THE STATE OF PAKISTAN'S ECONOMY

First Quarterly Report
for the year 2010-2011 of the
Central Board of State Bank of Pakistan

State Bank of Pakistan

The Team

Team Leader	
Mohammad Mansoor Ali	mansoor.ali@sbp.org.pk
Researchers	
Bilal Khan	bilal.khan@sbp.org.pk
Dr. Mian Farooq Haq	mian.farooq@sbp.org.pk
Farrukh Abbas Mirza	farrukh.mirza@sbp.org.pk
Fatima Khaliq	fatima.khaliq@sbp.org.pk
Imran Naveed Khan	imran.naveed@sbp.org.pk
Mohib Kamal Azmi	mohib.kamal@sbp.org.pk
Moinuddin	moinuddin@sbp.org.pk
Muhammad Akmal	muhammad.akmal@sbp.org.pk
Muhammad Farooq Arby	farooq.arby@sbp.org.pk
Muhammad Idrees	muhammad.idrees22@sbp.org.pk
Muhammad Laiq	muhammed.laiq@sbp.org.pk
Muhammad Naqi Akbar	naqi.akbar@sbp.org.pk
Muhammad Sharif Khawaja	sharif.muhammad@sbp.org.pk
Muhammad Usman Abbasi	muhammad.usman3@sbp.org.pk
Muhammad Zeb	muhammad.zeb@sbp.org.pk
Naila Iram	naila.iram@sbp.org.pk
Sabahat	sabahat@sbp.org.pk
Sabina Khurram Jafri	sabina.kazmi@sbp.org.pk
Shabbir Ahmed	shabbir.ahmed2@sbp.org.pk
Syed Qamar Hussain	Syed.qamar@sbp.org.pk
Syed Zulqernain Hussain	zulqernain.hussain@sbp.org.pk
Tamkinat Rauf	tamkinat.rauf@sbp.org.pk
Tosif Hussain	tauseef.hussain@sbp.org.pk
Waseem Fazal ur Rehman	waseem.fazal@sbp.org.pk
Zahid Hussain	zahid.hussain@sbp.org.pk
Editing	
Umar Siddique	umar.siddique@sbp.org.pk
Formatting	
Farrukh Abbas Mirza	farrukh.mirza@sbp.org.pk
Muhammad Akmal	muhammad.akmal@sbp.org.pk
Muhammad Usman Abbasi	muhammad.usman3@sbp.org.pk
Naila Iram	naila.iram@sbp.org.pk
Tosif Hussain	tauseef.hussain@sbp.org.pk

Contents		*Page No.*

1.	Economic Outlook and Executive Summary	1
1.1	Overview	1
1.2	Looking Forward	4
1.3	Executive Summary	7
2.	Real Sector	11
2.1	Overview	11
2.2	Agriculture Sector Performance	11
2.3	Large Scale Manufacturing	17
2.4	Services	23
3.	Prices	25
3.1	Overview	25
3.2	Consumer Price Index	27
3.3	Wholesale Price Index	32
3.4	Sensitive Price Indicator	34
4.	Money & Banking	35
4.1	Monetary Policy	35
4.2	Developments in Monetary Aggregates	37
4.3	Credit to Private Sector	40
4.4	Deposit Mobilization	43
4.5	Non-Performing loans	45
4.6	Money Market	46
5.	Fiscal Developments	51
5.1	Overview	51
5.2	Revenues	53
5.3	Expenditures	54
5.4	Domestic Budgetary Financing	56
5.5	FBR Tax Collection	57
5.6	Provincial Fiscal Operations	62
5.6	Total Domestic Debt and Liabilities	62
6.	External Sector	67
6.1	Overview	67
6.2	Current Account Balance	68
6.3	Financial Account	72
6.4	Trade in Services	78
6.5	Foreign Exchange Reserves	81
6.6	Exchange Rate	82
6.7	Trade Account	84
Special Section: Flood 2010: Lessons Drawn from Global Post Disaster Initiatives		93
Acronyms		103

CENTRAL BOARD OF DIRECTORS

Mr. Shahid H. Kardar	Governor & Chairman
Dr. Waqar Masood Khan	Member
Mr. Kamran Y. Mirza	Member
Mr. Zaffar A. Khan	Member
Mirza Qamar Beg	Member
Mr. Asad Umar	Member
Mr. Waqar A. Malik	Member
Mr. Aftab Mustafa Khan	Corporate Secretary

LETTER OF TRANSMITTAL

State Bank of Pakistan
Karachi.
February 01, 2011

Dear Mr. Chairman,

As required by Section 9A(f) of the State Bank of Pakistan Act, 1956, I am pleased to submit herewith the First Quarterly Report for the year 2010-11 of the Central Board of Directors of the State Bank of Pakistan on the State of the Economy.

(SHAHID H. KARDAR)
Governor

Mr. Farooq H. Naek
Chairman
Senate
ISLAMABAD

LETTER OF TRANSMITTAL

State Bank of Pakistan
Karachi.
February 01, 2011

Dear Madam Speaker,

As required by Section 9A(f) of the State Bank of Pakistan Act, 1956, I am pleased to submit herewith the First Quarterly Report for the year 2010-11 of the Central Board of Directors of the State Bank of Pakistan on the State of the Economy.

(SHAHID H. KARDAR)
Governor

Dr. Fehmida Mirza
Speaker
National Assembly
ISLAMABAD

1 Economic Outlook and Executive Summary

1.1 Overview

Pakistan's economy remains stressed in the aftermath of the unprecedented floods and due to the continued delays in the implementation of key economic reforms. While the growing macroeconomic imbalances in the economy are still quite manageable, further delay in implementing critical structural adjustments risks significantly increasing the future costs to the economy.

Uncertainty over the extent of damage to private and public infrastructure and the policy response to floods, direct and indirect impacts of supply disruptions, energy shortages and weak consumer & business confidence, took its toll on the domestic economy during the initial months of the fiscal year (see **Table 1.1**). The commodity producing sector suffered the most, as many crops were damaged and LSM growth plunged back into negative after recovering in FY10. Partly, as a consequence of floods, the government's fiscal position worsened, and the monetization of the deficit increased inflationary pressures, compounding the spike in prices of food staples.

Table 1.1: Selected Economic Indicators

		FY09	FY10	FY11
Growth rate (percent)				
LSM	Jul-Nov	-5.5	0.5	-2.3
Exports (fob)	Jul-Dec	9.4	-4.9	20.6
Imports (cif)	Jul-Dec	12.8	-16.3	19.6
Tax revenue (FBR)	Jul-Nov	26.2	7.1	7.6
CPI (12 month ma)	Dec	20.3	13.6	13.9
Private sector credit	Jul-Jan 8	5.4	2.9	4.1
Money supply (M2)	Jul-Jan 8	0.9	5.3	8.6
billion US dollars				
Total liquid reserves[1]	Jan 18	10.0	15.2	17.1
Home remittances	Jul-Dec	3.6	4.5	5.3
Net foreign investment	Jul-Dec	2.1	1.2	0.8
percent of GDP[2]				
Fiscal deficit	Jul-Sep	1.1	1.5	1.6
Trade deficit	July-Dec	5.0	3.3	2.9
Current a/c deficit	July-Dec	-4.8	-1.5	0.0

[1] With SBP & commercial banks.
[2] Based on full-year GDP in the denominator.

The one bright spot in the economy, ironically helped somewhat by the floods, was the strength of the external sector. A jump in remittances and aid flows for flood relief, helped by robust growth in exports largely due to sharp increase in the prices of cotton overshadowed the growth in imports, turning the current account for July-December FY11 to a surplus. The current account surplus would not have been possible, were it not for the one-off flood related receipts and inflows on account of logistic support.

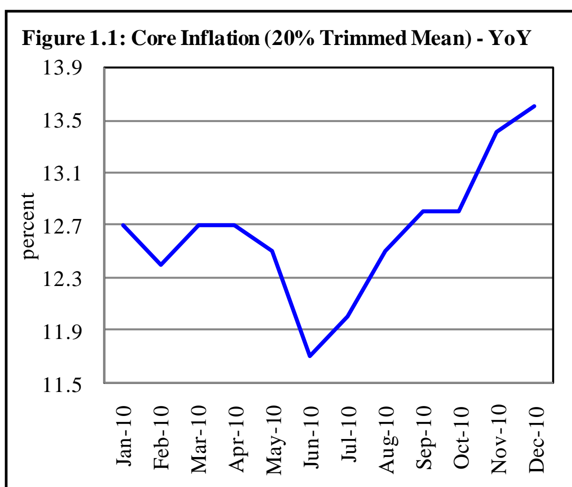
An unexpected source of support for the economy, particularly August 2010 onwards, emerged from the surprising strength in international commodity prices, and especially those of agri-products (see **Table 1.2**). Many crops saw considerable price rise. But this was a decidedly mixed blessing. On the one hand, the substantial windfall gains injected purchasing power in many rural areas and supported the growth in export receipts. But, on the other hand, inflationary pressures emanating from the floods were accentuated, with food inflation, in particular, heading for peaks seen in FY09. The rising energy prices were particularly disturbing, not only for the rising import bill, but also for its cost-push impact on inflation.

Table 1.2: Changes in Wholesale Prices
percent YoY

	Dec-09	Dec-10
Outputs		
Cotton	48.9	111.2
Sugarcane	43.6	63.4
Rice	-9.7	17.9
Tomatoes	-18.8	189.8
Potatoes	3.6	14.7
Onions	-1.5	130.4
Inputs		
Diesel	20.4	14.5
Fertilizers	-10.8	18.6

The combination of revisions in energy (fuel and electricity) prices, higher margins on many agri-products (as traders took advantage of perceived supply shortages and administrative weaknesses), rising cost of imports (as international commodity prices began to firm up), and the demand stimulus from the monetization of the fiscal deficit all contributed significantly to the rise in inflation to 15.5 percent YoY in December 2010, up from 12.3 percent YoY in the first month of the fiscal year. The trimmed mean core inflation measure, too, continued to rise (see **Figure 1.1**).

Figure 1.1: Core Inflation (20% Trimmed Mean) - YoY



While food inflation is expected to ease in the second half of the fiscal year, it is unlikely to approach single digit in FY11. Moreover, rising international commodity prices, and fiscal measures (to raise revenues, reduce energy subsidies,

etc.) will spur the rise in non-food inflation. In this context, it becomes even more important for policy to ensure that demand-pull inflationary pressures are kept to a minimum.

The rise in the consolidated fiscal deficit during Q1-FY11 to 1.6 percent of GDP is therefore disquieting. This is 0.1 percent of GDP higher than the corresponding figure last year, even though the FY11 annual target agreed with the IMF is 1.6 percent of GDP *lower* than recorded in FY10. Moreover, while provinces had recorded a deficit last year, this year the provinces are expected to show an aggregate surplus of 0.3 percent of GDP.

A part of the increase in the fiscal deficit is explainable; being a consequence of higher security related expenditures and the floods. However, anecdotal evidence suggests that another significant contribution was made by "subsidies", representing the partial payments of arrears on energy subsidies and for commodity operations. But, a larger contribution to the growth in the fiscal deficit came from significant weakness in revenues, and especially the fall in non-tax revenues.

The spending shock (e.g., for flood relief), as well as the unexpected weakness in the receipts (also partly a consequence of floods) only underline the urgent need to broaden the tax base, and rationalize spending growth, to better insulate the economy from shocks. There are some signs of progress in containing expenditure, with cuts in development spending, moves towards reduction in subsidies, and progress towards the devolution of ministries to provinces, but much remains to be done. The substantial revenue measure, a VAT based sales tax, however, remains mired in controversy.

The larger fiscal deficit, relatively disappointing availability of non-bank finance, and a surprising reluctance to borrow from the market (i.e., all bids in the PIB auctions were rejected) contributed to resurgence in monetization of the deficit. Government budgetary support borrowings from SBP rose by Rs 153.9 billion in July- Jan 8, FY11, up 19.3 percent YoY. As a result, despite a small pick-up in net private sector credit off-take, it was the government sector that, yet again, dominated the 15.94 percent YoY M2 growth during the period.

The nominal 5.0 percent YoY growth in net credit extended to the private sector, during the same period appears somewhat encouraging at first look. However, given that the entire increase was for working capital, and that input costs have increased for many industries, in real terms private credit off-take has probably contracted. The combination of increasing NPLs and high risk-adjusted returns on

government paper is clearly crowding out more productive private sector activities. The growing exposure of banks to government related lending has already led to a downgrading of some standalone bank financial strength rating (BFSR) of five Pakistani major banks by Moodys – a major credit rating agency.

The demand pressures of the fiscal expansion and monetization, concerns over the direct and indirect consequences of cost-push shocks, and underlying structural weaknesses in the external account led the central bank to steadily increase the policy rate by a cumulative 150 basis points in the first half of FY11.

Despite the 101.1 percent YoY decline in the July-December FY11 current account deficit, the overall external account has deteriorated. Specifically, capital and financial account receipts have continued to fall in this period, recording a surplus of US$ 887 million, in contrast to US$ 3.0 billion in the corresponding period last year. The situation looks grimmer taking into account:

(1) An expected fall in the flood related receipts in the months ahead.
(2) Increase in commodity prices, especially for energy that will strain the import bill.
(3) Failure to make substantial progress in economic reforms could continue to weigh upon external capital and financial account receipts.

In the absence of external inflows, the financing of an anticipated current account deficit will put pressure on the country's forex reserves. Maintaining an adequate level of reserves is a pre-requisite to ensure reduced volatility in the exchange rate.

1.2 Looking Forward

The performance of the commodity producing sectors of the economy is expected to improve in months ahead. Expectations of a recovery in agriculture, will however, depend crucially on the wheat harvest (including increased production from the rain-fed – "*barani*" - areas), and the livestock sector. Similarly, large-scale manufacturing growth is expected to turn positive again in the months ahead, as strong agri-prices support demand, and with the additional capacities coming on-line in some industries.[1] However, the persistent energy shortages and growing arrears of energy payments will continue to be a drag on economic activity.
The commodity producing sector gains are expected to receive some support from a good showing of the services and the construction sectors. Thus, the SBP forecast remains unchanged from initial post-flood assessment that FY11 real GDP growth would be in the range of 2-3 percent (see **Table 1.3**).

[1] New capacity is coming online in fertilizer, cement and steel industries during FY11. Capacity is also adding up in oil refinery during FY11, however, it will be operational in FY12.

In contrast, inflationary pressures have strengthened more than anticipated during the first half of FY11. A part of this, reflecting post-flood shocks will fade away, as will part of the price rise of sugar (by mismanagement of supply), but the fiscal expansion, proposed reduction in energy subsidies, and prospects of rising imported inflation will continue to drive inflationary expectations. Consequently, SBP estimates for FY11 inflation have been revised upwards from 13.5 – 14.5 percent to 15.0 – 16.0 percent.

Table 1.3: Projections of Major Macroeconomic Indicators

	FY10	FY11	
		Annual plan targets	SBP projections
growth rates in percent			
GDP	4.1[P]	4.5	2.0 - 3.0
Average CPI inflation	11.7	9.5	15.0 - 16.0
Monetary assets (M2)	12.5	-	14.0 - 15.0
billion US Dollars			
Workers' remittances	8.9	9.0	10.0 - 11.0
Exports (fob-BoP data)	19.7	20.0	22.0 - 23.0
Imports (fob-BoP data)	31.2	31.7	34.5 - 35.5
percent of GDP			
Fiscal deficit	6.3	4.0*	6.0 - 6.5
Current account deficit	2.3	3.4	1.0 - 2.0

[P]: Provisional; (*): Overall fiscal deficit target announced in the federal budget; however, this number rose to 5.3 percent of GDP as per announced consolidated federal and provincial budgets.

Note: Targets of fiscal and current account deficit to GDP ratios are based on nominal GDP in the Budget document for FY11, while their projections are based on provisional estimates of nominal GDP for the year.

A rise in prices of food staples has also led to calls for the government to intervene to keep prices in check. Pakistan's experience in recent years suggests that government interventions lead to market distortions, e.g., low domestic prices for wheat in FY08 only led leakages of the grain to neighboring countries with smugglers, in essence, pocketing the subsidy at the expense of farmers and consumers. Strong prices encourage farmers to invest in higher yields and support domestic demand. Therefore, the only sustainable way to protect low income groups from inflation is by targeted subsidies and the creation of ample employment opportunities.

Pakistan's experience suggests that markets should be allowed to work, although there is a need for strong anti-trust regulation. The presence of an aggressive regulator can be a major comfort factor in encouraging competition and market based activities to improve efficiencies in the economy.

The fiscal performance however remains a source of concern, given the outstanding issues with expenditure management as well as revenue shortfalls. For example, a variety of opinions have been offered on tax reforms, including the much maligned RGST (essentially VAT implementation of the GST), a wealth tax, extending the income tax net to agri-incomes, levying a capital gain tax (not

merely on financial assets), and improved tax governance.[2] In essence, the controversy is unnecessary, as arguably all of these proposals should be implemented to ensure widening of the tax base. This would then allow for a lowering of the average tax rate in the economy in order to improve competitiveness. In the final analysis, increased fiscal resources are necessary for macroeconomic stability to increase development spending (health, education, etc.). However, the importance of the VAT-based tax does not come from the immediate revenue bearing potential (as this may not be significant initially) but from the fact that, properly implemented, it gives economic agents an incentive to document their transactions (potentially leading to higher income tax collections as well).

The implementation of fiscal reforms and elimination of subsidies in the power sector are likely to broaden the tax net and reduce distortions in the economy. While, these reforms will induce cost-push inflationary pressures in the economy, in the short run, but these will help sustain high growth in the long run.

In contrast to inflation, the current account deficit (CAD) is likely to deteriorate in H2-FY11. A significantly strong growth in imports is expected to more than offset the gains from rise in exports and workers' remittances. The financing of the CAD will be challenging as inflows under financial accounts are likely to be significantly lower. In this perspective, the continuation of the structural adjustment program of IMF would be helpful in softening the external financial constraints, as well as to enhance the resilience and robustness of the economy.

[2] One intriguing suggestion is for the introduction of a temporary windfall tax on some specific agri commodities that have seen an extraordinary run up in prices. The proceeds of the one-off levy could be dedicated to flood relief, significantly augmenting the availability of resources for reconstruction, etc.

1.3 Executive Summary

1.3.1 Real Sector

Economic recovery suffered a setback in early FY11 as floods damaged about one-fourth of the country's agriculture heartland. Not only were crops and livestock destroyed by the floods, a number of agro-based industries, power plants and other manufacturing activities were also disrupted. However, an expected good performance by the services sector will provide support to GDP growth in FY11. Furthermore, a disproportionate rise in the prices of almost all agricultural produce led to a significant increase in the nominal income of the farmers, offsetting part of the negative impact of floods on domestic demand.

Agriculture

Kharif crops were planted on 9.7 million hectares, but heavy rains and floods damaged standing crops on approximately 2.4 million hectares. Initial assessments indicate significant severe losses to rice, cotton, maize, pulses, vegetables and fruits. However, losses to the sugarcane crop in flood areas were partially offset by an increase in yield in non-flood regions due to rains. On the positive side, floods and extended heavy monsoon rains raised the underground water table and soil moisture level, and increased water availability in reservoirs, improving prospects for the FY11 *rabi* cropping season.

Large-Scale Manufacturing

Cumulative large-scale manufacturing (LSM) production declined by 2.3 percent YoY during Jul-Nov FY11 compared with 0.5 percent growth in Jul-Nov FY10. This decline was principally driven by temporary disruptions and raw material shortages caused by unfavorable weather. Particularly, construction activity declined partly owing to cut backs in public development expenditure, production came to a stop in the country's largest refinery due to inundation, and the textile sector had to face raw material shortages for yet another year. The damage to road networks and power infrastructure also impeded overall industrial performance. It is expected that continued strength in private aggregate domestic would support positive growth in manufacturing.

The external sector had a mixed effect on local industry. Export demand declined for cement, pharmaceutical, and electric fans, as Pakistani manufacturers lost ground in some of the export markets captured in the past two years. However, a gradual demand recovery in the US and Europe provided a boost to the leather and textile sector with the export receipts of the latter growing largely as a result of the sharp increase in prices of cotton. For textiles, higher export prices in FY11 improved profit margins in comparison of regional peers.

Services
The services sector is expected to surpass its official growth target for FY11 on the back of strong growth in *social, community, and personal services* led by massive relief and rehabilitation efforts undertaken in flood-affected areas. The *finance & insurance* and *transport, storage, and communication* are also likely to have substantial growth contribution, as is reflected by the performance of these sectors during Q1-FY11.

1.3.2 Prices
Inflationary pressures significantly strengthened in recent months as headline inflation increased to 15.5 percent in November 2010 from 10.5 percent last year. This rise is attributed to supply shortages of most of the perishable food commodities due to floods and rains; the direct impact of pass through of rising international commodity prices; indirect impact of increased fuel prices on the transportation cost; upward adjustment in electricity tariff, as well as strong external demand for some key food staples and monetization of the fiscal deficit.

Strong inflationary pressures are also evident from core inflation measured by 20% trimmed mean measure, which rose to 13.4 percent in November 2010 from 10.5 percent during the same period last year. Core inflation measured by non-food-non-energy (NFNE) was recorded at 9.5 percent in November 2010 compared with 10.6 percent during the corresponding month last year, showing that the current inflationary pressures are mainly stemming from food and energy components of CPI basket.

1.3.3 Money and Banking
The SBP raised its policy rate by 50 bps in each of the three rate decisions during H1-FY11, taking it to 14 percent. At the start of the fiscal year, continued demand induced pressures on prices and macro stability prompted the central bank to begin tightening its policy stance. Soon after, the supply-shock from monsoon flooding heightened existing concerns over growth and inflation – notably food prices. While this complicated calibration of the policy stance; the monetary implications of the increasing monetization of the fiscal deficit – amid persistence in inflation - left the central bank with little choice but to continue tightening in the next two policy meetings.

Broad money supply (M2) expanded by 6.9 percent during Jul-Dec FY11, compared with 4.7 percent in the same period last year. Government led credit growth in the NDA of the banking system and a considerable rise in the NFA of scheduled banks provided the bulk of impetus to monetary expansion during the period under review. In addition, credit to the private sector also increased by Rs

81.8 billion during Jul-Dec FY11 – mainly reflecting increase in working capital loans on account of rise in the cost of inputs.

The deposit base of banks grew by 1.0 percent during Jul-Nov FY11, compared with 0.1 percent in the same period last year – mainly due to a large inflow of remittances in November and the sharp increase in the government borrowings from the SBP. Meanwhile, asset quality metrics of the banking industry deteriorated further; gross non-performing loans (NPLs) rose by Rs 34.2 billion, to Rs 494 billion during Q1-FY11. In the money markets, primary market activity during H1-FY11 was dominated by T-bills – where the government accepted Rs 199.6 billion net of maturities. The period under review also saw two successful auctions of the Ijara Sukuk, with acceptance of Rs 89.0 billion against a target of Rs 80.0 billion. While the first two PIB auctions resulted in rejection of all bids by the government, auction results improved considerably in the last two auctions of the period under review.

1.3.4 Fiscal Developments

The size of the fiscal deficit increased to 1.6 percent of projected annual GDP in Q1-FY11, regardless of the noticeable contraction in expenditures. The government reprioritized its spending pattern and scaled down the development expenditures to create space for the flood relief activities. However a significant part of fiscal slippage came from the revenue side, showing a fall in Q1-FY11; brought about by both a considerable fall in non-tax revenues and deceleration in tax revenues. Further, in the absence of ample alternate resources, the fragile fiscal stance forced the government to rely heavily on deficit monetization. All these developments suggest the need for urgent reforms in the taxation system for broadening the tax base and blocking leakages in revenue collection.

Domestic Debt and Liabilities

The total stock of domestic debt and liabilities posted an increase of 6.7 percent by end-Nov FY11 over the June FY10 stock. This increase in the domestic debt was witnessed on account of a higher fiscal deficit and limited availability of external financing. In terms of composition, the rise in total stock of domestic debt and liabilities came entirely from government’s domestic debt, whereas commodity operations and PSEs debt experienced retirements during this period. Within government’s domestic debt the increase in stock was led by government’s huge borrowing from the central bank, while the stock of scheduled banks debt recorded only a nominal increase by end-Nov FY11.

1.3.5 External Sector

Balance of Payments

The current account deficit contracted by 72.3 percent during Jul-Nov FY11 compared to the same period last year. This contraction was the result of significant export growth, sustained inflows of workers' remittances, and private and official grants for flood relief. The financial account surplus, on the other hand, declined sharply to US$ 0.5 billion from US$ 2.2 billion. A large part of this decline was result of a sharp fall in other investments despite the emergency loan of US$453 million for flood relief given by the IMF. The lower capital and financial account surplus resulted in the decline of the overall external account to US$0.1 billion compared to US$0.94 billion last year. Nevertheless, the overall surplus did help in shoring up country's foreign exchange reserves that reached US$16.9 billion by end November 2010. This also kept the exchange rate relatively stable which depreciated by 0.35 percent during Jul-Nov FY11 compared to 2.6 percent in the same period last year.

Trade Account

Trade deficit widened by US$ 938.2 million during Jul-Nov FY11 in contrast to a contraction of US$ 3220.3 million during the same period last year. Unlike last year, the sharp fall in imports improved trade account, the deterioration recorded during FY11 is principally due to an increase of US$ 2288.2 million in the import bill which outpaced the rise of US$ 1350 in export earnings.

The acceleration in the imports was a result of a increased import quantum of food and textile items. Apart from the higher import demand, relatively higher international commodity prices further inflated the import bill. In case of exports, the high value added sector of the textile group displayed a decent performance amid improved external demand, its receipts rising principally because of higher cotton prices. Export of primary commodities such as cotton, fruits and vegetables declined in quantitative terms; however this impact was partially offset by the rise in export prices.

2 Real Sector

2.1 Overview

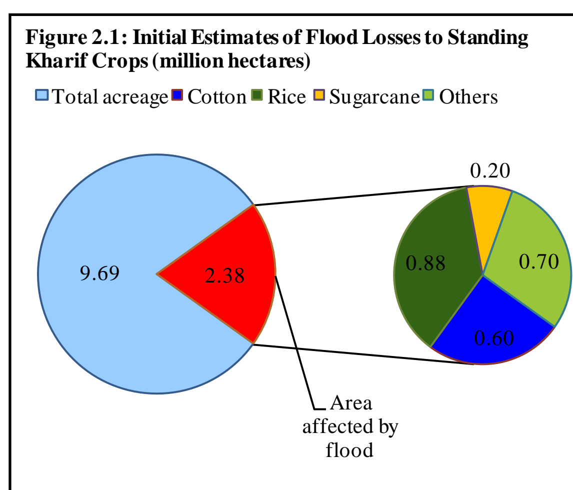
The economic recovery seen in FY10 suffered a setback in early FY11 as floods damaged about one-fourth of the country's agriculture heartland. Not only were crops and livestock destroyed, a number of agro-based industries, power plants, and other manufacturing activities were also disrupted. The combined impact of wealth and income losses is feared to have trickle down effects on domestic private consumption. Moreover, with limited fiscal space, given stringent needs for fiscal consolidation, any stimulus from public sector is hard to come.

However, an expected good performance by the services sector will provide support to GDP growth in FY11. Further, a disproportionate rise in the prices of almost all agriculture produce led to a significant increase in nominal income of the farmers. While this outcome helped sustain private aggregate demand, it also strengthened inflationary pressures in the economy. In this backdrop, SBP estimates remained unchanged from earlier assessment that FY11 real GDP growth is likely to be in the range of 2.0 – 3.0 percent.

2.2 Agriculture Sector Performance

Kharif[1] crops were planted on 9.7 million hectares, but heavy rains and floods damaged standing crops on approximately 2.4 million hectares. Initial assessment indicates huge losses to rice; cotton, maize, pulses, vegetables and fruits (see **Figure 2.1**). However, losses to sugarcane crop in flood areas were partially offset by an increase in yield in non-flood regions. The extended rains also caused higher viral/disease attacks on cotton and rice crops.

Figure 2.1: Initial Estimates of Flood Losses to Standing Kharif Crops (million hectares)



[1] Kharif season is from April-September.

Besides damages to crops, livestock and agriculture related assets and infrastructure[2] also suffered substantial losses. The State Bank of Pakistan, federal and provincial governments has initiated financial support programs for a quicker recovery of agriculture sector (see **Box 2.1**).

Box 2.1: Measures for Flood Affected Regions

The State Bank of Pakistan has announced several financial relief measures for a quick recovery of agriculture and SMEs in flood affected areas. These are:[3]

1. *Refinance scheme for revival of SMEs & agricultural activities in flood affected areas*. Rs.10 billion has been allocated to this scheme and it is launched through banks/DFIs at concessional mark up rates. Under this scheme:

a. Agricultural production/working capital loans shall be given under Prudential Regulations for agriculture finance for a maximum period of one year (based on cropping cycle).

b. Short term loans for working capital requirements of SMEs for a period of one year.

2. *Concessional financing and guarantee scheme for canola cultivation in flood affected areas*. An amount of Rs500 million was allocated under this scheme. It is also expected that MINFA and Provincial agri-departments would ensure timely availability of seeds, fertilizers, pesticides and proper technical guidance. Loan will cover under credit guarantee scheme, where SBP would share bona-fide losses of banks to the extent of 30 percent. These production loans will be given at affordable rates for a maximum period of six months (based on cropping cycle).

3. *Other relief packages*

a. Restructuring/rescheduling of overdue loans for 2 years.

b. Provision of fresh credit through SBP refinance window for 2 years at 8.0 percent per annum with bank spread of 3.0 percent.

c. Exemption from additional provisioning requirement for one year.

Crops

Cotton and rice harvests declined significantly during *kharif FY11*, whereas sugarcane output increased slightly due to substantial yield gains in non-flood areas (see **Table 2.1**). Despite low water availability at sowing time, area under cotton increased due to attractive prices. However, floods damaged FY11 cotton crop on about 0.6 million hectares (see **Table 2.2** and **Figure 2.2**), thus, effective area under cotton fell to 2.5 million hectares. Cotton crop was also damaged by heavy rains in major cotton districts. Consequently, cotton production dropped to 11.7 million bales, down by 9.4 percent during FY11. However, data of cotton arrival at ginning factories shows a larger decline. Specifically, 9.4 million bales of cotton arrived at ginning factories up to December 15, 2010, down by 16.8 percent from 11.3 million bales arrived in the same period last year. Anecdotal evidence suggests that farmers might have held back cotton due to rising prices.

---

[2] Dams, power stations, bridges, canal banks, water courses, tube-wells, agriculture wells, farm to market roads and storage/silos damaged in 78 districts across the country.

[3] For details visit: *www.sbp.org.pk/smefd/circulars/2010/C16.htm*

The difference between cotton harvest and arrival data may narrow January 2011 onwards.

Table 2.1:Performance of Major Crops

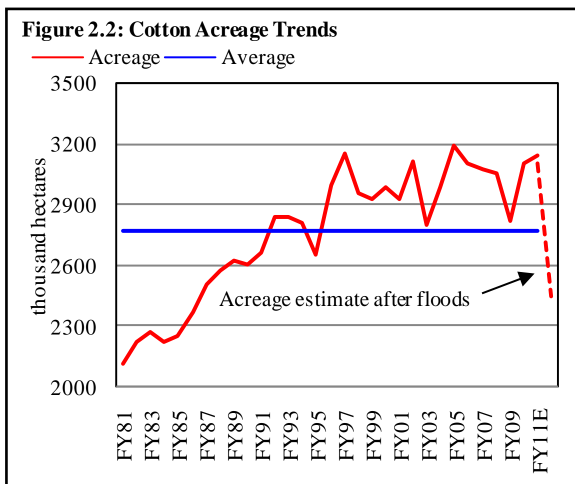
Crops	FY09	FY10^P	FY11^T	FY11^E	YoY growth in FY11
Area under cultivation (000 hectares)					
Cotton	2,850	3,106	3,200	3,142	1.2
Sugarcane	1,029	943	1,070	1,047	11.0
Rice	2,963	2,883	2,708	2,642	-8.4
Wheat	9,046	9,105	9,045	-	-
Gram	1,092	1,050	1,122	-	-
Maize	1,062	950	1,010	-	-
Production ('000 tons; cotton in '000 bales of 170.09 kg each)					
Cotton	12,060	12,914	14,010	11,700	-9.4
Sugarcane	50,045	49,373	53,665	49,400	0.1
Rice	6,954	6,883	6,048	5,949	-13.6
Wheat	24,032	23,917	25,000	-	-
Gram	740	571	619	-	-
Maize	3,548	3,477	3,452	-	-
Yield (Kg/hectare)					
Cotton	720	707	745	633	-10.4
Sugarcane	48,635	52,357	51,000	47,182	-9.9
Rice	2,347	2,387	2,228	2,252	-5.7
Wheat	2,657	2,627	2,764	-	-
Gram	696	544	552	-	-
Maize	3,341	3,660	3,419	-	-

P: Provisional, T: Target, E: Highly provisional estimates
Source: Ministry of Food & Agriculture estimates released on November 1, 2010.

