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1 Economic Outlook

1.1 Overview

The prospects of returning to macroeconomic stability improved in the initial months of FY10, with most key indicators continuing the positive trends that began in the closing months of FY09.

Available data on agriculture and the industrial sector, is in line with the expectations of a modest recovery in economic growth during FY10. While the performance of major crops during FY10 *kharif* (April-October 2009) cropping season was below expectations, growth in large-scale manufacturing has recovered substantially after recording a 20.6 percent YoY decline in March 2009 (see **Table 1.1**).

Similarly, a sharp reduction in inflation, contained government borrowings from SBP, substantial contraction in external imbalances, the stability in the rupee-US\$ parity, and easing monetary stance, are all likely to support economic stability. However, the drop in overall volume of trade, poor tax growth, risk of lower than expected aid receipts and, in particular, a rise in the fiscal deficit, highlight the fragility of the improvement and pose continuing risk to the recovery.

With the country engaged in a war against militants and facing weak international demand, policy options are relatively limited. In particular, the operations against militants in some northern regions of the country have resulted in additional expenditures, putting pressures on the federal budget. It is quite difficult to contain such discretionary government spending. Not surprisingly, the fiscal deficit for Q1-FY10 is reported at 1.5 percent of GDP as compared to 1.1 percent in Q1-FY09. However, it can be argued that the accommodative fiscal stance has

Table 1.1: Selected Economic Indicators

		FY08	FY09	FY10
<i>Growth rate (percent)</i>				
LSM	Jul-Oct	7.7	-5.0	0.7
Exports (fob)	Jul-Nov	6.5	12.0	-7.4
Imports (cif)	Jul-Nov	18.4	16.4	-23.0
Tax revenue (FBR)	Jul-Sep	11.6	27.7	0.6
CPI (12 month ma)	Nov	7.6	19.1	14.6
Private sector credit	Jul-5 th Dec	5.8	4.4	0.9
Money supply (M2)	Jul-5 th Dec	4.8	0.6	4.2
<i>billion US dollars</i>		-	-	-
Total liquid reserves ¹	end-Nov	15.7	9.1	13.7
Home remittances	Jul-Nov	2.6	2.9	3.8
Net foreign investment	Jul-Nov	2.1	1.4	1.1
<i>percent of GDP²</i>				
Fiscal deficit	Jul-Sep	1.5	1.1	1.5
Trade deficit	Jul-Nov	4.4	5.3	3.1
Current a/c deficit	Jul-Nov	2.9	4.4	0.8

¹. With SBP & commercial banks.

². Based on full-year GDP in the denominator. For FY10, estimated full-year GDP has been used.

probably helped trigger at least part of the modest recovery in aggregate demand, thus supporting business and consumer confidence. Business confidence was probably also helped by signs of a mild recovery in the global economy, which has improved export prospects somewhat. Nonetheless, the rising fiscal imbalance and greater quasi-fiscal activities have increased the risks to macroeconomic stability. Below expectation growth in external funding for budgetary support, and restricted access to borrowings from the central bank mean that the financing needed by the government from commercial banks has ballooned. To put this in perspective, a significant contribution to the 4.2 percent year-to-date (YTD) increase in broad money supply during Jul-Nov FY10 (compared to only 0.6 percent YTD last year) has essentially stemmed from fiscal and quasi-fiscal activities. By contrast, net private sector credit growth during the same period was an anemic 0.9 percent YTD.

Weak private demand for credit and the risk-averse behavior of banks allowed the government to finance its increased spending in FY10 without crowding out private sector activities. There is now evidence that this room will not persist for long. In this case, continued excessive fiscal needs can have adverse implications for market liquidity, interest rates and credit to private sector, which in turn will limit the central bank's ability to further reduce the policy rate. The continued fiscal stimulus could also complement an expected rise in imported inflation, raising the risk of resurgence in domestic prices.

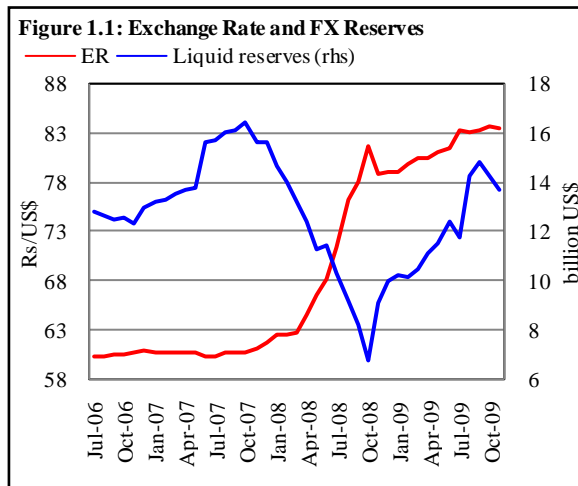
Although, headline CPI inflation dropped to 8.9 percent YoY in October 2009 (the lowest level in the preceding 26 months), it bounced back to 10.5 percent in the next month. Similarly, WPI inflation has seen a sharp jump in November 2009 to 12.5 percent, from only 3.8 percent YoY during the previous month. As a leading indicator, this shows growing inflationary pressures in the economy. This view is also reinforced by: a) an uptick in inflation measured by SPI in recent months, b) continued high levels of core inflation, as well as, c) strong CPI inflation numbers on a month-over-month basis for an extended period.

Indeed, it was concern over the combined impact of tight liquidity and risks of a re-emergence of inflationary pressures that led to only a measured easing of monetary policy. For example, while the central bank cut the policy rate by 50 basis points in November 2009, the reduction was lower than market expectations. The market was looking at a 100 bps reduction, in the backdrop of a sharp fall in headline inflation numbers and the considerable narrowing of current account deficit (83.9 percent lower YoY) during Jul-Nov FY10.

In any event, SBP caution seems justified, given the apparent reversal in inflation trends in November 2009. Moreover, in-house forecasts indicate the risk that an inflation uptrend could accelerate in H2-FY10 because of higher international commodity prices and lower than anticipated external receipts. The lower current account deficit during Jul-Nov FY10 is a result of strong growth in remittances, and a fall in imports (which more than offset the decline in exports). However, this improvement may not be sustained in the remaining months of FY10. Import demand, in particular, is projected to rise in months ahead with an expected revival in domestic manufacturing, and rising international commodity prices. At the same time, there are indications that the growth of some key exports (basmati rice, cement, etc.) may slow in the same period.

Similarly, the reasons for the strong improvement in remittances are still unclear, raising questions on the sustainability of the trend. Some analysts have raised concerns that this growth is mainly attributable to one-off transfers from expatriates who lost jobs in the Middle East, USA and Europe in the wake of the economic crisis. However, it is equally possible that a structural shift has taken place after the actions against alleged illegal activities by some foreign exchange companies. If so, recent SBP steps to facilitate remittances through official channels, could reinforce the positive trend.

Despite this improvement in the current account projected for FY10, Pakistan's overall external account remains vulnerable. This is because financing a significantly lower current account deficit remains very challenging on account of low external inflows. Net investment flows into the country for Jul-Oct FY10 are already 15.5 percent lower YoY, and access to international debt markets remains severely constrained (particularly after the debt restructuring requested by Dubai World). In this environment, funding under the Stand-by Arrangement with IMF has been a key to shore up the country's foreign exchange reserves and moderate the depreciation of rupee (see **Figure 1.1**). These are important gains for overall macroeconomic stability but



maintaining these gains and ensuring continuity of the nascent economic recovery remains challenging for the remaining months of FY10.

1.2 Looking Forward

SBP estimates suggest that FY10 GDP growth is likely to be around the annual target of 3.3 percent, a little higher than the 2.0 percent seen in FY09 (see **Table 1.2**). The major impetus for this growth is expected to come from the services sector. Within the commodity producing sector, an improvement in industrial output is expected to be partially offset by weaker agriculture.

Similarly, the current account deficit is likely to improve further in FY10 relative to the previous year, though some expected revival in import demand from manufacturing and rising commodity prices may possibly contain the improvement going forward.

However, while average CPI inflation during FY10 is projected to decelerate significantly from FY09 levels, it is likely to remain higher than the annual target of 9.0 percent for the year. The adjustment in administered prices of key fuels amid rising international oil prices and cut in electricity subsidies, are important factors behind the expected strengthening of inflationary pressures.

The government will try to achieve the quarterly SBA targets for the budget deficit. However, given exceptional circumstances arising from the stepped-up campaign against militants, these targets may not be achieved due to huge expenditures on defense and the rehabilitation of internally displaced people. The indirect cost of war entails weaker growth in tax collections, as industrial and trade activities (which are the main contributors to fiscal revenue) remain dull due to security uncertainties.

Table 1.2: Projections of Major Macroeconomic Indicators

	FY09	FY10	
		Annual Plan Targets	SBP Projections
<i>growth rates in percent</i>			
GDP	2.0	3.3	2.5 - 3.5
Average CPI inflation	20.8	9.0	10.0 - 12.0
Monetary assets (M2)	9.6	-	12.0 - 13.0
<i>billion US dollars</i>			
Workers' remittances	7.8	7.0	7.8 - 8.8
Exports (fob-BoP data)	19.2	19.9	18.5 - 19.0
Imports (fob-BoP data)	31.7	28.7	30.5 - 31.0
<i>percent of GDP</i>			
Fiscal deficit	5.2	4.9	4.7 - 5.2
Current account deficit	5.3	5.3	3.7 - 4.7

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

Thus, a major challenge in the economy is to improve the tax-to-GDP ratio. The 0.6 percent YoY increase in tax collection during Jul-Nov FY10 is a source of concern; if this continues, Pakistan's tax-to-GDP ratio will decline from an already low 9.8 percent seen in FY09. In view of the needs of the structural second generation reforms in the economy, it is necessary to strengthen the capability of FBR, increase documentation, reduce exemptions, equal treatment of incomes from different sources, and accelerate the levy of a comprehensive VAT. Another challenge in public finance is the increasing level of contingent liabilities of the government. In particular, the energy sector circular debt issue has not been resolved yet, and the government's borrowings for commodity operations have not seen the expected seasonal retirement in Q2-FY10. Since, a large part of these loans has been availed by the TCP and PASSCO, this needs to be settled before it creates another circular debt problem.¹

It must be stressed that excessive government involvement in commodity trade/finance, and the interference in market price setting, can be counter-productive and should be avoided. Cases of market failure are best handled through effective reforms and strengthening institutions like the Competition Commission of Pakistan.

¹ Wheat procurement in FY09 was over 9 million tons, substantially higher than the targeted 7 million tons that supplemented the existing stocks from imports in the preceding year. As a result, ample wheat stocks are lying with the provincial governments and agencies, much of which is without adequate storage facilities. This raises significant risks: a) given substantially lower international wheat prices, there may be some inward smuggling of cheaper wheat into the domestic market, b) there could be significant losses in case of rains, and, c) off-take from government wheat stocks could be significantly lower than anticipated. All of these raise corresponding concerns on banking sector liquidity.

1.3 Executive Summary

1.3.1 Real Sector

Agriculture

Initial estimates suggest that the performance of FY10 *kharif* crops has been significantly weaker than in the corresponding period last year. This was due to water shortages at sowing times and, more importantly, farmers' disappointment with prices received in the previous *kharif* season. The latter is particularly evident in the decline in area under rice and sugarcane cultivation. Conversely, the impact of favorable prices is reflected in the higher acreage under cotton during *kharif* FY10; cotton prices are currently at an all time high.

On the other hand, the announced support price for wheat may help the *rabi* crop; however, it is less likely that wheat could add significantly to growth given the high base set by the record FY09 crop. Early signals of poor *kharif* output, saturation in *rabi* and uncertain livestock due to decline in non-farm agri-credit, raise the risk of an overall weak performance of agriculture during the current fiscal year.

Large Scale Manufacturing

A modest improvement in aggregate demand was seen in Jul-Oct FY10 as manufacturing index increased by 0.7 percent compared with a decline of 5.0 percent in Jul-Oct FY09. This could be attributed to gradual easing in monetary policy and fiscal support as well as the impact of increase in farm incomes in FY09.

However, plagued by a multitude of structural issues, the recovery remained weak and patchy: a) although ginning numbers were strong, high lint and yarn exports resulted in raw material shortages for high-value added industries, bringing overall textile growth in the negative, b) automobile sales showed promising growth following a decline in both vehicle and fuel prices; but despite this, refinery production declined owing to the unsettled circular debt, c) domestic cement sales are expected to be impressive as modest recovery was seen in construction activities evident in high YoY growth in production of building material items (e.g., billets) as well as import of steel in October 2009. Nonetheless, export prospects are uncertain given capacity augmentations in importing countries as well as slowdown in construction industry in Afghanistan and Gulf.

With such unbalanced patterns of domestic recovery, expected upturn in global prices that will push up domestic energy costs, and lower sugarcane harvest

coupled with fears of late crushing (which could impede growth in sugar industry), the outlook for industry in FY10 remains uncertain.

1.3.2 Prices

Domestic inflationary pressures eased significantly during the first five months of FY10 compared with the corresponding period of FY09. Inflation measured by consumer price index (CPI) and the sensitive price indicator (SPI) declined, with CPI inflation YoY dropping to 10.5 percent YoY in November 2009, after reaching single digits (8.9 percent) during October 2009, for the first time in the preceding 21 months. While an uptick in November is largely attributed to higher food prices on account of Eid-ul-Adha, the recent disinflationary process is a result of: a) improvement in supply of most of the key staples (except sugar), b) constraints on the government's monetization of the fiscal deficit, c) lagged impact of tight monetary stance, and d) a decline in imported inflation.

However, variability in monthly inflation rates in WPI inflation (YoY) raises concern over the sustainability of the downtrend, particularly in the second half of the fiscal year. The risk of resurgence in inflationary pressures is also evident from strong core inflation. Both indicators, the non-food non-energy (NFNE) and 20 percent trimmed mean, though declining since H2-FY09, remained high. One of the main reasons for the persistence in both measures of core inflation, is the double digit increase in house rent index (HRI) despite an easing since June 2009. HRI has around 46 percent weight in NFNE and 29 percent weight in trimmed mean, hence, the pace of decline in core inflation is slow relative to headline inflation.

Moreover, the rising trend in international commodity prices, particularly crude oil, metals and some food items (e.g., rice and sugar) is likely to fuel inflationary pressures in the economy. The risk of higher inflation in food commodities also stems from weak monsoons in India, which would likely have negative spillovers on domestic prices.

1.3.3 Money and Banking

SBP continued to gradually ease monetary policy in FY10, reducing the policy rate by 150 bps in two rounds.² On cumulative basis, this means a reduction of 250 bps in the policy discount rate since the beginning of current easing cycle in April 2009. These policy measures were supported by substantial moderation in demand pressures. For instance, a very sharp drop in headline inflation, i.e., from

² A policy rate cut of 100 basis points in August 2009 was followed by another 50 basis point reduction in November 2009.

24.7 percent in November 2008 to 10.5 percent in November 2009; persistent YoY fall in import growth (particularly the negative growth in import volumes during Jul-Nov FY10) and the low growth in private sector credit expansion. The scale and speed of the decline in inflation suggest that the tight monetary policy and sharply constrained monetization of the fiscal deficit have eased excess demand pressures that had plagued the economy in the previous three years. This disinflationary impact received further support from lower imported inflation³ and improved domestic production of key staples.

However, the expansionary fiscal stance in Q1-FY10 (the deficit increased by Rs 223.7 billion compared with a rise of Rs 137.7 billion in the same quarter last year) has had some repercussions. For example:

1. A part of the growing deficit was financed through an IMF bridge finance loan, the inflationary impact of which is similar to that of deficit monetization.
2. The large jump in deficit, and lower recourse to SBP finance, meant that despite higher non-bank financing, government borrowings from commercial banks increased substantially. Net budgetary borrowing from scheduled banks was Rs 166.0 billion during Jul-5th Dec FY10 compared with a net retirement of Rs 67.0 billion in the corresponding period last year.
3. Strong government demand for financing, and low deposit growth is now constraining banks' ability and willingness to take additional exposure; this means an element of crowding out of private investment.

These problems are compounded by a significant increase in quasi-fiscal activities, such as financing of the circular debt, and borrowings by various public sector enterprises (PSEs), and government borrowing for commodity operation.

In terms of monetary aggregates, the YoY growth in M2 after witnessing the lowest level of 8.0 percent in April 2009 during the last eight years, reached 13.4 percent by December 05, 2009. This improvement came entirely from YoY rise in net foreign assets (NFA) of the banking system, as net domestic assets (NDA) of the banking system decelerated markedly by end-November 2009. Deposit mobilization by banks shows some recovery; on a cumulative basis, deposits recorded a growth of 0.1 percent during Jul-Nov FY10 in sharp contrast to previous year, when deposits contracted by 3.8 percent.

³ This was because of a relatively stable rupee and low international commodity prices in FY10.

1.3.4 Fiscal Developments

The Q1-FY10 fiscal deficit came in at 1.5 percent of projected annual GDP, raising concerns over the government's ability to meet the annual target of 4.9 percent of GDP. A significant part of the slippage owed to an unexpected rise in spending (e.g., increase in government wages, anti-militancy operations, etc.) and delays in some revenue receipts. If these factors are excluded, the quarterly fiscal deficit should be below 1.2 percent target for the first quarter of FY10.

One concern, however, is the heavier contribution of non-tax revenues within overall revenues during Q1-FY10. This is because jumps in non-tax revenues are unpredictable, and are often not sustainable. For example, non-tax revenues would have fallen by Rs 47.8 billion, had there not been a Rs 70 billion transfer from SBP profits to the government in Q1-FY10.

Despite sharp increase in fiscal deficit, financing from domestic sources has grown only moderately, because of the significant rise in net external financing. Also, quite encouragingly, the government has reduced its reliance on inflationary borrowing from the central bank.

The government faces very difficult choices, with considerable pressure to increase social sector spending and build infrastructure, even as the cost of the anti-militancy campaign continues to mount. At the same time, the weak economy constrains its ability to raise revenues from an unchanged tax base. This suggests the need to urgently work towards broadening the tax base to provide needed essential services and public goods.

A major success in fiscal policy, however, is the recent agreement between the federal and provincial governments on the 7th National Finance Commission (NFC) Award (see **Special Section 2** for details).

1.3.5 External Sector

Balance of Payments

Pakistan's external accounts improved significantly during Q1-FY10 compared to the same period last year. This improvement owed to both, a marked contraction in the current account deficit and an increase in the financial account surplus.

The major impetus came from a contraction in the trade account deficit, but the services and income account deficits also contracted significantly, reflecting lower economic activity. Current transfers were particularly robust recording 43.9

percent rise on account of increase in both, workers' remittances as well as other transfers.

The financing side also recorded marked improvement with the financial account surplus rising by 34.9 percent during Jul-Nov FY10. This improvement was primarily driven by increased inflows from the IFIs. Although net foreign investment contracted by 22.4 percent, net portfolio investment returned to positive territory, contributing US\$ 301 million during Jul-Nov, against a decline of US\$ 182 million in the corresponding period last year. Foreign direct investment, on the other hand, did not show any signs of recovery and declined by 52.3 percent during the period under review.

As a result of the improvement in the overall external account, Pakistan was able to rebuild its foreign exchange reserves, which reached US\$ 14.5 billion by end Nov 2009. The foreign exchange market also exhibited relative stability, and exchange rate depreciated by only 2.6 percent during Jul-Nov 2009 compared to 13.3 percent in the corresponding period last year.

Trade Account

Pakistan's trade deficit declined significantly by 37.6 percent YoY during Jul-Nov FY10, in contrast to a 20.8 percent rise in the same period last year. The decline in the trade deficit was entirely due to 23.0 percent YoY fall in the import bill as exports continued to decline, recording 7.4 percent YoY fall.

The contraction in imports was a result of restrained demand, better domestic production of some commodities (wheat and cotton), as well as fall in international commodity prices. Of these, however, the impact of the fall in the international commodity prices was strongest.

Like imports, the fall in exports was also broad-based. Growth in all the main categories, including food, textile, petroleum as well as other manufacturers groups, either extended their decline from the previous year or turned negative.

2 Real Sector

Aggregate demand in the economy showed some signs of recovery in the first five months of FY10; evident from higher sales of selected industrial and agriculture raw-material as well as consumer goods (see **Table 2.1**). A strong support came from higher farm incomes during FY09¹ which helped in sustaining consumption demand. The recovery was supported further by receding inflationary pressures that stabilized consumers' purchasing power to an extent. As a result, commodity producing sector is expected to exhibit a moderate recovery in FY10. Similarly, the performance of services sector is likely to improve in FY10, supported by *finance & insurance* as well as *public administration & defense*. Consequently, real GDP growth during FY10 is likely to be in the range of 2.5-3.5 percent, slightly up from 2 percent in FY09. It is important to note that the revival in aggregate demand is the combined impact of a gradual monetary easing and expansionary fiscal policy.^{2,3}

Further impetus to recovery came from relatively lower input prices during most of 2009, as international commodity prices declined due to global recession. Nonetheless, firms remained cautious in building-up inventories as the FY09 collapse of prices had already caused significant inventory losses to a number of manufacturing industries including edible oil, steel, refineries, etc. Therefore, the present recovery came without significant pressures on demand for bank credit as well as imports.

The pace of recovery, however, has remained weak so far due to uncertain domestic political and security situation which caused weakening in investment demand. Similarly from the supply side, banks through most of Jul-Oct FY10 were reluctant to finance private sector credit, which was another factor obstructing a quick recovery. A weak recovery has manifested in low real wages, slackening import demand for raw-materials, and weak tax collection during Q1-FY10. Similarly, the aggravating security situation in the country did not allow any improvement in mining activities.

¹ Three major crops (wheat, rice and sugarcane), which account for about two-third in value addition by major crops, saw record high harvests in FY09. In particular, the government also procured record quantity of wheat at a significantly high price of Rs 950/40 kg in FY09.

² Fiscal deficit rose from 1 percent of GDP during Q1-FY09 to 1.5 percent of GDP in Q1-FY10.

³ Support to manufacturing sector in FY10 came from fiscal side as government reduced FED on selected domestic end-products (e.g., cement, cars) and lowered import duties on raw-material.

The continuation of economic recovery will be challenging going forward as the global commodity prices continued to rise reaching 12-month high in November 2009. The increase in oil prices, especially, which resulted in increase in domestic prices of POL in December 2009 is going to be a major challenge in cost management. Similarly, although a rise in power tariff is inevitable, this increase will enhance cost of production. Also, while it is possible that gains in productivity could be achieved by minimizing load-shedding and winter gas outages; hydel electricity generation potential will be dependent on rains, while gas shortages seem probable.

Nonetheless, a stronger than expected surge in private credit since October 2009, substantial increase in cotton arrival,⁴ improvement in electricity supply in recent months, a reversal in rupee parity by end-November 2009, capacity expansions in some industries (refinery and fertilizer) and stronger export orders are promising developments from the perspective of a recovery in manufacturing activities in the economy. As a result, a recovery seen in LSM production during Jul-Oct seems sustainable in the remaining months of FY10.

Table 2.1: Indicators of Aggregate Demand

percent growth					
	FY09	FY10		FY09	FY10
A. Consumption indicators			B. Investment indicators		
POL sales (Jul-Oct) ¹	-5.2	16.4	Credit (manufacturing) (Jul-Oct)	6.4	-1.3
Cement sales-local (Jul-Nov) ²	-14.5	9.3	Capital goods production (Jul-Oct)	6.2	-20.5
Auto sales (Jul-Nov) ³	-20.5	29.7	FDI (Jul-Nov)	-17.7	-52.2
Fertilizer off-take (Jul-Oct) ⁴	2.7	32.2	Exchange rate (end Nov.)	28.8	6.1
Volume of cotton sold to textile ⁵	2.8	37.5	WPI (12-month ma)	25.0	7.4
Value of wheat ⁶	32.3	74.3	Int. comm. price (avg. Jul-Nov YoY)	17.6	-23.3
Consumer finance (Jul-Oct)	-6.0	-7.6	C. Govt. expenditures:		
Taxes (Q1)	27.7	0.6	Fiscal balance (Q1)	-12.8	62.4
Direct taxes (Q1)	13.8	-3.5	Total expenditure (Q1)	11.1	24.5
Sales taxes (Q1)	33.2	6.2	Development Expenditure (Q)	-48.9	92.1
Imports (Jul-Nov)	16.4	-23.0	D. Net exports		
CPI (Nov) (12-month ma)	19.1	14.6	Trade balance ⁷ (FBS - Jul-Nov)	-20.8	37.8

Source: ¹OCAC, ²APCMA, ³PAMA, ⁴NFDC, ⁵PCGA (cotton arrival statement as on 15th December)

⁶ Growth in value of wheat pertains to *rabi* 2008 and *rabi* 2009.

⁷ Trade balance with minus sign shows increase in trade deficit whereas plus sign shows decline in deficit.

⁴ Cotton arrival at ginning factories by December 15, 2009 is up by 24.2 percent (YoY).

2.1 Agriculture Sector Performance

Initial estimates suggest that the performance of FY10 *kharif* crops would be significantly weaker than in the corresponding period last year (see **Table 2.2**). This is mainly because of water shortages at sowing times and, more importantly, farmers' disappointment with prices received for some crops of the previous *kharif* season. The latter is particularly evident in the decline in area under rice and sugarcane cultivation. Conversely, the impact of favorable price signals is reflected in the higher acreage under cotton during *kharif* FY10; cotton prices had registered an increase for the fourth consecutive year in FY09.

Table 2.2: Performance of Major Crops

Area under cultivation (000 hectares)						% change in FY10 over FY09
Crops	FY08	FY09 ^T	FY09 ^P	FY10 ^T	FY10 ^E	
Cotton	3,055	3,220	2,850	3,200	3,020	6.0
Sugarcane	1,241	1,040	1,029	1,106	952	-7.5
Rice	2,516	2,594	2,963	2,526	2,854	-3.7
Wheat	8,550	8,610	9,045	9,045	-	-
Gram	1,107	1,012	1,092	1,022	-	-
Maize	1,037	1,001	1,062	1,039	971	-8.6
Production ('000 tons; cotton in '000 bales of 170.09 kg each)						
Cotton	11,655	14,110	12,060	13,360	12,100*	0.3
Sugarcane	63,920	56,516	50,045	56,527	48,622	-2.8
Rice	5,561	5,721	6,954	5,949	6,377	-8.3
Wheat	20,959	25,000	24,032	25,000	-	-
Gram	475	652	760	750	-	-
Maize	3,109	3,279	2,891	3,414	-	-
Yield (Kg/hectare)						
Cotton	649	750	720	710	710	-1.4
Sugarcane	51,507	54,342	48,635	51,109	51,074	5.1
Rice	2,210	2,205	2,347	2,355	2,234	-4.8
Wheat	2,451	2,904	2,657	-	-	-
Gram	429	644	696	-	-	-
Maize	2,998	3,276	2,722	3,410	-	-9.2

P: Provisional, T: Target, E: Estimates
 *: Projected on possibilities of 710 kg yield per hectare
 Source: MINFA

The initial estimate for cotton production does not appear to be substantially higher than the previous year,⁵ and the increase in value-addition may be offset by

⁵ However, the Sindh cotton crop is thought to be substantially higher than in the previous year, benefiting from increased cultivation of Bt cotton. If the Punjab crop follows this

the impact of a significant decline in rice and sugarcane production. Early signals of poor *kharif* output and uncertain livestock due to decline in non-farm agri-credit raise the risk of an overall weak performance of agriculture sector during the current fiscal year.

As variability in agricultural production has strong bearing on overall performance of the economy, it is extremely important to devise some mechanism that can help smoothing output in the crop sector. One such measure is the establishment of commodity futures market that can enhance information content in crop price-setting. In this context, an efficient legal and regulatory framework with crop insurance is important prerequisite for properly functional futures market.

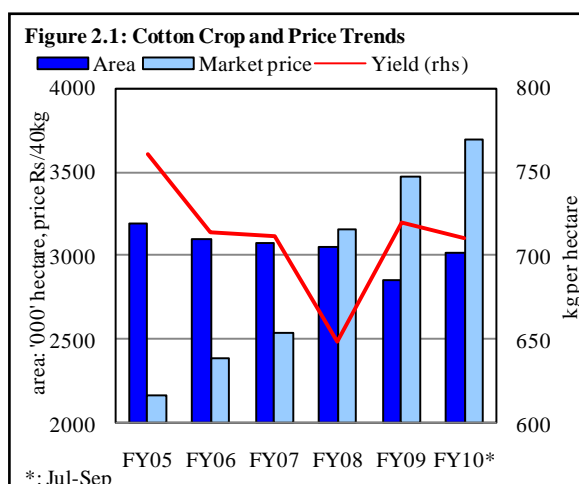
2.1.2 Kharif Crops

Cotton

Cotton was the only important major crop to see increase in cultivated area in *kharif* FY10. But despite this increase, production is projected to remain around the preceding year's level of 12.1 million bales against the target of 13.4 million bales. Area under cotton cultivation increased by 6.0 percent in FY10 against 6.7 percent decline witnessed last year

(see **Figure 2.1**). Initial estimates indicate that the shortfall in cotton output is principally from Punjab as the harvest in Sindh seems to be well above target.

The crop faced negative developments in the critical growth stages in August and September 2009, i.e., a) higher temperatures, resulting in excessive fruit shedding; b) incidence of pest attacks; and c) farmers unfamiliarity with *Bacillus Thuringiensis* (BT) cotton that led to excessive use of fertilizers. This raised the size of plant too much, which attracted multiplicity of insects.



pattern (or even remain unchanged from FY09), the FY10 cotton production could be significantly higher than suggested by initial estimates.

The cotton crop sown in normal season (May-June) also came under stress of extraordinary heat (45°C plus against 41°C last year), which restricted flower and boll formation. Moreover, a delay in winter arrival also damaged the crop at final stages of growth, which finally offset the impact of higher area under the crop.

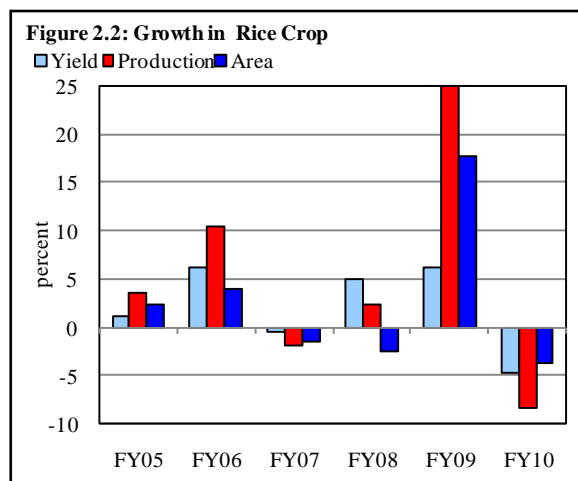
It is interesting to note that the arrival of cotton at ginning was about 24.2 percent higher than the preceding year by December 15, 2009. This was possibly because of excessive heat that forced growers to pick cotton early. Farmers were also incentivized by the prospect of sowing wheat by November, which would help increase yields and thus maximize the prospective gains due to high wheat prices and relatively low and stable fertilizer prices. If correct, this would suggest that the sharp jump in cotton arrival at ginning would likely to be sustained. However, there is a possibility that the stronger ginning arrival indicate a bigger than anticipated crop due to increased usage of early maturing high yield Bt cotton.

The view of an estimated lower annual production receives some support also from the strong demand for cotton in domestic markets that has driven local prices to record highs by early December 2009. It should also be remembered that domestic production of cotton remained lower than domestic consumption; domestic requirement for long staple is also met through imports. Thus domestic cotton prices increased due to: a) strong domestic demand with the revival of some exports, b) rising international prices, and c) a gradual weakening of rupee.

Rice

Initial estimates indicate a sharp decline in rice harvest relative to a record crop last year, though it is nonetheless higher than the target for FY10. This decline is the combined impact of lower area under rice, as well as, drop in its yield. The decline in area was anticipated due to a decline in international prices and farmers' disappointment over realized lower prices. Farmers were demanding a more active

government intervention in the rice trade to stabilize the prices. However, ad-hoc measures by the government entails substantial fiscal costs and yield sub-optimum



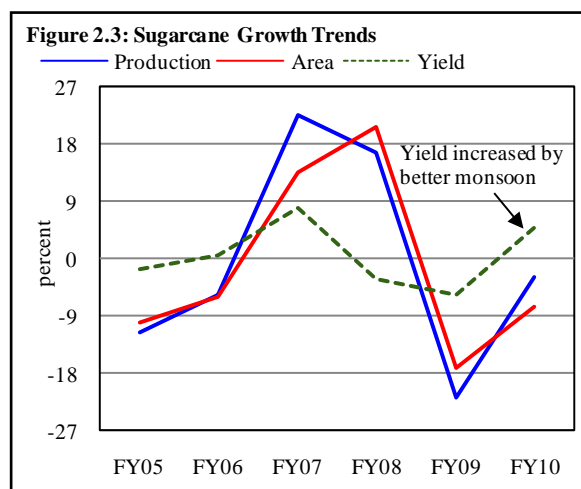
results. Therefore, improvement in market structure is an unavoidable need for the agri-commodity prices.

The decline in yield is mainly attributed to shortfall in irrigation water in some rice growing districts during sowing time: the impact was further compounded by dry weather, particularly in Multan and Sargodha region. Incidence of Leaf Borer also damaged crop in Punjab, resulting in decline in overall yield (see **Figure 2.2**). In addition, supply of sub-standard paddy seed was a major contributor to yield losses by 113 kg per hectare in FY10.

It is interesting to note that international rice prices are likely to resurge due to additional demand from India and Philippines. India is likely to become a net importer of non-basmati rice from a major exporter. It is also likely that people have started using basmati rice in India due to higher prices of non-basmati rice. This substitution would also put upward pressures on international prices of basmati rice due to lower exportable surplus with India. This suggests that farmers and traders may earn good price for rice in months ahead. This is not easy task, particularly for farmers especially in the absence of appropriate storage facilities. Farmers are typically forced to sale their produce to avoid wastages. Financing facilities and small investment in dry storage can make a strong impact on the motivation of the farmers.

Sugarcane

After achieving a record harvest of 63.9 million tons in FY08, domestic sugarcane output dropped for the second consecutive year during FY10 (see **Figure 2.3**). Farmers brought lower area under sugarcane due to continued dissatisfaction on marketing issues with sugar mills. Since carryover stock of 1.1 million tons from the bumper FY08 crop was substantial, sugar mills were relatively reluctant in aggressive buying and quick settlement of the payments during FY09. This discouraged farmers from sugarcane cultivation in FY10. This situation is quite frustrating as international sugar prices are on an uptrend and country has to



import a substantial quantity to meet domestic demand. Fixation of domestic sugar price below international prices during Q2-FY10 may also go against the farmers. It is likely that sugar mills would offer a lower price than expected by the farmers since mills would like to minimize their input cost given regulatory hurdles in passing on the impact of higher cost. This would make sugarcane crop outlook further gloomy for years to come. It should also be noted that the cane pricing issue in India may also lead to contain a sizeable increase in 2010 sugarcane output; as India is a major sugar consumer that could mean international sugar prices will stay high during most of 2010.

Although sugarcane yield is expected to rise in some parts of Sindh due to higher than normal monsoon, the crop still suffers from a number of problems: a) autumn sugarcane cultivation is being substituted by wheat due to water shortages, b) power outages, as well as, c) higher electricity tariff and input rates discouraged growers, particularly in Punjab, to increase area under sugarcane. Given the prevailing uncertainty in international commodity prices and serious repercussions of 2008 commodity price shock on developing economies, a long-term and sustainable policy to resolve issues between sugarcane growers and farmers is needed.

Other Crops

Initial estimates suggest that performance of other major *kharif* crops is also not encouraging in FY10 when compared with the preceding year. However, the relative stability in market prices for minor crops, particularly perishable goods, indicates an improvement in supply of these commodities (for details see **Chapter 3 on Prices**). These minor crops can also play an important role in earning foreign exchange, improving farm income as well as generating employment opportunities in rural areas. There is a need to invest in: a) proper transportation to market these items, b) establishment of small food processing and packaging units, as well as, c) dry and cold storage facilities. In particular, access to Middle East market at the initial

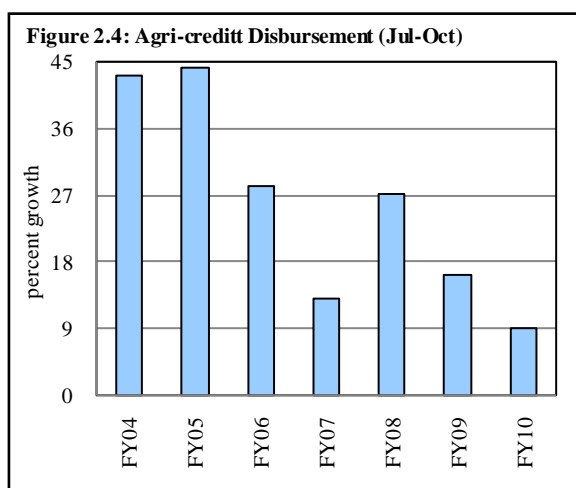


Table 2.3: Agri-credit Trends (Jul-Oct)

billion Rupees; change in percent

	Disbursement				Recoveries				Net credit		Outstanding	
	FY08	FY09	FY10	change	FY08	FY09	FY10	change	FY09	FY10	FY09	FY10
CBs	38.2	44.6	47.6	6.6	33.6	44.0	47.1	7.1	0.6	0.5	85.4	81.1
5 big CBs	26.8	31.5	36.9	17.4	24.7	30.9	35.9	16.0	0.6	1.1	58.6	56.3
DPBs	11.4	13.2	10.6	-19.2	8.9	13.1	11.3	-14.1	0.1	-0.6	26.8	24.8
Sp. banks	11.3	13.0	15.3	17.8	8.7	10.8	10.9	1.0	2.2	4.4	87.8	98.8
ZTBL	10	12.1	14.6	20.7	7.7	9.6	10.0	4.1	2.5	4.6	78.0	89.4
PPCBL	1.3	0.9	0.7	-21.3	1.0	1.2	0.9	-23.2	-0.3	-0.2	9.8	9.4
Total	49.5	57.6	62.8	9.1	42.3	54.8	58.0	5.9	2.8	4.8	173.2	179.9

stage is an advantage to Pakistan.

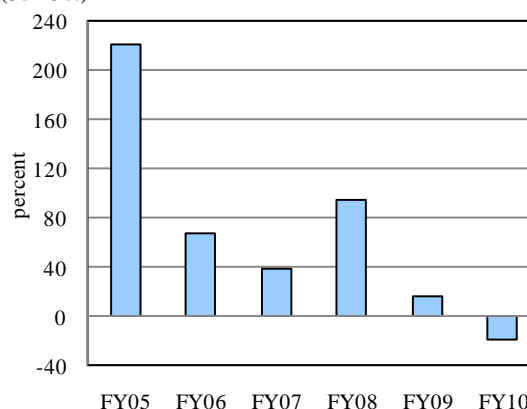
2.1.3 Agri-credit Performance

Agriculture credit disbursement growth during Jul-Oct FY10 slowed to 9.1 percent. Not only was this reduction in sharp contrast with FY09 growth of 16.2 percent, but was also the lowest in the last seven years for any Jul-Oct period (see **Figure 2.4**). The

deceleration in agri-credit is attributed to both demand and supply side factors. Demand for institutional credit weakened due to: a) increased farm incomes on the back of record harvests of three major crops in the preceding season, and, b) decline in the cultivated area under three major crops during FY10 *kharif* season. Anecdotal evidence suggests that the farmers preferred to purchase inputs from their own resources.

On the supply side, commercial banks, particularly smaller banks, become risk averse due to rising NPLs and liquidity crunch. It is evident from a fall in agri-credit by the domestic private banks (DPBs) for the first time since the entry of these banks in agri-credit market (see **Figure 2.5** and **Table 2.3**). Moreover, the opportunity to invest in government papers, given increased financing requirements of the government from domestic commercial banks, also reduced commercial banks' risk appetite.

Figure 2.5: Growth in Agri-credit Disbursement by DPBs (Jul-Oct)



Purpose-wise Agri-credit

A sharp fall in the agri-credit disbursement for developmental purposes by the commercial banks is in conformity with the risk-averse (cautious) agri-lending by these institutions (see **Table 2.4**), since developmental loans are settled in medium to long-run, while production loans cycle is short-term in nature. In addition, declines in disbursements for both

production and developmental purposes by the DPBs are a reflection of more cautious lending by these institutions as these banks were hit hard by the squeezed liquidity conditions in money market.

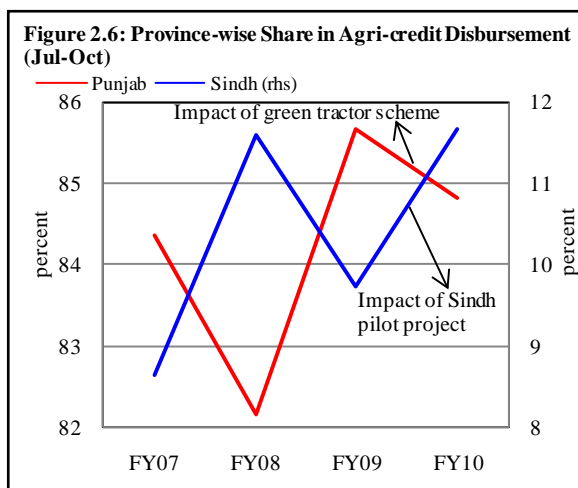
Table 2.4: Institution-wise Agri-credit

billion Rupees

	Production loans			Development loans		
	FY09	FY10	change %	FY09	FY10	change %
5-large (CBs)	27.8	35.9	29.2	3.6	1.0	-72.9
DPBs	11.8	10.2	-14.0	1.4	0.5	-64.6
Sub-total	39.6	46.1	16.3	5.0	1.5	-70.7
ZTBL	8.8	9.8	11.3	3.2	4.7	46.0
PPCBL	0.8	0.6	-18.2	0.1	0.1	-46.9
Sub-total	9.6	10.5	8.9	3.3	4.8	43.3
Total	49.3	56.6	14.9	8.3	6.3	-25.0

It should also be remembered that a major factor for high growth in the previous year was the successful implementation of a green tractor scheme in Punjab. It also increased the share of Punjab province in total agri-credit in FY09. Similarly, positive impact of Sindh Pilot Project⁶ for seven districts initiated by the SBP, is evident in rising share of Sindh province in total agri-credit during FY10 (see **Figure 2.6**).

It is expected that broadening the scope of this pilot project to the entire country in second phase as well as implementation of Benazir Tractor Scheme for all provinces would increase agri-disbursements in the country during the current fiscal year.



⁶ Under this initiative, it was mandatory for agri-credit disbursing banks to set up one window operation and post agriculture credit officers in their branches in 7 underserved districts of Sindh to increase agri-credit outstanding portfolio and number of borrowers. SBP will closely monitor and supervise the target achievement and implementation of the project.

Sector-wise Credit Disbursement

The slowdown in agri-credit was entirely attributed to a sharp deceleration in disbursement growth for non-farm sectors during Jul-Oct FY10 (see **Table 2.5**). This may adversely impact the outcome of FY10 livestock. While growth in agri-credit to poultry farmers decelerated, it declined sharply in the case of livestock dairy farmers and fisheries during this period.

Table 2.5: Holding-wise Agri-credit Disbursement (Jul-Oct)

billion Rupees	Growth rates				
	FY08	FY09	FY10	FY09	FY10
Subsistence	21.6	23.5	24.8	8.8	5.5
Economic	7.4	8.2	9.3	10.4	13.5
Above economic	6.8	6.2	6.5	-8.7	5.1
Farm	35.7	37.8	40.5	5.8	7.2
Non-farm	13.8	19.8	22.3	43.0	12.8
Small farms	2.2	3.6	3.7	63.7	4.7
Large farms	11.7	16.2	18.6	39.1	14.6
Total	49.5	57.6	62.8	16.2	9.1

Similarly, deceleration in agri-credit to farm sub-sector is emanating largely from subsistence farm holders during Jul-Oct FY10; as higher growth was registered under economic and above economic farm holders. A

similar trend was observed in non-farm sector. Although, growth in agri-credit slowed for both small and large farm holders under non-farm sub-sector, the impact was more pronounced in the former. This may probably be attributed to: a)

Table 2.6: Growth of Agri-credit and Fertilizer Off-take

	Disbursement		Urea		DAP	
	FY09	FY10	FY09	FY10	FY09	FY10
July	16.1	19.0	-26.7	26.3	-77.8	577.1
August	8.8	-8.7	-9.5	42.2	-68.4	737.3
September	38.8	-4.0	75.5	7.2	-2.5	160.5
October	-4.5	26.5	98.1	-3.8	24.3	-45.4

farmers used own resources due to increased farm income in FY09, as well as, b) cautious lending by the commercial banks to small farm holders. However, reduction in interest rates amid easing monetary stance of the central bank, a relative stability in commercial banks' NPLs and increasing credit requirements by the farmers for wheat crop, it is hoped that pace of institutional agri-credit disbursement is likely to improve November 2009 onwards during *rabi* season.

A monthly break-up of agri-credit disbursement and fertilizer off-take also support the direct relationship between the two variables (see **Table 2.6**).⁷ Specifically, a rise in credit disbursement during July 2009 had positive impact on fertilizer off-take in the following month. Similarly a fall in disbursement in September 2009 had a negative impact on fertilizer off-take. Given this trend and substantial

⁷ Some other factors such as fertilizer prices, water availability and prices of farm produce have influence on fertilizer off-take with agri-credit.

requirements of fertilizers for wheat on the back of farmers' optimism, due to high wheat prices and lower fertilizer prices, agri-credit disbursements are likely to see a jump in FY10 *rabi* season.

