Governor's Message

The Annual Performance Report of State Bank of Pakistan (SBP) provides an opportunity to take stock of institution's performance and offer report of accountability to all stakeholders and public at large. Like a number of central banks, SBP has legal mandate to perform multiple functions. The principal mandate, however, is to secure monetary and financial stability and foster a dynamic and sound financial system so as to achieve sustained and equitable economic growth in the country.

In delivering these responsibilities, SBP has steadily transformed and strengthened itself over the years to adapt modern approaches and modalities and international best practices in all principal areas of its policy mandate and operations. In the annual report, SBP management and staff have also attempted to capture the broad direction of structural reforms and policy debates underway in the central bank as well as banking industry to serve better the economic and social requirements.

Qualitative Changes in Monetary Management

Serving its legal mandate of achieving price stability, while promoting sustainable economic growth, SBP's monetary policy has helped contain core inflation. In the last year, SBP brought about substantive changes in the formulation, management and conduct of monetary policy. To further strengthen monetary policy framework, SBP has streamlined formulation, synchronization and implementation of monetary policy and is reviving financial programming and macroeconomic modeling to help feed in broader economic developments in monetary policy making process while ensuring consistency in monetary and macroeconomic framework. SBP Central Board invoked Section 9A of the SBP Act, 1956 and imposed annual ceiling on government borrowings and has also communicated to the Government its quarterly borrowing limits. These changes in debt policy, leading to reduction in reliance on central bank borrowing, should augur well for easing the monetary pressure, though ultimately scaling down of Government borrowings from banking system would be more desirable and would minimize crowding out of private credit.

Besides using standard tools, like adjustment in reserve ratios and increase in policy discount rate, SBP has proactively pursued Open Market Operations (OMOs) to mop up excess liquidity from the banking system. Monetary tightening yielded results while the aggregate demand pressures were contained and the core inflation (refers to non food non energy inflation) declined from 7.1% to 5.7%. Despite the high and rising level of external current account deficit, SBP exchange rate remained stable during FY07.

Monetary policy formulation process has also considerably benefited from the formation of a more comprehensive Monetary Policy Committee within central bank and replacement of the National Credit Consultative Council with a Private Sector Credit Advisory Committee. Other consultative forums facilitating credit policy and delivery mechanisms such as SME and Agricultural Credit Consultative Committee have also played their due roles.

Exchange Rate and Reserve Management

During FY 2007, the forex market in the country continued to grow both in capacity and volumes. The exchange rate depicted a stable trend with healthy volatility reflective of prevailing demand and supply conditions. SBP provided an enabling environment to the market forces for playing their due role in determination of exchange rate. During the year, support for POL products continued where SBP remained a net buyer of USD 192 million as against a net seller in the previous year. In addition to financing the external current account deficit, the strong inflow of foreign remittances that reached record high levels, helped Pakistan build up foreign exchange reserves to unprecedented levels touching $16.1 billion (31.5 weeks of imports) as of end September 2007.

Banking Sector Regulation & Supervision

Banking system is one of the best performing sectors of Pakistan. The enhancement in its capacities has facilitated significant growth in private sector credit which has helped promote broad based economic growth consecutively for the last few years. Growth in the size of banking industry and its profitability has had several positive impacts. The banks contributed almost Rs.39.5 billion annual taxes to Government, allowed over 30% of stock market capitalization, provided job opportunities to 117,856 persons and extended financial services to almost 26.6 million people in the country. The banking system mobilized cumulatively about USD 3.0 billion foreign inflows (including foreign direct investments and Global Deposit Receipts) over the last five years. This has helped mergers and acquisitions in the banking sector that in turn facilitated its consolidation. SBP introduced and implemented broad based policy reforms to ensure that the banking sector is robust and sound. A steady rise in capital requirements has allowed the increase in capital of banks to USD 3.2 billion. Similarly, the enforcement of prudential regulations helped to bring down the non-performing loans to record low levels with exposure to different groups and sectors well balanced.

The work on consumer concerns and protection is underway. Banks have now managed to raise deposit rates, though at slow pace, but offering different product ranges has helped steady growth in deposits. Similarly, an improved branch licensing policy allowed us to focus on the expansion of banks' branch network towards underserved areas, reduce financial exclusion and promote national savings. SBP also strengthened its own supervisory and regulatory capacity which allowed effective vigilance of banks/DFIs.