Sugarcane production was estimated at above 55 million tons during FY11. The floods damaged standing sugarcane crop on 0.2 million hectares. But as with the basmati rice, this crop also benefited from heavy rains and wet weather in non-flood areas and higher yields partially compensated for the flood losses. Provisional estimates by MINFA suggest sugarcane harvest at 49.4 million tons during FY11, slightly higher than in the preceding year.

Market prices for sugarcane were substantially higher than the indicative price set by the provincial governments. Although prices were higher than the corresponding season of FY10, farmers reportedly held back their crops for even higher prices. As a result, crushing in mills remained lower and some reports suggest that sugarcane divergence to *gur* has increased.

Figure 2.2: Cotton Acreage Trends



On positive side, floods and extended heavy monsoon rains improving the underground water table, soil moisture level and increasing water availability in reservoirs brightened the

prospects for FY11 *rabi* cropping season. In particular, a significant increase in wheat output is expected from un-irrigated (*barani*) areas in FY11. Government set a target of 25 million tons, and the possibility of a record wheat harvest in FY11 cannot be ruled out. Government maintained wheat support price at Rs.950/40 kg, but small farmers are likely to fetch better prices than the preceding years as both domestic prices, as well as, international wheat prices are expected to remain firm in the first half of 2011.

Table 2.2: Provisional Estimates of Cotton

Area in 000 hectare; production in 000 bales

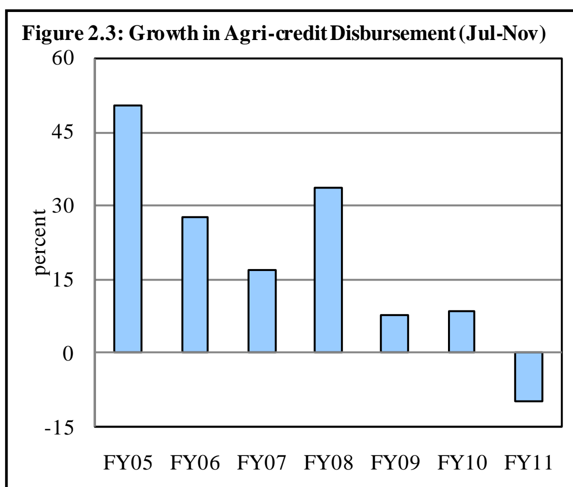
Province	Area sown	Area flooded	Prod. losses	Remaining prod.
Punjab	2,499	405	1,574	8,126
Sindh	650	191	1,020	3,180
Khyber Pukhtoonkhwa	10	0	0	10
Balochistan	40	2	5	95
Total	3,199	598	2,599	11,411

Source: Ministry of Food & Agriculture. This data is based on estimates released on October 13, 2010. The aggregate estimates were later revised by the Ministry on November 1, 2010 for which complete province-wise break up was not available.

Livestock

Livestock sub-sector, which accounts for 53.2 percent of agriculture sector value addition and 11.4 percent of GDP, also suffered losses due to floods. Not only thousands of animals died, various types of diseases (e.g., Hemorrhagic Septicemia (HSD), Liver Fluke, Foot rot, posterior paralysis, etc.) in flood hit regions also affected growth in this important sub-sector.

Figure 2.3: Growth in Agri-credit Disbursement (Jul-Nov)



It is important to note that a relatively stable growth in livestock sub-sector during the last few years had contributed strongly to agriculture growth and compensated for a higher volatility observed in crops sub-sector.[4] Given strong domestic and external demand for livestock products, flood related losses would further add pressure on prices in months ahead.

[4] Standard deviation of growth in livestock is 4.0 for FY01-FY10 as against standard deviation of 6.1 for growth in crops sub-sector during this period.

Agri-credit

Agri-credit disbursement showed a negative growth of 9.6 percent YoY, lowest in last six years, in Jul-Nov FY11, compared to reasonable growth of 8.7 percent in the same period of FY10 (see **Figure 2.3**). This fall is mainly attributed to (1) dismal lending activity by one of the specialized banks (see **Table 2.3**) due to its larger exposure in flood affected areas, and (2) cautious lending by five major commercial banks.

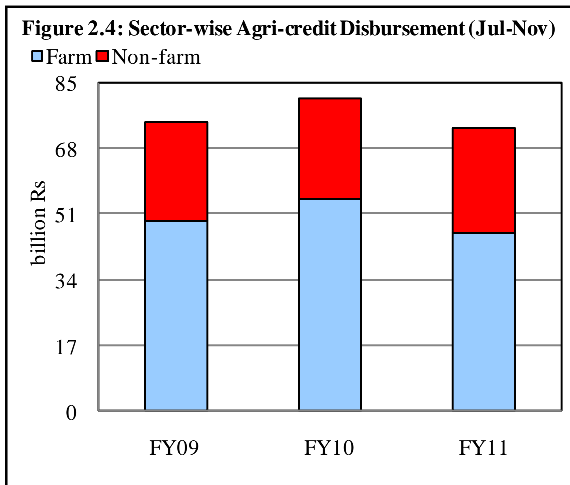
Table 2.3: Agriculture Credit Trends (Jul-Nov)

billion Rupees; Growth in percent

	Disbursement		Growth	
	FY10	**FY11**	**FY10**	**FY11**
Commercial banks (CBs)	*58.3*	*59.1*	*5.6*	*1.4*
5 big commercial banks	44.9	43.1	16.7	-4.2
Domestic private banks	13.3	16.0	-20.0	20.3
Specialized banks	*22.7*	*14.1*	*17.3*	*-38.0*
ZTBL	21.8	12.6	19.4	-42.3
PPCBL	0.9	1.5	-18.2	69.9
Total	**81.0**	**73.2**	**8.7**	**-9.6**

It is important to mention that rising NPLs in agri-sector are already a source of concern for the banks, and heavy losses due to floods further complicated the situation. Commercial banks may opt risk averse behavior and limit their exposure in agri-sector, which would hurt growth in this important sector.

Figure 2.4: Sector-wise Agri-credit Disbursement (Jul-Nov)



Moreover, the specialized banks were constrained by limited funds to lend as their lending is based on recoveries, which are low because of their higher exposure in long-term developmental loans. On the other hand, CBs and domestic private banks (DPBs) mainly lend for short-term production purposes.

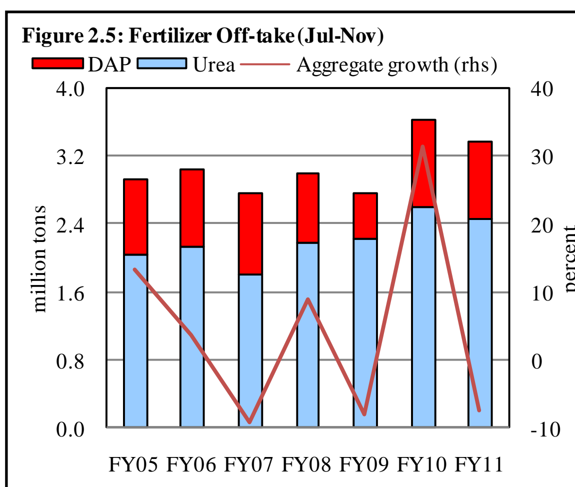
A disaggregated analysis shows that the share of farm sector in total agri-credit declined in Jul-Nov FY11. Credit disbursement to farm-sector declined by 15.8 percent during Jul-Nov FY11 compared with sharp increase of 12.1 percent in the same period last year. While, non farm sector showed a growth of 3.5 percent in Jul-Nov FY11, in contrast with 2.1 percent during Jul-Nov FY10 (see **Figure 2.4**). This analysis reinforces the view that the present contraction in credit

disbursement to agri-sector is a consequence of floods as farm sector was hit hard by this calamity.

Fertilizer

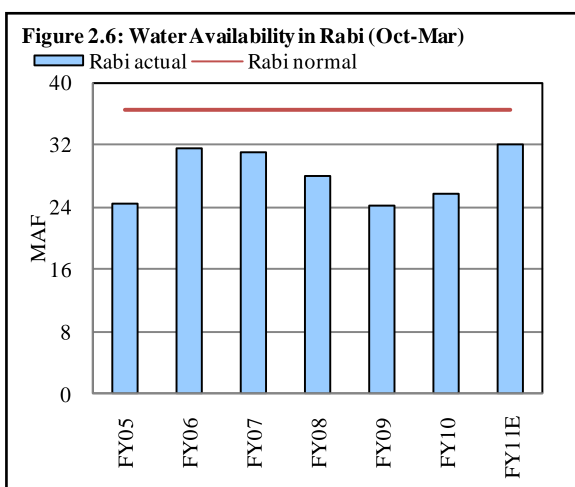
Heavy damages to the infrastructure, displacement of farmers and sluggish activities of farming sector restricted off-take of fertilizers during Jul-Nov FY11. However, the impact of flood on fertilizer off-take may be temporary as: (a) bright outlook for *rabi* crops would lead to higher off-take; (b) availability of concessional credit facilities in flood affected areas would also support off-take, as well as, (c) increased farm income (due to higher prices of most of the agri- produce) would encourage farmers to enhance yield of *rabi* crops by taking advantage of the soil moisture through increased use of fertilizers.

Figure 2.5: Fertilizer Off-take (Jul-Nov)

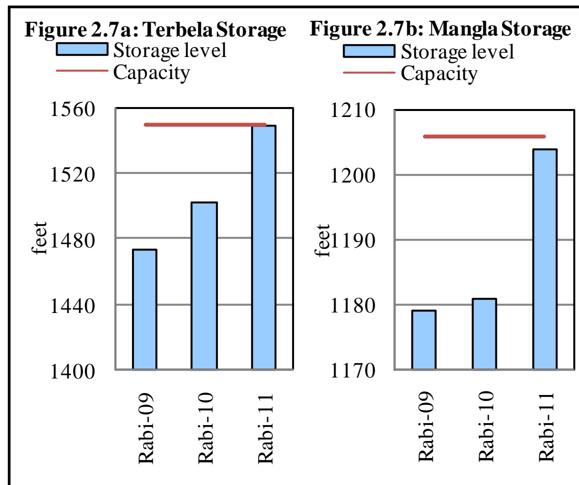


Apparently, a sharp decline of 7.4 percent in aggregate fertilizer off-take during Jul-Nov FY11 compared with a strong growth of 31.4 percent last year seems quite disappointing (see **Figure 2.5**). However, surge in fertilizer off-take during Jul-Nov FY10 was an exception as farmers aggressively piled up inventories due to lower prices.

Figure 2.6: Water Availability in Rabi (Oct-Mar)

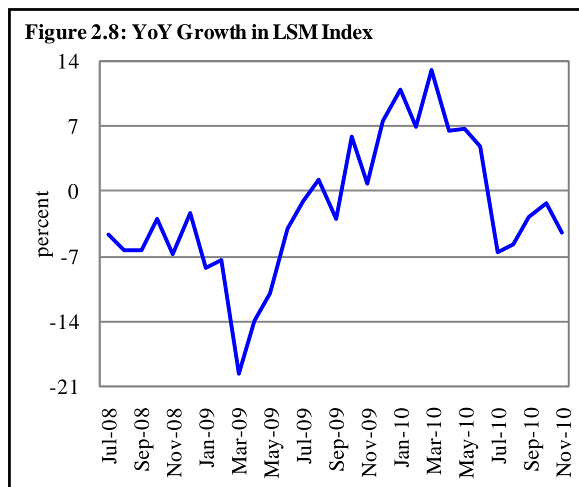


A disaggregated analysis indicates that DAP decline was more pronounced as its off-take dropped by 12.7 percent YoY, whereas urea off-take fell by 5.2 percent during Jul-Nov FY11. A fall in DAP off-take is a function of high base as DAP off-take rose sharply in FY10 amid substantially lower prices.



Water Availability

After heavy and extended monsoon rains, irrigation water availability for *rabi* FY11 improved to the highest level in over a decade (see **Figure 2.6**). This rise is also indicated in the water storage levels at Tarbela and Mangla dams, which are almost full to their capacities compared to the corresponding period in FY10 and FY09 (see **Figure 2.7a &b**).



The water availability in the reservoirs is likely to support wheat sowing in irrigated areas. Area under wheat in non-irrigated areas is also likely to increase due to higher moisture and likely rains during *rabi* FY11.

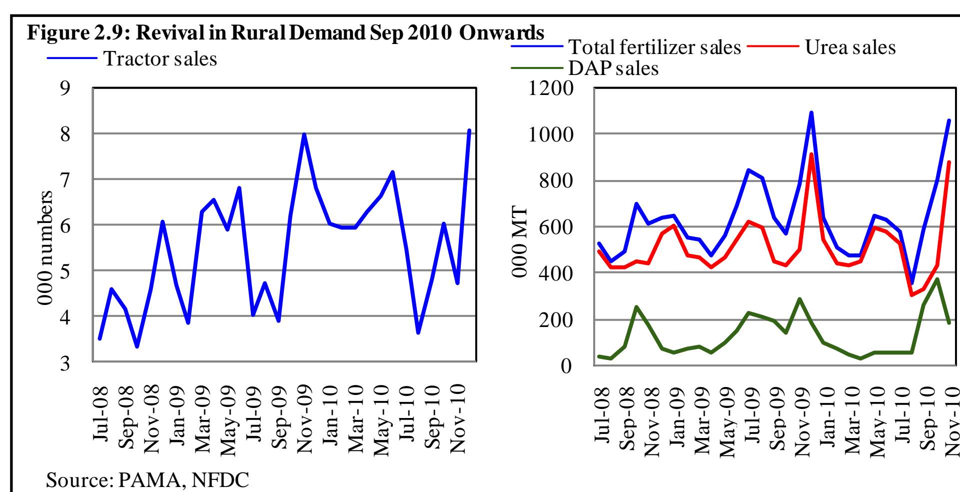
2.3 Large-Scale Manufacturing

The momentum in large-scale manufacturing (LSM) growth seen in FY10 was upset in the initial months of FY11 as YoY LSM growth turned negative in August 2010, for the first time in 11 months and remained in the negative in the following four months (see **Figure 2.8**). A decline was expected in the initial months of FY11 after heavy rains and floods, which particularly affected construction, petroleum refining, cotton textiles, and agro-based industries.

Nevertheless, strong domestic demand, helped partly by exceptionally high prices of most of the agri commodities, led to robust growth in automobiles, fertilizers, rubber, and engineering industries. Moreover, strong external demand supported the growth in chemicals and leather. Cumulative LSM production declined by 2.3 percent YoY during Jul-Nov-FY11 compared with growth of 0.5 percent in Jul-Nov-FY10.

Private demand sustained during the initial months of FY11 mainly supported by

Figure 2.9: Revival in Rural Demand Sep 2010 Onwards



Source: PAMA, NFDC

higher nominal incomes: a 50 percent increase in government employees' salaries, sharp increase in the prices of most of the agri produce that partly offset the decline in rural incomes caused by poor harvests in FY10, significant rise in workers' remittances, commercial banks' renewed interest in consumer financing, as well as, private and public transfer payments to the flood-affected population. Moreover, rural demand recovered swiftly, after a temporary setback in August 2010, as evident from the rebound in fertilizer and tractor sales (see **Figure 2.9**). The growth in tractors sales is particularly encouraging given that these purchases were made by farmers in the absence of subsidies offered last year under the Benazir Tractor Scheme. Besides, the drop in August sales is also partly attributable to temporary supply bottlenecks rather than slowdown in demand alone.

Table 2.4: Car Financing and Sales (Jul-Nov)

	FY10	FY11
Disbursements (mln Rs.)	6,252	22,969
Avg. car price (Rs.)*	854,122	912,822
Car sales	42,166	46,822

* Average of 11 car models; Source: PAMA, Automark.

Automobile demand was strengthened by higher bank financing which shored up car sales despite the increase in prices (see **Table 2.4**). Similarly, production of some of consumer electronics rose sharply despite imposition of federal excise duty in Budget FY11. In fact, continued indigenization of automobiles partly contained the pass-through of currency depreciation on local prices, while duty reductions on imports of some electronic parts have helped firms reduce their costs.[5]

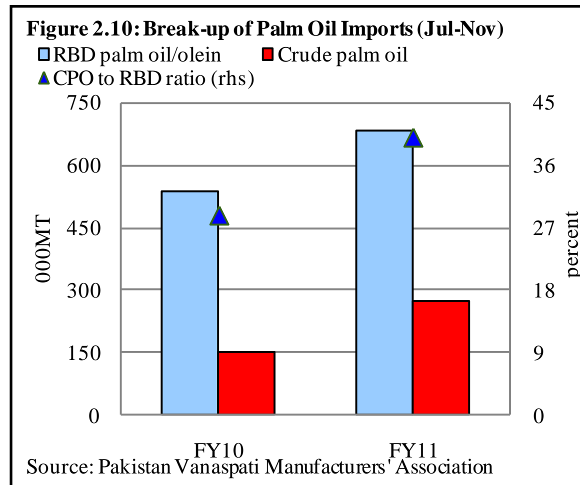


Figure 2.10: Break-up of Palm Oil Imports (Jul-Nov)

Source: Pakistan Vanaspati Manufacturers' Association

Vegetable oil and ghee processing was another industry that benefitted from fiscal measures, namely; Rs1, 000/MT duty reduction on crude palm oil imports. This has encouraged local processing units to import more crude palm oil as opposed to the value-added RBD (refined, bleached and deodorized) version (see **Figure 2.10**). However, the impact of this duty reduction was limited due to (1) the fact that out of over 100 oil and ghee processing units in the country, only 11 have refining capacity, and (2) cap on crude palm oil exports by the government of Malaysia. Pakistani importers purchase palm oil mainly from Malaysia because of a free trade agreement between the two countries.

Table 2.5: YoY Growth in Construction Activity Indicators (Jul-Nov)

percent

	FY10	FY11
Local cement sales	12.8	-8.8
Credit for construction	-3.2	4.5
FDI in construction	135.8	-44.3
Production in construction-related industries (Jul-Oct)	11.5	-15.3
Building material prices (WPI)	-14.3	12.1

Despite the resilience in private demand, construction activity sharply declined in Q1-FY11 due to adverse weather. A slowdown in construction material demand

[5] SRO 292(I) 2010 dated June 5, 2010, 5 percent import duty exemption is given on certain parts of evaporators and condensers for air conditioners, deep freezers, and condensers, as well as on LED (light emitting diode) panel sets, and on parts of energy saving lamps. Apart from the electronics industry, the SRO also mentions duty reduction on raw material for laundry soap/detergent, glass manufacturing (sodium sulphate), and leather tanning industries.

was also expected on the back of continued increase in building material prices. Furthermore, anecdotal evidence suggests that while housing construction is gradually growing, commercial ventures have slowed down considerably due to lackluster outlook for real estate in major urban centers (**Table 2.5**).

Encouragingly, a pickup in domestic cement sales October 2010 onwards hints that construction may recover sooner than expected.[6] Anecdotal evidence suggests that the sales are mainly driven by private housing demand as no major public construction work has started. However, expected construction of Bhasha dam along with repair of the infrastructure damaged in the floods is also hoped to spur public construction work in the months ahead.[7] Lastly, expansion of cement manufacturing capacity in Q2-FY11, and commissioning of a new private steel mill in Q3-FY11 is hoped to further support construction.

Export demand for cement, however, declined during the period under review, mainly due to expansion of cement capacities in importing countries and increasing global competition. It was fairly anticipated that the export-led growth in the cement sector seen in the recent past will lose some steam as competition tightened.

Some other export-based industries, including pharmaceutical and electric fans, which benefitted from geographical diversification in the past two years, lost ground in non-traditional markets. For the pharmaceutical sector, this decline came about in response to increasingly stringent quality requirements for drug exports, and growing competition from India, on the other hand, fan exports are losing to both Chinese and Indian manufacturers in destination markets.

On the other hand, gradual recovery in the US and EU provided a boost to export-based leather and textile industries. However, while higher exports are reflected in quantum growth of the leather industry, the textile sector is predominantly gaining from higher prices, since raw material shortages faced by the textile industry, particularly due to cotton crop damaged in the floods, have constrained production. Thus, overall, the external sector had a very mixed impact on local industries during Jul-Nov FY11 (see **Table 2.6**).

[6] Data provided by the All Pakistan Cement Manufactures Association shows that domestic cement dispatches grew by 2.1 percent YoY during Oct-Nov 2010, compared to a 16.0 percent YoY decline in Q1-FY11.
[7] According to the National Disaster Management Authority, 33 bridges have been damaged, including five that were washed out completely, railway tracks have suffered a loss of Rs. 5.3 billion, and 12,516 school buildings have received damage of some kind. Damages to health facilities along with fuel oil storage and refining facilities are in addition.

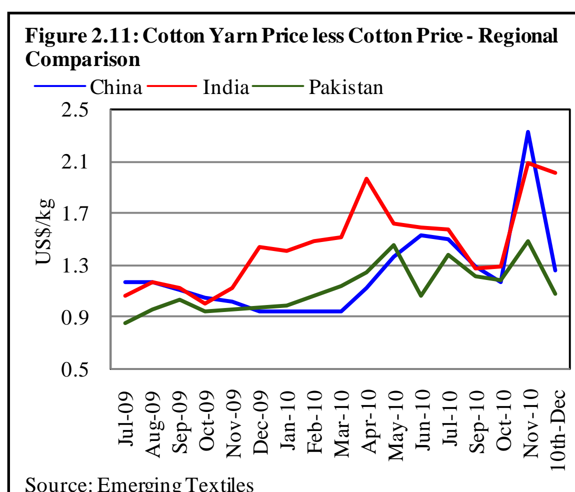
Table 2.6: Production & Trade of Selected Manufacturing Goods (Jul-Nov)
percent YoY growth

Growth in Industries Producing Exportable Surplus						**Growth in Industries Competing with Imports**					
		Production		**Export**				**Production**		**Import**	
	AdWt	**FY10**	**FY11**	**FY10**	**FY11**		**AdWt**	**FY10**	**FY11**	**FY10**	**FY11**
Cotton ginned	4.49	9.2	-10.5	109.9	-47.7	POL prod.	6.97	-7.1	-10.6	25.1	-7.6
Cotton yarn	17.40	-2.3	-12.3	41.8	-26.3	Steel products	0.15	-13.5	4.1	-8.2	-21.0
Cotton cloth	10.06	-0.7	-2.3	-27.6	6.4	M.M. yarn	2.55	-1.6	6.6	4.9	53.0
Leather f.wear	0.69	-1.7	18.6	-26.4	-3.3	Fertilizer	4.51	1.0	3.0	144.3	-53.7
Pharma	6.70	2.4	-3.2	68.0	-38.2	Tyre & tube	0.40	32.7	-7.7	-38.6	88.1
Cement	5.52	14.2	-11.2	6.8	-15.7	Auto CBUs	5.27	11.1	12.9	1.0	-1.3
Electric fans	0.24	15.6	-15.2	43.2	-8.6	Glass sheet [1]	0.07	-9.7	-17.5	-36.2	100.4
Chemicals	6.40	1.8	2.3	-11.2	14.0	Wood	0.04	-35.4	-20.4	3.8	32.9

[1] H.S. Codes 7003-7005.
Sources: FBS. Glass sheet import is based on SBP statistics. Automobile, chemical, wood, and SBP statistics refer to values while the rest are quantum growth numbers.

Aggravated by domestic shortage of cotton and tightening of export restrictions by India, cotton prices inflated sharply during Jul-Nov FY11.[8] Nevertheless, the strong recovery in value-added textile exports kept demand firm in the domestic cotton yarn market in the initial months of FY11, leading to an improvement in operating margins compared to last year. Although Pakistani spinning mills have the lowest yarn-cotton price differential compared to China and India, margins have slightly improved this

Figure 2.11: Cotton Yarn Price less Cotton Price - Regional Comparison

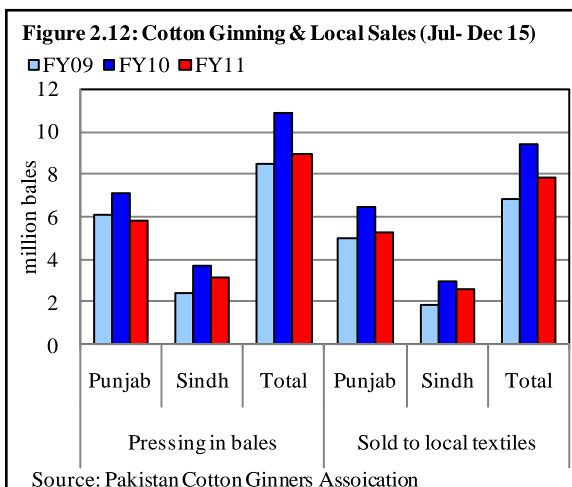


Source: Emerging Textiles

[8] Pakistani textile mills have placed orders with Indian cotton exporters. However, dispatch of orders was delayed due to India's export licensing requirements. Domestic raw cotton prices grew by an average 97.1 percent YoY during Jul-Nov-FY11 compared to an average decline of 1.1 percent in the comparable period last year.

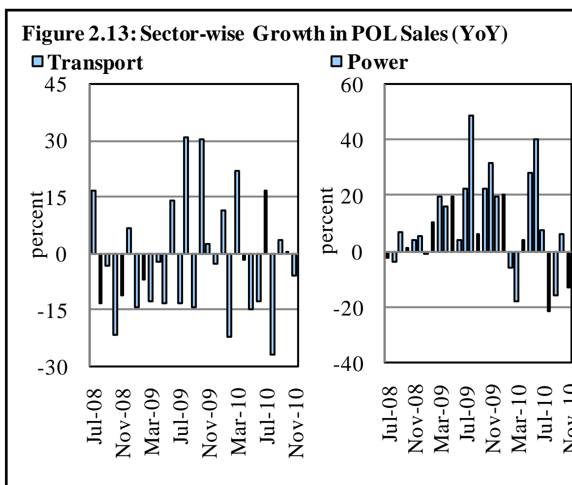
year (see **Figure 2.11**) which has led to relatively active buying by the spinning mills, especially in Sindh, where heavy exports of raw cotton in FY10 dried up the local market.[9] Although cotton arrivals for ginning up to mid Dec-FY11 were lower by 16.9 percent over the same period last year, sales to local textile mills declined by a smaller proportion (see **Figure 2.12**). Moreover, spinning mills are also making up for the shortage of natural fiber by increasing blending with synthetic yarn. This is reflected in higher production and imports of man-made fiber.

Figure 2.12: Cotton Ginning & Local Sales (Jul- Dec 15)



Source: Pakistan Cotton Ginners Assoication

Figure 2.13: Sector-wise Growth in POL Sales (YoY)



Raw material shortages were also pronounced in the steel industry during Jul-Nov FY11. This was partly due to flood-related disruptions caused by damaged road networks. Supply was further aggravated due to long standing unresolved financial issues which prevented adequate import of raw material.

In contrast, despite higher crude oil imports, production remained low in the POL sector as the country's largest refinery had to close down for over one month due to inundation in flood water.[10] Moreover, it appears that domestic demand also dropped due to both: (a)

[9] According to Pakistan Cotton Ginners' Association, Sindh exported 0.69 million MT of cotton in FY10 compared to 0.11 million MT exported by Punjab.
[10] Reference is to PARCO, 35 percent share in total refining capacity.

rising fuel prices (particularly diesel); and (b) in the aftermath of floods because of damages to road networks and power infrastructure (see **Figure 2.13**).

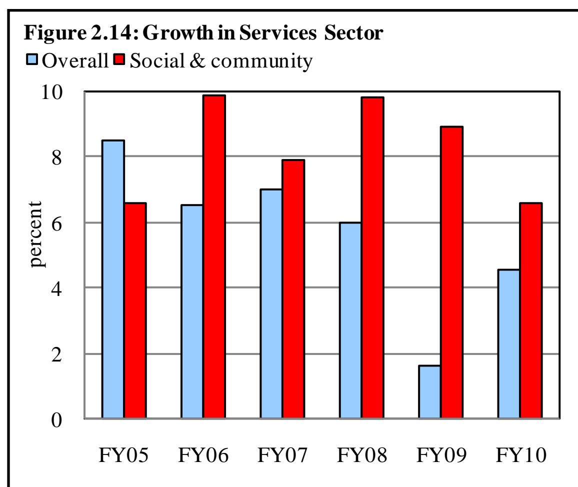
The floods have also caused significant damage to the country's power infrastructure, including power plants, gas fields, and grid stations. This has no doubt increased manifold the massive investment gap in the country's energy sector which could be a significant constraint for industrial growth in the coming months. In this regard, growing private investment, particularly foreign investment, in thermal power generation and oil & gas exploration is encouraging.

2.3 Services

Unlike the sluggish performance by the commodity producing sectors, services sector is likely to surpass the 4.7 percent growth target set in FY11. This expectation is based on the exceptional contributions by the *social & community services* sub-sector during the current fiscal year as extensive relief and rehabilitation work has been done in flood affected areas by public, private, and foreign organizations. It is important to note that this sub-sector grew by a *record* 9.9 percent in FY06 (see **Figure 2.14**) mainly due to relief and rehabilitation work after the October 2005 earthquake in Northern areas of the country.

However, key indicators of different sub-sectors paint a mixed picture of the performance of *wholesale & retail trade, transport & communication* and *finance & insurance*. For instance, contribution in value addition by the trade activities is likely to be lower from agriculture as FY11 *kharif* crops, mainly cotton, rice, and sugarcane, as well as, livestock was hit by the floods. At the same time a robust growth in imports (see **Table 2.11**) would support value addition growth by the trade sub-sector. Overall, trade sub-sector is likely to show a weaker growth during FY11 than the target for the year and growth seen in FY10. As with the trade sub-sector, growth in *transport, storage &communication* sub-sector also suffered some setback due to slowdown in economic activity during Q1-FY11 as reflected in decline in the POL sales to

Figure 2.14: Growth in Services Sector



the transport sector during the quarter (mainly due-to the lower sales of HSD) and fall in cargo handling at one major port. This sluggishness was mainly attributed to the damages to infrastructure and road network in recent floods, as well as rise in HSD prices amid gradual elimination of subsidy and passing on the impact of rising international prices. However, a slight increase in the transport sector's fuel demand in October and significant growth in commercial vehicle sales are indicating a recovery. Moreover, a significant growth in the telecom sub-sector in Q1-FY11 and likely increase in transportation following the bailout package of 11.5 billion rupees approved by the federal cabinet for Pakistan Railways are likely to provide further impetus to growth in *transport & communication* sub-sector.

Table 2.7: Indicators of Services Sector Performance during Jul-Nov

percent growth unless mentioned otherwise

	FY10	FY11
Wholesale & retail trade		
Credit to wholesale & commission trade	-1.3	-1.2
Credit to retail trade	4.4	14.0
FDI in trade	- 52.8	- 56.9
Manufacturing growth	0.5	-2.3
Import growth	-23.0	17.5
Transport, storage & communication		
Cargo handling at ports	15.2	5.7
Teledensity	62.4	64.1[1]
Telecomm imports	-52.2	55.7
Commercial vehicles sales	16.2	2.7
Transport group imports	7.1	7.1
Transport & communication prices	-3.7	16.2
Finance & insurance		
Profits of commercial banks (QoQ)	81.2	99.7
Credit to private sector	1.0	0.9
Deposits	-0.4	0.7
Interest rate spread- stock	7.4	7.6
Interest rate spread- incremental	6.5	6.2

[1] Data pertains to June 2010.