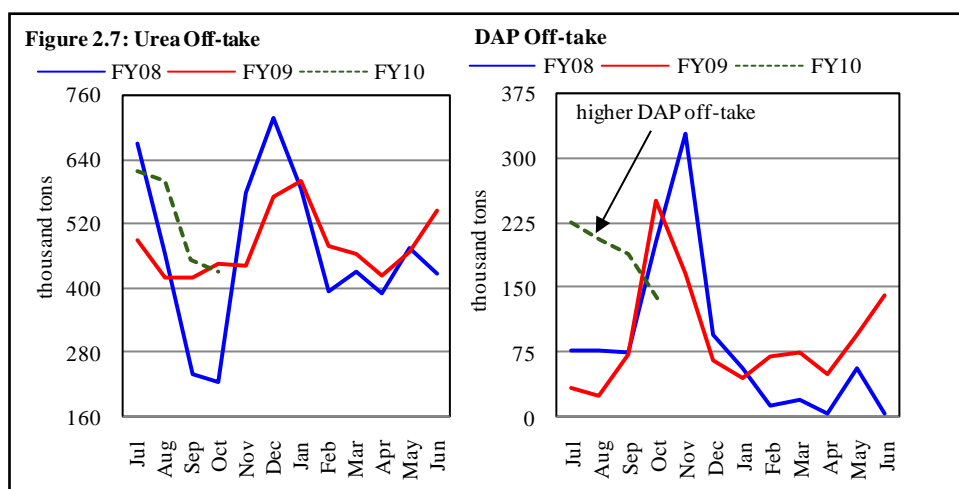
2.1.4 Fertilizer Off-take

Fertilizer off-take increased sharply during the first quarter of FY10 against negative growth seen in the same period last year. This growth was attributed to a fall in the prices of both urea and DAP (see **Figure 2.7**). While, a higher off-take was observed in the first two months of FY10, it declined in September 2009. However, fertilizer off-take is likely to increase further during *rabi* season given impetus from stable wheat support price and relatively lower fertilizer prices. Anecdotal evidence suggests that fears of a resurgence in fertilizer prices before wheat sowing season also encouraged growers to purchase fertilizer early. A sharp increase in DAP off-take is encouraging as a balanced use of nutrients is necessary to increase the yields, particularly for wheat (see **Table 2.7**).

Another factor, which contributed to higher fertilizer off-take, may be the market signals of higher prices of sugar in the domestic as well as in international

Table 2.7: Fertilizer Off-take (Jul-Oct)
(million tons)

	FY08	FY09	FY10
Urea	1.6	1.8	2.1
DAP	0.5	0.4	0.8
Total	2.1	2.2	2.9
Growth (%)			
Urea		11.2	18.0
DAP		-24.3	98.2
Total		2.7	32.2
Share (%)			
Urea	76.0	82.3	73.5
DAP	24.0	17.7	26.5



markets. Since sugarcane crop was cultivated on lower area, the growers may have sought to raise yield through higher application of fertilizers to maximize their gains. However, it is pertinent here to note that while a balanced use of fertilizer helps maximize the crop yields, market related issues impede farmers to apply an appropriate mix of the nutrients (see **Box 2.1**).

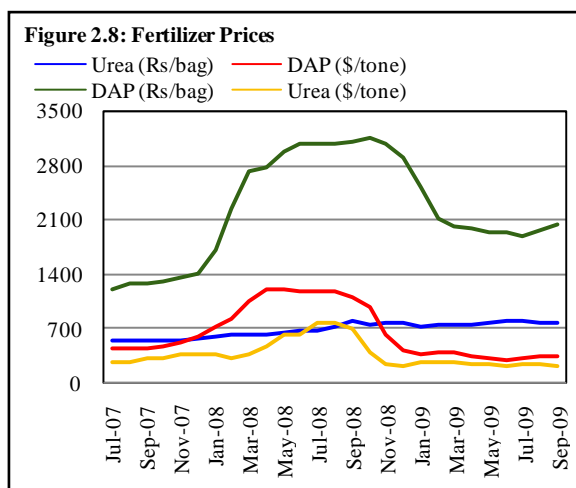
Box 2.1: Fertilizer Issues Faced by the Farming Sector

The main issues that farming sector faces today, regarding fertilizers consumption are: a) difficulties in timely availability at affordable prices, b) adulteration, and, c) imbalanced use of nutrients/fertilizers. At crucial stages fertilizers are usually missing from sale points and growers are on the mercy of traders. Efforts should be made to ensure regular supply of fertilizers. Delayed availability/application of fertilizers increases cost of production on one hand, and unable to play any active part in yield increase-resulting in misuse of resources and national wealth. Adulteration in fertilizers is common to maximize profit, which cause heavy cash and yield losses to the grower and shake their confidence. It is required to strictly impose law upon those found involved in fertilizer adulteration. Researchers/scientists agree that balanced use of fertilizers is necessary for yield maximization. Stakeholders should make efforts to educate farmers to apply balanced fertilizers. Through print and electronic media efforts should be made to inform growers regarding balanced use of fertilizers to maximize crop yields. Balanced use of fertilizers also helps to reduce various plant diseases, thus increases yield. Fertilizer is an expensive and valuable input; and should be used judiciously.

Fertilizer Prices

Domestic fertilizer prices started to ease from Q1-FY09 but a sharp declining trend since then led farmers to postpone purchases. Although prices resurged again in Q1-FY10, these are relatively stable (see **Figure 2.8**).

International fertilizer prices registered drop at a faster pace than the domestic prices. This difference is explained by the impact of depreciation of rupee.

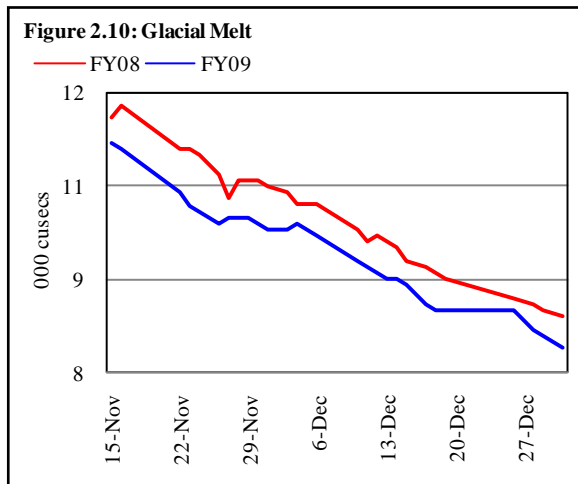
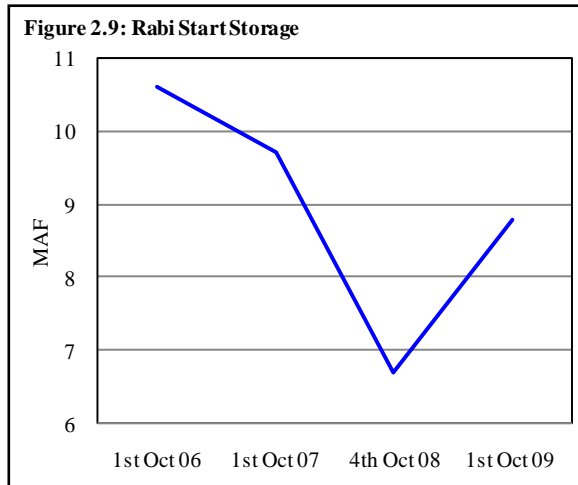


It may be noted that outlook of international fertilizer prices remains uncertain given rolling-coaster trend in energy prices. In addition, adjustment in the domestic utility prices may also have upward pressures on domestic prices. In case of higher variability in fertilizer prices, their off-take may slow down.

2.1.5 Water Availability

Water availability at the start of crucial *rabi* FY10 season (Oct-Mar) has improved compared to the last three years (see **Figure 2.9**). The anticipated water availability as per IRSA forecast was 23.9 million acre feet (MAF) in *rabi* FY10, up by 6.9 percent relative to the corresponding *rabi* season. IRSA estimates indicate 31.0 percent shortages in current *rabi* season against 39.0 percent shortages in the corresponding period in FY09.

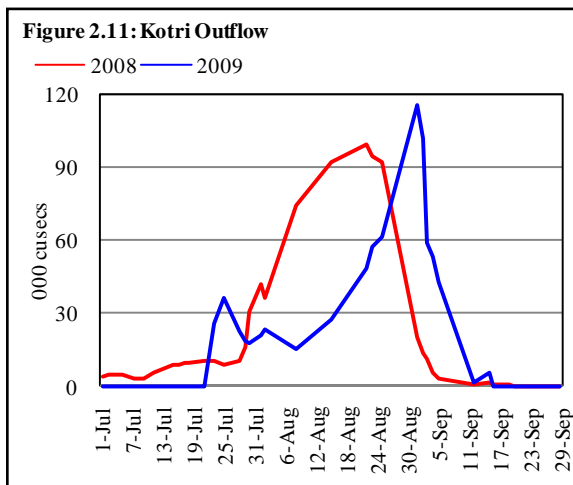
The slight improvement emanates from the combined storage at the start of *rabi* last year, which was 7.3 MAF while it was 8.8 MAF as on October 1, 2009. Late monsoon rainfall was instrumental in building-up the reservoir levels. It is pertinent to note here that the water reservoirs situation will deteriorate as winter approaches.



The water reservoirs' position at the time of clearing of irrigated area from sugarcane and cotton, when it is being prepared for wheat crop, is likely to be weak, with glacial melt discharges from Indus basin not exceeding 12000 cusecs in the month of November and likely to drop to 8000 cusecs by December 2009 (see **Figure 2.10**) due to falling temperatures. Winter rains would be a deciding factor for the final tally of the wheat sowing in the major wheat growing belts of Punjab. The positive impact of late monsoons was visible in the Kotri downstream outflows critical to the growth of mangroves in the Indus delta region

(see **Figure 2.11**). Outflows continued till end of September 2009 compared with mid September 2008. That was illustrative of the availability of water till the last stretches of the Indus canal system.

However, they were also indicative of the water flows that remain unutilized in the world's most elaborated canal network. That calls for the construction of new reservoirs as well as rehabilitation of the canal system. Further, better water management and efficient use of water through improved land leveling is also necessary to enhance yield as well as to face the future challenges.



2.1.6 Outlook

The growth outlook for FY10 agriculture sector seems gloomy and likely to be lower than the strong growth seen in FY09. However, an aggressive wheat sowing by end-November is encouraging as a bumper wheat crop may push up agri growth. A bumper wheat crop is expected due to: a) slight improvement in water availability during *rabi* FY10, b) relatively lower and stable fertilizer prices, as well as, c) stable domestic wheat prices despite substantial drop in international prices. This may also be supported by an improvement in minor crops. However, initial estimates suggested performance of FY10 *kharif* crops was below expectations, and expected lower growth in livestock (due to decline in credit to this sub-sector during Jul-Oct FY10) may largely offset gains from a good *rabi* harvest.

2.2 Large Scale Manufacturing

The LSM sub-sector, after declining for 13 consecutive months, recorded a mild recovery in Jul-Oct FY10. The 18-month high YoY growth in October 2009 took the cumulative LSM growth in Jul-Oct FY10 to 0.7 percent; compared with a decline of 5.0 percent in Jul-Oct FY09. Almost half of the LSM sub-groups showed improvement from the previous year, mainly including industries producing consumer and intermediate goods. However, monthly production trend shows quite an erratic pattern (see **Figure 2.12**). In specific terms, while

production declined in July and September compared with the corresponding months in FY09; it increased in August and October. Furthermore, the recovery during Jul-Sep FY10 was quite weak as huge production declines in petroleum and metal sub-sectors offset production gains in many industries. The YoY growth in October, however, looks firm mainly on the back of strong ginning activities during the month and consolidating improvements in cement and automobile industries. On cumulative basis, textiles, leather, automobiles and rubber were few sectors that recorded net improvement in production in Jul-Oct FY10. In contrast, petroleum, metals, and capital goods were major industries

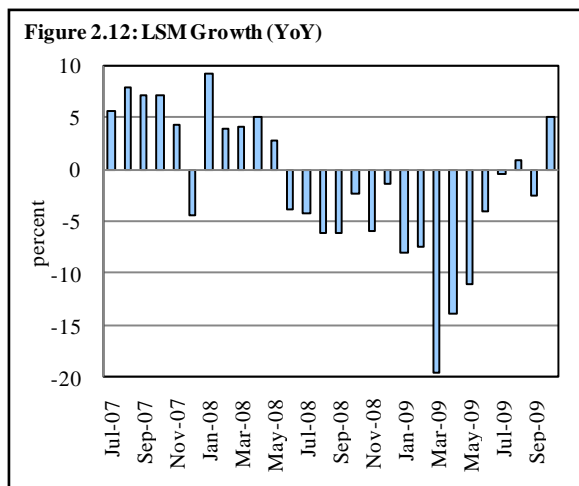


Table 2.8: Production and Trade of Major Manufacturing Goods during Jul-Oct

Growth in industries producing exportable surplus						Growth in industries competing with imports					
in percent		Production		Exports				Production		Imports	
	AdWt	FY09	FY10	FY09	FY10		AdWt	FY09	FY10	FY09	FY10
Textile	24.5	-0.4	-0.6			Automobile	5.3	-32.3	7.1		
Cotton yarn	13.1	-0.42	-2.2	-15.2	42.6	CBUs ²	3.4			-24.7	-40.3
Cotton cloth	3.4	-0.67	-0.7	23.6	-39.8	CKD ³				14.5	34.8
Cotton ginned		1.42	13.0	277.5	68.0	Electronics	3.3	-10.4	-15.2		
Leather	3.0	1.5	22.4			Fertilizer	4.5	12.1	2.3	-21.9	-35.2
Upper leather	1.5	0.6	12.3			Paper	0.8	2.2	7.7	-11.1	0.6
Sole leather		-15.8	103.1			Rubber	0.4	5.5	26.1	-42.9	-4.3
Footwear	0.7	24.0	-1.2	4.4	2.0	Food	19.1	-5.8	-0.2		
Pharma	6.7	0.4	0.7	5.3	-18.3	Edib. Oil ⁴	5.7	-6.50	7.0	-13.1	6.4
Ply-wood	0.0	45.7	-28.2			POL	7.0	-6.0	-11.4	22.5	21.3
Non-metallic	5.6	1.6	18.5			MS ⁵		-6.4	-0.9	-13.8	598.5
Cement ¹	5.5	1.4	18.8	72.9	18.0	FO		-7.4	-19.5	2.5	71.5
Chemicals	6.4	-0.7	1.0			HSD		1.2	-9.6	13.7	9.8
Engineering	0.6	9.0	-14.5			Metal⁶		-13.9	-21.3	-23.4	-21.2

¹ Source for cement export data is APCMA. Growth numbers presented here do not tally with FBS data.

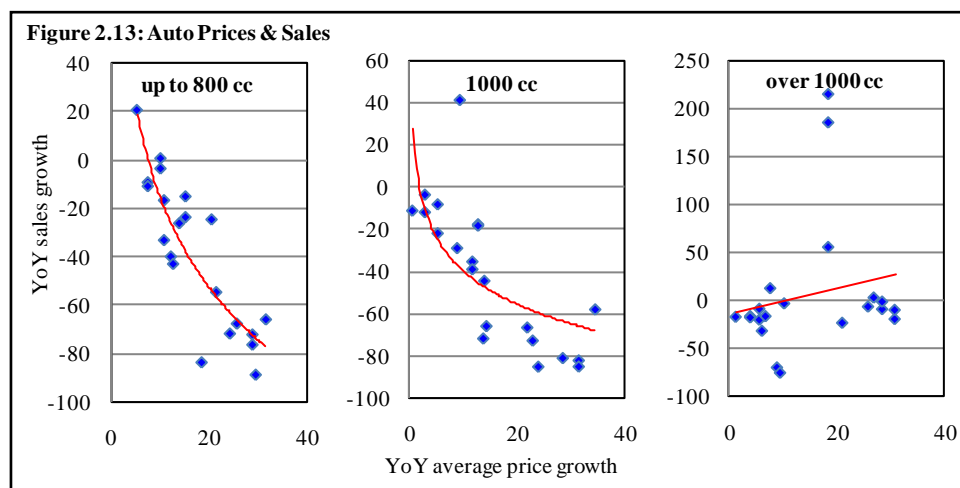
^{2,3} Dollar import value change as quantum change is not available, ⁴ Import of palm oil

⁵ Import data for all POL products is taken from OCAC website, ⁶ Import only includes iron & steel (incl. scrap)

showing production declines (see **Table 2.8**)

Robust growth in cement industry during Jul-Oct-FY10 emanated from higher domestic demand as well as strong export demand. Decline in local cement prices in the start of FY10, following the reduction of FED on cement in FY10 budget appears to be the major factor in higher domestic sales.⁸ Moreover, higher budgetary allocations for housing and works as well as decline in other building material prices further strengthened the local demand. Cement exports, on the other hand, slowed down during Jul-Oct FY10.⁹ The slowdown in exports was both broad-based as well as expected. Specifically, with new capacities coming on line in the regional economies, a slowdown in the cement exports was expected especially from India that had already imposed 20 percent duty on cement imports from Pakistan in January 2009. Moreover, with the global financial crisis penetrating into Dubai construction sector, a drastic weakening was observed in cement demand from the Gulf. Nonetheless, domestic demand for cement is likely to remain strong as a number of new housing projects are in line mainly in the private sector and government is also keen in initiating mega infrastructure projects.

Consumer durable industries showed some recovery despite the absence of bank finance. In FY09, a sharp jump in the prices of most of electronics and frequent electricity disruptions had caused a slackening demand for consumer durable

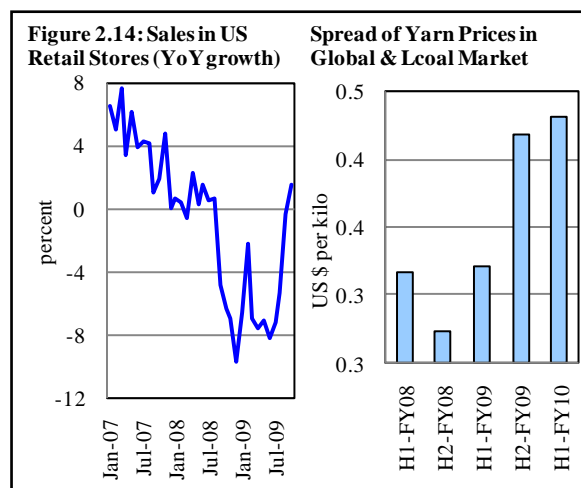


⁸ Local cement dispatches increased by 12.9 percent in Jul-Oct FY10 compared with a decline of 14.2 percent in Jul-Oct FY09.

⁹ Data from All Pakistan Cement Manufacturers Association shows an increase of 18.0 percent in cement exports during Jul-Oct FY10 compared with an increase of 72.9 percent in Jul-Oct FY09.

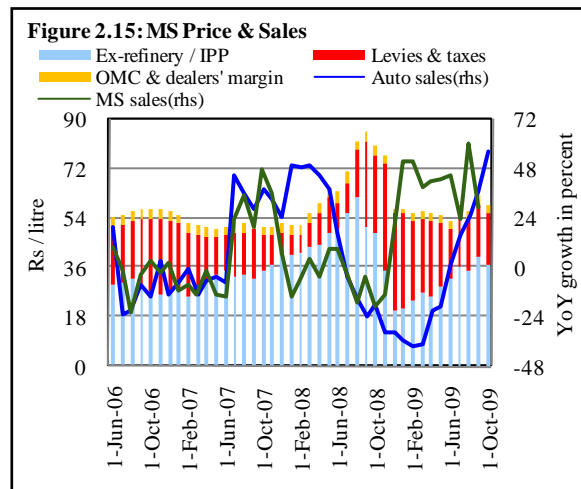
goods. Moreover, high cost and lower availability of bank finance further reduced production activities in automobiles and electronic industries. In Jul-Oct FY10 however, the automobile sub-sector, in particular, recorded higher production as the demand for cars and motorcycles increased mainly on the back of lower prices and higher agriculture incomes (see **Figure 2.13**).¹⁰ Specifically, the government removed FED on the purchase of cars 850 cc and above in Budget 2009-10 that was imposed in the previous year to curb excess demand pressures. As global commodity prices and exchange rates were relatively stable in Jul-Oct FY10 compared with last year, automobile companies passed on the benefit of duty elimination to the consumers.

In sharp contrast to the above, the growth in textiles sector during Jul-Oct FY10 came mainly from better arrival of the new crop and increase in external demand. Specifically, the domestic textiles benefited from: a) increase in cotton crop, b) some recovery in retail sales of textiles in advanced economies (see **Figure 2.14**), and c) higher international prices of cotton and cotton yarn following the sizable shortage in Chinese cotton crop. As a result of these factors, production and exports of cotton ginning industry registered a strong growth during Jul-Oct FY10. Moreover, although the operational bottlenecks that the spinning industry has been facing for the last couple of years including higher financing cost, electricity and gas outages, as well as unfavorable domestic security situation; the increased price differential in local and global yarn prices created a viable opportunity for spinners to produce more. With higher exports of cotton and cotton yarn, the upward pressures on local cotton and yarn prices started to emerge, increasing production cost of high value added sector. As a result, domestic weaving industry suffered and reportedly a number of small power looms shut down during Jul-Oct FY10.

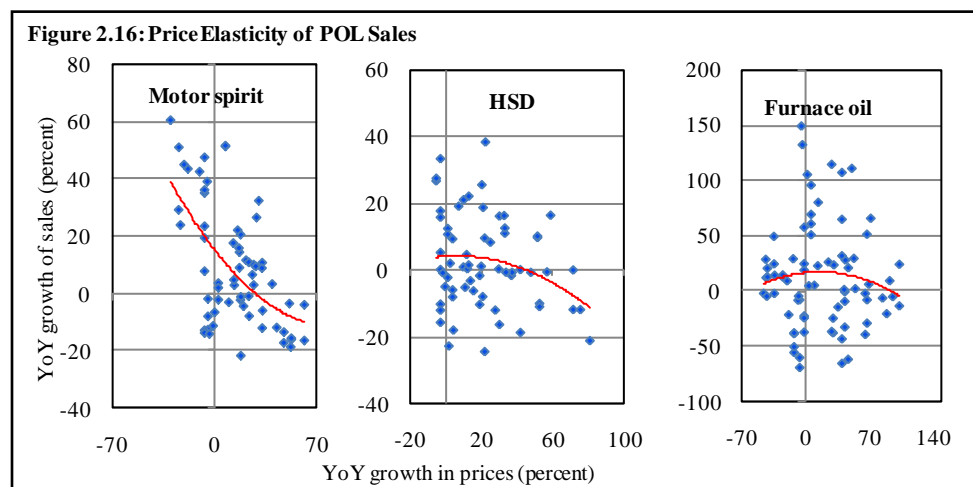


¹⁰ Major car makers reduced prices in Q1-FY10.

With recovery seen in major manufacturing sectors, demand for petroleum products increased. However, a large part of the demand was fulfilled through imports and domestic refineries faced severe liquidity problems in running the production processes smoothly. Specifically, the problem of circular debt in the refining sector did not allow refineries to import sufficient quantities of crude oil and operate at normal throughputs. As a result, country had to import refined petroleum products to fulfill domestic requirements.



Pick-up in demand for motor spirits appeared first in the initial months of 2009 following the collapse of global oil prices (see **Figure 2.15**). The decline in domestic petrol prices caused petrol-CNG price differential to narrow causing substitution of motorspirit over CNG. Although in the following months global prices started inching up again, but government adjusted the domestic levy structure to stabilize prices. Later in Q1-FY10, the sales of automobiles, especially motorcycles, picked up after declining for 12 consecutive months. The higher automobile sales were mainly a response to lower prices following the duty



cut in Budget FY10 (see **Figure 2.16**).¹¹

Going forward, LSM performance is expected to vary widely across the sectors. While the addition of new plants and further resurgence in demand tilt the scales towards a higher overall growth number, a host of uncertainties also linger in the near future.

Demand for refined POL products, mainly furnace oil and motor spirits, is likely to remain strong. While the demand for furnace oil is likely to emanate from increase in electricity generation capacity, the demand for motor spirit will remain strong as the automobile sales picked up and CNG-petrol price differentials narrowed further. Furthermore, government's decision to close CNG stations twice a week may also strengthen motor spirit demand. The refineries' response to higher demand is evident from 33.9 percent YoY increase in crude imports in Oct-Nov FY09. Production capacity of fertilizer and steel sector is likely to increase sharply with new plants coming online. Specifically, annual production capacity of nitrogenous fertilizer will increase by approximately 146 percent to 3.6 million MT by the end of the fiscal year. Furthermore, 30 percent increase in production capacity of steel sector is expected as a new steel producing unit will start commercial production in March 2010. Lastly, production of transformers is also likely to rise as demand increases, following expected up-gradation of the electricity distribution network.¹²

However, a number of downside risks also prevail that may inhibit an otherwise strong LSM recovery. If the recent uptrend in global commodity prices continues and gathers pace, the resultant increase in retail prices may hurt the demand. This is already evident in automobile sub-sector where car assemblers have increased retail prices November 2009 onwards following the increase in prices of aluminum and copper and further depreciation of rupee against yen. Moreover, domestic prices of raw material showed a year-on-year increase of 20.2 percent in November 2009.

Aside from domestic demand, several other factors put downward pressures on manufacturing growth; these include a lower sugarcane harvest along with fears of late cane-crushing, which could impede growth in sugar industry (5.5 percent weight in LSM).

¹¹ According to an estimate, of the total motor spirit sale in the country, 55 percent is consumed by motorcycles.

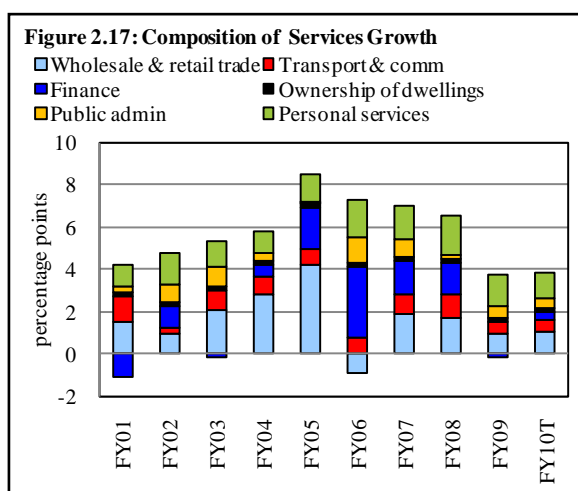
¹² In October 2009, production of transformers increased by 8.4 percent YoY after declining in previous 11 months.

Furthermore, the recovery in advanced economies has been weak so far. Credit markets in the US and EU are still depressed, employment levels are low, and as a result consumption patterns are weak. The recovery in these economies is still dependent on policy support and fear of premature policy reversals adds to uncertainties in the global outlook. The domestic exporting industries of textiles (other than spinning) and leather may not see any major demand impetus and would thus need to strive to capture a larger share in stagnant demand. The export demand for cement is not likely to sustain due to tougher competition with the lifting of export ban in Saudi Arabia. It must be noticed here that the cement export growth in the previous years was driven largely by newly-captured African and Gulf markets. Saudi Arabia, having the vicinity advantage, can give a tough competition to local exporters to maintain market shares. Price competition will also toughen as coal prices increase.¹³ Moreover, security crisis in the Frontier province could jeopardize cement supplies given the fact that NWFP has around 30 percent share in total cement production.

The pace of recovery in the domestic economy will also depend on the supply and costs of two key inputs: energy and finance. A tight monetary stance till Q2-FY09 had increased firms' financial costs significantly. This, coupled with squeezed operating margins in the face of depressed demand, had led to severe liquidity shortages in many industries. As a result, NPLs of manufacturing industries have increased substantially in recent years. To accommodate the slight increase in demand from private sector, the State Bank reduced the policy rate by 250 basis points on three different occasions since April 2009; lending rates have also responded, though gradually. Furthermore, a sharp increase in credit off-take by manufacturing sector during Oct-Nov FY10 bodes well for the sector's recovery.

2.3 Services

Services growth in FY10 was expected to maintain, and slightly surpass, the FY09



¹³ Particularly, Indonesian coal prices are expected to rise as the country plans to employ the fuel for thermal energy generation. A large proportion of coal employed in local cement manufacturing is imported from Indonesia (around 50 percent).

growth mainly on the back of an expected recovery in finance and insurance sub-sector (see **Figure 2.17**). The expectation of a stable growth was reinforced by the recovery in manufacturing in Q1-FY10 which is expected to support wholesale and retail trade activities (which have one-third share in overall services value addition) (see **Table 2.9**).

However, the sharp decline in external trade volume (mainly imports) may partially offset the gains from real sector recovery. Specifically, the decline of 23.0 percent in imports during Jul-Nov FY10 can have multiple implications for services sector growth: a) some slowdown in wholesale and retail trade activities, b) slowdown in import-related port/shipping activities, and c) some impact on inland freight (inland transport of imported goods). The decline in sale and production of trucks and LCVs as well as lower sales of HSD also reflect the decline in inland freight.

In addition to decline in imports, a further drag to growth in transport and communication may also come from the telecom sector. The telecom companies are operating within a highly competitive market competition which has already resulted in a significant decline in the ARPU (average revenue per user) and, therefore, the profits of these companies. In Budget 2009-10, the government reduced federal excise duties and SIM activation charges which could increase earnings, if not passed on to end users. However, it is highly likely that telecom companies would pass on this benefit to consumers in order to capture and maintain market shares. The decision to pass on the benefit to users would largely depend upon the demand for network services in months ahead. In this scenario, the government's decision to eliminate regulatory and reduce customs duties on

Table 2.9: Indicators of Services Sector Performance in Q1
percent growth, (mentioned otherwise)

	FY09	FY10
Wholesale & retail trade		
Credit to wholesale and commission trade (Jul-Oct)	-2.1	-4.7
Credit to retail trade (Jul-Oct)	16.6	2.2
FDI in trade (Jul-Nov)	2.5	-52.8
Manufacturing growth (Jul-Oct)	-5.0	0.7
Import growth (Jul-Nov)	16.4	-23.0
Transport, storage & communication		
Cargo handling at KPT (Jul-Nov)	9.0	10.2
Tele-density (percentage of population)	60.0	62.4
Telecom imports (Jul-Oct)	69.6	33.6
Sales of commercial vehicles*	-7.6	1.5
Transport group imports (Jul-Oct)	42.1	-25.6
Transport communication inflation (Nov)	23.8	6.2
Finance & insurance		
Profits of commercial banks (Sep on Jun)	23.4	47.2
Percentage of advances at 12% or above (Oct)	72.9	77.9
Percentage of deposits held at 8% or above (Oct)	34.5	37.4
Interest rate spread – stock	7.7	7.4
Interest rate spread - incremental (Oct)	6.0	6.5

* LCVs, tractors, buses and trucks (Jul-Nov)

import of mobile sets may increase network demand. Moreover, network suppliers are reciprocating to increased demand by up-grading operations, including: a) expanding network base to remote areas, b) providing value-added services through cellular phones, e.g., mobile banking, payments of utility bills, etc., and c) technical up-gradation of existing infrastructure. A strong growth in telecom imports during Jul-Oct FY10 and slight increase in cellular density also raised optimism regarding sector's prospects.

As mentioned earlier, the finance and insurance sector is likely to benefit from favorable supervisory measures announced during the quarter. These measures include: a) ease in regulations regarding the benefit of forced sale values of collateral while computing the provisioning requirements, and b) relaxation in loan classification and resultant lower provisioning requirements. Moreover, the net interest margins have widened which resulted in increased interest earnings during Q1-FY10. In addition, a higher banking spread in Q1-FY10 is expected to further boost banks' net interest earnings during the year. The recovery in finance and telecom sub-sectors is a welcome development given its strong implications for employment generation, export potential, and overall development in the country. Moreover, rapid job creation in these sectors in the recent past means that further expansion will result in more employment absorption (see **Table 2.10**).

Table 2.10: Contribution of Services in the Economy

	GDP growth ¹		% point contribution in GDP growth		Employment growth ¹		% point contribution in employment growth		Investment growth ¹		% point contribution in investment growth	
	CPS ²	Serv.	CPS	Serv.	CPS	Serv.	CPS	Serv.	CPS	Serv.	CPS	Serv.
1970s	3.2	6.1	1.7	2.8	2.6	5.1	2.0	1.3
1980s	5.9	6.7	2.9	3.4	2.1	3.1	1.5	0.9	4.9	5.2	3.0	2.0
1990s	4.5	4.5	2.2	2.3	1.2	4.6	1.4	1.2	-0.3	3.1	-0.7	1.8
2000s	4.2	5.7	2.0	3.0	3.3	4.5	2.1	1.5	-0.7	8.9	-0.3	5.1

¹Compound growth, ² CPS refers to commodity producing sectors.

Thus, the services sector is all set to grab a growing share in the economy. With employment numbers reaching 17 million in 2008, the sector is fast outpacing the agriculture sector, the economy's largest employer (with a 21 million-strong labor force). Not only that, services has consistently outpaced the commodity-producing sector (CPS) in terms of contribution to GDP growth; and the drawing on bulk of investment expenditure in the last decade paves the way for future growth in services.

3 Prices

3.1 Global Inflation Scenario

Since the beginning of FY10, a sluggish recovery has been witnessed in the global economy. The Organisation for Economic Cooperation and Development (OECD) expects moderate recovery in 2010.¹ Importantly, deflation has started decelerating in most of the developed countries amid improved consumer confidence (see **Table 3.1**).

Signs of recovery in global economy are also evident from increasing international commodity prices since the beginning of the current fiscal year (see **Figure 3.1**). Commodity hedging has also supported the upward trend in prices.

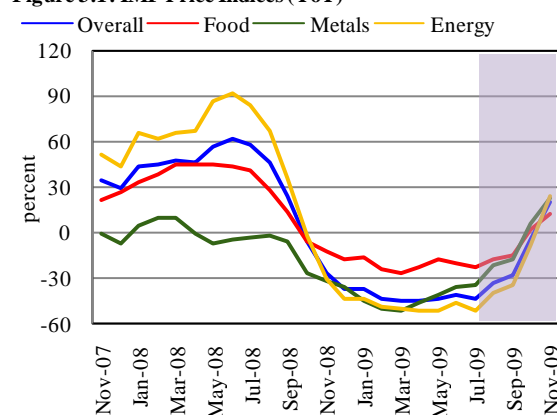
Rise in prices has been witnessed in all commodity groups, but is more pronounced in industrial metals. This is possibly because a substantial part of the fiscal stimulus, announced by various countries, has been allocated to infrastructure projects, which may have resulted in increased demand for metals. A weakness of dollar also

Table 3.1: Inflation (YoY) in Major Economies

Country	Nov-08	Jul-09	Nov-09
United States	1.1	-2.1	1.8
Japan*	1.0	-2.2	-2.5
Europe	2.1	-0.7	0.5
United Kingdom	4.1	1.8	1.9
China	2.4	-1.8	0.6
Sri Lanka	16.3	1.1	2.8
Indonesia	11.7	2.7	2.4
India*	10.4	11.9	11.5
Pakistan	24.7	11.2	10.5
Thailand	2.2	-4.4	1.9
Philippines	9.9	0.2	2.8
Vietnam	24.2	3.3	4.3
Malaysia*	5.7	-2.4	-1.6

Sources: Bloomberg, IMF, World Bank, OECD, The Economist and Central Banks websites. * Data pertains to October 2009
*Data pertains to October 2009

Figure 3.1: IMF Price Indices (YoY)



Source : IMF

¹ OECD Economic Outlook No. 86, November 2009.

supported increase in metal prices in recent months amid near zero interest rate in US. Metal prices registered a 22.2 percent YoY and 2.6 percent MoM growth during November 2009 (see **Table 3.2**). It is interesting to note that industrial metals prices started recovering after the monthly industrial production output figures turned positive in many of the industrial countries, e.g., Japan, China, Germany and United Kingdom.² Among the precious metals, gold prices in international market reached record levels during the quarter under review as demand for the commodity increased as a safe haven due to weaker dollar. Moreover, recently, some central banks have resorted to buying gold to diversify the composition of their reserves.

Table 3.2: Major Commodity Indices

Group	MoM change			YoY change			
	Nov-08	Jul-09	Nov-09	Jul-09	Sep-09	Oct-09	Nov-09
Overall	-17.5	-4.2	4.3	-44.6	-28.6	-4.7	20.4
Food	-5.7	-3.5	3.1	-21.8	-12.9	4.4	14.1
Metals	-11.7	3.1	2.6	-35.0	-17.8	5.2	22.3
Energy	-22.4	-6.4	4.5	-51.9	-34.9	-8.3	23.5

Source: IMF

Among other commodity groups, energy prices have also started recovering since the start of current fiscal year, mainly due to: a) increased concerns over sustainability of supply at lower prices, b) cut in production by OPEC, as well as, c) a moderate recovery in oil demand. Weakness of US dollar has also resulted in an increase in crude oil prices, as weak dollar affects the profitability of the producers. According to International Energy Agency, global oil demand is expected to rise further in the coming months. The expected rise in demand is likely to push oil prices upwards.

Food commodity prices also recovered during FY10. However, due to significant increase in their supplies, the pace of increase in prices remains slow. Wheat production in US, Ukraine, Argentina, Australia and Canada remained higher than expected. Similarly corn output remained better than expected. Soybean and palm oil production is also expected to remain higher. Keeping this in view, prices of these commodities in international market are expected to remain lower in near future. However, if winter wheat sowing in the US is delayed due to adverse weather conditions, prices may witness upward pressure.

It is important to note that International Grain Council has forecasted a 14 percent increase in use of cereals for the production of ethanol during 2009-10. This

² Source: Eurostat News Release 12th November, 2009.

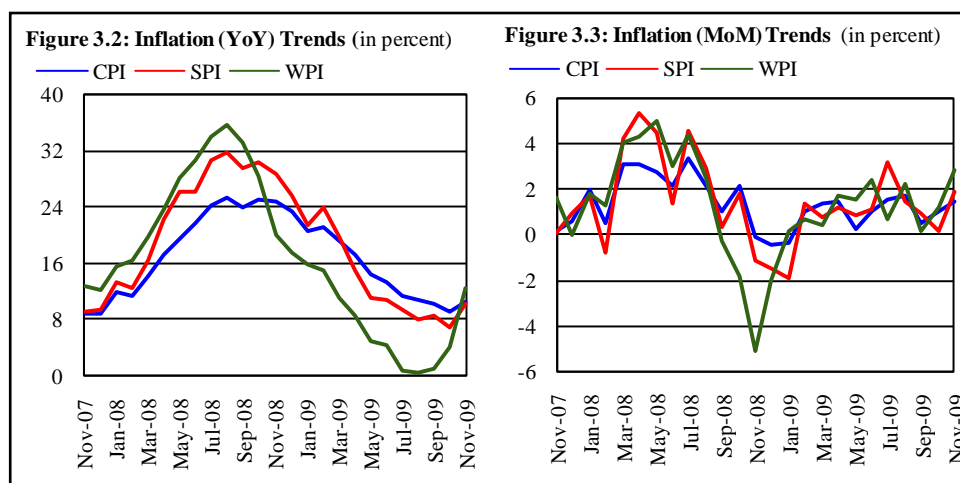
increase in demand is likely to put upward pressure on edible oil prices.³

On the other side, due to bad weather conditions in India and Philippines, rice crop for this season is lower than earlier estimates. Consequently, India is likely to become a net importer of rice this year putting upward pressure on prices of the grain.

It is also important to note that strong demand from China has forced freight costs for dry bulk commodities such as iron ore, coal and grains to reach peak levels during November 2009. Rising freight costs are likely to push commodity prices higher.

3.2 Domestic Scenario

Domestic inflationary pressures eased significantly during the first five months of FY10 relative to the corresponding period of FY09. Inflation measured by consumer price index (CPI) and sensitive price indicator (SPI) continued to decline, with CPI inflation YoY finally dropping to single digit (8.9 percent) during October 2009, for the first time in the preceding 21 months. However, CPI inflation YoY bounced back to 10.5 percent YoY during November 2009. It is important to note that variability in monthly inflation rates and trends in WPI inflation (YoY) raised concerns over the sustainability of the downtrend in headline inflation, particularly in the second half of FY10. WPI inflation has again started to increase since September 2009 and rose to 12.5 percent in



³ Crop Prospects and Food Situation, United Nations' Food and Agriculture Organization (November 2009).

November 2009 after troughing at 0.3 percent YoY in August 2009. More importantly, WPI inflation is expected to remain strong in coming months. Similarly, all price indices exhibit positive growth on month-on-month (MoM) basis since February 2009, which shows considerable risks to the present disinflationary process (see **Figure 3.2 & 3.3**).

Table 3.3: Different Dimensions of Inflation (percent)						
	Nov-08		Jul-09		Nov-09	
	MoM	YoY	MoM	YoY	MoM	YoY
Overall CPI	-0.1	24.7	1.5	11.2	1.4	10.5
Food group	-1.5	30.4	3.0	10.7	1.8	11.1
Non-food group	1.1	20.2	0.3	11.6	1.0	10.0
HRI	1.6	16.8	1.2	18.3	0.8	15.1
WPI	-5.1	19.9	0.7	0.5	2.8	12.5
Food group	-1.6	29.2	2.0	8.7	1.9	9.6
Non-food group	-7.9	12.8	-0.4	-5.4	3.5	14.9
SPI	-1.1	28.8	3.2	9.4	1.9	10.0
Core inflation						
NFNE	1.2	18.9	0.7	14	0.8	10.6
NFNE excluding HRI	0.9	20.8	0.1	10.1	0.8	6.4
Trimmed	0.7	21.3	0.8	13.9	0.7	10.5
Trimmed excluding HRI	0.3	24	0.7	12.1	0.9	9.0

The risk of resurgence in inflationary pressures is also evident from strong core inflation. Both indicators, non-food non-energy (NFNE) and 20 percent trimmed mean, although declining since H2-FY09, remain high. One of the main factors for the persistence in both measures of core inflation is the double digit increase in house rent index (HRI); even after the gradual moderation seen since June 2009. HRI has around 46 percent weight in NFNE and 29 percent weight in trimmed mean, hence the pace of decline in core inflation is slow relative to headline inflation. The high contribution of HRI to core inflation measures can also be observed from the fact that exclusion of HRI from the relative baskets of both measures of core inflation provide single digit inflation levels compared to their current double digit levels (see **Table 3.3**).

The recent disinflationary process is a function of: a) improvement in supply of most of the key staples (except sugar), b) constraint on government's monetization of the fiscal deficit, c) lagged impact of tight monetary stance, and d) a decline in imported inflation. The ease in inflationary pressures is encouragingly accompanied with a modest recovery in manufacturing sector as well as significant improvement in external account balances; build-up of reserves and

stability in rupee parity. All these factors allowed SBP to cut the policy rate by 50 bps to 12.5 percent effective from November 25, 2009.

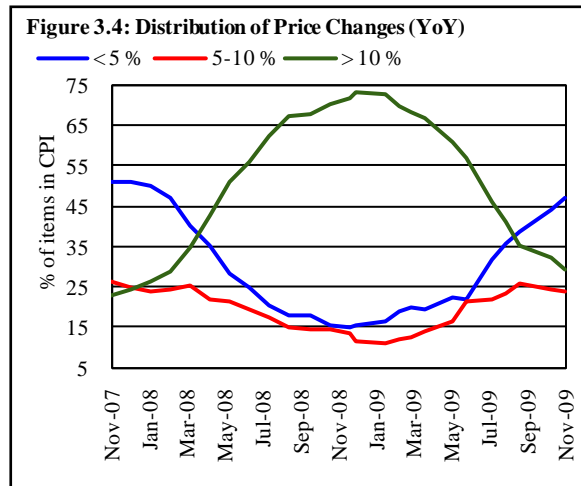
However, in the constrained monetization of the fiscal deficit and below expectation growth in external inflows, financing of fiscal deficit is becoming increasingly challenging. The government's reliance on borrowings from the domestic banking system coupled with quasi-fiscal activities such as the issuance of TFCs to resolve the energy sector circular debt raises the risk of crowding out private sector demand. Moreover, rising trend in international commodity prices, particularly crude oil, metals and some food items (rice, sugar) would likely to fuel inflationary pressures in the economy. Thus, the central bank will need to monitor overall macroeconomic and exogenous developments vigilantly.

The risk of higher inflation in food commodities also stems from the weak monsoon in neighboring countries that would likely have negative spillovers on domestic prices. The recent increase in potato prices may be a harbinger of increases in other such commodities.

Given the declining trend in headline CPI inflation during recent months and risks of a reversal in this trend, SBP forecasts suggest that average inflation during FY10 would be in the range of 10.0 - 12.0 percent against the target of 9.0 percent.