Recognizing that complacency in this financially integrated world would not be desirable, banks are positioning to augment their provisioning, strengthening risk management frameworks and bracing for more rigorous enforcement of internal audit and controls. Pakistani banks are also preparing themselves for further rise in the Minimum Capital Requirement (MCR), implement the road map for Basel-II, enhance corporate governance, adopt better technological solutions and improve credit information systems.

On the supervisory front, though largely unseen by the public, SBP through its various regulatory actions has strived to nudge the banks towards a more transparent and fair banking culture with consumer protection and awareness at the heart of these initiatives.

Broadening Access of Financial Services

Financial inclusion is a new and most important corporate social responsibility of central banks. Several initiatives are underway to improve access to financial services. A comprehensive Microfinance Strategy approved by the Government in February, 2007, is now well under implementation. A visible result is doubling of microfinance borrowers reaching 1.4 million as of August 2007. Institutional restructuring by way of expansion in microfinance banks and transformation of microfinance financial institutions/non-governmental organization into licensed microfinance banks should help microfinance institutions to emerge as more prominent players. Concurrently, new liquidity support mechanisms, technological solutions, credit enhancement and credit bureau system and other initiatives should all help deepen penetration, among others, in rural areas.

For the promotion of agriculture finance, SBP has developed a strategy which aims towards increasing the outreach level from 1.6 million to 3.3 million farmers in next 3-4 years. In order to achieve this target, SBP is removing the existing regulatory hurdles, ensuring an enabling policy environment, conducting research while focusing on development of Islamic products for agriculture finance and encouraging mobile banking for increased outreach and disbursements. Dealing with collateral issues through introduction of group based lending mechanism, corporate farming, development of collateral-free products; crop loan insurance mechanism and capacity building both at SBP and the commercial banks are also being prioritized for more focus.

Supporting Small and Medium Enterprises (SMEs) development policy, SBP has issued prudential regulations specifically designed for SME lending and is also working with the Government to enhance coverage and access. A Housing Advisory Group has finalized its recommendations toward removal of hurdles in financing for this sector.

Islamic finance is rapidly emerging in Pakistan. As six licensed Islamic banks take stronger foothold it will play a key role in extending financial services to un-banked population. SBP Shariah Advisory Board has been instrumental in approving Shariah manuals and standards. The task force has also submitted its recommendations to the Government for introducing Shariah compliant liquidity instruments. Further, SBP played a proactive role in the Islamic Financial Services Board which is now a well recognized international standard setter for the Islamic banking industry.

Strengthening of Payment Systems

The robustness of payment system is gaining increasing significance in the wake of automation and complexity of financial transactions. The FY 2007 saw the enactment of Payment Systems & Electronic Fund Transfer Act. This Act provides a regulatory framework for strengthening payment systems and e-banking in the country. By the same token, SBP is providing enabling environment for increasing the scope of e-banking by allowing the banks to accept payment of utility bills through ATMs. This step will not only provide convenience to customers of utilities but will also open up business opportunities for banks and the utility companies.

SBP is also in the process of linking up banking sector-wide electronic payment system through Real-Time Gross Settlement System (RTGS) named PRISM (Pakistan Real Time Interbank Settlement Mechanism). The PRISM when implemented will provide the capability to settle inter-bank transactions whether clean or against securities on real time basis and minimize the settlement risk for the participants involved.

Corporate Governance

SBP maintained high standards of corporate governance. In order to further improve the overall governance structure, in addition to implementation of cluster based reorganization, all the committees to the Central Board of Directors were reconstituted and their Terms of References were revised. Further, Board for National Institute of Banking & Finance (NIBAF)-one of the subsidiaries of SBP- was improved whereby prominent economists and individuals from academia were appointed. This allowed us to focus on its overall management and up-gradation of training programs. This enterprise-wide restructuring process permitted us to improve the overall governance. Further, in the wake of growing need for complex financial services to stakeholders, including the government, a change management exercise has been planned at our other subsidiary i.e. SBP-BSC.

Human Resource Initiatives

Recognizing that success of an institution hinges on the structural efficiency of an organization along with overall competence and commitment of staff, SBP has strengthened its organization and introduced a new Human Resource Development Strategy.

SBP has been successful in attracting seasoned professionals from reputed overseas financial institutions into areas like treasury, information technology, corporate services and research. At SBP our selection and training process is both a centripetal as well as centrifugal phenomenon where exposure to SBP is coveted by its talented staff members and the financial institutions find in our staff members competencies hard to find elsewhere.