Apparently, a massive improvement in the profitability of the banking sector during Q1-FY11 suggests that *finance & insurance* sub-sector will show an exceptional performance during FY11. However, the impact of rise in nominal profits is likely to be diluted due to higher headline inflation. In addition, imposition of withholding tax on cash withdrawals from banks in the budget FY11[11] may also result in some disintermediation.

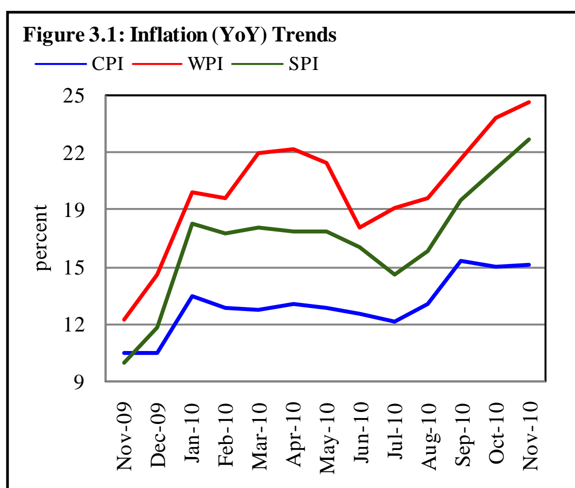
[11] Various banking transactions including withdrawals through a range of instruments related to Demand Draft, Pay Order, Online Transfer and Telegraphic Transfer are subjected to 0.3 percent deduction of the advance tax, if such transactions exceed threshold of Rs.25,000 in a single day.

3 Prices

3.1 Overview

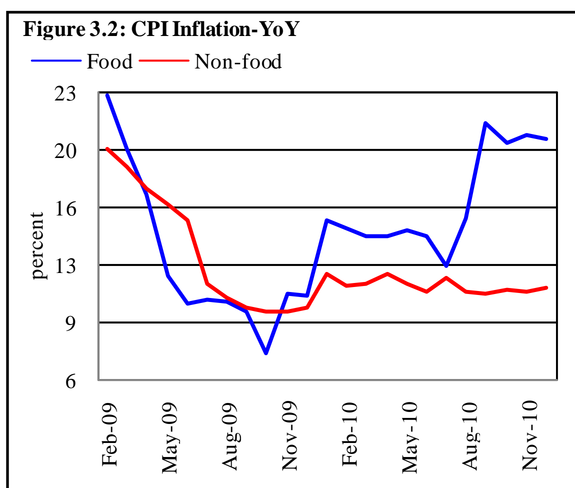
Inflationary pressures strengthened significantly in the economy during recent months. All price indices showed the rising inflation (see **Figure 3.1**). Specifically, headline CPI inflation (YoY) rose to a 17-month high of 15.7 percent in September 2010 before falling to 15.5 percent during November 2010. Similarly, inflation measured by WPI and SPI also surged during the first four months of FY11. The rising pace of WPI inflation is a source of concern, since it is likely to push up the otherwise stable CPI non-food inflation (see **Figure 3.2**).

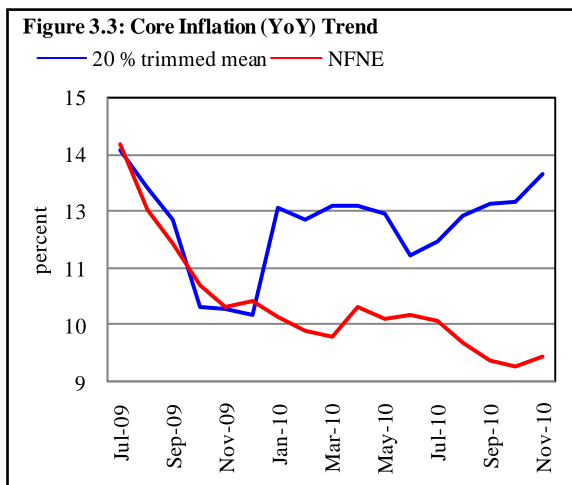
Figure 3.1: Inflation (YoY) Trends



The major contributors to rising inflationary pressures in recent months include: (a) supply shortages of many perishable food commodities due to floods and rains, (b) direct impact of passing on of the higher global commodity prices, (c) indirect impact of increased fuel prices on the transportation cost, (d) upward adjustment in electricity tariff, as well as, (e) strong external demand for some key food staples. At the same time, excessive government budgetary borrowing, particularly from the central bank, is not only supporting strength in aggregate demand, it is also diluting the impact of monetary measures to contain inflation.

Figure 3.2: CPI Inflation-YoY





Core inflation measured by 20% trimmed mean (20%TM) also indicates a gradual build up of inflationary pressures in the economy. Core inflation (20%TM) rose from 11.7 percent YoY in June 2010 to 13.4 percent YoY in November 2010. In contrast, core inflation measured by excluding food and energy from the CPI basket (NFNE) hit a 31-month low of 9.3 percent YoY in October 2010. However, the latter should not be taken in complacency, as it only reflects that the current inflation is principally driven by food and energy (see **Figure 3.3**). Prima facie inflation from both food and energy appears to be transitory shock, but unfortunately, both of these components strengthen inflationary expectations and have strong second-round effects through pressures on wages and increases in the cost of production.

It is also important to note that a large part of the transitory shock on the prices of perishable food commodities due to floods, already shown some ease[1] in October 2010, is likely to be over by mid December 2010. However, as a consequence of this temporary price shock coupled with jump in sugar prices, a sense of pricing power was instituted amongst the traders, which leads to abnormal profiteering, particularly at retail level. This tendency is an important hurdle in containing inflation, despite substantial improvement in supply of minor crops. Moreover, continued monetization of fiscal deficit is also contributing in fueling inflationary pressures in the economy.

In this background, SBP raised policy rates by 50 basis points effective from 30th November 2010; this was third consecutive rise of the same magnitude in the first five months of FY11.[2] While the policy stance helped stabilizing non-food inflation during CY2010, the imposition of RGST, a gradual weakening of rupee and continuation of upward adjustment in electricity tariff would augment

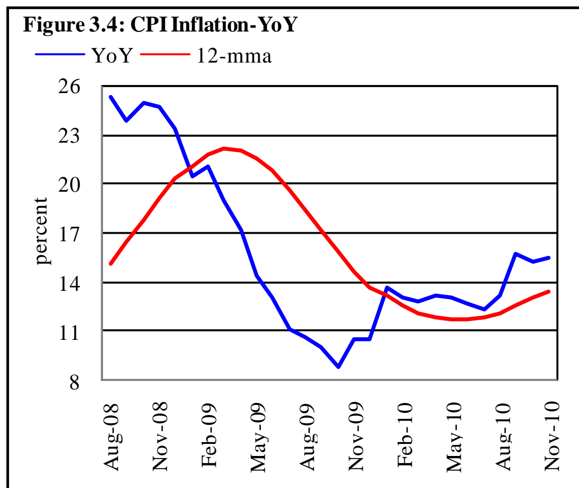
[1] Prices of perishable food commodities rose by 53.9 percent in September 2010, this pace slowed to 42.1 percent in November 2010.
[2] Earlier, SBP increased policy rate twice by 50 basis points each effective from 2nd August, 2010 and 30th September 2010.

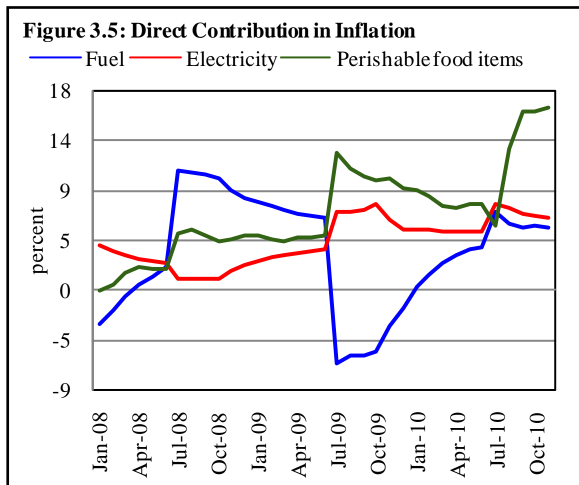
inflationary expectations in months ahead. Thus the SBP has to be vigilant to counter the impacts of these developments to mitigate the second round effects.

On positive side, imposition of proposed RGST will increase the possibility of fiscal consolidation during FY11. However, continuation of budgetary borrowings from the central bank will offset any gains from improvements in fiscal indicators. It should also be remembered that an expected deterioration in external balances would also build inflationary pressures from the weakening of rupee parity. Therefore, while monetary tightening can only attempt to maintain macroeconomic stability, fiscal prudence is a pre-requisite for price stability.

Consumer Price Index

The headline CPI inflation resumed its uptrend in the first four months of FY11, after witnessing resilience in H2-FY10 (see **Figure 3.4**). Headline CPI inflation (YoY) stood at 15.5 percent in November 2010, though slightly lower than the 15.7 percent registered in September 2010, was uncomfortably high. The recent surge in CPI inflation was largely due to rising food inflation. In addition, upward adjustment in the prices of key fuels amid rising international prices and gradual reduction in subsidy on electricity are also important contributors in the significantly high inflation in recent months (see **Figure 3.5**). Further, domestic prices of a number of commodities also pushed up as international commodity prices resurged on supply concerns, strong demand





from emerging economies and weakening of US dollar.

A disaggregated analysis suggests that over 40 percent of food inflation is contributed by vegetables, sugar and dairy products (see **Table 3.1**). In particular, contribution of perishable food commodities in overall CPI inflation rose to 16.5 percent YoY in November 2010 – the highest since September 2004.[3] While, increased transportation cost is a common factor for all these items, a large part of rise in the prices of these items is associated with market structure problems and absence of effective consumer associations. A collective move on reduction of consumption of at least perishable commodities may force traders to rationalize their margins. In the case of vegetables and fruits, media can play an important role by increasing the coverage of wholesale prices of these commodities at prime time that would create awareness amongst consumers and improve their bargaining at retail outlets.

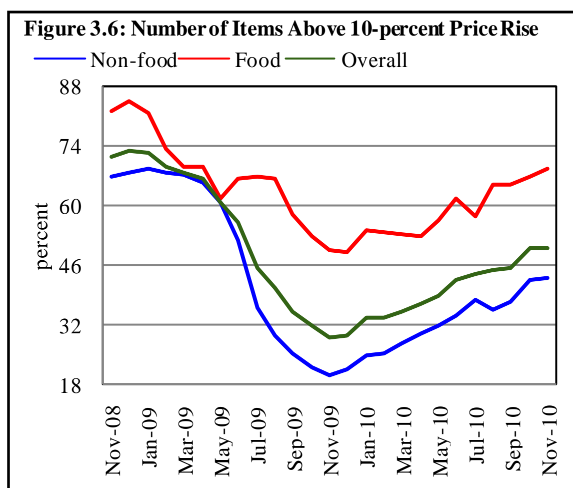
Table 3.1: Weighted Contribution to Food Inflation

percent

	Weights	CPI YoY Nov-09	CPI YoY Oct-10	CPI YoY Nov-10	Contribution
Vegetables	4.7507	20.2	47.7	26.2	7.8
Sugar	4.8255	50.1	81.2	56.2	10.8
Milk fresh	16.5127	14.0	15.3	18.1	14.3
Meat	6.6881	17.6	27.9	28.4	11.5
Vegetable ghee	6.6115	1.1	18.6	27.1	8.4
Onions	1.4806	14.2	65.1	167.7	12.4
Fresh fruits	4.0058	19.3	21.3	19.9	3.4
Pulse moong	0.5528	39.0	160.8	103.3	2.7
Readymade food	4.1726	11.7	15.7	17.5	3.6
Wheat flour	12.6723	6.3	3.2	4.5	3.4
Total	**62.2727**				**78.1**

Another significant development is that inflationary pressures are now more broad-based. This is evident from the rising number of items registering double digit increases in both food and non-food groups in recent months (see **Figure 3.6**).

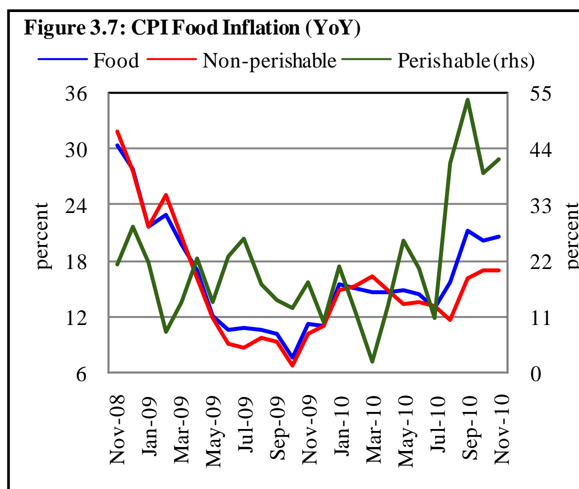
Figure 3.6: Number of Items Above 10-percent Price Rise



[3] The sharp surge in the prices of perishable food items in FY05 was largely due to low base effect as prices of these commodities plummeted during FY04 due to ample supply.

CPI Food Inflation

CPI food inflation rose to a 19 month high of 21.2 percent YoY in September 2010 before falling to 20.5 percent during November 2010. Recent surge in food inflation is mainly attributed to: (a) damages to minor crops and some major crops by floods and rains, (b) speculative hoarding of sugar, (c) higher transportation costs, (d) strong external demand for some commodities, and (e) rising international commodity prices.



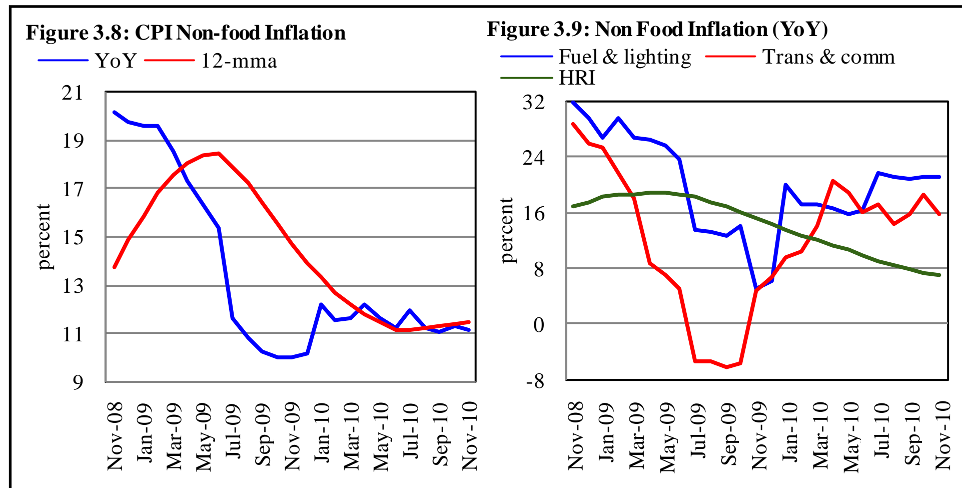
Segregated analysis of food group into perishable items and non-perishable items shows that generally food inflation is moving closely with the inflation in non-perishable commodities (see **Figure 3.7**). However, in the aftermath of the floods, a sharp jump in the prices of perishable commodities led to a departure of food inflation from the inflation in non-perishable items. Going forward, a rising trend in the prices of non-perishable commodities, albeit at lower pace, and a moderation in the prices of perishable items is likely to restore the earlier trend, i.e., convergence between food inflation and non-perishable items.

Inadequate imports, due to defaults by three international suppliers for import tenders of various quanta of sugar, resulted in domestic supply shortages. At the same time, hike in international sugar prices, gloomy outlook for domestic sugarcane harvest for FY11 and limited stocks with the government agencies drove domestic sugar prices to record high level. The contribution of only sugar in CPI food inflation was 10.1 percent in November 2010. These developments indicate weaknesses in the market structure and could be tackled through regulations and administrative measures. Above all, it appears that if private sector would have participated actively in sugar imports, sugar prices may not have soared to this level due to competitive pressures and sufficient supplies.

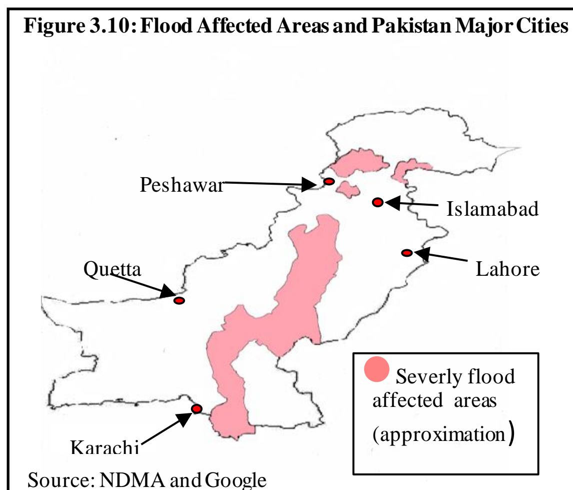
CPI Non-food Inflation

CPI non-food inflation has moved within narrow range during the recent months

(see **Figure 3.8**). Moderation in house rent index (HRI) offset the impact of significant increases in *fuel & lighting* and *transport & communication* sub-indices in recent months (see **Figure 3.9**).



House rent index, which has the highest weight in CPI commodity basket as a single item, dropped to 6.9 percent in November 2010 – the lowest figure since July 2007. Continued decline in HRI can be attributed to lower domestic demand, decline in cement prices amid fall in export demand of cement due to stiff competition and slowdown in construction activity in UAE.



On the other hand, rise in administered prices of fuels and electricity resulted in higher inflation within transportation and fuel & lighting sub-groups. Impact of higher prices of crude oil in international market was seen by a corresponding rise in domestic prices of petrol, diesel, and kerosene oil. Similarly, government's efforts to eliminate subsidies resulted in higher electricity tariffs. At the same time, prices of electrical

Table 3.2: City-wise Inflation (YoY) of Selected Cities			
percent			
	Nov-09	Oct-10	Nov-10
Overall CPI	**10.5**	**15.3**	**15.5**
Islamabad	9.5	12.4	12.4
Lahore	9.7	14.9	13.7
Karachi	9.7	13.9	14.5
Quetta	8.7	15.0	15.8
Peshawar	8.3	16.3	16.6

appliances also increased due to imposition of excise duty on these products in federal budget FY11, which is reflected in rising trend in household equipment sub-group. These factors combined to put energy inflation to the highest levels since February 2009 to 21.8 percent in October 2010, before it eased to 19.5 percent in November 2010.[4]

City-wise Inflation

City- wise inflation data of the federal and provincial capitals shows that CPI inflation in Peshawar remained higher than overall inflation; whereas inflation in other capital cities was lower than the overall CPI inflation (see **Table 3.2**). This shows that smaller cities were hit hard in the current episode of inflation, probably reflecting that supply to major urban centres is better than smaller towns. In addition, supply of perishable food products to major urban centres was not disrupted due to floods. Since, supply of these items in most major urban cities is from nearby rural areas, which were not severely hit by the floods (see **Figure 3.10**).

3.3.3 Incidence of inflation

The incidence of inflation remained higher on lower income groups (see **Table 3.3**) since present inflation is principally driven by food prices and a large part of income of low income groups is spent on food staples. However, even the lowest food inflation of 19.6 percent YoY for highest income group is uncomfortably high.

Table 3.3: Income Group-wise CPI Inflation – YoY
percent

	Upto 3000			Rs 3001-5000			Rs 5000-12000			Above Rs 12000		
	Sep-10	Oct-10	Nov-10	Sep-10	Oct-10	Nov-10	Sep-10	Oct-10	Nov-10	Sep-10	Oct-10	Nov-10
General	17.0	16.5	17.4	17.0	16.3	17.0	16.3	15.7	16.1	14.8	14.8	14.5
CPI food	21.9	21.0	22.2	21.8	20.7	21.7	21.4	20.1	20.8	20.7	19.7	19.6
CPI non-food	10.6	10.6	11.0	11.1	10.8	11.1	11.1	11.0	11.2	11.1	11.8	11.3

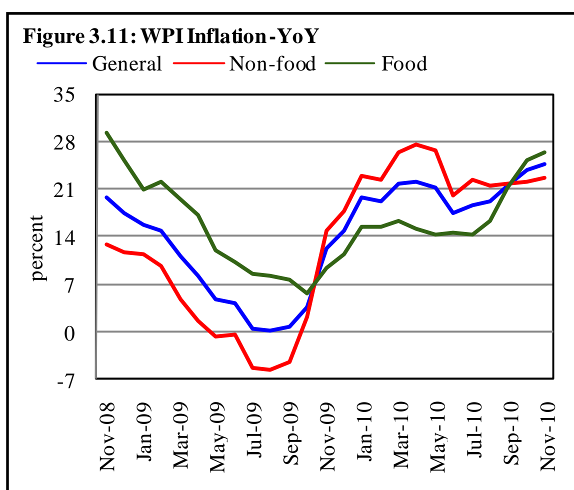
[4] Pakistan's energy index for October 2010 was higher than international energy index measured by IMF's Energy Index which was 17.7 percent during October 2010.

Similarly, incidence of non-food inflation is higher for the higher income groups since a dominating share of their budget was spent on non-food items. Rise in prices of energy including fuels, electricity and gas hit the high income groups the most (see **Table 3.3**).

3.4 Wholesale Price Index (WPI)

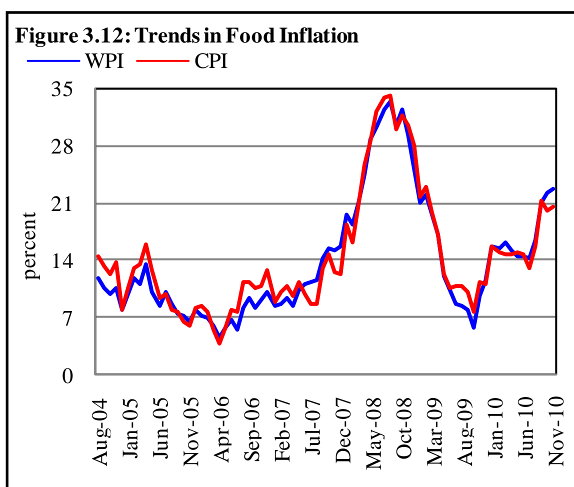
Unlike CPI inflation, WPI inflation has exhibited a continued up trend in recent months. WPI inflation rose to 24.7 percent YoY in November 2010 – the highest level since October 2008 (see **Figure 3.11**). Although both food and non- food groups of WPI contributed to this increase, the rise in non-food group was more pronounced. Rise in WPI inflation is attributed to supply side pressures in some agriculture commodities led by sugar and vegetables and rise in international commodity prices.

Figure 3.11: WPI Inflation-YoY



In food group, sharp increases were registered in the prices of onions, potatoes, tomatoes and vegetables due to domestic supply disruptions amid flood. Whereas, sugar prices surged by 60.0 percent YoY in November 2010 due to supply shortages. At the same time, firm international prices of palm oils, sugar, wheat, pulses and other food commodities also pushed up WPI inflation. It is important to note that food inflation in CPI and WPI baskets generally moves in tandem (see **Figure 3.12**), thus an ease in CPI food inflation and a rise in WPI food inflation is showing that at least a part of the increase in

Figure 3.12: Trends in Food Inflation



the prices of food items is absorbed by the retailers. A historical view also suggests that both CPI and WPI inflation will move in the same direction in months ahead.

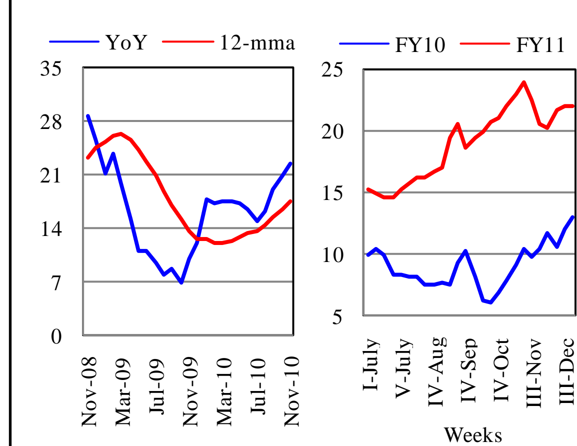
Within the WPI non-food group, all sub-groups witnessed acceleration in inflation during November 2010, except fuel & lighting sub-group (see **Table 3.4**). Specifically, inflation (YoY) in *raw materials* sub-group registered the highest growth of 70.7 percent. This surge in the prices of raw materials is mainly attributed to cotton, cotton seeds and sugarcane prices amid increasing international prices and domestic shortages due to crop damages amid flood.

Table 3.4: WPI Non-food Groups

	Raw materials	Fuel, lighting & lubricants	Manufactures	Building materials
Jun-10	50.5	12.6	19.5	13.2
Jul-10	54.6	15.7	22.2	7.5
Aug-10	52.8	15.4	20.6	8.0
Sep-10	58.3	13.3	21.5	10.5
Oct-10	65.8	14.7	25.7	15.5
Nov-10	70.7	12.8	28.4	18.9

Similarly, inflation in building materials sub-group is rising since July 2010. Prices of cement which had been declining since October 2009 resurged during November 2010 by 8.6 percent which was compounded by increases in the prices of other building materials, especially iron bars & sheets, paints & varnishes and wire & cables. This rising trend in building material sub-group also suggests that the declining trend of HRI (the single largest sub-group of CPI basket) will reverse in the third quarter of FY11.

Figure 3.13: SPI Inflation - YoY (in percent)



Inflation in fuel lighting and lubricants sub-group which remained higher during October 2010 due to upward adjustment in fuel prices, increase in electricity tariffs, as well as, rising international prices of petroleum products somewhat eased during November 2010. The surge in raw materials, as well as, increased transportation and energy costs also pushed up manufactures sub-group, which rose by 28.4 percent

in November 2010 compared to 7.4 percent in same month of last year.

3.5 Sensitive Price Indicator (SPI)

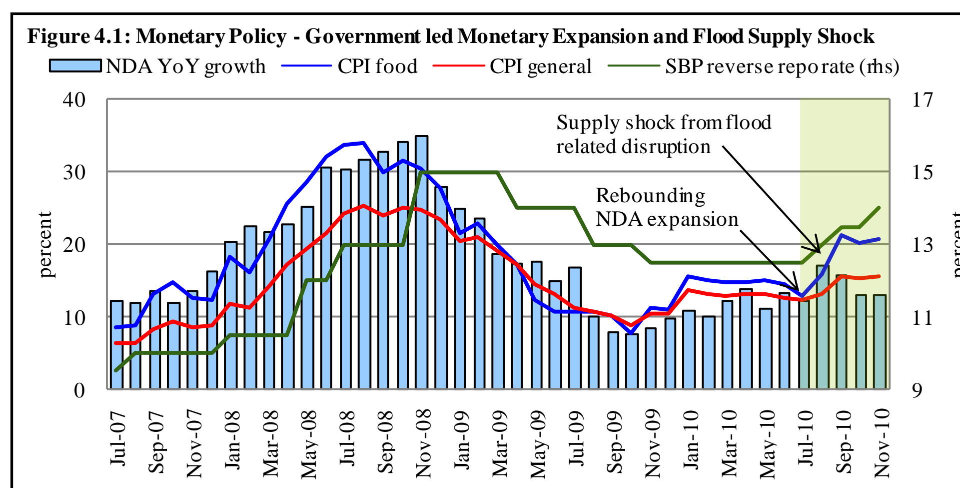
Unlike CPI inflation which slightly eased during October 2010, SPI inflation has shown a continued uptrend in recent months. This is due to a disproportionately higher weight of perishable food items in SPI basket. SPI inflation (YoY) was recorded 22.5 percent during November 2010 compared to 20.9 percent in October 2010 and 10.0 percent in November 2009 (see **Figure 3.13**). Similarly, weekly SPI (YoY) remained very strong since the start of FY11 and reached 90 weeks high level at 24.0 percent in the second week of November 2010 before settling at 22.0 percent in the third week of December 2010.

4 Money and Banking

4.1 Monetary Policy

While the SBP kept its policy rate on hold for most of FY10 to bolster a recovery in the domestic private sector, continued aggregate demand induced risks to price, and broader macro stability, prompted the central bank to raise its policy rate by 50 bps in each of the three policy rate decisions during H1-FY11 (see **Figure 4.1**).

Figure 4.1: Monetary Policy - Government led Monetary Expansion and Flood Supply Shock



Inflation persistence, risks to broader macroeconomic stability and tightening:

First Policy Meeting. In addition to demand pressure emanating from increase in public sector wages, the inflation outlook for FY11 faced additional headwinds from upcoming upward revisions in power tariffs and the proposed Reformed General Sales Tax (RGST). An ambitious fiscal deficit target also called for caution in assessing risks to price stability. In addition to inflation, the pickup in domestic demand amid forecasts for higher international commodity prices could increase the import bill; the impact of any resulting deterioration in the current account on the country's overall external position would depend on timely realization of official foreign flows. In this backdrop, the SBP's monetary policy committee (MPC) unanimously voted for a 50 bps increase in the policy rate to contain aggregate demand induced risks to macroeconomic stability; taking it to 13 percent on August 2, 2010.

Growing fiscal pressure on monetary management and disruption from floods augmented risks to price and macroeconomic stability:

Second Policy Meeting. With monetary policy focused on limiting the demand-pull on domestic inflation, the monsoon flooding aggravated risks to price stability as well as the country's growth prospects. In particular, inflation rose to 13.2 percent in Aug 10, with a sharp rise in food inflation (see **Figure 4.1**). [1] Further, monetary implications of the fiscal response[2] to the crisis called for additional caution in assessing future inflation - particularly in the face of rising government recourse to central bank borrowings as highlighted below. In addition to inflation, risks to the external position from a higher import bill could be exacerbated if the expected improvement in export growth for FY11 failed to materialize due to flood related productivity losses. In this scenario, the SBP raised its policy rate by an additional 50 bps to 13.5 percent on September 29, 2010.

Third Policy Meeting. Continued government led monetary expansion - as a result of a weak fiscal position - continued to weigh heavily on macroeconomic stability. In particular, even as the temporary spike in food prices – from the flood related supply chain disruption- began to subside, rising government borrowings from the SBP kept inflationary pressures up. [3] Going forward the enactment of explicit limits on government borrowings from the SBP would help in addressing medium-term inflation expectations. In the meanwhile, pursuit of macro stability through monetary policy tools called for additional tightening in the central bank's policy stance. In light of a forecast resurgent in fiscal induced inflationary pressures - while cognizant of the implications for the private sector- the SBP raised its policy rate further by 50 bps, taking it to 14 percent on Nov 29, 2010.

[1] Month-on-month food inflation rose to 5.1 percent in Aug 10; this was considerably high even after taking in to account Ramadan seasonality. See **Monetary Policy Statement (MPS) Sep2010**.

[2] While it was expected that relief and reconstruction efforts would raise government expenditure, uncertainty remained over the timing and implementation of the RGST, elimination of power subsidies, as well as introduction of additional measures to raise revenue for flood relief efforts.

[3] While the sharp rise in month-on-month food inflation observed during Aug and Sep 2010 began to subside in Oct2010, overall inflation remained persistent; CPI inflation fell only marginally by 40 bps in Oct2010 to 15.3 percent from 15.7 in the previous month. See **Monetary Policy Statement (MPS) Nov2010**.

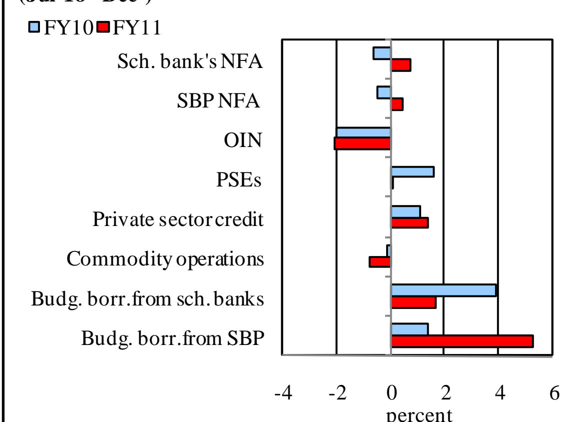
4.2 Developments in Monetary Aggregates[4]

Broad money (M2) growth accelerated to 6.9 percent during Jul-Dec FY11 from 4.7 percent in corresponding period last year (see **Table 4.1**). Almost all components show a trend reversal in their contribution to M2 growth during Jul-Dec FY11 compared to the corresponding period of FY10. In particular, government budgetary borrowings from the central bank provided the largest impetus to monetary expansion; as borrowings from scheduled banks slowed compared to last year (see**Figure4.2**). Meanwhile, an increase in the net foreign assets (NFA) of the banking system during Jul-Dec FY11 also supported M2 growth (see **Figure 4.2**).

