector explains at least a part of rising imports as well as inflationary pressures during Q3-FY10 (see **Figure 2.1**).

Figure 2.1: Building-up Demand Pressures (YoY Growth based on 3-Months Moving Averages)

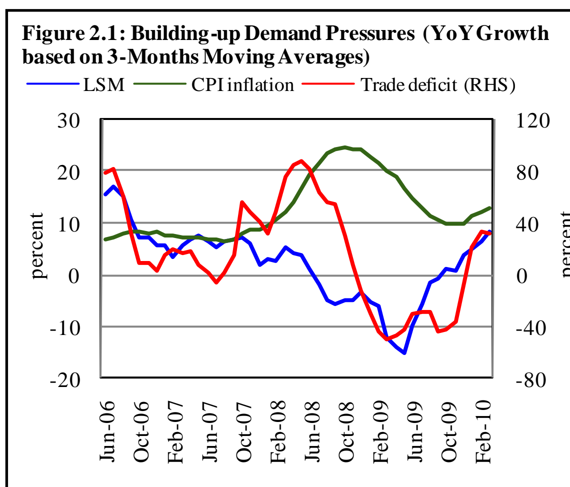

Table 2.1: Indicators of Aggregate Demand

percent YoY growth

	H1		Q3	
	FY09	FY10	FY09	FY10
Oil sales[1]	-4.1	14.7	-1.0	2.4
Gas sales to industry[2]	-2.1	2.0	0.3	6.3
Other gas sales[2]	1.0	-0.6	-3.5	-0.5
Power use agri/ind[3]	-6.2	4.4	-3.2	3.8
Power use commercial[3]	-7.6	6.9	-3.4	7.4
Local cement dispatches[4]	-13.7	16.6	-6.5	18.3
Consumer auto sales[5]	-22.1	38.6	-37.8	67.2
Commercial auto sales[5]	-18.6	18.4	-30.4	42.4
Exports	9.4	-4.5	-18.2	29.2
Imports	12.8	-28.6	-36.4	30.1
Loans to business	9.2	5.8	-4.1	1.0

Source: [1]OCAC, [2]SSGC & SNGPL, [3]PEPCO, [4]APCMA, [5]PAMA

Major stimulus to the domestic demand in Q3-FY10 came from private consumption as rural incomes improved considerably due to a rise in prices of major agriculture commodities during FY10. Some support to consumption demand also came from banks' renewed interest in consumer finance business January 2010 onwards that partly explained larger volume of automobile sales (see **Table 2.1**), despite increase in prices during the period. The resultant increase in demand for intermediate goods

was bolstered with improvement in corporate liquidity emanating from better earnings and improved availability of bank loans.

The external demand also gathered pace further following sharp growth in Asian economies and decent recovery in advanced economies in Q3-FY10. As a result, country's export of manufactured goods as well as agricultural products increased sharply in Q3-FY10. Putting this in perspective, the export growth in Q3-FY10 is the largest YoY export growth in any quarter since Q4-FY03. Notably, the strengthening recovery in aggregate consumption appears to have lifted investors' confidence as is evident from higher production of capital goods during Q3-FY10 and increase in demand for machinery in some sectors, including agriculture and textiles.[1]

The domestic manufacturing sector was well placed to respond to rising demand given the available capacities. As a result, the LSM sector grew by 9.6 percent in Q3-FY10 which is the strongest quarterly growth since FY07. The higher Q3 growth took the cumulative growth in Jul-Mar FY10 to 4.4 percent as against a decline of 7.4 percent in the same period of FY09. Most of the growth was seen in consumer automobiles and electronics industries followed by a few exporting industries including textiles, pharmaceuticals, etc. Thus, it appears that prevailing energy shortages in the country did not obstruct LSM activities to a larger extent; though it may be argued that a higher LSM growth rate could have been achieved if not for energy shortages.

Table 2.2: Composition of Energy Consumption by Industrial Sector (Excluding Gas for Feedstock)

percent share

	FY06	FY07	FY08	FY09
Oil	14.7	12.7	7.9	8.4
Gas	40.4	41.5	40.1	44.7
Electricity	13.9	13.4	12.4	13.5
Coal	31.1	32.4	39.6	33.4

Source: HDIP

The apparent resilience of LSM sector to energy shortages stemmed mainly from the composition of energy requirement and its sources (see **Table 2.2**). In specific terms, 40-45 percent of the industry's energy requirements are met through natural gas (excluding gas used as feedstock in fertilizer production). Furthermore, in terms of priority allocation, gas supplies to industries where it is used as raw material (mainly fertilizers, synthetic fiber, etc.), order above the supplies for power generation and transport

1 Capital goods industries registered a growth of 47.6 percent in Q3-FY10 compared with a decline of 29.2 in Q3-FY09.

usage.[2] As far as the general industries are concerned, the data for Q3-FY10 suggests a sharp rise in gas sales; 4.0 percent growth over Q3-FY09 sales and 1.2 percent growth over Q3-FY08 sales. Similarly, the energy from coal and oil constitute another 40-45 percent of industrial requirements which is largely met through imports. Thus productivity losses caused by power disruptions are limited to that fraction of the industry that has direct reliance on the power network.[3] For large scale manufacturing, this effect was slightly mitigated by the fact that large firms can cope with energy shortages by operating on expensive back-up supplies. Furthermore, a few textiles, sugar, chemicals and steel industries are operating with captive power plants that ensure sufficient availability to their own units.

In contrast, small scale manufacturing appears to have been hit hard by power outages, and reportedly a large number of small manufacturing units closed down with negative repercussions on exports and employment.[4] Meanwhile, activities in local construction industry strengthened further with stable building material prices and growing housing demand, as is evident from higher growth in cement dispatches during Q3-FY10 compared with Q3-FY09 as well as H1-FY10.

Thus, the overall industrial sector production comfortably surpassed the annual target of 1.7 percent in FY10. The improvement in industrial production and rising trade volumes has brightened the prospects of recovery in services sector. Specifically, higher than expected growth in *wholesale & retail trade*, strong contribution from *public administration & defense*, rising transport related activities and increase in investments in telecommunications have lifted services sector growth. The higher industry and services sector growth more than offset slight weakening in agriculture sector during the year and, as a result, the GDP growth rebounded strongly and rose to 4.1 percent in FY10.[5] The GDP growth is envisaged to increase further in FY11 with prospects of recovery in major crops, induction of new capacities in major LSM sector and a little improvement in energy supplies.

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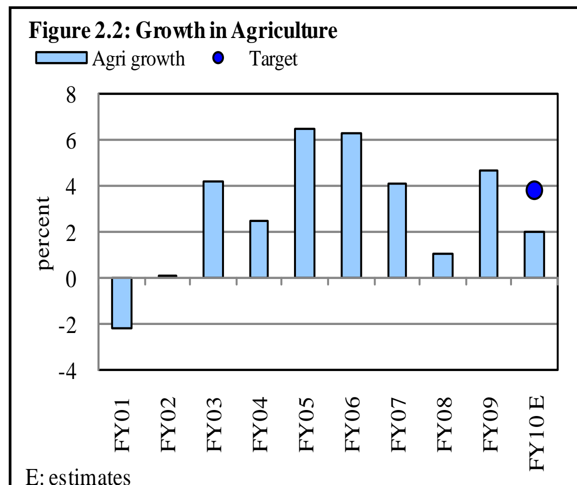
[2] As per Natural Gas Allocation and Management Policy 2005.
[3] Indirect effects include limited activities in commercial sectors, increase in consumer spending on UPS/generators and limited use of household appliances, etc.
[4] According to relevant business associations, 75 percent of ready-made garments, towels and bed-wear exporting firms are small and medium sized.
[5] Provisional estimates by FBS; retrieved on May 21, 2010, from http://www.statpak.gov.pk/depts/fbs/statistics/national_accounts/national_accounts.html

2.1 Agriculture Sector Performance

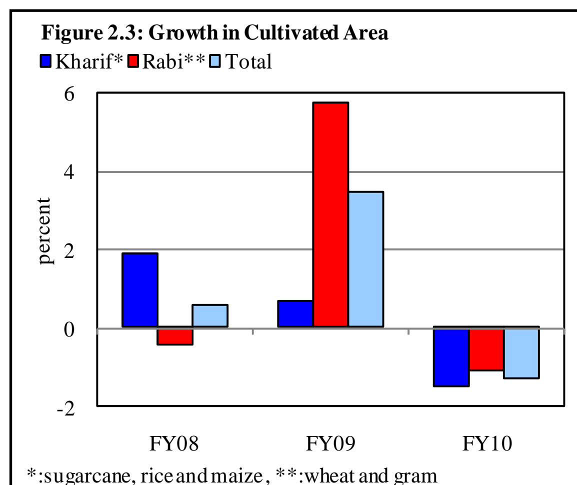
Despite water shortages and unfavorable weather conditions during FY10, agriculture sector achieved a reasonable growth of 2.0 percent, against the target of 3.8 percent (see **Figure 2.2**). This growth is principally driven by an impressive performance by the livestock sector. The growth by major crops was hit hard by water shortages and lower prices of rice and sugarcane at sowing time resulting in decline in area under important major crops except cotton (see **Figure 2.3**). The impact of this was compounded by a fall in wheat and cotton yields. It is important to note that decline in wheat harvest would have been much greater, if farmers had not used balanced mix of nutrients in FY10. In fact, relatively lower prices of DAP helped farmers to offset the impact of water shortages.

Figure 2.2: Growth in Agriculture



E: estimates

Figure 2.3: Growth in Cultivated Area



*:sugarcane, rice and maize, **:wheat and gram

Contrary to expectations that growth by minor crops would be strong due to switch over of area from major to minor crops, initial information suggests that most of the minor crops also suffered from lower winter rains during FY10. On positive glimpse, strong domestic and external demand for livestock, adequate availability of fertilizer and agri-credit during FY10 helped the sector to contribute positively in overall economy.

Another positive development during FY10 was a significant contribution of agriculture sector in exports. While, it resulted in relatively higher domestic prices of most of the agri-produce, this will encourage farmers to continue efforts to increase output.

Cropping sector

Although FY10 wheat harvest slightly declined compared to the preceding year's record output, (see **Table2.3**) it is better than expectations given lower availability of irrigation water and winter rains. Even increased area under wheat cultivation in Punjab (by 0.8 percent) failed to offset the impact of lower yield. The impact of water shortages was further compounded by late sowing amid delayed sugarcane crushing, extended cotton picking, unfavorable weather (rising temperatures at pre-harvesting period), and weakened wheat seed size that led to decline in yield in Punjab. Despite fall in area under wheat and water shortages, Sindh harvested a bumper wheat crop with efficient farm management, favorable weather, and balanced use of nutrients (see **Figure 2.4**).

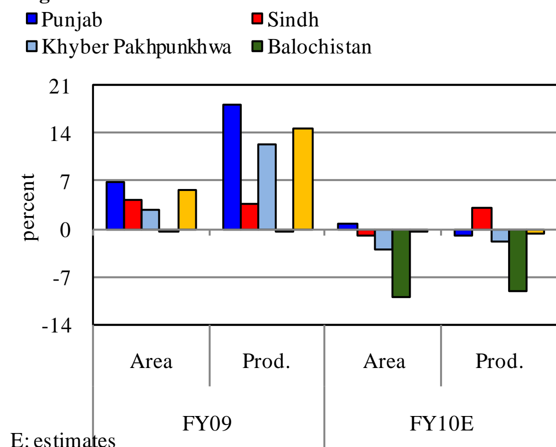
A second record high wheat harvest in FY10 and substantial carryover stocks of about 4.0 million tons of wheat[6] posed a challenge to the government for financing commodity operations and storage of the grain. The government intends to export 2.0 million tons of wheat to

Table 2.3 :Performance of Major Crop

Crops	FY08	FY09^{P}	FY10^{T}	FY10^{E}	% change in FY10 over FY09
Area Under Cultivation (000 hectares)					
Cotton	3,055	2,850	3,200	3,072	7.8
Sugarcane	1,241	1,029	1,106	939	-8.7
Rice	2,516	2,963	2,526	2,858	-3.5
Wheat	8,550	9,046	9,045	9,026	-0.2
Gram	1,107	1,092	1,022	-	-
Maize	1,037	1,062	1,039	915	-13.8
Production ('000 tons; cotton in '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	47,030	-6.0
Rice	5,561	6,954	5,949	6,741	-3.1
Wheat	20,959	24,032	25,000	23,863	-0.7
Gram	475	740	749	571	-22.8
Maize	3,109	3,548	3,414	3,204	-9.7
Yield (Kg/hectare)					
Cotton	649	720	710	709	-1.5
Sugarcane	51,507	48,635	51,109	50,085	3.0
Rice	2,210	2,347	2,355	2,359	0.5
Wheat	2,451	2,657	2,764	2,644	-0.5
Gram	429	696	733	-	-
Maize	2,998	3,341	3,286	3,502	4.8

P: provisional, T: target, E: estimates *Source: MINFA*

Figure 2.4: Wheat Area and Production Growth



E: estimates

[6] By end-March 2010.

resolve both these issues. However, given lower international prices, this policy entails a substantial fiscal cost. Ironically, it is difficult to reduce wheat support price that enable private sector to come forward and buy wheat for export and domestic consumption. It would also be challenging for the government to arrange financing and proper storage of targeted procurement quantity of wheat. In case of a below target procurement, wheat price in open market are likely to collapse and farmers would face unanticipated losses. This situation suggests that (a) government involvement in commodity market and price setting should be restricted only to ensure food security as excessive intervention creates distortions; and (b) there is a need to introduce futures market with all its prerequisites.

Minor Crops

A fall in the output of minor crops is quite surprising given a decline in area under major crops during FY10, a relative stability in the prices of most of the minor crops, as well as, an impressive performance of these on the exports front. However, since a number of minor crops are grown in non-irrigated (barani) areas, these were hit hard by the lower rains during FY10. In particular, pulses output dropped for the second consecutive year. Almost all minor crops, except potatoes, witnessed fall in output during FY10. Importantly, a drought in India created

Table2.4: Minor Crops

Commodities	Production[1] (thousand tons)		Consumption[1] (thousand tons)	Export[2] (thousand US$)		Domestic prices[3] (Rs/kg for Jul-Apr)	
	FY10	% change over FY09	FY10	FY10	% change over FY09	FY10	% change over FY09
Mash	13.3	-2.1	45.0	10.4	-99.2	121.9	62.8
Mong	126.1	-19.9	102.0	1,204.3	1,577.3	71.2	41.3
Masoor	11.7	-19.0	50.0	206.6	95.1	121.9	-0.6
Potato	3,007.9	2.3	1,700.0	15,671.9	68.6	22.9	15.7
Onion	1,533.2	-10.0	1,400.0	20,997.9	375.6	25.3	-3.1
Chillies *	104.5	-44.3	149.0	2,412.0	29.8	47.6	11.7

Sources: [1]MINFA, [2]SBP, [3]FBS.

* Total consumption of chilies based on per capita consumption for 2005-06 in HIES-FBS.

severe shortages or delayed harvesting of various agri-products in India. This situation provided an opportunity to Pakistani traders to export agri-produce to India and capture Indian share in other countries. The combined impact of lower production of minor crops during FY10 and substantial rise in exports resulted in surge in domestic prices (see **Table 2.4**).

Livestock Market Opportunities

Like minor crops, exports of livestock products increased[7] by 40.7 percent YoY to 24.1 thousand tons in Jul-Feb FY10.[8] Here too, rising exports put pressures on domestic prices in recent months. Reports[9] suggest that Middle East will remain a major market for livestock, particularly sheep, cattle, goats and camels. Pakistan may enhance its share in this region by providing quality livestock and adopting international *halal* standards (see **Box 2.1**). However, there is a concern regarding exports of live animals. Country should promote exports of value added products to earn better returns and protect domestic employment. It should also be noted that slaughtering also provides raw material to domestic leather industry, which is also an important export industry in Pakistan.

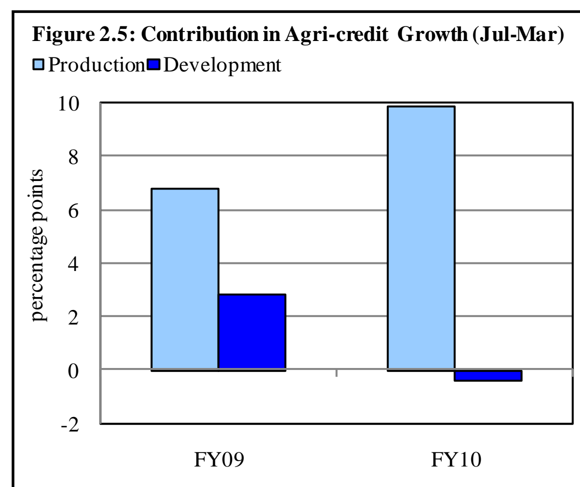
Box 2.1: MOU between Pakistan and Malaysia to Increase Livestock Trade

Pakistan will benefit from MoU signed between Pakistan and Malaysia regarding development of meat trade with standardization of *halal* meat in Pakistan with Malaysian assistance. To ensure quality and authentication, Malaysian International Halal Integrity (IHI) group, will assist to setup a Halal standard board and accreditation body in Pakistan. The alliance will also provide expertise with testing laboratories and arrange training series in Pakistan. This will not only increase livestock trade between Pakistan and Malaysia but will also improve export opportunities for livestock products to the Middle Eastern region in particular and Muslims around the globe.

Agriculture Credit Performance

Agri-credit disbursement[10] increased by 9.5 percent YoY in Jul-Mar FY10, slightly lower than the increase of 9.6 percent during the same period of FY09 (see **Table 2.5**). This was entirely due to a fall in developmental loans which offset the impact of 11.2 percent increase in production related loans (see **Figure 2.5**). The rise in the latter is attributed to higher credit

Figure 2.5: Contribution in Agri-credit Growth (Jul-Mar)



[7] Meat and meat preparations.
[8] Export of livestock products was only 9.9 thousand tons in FY07.
[9] Western Australian Agri-food and Fiber Market Outlook-Middle East http://agric.wa.gov.au/objtwr/imported_assets/content/amt/bn_middle_east_to_2015.pdf
[10] Agri-credit disbursement slowed to 7.6 percent during Jul-Apr FY10 compared with 10.9 percent last year.

disbursement for *rabi* crops amid surge in fertilizer off-take. On supply side, aggressive lending by the five large commercial banks (5 CBs) for production purposes has mainly supported the growth in agri credit. Consequently, the share of 5 CBs in agri-credit market rose to 51.2 percent. The rise in disbursement by these institutions is a reflection of (a) improvement in loan recovery by banks; and (b) declining NPLs during the first nine months of the current fiscal year. Disbursements by domestic private banks (DPBs) also exhibited a trend reversal and posted a marginal increase during Jul-Mar FY10. However, disbursements for development purpose from both 5 CBs and DPBs contracted during Jul-Mar FY10. In contrast, growth in agri-credit disbursement by ZTBL slowed in Jul-Mar FY10, mainly due to decline in lending for production purposes.

Table2.5: Agriculture Credit Growth (Jul-Mar)

Name of Banks	Disbursement		Recoveries	
	FY09	FY10	FY09	FY10
All CBs	**8.2**	**10.6**	**15.3**	**14.3**
5 Big CBs	14.2	14.5	13.7	19.3
DPBs	-4.8	0.3	19.3	1.7
Spec. banks	**12.5**	**7.3**	**14.9**	**2.0**
ZTBL	14.6	7.9	15.3	2.4
PPCBL	-11.5	-0.3	11.5	-1.1
Total	**9.6**	**9.5**	**15.1**	**10.5**

Crop-wise credit disbursement shows that lending for fruits and vegetables declined during Jul-Mar FY10. However, disbursement for other crops increased during Jul-Mar FY10 over the last year (see **Table 2.6**). It is important to note that the disbursement in absolute terms to fruits, vegetables and other crops (mostly minor crops) are significantly low. In particular, modern cultivation methods (drip irrigation, hydroponics, green houses, etc.), marketing and storage for most of the minor crops, vegetables and fruits require substantial investment. Access to institutional credit would help boost production and exports of these commodities.

Table 2.6: Agriculture Credit in Cropping Sector (Jul-Mar)

amount in billion Rupees, growth in percent

Groups	Amount			Growth	
	FY08	FY09	FY10	FY09	FY10
All crops	59.8	80.2	81.4	34.0	1.6
Vegetables	18.6	2.3	2.3	-87.6	-0.5
Fruits	3.1	3.1	2.9	-0.9	-4.5
Others	13.0	11.3	15.4	-13.4	36.3

Purpose wise Agri-credit

Lending performance of banks revealed their exposure to different sectors. Commercial banks are cautious in lending for developmental purposes. However, short term lending by 5-large CBs showed a considerable growth of 22.6 percent YoY during Jul-Mar FY10 compared with 9.8 percent in Jul-Mar FY09 (see

Table 2.7). In case of specialized banks, strong growth was seen in medium to long term financing by ZTBL probably due to tractor financing schemes. In addition, disbursement by ZTBL also increased for land improvement, orchards, godown, cold storage silos, and seed processing units. Furthermore, ZTBL put more efforts to maintain the production to development ratio at normal level (70:30) previously it was about 80:20. This would probably help improve farm mechanization in the country.

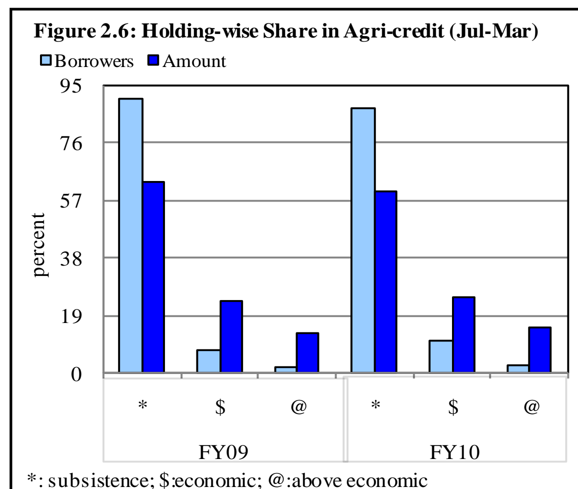
Table 2.7: Purpose-wise Agri-credit Growth (July-Mar)

Banks	Production		Development	
	FY09	FY10	FY09	FY10
5- large CBs	9.8	22.6	91.0	-67.4
ZTBL	11.4	-3.4	33.1	60.9
PPCBL	-0.4	1.6	-64.0	-24.1
DPBs	-2.0	3.6	-30.0	-40.9
Total	**7.5**	**11.2**	**29.9**	**-3.3**

Sector-wise Credit

A disaggregate analysis suggests that the growth in disbursement to farm sector was lower than the rise in credit to the non-farm sector yet for another year. Resultantly, the share of farm sector in total credit disbursement dropped to 69.0 percent by Jul-Mar FY10 compared with 70.0 percent in the same period last year. Within farm sector, the share of subsistence farmers is 87.3 percent in total number of borrowers but their share in total credit is only 60.0 percent (see **Figure 2.6**). Small farmers mostly rely on non-institutional resources for financial requirements, albeit at high interest rates and exploitative terms to market their produce.

Figure 2.6: Holding-wise Share in Agri-credit (Jul-Mar)



*: subsistence; $:economic; @:above economic

Despite slowdown in growth, disbursement to non-farm sector increased by a healthy 13.1 percent YoY during Jul-Mar FY10. Major sources of sustained rise in disbursement in this sector are livestock and fisheries sub sectors. High prices of meat, fish, and export of live animals attract investment in non-farm sector. Moreover, running finance for poultry sector also increased on account of record high prices of poultry amid strong domestic demand. It is expected that poultry

output would increase further and financing requirements for working capital as well as fixed investment would continue to grow.

Provincial Agri-credit Disbursement

The increasing share of Sindh province in agriculture credit exhibited a decline during the first nine months of FY10 (see **Figure 2.7**). As a mirror image, share of the Punjab increased reaching over 85 percent. Some of the decline in the share of Sindh is owed to restriction in changes in land record with the revenue department in the province.[11]

Figure 2.7: Share in Agri-credit Disbursement (Jul-Mar)

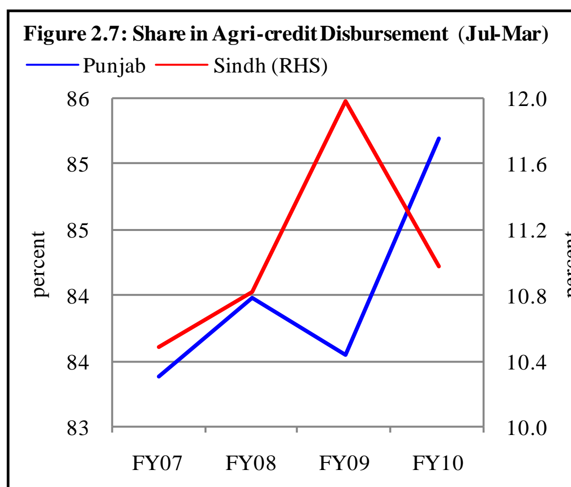


Table 2.8: Agriculture Credit Disbursement

billion Rupees

	FY07	FY08	FY09	FY10
Punjab	92.8	116.7	127.0	142.4
Sindh	11.7	15.0	18.2	18.3
Khyber Pakhtunkhwa	6.1	6.1	5.8	4.7
Balochistan	0.3	0.3	0.3	0.4
Azad Kashmir	0.2	0.3	0.4	0.3
Gilgit - Baltistan	0.1	0.2	0.2	0.2
All Pakistan	111.2	138.6	151.9	166.3

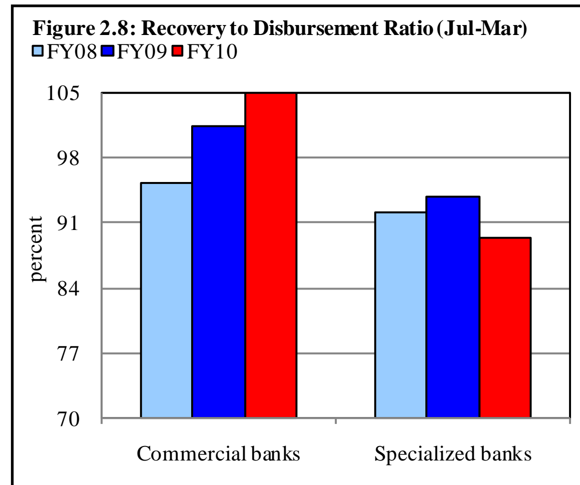
The major imputes to growth in Punjab came from a healthy 15.0 percent rise in production related loans, as developmental loans dropped by 8.5 percent during Jul-Mar FY10. In contrast, production related loans declined by 2.7 percent in Sindh during this period, probably showing the impact of restriction on land mutation.

The share of other provinces and regions is negligible in agri-credit (see **Table 2.8**). This may be due to both weak demand and inadequate supply. SBP is conducting regional seminars/workshops to create awareness regarding availability of agri-credit, to create demand for institutional finance. At the same time, provincial governments may speed up the provision of title documents to farmers that would help them to avail institutional finance. On supply side, specialized and commercial banks need to tap the potential of agri-credit market

[11] Revenue Department of Sindh has been restrained from effecting mutation of any entry in the village record. However, the same directives were eased in the case of already approved agricultural loans effective from 16th March, 2010 for a period of three months.

through increase in outreach and use of modern technology. For example, commercial banks in some developing countries are using mobile banking in far flung rural areas with the help of internet, laptop and identification equipment to get thumb impression. All these measures could help bolster the size of agri-credit market and increase the share of smaller provinces.

Figure 2.8: Recovery to Disbursement Ratio (Jul-Mar)



Recovery

Like weaker growth in credit disbursement, recovery also demonstrated a slower growth of 10.5 percent during Jul-Mar FY10 compared to 15.1 percent in the same period last year. However, recovery ratios[12] for commercial banks improved due to their focus on disbursements for short-term production loans (see **Figure 2.8**). In contrast, a bulk of disbursements by ZTBL was extended for long tenure developmental loans, thus their recovery ratios deteriorated during the first nine months of the current fiscal year.

Table 2.9: Fertilizer Off-take Growth

percent

	FY08	FY09	FY10
Urea			
Jul-Sep	20.2	-2.9	25.6
Oct-Dec	0.7	-3.3	26.0
Jan-Mar	60.9	10.0	-8.4
Oct-Mar (Rabi)	23.2	2.7	8.7
Jul-Mar	22.2	0.9	13.6
DAP			
Jul-Sep	76.5	-56.7	376.9
Oct-Dec	-36.7	-22.6	24.0
Jan-Mar	-50.0	111.1	10.5
Oct-Mar (Rabi)	-37.9	-6.9	20.9
Jul-Mar	-24.1	-20.8	77.3
Total (urea and DAP) Jul-Mar	9.3	-3.0	23.8
Oct-Mar (Rabi)	3.1	0.8	10.9

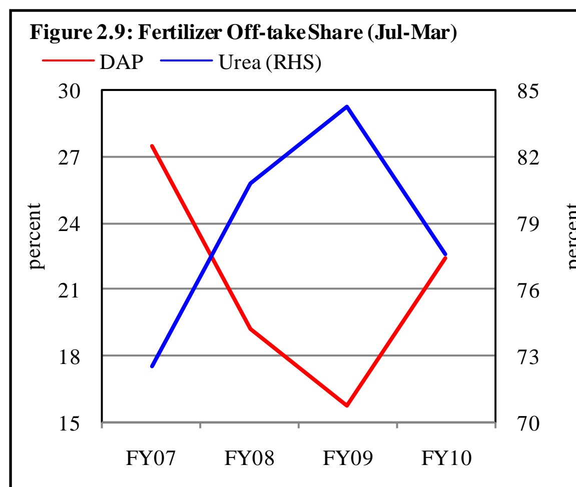
Fertilizer off-take

Following higher commodity prices of most of agriculture commodities, farmers increased fertilizer off-take to enhance crop yields. Fertilizer off-take increased by 23.8 percent in Jul-Mar FY10 as against 3.0 percent fall during the corresponding period of FY09. This increase is mainly attributed to lower

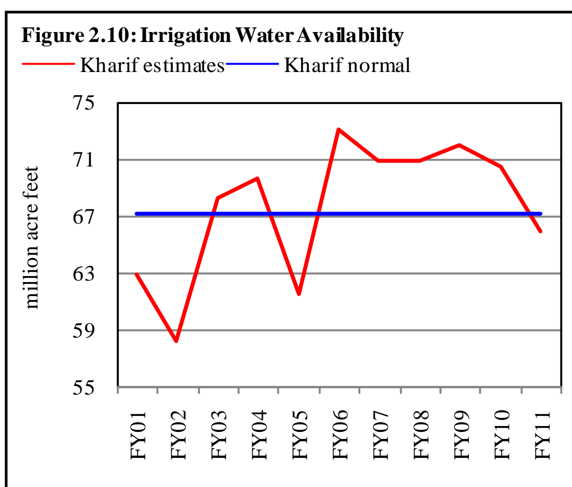
[12] Ratio of recovery to disbursements.

fertilizers prices than last year, ample availability, improved farm income and strong commodity prices. During Oct-Mar FY10 (*rabi*) fertilizer off-take increased by 10.9 percent compared with 0.8 percent in the same period last year (see **Table 2.9**).

Higher off-take is largely due to strong increase in DAP, which recovered with an impressive growth of 77.3 percent in Jul-Mar FY10 against a decline registered during the preceding two years. Higher DAP off-take during pre wheat sowing period proved a wise decision as farmers were able to make heavy purchases when DAP prices were at their lowest levels. During the preceding year, farmers used excessive urea instead of DAP due to higher prices of the latter. However, share of DAP in total fertilizer off-take increased during Jul-Mar FY10 as a result of use of balanced nutrients mix (see **Figure 2.9**).



Urea off-take also increased by 13.6 percent during Jul-Mar FY10 compared with only 0.9 percent rise in the same period last year. Its off-take mainly increased in the first two quarters of FY10, crucial growth period of *kharif* and sowing of *rabi* crops. Urea off-take during the third quarter, however, declined by 8.4 percent against 10.0 percent increase in Q3-FY09. Overall off-take during *rabi* FY10 (Oct-Mar) also registered 8.7 percent increase compared with 2.7 percent last year.



Given the positive impact of balanced use of fertilizers on yields during FY10,

particularly on wheat crop,[13] farmers are likely to continue this practice. However, uninterrupted availability of fertilizers at reasonable prices coupled with clear price incentives are some important factors to ensure the use of balanced mix of the nutrients.

Irrigation Water

IRSA[14] estimated a 6.4 percent drop in irrigation water availability for FY11 *kharif* season on top of a 2.1 percent decline in the same season last year (see **Figure 2.10**). Consequently, irrigation water availability would be 1.9 percent less than the normal levels for *kharif* FY11. The dropping level of irrigation water[15] poses a risk to the agriculture and the economy; urgent measures are needed to improve water management and efficient use of available water. Inadequate storage capacity of reservoirs in the country and waterworks by India are adding to the stress.

In addition, power shortages, rising prices of diesel oil and deepening underground water level also make tube-well water expensive for farmers. It is pertinent to note that *kharif* season is traditionally influenced by the glaciers melting in May and June, whereas the monsoon rains play an important role in filling up the major reservoirs and improve river/canal supply.

