2nd December, 2006

STATE BANK RELEASES ITS ANNUAL REPORT
FOR THE FISCAL YEAR 2005-2006

The State Bank of Pakistan today released its Annual Report for the fiscal year 2005-06. The Report is in two volumes. Volume-I of the Report contains a comprehensive review of Pakistan's economy during the year 2005-06 while Volume II deals with the performance of the State Bank itself. The Volume-II also contains the balance sheets of the State Bank and its subsidiaries.

The Governor, State Bank of Pakistan, Dr. Shamshad Akhtar briefed the newsmen about the salient features of the Report at a press conference held at Karachi this morning. The following are the highlights of the Report.

HIGHLIGHTS OF STATE BANK'S ANNUAL REPORT 2005-06

1. Pakistan's economy turned in a strong performance for yet another year in FY06 with real GDP growth of 6.6 percent remaining higher than the desired long-term average of 6 percent. This was supported by strong growth in exports and private investment and probably contributed to a further reduction in poverty. The sustained high growth is quite creditable given the many adverse developments, such as very sharp increase in oil prices, and the October 2005 earthquake.

2. For the first time in six years, the expansion in broad money (M2) was lower than the nominal growth of the economy, i.e. the pace of money creation was lower than the generation of goods and services in the economy. The monetary tightening, coupled with administrative actions by the government to lower food inflation, helped contain average CPI inflation within the 8 percent annual target, without prejudice to the country's long-term growth momentum.

3. There are however some areas of concern, in particular due to (i) a relatively narrow growth base, (ii) persisting high inflation, (iii) pressures in fiscal deficit in the backdrop of a nearly stagnant tax base which has kept the tax/GDP ratio in the 10 to 11 percent range for over a decade, and (iv) widening of the current account deficit.

4. The policy environment for FY07 is even more challenging as monetary policy is required to support both a lower inflation target of 6.5 percent in FY07 as well as a higher real GDP growth. SBP projections suggest that real GDP growth is likely to be close to the 7 percent annual target in FY07, helped by a recovery in agriculture and industry as well as yet another robust performance by the services sector.

5. The expansionary fiscal policy in FY07 has compounded the risks to the economy. Besides adding to inflationary pressures, the Government's higher funding requirement

induces more pressures to raise interest rates to curb incremental pressures on the economy. The key fiscal risk may emerge if the necessary growth in expenditures is not matched by a commensurate increase in revenues, resulting in the loss of the hard-won fiscal space gained in recent years.

6. Other than improving the tax base in order to sustain robust development spending as well as contain growth in the fiscal deficit, the government needs to diversify its sources of borrowings, adopt a judicious mix of short-term and long-term borrowings and ensure that the sanctity of the overall yield curve (which has evolved as a result of effective market price determination of debt) is maintained. Greater focus and reliance on different maturity and, in particular, long term PIB issues would be desirable rather than once again offering NSS instruments on-tap to institutional investors. As a matter of fact, effective debt management and its pricing are critical to facilitate the development of a long-term corporate debt market – an area where progress has been stalled.

7. The widening external imbalance has been another concern. Pakistan has so far been able to finance current account deficit smoothly because Pakistan's overall strong economic performance and reforms have enhanced investor confidence, helping the country access the international debt market on relatively favorable terms. However, this cannot be continued over the medium term without incurring high costs, including a rise in the cost of accessing international capital markets, lower investment flows, and greater vulnerability to external shocks.

8. Strong fiscal stimulus and a widening current account deficit together with the risk of an above-target inflation outcome serves to highlight the need for a continuation of a tight monetary posture in FY07. In doing so, the central bank would be mindful of inherent danger of excessive tightening hurting growth momentum. In view of this, SBP's monetary policy measures to curb inflationary pressures on economy will have to be assisted by administrative measures since food inflation, exacerbated typically by supply-side factors, can be a significant contributor to domestic inflation.

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