Table 4.1: Monetary Aggregates (Jul-18th Dec)
flows in billion Rs, growth in percent

	Flows		Growth rates	
	FY10	**FY11**	**FY10**	**FY11**
Broad Money (M2)	242.1	398.4	4.7	6.9
NFA	-55.3	69.0	-11.2	12.7
SBP	-25.4	27.8	-8.4	7.3
Scheduled banks	-30.0	41.2	-15.5	24.8
NDA	297.4	329.4	6.4	6.3
SBP	183.5	265.7	20.4	26.9
Scheduled banks	113.9	63.7	3.0	1.5

Figure 4.2: Contribution in Cumulative Growth of M2 (Jul-18th Dec)



4.2.1 Net Foreign Assets (NFA)

Reflecting the surplus in the country's external balance, NFA of the banking system expanded by Rs 69.0 billion during Jul-Dec FY11; compared with a fall of Rs 55.3 billion in the corresponding period last year. The improvement in overall NFA came from both, the central bank and scheduled banks.

Inflows from the IMF under the Emergency Natural Disaster Assistance (ENDA) in Sep 2010 reversed the fall in the central bank's NFA seen in the first two months of current fiscal year. In addition to institutional inflows and grants, net purchases of foreign exchange in the interbank market also contributed to the rise in SBP NFA during Jul-Oct FY11.

[4] This section is based on monetary survey data available up to Dec 18, 2010.

The expansion in scheduled banks' NFA came from a contraction in the current account deficit; due to robust inflows of workers' remittances and an improvement in the trade balance. As a result, commercial banks' NFA expanded despite considerably higher oil import payment pressure.[5]

4.2.2 Net Domestic Assets (NDA)

NDA of the banking system grew by 6.3 percent in Jul-Dec FY11 almost same as in the corresponding period last year. Two developments in NDA growth stand out:a) rising government budgetary borrowings from the banking system – in particular increased reliance on the central bank for financing, and b) retirements under commodity finance and a sharp deceleration in loans to public sector enterprises (PSEs) (see **Table 4.2**).

Table 4.2: Developments in NDA Components(Jul-18th Dec)
flows in billion Rs, growth in percent

	Flows		Growth rates	
	FY10	FY11	FY10	FY11
Government borrowing	263.3	356.9	12.9	14.6
For budgetary support	272.2	400.3	16.2	19.9
SBP	72.8	304.5	6.3	25.2
Scheduled banks	199.3	95.8	38.6	11.9
Commodity operations	-7.2	-44.7	-2.1	-10.8
Non government sector	137.7	89.3	4.3	2.6
Credit to private sector	56.6	81.8	1.9	2.7
Credit to PSEs	81.9	6.8	30.7	1.9
Other items net	-103.7	-116.8	17.8	19.5

Government Borrowing for Budgetary Support

The government's reliance on the banking system was considerably higher during Jul-Dec FY11 compared to the same period last year. This was because of (a) large financing requirements of quasi-fiscal activities and defence outlays; interestingly, government spending does not appear to be led by flood relief and reconstruction activities (b) low external receipts; and (c) lower inflows in NSS during Q1-FY11 compared with the same period last year.[6]

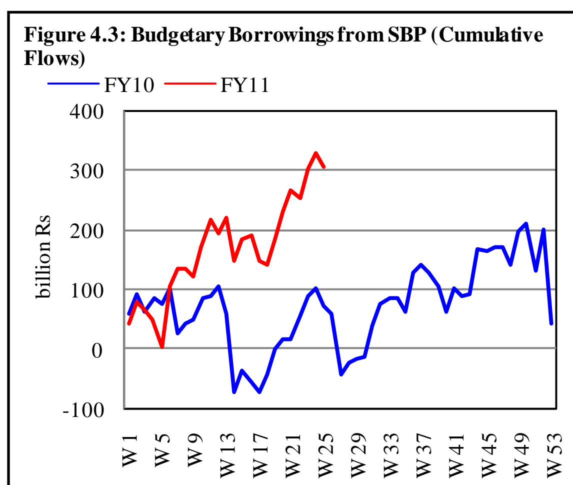
The bulk of budgetary financing requirements during Jul-Dec FY11 were met by borrowings from the SBP[7], while borrowings from scheduled banks slowed (see **Table 4.2**). Lower borrowings from scheduled banks – and higher SBP borrowings - appear to reflect the rejection of bids by the government in the two PIB auctions held during Q1-FY11; however this was despite higher than targeted

[5] The SBP shifted oil payments to scheduled banks from Dec 14, 2009 onwards.
[6] The government mobilized Rs 34.8 billion through NSS in Q1-FY11 compared to Rs 53.0 billion in the same period last year.
[7] This is in contrast to last year when the government relied heavily on borrowings from scheduled banks to comply with the IMF's SBA program parameters.

acceptance from T-bill auctions and two Ijara Sukuk auctions held during this period.[8]

In fact, despite the materialization of IMF support funds in Sep 10, deficit monetization from the central bank still remained high (see **Figure 4.3**). The inflationary nature of such financing poses serious challenges for medium to long-term monetary management.

Figure 4.3: Budgetary Borrowings from SBP (Cumulative Flows)



Credit to Public Sector Enterprises

Borrowings of public sector enterprises (PSEs) decelerated considerably to Rs 6.8 billion during Jul-Dec FY11 compared with Rs 81.9 billion in the corresponding period last year. While the sharp rise in credit last year reflects the issuance of privately placed term finance certificates (PPTFCs), the slowdown in the current fiscal year is mainly the result of retirements by a power distribution company - probably due to partial payments of outstanding subsidy arrears owed by the government.

Commodity Finance

A key development in commodity finance during Jul-Dec FY11was a retirement of Rs44.7billion, compared with a fall of Rs7.2 billion in the same period last year. The bulk of the retirement was observed in wheat advances, whereas outstanding paddy advances also recorded a fall in Jul-Dec FY11. The outstanding stock of wheat loans was reduced by Rs 52.3billion. This was primarily due to a sharp retirement by the Punjab food agency during the last few weeks of the period under review as it off-loaded procured stocks in the market. In addition, by Dec 10, the TCP also reduced its loans to almost half the level of Jun10; this was made possible with the receipts of sales proceeds.[9] Meanwhile in paddy advances, PASSCO began retiring its loans by offloading previously

[8] See **4.6 Money Market**

[9] During Jul-Nov FY09 the TCP obtained commodity financing from scheduled banks for wheat import. In Sep 2010 the agency retired Rs 13.2 billion against wheat advances; its outstanding stock now stands at Rs 11.9 billion (on Dec 18, 2010).

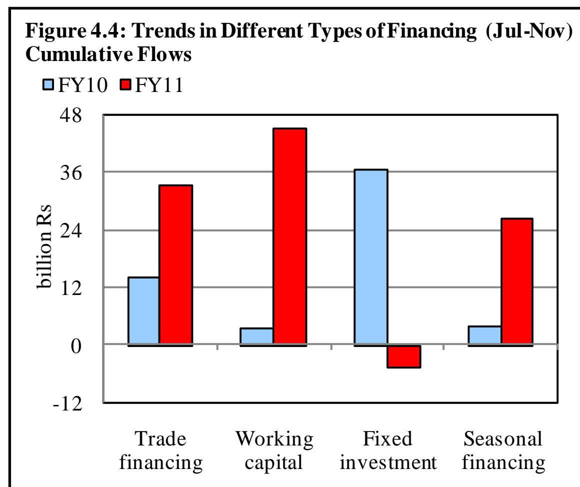
procured stock at a higher market price. However, despite the overall retirement in commodity financing, advances against sugar - mainly for import - were higher during Jul-Dec FY11 compared to the same period last year.

4.3 Credit to Private Sector (net)[10]

Net credit to the private sector expanded by Rs 81.8 billion during Jul-Dec FY11; this is encouraging when compared to a lower expansion of Rs 56.6 billion last year.

Detailed information for the available period Jul-Nov FY11 shows that the improvement in credit was mainly due to higher demand for seasonal and trade financing. Fixed investment loans declined during the period under review (see **Figure 4.4**). The bulk of demand for credit came from textile, retail trade, power, cement, and fabricated metals sectors.

Figure 4.4: Trends in Different Types of Financing (Jul-Nov) Cumulative Flows



Seasonal retirement of sugar financing lowered overall net credit demand:
A disaggregated analysis of advances shows that seasonal retirements from the sugar sector dragged down overall credit demand of the private sector (see **Table 4.3**). More specifically, private sector advances excluding sugar increased by Rs 104.1 billion during Jul-Nov FY11 compared with Rs 83.6 billion in the same period last year.

Seasonal retirements of sugar advances remained pronounced during FY11. This is explained by a higher credit off-take during the previous credit season[11] and strong profitability of sugar mills. However, a slowdown in the extent of retirement in Oct-Nov 2010 reflects the impact of fresh credit demand generated from the new crushing season which has already commenced in some areas; although some sugar mills have delayed crushing in anticipation of lower sugarcane prices.

[10] The discussion on net credit to the private sector is based on data available up to Dec 18, 2010.
[11] See Annual Report FY10

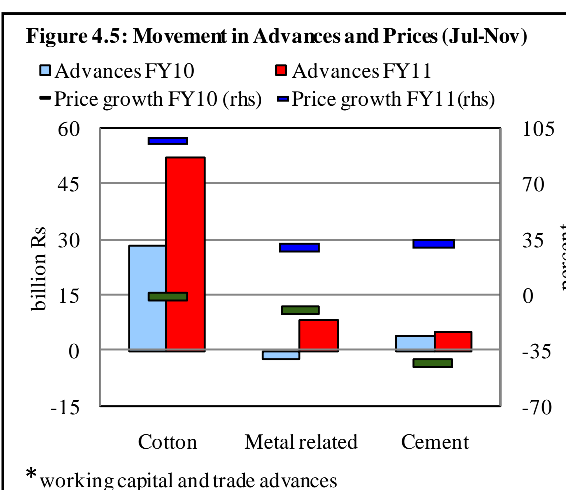
Higher raw material prices generated credit demand in some industries:
Higher domestic and international prices of raw materials provided an impetus to credit demand in some sectors such as textile, cement, iron & steel and fabricated metals.

Table 4.3: Working Capital Loans (Jul-Nov)
flows in billion Rs, growth in percent

	Flow		Growth	
	FY10	**FY11**	**FY10**	**FY11**
Business sector advances	3.7	45.0	0.3	4.1
Manufacturing	2.4	20.0	0.4	3.6
Rice Processing	1.5	8.2	5.6	31.9
Sugar	-29.3	-30.5	-60.0	-58.6
Textiles	35.3	47.5	17.2	26.1
a. Spinning	24.3	36.7	20.6	38.7
b. Weaving	6.6	5.8	24.8	20.7
Cement	0.4	-1.7	1.6	-6.9
Basic metals	-2.8	2.2	-16.1	14.0
Domestic appliances	-0.1	1.6	-1.2	32.9
Electricity, gas and water supply	-3.5	3.7	-7.4	6.6
Construction	-2.7	2.4	-5.9	6.0
Commerce and Trade	1.6	13.2	0.9	8.0
a. Retail trade	3.4	19.3	5.2	26.4

More specifically, with the onset of the procurement season, financing requirements of the spinning sector picked up in Oct 2010; after a net retirement during initial three months of FY11. Working capital loans formed the bulk of the increased financing requirements of the spinning sector, probably due to higher raw cotton prices. Moreover, on the back of a recovery in global demand for textile products, trade loans other than the EFS scheme also contributed to the increased credit off-take by the spinning sector.

Figure 4.5: Movement in Advances and Prices (Jul-Nov)



* working capital and trade advances

The increase in advances to the cement sector during Jul-Nov FY11came largely from import financing; anecdotal evidence suggests that the recent rise in international coal prices has translated into higher credit demand for import financing.[12] Similarly, fabricated metals and iron &

[12] Anecdotal evidence suggests that cost of raw material (coal) is 25-30 percent of the total costs of production of cement manufacturers.

steel industries also availed considerably higher import financing compared to last year on account of higher input prices in international markets (see **Figure 4.5**).

Demand led recovery also seen in a few sectors:
In addition to the rise in input prices, a higher credit off-take in certain sectors reflects growth in production. For instance, credit demand from the domestic appliances sector probably reflects increased production during Jul-Nov FY11; this can be substantiated by the positive contribution of consumer durables demand in overall consumer financing.

Similarly the recovery in global demand for textile products led to higher activity in the weaving sector. The sector expanded its production capacity, as shown by the increase in fixed investment loans during Jul-Nov FY11. It may be noted that in the 2010-11 budget the government offered an incentive to tax-paying companies undergoing balancing, modernization, and replacement (BMR) by extending a 10 percent tax credit. This also contributed to the rise in fixed investment loans.[13]

Furthermore, a revival in construction activities increased the working capital requirements of construction and allied industries. The commerce and trade sector also showed strong demand for credit during Jul-Nov FY11- particularly in the retail trade sector.

Consumer Loans
During Jul-Nov FY11, retirements in consumer loans were less than half the amount returned in the same period last year. All categories of consumer loans witnessed a slowdown in net retirements - notably personal loans. In fact, loans for consumer durables witnessed a net expansion during Jul-Nov FY11.

A deceleration in net retirements of auto loans during Jul-Nov FY11 was due to a significant increase in sales of both cars and motorcycles. This deceleration is purely demand-led since not only has the production and sale of locally manufactured cars and motorcycles increased during Jul-Nov FY11, the import of motor vehicles has also rebounded in the period under analysis (see **Table 4.4**).

[13] The tax credit concession is proposed for five years from FY11 to FY15 and the concession will be available in the same year in which the costs will be incurred.

Table 4.4: Production, Sales and Imports of the Auto Sector
Production and sales in units, imports in million US $

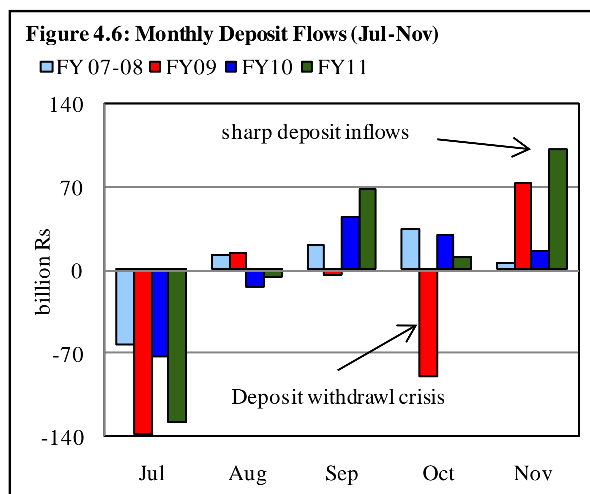
	Cars			Motor Cycles		
	FY10	**FY11**	**Growth (%)**	**FY10**	**FY11**	**Growth (%)**
Production	46,593	54,381	16.7	292,231	319,297	9.3
Sales	46,497	52,200	12.3	290,461	318,429	9.6
Imports*	192.8	231.6	20.1	24.4	31.8	30.2

*Imports of cars and motorcycles includes both completely built and knock down units (FBS Jul-Oct data)
Source: PAMA

4.4 Deposit Mobilization[14]

Banks' deposit base grew by 1.0 percent during Jul-Nov FY11 compared with a decline of 0.1 percent in the same period last year. However, this growth appears to be driven by an exceptionally sharp inflow in Nov 2010 (see **Figure 4.6**).

Figure 4.6: Monthly Deposit Flows (Jul-Nov)



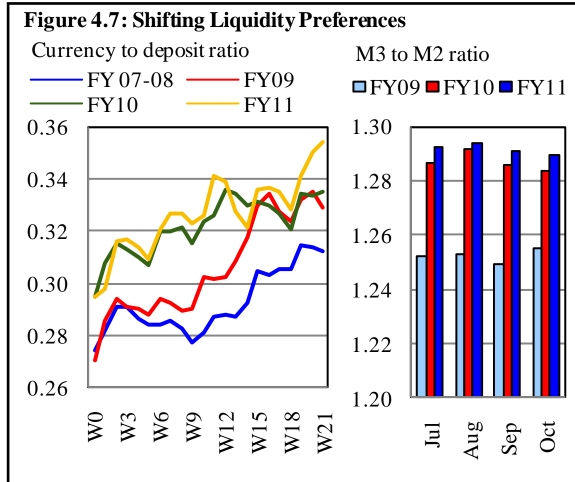
Indeed, excluding Nov, deposit performance for Jul-Oct FY11 shows a larger contraction than in the same period in previous years.[15] In fact, the slowdown in banks' deposit base in the last couple of years reflects a more general shift in agents' liquidity preferences away from bank deposits.

In addition, in the current fiscal year, government deposits witnessed a withdrawal during the period under review; net withdrawals of government deposits during Jul-Nov were unusual[16].

[14] The analysis presented in this section is based on customer deposits of the banking industry for the period Jul-Nov FY11; this does not include the deposits of financial institutions.
[15] During Jul-Oct FY11, deposits experienced a larger contraction of 1.2 percent compared with a decline of 0.3 percent in the same period last year; and growth of 0.1 percent for FY07-08.
[16] However, even excluding government deposits, banks' deposit base contracted by 1.0 percent during Jul-Oct FY11.

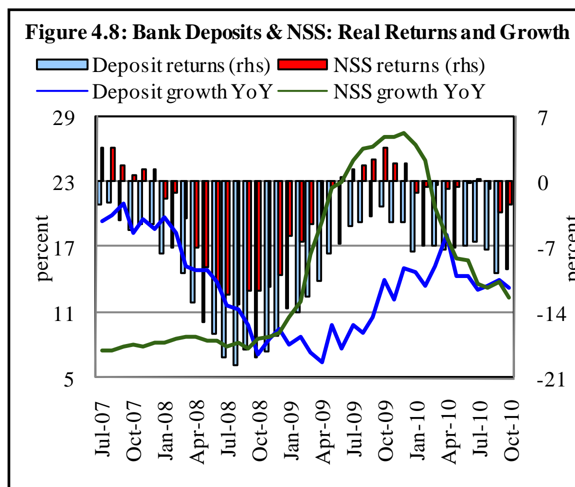
Shifting liquidity preferences: Both, the currency to deposit ratio, and M3 to M2 ratio, have been rising over the last couple of years; their rise represents a shift in agents' preferences away from bank deposits (see **Figure 4.7**). In particular, while a rising currency-to-deposit ratio reflects a shift in preferences towards currency holdings; the rise in M3 relative to M2 represents the rising competition banks face in deposit mobilization from non-bank sources, most notably National Savings Schemes (NSS).[17]

Figure 4.7: Shifting Liquidity Preferences



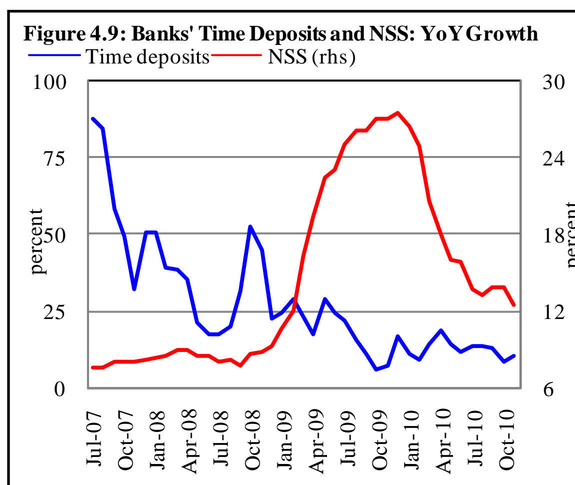
This shift in preferences away from bank deposits may be due to rising costs of using the banking system e.g., the withholding tax on financial transactions and negative real returns on bank deposits (see **Figure 4.8**).[18] Indeed, it appears that higher real returns, along with the security of investment in NSS instruments have provided strong competition to banks' time deposits in recent years (see **Figure 4.9**).

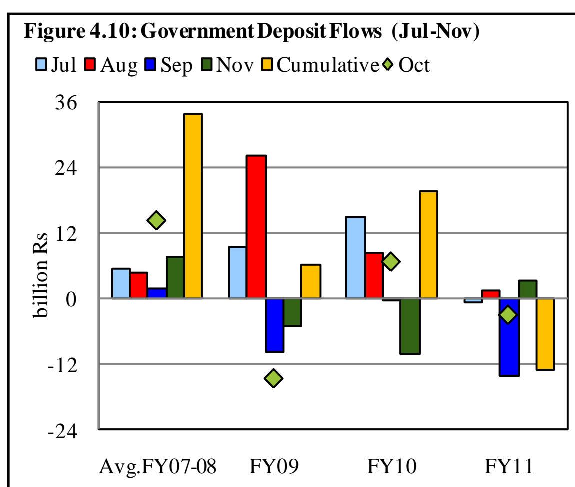
Figure 4.8: Bank Deposits & NSS: Real Returns and Growth



[17] It may be noted that institutional investments in NSS were re-allowed in Oct 2006, after a ban imposed in Mar 2000. For details see **First Quarterly Report FY07**.
[18] For FY11 the scope of the tax has been extended to include all bearer financial instruments. For a detailed analysis of the rising role of currency in monetary assets see **Annual Report FY10**.

Government Deposit withdrawals from a few large banks during Jul-Nov FY11: In addition to seasonality and the impact of shifting liquidity preferences, government deposits witnessed a net withdrawal of Rs 13.1 billion during Jul-Nov FY11.[19] This was in contrast to net inflows during the same period in previous years (see **Figure 4.10**). In line with the trend over the last couple of years, government deposit withdrawals appear to be concentrated in the industry's largest banks; three large banks account for the bulk of these withdrawals during Jul-Nov FY11.[20]





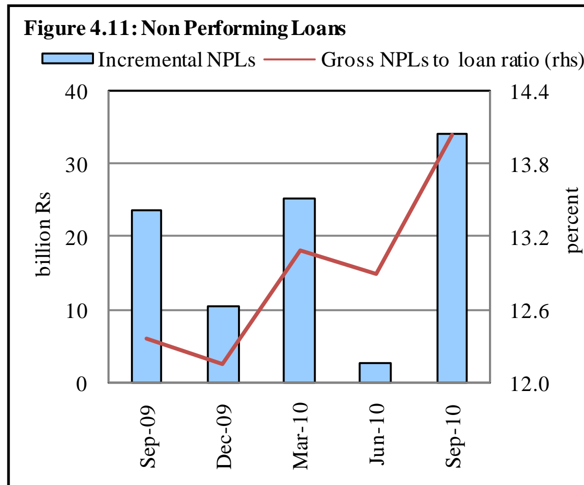
4.5 Non-Performing Loans[21]

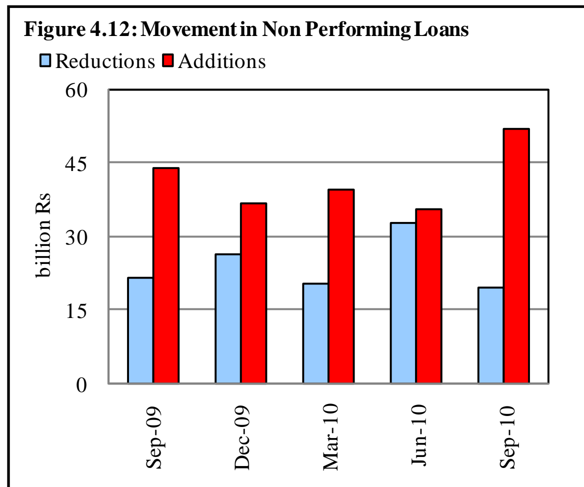
Commercial banks' asset quality metrics deteriorated further during Q1-FY11; gross NPLs increased by Rs 34.2 billion over June 2010, to reach Rs 494 billion. The increase in infected loans was considerably higher than in the four quarters of FY10. Further, advances also fell by Rs 49 billion; resulting in a worsening of the NPLs to loan ratio (see **Figure 4.11**).

The movement of NPLs shows that both the additions and reductions reflect deterioration during Q1-FY11 (see **Figure 4.12**). More specifically, total additions to NPLs were Rs 51.8 billion; considerably higher when compared to an

[19] Withdrawals occurred at both federal and provincial levels.
[20] These include a public sector bank and two local private banks.
[21] This section is based on quarterly data available up to Q1-FY11.

increase of Rs 43.9 billion during Q1-FY10. This deterioration in higher additions was primarily experienced by the corporate sector in both working capital and fixed investment loans during Q1-FY11 compared with the same period a year before.





4.6 Money Market[22]

Liquidity conditions in the money markets improved during H1-FY11 compared with the same period last year (see **Figure 4.13**).

In the primary market, activity was dominated by T-bills and above target acceptance in the two Ijara Sukuk auctions; the government rejected all bids received in the first two Pakistan Investment Bond (PIB) auctions during H1-FY11, but accepted slightly above the target in the last auction. Further, T-bill auction results highlight considerable government appetite for borrowing and a shift in agent's bidding preferences towards shorter-tenor maturities; reflecting that the most recent increase in the SBP's policy rate in Nov 2010 was widely expected by the market.

[22] This section is based on data for the period Jul-Dec FY11.

4.6.1 Liquidity Management

As liquidity conditions in the money markets improved, the SBP made a lower net injection of Rs 121.3 billion into the system through its Open Market Operations (OMOs) during H1-FY11, compared with Rs 1949.7 billion in the corresponding period last year (see **Figure 4.14**).

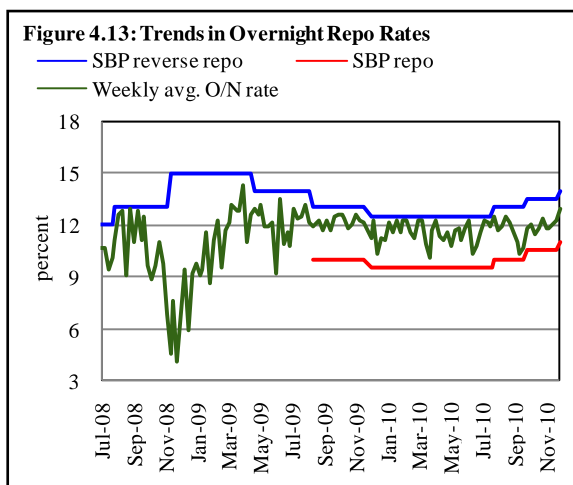


Figure 4.13: Trends in Overnight Repo Rates

Mop ups during Q1-FY11 were also considerably lower than the same quarter last year; perhaps due to banks' access to the SBP's Repo Facility to deposit their day-end funds with the central bank.[23] However, a considerable net absorption by the central bank during Q2-FY11 - in order to maintain consistency of the overnight repo rate with the policy stance - led to a higher mop up for the cumulative H1-FY11 period against the comparable period last year (see **Figure 4.14**).

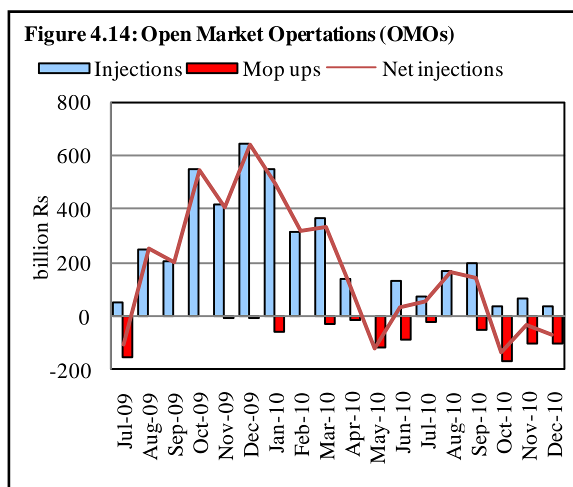


Figure 4.14: Open Market Opertations (OMOs)

4.6.2 The Primary Market

Treasury Bills

Activity in the primary market for T-bills reflects considerable government appetite for borrowing. While the net target (adjusted for maturities) for H1-FY11was considerably lower compared with the same period last year, the government borrowed above target; Rs 199.6 billion were accepted net of maturities (see **Table 4.5**).

[23] The Repo Facility was introduced in Aug 2009 as part of the new liquidity management system. The facility allows banks to deposit their day-end surplus funds with the SBP at a rate 300 bps below the Reverse Repo rate. See **Monetary Policy Statement (MPS) Jul-Sep 2009**.

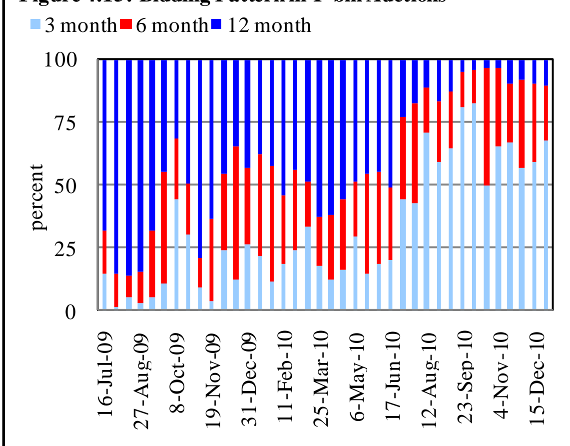
On the supply-side, while risk-averse banks[24] showed continued interest in government securities, the bid-to-cover ratio declined to 1.9 during H1- FY11, compared with 2.7 last year.[25] This may reflect the considerable roll-over of maturing securities, in the face of a gradual opening up of alternative asset allocation avenues for banks in the private sector[26] (see **Table 4.5**). Further, the bulk of bids received in T-bill auctions were for 3 month maturities; as agents' preferences shifted towards the short-end of the yield curve in anticipation of the increase in the SBP's policy rate on Nov 29, 2010 (see **Figure 4.15**).

Table 4.5: Treasury Bills Auction Profile (H1-FY11)

billion Rs

	Maturities	Target	Offer	Accepted
FY09	720.7	855.0	1014.4	736.3
FY10	257.4	470.0	1290.3	531.0
FY11	1226.7	1220.0	2320.8	1426.3

Figure 4.15: Bidding Pattern in T-bill Auctions



Pakistan Investment Bonds

Four auctions of Pakistan Investment Bonds (PIBs) were scheduled for H1-FY11. While bids were received in all tenors, the government rejected all bids in the first two auctions. However, the last two auctions saw a pickup in acceptance of offers for long-term securities; the last auction in particular resulted in above targeted acceptance (see **Table 4.6**). The rejection of bids for longer-term securities during Q1 FY11 reflects the government's reluctance to raise funds at higher rates. This may also explain the higher than targeted acceptance in T-bill auctions as

Table 4.6: PIB Auctions (H1-FY11)

billion Rs

Auction Date	Target	Offered	Accepted
22-Jul-10	20.0	19.9	0.0
18-Aug-10	25.0	15.6	0.0
13-Oct-10	20.0	17.1	7.9
22-Dec-10	20.0	33.1	21.1

[24] Banks' asset quality metrics deteriorated during Q1-FY11; see **4.5 Non-Performing Loans (NPLs)**.

[25] The bid-cover is defined as the ratio of the offered amount to the target. A higher ratio indicates aggressive bidding by participants and hence a successful auction.

[26] See **4.3 Private Sector Credit**

well as higher government borrowings from the central bank.[27]

Ijara Sukuk

In line with the announced calendar, two auctions of the 3-year Government of Pakistan Ijara Sukuk were held during Q2-FY11. Again, auction results highlight considerable government appetite for borrowing; not only was the target at Rs 40 billion for each auction considerably higher than previous auctions[28], the government accepted above target at Rs 89.0 billion from these auctions.