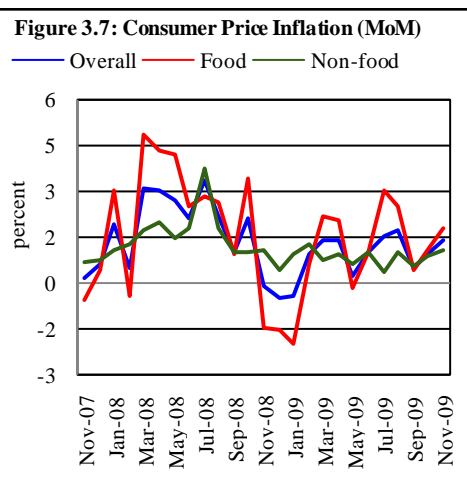
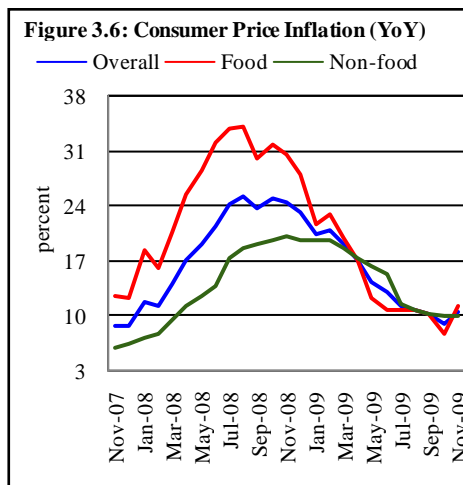
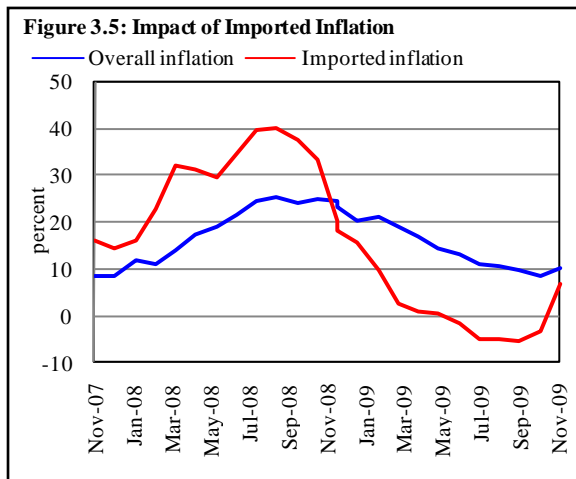
3.3 Consumer Price Index (CPI)

Despite showing a slight uptick during November 2009, CPI inflation YoY has generally maintained a downtrend since H2-FY09. A relative ease in inflationary pressures is also evident from the declining number of items recording double digit price increases in CPI basket from Q3-FY09 onwards (see **Figure 3.4**). It is important to note that relatively lower contribution by imported inflation helped achieve the current disinflation despite an uptrend in international commodity prices. The major source of relative ease in imported inflation is a relative stability in rupee parity (see **Figure 3.5**). This suggests that stability in exchange



rate may now be an important source of inflationary expectations in Pakistan.

Although both food and non-food groups of CPI contributed to the downtrend in inflation, the impact of food group was more pronounced. Consequently the weighted contribution of food group to overall CPI inflation after remaining above 50 percent during H1-FY09, has been contributing less than 50 percent since January 2009 (see **Figure 3.6 & 3.7**).



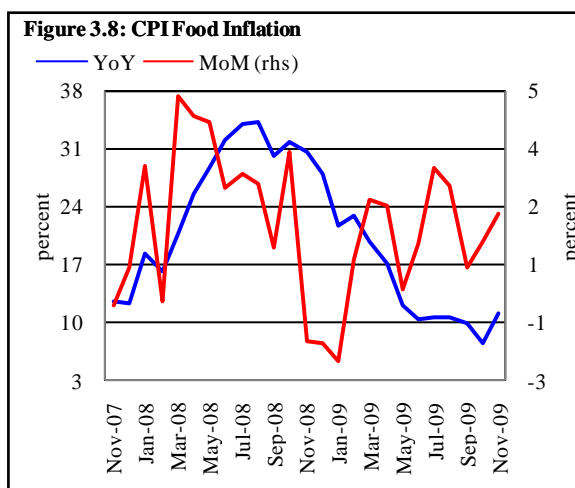
An analysis of the weighted contribution of individual items to overall CPI inflation (YoY) shows that despite a slowdown in HRI inflation, the contribution of HRI to overall inflation has increased persistently, compared to the last year, from 15.7 percent during November 2008 to 31.0 percent in November 2009 (see **Table 3.4**). Similarly, electricity and sugar have also shown an increase in their contribution to overall CPI inflation. An expected increase in electricity charges during H2-FY10 is likely to further increase its contribution to non-food and headline inflation.

Table 3.4: Weighted Contribution to CPI Inflation (YoY)

percent								
		Weights	Nov-08	Dec-08	Jun-09	Jul-09	Oct-09	Nov-09
1	House rent index	23.43	15.7	17.5	30.8	35.0	38.3	31.0
2	Milk fresh	6.66	7.1	7.4	8.8	10.4	11.6	9.6
3	Wheat flour	5.11	14.9	12.1	7.1	7.9	4.4	4.4
4	Electricity	4.37	4.6	4.8	6.1	7.0	9.3	0.9
5	Meat	2.70	2.4	2.5	4.3	4.9	7.0	6.0
6	Vegetable ghee	2.67	1.9	0.7	-4.9	-6.1	-4.9	0.3
7	Sugar	1.95	1.3	1.7	4.7	4.9	3.0	6.4
8	Vegetables	1.92	3.0	2.2	4.7	4.3	5.4	5.0
9	Petrol	1.73	0.6	0.7	-3.2	-7.2	-4.9	2.4
10	Rice	1.34	3.9	3.4	-4.8	-5.3	-3.4	-2.8

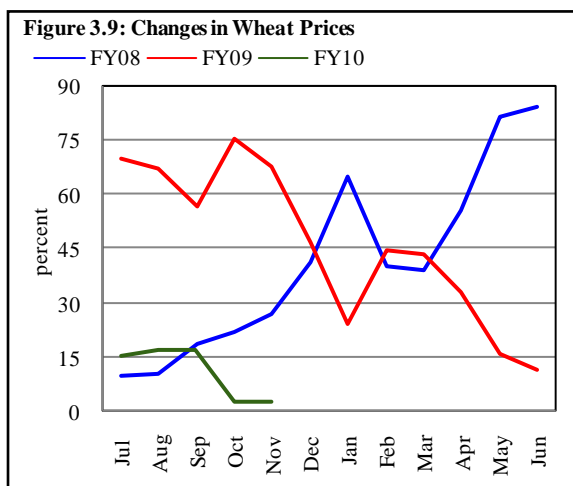
3.3.1 CPI Food Inflation

CPI food inflation (YoY) continued its declining trend since H2-FY09 and recorded single digit inflation for the first time in 25 months during October 2009. While, an uptick in CPI food inflation was witnessed during November 2009 as it increased to 11.1 percent, this level is still considerably lower than 30.4 percent recorded in the same month last year (see **Figure 3.8**).



A substantial decline in food inflation is mainly attributed to slowdown in the pace of rise in domestic wheat prices. It is important to note that wheat prices generally rise in October (before sowing season) because of limited supply. However this year, the increase was negligible due to ample stocks in the country (see **Figure 3.9**). In light of the government's decision to maintain support price at Rs 950 per 40 kg for FY10 wheat crop, it is likely that given favorable weather, wheat harvest could set a new record, as lower fertilizer prices would provide support to increase yields. This bodes well for the price stability of wheat, which is not only the key staple but also a wage commodity in rural area, and thus has significant impact on inflation. In contrast, despite significant fall, domestic sugar prices witnessed a

substantial increase of 50.1 percent during November 2009. However, variance in retail sugar prices increased across the markets and cities due to acute supply shortages and active administrative role. Given a drop in sugarcane output in FY10, there is a need to import at least 1 million tons of sugar to meet the domestic demand. This is an appropriate time to allow free trade of sugar by the private sector. The role of TCP may be redefined to procure adequate sugar to ensure supply to Utility Stores Corporation to support the government's targeted subsidy program.



Rice prices are declining in the domestic markets since April 2009. However, this trend is likely to be reversed in the second half of FY10 due to a rise in international rice prices amid lower rice output in India and damage to the rice crop in the Philippines. Farmers and traders may therefore see better prices in international rice market towards the middle of Q3-FY10.

Among other commodities, milk and meat continue to remain among the stronger contributors to overall inflation during the current fiscal year. Given that milk has the highest weight within food group, persistent rise in milk prices is a source of concern. Pakistan is one of the major milk producing countries, but a large quantum of milk could not be marketed. There is a need to expand the outreach of milk collection centers in rural areas with investment in storage at these centers. This would help improve supply and reduce wastages, and likely to help stabilize milk prices.

3.3.2 CPI Non-food Inflation

The downward trend in CPI non-food inflation (YoY), that started from December 2008 has continued into CY2009, though the pace of decline is not as pronounced as in food group. CPI non-food inflation was recorded at 10.0 percent during November 2009 as compared to 20.2 percent in November 2008 (see **Figure 3.10**).

Group-wise analysis of non-food group reveals that all sub-indices have generally depicted a downtrend in the last 12 months, though the pace of decline has varied across the sub-groups (see **Table 3.5**). In particular inflation in *transport & communication* has declined sharply to 4.7 percent in November 2009 from 28.6 percent in November 2008 mainly due to relatively lower domestic fuel prices compared to a year ago. However, deflation in this sub-group is likely to reduce

Table 3.5: CPI Non-food Inflation by Groups

	Weights	MoM change			YoY change		
		Nov-08	Oct-09	Nov-09	Nov-08	Oct-09	Nov-09
Non-food group	59.7	1.1	0.8	1.0	20.2	10	10
Apparel, textile, etc.	6.1	0.7	0.2	0.4	15.9	5.1	4.7
House rent	23.4	1.6	0.9	0.8	16.8	16	15.1
Fuel & lighting	7.3	9.5	1.4	0.9	31.9	14.1	5.1
Household furniture & equipment	3.3	1.3	0.4	0.8	15	6.2	5.7
Transport & communication	7.3	-7.6	0.1	2.7	28.6	-5.9	4.7
Recreation & entertainment	0.8	0.3	0.0	0.8	12.5	2.1	2.6
Education	3.5	0.7	0.5	0.5	16.3	13.7	13.4
Cleaning, laundry, etc.	5.9	1.2	1.5	1.6	20.4	10.7	11.1
Medicare	2.1	0.1	2.0	0.0	12.5	5.4	5.3

significantly November 2009 onwards due to increasing prices of key fuels. Similarly *fuel & lighting* sub-group is likely to experience an increase in inflationary trends in coming months on the back of expected increase in electricity charges in H2-FY10.

House rent index, having the largest weight in CPI basket, although on a declining trend, has remained in double digits. It is significant to

note that a disproportionately higher contribution by HRI is a major factor for a slow pace of disinflation in recent months. Given an ease in cement prices and a relative stability in other construction material costs, HRI is likely to decline for another year, barring an extraordinary surge in international prices.

Figure 3.10: CPI Non-food Inflation

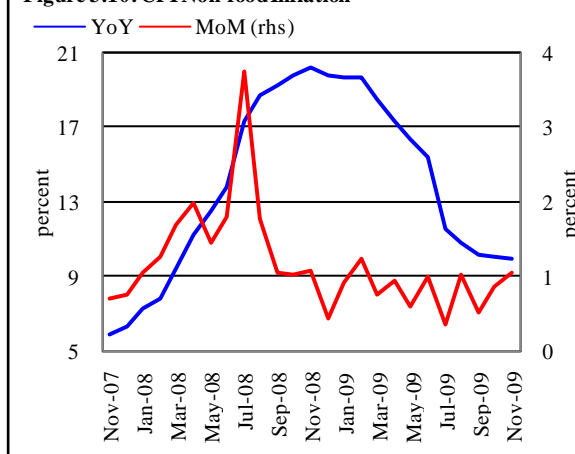


Table 3.6: Income Group-wise CPI Inflation
percent

	Upto 3000		Rs 3001-5000		Rs 5000-12000		Above Rs 12000	
	Nov-08	Nov-09	Nov-08	Nov-09	Nov-08	Nov-09	Nov-08	Nov-09
Year on Year (November over November)								
General	27.3	10.5	27.4	10.3	26.1	10.3	22.5	10.8
CPI food	33	11.2	32.4	11	31.2	11	28.5	11.3
CPI non-food	22.9	10	23.7	9.7	22.2	9.7	17.7	10.3
Month on Month (November over October)								
General	-0.4	1.5	0.1	1.5	0.1	1.4	-0.5	1.4
CPI food	-1.5	2	-1.7	1.9	-1.5	1.8	-1.4	1.7
CPI non-food	0.6	1.2	1.6	1.1	1.6	0.9	0.3	1.2

3.3.3 Incidence of inflation

Income group-wise inflation during Q1-FY10 shows that the highest incidence of inflation on YoY basis was recorded for the highest income groups (with earnings above Rs 12,000 - see **Table 3.6**). The relatively lower inflation (YoY) in the lowest income group was primarily due to significant decline in food inflation.

Table 3.7: City-wise Inflation of Selected Cities (in percent)

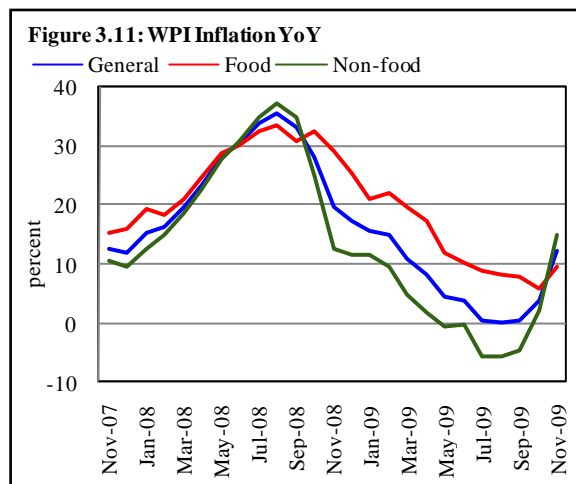
	Nov-08		Oct-09		Nov-09	
	MoM	YoY	MoM	YoY	MoM	YoY
Overall CPI	-0.1	24.7	1.0	8.9	1.4	10.5
Islamabad	-0.6	21.0	0.4	8.1	0.6	9.5
Lahore	-0.1	22.5	0.4	8.4	1.0	9.7
Karachi	-0.5	24.2	0.7	7.5	1.5	9.7
Quetta	-0.6	26.9	0.9	6.5	1.5	8.7
Peshawar	-1.1	27.8	0.7	5.2	1.8	8.3

City-wise inflation data of the federal and provincial capitals shows that inflation on both YoY as well as MoM basis generally remained lower in these cities compared to overall CPI inflation (see **Table 3.7**).

3.4 Wholesale Price Index

After showing a declining trend since September 2008, WPI inflation showed an uptrend from September 2009 and rose to 12.5 percent YoY during November 2009. However, current inflation level is still less than 19.9 percent witnessed in November 2008.

This trend reversal in WPI YoY inflation is mainly due to WPI non-food group, which after registering negative growth since May 2009 is showing positive growth since October 2009. Similarly, WPI food inflation, after maintaining a continuous downtrend during the first four months of FY10, also registered an increase in inflation during November 2009 (see **Figure 3.11**).



Within non-food group, all sub-groups excluding *building materials* have started to rise since September 2009. In particular, *fuel, lighting & lubricants* sub-group, after registering negative growth during early part of FY10, has also shown positive growth since October 2009. Inflation in this sub-group was 26.9 percent during November 2009 compared to 9.0 percent during November 2008 (see **Table 3.8**). This uptrend in *fuel, lighting & lubricants* sub-group inflation reflects the impact of rising electricity charges and furnace oil prices. The rise in domestic furnace oil prices was mainly due to increasing international crude oil prices. If global crude oil prices remain strong, and the expected increases in domestic electricity charges implemented, inflation under this sub-group will rise further.

Table 3.8: Percentage Change in WPI (YoY)

	Nov-08	Jan-09	Jun-09	Jul-09	Sep-09	Oct-09	Nov-09
General	19.9	15.7	4.1	0.5	0.7	3.8	12.5
Food	29.2	21.0	10.2	8.7	7.8	5.8	9.6
Non-food group	12.8	11.6	-0.3	-5.4	-4.6	2.2	14.9
Raw materials	11.7	16.4	11.9	8.3	4.7	12.1	20.2
Fuel, lighting & lubricants	9.0	11.7	-4.0	-11.8	-7.9	4.7	26.9
Manufactures	12.2	7.5	3.2	1.2	-0.5	0.2	7.4
Building materials	38.3	20.3	-10.1	-11.5	-13.9	-16.1	-16.7

Similarly inflation in the *raw materials* sub-group has remained in double digits since October 2009. This uptrend was contributed by items like sugarcane and cotton. The prices of both of these items increased due to strong domestic demand and rise in their international prices in recent months.

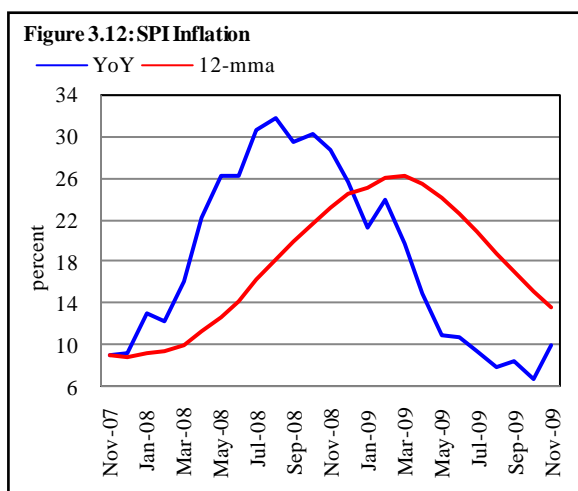
Manufactures sub-group also registered a trend reversal in inflation (YoY) since October 2009. It is important to note that if *manufactures* sub-group's inflation will increase further in months ahead, it would push up WPI non-food inflation as it has the highest weight (45 percent) within non-food group of WPI.

The only sub-group of WPI that has not yet registered positive YoY growth during FY10 is the *building materials* sub-group. The downtrend in this sub-group is entirely due to declining prices of two items, i.e., iron bars & sheets and cement, as prices of all other commodities in this, sub-group, have been recording increases. The downtrend in domestic cement prices is mainly due to: a) Competition Commission of Pakistan (CCP) measures against the alleged formation of a cartel by the cement industries, and b) increase in domestic supply following declining cement export volumes since June 2009 amid stiff competition as well as gloomy construction activities in Middle East. It is important to note that although the iron bars & sheets are still showing around 20 percent deflation, there are risks of future inflation. The pick up in global demand for iron ore will eventually be reflected in the domestic prices of the commodity.

Going forward, if global commodity prices continue to show strength, they are likely to be reflected in higher WPI inflation levels in months ahead as prices of important commodities in the WPI basket such as furnace oil, motor spirit, mobil oil, etc., are directly linked to prices in international markets.

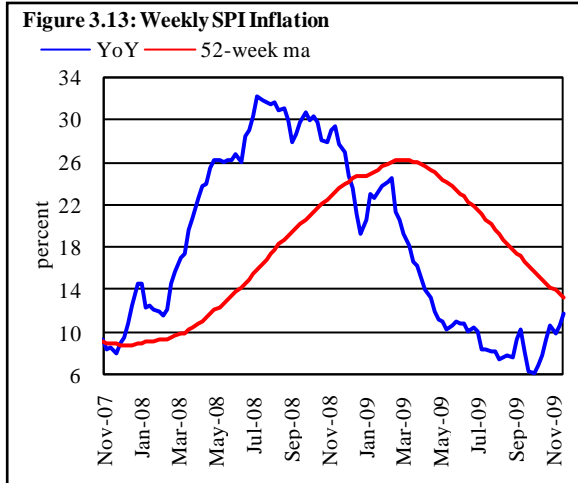
3.5 Sensitive Price Indicator (SPI)

Inflation (YoY) measured by sensitive price indicator (SPI) generally maintained a declining trend during the first four months of FY10 and reached 6.7 percent during October 2009, compared to 30.3 percent in the same month last year. Although SPI inflation showed an increase during November 2009 to reach 10.0 percent, this level is still lower compared to 28.8 percent in November 2008. The long-run trend, measured by 12-month moving average, after peaking out in March 2009 (26.3 percent),



has remained on a declining path to reach 13.6 percent during November 2009 (see **Figure 3.12**). This downtrend is mainly due to relative ease in food inflation, as food commodities comprise more than 60 percent of items in the SPI basket.

In line with the trend in monthly SPI inflation, weekly SPI inflation (YoY) has also maintained a downtrend during Q1-FY10 (see **Figure 3.13**). However, it is pertinent to note that since the third week of October 2009, weekly SPI inflation has again started to rise due to rising prices of dairy products, pulses and poultry items. If this uptrend in weekly SPI inflation continues, then it is likely to be reflected in CPI food inflation in the months ahead.



4 Money and Banking

4.1 Monetary Policy

Substantial improvements in many key macroeconomic indicators, including a very sharp drop in headline inflation (see **Table 4.1**), allowed SBP to continue gradually easing its monetary policy during FY10. A policy rate cut of 100 basis points in August 2009 was followed by another 50 basis point reduction in November 2009, representing a cumulative fall of 250 basis points in the policy discount rate since the current monetary easing cycle was initiated in April 2009.¹

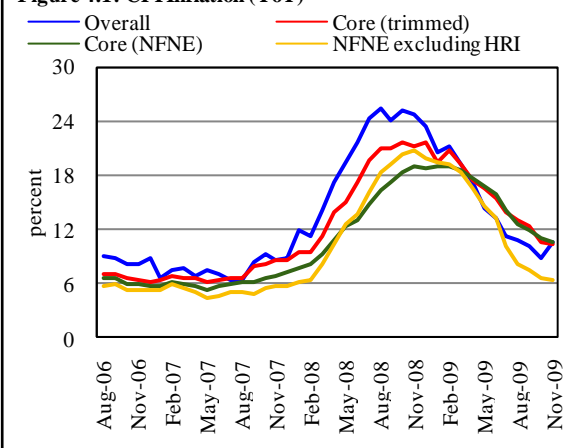
The scale and speed of the decline in headline inflation, from 24.7 percent in November 2008 to 10.5 percent in November 2009,² suggests that the tight monetary policy and constrained monetization of the fiscal deficit have significantly eased excess demand pressures that had bedeviled the economy in the past three years. The disinflationary impact of this was probably also aided by

Table 4.1: Key Macroeconomic Indicators

YoY growth (percent)	Jul-Nov	
	FY09	FY10
Current a/c deficit	56.1	81.4
Imports	25.6	-21.2
LSM ²	-5.0	0.7
Private sector credit ¹	4.4	0.9
Money supply (M2) ¹	0.6	4.2
CPI inflation (YoY)	24.7	10.5
Tax receipts ³	27.7	0.6

¹ Jul-5th Dec; ² Jul-Oct; ³ Jul-Sep

Figure 4.1: CPI Inflation (YoY)



¹ SBP had decreased its policy rate by 100 bps in April 2009.

² At the same time, demand pull inflationary pressures as captured in core inflation both non-food non-energy (NFNE) and 20 percent trimmed mean, though decelerating, remained in double digits and higher than that of overall inflation (see **Figure 4.1**). This was essentially due to House Rent Index (HRI), which being computed as a 24 month geometric mean, changes very gradually.

the lower impact of imported inflation (due to a relatively stable rupee in FY10 and relatively low international commodity prices) and improved domestic production of key staples.

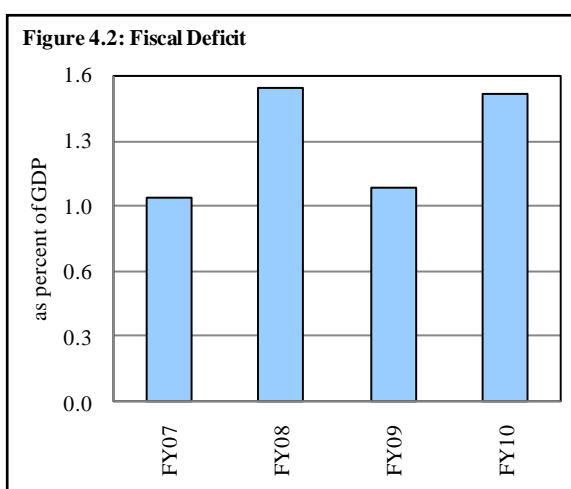
The moderation in demand pressures is evident from the persistent YoY fall in imports (particularly the negative growth in import volumes during Jul-Nov FY10) that led to a sharp contraction in the current account deficit, and also in the lower growth of private sector credit in the same period. The weaker credit demand, tight liquidity conditions³ and risk averseness of banks further kept monetary expansion in check during the period under review (see **Table 4.2**).⁴

The 14.2 percentage point decline in inflation over the last 12 months and evidence of a contemporary weakness in the domestic economy, as suggested by indicators such as low growth in monetary aggregates, stagnancy in tax receipts, weakness of large scale manufacturing, declining exports, etc., have all led to calls for a much more accommodative monetary posture.

However, from the SBP perspective, room for aggressive monetary easing is constrained by number of factors:

Fiscal and quasi-fiscal activities are adding to upward pressures on rates

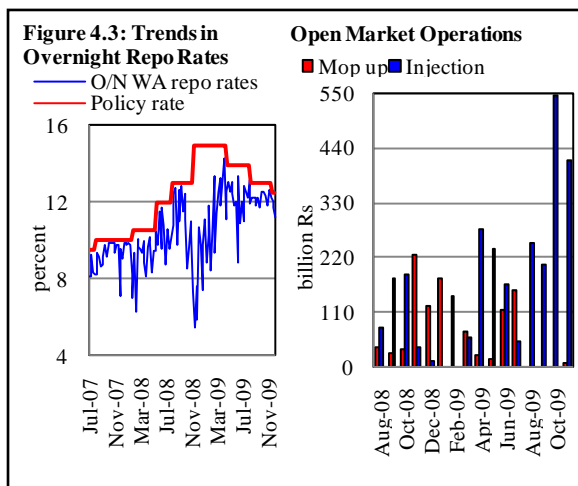
The fiscal deficit rose to 1.5 percent of GDP during Q1-FY10 compared with 1.1 percent of GDP in Q1-FY09, representing a 62.4 percent increase in rupee terms (see **Figure 4.2**). While this did not lead to a sharp rise in budgetary borrowings from SBP, in line with the quarterly target agreed with the IMF, the higher deficit did have some negative connotations:



³ As banks' funds are locked due to credit extended for both circular debt and commodity procurement.

⁴ For detail, see section on **Private Sector Credit**.

1. A part of the deficit was financed through an IMF bridge finance loan, the inflationary impact of which is similar to that of deficit monetization.
2. The large jump in the rupee value of the deficit, and lower recourse to SBP finance meant that government borrowings from commercial banks increased substantially. Net budgetary borrowing from scheduled banks, was Rs 166.0 billion during Jul-5th Dec FY10 compared with a net retirement of Rs 67.0 billion in the corresponding period last year. This was despite better availability (i.e., Rs 107.6 billion in Jul-Sep FY10) from non-bank sources.
3. The high government sector demand, and low deposit growth is now constraining banks' ability and willingness to take additional exposure in the private sector, and risking the crowding out of private investment.



The problems emanating from expansionary fiscal policy are compounded by a significant increase in quasi-fiscal activities such as financing of the energy sector circular debt and borrowings by various procurement agencies and provincial food departments for commodity operations.⁵ For instance, delays in realization of subsidies from federal government made it difficult for procurement agencies and food departments to retire bank loans in time.⁶ This has not only caused pressure on banks' liquidity but also lowered banks' willingness to lend for procurement of fresh crops.

In response to these liquidity shortages, SBP provided extensive liquidity support through OMOs during Jul-Nov FY10 (see **Figure 4.3**). The timely support of SBP to improve market liquidity and continued expectation of lowering inflation kept the overnight repo rate within the interest rate corridor.

⁵ Procurement agencies and provincial food departments obtained bank finance to procure different commodities such as wheat, rice, fertilizer, etc., to stabilize the market price and to build-up strategic reserves to ensure smooth domestic supply.

⁶ This impact was further compounded by buildup of receivables from different government organizations.

Possible slippages in fiscal account can add demand pressures

Moreover, there are concerns that fiscal account will show some weakness in FY10. For example, the on-going anti-terrorist operations could significantly add to budgetary expenditures through the year. Similarly, there are risks of shortfalls in revenues (due to the weaker economy). The increase in the fiscal deficit would potentially be exacerbated by lower than planned external financing flows. This would add to pressures on the domestic banks, and raise inflationary pressures.

Imported inflation could re-emerge

Another allied risk for aggressive monetary easing is the possible increase in external current account deficit. It may be kept in mind that imports have already started to indicate some upward pressures since October 2009 partly reflecting recent resurgence in international commodity prices. Even small domestic recovery may further add pressures on the import bill in coming months. Given the concerns on resumption of external inflows, financing of current account deficit would remain challenging. The concerns on uncertain external flows can be viewed from the

fact that even in Q1-FY10, official inflows other than IMF short-term bridge financing was much lower than anticipated. Moreover, the pass-through of high global prices is also expected to translate into greater exchange rate volatility which will likely add further pressure on the external account.

Table 4.2: Monetary Aggregates (Jul-5th Dec)

flows in billion rupees, growth in percent

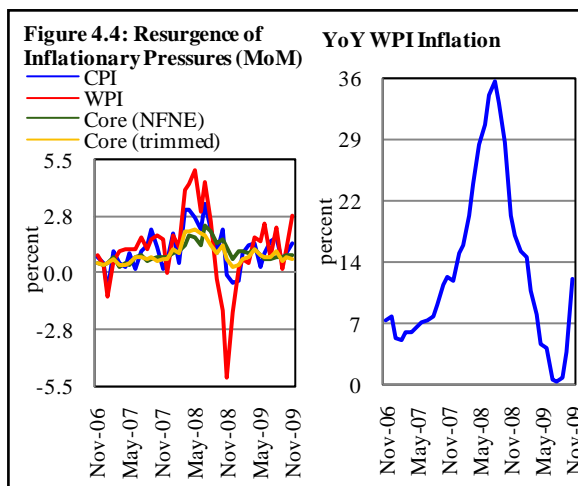
	Flows		Growth rates	
	FY09	FY10	FY09	FY10
Broad money (M2)	29.7	215.8	0.6	4.2
NFA	-357.9	58.0	-53.6	11.2
SBP	-357.8	65.9	-74.5	20.3
Scheduled banks	-0.1	-7.9	-0.04	-4.1
NDA	387.6	157.8	9.6	3.4
SBP	315.7	114.3	40.8	13.0
Scheduled banks	71.9	43.5	2.2	1.2
of which				
Government borrowing	350.4	250.4	23.1	12.3
For budgetary support	338.2	254.9	24.8	15.2
SBP	405.2	88.9	39.2	7.6
Scheduled banks	-67.0	166.0	-20.2	32.2
Commodity operations	13.7	-2.8	10.1	-0.8
Non-government sector	182.8	101.4	6.1	3.2
Credit to private sector	127.3	27.1	4.4	0.9
Credit to PSEs	55.6	75.1	48.9	28.2
Other items net	-145.7	-194.1	28.7	32.1

Inflationary pressures may already be building up

The persistent rise in month-over-month (MoM) inflation in all price indices since February 2009 suggests that inflationary pressures are rebounding (see **Figure 4.4**). In specific terms, on MoM basis all inflation indices witnessed positive growth in the last consecutive ten months. Making things worse, recent uptrend in

imported inflation – international crude oil prices in particular– have started to show up in WPI index.⁷ Specifically, WPI inflation after witnessing downtrend since September 2008 has again gained some momentum from September 2009; even recording YoY sharp rise of 12.5 percent in the month of November 2009 compared with an average rise of 1.3 percent in the first four months of FY10.

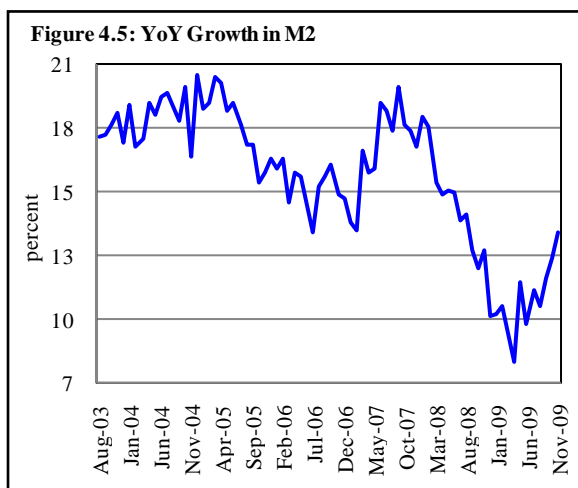
Though the contribution of global commodity prices in WPI is still low, however, it may gain more strength in months ahead, if international prices continue to show resilience.⁸ Moreover, planned adjustments in electricity tariff rate are likely to add upward pressures on WPI and thus overall inflation.



4.2 Developments in Monetary Aggregates

The YoY growth in broad money (M2) after witnessing the lowest level of 8.0 percent in April 2009 during the last eight years, reached 13.4 percent by December 5, 2009 (see **Figure 4.5**).

This rise resulted entirely from YoY increase in net foreign assets (NFA) of the banking system as growth in net domestic assets (NDA) of the banking system slowed markedly to 8.4 percent YoY basis by December 5, 2009.



⁷ Apart from commodity prices, the uptrend in WPI was also contributed by sugarcane and cotton prices in domestic market. For details, see **Chapter 3 on Prices**.

⁸ It may be noted here that a few commodities in WPI such as crude oil, motor spirit, etc., are directly influenced by movement in international prices.

It is worth mentioning here that in August 2009, IMF has increased the SDR quota allocation for all of its member countries.⁹ Though the amount disbursed under SDRs does not have any impact on M2, and reserve money; it has changed the composition of M2 growth. More specifically, NFA of the SBP increased by Rs 99 billion whereas the other items net (OIN) of the SBP fell by the same amount thus resulting in weakening of NDA of the SBP (see **Table 4.3**).

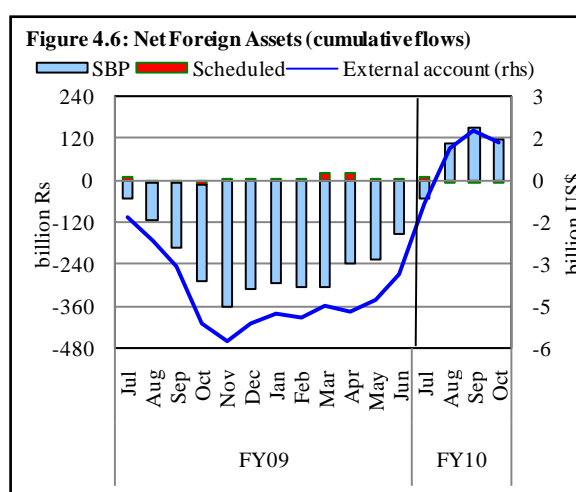
Table 4.3: Impact of SDRs Allocation

billion Rupees	Jul-5 th Dec	
	FY09	FY10
NFA	-357.9	58.0
Adjusted for SDRs	-357.9	-41.0
SBP NFA	-357.8	65.9
Adjusted for SDRs	-357.8	-33.1
NDA	387.6	157.8
Adjusted for SDRs	387.6	256.8
SBP NDA	315.7	114.3
Adjusted for SDRs	315.7	213.3

Net Foreign Assets (NFA)¹⁰

The NFA of the banking system registered a lower contraction of Rs 41.0 billion during Jul-5th Dec FY10 compared with an extraordinary decline of Rs 357.9 billion in the corresponding period last year (see **Table 4.3**).

The sharp unexpected rise in portfolio investments, persistent increase in workers' remittances and substantial inflows from multilateral agencies were major factors responsible for a low contraction in NFA. Persistent contraction in trade deficit also lowered the payment pressures on NFA of the banking system during the period of analysis (see **Figure 4.6**).

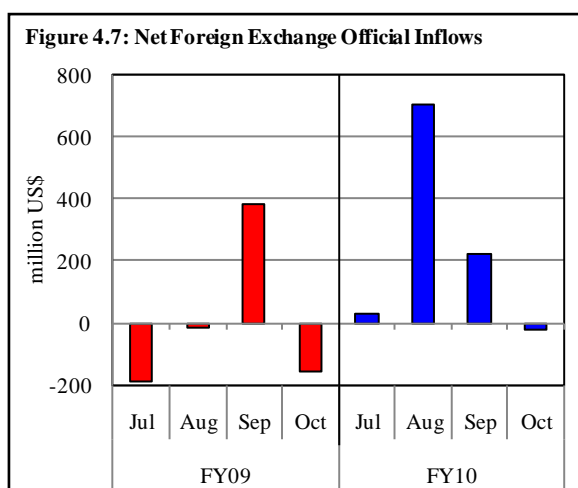


Similar to FY09, the contraction in NFA of the banking system during Jul-5th Dec FY10 was mainly contributed by SBP's NFA; though the pace of contraction in

⁹ On August 29, 2009 IMF increased SDR quota allocation for its member countries in primary response to global financial crises. The main purpose of this increased allocation is to provide significant unconditional financial resources to liquidity constrained countries.

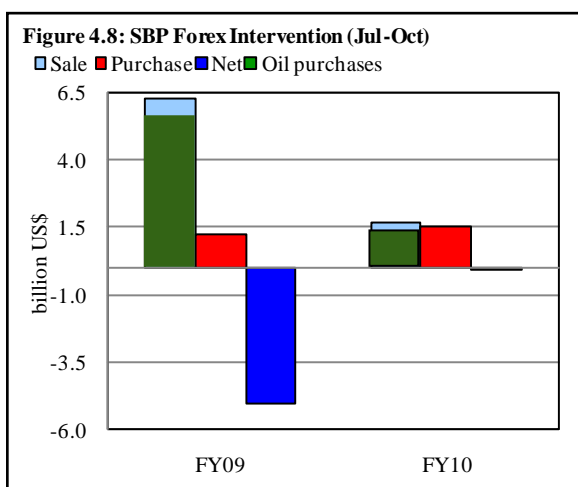
¹⁰ The discussion here onwards is based on NFA and NDA adjusted for SDRs.

NFA of SBP declined sharply in the period of analysis. More specifically, the availability of external resources for budgetary finance; particularly short-term bridge finance from IMF lower the pace of contraction in NFA of the SBP (see **Figure 4.7**). Had this inflow not materialized, SBP NFA would have witnessed an even higher decline.¹¹



The pressure on SBP NFA was further eased by gradual shifting of oil imports financing towards interbank market.¹² Resultantly, SBP's net intervention in the inter-bank foreign exchange market remained significantly lower in Jul-Oct FY10 compared with the same period last year (see **Figure 4.8**).

Net contraction in commercial banks' NFA was limited to Rs 7.9 billion during Jul-5th Dec FY10 as against Rs 0.1 billion in the corresponding period FY09 (see **Table 4.2**). The higher contraction is partly explained by oil import payments. However, uptrend in deposit base, in the wake of net private inflows, of the scheduled banks partly offset the oil payment pressures



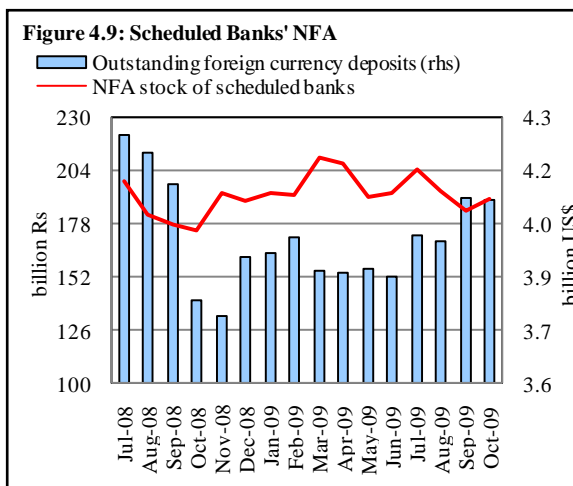
¹¹ Excluding IMF loan, SBP NFA recorded a decline of Rs 42.1 billion during Jul-5th Dec FY10.

¹² SBP has gradually shifted the burden of foreign exchange purchases for import of POL products on scheduled banks. In the first step, from February 2009 SBP directed scheduled banks to finance the import of furnace oil, whereas import of diesel and other refined products were still financed by SBP. Further, from August 2009, purchase of diesel and other POL products were also shifted to scheduled banks, and thus SBP financed only crude oil purchases. Finally, by mid-December 2009, all purchases of oil products are shifted to the inter-bank market.

(see **Figure 4.9**).

Net Domestic Assets

The contraction in domestic demand kept the growth in NDA of the banking system to 5.6 percent during Jul-5th Dec FY10 compared with a strong growth of 9.6 percent in the same period of the previous year. More specifically, it was the weakened demand for private sector credit, low budgetary borrowing and sluggish credit off-take under commodity finance that had limited the net expansion in NDA during the period under analysis.



Government Borrowing for Budgetary Support

Government budgetary borrowing from the banking system during Jul-5th Dec FY10 remained lower compared to the corresponding period of FY09. This was despite a rise in total budgetary finance in Q1-FY10 as deficit increased to Rs 223.7 billion compared with Rs 137.7 billion in the same quarter last year. A disaggregated analysis suggests that a substantial increase in receipts of external budgetary flows as well as rise in non-bank finance especially from NSS made it possible to arrest the borrowings from the banking system (see **Table 4.4**).¹³

Table 4.4: Deficit Financing (Jul-Sep)

billion Rupees

	FY09	FY10
Deficit	137.7	223.7
External	6.2	77.1
Domestic	131.7	146.6
Non-bank	27.1	107.6
Bank	104.6	39.0

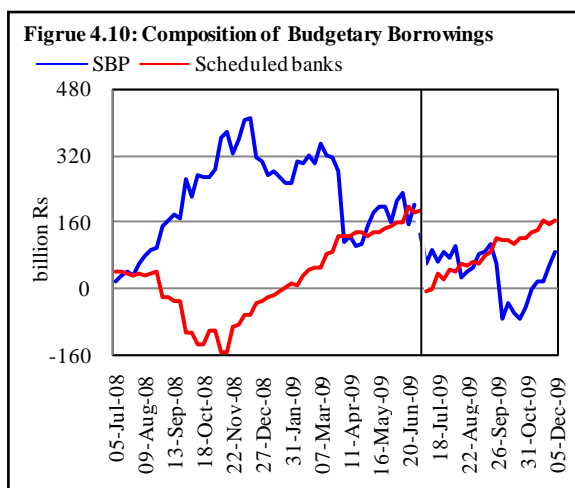
While the exceptional financing burden in Jul-6th Dec FY09 entirely fell on the central bank, the expansion in budgetary borrowing from the banking system during Jul-5th Dec FY10 mainly stemmed from commercial banks as borrowings from the central bank remained low (see **Figure 4.10**). It may be recalled that

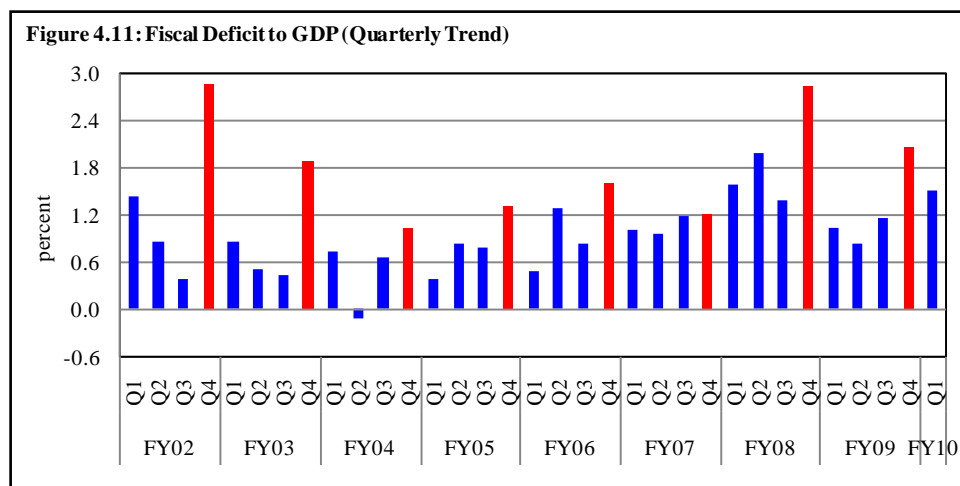
¹³ Within non-bank borrowing, government mobilized Rs 53.0 billion through NSS in Q1-FY10 compared to Rs 20.9 billion in the same period last year.

during the first four months of FY09, deficit monetization was substantially higher. Indeed, it was only after the implementation of macroeconomic stabilization program in November 2008 that contained the government borrowings from the central bank.

A detailed data suggests that by end-September 2009, government retired its debt with SBP by: a) using the proceeds from the transfer of SBP profits to government accounts, and b) borrowings from commercial banks by issuing Rs 40.5 billion worth of T-bills in the same month. Resultantly, stock of MRTBs with SBP declined to Rs 1010.8 billion by end-September 2009 compared to Rs 1256.9 billion at end-September 2008. On the other hand, borrowing from the commercial banks remained intact as: a) banks are still reluctant to lend aggressively to the private sector, and b) credit demand from private sector also remained sluggish.

Nonetheless, the monetary implication of current fiscal trend appears worrisome. The fiscal deficit for Q1-FY10 reached 1.5 percent of GDP, which is high relative to the full year target of 4.9 percent of GDP. To put this in perspective, the normal pattern in quarterly fiscal deficit shows that it would jump sharply in the final quarter of the year (see **Figure 4.11**). This suggests the risk of high recourses from the banking system in months ahead in case of delays in materialization of committed external flows, particularly given the uncertainty attached with funds mobilized through NSS.





Further, public sector enterprises (PSEs) borrowings from the commercial banks continued unabated in FY10, rising Rs 75.1 billion during Jul-5th Dec FY10, compared with Rs 55.6 billion in the corresponding period last year. Similar to last year, credit requirements from a few PSEs mainly came on account of delays in settlement of energy claims with the government. This impact was further compounded by credit demand from the newly established power holding company in September 2009. The power holding company issued a government backed privately placed term finance certificates (PPTFCs),¹⁴ which was meant to reduce significant part of banks' claim on a few PSEs and private entities.^{15,16} Though with the issuance of PPTFCs, a few PSEs had settled some of their loan obligations with the banks, however, it was observed that they had again acquired more advances from banks as they got cushion for fresh borrowing.