Outlook-Kharif FY11

Despite water shortages prospects for *kharif* FY11 are bright due to increasing use of quality seeds – Bt cotton and rice hybrid seed, sufficient fertilizer availability and clear incentives in terms of strong commodity prices. Government supportive policies such as (a) Rs 500 per bag subsidy on potash to promote balanced use of fertilizer; and (b) distribution of 10,000 tractors under Benazir Tractor Scheme, would also help increase

Table 2.10 : Crop Targets

area in '000 hectares; production in '000 tons

Crops	FY10		FY11	
	Area	Production	Area	Production
Cotton	3,200	13,360	3,200	14,000
Rice	2,526	5,949	2,708	6,048
Sugarcane	1,106	56,527	1,070	53,665
Maize	1,039	3,414	1,010	3,452
Mung	205	126	232	160
Mash	27	13	30	15
Chillies	49	105	65	158

Note: cotton in thousand bales of 170.09 kg each

[13] FY10 wheat yield could have dropped substantially due to water shortages.
[14] Indus River Water Authority.
[15] Pakistan is fast moving from being a water stressed country to a water scarce country, groundwater is over-exploited and polluted in many areas; most of the water infrastructure (even some of the major barrages) is in poor repair (World Bank, 2006).

enthusiasm among the farmers. There is a strong likelihood that FY11 cotton, sugarcane and rice harvests would surpass their targets (see **Table 2.10**). However, final outcome will mainly be determined by the favorable weather and water availability.

2.2 Large-Scale Manufacturing

Growth in LSM sector gained further momentum in Q3-FY10, largely in response to rising domestic consumption as well as global recovery (see **Table 2.11**). Specifically, a large part of the LSM growth was driven by a sharp rise in consumer durable industries including automobiles and consumer electronics. Furthermore, in textiles, pharmaceuticals, and chemicals sub-sectors manufacturers benefited from rising export orders. As a result, LSM index showed a strong growth of 9.6 percent in Q3-FY10; the strongest quarterly growth since FY07. A number of positive developments reinforced growth January 2010 onwards and dispelled earlier fears of significant moderation, to a large extent.

Table 2.11: Performance of Selected Industries
percent YoY growth

	H1		Q3	
	FY09	**FY10**	**FY09**	**FY10**
Overall LSM	-4.8	1.6	-12.0	9.6
Consumer durable				
Cars & M. cycles	-42.4	22.9	-50.4	82.9
Cons. electronics	-14.3	-3.2	-59.9	115.5
Construction-led				
Cement	2.3	15.7	12.2	3.4
Steel coils & sheets	-28.7	-8.8	-17.6	4.3
Paints	18	-4.4	13.9	9.2
Transformers	-4.4	-26.2	-38.0	51.6
Export-led				
Cotton cloth	-0.3	-0.3	-0.4	1.1
Cotton yarn	-0.5	-2.1	0.3	-1.1
Pharmaceutical	0.9	4.9	2.7	12.2
Leather	2.5	26.9	5.5	17.3
Agriculture-led				
Fertilizer	22.4	1.7	18.6	43.8
Tractors	7	27.3	20.1	26.1
Agri. machinery	-37.8	51	50	21.5
Food	-4.4	-2.6	-16.3	-4.6

For detailed data please visit: www.statpak.gov.pk

For instance, the growth in consumer auto industry proved resilient to frequent upward price adjustments by local auto assemblers. The strong demand was supported by banks' renewed interest in consumer finance business January 2010 onwards. Anecdotal evidence suggests that auto assemblers and banks established liaisons whereby a number of banks are offering car-financing at reduced mark-ups for specific car brands.

Similarly, it was earlier feared that the activities in textiles might slow down with the end of cotton season as a large part of textile sector activities in H1-FY10 were observed in low value-added sector (ginning and spinning). However, the pick-up in value-added textile exports has eased these concerns. Specifically, the

imposition of quota on yarn exports improved the availability of raw material for high value added textiles which explains at least a part of pick up in high value-added textile exports in the third quarter.[16] Nonetheless, the value added textile sector is still complaining of high yarn prices and demanding the imposition of 25 percent regulatory duty along with quota restrictions on yarn export. On the other hand, the spinning sector that suffered huge losses in previous 3 years due to depressed global cotton and yarn prices wants to benefit from favorable prices in FY10 and is therefore against any interventions to free market. Succumbing to rising pressures from both the stakeholders, the government decided on May 12, 2010, to impose 15 percent regulatory duty (for 60 days) but withdrew the quota restrictions on yarn exports.

Finally, demand for electronic appliances remained strong. Anecdotal evidence suggests that the last year's low sales of cooling appliances have shifted the deferred demand to this year. Nonetheless, the fear of slowdown in manufacturing growth cannot be disregarded given the prevalent energy bottlenecks, rising commodity prices and a vulnerable law & order situation. From the capacity point of view, however, it appears that the growth momentum can be maintained with better administrative mechanism and utilizing available export opportunities.

Table 2.12: Capacity Utilization in Selected Industries (estimated)

percent

	Annual utilization					Jul-Mar	
	FY05	**FY06**	**FY07**	**FY08**	**FY09**	**FY09**	**FY10**
POL	88.4	88.2	87.4	89.9	82.9	81.6	75.0
Cement	91.3	88.6	74.3	72.0	68.0	65.4	67.7
Wheat milling	16.5	16.5	17.6	17.0	17.3	17.1	16.5
Edible oil & ghee	42.5	46.9	48.3	46.9	44.9	44.2	44.0
Sugar	47.9	45.5	54.3	72.8	49.1	65.4	63.1
Pig iron	92.5	62.4	82.0	80.8	64.3	69.5	42.1
Coke	79.7	18.8	33.6	30.0	43.7	45.3	36.2
Cars (single shift)	77.3	98.0	97.9	89.9	45.5	44.8	64.4

Source for installed capacity: OCAC, APCMA, PFMA, PVMA, PSMA, Pakistan Steel, FBS

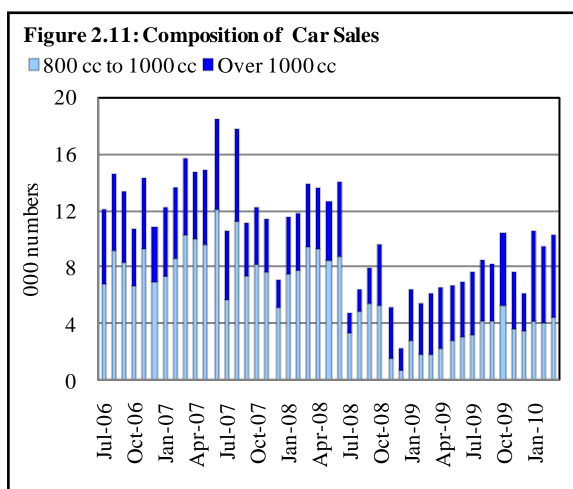
Specifically, production levels are still low in a number of industries despite a high growth, and the manufacturing capacity is largely under-utilized in many industries (see **Table 2.12**).

[16] Government first imposed a quota of 50 million kg per month via SRO 26(I)/2010. However, the quota was reduced to 35 million kg per month March 01, 2010 onwards vide SRO 119(I)/2010.

For instance, there is excess capacity in food sector which can be brought on line with appropriate market mechanism. This is especially true in case of sugar manufacturing where sugar production declined for the second consecutive year due to conflicts among cane growers and mill owners over price settlement during FY08 and FY09. Similarly, the country's capacity for wheat milling is reported to be around four times larger than the current demand for wheat products. Wheat milling activities have been low since FY08 when the government banned export of wheat products to Afghanistan due to domestic wheat shortages.[17] Although the ban was lifted in January 2010 due to better availability of wheat in the country, a large price differential in domestic and international wheat prices does not allow these exports to increase substantially. Flour mill owners are therefore demanding from the government to also allow export of wheat products at subsidized rates in addition to allowing wheat exports. The export of wheat products will result in increased value-addition and employment in the country.

Likewise, liquidity shortages driven by fiscal constraints in petroleum refining and metal industry are forcing manufacturing firms to operate at low utilization level. Not only has this caused a decline in domestic production but also led to increased import pressures in the face of high domestic demand. For instance, the refining industry is operating at around 76 percent utilization level as against over 86 percent utilization in the last few years. Similarly, Pakistan's largest steel mill is going through severe financial constraints. The mill is facing acute raw material shortage and is not able to utilize a large part of its capacity despite strong demand. Resultantly, import payments during Jul-Mar FY10 increased by 18.5 percent on petroleum products and 35.8 percent on pig iron over Jul-Mar FY09. Furthermore, the existing production levels in automobiles and cement sector are quite low compared with the available capacities. In case of automobiles, low production levels are seen mainly in cars with engine capacities within 1000 cc, which cater to the demand of medium-income group and mostly financed through banks (see **Figure 2.11**). With the renewed

Figure 2.11: Composition of Car Sales



[17] Exports to Afghanistan used to constitute 15 to 25 percent of total wheat milling in the country.

interest of banks in car financing, it appears that sales and production levels of automobiles will increase in coming months.

Besides available capacities, local manufacturers may also benefit from opportunities arising from export demand. The exporting industries should take benefit of appreciation of Chinese and Indian currencies which renders their exports more expensive in the global markets. Moreover, some improvement in liquidity of textile firms with the provision of 2.5 percent mark-up rate facility[18] (as per the textile policy 2010) as well as a rise in profitability of most textile companies also provides opportunity to these firms benefiting from rising global demand. Similarly, in case of pharmaceuticals and cement industries, rising demand in African countries provides a strong opportunity for local manufacturers to increase export penetration.

Thus, given the demand potential and capacities available in the sector; the debate on sustainability of LSM growth boils down to the issue of energy sufficiency. So far in FY10, gas supplies seem more or less sufficient to cater to LSM requirements. However, with the commissioning of a new gas-run steel plant in mid-May 2010, rising capacity utilization of a newly commissioned fertilizer plant and induction of new fertilizer capacity in Q1-FY11 will add to pressures on gas demand. Urea production, in particular, entails the usage of natural gas as both a raw material and as a source of fuel. Moreover, increasing use of gas-based generators and other appliances has lifted up domestic demand.

The rising demand for gas in fertilizer and household sectors means that the availability of gas for thermal generation will be less as both household/commercial sector and fertilizer production hold the top two priority positions for gas supplies. However, to improve gas supply to power sector, the government has decided to suspend CNG supplies for one day in a week to ensure supply to power sector. Although such re-allocations might help in lessening economic losses for a short term, for sustainable growth, there is a need to enhance gas provisions. In this regard, it is unfortunate that gas exploration activities have weakened significantly in the past few years mainly due to natural decline in gas reserves. Nonetheless, with a global decline in gas prices owing to adoption of cost effective extraction technologies, the import of gas might be a convenient option going forward.

As far as electricity supplies are concerned, the energy summit in end-April 2010 has taken a number of sweeping measures for energy conservation. Moreover, it

[18] SMEFD Circular No. 03 of 2010.

is also expected that at least a couple of private power projects would be completed by end of 2010. Besides electricity generation, government is also working at replacing existing transmission infrastructure to reduce transmission & distribution losses as already evident in recent increase in production of transformers and other power related products.

From long-run sustainability perspective, it is crucial to bring dams' construction on top priority to avoid possible water shortages as well as to increase cheaper hydel generation. Equally important is to expedite the infrastructure build-up to tap available coal reserves in the country. This would not only ensure energy sufficiency at low cost for economic activities but will also be helpful in mitigating pressures of increasing growth on energy driven external imbalances. Specifically, energy related imports have reached 4 percent of GDP in FY09 and FY10 and any substantial increase in growth will further increase import pressures.

2.3 Services Sector

The first nine months data for FY10 on major indicators reinforces the earlier assessment of an above-target services growth in FY10. Initial estimates suggest growth of 4.6 percent in services sector compared with the target of 3.9 percent. Most of the improvement in growth during FY10 has come from *wholesale & retail trade* that benefited from rising LSM production and imports (see **Table 2.13**). Contribution from *public administration & defense* has also remained strong.

Table 2.13: Services Growth Rate Targets

	5-yr. avg. share	FY09r	FY10t	FY10p
Overall		1.6	3.9	4.6
Transport & comm.	19.5	2.7	3.0	4.5
Wholesale & retail trade	33.6	-1.4	3.3	5.1
Finance & insurance	10.6	-7.0	3.0	-3.6
Public admin. & defense	11.5	3.6	4.0	7.5
Community & personal	19.5	8.8	6.0	6.6
Ownership of dwellings	5.3	3.5	3.6	3.5

r=revised, t=target, p=provisional; Source: Provisional estimates by FBS; retrieved on May 21, 2010 from http://www.statpak.gov.pk/depts/fbs/statistics/national_accounts/national_accounts.html

Secondly, activities in transportation services also witnessed a sharp increase in FY10 due to higher demand for both public and private cargo transport. This is evident from higher sales of petrol and passenger vehicles (approximately 58 percent of total transport value-addition[19]), as well as increased sea and road freight.[20] Within the goods transport, it appears that the sea transport constituted the bulk of FY10 growth as PIA has

[19] Includes Pakistan Railways, PIA, buses, passenger wagons, taxies, and rikshaws.

reported a decline in cargo during Jul-Mar FY10. However, the national shipping company (PNSC) could not benefit from this recovery in the face of tough global competition in the form of low tariffs as well as shortage of vessels.[21] Consequently, a part of the shipping demand had to be met via imports.[22] However, the recent addition of two oil-carrier ships and scrapping of outdated vessels could strengthen earnings in the next quarter.

Similarly, the *telecommunications* sector presents a mixed trend. While the largest fixed line services provider posted a decline in earnings during FY10, the growth in cellular companies is expected to register some recovery due to increase in the subscriber base by 2.0 percent over June 2009. This increase in mobile subscribers is despite the fact that PTA discarded three million unverified mobile SIMs in FY10, and has largely come about in response to the fiscal incentives introduced in FY10.[23] The growing demand has been followed by network expansion projects by the cellular services' suppliers.

Public administration & defense registered the strongest growth within the services sector. In particular, an inevitable expansionary fiscal deficit mainly due to war against terror has helped significant growth under *public administration & defense* sub-sector in FY10.

Finally, the financial accounts of most listed banks confirm higher earnings in FY10, despite a rise in provisioning expenses, mainly due to volumetric expansion and high spreads (see **Tables 2.13** and **2.14**). However, as a result of a fall in the value addition by other components, growth in *finance & insurance* declined during FY10.

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[20] Interestingly, despite the sharp increase in the sales of diesel-run trucks and LCVs, a similar growth was not observed in diesel sales. Anecdotal evidence suggests that diesel is being smuggled into Pakistan via Iran where the fuel is highly subsidized.

[21] It appears that revenues of PNSC could have been higher if not for low crude-oil imports. In specific terms, the national shipping company has long-term contracts with three major refineries and due to circular debt issue, the refineries were not able to import sufficient crude quantities.

[22] Chartering of foreign ships increased to $24 million in Jul-Mar FY10, up from US$ 12 million last year.

[23] These included reduction in FED and activation charges on new mobile connections, custom duty reduction on the imports of mobile sets, and elimination of regulatory duty on mobile set imports. The resulting demand recovery is evident from a sharp increase in mobile phone imports during the review period.

Table 2.14: Indicators of Services Sector Performance

percent YoY growth unless mentioned otherwise

	Q3		*Jul-Mar*	
	FY09	**FY10**	**FY09**	**FY10**
Wholesale & retail trade (33.6)				
Credit to wholesale and commission trade	-5.5	-11.1	5.1	-14.9
Credit to retail trade	21.0	7.0	32.9	4.8
FDI in trade	-6.3	-53.6	-5.8	-53.6
Manufacturing growth	-12.1	9.7	-7.5	4.5
Import growth	-36.4	30.1	-6.6	-3.9
Transport (16.0)				
Cargo handling at ports	-8.0	11.9	-0.2	17.4
PNSC operating profit – Dec. latest	34.8	-33.2	12.1	-42.2
Commercial vehicles sale	-35.0	45.4	-15.7	16.7
HSD & MS sales for transport	17.1	-0.7	0.5	2.9
Transport & communication price index	21.4	11.3	30.5	2.1
PIA operating profit	-110.5	-132.7	223.4	-81.6
Passage earnings of Pakistani air companies	-0.7	12.7	8.1	-0.6
Trade volume	-16.9	29.7	-4.6	-8.8
Communication (3.0)				
Teledensity (percentage of population)	60.3	62.4	..	..
PTCL operating profit	20.7	22.5	-10.9	-6.7
Telecomm imports	-66.2	2.7	-52.4	-35.3
Mobile phone imports	-88.7	299.2	-76.0	54.6
Communication services exports	44.1	53.4	-16.7	136.1
Finance & insurance (10.6)				
Transfer of SBP profits to govt.	..	-29.0	22.9	101.6
PAT of 7 major banks	-16.1	10.4	11.9	19.0
Percent of advances at 12% or above - inc	84.0	82.0	..	..
Percent of deposits held at 8% or above - inc	57.2	53.2	..	..
Interest rate spread - stock	7.7	7.3	..	..
Interest rate spread - inc.	6.3	6.1	..	..
Financial services exports	114.6	-61.3	73.7	43.3
Insurance services exports	-35.7	41.5	45.6	-23.9
Government services (11.5)				
Government borrowing	62.0	101.1	50.8	137.5
Govt. services exports	-58.3	171.7	10.3	28.0

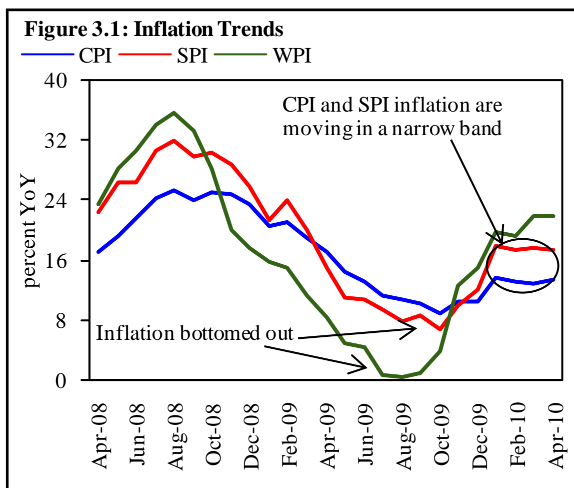
Figures in parentheses are 5-year average contribution to services value-addition.

3 Prices

3.1 Overview

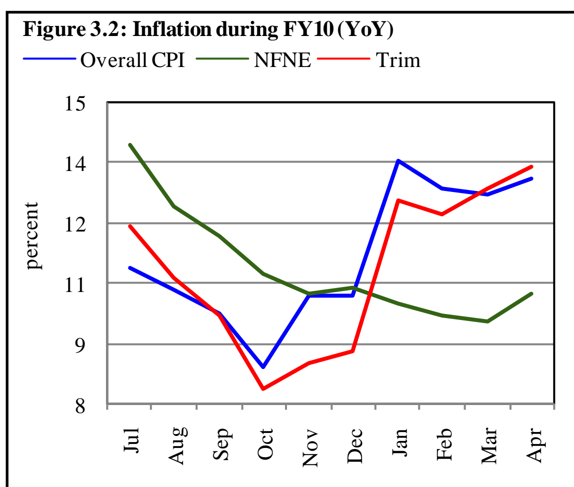
Inflationary pressures eased during H1-FY10 resurged January 2010 onwards[1] (see **Figure 3.1**). Importantly, inflationary pressures largely emanated from non-core (food & energy) components. Rise in food and energy prices have strong second-round effects, therefore, core inflation is also likely to increase in months ahead. Inflation measured by both CPI and SPI is moving in a narrow range; evident from lower variability during Jan-Apr FY10.[2]

Figure 3.1: Inflation Trends



Headline CPI inflation (YoY) rose to 13.3 percent by April 2010, slightly higher than 12.9 percent seen in the preceding month, but significantly higher than the short-term low of 8.9 percent in October 2009. Core inflation measured by 20% trimmed mean is in the trajectory of headline CPI inflation (see **Figure 3.2**). However, core inflation measured by non-food non-

Figure 3.2: Inflation during FY10 (YoY)



[1] Average CPI inflation was 10.3 percent during H1-FY10, rose to 13.2 percent in the third quarter of FY10.

[2] Standard deviation reduced to 0.4 during Q3-FY10 compared with 0.8 in H1-FY10 and 1.0 in Q3-FY09. A low standard deviation with high average inflation indicates persistence of inflation at high level.

energy (NFNE) was declining up to March 2010 and dropping to single digits, for the first time in 23 months. However, NFNE measure of core inflation also witnessed an uptick during April 2010, showing that inflationary pressures are strengthening (see **Table 3.1**). A resurge in NFNE and an unchanged trimmed mean indicate that inflationary pressures are broad-based and probably reflect second round effects of persistently high food and energy inflation in the economy during recent months.

Table 3.1: Different Dimensions of Inflation

percent YoY

	Apr-09	Mar-10	Apr-10
Overall CPI	**17.2**	**12.9**	**13.3**
Food group	17.0	14.5	14.5
Non-food group	17.3	11.6	12.2
HRI	18.9	12.0	11.2
WPI	**8.3**	**21.8**	**22.0**
Food group	17.2	16.3	15.2
Non-food group	1.8	26.5	27.7
SPI	**15.0**	**17.6**	**17.4**
Core inflation			
NFNE	**17.7**	**9.9**	**10.6**
NFNE excl. HRI	16.6	8.0	10.0
Trimmed	17.6	12.7	12.7
Trimmed excl. HRI	17.4	13.0	13.5

Increase in inflation in recent months is largely attributed to a number of factors, such as: (a) higher international commodity prices, particularly crude oil, metals, pulses and cotton; (b) upward adjustment in electricity tariffs and administered domestic fuel prices; (c) relatively poor harvests amid water shortages coupled with strong growth in exports of vegetables, fruits, livestock, etc.,[3] (d) expansionary fiscal stance; and (e) recovery in domestic economy as indicated by a 4.4 percent rise in LSM growth during Jul-Mar FY10 against a fall of 7.4 percent in Jul-Mar FY09.

Small resurgence in inflationary pressures was already anticipated given scheduled upward revisions in electricity tariff and pressures on international prices of crude oil. As elaborated in previous Monetary Policy announcement at end-March 2010, persistence of high inflation was one of the reasons that the central bank adopted a cautious monetary stance. Moreover, expansionary fiscal stance also infuses inflationary pressures. However, SBP was mindful of the fact that an increase in policy rate to curb inflationary pressures may hurt the recovery in manufacturing sector, which is in its initial stage. In this backdrop, SBP forecasts suggest that annual average headline CPI inflation will be slightly higher than estimated earlier, falling in the range of 11.5 – 12.5 percent during FY10.

[3] For details see Section 2.1 Performance of Agriculture Sector.

3.2 Consumer Price Index (CPI)

Headline CPI inflation (YoY) is hovering around 13 percent for the fourth consecutive month in April 2010 (see **Figure 3.3**). Although, CPI inflation at 13.3 percent by April 2010 is substantially lower than the 17.2 percent seen in April 2009, it remained at uncomfortably high level. Importantly, while inflation was sharply declining in the corresponding period, inflation is moving in a narrow range in recent months. This persistence in inflation is largely due to; (a) high-food inflation (see **Figure 3.4**); (b) upward adjustment in electricity tariffs; and (c) rise in the prices of key fuels. Upward pressures on CPI inflation are also evident from the fact that share of number of items registering double digit inflation during recent months has been increasing since November 2009 (see **Figure 3.5**). Most of the commodities witnessing higher increases in prices were from food and energy sub-groups. However, a rise in CPI non-food inflation from 11.6 percent in March 2010 to 12.2 percent in April 2010 is also contributed by; (a) impact of higher cotton prices on apparel & textiles; (b) rise in the prices of medicines; and (c) sharp upward revision in television license fee.

Figure 3.3: CPI Inflation (YoY)

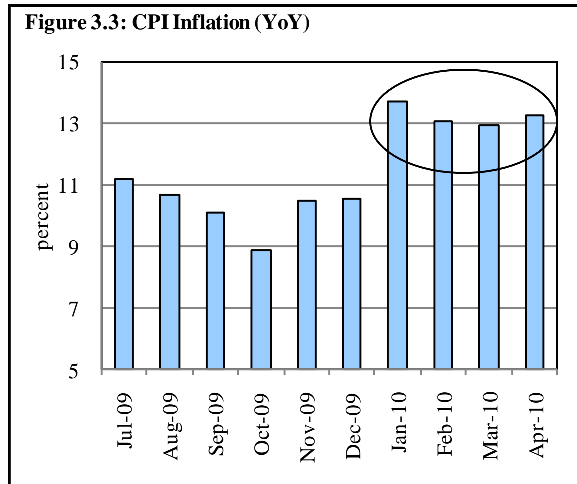
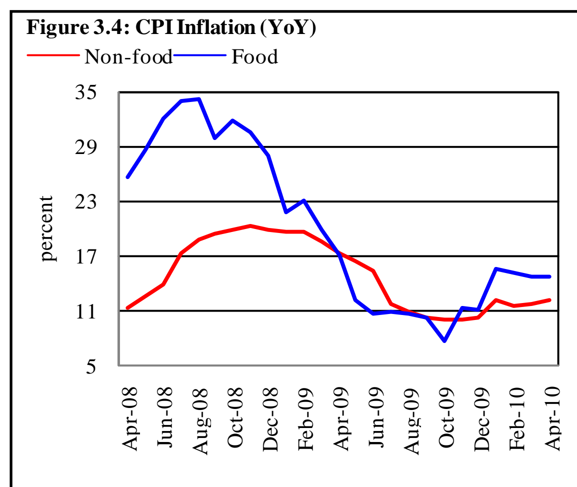
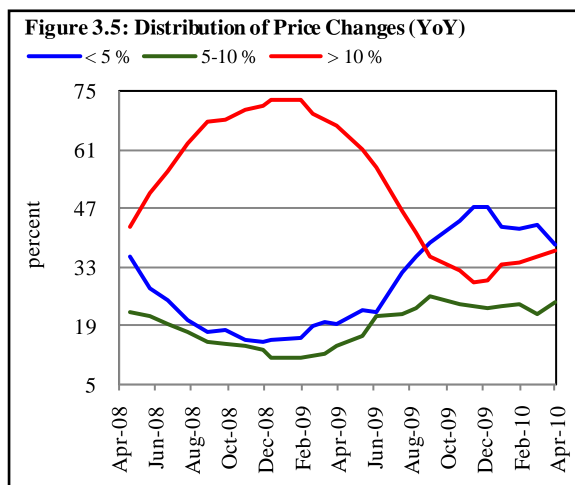


Figure 3.4: CPI Inflation (YoY)



At glance, **Table 3.2** reveals that major contribution in CPI inflation was from food and energy items. Out of top ten commodities contributing in CPI inflation during April 2010, six were from food group and three from energy group.



Combined weighted contribution of these food items[4] in overall CPI inflation was 32.1 percent. A very high contribution (9.6 percent) in food inflation is from wheat flour, which is mainly a function of government's pricing policy. While wheat price in international market plummeted, its impact on domestic market has not been fully realized. This is despite the fact that the country achieved bumper wheat harvest for the consecutive two years and ample domestic stocks.

On the other hand, domestic fuel prices are increasing due to rising international oil prices. It suggests that the government's involvement in price setting mechanism is harmful for the consumers. It becomes more important when government is unable to extend subsidies to consumers due to either limited fiscal space or in compliance with IFIs. Reduction in subsidy on electricity is the case in point here. The combined impact of fuel and electricity charges on inflationary expectation cannot be underestimated. While a part of food inflation is due to significantly lower availability of vegetables and fruits, increased transportation cost is also responsible for rising food prices. In contrast, despite a downtrend,

Table 3.2: Weighted Contribution in CPI Inflation (YoY)

		Weights	Apr-08	Apr-09	Jul-09	Feb-10	Mar-10	Apr-10
1.	House rent index	23.4298	15.4	24.4	34.9	22.1	21.0	19.1
2.	Milk fresh	6.6615	8.7	6.7	10.4	8.1	8.7	9.2
3.	Meat	2.6981	1.5	3.7	4.9	5.5	6.4	6.6
4.	Electricity	4.3698	1.4	4.9	7.0	5.3	5.2	5.0
5.	Wheat flour	5.1122	15.8	9.9	7.9	9.6	9.8	4.8
6.	Sugar	1.9467	-1.5	4.8	4.9	7.4	6.1	4.6
7.	Petrol	1.7253	3.5	-2.1	-7.2	2.9	3.5	3.8
8.	Vegetables	1.7623	2.2	1.2	4.0	4.4	4.4	3.6
9.	Natural gas	2.0458	1.2	4.3	0.8	4.0	4.0	3.5
10.	Vegetable ghee	2.6672	10.5	-4.0	-6.1	2.8	3.0	3.3

[4] Having a total weight of 20.8480 percent in CPI basket.

house rent index (HRI) has continuously remained higher contributor in CPI inflation[5] due to its high weight.

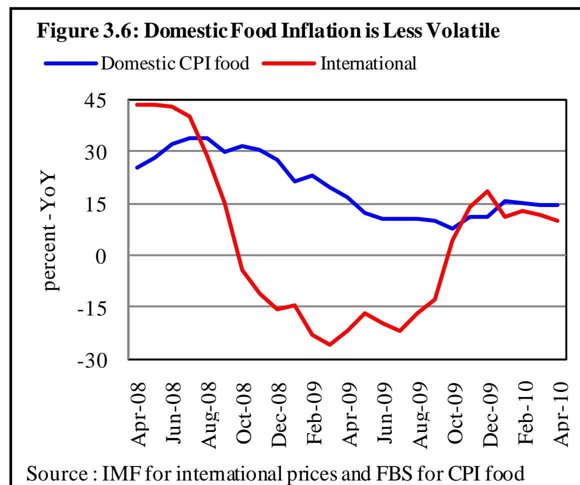
3.2.1 CPI Food Inflation

CPI food inflation bottomed out at 7.5 percent YoY in October 2009, has bounced back in double digits since then. Encouragingly, while it showed no change in April compared to March 2010, it remained at very high level of 14.5 percent. The impact of declines in the prices of sugar, wheat and some perishable commodities during April 2010 relative to the preceding month was offset by the increases in the prices of pulses, milk, rice, tomatoes and some beverages.

Domestic sugar prices retreated due to falling international prices since January 2010. International sugar prices plummeted due to increased production in Brazil and India.[6] However, going forward, sugar-importing countries are expected to make fresh purchases to replenish domestic stocks. Therefore international sugar prices are likely to rise again by mid 2010. In this background, it would be prudent to import adequate sugar to meet strong domestic demand in summer and holy month of Ramadan.

A recent moderation in wheat prices may not last long due to aggressive public procurement and possible export. A major contribution to CPI food inflation came from dairy & livestock products. A part of this rise is coming from increasing cost of transportation and fodder. However growing domestic as well as external demand is also instrumental in a continuous surge in the prices of meat and milk.

Figure 3.6: Domestic Food Inflation is Less Volatile



Source : IMF for international prices and FBS for CPI food

[5] HRI has the highest weight of 23.43 percent in CPI basket. The high contribution of HRI in CPI inflation is primarily due to its high rate in the consumer basket. Therefore, if the objective is to analyze inflation itself, then HRI contribution becomes less significant. Thus major drivers of inflation remain food and energy items.

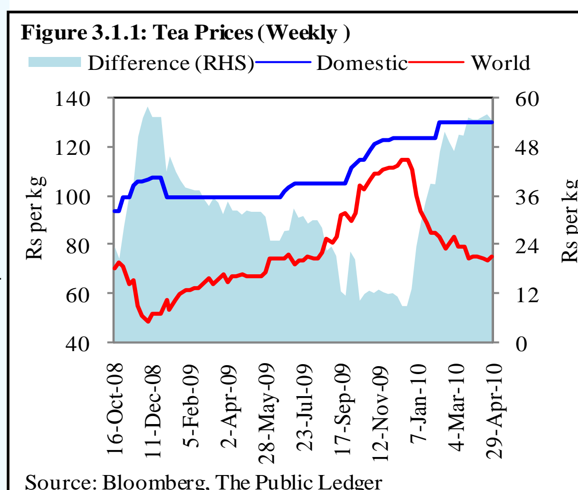
[6] Sugar output is estimated to increase by 17.0 percent YoY (from 33.1 to 38.7 million tons) in Brazil during 2010. Indian sugar output estimates have been gradually revised upward from 14.5 million tons to 18.5 million tons during 2010.

It is instructive to note that a sustained rise in the prices of some food commodities (e.g., milk & meat), nominal stickiness in domestic food prices, as well as, government intervention led to a lower volatility in domestic food inflation relative to highly volatile international food prices (see **Figure 3.6**). However, domestic food inflation remained higher most of the time, which implies that domestic consumers are paying the cost of: (a) lower productivity in some areas; (b) imperfect markets; and (c) government intervention in commodity prices. It has also been observed that domestic prices of most of the food items rise with the surge in their international prices. However, in case of a decline in international prices, the pass through is largely insignificant. For example, tea prices rose in international market during Q4-CY09 then came back to their normal levels by March 2010. In contrast, domestic tea prices are witnessing a continued uptrend (see **Box 3.1**). Price trends of sugar, wheat, rice, palm oil etc. also reveals similar story.

Box 3.1: Tea Prices

International tea prices surged above US$ 5.0/kg by end-October 2009 from its average of US$ 3.5/kg for the last one year (November 2008-October 2009). The departure from its normal range was mainly attributed to reduction in production due to drought in key tea producing countries, mainly Kenya. However, international tea prices peaked out at US$ 5.5/kg by end-December and retreated to their normal levels (US$ 3.6/kg) by end-April 2010 after improvement in weather conditions.