In order to keep our staff motivated the primary focus remained on development of HR policies & procedures which could help institute a performance based culture in the bank. Some of the major achievements include the launch of New Compensation and Benefits Structure (NCBS) for officers in OG-2 & above, (including employees in Separate Salary Structure for Specialized Professionals) and the Voluntary Separation Scheme (VSS) for employees in OG-1 & below.

Information Technology & Infrastructure Development

SBP has successfully completed all the major projects with regard to implementation and up-gradation of Oracle ERP system, GLOBUS and Data Warehouse applications. The steps undertaken to improve Information Systems & Technology have translated into smooth functioning of SBP’s business processes and operations. In order to ensure the integrity of information stored and processed a separate IT Security Division has been established which is responsible for defining Policies & Procedures of IT Security and Risk Management. During the year, SBP drafted the policies on IT Change Management, IT Incident Response and IT Physical Security. SBP further launched a department-wise information security risk assessment of core IT assets and renewed the ISO 9001:2000 certification.

Moving forward, while SBP will continue to perform its role and responsibilities with highest level of integrity and ethical standards our primary emphasis for next year will again be towards maintenance of monetary and financial stability. The banks will be steered to nurture access to development finance, adopt Basel-II, strengthen capital base and implement technology. High standards of regulation and supervision with an emphasis on improving quality of service and efficiency will be enforced.

I would like to acknowledge the role of members of the Central Board of Directors whose timely and effective guidance has strengthened the governance of the central bank. I would also acknowledge the dedication of staff for their continued hard work which has helped SBP to enhance its performance across the board. Finally, I urge the SBP employees to continue their efforts to take the central bank to new heights.

Dr. Shamshad Akhtar
Governor

State Bank of Pakistan

Highlights of the SBP's Annual Report 2006-2007

This report has two volumes: Volume –I discusses trends and analysis of the recent economic outcome and performance, and Volume II is the central bank's accountability report offering a perspective on the structural changes and activities of SBP and major policy initiatives launched by SBP and the banking industry in striving to keep the banking sector healthy and robust.

1. Real Sector

GDP Growth

- Pakistan's economy recorded one of the fastest growth rates in Asia during FY07. Real GDP growth accelerated to 7.0 percent, which was surpassed only by China and India.

- Consistent with recent trends, FY07 growth profile is broad based. Most vibrant has been once again the services sector, though accompanied this year by the above-target performance of the agriculture sector, and an improvement in industrial growth over the preceding year.

- Sound macroeconomic policies have successfully transformed the initial consumption-led growth impetus of a few years back to one with a greater role for investment-led demand. The investment to GDP ratio rose to a record 23 percent in FY07. This was contributed by a surge in domestic private investment and record FDI flows. As a result, the economy looks well-poised to continue on a high growth trajectory in coming years.

- Despite the improvement, the investment to GDP ratio remains low in Pakistan. Moreover, the low domestic savings rate remains a key impediment to sustaining high investment rates. Although the savings to GDP ratio has also increased to 18 percent during FY07 compared with 17.2 percent in the preceding year, it is still low compared to regional and international standards.

- To increase the savings rate, it is necessary to expand the network of bank branches in all parts of the country, increase the reach of microfinance institutions and postal savings to the far flung areas with simple procedures and friendly atmosphere to encourage small depositors.

Agriculture

- Agriculture sector witnessed a strong growth of 5.0 percent in FY07. The recovery in the agricultural growth during FY07 is principally driven by a remarkable growth of 7.6 percent by major crop sub-sector.

- A striking feature in FY07 is that the yields obtained on almost all important major crops, were either at or near 10-year highs. Apart from favorable weather, the improvement in yields in recent years was probably helped by the improved access to credit and supportive government polices (the latter includes ensuring better seed availability, provision of subsidy on DAP fertilizers, incentives for exports of agri-commodities, etc.).

Industry

- The industrial sector witnessed a moderate recovery during FY07 with a growth of 6.8 percent, supported by the strong growth in the manufacturing and the construction sub-sectors. The impressive 17.2 percent growth in the construction sector is mainly attributed to higher development expenditures by the government, increased foreign direct investment (FDI) in the construction sector, and record worker's remittances.

- The most significant contribution to the FY07 LSM growth came from the textiles sector, which staged a strong recovery, shrugging off the impact of a relatively disappointing domestic cotton harvest. The cement industry was amongst the few bright spots in LSM in FY07. Production growth accelerated during the year, helped by the substantial capacity additions in recent years and a booming domestic construction industry.