Commodity Finance¹⁷

A prominent feature in the FY10 commodity finance is the absence of customary seasonal retirements during the initial four months of the fiscal year. Indeed, the first few months of each fiscal year usually coincides with repayment of commodity loans particularly rice, fertilizer and sugar.¹⁸ However, retirements under these commodities were exceptionally low in FY10 (so far) given the

¹⁴ For detail see **Chapter 4 on Money and Banking**, SBP Annual Report FY09.

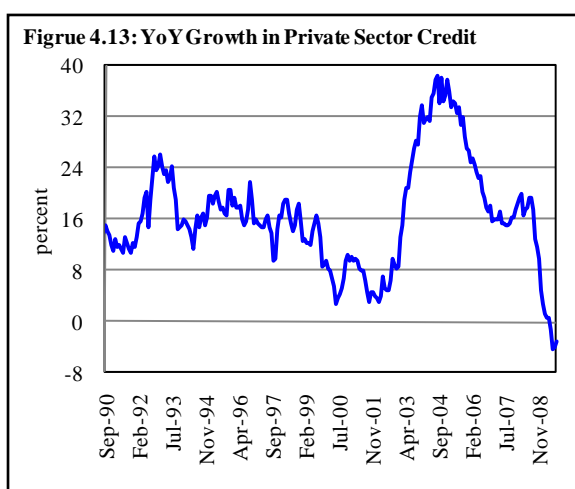
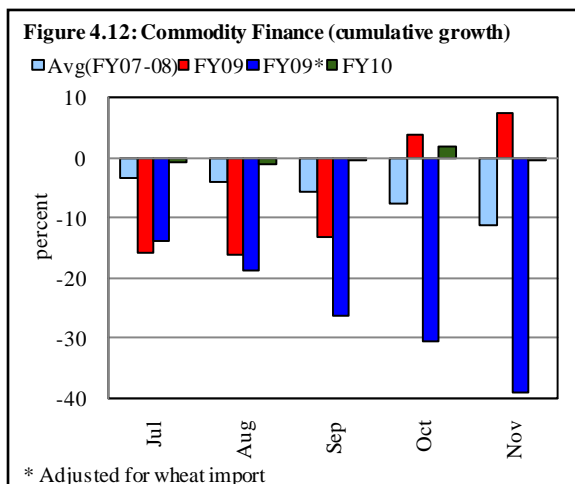
¹⁵ These claims rose as some of the PSEs used banks' credit to finance their cash flows due to buildup of inter-corporate debt.

¹⁶ This was a second major efforts made by the government to resolve circular debt issues. For detail see **Annual Report for FY09**.

¹⁷ Different procurement agencies and provincial food departments availed bank loans for procurement of different commodities such as wheat, rice, fertilizer, etc., to: a) stabilize the market price and b) to build up strategic reserves to ensure domestic supply on sustained basis.

substantial borrowings seen in the previous year (see **Figure 4.12**). This was probably due to delays in settlement of price differential claims with the government that have adversely affected the repayment capacity of few public entities (see **Box 4.1**).¹⁹

In addition, demand for wheat from government stocks remained weak due to substantially higher issue price relative to international prices.²⁰ Resultantly, commodity finance recorded a decline of Rs 2.8 billion in Jul-5th Dec FY10 compared with a rise of Rs 13.7 billion in the corresponding period last year. It may be pointed out that higher borrowings during Jul-6th Dec FY09 mainly reflects credit requirement by TCP for wheat import.²¹



Box 4.1: Accumulation of Bank Loans for Commodity Operations

In the last two years, increasing fiscal constraints led to delays in the disbursement of accrued payables by the government. In particular, the government has been consistently failing to release subsidy payments to domestic institutions on time, and the unpaid arrears have cascaded through the economy, as affected firms were then unable to make payments to supplier and/or repay loans taken

¹⁸ Rice procurement starts mostly from month of November, whereas procurement of wheat lasts for April to June of each year.

¹⁹ However, in the month of October 2009, a slight increase in demand was seen for procurement of new crops (i.e., rice and sugar) and also for fertilizer import.

²⁰ Anecdotal evidence indicates inward smuggling of wheat.

²¹ During Jul-6th Dec FY09, TCP obtained Rs 53.3 billion from scheduled banks for wheat import. Excluding this, the commodity finance seen a net retirement of Rs 39.6 billion in the same period.

from the financial system. The most visible example of this is the circular debt problems reported in the energy sector. A lesser known example is the recent emergence of another pool of claims unpaid by the government (and government entities), resulting from the government's commodity operations, which is potentially as large and intractable.

The commodity operations of government are typically due to its desire to either:

- (1) ensure "good" (above market) prices for farmers/producers,
- (2) provide subsidies to economic agents,
- (3) ensure the availability of buffer stock of some commodity to smooth out excessive volatility in its price.

These operations are generally conducted through the Federal and/or provincial government entities and are funded by loans from banks. These loans, that typically carry an implicit government guarantee, are largely expected to be self-liquidating. For example, loans taken to ensure the availability of government wheat stocks to forestall speculative price hikes by hoarders, would be expected to wind-down as the stocks are gradually issued (sold) to millers, and the proceeds used to repay loans. Thus, there is often a seasonal variation in the stock of commodity operation loans.

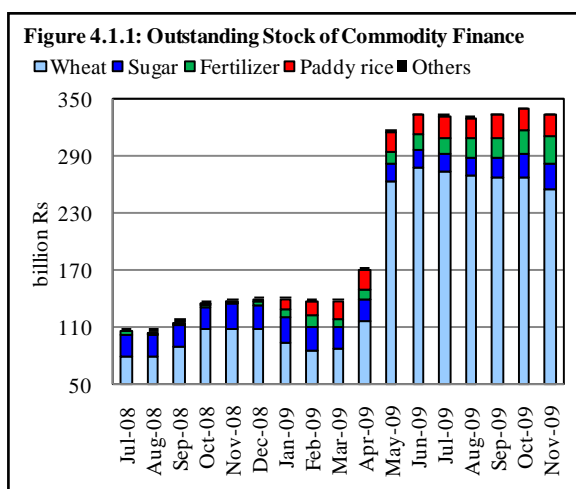
These commodity operations do entail some fiscal cost for the government, as stocks are often sold at rates below market rates; the difference between the cost of the commodity operations (procurement, storage losses, financial charges, etc.) and the sale proceeds being covered by budgetary allocations. However, if the government defers payments of the differential claims, these loans cannot be retired on time, leading to liquidity issues for lending institutions from the unanticipated (and involuntary) lengthening of loan maturities. In the long term, this can also add to fiscal costs for government due to greater loan period, increase in interest cost as financial institutions account for liquidity risk, adverse changes in prices of stocked commodities, etc.

Recent emergence of rising stock of commodity loans over last 12 months

The volume of subsidy claims had not been significant in recent years as traditional borrowing for commodity operation remained low.²² However, in FY09, a combination of heavy interventions in a number of commodities

(particularly wheat), increasing fiscal constraints, and adverse commodity prices movements led to a sharp rise in outstanding commodity financing. By end-November 2009, outstanding bank loan for commodity procurement reached Rs 334.9 billion as the federal and provincial governments were unable to release required funds to procurement agencies (i.e., TCP, PASSCO) and provincial food departments, respectively (see **Figure 4.1.1**).

The sharp accumulation in borrowing was largely visible



²² The stock of borrowing for commodity operation had remained around Rs 100.0 billion on end-June basis historically.

during the last quarter of FY09. These loans were mainly acquired for wheat procurement, with smaller amounts for rice and fertilizer. The interventions followed bumper domestic crops of rice and wheat. A commodity-wise breakup indicates that price differential claims were substantially high under wheat procurement compared with other commodities. More specifically, the government had announced the high wheat support price prior to sowing season in 2008 which not only resulted into record wheat crop, but also increased the bank credit requirements by the procurement agencies. While both tiers of the government contributed in wheat procurement, the major rise came from provincial food departments, particularly, the Punjab.²³

The difference between procurement & storage cost and the issue price continues to rise with time. At the same time, the provincial food departments have been unable to aggressively offload their stocks of wheat in domestic market in recent months which demand a lower price.²⁴ Another cost driver was the Punjab government's provision of wheat at a very subsidized rate in the month of Ramadan.²⁵ All these factors led to build-up of huge price differential claims towards the government. Since these claims have not been paid by the government, provincial food departments faced liquidity shortages in settling bank loans. The liquidity condition may even get worse in coming months given the seeming weak ability of procurement agencies to off-load the existing wheat stock. Specifically, around 9.0 million ton of wheat was procured in 2009 and on the face of surplus wheat in the market, it is unlikely that procurement agencies will be able to off-load the entire stock before March 2010 when procurement of the next (2010) harvest is expected to begin.

In case of rice, PASSCO had procured 432,534.9 M tons of rice in the previous year at the minimum guaranteed price ranging from 700 to 1500 per 40 kg. Anecdotal evidence suggests that PASSCO could not able to offload the significant portion of procured stock in the domestic market as traders offered substantially low price to purchase rice. The low tender price could be partly attributed to the ample domestic stock from the 2008 crop in the market, weakness in international prices at least till October 2009, and arrival of new crop in the market. More importantly, PASSCO is also not willing to sell the product at very low price in anticipation of delays in the realization of price differential claims by the government. Likewise, the price differential claims²⁶ of Trading Corporation of Pakistan (TCP) for fertilizer, rice and sugar also contributed in the outstanding banks' exposure in commodity finance.²⁷ Apart from price claims by the government, TCP receivables from a few public entities including utility stores and food departments have also built up in recent months.

The discussion above clearly shows that non-realization of price differential claims by the government did not allow procuring agencies to settle bank debts. Moreover, it is also expected that in coming months a large volume of bank debts would remain unsettled, as in addition to a domestic supply glut, the low international prices (particularly of wheat) have made it difficult to export surplus commodities. This has several implications:

Banks became reluctant to extend incremental loans in light of existing large exposure

²³ Over 9.0 million ton of total wheat procurement in 2008 around 6.0 million ton is procured by the provinces.

²⁴ Issue price is the price at which mill owner purchase wheat from procured agencies. Presently, government fixed issue price at Rs 975/40 kg. Anecdotal evidence suggests that the reason for weaker demand from private sector for the wheat held by the government is an inward smuggling of wheat in the country from Central Asian Republics due to lower international prices.

²⁵ Anecdotal evidence suggests that during Ramadan the wheat was sold at Rs 304/40 kg.

²⁶ This refers to differential between the procurement & storage cost and the issue price.

²⁷ TCP is the only agency which import fertilizer, particularly urea, and sugar.

A bank-wise analysis suggests that the loan extended for the commodity operation by end-November 2009 was mainly concentrated in five largest banks. This has not only exerted pressures on banks' liquidity but also explained banks' reluctance to extend incremental loans to these entities for 2010 crop procurement.²⁸

Commodity operations may crowd out the private sector, and distort price signals

Procuring agencies and provincial food departments seems unable to repay bank loans unless government releases subsidy amount. This suggests that bank funds may remain stuck for some times. Till Q1-FY10, private sector credit remained weak which did not highlight these liquidity constraints so far. October 2009 onwards developments, however, indicate that the stuck-up loans in commodity finance may even crowd out private sector credit. These developments include: (a) a rise in private sector credit October 2009 onwards, (b) a relatively muted deposit growth during the same period, and (c) a sharp increase in government budgetary borrowings from commercial banks.

Possible burden on the fiscal account

If government would disburse the subsidy to different agencies then this will lead to increase in fiscal burden and thereby resulting into higher financing requirements. Moreover, if procurement agencies could not start the timely procurement of new crops then it may distort price signals in the market and would impact prospects for 2011 crops.

To sum up, a prompt settlement of price differential claims is essential to ease-off banks funds. The current situation signifies just one problem associated with government providing subsidies in various sectors of the economy. Not only have such subsidies distorted relative prices in the economy and caused demand pressures; the fluctuating domestic and international prices of key commodities have caused problems in assessing the required fiscal spending.

4.3 Credit to Private Sector (net)²⁹

The steep contraction in corporate demand³⁰ for bank credit which began in the second half of FY09 further intensified in the initial months of FY10. Resultantly, the private sector credit witnessed the worst performance in twenty three years; with YoY growth recording net retirement of 2.7 percent by December 05, 2009 (see **Figure 4.13**).

On cumulative basis, a low level of 0.9 percent growth in private sector credit during Jul-5th Dec FY10 stemmed entirely from net retirement in working capital loans. This was despite of some signs of revival in a few industries. The anomaly is perhaps due to the fact that in FY09 a number of industries³¹ were piling up inventories in anticipation of both high domestic demand and rise in raw material prices (both in global and domestic markets). However, the said behavior from

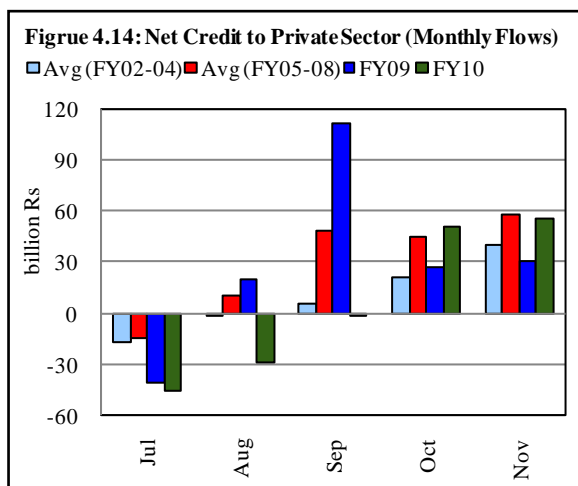
²⁸ It was one of the large public sector banks that had actually explained the incremental credit demand for commodity operation during the month of October 2009.

²⁹ The reported credit numbers comprise of banks' investments and advances to the corporate sector. This data is based on Monetary Survey which is available till 5th December 2009; whereas, sector-wise discussion covers Jul-Oct period.

³⁰ More than 85.0 percent of total private sector credit is extended to the corporate sector.

³¹ For instance, refineries, edible oil and steel.

those industries reversed in Jul-5th Dec FY10; thus the incremental credit demand to build up inventories during the period under review was not as significant as in Jul-6th Dec FY09. Moreover, a number of factors such as: a) some export-based industries (e.g., cement³²) were capable of generating cash flows from their export earnings of last year, b) a number of companies had reported closures in H2-FY09³³, particularly in textile sector, and c) a steep fall in raw material prices in few categories such as raw cotton and iron & steel bar prices in the domestic market had put lower pressures on incremental demand for credit during the period of analysis.



On the other hand, demand for long-term loans remained persistently higher compared with working capital requirement. Similar to last year, the power, fertilizer, cement and construction sectors were few main sectors accounting for continuing higher demand for fixed investment loans. Disbursements in power and fertilizer sectors, in particular, seems quite surprising given that a number of companies had already drawn significant amount of assigned limits with banks in FY09. This was probably due to commencement of a few projects which had actually accelerated the incremental demand for credit. Moreover, exchange rate fluctuations in recent past have also made LC commitment costlier for some corporates.³⁴ As a result, number of companies arranged rupee funding from banks to fulfill their additional requirements in the period of analysis.

The commencement of long-term projects, particularly power and fertilizer, will increase the running finance requirements in months ahead. In fact, a few banks

³² It may be recalled that in FY09 cement export grew by 97.7 percent during Jul-Oct; though lower from 105.5 percent rise in the corresponding period of FY08.

³³ Anecdotal evidence suggests that industrial recovery during Q1-FY10 is concentrated in a few large companies.

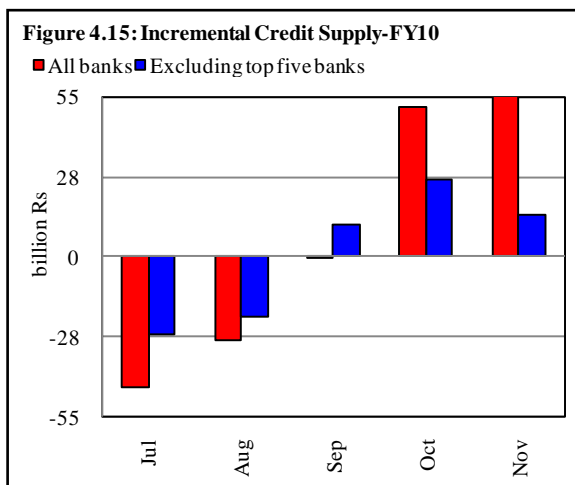
³⁴ SBP temporarily suspended the forward foreign exchange cover against all types of imports since July 8, 2008. For details, see EPD FE Circular No. 08 of 2008. The forward cover was earlier allowed to authorize dealers so they could hedge against exchange rate risk in import payments.

have already committed the running finance limits to their clients in above mentioned sectors. Besides working capital loans, resilience in demand for fixed investment may also continue as commencement of new projects in few sectors such as real estate, refineries³⁵ and rental power will boost the project financing need from corporates. Therefore, it is quite possible that the visible fall in private sector credit in the recent past may not continue going forward.

Indeed, it is obvious from **Figure 4.14**, that October 2009 witnessed a pickup in credit demand which is unusually higher than the average increase in the same month preceding years.³⁶

The supply side perspective suggests that banks' risk-averse lending which was seen in FY09 consequent to rise in non-performing loans of corporates, continued in the initial few months of FY10 as well. As a result, banks were remained conservative in their lending to the private sector.

Though, the growth in gross NPLs, corporate sector loans in particular, slowed down during Q1-FY10, stringent credit assessment in a number of banks resulted in limited supply of funds.³⁷ At the same time, a number of banks also witnessed increase in cash recoveries against NPLs.³⁸ While, the lower increase in gross NPLs was partly anticipated as net credit fell sharply since January 2009, high cash recoveries reflect banks' greater efforts.



³⁵ In most of the refineries the desulphurization projects are in progress, as to ensure compliance with the government's requirement of reducing sulphur content in HSD, to 500 parts sulphur per million till calendar year 2012.

³⁶ Month of July is an exception which usually coincides with seasonal retirement each year.

³⁷ In contrast to the same period last year, a sharp increase in gross NPLs of corporate sector loans was largely explained by working capital; however, the contribution of working capital NPLs in gross NPLs of corporate sector in Q1-FY10 was significantly low.

³⁸ For detail, see section on NPLs.

This said, net credit growth may not attain the same growth momentum, as seen over the preceding few years³⁹, as banks are now increasingly focused to finance certain projects that have sound cash flows. This is in contrast to the practice in the boom years when bank finance was provided mainly depending upon the collateral value; including inventories, fixed assets and receivables with much less consideration on cash flows of businesses. Thus the conservative approach is likely to contain the growth of private sector credit.

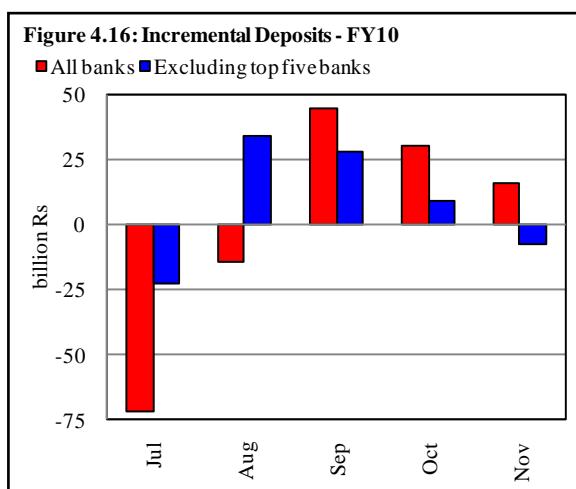
The bank-wise incremental credit distribution suggests that top five banks, which traditionally have had the largest share in credit supply, recorded higher contraction in their lending activities compared with the remaining banking groups, particularly during Jul-Sep FY10 (see **Figure 4.15**). An in-depth analysis suggests that significant exposure of the top five banks in PSE credit and commodity finance in the recent months probably

resulted in lower loanable funds for private sector. To make things worse, deposit growth in the top five banks also remained significantly lower compared with other banks, particularly in the first three months of FY10 (see **Figure 4.16**). Apart from liquidity concerns, high net budgetary borrowing of government also constrained banks' ability to extend funds to private sector during the period under review (see **Table 4.5**).

Private Sector Advances

While demand for consumer loans has been falling from last year, a sharp contraction in business sector advances led to a marked drop in private sector advances during Jul-Oct FY10.

The business sector advances contracted by 0.6 percent in Jul-Oct FY10 as compared to an average growth of over 5.0 percent in the same period during last five years. As evident from **Figure 4.17**, net retirement under



³⁹ Excluding last year, on average private sector credit grew by 24.6 percent during FY04-FY08.

working capital loans explained the entire decline in advances growth. Demand for fixed investment and trade loans, though slowed down markedly, still had positive contribution in advances growth.

The monthly trend suggests that the contraction in advances was mainly concentrated in the first three months of FY09 whereas slight recovery in advances demand was seen in the month of October 2009 (see **Table 4.6**). More specifically, pickup in credit demand in October 2009 is partly a reflection of seasonal running finance requirement; particularly for cotton procurement. Moreover, in sugar sector, the seasonal demand was absent during the period under review. This was due to the fact that manufacturers have delayed sugarcane crushing and a number of industries are repaying loans availed last year.

Apart from seasonal finance, power sector witnessed acceleration in demand for working capital loans in October 2009; though it showed net retirement during Jul-Oct FY10 period. In fact, the settlement of loans by a few IPPs on account of PPTFCs issuances in September 2009 provided them room to borrow in the following month. The need for additional borrowing stemmed from the fact that circular debt issue has not been resolved yet.

Finally, an increase in demand from commerce and trade during the month of October 2009 probably reflects slight improvement in industrial performance and rising trade volume.

Table 4.5: Banks' participation in T-bills Auctions

billion rupees

	FY09		FY10
	Jan-Mar	Apr-Jun	Jul-Oct
Maturity	514.8	250.5	205.9
Net target	50.2	99.5	174.1
Net offered	1011.7	462.6	704.2
Net accepted	169.4	108.4	162.5

Table 4.6: Break-up of Working Capital Loans during FY10

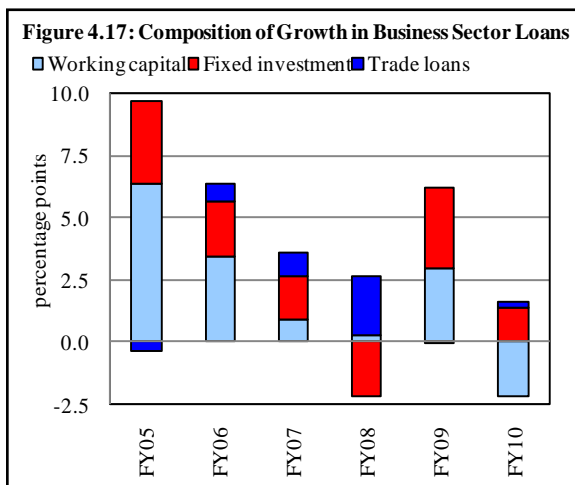
billion rupees

	Jul-Oct		Oct
	FY09	FY10	FY10
Working capital loans	62.6	-46.3	30.4
A. Agriculture	2.8	0.9	-0.8
B. Manufacturing	54.1	-33.1	14.4
a. Rice processing	-5.4	-8.7	0.2
b. Manufacture of sugar	-10.8	-25.8	-4.6
c. Textile	21.9	13.0	24.1
Spinning of fibers	18.7	9.0	18.6
b. Refined petroleum products	11.2	-1.8	-1.6
c. basic metal	2.4	-3.6	-0.1
c. Chemicals and chemical products	14.3	-0.2	-3.5
d. Manufacture of machinery	2.0	-0.9	-0.8
C. Power	1.1	-8.7	7.9
D. Construction	-5.6	-3.5	1.0
E. Commerce & trade	8.7	-7.0	3.6
D. Transport & communications	-1.0	2.1	-0.3
E. Other business activities	9.7	1.0	0.5

Consumer loans

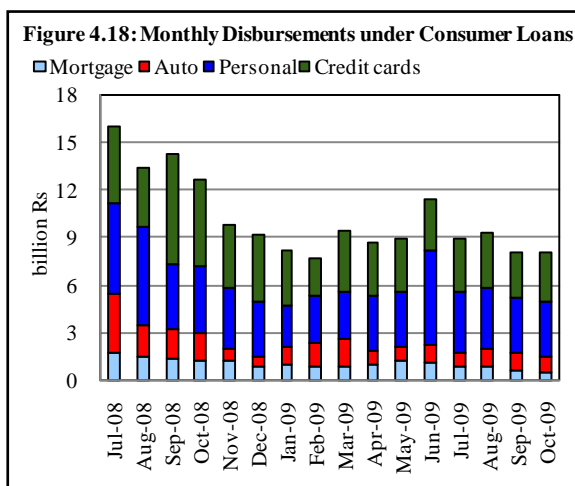
The growing number of bad loans in consumer sector, emanated partly from rise in borrowing cost and fall in real income of borrowers, hampered adversely banks' willingness as well as ability to lend aggressively during the last two years.

Resultantly, consumer loans which had been decelerating since December 2006, witnessed a net contraction of 6.0 percent in Jul-Oct FY09 and further 7.6 percent during Jul-Oct FY10. Similar to previous year, the contraction in consumer loan is visible in all categories.



The auto loans, in particular, continued to fall during Jul-Oct FY10 despite a recent increase in local car sales.⁴⁰

This is because the recent demand for automobiles was largely financed by customers' equity rather than bank loans. This said, a number of banks have seen an upsurge in demand for auto finance in recent months. Therefore, it is likely that auto finance may increase somewhat in coming months; though banks will likely be more conservative while making consumer loans.



⁴⁰ In fact, anecdotal evidence suggests that consumer demand for automobiles is directly influenced by the auto finance availed from banks. However, increase in borrowing cost and banks' cautious lending following rise in NPLs, made banks loans more expensive for borrowers.

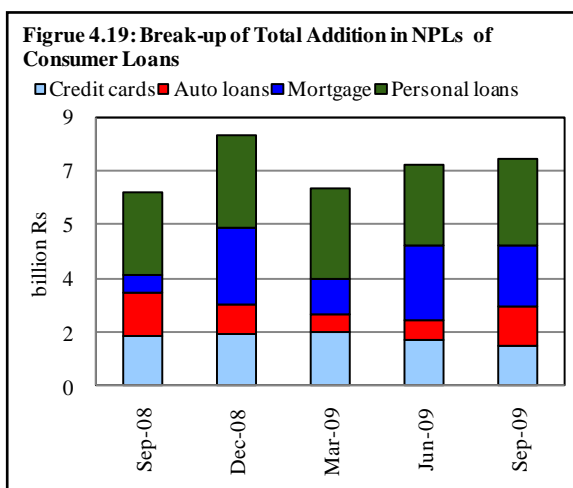
Viewed from disbursement side, a significant portion of consumer loans still comprises personal loans followed by credit cards-the most risky lending as it is largely uncollateralized (see **Figure 4.18**). This was despite a sharp rise in total addition in NPLs under these categories in recent past (see **Figure 4.19**). A detailed analysis suggests that these loans are concentrated in few banks which are mainly focusing on lending to clients with whom they have long established relationships. For example, some banks are offering these loans mainly to those borrowers whose salary accounts are maintained with them. This not only ensures the regular income streams of borrower but also provide authority to banks to debit the account of customer when payments become due.

4.4 Deposit Mobilization⁴¹

Deposit mobilization by banks shows some recovery as YoY deposit growth witnessed an uptrend since May 2009 reaching 12.2 percent by end-November 2009 (see **Figure 4.20**). However, given a considerable increase in country's foreign exchange reserves in the recent past, the current level of YoY deposit growth is still low (see **Figure 4.20**). In recent years, increases in total forex

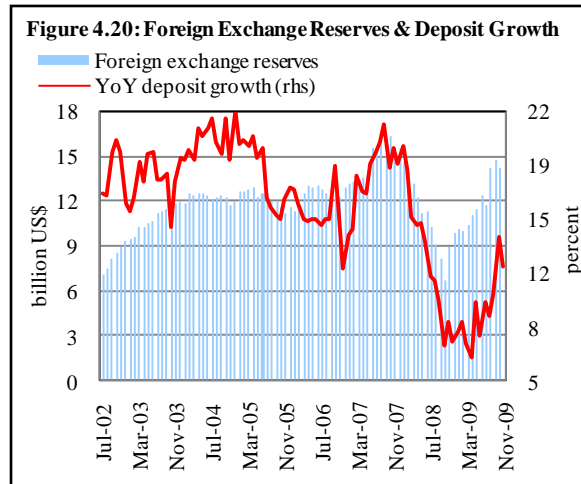
reserves were a very important contributor to deposit growth in the domestic banks. However, this linkage now seem to have weakened.

During FY09, the dollar liquidity for imports was increasingly being funded by forex purchases from the central bank, with a commensurate fall in rupee deposits (amid a contraction of broad money). However, the subsequent recovery in SBP forex reserves was not through market purchases (which would have re-injected liquidity into the system) but rather largely through IMF loans (which do not impact market liquidity or broad money growth).



⁴¹ The discussion on deposits is based on total deposits of the banking industry including government deposits.

Another reason for the relatively low YoY deposits growth in Jul-Nov FY10 is the much reduced monetization of the fiscal deficit. More specifically, the cumulative net budgetary borrowing from central bank witnessed lower rise of Rs 88.9 billion in Jul-5th Dec FY10 as against substantial borrowing of Rs 405.2 billion in the corresponding period last year.

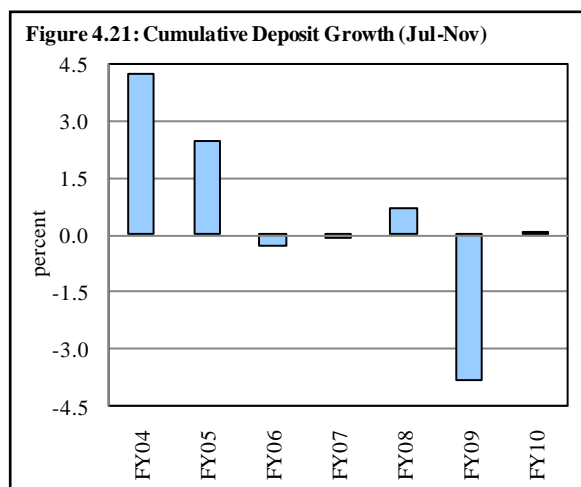


Nonetheless, on cumulative basis deposits of the banking system recorded a growth of 0.1 percent during Jul-Nov FY10 in sharp contrast to same period of previous year when deposit base contracted by 3.8 percent (see **Figure 4.21**).

More encouraging is the fact that this improvement in deposits was borad-based as a large number of banks have witnessed rise in their deposit. A further analysis suggests that a number of factors explains this growth in deposit during Jul-Nov FY10. For example:

1. Ease in external account pressures has started to show some positive impact on deposit growth. More specifically, external account balance for Jul-Nov FY10

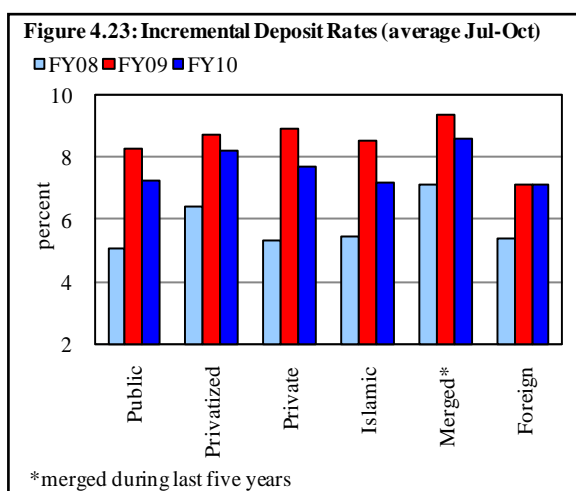
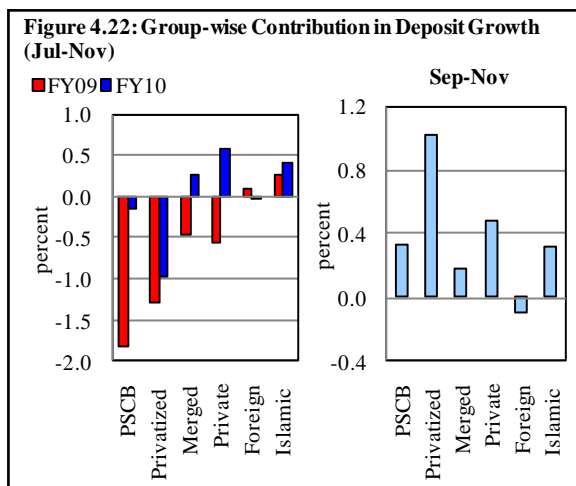
witnessed a surplus of US\$ 0.9 billion compared to a deficit of US\$ 5.6 billion in the corresponding period last year. Therefore, the resulting rupee liquidity eventually contributed into deposit growth, and



2. Sign of revival in a few industries, particularly wholesale and retail trade, power and automobile, also explains part of growth in deposits. In particular, the deposit growth under motor vehicles possibly reflects increased sales of locally manufactured cars.

A bank-group wise analysis suggests that except *large privatized banks* deposits of other remaining banks depicts increase in their deposit base over June 2009 (see **Figure 4.22**).⁴² More specifically, it was one of the *large privatized banks* that had mainly contained the deposit growth in this group. Excluding this, deposits of *large privatized banks* also depicts a small rise of 0.1 percent.⁴³

The large erosion in the deposit of one *large privatized bank* mainly stemmed from massive withdrawals from its fixed deposits. In fact, squeezed profit margins in the wake of high provisioning expenses forced the bank to reduce the stock of expensive deposits by not encouraging the depositors to reinvest in long-term deposits. Besides privatized banks, public sector deposits also witnessed net withdrawal



⁴² Even withdrawals from large privatized banks are mainly concentrated in first two months of FY10 as their deposits witnessed an increase in the following months (see **Figure 4.22**). Sep-Nov data pertains to FY10.

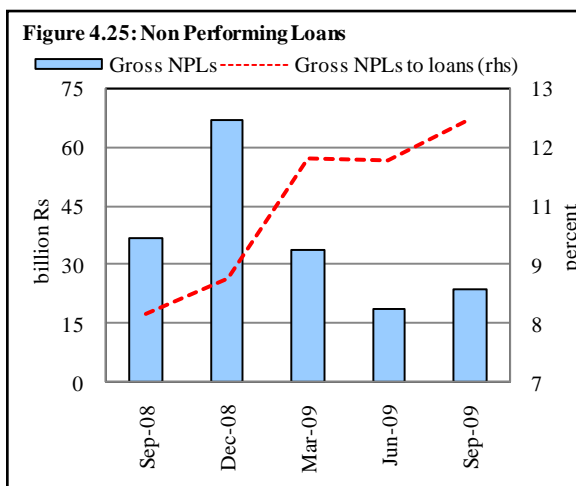
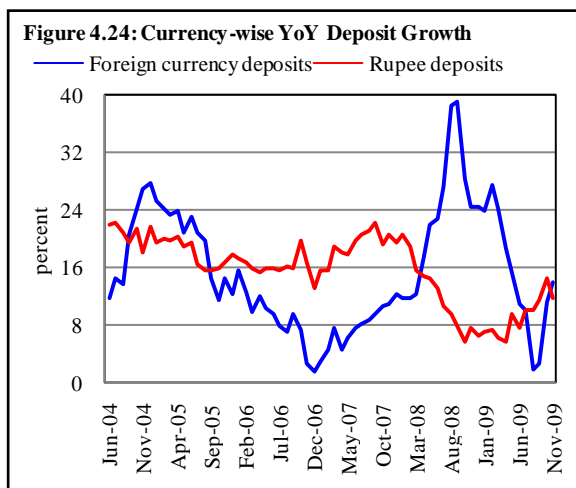
⁴³ Total deposit base adjusted for this large privatized bank depicts 1.3 percent growth in Jul-Nov FY10.

during Jul-Nov FY10; though the fall in deposit growth is much lower than the corresponding period last year.

On the other hand, other banks witnessed an increase in their deposits during Jul-Nov FY10. More specifically, a rise in deposits of merged banks was because a number of banks in this group offered impressive incremental returns relative to the remaining banks (see **Figure 4.23**).

The currency wise composition of deposits depicts that the YoY growth in foreign currency deposits after witnessing steep fall since October 2008, started gaining momentum reaching 14.0 percent by end-November 2009 (see **Figure 4.24**).

Within the foreign currency deposits, the major increase came from US dollar denominated accounts mainly from deposits of PSEs.



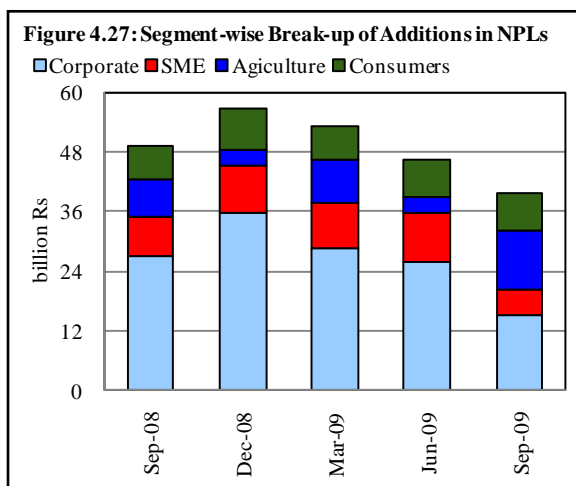
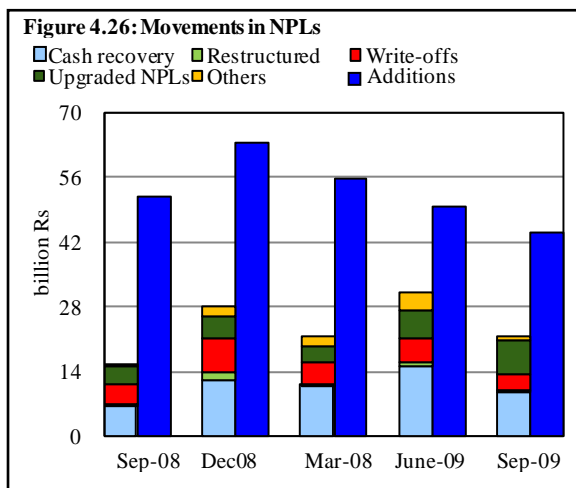
4.5 Non Performing Loans

Asset quality of the banking system shows some weakness in Q1-FY10 as gross NPLs increased by Rs 23.7 billion over June 2009 and reached Rs 421.6 billion;

though this increase was considerably lower than the sharp rise seen in the first three quarters of FY09 (see **Figure 4.25**).⁴⁴

The movement in NPLs depicts that both, total additions and reductions, in NPLs for Q1-FY10 reflects some improvement (see **Figure 4.26**). More specifically, total addition in NPLs during Q1-FY10 was limited to Rs 43.9 billion, much lower than a rise of Rs 51.7 billion recorded in Q1-FY09. This improvement was evident mainly in lower rise seen in corporate sector loans during Q1-FY10 compared with the same period a year earlier when most of the addition came from this segment (see **Figure 4.27**). On the other hand, not only the reduction in NPLs during Q1-FY10 was higher than the corresponding period last

year, the composition also showed improvement over last year. In particular, the recent reduction in NPLs constituted mainly of cash recoveries⁴⁵ and upgraded NPLs compared with Q1-FY09 when the volume of cash recoveries and upgraded NPLs was low. Further analysis shows that although the contribution from corporate sector loans remained high in the gross NPLs growth, the credit quality of consumer and agriculture loans seem to have worsened more (see **Figure 4.27**). More



⁴⁴ Continued rise in NPLs to loan ratio in September 2009 may be read with some caution as net credit extended from banks declined sharply since January 2009.

⁴⁵ Anecdotal evidence suggests that cash recoveries mainly stemmed from working capital in construction sector, sugar and textile industry, and commerce & trade sector.

specifically, the increase in gross NPLs of agriculture sector in Q1-FY10 was almost double than the rise seen in Q1-FY09 (see **Table 4.7**). It may, however, be noted here that this increase was mainly concentrated in one of large public sector banks. In consumer loans, the increase was witnessed in all categories largely reflecting continued worsening in purchasing power of individuals.

Table 4.7: Break-up of Increase in Gross NPLs (Jul-Sep)

billion rupees

Segments	FY09	FY10
Corporate	20.5	12.7
Agriculture	4.5	7.6
SME	8.5	-1.5
Consumer	2.0	4.2
Others	1.3	0.7
Total increase	36.8	23.7

5 Fiscal Developments

5.1 Overview

Data for Q1-FY10 shows the fiscal deficit at 1.5 percent of projected annual GDP compared to 1.1 percent in Q1-FY09, raising concerns over the ability of the government to meet the annual target of 4.9 percent of GDP. It is claimed that a significant part of the slippage owes to an unexpected rise in spending (e.g., increase in government spending related to the anti-terrorist operations, etc.) and delays in some revenue receipts into the next quarter. If this is correct, then the fiscal deficit trend should become consistent with the annual target by the end of the next quarter.

One concern, however, is the higher contribution of non-tax revenue within the marginal increase in overall revenue during Q1-FY10. This is because jumps in non-tax revenue are unpredictable, and are often not sustained in each quarter of the fiscal year. For example, non-tax revenue would have fallen to Rs 58.5 billion had there not been a Rs 70.0 billion transfer from SBP profits to the government.

Despite the sharp growth in fiscal deficit in rupee terms, financing from domestic sources has grown only moderately, because of the significant rise in net external financing. Also, quite encouragingly, the government has been successful in reducing reliance on the extremely inflationary borrowing from the central bank.

The government faces very difficult choices, with considerable pressure to increase social sector spending, and to build infrastructure, even as the costs of the anti-militancy campaign continue to mount. At the same time, the weak economy constrains its ability to raise revenue from the same tax base. This suggests the need to urgently work towards broadening the tax base to provide needed essential services and public goods.

It must be kept in mind that the government's ability to heavily fund the fiscal deficit from the domestic banks in FY09 and FY10 has been helped by the sharp decline in net credit to the private sector. This is not a sustainable position, and points to the need for developing domestic savings, and domestic debt market.

In the medium-term, given the rigidities in the structure of government expenditure, revenue enhancement through tax reforms will be a key to fiscal consolidation. However, one very important development in fiscal policy is the

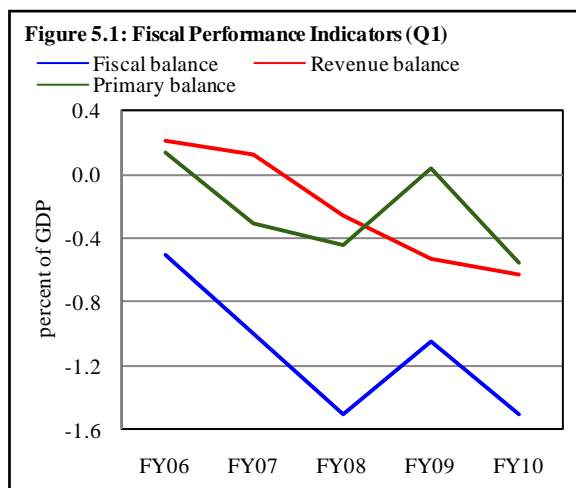
recent agreement between the federal and provincial governments on the 7th National Finance Commission Award (see **Special Section 2** for details).

5.2 Fiscal Performance Indicators

After improvement in the fiscal performance during FY09, the key fiscal indicators deteriorated significantly in Q1-FY10. Deficit in the revenue balance as percent of GDP,¹ has been deteriorating since FY05, touching 0.6 percent in Q1-FY10 – the highest level since quarterly data was made available in FY02 (see

Figure 5.1). This rise would be even higher if Rs 14.2 billion in *unidentified expenditure* is recorded in the

current expenditure. Deterioration in revenue balance is troubling, as it entails borrowings to meet current expenditure that, unlike development spending, do not add to the repayment capacity of the economy. This is why the Fiscal Responsibility and Debt Limitation Act 2005 (FRDL) required the generation of revenue surpluses from FY08 onwards.



Similarly, the primary balance as percent of GDP,² also turned into deficit from zero in the same period last year to 0.6 percent in Q1-FY10. This is a reflection of expansionary fiscal policy, i.e., increase in government expenditure net of interest payments. As a result, stock of public debt in relation to the gross domestic output is likely to increase. It may be added here that persistent primary deficits create problem of debt sustainability.

5.3 Revenue

Total revenue stood at Rs 427.3 billion in Q1-FY10, registering a growth of 11.0 percent compared to 23.1 percent in the same period last year (see **Table 5.1**). The weaker growth in revenue receipts was largely due to deceleration in tax

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

² Primary balance helps assess the sustainability of fiscal deficit. It highlights the current discretionary budgetary stance by excluding the impact of interest payments.

revenue growth. On the other hand, non-tax revenue witnessed a strong growth, but this was not enough to neutralize the impact of deceleration in the tax revenue growth.