[27] See 4.2 Monetary Aggregates

[28] The target for each of the previous four auctions held between Sep 2008 and Sep 2009 was set at Rs 10 billion.

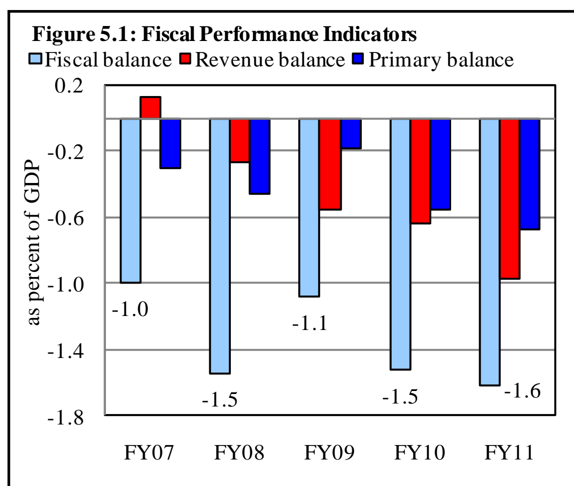
………………This page is left blank intentionally……………….

5 Fiscal Developments

5.1 Overview

Despite visible contraction in expenditure growth, the size of consolidated fiscal deficit increased to 1.6 percent of GDP in Q1-FY11 compared to 1.5 percent in Q1-FY10 (see **Table 5.1**). Being conscious of the spending needs for reconstruction and rehabilitation activities, the government scaled down and re-prioritized spending introducing steep cuts in development spending. However, the potential gains from these measures could only be partially realized due to sharp fall in non-tax revenues during Q1-FY11.[1] Hence, the weak performance of revenues resulted in deterioration of all fiscal performance indicators during Q1-FY11 (see **Figure 5.1**). Further, the financing difficulties witnessed during Q1-FY11 also exposed the fragility of government's fiscal stance as in the absence of ample alternate resources government relied heavily on deficit monetization.

Figure 5.1: Fiscal Performance Indicators



The fiscal deficit recorded during Q1-FY11 also obscured the aggregate 0.5 percent of GDP budget surplus recorded by provinces during this period.[2] This situation highlights the structural rigidities in federal government's spending requirements. During Q1-FY11 while a part of spending pressures were contributed by the flood relief and rehabilitation activities, the disbursement of subsidies, defense and security related spending were some of the major claimants on fiscal resources. In this context, going forward, while the gradual removal of power tariff subsidies, which comprised 6 percent share of country's total fiscal spending during Q1-FY11,[3] will provide some respite to the government, the increase in current expenditures with pick up in relief and rehabilitation task is likely to offset some of these gains.

---

[1] While tax revenue recorded 6.2 percent YoY increase during Q1-FY11, non-tax revenues growth recorded a steep 35.5 percent YoY fall during this period.

[2] In aggregate, provinces recorded Rs 81.3 billion surplus during Q1-FY11 compared to Rs.10.1 billion deficit registered during Q1-FY10.

[3] Government has announced 2 percent hike in the power tariff subsidies November 2010 onwards.

Thus, the experience of Q1-FY11 highlights the grave pitfalls faced by the country in the absence of serious and urgent reforms in the taxation system for broadening the

Table 5.1: Summary of Consolidated Public Finance
billion Rupees

	Q1				YoY Change (%)	
	FY08	**FY09**	**FY10**	**FY11**	**FY10**	**FY11**
Total revenue	312.6	385.0	427.3	400.0	11.0	-6.4
Tax revenue	215.6	276.8	298.8	317.3	7.9	6.2
Nontax revenue	97.0	108.1	128.5	82.9	18.8	-35.5
Total expenditure	470.7	522.8	650.9	676.3	24.5	3.9
Current	340.0	456.1	521.0	566.7	14.2	8.8
Development and net lending	129.8	57.6	115.7	62.8	100.8	-45.7
Unidentified expenditure	0.9	9.1	14.2	46.8	56.3	229.9
Fiscal balance	-158.1	-137.9	-223.7	-276.2	62.2	23.5
As percent of GDP						
Total Revenue	3.1	3.0	2.9	2.3	--	--
Tax revenue	2.1	2.2	2.0	1.9	--	--
Nontax revenue	0.9	0.8	0.9	0.5	--	--
Total expenditure	4.6	4.1	4.4	4.0	--	--
Current	3.3	3.6	3.6	3.3	--	--
Development and net lending	1.3	0.5	0.8	0.4	--	--
Fiscal balance	-1.5	-1.1	-1.5	-1.6	--	--
Revenue balance	-0.3	-0.6	-0.6	-1.0	--	--
Primary balance	-0.5	-0.2	-0.6	-0.7	--	--

tax base and plugging leaks in the revenue collection. Given the significant spending pressures, failure to bring improvements in revenue performance implies disruption in the fiscal adjustment agenda of the government and hence a sharp increase in fiscal deficit.

For improving revenue performance government is moving to introduce Reformed General Sales tax (RGST), to enlarge tax base and tax revenue of the economy. In addition, revenue mobilization efforts also include some stopgap measures, for

Table 5.2: Composition of Tax and Non-tax Revenue
billion Rupees

	Jul-Sep			YoY change (%)		
	FY09	**FY10**	**FY11**	**FY09**	**FY10**	**FY11**
Tax Revenue	278.7	298.8	317.3	26.8	7.2	6.2
Direct taxes	89.7	84.1	94.4	13.3	-6.3	12.3
Taxes on property	1.8	1.7	2.1	73.1	-9.1	28.5
Taxes on goods and services	136.6	146.1	156.9	39.4	7.0	7.4
Taxes on international trade	38.2	33.1	36.5	31.0	-13.4	10.4
Petroleum levy	1.8	24.1	15.3	-55.6	1206.1	-36.4
Other taxes	10.5	9.9	12.0	28.2	-6.5	21.8
Nontax Revenue	106.3	128.5	82.9	14.5	20.9	-35.5
Profit of Post office / PTA	0.0	0.0	0.0	--	--	--
Interest	1.6	0.1	0.5	-87.1	-93.5	337.7
Dividends	9.5	18.9	0.5	372.2	98.7	-97.6
SBP profits	28.0	70.0	40.0	-40.8	150.0	-42.9
Defense	29.2	1.9	1.4	2070.2	-93.4	-25.7
Royalty on gas and oil	10.4	9.2	19.6	-7.8	-10.9	111.7
Development surcharge on gas	6.4	5.7	5.0	37.4	-9.9	-12.2
Discount retained on crude oil	4.1	0.0	3.0	--	--	--
others	17.1	22.6	12.9	24.7	31.9	-42.6
Total Revenue	**385.0**	**427.3**	**400.1**	**23.1**	**11.0**	**-6.3**

Source: Ministry of Finance

instance, introduction of a flood surcharge and increase in special excise duty on luxury items during FY11. Due to huge political opposition, the decision on these measures, however, has been postponed to a later date.

The fiscal space created by diverting development expenditures to reconstruction task is only a short term remedy because of its downside implications for economic growth. Therefore, efforts for improving revenue mobilization should also be complemented by sincere efforts for introducing stringent fiscal discipline on both the federal and provincial levels. In this context government's decision of devolution of five ministries to provinces in line with the 18th amendment is a positive step which is likely to induce greater fiscal responsibility in the provinces.

5.2 Revenues

Total revenues amounted to Rs 400.1 billion during Q1-FY11 compared to Rs 427.3 billion in the same period last year, showing a YoY negative growth of 6.3 percent.

The decline in total revenues was brought about by both a considerable fall in non-tax revenues and deceleration in tax revenues (see **Table 5.2**).

The tax revenue showed a decelerated growth of 6.2 percent and reached Rs 317.3 billion during the period under review. A compositional analysis of tax revenue showed that although FBR taxes showed an accelerated growth during Q1-FY11 compared to the same period last year, the decline in collection from petroleum levy drag the growth in total tax revenue. The collection from petroleum levy declined in line with the decline in sale of petroleum products particularly high speed diesel (HSD) oil during Q1-FY11 compared to the same period last year. The decline in sale of petroleum products was more pronounced in industrial, agriculture, and power sector compared to domestic, transport, and government sector.

The encouraging growth in voluntary payments turned the growth rate in direct taxes from negative in the last year to positive in the ongoing fiscal year. The enhanced collection under the head of taxes on international trade stemmed from the accelerated growth in rupee value of imports during Q1-FY11. In fact, the growth in rupee value of imports also helped raise the collection under the head of taxes on goods and services.

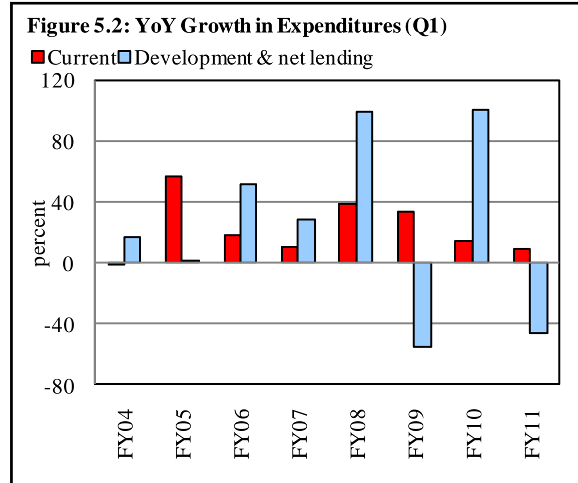
The non tax revenue in Q1-FY11 stood lower than the same period last year by Rs 45.6 billion. This decline was triggered largely by fall in; (a) transfer of SBP profits to government; and (b) dividends receipts from public sector financial and non-financial institutions during Q1-FY11 compared to the same period last year. In fact during Q1-FY10, the amount of SBP profits transferred to government also included payment of Rs 31 billion from government's reserve fund with SBP. The absence of this factor resulted in reduction in transfer of SBP profits during Q1-FY11. The fall in dividends might be the result of both lower earnings of public sector financial and non-financial institutions and a delay in dividend income receipts from these institutions. The collection from royalty on gas and oil was encouraging during the recent quarter. Decline in non-tax revenues under the head of defense probably reflects the holding back of reimbursements by the US for logistic support services provided by Pakistan to the coalition forces.

5.3 Expenditures

After recording double-digit YoY growth in the first quarter of FY05-FY10, growth in expenditures recorded a sharp deceleration to 3.9 percent in Q1-FY11. This substantial slowdown in expenditures was a result of conscious government effort to create fiscal space for the huge spending needs for reconstruction and rehabilitation

task. As a result of this drastic cut in spending, total expenditures to GDP ratio also recorded a marginal improvement from the level of 4.4 percent in Q1-FY10 to 4 percent in Q1-FY11. The cut-down in total expenditures was obtained by introducing a steep slash in the development & net lending expenditures. Current expenditures, however, recorded a smaller deceleration in growth during the first quarter (see **Figure 5.2**). This pattern emanates from structural rigidities, for instance, spending for debt servicing and defense, which have rendered the demand for current spending relatively less elastic (see **Table 5.3**). Further breakup of data highlights that around two-third of the total increase in current spending was contributed by federal government, whereas provincial governments' expenditures recorded only a marginal increase during this period. This might be in response to the central government's advice to the provinces for freezing their expenditures at last year's level.

Figure 5.2: YoY Growth in Expenditures (Q1)



Current expenditures during Q1-FY11 remained under pressure on account of a number of factors, which include; (a) Flood related expenses for initial relief efforts. In this regard one particular initiative undertaken by government was *Watan cards* scheme. Under this initiative federal and provincial governments have planned to distribute Rs 20,000 among flood affected families[4]. Of the total funds required for expenses on *watan cards*, 50 percent expenses will be shared by the federal government, while provincial governments will arrange for the rest by curtailing their provincial development budgets. (b) In addition to this, provision of power tariff subsidies, commodity finance and security operations also remained a large drag on country's resources during Q1-FY11. Specifically, the total provision of subsidies amounted to Rs 65.8 billion during Q1-FY11, which was 51.9 percent of the total annual target set for subsidies during FY11.

[4] Till November 24, 2010, NADRA processed 1,215,672 *Watan cards* through which a total of Rs 22.4 billion was disbursed.

Table 5.3: Composition of Current Expenditures (Q1)
billion Rupees

				YoY Change		Shares	
	FY09	**FY10**	**FY11**	**FY10**	**FY11**	**FY10**	**FY11**
Current Expenditure	**456.1**	**521.0**	**566.7**	**14.2**	**8.8**	**100.0**	**100.0**
of which							
Interest payments	142.3	141.5	161.6	-0.6	14.2	27.2	28.5
Domestic	128.1	129.3	146.6	0.9	13.4	24.8	25.9
Foreign	14.2	12.2	14.9	-14.2	22.5	2.3	2.6
Pension	9.2	16.4	14.3	78.1	-12.3	3.1	2.5
Grants to non-govt.	16.4	60.1	39.1	266.0	-34.9	11.5	6.9
Other general public service	26.3	47.3	53.9	79.8	13.9	9.1	9.5
Defense	82.2	86.2	93.1	4.9	8.1	16.5	16.4
Economic affairs	50.6	11.0	29.6	-78.2	169.1	2.1	5.2
Health	1.1	1.4	1.7	22.0	24.6	0.3	0.3
Educational affairs and services	5.3	6.8	7.0	28.8	2.7	1.3	1.2
Provincial	115.1	139.6	147.7	21.3	5.8	26.8	26.1

Going forward, the payment of power tariff subsidies may record some deceleration as the government has further announced gradual removal of this subsidy November 2010 onwards by introducing monthly increases in the power tariffs. However, current expenditures are likely to increase due to the spending needs for reconstruction activities.

5.4 Domestic Budgetary Financing

In the absence of adequate external assistance, domestic sources contributed a hefty 79.4 percent share in deficit financing during Q1-FY11. Specifically a little less than half of the total financing requirements were met through deficit monetization during the first quarter, whereas a greater share of the remaining deficit was financed by non-bank sources (see **Table 5.4**).

This pattern was in sharp contrast to the experience of Q1-FY10, when borrowing from scheduled banks contributed 54.6 percent share in financing of the deficit. During Q1-FY11, although, government raised 106 percent of the target amount in the T-bill auctions,[5] this amount was not sufficient to finance the deficit and government had to tap the option of borrowing from the central bank for deficit

[5] The targets for t-bill auctions are set by the government on quarterly basis. The T-bill auction target for Q1-FY11 was set at Rs. 535 billion while government raised Rs 567.7 billion.

financing. Further, the share of financing from non-bank institutions also recorded fall during Q1-FY11, because of lower investment in NSS instruments.

Table 5.4: Sources of Financing (Q1)

billion Rupees

				Share	
	FY09	**FY10**	**FY11**	**FY10**	**FY11**
Total financing of budget	137.9	223.7	276.2	100.0	100.0
External resources (net)	6.2	77.1	56.9	34.5	20.6
Internal resources (net)	131.7	146.6	219.3	65.5	79.4
Banking system	104.6	39.0	120.9	17.4	43.8
SBP	211.1	-82.6	118.3	-36.9	42.9
Scheduled banks	-106.5	122.2	2.6	54.6	0.9
Non-bank	27.1	107.6	98.4	48.1	35.6
NSS	21.0	53.0	33.8	23.7	12.8
Others*	6.1	54.6	64.6	24.4	24.4

* Others include non bank borrowing (MTBs, PIBs etc), prize bonds minus NSS

5.5 FBR Tax Collection

Aided by a substantial growth in rupee value of imports, the FBR tax receipts reached Rs 494.7 billion during Jul-Nov FY11 maintaining growth rate of above 7 percent as in the last year despite disruption in the economic activities due to floods and rains (see **Table 5.5**). Sales tax was the largest contributor to the growth in overall tax collection (5.8 percentage points) followed by custom duty collection which contributed 1.3 percentage points to the overall growth. Import related tax collection accounted for 6.4 percentage points of the total growth in FBR taxes. As a percent of annual target, FBR tax collection remained below the previous year amount.

Table 5.5: FBR Tax Collection (Jul-Nov)

billion Rupees

	Net Collection		Growth (%)		% of annual target	
	FY10	**FY11**	**FY10**	**FY11**	**FY10**	**FY11**
Direct taxes	155.9	159.5	14.0	2.3	28.9	24.3
Indirect taxes	303.7	335.2	3.9	10.4	36.2	35.4
Sales tax	199.0	225.7	6.9	13.4	36.9	35.6
FED	48.0	46.7	7.6	-2.7	35.7	33.1
Customs duty	56.7	62.8	-8.0	10.8	34.4	36.2
Total	**459.6**	**494.7**	**7.1**	**7.6**	**33.3**	**30.8**

Source: Federal Board of Revenue

Direct Taxes

Direct tax collection reached Rs 95.7 billion during Q1-FY11 showing a growth of 12.4 percent over the collected amount in the same period last year.
A break up of the income tax collection for Q1-FY11 indicate an overall increase of 13.4 percent in gross collections, mainly on the back of higher contributions from voluntary payments and withholding taxes (WHT) while collections on demand witnessed an enormous decline over the preceding year (see **Table 5.6**).

Table 5.6: Components of Income Tax Collection

billion Rupees

	Jul-Sep		% Δ	
	FY10	**FY11**	**FY10**	**FY11**
Coll. on demand	10.9	2.4	21.9	-78.0
	(11.8)	(2.3)		
Voluntary	19.5	31.8	-38.7	63.0
	(21.2)	(30.4)		
Withholding	61.7	70.2	19.3	13.6
	(67.0)	(67.1)		
Miscellaneous	0.0	0.2	54.3	342.7
	(0.0)	(0.2)		
Gross Income Tax	**92.2**	**104.5**	-0.3	13.4
Refunds	9.3	11.3	59.3	21.3
Net collection	**82.9**	**93.3**	-4.4	12.5

Note: Figures in the brackets show the shares of the components in gross income tax

More encouraging is the 63 percent YoY rise in voluntary payments resulting in an increase in the relative share of voluntary payments in the gross income tax collection. The decline in the arrear component of collection on demand (COD) is explained by the fact that FBR could not realize tax collection through audit. The current component of the COD also witnessed a decline which corresponds to the fact that FBR announced an extension of one month upto October 30, 2010 for filing of income tax return due at end-September 2010.

Table 5.7: Components of Withholding Tax

billion Rupees

	Jul-Sep			%Δ	
	FY09	**FY10**	**FY11**	**FY10**	**FY11**
Imports	8.0	10.4	13.7	30.2	31.8
Salaries	5.4	7.1	9.3	32.6	29.9
Dividends	1.6	1.4	1.8	-10.7	31.9
Bank interest	2.5	3.5	4.2	41.3	19.3
Technical fee	1.2	1.2	1.1	4.1	-9.6
Contracts	17.2	18.1	17.3	5.4	-4.3
Export	3.6	3.7	4.5	3.2	21.0
Cash withdrawal	2.2	2.9	3.0	30.0	2.3
Electricity bills	1.6	3.4	3.4	111.1	1.6
Telephone	4.9	5.3	6.2	6.5	17.3
Others	3.6	4.8	5.7	31.3	19.4
WHT total	**51.7**	**61.7**	**70.2**	**19.3**	**13.6**

Source: Federal Board of Revenue

As collection from WHT roughly grew at the same rate as that of the gross income tax, its share remained the same in the income tax collection. Major heads that contributed to the growth in WHT includes import, salaries, securities and telephone (see **Table 5.7**).

Growth contributed by salaries probably reflects the increase in the salaries of employees; especially the substantial increase in that of the government employees as well as the increase in the number of employees compared to the previous year. However, the enhancement of the minimum income threshold announced in the budget FY11 limited the growth under the head of salaries[6]. The deceleration in collection under the head of bank interest probably reflects the decrease in deposit rates compared to the last years. The amount added under the head of telephone corresponds to the number of prepaid cards used by mobile phone subscribers.

WHT from contracts witnessed a decline largely due to the cut in PSDP by the government. Also, the possible cuts in development expenditures in the remaining months of FY11 could intensify the declines in withholding tax receipts from contracts. Decelerated growth in collection from cash withdrawal points towards the increased transactions in the informal economy due to increase in the withholding tax on the cash withdrawal from banks. The deceleration in the growth in collection from electricity bills might be due to the effect of flood on electricity consumption

Table 5.8: Major Revenue Spinners of CD and Import Based Sales Tax

billion Rupees

	Customs Duty (Jul-Sep)				Sales Tax (import) (Jul-Sep)			
	FY08	**FY09**	**FY10**	**FY11**	**FY08**	**FY09**	**FY10**	**FY11**
Vehicle (Non-Railway)	6.2	5.7	4.4	6.7	3.2	3.3	2.8	4.5
Edible oil	4.3	3.5	3.2	4.5	3.4	4.7	3.6	6.4
Machinery & mechanical appliances	2.5	3.1	2.6	2.8	1.5	1.8	1.6	2.1
POL Products	2.2	7.6	3.7	2.3	19.9	23.2	21.4	20.9
Electrical machinery	3.0	4.1	2.5	2.2	1.5	1.6	1.5	1.8
Plastic resins etc	1.5	1.9	1.5	2.0	3.3	4.6	3.9	5.6
Iron and steel	1.3	1.4	1.5	1.6	2.6	2.7	3.1	3.9
Paper & paperboard	1.0	1.0	1.1	1.3	1.1	1.3	1.1	1.4
Tea & coffee	0.4	0.6	0.7	0.8	0.5	1.0	1.1	1.5
Organic chemicals	0.7	1.0	0.9	0.8	1.1	1.7	1.5	1.6
Dyes and paints	0.5	0.7	0.6	0.7	0.3	0.4	0.4	0.5
Subtotal	**23.6**	**30.7**	**22.7**	**25.7**	**38.5**	**46.4**	**42.1**	**50.1**
Others	5.3	7.5	10.4	11.4	9.1	9.3	10.0	13.9
Total	**29.0**	**38.2**	**33.1**	**37.2**	**47.6**	**55.7**	**52.1**	**64.0**

Source: Federal Board of Revenue

[6] The limit of the Basic exemption in respect of salaried taxpayers was enhanced from Rs 200,000 to Rs 300,000 in the budget FY11.

and on payment of electricity bills.

Indirect Tax Collection

The indirect tax collection reached Rs 197.8 billion showing an accelerated growth of 10.8 percent. Of the total growth in indirect tax collection 9.6 percent was brought by import component of the indirect tax collection. Also the share of import component in indirect tax collection increased to 53.1 percent from 49.3 percent during the same period last year. Commodity wise analysis shows that the growth in collection from import was mainly brought by vehicles (motors), edible oil and plastic resins. POL products contributed negatively (see **Table 5.8**).

Table 5.9: Major Revenue Spinners of sales Tax Domestic

billion Rupees

	Jul-Sep			Growth (%)	
	FY09	**FY10**	**FY11**	**FY10**	**FY11**
POL Products	27.4	26.9	29.4	-2.0	9.3
Telecommunicat ions services	10.4	10.9	11.5	4.7	5.6
Natural Gas	4.5	5.2	6.6	14.9	26.5
Sugar	2.3	3.8	1.5	69.2	-60.0
Cigarettes	1.9	1.8	1.9	-6.1	10.6
Electrical energy	2.0	3.5	4.5	75.7	30.8
Services	1.5	2.9	4.8	92.9	66.2
Beverages	1.3	1.8	2.2	35.0	27.0
Cement	1.0	1.4	0.8	50.8	-47.7
Tea	0.2	0.7	1.3	171.7	87.4
others	10.0	12.3	13.9	23.2	12.9
Total	**62.5**	**71.2**	**78.5**	**13.9**	**10.3**

Sales Tax

Collection from sales tax stood at Rs 133.7 billion with a growth rate of 14.2 percent during Q1-FY11. Of the total addition of Rs 16.6 billion in sales tax, Rs 11.8 billion came from imports.

The growth in domestic source of sales tax was mainly contributed by POL products, natural gas, and services (see **Table 5.9**). The increased collection from POL and natural gas compared to the previous year mainly reflects the increase in prices. The collection realized from sugar has come down

Table 5.10: Major Revenue Spinners of FED Domestic

billion Rupees

	Jul-Sep			% Δ	
	FY09	**FY10**	**FY11**	**FY10**	**FY11**
Cigarettes	7.0	7.8	7.3	10.8	-6.8
Cement	4.2	4.2	3.2	0.0	-22.8
Natural Gases	1.5	1.5	2.6	3.4	70.5
Beverages	1.4	1.7	1.3	19.5	-20.1
Concentrates	1.9	1.5	1.4	-17.0	-7.1
POL Products	0.9	1.0	0.9	18.2	-9.5
Cosmetics	0.1	0.2	0.3	35.6	71.2
1 % Special FED	1.2	2.0	2.1	70.0	4.4
Subtotal	**18.1**	**19.9**	**19.2**	**10.0**	**-3.6**
Others	3.3	5.7	3.8	71.0	-33.3
Total	**21.4**	**25.6**	**23.0**	**19.5**	**-10.2**

by 60 percent due to lower sales of sugar and slashing down of sales tax rate on sugar from 16 to 8 percent in August 2009. A 47.7 percent decline in sales tax collections from cement during Q1-FY11, despite an increase in prices, probably reflects the lower sales of cement.

Federal Excise Duty

Collection from FED declined by 5.2 percent compared to the last year due to its domestic component. The import based FED which accounted for 10 percent of the total collection during Q1-FY10 rose to 14.5 percent in the period under review.

The decline in domestic component was mainly brought by collection from cigarettes, cement, and beverages (see **Table 5.10**). After the government enhanced the FED on cigarettes in the budget FY11, the export of raw tobacco rose during Q1-FY11 hence bringing the domestic production of the cigarettes lower and resulting in lower collection under this head. The setback of the collection from cement suggests the decline in its sales in the country.

Table 5.11: Provincial Finance -Q1

billion Rupees

	Punjab		Sindh		KP		Baluchistan	
	FY10	FY11	FY10	FY11	FY10	FY11	FY10	FY11
Total revenue	**73.8**	**96.4**	**48.0**	**60.2**	**32.7**	**59.5**	**18.7**	**33.0**
Provincial share in fed. revenue	65.0	82.5	40.1	52.8	15.7	28.8	11.4	26.0
Provincial taxes	6.1	8.0	4.4	5.3	0.5	0.9	0.2	0.2
Provincial nontax	3.1	3.4	1.0	0.8	5.7	3.5	0.2	1.0
Federal Loans and transfers/Grants	-0.4	2.5	2.4	1.3	10.8	26.3	6.9	5.7
Total expenditure	105.5	73.1	35.0	49.4	30.9	29.4	11.8	15.9
Current expenditure	81.0	64.8	31.5	46.0	20.4	26.5	10.9	14.5
Development expenditure	24.5	8.3	3.6	3.4	10.4	2.9	0.9	1.4
Overall balance	-31.7	23.3	13.0	10.9	1.8	30.1	6.9	17.1

Customs Duty

Collection from customs duty amounted to Rs 37.2 billion, up by 12.4 percent YoY compared to the decline of 13.4 percent YoY during the same period last year. This rise simply reflects the increase in the country's import bill during the period. A break-up of the collections shows that motor vehicles continued to remain a major revenue spinner, followed by edible oils.

5.6 Provincial Fiscal Operations

Provincial public finances witnessed noticeable improvement recording Rs 81.3 billion surplus during Q1-FY11 compared to the 10.1 billion deficit registered during Q1-FY10. As a ratio to GDP this amounts to a surplus of 0.5 percent compared to the deficit of 0.1 percent in the same period last year. This improvement was witnessed mainly on the back of increase in provincial shares in federal revenues during this period (see **Table 5.11**). In the wake of 7th NFC award, the revenue position of provinces was already expected to improve because of increased share of provinces in the divisible pool. The impact of this development was complemented by improved fiscal discipline in the provinces of Punjab and KP.

Province wise details show that largest improvement of fiscal accounts was registered in Punjab, which was brought about by a steeper cut in both current and development expenditures. Resultantly, the fiscal balance of Punjab turned into Rs. 23.3 billion surplus during Q1-FY11, compared to Rs 31.7 billion deficit recorded during Q1-FY10. The province of Khyber Pakhtunkhwa (KP) also witnessed sizeable improvement in fiscal balance. This was mainly an off shoot of greater receipts of provincial share and loans/grants from federal government, while, the total expenditures of KP also registered a nominal fall during Q1-FY11.

Table 5.12: Composition of Total Domestic Debt & Liabilities (Jul-Nov)

	FY10	FY11
as percent of GDP		
Total domestic debt & Liabilities stock	33.7	33.9
Government domestic debt	28.9	29.7
PSE debt	2.5	2.0
Domestic liabilities	2.3	2.2
Growth over end-June stock (percent)		
Total domestic debt & liabilities	10.1	7.6
Government domestic debt	9.8	9.2
PSE debt	26.3	-7.3
Domestic liabilities*	-0.1	-8.6
Memorandum item:		
Total domestic debt & liabilities stock	4940.3	5857.9

* Include commodity finance operations loans to provincial governments & PSE borrowings for commodity operations.

The provinces of Balochistan and Sindh also recorded surplus in overall balance despite increases in total expenditures during Q1-FY11.

5.7 Total Domestic Debt & Liabilities

Reflecting the expansion in fiscal deficit, and inadequate availability of external financing, country's total domestic debt & liabilities stock recorded a 7.6 percent increase over the end-June 2010 stock, reaching Rs 5.9 trillion on end-November FY11 (see **Table 5.12**). The increase originated from rise in government domestic

debt while PSE debt and domestic liabilities owed due to commodity finance operations witnessed retirement during this period.[7]

5.7.1 Government Domestic Debt

For financing of the fiscal deficit, the government relied heavily on borrowing from central bank during Jul-Nov FY11, which comprised 61.8 percent share in net flows in the government debt stock during this period (see **Table 5.13**). This was in sharp contrast to the experience of the same period last year, when government borrowing needs were largely met from scheduled bank sources.

Table 5.13: Components of Change in Government Domestic Debt Stock (Jul-Nov)

billion Rupees, shares: in percent

	Net flows		Share in net flows	
	FY10	**FY11**	**FY10**	**FY11**
Government domestic debt	**377.5**	**478.4**	**100.0**	**100.0**
Institution- wise				
A. Through banking system	207.1	337.9	54.9	70.6
From scheduled banks	193.2	42.3	51.2	8.8
From SBP	13.9	295.6	3.7	61.8
B. Through non-bank debt	170.2	141.8	45.1	29.6
C. Foreign currency instruments	0.1	-1.3	0.0	-0.3
Instrument- wise				
A. Permanent debt	59.6	60.0	15.8	12.5
B. Floating debt	233.2	363.6	61.8	76.0
C. Unfunded debt	84.5	56.1	22.4	11.7
D. Foreign currency Instruments	0.1	-1.3	0.0	-0.3

This might be attributed to mis-judgment of the government regarding the extent of deficit and availability of funds from alternate channels, e.g., external assistance, logistic support, and NSS instruments. This is partly reflected from the pre-auction targets of MTBs set by the government at 105.2 percent of the upcoming maturity of MTBs in Jul-Oct FY11, which showed government's intention to roll-over the existing debt stock of scheduled banks during this period (see **Table 5.14**). Although, the offered amount of scheduled banks stood at 201 percent of T-bills maturities during Jul-Oct FY11, government did not raise this amount to avoid higher cost of borrowing.

Table 5.14: Analysis of MTB Auctions (Jul-Oct)

billion Rupees

			As percent of maturity			As percent of target
	Target	**Maturity**	**Target**	**Offer**	**Acceptance**	**Acceptance**
FY10	380.0	205.9	184.6	447.5	203.7	110.3
FY11	710.0	674.6	105.2	201.0	114.7	109.0

[7] For details on PSE debt and commodity finance operations see Chapter 4, *Money and Banking*.