Figure 3.1.1: Tea Prices (Weekly)



Source: Bloomberg, The Public Ledger

Domestic tea prices also responded to rise in international prices, almost immediately. However, despite a significant downward correction in international prices, domestic tea prices continued to rise in recent weeks (see **Figure 3.1.1**). A part of adjustment in domestic tea prices is justified given rise in electricity tariff, transportation cost and pressures on wages. However, these components have very small share in cost of tea supplied in the domestic markets. The disappointment here is that the domestic tea prices did not see any correction, rather the uptrend is continued.

A plausible justification of accumulated inventory can be made. However, if traders enjoyed inventory gains when international tea prices were rising (Oct-Dec 2009), a continued rising trend in domestic tea prices seems unjustified, since international prices are declining from January 2010.

3.2.2 CPI Non-food Inflation

CPI non-food inflation (YoY) remained in double digits and moving in a narrow range during recent months. CPI non-food inflation was recorded at 12.2 percent in April 2010, slightly higher than 11.6 percent registered in the preceding month, but significantly lower than 17.3 percent in April 2009 (see **Figure 3.7**). In fact, the

Figure 3.7: Components of CPI Non-Food Inflation

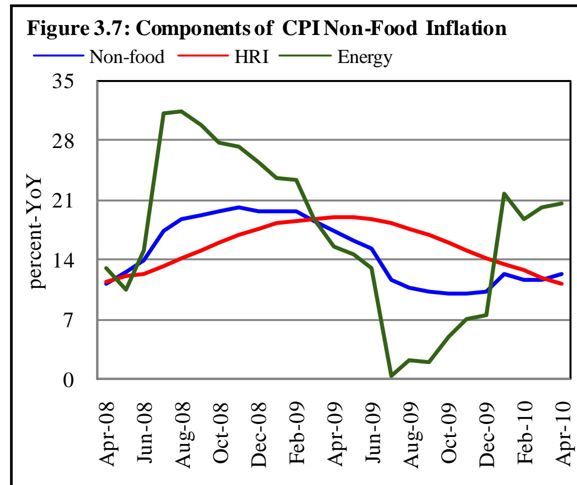


Table 3.3: CPI Non-food Inflation (YoY) by Groups

percent

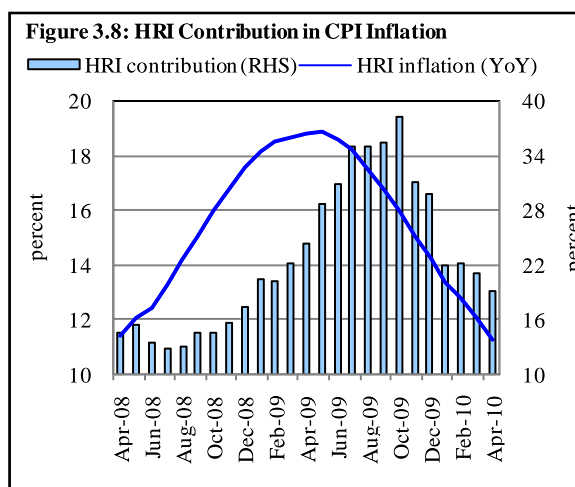
		MoM			YoY		
	Weights	**Apr-09**	**Mar-10**	**Apr-10**	**Apr-09**	**Mar-10**	**Apr-10**
Non-food group	59.6584	0.9	0.8	1.5	17.3	11.6	12.2
Apparel, textile, etc.	6.0977	0.7	0.8	2.2	12.3	6.1	7.7
House rent	23.4298	1.3	0.6	0.6	18.9	12.0	11.2
Fuel & lighting	7.2912	0.0	-0.1	-0.4	26.7	17.1	16.7
Household furniture & equipment	3.2862	0.3	0.4	0.9	12.6	5.3	5.9
Transportation & communication	7.3222	0.1	3.4	5.8	8.6	14.0	20.5
Recreation & entertainment	0.8259	0.1	0.1	10.0	13.9	4.3	14.7
Education	3.4548	6.2	0.2	2.7	23.0	12.5	8.8
Cleaning & laundry	5.8788	0.0	0.3	0.4	16.0	8.6	9.1
Medicare	2.0704	0.1	0.2	2.6	13.4	6.0	8.6

impact of a slowdown in HRI and *education* sub-groups was more than offset by acceleration in *transport & communication, apparel, textiles & footwear, recreation & entertainment, cleaning & laundry* and *medicare* sub-groups during April 2010 over the preceding month.

Inflation in *transport & communications* sub-group surged as a result of rising crude oil prices in international market and subsequent upward adjustment in the prices of key fuels (see **Table 3.3**). *Apparel, textile & footwear* sub-group continued to exhibit acceleration since December 2009 mainly due to rising prices of cotton and cotton products (see **Box 3.2**).

The contribution of HRI in CPI is declining gradually (see **Figure 3.8**). However, the pace of this decline is slowing. In fact, a moderation in HRI inflation was principally a function of falling prices of cement amid weaker demand. However, a surge in the prices of other construction material, particularly iron bars and copper is offsetting the impact of lower cement prices. It is expected that downtrend in HRI would be reversed in early months of the next fiscal year.

Figure 3.8: HRI Contribution in CPI Inflation



3.2.3 Incidence of Inflation

Since present inflation continued to be driven by rising prices of food commodities, the incidence of inflation is disproportionately higher in low income groups. This suggests that targeted subsidy programs for low income households should be introduced to protect them from the rising prices of essential food items. However, recent surge in non-food inflation, particularly rise in the prices of fuels, apparel, laundry etc have also hit higher income groups as evident from higher non-food inflation for the highest income group (see **Table 3.4**).

Table 3.4: Income Group-wise CPI Inflation
percent YoY

Income group		Overall CPI	CPI food	CPI non-food
Up to Rs 3,000	Apr-09	17.7	18.5	16.7
	Mar-10	13.8	16.0	11.1
	Apr-10	13.5	15.4	11.1
Rs 3,001-5,000	Apr-09	17.8	17.8	17.8
	Mar-10	13.6	15.6	11.3
	Apr-10	13.4	15.2	11.3
Rs 5,001-12,000	Apr-09	18.0	17.3	18.7
	Mar-10	13.1	14.9	11.4
	Apr-10	13.2	14.8	11.6
Rs 12,000 and above	Apr-09	16.2	16.3	16.1
	Mar-10	12.5	13.6	11.9
	Apr-10	13.3	13.8	12.9

3.3 Wholesale Price Index

Inflationary pressuures are more evident in stubbornly high WPI inflation. WPI inflation rose to 22.0 percent YoY during April 2010 from its bottom of 0.3 percent in August 2009 (see **Figure 3.9**). While CPI non-food inflation is moving in a narrow range , WPI non-food inflation is increasing sharply. This is due to the direct impact of rising international prices of cotton, base metals and POL on WPI.

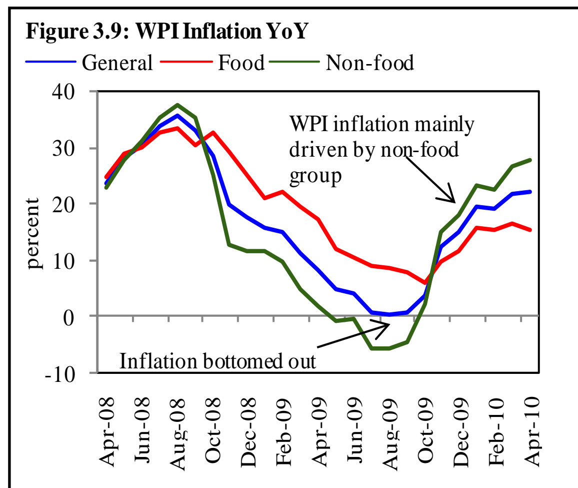


Figure 3.9: WPI Inflation YoY

During the initial months of FY10, WPI inflation was significantly lower than the CPI inflation. Nonetheless, WPI inflation surpassed CPI inflation in recent months. This divergence is explained by the surge in WPI non-food inflation as food inflation in both indices are moving in tandem (see **Figure 3.10**). In addition, bullish prospects of international commodity prices suggests that WPI inflation would remain strong in months ahead.

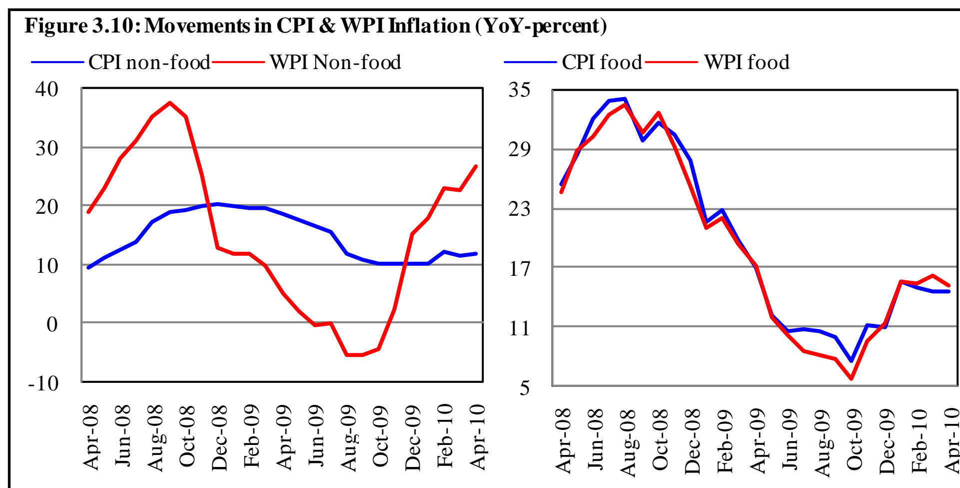
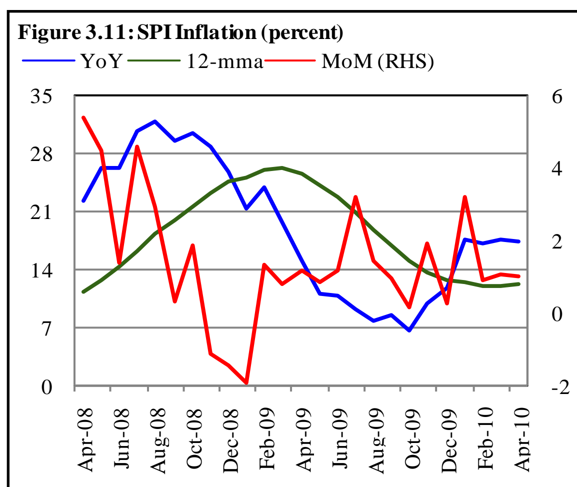


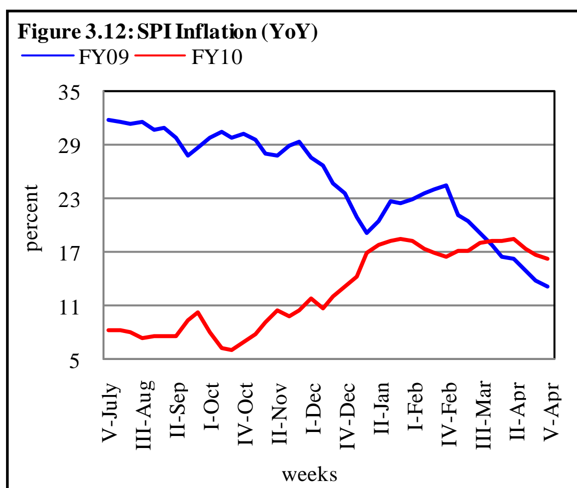
Figure 3.10: Movements in CPI & WPI Inflation (YoY-percent)

Within WPI non-food group, *raw materials, building material,* and *fuel & lighting*

sub-groups witnessed significant acceleration in inflation. Inflation in the former group rose sharply largely due to surge in the prices of cotton and cotton products. *Fuel & lighting* sub-component witnessed increase amid rising prices of crude oil in international market.



Buidling materials sub-group was dragging WPI inflation downward due to continued deflation. However, inflation in in *building materials* sub-index has increased significantly to 7.8 percent in April 2010 from deflation in the preceding months. This trend reversal is attributed to sharp rise in the prices of base metals and cement products. The rising prices of cement blocks, despite declining prices of cement, probably indicate pressures on wages, rising prices of other material and increasing transportation cost. This shows that the contribution of this group will further increase in WPI inflation in months ahead.



3.4 Sensitive Price Indicator

Following trends in CPI and WPI, SPI inflation has also increased during recent months. SPI inflation (YoY) was 17.4 percent during April 2010 compared to 17.6 percent in March 2010. Higher incidence of SPI inflation was mainly due to rise in the prices of essential food items (see **Figure 3.11**).

On the other hand, weekly SPI inflation (YoY) bottomed out at 6.1 percent in the third week of October 2009, but remained above 16 percent from the 1st week of January 2010 (see **Figure 3.12**). SPI inflation reached as high as 18.4 percent by

the 2nd week of April 2010 before retreating to 16.3 percent by the fifth week of April 2010.

3.5 Global Inflation Scenario

Inflation worldwide has trended upwards due to a stronger global recovery than anticipated earlier. Growth in emerging economies is strong, and largely driven by strong domestic demand whereas, in developed economies though growth is fragile but real activity is rebounding with supportive monetary and fiscal policies. Uptrend in inflation is partially attributed to fiscal and monetary stimulus and partly attributed to rising international commodity prices.

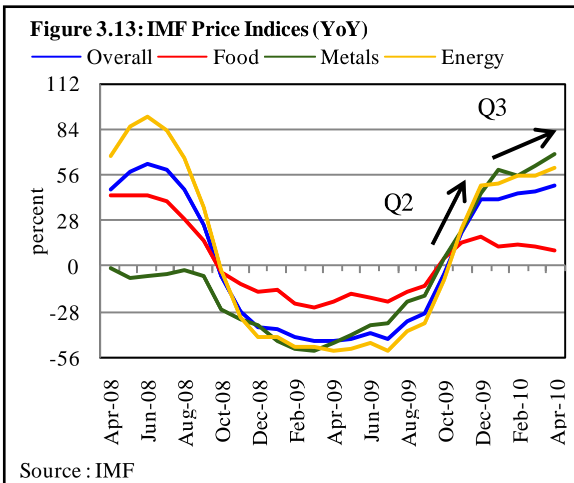
Table 3.5: Policy Rates in Major Economies

Major economies	Current policy rate	Previous	Changed on
United States	0.25	1.00	Dec 16 2008
United Kingdom	0.50	1.00	Mar 05 2009
Euro Area	1.00	1.25	May 07 2009
Japan	0.10	0.30	Dec 20 2008
Canada	0.25	0.50	Apr 21 2009
Australia	**4.50**	**4.25**	**May 04 2010**
China	5.31	5.58	Dec 22 2008
India	**5.25**	**5.00**	**Apr 20 2010**
Korea, South	2.00	2.50	Feb 12 2009
Malaysia	**2.25**	**2.00**	**Mar 04 2010**
Indonesia	6.50	6.75	Aug 05 2009
Philippines	4.00	4.25	Jul 09 2009
Thailand	1.25	1.50	Apr 08 2009
New Zealand	2.50	3.00	Apr 30 2009
Pakistan	12.50	13.00	Nov 24 2009

Sources: Bloomberg, central banks' websites.

Resurge in inflation is most evident in developing countries where food and fuel represents a larger share of consumer spending. Whereas, according to the World Bank's Economic Monitoring Team, core inflation has been more stable and continue to moderate across many countries (similar to the case of Pakistan). In order to manage inflationary pressures led by growth amid excess liquidity (injected through fiscal stimulus packages), central banks are moving towards contractionary policies. Australia, India, Malaysia and Singapore have recently raised their inertest rates (see **Table 3.5**). Going forward it is likely that some other countries also tighten monetary policy in order to avoid the formation of asset bubbles.

Figure 3.13: IMF Price Indices (YoY)



Source : IMF

3.5.1 International Commodity Prices

International commodity prices rose by 48.4 percent YoY in April 2010 compared with a fall of 45.5 percent a year earlier. In particular, increase in energy and metal prices was more pronounced (see **Figure 3.13**). This has been attributed to (a) relative weakening of US dollar; (b) recovery in global economy; and (c) revision in price setting mechanism for iron ore.

Food

Fortunately, rise in food prices slowed down somewhat amid ample supplies of food grains based on huge carryover stocks and favorable prospects for 2010 crops. Decline in sugar prices was the major source of deceleration in food commodity prices. Upward revisions in sugar production estimates in India and significant rise in sugar production in Brazil resulted in sharp contraction in the international sugar prices. Raw sugar prices dropped from a 29 year high of US cents 28.4/pound in January 2010 to US$ 16.3/ pound by April 2010. Tea prices also declined during the third quarter of FY10 owing to improvement in weather in dorught striken parts of Kenya and Uganda.

Energy

Crude oil prices remained in the range of US$70 – US$80 per barrel during Q3-FY10. In April 2010, it rose to US$ 84.2 per barrel, the highest level since September 2008. Positive macroeconomic developments such as; (a) improved manufacturing and services sectors along with employment generation in the US, the largest consumer of oil in the world and; (b) IMF upward revision in its forecast of world economy growth to 4.2 percent from January 2010 forecast of 3.9 percent, kept crude oil prices at higher levels during recent months.

Metals

Industrial metal prices recovered sharply during last six months registering 69.3 percent growth in April 2010. Metals prices also rose on economic optimism based on strong growth in China and India coupled with encouraging news from OECD countries led by US and Japan. Revision in the mechanism of customary annual contract price of iron ore has also pushed up base metal prices in international market.

Cotton

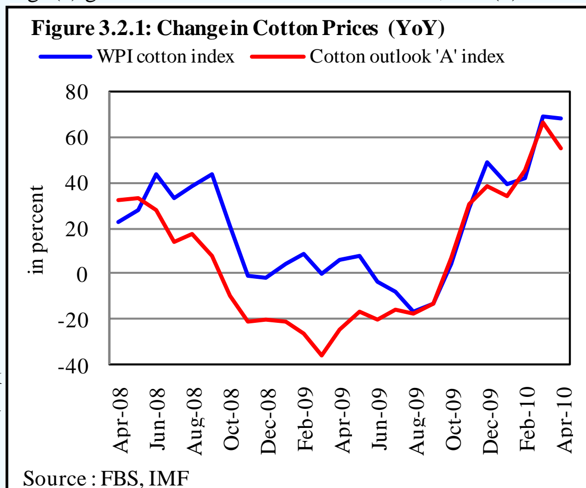
Cotton prices have increased sharply since November 2009 due to recovery in textile demand together with supply shortage in raw cotton markets (see **Box 3.2**). Cotton prices retreated by mid March 2010. However, as a result of imposition of a ban on exports by India, cotton prices resurged again by the second week of April 2010.

Box 3.2: Surge in International Cotton Prices

International cotton prices rose to a record US$ 0.88/pound by April 2010 from US$ 0.57/pound in April 2009. This sharp jump was mainly driven by; (a) increase in cotton consumption amid recovery in global economy; (b) decline in cotton output principally in China and US; as well as, (c) estimated decline in cotton stocks by end of this year. According to US Department of Agriculture Foreign Agricultural Services (USDA FAS),[7] global cotton production this year is estimated to be 22.3 million metric tons (MMT) against earlier estimates of 22.4 MMT and 23.4 MMT during 2008-09 (see **Figure 3.2.1**).

Apparently, the pace of rise in domestic cotton prices seems higher than the international cotton prices. This difference however, disappeared after exchange rate adjustment. It means the movements in domestic cotton prices fully explained by changes in international prices. This is an outcome of a number of factors including: (a) government is out of cotton business; and (b) domestic cotton market is performing well. Domestic cotton prices reached to as high as Rs 6800/40kg by end April 2010, almost double than a year earlier. The recent spike (end-April 2010) in cotton prices is a result of imposition of a ban on cotton export by India.

Figure 3.2.1: Change in Cotton Prices (YoY)



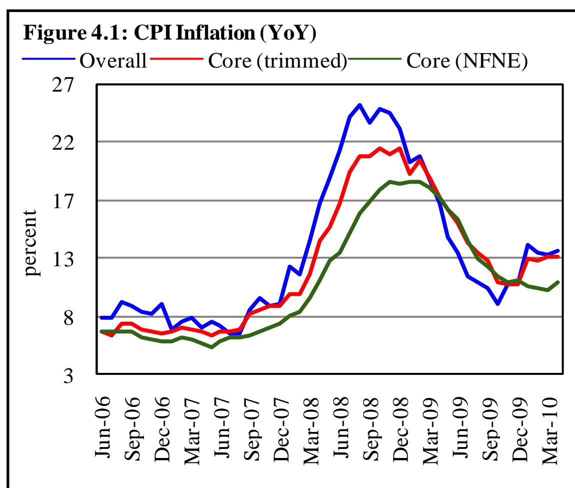
Source : FBS, IMF

An improvement in FY10 cotton harvest was quite fortunate for the domestic farmers, particularly in Sindh where farmers were able to raise yield. Spinning sector also took advantage of higher global prices and export of cotton yarn increased by a hefty 38.9 percent in value (31.7 percent in quantum) during Jul-Mar FY10. Given, importance of cotton in agriculture and economy, there is a need to increase domestic output by using quality seeds and modern cultivation methods to meet the growing domestic and external demand. The role of government is appreciable in cotton market; it should continue to act as a facilitator and regulator.

[7] USDA FAS revised its estimates of world cotton supply, use, and trade in April 2010 from earlier forecasts in March 2010.

4 Money and Banking[1]

4.1 Monetary Policy



The key challenge for the SBP in the last 12 months has been to support the recovery in economic growth while curbing inflationary pressures. Easing of inflation from an average of over 20.8 percent in FY09 to about 10.3 percent in H1-FY10 allowed the SBP to cut its policy rate by 150 basis points during the first six months of the current fiscal year. However, resurgence in inflationary pressures in Q3-FY10 (with an average of 13.2 percent during the quarter) along with an expansionary fiscal stance and weakening external receipts, all militated against a further easing of monetary policy. Consequently, the SBP decided to keep the policy rate unchanged at 12.5 percent in two consecutive monetary policy announcements (i.e. January and March 2010).

Despite a sustained rise in LSM production during Q3-FY10 over the same period last year,[2] contribution of domestic supply-side pressures to inflation remained limited due to the prevailing excess capacity in a number of industries.[3] This is also evident from a gradual decline in core inflation - as measured by NFNE (non-food, non-energy) –to single digit (i.e. 9.9 percent) by March 2010.[4] However, NFNE bounced back to 10.6 percent in April, 2010. The trend reversal in NFNE in April 2010 indicates strengthening inflationary pressures, possibly due to second round effects of persistently high food and energy inflation (see **Figure 4.1**). Though a part of the rise in inflation was expected on account of upward revisions in electricity tariffs, increases in prices of key international commodities

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[1] The money and banking analysis is based on data available up to April 2010.
[2] During Q3-FY10 LSM growth was 9.6 percent compared with a fall of 12.0 percent in the same period last year.
[3] For detail, see section 2.2: Large Scale Manufacturing.
[4] NFNE YoY inflation dropped to 9.9 percent by end-March 2010, compared with 18.5 percent in March 2009.

such as crude oil, pulses, metal and cotton compounded the inflationary pressures. While CPI YoY inflation in April 2010 has been substantially low when compared with 17.2 percent in April 2009, it exhibits persistence and thus carries the potential to fuel the inflation expectations in the economy.[5]

An allied concern is the persistent upwards pressure on the external account. Though the current account deficit dropped to US$ 3.0 billion during Jul-Apr FY10[6] – the lowest deficit in the last four years - compared with US$ 9.0 billion in Jul-Apr FY09, the continued fall in capital and financial inflows has exerted considerable pressure on the overall external account balance. Putting this in perspective, financing of even a small current account deficit became increasingly challenging given the uncertainty on realization of promised external inflows, particularly the Tokyo pledges.

The problems attached with timely realization of external inflows were worsened by rising fiscal spending and low tax receipts, pushing the fiscal deficit upward.[7] This situation coupled with lingering quasi-fiscal activities such as continued borrowing of energy sector due to circular debt and lower than expected retirement by procurement agencies and food departments for commodity operations led to a buildup of pressures on banking system liquidity. As a result, it appears that financing costs for the government may go up considerably. The sharp increase in government borrowing costs has implications not just for the fiscal account, but also exerts upward pressure on the corporate sector lending rate. Anecdotal evidence suggests that banks are benchmarking corporate sector rate equivalent to the high government rate.

In the face of lower than anticipated external inflows (mainly the third IMF tranche) the financing mix of the fiscal deficit in Q3-FY10 is likely to skew towards the banking system.[8] Specifically, the

Table 4.1: Breakup of NDA Contribution in FY10

percentage points

	Jul-Apr	Q1	Q2	Q3
NDA growth (percent)	**9.8**	**0.1**	**7.2**	**0.4**
Government	7.1	0.8	1.9	**1.0**
Non-government	2.7	-0.7	5.3	-0.6

[5] More importantly, core inflation measured by trimmed mean has also shown resilience in recent months.

[6] It must be noted here that the recent increase in imports were largely offset by the receipts against logistic supports and high worker remittances.

[7] It may be noted here that fiscal deficit in H1-FY10 was Rs 403.3 billion much higher compared with Rs 249.5 billion in H1-FY09. Even though the IMF also provided relaxation in the target of fiscal deficit for Q2-FY10. For detail, see Chapter 5: Fiscal Developments.

[8] Data for Q3-FY10 was not available. However, anecdotal evidence suggests that government borrowing from the banking system has increased substantially.

government exceeded its quarterly limits of deficit monetization agreed with IMF for end March 2010. Government borrowing from the SBP was in addition to the government financing requirement for heavy maturities of T-bills; though these have been rolled over by scheduled banks as the seasonal credit off-take remained low during the period of analysis.

Consequently, most of the contribution in NDA of the banking system came from government related financing in Jul-Apr FY10 (see **Table 4.1**). Thus, unlike last year, M2 growth is largely explained by NDA expansion during Jul-Apr FY10.

4.2 Developments in Monetary Aggregates

Growth in broad money aggregates (M2) increased sharply to 8.1 percent during Jul-Apr FY10, despite a steep contraction of Rs 56 billion in Jan-23 Apr FY10 (see **Table 4.2**). Indeed the cumulative growth in M2 was 5.5 percent during Jul-

Table 4.2: Monetary Aggregates

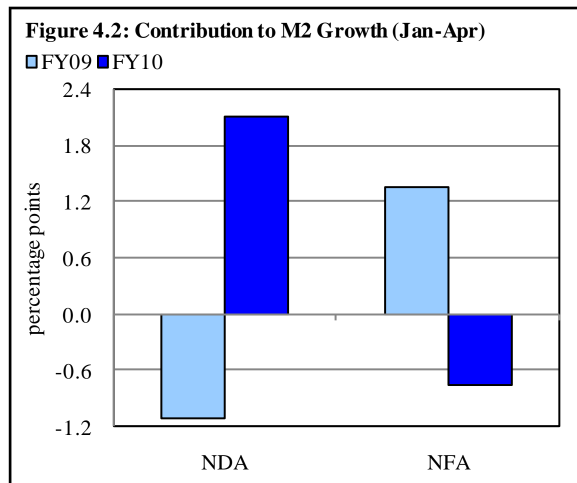
flows in billion Rupees, growth in percent

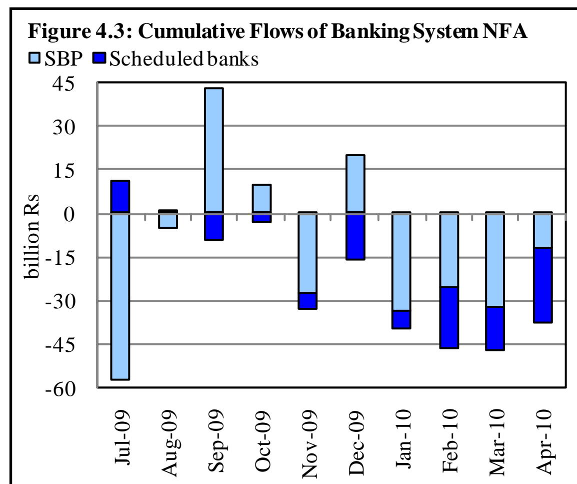
	Flows				Growth	
	Jul-Apr		Jan-Apr		Jul-Apr	
	FY09	FY10	FY09	FY10	FY09	FY10
Broad money (M2)	114.1	414.0	11.4	74.4	2.4	8.1
NFA	-226.9	-37.5	65.0	-41.5	-34.0	-7.2
SBP	-246.9	-12.2	47.0	-32.4	-51.4	-3.8
Scheduled banks	20.0	-25.3	18.0	-9.1	10.7	-13.1
NDA	341.0	451.5	-53.6	115.9	8.5	9.8
SBP	157.1	121.6	-56.8	12.8	20.3	13.8
Scheduled banks	184.0	329.9	3.2	103.1	5.7	8.8
of which						
Government borrowing	315.2	325.0	95.7	203.5	20.9	16.0
For budgetary support	250.3	361.4	40.0	230.6	18.3	21.5
SBP	124.4	168.5	-98.4	231.2	12.0	14.5
Scheduled banks	125.9	192.9	138.4	-0.6	38.0	37.3
Commodity operations	66.7	-35.6	55.8	-27.6	52.4	-10.6
Non-government sector	185.3	217.7	-79.1	0.9	6.1	6.8
Credit to private sector	43.4	144.3	-159.89	19.7	1.5	5.0
Credit to PSEs	142.1	72.5	80.7	-20.5	125.0	27.2
Other items net	-159.5	-91.1	-70.2	-88.5	31.5	15.1

23rd Apr FY10. The large impetus to M2 growth in the last week of April 2010 came from a continued increase in government financing requirement for

budgetary borrowing [9]and rise in net foreign assets (NFA) of the banking system.[10,11]

It may be noted here that though government recourse to bank financing remained substantially higher during FY10 so far than the increase seen in the corresponding period of last year,[12] the impact of this on M2 growth was partly offset by a contraction in NFA of the banking system.





Net Foreign Assets (NFA)

The contraction in the stock of NFA of the banking system which began in October 2009 continued in Jan-Apr FY10 as well; as pressures on external account persisted largely on account of lower than anticipated external inflows (see **Figure 4.3**). Putting this in perspective, had these expected external inflows realized, NFA of the banking system would have witnessed a net inflow during the period of analysis. Similar to Q2-FY10, the depletion in NFA of the banking system during Jan-Apr FY10 was mainly evident in the SBP NFA due to the retirement of official loans;

[9] During the last week of April 2010 government borrowed Rs 75.0 billion from the banking system compared to Rs 155.6 billion during Jan-23rd Apr FY10.

[10] Consequently, growth in M2 during Jan-Apr FY10 is mainly driven by NDA, which is in contrast to Jan-Apr FY09, when NFA was mainly responsible for M2 growth (see **Figure 4.2**).

[11] During the last week of Apr FY10, NFA of the banking system rose sharply mainly on account of inflows of logistic support funds of US$188 million.

[12] In particular, government borrowing from SBP exceeded its quarterly ceiling by end Mar 2010. The outstanding stock of government borrowing from SBP on cash basis reached Rs 1,193.7 billion by end March 2010, Rs 63.7 billion higher than the quarterly target ceiling.

particularly the Sukuk bond payment in the month of January 2010 (see **Figure 4.4**).[13] These payment pressures on SBP NFA were compounded by (a) SBP net forex interventions in the interbank market January 2010 onwards, and (b) non-materialization of IMF third tranche of US$ 338 million in March 2010. The impact of these factors overshadowed the inflows of official grants and coalition support funds.[14]

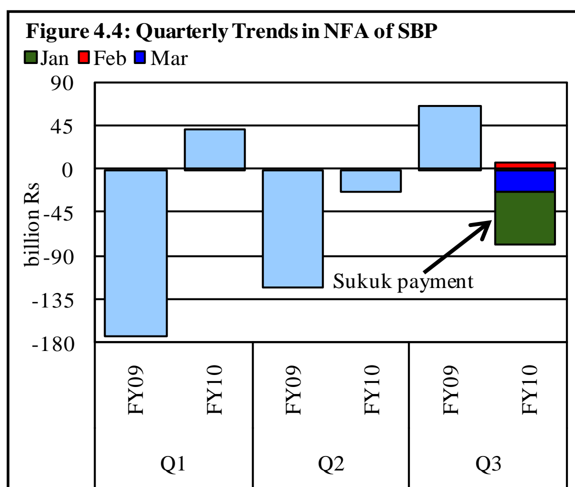


Figure 4.4: Quarterly Trends in NFA of SBP

NFA of the scheduled banks witnessed a depletion of Rs 25.3 billion during Jul-Apr FY10 compared to a net expansion of Rs 20 billion in the corresponding period last year. Substantial retirement of foreign currency loans by the traders last year, mainly explained the net expansion in NFA of the scheduled banks. However, these retirements remained significantly lower during Jul-Apr FY10. This coupled with high payments of oil imports, a fall in foreign investments and lower inflows under net foreign private loans exerted considerable pressure on NFA of the scheduled banks during the period under review.