Table 5.1: Summary of Consolidated Public Finance

billion rupees

	Jul-Sep				YoY change (%)	
	FY07	FY08	FY09	FY10	FY09	FY10
Total revenue	255.7	312.6	385.0	427.3	23.1	11.0
Tax revenue ³	199.2	219.7	278.7	298.8	26.8	7.2
Non-tax revenue	56.5	92.9	106.3	128.5	14.5	20.9
Total expenditure	342.4	470.7	522.8	650.9	11.1	24.5
Current	244.2	340.0	456.1	521.0	34.2	14.2
Development and net lending	65.2	112.9	57.6	115.7	-55.6	100.8
Unidentified expenditure	33.0	17.8	9.1	14.2	-49.0	56.3
Fiscal balance	-86.7	-158.1	-137.7	-223.7	-12.8	62.4
<i>As percent of GDP⁴</i>						
Total revenue	2.9	3.0	2.9	2.9	--	--
Tax revenue	2.3	2.1	2.1	2.0	--	--
Non-tax revenue	0.6	0.9	0.8	0.9	--	--
Total expenditure	3.9	4.5	4.0	4.4	--	--
Current	2.8	3.2	3.5	3.5	--	--
Development and net lending	0.7	1.1	0.4	0.8	--	--
Unidentified expenditure	0.4	0.2	0.1	0.1	--	--
Fiscal balance	-1.0	-1.5	-1.1	-1.5	--	--
Primary balance	-0.3	-0.4	0.0	-0.6	--	--
Revenue balance	0.1	-0.3	-0.5	-0.6	--	--

Source: Ministry of Finance

Relatively strong growth in non-tax revenue (against tax revenue) pushed its share in total revenue to 30.1 percent in Q1-FY10 compared to 27.6 percent in the same quarter last year. This increased share of non-tax revenue in total revenue can hardly be termed a welcome development due to its unpredictable nature.

Tax revenue recorded an increase of 7.2 percent in Q1-FY10, much lower than the 26.8 percent realized in the corresponding period last year (see **Table 5.2**).

Compositional break-up of tax revenue shows that all major tax-heads except 'petroleum levy' contributed to the deceleration. Specifically, petroleum levy contributed Rs 24.1 billion in tax revenue during Q1-FY10 against Rs 1.8 billion

in the same period last year. It is pertinent to note here that petroleum levy was imposed as fixed consumption tax from the start of the current fiscal year. Also, the surcharges on POL have been replaced with petroleum levy and are now considered part of tax revenue. On the other hand, taxes on goods and services showed signs of weakening due to slowdown in the domestic demand. Similarly, taxes on international trade also declined due to fall in the volume of imports and relatively lower international commodity prices. The decline would have been greater, were it not for the substantial weakening of the rupee over the year.

Table 5.2: Composition of Tax and Non-tax Revenue

billion rupees

	Jul-Sep			YoY change (%)	
	FY08	FY09	FY10	FY09	FY10
Tax revenue	219.7	278.7	298.8	26.8	7.2
Direct taxes	79.2	89.7	84.1	13.3	-6.3
Taxes on property	1.0	1.8	1.7	73.1	-9.1
Taxes on goods and services	98.0	136.6	146.1	39.4	7.0
Taxes on international trade	29.1	38.2	33.1	31.0	-13.4
Petroleum levy	4.2	1.8	24.1	-55.6	1206.1
Other taxes	8.2	10.5	9.9	28.2	-6.5
Non-tax revenue	92.9	106.3	128.5	14.5	20.9
Profits from PTA/Post office dept	0.0	0.0	0.0	--	--
Interest (PSE and others)	12.6	1.6	0.1	-87.1	-93.5
Dividends	2.0	9.5	18.9	372.2	98.7
SBP profits	47.3	28.0	70.0	-40.8	150.0
Defence	1.3	29.2	1.9	2070.2	-93.4
Development surcharges on gas	4.6	6.4	5.7	37.4	-9.9
Discount retained on crude oil	--	4.0	0.0	--	--
Royalty on oil/gas	11.3	10.4	9.2	-7.8	-10.9
Others	13.7	17.1	22.6	24.7	31.9
Total revenue	312.6	385.0	427.3	23.1	11.0

Source: Ministry of Finance

Non-tax revenue added Rs 128.5 billion in Q1-FY10 compared to Rs 106.3 billion in the same period last year, registering strong growth of 20.9 percent. The acceleration in the non-tax revenue receipts is largely attributable to: a) strong inflows received in the form of dividends, and b) sharp increase in the transfer of SBP profit to the government. The increase in the latter was primarily attributed

to huge stock of government debt held by the central bank. The rise in the transfer of SBP profit and increased dividend income both helped to compensate for the deceleration in the other heads of non-tax revenue.

5.4 Expenditure

Total expenditure grew by 24.5 percent during Q1-FY10, significantly higher than 11.1 percent recorded in the same period last year.

Compositional break-down of total spending shows that growth in expenditure was contributed by increase in current expenditure as well as development expenditure. The latter showed an exceptional YoY increase of 92.1 percent in Q1-FY10, compared to 48.9 percent decline during the same period last year. The large growth in total expenditure is also evident from increased total expenditure to GDP ratio to 4.4 percent in Q1-FY10 from 4.0 percent in the same period last year (see **Figure 5.2**).

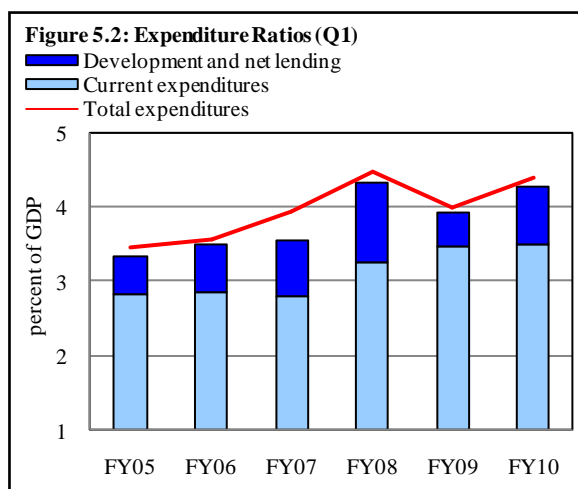


Table 5.3: Composition of Current Expenditure

billion rupees

	Jul-Sep			YoY change (%)	
	FY08	FY09	FY10	FY09	FY10
Current expenditure	340.0	456.1	521.0	34.2	14.2
<i>of which</i>					
Interest payments	111.1	142.3	141.5	28.1	-0.6
Domestic	98.5	128.1	129.3	30.0	0.9
Foreign	12.6	14.2	12.2	12.8	-14.2
Grants (other than provinces)	7.7	16.4	60.1	112.1	266.0
Defence	57.5	82.2	86.2	42.8	4.9
Economic affairs	25.6	50.6	11.0	97.7	-78.2
Health	1.1	1.1	1.4	-0.2	22.0
Education affairs and services	5.0	5.3	6.8	6.3	28.8
Provincial	102.6	115.1	139.6	12.2	21.3

Source: Ministry of Finance

Within total expenditure, current expenditure increased by 14.2 percent to reach Rs 521.0 billion in Q1-FY10 (see **Table 5.3**), which are 3.5 percent of GDP. Further analysis reveals that the current expenditure of the provinces increased by 21.3 percent in Q1-FY10, compared to 12.2 percent rise recorded in the first quarter of the last fiscal year.

Furthermore, surge in the current expenditure of the federal government reflects: a) acceleration in the defense expenditure on account of continued military operations against militants in some areas in the north of Pakistan, and b) rise in grants to the non-government entities. Increase in the latter is attributable to the support programs for poor and payments to internally displaced people (IDPs). On the other hand, the government spending on interest payments remained almost unchanged at Rs 141.5 billion in Q1-FY10 compared to Rs 142.3 billion in the same period last year. Additionally, sharp fall in the expenditure under 'economic affairs' probably reflects a decline in subsidies provided by the government to various sectors in the preceding year.

Government development spending increased to Rs 109.0 billion in Q1-FY10 from Rs 56.8 billion in the same period last year. Further break-up of data reveals that increase was largely on account of provincial governments whose share in total PSDP spending has increased to 46.3 percent in Q1-FY10 from 37.0 percent during Q1-FY09.

5.5 Domestic Budgetary Financing⁷

A higher than projected fiscal deficit in Q1-FY10 has placed pressures on both external and domestic sources of financing. Of the total financing requirement, approximately one-third was met through external sources compared to only 4.5 percent in Q1-FY09. The sharp increase in the external financing mainly reflects inflows under bridge financing⁸ provided by the IMF in August 2009. Despite this sharp increase in the net external financing, budgetary financing from domestic sources also continued to rise, touching Rs 146.6 billion in Q1-FY10 (see **Table 5.4**).

⁷ Budgetary financing from the banking system is worked out on cash basis and hence, this will differ from government borrowing numbers reported in **Table 4.1** where data is measured on accrual basis.

⁸ Bridge financing is temporary financing and is used as a bridge to maintain liquidity while waiting for expected cash inflow.

Table 5.4: Sources of Financing

billion rupees

	Jul-Sep			Growth (%)		Percent share ¹	
	FY08	FY09	FY10	FY09	FY10	FY09	FY10
Total financing of budget	158.1	137.7	223.7	-12.9	62.5	100.0	100.0
External resources (net)	36.8	6.2	77.1	-83.3	1151.2	4.5	34.5
Internal resources (net)	121.3	131.7	146.6	8.6	11.3	95.5	65.5
Banking system	69.9	104.6	39.0	49.8	-62.7	(79.4)	(26.6)
Non-bank	51.4	27.1	107.6	-47.3	297.3	(20.6)	(73.4)

Source: Ministry of Finance

¹ Numbers in parenthesis represent share in internal source of financing

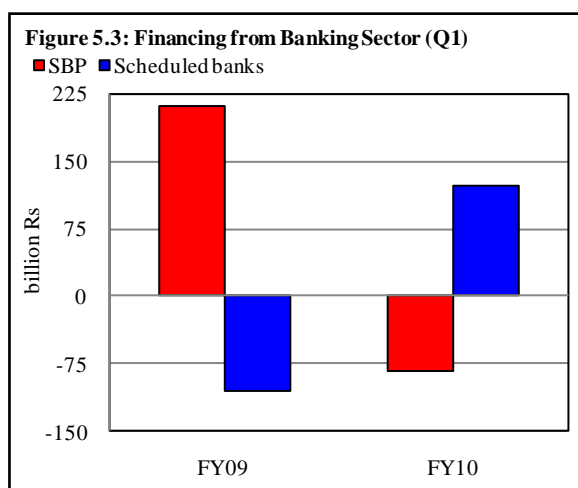
Within domestic sources of budgetary finance, non-bank's contribution witnessed a strong expansion. As a result, the share of non-bank in domestic source of financing jumped to 73.4 percent compared to 20.6 percent in the same period last year. Financing from the banking system also witnessed significant change during Q1-FY10.

Financing from the Banking Sector

Net budgetary financing from the banking system was Rs 39.0 billion in Q1-FY10, compared to Rs 104.6 billion in the same period last year.

However, the financing structure from the banking system changed, as the government borrowings from the scheduled banks increased significantly in the period under discussion. On the other hand, the financing from the central bank saw net retirement of Rs 82.6 billion in Q1-FY10 (see **Figure 5.3**),

reflecting successful implementation of the limit on government borrowings from the central bank imposed under Stand-By Arrangement with IMF. While a reduction in deficit monetization would help contain inflationary pressures somewhat, a rise in government borrowings from the scheduled banks will have consequences on liquidity and interest rates.

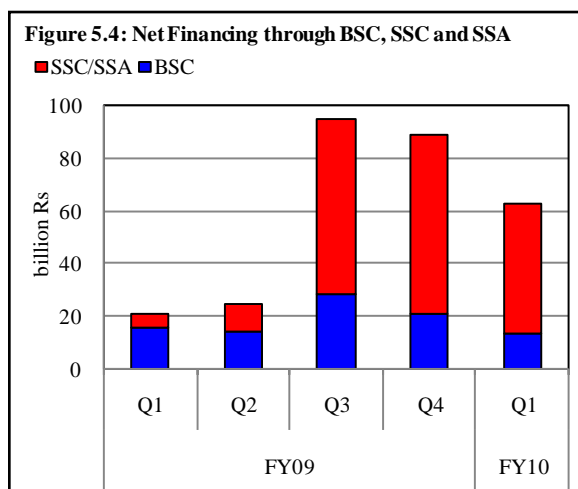


Financing from the Non-bank Sources

Non-bank borrowings stood at Rs 107.6 billion in Q1-FY10, compared with Rs 27.1 billion in the corresponding period of the previous year. NSS with Rs 53.0 billion addition was the largest contributor in the total financing received from non-bank sources in Q1-FY10.

Within NSS, net investment in Behbood Saving Certificates (BSC), Special Saving Certificates (SSC) and

Special Saving Accounts (SSA) increased significantly. These three instruments contributed Rs 62.7 billion in total NSS financing, but the net retirement of other instruments has reduced the net inflows through NSS (see **Figure 5.4**). It is worth noting that the performance of NSS instruments is dwindling after large jump in the second half of FY09. A part of this weakness probably owed to recent cuts in profit rates on major NSS instruments in line with the fall in the interest rates on long-term government papers.



5.6 FBR Tax Collection

Total tax collection reached Rs 263.7 billion during Q1-FY10 against Rs 262.1 billion in the corresponding period a year earlier (see **Table 5.5**). The amount collected portrays poor performance of all the four major heads of the FBR taxes.

Table 5.5: FBR Tax Collection (net) (Jul-Sep)

billion rupees

	Annual target		Net collection		% of annual target		YoY change (%)	
	FY09	FY10	FY09	FY10	FY09	FY10	FY09	FY10
Direct taxes	498.9	565.6	88.2	85.2	17.7	15.1	13.8	-3.5
Indirect taxes	751.1	751.1	173.9	178.5	23.2	23.8	36.1	2.7
Sales tax	469.9	499.4	110.2	117.1	23.5	23.4	33.2	6.2
FED	112.0	152.8	25.5	28.4	23.4	18.6	58.9	11.5
Customs	169.2	162.2	38.2	33.1	22.6	20.4	31.7	-13.4
Total collection	1,250.0	1,380.0	262.1	263.7	21.0	19.1	27.7	0.6

Source: Federal Board of Revenue

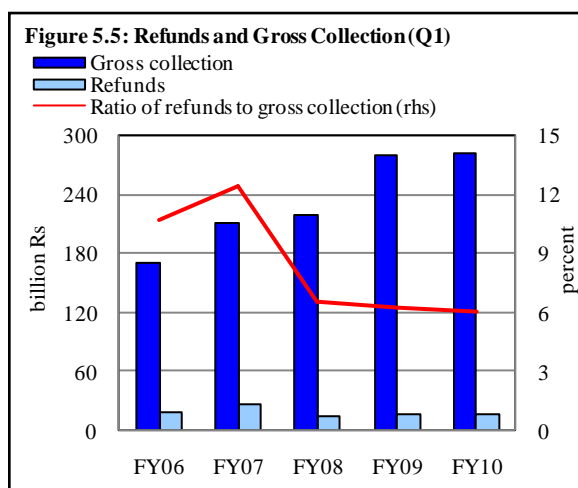
Direct taxes registered a decline, while indirect taxes on the whole grew by only 2.7 percent.

Deceleration in the FBR tax receipts is a reflection of overall weak economic activities. Specifically, low expected earnings of the corporate sector and decline in imports translated into below expected performance of the tax collection. Further, production in large scale manufacturing sector has declined during Q1-FY10 on top of a substantial 6.0 percent fall in Q1-FY09, which continued to drag tax receipts.

An analysis of the FBR tax performances with respect to the annual target reveals that only 19.1 percent of the annual target has been achieved compared with 21.0 percent in Q1-FY09. The FBR has to collect over Rs 124.0 billion per month on average during the remaining nine months of the fiscal year to meet annual target of FY10. Last year average monthly tax collection stood at Rs 96.4 billion which also remained the highest so far. Given these facts and weak economic activities, the target for FY10 clearly looks ambitious.

Refunds

The gross tax collection has recorded 0.5 percent growth during the first quarter of FY10 compared to 27.2 percent increase during the comparable period last year. The ratio of refund to gross collection has remained stagnant for the last three years (see **Figure 5.5**). This indicates that the government is not trying to hold refunds to meet its budgetary needs and to show increase in net receipts.



Direct Tax Collection

Collection from direct taxes registered negative growth of 3.5 percent during Q1-FY10 to Rs 85.2 billion. As gross income tax accounts for 97.0 percent of the gross direct taxes, a compositional break-down of gross income tax will help to trace out the reasons behind the fall in direct tax receipts.

During Q1-FY10, gross income tax collection was only Rs 91.1 billion compared to Rs 92.5 billion collected during the corresponding period a year earlier. A major setback to the gross income tax came from short fall in voluntary payments (VP). Revenue from the voluntary component was Rs 19.0 billion during the period under discussion against Rs 31.8 billion during the same period last year (see **Figure 5.6**).

A break-down of VP, which comprises payments with returns and advance tax payments, shows that payments with return contributed Rs 3.6 billion to the total voluntary receipts compared to Rs 2.2 billion a year earlier. However, advance tax payments were only Rs 15.3 billion during Q1-FY10 compared to Rs 29.6 billion in the corresponding period a year earlier. Consequently, the reason of the short fall in direct taxes during Q1-FY10 can be narrowed down to the dismal performance of advance tax payments. The advance tax is paid by corporate sector on the basis of expected profitability. The decline in this component thus shows that the corporate sector was expecting a lower profit during Q1-FY10.

The collection on demand, which is a major component of gross income tax, grew by 19.1 percent in Q1-FY10 (YoY), but this rise was not sufficient to make up for the fall in advance tax payments. Last year, the FBR fully utilized the system for audit and assessment of the tax returns resulting in 118.0 percent YoY growth for collection under demand.

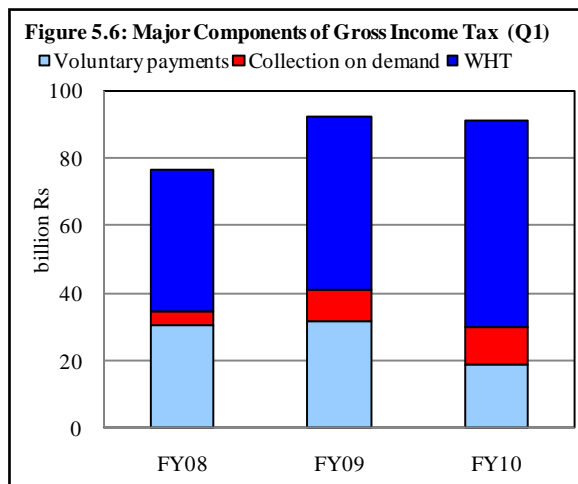


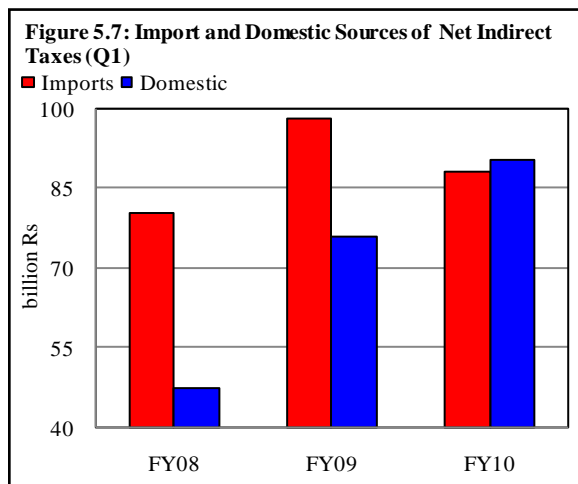
Table 5.6: Withholding Tax Collection

billion rupees

	Jul-Sep			Absolute difference	
	FY08	FY09	FY10	FY09	FY10
Imports	6.4	8.0	10.4	1.5	2.4
Salaries	4.3	5.4	7.1	1.1	1.8
Dividends	1.1	1.6	1.3	0.5	-0.3
Securities	3.3	3.2	4.5	0.0	1.3
Contracts	13.9	17.2	18.0	3.2	0.8
Exports	2.3	3.6	3.7	1.3	0.1
Cash withdrawal	1.3	2.2	2.8	0.9	0.6
Electricity bills	1.3	1.6	3.4	0.3	1.8
Telephone	4.4	4.9	5.1	0.6	0.2
Others	4.1	4.1	5.1	0.0	1.0
Total (gross)	42.3	51.7	61.5	9.4	9.7

Source: Federal Board of Revenue

The third major component of the income tax, i.e., withholding tax (WHT) grew by 18.8 percent in Q1-FY10 compared to 22.3 percent increase during the same period a year earlier (see **Table 5.6**). Collection from imports and electricity bills remained the top most contributors in terms of total addition to the WHT collection during the quarter. Increased contribution under the head of electricity bills despite power outages across the country owed to rise in electricity charges. Collection under the head of salaries also stood higher than the previous year. This reflects rise in salaries by the employers to compensate the historic high inflation. Receipts from exports could add only Rs 0.1 billion due to 4.0 percent decline in exports during Q1-FY10 over the corresponding period of the previous year.



Indirect Taxes

Net collection from indirect taxes grew by only 2.7 percent in Q1-FY10 compared to 36.1 percent in the corresponding period of the previous year. In absolute terms, indirect tax collection was Rs 178.5 billion in Q1-FY10 compared to Rs 173.9 billion during Q1-FY09. A detailed data of indirect taxes shows that major setback came from the imports. Import related indirect taxes declined by 10.2 percent over the previous year (see **Figure 5.7**). This was mainly on account of 21.0 percent decline in the rupee value of imports.

Growth in indirect tax collection from domestic source decelerated to 19.3 percent during the period under discussion compared to 60.0 percent increase a year earlier. The considerable growth in Q1-FY09 in indirect tax collection from domestic sources was helped by the hefty increase in tax receipts from POL products due to increase in international prices.

Commodity-wise analysis shows that major shortfall came from POL products as collection from POL products remained below the previous year collection by Rs 6.0 billion (see **Table 5.7**). This was mainly due to 46.0 percent decline in the dutiable import value of the POL products. Collection under the head of services

Table 5.7: Indirect Tax Collection from Major Commodities (Domestic + Imports)

billion rupees

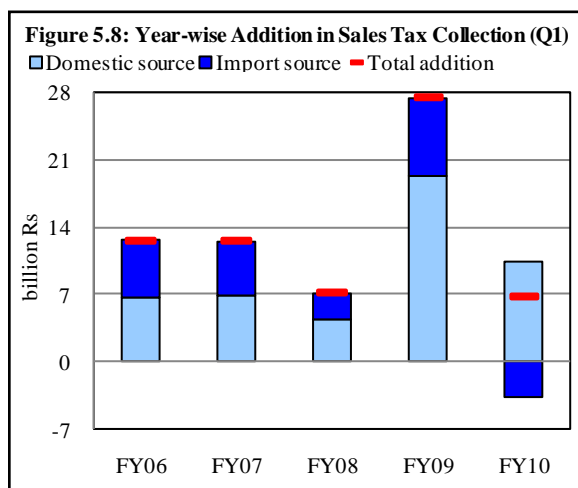
	Jul-Sep			Absolute difference		Share in total (%)		
	FY08	FY09	FY10	FY09	FY10	FY08	FY09	FY10
Total indirect tax collection	127.8	173.9	178.5	46.1	4.6	100.0	100.0	100.0
<i>of which</i>								
POL products	31.1	59.1	53.1	28.1	-6.0	24.3	34.0	29.8
Edible oil	8.3	8.4	6.9	0.2	-1.6	6.5	4.9	3.9
Vehicles (non-railway)	9.5	9.4	7.3	0.0	-2.1	7.4	5.4	4.1
Iron and steel	3.9	4.1	4.6	0.1	0.5	3.1	2.3	2.6
Electric machinery	4.5	5.7	4.0	1.2	-1.7	3.5	3.3	2.3
Tea and coffee	0.9	1.6	1.8	0.7	0.2	0.7	0.9	1.0
Machinery & mechanical appliances	4.1	5.0	4.2	0.9	-0.7	3.2	2.9	2.4
Plastic resins etc	4.8	6.6	5.4	1.8	-1.2	3.7	3.8	3.0
Cigarettes & tobacco	5.9	8.9	9.6	3.1	0.7	4.6	5.1	5.4
Cement	3.7	5.3	5.6	1.6	0.4	2.9	3.0	3.1
Services	3.3	5.0	8.3	1.8	3.2	2.6	2.9	4.6
Sub-total	79.8	119.1	110.7	39.3	-8.4	62.4	68.5	62.0

Source :Federal Board of Revenue

and iron & steel generated higher revenue when compared to their contributions during Q1-FY09. The dutiable import value of the iron & steel grew by 24.2 percent during Q1-FY10 as against 18.3 percent decline in the corresponding period a year earlier. Increased contributions in terms of domestic source mainly came from: a) cement b) cigarettes and tobacco, c) electrical energy, d) natural gas, and e) services.

Sales Tax

Net collection from sales tax stood at Rs 117.1 billion during Q1-FY10 higher by Rs 6.8 billion from the corresponding period a year earlier. Of the total addition in the sales tax, Rs 10.4 billion came from domestic source which implies that collection of sales tax from import source fell below the previous year amount by Rs



3.6 billion (see **Figure 5.8**).

A break-up of the domestic related sales tax shows that collection under the head of: a) natural gas, b) electric energy, c) beverages, d) cement, e) motor cars, f) sugar, and g) services exceeded that of the comparable period last year. Collection from the import source declined by 6.5 percent compared to the corresponding period of the previous year. Of this, collection under the head of iron & steel exceeds that of the comparable period of the last year. The decline in the import related sales tax is aligned with the decline in the rupee value of the imports.

Federal Excise Duty (FED)

Q1-FY10 collection from FED stood at Rs 28.4 billion compared to Rs 25.5 billion collected during the first quarter of the previous year. A break-up of

Table 5.8: Summary of Consolidated Provincial Finance

billion rupees

	Jul-Sep				YoY change (%)	
	FY07	FY08	FY09	FY10	FY09	FY10
Total revenue	98.7	142.0	160.2	173.2	12.8	8.1
Provincial share in federal revenue	78.5	90.9	124.4	132.1	36.9	6.2
Provincial taxes	9.9	9.4	12.6	11.2	34.0	-10.7
Property taxes	1.5	1.0	1.8	1.7	80.0	-8.3
Excise duties	0.5	0.6	0.6	0.6	0.0	4.8
Stamp duties	2.4	2.7	2.6	2.3	-3.7	-10.8
Motor vehicle tax	2.0	2.3	2.1	2.5	-8.7	18.6
Other	3.5	2.8	5.5	4.2	96.4	-24.4
Provincial non-tax	4.9	18.3	8.4	10.0	-54.1	19.4
Interest	0.0	9.5	0.0	0.0	-	-
Irrigation	0.5	0.5	0.4	0.4	-20.0	-10.5
Others	4.4	8.3	8.0	9.7	-3.6	20.8
Federal loans and transfers/grants	5.4	23.4	14.8	19.7	-36.7	33.3
Loans (net)	-1.5	1.3	1.5	0.1	11.8	-91.1
Grants	6.9	22.0	13.3	19.6	-39.6	47.4
Total expenditure	111.7	167.7	140.1	183.2	-16.5	30.8
Current expenditure	88.2	107.0	119.3	143.8	11.5	20.5
Interest payments to federal govt	5.1	4.4	4.2	4.2	-4.5	0.1
Other current expenditure	83.1	102.6	115.1	139.6	12.2	21.3
Development expenditure	23.5	60.7	20.8	39.4	-65.7	89.6
Overall balance	-13.0	-25.7	20.1	-10.1	-178.1	-150.1

Source: Ministry of Finance

collection from FED into import and domestic sources reveals that collection from the import related FED declined by 31.1 percent and stood at Rs 2.8 billion. Domestic source generated Rs 25.6 billion during Q1-FY10 compared to Rs 21.5 billion a year earlier. A break-up of FED collected from domestic source reveals that tax receipts from beverages and cigarettes & tobacco were higher than in the corresponding period a year earlier.

Custom Duty (CD)

The net collection realized under the head of custom duty during Q1-FY10 has been Rs 33.1 billion, entailing negative growth of 13.4 percent over the corresponding period of the previous year. Collection from custom duty moves in tandem with the rupee value of imports.

5.7 Provincial Fiscal Operations

Provincial public finances indicate noticeable deterioration in Q1-FY10, as total expenditure witnessed considerable acceleration coupled with fall in the revenue receipts (see **Table 5.8**). Consequently, the overall balance turned into Rs 10.1 billion deficit compared to a surplus of Rs 20.1 billion during Q1-FY09.

Table 5.9: Provincial Finance during Jul-Sep
billion rupees

	Punjab		Sindh		NWFP		Baluchistan	
	FY09	FY10	FY09	FY10	FY09	FY10	FY09	FY10
Total revenue	72.6	73.8	47.1	48.0	21.7	32.7	18.8	18.7
Provincial share in federal revenue	59.8	65	37.4	40.1	15.5	15.7	11.7	11.4
Provincial taxes	5.7	6.1	6.2	4.4	0.6	0.5	0.2	0.2
Provincial non-tax	5.4	3.1	0.8	1.0	1.8	5.7	0.4	0.2
Federal loans and transfers/grants	1.8	-0.4	2.7	2.4	3.9	10.8	6.5	6.9
Total expenditure	68.1	105.5	46.6	35.0	17.0	30.9	8.4	11.8
Current expenditure	56.8	81.0	41.3	31.5	14.5	20.4	6.9	10.9
Development expenditure	11.3	24.5	5.4	3.6	2.5	10.4	1.5	0.9
Overall balance	4.5	-31.7	0.5	13.0	4.8	1.8	10.4	6.9

Source: Ministry of Finance

Revenue receipts of all provinces stood at Rs 173.2 billion, registering a growth of 8.1 percent in Q1-FY10 against 12.8 percent rise last year. Federal tax assignments to provinces increased marginally in Q1-FY10 due to small expansion in the divisible pool (also visible from deceleration in the growth of the FBR tax collection).

Province-wise details show that Punjab experienced enormous deterioration in the overall balance, turning from surplus into deficit in Q1-FY10. Sindh recorded improvement in the overall surplus; while Baluchistan and NWFP recorded reduction in the surpluses in overall balance (see **Table 5.9**).

5.8 Domestic Debt

Pakistan's domestic debt stood at Rs 4.1 trillion at end-October 2009, registering a growth of 5.7 percent in Jul-Oct FY10

compared to 6.3 percent rise in the same period last year (see **Table 5.10**).

This deceleration in the growth of domestic debt in the presence of increased

fiscal deficit for Q1-FY10 reflects relatively higher availability of external resources to finance the budget deficit.

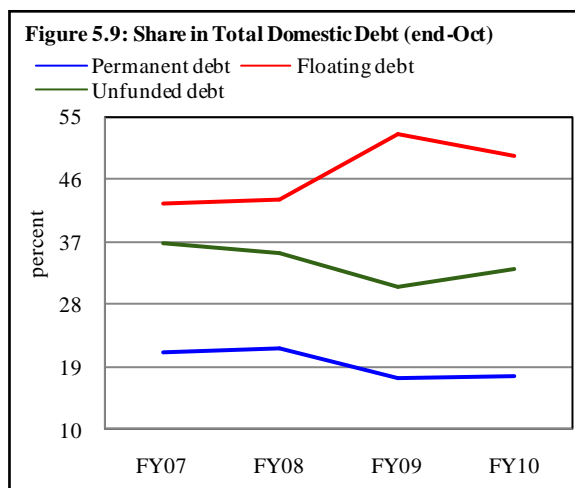
Table 5.10 : Key Developments of Domestic Debt

	Jul-Oct	
	FY09	FY10
Growth in domestic debt (percent)	6.3	5.7
Contribution of LT debt (billion Rs)	25.8	116.5
Contribution of ST debt (billion Rs)	179.3	103.0
Domestic debt (billion Rs)	205.0	219.5
Domestic debt stock (end-Oct; billion Rs)	3471.1	4072.1

Composition of Domestic Debt

Compositional break-up of domestic debt indicates that the floating debt grew by 5.4 percent during Jul-Oct FY10, compared to 10.9 percent increase in the same period last year. Despite this decline, floating debt remained the largest component of domestic debt (see **Figure 5.9**). The government was able to mobilize substantial amount from non-bank sources in Jul-Oct FY10. As a result, the share of unfunded debt in

total domestic debt increased to 33.0 percent by end-October 2009 from 30.4 percent by end-October 2008. On the other hand, the share of permanent debt in total domestic debt observed a marginal increase to reach 17.7 percent by end-October 2009.



The break-up of domestic debt reveals that the outstanding stock of permanent debt rose by Rs 42.1 billion in Jul-Oct FY10 compared to a net retirement of Rs 8.1 billion in the same period last year (see **Table 5.11**).

Within the permanent debt, PIB retained its dominant share by contributing Rs 15.7 billion in Jul-Oct FY10. The government was able to borrow Rs 14.4 billion through single auction of Ijara Sukuk Bond in September 2009. Additionally, mobilization through prize bonds saw a significant improvement, adding Rs 13.0 billion in Jul-Oct FY10. This was mainly due to the decision of the government to increase the amount of prizes on different denominations in February 2009.

Table 5.11 : Profile of Permanent Debt (Jul-Oct)

billion rupees

	FY09		FY10	
	Net receipts	Debt (end-Oct)	Net receipts	Debt (end-Oct)
PIBs	-12.5	399.1	15.7	456.7
Ijara sukuk	6.5	6.5	14.4	42.2
Prize bonds	-2.1	180.7	13.0	210.4
Others	0.0	14.0	-1.0	10.8
Total	-8.1	600.3	42.1	720.1

Growth in the floating debt went down by 5.5 percentage points to 5.4 percent in Jul-Oct FY10, compared to corresponding period last year. The sharp deceleration in the growth of floating debt largely stemmed from lower government

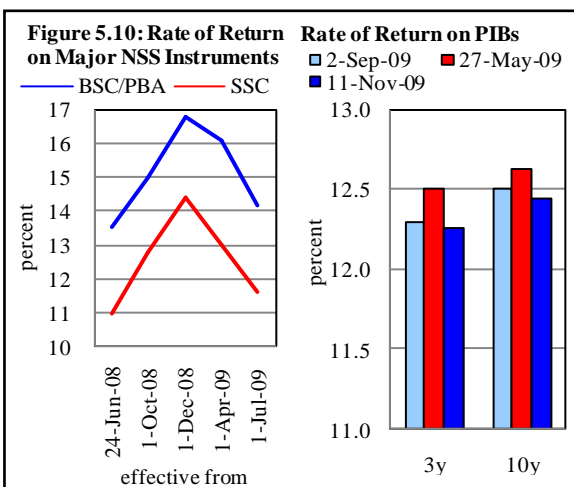
Table 5.12 : Net Flows Through T-bills (Jul-Oct)

billion rupees

	FY08	FY09	FY10
MTBs	108.2	-94.3	184.9
MRTBs*	-46.7	273.5	-81.9
Total	61.6	179.3	103.0

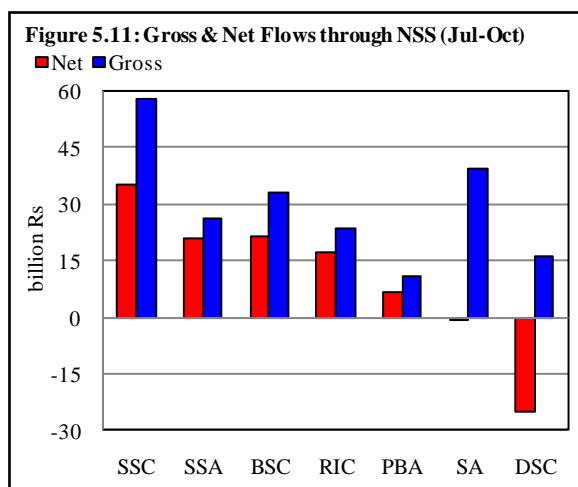
*inclusive of outright sale of MTBs to commercial banks

borrowings through treasury bills for replenishment, which recorded a net retirement of Rs 81.9 billion in Jul-Oct FY10; against an addition of Rs 273.5 billion in the same period last year (see **Table 5.12**). The outstanding stock of t-bills (auction) increased by 23.2 percent in Jul-Oct FY10 compared to a decline of 17.6 percent in the same period last year. The reversal resulted from increased participation of the commercial banks in the t-bills auctions due to: a) expectations of downward



movement in policy rate due to easing inflation, and b) slowdown in the demand for credit from the private sector. Unfunded debt, mainly comprising national savings schemes saw an increase of Rs 74.5 billion in Jul-Oct FY10 compared to increase of Rs 33.8 billion in the corresponding period last year. This increase was mainly on account of investors' expectations about further reduction in the rate

of returns on NSS. Despite this increase in Jul-Oct FY10, the government may have difficulty in mobilizing funds through NSS in the coming months, as average monthly flows observed declining trend. Gradual fall in the net mobilization through NSS was mainly due to the government's decision to lower the profit rate on the major NSS instruments since April 2009. The persistent fall in the yield of PIBs could result in further cut in the profit rates on NSS instruments (see **Figure 5.10**).⁹



Gross sales of NSS instruments rose significantly to Rs 207.6 billion during Jul-Oct FY10 (see **Figure 5.11**). However massive encashment of these instruments coupled with the larger maturities of Defense Saving Certificates (DSC) has lowered the net receipts in the same period. Despite the higher interest rate offered by BSC and PBA, SSC and SSA remained the attractive instruments for the investor. This was probably due to: a) free encashment facility on these schemes at any time after one month of the date of purchase, and b) exemption from withholding tax, if the profit earned on these schemes remains in specified limit. Additionally, the investment scope is quite high as institutional investors are also eligible to invest in these instruments.

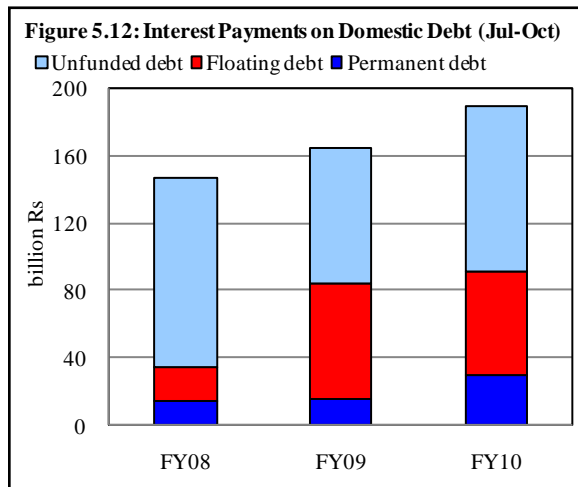
Interest Payments on Domestic Debt

Interest payments on domestic debt increased by 14.9 percent to Rs 189.4 billion in Jul-Oct FY10 compared to Rs 164.8 billion in the same period last year (see **Figure 5.12**). The break-up of domestic debt servicing data reveals that interest

⁹ The tenor of BSC and PBA is ten years, while that of SSC is three years.

payments on permanent debt increased significantly during Jul-Oct FY10 compared to the same period last year. This increase largely stemmed from the interest payments on 10 year PIBs, consistent with its increasing share in outstanding stock of PIBs. In contrast, interest payments on floating debt decreased moderately in Jul-Oct FY10 compared to the same period last year. This decrease is largely due to

lesser maturities of the t-bills (auction), as banks were reluctant to participate in the 12 months t-bills auctions during Jul-Oct FY09. However, the decrease in interest payments to commercial banks is largely compensated by rise in the interest payments on MRTBs, with its more than Rs 1 trillion debt stock as on October 30, 2009. The debt servicing cost on unfunded debt stood at Rs 98.7 billion registering a growth of 23.0 percent in Jul-Oct FY10. The interest payments on the matured stock of DSCs still constitute a major share in the total interest payments on unfunded debt. On the other hand, the interest payments on SSC and BSC also increased significantly in Jul-Oct FY10. This seems to be consistent with their rising share in total unfunded debt.



6 External Sector

6.1 Overview

Pakistan's overall external account recorded a surplus of US\$ 0.9 billion during Jul-Nov FY10 compared to a deficit of US\$ 5.6 billion in the same period last year (see **Table 6.1**). This improvement owed to both, a marked contraction in the current account deficit and an increase in the financial account surplus.

While all the components of current account recorded YoY improvement, the major impetus came from the contraction in the trade account deficit, which declined by 33.4 percent (see **Figure 6.1**). The entire improvement in the trade account was due to a 21.2 percent fall in the imports as exports continued to weaken, contracting by almost 11.3 percent YoY during Jul-Nov FY10.

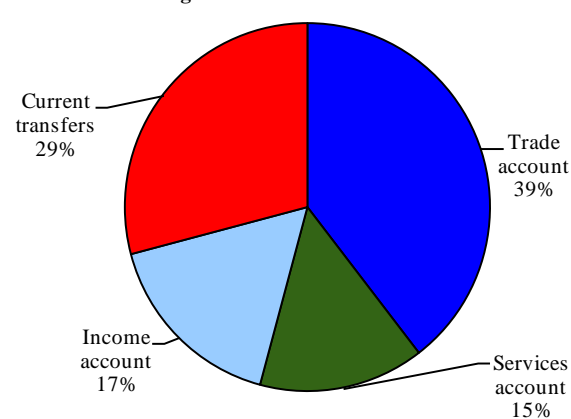
Besides the trade account, services and income account deficits also contracted significantly, reflecting lower economic activity. Specifically, services deficit fell by 40.3 percent mainly

Table 6.1: Summary of External Account (Jul-Nov)

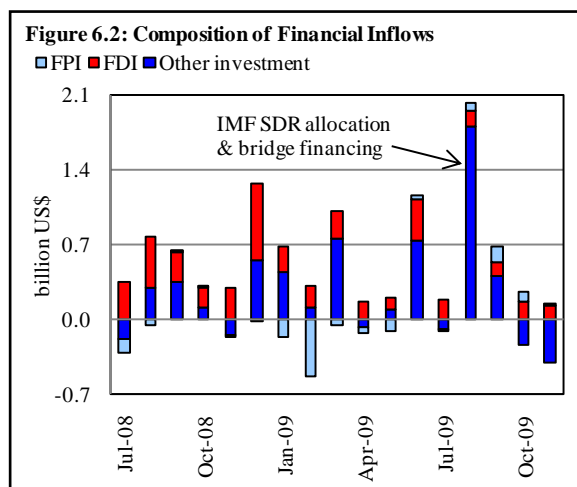
billion US dollar

	FY09	FY10
A. C/A balance	-7.3	-1.4
i) Trade balance	-7.1	-4.7
Exports	8.7	7.7
YoY growth (%)	11.2	-11.3
Imports	15.7	12.4
YoY growth (%)	25.6	-21.2
ii) Invisible balance	-0.3	3.3
Remittances	3.0	3.8
B. Financial/Capital balance	1.9	2.5
i) FDI	1.6	0.8
ii) FPI	-0.2	0.3
iii) Other investment	0.4	1.4
C. Errors & omissions	-0.2	-0.2
D. Overall balance	-5.6	0.9
Foreign exchange reserves (end-period)	9.1	13.7
Spread on Euro bond (percent)	20.0	5.9
Credit rating (end-period)	CCC+	B-

Figure 6.1: Contribution in Current Account YoY Contraction during Jul-Nov FY10



due to fall in imports related transportation charges and lower outflow from foreign exchange companies. Whereas 48.5 percent fall in income accounts deficit was the result of both lower purchases of crude oil and repatriation of profit & dividends. Current transfers on the other hand, remained robust recording 43.9 percent rise on account of both, increase in workers' remittances as well as other transfers.



Financing side also recorded marked improvement with financial account surplus rising by 34.9 percent during Jul-Nov FY10. This improvement was primarily driven by increased inflows from the IFIs (see **Figure 6.2** and **Box 6.1**). Although the net foreign investment contracted by 22.4 percent, net portfolio investment returned to positive territory, contributing US\$ 301 million during Jul-Nov FY10 against a decline of US\$ 182 million in the corresponding period last year. Foreign direct investment, on the other hand, did not show any signs of recovery and declined by 52.3 percent during the period under review.

As a result of improvement in the overall external account, Pakistan was able to rebuild foreign exchange reserves, which reached US\$ 13.7 billion by end-November 2009. It may be recalled that in the corresponding period last year, Pakistan's foreign exchange reserves were under severe stress and had declined to US\$ 9.1 billion. Foreign exchange market also exhibited relative stability and exchange rate depreciated by 2.6 percent during Jul-Nov FY10 compared to 13.3 percent in the corresponding period last year.

Although Pakistan's external position has improved considerably over Jul-Nov FY09, it remains fragile. For one, the contraction in the current account deficit is largely on the back of decline in imports, which may have bottomed out. The rising trend in the international commodity prices and likely recovery in the domestic economy would tend to widen the trade deficit as exports may not be able to stage a significant comeback in the presence of acute power shortages and poor law and order situation.

The nature of improvement in financial account is also a source of concern. Most of the improvement in financial account, as described earlier, is on account of debt creating flows. The repayments of these flows in coming years would put pressure on the current account. Thus improvement in the external position may be short-lived, and has a risk of future sustainability.

Box 6.1: IMF SDRs Allocations

In response to Group of Twenty (G-20) April-2009 call of boosting global liquidity through general SDR allocation, IMF injected SDR 161.2 billion (US\$ 250 billion) to its member countries in August 2009. This allocation was made in fixed proportion (74.13 percent) to SDR quota of member countries. As a result, IMF member countries' SDRs holdings (foreign reserves) have increased simultaneously. Apart from general allocation, IMF has also allocated SDR 21.5 billion (US\$ 34 billion) under special allocation of SDRs in September 2009.

SDR is an interest-bearing international reserve asset and can be turned into usable currencies through voluntary trading agreement with other IMF member countries. This allocation provides members with an additional method to obtain hard currencies. If a member country purchases SDR from another member it will earn interest on the amount excess of its allocation and if a member sells SDR it will pay interest on the amount short of its allocation.