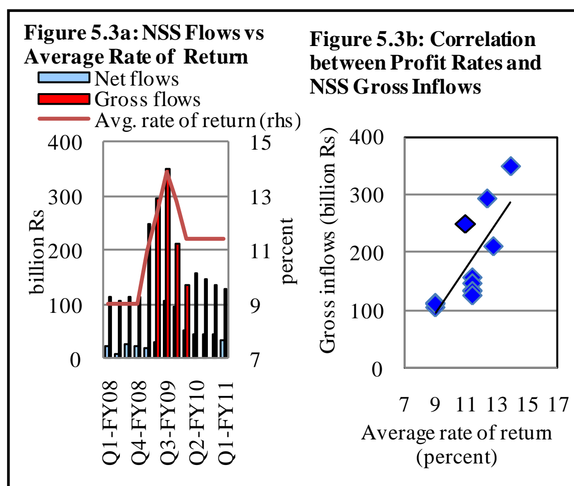
Resultantly, when adequate financing from alternate channels was not forthcoming, the government relied on monetization of deficit during the first quarter.

Table 5.15: Auction Summary (Jul-Oct)
billion Rupees

					Average Bid rate in	
	Offered	**Accepted**	**Maturity**	**Net (of maturity) acceptance**	**FY10**	**FY11**
3M	848.2	524.0	198.7	325.3	11.7	12.6
6M	367.7	257.2	180.3	77.0	12.5	12.7
12M	141.8	61.5	305.3	-243.8	12.4	12.9
Total	930.9	842.7	684.3	158.4	---	---

Scheduled banks debt stock recorded a nominal increase during Jul-Oct FY11 over the end-June 2010 position, while the composition of net flows shifted towards shorter tenor securities. Being aware of the fiscal constraints of the government, scheduled banks were anticipating further tightening of monetary policy and offered large amounts in T-bill auctions at higher rates, with the greater interest in the short tenor-bills (see **Table 5.15**). Government responded to this behavior by accepting larger amounts in the 3-month maturities, and retired its 12-month t-bills. Thus, the composition of net flows tilted towards shorter tenor securities during Jul-Oct FY11.

Growth in unfunded debt instruments decelerated during Jul-Nov FY11.[8] This was in continuation of the trend observed in FY10. The inflows into NSS schemes have been declining since Q4-FY09 after the downward adjustment on the rates of return on these schemes, due to fall in the policy rate. However, the net flows in NSS schemes during Q1-FY11 were still higher than the quarterly average observed prior to the hike in interest rates (see



[8] The growth in the stock of unfunded debt instruments decelerated to 3.9 percent on end-November FY11 from 6.7 percent in end-Nov FY10 over the respective end June stock.

Figure 5.3a). In this context this is worth mentioning here that as monetary policy tightened, the rates of return on all NSS instruments were also adjusted upward in October 2010. Based on the strong positive correlation in the rates of returns and inflows into NSS schemes, this highlights the possibility of a healthy growth in unfunded debt stock Q2-FY11 onwards (see **Figure 5.3b**).

Permanent debt stock also had a lower contribution in net inflows in domestic debt stock during Jul-November. This was despite a substantial Rs. 51.8 billion increase in the stock for the three year's Ijara Sukuk during November FY11.[9] This is due to unwillingness of government to raise funds through PIBs because of their higher cost. According to the PIB auction calendar, government had targeted to raise Rs 65 billion through three auctions in the Jul-Oct FY11 period. However, due to higher bid rates offered by banks, only Rs. 7.9 billion were raised in these auctions.

Table 5.16: Interest payments on Government Domestic Debt (Jul-Oct)

billion Rupees

	Absolute amount			Percent growth	
	FY09	**FY10**	**FY11**	**FY10**	**FY11**
Total	**200.7**	**217.7**	**229.8**	**8.5**	**5.6**
Permanent debt	14.3	26.0	26.3	81.9	1.1
Floating debt	88.3	72.6	127.9	-17.8	76.2
Treasury bills					
3-months	8.7	0.8	10.6	-90.3	1156.1
6-months	2.0	11.6	13.4	494.6	15.6
12-months	22.8	2.6	37.4	-88.4	1319.8
MRTBs	54.8	57.5	66.4	4.8	15.6
Unfunded debt	98.1	119.1	75.6	21.4	-36.5

Interest payments on government domestic debt recorded a decelerated 5.6 percent YoY rise in Jul-Nov FY11. The slowdown in interest payments on domestic debt was mainly the impact of extinguishing stock of DSCs which resulted in a substantial Rs. 51.7 billion YoY fall in interest payments on these certificates during Jul-Nov FY11. The interest payments on floating debt instruments, however, recorded a significant increase during the first five months of FY11, which was led by heavy reliance of government on these instruments for financing the fiscal deficit during FY10 (see **Table 5.16**).

Going forward, the pressure of interest payments is likely to grow further in the

[9] The Ijara sukuk auction was held after a gap of 13 months. This long gap might be attributed to technicalities involved in the launching of this bond. Being an Islamic bond this needs to be backed by a real asset. After the asset is identified, its value is evaluated, which is then purchased by an asset company comprising of Islamic banks. This asset is then rented to the government in the Ijara sukuk auction on 6-monthly basis.

floating debt instruments. However, a sizeable part of this surge is likely to be offset by falling interest payments on DSCs.

6 External Sector

6.1 Overview

Sustained inflow of workers' remittances and significant growth in exports together with by official and private inflows for flood relief contributed to a sharp YoY improvement in the current account during Jul-Nov FY11. The impact of this improvement on overall external account was, however, subdued due to substantial declines in capital and financial account surpluses (see **Table 6.1**).

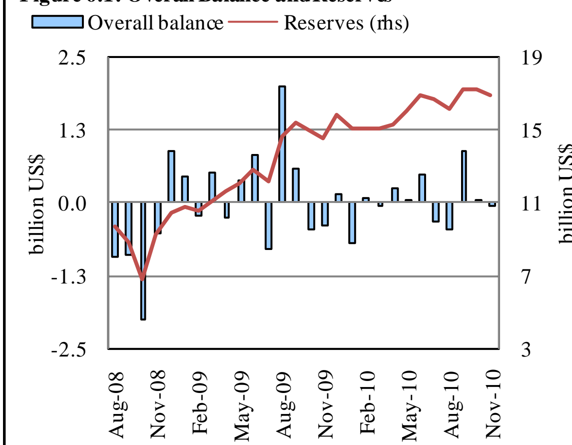
Table 6.1: Summary of External Balances (Jul-Nov)

billion US$

	FY09	FY10	FY11
Current A/C	**-7.24**	**-1.82**	**-0.50**
Trade Balance	-7.05	-4.74	-4.53
Exports	*8.65*	*7.70*	*9.03*
Imports	*15.71*	*12.44*	*13.56*
Invisible Balance	-0.19	2.91	4.03
Remittances	*2.97*	*3.83*	*4.43*
Capital& Financial A/C	**1.84**	**2.24**	**0.51**
FDI	1.62	0.73	0.57
FPI	-0.18	0.30	0.17
Other Investment (net)	0.37	1.17	-0.27
of which			
Public sector loans (net)	*-0.01*	*0.42*	*-0.04*
Private sector loans (net)	*0.10*	*-0.01*	*0.06*
Error& Omission	**-0.23**	**0.53**	**0.10**
Overall Balance	**-5.63**	**0.94**	**0.11**
Memorandum Items			
Foreign reserves (end period)	9.27	14.52	16.93
Exchange rate (end period)	78.78	83.56	85.77

Though overall external account deteriorated compared to the same period last year, it remained in surplus. As a result country's foreign exchange reserves rose to US$ 16.9 billion at end- Nov 2010 (see **Figure 6.1**). This also helped in keeping the exchange rate relatively stable, which depreciated by 0.35 percent during Jul-Nov compared to 2.6 percent in the same period last year.

Figure 6.1: Overall Balance and Reserves



Looking forward, there is risk that contraction in current account deficit may not sustain, on grounds that: (1) anticipated rise in import of sugar, palm oil, textile

machinery, pulses, and raw cotton; (2) a slowdown in export growth as gains from strong growth in high value added textile exports could be partially offset by lower exports of primary commodities (rice, raw cotton, fruits, and vegetables), cement, meat & meat preparation and pharmaceuticals; (3) current transfers could lose momentum once reconstruction activities slow down.

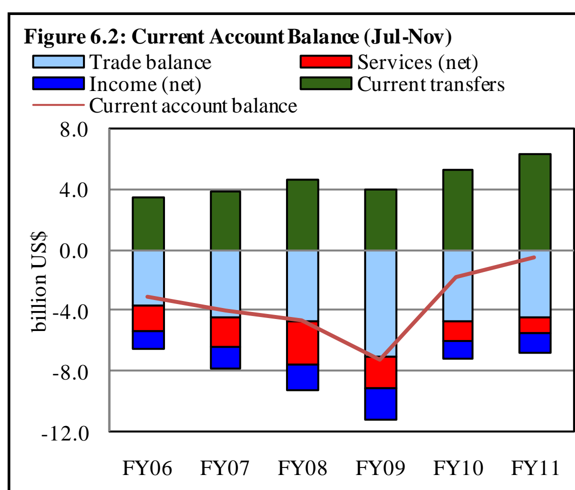
The overall external account is likely to remain under pressure because of dwindling financial account surplus despite a moderate current account deficit. Given the anticipated slowdown in global economic recovery and no improvement in the country's sovereign credit rating since 2009, chances of significant increase in foreign investment inflows is unlikely. Moreover, securing debt flows will be challenging if the IMF's Stand-By Arrangement is jepradised and if structural reforms are further delayed.

On a positive note, given the influx of liquidity in the world economy as a result of fiscal stimulus packages by different countries, Pakistan has plenty of opportunities to attract foreign capital if the economic and political problems are addressed promptly.

6.2 Current Account Balance

Current account deficit contracted sharply by 72.3 percent during Jul-Nov FY11 (see **Figure 6.2**). This contraction was contributed by trade and services accounts along with current transfers. Most notably, significant growth in exports, record inflows of workers' remittances, and private and official grants for flood relief contributed to this improvement.

Figure 6.2: Current Account Balance (Jul-Nov)



6.2.1 Trade Account[1]

During Jul-Nov FY11, trade deficit contracted by 4.4 percent compared to 32.9 percent contraction during the same period last year. Improvement in trade

[1] This section is based on exchange record data compiled by SBP that does not tally with the Custom data compiled by FBS. For detailed analysis on trade account please see section 6.7 on trade account.

account was attributed to higher export growth (17.3 percent) rate than imports (9.1 percent). Growth in exports was broad based. In particular, textile and petroleum exports increased by 18.8 percent and 40.8 percent respectively; result of a mix of higher quantum and unit prices. The import growth, on the other hand, was mainly a result of strong growth in food and textile group's imports.

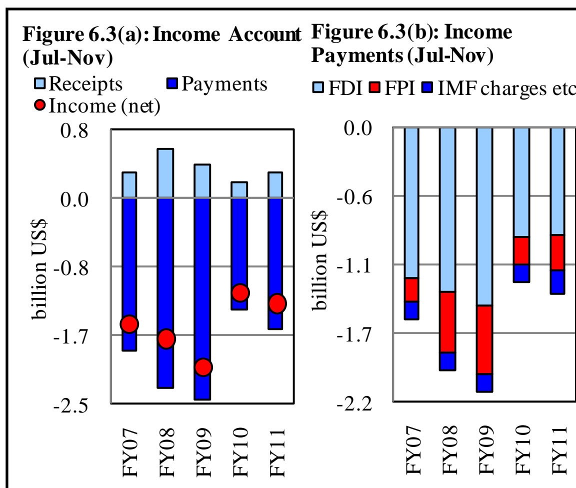
6.2.2 Services (net)

In comparison to a 40.0 percent decline during the comparable period last year, deficit in services trade contracted by 18.5 percent during Jul-Nov FY11. This improvement was mainly the result of 20.8 percent higher services exports.

A sizable increase of US$ 295 million in services exports is mainly attributed to government services exports on account of logistic support fund and higher receipts by international organizations and their attached offices involved in flood relief activities. On the other hand 3.3 percent growth in services imports was mainly the result of higher freight payments under transportation on the back of rising import bill and rise in travel payments on account of Hajj related outflows (see **Table 6.2**).

Table 6.2: Services Account (Net) (Jul-Nov)
million US$

	FY10	FY11	Change
Overall Services	-1258	-1025	233
Transportation	-891	-996	-105
Travel	-275	-282	-7
Other business services	-276	-166	110
Government services	185	479	294
Other Services	-2	-60	-58

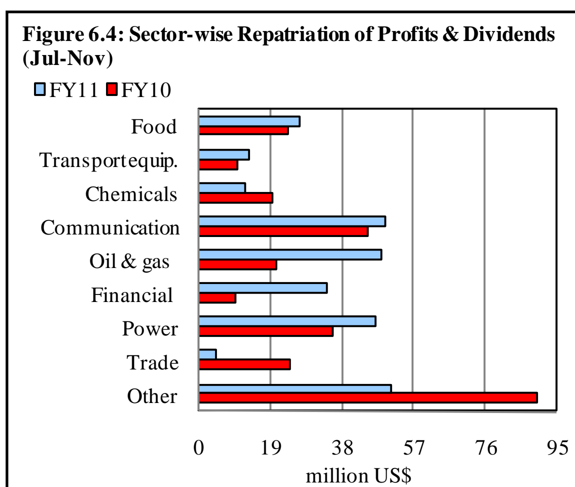


6.2.3 Income Account

Income account deficit increased by 10.5 percent during Jul-Nov FY11aganist contraction of 43.1 percent in the corresponding period last year (see **Figure 6.3**). This expansion stemmed from rise in payments largely on account of interest payments on public long term loans and IMF charges. This offset the lower outflows of profit and dividends and decline in interest payments on Eurobonds during Jul-Nov FY11.

As regards the investment income, portfolio investment payment increased by US$ 76 million that offset the decline of US$23 million in direct investment income during Jul-Nov FY11. In direct investment income, outflows under repatriation of profits and dividends did not show a significant change. This shows that companies are reluctant in expanding their businesses in Pakistan on grounds that direct investment as well as reinvested earnings declined remarkably during the first four months of FY11.

Figure 6.4: Sector-wise Repatriation of Profits & Dividends (Jul-Nov)

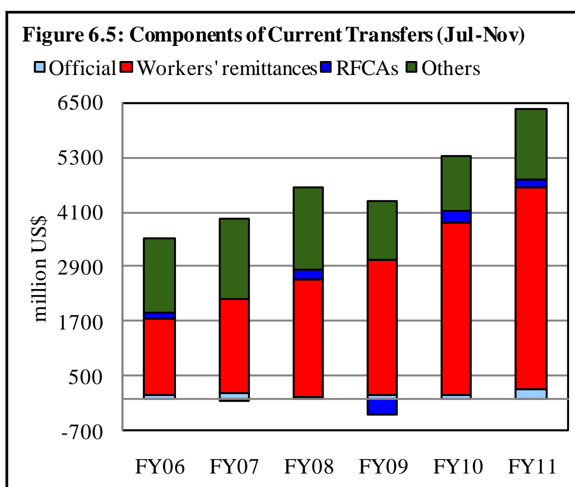


The highest amount of repatriation of profits & dividends came from *communication sector* reflecting high earnings of the telecom companies followed by oil & gas, power, and financial business sectors (see **Figure 6.4**). On the other hand, chemicals, and trade sectors witnessed lower repatriation of profits and dividends during Jul-Nov FY11.

6.2.4 Current Transfers

Record inflows of workers' remittances and significant inflows of official transfers helped improve current transfers by 18.7 percent during Jul-Nov FY11 compared to the same period last year (see **Figure 6.5**). This growth is a welcome development as it came in the presence of high base set last year on one hand, and significant decline in Residents Foreign Currency Accounts (RFCAs) on the other.

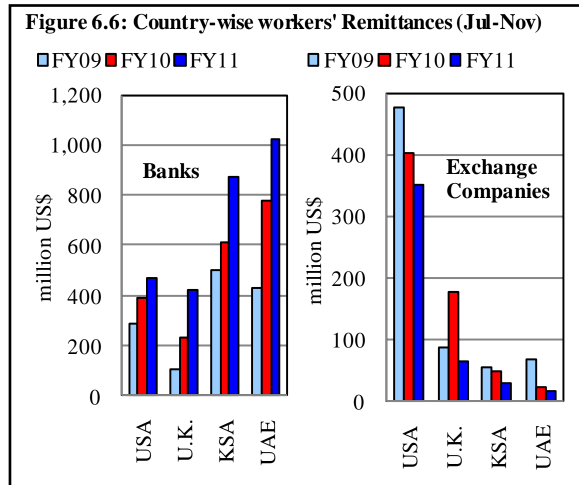
Figure 6.5: Components of Current Transfers (Jul-Nov)



Workers' Remittances

The inflow of workers' remittances remained strong with 15.6 percent YoY growth during Jul-Nov FY11 on top of 29.2 percent growth in the comparable period last year. The current increase in workers' remittances can be attributed to: (a) government and SBPs efforts to attract workers' remittances through banking channels; (b) seasonal increase because of Eid festival; and (c) expatriates' increased support to flood affected people. Country-wise data shows that all traditional sources recorded an increase in workers' remittances through banking channels. Since FY09, UAE has taken over USA as a major source (see **Figure 6.6**). The increasing remittances from Saudi Arabia can be attributed to higher demand of Pakistani workers after a ban was imposed on Bangladeshi workers by Saudi government due to some administrative issues[2]. Moreover, initiatives under PRI such as recently introduced Xpress money, incentives in the form of interbank fund transfer (IBFT) facility, and HBL's step by dedicating special time for remittances in Dubai also helped improve remittances flows to Pakistan (see **Box 6.1**).

Figure 6.6: Country-wise workers' Remittances (Jul-Nov)



Box 6.1: New Initiatives to Increase Workers' Remittances

One of the major determinants that encourage the inflow of remittances is the predictability of receiving payments by the beneficiaries. A number of new steps have been taken recently to make it more predictable in terms of time of receiving money. These initiatives include:

1. Xpress Money. Under xpress money: (i) there is no charges either on remitters or on receivers (no end to end charges), (ii) in addition to cash over counter facility express money offers cash to account facility, i.e., money is transferred in the account even if remitted in cash.

2. **Easypaisa by Telenor Pakistan** has expanded its mobile money service with the launch of international transfer service, in collaboration with xpress money, UK. The senders of funds from abroad can transfer the money through a wide network of xpress agents present in more than 80 countries including UAE, Saudi Arabia, and UK. Easypaisa user can visit any

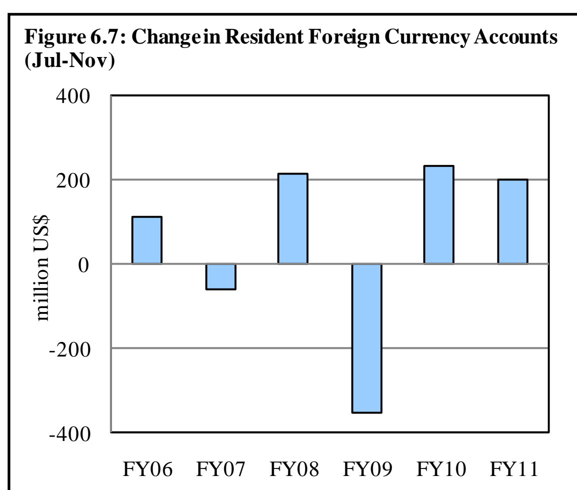
[2] According to anecdotal evidence, Saudi Arabia put a limit on Bangladeshi workers in housing and agricultural sector due to some administrative reasons. The ban was put in 2008 as the quota for Bangladeshi workers exceeded the limit of 1.5 million workers. Now Pakistani workers seem to be benefiting from this situation as their demand has increased.

Telenor service center to get money. On the remitter side they can visit any xpress money center to send money. To use these services Easypaisa or Xpress money account is not required.
3. Inter-bank Fund Transfer (IBFT) Facility. Inter Bank Fund Transfer (IBFT) initiative has made it easy to transfer funds to the third party.

Resident FCAs

Resident FCAs showed inflows of US$199 million during Jul-Nov FY11 as a result of healthy trade activity (see **Figure 6.7**). However, this inflow of RFCAs remained significantly lower than that in the same period last year. This is probably due to relative stability in exchange rate and declining weighted average lending rates on FCAs[3] that provided weak incentive to foreign currency account holders to maintain their dollar account.

Figure 6.7: Change in Resident Foreign Currency Accounts (Jul-Nov)



6.3 Financial Account Balance

In contrast to the previous year, financial account deteriorated in Jul-Nov FY11. Financial account surplus declined significantly from US$ 2150 million during the same period last year to US$ 462 million. A large part of this decline is explained by the sharp fall in other investments despite the emergency loan of US$453 million given by the IMF. This fall in other investments was expected as increase in other investment last year was due to the Special Drawing Rights (SDRs) allocation and bridge financing from IMF. As far as the other two important components of financial account are concerned, the fall in

Table 6.3: Components of Financial Account Balance (Jul-Nov)
million US$

	FY08	FY09	FY10	FY11
Financial Account	4270	1796	2150	462
FDI	1969	1621	731	574
FPI	102	-182	301	173
Other investments	2209	365	1172	-270
of which:				
Loans	780	93	383	-26
SDR Allocation	0	0	1280	0

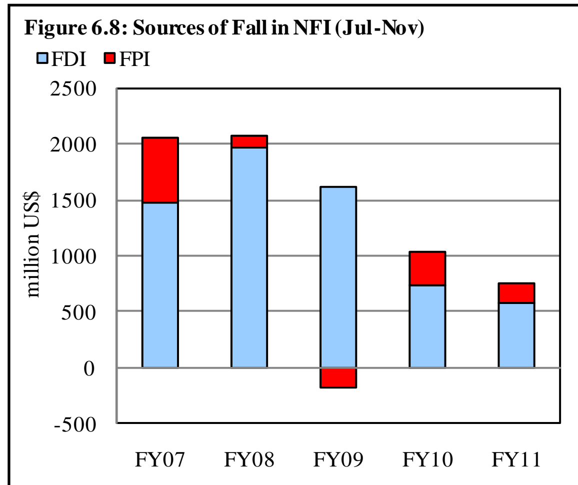
[3] Weighted average lending rate on foreign currency accounts declined gradually from 1.28 percent in Sep 2009 to 0.97 percent in Sep 2010.

foreign direct investment was the continuation of last two years trend; low investment in equity and outflows from debt securities explain the falling portfolio investment (see **Table 6.3**).

6.3.1 Net foreign investment (NFI)

Factors such as poor law & order, political uncertainty, energy crisis, and circular debt issues continued to depress NFI into the country during Jul-Nov FY11. Resultantly, net foreign investment declined for the third consecutive year. The fall was broad based. And both foreign direct investment and portfolio investment dropped during the period under review (see **Figure 6.8**). Although it was expected that with the gradual improvement in international financial market, net foreign investment would improve, volatile domestic situation and macroeconomic outlook after the floods kept investors reluctant to invest in Pakistan.

Figure 6.8: Sources of Fall in NFI (Jul-Nov)

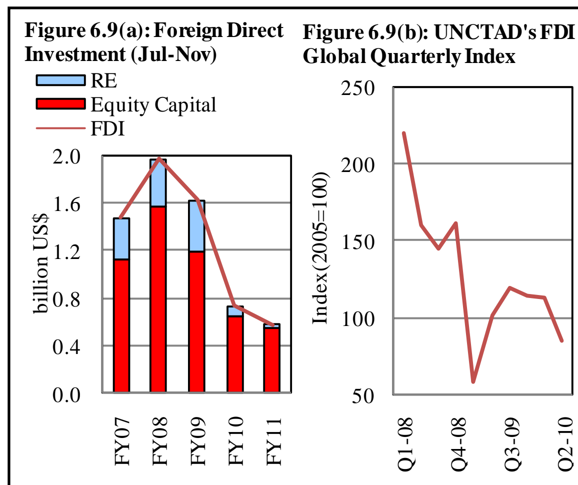


6.3.2 Foreign Direct Investment

As in the previous year, foreign direct investment remained under pressure during Jul-Nov FY11. In absolute terms, FDI dropped by US$ 157 million during the period under review. This decline was contributed by both: a fall in equity capital and reinvested earnings. However, major share was contributed by the fall in equity capital (64 percent).

Figure 6.9(a): Foreign Direct Investment (Jul-Nov)

Figure 6.9(b): UNCTAD's FDI Global Quarterly Index



This consistent decline in

Foreign Direct Investment (FDI) flows is attributed to both global and domestic conditions. On the global front, FDI flows declined sharply in Q4-FY10 after a slight recovery in the latter half of 2009. This is indicated by United Nations Conference on Trade and Development (UNCTAD's) FDI Global Quarterly Index[4] (see **Figure 6.9b**). This decline was mainly due to falling reinvested earnings and intra-company loans. It happened as parent companies repatriated a larger share of their profits instead of reinvesting and withdrew the loans to their affiliates to strengthen their balance sheets[5]. This phenomenon was more significant in the developed countries compared to developing countries where the fall in FDI flows remained relatively small. In Pakistan although dynamics of FDI flows are different from developed countries, decline in FDI was for different reasons and continued to have a declining trend in Q1-FY11 (see **Figure 6.9a**). Factors like weak economic growth, political uncertainty, poor law & order, issues like circular debt, and energy crises restricted the FDI in the economy. Adding to these factors was the recent post flood macroeconomic outlook of the country. In these circumstances, investors are reluctant to invest and hence, FDI declined significantly during the period under review.

Sector-wise analysis shows that although telecommunication, cement, and financial business recorded a YoY increase, this was more than offset by the lower

Table 6.4: Sector -wise Foreign Direct Investment (Jul-Nov)
million US dollar

	FY10			FY11		
Sectors	**Cash**	**Re-invested earnings**	**Total**	**Cash**	**Re-invested earnings**	**Total**
Chemicals	35.9	21.0	56.9	23.0	8.2	31.2
Petroleum refining	4.7	15.8	20.6	7.1	-14.1	-6.9
Oil & gas explorations	154.9	52.4	207.3	163.4	6.5	169.9
Cement	0.1	3.9	3.9	5.3	3.7	9.0
Power	50.5	13.8	64.2	26.1	25.3	51.4
Construction	44.9	-2.3	42.6	26.5	-2.8	23.7
Trade	27.3	6.0	33.3	17.6	-3.3	14.4
Telecommunications	97.9	-38.7	59.3	99.1	-16.8	82.3
Financial business	18.7	-0.7	18.0	8.3	14.2	22.5
Personal services	18.6	1.7	20.4	11.3	2.1	13.4
Others	185.1	18.7	203.8	149.4	12.6	162.0
Total	**638.6**	**91.8**	**730.4**	**537.1**	**35.7**	**572.9**

[4] This index is based on national data on FDI flows for over 60 major FDI recipients around the world.
[5] UNCTAD Global Investment Trends Monitor No.4, 14 October 2010.

investment in oil & gas exploration, chemicals, petroleum refining, and power groups (see **Table 6.4**).

An encouraging sign is the improved level of investment in the traditional groups like telecommunication and financial business. In case of telecommunication, major inflows were recorded by a single mobile telephone company (US$ 60 million) during the month of September 2010. However, anecdotal evidence suggests that negative reinvested earnings show losses of some of the companies in the telecom industry. On the other hand, reinvested earnings in the financial business turned positive from negative in the corresponding period last year. This reflects overall profitability in the financial industry, which is helpful in attracting more FDI flows in this sector.

FDI in oil & gas exploration, chemicals, power and petroleum refining sectors recorded significant declines. Specifically, petroleum refining and oil & gas exploration sector registered significant decline on account of reinvested earnings. The dismal performance of refineries and oil & gas exploration is mainly caused by the circular debt issue.

6.3.3 Portfolio Investment

Portfolio investment plummeted by 42.5 percent during Jul-Nov FY11. This was largely a function of low inflows in equity securities during the period under review. The outflows of debt securities further aggravated the portfolio investment (see **Figure 6.10**).

Figure 6.10: Foreign Portfolio Investment (Jul-Nov)

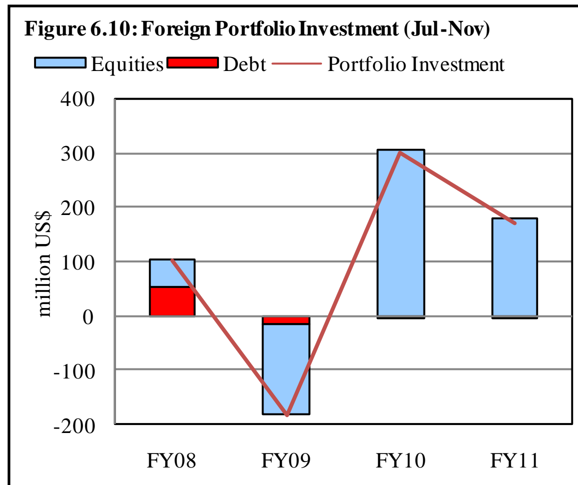
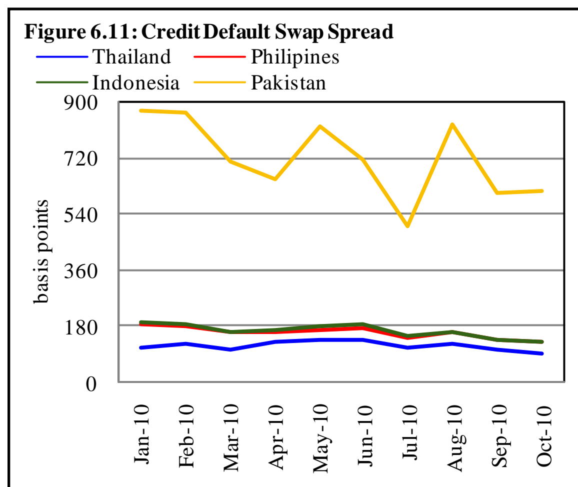


Figure 6.11: Credit Default Swap Spread



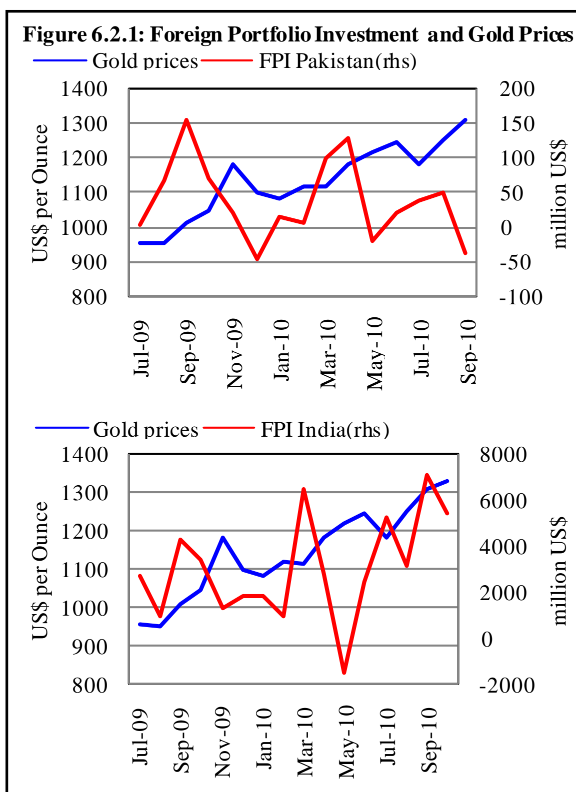
While the outflow of debt securities owed to Treasury Bills (T-bills) net payment of US$ 60 million in the month of September, low inflows in equity securities is not an encouraging sign as Pakistan's stock market remained relatively stable during the period under review. Moreover, Credit Default Swap (CDS) spread also fell significantly from January 2010 position. However, CDS spread showed erratic trend and is still higher than other regional economies (see **Figure 6.11**).

Anecdotal evidence suggests that most of the investors preferred to invest in gold rather than investing in stock markets of India and Pakistan. This is probably due to safe haven tag of gold (see **Box 6.2**).

Box 6.2: Relationship between Gold Prices and Investment in Stock Market

Investment in stock markets by foreign investors is determined by a number of factors, for instance, macroeconomic outlook of the country, stability of the stock market, rating of the country. However, with the emergence of risk averse environment after the recent financial crisis, investment in gold has increased probably due to the fact that it is considered as a hedge against inflation and risk free asset. Investors tend to buy gold due to its safe haven appeal. This has become more apparent after the recent global slowdown as investors are investing in gold, resultantly investment in equity markets are declining.