Services

- The services sector continued its impressive performance for another year, registering 8.0 percent growth, well above the 7.1 percent target set for the year. The sustained strong growth by the services sector for the last six successive years has contributed to a structural shift in the economy, and the share of the services sector in GDP rose to a new high of 53.3 percent during FY07.

Prices

- Inflationary pressures remained strong throughout FY07 despite a visible slowdown in non-food inflation. Strength of food price inflation drove the annual average CPI inflation for FY07 to 7.8 percent -- resulting in price index slippage by 1.3 percent relevant to the annual target of 6.5 percent.

- Food inflation remained in double digits for most of the months of FY07 mainly due to (i) rising food prices in international market, (ii) domestic supply shortages of some important minor crops, and (iii) higher demand on the back of increasing income levels.

- In contrast to *food* inflation, *non-food* CPI inflation witnessed a secular decline and averaged 6.0 percent during FY07, significantly lower than the 8.6 percent average for FY06. The major contributors to this slowdown in CPI *non-food* inflation are the *transport & communication, house rent* and *fuel & lighting* sub groups.

- Inflationary risks persist in the economy. This is captured by the edging up of the core inflation since May 2007, although it is still lower than in corresponding period last year. Inflationary pressures may be further generated if international food commodity prices remain high and/or if fiscal compulsions drive the Government to pass through a rise in fuel prices in the face of rising international energy prices.

2. Monetary Sector

- SBP monetary policy continued to strike a balance between reducing inflation and supporting a sustainable strong economic growth. While the economic growth momentum remains intact in FY07, the headline CPI inflation while lower than FY06 remained high, mainly due to the continued strength of food inflation.

- Administrative actions and policies targeting market structure issues (including collusive behavior by producers and distributors) are more effective in containing food inflation. At the same time, a continuing focus on tight monetary policy is needed so that the inflationary expectations are contained and the seepage of pressures from rising food prices into the broader economy is prevented.

- A tight monetary posture is all the more important given the exceptional rise of 19.3 percent in monetary aggregates during FY07. The acceleration in broad money growth, particularly in the last month of FY07, risks exacerbating the demand pressures already visible in the economy towards the end of FY07. These pressures are evident in two core inflation measures, each of which bottomed out in May 2007. After reaching 5.2 percent in May 2007, the non-food non-energy (NFNE) core inflation reached 6.0 percent in August 2007. Similarly the trimmed mean core inflation measure also reached a trough at 6.2 percent YoY in May 2007 before climbing to 6.7 percent YoY in August 2007.

- The slippages in M2 growth mainly stemmed from an expansion in net foreign asset (NFA). While the larger part of the NFA increase was due to a welcome rise in foreign investment flows, it is worth noting that a significant portion also comprised of external financing support for budgetary expenditures, particularly during June 2007. The greater than expected NFA increase led the SBP to aggressively mop up liquidity. In particular, during H2-FY07, net of maturities, the acceptances in T-Bill auctions totaled almost Rs 291 billion against the target of Rs 50 billion.

- As a result of the aggressive sterilization, M2 growth during Jul-May FY07 was 14.1 percent which was slightly less than the nominal GDP growth of 14.7 percent for the year. However, June 2007 saw an exceptional jump in SBP NFA, which saw M2 growth increase by 5.2 percentage points, although the SBP mopped up Rs 61.8 billion through OMOs in this month alone.

- Thus, while the government budgetary borrowings from the banking system during FY07 remained comfortably within the target, the pressures from the fiscal account continued to pose difficulties to the conduct of monetary policy during the course of the year. This is evident from the high central bank borrowings during some months of FY07.

- In addition, the high level of SBP refinancing extended for both working capital and long-term investment to exporters partially offset the SBP measures to tighten liquidity from the inter-bank market. Disappointingly, the SBP concessional financing did not either lead to a higher export growth nor new investments in the textile sector.

- It is in the context of these FY07 developments that the SBP made significant changes to its monetary policy framework in July 2007 by raising the policy rate by 50 basis points with effect from August 1, 2007, and complementing this tightening with non monetary measures to curtail reserve money growth. The SBP moved to limit the impact on monetary growth of the concessional financing for exports (by reducing provision of re-finance) and, for the first time, the SBP also advised the government to contain its borrowings from the central bank within a specified limit.

3. Public Finance and Fiscal Policy

- The fiscal deficit remained at 4.3 percent of GDP in FY07, same as that of last year. This was because the impact of an exceptional 18.6 percent YoY growth in CBR tax collections and strong non-tax receipts, was offset by a rise in expenditures.