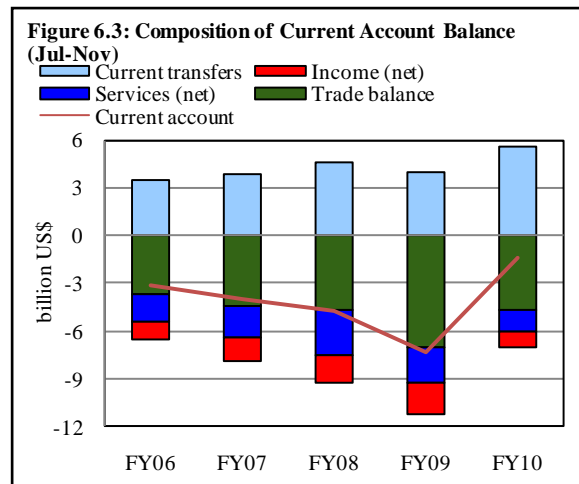
This allocation has no impact on member countries' SDR quota, however, this is broadly based on its relative size in the world economy. Thus member countries voting rights in the organization and access to IMF financing remains unaffected as these are based on SDR quotas.

Pakistan has received SDR 766.3 million (US\$ 1197 million) under general allocation and SDR 52.3 million (US\$ 83 million) under special allocation.

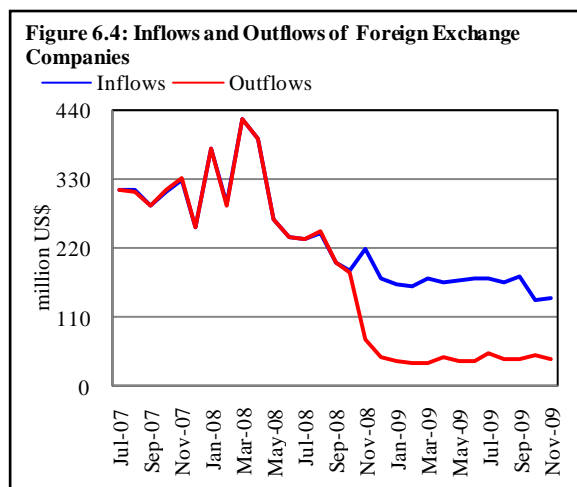
6.2 Current Account Balance

During Jul-Nov FY10, current account deficit declined to US\$ 1.4 billion compared with US\$ 7.3 billion in the corresponding period last year. This is the lowest current account deficit for the Jul-Nov period during the last five years (see **Figure 6.3**).

Contraction in current account deficit during Jul-Nov FY10 was broad based as all sub accounts, i.e., trade, services, income and current transfers recorded improvement during the period.



Decline in trade deficit entirely owed to a large fall in imports (offsetting a smaller reduction in exports), while increase in invisible surplus (services, income and current transfers) mainly reflected higher remittances and higher net inflows through foreign exchange companies (FECs). Moreover, fall in both freight charges and repatriation of profit & dividends also increased invisible surplus during the period.



It may be pointed out that transactions through FECs used to have no impact on current account balance.¹ However, outflow from FECs fell drastically in the wake of various restrictions and action against one of the company. As a result, FECs outflows fell below their inflows November 2008 onward. This, in turn, is having positive impact on current account balance (see **Figure 6.4**). Foreign exchange companies sell the surplus foreign currency in the inter-bank market.

6.2.1 Trade Account²

In sharp contrast to 49.2 percent expansion in Jul-Nov FY09, trade deficit contracted by 33.4 percent during Jul-Nov FY10. This was entirely attributed to 21.2 percent fall in imports that more than offset an 11.3 percent fall in exports during the period under review.

Decline in import growth is contributed by both falling international prices and contraction in domestic demand. The impact of former was more visible in petroleum group imports while the impact of latter was more pronounced in machinery and other raw material import.

¹ Outflows through exchange companies used to be offset by inward home remittance and contra entry as other inflows.

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

Similarly, there was an across-the-board decline in exports. Fall in textile exports is partly attributed to lower unit prices amid subdued demand from US and EU and partly to domestic factors such as energy shortages and poor law & order situation. Likewise, fall in non-textile exports mainly owed to falling international prices of rice and lower production of petroleum products (for detail, see section on **Trade**).

6.2.2 Services (net)

During Jul-Nov FY10, deficit in services trade fell to the lowest level in the corresponding period of last five years. Lower outflow from foreign exchange companies for travel and other business purposes along with lower import related freight payments were the main contributory factors behind this improvement. However, absence of receipts against logistic support offset a part of the gains. Encouragingly, receipts against logistic support are likely to materialize in the months ahead.

6.2.3 Income (net)

After rising continuously in the last six years, deficit in the income account declined considerably during Jul-Nov FY10 (see **Figure 6.5**).

Specifically, the deficit dropped to US\$ 1.1 billion during Jul-Nov FY10 from US\$ 2.1 billion in the same period last year. Although a large part (more than 80 percent) of this fall was contributed by lower investment outflows, fall in net interest payments also contributed positively to overall improvement. During

Figure 6.5: Income Account Deficit Trend (Jul-Nov)

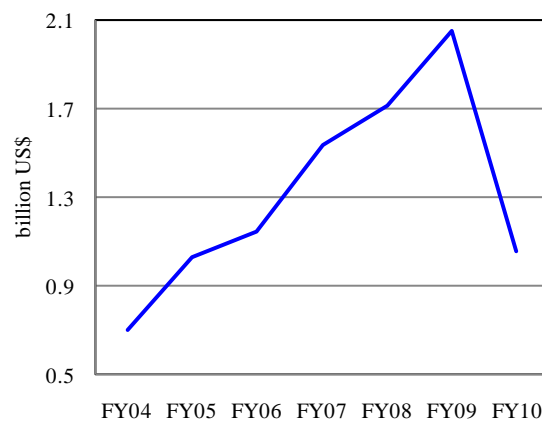
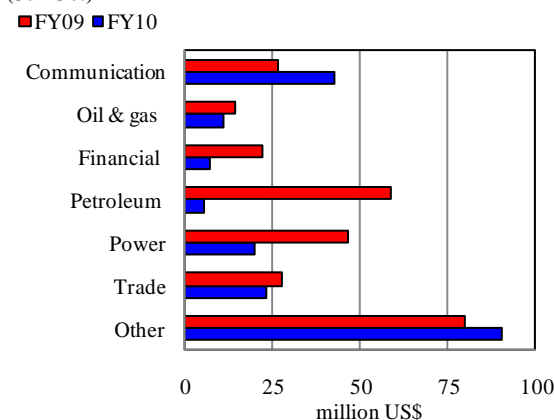


Figure 6.6: Sector wise Repatriation of Profit & Dividend (Jul-Oct)



Jul-Nov FY10, decline in investment income outflow was broad-based as all the major heads like repatriation of profit & dividends, purchase of crude oil & mineral and reinvested earnings recorded large declines. Lower repatriation of profit & dividends and reinvested earnings³ mainly owed to falling profits of most of the sectors. The profits were adversely hit by combinations of factors such as weak economic growth, fall in average prices of oil & gas, circular debt issue, energy crises and deteriorating law & order situation. Sector-wise data shows that almost all the major sectors recorded decline in repatriation of profit & dividends during Jul-Oct FY10 compared with Jul-Oct FY09 (see **Figure 6.6**).

The only exception was the communications sector, where a large privatized company returned to high profitability after successful completion of Voluntary Separation Scheme initiated last year. Likewise, decline in government's purchase of crude oil and minerals mainly showed both lower average gas and oil prices and lower extraction of oil and gas.

Fall in the net interest payment during Jul-Nov FY10 mainly resulted from lower gross payments which more than offset the fall in interest earnings on foreign exchange reserves. The decrease in interest payments, in turn, is contributed by lower payments on both the public and private external debt (see **Table 6.2**).

Decline in net interest payments partly owed to contraction in the stock of Euro bonds debt and partly to lower interest payment on floating debt (one fifth of total public sector debt) on account

Table 6.2: Details of Interest Payments and Receipts (Jul-Nov)

million US dollar

	FY09	FY10 ^P	Absolute change
Payments (I+II)	582.0	299.0	-283.0
I. Total external debt	468.0	250.0	-218.0
Public & publicly guaranteed	400.0	184.0	-216.0
Long-term	291.0	133.0	-160.0
Military	2.0	0.0	-2.0
Euro bonds	89.0	42.0	-47.0
Commercial loans/credits	2.0	5.0	3.0
IDB	14.0	4.0	-10.0
Private loans/credits	50.0	23.0	-27.0
IMF	18.0	43.0	25.0
II. External liabilities	114.0	49.0	-65.0
Foreign currency deposits	39.0	31.0	-8.0
Special US\$ bonds	1.0	0.0	-1.0
Central bank deposits	9.0	4.0	-5.0
Others	65.0	14.0	-51.0
Receipts	83.0	28.0	-55.0
Interest on reserves	40.0	6.0	-34.0
Others	43.0	22.0	-21.0
Net	-499.0	-271.0	228.0

P: Provisional

Source: State Bank of Pakistan

³ For discussion on reinvested earnings, see section on **Foreign Direct Investment**.

of falling LIBOR. However, increase in interest payment on IMF loans offset part of the above-mentioned gains.

6.2.4 Current Transfers

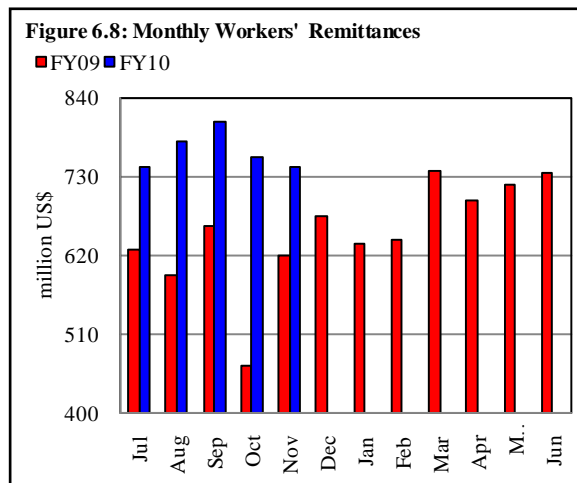
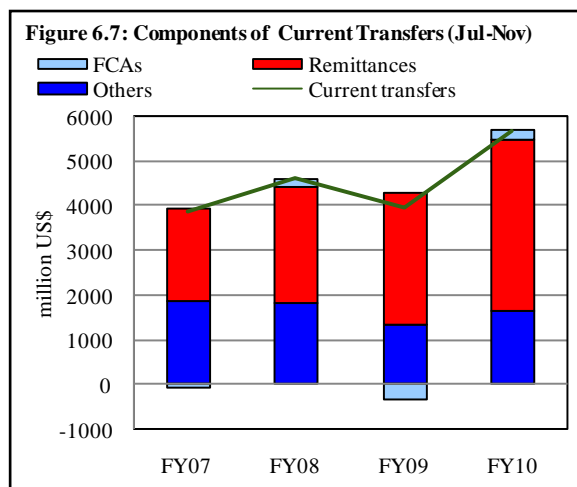
Commendable increase in workers' remittances, revival of inflows in both the Resident Foreign Currency Accounts (FCAs) and other private transfers led to a remarkable increase (43.9 percent) in overall current transfers during Jul-Nov FY10 (see **Figure 6.7**).

While a part of this growth is attributed to lower base set last year⁴, government and SBPs efforts to attract transfers through banking channel also paid dividends.

Workers' Remittances

Following the trend of last five years, workers' remittances showed a tremendous growth (29.2 percent) during Jul-Nov FY10. Monthly data shows that remittances remained higher than the previous year throughout the period (see **Figure 6.8**).

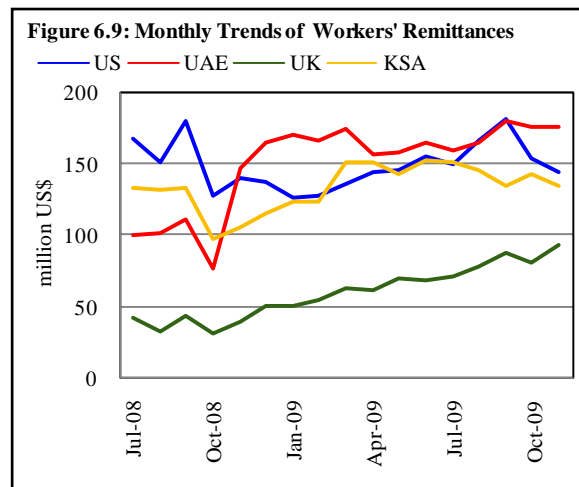
Country-wise data suggests that a large part of this growth was driven by United Arab Emirates (37.0 percent) and United Kingdom (25.4



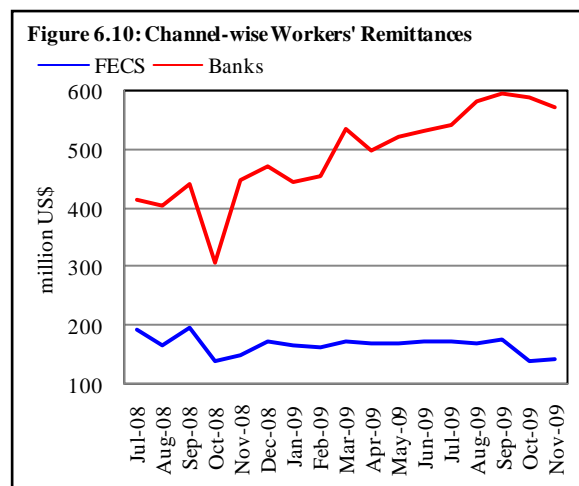
⁴ During Jul-Nov FY09, workers' remittances fell and RFCAs recorded withdrawals amid various rumors about FCAs freeze and substantial pressure on exchange rate.

percent) followed by Kingdom of Saudi Arabia (12.5 percent) (see **Figure 6.9**). The remittances from other countries like USA, Canada, Germany and Australia also exhibited moderate growth during the period under review.

The probable factors behind higher remittance from UAE are: a) diversion of a part of remittance from informal to formal channel as is evident from trend shift following the crackdown on illegal fund transfer, and b) increased outreach of banks having arrangements with overseas entities. Higher remittances from UK, on the other hand, possibly owed to expatriates shift of investment from Dubai to Pakistan in the wake of attractive asset prices here. In addition, increased outreach of banks and diversion of flows to formal channel are also playing their role. Encouragingly, remittance flow from USA is also recovering steadily.



Channel-wise data suggests that remittances routed through banking channel have increased quite significantly while through exchange companies' recorded nominal fall (see **Figure 6.10**). This is because of: a) fear of fund being stuck up in an event of action against the exchange company, as has been the case in past, b) increased competition as like exchange companies banks are also having bilateral tie-ups with the foreign entities and c) lower costs as sending funds through banks is free of charges since central bank reimburses the TT charges to the beneficiary's bank, and d) efforts, such as PRI, to attract funds through banking channel (see **Box 6.2**).



Box 6.2: Incentives for Remittance through Banks

1) Exchange Policy Department of State Bank is encouraging commercial banks to increase outreach. In this back drop, to support and facilitate banks in their diligence process, this Department will provide its input, if any, on the intended draft agreements between banks and other entities both within and outside Pakistan (FE Circular Letter No. 05. May 30, 2008).

2) To protect the beneficiary and remitter from any loss and encourage remittance through banking channel, SBP, Ministry of Finance and Ministry of Overseas Pakistanis jointly launched Pakistan Remittance Initiative (FE Circular No. 04, August 22, 2009).

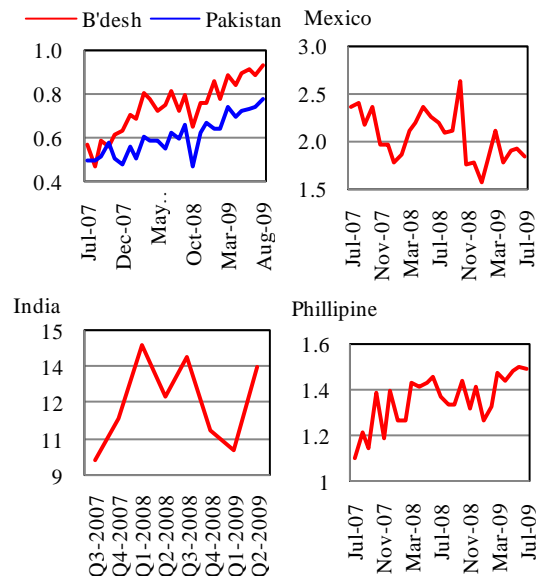
3) In order to encourage overseas entities (having specific home remittance related arrangements with banks in Pakistan) to enhance marketing effort at their end, Government of Pakistan shall reimburse marketing expenses (see **Table 6.2.1**) (FE-circular No 06, dated October 19, 2009).

Table 6.2.1: Incentives for Remittance through Banks

Remittances Mobilized by an Overseas Entity from any One Particular Jurisdiction (in Equivalent US\$)	Marketing Expenses Reimbursement (as % of Remittances Mobilized - in Equivalent US\$)
Up to 100 million	Nil
Above 100 million to 400 million	0.50 percent on incremental amount (i.e., on remittances above 100 million).
Above 400 million to 800 million	0.75 percent on incremental amount (i.e., on remittances above 400 million), plus amount calculated in the above slab.
Above 800 million to 1,200 million	1 percent on incremental amount (i.e., on remittances above 800 million), plus amount calculated in the above slab.
Above 1,200 million	1 percent on total remittances mobilized.

Impact of Global Recession

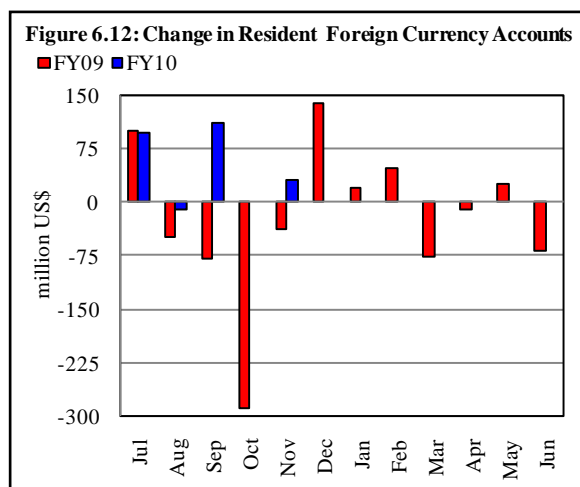
The behavior of remittances from various destinations during the current recession shows relatively higher impact on the remittances of countries with higher migrants stock in North America and Europe (see **Figure 6.11**). On the other hand, remittances to the countries with higher migrant stock in Asia (Middle East in particular) showed resilience. This is because of: a) the migrants in Middle East are low profile and on non permanent basis who remit a major chunk of their income to support their spouses and

Figure 6.11: Country Comparison of Inward Workers' Remittances (billion US\$)

families back home, and b) recession in these countries was not as severe as in the west.

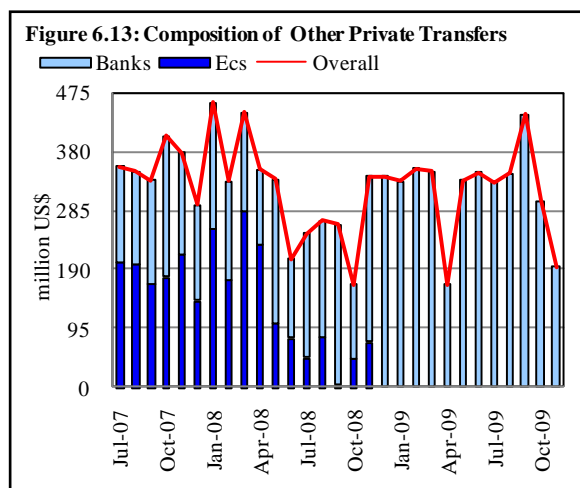
Resident FCAs

Higher enterprises inflows led to US\$ 231 million increase in RFCAs during Jul-Nov FY10 compared with net outflows of US \$ 352 million in the same period last year. Major enterprises inflows during the period included OGDC, KESC and UN mission. Monthly trend of resident FCAs suggests that most of these inflows were concentrated in July and September 2009. It may be pointed out that RFCAs recorded massive outflow during the comparable period last year on account of pressure on exchange rate. However, in the ensuing months stability in exchange rate had revived RFCAs inflows to the great extent (see **Figure 6.12**).



Other Private Transfers

After falling in Jul-Nov FY09, other private transfers recovered noticeably during Jul-Nov FY10. It may be noted that composition of the transfers has also undergone some change in the recent months. In contrast to past trend, when these transfers were routed through both FECs and banks, other private transfers were only routed through banks in FY10 (see **Figure 6.13**). Transfers through FECs fell mainly because of fall in their outflows.⁵ Increase in bank transfers, on the other hand, is



⁵ Other than home remittance inflows of FECs were recorded as contra entry of the FECs outflows in services account.

attributed to sharp increase in RFCAs conversion by other enterprises. This increase in RFCAs conversion coincided with the SBP decision to instruct FECs to close their nostros with banks abroad and shift their balance to RFCAs of banks in Pakistan (see **Box 6.3**). Thus this increase in banks' other transfers may be attributed to increased RFCAs conversion of e FECs.

Box 6.3: Steps to Route Foreign Exchange Companies Inflows through Banks

- 1) All Exchange Companies were required to close all their existing Nostros and bring back the balances held in those accounts into their FCAs in Pakistan. Moreover, all permissible inflows/outflows of exchange companies are to be routed only through FCY Accounts maintained with Commercial Banks in Pakistan (FE Circular No. 04, May 09, 2008)
- 2) Exchange Companies must bring a minimum of 25 percent of foreign currencies exported by them in their FCAs maintained with banks in Pakistan. Out of this, 10 percent is to be sold in interbank market and remaining amount must be withdrawn in cash US dollar from FCAs in Pakistan (FE Circular No. 02, April 29, 2008).
- 3) Minimum 15 percent, instead of earlier 10 percent, of inward home remittance (equivalent US dollar) must invariably be sold in interbank market (FE Circular No. 02, April 29, 2008).
- 4) Exchange companies should make arrangement with those foreign entities which has proper KYC policy, physical presence and affiliated with a regulated financial group (FE Circular No. 01, January 01, 2009).

6.3 Financial Account

Financial inflows revived to greater extent during Jul-Nov FY10, after sharp fall in the same period last year (see **Figure 6.14**). This improvement mainly resulted from increased inflows from IMF and modest revival of foreign inflows to equity market. However, foreign direct investment fell substantially during the period owing to both global and domestic recession along with increasing security risk and continued energy crises.

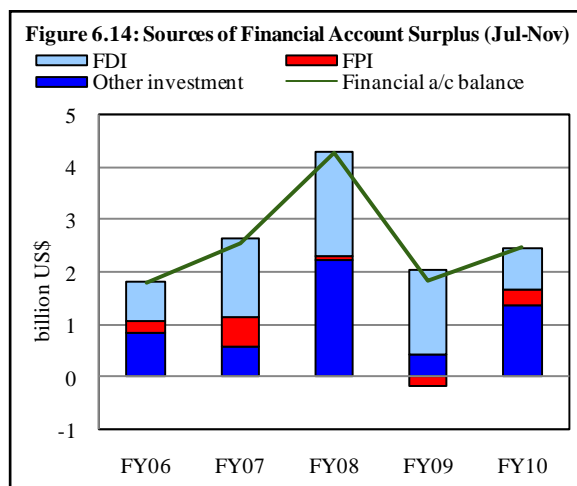


Table 6.3: Current Account Balance (Jul-Nov)

million US dollar

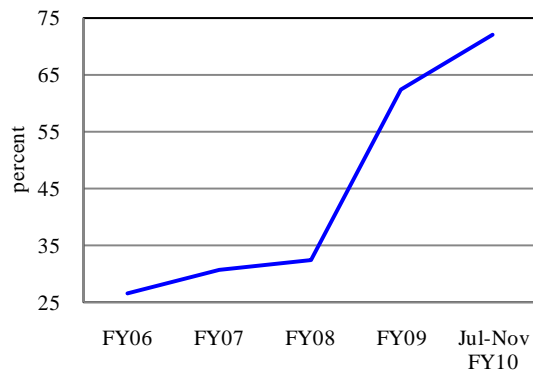
	FY09	FY10^P	Absolute change
1. Trade balance	-7,053.5	-4,697.0	2,356.5
Exports	8,651.5	7,677.0	-974.5
Imports	1,5705.0	1,2374.0	-3,331.0
2. Services (net)	-2,166.0	-1,294.0	872.0
Transportation	-1259.0	-921.6	337.4
Travel	-615.0	-273.6	341.4
Communication services	-14.0	41.0	55.0
Construction services	-14.0	-5.8	8.2
Insurance services	23.0	11.8	-11.2
Financial services	-45.0	29.0	74.0
Computer & information services	38.0	28.0	-10.0
Royalties and license fees	-24.0	-32.0	-8.0
Other business services	-644.0	-276.0	368.0
Personal & cultural & recreational services	0.0	-11.0	-11.0
Government services	429.0	178.0	-251.0
of which: Logistic support	365.0	0.0	-365.0
3. Income (net)	-2,051.0	-1,056.0	995.0
Investment income (net)	-2,056.0	-1,058.0	998.0
Direct investment	-1,433.0	-775.0	658.0
of which: Profit & dividends	-311.0	-213.0	98.0
Purchase of crude oil and minerals	-692.0	-545.0	147.0
Portfolio investment	-235.0	-60.0	175.0
of which: Dividend	-72.0	-48.0	24.0
IMF charges & interest on off. external debt	-327.0	-185.0	142.0
Interest on private external debt	-50.0	-23.0	27.0
Interest on reserves	40.0	6.0	-34.0
Others (net)	-46.0	-19.0	27.0
4. Current transfers (net)	3,953.0	5,688.0	17,35.0
Private transfers	3,868.0	5,657.0	1,789.0
Workers' remittances	2,966.0	3,832.0	866.0
FCA - residents	-352.0	231.0	583.0
Others	1,254.0	1,594.0	340.0
of which: Exchange companies	247.0	0.0	-247.0
Official transfers	85.0	31.0	-54.0
Current account balance	-7,317.5	-1,359.0	5,958.5
P: Provisional			

Importantly, this improvement in financial inflows is difficult to sustain. This is because of: (a) higher inflows from IMF mainly reflects one off SDRs allocation and, (b) inflows in equity markets are uncertain as is evident from their erratic behavior in the past.

Moreover, as a result of higher debt creating inflows, their share in overall financial inflows is on increase (see

Figure 6.15). The shift toward debt flows does not bode well for the medium to long term sustainability of external accounts.

Figure 6.15: Share of Debt Creating Flows (net) in Total Financial Net Inflows



Debt creating flows include IMF loans, SDR allocation and liabilities

6.3.1 Net Foreign Investment (NFI)

Net foreign investment continued declining for the second consecutive year. Unlike the previous year, however, when the decline was broad based; a part of fall in foreign direct investment was offset by higher portfolio inflows during Jul-Nov FY10. As a result, decline in NFI was limited to 25.6 percent during Jul-Nov FY10 against 29.6 percent fall during the corresponding period last year (see **Table 6.4**).

Table 6.4: Net Inflow of Foreign Investment in Pakistan (Jul-Nov)
million US dollar

	FY09	FY10	Growth (%)
Foreign investment	1,457.8	1,085.3	-25.6
I. Private investment	1,474.6	1,092.1	-25.9
Foreign direct investment	1,620.7	774.0	-52.2
Portfolio investment	-146.1	318.1	317.7
Equity securities	-146.1	318.1	317.7
Debt securities	0	0	0
II. Public investment	-16.8	-6.8	59.5
of which: Debt securities*	-16.8	-6.8	59.5

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

Foreign Direct Investment

As in the previous year, foreign direct investment remained under pressure during Jul-Nov FY10. With the recession at global and domestic level, a part of foreign direct investment 'reinvested earnings' was bound to weaken. The affect of recession on foreign direct investment in Pakistan was further exacerbated by

deteriorating law & order situation and energy crises. Fall in reinvested earnings accounted for 32 percent and fall in cash investment around 68 percent of the overall decline (52.3 percent) in foreign direct investment during the period under review (see **Table 6.5**).

Table 6.5: Sector wise Foreign Direct Investment (Jul-Nov)

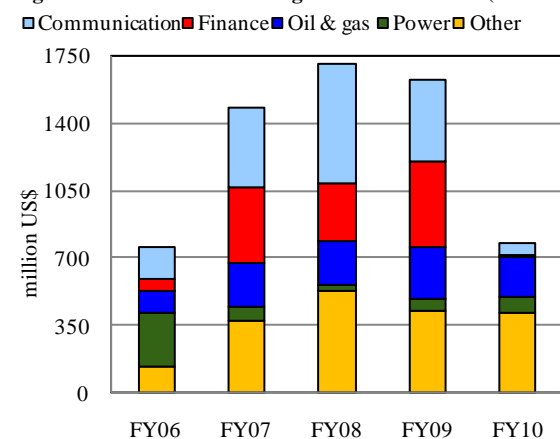
million US dollar

	FY09			FY10		
	Cash	Re-invested earnings	Total	Cash	Re-invested earnings	Total
Chemicals	-1.9	19.5	17.5	35.9	21.0	56.9
Petroleum refining	10.7	28.1	38.8	4.7	15.8	20.6
Oil & gas explorations	183.7	91.9	275.5	154.9	52.4	207.3
Cement	8.0	17.5	25.6	0.1	3.9	3.9
Power	58.3	1.9	60.2	64.0	13.8	77.7
Trade	53.1	20.1	73.1	27.3	6.0	33.3
Telecommunications	329.6	37.1	366.7	97.9	-38.7	59.3
Financial business	309.1	135.0	444.1	19.61	-0.7	18.0
Personal services	47.9	1.7	49.7	18.4	1.7	20.1
Others	192.9	76.4	269.3	260.3	16.5	276.8
Total	1,191.5	429.2	1,620.7	683.2	91.8	774.0

It may be pointed out that during the last three years (FY07-FY09) more than 70 percent of Pakistan foreign direct investment was concentrated in three sectors, i.e., communication, financial business, and oil & gas exploration. With the increase in provisioning costs of financial business and stiff competition in communication, foreign direct investment inflows in these two sectors dried up during Jul-Nov FY10 (see

Figure 6.16). Likewise, foreign direct investment in oil & gas exploration, petro chemicals, pharmaceuticals, cement, and trade also declined. However,

Figure 6.16: Sector-wise Foreign Direct Investment (Jul-Nov)



investment in power sector increased by 28.9 percent during the period. The developments in major sectors are as follows:

Communication

Lower investment in communication sector largely reflected market saturation and losses of some of the companies. Major contributory factors behind fall in profits or higher losses of the business are: a) re-registration of SIMs, b) heavy taxes and SIM activation charges, and c) higher advertisement cost due to stiff competition.

Financial Business

Absence of merger and acquisition and lower reinvested earnings on the back of increase in provisioning costs of banks were the major reasons behind fall in FDI flows to the sector. Moreover, repayment of US\$ 14 million inter-company loan of one of the banks also contributed to lower investment in the sector.

Oil and Gas Exploration

After increasing in Jul-Nov period of five successive years, FDI in oil & gas exploration recorded decline during Jul-Nov FY10. This decline is partly explained by war against terrorism that restricted the operations of OGDC in the NWFP and partly to lower reinvested earnings on account of lower average prices of oil and gas during the period.

Power Sector

Unlike the above sectors, power sector registered a significant growth mainly on account of US\$ 30 million investment in KESC 560 MV project at Port Qasim and US\$ 20 million for Uch power project.

Other major receipts recorded in Packages (Pvt) Limited (paper & pulp) US\$ 80 million and Procter & Gamble Pakistan (chemicals) US\$ 24 million during Jul-Nov FY10.

Country wise data shows that FDI flows from major contributors like USA and UK declined while from UAE and Netherlands increased during the period under review. Other major countries that witnessed decline in foreign inflows included Hong Kong, Japan and Singapore.

Looking ahead, in line with global economic recovery and expected revival in profits, foreign direct investment is likely to increase to emerging markets in the latter part of FY10. This is because of: a) the recent growth rebound is led by emerging economies, and b) relatively low interest rates in developed economies

may encourage capital flows to emerging economies.⁶ In this perspective, addressing structural problems and boosting economic growth in Pakistan is pivotal to attract foreign direct investment once international financial conditions normalize. Moreover, foreign direct investment also needs to be diversified from services sector to manufacturing sector in general and export oriented industries in particular.

Portfolio Investment

In sharp contrast to net outflow of US\$ 182 million during the comparable period of last year, portfolio investment recorded net inflow of US\$ 301 million during Jul-Nov FY10. The entire increase stemmed from higher investment in stock market (see **Figure 6.17**).

This increase was attributed to a series of positive developments like a) re-entry of Pakistan index in MSCI frontier Index, b) IMF augmentation of SBA and SDR allocation, and c) Standard & Poor's upgraded Pakistan sovereign rating from CCC+ to B- while Moody's changed Pakistan's economic outlook from negative to stable. Higher investment in Pakistan's stock market is also in line with international trend. With massive fiscal and monetary stimulus and consequent global liquidity ease, foreign flows to emerging equity markets revived

Figure 6.17: Foreign Investment in Pakistan Equity Market

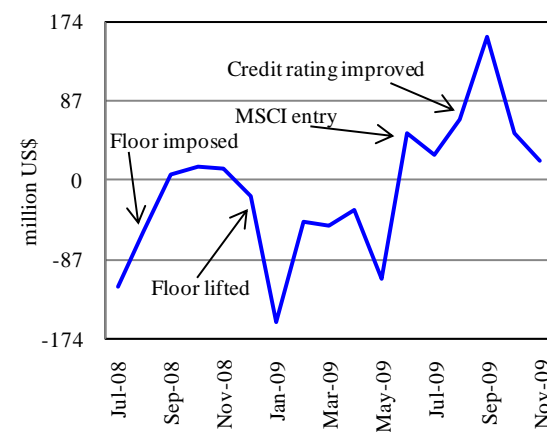
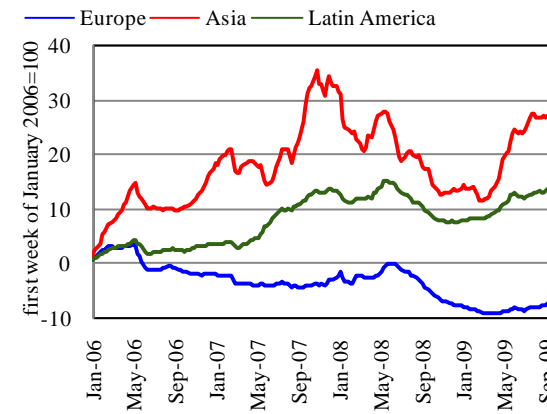


Figure 6.18: Net Foreign Flows to Emerging Economies Equity Markets



⁶ Institute of International Finance Research note on capital flows to emerging market economies (October 3, 2009).

in second quarter of CY09 and further strengthened in third quarter of CY09 (see **Figure 6.18**).

Table 6.6: Performance of Various Sovereign Bonds

value: million US dollar , yield in percent

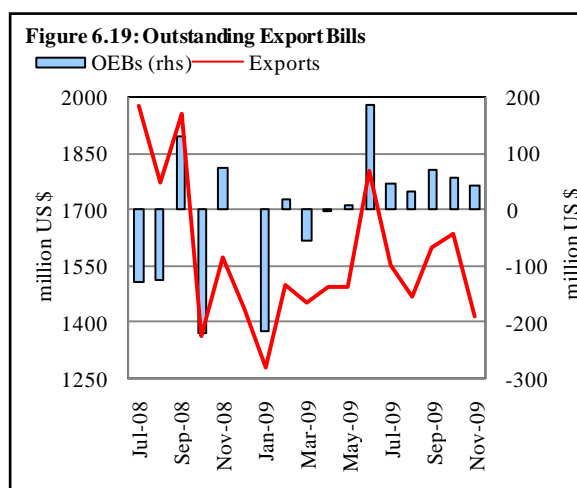
Issue Year	Bond	Tenor	Maturity	Value	Yield at issue	Yield at 30 Jun, 2009	Yield at 30 Nov, 2009
FY06	Euro	10-years	Mar-16	500	7.1	15.3	9.1
FY06	Euro	30-years	Mar-36	300	7.9	15.0	10.5
FY07	Euro	10-years	Jun-17	750	6.9	14.2	9.9
Spread Over US treasury bond							
Issuing date				30-Jun-09	30-Nov-09		
FY06	Euro	10-years	2.4	11.8	5.9		
FY06	Euro	30-years	3.1	10.7	6.3		
FY07	Euro	10-years	1.8	10.7	6.7		

Moreover, like other emerging markets, spread on yield between Pakistan euro bond and US Treasury bond has narrowed, close to the trend but above the rate at date of issue (exceptionally low pre-crises rates) (see **Table 6.6**).

With the narrowing spreads, access of many emerging markets to international capital market has restored. Thus Pakistan may also consider tapping international capital markets, though at higher rates compared with that of previously issued bonds.

6.3.2 Outstanding Export Bills

The stock of aggregate outstanding export bills has increased by US\$ 246 million during Jul-Nov FY10 against decline of US\$ 268 million in the comparable period last year. Monthly data shows that change in stock of outstanding exports bills is in line with export proceeds (see **Figure 6.19**).



6.3.3 Currency and Deposits (Assets)

In sharp contrast to decline of US\$ 123 million during the Jul-Nov period of last year, currency and deposits increased by US\$ 111 million during Jul-Nov FY10. This increase is largely attributed to increase in FE-25 nostros during the period.

6.3.4 Official Long-term Loans

Official long term loans recorded a net inflow of US\$ 986 million during Jul-Nov FY10 against an inflow of US\$ 126 million received during the corresponding period previous year. The improvement mainly emanated from US\$ 745 million from IMF for bridge financing. Along with this, loans receipts of US\$ 151 from ADB for Punjab government efficiency improvement program and US\$ 265 from World Bank under Benazir Income Support program and higher education also contributed. On the payment side, amortizations decreased by US\$ 222 million during the period under review.

6.3.5 Official Short-term Loans

The official short term loans registered net outflow of US\$ 434 million during the period under review. This was mainly due to repayment of US \$ 334 million to Islamic Development Bank during Jul-Nov FY10.

6.3.6 Private Loans

The private loans recorded a net outflow of US\$ 11 million against net inflow of US \$ 147 million during corresponding period last year. During Jul-Nov FY10, private sector recorded an inflow of US\$ 167 million against US \$ 178 million of loans repayments. Major companies that recorded inflows were Warid Telecom (US\$ 19.7million), Wateen Telecom (US\$ 17.3 million) and Engro Energy (Pvt) Limited (US\$ 34 million) during the period under review.

6.3.7 Currencies and Deposits (liabilities)

Currency and deposits increased by US\$ 19 million during Jul-Nov FY10 compared with a decline of US\$ 142 million in the corresponding period last year. This increase was largely on account of lower retirement of trade financing compared to the corresponding quarter of last year. During Jul-Nov FY09, trade financing declined by US\$ 397 million. Nonetheless, in current fiscal year it is only limited to US\$ 41 million on account of exchange rate stability.

Table 6.7: Financial Account (Jul-Nov)

million US dollar

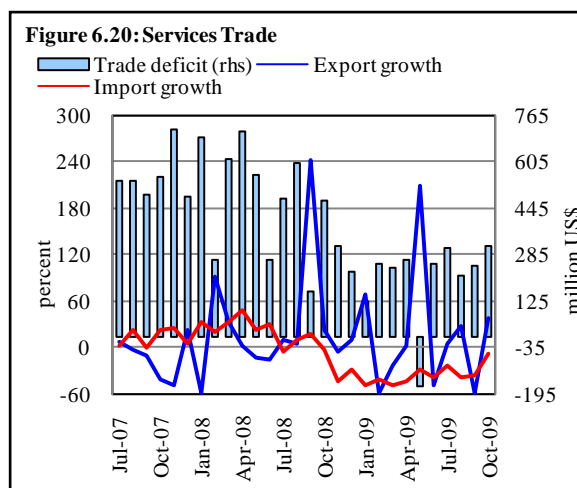
	FY09	FY10 ^P	YoY change (%)
Financial account (net)	1,845.0	2,488.0	34.9
Direct investment abroad	-8.0	36.0	-550.0
Direct investment in Pakistan	1,621.0	774.0	-52.3
Equity capital	1,191.0	614.0	-48.4
of which: Privatization receipts	0.0	0.0	0.0
Reinvested earnings	430.0	160.0	-62.8
Portfolio investment	-182.0	301.0	265.4
Equity securities	-168.0	308.0	283.3
Debt securities	-14.0	-7.0	50.0
Net foreign investment	1,431.0	1,111.0	-22.4
Other investment	414.0	1,377.0	232.6
Assets	391.0	-357.0	-191.3
1. Outstanding export bills (exporters)	123.0	-213.0	-273.2
2. Outstanding export bills (DMBs))	145.0	-33.0	-122.8
3. Currency and deposits	123.0	-111.0	-190.2
of which banks	73.0	-81.0	-211.0
Liabilities	23.0	1,734.0	7,439.1
1. Foreign Long-term govt. loans / credits (net)	126.0	986.0	682.5
Project loans	298.0	284.0	-4.7
Non- project loans	565.0	1,217.0	115.4
Amortization	737.0	515.0	-30.1
2. Private loans	147.0	-11.0	-107.5
of which: Supplier credits	254.0	167.0	-34.3
Suppliers credit repayments	107.0	178.0	66.4
3. Short term capital (official)	-137.0	-434.0	-216.8
of which: IDB (net)	-37.0	-334.0	-802.7
4. Currency and deposits	-142.0	19.0	113.4
5. Other liabilities	23.0	1,174.0	5,004.3

P: Provisional

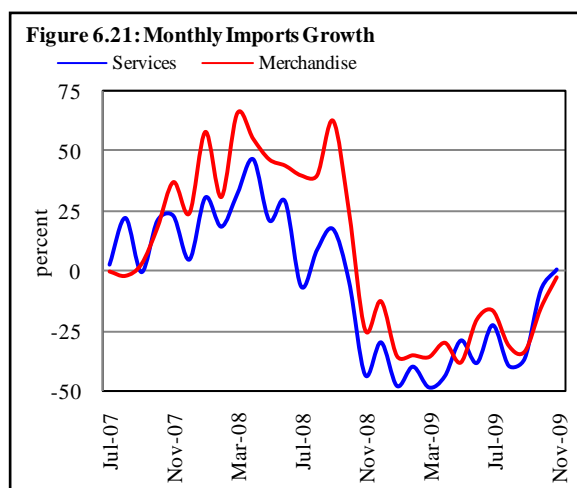
Source: Statistics Department, SBP

6.4 Trade in Services

Continuing the trend of FY09, the services trade deficit contracted considerably by 40.3 percent during Jul-Nov FY10 as compared to a 24.1 percent fall during the same period last year (see **Figure 6.20**). This welcome reduction in services trade deficit is principally due to the decline in services imports which overwhelmed the impact of decline in services exports during the period under analyses.



All major categories of services imports witnessed fall, apart from government services and construction & insurance services (share of these two is negligible in overall services imports). The overall decrease in merchandise imports (see **Figure 6.21**) coupled with the rigorous check on outflows of foreign exchange companies by SBP (see **Box 6.4**) still continued to hold down the services imports.



A part of reduction in services exports growth can be explained by factors such as decline in merchandise exports, lower seat occupancy of Pakistan Airlines, absence of logistic support receipts and fall in information technology services exports during Jul-Nov FY10.

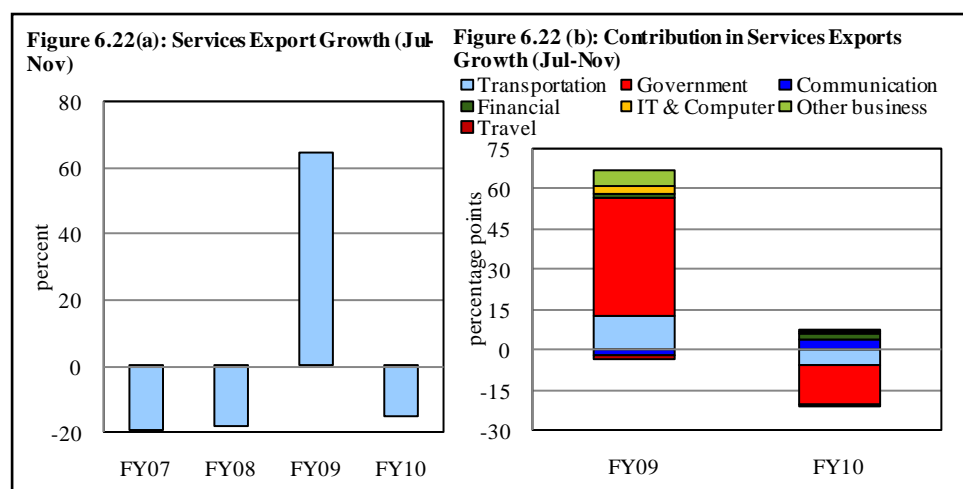
Box 6.4: SBP's Restrictions on Outflows of Foreign Exchange Companies

As a regulator, SBP introduced necessary measures to control the activities in the forex market. During the last eighteen months, SBP has taken many steps to improve monitoring of the activities of exchange companies including the following:

1. Exchange company permissible outflows were restricted to 75 percent of the home remittances mobilized by the company during the preceding month (FE Circular No. 04, May 09, 2008).
2. In addition to US dollar, exchange companies were not allowed to export cash in U.K. Pound Sterling, Euro and UAE Dirhams (FE Circular No. 04, May 09, 2008).
3. All the currency carriers must be employees of the exchange company (FE Circular No. 10, December 12, 2008).
4. It would be compulsory for exchange companies to finalize the deal with overseas entity before the shipment of each export consignment. The system generated deal ticket must be accompanied with the each request for exporting permissible FCYs (FE Circular No. 10, December 12, 2008).
5. All the Exchange companies will be required to take prior approval of State Bank for all transactions of US \$ 50,000 or above (or equivalent in other foreign currencies) on account of outward remittances or sale of foreign currencies to the customers (FE Circular No. 06, July 08, 2008).
6. Exchange companies are also required to report to SBP on daily basis, all transactions of US\$ 5000/- or above (or equivalent thereof) made by the exchange company on account of (i) sale/purchase over the counter and (ii) outward remittances with all related particulars (FE Circular No. 02 . April 29, 2008).