Net Domestic Assets (NDA)

After hitting a 32- month low YoY growth in end-October 2009 (10.2 percent), the YoY growth in NDA accelerated in the following months (see **Figure 4.5**). Resultantly, NDA of the banking system grew by 9.8 percent in Jul-Apr FY10; slightly higher than the growth (8.5 percent) recorded in the

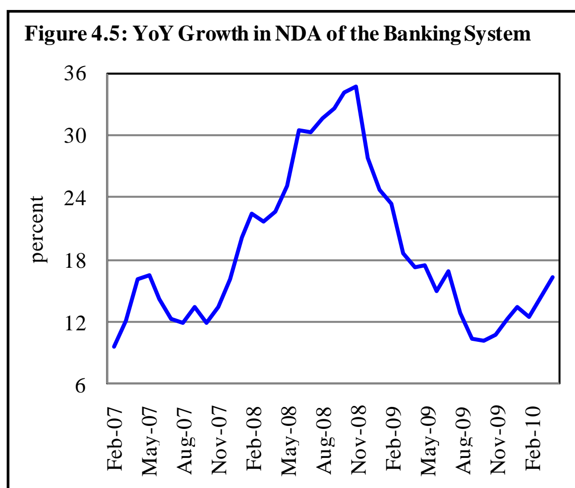


Figure 4.5: YoY Growth in NDA of the Banking System

[13] Besides Sukuk bonds, other official payments include IDB and World Bank.
[14] The country received US$ 184.9 million official grants and US$ 537.4 million as logistic support during Jan-Apr FY10.

same period last year. Two developments make the Jul-Apr FY10 NDA growth particularly significant: persistently high governement borrowing from the banking system, and lower than expected retirement under commodity finance.

Government Borrowing for Budgetary Support

The government's borrowing from the banking system during Jul-Apr FY10 rose by Rs 361.4 billion compared to Rs 250.3 billion in the corresponding period last year. Half of this cumulative increase in government borrowing during Jul-Apr FY10 was visible January 2010 onwards.[15] A considerably high reliance on the banking system by the government for budgetary borrowing during Jan-Apr FY10 was caused mainly by (a) a continued increase in fiscal spending; (b) lower than anticipated external flows; and (c) low inflows in NSS during Q3-FY10 compared with the same period last year.

Within the banking system, the central bank provided the bulk of budgetary finance during Jan-Apr FY10. It may,however, be noted that this incremental budgetary borrowing from the SBP does not include the government's funding requirements related with maturing T-bills that were rolled over by commercial banks. The government borrowed above its auction target (net of maturity) in Q3-FY10 (see **Table 4.3**), and exceeded the quaterly limits for deficit monetization agreed with IMF by end-March 2010. Interestingly, the later was despite the transfer of non-tax reciepts in the month of March 2010. This suggests that the available room for the government's borrowing from SBP in the final quarter of FY10 would be lower given the end-June 2010 target. In addition, uncertainty attached with the realization of committed external flows and funds mobilized through non-bank sources suggests high recourse to the scheduled banks in months ahead.

Table 4.3: T-bills Auction Analysis during FY10

billion Rupees

	Jul-Apr	Q1	Q2	Jan-Apr
Net targets	248.3	144.2	70.1	34.0
Net offer	1,667.4	596.7	438.0	632.7
Net acceptance	376.4	188.7	86.6	101.1
Auction maturities	796.7	180.8	74.9	541.0

Commodity Finance

The outstanding stock of commodity finance declined by Rs 35.6 billion during Jul-Apr FY10, compared with net increase of Rs 66.7 billion in the same period last year. Most of this retirement was recorded in wheat finance and is visible in Jan-Apr FY10. In particular, the stock of wheat loans declined by Rs16.3 billion

[15] During Jan-Apr FY10, government borrowing increased by Rs 203.5 billion – substnatially higher when comapred with a rise of Rs 95.7 billion in the same period last year.

during Jan-Apr FY10 to reach Rs 220.3 billion by end April 2010; still higher than Rs 149.9 billion in April 2009.

With less than the expected retirement under wheat finance by the government agencies, additional bank finance for the procurement of the 2010 wheat crop will exert pressures on banks' liquidity. In this enviroment, it appears that financing rates for commodity operations may go up considerably as banks are pricing liquidity and maturity risks associated with commodity operations.[16] Further, given the limited funding resources available to the government, the pricing power of banks appears to have increased in recent months.

Public Sector Enterprises (PSE)

The cumulative growth in PSE borrowing was 27.2 percent in Jul-Apr FY10 compared with a robust growth of 125.0 percent in the same period last year. Retirements by a few POL related PSEs, and low credit disbursement to a public sector steel mill in Jan-Apr FY10 has limited the net expansion of PSEs borrowing during FY10 so far.[17]

This public sector steel mill is unable to open LCs for raw material imports despite strong demand as banks are reluctant to disburse incremental loans on account of huge net losses of the entity.

Despite the lingering issue of circular debt in the energy sector, a few POL related PSEs showed retirement during Jan-Apr FY10 on account of their receipts from the suppliers in the month of March 2010.

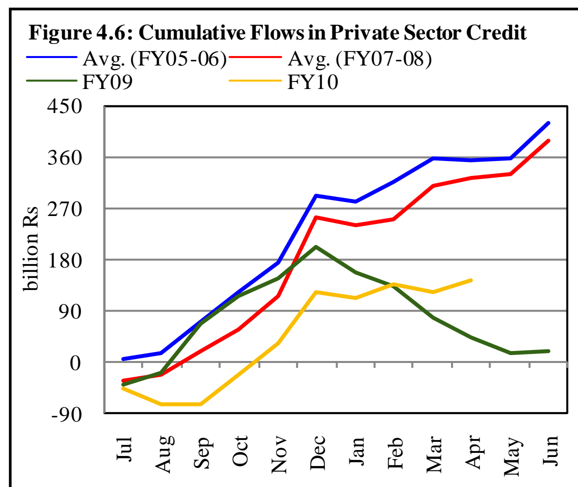
4.3 Private Sector Credit

Credit to the private sector expanded in Q3-FY10 by Rs 22.6 billion compared with a sharp contraction of Rs 127.1 billion in the same period last year (see **Figure 4.6**).

Table 4.4: Flows in Advances to Private Sector
billion Rupees

	Jul-Dec		Jan-Mar	
	FY09	**FY10**	**FY09**	**FY10**
Credit to private sector	203.1	124.6	-127.1	22.6
Business sector advances	194.1	124.7	-93.6	23.0
Working capital	74.0	58.6	-109.3	2.8
Fixed investment	122.0	46.0	15.1	21.6
Trade financing	-1.3	19.6	0.5	-0.8

[16] For instance, banks are charging around KIBOR plus 2.5 to 2.75 percent on commodity operation loans at present, which is considerably high when compared with KIBOR plus 2.0 in June 2009.
[17] High PSE borrowing in Q3-FY09 was on account of issuance of PPTFCs by a public sector entity to settle part of circular debt claims.



The deceleration in credit was largely explained by exceptionally low demand for working capital loans during the period under review (see **Table 4.4**). The decline was broad-based, as a large number of industries witnessed retirement; except a few industries (see **Table 4.5**). For instance, the seasonal credit demand in sugar sector was Rs 47 billion in Q3-FY10- exceptionally high- compared with an average increase of Rs 18.7 billion during the last four years. Interestingly, this increase in credit demand was despite the decline seen in the sugar production. This apparent anomaly is explained by high sugarcane prices in response to supply shortages as a result of a poor 2010 crop.

In contrast, demand for fixed investment loans witnessed a rise in Q3-FY10, largely visible in a few sectors such as power, telecoms, and textile. Borrowing by few corporates in the telecommunications sector was largely to finance import LCs. Further, a rise in textile machinery imports as a result of incentives announced by the government and the SBP[18] partly explain credit demand for long-term loans under the long term financing facility (LTFF) during the period of analysis.

Since most industries are still operating under capacity, demand for additional financing for capital expenditure is likely to remain limited in the months ahead.

[18] In September 2009, import duty on textile machinery was completely eliminated, compared to 5 percent previously. Further, SBP has extended the refinancing of second hand machinery under the LTFF scheme up-to June 30, 2010. For detail, see SMEFD Circular Letter No. 3 of 2010.

Further, it is worth mentioning that renewed interest by banks' towards consumer financing – primarily auto finance - was observed January 2010 onwards. Recovery in this segment reflects a strong performance of the automobile industry coupled with significantly increased efforts by banks. Anecdotal evidence suggests that banks campaigns –e.g. partnerships with automakers to facilitate the financing procedure for clients and offering specific car brands on reduced mark ups – supported credit off-take observed during the period under review.

Table 4.5: Break-up of Working Capital Loans (Jan-Mar)
billion Rupees

	FY09	FY10
Working capital loans	-109.3	2.8
Excluding advances to sugar sector	-131.0	-44.2
A. Agriculture	-0.9	-1.6
B. Manufacturing	-51.7	16.8
a. Food products and beverages	10.7	43.4
Rice processing	-4.0	-2.1
Edible oil and ghee	-3.6	0.0
Sugar	21.6	47.0
b. Textiles	-30.8	-16.1
Spinning of fibers	-17.6	-12.9
c. Coke, refined petroleum products	-1.4	2.2
d. Chemicals	-13.1	-6.9
Fertilizers and nitrogen compounds	-6.2	-3.7
e. Non-metallic mineral products	-4.4	0.5
Cement	-2.7	0.0
C. Electricity, gas and water supply	-26.8	2.0
Production, transmission, distribution of power	-25.7	2.2
D. Construction	-2.0	-1.4
E. Commerce and trade	-9.5	-9.8
F. Transport, storage, and communications	-5.4	2.0
Telecommunications	-5.4	1.6
G. Real estate, renting, and business activities	-7.5	-1.5
Other business activities	-7.1	-0.3

4.4 Deposit Mobilization[19]

The gradual pickup in the deposit base which began in September 2009 continued in the subsequent months. Resultantly, deposits of the banking industry recorded robust growth of 8.6 percent during Jul-Apr FY10, in stark contrast to a contraction of 0.2 percent in the corresponding period of FY09.[20] While monetary expansion supported deposit growth in Q2-FY10, growth during Q3-FY10- despite a contraction in M2- largely reflects the absorption of currency in circulation into the banking system. [21]

The acceleration in deposit growth during Jul-Apr FY10 is particularly significant because of:

[19] The analysis is based on total deposits of the banking industry, including government deposits.
[20] It may be noted that average growth for the Jul-Apr period for FY07-08 stood at 7.7 percent.
[21] The currency-to-deposit ratio declined to 31.3 percent by end-April 2010, from 34.1 percent in November 2009. However, it remained higher than the average of 29.8 percent for Apr FY08-09.

(1) A phenomenal rise in government deposits, and
(2) Shift in the maturity profile of large privatized banks' incremental deposits towards lower cost funding.

Sectoral analysis suggests that although deposit growth during Jul-Apr FY10 was visible in all sectors, almost half of this increase is explained by a strong rise in government and public sector deposits (see **Table 4.6**).

Table 4.6: Selected Sector-wise Deposit Flows (Jul-Apr)
billion Rupees

	Avg.FY06-08	FY09	FY10
Government	36.8	29.0	80.3
PSEs	22.7	-16.1	59.5
Private sector business	28.0	9.9	59.9
of which			
Textiles	-2.2	-2.9	0.2
Electricity, gas & water	-3.0	-0.5	23.3
Motor vehicles	-3.4	-3.9	5.9
Construction	-4.6	-2.7	3.9

Government deposits witnessed a sharp increase during Jul-Apr FY10 which was unusually high compared to the same period last year, as well as the average for Jul-Apr FY05-08.

This seems quite surprising given the substantially high government borrowings from bank and non-bank sources. Further analysis shows that while government deposits recorded a rise throughout FY10 so far-except withdrawals in a few months-the steep increase was largely concentrated in the month of December 2009 and March 2010 (see **Figure 4.7**).[22]

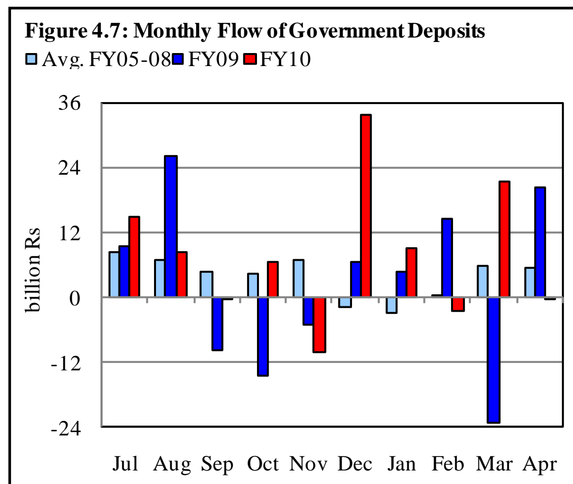


Figure 4.7: Monthly Flow of Government Deposits

Though both federal and provincial government organizations contributed in deposit growth, the major increase in deposits came from three federal government agencies.[23] Government

[22] The incremental government deposits in these two months were substantially higher when compared with the average increase in the same months in preceding years. However, considerable government deposit inflows were received in April 2010 in contrast to marginal withdrawals during April 2009.
[23] These agencies contributed over half of total government deposit inflows during Jul-Apr FY10.

deposits were not only concentrated in a few agencies, but also in a few banks. Specifically, more than half of incremental government deposits in Jul-Apr FY10 were recorded in three public sector banks.[24]

Table 4.7: Maturity-wise Contribution to Deposit Growth (Jul-Apr)

percentage points

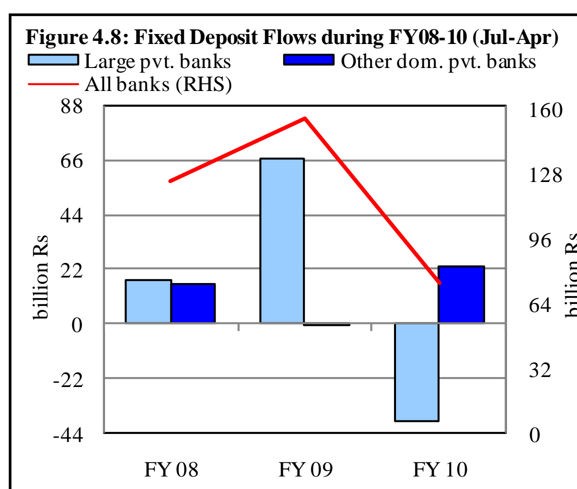
	Avg.FY07-08	FY09	FY10
Fixed	5.3	4.1	1.8
Savings	1.3	-0.9	4.1
Current	1.1	-3.3	2.7
Total growth (percent)	**7.7**	**-0.2**	**8.6**

* includes all current and other categories

Similar to government deposits, public sector enterprises (PSEs) recorded buoyant deposit inflows during the current fiscal year compared to net withdrawals during Jul-Apr FY09. Interestingly, PSE deposit inflows were also visible mainly in the months of December 2009 – led by a few power sector entities – and April 2010.[25]

In terms of *maturity profile*, incremental deposits of the banking system shifted sharply towards shorter tenors during Jul-Apr FY10 compared to previous years[26]. In particular, inflows under the fixed category slowed; as banks mobilized nearly half of their deposits under the savings category (see **Table 4.7**).

Figure 4.8: Fixed Deposit Flows during FY08-10 (Jul-Apr)



The lower contribution of fixed deposits[27] in total deposit growth during Jul-Apr FY10 mainly reflects considerable

[24] It may be noted that one large public sector bank alone accounted for over half of the total increase in government deposits over Jul-Apr FY10 period.

[25] PSE deposit inflows of Rs 30.1 billion were registered in Dec 2009, with one enterprise accounting for one-third of the inflow. Further inflows of Rs 36.7 billion received in April 2010 with one entity contributing almost half of this.

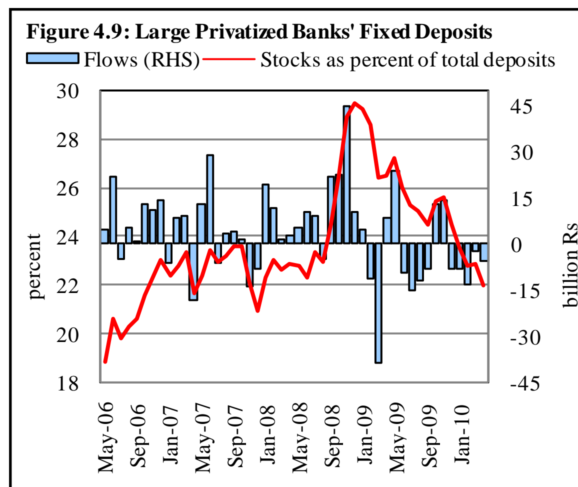
[26] It may be noted that during FY09, large privatized banks provided a significant impetus to fixed deposit growth.

[27] It may be noted that the contribution of fixed deposits to total deposit growth for Jul-Feb FY10 is almost half of that for the Jul-Apr period – this reflects significant government current withdrawals in a large public sector bank, and subsequent placement under the fixed category in March 2010.

fixed deposit withdrawals in the *large privatized banks*[28] during Q1 and Q3. These withdrawals were strong enough to offset the increase seen under the same category in o*ther domestic private banks* [29] (see **Figure 4.8**).

However, fixed deposit withdrawals in large privatized banks, must be seen in the context of the extraordinary surge in the same category due to the rumor driven deposit withdrawal during the period of Sep-Oct 08. Last year, these banks faced considerable withdrawals in shorter tenor deposits, and responded by increasing their fixed deposit base.[30] Therefore, fixed deposit withdrawals during Jul-Apr FY10 possibly reflect a strategic shift by these banks to lower the interest burden associated with longer-tenor time liabilities. Consequently, these withdrawals brought the share of fixed deposits in their total deposit base close to its pre-crisis level by end-April 2010 (see **Figure 4.9**).

Figure 4.9: Large Privatized Banks' Fixed Deposits



Nonetheless, total deposits of large privatized banks increased by Rs 56.5 billion, on account of mobilizing shorter tenor individual and corporate deposits during Jul-Apr FY10; compared with a net withdrawal of Rs 11.5 billion in the same

Table 4.8: Bank Group Deposit Flows (Jul-Apr)

billion Rupees

	FY09	FY10
Public sector	38.7	113.1
Large privatized	-11.5	56.5
Other domestic private	-3.3	99.6
Merged	6.1	30.6
Islamic	28.9	41.0
Foreign	15.0	10.7
All banks*	**-5.9**	**351.6**

*includes specialized banks

[28] Large privatized banks faced fixed deposit withdrawals of Rs 39.3 billion during Jul-Apr FY10. However, it may be noted that in contrast to other large privatized banks, one bank in the group increased its fixed deposit base during this period.
[29] This group comprises domestic private banks that are not in the merged or Islamic category.
[30] To put this in perspective, Rs 66.6 billion was mobilized under the fixed category by these banks during Jul-Apr FY09. This was exceptionally high compared to an average increase of Rs 23.5 billion for Jul-Apr FY 07-08.

period last year (see **Table 4.8**)[31].

On the other hand, *other domestic private banks* witnessed a sharp increase in their fixed and saving deposits during Jul-Apr FY10 compared with the same period last year. These banks attracted longer-tenor deposits by offering competitive returns, as well as a wide range of savings products. Thus, the total deposit base of other domestic private banks increased by Rs 99.6 billion during Jul-Apr FY10 compared with Rs 3.3 billion in the corresponding period last year.

A disaggregated analysis highlights two banks from this group that received almost one-fourth of the banking industry's fixed and saving deposit inflows for Jul-Apr FY10. While one bank received considerable government deposits during this period, the other bank achieved this mainly by mobilizing private individual deposits.

[31] It may be noted that Islamic banks recorded significant deposit growth during Jul-Apr FY10 as well as in the corresponding period in previous years. Anecdotal evidence suggests this significant increase in the deposit base enabled these banks to actively participate in Shariah compliant interbank placements in an environment of liquidity pressures facing the banking industry.

5 Fiscal Developments

5.1 Overview

The budgetary data for Q3-FY10 is not yet available, but some preliminary information suggests that the fiscal sector is under stress and the government is likely to miss its budget deficit target. Although the FBR has regained its revenue path in the third quarter of the year and non-tax revenue also propped up by appropriation of SBP profit and realization of coalition support fund of US$ 349.0 million, the budget deficit is expected to be higher than the target primarily because of higher than budgeted public expenditure.

After revenue shortfall in H1-FY10, FBR improved its performance in the third quarter of the year with 26 percent growth in the tax receipts. However, going forward, achievement of tax revenue target for FY10 will remain challenging for the FBR as it would require a YoY growth of 37.6 percent during Q4-FY10 to attain Rs 1.38 trillion tax collection (budget) target for the year; compared with 5-year average tax revenue growth in the last quarter at 15.7 percent.

The widening budgetary imbalance was predominantly financed by banking system during Jul-Mar FY10 raising risks of crowding out of private investment. The government needs to take steps for fiscal consolidation challenged by high security outlays and severe external financing shortfalls. The government has indicated that it intends to slash non-priority development spending to handle these fiscal risks. This suggests the need to urgently work towards broadening the tax base to provide required essential services and public goods. It remains to be seen if the current drive by FBR to replace general sales tax by a value added tax (VAT) will significantly help expand the tax base and curb leakages in the revenue stream.

5.2 Domestic Budgetary Financing[1]

Budgetary financing from domestic sources stood at Rs 535.3 billion during Jul-Mar FY10 compared to Rs 321.2 billion in the same period a year earlier. Apart from showing a rise in fiscal deficit, the sharp increase in financing from domestic sources was due to the shortfall in financing from external sources. Within

[1] This section is mainly based on SBP estimates, derived from Monetary Survey and outstanding stock of domestic debt, as MoF numbers will only be available by end-May 2010. Also, budgetary financing numbers consider the impact of government deposits with the banking system whereas the debt numbers do not.

domestic sources of budgetary finance, non-bank contribution witnessed a strong expansion with its share in the total domestic source of financing jumping to 60.6 percent in Jul-Mar FY10 from 44.7 percent in the same period last year. Moreover, financing from the banking system, during this period, increased by 19.6 percent YoY.

Financing from Banking System[2]

Net budgetary financing from the banking system was Rs 210.8 billion during Jul-Mar FY10 compared to Rs 176.2 billion during the same period last year. Although, government financing from the SBP decreased compared to the same period last year, it exceeded the quarterly limit imposed by IMF for the first time since the inception of the program. During Jul-Mar FY10, the SBP provided Rs 66.8 billion through issuing of fresh MRTBs to the government. However the net budgetary financing amounts to Rs 30.0 billion, as government deposits with the SBP (including other deposits) stood at Rs 36.8 billion during the period (see **Figure 5.1**).

Figure 5.1: Borrowing from the Banking System

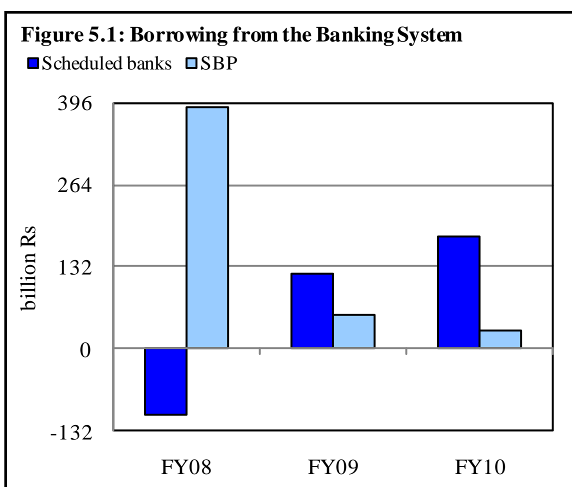
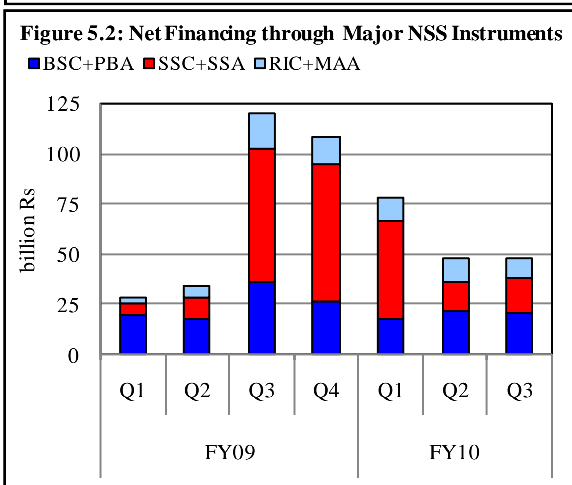


Figure 5.2: Net Financing through Major NSS Instruments



During Jul-Mar FY10, financing from scheduled banks through government securities amounted to Rs 261.2 billion which is more than twice the amount

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

invested a year earlier during the same months. The increase in financing from scheduled banks through government securities reflect their interest in relatively risk free government T-bills compared to risk prone credit to private sector. The increase in government deposits with the scheduled banks limited the net financing to Rs 180.8 billion. Although a reduction in financing from SBP would be helpful in containing inflationary pressures to some extent, a rise in government financings from the scheduled banks will have negative implications for liquidity and will place upward pressure on interest rates.

Financing from Non-bank

Net receipts from NSS instruments (including prize bonds) during Q3-FY10 stood lower than that of the same period last year. However, due to higher net receipts in the first two quarters of FY10, net financing through NSS instruments during Jul-Mar FY10 reached Rs 169.4 billion compared to Rs 163.6 billion during the same period last year.

Within NSS instruments, Behbood Savings Certificates (BSC) and Pensioners Benefit Account (PBA) together fetched Rs 59.2 billion during Jul-Mar FY10 for budgetary financing that is less by an amount of Rs 14.7 billion from the previous year (see **Figure 5.2**). Special Savings Certificates (SSC) and Special Savings Account (SSA) together fetched an amount almost equal to that of the corresponding period a year earlier. Also the government issued a new NSS instrument 'National Savings Bonds' (NSB) in January 2010 through which an amount of Rs 3.7 billion was mobilized up to March 2010.

5.3 FBR Tax Collection

During third quarter of FY10, FBR tax revenue showed robust performance largely due to increased collection under the head of direct taxes and import-based indirect taxes. During Jul-Mar FY10 total tax collection stood at 65.9 percent of

Table 5.1: FBR Tax Collection (Net) during Jul-Mar
billion Rupees; change in percent

	Annual target		Net collection		Percent of annual target		YoY change	
	FY09	FY10	FY09	FY10	FY09	FY10	FY09	FY10
Direct taxes	498.9	565.6	307.6	342.3	61.7	60.5	19.4	11.3
Indirect taxes	751.1	814.4	507.5	567.3	67.6	69.7	20.2	11.8
Sales tax	469.9	499.4	321.1	371.2	68.3	74.3	24.2	15.6
FED	112.0	152.8	81.0	84.4	72.3	55.2	31.1	4.2
Customs	169.2	162.2	105.4	111.7	62.3	68.9	3.4	6.0
Total collection	**1,250.0**	**1,380.0**	**815.1**	**909.6**	**65.2**	**65.9**	**19.9**	**11.6**

Source: Federal Board of Revenue

the annual budget target (see **Table 5.1**). To achieve the annual target, FBR is required to collect Rs 157.0 billion per month on the average in the remaining three months of FY10.

Direct Tax Collection

Growth in direct tax collection which remained very subdued in H1-FY10 accelerated to 11.3 percent during Jul-Mar FY10. The collection of the direct taxes during Jan-Mar 2010 remained robust compared with the same months of the last year. This reflects the effect of the extension announced by the FBR in the due date of filing the income tax returns.[3]

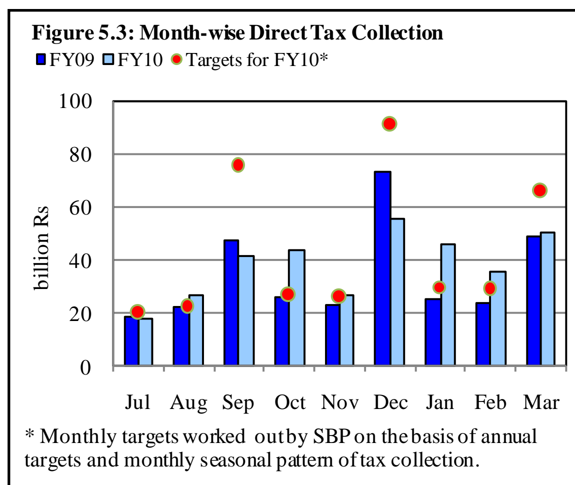


Figure 5.3: Month-wise Direct Tax Collection

* Monthly targets worked out by SBP on the basis of annual targets and monthly seasonal pattern of tax collection.

The FBR administration introduced a change in the advanced tax payment system according to which the quarterly advanced tax payment is now to be paid by 15th of the following month. As a result, we see a shortfall in direct tax collection compared to interpolated monthly targets in last month of each quarter and a corresponding increase in next month, i.e., October 2009, January 2010 and expectedly April 2010 (see **Figure 5.3**).

Indirect Tax Collection

Collection from indirect taxes also improved in the third quarter of FY10 largely due to increase in tax receipts from import source (see **Table 5.2**). During Jul-Mar FY10, indirect tax collection reached 69.7 percent of the annual budget

Table 5.2: Indirect Tax Collection (Net) during Jul-Mar

billion Rupees, growth in percent

	Collection		Growth rate	
	FY09	**FY10**	**FY09**	**FY10**
Imports	**263.3**	**294.0**	**3.7**	**11.6**
Sales tax	147.3	172.9	3.9	17.4
FED	10.7	9.4	4.2	-12.1
Customs duty	105.4	111.7	3.4	6.0
Domestic	**244.2**	**273.3**	**44.9**	**11.9**
Sales tax	173.9	198.3	48.7	14.0
FED	70.3	75.0	36.3	6.7
Total collection	**507.5**	**567.3**	**20.2**	**11.8**

Source: Federal Board of Revenue

[3] FBR extended the date for filing of income tax returns up to January 25, 2010. This is why income tax payment shifted to month of January 2010, resulting in an increase in direct tax collection during January 2010.

target reflecting 11.8 percent YoY growth. Within indirect taxes the performance of sales tax remained encouraging.

Sales Tax

During Jul-Mar FY10 sales tax collection registered YoY growth of 15.6 percent, while collection amounted to 74.3 percent of the annual target. This was contributed by sales tax from imports that showed a growth of 17.4 percent during Jul-Mar FY10 compared with 3.9 percent growth in the corresponding period last year. Although sales tax collection from domestic goods and services has not been encouraging so far compared to the last year, a revival in the economy coupled with increase in prices of electricity are likely to increase collection from domestic sources in the months ahead.

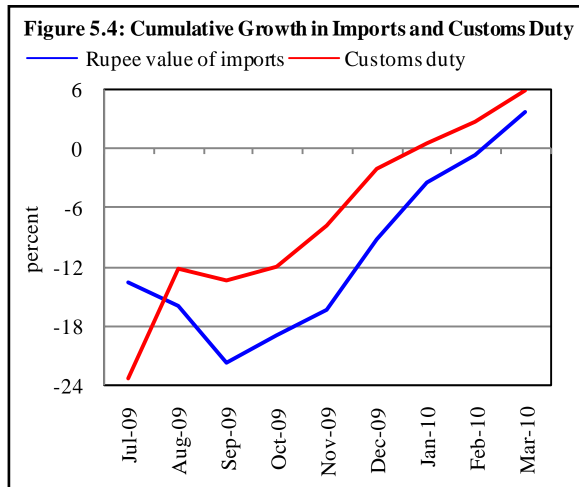
Federal Excise Duty (FED)

Federal excise duty registered the lowest growth of all the FBR taxes during Jul-Mar FY10. Unlike other FBR taxes, collection from FED during Q3-FY10 remained slightly below than the first two quarters of FY10.

Customs Duty

Growth in collection from customs duty which remained negative upto H1-FY10 turned positive during January 2010, resulting in an overall growth of 6.0 percent during Jul-Mar FY10. This is in line with recent growth in rupee value of imports (see **Figure 5.4**). A higher growth in customs duty than the growth in its base, i.e., imports, indicates the buoyant nature of the tax. However, actual performance of this tax can be analyzed with disaggregated information of dutiable and non-dutiable imports that is not available yet.

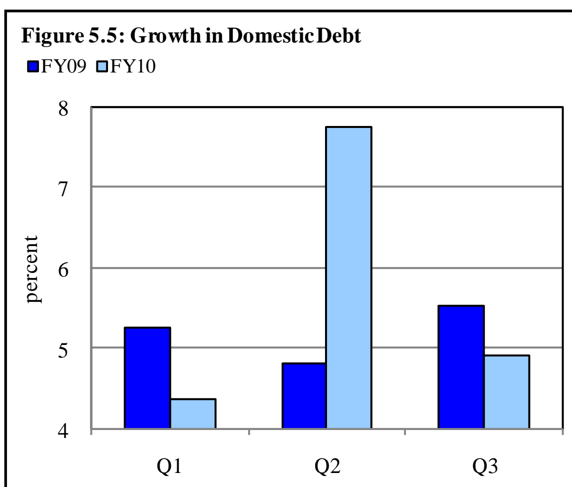
Figure 5.4: Cumulative Growth in Imports and Customs Duty



5.4 Domestic Debt[4]

After sharp rise of 7.0 percent in Q2-FY10, the growth in domestic debt moderated to 4.4 percent during Q3-FY10 (see **Figure 5.5**). The slowdown in the growth of domestic debt was despite the increase in the fiscal deficit and weak external financing inflows. The apparent disconnect is explained by huge withdrawals of government deposits with the central bank.