- However, it should be noted that a better picture emerges on adjusting for expenditure on account of relief and rehabilitation of earthquake affected areas. The adjusted overall fiscal deficit in FY07 drops to 3.9 percent of GDP.

- A significant contribution to the fiscal deficit in FY07 was also from the strong growth in development spending. This needs to be sustained, but the persistent revenue deficit is unwelcome. In FY07 the revenue deficit was 0.9 percent of GDP, and under the Fiscal Responsibility and Debt Limitation Act 2005, the revenue balance has to be zero (or in surplus) during FY08.

- Also, while the fiscal deficit needs to be reduced, there is also a need to improve infrastructure and other development spending. In order to resolve this apparent conflict, the government should focus spending on priority areas and public goods, and encourage private investment in other areas through private-public partnerships and polices to encourage infrastructural investment.

- Compositional shift was witnessed in the borrowing from banking system with shifting dependence from central bank to commercial banks. This needs to continue.

4. Domestic and External Debt

- Pakistan's debt indicators continued to improve in FY07, with total debt and liabilities (TDL) as a share of GDP dropping to 56.7 percent in FY07. However, in absolute terms the country's TDL rose by 10 percent in FY07 to Rs 5,024 billion. This principally reflects the country's large current account and fiscal deficits.

- The increase in the TDL was contributed by an increase in both domestic and external debt – domestic debt recorded 11.9 percent growth to reach Rs 2,597 billion, whereas external debt and liabilities stock (EDL) recorded 8 percent YoY growth to reach US$ 40.1 billion during FY07.

- Two thirds of the rise in domestic debt was caused by growth in the floating debt (which comprises of T-bills). The share of short term debt thus rose from 40 percent in FY06 to 43 percent in FY07. Similarly, 62.5 percent of the rise in the EDL during FY07 was contributed by floating interest rates loans. The rising share of short-term and floating rate debt in the country's TDL indicates a relatively greater vulnerability of debt serving costs to adverse future interest rate movements.

5. External Sector

Balance of Payments (Exchange record data)

- The rates of growth of the trade and current account deficits have decelerated in FY07. However, the size of the current account deficit rose to US$ 7 billion – 4.9 percent of GDP. Three key factors contributed to the widening of external current account imbalance: First, the country's import bill for petroleum products reached US$ 7 billion and both the service and income accounts deficits (net) rose to US$ 7.5 billion - the former alone is equivalent to the size of current account deficit. Second, the exports slowdown was significant in the wake of last three years' average growth of 14.6 percent. Third, the income account deficit (net) turned to be another US$ 1 billion - higher than last year's payment as the payments for interest liabilities on sovereign bonds & other loans, crude oil and profit & dividend transfers, etc. exceeded the inflows in this account.

- What was comforting in FY07 is the moderation in the growth of the external current account deficit (which grew by 42 percent relative to 225 percent in the preceding year) as the import demand fell significantly, partly a consequence of monetary tightening and partly a reflection of the lower demand for capital, food and consumer goods. Gains from the slowdown in import growth were offset by the unexpected deceleration in export growth and rising investment income outflows which together contributed to the growth of current account deficit. Notwithstanding this, the recent growth in current transfers (net), that have reached close to US$ 10.5 billion, helped finance the trade deficit.

- Given Pakistan's rising industry and infrastructural requirements, increasing oil prices, and food imports in eventuality of shortages of strategic products, the country's imports are likely to remain strong. Thus, it is essential that the growth in exports be accelerated.

- More distinctly, industrial diversification would be a key to export diversification. Substantial reforms and corrective polices are needed to broaden the industrial base and to increase productivity, reduce the cost of doing business, remove bureaucratic hurdles, reduce the costs for energy & water, and lower inflation in the economy. In short, the reduction in external imbalances must focus on a long-term perspective rather than on the provision of ad-hoc short-term support.

- The foreign investment inflows, led principally by equity investments, emerged as the single largest source of external finance during FY07. This almost doubled the financial account surplus to US$ 10.1 billion in FY07, up from US$ 5.8 billion during FY06. During the year, foreign inflows from different sources reached a record high at US$ 8.3 billion mainly caused by strong equity capital inflows, a remarkable surge in stock markets and GDRs.

- The record surplus in the capital & financial account helped increase the country's foreign exchange reserves by US$ 2.5 billion in FY07. As a result, the country's liquid foreign exchange reserves rose to a record US$ 15.6 billion in FY07, with the imports coverage ratio rising to 26.2 weeks, as compared to 22.8 weeks at end-June 2006.