6.4.1 Services Exports

Overall services exports experienced a reduction of 8.6 percent during Jul-Nov FY10 against a remarkable growth rate of 51.2 percent in the corresponding period of preceding year (see **Figure 6.22a** and **Table 6.8**). The decline in the exports of transportation and government services were the primary reasons behind the fall in overall services exports (see **Figure 6.22b**). In contrast to the above mentioned



services groups, travel, telecommunication, financial services and other business services exports showed growth during the first four months of current fiscal year.

Table 6.8: Services Exports (Jul-Nov)

million US dollar

Groups	Absolute Value		Growth (%)		Share (%)	
	FY09	FY10	FY09	FY10	FY09	FY10
Transportation	573.0	478.0	32.6	-16.6	34.9	31.8
Government services	572.0	418.0	168.5	-26.9	34.8	27.8
Other business services	215.0	214.0	36.1	-0.5	13.1	14.3
Travel	87.0	111.0	-18.7	27.6	5.3	7.4
Communication services	36.0	108.0	-39.0	200.0	2.2	7.2
Financial services	27.0	70.0	50.0	159.3	1.6	4.7
Computer & IT.	82.0	77.0	49.1	-6.1	5.0	5.1
Insurance services	31.0	16.0	138.5	-48.4	1.9	1.1
Construction services	9.0	6.0	-40.0	-33.3	0.5	0.4
Royalties and license fees	10.0	3.0	-37.5	-70.0	0.6	0.2
Total exports	1,642.0	1,501.0	51.2	-8.6		

Transportation services exports witnessed a decline of 16.6 percent during Jul-Nov FY10 against an increase of 32.6 percent during the same period last year. The reduction in exports of transportation services is attributing to lower earnings of domestic airlines, falling merchandise exports and declining payments by foreign airlines due to curtailed operations.

The major sub-category 'passage earnings' of domestic airlines which comprise more than half of the overall transportation services exports fell by 5.9 percent during Jul-Oct FY10 compared to 12.9 percent growth in Jul-Oct FY09. The fall in seat occupancy of the international flights of national airlines, probably reflecting the weakness in the global and domestic economies.

Similarly, freight earnings declined by 45.6 percent due to declining exports growth during Jul-Oct FY10. Other local disbursements of foreign airlines and shipping companies fell by 8.6 percent on account of stoppage of flight operations by six gulf-states airlines followed by terrorist attacks in the province of NWFP.⁷ As in the transportation services exports, a decline was also observed in *computer & information services* exports which fell by 6.1 percent during Jul-Nov FY10, (US\$ 3.6 million) compared to 49.1 percent strong growth in the same period of

⁷ These include Saudi Arabian Airlines, Emirates Airlines, Gulf Air, Air Arabia, Etihad Airways and Qatar Airways.

FY09. The noteworthy performance of software consultancy services (YoY growth of 95.4 percent in Jul-Oct FY10) is offset by the decline in other computer services category (YoY fall of 61.1 percent Jul-Oct FY10).

On the domestic front, IT industry is hampered by the issues such as weak enforcement of legal framework, shortage of quality human resource and financing issues. Moreover IT industry has started feeling the taste of global economic slowdown as offshore demand of exports has been declining since FY09, however exports of the category are likely to grow once the demand revives in the advanced economies (the major buyers of Pakistani IT related products).

The global economic downturn has resulted in longer sales cycle, in-sourcing and price pressure. According to CBI⁸, in the coming years, the EU market will take on off-shoring activities to a much larger extent than before the crisis. So, the developing countries service providers must be prepared to tap the upcoming opportunities.

The government on its part is trying to promote IT exports by taking some concrete steps as mentioned in SBP's Annual Report for 2008-09. In this regard, the government has formulated Information and Communication Technology (ICT) task force to promote software exports, development of domestic software/ computer hardware and telecom equipment industry, development of citizen centric applications/services especially in local language, raising quality and enrolment of IT education, make recommendations for the promotion of IT/Telecom sectors, suggest incentives; and estimate the investment requirements for the public and private sector. The ICT task force has submitted a final document on first five years Information Technology (2010-2015) to the Planning Commission. The IT policy should not only be incorporated in Trade Policy but also included in the next five year plan. The ICT task force is also making contingency planning for reducing the impact of global economic recession on Pakistan.

Like services exports, the *government* services exports experienced a decline of 26.9 percent during Jul-Nov FY10 compared to 168.5 percent growth in the corresponding period of preceding year. The volatility reflects the uncertainty in receipts from USA for logistic support to NATO forces in Afghanistan.

However, the performance of non-logistic support is remarkable; it rose by 101.9 percent YoY during Jul-Nov FY10 compared to the decline of 2.8 percent in the

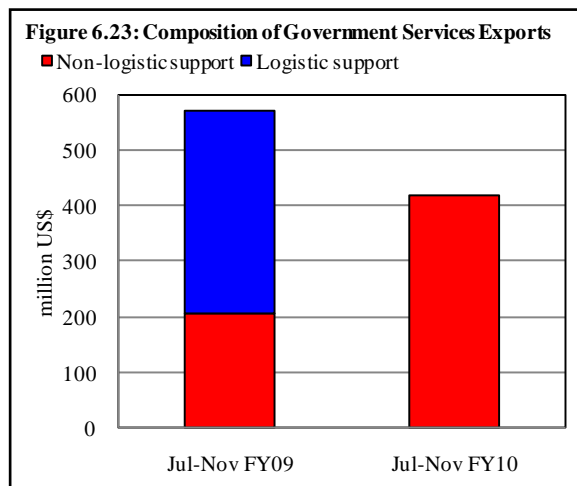
⁸ CBI stands for "Centre for Promotion of Imports from Developing Countries" in EU.

corresponding period last year (see **Figure 6.23**). The notable performance of non-logistic supports services is attributable to the increased remittances of Pak missions from abroad and higher volumes of transfers received by international organizations.

In contrast to decline in the exports of transportation, IT and government services in Jul-Nov FY10, encouraging growth was observed in the exports of communications, travel and financial services during the first five months of the current fiscal year.

Exports of *communication* services recorded an appreciable growth rate of 200 percent during Jul-Nov FY10 compared to the decline of 39 percent during the same

period previous year. The remarkable growth of this category is attributable to the rising exports of telecommunication services through the recognized telecom operators following aggressive action by Pakistan Telecommunication Authority (PTA) against illegal exchanges. As a result, the share of communication services in overall services exports increased to 7.2 percent in Jul-Nov FY10 from 2.2 percent in the corresponding period last year.



Similar to communication services, travel services export performed well in the first five months of current fiscal year. Travel services exports on account of foreign tourists (foreign tourists constitute almost 90 percent of overall travel services exports) recorded 27.6 percent growth during Jul-Nov FY10 compared to 18.7 percent decline in the same period of FY09. This growth however, shows somewhat low base as the incremental amount is only US\$ 24 million in the period under review as compared to the fall of US\$ 20 million in the same period last year. Due to global recession, tour operators have shortened the projects and multinational companies have cut back on business trips & events, which probably reduced the exports of travel services.

The travel industry depends upon its allied industries of tourism and hotel industries, in which Pakistan has a huge potential for both investors and tourists. Revenue growth in the hotel industry has dropped steeply in wake of the global recession and persistent poor law & order situation in some areas of Pakistan.

Other business services

recorded a moderate fall of 0.5 percent during Jul-Nov FY10 as compared to 36.1 percent strong growth in the same period last year. During Jul-Oct FY10, none of the categories has seen a major change apart from refunds on weight loss or claims on price which has seen a fall of 70.7 percent due to lower level of imports during the period under analysis. The gain from refunds is partially offset by declining miscellaneous items which are down by 22 percent during Jul-Oct FY10 as compared to the healthy growth of 84.6 percent in Jul-Oct FY09 (see **Table 6.9**).

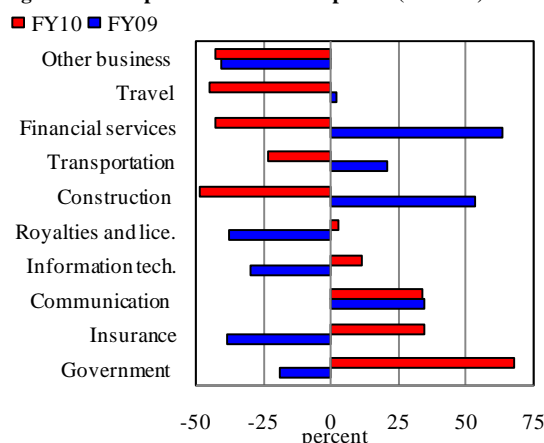
Table 6.9: Other Business Services Exports - Major Items (Jul-Oct)

million US dollar			
	FY08	FY09	FY10
Merchant. & trade related services	14.0	4.5	8.8
Bus. & manag. consultancy	18.0	26.9	29.7
Agency commission	39.6	48.0	50.3
Adv. market research & pub. opinion	6.9	8.1	6.7
Arch., engineering, & technical	7.0	21.5	12.5
Misc. other business services,	48.0	88.7	69.3
Refund	-29.1	-42.9	-12.6
Total	117.0	170.7	173.2

6.4.2 Services Imports

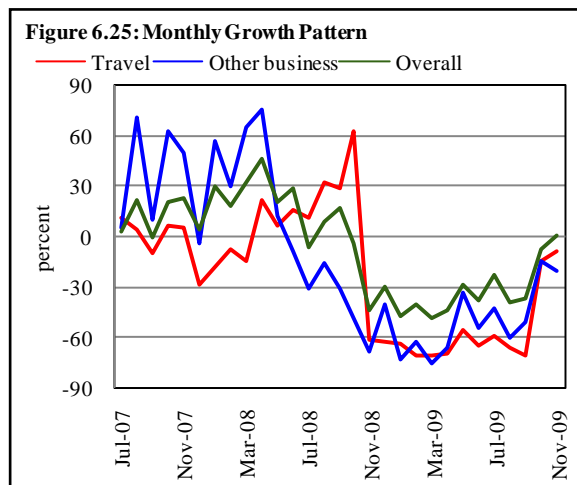
A depressed performance was shown by overall services imports in the first five months of FY10, with a decline of 26.6 percent against the fall of 3.3 percent in the corresponding period of previous year. The decline in the imports was broad based with all major groups (having more than 85 percent share in import services) experienced negative growth with the exception of government services, insurance and communication services groups having about 11 percent share in the overall services imports (see **Figure 6.24**).

Figure 6.24: Imports Growth - Group-wise (Jul-Nov)



Overall services imports declined persistently since October 2008 primarily after the crackdown on the exchange companies as two of the major categories namely travel and other business captured a larger portion of import routed through exchange companies. In fact, any cash selling on the counters of foreign exchange companies used to record as for travel. The same was the case with other business

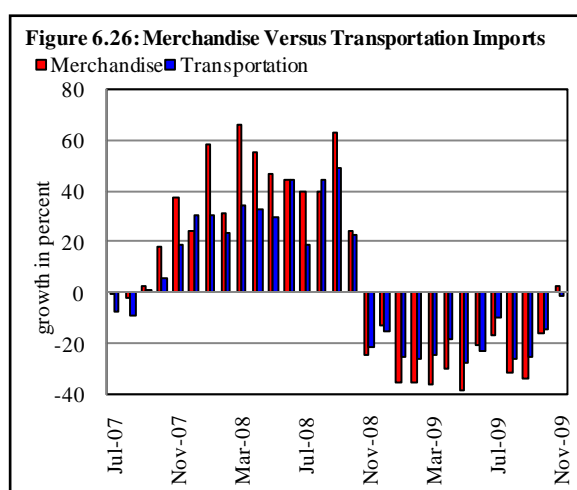
services where both the categories had larger portion under the sub category 'through exchange companies'. SBP's restrictions on exchange companies (see **Box 6.4** and **Figure 6.25**) forced the transactions of foreign exchange companies to be routed through the commercial banks.



The other major factor behind the fall of overall services imports was the falling payments of freight due to declining merchandise imports during the period under analysis.

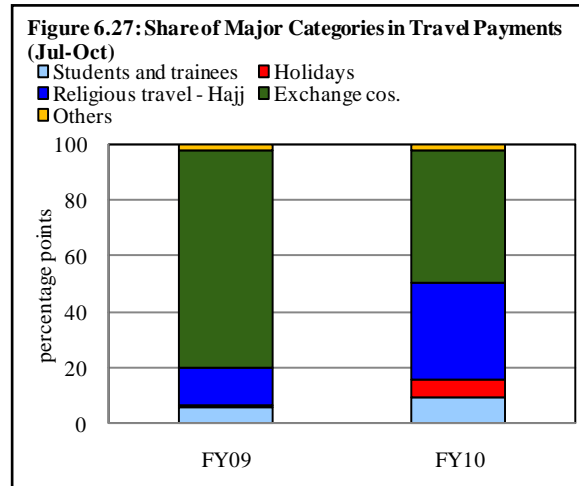
Transportation services imports fell by 23.6 percent during Jul-Nov FY10 compared to the hefty growth rate of 31.8 percent in the corresponding period last year. The decline in imports

of transportation services is attributed to decline in merchandise imports (see **Figure 6.26**) on account of lower freight payments. The payments to foreign airlines also witnessed fall of 27.2 percent during Jul-Oct FY10 compared to 49.2 percent in the same period of previous year. The suspension of flight operations by British, French and Dutch airlines continued to restrict the category's imports.



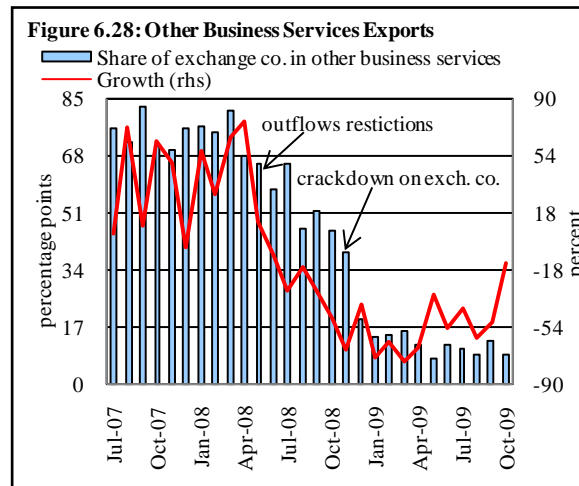
Further, the recent terrorist activities also called for the end of flight operations by six Gulf countries airlines to and from Peshawar.

Similar to transportation, *travel* services imports declined by 45.2 percent on account of outflows restrictions on exchange companies during the period under consideration as compared to the growth rate of 3.2 percent in Jul-Nov FY09. As a result, share of exchange companies in travel services imports declined to 46.5 percent in Jul-Nov FY10 from 72.7 percent in the corresponding period last year (see **Figure 6.27**).



However, payments under the religious travel (Hajj) increased by 1.0 percent during Jul-Nov FY10. A part of this increase might be due to the higher numbers of pilgrims and rise in compulsory Hajj dues.⁹

Further, the increase in the category of *holiday on recreational tours abroad* probably reflects the shifting of the local tourist from northern areas to international tourism on the back of operation against terrorist and shifting of payments through formal channel.



⁹ The number of pilgrims is estimated to increase by 5000 and compulsory Hajj dues are increased by 100 Saudi Riyals.

As in travel services imports, the *other business* services also experienced a fall of 43.0 percent during Jul-Nov FY10 compared to the decline of 38.9 percent in the corresponding period of previous year. Other business services recorded fall for 17 consecutive months. Since the outflows restrictions by SBP on exchange companies initiated from May 2008, the other business services are falling continuously. The share of exchange companies was nearly 90 percent in early 2008 in overall other business services imports which gradually came down to under 10 percent (see **Figure 6.28**).

The outflows restrictions on foreign exchange companies made them to use the formal channel through their accounts with commercial banks. Interestingly, the absolute decline in overall business services imports is explained by an equivalent decline in foreign exchange companies (see **Table 6.10**).

Going forward, services trade deficit is likely to contract further on the basis of increase in services exports and decline in services imports. The rise in services

Table 6.10: Other Business Services Imports (Jul-Nov)

million US dollar			
	FY08	FY09	FY10
Merchant services	4.2	4.1	6.1
Charter of ships without crew-operating leasing	0.1	0.0	11.7
Legal services	18.0	11.4	3.3
Business & management consultancy, and public relations	12.7	25.1	25.2
Agency commission	64.1	64.3	71.5
Adv., market res., & public opinion poll.	11.6	3.1	4.8
Research and development services	0.8	1.0	0.6
Architect., eng., and technical services	18.2	68.4	63.2
Payments to journalists	0.0	1.4	0.1
Technical fees to foreigners	176.3	209.8	212.4
Miscellaneous services, n.s.e.	35.1	63.5	68.2
Exchange companies	1,060.7	425.0	49.0
Refund	-14.2	-29.2	-26.8
Total	1,395.1	858.8	490.0
Absolute difference in total amount		-536.2	-368.8
Absolute difference payments through FECs		-635.7	-376.0

exports is expected on account of more logistic support and good performance of communication services in the ensuing months. Further services imports growth

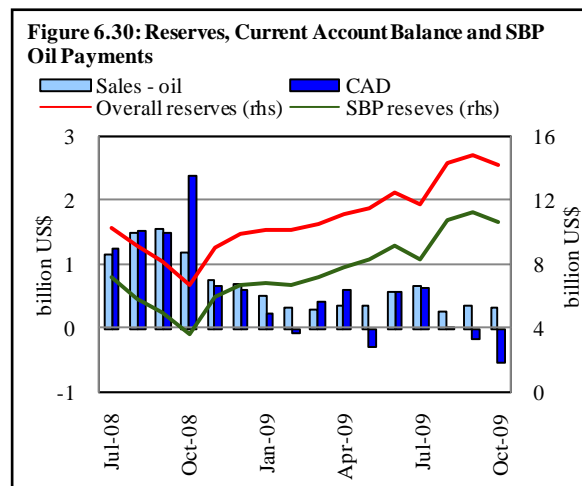
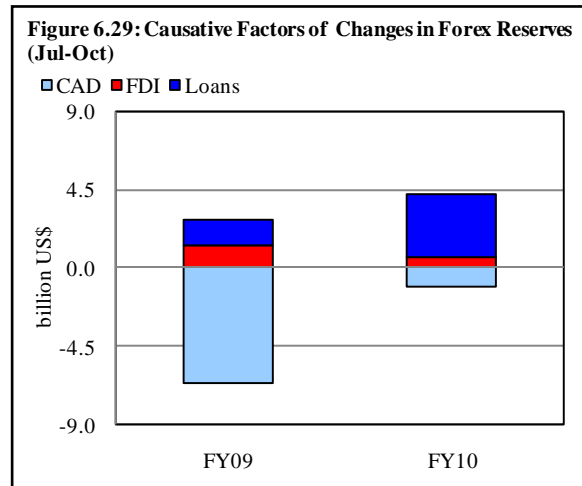
is likely to remain subdued due to outflows restrictions on foreign exchange companies.

6.5 Foreign Exchange Reserves

The reserve position during Jul-Nov FY10 benefitted from a combination of substantial increase in financial inflows and fall in current account deficit (see **Figure 6.29**). As a result, Pakistan's total foreign exchange reserves increased to US\$ 13.7 billion by end-Nov 2009.

The increased inflows and lower outflows decreased the need for SBP market interventions compared to the same period last year. Since most of the SBP interventions were oil related, the gradual shifting of the same to inter-bank resulted in marked decline in SBP's market support (see **Figure 6.30**). Specifically, market support for oil payments declined from US\$ 6.1 billion in Jul-Nov FY09 to US\$ 1.9 billion in Jul-Nov FY10.¹⁰

In contrast to SBP reserves, which increased by US\$ 1.0 billion during Jul-Nov FY10, scheduled banks' reserves increased marginally by US\$ 300 million compared to US\$ 293 million in the corresponding period last year.



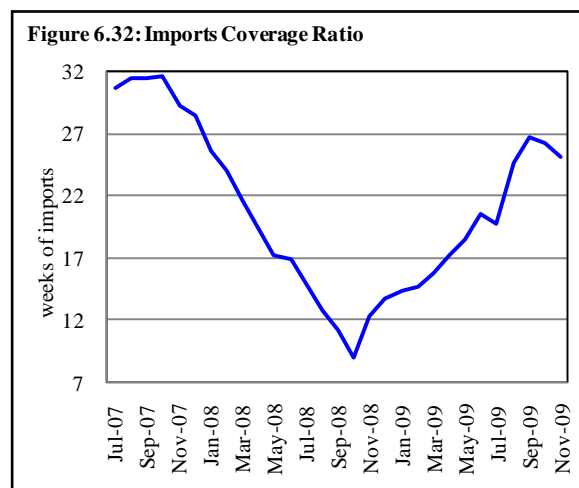
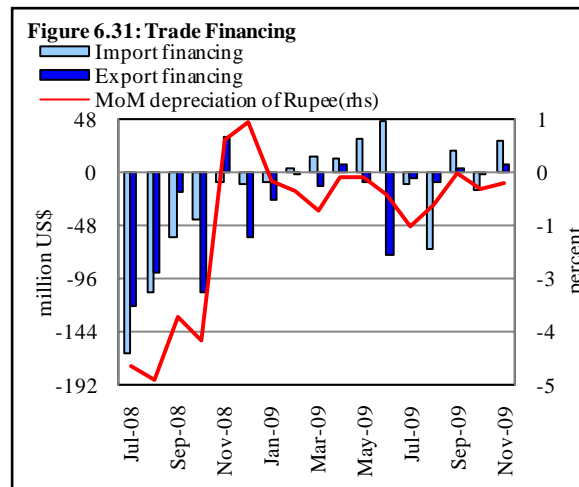
¹⁰ According to SBP F.E. Circular 03 dated July 15, 2009, with effect from August 01, 2009, in addition to furnace oil, all purchases of foreign exchange related to imports of diesel and other refined products shall be made by banks from inter-bank market. SBP further discontinued the support payments for crude oil from December 14, 2009 onwards.

Scheduled banks reserves were constrained by not only shifting of the oil payments to the inter-bank but also due to lower retirement of trade loans against FE-25 deposits.¹¹ During Jul-Nov FY09, weakening rupee along with strong expectations of further depreciation had resulted in retirement of US\$ 685.7 million. In Jul-Nov FY10, both export and import financing declined reflecting: a) fall in the economic activity, as well as, b) decline in the interest rate differential between the foreign and domestic currency lending rates. As a result, retirements also declined to US\$ 51.5 million (see **Figure 6.31**).

6.5.1 Reserve Adequacy

Fall in the import bill coupled with build-up of foreign exchange reserves substantially improved Pakistan's reserve adequacy in terms of weeks of imports coverage. Specifically, import coverage ratio

increased from 12.5 week as of end-Nov 2008 to 25.2 weeks in November 2009 (see **Figure 6.32**).



¹¹ When banks lend foreign currency loans their foreign assets fall with corresponding increase in the domestic assets, when these loans are retired it has the opposite impact.

6.6 Exchange Rate

Owing to the relative improvement in economic fundamentals, Pakistan's currency vis-à-vis US dollar depreciated by only 2.6 percent during Jul-Nov FY10 compared to the sharp decline of 13.3 percent in the corresponding period last year (see **Figure 6.33**).

Depreciation of rupee despite the improvement in the overall external account

position signifies pressures in the forex market as most of the inflows leading to improvement in overall foreign reserves were received directly by SBP (e.g., IMF disbursements). Although, scheduled banks benefited from the rise in remittances, but the impact of increase in remittances was offset by the shifting of significant part of the oil payments to the interbank market. Continued trade deficit also kept the forex market tight as is evident from the overdrawn nostros of commercial banks.

Kerb market premium, however, remained insignificant during the period of analysis (see **Figure 6.34(b)**). SBP's restrictions on outflows from FECs were the major reason behind the lower demand of foreign exchange through FECs that

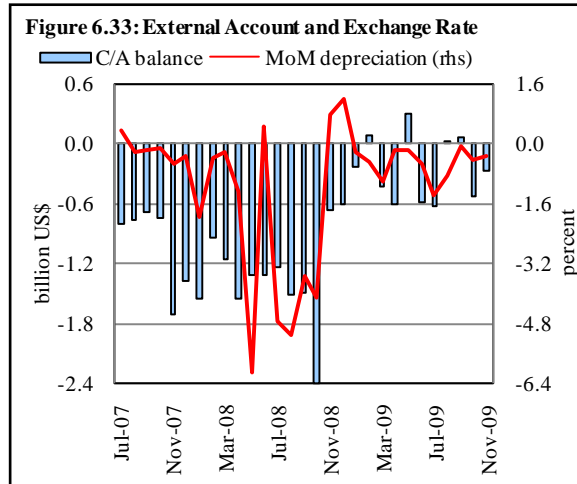


Figure 6.34 (a): Role of Expectations

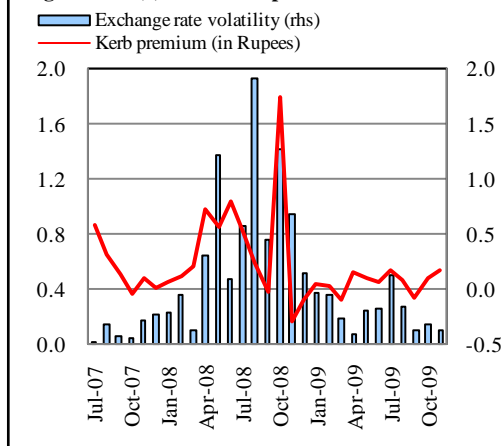
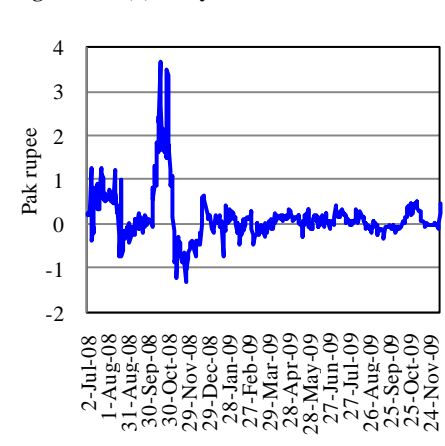


Figure 6.34 (b): Daily Kerb Premium



kept the kerb premium within a narrow band.

The rise in the kerb premium from mid October to mid November 2009 may be attributed to increased demand of hard currency for Hajj related expenses.

In nominal terms, Pakistan's currency depreciated by 5.8 percent against the basket of currencies. Higher nominal depreciation against basket of currencies compared to US dollar is attributable to the weakness of US dollar against major currencies during Jul-Oct FY10 (see **Figure 6.35**).

A large part of this gain, however, was offset by the relatively higher inflation in Pakistan compared to its trading partners and competitors, i.e., RPI rose by 4.4 percent. Consequently, real effective exchange rate (REER) depreciation was limited to 1.6 percent during Jul-Oct FY10 (see **Figure 6.36**).

Figure 6.35: Movement of US Dollar Against Major Currencies (Jul-Nov)

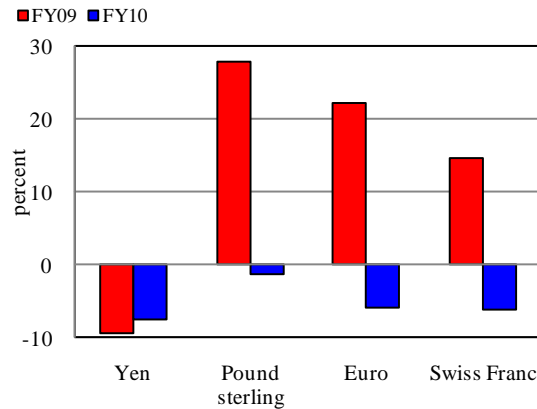
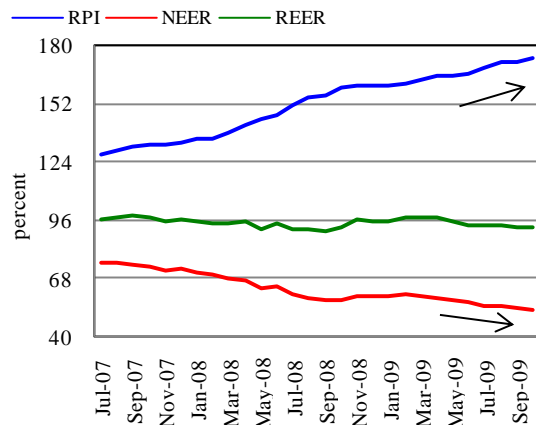


Figure 6.36: Changes in NEER, REER and RPI

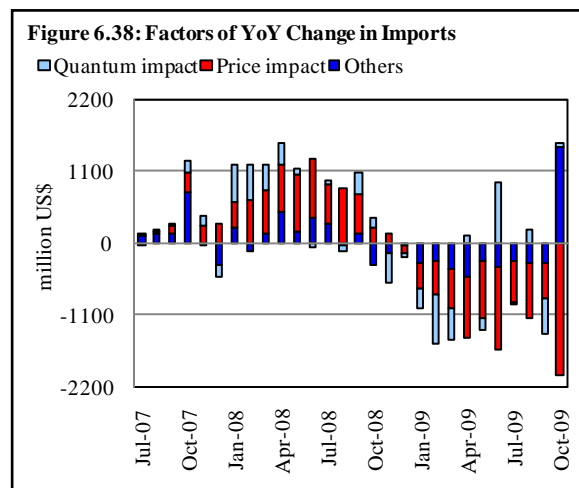
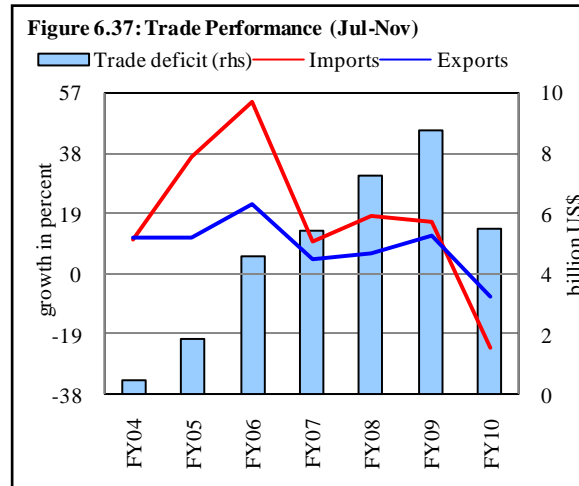


6.7 Trade Account

Pakistan's trade deficit declined significantly by 37.8 percent YoY during Jul-Nov FY10 in contrast to 20.8 percent rise in the same period last year. The decline in trade deficit was entirely due to 23.0 percent YoY fall in the import bill as exports continued to decline, recording 7.4 percent YoY fall (see **Figure 6.37**).

The contraction in imports was a result of combination of restrained demand, better domestic production of some key commodities (wheat and cotton), as well as fall in the international commodity prices. Of these, however, the impact of the fall in the international commodity prices was the strongest (see **Figure 6.38**).

Similar to imports, the fall in exports was also broad-based (see **Figure 6.39**). Growth in all the main categories either further declined or turned negative. Both the star performers of FY09, rice and cement, posted negative growth during Jul-Nov FY10. Rice exports suffered due to fall in prices as international supply conditions improved. Cement exports on the other hand declined owing to fall in demand during Jul-Nov FY10.



Although overall textile group exports declined further by 3.2 percent compared to 3.0 percent in the corresponding period last year, exports of raw cotton and cotton yarn posted significant positive growth during Jul-Nov FY10.

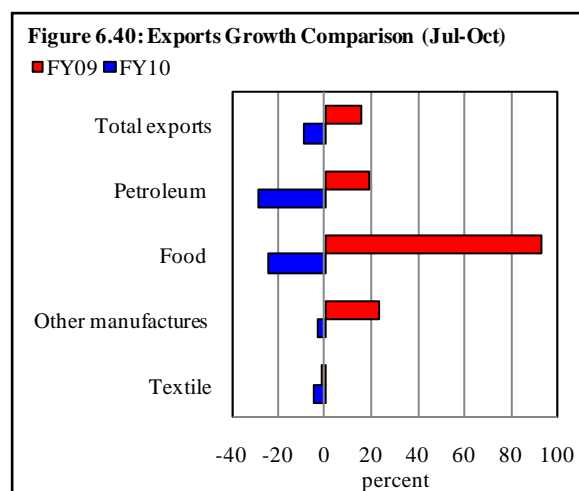
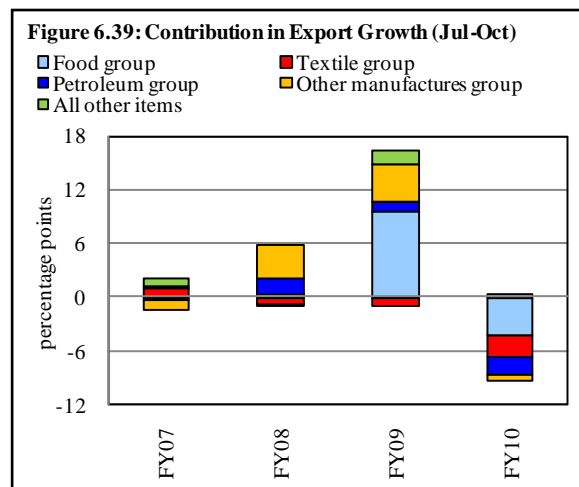
Even though there are some signs of global economic recovery, exports are likely to remain under pressure owing to persistent domestic issues like infrastructural constraints, particularly energy supply shortage and poor law & order, etc.

Imports on the other hand, are expected to increase following the rise in international commodity prices, recovery in domestic demand and shortages of some key commodities.

Thus it appears that, the fall in trade deficit has probably bottomed out, and there is a likelihood that it will start to widen again in the remaining months of FY10.

6.7.1 Exports

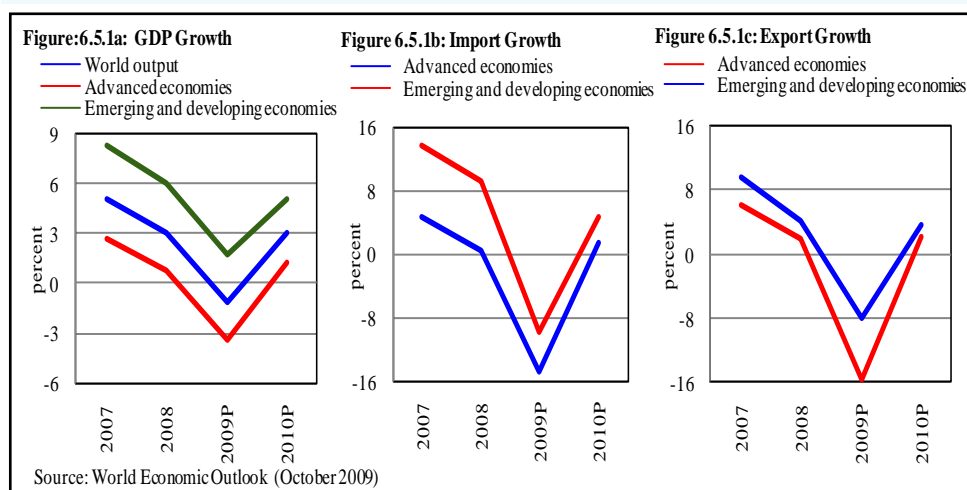
External and domestic factors that hampered export growth in the second half of FY09, persisted during Jul-Nov FY10. As a result, exports fell by 7.4 percent YoY during Jul-Nov FY10, compared to a decent growth of 12.0 percent during Jul-Nov FY09. Analysis of the export performance of major groups reveals that domestic power crisis, circular debt issue, low international prices and compression in external demand were the main factors



behind sluggish growth of exports during Jul-Nov FY10. Resultantly, exports of food, textile, petroleum, as well as other manufacturers group declined during the period under review (see **Figure 6.40**). Although external demand is expected to recover (see **Box 6.5**), timely resolution of internal constraints is imperative to foster exports growth.

Box 6.5: Prospects for Trade of Regional Economies as Global Economic Indicators Improve

Global trade recorded a significant contraction in 2008 as the world economy remained in the corridor of uncertainty. The recession that hit the world's developed countries spilled over to emerging and developing economies owing to globalization and market integration. The intensity of the impact of falling world incomes on emerging and developing economies' exports was evident in H2-CY08 and H1-CY09 as exports plummeted.



Although exports of all regional economies were battered due to slowdown in external demand, Pakistan was particularly unfortunate, as internal supply constraints further hampered exports and macroeconomic instability left little room for fiscal or monetary stimulus. Imports also contracted owing to falling domestic demand amid declining consumer and investor confidence.

The good news is that both domestic and global economic indicators are improving. The latest World Economic Outlook (October 2009) reports that the global economy is finally on the path of recovery and offers upbeat projections for the year ahead. (see **Figure 6.5.1**). Trade prospect for all, developed, emerging, and developing economies, indicate a rise in the trade volume of both imports and exports.

A lot depends on textiles

According to the Asian Development Outlook (September) 2009 Update¹², forecasts 'a modest improvement in growth during FY10'. However growth in the case of Pakistan would depend on both internal policies and global economic developments. Key determinants will be oil prices and

¹² <http://www.adb.org/Documents/Books/ADO/2009/Update/pak.pdf>

performance of the major trading counterparts. Industrial revival is imperative. The pace of growth in textile demand will be very important as the sector constitutes over 50 percent of overall exports. How Pakistani exports compete in this scenario will depend much on timely resolution of internal constraints, such as the power crisis and banks' liquidity.

Food Group exports fell by 22.5 percent during Jul-Nov FY10. The fall in rice exports, which has 60 percent share, was the main reason for the negative exports in food group. Export proceeds from *rice* fell by 30.9 percent owing to fall in international rice prices as quantity exported increased compared to the same period last year.

Table 6.11: Major Exports (Jul-Nov)

million US dollar

	Unit	FY09		FY10(P)		Abs.Δ val	% YoY Δ		
		Value	Unit value	Value	Unit value		Qty	Value	Unit value
Food group		1,453.7		1,127.6		-326.1		-22.4	
of which									
Rice	MT	1,012.2	915.8	699.2	597.3	-313.0	5.9	-30.9	-34.8
Textile group		4,343.2		4,203.8		-139.4		-3.2	
of which									
Cotton yarn	MT	498.8	2,361.7	590.0	1,971.3	91.2	41.7	18.3	-16.5
Cotton fabrics	SQM	949.6	976.0	665.7	1,061.7	-283.9	-35.6	-29.9	8.8
Knitwear	DOZ	826.7	17.1	764.5	16.2	-62.2	-2.3	-7.5	-5.4
Bed wear	MT	755.5	5,328.4	701.0	4,975.3	-54.5	-0.6	-7.2	-6.6
Towels	MT	287.9	3,790.4	270.6	3,417.2	-17.3	4.2	-6.0	-9.8
Readymade garments	DOZ	510.0	40.0	521.7	46.8	11.8	-12.5	2.3	16.9
Synthetic textiles	SQM	110.3	0.8	205.5	1.0	95.2	59.9	86.4	16.6
Other textile made- up		212.5		210.0		-2.5	---	-1.2	---
Other textile material		92.1	---	126.4	---	34.3	---	37.3	---
Petroleum group		471.8		357.0		-114.8		-24.3	
Other manufactures		1,614.7		1,521.8		-92.8		-5.8	
of which									
Chemicals/pharma		280.3	---	269.9	---	-10.4	---	-3.7	---
Molasses	MT	42.9	100.0	16.7	119.1	-26.2	-67.4	-61.1	19.2
Cement	MT	264.5	64.4	215.9	79.4	-48.6	-33.8	-18.4	23.3
All other items		334.1		399.2		65.1		19.5	
Total exports		8,217.9		7,609.5		-608.4		-7.4	

P: Provisional

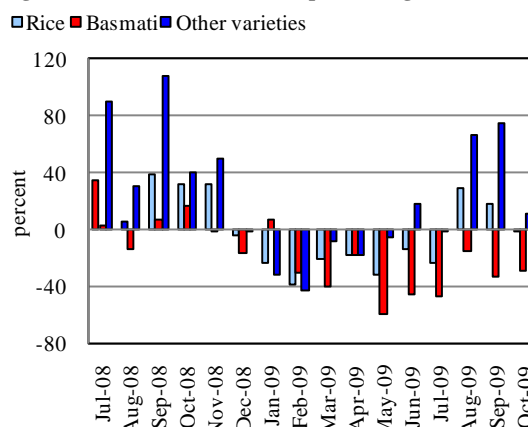
While exports of basmati and non-basmati rice declined, the fall in basmati was more prominent (see **Figure 6.41**).¹³ State Bank on its part has relaxed the financing facility available to rice exporters to ease some of their problems.¹⁴

Textile group exports declined by 3.2 percent during Jul-Nov FY10 as compared to a fall of 3.0 percent during the same period last year. The export of low value added products, i.e., raw cotton and cotton yarn showed some recovery but high value added products, except for readymade garments continued depicting a dismal performance.¹⁵

Raw Cotton and *cotton yarn* exports increased during the period under review amid early arrival of crops and better production. Pakistan Cotton Ginners Association data suggests that this season, the number of bales sold to exporters increased by 192.1 percent by end-November 2009.¹⁶ Moreover, due to ample availability of raw cotton for domestic use, import of raw cotton also exhibited a negative growth during the period under review.¹⁷

Cotton fabric exports declined by 29.9 percent YoY during Jul-Nov FY10 as Pakistan is losing its lower price advantage due to persistent rise in cost of production. High cost of production has led to increasing unit values; resultantly

Figure 6.41: Quantum of Rice Export (YoY growth)



¹³ Lower yield of basmati rice is compelling the growers to focus on production of Irri and other non-basmati rice. As a result, export of Irri and other varieties in particular rose substantially during the period under review.

¹⁴ SMEFD Circular Letter No. 16, dated November 25, 2009; the SBP has decided that rice exporters will now get financing up-to 100 percent instead of 85 percent of the value of firm export order/contract/letter of credit and will be required to make shipments equivalent to 100 percent instead of 117 percent against refinance available for 270 days from the export of eligible commodities under Part-I (pre-shipment). This relaxation will be available to rice exporters for FY10.

¹⁵ Raw cotton export surged by 107.4 percent while yarn export increased by 18.3 percent during Jul-Nov FY10.

¹⁶ According to Pakistan Cotton Ginners Association data, 25.1 percent YoY growth in number of bales was observed by end-November 2009.

¹⁷ Import of raw cotton dropped by 51.4 percent YoY during Jul-Nov FY10.

the export quantum failed to increase.¹⁸ Fabric exports, however, could revive in coming months as anecdotal evidences suggest that Bangladesh is expected to allow its garment manufacturers to import Pakistani fabric from January 2010.¹⁹

Readymade Garments exports also exhibited signs of improvement, registering 2.3 percent growth during Jul-Nov FY10 as compared to a negative growth of 15.9 percent during Jul-Nov FY09. Readymade garments were adversely impacted by compression in external demand during FY09. However, external demand is likely to revive due to higher Christmas sales in the US and EU in FY10 compared with FY09; the major importer of Pakistan's readymade garments products. Anecdotal evidence, on the other hand, indicates that exporters are facing difficulty in fulfilling these orders due to continuing power shortages and rising cost of production.

Knitwear exports declined by 7.5 percent YoY during Jul-Nov FY10 compared with a modest growth of 1.7 percent during the same period last year. *Bed wear* exports dropped by 7.2 percent YoY during Jul-Nov FY10 despite the removal of anti-dumping duties imposed by EU. Tough competition from regional economies is hampering knitwear and bed wear exports.

Towel exports declined by 6.0 percent during Jul-Nov FY10 compared to a decent growth of 22.4 percent during the same period last year. Unit value of towel is persistently declining since April 2009 as the demand for the same has not picked up in the key markets.

Although external demand from developed countries is projected to revive in upcoming months, internal issues are still hindering Pakistan's textile exporters. Similarly, although liquidity conditions have eased, but power crisis and deteriorating law & order conditions of the country is hampering the performance of the textile sector.

To foster textile exports, the government has formulated the first ever textile policy with the aim to realize the sector's true potential. A Textile Investment Support Fund has also been proposed for modernization of machinery and technology, infrastructure development, skill development, marketing and the use of information and communication technology. However realization of these proposals is yet to take effect.

¹⁸ Unit value of cotton fabric increased by 13.0 percent YoY during Jul-Nov FY10.

¹⁹ Bangladesh having the GSP-plus status from EU had the facility of duty free export to EU, but the facility was limited to exporters who were using local fabric. However, Bangladesh has agreed in principle to import Pakistani fabric.

Other manufactures group export declined by 5.9 percent YoY during Jul-Nov FY10 compared with a positive growth of 18.9 percent during Jul-Nov FY09.

Leather garments export dropped by 15.9 percent during the period under review amid low international demand and domestic issues such as lack of preservation technologies, poor infrastructure, security issues, lack of skilled labor and power crisis.²⁰ Tough competition from regional economies is also hitting the leather sector. Realizing the importance of this sector, an Export Investment Support Fund has been proposed for upgrading production, designing facilities and installing flaying machines.²¹ The incentives announced in the Trade Policy are, however, yet to be implemented.