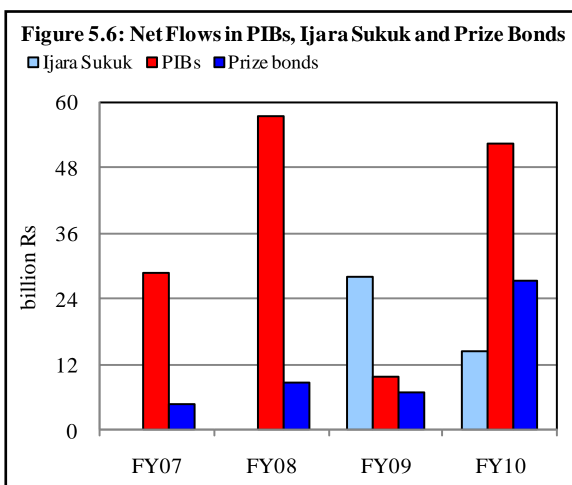
Figure 5.5: Growth in Domestic Debt



Composition of Domestic Debt

With shortfall on account of budgeted external financing in the presence of higher fiscal deficit, the government had to rely on additional financing from domestic sources. In the absence of substantial inflow from NSS, financing structure remained skewed toward banking system during Jul-Mar FY10. Scheduled banks' increased participation in T-bills auctions; funded Rs 310.6 billion government budget deficit compared to Rs 159.1 billion in the same period last year. Consequently, dominance of short term debt in total domestic debt continued for the second consecutive year. This reflects increased vulnerability to adverse short-term interest rate movements that could introduce uncertainty in future debt management.

Figure 5.6: Net Flows in PIBs, Ijara Sukuk and Prize Bonds



[4] It includes FEBCs, FCBCs, DBCs and Special US Dollar Bonds held by the residents. Previously, these were the part of External Debt Liabilities which are now in Domestic Debt.

The breakup of permanent debt data reveals that PIBs retained its dominant share in outstanding stock of permanent debt by adding Rs 52.4 billion during Jul-Mar FY10 against Rs 9.7 billion in the same period last year. Mobilization through prize bonds also saw significant improvements during Jul-Mar FY10 by adding Rs 27.3 billion in total deficit financing (see **Figure 5.6**). Although the government received Rs 94.4 billion through fresh creation of prize bonds during Jul-Mar FY10, huge encashment has reduced the net receipts to much lower level.

Table 5.3: Domestic Debt (Jul-Mar)
debt in billion Rupees, growth and share in percent

	Debt		Growth rate		Share	
	FY09	**FY10**	**FY09**	**FY10**	**FY09**	**FY10**
Permanent	652.3	771.2	7.2	13.7	17.4	17.2
Floating	1,923.5	2,299.8	17.5	20.8	51.2	51.2
of which						
MTBs	696.1	1,106.7	*29.6*	*39.0*	18.5	24.6
*MRTBs**	1,227.3	1,193.1	*11.5*	*7.7*	32.7	26.6
Unfunded	1,174.7	1,411.7	15.1	11.1	31.3	31.4
Foreign currency	8.0	8.0	-5.9	0.0	0.2	0.2
Domestic debt	**3,758.4**	**4,490.7**	**14.8**	**19.5**	**100.0**	**100.0**

*Includes outright sale of MRTBs to commercial banks.

Floating debt, comprising treasury bills recorded relatively higher growth in Jul-Mar FY10 compared to last year (see **Table 5.3**). The sharp rise in floating debt stemmed from commercial banks' holding of T-bills which increased by 39.0 percent in Jul-Mar FY10 compared to 29.6 percent increase in the corresponding period last year. On the other hand, T-bills for replenishment grew by 7.7 percent in Jul-Mar FY10 compared to 11.5 percent a year earlier. The growth of MRTBs, however, remained a source of concern, as it has breached the quarterly limit on government financing from the central bank imposed by IMF under Stand-By Arrangement.

Table 5.4: Gross & Net Receipts of Major NSS Debt Instruments (Jul-Mar)
billion Rupees

	FY09		FY10	
	Gross	**Net**	**Gross**	**Net**
DSCs	53.5	-15.7	37.4	-35.1
SSCs	220.5	69.0	95.4	52.0
RICs	67.3	26.4	48.3	33.9
BSCs	285.2	57.6	72.7	45.1
SSAs	57.4	13.4	46.5	29.8
others	210.4	5.9	140.0	16.4
Total	**894.3**	**156.6**	**440.8**	**142.1**

Source: Central Directorate of National Savings (CDNS)

Quarterly growth in the outstanding stock of unfunded debt continued its downward slide in Q3-FY10. The main cause of this slowdown was lower net sales of National Savings Schemes instruments. The outstanding debt against all major NSS instruments recorded positive growth except for DSCs which showed a net retirement of Rs 35.1 billion. It is important to note that the net mobilization

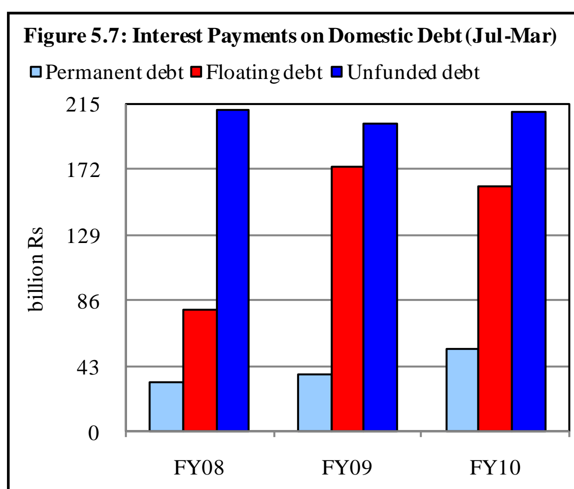
through NSS stood at Rs 141.1 billion during Jul-Mar FY10, which constitutes only 61.4 percent of the government budgetary estimates for FY10. As a result, the government financing requirement from the banking system increased sharply during this period.

Gross mobilization through NSS stood at Rs 440.8 billion during Jul-Mar FY10, almost three times compared with the net receipts in the same period (see **Table 5.4**). Secondary market information on domestic debt reveals that the non banks investment in the government securities (T-bills & PIBs) increased abruptly during the period. For instance, non bank holding of the T-bills stood at Rs 96.7 billion during Jul-Mar FY10 compared to Rs 4.7 billion in the same period last year. This reflects investors' preferences to invest their funds in the short term debt instruments.

Interest Payment on Domestic Debt

Interest payment on domestic debt registered 3.1 percent growth in Jul-Mar FY10, considerably moderate compared to 27.2 percent recorded in the same period last year. The deceleration in the growth of interest payment on domestic debt is attributed to decline in interest payment on floating debt in the period under discussion (see **Figure 5.7**).

Figure 5.7: Interest Payments on Domestic Debt (Jul-Mar)



A further break up shows that debt servicing cost of permanent debt rose sharply during Jul-Mar FY10. This increase was largely due to interest payment 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 registered a decline of 7.1 percent during Jul-Jan FY10 compared to a rise of 115.6 percent in the same period last year. This slowdown largely came from reduced interest payments on MRTBS, as government was able to retire substantial amount in the initial period of current fiscal year. However, increased reliance on commercial banks' financing by the government through T-bills can boost the interest payments on floating debt in the remaining months of current fiscal year.

The interest payments on unfunded debt stood at Rs 210.0 billion during Jul-Mar FY10 compared to Rs 202.1 billion in the same period last year. The disaggregation of data reveals that the interest payments on BSCs, SSCs and PBAs increased significantly during the period. This seems in line with their increased share in the outstanding stock of unfunded debt. On the other hand, monthly outflow in the form of interest payment on DSCs observed a persistent declining trend. However with net addition of Rs 126.2 billion in total interest cost, DSCs still remained the largest contributor among servicing of unfunded debt components.

Box 5.1: Government Guarantees-A Risk to Fiscal Sustainability

Countries with higher and persistent budget deficits have serious implications of government guarantees for fiscal outlook of the country. Most recently, many governments have introduced new methods of public support by issuing guarantees to many public sector enterprises and government institutions. These off-budget activities result in additional burden on the government outlays and consequently can lead to increasing debt/GDP ratios.

In case of Pakistan, government guarantees normally exist in the form of contingent liabilities. These liabilities are not recognized as direct, as the actual cost of the government is linked with the occurrence of any particular event in future. The element of uncertainty in the contingent liabilities results in several complications in fiscal analysis. The coverage of government guarantees in fiscal analysis is also important, as government normally covers all risks that in turn can increase the possibility of default. Although it is impossible for the government to avoid all fiscal risks, however, these risks can be minimized by recognizing and considering these issues in their policy choices.

Table 5.1.1 shows that the new guarantees issued during Jul-Mar FY10 reached Rs 177.9 billion reaching at 1.18 percent of GDP, less than the full year limit of 2 percent imposed by FRDL Act 2005. It is important to note that the volume of government guarantees issued during FY09 has reached Rs 274.3 that has breached the limit imposed by FRDL Act 2005.

Table 5.1.1: Guarantees Issued by Government
billion Rupees

	FY09	Jul-Mar FY10
PIA	25.0	6.8
WAPDA	228.3	133.0
PAF Shahbaz Air H.Q	1.0	6.0
NIT	20.0	
Railways division		17.0
PSM		10.0
KESC		3.0
Pak Textile City Ltd.		1.0
TIP		1.1
Total	**274.3**	**177.9**
As % of GDP	2.1	1.18

Source: Budget Wing, EF Wing and DPCO staff calculations

Information on new liabilities incurred by the government suggests that WAPDA remained the major recipient among the guarantees issued during the period, as government provided guarantees of Term Financing Certificates (TFCs) issued by Pakistan Electric Power Company (PEPCO) in settling the circular-debt. The power holding company, established by the GoP has partially owed the power companies debt by issuing Rs 85.0 billion worth of TFCs on 30th September 2009. The volume of these guarantees can increase in the coming months due to extension in the deadline for the elimination of remaining stock of circular debt and delays in the power tariff differentials

adjustments. These steps would result in additional burden on the government outlays and could lead to ever increasing debt to GDP ratios.

In addition to the guarantees already issued to many PSEs, the government is now issuing guarantees on TCP, PASSCO and provincial governments commodity financing loans. These guarantees, however, were never included in the limit of 2 percent of GDP imposed by FRDL Act 2005. Such activities not only understate the volume of the public debt stock and pose a risk of increasing future liabilities but also potentially crowed out private investment.

Moving forward, government should re-examine the role of numerous public sector entities involved in quasi-fiscal activities. Specifically, the efficiency of these public sector entities can be enhanced by strengthening governance structures. The government needs to remain transparent while issuing guarantees to PSEs and should provide estimates of resulting stock of its hidden debt. Also, there should be a clear policy initiative to deal with such contingencies. Although in FRDL Act 2005, the government control over issuance of new guarantees is restricted, the solution must include the creation of a legal and institutional framework that forces proper accounting of these hidden costs to the government.

The problem in this case is the fiscal accounting that sometimes misrepresents the effect of the government's stance. Usually, public finance data is recorded on cash basis. In case of Pakistan, guarantees are usually adjusted in the fiscal accounts when contingency occurs and cash payment is actually made. International accounting standards require the recording of the guarantees on accrual based accounting. The government needs to judge the guarantees to be recorded as liability or contingent liability at the time of budgeting and if the probability that the expense will be realized is high, government can estimate the expected cost and can make provisions in the budget.

6 External Sector

6.1 Overview

Aided by lower imports and sustained inflow of remittances the current account deficit during Jul-Apr FY10 remained significantly lower than in the corresponding period last year. The impact of this improvement on overall external balance was, however, limited by considerable fall in capital and financial account surplus during the period (see **Table 6.1**).

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

billion US dollar

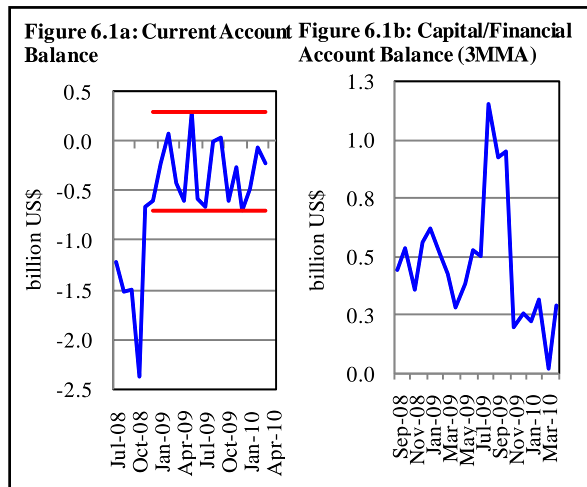
			FY10		
	FY09	FY10	Q1	Q2	Jan-Apr
A-C/A balance	**-9.0**	**-3.1**	**-0.6**	**-1.5**	**-0.9**
i) Trade balance	-11.1	-9.1	-2.8	-3.0	-3.3
Exports	15.8	16.2	4.6	4.7	6.9
YoY growth (%)	-3.6	2.1	-19.1	6.8	*19.7*
Imports	27.0	25.2	7.4	7.7	10.2
YoY growth (%)	-5.9	-6.3	-27.4	-5.2	*17.6*
ii) Invisible balance	2.2	6.0	2.2	1.4	2.4
Remittances	6.4	7.3	2.3	2.2	2.8
B-Financial/capital balance	**4.5**	**3.9**	**2.8**	**0.5**	**0.7**
i) FDI	3.2	1.8	0.5	0.5	0.8
ii) FPI	-1.0	0.0	0.2	0.1	-0.3
iii) Other investment	2.1	2.0	2.0	-0.2	0.1
C-Errors & omissions	**0.2**	**-0.2**	**-0.4**	**0.4**	**-0.1**
D-Overall balance	**-4.3**	**0.7**	**1.8**	**-0.7**	**-0.4**
Drawings from IMF*	3.9	1.3	0.5	0.8	0.0
Net change in overall reserves	0.1	2.4	2.5	0.5	-0.6

* This does not include IMF support for bridge financing

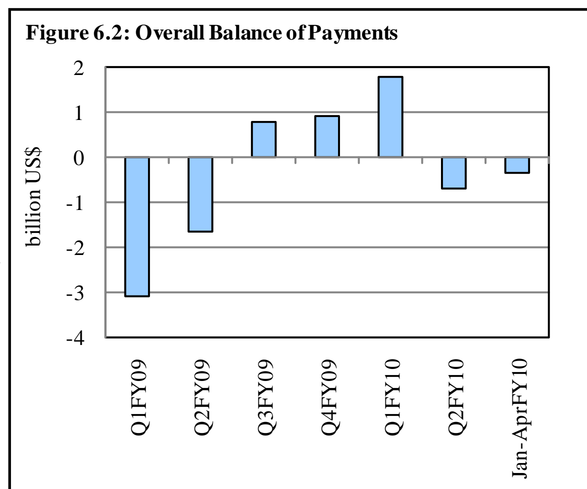
In fact, given the rise in current account deficit recorded in Q2 over Q1, it was expected that current account deficit would rise further in subsequent months due to an anticipated rise in imports. In the event, not only was the rise in imports during Jan-Apr less than expected, but exports also staged a significant recovery. As a result, the current account deficit in Jan-Apr was lower than Q2-FY10. Accordingly, SBP now expects the current account deficit for FY10 to range between 2.2-2.8 percent of GDP against earlier estimates ranging between 3.2-3.8 percent of GDP. This would be much lower than the 5.6 percent in FY09.

The news on the financing side, however, is not encouraging. Specifically, the financial account after recording a substantial surplus in Q1-FY10, witnessed sustained decline in the ensuing months. Thus, for aggregate Jul-Apr FY10 period, the surplus in the financial account remained noticeably lower than the same period last year.

The weakness of the financial account mirrored the declines in both, equity and loan inflows. Lower equity inflows are not surprising, given the uncertainties surrounding the both the domestic economy and the global financial markets, but non-realization of FoDP pledges and commitments made by some other lending agencies led to an unexpected shortfall from levels projected earlier.[1]



The persistent fall in financial inflows has impaired country's ability to finance even the smaller current account deficit (see **Figure 6.1**). For instance, despite movement of current account deficit in a narrow range, overall external account position deteriorated in the post Q1-FY10 period (see **Figure 6.2**).



It should be remembered that the sustainability of the current account also depends on the country's ability to finance it (preferably from the non-debt creating inflows). Pakistan, for a number of years, supported large current account deficits only because it was able to finance it. The external position becomes highly risky if both the current and financial accounts are in deficit.

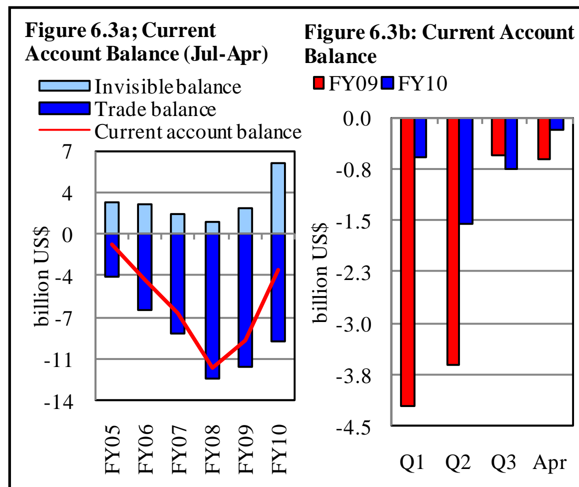
So far, overall external account for Jul-Apr FY10 period is showing nominal surplus. As a result, Pakistan foreign exchange reserves showed improvement and

[1]For instance, realization of Tokyo pledges during Jul-Apr FY10 remained less than 10 percent of the total budget estimate.

the exchange rate has also exhibited relative stability during the period under review. The situation, however, remains precarious and can deteriorate rapidly.

6.2 Current Account Balance

Current account deficit recorded 65.9 percent YoY contraction during Jul-Apr FY10 compared with a 20.1 percent decline in the same period last year. In absolute terms, this is the lowest deficit for the Jul-Apr period in the last four years (see **Figure 6.3a**).



While all components of the current account deficit recorded YoY improvement during the period under review, a major impetus came from a fall in imports and a strong increase in current transfers, which together contributed around 54.5 percent of the overall improvement. Fall in payments on account of repatriation of dividends, interest on debt, freight on merchandise imports and lower outflows from foreign exchange companies were other major contributory factors behind the contraction in the current account deficit during the period under consideration.

Quarterly analysis, however, shows that a large part of the YoY improvement in current account deficit was concentrated in H1-FY10 as it has shown deterioration during Q3-FY10 (see **Figure 6.3b**).

6.2.1 Trade Account[2]

Trade deficit declined by 18.3 percent during Jul-Apr FY10 compared with 9.0 percent fall in the same period last year. Although, this decline is largely driven by fall in imports, a small recovery in exports also contributed to decline in the deficit.

While recovery in exports is mainly attributed to better agriculture performance (rice, cotton and fruits), fall in imports was chiefly on account of lower average

[2]This section is based on exchange record compiled by SBP that does not tally with more detailed FBS data used in section 6.7: Trade.

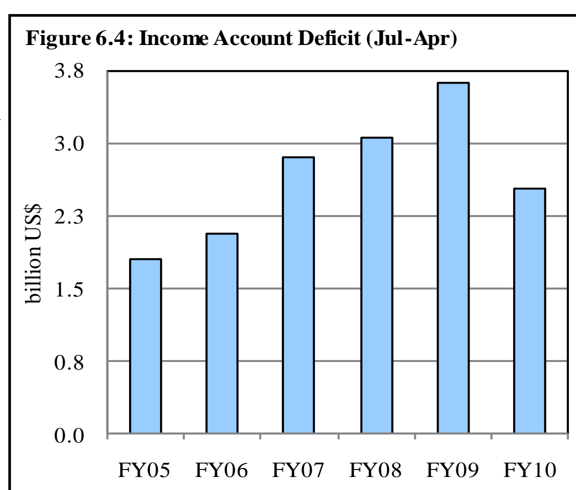
import prices. However, a part of YoY decline in imports was offset by rising import volumes (especially for petroleum products and fertilizer) during Jul-Apr FY10.

Almost the entire YoY improvement in trade deficit during the period was concentrated in H1-FY10. Indeed, as international prices begin recovering, YoY increase in imports more than offset modest recovery in exports in the following quarter. As a result, trade deficit increased during Jan-Apr FY10 compared with the same period last year.

6.2.2 Services (net)

Services account deficit declined by 39.0 percent during Jul-Apr FY10 on the top of 42.8 percent decline in the same period last year. A large part (61.9 percent) of this improvement stemmed from lower services imports, while the rest was contributed by an increase in services exports. (For details, see section 2.3: Services).

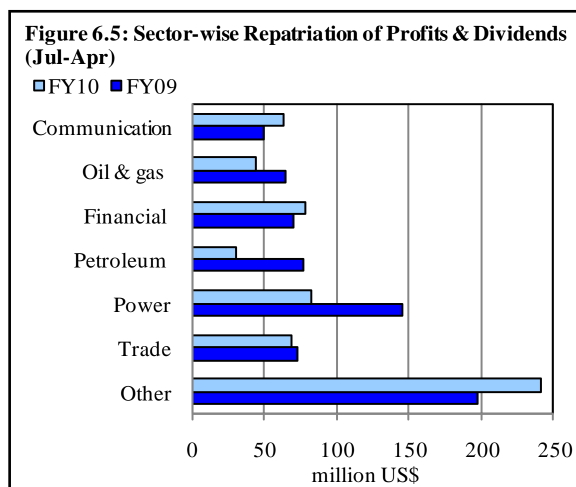
Figure 6.4: Income Account Deficit (Jul-Apr)



6.2.3 Income Account

After widening continuously in the last four years, deficit in the income account declined considerably (29.9 percent) during Jul-Apr FY10 (see **Figure 6.4**). Fall in the payments on both investment (repatriation of profit & dividends) and debt (interest) contributed to this decline. Specifically, the fall in investment income contributed around 86.0 percent of the decline in income account deficit while interest payment contributed around 14.0 percent during the period.

Figure 6.5: Sector-wise Repatriation of Profits & Dividends (Jul-Apr)



The decline in payments on investment during Jul-Apr FY10 mainly reflects a fall in repatriation of dividends and lower government's purchases of crude oil & gas. The major sectors recording decline in repatriation of profit & dividends during the period included petroleum refining, power and oil & gas, i.e. the sectors severely affected by circular debt issue (see **Figure 6.5**).[3]

On the other hand, financial business and communication sectors recorded YoY increase in repatriation of profit & dividends during Jul-Apr FY10. Dividends payments by a major bank[4] chiefly explain the increase in the former while repatriation of profit by a large telecom company explains the increase in the latter.

In line with the repatriation patterns, a larger part of dividends repatriation was concentrated in second quarter during current fiscal year (see **Figure 6.6b**). Seasonal pattern suggests that profit & dividends payments are likely to increase in the last quarter of current fiscal year as well.[5]

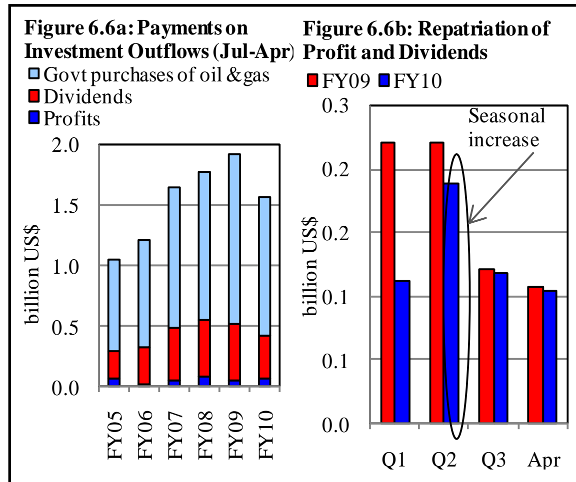


Figure 6.6a: Payments on Investment Outflows (Jul-Apr)

Figure 6.6b: Repatriation of Profit and Dividends

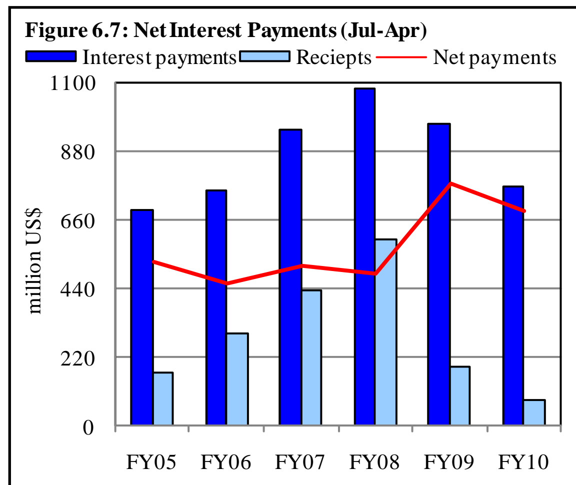


Figure 6.7: Net Interest Payments (Jul-Apr)

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[3]As large part of repatriation of profit& dividends is based on FY09 results, for detail analysis, please see *Second Quarterly Report* on State of Pakistan Economy for FY10.
[4]Out of total US$ 47.7 million profit & dividends payments of financial business, HBL's amount was around US$ 30 million. Based on results for the full-year 2009, HBL announced final cash dividends of Rs 6.00 per share at end Feb-2010.
[5]Most of the companies repatriate their profits and dividends on annual basis. Some of the companies have financial year Jan-Dec and some have financial year Jul-Jun. In this respect, they repatriate their profits & dividends with the lag of 3 or 4 months after audit and other procedures.

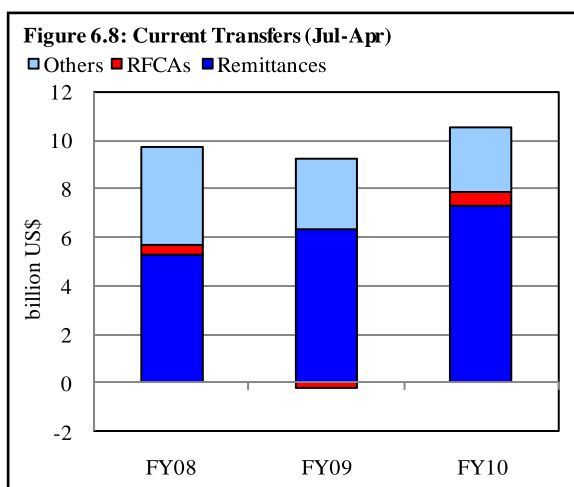
Almost the entire decline in net interest payments emanated from lower gross interest payments during Jul-Apr FY10 (see **Figure 6.7**). Along with relatively lower international interest rates; a fall in stock of expensive debt stock (IDB loans and Euro bond) also contributed to this decline as did lower interest payments on foreign currency deposits.

Nonetheless, higher payments on IMF loan in the wake of rising debt stock and lower earnings on foreign exchange reserves offset a part of the abovementioned gains.

6.2.4 Current Transfers

In sharp contrast to 7.0 percent fall last year, current transfers increased by 16.9 percent during Jul-Apr FY10. Apart from persistent increase in workers remittance, reversal of inflows in Resident Foreign Currency Accounts (RFCAs) and higher cash grants for government[6] contributed to this increase (see **Figure 6.8**).

Figure 6.8: Current Transfers (Jul-Apr)



However, fall in other private transfers (mainly RFCAs conversion) offset a part of the aforementioned gains during the period under review.

Workers' Remittances

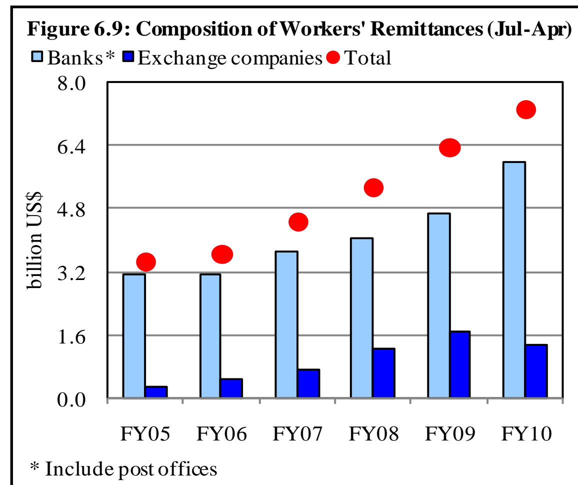
Worker remittances have recorded strong growth for the Jul-Apr period of last six successive years. Specifically, workers' remittances increased by 15.0 percent during Jul-Apr FY10 on the top of 14.9 percent average increase during the corresponding period of the last five years.

Given the difference in their financial year, their outflows mostly fall in the second and fourth quarter as per our fiscal year.

[6]This mainly shows United States Support worth US$ 44.0 million for Internally Displaced Persons (IDPs).

Unlike the previous years, however, almost the entire growth during current year stemmed from remittances through banks; remittances routed through exchange companies fell for the first time in the last six years (see **Figure 6.9**). Strong increase in remittances through banks probably reflects PRI's effort to attract remittances through this channel. Moreover, at least a part of remittances is also diverted from exchange companies to banks in the wake of;
(a) Possibility of further action against foreign exchange companies involved in illegal funds transfer; and
(b) Tough competition from banks.

Figure 6.9: Composition of Workers' Remittances (Jul-Apr)



* Include post offices

Table 6.2:Country-wise Workers' Remittances (Jul-Apr)
million US$; share percent; growth contribution percentage points

Countries	FY09	FY10	Share	Contribution in growth
Gulf region:	**3,626.9**	**4,222.1**	**57.8**	**9.4**
Bahrain	127.6	128.5	1.8	0.0
Kuwait	360.3	369.3	5.1	0.1
Qatar	276.7	299.1	4.1	0.4
Saudi Arabia	1,264.1	1,525.9	20.9	4.1
Oman	231.4	236.0	3.2	0.1
U.A.E.	1,366.8	1,663.2	22.8	4.7
U.S.A.	**1,435.7**	**1461.8**	**20.0**	**0.4**
U.K	**468.0**	**734.6**	**10.1**	**4.2**
Canada	**65.1**	**94.0**	**1.3**	**0.5**
Germany	**80.3**	**69.0**	**0.9**	**-0.2**
Japan	**3.6**	**5.0**	**0.1**	**0.0**
Australia	**26.8**	**48.6**	**0.7**	**0.3**
Others	**648.9**	**670.6**	**9.2**	**0.3**
Total	**6,355.1**	**7,305.6**	**100.0**	**15.0**

Country-wise data suggests that a large part of remittances growth during Jul-Apr FY10 was sourced from United Arab Emirates, United Kingdom, and Saudi Arabia. Other important contributors included Qatar, United States Canada and Australia (see **Table 6.2**).

Monthly Trends

Monthly trend shows that a large part of remittances growth was concentrated in Jul-Oct FY10 and remittances growth slowed down significantly in the subsequent months (Nov-Apr) (see **Figure 6.10**). Slowdown in workers' remittances growth is partly a statistical artifact, reflecting the stronger numbers seen October onward last year. Moreover, this deceleration in remittances growth may also be attributed to high

kerb market premium and the disruptions in the last week of December 2009 on account of religious holidays and closure of businesses following terrorist acts.

In particular, kerb market premium appears to be an important factor for remittances inflows. For instance, exceptionally high premium in Oct-2008 as well as in Feb-2010 caused sharp fall in remittances inflows (see **Figure 6.11**).

Recovery in Mar-Apr 2010
During Mar-Apr FY10, however, remittances from all major source countries recorded an uptick, mainly on account of a fall in kerb market premium (see **Figure 6.11**). This was an across the board improvement as remittances not only increased from all major source countries but also through all the channels (see **Figure 6.12**).