Figure 6.2.1: Foreign Portfolio Investment and Gold Prices



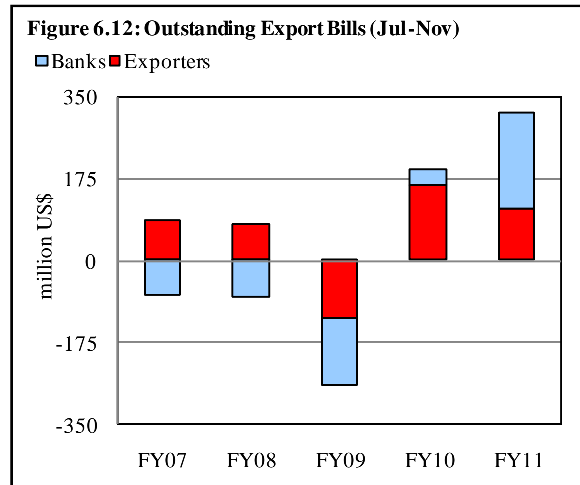
Monthly analysis of gold prices and investment in stock markets of India and Pakistan shows that there exists an inverse relationship (see **Figure 6.2.1**). Investment in stock market declines when gold prices are going up and vice versa. This inverse relationship has become even more significant/apparent during the last three to four months due to the bullish trend in gold market. Foreign investors are reluctant to invest in the stock markets of these two countries despite easing of the global financial crisis.

It is expected that as long as bullish sentiment prevails in the gold market, investment in equity markets of these two countries may not increase substantially.

6.3.4 Outstanding Export Bills

The stock of aggregate outstanding export bills has increased by US$ 316 million during Jul-Nov FY11 compared to the increase of US$ 194 million in the same period last year. Unlike last year, when the large part of increase was due to the outstanding bills held by the exporters, the increase in FY11 is explained largely by the outstanding export bills held by the banks (see **Figure 6.12**). Despite relative exchange rate stability, increase in outstanding export bills is attributed to better performance of exports during the period under review.

Figure 6.12: Outstanding Export Bills (Jul-Nov)



6.3.5 Currency and Deposits (Assets)

Currency and deposits increased by US$ 225 million during Jul-Nov FY11 compared to an increase of US$ 115 million during the same period last year. This increase is largely attributed to the rise in commercial bank FE-25 nostros.

6.3.6 Official Long Term Loans (net)

Net official long term loans recorded an outflow of US$ 44 million against an inflow of US$ 957 million during the same period last year. Despite US$ 453 million of emergency loan by IMF, net official loans recorded outflows on account of higher amortization during the period under review.

6.3.7 Private Loans

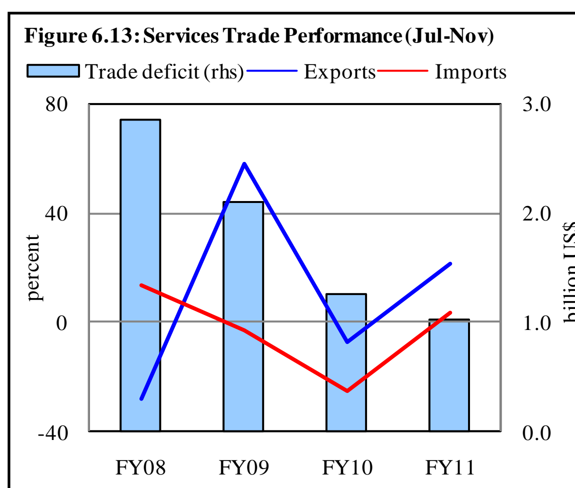
The private loans recorded net inflows of US$ 60 million during Jul-Nov FY11 in contrast to net outflows of US$ 10 million during the same period last year. It is important to mention that the level of inflows was not significantly higher; however, it was the decline in repayments of private loans that resulted in overall improvement during the period under review. The major companies that recorded loan inflows were COCA COLA BEVERAGES PAKISTAN (PVT) LTD (US$ 60

million), LARAIB ENERGY LTD ISLAMABAD (US$ 23 million), KESC (US$ 20 million) and WI-TRIBE PAKISTAN LIMITED (US$ 20 million) during Jul-Nov FY11.

6.4 Trade in Services

Pakistan's services trade deficit contracted by 18.6 percent in Jul-Nov FY11 compared to 40.0 percent in the same period last year. The fall was due to 20.8 percent YoY increase in services exports (see **Figure 6.13**). On the contrary, services import increased by 3.3 percent in Jul-Nov FY11 compared to a decline of 25.5 percent in the same period last year.

Figure 6.13: Services Trade Performance (Jul-Nov)



Expansion in services imports resulted from increase in transportation and travel services related to the religious affairs. In services exports, apart from communication services, all major heads recorded increase during the period under consideration.

6.4.1 Services Exports

Pakistan's services exports increased by 20.8 percent during Jul-Nov FY11 as against a decline of 7.7 percent in the same period last year. The major chunk of

Table 6.5: Major Services Exports (Jul-Nov)

Values in million US$, growth and share in percent

	Absolute Values		Growth		Share	
	FY10	FY11	FY10	FY11	FY10	FY11
Transportation	544.6	558.3	-5.0	2.5	34.5	29.3
Travel	110.8	130.5	-29.1	17.8	7.0	6.8
Other Business	214.3	259.6	-0.2	21.2	13.6	13.6
Communication	107.7	102.6	201.0	-4.7	6.8	5.4
Government	430.0	724.6	-24.8	68.5	27.2	38.0
Total	**1580.0**	**1908.4**	**-7.7**	**20.8**	**100**	**100**

this growth came from rise in receipts under transportation, travel, government services, and other business services sub-groups (see **Table 6.5**). During Jul-Nov

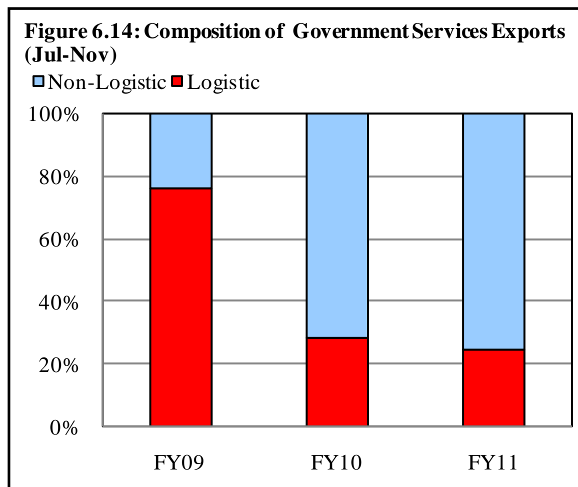
FY11, the overall services exports grew on account of improved freight earnings of national airline/shipping companies, increased disbursements of foreign transport companies domestically, and the increased funds received from international organizations.

Transportation services exports increased by 2.5 percent during Jul-Nov FY11 against a decline of 5 percent in the same period last year. The increase in exports of this category was on account of higher freight earnings, following the revival of economic activities in the international markets. This also led to increased disbursements of foreign air and shipping companies.

Travel Services exports increased by 17.8 percent on account of increased receipts through foreign tourists, indicating a revival of the tourism industry in Pakistan. On the other hand, receipts through exchange companies continued on declining trend following restrictions imposed on exchange companies by SBP.

Other business services exports witnessed increase of 21.2 percent during Jul-Nov FY11 compared to a decline of 0.2 percent in the same period last year. This rise is attributable to the increase in Arch., engineering & technical services, and the others business services head.

Figure 6.14: Composition of Government Services Exports (Jul-Nov)



Government services exports increased by 68.5 percent owing to the remarkable performance of both logistic and non-logistic sector during the period under analysis. Specifically, non-logistic support recorded healthy increase of 77.7 percent in the period under discussion. Consequently the share of non-logistic support in overall government services exports reached 75.4 percent during Jul-Nov FY11 (see **Figure 6.14**). Among the non-logistic support, funds received by international organizations recorded healthy growth of 425.5 percent during Jul-Nov FY11 compared to the increase of 224.3 percent in the same period last year. This probably reflects the increased activities of the international organizations in the flood affected areas. In addition to this, funds received by the foreign missions in

Pakistan also saw an increase, reflecting increased security of foreign embassies and consulates. On the other hand, logistic support increased by 45.4 percent during Jul-Nov FY11 by adding US$ 113.1 million in November 2010 only.

Table 6.6: Major Services Imports (Jul-Nov)

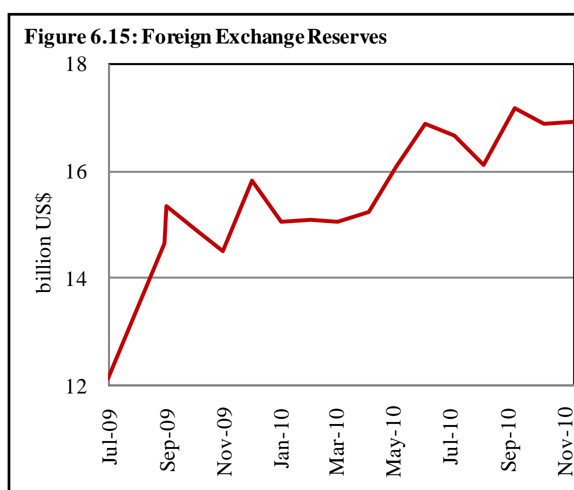
Values in million US$, growth and share in percent

	Absolute Values		Growth		Share	
	FY10	FY11	FY10	FY11	FY10	FY11
Transportation	1436.0	1554.6	-21.6	8.3	50.6	53.0
Travel	385.6	411.5	-45.0	6.7	13.6	14.0
Other Business	490.1	425.7	-42.9	-13.1	17.3	14.5
Government	244.9	246.0	71.0	0.4	8.6	8.4
Total	**2838.2**	**2932.8**	**-25.5**	**3.3**	**100.0**	**100.0**

6.4.2 Services Imports

Increased travel services imports along with robust growth in the transportation services resulted in 8.3 percent expansion in the overall services import during Jul-Nov FY11, compared with the fall of 25.5 percent in the corresponding period last year (see **Table 6.6**).

Figure 6.15: Foreign Exchange Reserves



Import of the ***transportation services,*** being the largest contributor in the overall service import recorded an increase of 8.3 percent against a decline of 21.6 percent last year. This seems in line with the increase in the imports of the merchandise goods.

Likewise, ***travel services payments*** also increased on account of higher Hajj payments (under the head religious travel) which registered an increase of 17.8 percent during Jul-Nov FY11. On the other hand, outflow through exchange companies continued on declining trend on account of outflow restrictions on exchange companies by SBP.

6.5 Foreign Exchange Reserves

In November 2010, Pakistan's foreign exchange reserves reverted to FY10 position, after reaching an all time high of US$ 17.2 billion by end- October 2010 (see **Figure 6.15**). The improvement earlier in the reserve position was mainly due to the inflow of US$ 451 million from the IMF under the Emergency Natural Disaster Assistance (ENDA) for Pakistan in September 2010.

Of US$ 22 million increase in the overall reserves during Jul-Nov FY11, SBP reserves increased by US$ 113.0 million, while that of the scheduled banks declined by US$ 91.0 million. Most of the increase in the SBP reserves was on account of inflows from the IMF under ENDA. Besides these inflows, SBP reserves also benefited from lower outflows due to shifting the oil payments to inter-bank market. Consequently, SBP support for oil payments was completely phased out in the period under discussion (see **Table 6.7**). In contrast to SBP reserves, decline in the scheduled bank's reserves reflects increase in both import and export financing

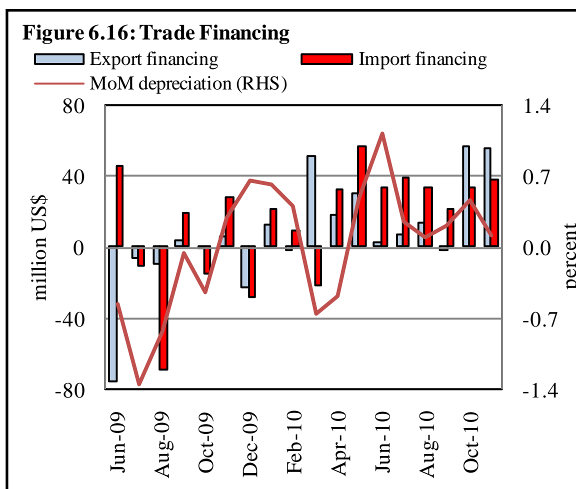
Table 6.7: SBP Reserves[6]

million US$

	Jul-Oct	
	FY10	**FY11**
Inflows	**8217**	**4630**
Purchases	1,320	315
Loans & Grants	3,022	596
ADB	216.8	60.8
IMF	2481.0	453.4
Others	2,862	2,685
Forward maturities	2,505	1,969
Interest on dep./discount	12.5	53.3
Miscellaneous receipts	182.4	558.2
Outflows	**6644**	**4369**
Inter-bank sales	20.0	90
Inter-Bank sales (Oil)	1292.1	0
Debt Servicing	405.7	365.1
Others	3,335	2,878
Forward maturities	2336.3	1,944
Defence (Army / PAF / Navy etc.)	445.3	147.9
Miscellaneous payments	138.0	197.2
Net change in reserve	**1573**	**260.5**

Source: DMMD

Figure 6.16: Trade Financing



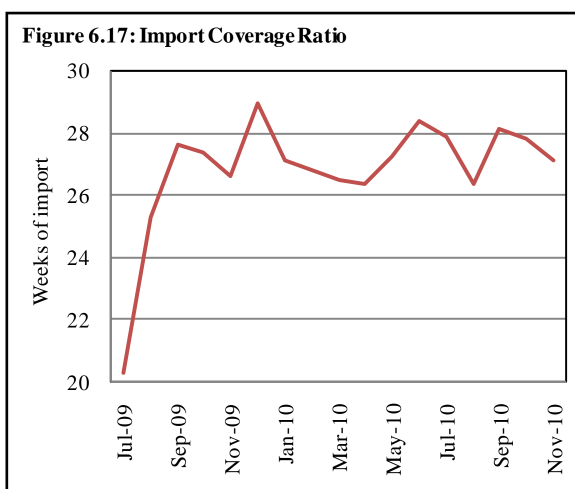
[6] Detailed data on SBP reserves pertains to October 2010.

(see **Figure 6.16**). Consequently, the volume of Foreign Exchange (FE) lending to importers increased to US$ 166.0 million during Jul-Nov FY11. The rise in EFS rate coupled with increase in the interest rate differential between Weighted Average Foreign Currency (WAFC) lending and Karachi Inter Bank Offer Rate (KIBOR) led to an increase in the FE lending to importers. Also, the escalating food and petroleum prices in the international market added pressure on the import payments during the period under discussion.

6.5.1 Reserve Adequacy

Reserve adequacy indicator in terms of weeks of imports declined from 28.4 weeks at end- June 2010 to 27.3 weeks at end-November 2010 (see **Figure 6.17**). Although the reserves increased reasonably during this period but the increase in the import bill was more pronounced resulting in fall of import coverage ratio. Monthly analysis reveals that the overall reserves depleted in the initial two months and imports increased, pushing import coverage ratio down to 26.3 weeks. However, improved reserve position in September and October 2010, with almost stable import bills with respect to previous months has pushed this ratio up again to 28.2 weeks by end- October 2010.

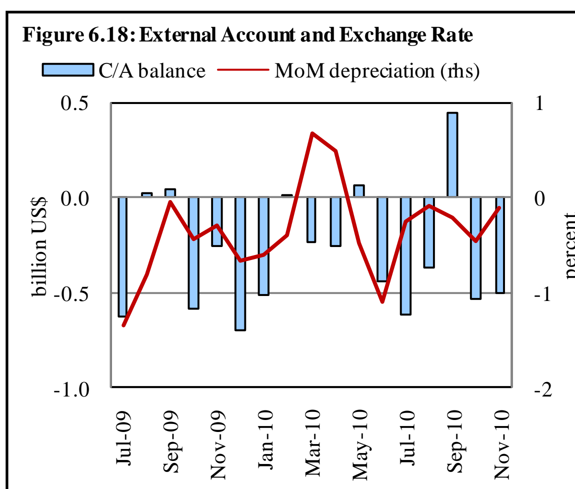
Figure 6.17: Import Coverage Ratio



6.6 Exchange Rate

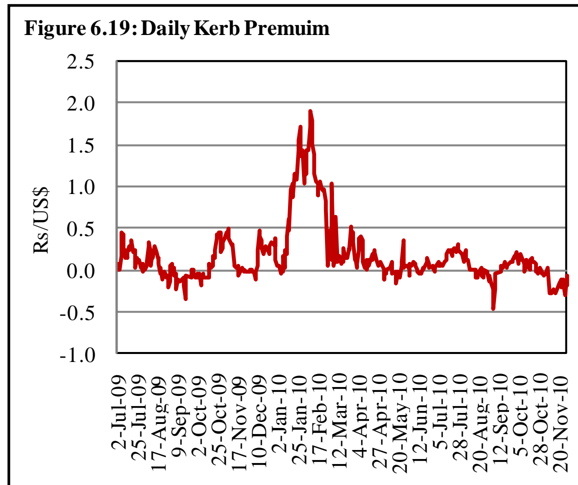
Owing to improvement in the overall external accounts, Pakistan's currency vis-à-vis US dollar depreciated by only 0.35 percent during Jul-Nov FY11 compared to a fall of 2.6 percent in the corresponding period last year (see **Figure 6.18**).

Figure 6.18: External Account and Exchange Rate



Depreciation of rupee signifies pressures in the interbank forex market, as most of the inflows leading to improvement in overall foreign reserves were received directly by SBP (e.g., Emergency Natural Disaster Assistance (ENDA) disbursements by the IMF). Although, scheduled banks' reserves benefited from the rise in remittances, but the increased pressure of the oil payments on the interbank market more than offset the impact of rise in remittances. Specifically, the depreciation of Pak rupee was more evident in the second half of September 2010, reflecting heavy demand for foreign exchange by the oil marketing companies for making payments for the import of crude oil.

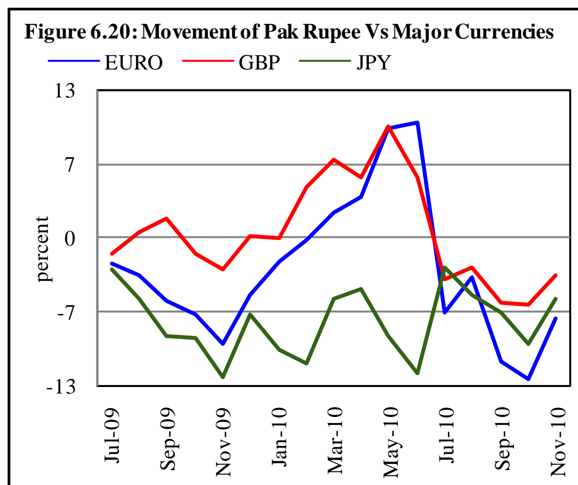
Figure 6.19: Daily Kerb Premuim



During Jul-Nov FY11, kerb market premium remained insignificant, reflecting lower demand of foreign exchange through FECs following SBP's restrictions on outflows from FECs (see **Figure 6.19**).

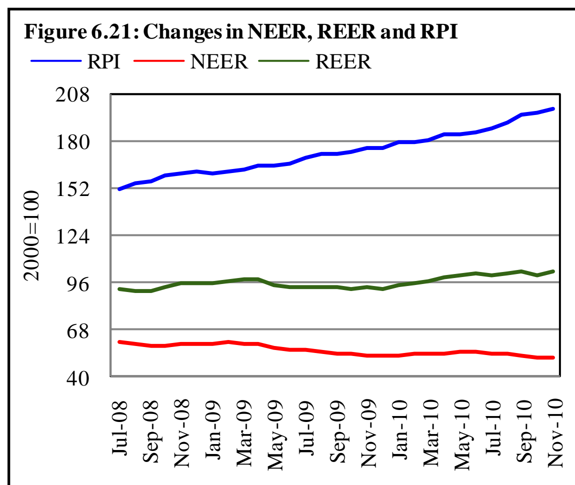
In nominal terms, Pakistan's currency depreciated by 4.4 percent against the basket of currencies. Higher nominal depreciation against basket of currencies compared to US dollar is attributable to the weakness of US dollar against major currencies during Jul-Nov FY11. The depreciation of US dollar has caused Pak rupee to depreciate against these currencies (see **Figure 6.20**).

Figure 6.20: Movement of Pak Rupee Vs Major Currencies



The Nominal Effective Exchange Rate (NEER) depreciated by 4.4 percent during Jul-Nov FY11 compared to 7.0 percent during the same period last year (see **Figure 6.21**). The increase in the Relative Price Index (RPI) due to higher domestic inflation compared to the trading partner countries has caused the Real Effective Exchange Rate (REER) to appreciate by 0.88 percent compared to last year.

Figure 6.21: Changes in NEER, REER and RPI



6.7 Trade Account[7]

Trade deficit widened by US$ 938.2 million during Jul-Nov FY11 in contrast to a contraction of US$ 3220.3 million during the same period last year (see **Table 6.8**).

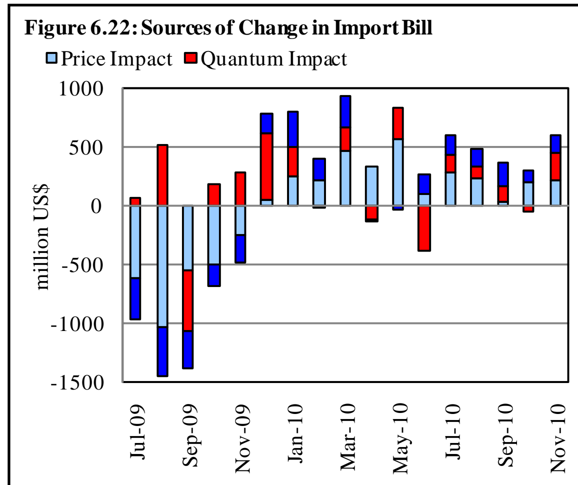
Unlike last year, when sharp fall in imports improved trade account, the deterioration recorded during FY11 is principally due to an increase of US$ 2288.2 million in the import bill which outpaced the rise of US$ 1350 in export earnings.

Table 6.8: Absolute Changes in Trade Account (Jul-Nov)

million US$

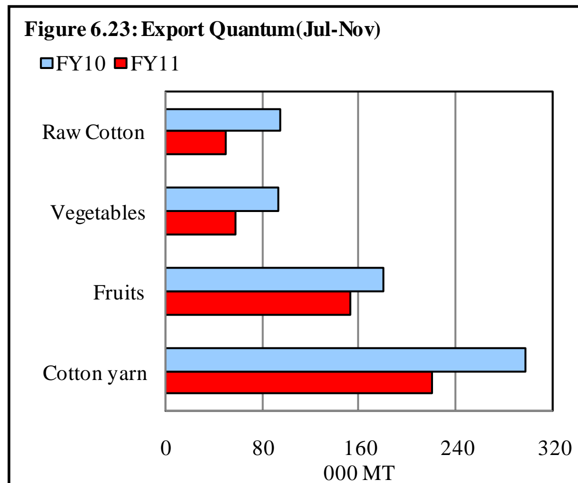
	FY10	FY11
Trade Deficit	**-3220.3**	**938.2**
Imports	**-3905.0**	**2288.2**
of which		
POL	-1696.8	474.5
Food	-703.5	853.6
Exports	**-684.7**	**1350.0**
of which		
Textile	-170.8	948.3
Non-Textile	-513.9	401.7

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



Analysis of import bill shows that a significant part of the rise was due to increased import quantum of food, petroleum, and textile products. Apart from higher import demand, relatively higher international commodity prices further inflated the import bill (see **Figure 6.22**).

The breakdown of the YoY change recorded in export earnings shows that main impetus came from the high-value products of the textile group. This rise can be attributed to relatively higher demand from the US market.[8] However, raw cotton exports declined in terms of quantum due to domestic shortfall.

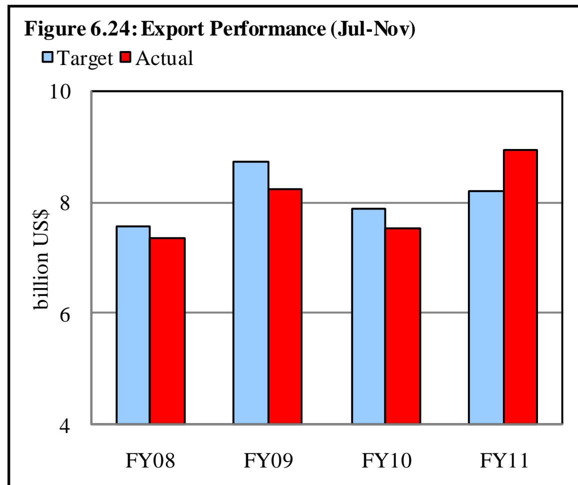


As far as performance of non-textile export is concerned, on one hand, food exports recorded a rise primarily on the back of higher export prices as export quantum registered a decline compared to last year (see **Figure 6.23**). On the other hand, other manufactures exports fell amid subdued external demand.

[8] US textile imports from the world increased by 17.9 percent during Jul-Aug FY11.

The import bill is likely to inflate further, going forward, on account of both, rising import price impact as well as domestic shortages of some key commodities, for instance, sugar and raw cotton. Export growth, on the other hand, may not accelerate at a sharp rate as flood impact on primary commodities[9] is likely to impede the export performance. Thus, trade deficit is likely to widen in coming months.

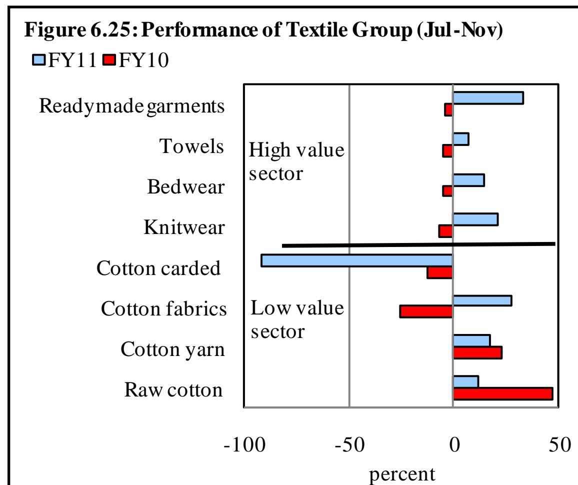
Figure 6.24: Export Performance (Jul-Nov)



6.7.1 Exports

Exports posted a growth of 17.9 percent during Jul-Nov FY11 in contrast to a fall of 8.3 percent during the same period last year. Exports performance is appreciable as this is the first time during the recent years that actual export has surpassed the target export set for the period (see **Figure 6.24**).

Figure 6.25: Performance of Textile Group (Jul-Nov)



Textile Exports

In case of textile exports, positive development was improved performance of the high value products such as readymade garments, knitwear, towels and bed wear (see **Figure 6.25**).

[9] It is estimated that cotton production will fall short by 2.5 million Metric Ton (MT), while rice production is estimated at 3.5 million MT compared with production level of 6.7 million MT. Similarly, loss of live animals is likely to impact meat exports.

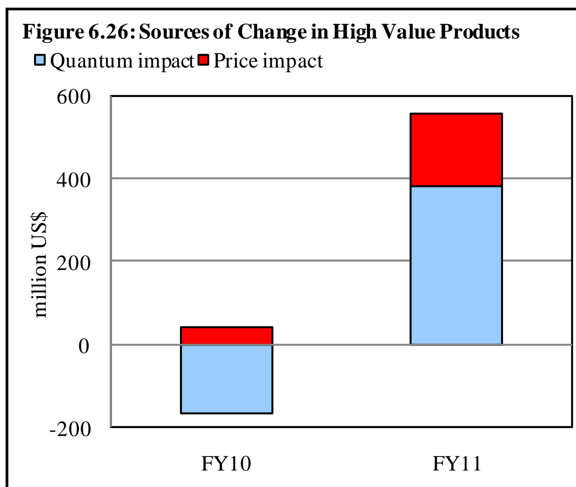
Anecdotal evidence suggests that high value sector was facing two major problems in the last two years. First, compressed external demand led to low export orders. Second, supply-side issues such as liquidity constraints, shortage of raw material, and prolonged power crisis were adversely impacting the production process.

Table 6.9: US Apparel Demand (Jul-Sep)

growth in percent

Apparel Imports	FY09	FY10	FY11
Bangladesh	12.9	-7.5	18.4
China	0.8	-3.8	23.5
India	-8.1	-3.1	6.6
Pakistan	-4.9	-11.3	15.3
World	-2.4	-14.5	17.9

Figure 6.26: Sources of Change in High Value Products



However during Jul-Nov FY11, boosted by increased US textile and apparel imports, Pakistan's exports recorded a YoY rise during the initial months of FY11 compared to a substantial fall during the same period last year. In the presence of tough competition from regional competitors, Pakistan's performance, especially in case of apparel, is largely in line with export growth of competitors (see **Table 6.9**). Despite the shortfall of domestic cotton and pro-longed power crisis, Pakistan's competitiveness improved relatively as increased labor cost in Bangladesh, and appreciation of Chinese and Indian currencies [10] resulted in a loss of competitive strength for their exports in the US market.

On the supply side, availability of raw material such as cotton yarn improved after government imposed restrictions on export of this category. Due to these developments, export quantum of high value products registered a substantial rise. The rise in international cotton prices also kept the export price impact positive during the period under study (see **Figure 6.26**).

[10] Labor wages in Bangladesh increased by 60 percent while Chinese and Indian currencies appreciated by 2.0 and 5.1 percent against the dollar respectively.

Box 6.3: Impact of EU's trade concessions on Pakistan's textile exports

European Union (EU) offered trade concessions to Pakistan on 75-items mostly related to textile sector.[11] After legal modalities, i.e., approval from EU governments and European parliaments, tariff concession would be given for a period of three years effective from January 1, 2011. These 75-items account for approximately 27 percent of Pakistan's total exports to the EU. In 2009, export earnings from these textile-related items were around US$ 1.0 billion. Average export earnings during the last three years were US$ 1.2 billion. Pakistan's export share of these commodities in EU imports is approximately 3 percent.

Table 6.3.1: EU Clothing Imports in H1-2010 (Unit value)

US$/per kg

Woven cloths	Bangladesh	China	India	World	Pakistan
Men overcoats	11.2	15.8	18.5	17.2	9.8
Men suits	11.6	9.6	14.3	12.6	10.1
T-shirts	10.1	15.1	19.0	16.1	10.6
Knit-clothing					
Men overcoats	19.4	18.5	23.2	21.0	18.4
Men suits	12.4	15.3	19.6	18.4	12.9
Women suits	13.7	18.2	33.2	22.5	14.0

Table 6.3.2: EU Clothing Imports in H1-2010 (Volume Share)

share in percent

Woven cloths	Bangladesh	China	India	Other	Pakistan
Men overcoats	5	62	3	24	6
Men suits	11	53	5	25	5
T-shirts	35	22	8	34	1
Knit-clothing					
Men overcoats	2	77	1	19	1
Men suits	16	45	6	27	7
Women suits	8	54	7	28	3

The direct benefit of this package is that it will lower the prices of Pakistani products in EU. However, analysis of EU's textile and apparel imports shows that Pakistan's unit prices in most of the categories are already much lower than competitors (see **Table6.3.1**). But still Pakistan's share in EU market is lower than its peers (see **Table 6.3.2**). Anecdotal evidence suggests that lack of modern technology; designing techniques and exporter's inability to meet large orders are the major impeding factors.

Table 6.3.3: Analysis of EU Concession List

value in million US$, share a& tariff in percent

	Value of exports in 2009	Share	Current avg tariff
Yarn	87.4	8.3	3.2
Fabric	414.4	39.6	6.4
Knit-clothing	545.2	52.1	9.6
Total	**1047.0**	**100.0**	**6.4**

Furthermore, if low value products are exported to EU to get benefit of trade concessions, then domestic availability of raw material would be a problem and imports of these products could increase the cost of production. The shortage especially hurt the production and exports of towels and bed sheets which have not been provided any concession.