Cement exports fell by 18.4 percent during Jul-Nov FY10 compared to a remarkable growth of 97.3 percent during Jul-Nov FY09 as export quantum fell well below the 2 year average (see **Figure 6.42**).²² Export proceeds from cement dropped amid increased competition and fall in demand in neighboring countries of Afghanistan and India. Saudi Arabia also lifted ban on its cement exports, the move is likely to

Figure 6.42: Quantum of Cement Export

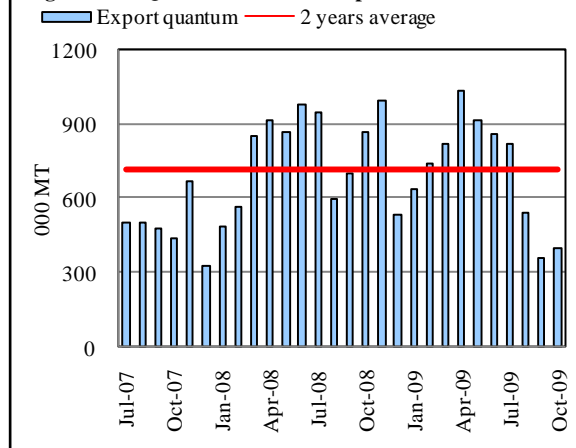
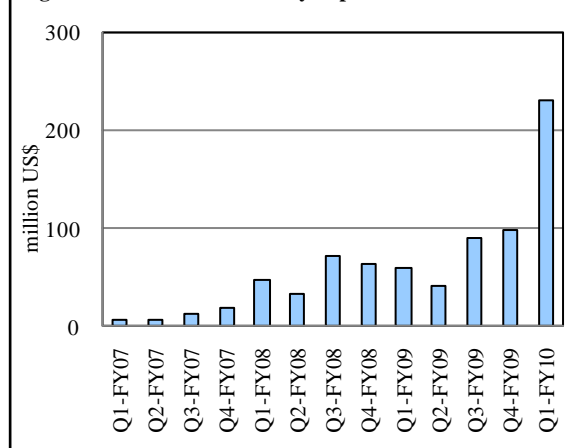


Figure 6.43: Value of Jewellery Exports



²⁰ Demand for leather gloves in particular declined owing to slowdown in global auto and steel industry.

²¹ <http://www.commerce.gov.pk/Tradepolicy.asp>

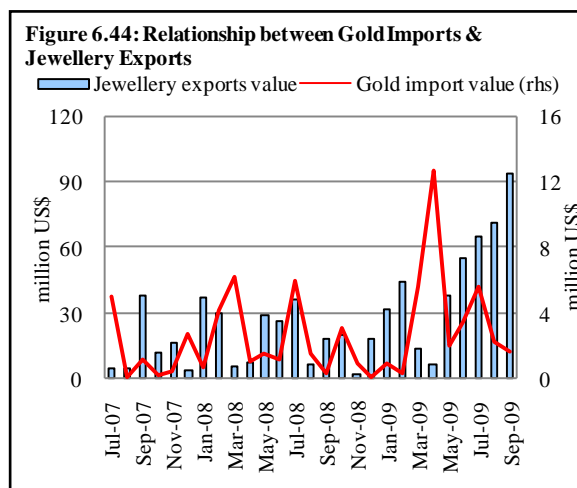
²² However, All Pakistan Cement Manufacturers Association data shows 12.8 percent increase in export dispatches during Jul-Nov FY10.

give tough competition to Pakistan cement exporters as Saudi Arabia has an advantage of low transportation cost. The Middle East, with almost 20 percent share in total cement exports has remained one of the most important markets for Pakistan; however Saudi Arabia, due to its geographical proximity could capture Pakistan's share in Middle East and Africa.

Jewellery exports posted an extraordinary growth of 221.8 percent YoY during Jul-Nov FY10 compared to 9.6 percent in the corresponding period last year (see **Figure 6.43**).²³ Exemption of GST on imports and local supply of platinum, palladium, diamonds and precious stones coupled with surge in gold prices induced bullish sentiment in jewellery exporters. Moreover, Pakistan Gems and Jewellery Development Company facilitated the exporters by conducting and participating in seminars and exhibitions in order to promote and explore new markets for Pakistani products.²⁴

It is pertinent to mention that to export gold jewellery, minimum value addition in imported gold is imperative: a) 4.0 percent on plain gold bangles and chains, b) 6.0 percent on other plain jewellery, and c) 9.0 percent on studded or embedded jewellery.²⁵

However, a mis-match between the reported gold imports and jewellery exports exists. Monthly analysis shows that jewellery exports are rising but import quantum of gold is declining (see **Figure 6.44**). Anecdotal evidence suggests that part of non-value added gold export is being smuggled from a neighboring country facing trade restrictions.



²³ Strategic Trade Policy Framework 2009-12.

²⁴ PGJDC participated in Hong Kong Jewellery & Gem Fair in Wan Chai, Hong Kong dated 23-27 September 2009.

PGJDC participated in the 44th Bangkok Gems & Jewelry Fair 2009 dated 15-19 September.

PGJDC organized 7th Gem Bazaar at Gem Exchange, Namak Mandi, Peshawar dated 17th August, 2009.

²⁵ S.R.O 266(I)/2001 dated 7th May 2001, Ministry of Commerce, Government of Pakistan.

6.7.2 Imports

Falling import price coupled with decline in the quantities imported led to 23.0 percent YoY contraction in the import bill during Jul-Nov FY10, compared to 16.4 percent YoY rise in the corresponding period last year.

Fall in the prices of petroleum group was particularly sharp and alone contributed to 43.5 percent fall in the overall import bill. In overall terms, around 64 percent of the fall in import bill was on account of decline in the international commodity prices.²⁶

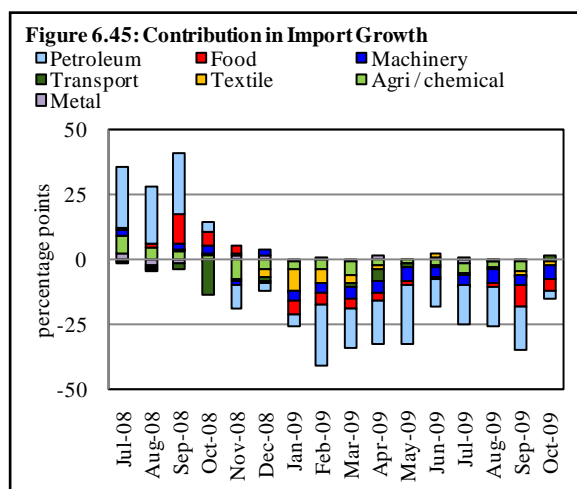


Table 6.12: Composition of Fall in Imports (Jul-Nov)

million US dollar

	FY10			FY09		
	QI	PI	Total change	QI	PI	Total change
Petroleum crude	724.5	-1,380.3	-655.8	57.7	1,036.8	1,094.5
Petroleum products	-137.4	-903.9	-1041.3	-246.8	856.7	609.9
Raw cotton	-138.3	-15.2	-153.4	-98.3	60.6	-37.7
Fertilizer manufactured	42.3	-6.5	35.9	-224.5	123.9	-100.6
Palm oil	58.9	-225.5	-166.7	-101.8	170.2	68.4
Wheat	-747.3	0.8	-746.5	884.0	-155.7	728.3
Plastic material	-16.6	-50.6	-67.2	-81.3	79.8	-1.5
Total imports	-183.0	-2,539.8	-3,905.0	2.0	2,384.0	2,389.6

²⁶ Total Price and quantum impact is calculated for 21 items of imports, which had 50 percent share in total imports during the period under review. Main categories excluded are transport and machinery group.

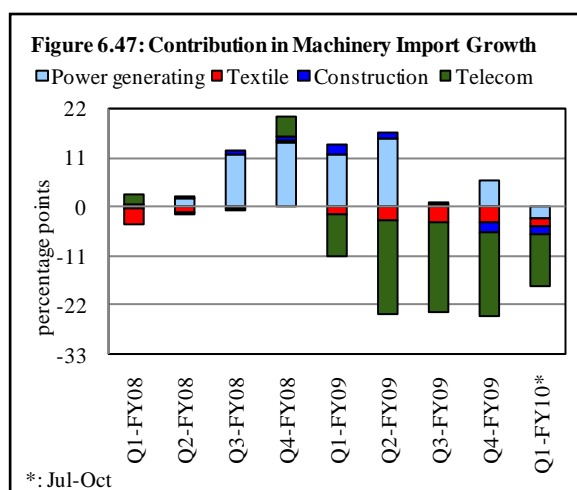
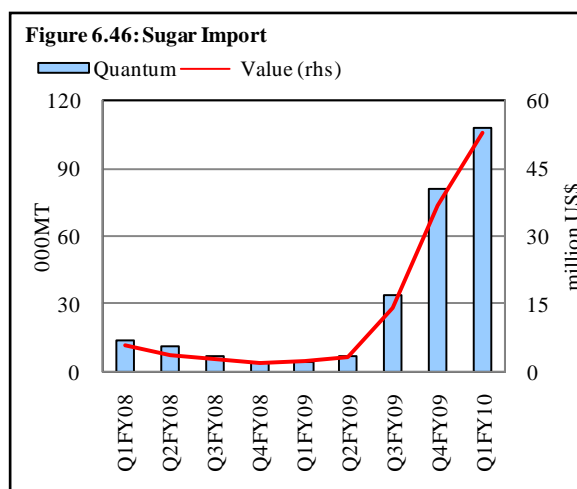
Similarly, a large number of categories witnessed compression in import demand during Jul-Nov FY10, as reflected by substantial negative quantum impact compared to last year when rise in quantity also added to the import bill (see **Table 6.12**).

Food, transport, machinery, textile, petroleum, agriculture and other chemical, metal, and miscellaneous groups showed contraction during the period under review (see **Figure 6.45**).

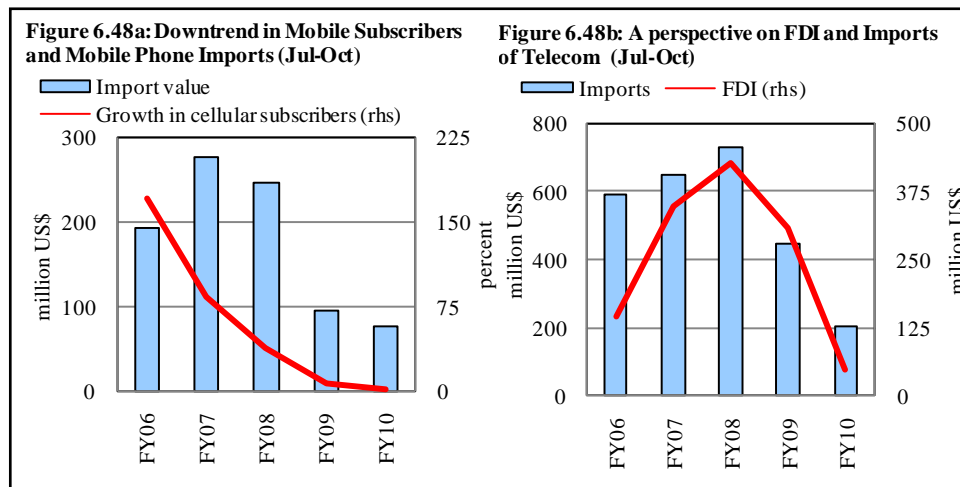
Food group imports fell by 35.5 percent YoY during Jul-Nov FY10 with largest fall recorded in wheat. Imports of wheat fell by 97.0 percent amid better domestic production of wheat. Palm oil and soya bean oil import also observed contraction of 26.2 and 77.7 percent on the back of falling international commodity prices.²⁷

On the other hand, import of sugar increased substantially during the period under review (see **Figure 6.46**). Import of sugar may continue to rise as domestic shortage of sugar is likely to persist.

Machinery Group import fell by 26.4 percent during Jul-Nov FY10 with largest fall registered by the telecom group (see **Figure 6.47**). The declining trend of telecom imports in both the categories of mobile phones and telecom apparatus



²⁷ Palm oil unit value fell by 32.5 percent during Jul-Nov FY10.

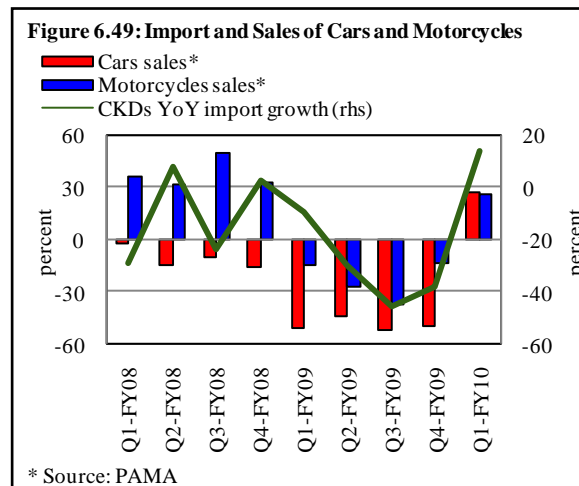


continued for the fifth consecutive quarter despite relaxation in import duties.²⁸ The fall in telecom group imports probably reflects cellular market saturation also evident from falling growth in subscriber base and FDI (see **Figure 6.48**)

Import of power generating machinery dropped by 10.1 percent during Jul-Nov FY10, due to subdued demand from both, the household and non-domestic sector. Pile-up of inventories by importers in the previous year also contributed to fall in the power generating machinery imports.²⁹

Transport group imports decreased by 4.6 percent during Jul-Nov FY10.

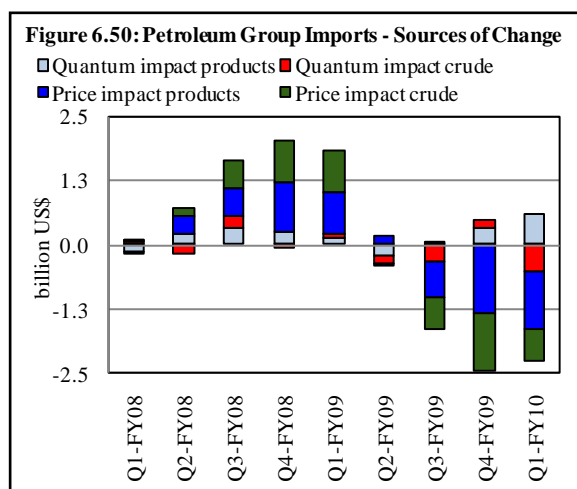
However, some signs of recovery were observed in completely knocked-down (CKDs) kits of motor cars and motor cycles as import of these categories surged



²⁸ The budget for FY10 introduced a 50 percent reduction in sim activation charges and reduction of custom duty from Rs 500/set to Rs 250/set.

²⁹ The growth of gas turbines and parts of gas turbines declined by 43.0 and 73.0 percent YoY respectively during Jul-Oct FY10.

by 35.2 and 107.8 percent during Jul-Nov FY10. The introduction of new models in CY09 and rise in agriculture income revived the demand for cars and motor cycles. As a result, the sales of motor cars and motorcycles also surged during the period under analysis (see **Figure 6.49**). Improvement in production & sales of motor cars and motor cycles also resulted in increased demand for *rubber tyres and tubes*.³⁰



Petroleum group imports dropped by 31.0 percent amid falling prices and quantity during Jul-Nov FY10 (see **Figure 6.50**). Besides the fall in international oil prices, the low import of crude oil could also be attributed to the ongoing circular debt issue, which resulted in the decline in quantity of crude oil imports.

Decline in international prices was however, the major factor for the fall in imports of petroleum products during Jul-Nov FY10 compared with the massive growth observed during Jul-Nov FY09 (see **Table 6.13**). However, petroleum products import rose in terms of quantum.³¹ Motor Spirit (MS) and furnace oil (FO) sales rose amid high domestic demand. Power crisis and dependence on

Table 6.13: Analysis of Imported Petroleum Products (Jul-Oct)

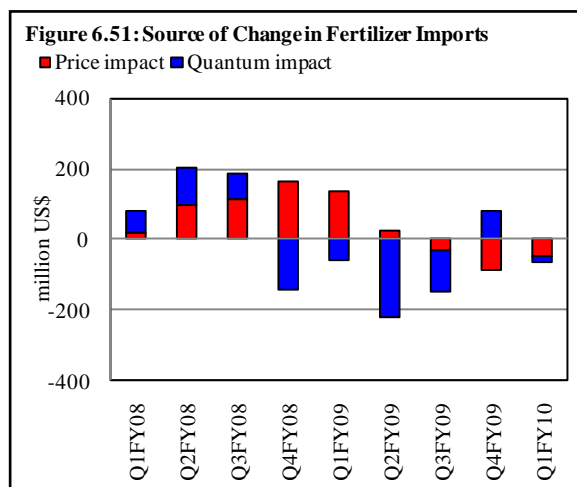
in percent							
Product	Share			Growth		Contribution in POL imports	
	FY08	FY09	FY10	FY09	FY10	FY09	FY10
Furnace oil	37.4	34.6	50.4	93.7	11.2	19.3	2.1
High speed diesel oil	38.3	46.8	37.8	156.2	-38.4	32.9	-9.8
Motor spirit	1.0	3.0	5.7	568.2	43.8	3.0	0.7
Kerosene type jet fuel (JP I)	0.6	1.2	4.2	344.9	167.4	1.1	1.1

³⁰ Import of rubber tyres and tubes posted a positive growth of 4.0 percent during Jul-Nov-FY10 as compared to a negative growth of 25.9 percent during the same period last year.

³¹ Furnace oil imports in terms of quantum increased by 71.5 percent YoY during Jul-Oct FY10.

thermal power generation resulted in increased demand for furnace oil.³² On the other hand, lower price differential between CNG and MS increased the demand for motor spirit.

Fertilizer imports increased by 10.4 percent during Jul-Nov FY10 in contrast to 22.6 percent fall during the comparable period of last year. This increase was entirely driven by higher quantum imports as fall in international prices translated into lower unit values (see **Figure 6.51**).³³ Quantum rose by 12.3 percent YoY during Jul-Nov FY10 whereas import value increased by 20.7 percent YoY during the period under review.



³² Sales of motor spirit and furnace oil increased by 37.8 and 26.1 percent YoY during Jul-Sep FY10.

³³ Domestic production of urea remained 259 (000 tonnes) while DAP production remained 323 (000 tonnes) during *Kharif* 2009.

Table 6.14: Major Imports (Jul-Nov)

million US dollar

	Unit	FY09		FY10(P)		Abs.Δ val	% YoY Δ		
		Val	Unit Val	Val	Unit Val		Qty	Val	Unit Val
Food group		2,000.5		1,290.2		-710.2	---	-35.5	-
of which									
Wheat	MT	769.5	393.9	23.0	408.9	-746.5	-97.1	-97.0	3.8
Palm oil	MT	637.2	1070.8	470.5	723.8	-166.7	9.2	-26.2	-32.4
Machinery		2,947.6		2,168.9		-778.7	---	-26.4	---
of which									
Power generating		694.2		624.0		-70.2	---	-10.1	---
Telecom		507.5	---	246.7	---	-260.8	---	-51.4	---
Transport group		556.7		531.1		-25.5	---	-4.6	---
of which									
Road motor vehicles		431.1	---	431.4	---	0.3	---	0.1	---
Aircrafts/ships,		121.5	---	98.7	---	-22.8	---	-18.8	---
Petroleum		5,475.9	772.7	3,778.8	481.2	-1,697.1	10.8	-31.0	-37.7
Petroleum	MT	3,046.4	769.1	2,390.6	487.6	-655.8	23.8	-21.5	-36.6
Petroleum crude	MT	2,429.5	777.2	1,388.2	470.7	-1,041.3	-5.7	-42.9	-39.4
Textile group		734.0		574.1		-159.9		-21.8	
of which									
Raw cotton	MT	298.4	1,743.9	144.9	1,578.8	-153.4	-46.3	-51.4	-9.5
Agricultural & other chemical		2,520.4		2,298.6		-221.8		-8.8	
of which									
Fertilizer	MT	345.2	549.0	381.0	539.9	35.9	12.3	10.4	-1.7
Other chemicals		1,393.2	---	1,090.3	---	-302.9		-21.7	
Metal group		1,033.6		912.5		-121.0		-11.7	
of which									
Iron & steel scrap	MT	226.3	311.9	170.1	280.1	-56.2	-16.3	-24.8	-10.2
Miscellaneous		299.6		248.2		-51.4		-17.2	
All other items		1,423.9		1,284.3		-139.5		-9.8	
Total imports		16,991.7		13,086.7		-3,905.0		-23.0	

P: Provisional

Special Section 1: Carbon Trading: An opportunity for Pakistan

SS1.1 Background

There is an international consensus that global warming has significantly jeopardized the sustainability of atmosphere essential for economic and social development. Food and water scarcity, increase in coastal floods, and deterioration in health emanating from spread of diseases are some likely repercussions of global warming. Therefore extensive measures are required to reduce Green House Gas (GHG) concentration to cope with global warming.¹ According to the United Nations Inter-governmental Panel on Climate Change (IPCC), GHG emission needs to be reduced by 60-80 percent from the level of 1990s to stabilize the global temperature. The Kyoto Treaty (KT) in 1997 presented a global consensus that increasing global atmospheric temperature may be a serious threat to global economic development and therefore needs to be monitored and controlled. An effort was made to convert this consensus into legal binding through the creation of Kyoto Protocol (KP) in 2005. However, only 35 countries (western and eastern Europe, Canada and Japan, etc.) have ratified the protocol while a vast majority has only accepted or approved² the protocol.

Under the Kyoto Protocol, developed countries have been given a binding target of reducing combined GHG emission by 5.2 percent³ from the level of 1990s during the period 2008-2012. This was mainly due to the fact that developed countries are contributing more to the global current stock of GHG concentration. On the other hand, flexibility has been extended to developing countries by not putting any cap on their carbon emission level. This flexibility shows the realization at international level that developing countries lack resources and capacity to monitor climate change. However, greater vulnerability of developing countries⁴ to climate change cannot be ignored due to high population growth, poor health status, and incapability of coping up with natural disasters like flood and earthquakes, etc. This signifies a greater need for developing countries to switch to clean industries and to develop capacity for emission reduction. Lack of

¹ Greenhouse gases are gases in an atmosphere that absorb and emit radiation within the thermal infrared range. This radiation is the fundamental cause of the heating of the surface of a planet (known as greenhouse effect).

² Ratification defines the international act whereby a state indicates its consent to be bound to a treaty if the parties intended to show their consent by such an act. However, in practice of certain states acceptance and approval have been used instead of ratification when, at a national level, constitutional law does not require the treaty to be ratified by the head of state (Arts.2 (1) (b), 14 (1) & (2) and 16, Vienna Convention on the Law of Treaties 1969).

³ USA has been given the target of reducing GHG emission by 7 percent, EU by 8 percent and Japan by 6 percent.

⁴ UNFCCC, IMF

resources and absence of modern technology are major constraints of developing countries in achieving environment sustainability.

These facts highlight the climate change as one of the greatest global action problems with differentiating motives of developed and developing countries. Addressing this issue, KP offers following market mechanisms:

1. Joint Implementation (JI)
2. International Emission Trading (IET)
3. Clean Development Mechanism (CDM)

In all the three mechanisms, permission can be granted to the developed countries that have a commitment on carbon emission to emit more than the prescribed limits. This can either be done through: a) carbon acquisition (which is allowed under JI and IET, and b) carbon trading (which is allowed under CDM). Carbon acquisition is an international transaction of carbon between countries that have commitment under the KP. For instance, a country that is currently emitting above its limit of carbon emission can actually compensate by acquiring permission for additional emission of carbon from the country which is emitting less than its limit. Unlike carbon acquisition, carbon trading has no pre-condition of having cap on carbon emission under KP. In other words, voluntary participants (mainly developing countries) can also benefit from this mechanism (*Article 12, Kyoto Protocol*). For instance, a country that is currently emitting at its limit of carbon emission can acquire permission for additional carbon emission by investing in emission reduction projects in developing countries. The absence of pre-conditions for participating in CDM projects shows its relevance to developing countries including Pakistan.

SS1.2 Carbon Trading (CT)

CT is a market-based mechanism for dropping GHG concentration through reducing carbon dioxide emission in the atmosphere. Under CDM, carbon trading takes place through the exchange of Certified Emission Reduction (CER) units.⁵ Specifically, the developed countries help developing countries in carrying emission reduction/removal projects and in exchange, earn CERs from developing countries. Purchasing one unit of CER allows developed country to emit one tonne of carbon dioxide in addition to its limit. These CERs are actually traded internationally through carbon exchanges.⁶ To facilitate the settlement of transactions and funding, banks and investment companies are extending services.

⁵ One CER is equivalent to reduction of one tonne of carbon dioxide.

⁶ Presently, five carbon exchanges are operational around the globe: Chicago Climate Exchange, European Climate Exchange, Nord Pool, Power Next and the European Energy Exchange.

Average price of issued CERs is estimated to be Euro 17.5 with a range of Euro 10 to Euro 25 for the period 2008-2012.⁷

China is the largest seller of CERs capturing almost 60 percent share (see **Figure SS1.1**) followed by India having 11.3 percent share and Brazil having 6.5 percent. However, in terms of numbers of registered projects by host party,⁸ India leads (see **Table SS1.1**) the seller side by 31.42 percent followed by China with 21.68 percent. On the buyer side, UK has got the highest share of 28.8 percent followed by Switzerland with 20.7 percent and Japan with 11.3 percent.

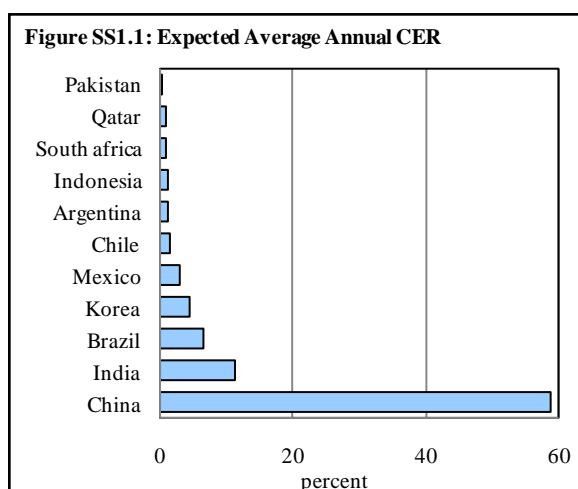


Table SS1.1 : Registered Project Wise Top Traders of CDM Market (Percent)

Sellers	Market share	Buyers	Market share
China	58.9	UK	28.82
India	11.3	Switzerland	20.71
Brazil	6.5	Japan	11.27
Mexico	2.9	Netherlands	11.05
Chile	1.5	Sweden	6.33

Source: UNFCC Website

It appears as a paradox that both India and China are among top ten polluters of the world due to their high growth⁹ yet are sellers of carbon credits in the market. This flexibility of KP trading mechanism signifies its acknowledgement that developing countries may continue for time being with their development process given their limited resources. However, these countries need to build-up their capacity to handle the critical issue of environment sustainability going forward.

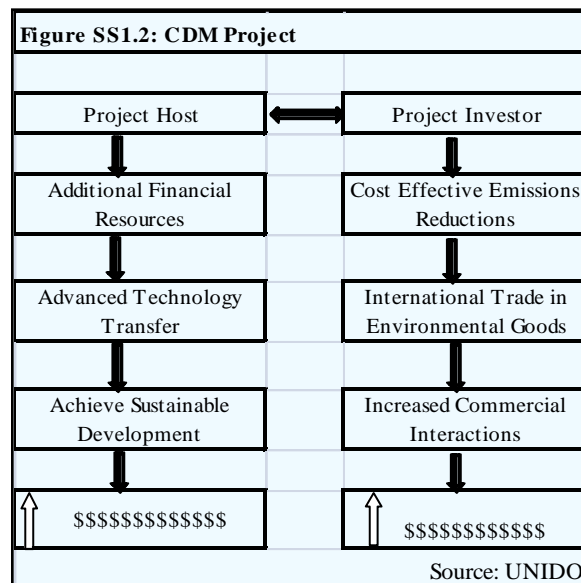
CDM project appears to be mutually beneficial for both developing and developed countries (see **Figure SS1.2**). Developed countries (project investor) can make use of these credits to meet their carbon cap targets under KP. Developing countries (project host), on the other hand, can benefit from this mechanism in terms of technology transfer and resource inflow to ensure sustainable development.

⁷ Clean Development Mechanism 2008 In-Brief, UNFCC.

⁸ The country where project takes place to earn CERs is the host party.

⁹ High per capita GDP growth and population growth are among major factors leading to higher GHG concentration (Source IMF).

However, the debate regarding the effectiveness of trading cannot be ignored, especially when the situation after KP expiry (in 2012) is unclear. Many developing countries are also suspicious about motives of developed countries¹⁰ and perceive this mechanism as an entry point for developed countries to intervene in their development process. On the other hand, developed countries claim that they are paying more for this global action problem recognizing the limited resources of developing countries.



SS1.3 Carbon Trading in Pakistan

IPCC has identified Pakistan as one of the countries that can be hit hard by climate change. This is mainly due to the dependency of the economy on agriculture and its low forest cover¹¹ with a high rate of deforestation at around 0.2-0.4 every year.¹² Though government has allocated funds to compensate for the estimated annual loss of US \$1.8 billion due to climate change;¹³ ministry of environment (MoE) has indicated the gap of 67 million rupees in the allocated budget. Realizing the vital role of climate change for sustainable development, Pakistan has started participating in the international arena of environment. For instance, Pakistan has been signatory to all significant international declarations of environment, including, Kyoto Treaty, Millennium Declaration; however, the relatively active participation of the country at international level started with the acceptance of KP in January 2005. KP has provided the country an entry avenue in the form of carbon trading to the international environment market. For CDM projects, Ministry of Environment has been declared a focal point while its National Operational Strategy was approved in 2006.

¹⁰ Agarwal, R. (2008). Towards a Global Compact for Managing Climate Change, Discussion Paper 08-22, Harvard Kennedy School.

¹¹ 5.2 percent of country's land (Source: Annual Report 2008-09, State Bank of Pakistan)

¹² MOE, Pakistan.

¹³ Abdullah, (2006). Sources and Consequences of Environmental Pollution and Institutions' Role in Pakistan. *Journal of Applied Science*.

Another critical factor for Pakistan to participate in carbon trading can be the fear of exclusion. Fear of exclusion refers to the larger opportunity cost of non-participation for any country when other countries are participating. This opportunity cost can be huge for Pakistan as not only its peer countries are participating but one of its biggest export markets- Europe, has got serious concerns about Pakistan's environment standards.¹⁴ The concern of Europe may result in restricting our exports to the region thus adversely affecting the export earnings and BoP of the country. The country's current ranking on Environment Performance Index (EPI);¹⁵ 124th among 149 countries, is not satisfactory as well. An active participation at international level towards environment sustainability can not only improve the environment status of the country, but may also enable the country to enhance its credibility internationally in this regard.

SS1.4 Current Status

Currently, Pakistan has 14 approved CDM projects¹⁶ with a status of host country while sixty projects are in pipeline. The main objective of these projects is to bring positive impact on socio-economic status of the country along with its contribution towards environment sustainability. To achieve this, the government has set conditions on the following four criteria for projects' approval: environment criteria, social criteria, economic criteria and technological criteria. According to CDM cell, MoE Pakistan, these projects are expected to bring US \$ 345 million foreign investment along with 3.35 million tonnes GHG reduction per year as well as a positive impact on agriculture productivity, employment opportunity and technology transfer.

Following the international trend, MoE, Pakistan, has identified six major groups as priority sectors (see **Table SS1.2**). The table indicates that even among selected sectors for CDM, few have not been explored as yet. However, the distribution of CDM projects among the sectors is in accordance with the

Table SS1.2: Sector Wise CDM Projects (percent)

Sectors	Pakistan		
	Global	Current Projects	Pipeline Projects
Energy	64.96	57.14	58.33
Waste management	19.45	28.57	16.67
Industrial process	9.63	14.29	16.67
Transportation	0.13	0	0
Land use & forestation	0.08	0	8.33
Agriculture & livestock	5.78	0	0

Source: UNFCCC & CDM Cell, MOE, GOP

¹⁴ Ayub Qutub, S (2003). Trade in Environmental Services and Human Development Country Case Study Pakistan, UNDP

¹⁵ EPI is based on 25 indicators in six policy categories: Environmental Health, Air Pollution, Water, Biodiversity and Habitat, Productive Natural Resources, Climate Change.

¹⁶ Only three projects are registered with UNFCCC

international trend.¹⁷

Pakistan at present possesses a very small share (0.4 percent) of the CT market. One possible explanation for this small share can be that a country having significant population below poverty line cannot afford to allocate significant resources for monitoring climate change. That said, climate uncertainties can have more devastating impact on poor and vulnerable societies.¹⁸ The inclusion of sustainable environment in millennium development goals is an indication of universal consensus on the linkage between poverty reduction and environment sustainability. Acknowledging the relationship, the government has included environment not only as an important aspect of Poverty Reduction Strategy Paper (PRSP) but has also made it part of the Public Sector Development Program (PSDP); 38.39 million rupees have been allocated for CT. The government is also responsive to the needs of capacity building and mass awareness to increase market participation in carbon trading. In this regard, the ministry has not only arranged many workshops and seminars but has also initiated few joint ventures with donors (see **Table SS1.3**)

Table SS1.3: Current CDM Capacity Building Projects

Project Name	Donor	Duration	Cost (US \$ million)
Capacity Building for Development and implementation of Carbon Finance Projects	World Bank	18 months	0.57
Institutional Capacity Enhancement	United Nations Industrial Development Organization	18 months	0.674
Hands on Capacity Building of Forest Official in Developing Proposals for Afforestation/ reforestation Project Design documents	Swiss Agency for Development Cooperation	2 Years	9.84 million rupees

Source: CDM Cell, MoE, GoP

SS1.5 Way Forward

Pakistan has yet to maximize benefits of carbon trading in terms of technology transfer and resource inflow. This avenue can be utilized for economic development and poverty alleviation by integrating it with development policies. Capacity building along with strengthening of CDM set-up in the country may help in creating conducive environment for the efficient functioning of the domestic environment market. As mentioned earlier, a major criticism on KP is its uncertain status after 2012. However, Pakistan should focus on KP as an opportunity for addressing environmental issues while capitalizing on economic benefits of the protocol.

¹⁷ The numbers of energy project are low though their share is highest due to the quantity.

¹⁸ Patel,P.& Ahmed,S.(2007).Managing Climate Change

Special Section 2: National Finance Commissions Awards – A Review

A very important and welcome development was the approval of 7th National Finance Commission (NFC) Award 2009 by all four provincial and the federal governments, reflecting political will to resolve key issues.

The National Finance Commission is constituted by the President of Pakistan under article 160 of the constitution which recommends an appropriate mechanism of revenue sharing between the federation and provinces to the President. Keeping in view the regional disparities in level of economic activities and revenue generation capacities, the constitution of Pakistan empowers federal government to collect certain types of taxes from all over the country and to put them in a divisible pool. These resources are then distributed among four units of the federation so that their financial needs can aptly be met. In order to maintain harmony and a sense of brotherly bond among provinces, a consensus over resource sharing formula is highly important. The distribution formula has essentially two components; one vertical distribution between federal government and provinces and other horizontal distribution within provinces.

As per constitution, the NFC has to be constituted after every five years which consists of finance minister of the federal government, four provincial finance ministers and such other persons as may be appointed by the President after consultation with the governors of the provinces. Starting from 1974, seven NFC awards have been announced up till now with the most recent coming in December 2009 (**Table SS2.1**).

The first NFC was constituted in 1974 that recommended population as the criterion for resource distribution among the provinces. The second (1979) and third (1985) NFCs could not offer any recommendations; thus resources continued to be distributed according to the first award until 1990.

In 1990, fourth NFC award was announced through which the divisible pool was expanded and special grants were also provided to the provinces. The provinces' right on net hydel profit, development surcharge (on gas) and excise duty on crude oil was also admitted in that award. The next successful NFC award was announced in 1996. It brought more sophistication to the mechanism of intergovernmental fiscal transfers. All taxes, royalties and development surcharges were included in the divisible pool that drastically increased the pie.

Table SS2.1: Resource Distribution under Various NFC Awards*

percent

No	Year	Federation: provinces distribution	Distribution within provinces			
			Punjab	Sindh	NWFP	Baluchistan
1 st	1974	20:80	60.25	22.5	13.39	3.86
2 nd	1979	20:80	57.97	23.34	13.39	5.30
3 rd	1985			Interim award		
4 th	1990	20:80	57.87	23.29	13.54	5.30
5 th	1996	62.5:37.5	57.88	23.38	13.54	5.30
6 th	2000			Interim award		
	2006**	55:45	57.36	23.71	13.82	5.11
7 th	2009	44:56	51.74	24.55	14.62	9.09

* Adopted from Ahmad et al (2007)¹ & media reports for 7th award.

** By Presidential order

The national finance commissions constituted in 2000 and 2006 could not come up with consensus formulae. The President of Pakistan, therefore, promulgated an ordinance for resource distribution in 2006. According to this ordinance, the provincial share was revised upward to 45 percent which would reach 50 percent with subsequent increase of 1 percent per annum. Net proceeds equal to 1/6th of sales tax were given to the provinces to transfer it further to the district government and cantonment boards with Punjab receiving 50 percent, Sindh 34.85 percent, NWFP 9.93 percent and Balochistan 5.2 percent share. It was decided to distribute the remaining balance amongst the provinces on the basis of their respective population.

SS2.1 NFC Award 2009

The 7th NFC 2009 award introduced significant changes in resource distribution mechanism to the satisfaction of all units of the federation.

Under the award, the federal government agreed to increase the share of provinces in divisible pool to 56.0 percent in the first year of NFC and to 57.5 percent in the remaining years of the award from existing level of 47.5 percent. The federal government has also agreed to reduce collection charges to just one percent from the existing level of five percent, which will increase the actual transfers to the provinces from the divisible pool.

To increase the share of Baluchistan to 9.09 percent, the three provinces agreed to slash their percentage shares. The NWFP is entitled to get an additional one percent of the total divisible pool, regarding its role as a frontline province in the

¹ Ahmad, Iftikhar, Mustafa, Usman and Khalid, Mahmood (2007), National Finance Commission Awards in Pakistan: a Historical Perspective; Pakistan Institute of Development Economics Working Paper 2007:33.

continued war against terror. This would be equivalent to 1.83 percent of the provincial poll. Similarly, the center also gave the option to the provinces by allowing them to collect sales tax on services.

Another notable development was the consensus on using other parameters in addition to population for revenue sharing among the provinces (**Table SS2.2**). To assign weight to poverty and backwardness, the NFC used database from three studies, i.e., 1999-2000 report of Poverty Reduction Strategy Paper (PRSP), Human Development Index (HDI) of 2003-04, and HDI 2007-08 developed by Federal Bureau of Statistics (FBS). Again to resolve the conflict among provinces regarding use of studies, NFC agreed to use average of the three reports.²

To resolve the issue regarding the use of indicator to assign weight to revenue generation or collection, NFC used the electricity consumption by collections of withholding tax. In order to avoid conflicts on the distribution of 2.5 percent GST, the federal government agreed to transfer Rs 6.0 billion to Sindh from its own kitty.³

Table SS2.2: Revenue Sharing Formula for 7th NFC (2009)

percent

Indicators	Weight	Share of provinces in terms of indicators			
		Punjab	Sindh	NWFP	Baluchistan
Population share (SBP estimates) *	82.0	57.36	23.71	13.82	5.11
Poverty/backwardness **	10.3	23.16	23.41	27.82	25.61
Revenue generation/collection **	5.0	44.0	50.0	5.0	1.0
Inverse population density (SBP estimates) *	2.7	4.34	7.21	6.54	81.92
Total share	100.0	51.74	24.55	14.62	9.09

* Province-wise distribution of population and inverse population density is estimated on the base of data obtained from Pakistan Statistical Year Book 2008 published by Federal Bureau of Statistics Islamabad.

** Distribution of Poverty/backwardness and Revenue generation/collection are taken from Daily The News, December 14 2009.

² Daily *The News*, December 14, 2009.

³ Ibid

Acronyms

ADB	Asian Development Bank
APCMA	All Pakistan Cement Manufacturers Association
ARPU	Average Revenue per User
BMR	Balancing Modernization and Restructuring
BoP	Balance of Payments
BSC	Behbood Saving Certificate
Bps	Basis Points
CBI	Centre for the Promotion of Imports from developing countries
CCP	Competition Commission of Pakistan
CD	Custom Duty
CDM	Clean Development Mechanism
CELSS	Controlled Ecological Life Support System
CER	Certified Emission Reduction
CLCV	Cotton Leaf Curl Virus
CPI	Consumer Price Index
CRR	Cash Reserve Requirement
CT	Carbon Trading
DAP	Di-Ammonium Phosphate
DMBs	Deposit Money Banks
DMMD	Domestic Market and Monetary Management Department
DPBs	Domestic Private Banks
DSC	Defense Saving Certificate
EBIT	Earning Before Interest and Taxes
EFS	Export Finance Scheme
EPD	Exchange Policy Department
EPI	Environment Performance Index
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
FCBCs	Foreign Currency Bearer Certificates
FDI	Foreign Direct Investment
FE	Foreign Exchange
FEBCs	Foreign Exchange Bearer Certificates
FECs	Foreign Exchange Companies
FED	Federal Excise Duty

FE-25	Foreign Exchange Cir.No.25
FPI	Foreign Portfolio Investment
FRDL	Fiscal Responsibility and Debt Limitation
FSV	Forced Sale value
FY	Fiscal Year
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
GDR	Global Depository Receipts
GHG	Green House Gas
GST	General Sales Tax
GSP	Generalized System of Preferences
HRI	House Rent Index
HSD	High Speed Diesel
IBRD	International Bank for Reconstruction and Development
ICT	Information and Communication Technology
IDB	Islamic Development Bank
IDPs	Internally Displaced Persons
IET	International Emission Trading
IFIs	International Financial Institutions
IMF	International Monetary Fund
IPCC	Inter-governmental Panel on Climate Change
IPPs	Independent Power Projects
IRSA	Indus River System Authority
IT	Information Technology
JI	Joint Implementation
KAPCO	Kot Addu Power Company Limited
KESC	Karachi Electric Supply Corporation
KIBOR	Karachi Inter Bank Offer Rate
KP	Kyoto Protocol
KT	Kyoto Treaty
KYC	Know Your Customer
LIBOR	London Inter Bank Offer Rate
L/C	Letter of Credit
LSM	Large Scale Manufacturing
LT	Long Term
LTFF	Long Term Financing Facility
MINFAL	Ministry of Food, Agriculture and Live Stock
MNCs	Multi National Corporations
MoM	Month-on-Month
MoE	Ministry of Environment
MPS	Monetary Policy Statement

MRTB	Market Related Treasury Bills
MSCI	Morgan Stanley Capital International
MT	Metric Ton
NDA	Net Domestic Asset
NASA	National Aeronautics and Space Administration
NATO	North Atlantic Treaty Organization
NEER	Nominal Effective Exchange Rate
NFA	Net Foreign Asset
NFDC	National Fertilizer Development Centre
NFNE	Non Food Non Energy
NPLs	Non Performing Loans
NSS	National Savings Scheme
NWFP	North-West Frontier Province
OCAC	Oil Companies Advisory Committee
OECD	Organization for Economic Co-operation and Development
OGDC	Oil and Gas Development Corporation
OGRA	Oil and Gas Regulatory Authority
OICCI	Overseas Investors' Chamber of Commerce & Industry
OIN	Other Items Net
OMCs	Oil Marketing Companies
OMOs	Open Market Operations
OPEC	Organization of the Petroleum Exporting Countries
PAMA	Pakistan Automotive Manufacturers Association
PBA	Pensioners Benefit Account
PCGA	Pakistan Cotton Ginners' Association
PET	Polyethylene Terephthalate
PGJDC	Pakistan Gems and Jewellery Development Company
PIA	Pakistan International Airlines
PIBs	Pakistan Investment Bonds
POL	Petroleum, Oil and Lubricants
PPCBL	Punjab Provincial Cooperative Banks limited
PPTFC	Privately placed Term Finance Certificates
PRI	Pakistan Remittance Initiative
PRSP	Poverty Reduction Strategy Paper
PSC	Private Sector Credit
PSDP	Public Sector Development Program
PSEs	Public Sector Enterprises
PTA	Pakistan Telecommunication Authority
PTCL	Pakistan Telecommunication Company Limited
REER	Real Effective Exchange Rate
RFCAs	Residents Foreign Currency Accounts

RHS	right Hand Side
RIC	Regular Income Certificate
RPI	Relative Price Index
Rs	Rupees
S&P	Standard & Poor's
SA	Saving Account
SBA	Stand-By Arrangement
SBP	State Bank of Pakistan
SDR	Special Depository Rights
SECP	Securities and Exchange Commission of Pakistan
SMEFD	Small and Medium Enterprises Finance Department
SMEs	Small and Medium Enterprises
SPI	Sensitive Price Index
SQM	Square Meter
ST	Short Term
SSA	Special saving Account
SSC	Special saving certificate
T-bills	Treasury Bills
TCP	Trading Corporation of Pakistan
TFCs	Term Finance Certificates
UAE	United Arab Emirates
UK	United Kingdom
UN	United Nation
USA	United States of America
VP	Voluntary Payments
WAPDA	Water and Power Development Authority
WEO	World Economic Outlook
WHT	Withholding Tax
WPI	Wholesale Price Index
YoY	Year on Year
ZTBL	Zarai Taraqiati Bank Limited

Corrigendum

The SBP Annual Report 2008-09, on page 29, states

“This observation is also supported by the fact that significant increase in recovery ratio witnessed by Bank Al-Falah, Bank of Punjab, Bank Al-Habib and Soneri Bank; banks that were severely hit by liquidity crisis during H1-FY09.”

The tight liquidity position of the banks mentioned in the report was inferred from their use of rediscount window. However, this would appear to be have been for operational rather than liquidity reasons. In terms of level of excess reserves placed with the SBP, the liquidity position of these banks, such as Bank Al-Falah and Bank Al-Habib, appeared sound.