Within different channels, a large part of increase in inflows during Mar-Apr FY10 was attributed to banking channel. In particular, remittances through banks touched an all-time high during Mar FY10. This is because, on the one hand, stability in exchange rate led to increase in rupee conversion from foreign currency accounts, and, on the other hand

Figure 6.10: Workers' Remittances Growth (YoY)

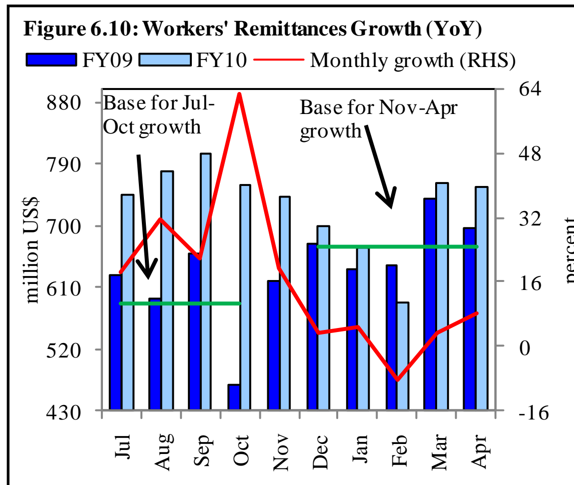


Figure 6.11: Workers' Remittances Vs Kerb Premium

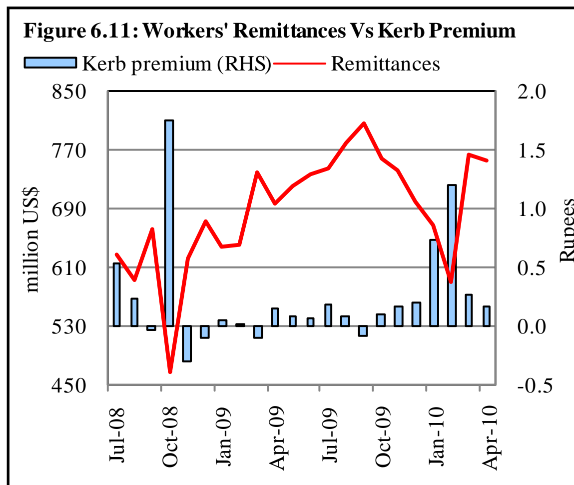


Figure 6.12a: Remittances from Major Countries

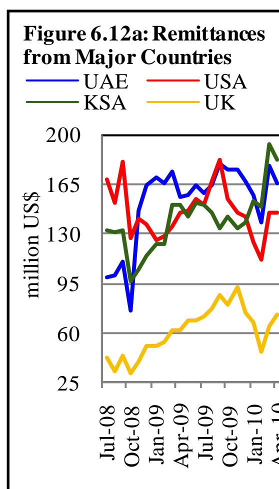
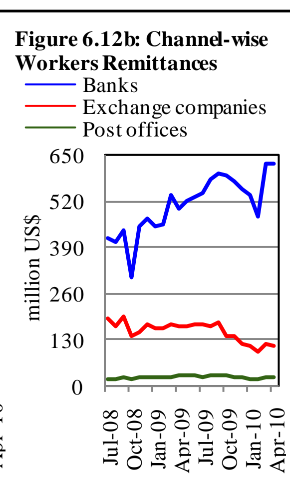


Figure 6.12b: Channel-wise Workers Remittances



remittance for family maintenance purpose increase may possibility be on account of continued efforts under Pakistan Remittance Initiative. Moreover, high remittance inflows during the month of March may also reflect seasonal increase and clearing backlog of February transactions.[7]

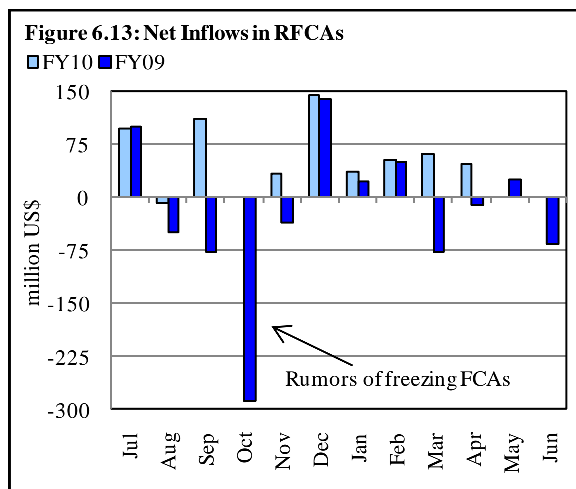
Going forward, higher growth in workers' remittances is difficult to sustain on account of high base set during 2009 and possible lag impact of global recession.

Resident FCAs

Inflow (net) in the RFCAs increased to US$ 574 million during Jul-Apr FY10 against the net outflow of US$ 230 million in the same period last year.

Encouragingly, net inflows showed YoY improvement throughout the year (see **Figure 6.13**). Part of this improvement is attributed to relative exchange rate stability as well as to higher inflows from UN, OGDC, and power utility company.

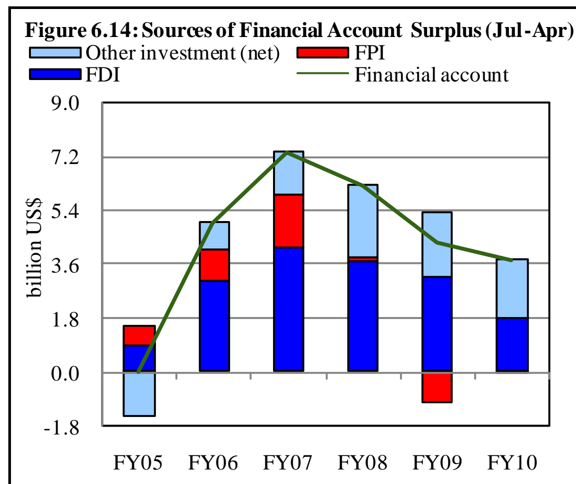
Figure 6.13: Net Inflows in RFCAs



6.3 Financial Account Balance

Deterioration in financial account surplus, which emerged in FY08, continued in Jul-Apr FY10 as well (see **Figure 6.14**). Specifically, financial account surplus recorded a YoY fall of 14.5 percent during Jul-Apr FY10 compared with average fall of 22.6 in the corresponding period of last two years.

Figure 6.14: Sources of Financial Account Surplus (Jul-Apr)



On the one hand, foreign investors' risk averseness amid

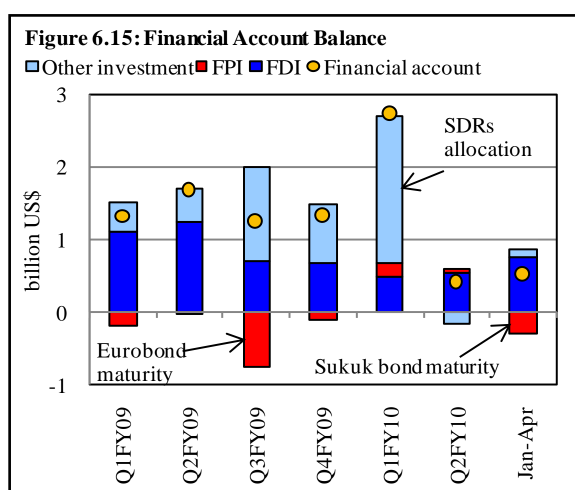
[7]Last ten years trend suggests that remittances recorded in the months of March were usually the highest in the twelve months.

global crises and severe power deficit in Pakistan led to substantial fall in foreign direct investment. On the other hand, lower than anticipated disbursement by international donors' reduced net loan inflows. The fall in financial account surplus would have been even higher, had it not been for (a non-recurring) SDRS allocation by the IMF.

On the positive side, foreign investment in stock market has revived significantly during the period under review[8]. However, these inflows are short term in nature and notoriously volatile.

The quarterly trend suggests that after recording surplus in Q1-FY10, surplus in financial account fell drastically in the subsequent quarters (see **Figure 6.15**). During Oct-Apr FY10, substantial fall in financial inflows (net) mainly reflected lower loan inflows and the maturity of sovereign financial instrument (Sukuk worth US$ 600 million).

Figure 6.15: Financial Account Balance



Net Foreign Investment

Fall in foreign investment (net) during Jul-Apr FY10 mainly owed to substantial fall in foreign investment. This was unlike the previous year, when considerable outflow from portfolio investment largely explained fall in overall investment.

Table 6.3: Pakistan Foreign Investment(Net Inflow) Jul-Apr

million US Dollar; growth percent

	FY09	FY10	Growth
Foreign investment	**2,212.4**	**1,726.3**	**-22.0**
I. Private investment	**2,753.5**	**2,343.8**	**-14.9**
Foreign direct investment	3,205.0	1,772.9	-44.7
Portfolio investment	-451.5	570.9	226
Equity securities	-451.5	570.9	226
Debt securities	0	0	0
II. Public investment	**-541.1**	**-617.5**	**-14.1**
of which: Debt securities*	**-541.1**	**-617.5**	**-14.1**

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

Specifically, foreign direct investment fell by 44.7 percent while net outflows from portfolio investment decelerated

[8]Investment in stock market has revived to US$ 570.9 million during Jul-Apr FY10 compared with net outflows of US$ 451.5 million in the same period last year.

by 95.4 percent during Jul-Apr FY10. This deceleration in net outflows from portfolio investment mainly owed to considerable investment in equity market which offset a large part of outflows from debt securities (mainly Sukuk bond repayment) (see **Table 6.3**).

Foreign Direct Investment

After remaining relatively stable for two years, foreign direct investment fell drastically during Jul-Apr FY10 (see **Figure 6.16**). In particular, YoY fall in foreign direct investment accelerated to 44.7 percent during Jul-Apr FY10 compared with 12.4 percent average fall in the same period of last two years.

Figure 6.16: Foreign Direct Investment (Jul-Apr)

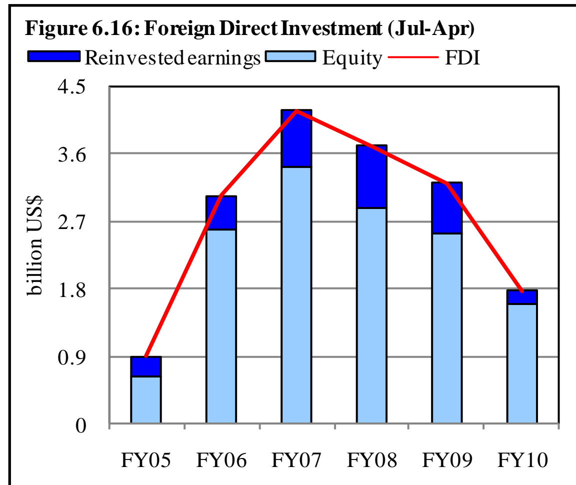
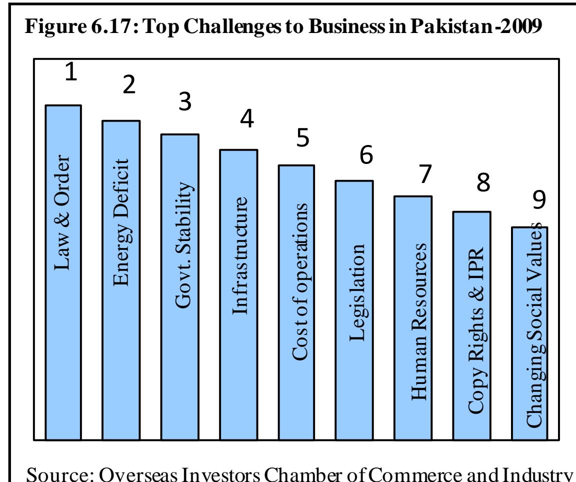


Figure 6.17: Top Challenges to Business in Pakistan-2009



Source: Overseas Investors Chamber of Commerce and Industry

Although a combination of factors explains this fall, the most prominent amongst them are: foreign investors risk averseness amid uncertainty about pace and extent of the global economic recovery and adverse security developments as well as electricity shortages at home. The risk averseness of foreign investors is reflected in across the globe fall in foreign direct investment. Further in Pakistan, Overseas Investors Chamber of Commerce and Industry (OICCI) survey 2009 shows foreign investors plan lower investment mainly because of law & order situation and power deficit (see **Figure 6.17**).

Component-wise analysis suggests that around one- third of the fall in overall investment during Jul-Apr FY10 was explained by lower reinvested earnings while rest of the fall was explained by lower equity inflows and decline in intra-company loans. The former mainly owed to either lower profits or higher losses while the latter may be explained by both the lower margins and foreign investors difficulty in obtaining credit. Although foreign direct investment recorded across the board fall during Jul-Apr FY10, main share (around 70 percent) came from lower investment in telecommunication and financial business (see **Table 6.4**).

Table 6.4: Sector -wise Foreign Direct Investment (Jul-Apr)
million US Dollar

	FY09			FY10		
Sectors	**Cash**	**Re-invested earnings**	**Total**	**Cash**	**Re-invested earnings**	**Total**
Chemicals	4.2	53.7	58.0	46.9	32.2	79.1
Petroleum refining	30.4	73.3	103.7	15.1	55.2	70.3
Oil & gas explorations	423.3	188.9	612.1	448.0	156.7	604.7
Cement	9.0	22.7	31.7	0.1	0.5	0.5
Power	91.6	-18.3	73.3	112.5	-101.5	11.0
Construction	78.1	-1.3	76.8	91.3	-5.0	86.3
Trade	109.3	38.4	147.7	51.3	26.7	78.0
Telecommunications	809.4	-42.4	767.1	394.5	-84.7	309.8
Financial business	494.3	186.7	681.0	101.9	31.1	133.0
Personal services	75.6	4.4	79.9	40.7	3.8	44.5
Others	415.8	157.7	573.5	306.0	49.7	355.7
Total	**2,541.1**	**663.9**	**3,205.0**	**1,608.2**	**164.7**	**1,772.9**

Apart from lower reinvested earnings, foreign investment in telecom sector was adversely affected by market saturation and stiff competition while investment in financial business was hurt by lack of merger& acquisition and repayment of intra-company loans.

Moreover, investment in petroleum refining declined mainly on account of circular debt issue while lower investment in oil& gas largely reflects poor law& order situation.

Foreign Portfolio Investment

Net outflow from foreign portfolio investment has shown considerable YoY deceleration during Jul-Apr FY10. This improvement entirely owed to revival of foreign inflows in equity market which offset a large part of Sukuk payment worth US$ 600 million (see **Figure 6.18**). Specifically, net outflow from portfolio

investment decelerated to US$ 46 million during Jul-Apr FY10 from net outflow of US$ 1.0 billion[9] in the same period of last year.

In line with regional trends, investment in the stock market staged an appreciable recovery, increasing to US$ 571 million during Jul-Apr FY10 compared to net outflow of US$ 451 million in the same period last year. Market sources suggest that foreign institutional investors often invest in Pakistan's stock market while investing in other major regional markets. For instance, foreign investment in stock markets of India and Pakistan are closely associated (see **Figure 6.19**). Other factors contributing to higher foreign investment inflows in Pakistan's equity market includes: a) re-entry of the country into MSCI frontier market index,; b) the fact that Pakistan's market is trading at discount compared with regional markets; and c) considerable fall in Pakistan's risk premium as reflected by fall in Credit Default Swap (CDS) spread.

Figure 6.18: Foreign Portfolio Investment

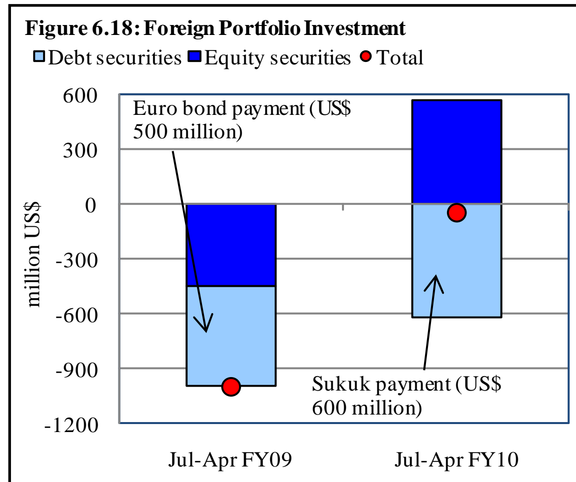
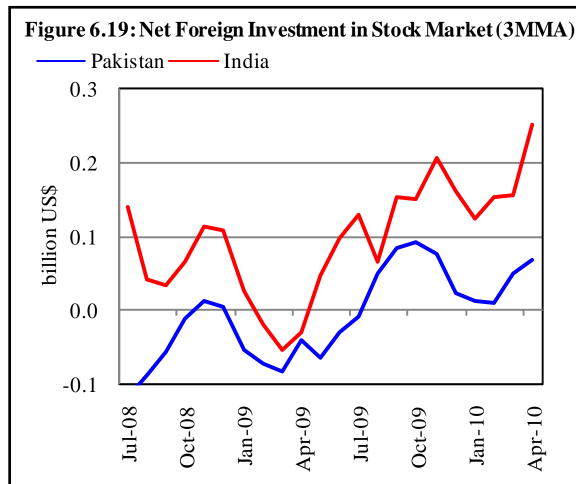


Figure 6.19: Net Foreign Investment in Stock Market (3MMA)



Outstanding Export Bills

The stock of aggregate outstanding export bills has increased by US$ 370 million during Jul-Apr FY10 against a decline of US$ 526 million in the comparable period last year. This increase is entirely explained by the outstanding export bills held by the exporters, because the bills held by banks declined by US $ 7 million during the period under review

[9] This included US$ 500 million Euro bond payment.

This increase may partly be attributed to recovery in exports and partly to expectations of exchange rate depreciation.

Currency and Deposits (Assets)
Currency and deposits declined by US$ 270 million during Jul-Apr FY10 against an increase of US$ 36 million during the same period last year. This decline is largely attributed to fall in commercial bank trade nostros in the wake of shifting oil payments to interbank market.

Loan Inflows (Net)
Net loan inflows declined to US$ 0.6 billion during Jul-Apr FY10 from US$ 1.3 billion during the same period last year. This decline owed to lower gross disbursements for the private sector as well as fall in official loan inflows (net). Major official loan inflows are IMF's bridge financing (US$ 1.1 billion), ADB (US$ 0.2 billion) and World Bank (US$ 0.3 billion).

It may be pointed out that IDB loan repayment (US$ 323 million) which was due in December 2009 has been rolled over for six months.

Other Liabilities (Net)
Other liabilities (net) recorded a substantial increase of US$ 1.1 billion during Jul-Apr FY10. The entire increase reflects IMF SDRs allocation.

6.4 Services Trade

During Jul-Apr FY10, services account deficit declined to US$ 2.0 billion, contracting by 39.0 percent compared to the contraction of 42.8 percent in the same period last year. The contraction in services trade deficit was a combination of 12.2 percent decline in services imports and 15.3 percent rise in services exports.

The decline in the import growth was expected on account of restrictions on outflows of exchange companies and decline in freight payments resulting from falling merchandise imports. Fortunately, deceleration in import growth was complimented by an increase in government services exports and commendable performance of telecommunication services exports that resulted in substantial decline in the services trade deficit (see **Table 6.5**).

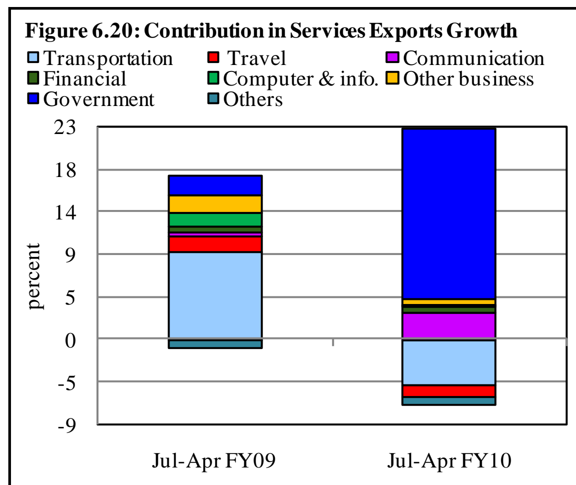
Table 6.5: Causative Factors of Contraction in Services Trade Deficit (Jul-Apr)
million US Dollar

	FY09		FY10	
	Value	Abs. Change	Value	Abs. Change
Exports	**3,126**	**442**	**3,605**	**479**
Of which:				
Transportation receipts	1,106	248	952	-154
Telecommunication	95	7	185	90
Logistic	465	183	537	72
Non-logistic	461	-127	950	489
All others	999	131	981	-18
Imports	**6,344**	**-1,966**	**5,567**	**-777**
Of which:				
Transportation payments	3,119	103	2,812	-307
Travel & other business	2,298	-2,017	1,646	-652
Of which:				
Payments through FECs	*1,138*	*-2,161*	*553*	*-585*
Government services	319	-37	505	186
All others	608	-15	605	-3
Trade deficit	**3,218**	**-2,408**	**1,962**	**-1,256**

Services Exports

Services exports registered a growth of 15.3 percent during Jul-Apr FY10 compared to growth of 16.5 percent in the same period last year, largely on account of improvement in receipts under "government services". In addition, telecommunication, financial and other business also contributed to services export growth during Jul-Apr FY10 (see **Figure 6.20**).

Figure 6.20: Contribution in Services Exports Growth



Monthly YoY analysis of services export reveals improvement in the exports Feb-2010 onwards. This recovery stemmed from a combination of factors like logistic support inflows, increased passage earnings of Pak airlines, higher receipts from international tourists, continuity of telephone traffic from legitimate channel and

increase in other miscellaneous business services (see **Table 6.6**).

Table 6.6: Major Services Exports (FY10)

million US Dollar; growth percent

	Absolute value			Growth		
	Jul-Jan	**Feb-Mar**	**Jul-Mar**	**Jul-Jan**	**Feb-Mar**	**Jul-Mar**
Transportation	661	287	948	-22.5	13.4	-13.9
Travel	166	72	238	-20.2	12.5	-12.5
Communication	144	56	200	182.4	-6.7	80.2
Construction	9	4	13	-60.9	-20.0	-53.6
Insurance	25	10	35	-30.6	-16.7	-27.1
Financial	74	21	95	100.0	0.0	44.8
Computer and information	114	41	155	0.9	-2.4	0.0
Royalties and license fees	4	2	6	-60.0	100.0	-45.5
Other business	288	144	432	-3.7	28.6	4.9
Personal, cultural & recreational	1	3	4			
Government services	618	868	1,486	-22.1	552.6	60.6
Of which: logistic support	0	537	537	-100.0		15.5
Total	**2,104**	**1,508**	**3,612**	**-13.2**	**114.5**	**15.3**

The ***exports of transportation services*** declined by 13.9 percent YoY during Jul-Apr FY10, sharply down from the growth of 28.9 percent during the same period of FY09 on account of relatively lower freight earnings, reduced passage earning of domestic airlines, and curtailed operations of foreign transport companies. Passage earnings of Pakistani airlines, having the largest share in transportation receipts, witnessed a modest fall of 1.1 percent during Jul-Apr FY10 compared to an increase of 6.4 percent last year.
Monthly analysis shows

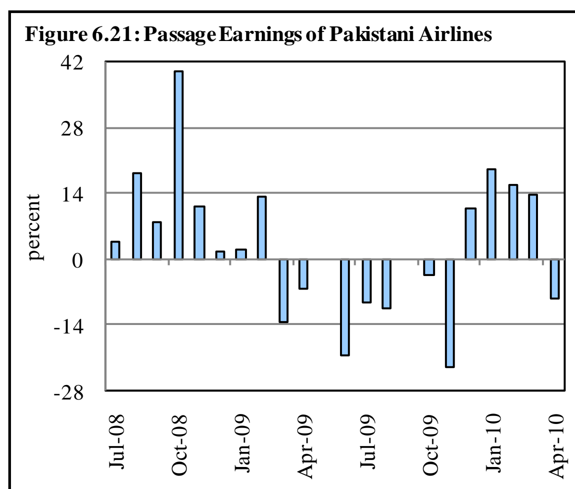


Figure 6.21: Passage Earnings of Pakistani Airlines

recovery in passage earnings of Pakistani airlines (see **Figure 6.21**) that came in wake of decisions by some of the international airlines to discontinue their operations in Pakistan on security concerns.[10] Furthermore PIA opened up some new destinations and increased flight frequency to some of the established destinations. This also explains the increase in the category foreign travelers under travel services exports during the period under review.

Freight earnings declined by 29.7 percent during Jul- Apr FY10 against an increase of 1.8 percent last year. It may be pointed out that unlike the link between merchandise imports and freight payments: the link between merchandise exports and freight earnings is weak. Domestic shipping lines only cater to12-13 percent of the total requirement, while payments made by foreign importers to other than domestic shipping lines are not reflected in country's accounts. Thus even if the merchandise exports rise, it would not necessarily result in higher freight earnings as in the case of freight payments and merchandise imports.

Travel Services exports fell by 12.3 percent on account of decline in receipts through foreign exchange companies. The decline of US$ 56 million in receipts through exchange companies was on account of restrictions imposed on exchange companies by SBP.[11]

This fall in receipts of exchange companies was partially offset by the increase in the category: Foreign Tourists. The receipts from foreign national tourists improved slightly from US$ 168 million in Jul-Apr FY09 to US$ 193 million during Jul-Apr FY10 reflecting an increase of 14.5 percent.

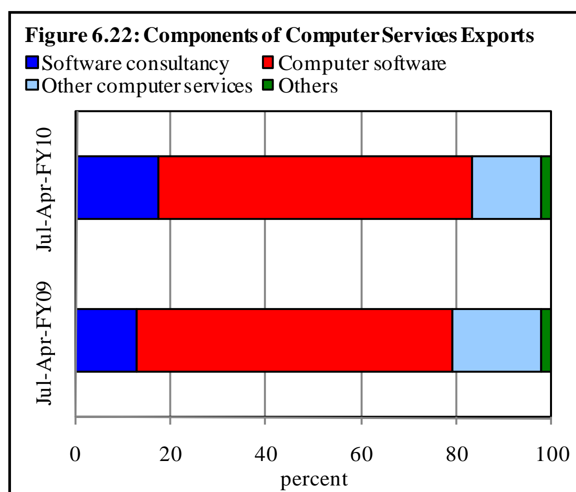
Communication services exports recorded a phenomenal growth of 80.3 mainly on the back of telecommunication services exports, which grew by 95.6 percent during the period under consideration. This remarkable increase is attributable to the PTA's implementation of *Monitoring and Reconciliation of International Telephone Traffic* to curtail the illegal traffic. The lowering of settlement rates during the current fiscal year also contributed to this increase.[12]

[10]British Airways discontinued its operations from Pakistan in March 2009; Gulf airlines suspended its operations from Peshawar in August 2009, while Singapore Airway discontinued its operations from Pakistan in March 2009 in Feb 2010.
[11]These receipts prior to 2009 were recorded in the current transfers as a contra item. Outflows through exchange companies used to be offset by the inward workers' remittances and other inflows. These other inflows 2009 onwards are being recorded in travel services receipts through FECs.
[12]As per Telecom Quarterly Review of Dec 2009, settlement rates declined from US cents 12.5 per minute to US cents 10.5 per minute

Monthly data reveals deceleration in the growth of telecommunication services exports Mar-FY10 on wards. It may be recalled that International telephone traffic started to rise Mar-09 onwards after PTA, with the support of FIA, raided many illegal operators in different cities.

Computer and information services exports witnessed a modest increase of 0.4 percent during Jul-Apr FY10 in contrast to the outstanding growth rates of 31.7 and 44.9 in the same periods of last two years. The deceleration in growth of this sector might be attributed to falling foreign demand. Software consultancy services recorded an increase of 35.4 percent while exports of computer software and other computer services witnessed a fall of 0.2 percent and 21.5 percent during the period under review. The overall group's exports are dictated by the exports of software because of its substantial share (see **Figure 6.22**).

Figure 6.22: Components of Computer Services Exports



According to the Global Information Technology Report 2009-2010[13], Pakistan's ranking improved to 87 from the last year's ranking of 98. This signifies the huge potential in this sector to grow and become one of the leading foreign exchange earners for Pakistan.[14]

Having said this, there is a dire need to adopt a comprehensive policy to address the issues facing the IT sector such as weak enforcement of legal framework, lower volumes of quality workforce and financing issues. Apart from these, incentives should be given to the unregistered software houses which are carrying out their business on web portals.

Government services exports posted a robust growth of 60.7 percent during Jul-Apr FY10 compared to 6.4 percent in the same period last year. Major

[13]Global Information Technology Report 2009-2010 was released by World Economic Forum.
[14]According to PSEB, the industry size is estimated to be US$ 2.8 billion, whereas the export earnings of the sector are calculated to be US$ 1.4 billion.

contribution came from the non-logistic receipts which recorded an increase of 106.1 percent during the period under review (see **Figure 6.23**).

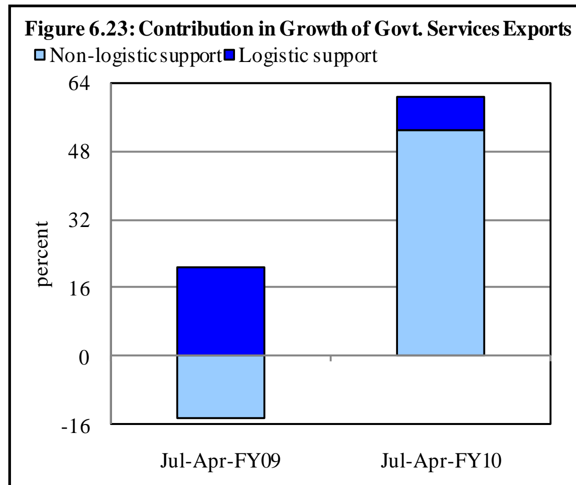


Figure 6.23: Contribution in Growth of Govt. Services Exports

Non-logistic support rose on account of increases in remittances by foreign missions in Pakistan as well as remittances received by international organizations. A part of this rise in non-logistic support could be attributed to the increase in diplomatic operations of US.

Other business services exports increased by 5.0 percent during Jul-Apr FY10 compared to 14.2 percent rise recorded in the corresponding period last year. The increase in the group's exports was mainly due to the decline in *refunds,* although increase in exports of *merchant. & trade related activity* and *business consultancy* also contributed positively to the group's exports (see **Figure 6.24**). *Miscellaneous* category, which has the largest share (42.6 percent) in overall business services exports, increased by 2.4 percent. However, the categories *agency commission* and *technical & engineering* services witnessed fall during the period under analysis.

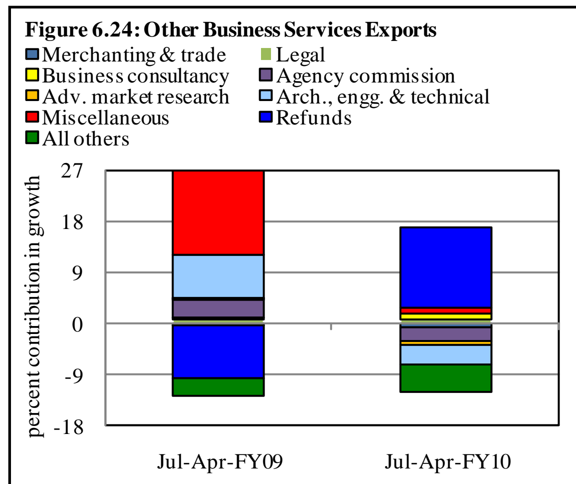


Figure 6.24: Other Business Services Exports

Services Imports

Overall services imports fell by 12.2 percent during Jul-Apr FY10 compared to 23.6 percent fall recorded in the same period last year. A continuous decline in outflows through exchange companies as well as lower freight payments on

account of decline in merchandise imports were the main factors behind this fall in services imports (see **Figure 6.25**).

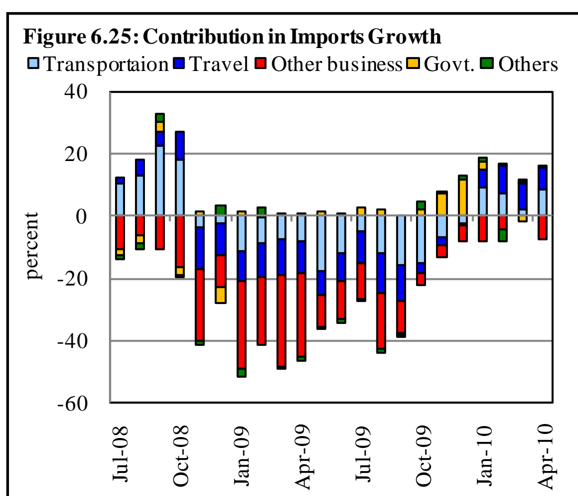


Figure 6.25: Contribution in Imports Growth

Services import growth dropped sharply in November 2008 (FY09) as the impact of crackdown on one of the exchange companies and outflows restrictions imposed by SBP were complimented by fall in imports (see **Figure 6.25**). This trend continued for a year, however, Dec 2009 onwards, services imports have started to recover. The YoY monthly recovery in services imports owes to rise in merchandise imports, higher travel payments and increase in payments through international bodies.[15]

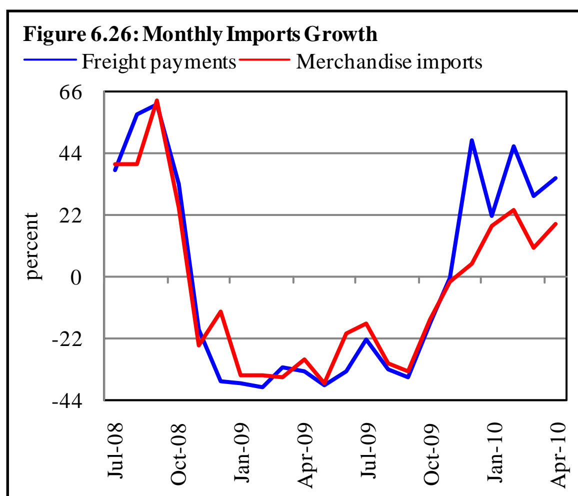


Figure 6.26: Monthly Imports Growth

Transportation services payments which account for half of the total services import payments fell by 9.8 percent during Jul-Apr FY10 compared to a 3.4 percent increase in the comparable period last year. The principal reason for this fall was lower freight payments compared to last year due to fall in merchandise imports in H1-FY10 (see **Figure 6.26**).