However, it is pertinent to mention that the tariff on different categories of yarn is already low, so a zero tariff on these categories would not drastically lower the unit prices. On the other hand, few categories of fabrics and knit-clothing could benefit from the trade concession as the current average

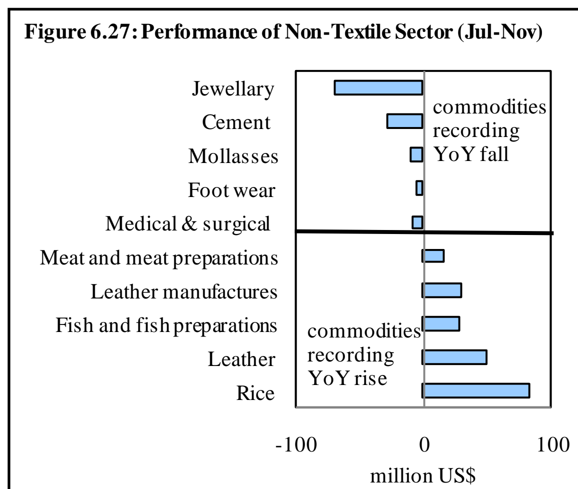
[11] Out of 75-items, 68 are related to textile sector, 6 are associated with the leather industry, while the remaining item is dried mushrooms and truffles.

tariff on these categories is relatively high (see **Table 6.3.3**). Unit prices would decrease dramatically in this case and Pakistan's price competitiveness would increase.

Non-Textile Exports

Analysis of non-textile exports shows that on one hand, exports of food group recorded a YoY rise of 7.3 percent with main contribution coming from rice, meat, fish, and vegetables. While on the other hand, exports of others manufactures marginally increased by 0.3 percent during the period under study (see **Figure 6.27**).

Figure 6.27: Performance of Non-Textile Sector (Jul-Nov)



Rice exports registered a growth of 11.9 percent with major contribution coming from non-basmati rice recording a growth of 13.4 percent during the period under study. This rise in rice exports was largely due to the carryover stocks. However, rice exports may slowdown going forward as production of rice is estimated to remain 3.5 million MT during FY11 compared with last year's production level of 6.7 million MT. However international rice prices are expected to rise due to low production in Philippines[12], which would partially offset the impact of lower export quantum.

Meat and fish exports were increased by 48.2 and 34.3 percent respectively during Jul-Nov FY11. The rise in meat exports was principally due to higher unit values. Moreover, increased demand from Saudi Arabia probably due to the ban imposed by the Saudi government on meat imports from Ethiopia facilitated the Pakistani exporters. On the other hand, rise in fish export was due to increased demand from Egypt.

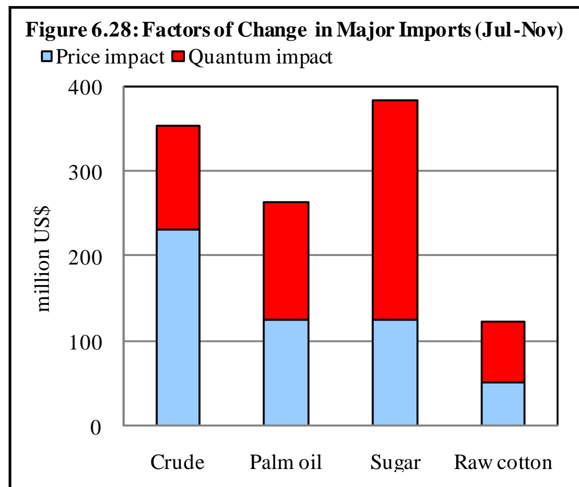
Exports of *leather and leather manufactures* posted a decent rise during the initial months of FY11. The rise in this category is attributed to market diversification and increased external demand of leather jackets. A number of new markets were

[12] According to Philippines department of Agriculture, the estimated production losses (222,000 MT) as a result of Typhoon Megi represent about 3.2 percent of the projected 7.0 MMT national rice production for the last quarter of 2010.

explored, such as South Africa and Turkey. Apart from these new destinations, increased demand from European countries also encouraged the exporters.

Cement exports declined by 13.3 percent during Jul-Nov FY11. This decline in exports was in line with the compressed demand from Middle East countries. Moreover, commissioning of new cement capacities in India led to fall in exports to India during the period under review.

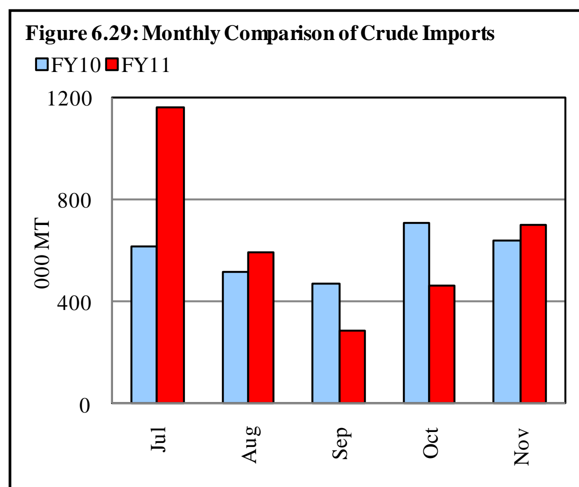
Figure 6.28: Factors of Change in Major Imports (Jul-Nov)



6.7.2 Imports

In contrast to a fall of 23.0 percent during Jul-Nov FY10, import registered an expansion of 17.5 percent during Jul-Nov FY11. This rise in import bill came due to increased import quantum of products like crude oil, palm oil, sugar & raw cotton. Relative increase in international commodity prices also played a part in inflating the import bill (see **Figure 6.28**).

Figure 6.29: Monthly Comparison of Crude Imports



Food group imports recorded a YoY rise of 65.8 percent in contrast to a fall of 35.2 percent during the same period last year. The trend of rising sugar import which emerged during FY10 due to domestic shortages continued in the initial months of FY11 as well. Sugar imports are likely to increase further going forward due to domestic shortage.

Similarly, the dominant factor behind palm oil imports was the quantum impact amid higher domestic demand and reduction of import duty.[13]

Petroleum group imports increased by 12.6 percent during Jul-Nov FY11, as against a drop of 31.0 percent during the same period last year. The price impact in case of both crude oil and petroleum products turned positive in FY11 broadly in line with the increase in international oil prices. In case of crude oil, monthly analysis shows that import quantum substantially decreased after high imports

Table 6.10: Imports of Machinery (Jul-Nov)
million US$

	FY10	FY11	Abs. change
Textile	83.2	193.3	110.0
Telecom	242.6	377.6	135.0
Electrical Machinery and Apparatus	281.6	343.6	62.0
Agricultural	57.2	39.4	-17.8
Power Generating	623.5	459.6	-163.9
Construction and Mining	79.8	51.1	-28.7
Other Machinery	667.3	647.7	-19.6
Total	2137.6	2207.6	70.0

during the month of July (see **Figure 6.29**).[14] Suspension of work at one of the largest refineries resulted in sharp fall of crude imports during September and October.

Machinery group imports posted a growth of 3.3 percent in contrast to a fall of 27.5 percent during the same period last year. Category-wise analysis reveals that imports of textile, telecom and electricity machinery increased in absolute terms, however, power generating, construction and other machinery continued to register a fall (see **Table 6.10**).

Import of textile machinery started rising from September 2009 onwards following the elimination of import duty.[15] The trend of rising import further strengthened after the inclusion of textile machineries under the Long Term

[13] Import duty on crude palm oil was reduced from Rs8,000/MT to Rs7,000/MT
[14] This rise is also due to apparent reporting error, which resulted in oil imports of June to be reflected in July, this is quite obvious as crude imports during June were recorded zero. Avg. crude imports per month is around 600 MT, however, in July, crude imports were reported at 1200 MT.
[15] SRO 809(I)/2009 dated 19th September 09, allows reduction of import duty on textile machinery from 5 percent to zero.

Financing Facility (LTFF).[16] The demand of textile machinery is emanating from low value as well as value added sectors amid improved external demand. Anecdotal evidence suggests that some of the firms are either upgrading or increasing their capacities. The government announcement to grant 10 percent tax credit to firms under BMR would also result in further up-gradation of textile units going forward.

In case of the rise in *telecom* imports, out of the US$ 135.0 million increase, US$89.7 million was due to imports of cellular phones while rest of the increase was due to imports of apparatus. The demand of cellular phone has been on a rise since the reduction of custom duty from Rs. 500 to Rs. 250 and 50 percent reduction in SIM activation charges.

Transport group registered a growth of 7.1 percent. Main contribution in this import growth was the rising imports of CKDs of motor cars. Increased import of CKDs is a function of increased demand from the domestic auto industry. Increased demand is evident from the domestic production and sales numbers which increased by 18.7 and 12.2 percent respectively during Jul-Sep.

Import of *raw cotton* increased during the initial months of FY11 owing to both quantum as well as price impact. First, the expected shortfall in domestic production due to floods led to increased import quantum of cotton. Second, the rise in international cotton prices led to high unit values.

Revival in construction activities, low domestic capacity utilization, and delay in commissioning of a new steel mill largely explains the rising import demand of *iron and steel scrap.* Moreover, the rising demand of the re-rolling industry was also apparent in imports of ship breaking vessels, which recorded a YoY rise of 101 percent during the period under review.

[16] Small and Medium Enterprises Finance Department (SMEFD) Circular Letter No. 03 of 2010, according to which import of second hand machinery shall be eligible for refinancing under the Long Term Financing Facility.

Special Section 1
Flood 2010: Lessons Drawn from Global Post Disaster Initiatives

"Disasters are increasingly recognized as a threat to sustainable development, poverty reduction, and achievement of the Millennium Development Goals. Poor households are particularly vulnerable to negative shocks arising from disaster events for a number of reasons: the poor own fewer productive assets; are more likely to reside in hazardous locations and in substandard housing; and are primarily dependent on their own labor to meet their livelihood needs. Such risk profiles give them fewer options to cope with and recover from the loss of assets, or the death or disability of household members in the event of a disaster. In such situations, poor households may use sub-optimal or even harmful coping strategies such as reducing consumption expenditures on food, health, and education or trying to increase incomes by sending children to work. This can have long-term implications in the form of negative human development impacts and lower future income streams, and thus poverty traps.[1]"

Flood in Pakistan 2010; Extent of Damages:
Pakistan suffered one of the biggest natural disasters of its history. The unprecedented flood of 2010 dislodged more than 20 million people residing over an area of 132,000 kilo meters.

According to estimates of the Asian Development Bank (ADB) and the World Bank, damage to infrastructure, farms, homes, as well as other direct and indirect losses amounted to around US$ 9.7 billion. Of the various sectors affected, agriculture and livestock were worst hit, followed by complete or partial damage to a large number of houses. Other infrastructural facilities also received huge damages.

With a major portion of the population associated with agriculture sector and almost 40 percent of population living around the poverty line in Pakistan[2], the flood is likely to have severe socioeconomic consequences for some time to come. According to ILO more than 5.3 million jobs were lost and/or were affected due to flood[3]. As many hospitals, schools, and roads were either destroyed or damaged in

---

[1] Source: "Building Resilient Communities: Risk Management and Response to Natural Disasters through Social Funds and Community-Driven Development Operations", World Bank (2010).
[2] For details see Social Sector Developments, State Bank of Pakistan Annual Report for 2009-2010 on the State of Pakistan's Economy.
[3] Source: http://www.ilo.org/islamabad/info/public/pr/lang--en/WCMS_144470/index.htm

Table SS1.1: Country wise Foreign Assistance for Flood Affectees							
Country / Agency	**Total Commitment (US $ Million)**	**Grant (US $ Million)**		**In-Kind (US $ Million)**		**Implementing Agency**	
		Committed Pipeline	**Disbursed**	**Committed pipeline**	**Received**	**UN/INGOs**	**GoP**
US / USAID	381.5	313.5	TBD	Twelve flights plane load of goods including Boats, Shelter and settlements, water sanitation and hygiene, plastic sheetings, blankets	68.0	381.5	
Saudi Public Fund Relief	242.0			242.0			242.0
EU	187.5	100.0	87.5			187.5	
Turkey private / public fundraising	130.9			130.9			130.9
UK / DFID	117.7	69.7	48.0	Tents, blankets, water containers, shelter kits, water purification tablets	All received	117.7	
Iran	101.2			100.0	1.2	1.2	100.0
Saudi Arabia	100.0			55.0	45.0	95.0	5.0
Australia	67.5	67.5	TBD	Three Plane load of relief goods	Sent two plane	67.5	
China	50.7		0.2	29.5	21.0		50.7
Turkey	45.0		10.0		35.0	35.0	10.0
Germany	43.8	6.3	37.5	Tents, nets, blankets, kitchen sets, water purification tablets, etc	As indicated in kind monetized column	43.8	
Netherlands	43.3	34.9	8.4			43.3	
Canada	33.0	33.0				33.0	
Denmark	33.0	21.0	12.0			33.0	
UN	29.0		29.0			29.0	
Others*	264.2	93.6	54.9	73.7	31.8	169.1	95.8
Total	**1870.3**	**739.4**	**287.5**	**631.1**	**202.0**	**1236.5**	**634.4**
*Does not include US$10.0 million committed by IDB as soft loans							
Source: http://www.ead.gov.pk/							

the flood areas, these facilities are no longer as effective as these were before the flood. Under these conditions it will be challenging to maintain progress in socio economic indicators of the country. Moreover, efforts to reduce poverty and achieve Millennium Development Goals by 2015 are also likely to suffer.

This special section reviews the relief response from various sources and discusses experiences and lessons drawn from similar post disaster rehabilitation activities.

What Has Done So Far

Following huge damages caused by flood, the world community stepped up rehabilitation efforts for providing basic necessities of life including water, food, basic health facilities and shelter to flood affected people (Table **SS1.1**). Despite a support from world community, the required assistance could not be provided as many people still face desperate conditions. International aid agency Oxfam has warned that flood rehabilitation funds are drying up, putting millions at risk.

The winter has arrived and failing to provide weather related needs to the people living in temporary shelters, tents, and makeshift shelters is a source of concern. In these conditions, the rehabilitation of flood affected people and reconstruction of destroyed or damaged social and physical infrastructure is an uphill task requiring efforts from all stake holders.

The Government of Pakistan has started Watan Card Scheme according to which flood affected families will initially receive Rs 20,000 with a further pledge to receive Rs 80,000 in order to help in reconstruction activities.

State Bank of Pakistan has also taken relief measures for the people in flood affected areas. Details of these measures are presented in **Box SS1.**

Box SS1: Initiatives by State Bank of Pakistan for Flood Affected Areas: In order to facilitate the borrowers of flood affected areas State Bank of Pakistan has initiated various schemes. Salient features of these schemes are discussed below:

- **Concessional Financing & Guarantee Scheme for Canola Cultivation in Flood Affected Areas:** In order to encourage farmers to sow canola in the flood affected areas in Rabi season, a concessional financing scheme has been introduced under which financing will be provided at affordable/concessional mark up rates through banks with an allocated amount of Rupees 500 million for the scheme. The loans extended under the scheme are also covered under credit guarantee scheme, where SBP would shares bonafide losses of banks to the extent of 30 percent. Credit under the scheme is granted to the farmers of the affected districts/regions as identified by MINFA (Ministry of food and Agriculture). Tenor of the crop production loans and its repayment is based on the cropping cycle up-to a maximum period of 6 months. Refinance under the scheme is provided to banks at 5.0 percent per annum. Banks are permitted to charge a maximum spread of 3.0 percent per annum from the borrowers, therefore

credit to farmers is available at 8 percent per annum. Principal amount of loans under the scheme is to be repaid on agreed date between bank and the borrower, however, not later than 60 days from the date of harvest of the crop. Whereas mark-up is to be paid on maturity of loan.

- **Refinance Scheme for Revival of SMEs & Agricultural Activities in Flood Affected Areas:** Under this scheme concessional financing through banks for agri. production/working capital finance to farmers and Small & Medium Enterprises (SMEs) in districts affected by recent flood as notified by National Disaster Management Authority is provided at affordable/concessional mark-up rates through banks/DFIs for which Rs. 10 billion is allocated. Under agricultural production loans, tenor of the crop production loans and repayment of principal amount is based on cropping cycle up-to a maximum period of one year, whereas borrowing limit of farmer is fixed by the bank keeping in view credit requirements, cash flows, repayment capacity, risk profile of the borrower, etc. For SMEs, banks provide short-term loans to SME borrowers, as defined in Prudential Regulations for SMEs in flood affected districts. Refinance under the Scheme is provided to banks at 5.0 percent per annum. Bank is permitted to charge a maximum spread of 3.0 percent per annum from the borrowers, therefore credit to SMEs/farmers will be available at 8.0 percent per annum. Principal amount of loans under the scheme is to be repaid on agreed date between bank and the borrower within a maximum period of one year. Mark-up is to be paid on quarterly basis in case of financing to SMEs. However, mark up on agri. loans is to be paid on half yearly basis.

- **Microfinance Relief Measures for Borrowers of flood Affected Areas:** Under this scheme, microfinance banks (MFBs) are encouraged to reschedule/restructure loans to borrowers of flood affected areas identified by the National Disaster Management Authority (NDMA), as per existing Prudential Regulations (PRs) for MFBs, where the possibility of recovery exists. For all such rescheduled/restructured loans and advances, MFBs may defer loan provisioning up to December 31, 2011. This relaxation is available for loans and advances which have become non-performing since July 1, 2010.

- **Relief Measures for Agriculture and SME Loans/advances of Flood Affected Areas:** Under this scheme, banks/DFIs are encouraged to reschedule/restructure Agriculture and SME loans/ advances to borrowers of flood affected areas identified by the National Disaster Management Authority (NDMA) as per existing Prudential Regulations (PRs) of Agriculture and SME Financing, where the possibility of recovery exists. For all such rescheduled/restructured loans and advances, Banks/DFIs may defer loan provisioning up to December 31, 2011. This relaxation is available for loans and advances which have become non-performing since July 1, 2010.

Lessons from Global Disasters

The first decade of the new millennium witnessed a number of natural disasters around the globe including Tsunami (Indian Ocean 2004), Katrina Cyclone (USA 2005) and Nargis Cyclone (Myanmar 2008). The extent of damages caused by these disasters varies (see **Table SS1.2**). However, relief and rehabilitation efforts in response to these natural disasters offer some common lessons that can be used as a guide while scaling up rehabilitation efforts following the recent flood in

Pakistan. Some of the measures taken by the world community to deal with the aftermath of these calamities are discussed below.

1. **Coordination of Rehabilitation Activities:** An effective rehabilitation strategy can only be successful if there is coordination amongst all participants of relief work. It is therefore necessary to establish a mandate in order to avoid conflicts. Lessons from post Tsunami recovery in Aceh (Indonesia) show that it is necessary to build a relationship of trust with the government for successful coordination of activities. It is also highly imperative to ensure local community participation, in particular the affectees, in order to ensure greater ownership of the recovery process.

   Given that the government has the required infrastructure and access to all affected areas, lead role in the rehabilitation phase has to be carried forward by the government with other agencies partnering with it for implementing a coordinated relief plan. It is therefore necessary for all agencies/NGOs providing relief to flood affectees to work in association with the government of Pakistan for successful rehabilitation program.

Table SS1.2: Comparison with other Natural Disasters

	Flood (Pakistan-Aug 2010)	Earthquake (Pakistan-Oct 2005)	Katrina Cyclone (USA- Aug 2005)	Nargis Cyclone (Myanmar-May 2008)	Tsunami (Indian Ocean- Dec 2004)
Population effected	20,251,550	3,500,000	500,000	2,420,000	2,273,723
Area effected (sq. km)	132,000	30,000	N.A	23,500	N.A
Deaths	1,767	73,338	1,836	84,537	238,000
Injured	2,865	128,309	N.A	19,359	125,000
Household damage	1,884,708	600,152	200,000	450,000	N.A

Source: NDMA website

2. **Provision of Information:** Coordination of rehabilitation activities cannot be implemented unless necessary information regarding recovery process is available to all people concerned including affected population. Post-Tsunami recovery process shows that UNDP and ADB worked together for customizing the existing Development Assistance Database (DAD), in order to track the given aid. Successful Tsunami rehabilitation program in Tamil Nadu (India) was aided by providing reliable village-level data and allied information through a network of state and district level knowledge centers. This helped in accountability as well as coordinating recovery process.

The National Disaster Management Authority (NDMA) has already provided flood related information including the extent of damages, response, relief requirements, recovery and rehabilitation progress and pledges and commitments by donors and sponsors on its website. However, it is necessary that all concerned stake holders should properly use available information and provide further information to the concerned authority regarding their relief efforts and the requirements of the affected population so that a coordinated relief program can be implemented.

3. **Targeting Strategy:** In a relief program it is often difficult to identify and reach out to the most vulnerable people for quick targeted support and certain biases can occur in targeting. Previous relief efforts have shown that gender, ethnicity, age, class, religion or occupation can result in little or no access to assistance following disaster. In particular gender related discrimination is common in recovery processes.

   It is therefore necessary that a targeting strategy should try to minimize such biases. Experience from Indonesia post tsunami recovery show that gender related biases can be minimized by providing gender specific data for monitoring and evaluation purposes. The ongoing flood relief activity should also be planned and implemented in such a manner that the most vulnerable segments of the society are not ignored.

4. **Specific Government Interventions:** Following any natural disaster governments use various interventions for recovery of the affected people. These include free food distribution, food for work, cash for work etc. Experiences from various natural disasters have shown that such interventions have remained successful. Following the flood in Kenya in 1996, government introduced cash schemes that allowed the affectees to invest in small-scale income generating activities.

   Banks and other financial institutions can play an important role for providing local communities with necessary access to capital through micro finance schemes and financing for small and medium enterprises. It is, however, necessary that any such program should be based on proper market assessments with appropriate design and awareness of the facility should be properly disseminated.

   Rehabilitation efforts have been successful in Aceh (Indonesia) and Gujarat (India) following Tsunami. Experience of World Bank Kecamatan

Development Program (KDP) in Indonesia shows that community-based assistance grants can also work well for recovery (for details of selected post disaster livelihood recovery success stories see **Box SS2**). Though State Bank of Pakistan has already taken steps for providing relief to the population of flood affected areas, this is necessary for financial institutions to come up with innovative schemes that help in livelihood recovery of flood affected population of the country.

5. **Final Costs of Construction Exceed Initial Estimates:** Experience from natural disaster rehabilitation work points to the fact that there is high probability that final costs of construction programs would exceed initial estimates by substantial amounts because of rising local construction costs, following a sudden increase in demand in local markets for materials and labor inputs.

   World Bank data provided by USAID shows that following Tsunami the average wage for bricklayers, plumbers, and construction supervisors in Aceh (Indonesia) increased 55 percent, 72 percent, and 81 percent, respectively[4]. It is, therefore, necessary to expect such cost increases and hence rehabilitation work should be appropriately budgeted while estimating funding requirements.

6. **Provision of Basic Health Facilities:** Natural disasters are often accompanied by various health risks including spread of epidemic diseases amongst disaster survivors. Provision of basic health facilities while limiting control of such epidemics is highly imperative under these conditions. A major step towards limiting outbreak of such diseases can be through quick provision of shelter to the affectees. However, it is necessary that the provided shelters should also have allied infrastructure facilities for water, sanitation and cooking etc. Given that winter is setting in, provision of shelter is highly imperative as women, elderly people and children are vulnerable to weather related diseases.

7. **Ensuring Accountability and Transparency During Rehabilitation Stage:** For successful rehabilitation of affectees it is necessary that monitoring and evaluation of various programs should be an integral part of the process. Such monitoring should ideally be ongoing so that not only

[4] Source: "Reconstruction after a Major Disaster: Lessons from the Post-Tsunami Experience in Indonesia, Sri Lanka, and Thailand", ADB Institute Working Paper No. 125 (2008).

the program progresses but any necessary adaption in the program in relation to changing requirements of the concerned population can be done.

Given that recovery involves huge sum of money; chances of corruption become high. Experiences from post Tsunami rehabilitation indicates that corruption levels can be kept to a minimum. This was mainly because corruption was considered as a core threat to reconstruction and hence governments established several levels of transparency and accountability mechanisms[5]. In Aceh (Indonesia) a comprehensive information management system, the Recovery Aceh-Nias Database (RAND) was developed and all agencies involved in tsunami recovery were required to register and send regular updates on funds committed and disbursed.

An allied factor with accountability is a strong complaint mechanism where grievances of affected people can be heard. Proper function of such mechanisms during the ongoing recovery and rehabilitation process can go a long way in reducing the levels of corruptions and injustices to vulnerable groups.

8. **Future Preparedness:** In order to minimize the extent of damages caused by natural disasters increased use of technology is generally recognized necessary for developing suitable early warning systems, disaster preparedness mechanisms and management of rehabilitation activities after disasters. International experience shows that following the devastating earthquake in Indian state of Gujarat (2001), appropriate use of telemedicine allowed specialists to provide consultations to the affected population from far-off places when all other means of communication were disrupted.

   It is, therefore, necessary that the Government of Pakistan should look into ways and means for improving the existing technological facilities so that the country should be better prepared for encountering any future disasters. Investment in technological progress can go a long way in limiting the extent of damages in case of future disasters.

9. **Use Disaster as an Opportunity to Reform:** The most important lesson drawn from the rehabilitation from natural disasters is that countries used

[5] Source: www.ifrc.org/Docs/pubs/Updates/the-tsunami-legacy.pdf

these disasters as an opportunity to reform and improve themselves as seen in all the five countries affected by Tsunami. These countries have learnt to create disaster preparedness institutions equipped with early warning systems. They have also learnt to encourage community participation in disaster awareness and preparedness programs. It is therefore necessary for the government of Pakistan to turn around this crisis into an opportunity to reform and rebuild better systems.

Conclusion

Pakistan is currently facing unprecedented damage caused by devastating flood that has hampered lives of millions of people. Given the high magnitude of destruction, full recovery will not be easy and strong support and cooperation between external and domestic stakeholders are required. International community has extended an arm of support, however still more needs to be done for rehabilitation of the affectees. Given that Pakistan is entering the rehabilitation stage, it is important to capitalize on experiences from similar natural disasters. Lessons learnt from earlier post disaster activities can help the government in better planning and implementation of recovery initiatives.

Box SS2: Post Disaster Livelihood Recovery, Selected Success Stories:

- **UNDP Cash for Work Programme (Haiti, 2010):** In response to the devastating earthquake in Haiti, UNDP started cash for work programme, under which short-term jobs like clearing rubble and rehabilitating infrastructure were created. Under the scheme more than 100,000 workers, with more than 40 percent women, were provided a livelihood which covers for their basic necessities. An allied programme for supporting micro and small enterprises is also under progress which aims to provide small grants for asset replacement apart from providing management and skills training to nearly 20,000 small businesses. Moreover in order to build local capacities through trainings, a series of projects under Area-Based Recovery is also aimed. The overall budget for the livelihoods, cash-for-work and Area-Based Recovery components of UNDP's programme for the 2010–2012 period is $149.2 million.

- **Indonesia Kecamatan Development Program (World Bank):** This programme was run in association with the Government of Indonesia aimed at alleviating poverty, strengthening local government and community institutions, and improving local governance. Loans from World Bank, government budgetary allocations and donor grants supported the programme. According to the scheme villagers engage in a participatory planning and decision-making process to allocate resources for their self-defined development needs and priorities. The outcome of the programme has been successful as apart from improving local governance, KDP has funded some 116,300 infrastructure, economic and social activities across the country.

- **ADB assisted Earthquake and Tsunami Emergency Support Project (Aceh Micro and Small Enterprises):** In order to develop sustainable financial services for micro and small enterprises in Aceh rural banking network was redesigned. Accordingly 12 small rural banks were merged thereby increasing the overall equity base. Moreover ADB also assisted in hiring

and training of old and new staff in accordance with formulated standard operating policies and procedures. The consolidated rural bank has been able to serve the more remote and "under-banked" areas of Aceh.

- **ADB assisted Earthquake and Tsunami Emergency Support Project (Aceh and Nias Microfinance projects):** Under the project technical assistance was provided to microfinance banks operating in the region. The technical training encouraged banks to lend on group basis following the Grameen model. The results of the scheme were very productive as the banks engaged in expansive micro financing catering the financial needs of a larger network of clientele with a very high repayment rate.

Acronyms

ADB	Asian Development Bank
BFSRs	Banking Financial Strength Ratings
BMR	Balancing Modernization and Restructuring
BoP	Balance of Payments
bps	Basis Points
CAD	Current Account Deficit
CBs	Commercial Banks
CDS	Credit Default Swap
CKD	Completely Knockdown
COD	Collection on Demand
CPI	Consumer Price Index
CY	Calendar Year
DAD	Development Assistance Database
DAP	Di-Ammonium Phosphate
DFID	Department for International Development
DFIs	Development Finance Institutions
DPBs	Domestic Private Banks
DSC	Defense Savings Certificate
EDL	External Debt & Liabilities
EFS	Export Finance Scheme
ENDA	Emergency Natural Disaster Assistance
ER	Exchange Rate
EU	European Union
FBR	Federal Board of Revenue
FBS	Federal Bureau of Statistics
FCAs	Foreign Currency Accounts
FDI	Foreign Direct Investment
FE	Foreign Exchange
FECs	Foreign Exchange Companies
FED	Federal Excise Duty
f.o.b	Free on Board
FOREX	Foreign Exchange
FPI	Foreign Portfolio Investment

FY	Fiscal Year
GDP	Gross Domestic Product
GoP	Government of Pakistan
GST	General Sales Tax
H	Half
HBL	Habib Bank Limited
HRI	House Rent Index
HSD	High Speed Diesel
HSD	Hemorrhagic Septicemia Disease
IBFT	Inter Bank Fund Transfer
ILO	International Labor Organization
IMF	International Monetary Fund
KDP	Kecamatan Development Programme
KESC	Karachi Electric Supply Corporation
KIBOR	Karachi Inter Bank Offer Rate
kg	Kilograms
KP	Khyber Pakhtunkhwa
LED	Light Emitting Diode
LSM	Large Scale Manufacturing
LTFF	Long Term Financing Facility
MoM	Month-on-Month
MoU	Memorandum of Understanding
MINFA	Ministry of Food and Agriculture
MPS	Monetary Policy Statement
MPC	Monetary Policy Committee
MRTB	Market Related Treasury Bills
MT	Metric Ton
MTBs	Market Treasury bills
NBFIs	Non Banking Financial Institutions
NDA	Net Domestic Asset
NDMA	National Disaster Management Authority
NEER	Nominal Effective Exchange Rate
NFA	Net Foreign Asset
NFC	National finance Commission

NFI	Net Foreign Investment
NFNE	Non Food Non Energy
NGOs	Non Governmental Organizations
NPLs	Non Performing Loans
NSS	National Savings Scheme
OMOs	Open Market Operations
PAMA	Pakistan Automotive Manufacturers' Association
PASSCO	Pakistan Agriculture Storage & Services Corporation
PIBs	Pakistan Investment Bonds
POL	Petroleum, Oil and Lubricants
PPTFC	Privately Placed Term Finance Certificates
PRI	Pakistan Remittance Initiative
PSC	Private Sector Credit
PSDP	Public Sector Development Program
PSEs	Public Sector Enterprises
Q	Quarter
QoQ	Quarter on Quarter
RAND	Recover Aceh-Nias database
RBD	Refined, Bleached and Deodorized
REER	Real Effective Exchange Rate
RFCAs	Residents Foreign Currency Accounts
RGST	Reformed General Sales Tax
RHS	Right Hand Side
RPI	Relative Price Index
Rs	Rupees
SBA	Stand-By Arrangement
SBP	State Bank of Pakistan
SDRs	Special Drawing Rights
SMEs	Small and Medium Enterprises
SMEFD	Small and Medium Enterprises Finance Department
SPI	Sensitive Price Index
SRO	Statutory Regulatory Order
T-bills	Treasury Bills
TCP	Trading Corporation of Pakistan

TM	Trimmed Mean
UAE	United Arab Emirates
UK	United Kingdom
UNDP	United Nations Development Program
UNCTAD	United Nations Conference on Trade and Development
USA	United States of America
USAID	United States Agency for International Development
VAT	Value Added Tax
WHT	Withholding Tax
WPI	Wholesale Price Index
YoY	Year on Year