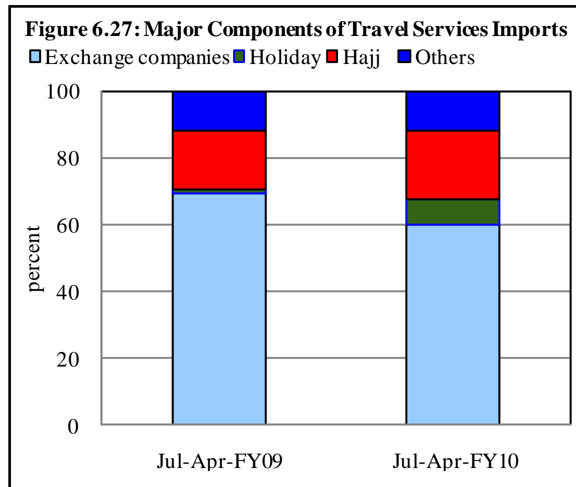
Passage earnings of foreign airlines and Pakistani transport companies' expenses also fell during the period under review. Closure of flight operations by some major international airlines continued to restrict the passage earnings of foreign

[15]Payment to international bodies (such as UN, WHO, USAID, etc.) is paid in rupee counterpart (converted to dollars for accounting purposes) to these organizations against receipts from these organizations.

airlines. The category's imports are likely to decline further after the discontinuation of flight operations by Singapore airlines.[16]

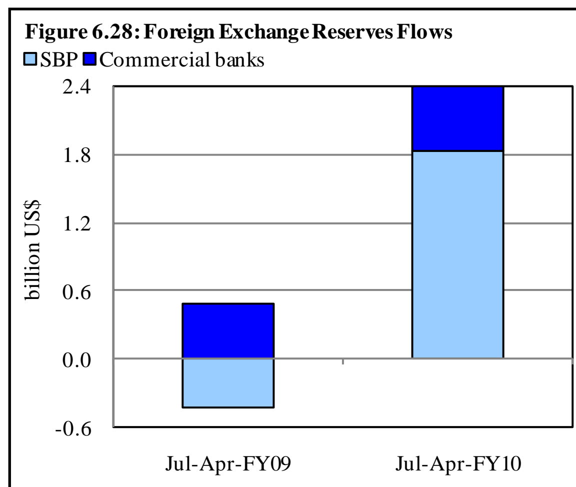
In line with the expectations, ***travel services*** and ***other business services imports*** declined on account of restrictions on outflows through exchange companies. Payments through exchange companies, which constitute the bulk of overall groups' imports, declined by 51.4 percent during Jul-Apr FY10 (see **Figure 6.27**).

Figure 6.27: Major Components of Travel Services Imports



Although travel services payments fell by 18.2 percent, its sub category *'holiday on recreational tours abroad'* increased to US$ 55 million during Jul-Apr FY10 from US$ 8 million in the corresponding period last year. This probably reflects the shift of local tourists to international destinations due to security concerns within the country.

Figure 6.28: Foreign Exchange Reserves Flows



Similar to travel services imports, other business services imports also fell by 35.0 percent. Monthly data however, shows deceleration in the declining trend of both these categories. Travel services even posted a positive growth in Q3-FY10. The rising trend in both, travel and other business services imports reflect the withering of the impact of fall in the payments through exchange

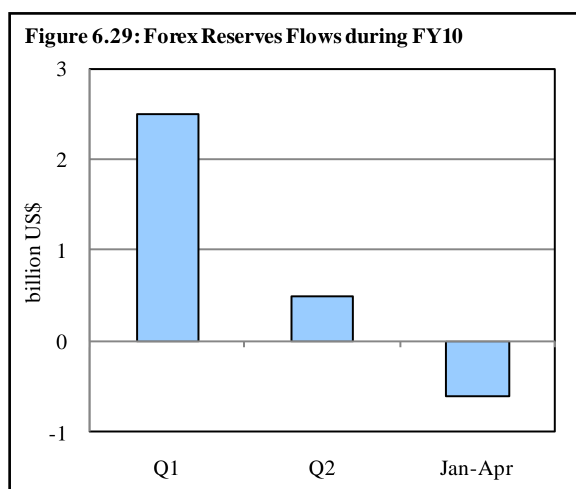
[16]Singapore Airlines, the flag-carrier airline of Singapore, has informed the Civil Aviation Authority of Pakistan it will stop flight operations from February 17, 2010.

companies[17] in the aftermath of crackdown and outflows restrictions imposed by SBP.

6.5 Foreign Exchange Reserves

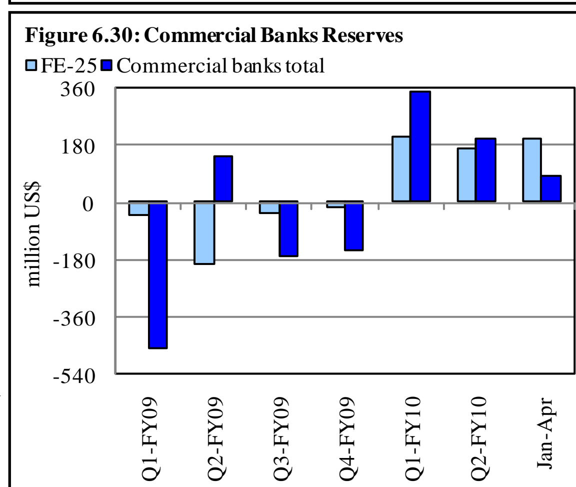
Pakistan's foreign exchange reserves increased by US$ 2.4 billion to reach US$ 15.2 billion by the end of April 2010 (see **Figure 6.28**). While a large part (US$ 1.8 billion) of this increase was contributed by SBP's reserves, commercial banks' reserves also made a positive contribution of US$ 560 million.

Figure 6.29: Forex Reserves Flows during FY10



Quarterly analysis suggests that accumulation in reserves was concentrated in Q1-FY10, while reserves increased only marginally in the subsequent quarters. This is because a substantive part of the rise in reserves during Q1-FY10 owed to SDRs allocation and disbursements by IMF under SBA. Thus, lower disbursement from IMF in the following quarters limited the rise in reserve (see **Figure 6.29**).

Figure 6.30: Commercial Banks Reserves



Apart from IMF support, increase in SBP's reserves during Jul-Apr FY10 may also be attributed to shifting of oil payments to interbank market and exchange rate adjustment. While the former significantly reduced need for market interventions, the latter helped in curtailment of current account deficit.[18]

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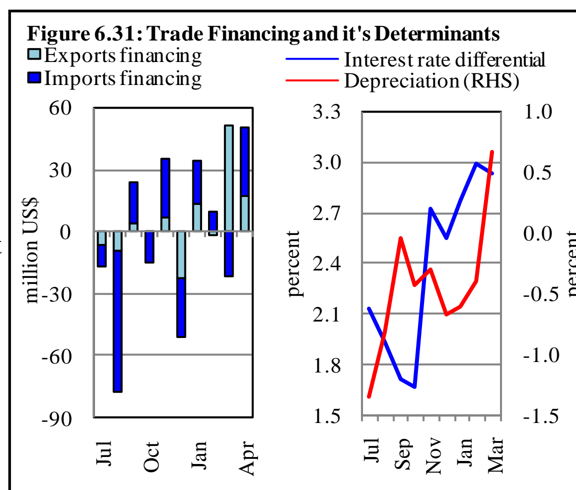
[17]During FY09 SBP imposed number of restrictions on outflows from exchange companies. In Oct FY09 one of the exchange companies was also raided by the FIA. These two factors substantially curtailed both imports and export payments through exchange companies.

[18]Had current account deficit not contracted, foreign exchange reserves would have either depleted or would not have shown any improvement

The rise in commercial bank reserves during Jul-Apr FY10, on the other hand, largely reflects increase in foreign currency deposits and retirement of foreign currency loans (see **Figure 6.30**). Increase in both of them was a function of expectation of exchange rate depreciation, which not only encouraged inflows in foreign currency accounts but also discouraged lending from FE-25 deposits. The increase in commercial bank reserves is quite remarkable, given the shifting of oil payments to interbank market which led to negative trade nostros of commercial banks.

While there was a US$ 19.5 million YoY decline in the net trade financing during Jul-Apr FY10, export financing recorded substantial disbursements in Mar-Apr 2010. The rise in disbursements in March and April 2010 seems to be the result of 0.7 and 0.5 percent monthly appreciation of Pak rupee vis-à-vis US dollar and the increase in interest rate differential between EFS and weighted average foreign currency lending rate (see **Figure 6.31**).

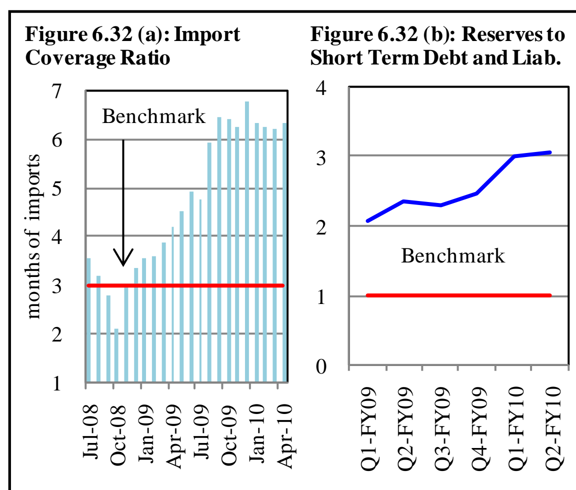
Figure 6.31: Trade Financing and it's Determinants



Reserve Adequacy Indicators

There are a number of methods to assess the reserves adequacy, of these the most common is import coverage ratio or import adequacy ratio. This ratio is particularly relevant for low-income countries exposed to current account shocks and without significant access to capital markets. During Jul-Apr FY10 owing to fall in imports, Pakistan's import coverage ratio remained fairly stable with reserves adequate to finance more than six months of imports (see **Figure 6.32a**).

Figure 6.32 (a): Import Coverage Ratio **Figure 6.32 (b): Reserves to Short Term Debt and Liab.**



Another benchmark, known as the Greenspan-Guidotti rule, is widely used measure of assessing vulnerability to capital account crisis. Pakistan's foreign exchange reserves to short term debt & liabilities (STDL) ratio also stood comfortably at 3.1 by the end-Dec-09 (see **Figure 6.32b**). The benchmark level of this ratio is 1(see **Box 6.1**).[19]

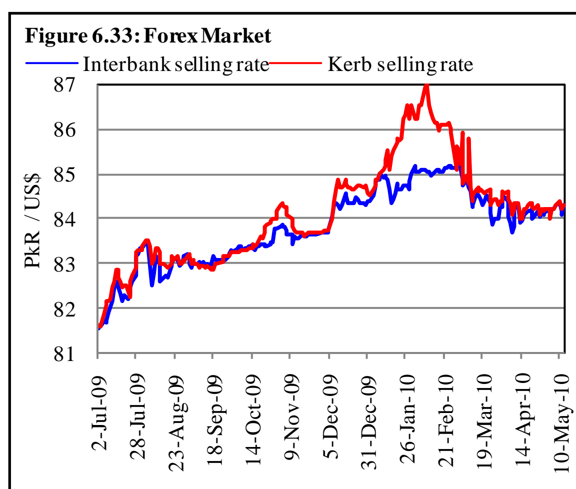
Box 6.1: Significance of Reserves to STDL Ratio and Definition of Short-Term External Debt
The significance of forex reserves/short term debt and liabilities ratio as a vulnerability indicator has become increasingly evident,
(1) A country with a low international reserves/short-term external debt ratio is more vulnerable to external shocks; (2) A low reserves/short-term external debt ratio may be an indication of imprudent macroeconomic policies; (3) An economic crisis will tend to be more severe if the ratio is low, as the current account and exchange rate adjustments required to balance the macroeconomic accounts are magnified.

However, calculating this indicator is not an easy task. The definition of short term debt and liabilities is one of the major obstacles in computing this vulnerability indicator apart from data issues. Short term external debt is identified as a cross border debt with the maturity of a year or less. At present two definitions are being used for short term debt[20] .
1) Remaining maturity concept: According to this concept all external or cross border debt is regarded as short term debt which becomes due within a year, regardless of its original maturity. This definition is being used by Bank for International Settlements (BIS).
2) According to World Bank's publication *Global Development Finance,* short term debt encompass only external liabilities, including official trade credits extended to developing countries as reported by OECD, with original maturities of one year or less.

6.6 Exchange Rate

During Jul-Apr FY10 Pak rupee exhibited relative stability, depreciating by only 3.5 percent compared to 16.3 percent in the same period of the previous year. While lower trade deficit and sustained growth in workers' remittances lent support to rupee stability, decline in financial inflows acted adversely. Nevertheless, as overall external account balance remained in surplus and

Figure 6.33: Forex Market



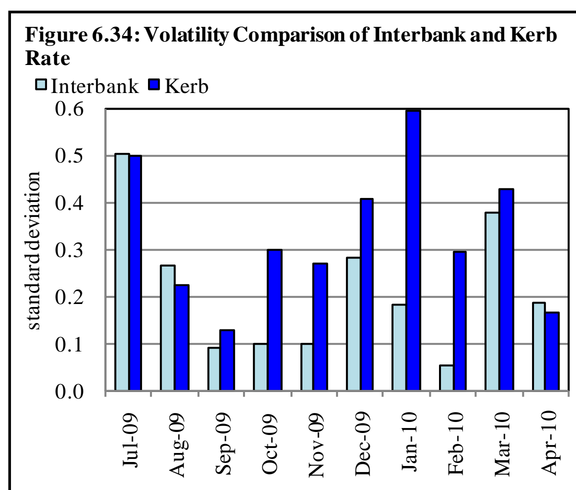
[19]STDL constitutes the total short term external debt as well as the payments of principal and/or interest due within a year or less.
[20]Source: IMF

the reserve position was stable, pressures on the rupee remained manageable.

Volatility in the kerb-market however, remained substantial throughout the Jul-Apr FY10 period, initially on account of Hajj related demand and later due to shifting of oil payments. Demand for the US$ in the kerb-market was particularly high in January and February 2010, which led to substantial rise in the kerb premium and volatility in the exchange rate (see **Figure 6.33 and 6.34**).

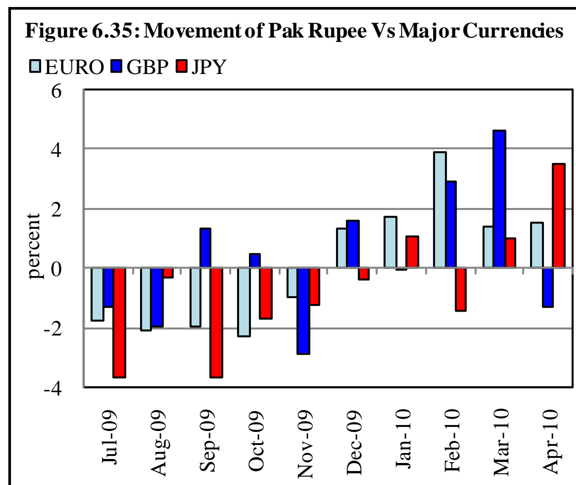
Anecdotal evidence suggests that the exaggerated demand for the hard currency in Jan-Feb FY10 was mostly speculative as it died out in the following month (March 2010). The calming of the speculative pressure in the kerb-market may also have been influenced by rise in portfolio investment and increased in workers' remittances in this month.

Figure 6.34: Volatility Comparison of Interbank and Kerb Rate



The improvement in inflows allowed Pak rupee to regain some of the ground it lost in February as rupee appreciated by 1.22 percent vis-à-vis US dollar between end- Feb and end-Apr 2010.

Figure 6.35: Movement of Pak Rupee Vs Major Currencies



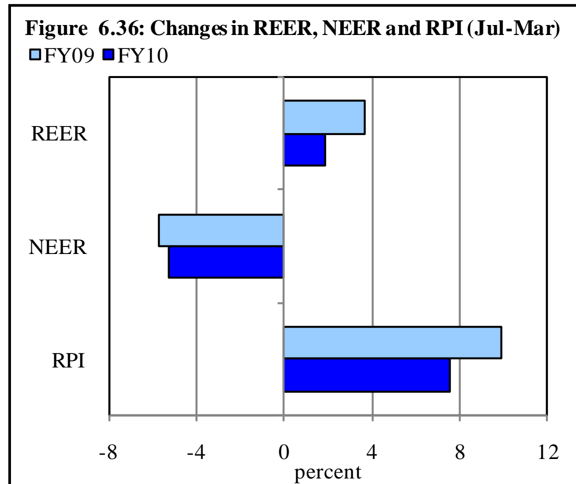
Pak Rupee Performance against Major Currencies

US dollar has been gaining strength against major currencies i.e. euro and pound since December 2009. Events in Greece and concerns about future problems in other European countries: Portugal, Ireland and Spain are keeping the dollar stronger. Also the fact, that the economy is improving more in the US than in Europe is helping dollar gain strength.

The relative strength of dollar against euro and pound, and Pak rupee's stability against the US dollar resulted in Pak rupee's appreciation against major international currencies Dec-09 onwards (see **Figure 6.35**).

Pak rupee, however, depreciated against the trade weighted basket of currencies. The Nominal Effective Exchange Rate (NEER) depreciated by 4.6 percent during Jul-Mar FY10 compared to 6.4 percent during the same period last year (see **Figure 6.36**). This depreciation was more than offset by the increase in the Relative Price Index (RPI) that is due to higher domestic inflation compared to the trading partner countries. As a result Real Effective Exchange Rate (REER) appreciated by 3.5 percent (see **Figure 6.36**).

Figure 6.36: Changes in REER, NEER and RPI (Jul-Mar)

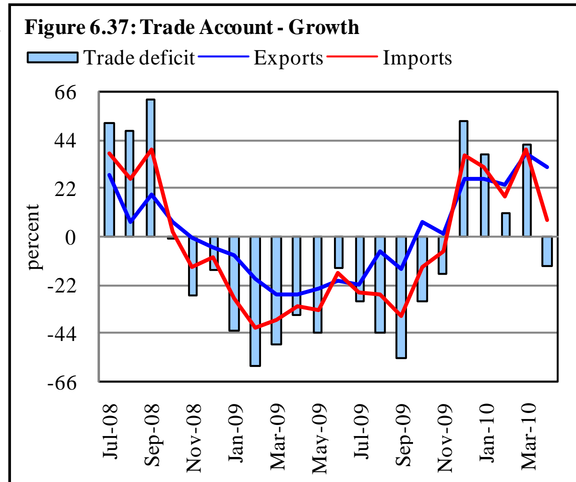


6.7 Trade Account[21]

A decent 8.0 percent YoY rise in exports accompanied by a smaller 2.8 percent YoY contraction in imports caused the country's trade deficit to record 13.9 percent YoY fall during Jul-Apr FY10.

The entire improvement in trade deficit was concentrated in the initial five months of the period under review. This was principally due to compression in imports on account of sharp fall in import prices during this

Figure 6.37: Trade Account - Growth

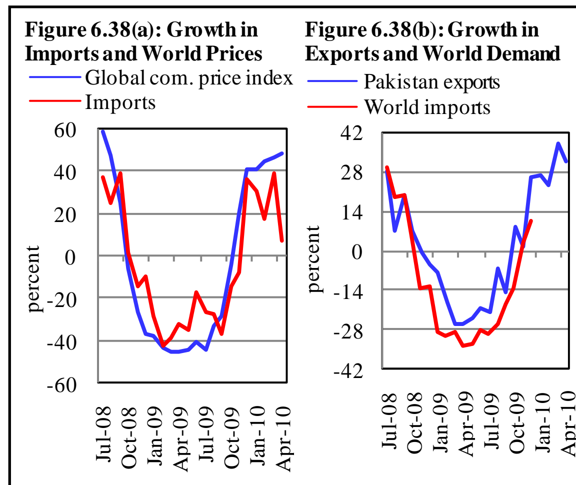


[21]The analysis is based on provisional data provided by the Federal Bureau of Statistics, which is subject to revisions. This data may not tally with the exchange record numbers posted in the section of *Balance of Payments.*

period. Import growth, however, recovered strongly December 2009 onwards outpacing a substantial recovery in export growth. As a result, trade deficit recorded YoY increase from December 2009 (see **Figure 6.37**).

The December 2009 onwards increase in import growth is attributable to, reemergence of a positive price impact; (see **Figure 6.38a**) as well as, some revival in domestic demand. The revival in domestic demand probably benefited from the government policies which aimed at stimulating economic activity. Encouragingly, these policy support measures, along with some recovery in the global economy, were also helpful (see **Figure 6.38b**) in bringing about a reasonable recovery in exports growth post Q2-FY10.

Figure 6.38(a): Growth in Imports and World Prices **Figure 6.38(b): Growth in Exports and World Demand**



Going forward, imports bill is likely to rise on account of continued price and demand pressures. A corresponding recovery in exports, however, is likely to keep trade deficit for the whole FY10 in the negative territory.

Exports

A variety of supportive external and domestic factors led country's exports to record a redeemably 8.0 percent YoY growth during Jul-Apr FY10, compared to a marginal 3.6 percent YoY decline recorded during the same period last year.

In terms of monthly performance, after remaining in the negative territory for almost a year, export growth started to pickup from October 2009 (see

Figure 6.39: Contribution in Export Growth

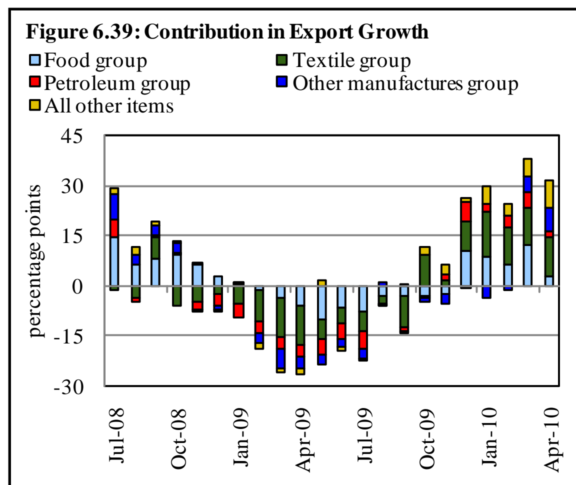


Table 6.7: Export Growth Composition Analysis

value million US Dollar; growth percent

	Jul-Apr FY10					Quarterly YoY growth		
	Value	Growth	Abs Δ	Quantum impact	Price impact	Q1	Q2-	Jan- Apr
Major drivers of export growth								
of which								
Other varieties of rice	1,108.9	44.1	339.1	758.4	-418.8	-18.5	30.6	116.6
Cotton yarn	1,211.0	32.1	294.5	272.0	22.5	9.0	53.8	34.2
Art silk and synthetic textiles	381.5	66.9	153.0	102.2	50.7	-28.1	360.2	72.7
Jewelry	397.0	102.6	201.1			293.6	26.0	16.1
Raw cotton	194.2	140.2	113.3	94.2	19.2	39.3	200.8	188.5
Fruits	208.8	55.1	74.1	54.7	21.8	11.8	147.4	46.0
Chemicals and pharmaceuticals	621.6	22.0	112.3	-	-	4.7	10.9	44.4
Other textile material	229.0	31.4	54.7	-	-	-6.5	34.9	82.1
Readymade garments	1,059.6	5.2	52.5	-71.1	123.6	-2.7	-1.3	19.2
Petroleum products	456.2	13.7	55.1	76.5	-21.5	-43.9	21.1	112.4
Others	**10,016.3**	**-2.6**	**-269.2**	**-3.2**	**-495.2**	**-22.6**	**-2.1**	**18.0**
Total exports	**15,884.1**	**8.0**	**1,180.0**	**1,283.8**	**-697.7**	**-14.9**	**10.4**	**29.8**

Figure 6.39). The recovery in exports has been broad based led by better performance of food group; textile and jewelry exports (see **Table 6.7**).

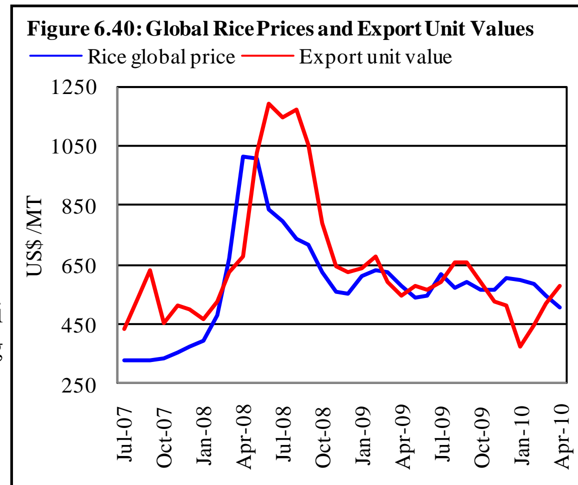
The rise in food group exports was largely on account of increase in exports quantum of *other varieties of rice, fruits & vegetables, meat*, etc., with rise in export quantum of *other varieties of rice* making highest contribution to export growth during Jul-Apr FY10. This was, in turn, helped by higher left over stocks of FY09 (see **Box 6.2**) and better than targeted rice production during FY10. [22] In addition weak rice crop in Philippines and India, preferential duty extension to Pakistan's Irri-6 rice by Kenya also helped in achieving higher export volumes during the period under review.[23] More than half of the impact of rise in export quantum, however, was offset by a YoY fall in export unit values of rice during this period.

[22]The target of rice production for FY10 was 5.9 million tons, while the estimated production is 6.3 million tons.
[23]Pakistani rice exports are being charged 35 percent import duty while others are charged 70 percent.

The fall in the unit values was not surprising as international rice prices were expected to revert back to long-term trends after recording an unusual rise during Jan to Jun, 2008 (see **Figure 6.40**).

The fall in unit values of basmati and *other varieties of rice* during Jul-Apr FY10 resulted in large negative price impact in both these categories.

Figure 6.40: Global Rice Prices and Export Unit Values



Box 6.2: Rice Exports and Domestic Stocks Position

Pakistan's rice export season starts around October with the arrival of new crop and lasts till around March. During this time around 50 percent of the total rice production is exported, while the remaining is available as unsold stocks for domestic consumption and gradual exports till the arrival of new crop. During FY09, country harvested a bumper rice crop to the tune of 6.9 million tonnes, however, due to a variety of reasons, only 40 percent of the total production was exported.[24] As a result there was a large stock carried forward to FY10 (see **Table 6.2.1**).

In FY10 also, rice production was better than the targets set by the government. Hence, during Jul-Apr FY10 although the rice export quantum recorded a sharp 66.6 percent surge, a significant stock is still lying unsold with the growers and exporters.

Table 6.2.1: Estimated Rice Exports, Consumption, Stock Position

million metric tonnes

		FY08	FY09	Jul-Mar FY10
A	Production	5.6	6.9	6.7
B	Wastage[25]	0.3	0.3	0.3
C	A-B+ Previous carried forward stock	5.7	7.5	9.1
D	Exports	2.8	2.7	3.3
E	Average approx. consumption	2	2	1.5
	C-D-E = carry forward	0.9	2.8	4.3

With production of Vietnam and Thailand entering the international market Feb onwards, it would become increasingly difficult for Pakistan to unload its existing stocks at competitive prices. In this scenario there is a possibility of a large carried forward stock of rice from FY10 to FY11 as well. This could potentially lead to a supply glut in the domestic market that is likely to adversely affect both, the exporters and the rice farmers. What is more worrying is the fact that the losses may force farmers to reduce area under cultivation for rice crop thus depriving country of an important foreign exchange earner in FY11.

[24]These include 1) tough competition from competitors 2) the government procurement of rice by PASSCO and TCP, which prevented an expected large fall in the domestic prices of rice, thus hurting competitiveness of country's exporters 3) ambiguity regarding the crop size which hindered exporter's ability to make proper assessment of exportable surplus.

[25]Wastage refers to harvesting and milling losses. These are taken as 5 percent of the whole produce for the purpose of analysis.

As with rice, the rise in *fruits, vegetables and meat* exports was also helped by large increases in quantum (see **Table 6.8**) during Jul-Apr FY10. The rise in fruits exports was recorded in the categories of mangoes, dates, edible nuts, and kinos[26]. Better marketing efforts were instrumental in this improved performance of the fruit export category.[27]

Table 6.8: Food Group Exports (Jul-Apr)
change in million US dollar; growth percent

	Abs change	Growth in value	Growth in quantity
Rice	125.6	7.4	66.2
Basmati	-212.9	-23.4	2.7
Non-basmati	339.5	44.1	100.5
Fruits	74.1	55.0	40.6
Vegetables	41.9	71.2	7.3
Meat and meat preparation	23.8	39.8	42.0
Total	**180.2**	**8.0**	**N.A**

Similarly, *meat* exports also recorded a large volume increase during Jul-Apr FY10. Specifically, exports of goat meat to Saudi Arabia doubled in absolute terms, due to which its share in total meat exports increased from 21 to 35 percent. The increase in the meat exports appears to be the result of ban imposed by Saudi Arabia on meat imports from Ethiopia in FY09. Ethiopia has been one of the main suppliers of meat to Saudi Arabia.

Exports of many agricultural categories (*fruits, vegetables, meat, fish, etc.)* are, however, under pressure due to large scale smuggling of these products. Smuggling is rampant due to 1)-Export of these categories generally faces strict SPS related requirements, and smuggling is the means to avoid these restrictions; 2) The rise in smuggling to Iran may also be the result of international sanctions on this country due to which, many banks decline to open letter of credits for this country; 3) Smuggling is also a mean to avoid high import duties imposed by importing countries. The smuggling of these products not only deprives country from earning foreign exchange on these goods (due to barter or payments made in domestic currency), but it also leads to rise in their domestic prices. Further sometimes, the poor quality of smuggled products also leads to imposition of restrictions on formal trade.

Textile exports recorded a 7.1 percent YoY rise during Jul-Apr FY10 compared with a 9.2 percent YoY fall observed during the same period last year. A large share of this increase was contributed by low value added categories such as raw

[26]Mangoes, dates, edible nuts and fresh kinos exports posted growth of 34.0, 29.0, 450.0 and 28.0 percent, respectively, during Jul-Apr FY10.
[27]Country was able to increase exports to Russia, Iran, Poland, Sudan, etc. due to rising demand as well as better marketing efforts.

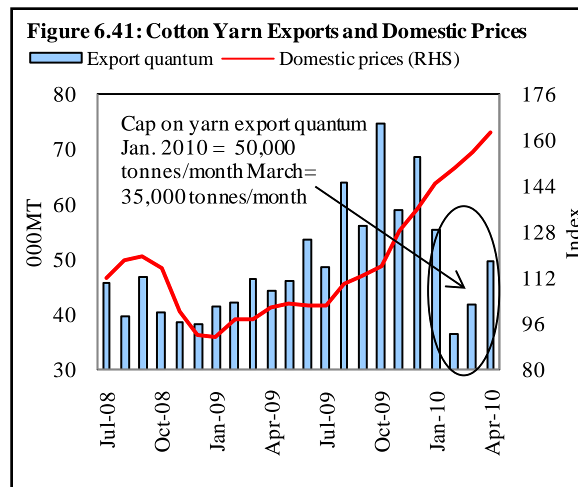
cotton, and cotton yarn, etc. (see **Table 6.9**). In high value categories readymade garments and towels recorded some increases.

Table 6.9 : Major Textile Exports Price & Quantum Impact (Jul-Apr)
million US Dollar

	FY09			FY10		
		Due to			Due to	
	Absolute Δ	Quantum	Price	Absolute Δ	Quantum	Price
Textile Group	**-800.8**			**556.3**		
of which						
Raw cotton	22.8	32.2	-9.4	113.3	94.2	19.2
Cotton yarn	-166.5	-97.5	-69.0	294.5	272.0	22.5
Cotton fabrics	15.2	-3.3	18.5	-175.4	-223.2	47.7
Knitwear	-95.3	145.2	-240.6	-10.1	-121.2	111.1
Bed wear	-175.2	-67.3	-108.0	-8.6	27.8	-36.4
Towels	27.1	65.1	-38.0	25.5	141.5	-116.1
Readymade garments	-176.5	-289.3	112.8	52.5	-71.1	123.6
Art silk and synthetic textiles	-0.1	-0.1	0.0	153.0	102.2	50.7

The improved domestic cotton production during FY10[28] and lower production of cotton in China[29] raised demand for *raw cotton, cotton yarn* and *synthetic textiles* exports from Pakistan during Jul-Apr FY10. The increase in cotton yarn exports led to domestic shortage of this category resulting in an increase in domestic prices of cotton yarn. This raised concerns from exporters of downstream high value added sector[30]. To mitigate these concerns, government capped cotton yarn exports in January 2010[31](see **Figure 6.41**). As a result of this decision the surge

Figure 6.41: Cotton Yarn Exports and Domestic Prices



[28]Cotton production increased from 12.06 million bales to 12. 70 million bales during FY10.
[29]In FY10, cotton production in China declined by 14.4 percent YoY.
[30]The quantum of yarn exports in total cotton yarn production increased from 18,000 tons per month in FY09 to 25000 per month during Jul-Mar FY10.
[31]In January, government imposed a cap on export quantum of 50,000 tons per month, while in March 2010 the cap was revised downward to 35,000 tons per month.

in the export of this category is likely to cool down in the remaining months of FY10.

It is also probable that the rise in domestic yarn prices adversely affected country's *cotton fabrics* exports, resulting in significant fall in their export quantum during Jul-Apr FY10 (see **Table 6.9**).

The exports of high value categories recorded a modest revival from Q2-FY10 (see **Figure 6.42**). Much of the increases in high value added categories' exports in Q2 and Q3 FY10 were contributed by increases in export quantum (see **Figure 6.43**). This reflects improved external demand as well as better domestic manufacturing conditions during this period.

The rise in *jewelry* export was mainly caused by a sharp 23.2 percent YoY rise in international gold prices along with higher demand from UAE and US. Further, the facilities and incentives provided by the government[32] may also have helped to improve exports of this category.

Figure 6.42: Textile Export - YoY Growth

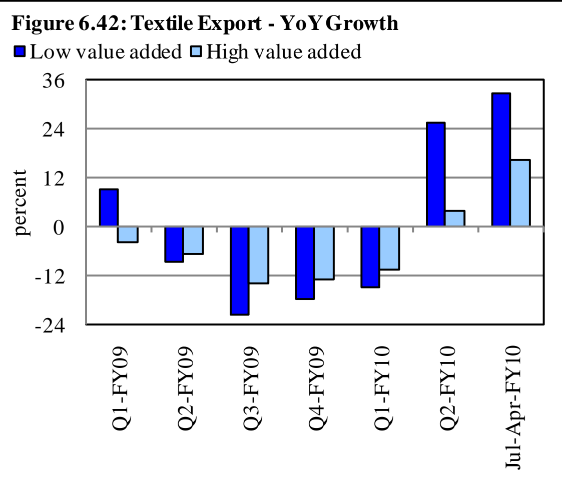


Figure 6.43: High Value Added Textile Exports

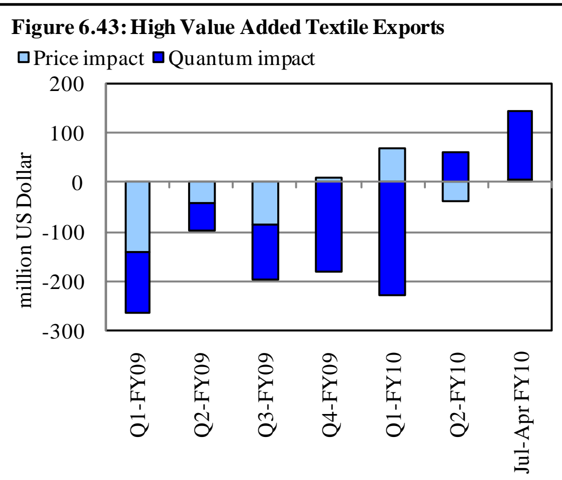


Table 6.10 : Other Manufactures Exports (Jul-Apr)

change million US$, shares percent

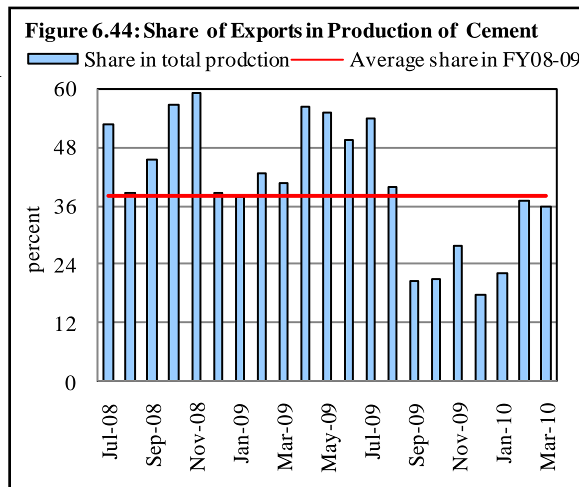
	Abs Δ	Growth	Share in other manufacturers
Leather manufactures	-102.3	-21.7	12.7
Engineering goods	-13.4	-6.3	7.35
Jewelry	201.0	102.6	12.58
Molasses	-42.4	-49.9	1.27
Cement	-81.1	-17.0	13.48
Total	**21.8**	**0.7**	**N.A**

[32]The shipment period for export of gold jewelry against imported gold under Entrustment Scheme, has been enhanced from 120 days to 180 days. Import of gold, silver, platinum, palladium, diamonds and gemstones under all schemes are exempted from normal import tariffs.

Apart from the categories with improved export performance, some major categories for instance *leather manufacture* and *cement* recorded large YoY declines during Jul-Apr FY10 (see **Table 6.10**).

The fall in leather manufactures exports is attributable to both falling external demand as well as persistence of domestic structural bottlenecks.

As regards cement exports, the YoY fall in this category was led by both falling quantum and export unit values during Jul-Apr FY09. [33]Although the production of cement increased during the period under consideration, the share of exports in total production declined substantially (see **Figure 6.44**).



The decline in export quantum can be explained by depressed demand from major importers i.e. Afghanistan, India, U.A.E, Oman, and Qatar, etc. [34] However, going forward there is a likelihood of a rise in demand from African countries.

Imports

During Jul-Apr FY10 imports recorded a 2.8 percent YoY fall against a 9.8 percent decline recorded during the same period last year. The contraction in import bill was due to a large negative price impact that deflated import bill in the first five

[33]The APCMA (All Pakistan Cement Manufacturers Association) data shows 4.1 percent YoY increase in export dispatches during Jul-Mar FY10.

[34]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.

Table 6.11: Import Growth Composition Analysis (Jul-Apr)
value: million US Dollar, growth percent

	FY09	FY10	Growth	Absolute change	Percentage point share in growth	Price impact	Quantum impact
					FY10		
Major commodities recording Increase							
of which							
Petroleum products	4,612.4	5,305.3	15.0	692.9	2.4	-420.0	1,112.9
Air crafts, ships and boats	379.7	579.2	52.6	199.5	0.7	N.A	N.A
Road motor vehicles	755.3	948.9	25.6	193.6	0.7	N.A	N.A
Medicinal products	447.8	611.4	36.5	163.6	0.6	2.8	160.9
Fertilizer manufactured	494.4	666.6	34.8	172.2	0.6	-218.6	415.3
Major commodities recording fall							
of which							
Wheat un-milled	1,053.8	35.4	-96.6	-1,018.3	-3.5	-1,024.3	6.0
Petroleum crude	3,404.6	2,813.3	-17.4	-591.4	-2.0	-334.9	-256.5
Other machinery	1,845.7	1,336.0	-27.6	-509.7	-1.8	N.A	N.A
Telecom	857.1	598.6	-30.2	-258.5	-0.9	N.A	N.A
Iron and steel	1,090.7	1,017.7	-6.7	-73.1	-0.3	-16.3	-56.3
Others	**13,979.8**	**14,236.1**	**1.8**	**256.3**	**0.9**	**-271.3**	**452.9**
Total imports	**28,921.3**	**28,122.6**	**-2.8**	**-798.8**	**-2.8**	**-1,173.9**	**726.5**

months of FY10.[35] The negative price impact more than offset the rise in quantum of imports during almost the entire Jul-Apr period.[36]

In terms of monthly performance, due to anincrease in international commodity prices and some revival in domestic demand of number of categories, import growth also moved in positive range from December 2009 onwards (see **Figure 6.45 & Table 6.11**).

Categories with rising quantum impact:

Petroleum group imports recorded a marginal YoY rise of 1.3 percent during Jul-Apr FY10. In terms of quantum, while petroleum crude recorded a marginal YoY decline, petroleum products increased substantially (see **Table 6.12**). [37]

[35]Specifically, 58 percent of the fall in petroleum group import was on account of the price impact.
[36]During Jul-Apr FY10 period, quantum impact is 644.0 million US$, while price impact is -1,136.3 million US$.
[37] In terms of quantum, largest increase was observed in the import of furnace oil. Demand for furnace oil emanated from the power generating sector, while strong auto and motor cycle sales, narrowing CNG-petrol price differential and increasing use of generators resulted in higher demand for motor gasoline.

Liquidity shortage, arising from the circular debt issue, along with negative product margins curtailed refineries ability to import crude oil and thus provide relatively cheaper petroleum products domestically. SBP's internal estimates indicate that the country could have saved significant amount on petroleum group imports during Jul-Apr FY10 if refineries were able to import the same level of crude as they did in FY08.[38] In that case POL group imports during Jul-Apr FY10 would have registered negative growth.

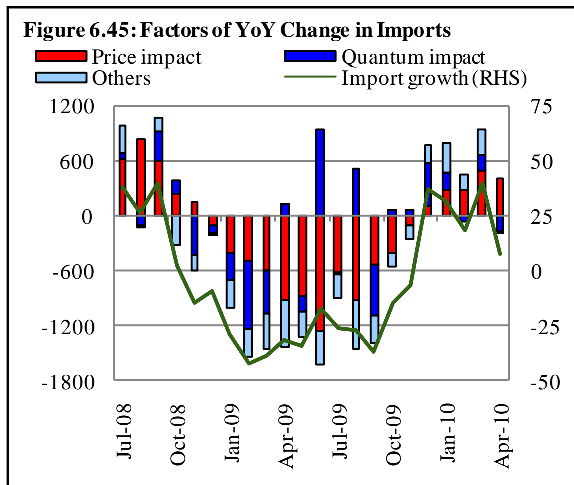
Table 6.12: POL Group Imports (Jul-Apr FY10)
value million US Dollar; growth percent

	YoY growth	Absolute YoY Δ	Quantum impact	Price impact
Petroleum group	**1.3**	**101.6**		
Petroleum products	15.0	692.9	1,112.9	-420.0
Petroleum crude	-17.4	-591.4	-334.9	-256.5

Transport group imports recorded a significant 35.5 percent YoY growth during Jul-Apr FY10. This was largely on the back of a revival in domestic demand for r*oad motor vehicles*). In this category, imports of CKDs in particular, increased due to high demand from local producers.

Sugar imports also recorded a sharp increase during the period under review owing to domestic shortages caused by lower production during FY10 crop season.[39] In addition rise in the international sugar prices also inflated the import bill.[40] Sugar imports are likely to rise further in the remaining months of FY10, as the government has plans to import a large quantum

Figure 6.45: Factors of YoY Change in Imports

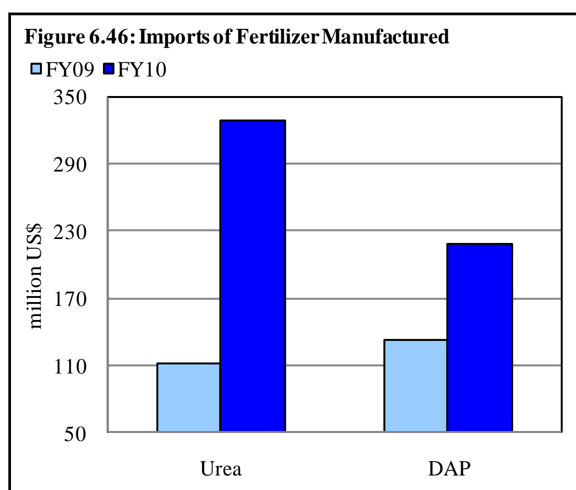


[38]For this exercise the volume of crude imported during Jul-Apr FY08 i.e. 7.0 million tonnes is taken as a base.
[39]Domestic production during FY10 was recorded at 2.8 million MT compared to production of 3.1 million MT during FY09.
[40]The average unit import value was 566.9 US$/MT during Jul-Apr FY10 compared with 433.4 US$/MT during Jul-Apr FY09.

to fill the domestic demand-supply gap.[41]

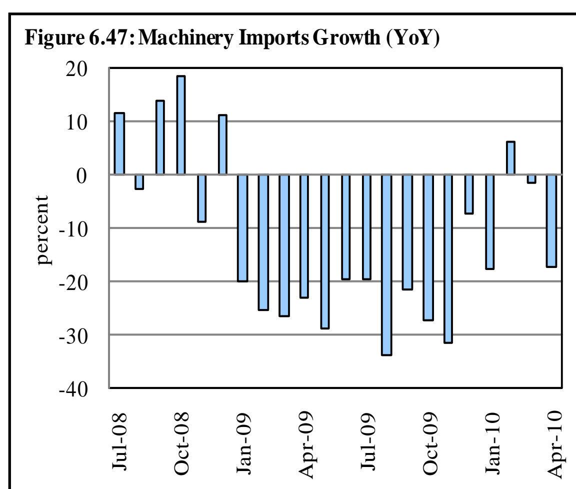
Fertilizer imports increased substantially during Jul-Apr FY10 due to rising volumes, as well as, import prices. Demand for imported fertilizer originated from high off-take of both Urea and DAP during Rabi 2009-10 [42] (see **Figure 6.46**). The higher import of Urea is attributable to shortages of gas, which led to a fall in its domestic production. The production of Urea is expected to gain momentum with the start of a new plant in March 2010, while another plant is also expected to start operating in the coming months.[43]

Figure 6.46: Imports of Fertilizer Manufactured



Although *machinery group* imports recorded a large 18.7 percent YoY fall during the whole Jul-Apr FY10 period (see **Figure 6.47**), import of this category increased during Jan-Apr-FY10. This rise was observed in power generating machinery, cell phones, textile machinery, agriculture machinery, etc. [44]

Figure 6.47: Machinery Imports Growth (YoY)



In the case of p*ower generating*

[41]Average consumption of sugar is estimated to be around 3.8 million MT per year, whereas production during FY10 is 2.8 million MT. Keeping this in view, the government announced 1.0 million MT imports of sugar in order to bridge the demand-supply gap during FY10. So far only 0.27 million MT sugar has been imported.

[42]According to National Fertilizer Development Centre, urea off-take increased by 11.6 percent, while DAP imports increased by 26.6 percent during Rabi 2009-10.

[43]Fatima Fertilizer came online in March 2010.

[44]Imports of power generating machinery, mobile phones, textile machinery and agricultural machinery increased by 3.3, 299.2, 125.8 and 411.1 percent YoY respectively during Q3-FY10.

machinery imports, the rise could be attributed to depletion of inventories and rise in industrial as well as household demand, due to continuous power outages.

The increase in the *textile machinery* imports is attributable to government and SBP support announced for this sector.[45, 46] These support measures were in response to the demand of high value added sector, to improve its productivity.

Imports of *mobile phones* recorded a large 69.9 percent YoY increase during Jul-Apr FY10. Anecdotal evidence suggests that improvement in overall consumer demand, launching of new models, and slowdown in sales of smuggled Chinese cell phones along with relaxation in import duties led to rise in the imports of this category.[47]

[45]SRO 809(I)/2009 dated 19th September 09, allows elimination of 5 percent import duty on textile machinery.
[46]SMEFD Circular Letter No. 03 of 2010, according to which import of second hand machinery up-to June 30, 2010 shall also be eligible for refinancing under the Long Term Financing Facility.
[47]Reduction of custom duty from Rs 500 to Rs 250 per set and 50 percent reduction in Subscriber Identification Module (SIM) activation charges.

Special Section 1

Low Income Housing in Pakistan: Opportunities and Challenges

According to resolution 22/2 of the Governing Council of UN-HABITAT on affordable housing finance,

Encourages all member States, including the regional ministerial conferences on housing and urban development, to establish sound and conducive frameworks and mechanisms to enable extended public and private investment in slum upgrading and prevention, affordable housing and urban development including infrastructure and basic services.

Housing is one of the most important sectors of the economy with large positive externalities in terms of economic growth, public health and societal stability[1]. Provision of adequate housing[2] is a necessity for survival and is considered a vital investment in health leading to increase in productive capacity and overall well being of a person and his/her family[3]. Importance of housing can be gauged from the fact that Article 25 (1) of Universal Declaration of Human Rights, Article 11(1) of International Covenant on Economic, Social and Cultural Rights, United Nations Declaration on Social Progress and Development (1969) and the United Nations Vancouver Declaration on Human Settlements (1976), all recognize adequate housing as the right of everyone[4].

Despite the fact that housing constitutes one of the basic human rights, more than a billion people around the globe, including over 14 percent of the population of South Asia, live in inadequate housing[5]. Pakistan is no exception to this problem. According to some estimates housing shortage in the country has reached around

[1] Abhas K. Jha (2007), Low-income Housing in Latin America and the Caribbean, Enbrve No. 101, World Bank

[2] United Nation's Special Rapporteur on the Right of Adequate Housing's working definition of the human right to adequate housing is the right of every woman, man, youth and child to gain and sustain a secure home and community in which to live in peace and dignity.

[3] Speech by Mr. Muhammad Shamsul Haque, Deputy Managing Director, Operations Wing, Islami Bank Bangladesh Limited, at Workshop on Housing Finance in South Asia, May 28, 2009, Jakarta.

[4]Source: http://www.ohchr.org/Documents/Publications/FactSheet21en.pdf

[5] Source: "Expanding Housing Finance to the Underserved in South Asia: Market Review and Forward Agenda". Presented by Ms. Tatiana Nenova, Senior Economist (South Asia) World Bank Group, at South Asia Regional Housing Finance Conference January 27-29, 2010, New Delhi, India.

7.57 million units in 2009 with nearly 80 percent of the shortage attributed to lower and middle income groups[6].

Like other developing countries, rapid urbanization over the years in Pakistan has resulted in growth of slums in urban areas of the country, adding pressure on low income housing demand. This rising trend of urbanization compounded with a rapidly growing population[7] implies that demand for housing is increasing at a high pace. According to some estimates, housing deficiency in the country has been increasing by 300000 houses annually[8].

Given the importance of housing and prevailing shortfall of housing facilities in the country, this special section discusses supply side issues of housing finance, while focusing on low income housing in particular. It concludes with some policy recommendations.

Housing Finance Portfolio in Pakistan

In Pakistan most of the housing finance is arranged through personal resources. The formal financial sector caters to only 1 to 2 percent of all housing transactions in the country[9]. Within the formal sector, commercial banks and House Building Finance Corporation (HBFC), a specialized housing finance institution, are providing housing finance.

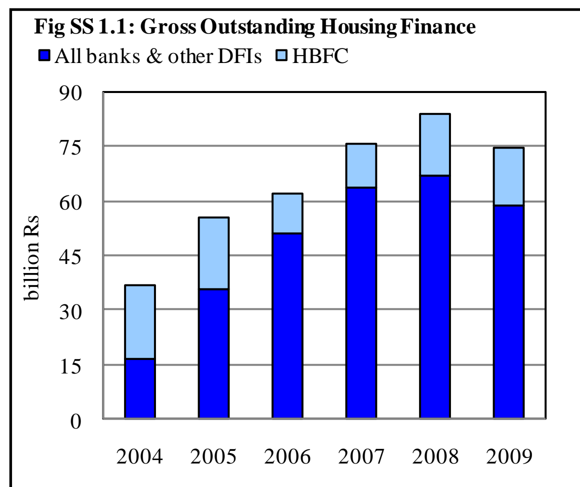
With expansion of HBFC over the years the institution's present loan portfolio covers 80 cities and towns of the country with a target to expand its business to 150 towns and cities[10]. On the other hand, housing loan portfolio of commercial banks is generally confined to major metropolitan cities of the country[11]. Further analysis of housing finance portfolio shows that the share of HBFC in overall housing finance portfolio has witnessed a fall from 55 percent in 2004 to 21 percent in 2009. Consequently the gross outstanding housing finance portfolio of HBFC decreased from Rs 20.3 billion in 2004 to Rs 15.6 billion in 2009 (see **Figure SS 1.1**).

[6] Source: Special Address by Kamran Shehzad, Deputy Governor, State Bank of Pakistan, at South Asia Regional Housing Finance Conference January 27-29, 2010, New Delhi, India.
[7] Population growth rate in Pakistan currently stands at 1.7 percent.
[8] Presentation by Kamran Shehzad, Deputy Governor, State Bank of Pakistan on Housing Finance Market in Pakistan, at World Bank- IFC Conference on Housing Finance, May 27-29, 2009, Jakarta.
[9] Speech by Kamran Shehzad, Deputy Governor, State Bank of Pakistan, at Workshop on Housing Finance in South Asia, May 27, 2009, Jakarta.
[10] Source: www.hbfc.com.pk
[11] Source: http://sahf-forum.info/Presentation/Rizvi_SessionOverview_RegionalCountriesPresentations.pdf

One of the reasons for this decrease in HBFC share is rise in NPLs[12] that have led to low disbursement in the subsequent period. On the other hand, banks and other DFIs witnessed an increase in their outstanding portfolio from Rs 16.6 billion in 2004 to Rs 67.0 billion in 2008 before registering a decline in 2009 to reach Rs 58.8 billion. However, in terms of number of borrowers HBFC still caters around 76 percent of the total borrowers in the housing finance sector. This implies that HBFC generally disburses smaller amount of loan to a larger number of borrowers, as compared to commercial banks and other DFIs which are more inclined to disbursing larger amount of loan to relatively smaller number of borrowers.

It is important to note that since the active involvement of commercial banks in housing finance, the overall housing finance portfolio grew significantly from Rs37 billion in 2004 to Rs84 billion by December 2008. However, in 2009, the housing sector witnessed downturn as housing finance portfolio experienced a dip of 11 percent, reflecting the impact of economic slowdown, and now stands at around Rs74 billion by the end of calendar year 2009 (see **Figure SS 1.1**).

Fig SS 1.1: Gross Outstanding Housing Finance



Despite showing an increase in overall housing finance portfolio, the current level still remains insufficient[13] to address the housing needs in the country. In particular, lower income groups seem to be deprived of housing finance facilities, as numerous barriers prevent the poor from accessing financing from formal financial institutions including lack of formal employment, regular incomes and formal credit histories[14]. Given the importance of housing finance, several policy initiatives have been taken over the decades, with a focus on expanding housing finance activities in the country. Some of these are discussed below.

[12] NPLs of HBFC have increased from Rs 6.2 billion in 2008 to Rs 6.5 billion in 2009.
[13] Consumer financing by commercial banks for house building/construction/renovation constitutes only 2.5 percent of the overall private sector business.
[14] Source: GH Bank Housing Journal, Volume 3 Number 8, July-September 2009.

Policy Initiatives in Pakistan

As an initial step HBFC was established as a statutory federal body in 1952 with the objective of providing financial assistance for the construction of houses. However, after the establishment of HBFC, no major steps towards providing housing facilities were seen until the establishment of Pakistan Housing Authority (PHA) in 1999. PHA is a subsidiary of Ministry of Housing and Works and was established to undertake construction of approximately 4500 apartments at affordable prices for low and middle income groups. PHA has so far undertaken 18 projects involving 4476 housing units in four major cities including Karachi, Lahore, Islamabad and Peshawar[15].

In 2001, National Housing Policy was initiated realizing the fact that housing is one of the major pillars of the macro-economy and that there is ever increasing short fall of housing stock in the country. The policy emphasised on resource mobilization, increasing land availability, provision of incentives for home ownership, provision of incentives to developers and constructors and promotion of research and development activities to make construction cost effective[16].

Apart from the above mentioned steps various other initiatives have also been taken for improving housing facilities in the country. Amongst these are the Prime Minister's housing programme that was announced in 2008 under which one million housing units would be constructed for government employees, media men and general public at affordable cost mainly through foreign investment and joint ventures. Such a step on part of the government is appreciable but the focus of this scheme does not seem to be on low income housing.

State Bank of Pakistan is also striving hard for improving housing finance activities in the country[17]. In this regard the central bank is working with the International Finance Corporation of the World Bank for the establishment of Mortgage Refinance Company (MRC), for availability of low cost housing finance and establishment of an observatory for real estate market. Housing Advisory Group (HAG) has also been established by the SBP in order to carry out a comprehensive analysis of the current regulatory and policy framework regarding housing finance.

In order to improve human capital related to the housing industry, SBP has launched a comprehensive housing finance training program covering all aspects

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[15] www.pha.gov.pk

[16] Source: Board of Investment, Government of Pakistan.
http://www.pakboi.gov.pk/pdf/Sectoral%20Policies/National%20Housing%20Policy%202001.pdf

[17] For details see http://www.sbp.org.pk/SME/pdf/DFG-Dec-09.pdf

of housing finance from product development, loan marketing and origination to loan underwriting, servicing, and risk management.

In accordance with the recommendations of HAG, SBP in coordination with Association of Mortgage Bankers is also working towards the development of web portal aimed at providing reliable information on various factors of housing/mortgage industry.

Challenges & Way Forward

Though various steps have already been taken for providing housing base in the country, a high number of people still remain without access to adequate housing finance. Lower segments of the society, particularly in the urban areas[18], still remain deprived of appropriate housing facilities.

The widening gap between demand and supply of housing in the country can be seen as an opportunity by private entrepreneurs and developers. However, incentives are necessary in order to attract entrepreneurs and private developers. Global experience shows that in order to attract private developers into low-income housing construction, governments use wide range of incentives at the central and local level, including tax deductions, density bonuses, direct subsidies, land grants, land classification shifts from commercial to residential use, and bureaucratic and administrative streamlining to reduce processing costs and time[19]. Given the labor intensive nature of construction in the country, growth in the construction activities also has the potential of bringing major socio-economic impacts in the country including generation of job opportunities as several industries are directly or indirectly linked with construction activities[20].

However there are several challenges confronting the domestic housing finance industry at present. These include: (a) shortage of finance especially for low income housing; (b) limited land registration information system; (c) lack of proper legal framework protecting rights of house owners; (d) issues in land availability for construction purposes especially in urban areas; (e) limited targeted subsidy programs for low income housing; (f) inadequate research for introducing cost effective construction techniques; and (g) lack of incentives for private developers to enter low income housing schemes. It is therefore necessary

[18] Over 45 percent of the total urban population is believed to be living in slums, Source: Development of Strategic Goals for Housing Finance in Pakistan (2009): Infrastructure and Housing Finance Department State Bank of Pakistan

[19] Source: Low-Income Housing Policies: Lessons from International Experience: Observations and Suggestions, Asian Development Bank (ADB) 2009.

[20] Source: GH Bank Housing Journal, Volume 3 Number 8, July-September 2009

that all housing finance stake holders put concerted efforts for improving housing base in the country. Some of the measures that can serve towards betterment in providing housing finance facilities are discussed below.

A major step towards improvement can be the introduction of appropriate legal reforms ensuring private property rights that augment housing finance activities. There should also be proper documentation, computerization, and automation of title registration and title transfer.

Given that major urban centers of the country are already densely populated, one of the options available with the government is to start housing and infrastructure improvement programs in the suburb areas of urban centers. However such an effort is both costly as well as difficult. Therefore priority can be given to improvements in the already existing poor communities (see **Box 1**).

One of the major steps towards provisioning of affordable housing to lower and middle income groups can be the reduction in overall cost of construction activities. In this regard improving land availability for construction activities can help in reducing land price escalation in the country. This can be achieved by utilization of vacant public land for construction activities especially for low income housing schemes[21]. Moreover construction of high rise buildings accommodating a large number of people, can also serve to solve the problem of land availability.

Micro housing finance is another area that can be explored for enhancing the access to finance for lower and middle income groups. Though SBP has already made amendments in prudential regulation for microfinance banks (PR 10), whereby maximum loan size up to Rs 500,000 to a single borrower with household annual income up to Rs 600,000 is allowed, this area is still in its infancy stage. Micro housing program of Grameen Bank Bangladesh shows that such programs can help in providing housing facilities to low income groups (see **Box 1**).

Given that access to adequate housing facilities cannot be provided to lower income groups without government intervention it is therefore necessary that appropriate subsidy programs should be developed with a focus on the poor segments of the society. Since government has already introduced various safety net programs, data available from such programs can be used to identify potential

[21] Source: Recommendations for Nationwide Provision of Housing Finance, Housing Advisory Group (HAG), State Bank of Pakistan.

recipient of these subsidy programs. Such subsidy programs are already prevalent in the regional economies and have remained successful, e.g., India, China, Hong Kong, Malaysia, and Indonesia, provide subsidies targeted for low-price housing[22].

Conclusion

Domestic housing finance sector has shown growth over the years but the present level still remains far below the housing requirements in the country. Given the huge backlog in housing sector and an increasing housing deficiency in the country, opportunities remain abundant especially if efforts are concentrated in the lower and middle income groups which form a major part of the housing backlog. Present housing finance portfolio seems to be concentrated in the upper income groups and appropriate targeted schemes for lower income groups remains a challenge.

Though several policy initiatives have already been taken but there is still room for improvement. Joint efforts by all housing finance stakeholders particularly, the public sector-federal government, provincial governments, and housing finance institutions are required. Such joint efforts will increase both transparency as well as efficiency for providing adequate housing to lower and middle income segments of the society.

Box 1: Low Income Housing (Success Stories)

Housing Micro Finance Grameen Bank Bangladesh. Grameen started providing housing micro finance in 1984. Loans are provided to customers on group basis and cost efficient houses are built according to functional design/technology specified by Grameen Bank. The repayment period is 5 years with a concessionary interest rate of 8 percent per annum. As of March 2010, the total outstanding loan of housing finance stands at US $ 2.67 million with overdue loan accounting for only US $ 0.162 million.

Saiban Pakistan. Saiban incremental housing has been operational in Pakistan for the last 20 years providing housing needs to poor segments of the society through Khuda Ki Basti's (KKBs). According to the scheme after necessary verification, an onsite plot is provided to a family with payment in installments. Construction is initiated by the family on an incremental basis subject to their financial means with technical and other support in construction provided by the management. The program requires the fulfillment of on-site living conditional for a non-transferable ownership of the plot to the family.

Each KKB offers regular and prime plots. The regular plots are provided on no profit no loss basis to low income families earning between Rs 5000 to Rs 15000. The remaining plots are sold in the open market for profit. Presently, fourth KKB project is operational in Lahore in association with

[22] Source: GH Bank Housing Journal, Volume 3 Number 8, July-September 2009

Acumen Fund of USA. According to some estimates, over 30000 people have so far benefited from the KKB schemes.

Metro Manila Slum Resettlement: Philippines. In 1997, for expansion of Metro Manila Railway tracks, around 80000 slum dwellers had to be evacuated. The National Housing Authority constructed a rehabilitation program for which financing was provided by a Chinese government consortium. According to the resettlement program, land at subsidized cost (US $ 2200) along with housing material (US $ 870) and cash for labor (US $ 220) was provided to the people on cost-recovery basis. The total amount of US $ 3290 is to be repaid in 30 years at 6% annual interest, in monthly payments. As of 2005, 7297 families from Metro Manila have been relocated.

Phnom Penh, Cambodia. Since 1998 organized poor communities of Phnom Penh along with district, municipal and national governments and support from UPDF (the local community development fund) are working collectively for developing housing and settlement improvement projects for nearly one third of city's poor communities. According to the scheme municipality and government pays for new land where local people design and build their own houses. For construction activities, UPDF provides soft housing loans and infrastructure subsidies. Available data shows that the partnership has planned, built, managed and paid for 3,000 houses in 108 communities since its inception.

Lyari Expressway Resettlement Project, Pakistan. For resettlement of more than 250,000 people displaced due to construction of Lyari Expressway, Karachi, a resettlement program was initiated by the government. According to the program land and financial compensation for construction at newly developed suburbs in Hawk's Bay, Taiser Town and Baldia Town was provided to the displaced people. These suburbs are properly planned with utilities, transport, schools, parks and roads. Thus people living in unplanned localities at the banks of Lyari River were resettled at comparatively better living environments.

Baan Mankong Up-gradation Program Thailand. Since 2003, Thailand's Community Organizations Development Institute (CODI) has started a slum up-gradation program named Baan Mankong, for poor urban communities. According to the program local communities create slum up-gradation plans that can be accomplished in three years. Communities create collective savings accounts while government provides funds in the form of infrastructure subsidies and soft housing loans directly to those communities. The local community carries out improvements to their housing, environment and basic services and manage the budget themselves. Approximately 54,000 households are directly receiving CODI's financial resources and technical support under the program.

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- www.grameen.com

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 Savings Certificate
BSF	Business Support Fund
CA	Current Account
CAD	Current Account Deficit
CBs	Commercial Banks
CBU	Completely Built Unit
CGS	Credit Guarantee Schemes
CIB	Credit Information Bureau
CiC	Currency in Circulation
c.i.f	Cost of Insurance and Freight
CKD	Completely Knockdown Unit
CODI	Community Organizations Development Institute
CPI	Consumer Price Index
CSF	Competitiveness Support Fund
CY	Calendar Year
DAP	Di-Ammonium Phosphate
DBCs	Dollar bearer certificates
DD	Domestic Debt
DFIs	Development Finance Institutions
DPBs	Domestic Private Banks
DS	Debt Servicing
DSC	Defense Savings 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
GH Bank	Government Housing Bank
GoP	Government of Pakistan
H	Half
HAG	Housing Advisory Group
HBFC	House Building Finance Corporation
HBL	Habib Bank Limited
HDIP	Hydrocarbon Development Institute of Pakistan
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
MAA	Mahana Amadni Account

MAF	Million Acer Feet
MFN	Most Favored Nation
MMA	Months Moving Average
MoM	Month-on-Month
MoU	Memorandum of Understanding
MPS	Monetary Policy Statement
MRC	Mortgage Refinance Company
MRTB	Market Related Treasury Bills
MS	Motor Spirit
MSCI	Morgan Stanley Capital International
MT	Metric Ton
NBFIs	Non Banking Financial Institutions
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
NIT	National Investment Trust
NPLs	Non Performing Loans
NSS	National Savings Scheme
NSB	National Savings Bond
NWFP	North-West Frontier Province
OAEM	Other Items Especially Mention
OCAC	Oil Companies Advisory Committee
OECD	Organization for Economic Cooperation and Development
OGDC	Oil and Gas Development Corporation
OIN	Other Items Net
OMOs	Open Market Operations
OPEC	Organization of the Petroleum Exporting Countries
PAF	Pakistan Air Force
PAMA	Pakistan Automotive Manufacturers' Association
PASSCO	Pakistan Agriculture Storage & Services Corporation
PBA	Pensioners Benefit Account
PCGA	Pakistan Cotton Ginners' Association
PEPCO	Pakistan Electric Power Company (Private) Limited
PFMA	Pakistan Flour Mills Association
PHA	Pakistan Housing Authority
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
PSM	Pakistan Steel Mills
PSMA	Pakistan Sugar Manufacturers' Association
PTA	Pakistan Telecommunication Authority
PTCL	Pakistan Telecommunication Company Limited
PVMA	Pakistan Vanaspati Manufacturers' Association
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
RIC	Regular Income Certificate
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
SMEFD	Small and Medium Enterprises Finance Department
SNGPL	Sui Northern Gas Pipelines Limited
SPI	Sensitive Price Index
SRO	Statutory Regulatory Order
SSA	Special Savings Account
SSC	Special Savings Certificate
SSGC	Sui Southern Gas Company
T-bills	Treasury Bills
TCO	Textile Commissioner's Organization

TCP	Trading Corporation of Pakistan
TED	Total External Debt
TFC	Term Finance Certificate
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
USDA	United States Department of Agriculture
VAT	Value Added Tax
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