- During FY07, the Pak Rupee exhibited a mixed trend. In the first half of the year, the Rupee depreciated vis-a-vis the benchmark currency US Dollar by 1.14 percent, as the trade deficit widened; but in the second half, particularly during the last two months of the fiscal year, strong foreign inflows stabilized the Pak Rupee-US Dollar parity, as is evident from 0.31 percent depreciation of Pak Rupee against US Dollar in FY07. The relative stability of the rupee against the US dollar appears to be a function of the structure of the foreign exchange markets, dynamics of trade, and special arrangements set in place for lumpy oil payments. SBP has now enhanced the foreign exposure limits of commercial banks, and banks are now self-financing 20 percent of the oil product import market.

<u>Exports (FBS data)</u>

- The slowdown in export growth was broad based as the textile exports growth declined from last four years average of 14.4 percent to only 4.9 percent during FY07, whereas non-textile export growth declined from last four years' average of 19.2 percent to only 0.6 percent during FY07.

- Poor rice, fruit and cotton crops together with EU ban on fish & fish preparations imports from Pakistan and industry specific issues are considered as some of factors behind the sluggish growth in non-textile exports during FY07.

- Slowdown in the textiles exports can be attributed to: (i) low quality of the textile products on account of contaminated cotton and unskilled labor, (ii) concentration of exports in the low and middle value added textile items, (iii) frequent power failures in the country, and (iv) EU market specific issues such as the antidumping duty on the bedwear exports and only partial restoration of GSP facility.

- Other contributory factors of the slowdown in exports is lack of export diversification, delay in adoption of international standards, reduction in duty drawbacks and zero rating of sales tax for major exports (that may have reduced incentive for over-invoicing).

- Going forward, Pakistan's apparel exports to the US and the EU markets may face increased competition following the end of the US and EU safeguard measures imposed on China.

Imports (FBS data)

- The broad based slowdown in import growth is mainly attributed to: (i) a moderate decline in global oil prices, (ii) the reduction in excess demand, (3) gradual absorption of one-off impact of liberalizing of automobile & telecommunication sectors, and (4) improved domestic production of food items such as sugar and wheat.

- Going forward, uncertainly in the global oil prices and increasing commodity prices which have been on the rise in the last few weeks, an anticipated increase in the import of telecom following China's investment in Pakistan's telecom sector, and the likely rise in power generating machinery imports may put upward pressure on the import bill.

Based on preliminary data, at this stage it appears that the economy will grow in line with the projections placed at 7.2 percent. Monetary tightening has been quite aggressive to contain the spillover of demand pressures emanating from the last quarter slippages in money supply. The first quarter data suggests that inflationary pressures are however strong given the food prices have reverted to double digits in September 2007. Key further risks to the inflation outlook appear to be the energy and food staple prices in wake of rising international prices. Enhancing production in FY08 would be critical for easing some of the supply constraints, both to ease inflationary pressures as well as provide for export growth. Private sector credit off-take has been low in the first quarter partly reflecting the seasonal trends and partly because companies are positioning themselves to gear up as the emerging environment unfolds. Foreign inflows remained in line with FY07 trends in first quarter and are likely to gain momentum in the second half of the year.

Pakistan's external current account deficit, though sustainable in the short term, would remain a key challenge for the economy. In the short term, Pakistan's current account imbalances have been kept within manageable limits by the compression in import demand maneuvered through monetary policy tightening and the strong growth in foreign direct investment and remittances helped by investor confidence, exchange rate stability, efficiency in transmission of funds through official channels and competitive returns to investment both in corporate and asset markets, and boom in UAE and Saudi Arabia (the two largest growth areas for remittances in Pakistan) which has had a positive impact on earnings and capital flows. Over the long term, however, sustainability of external account is critically linked to the dynamics of the private-investment gap as well as the behavior of the fiscal account. Industrial diversification, enhanced competitiveness and access to international markets are key to the revival and broadening of the export base. This, in turn, is a key to the reduction in trade deficit, which is likely to come under renewed pressure to serve the import requirements of a vibrant economy.

In FY07 a wide range of export incentives were provided to textile exporters. Among others, these included a generous Research and Development grant and concessional credit for both long and short term financing requirements. These incentives have, by and large, persisted in FY08. The budget for FY08 included some additional measures such as rationalization of duty structure for a number of export oriented industry, tax free dedicated export processing zones and 100 percent export oriented industry, as well as support for textile city, skill development, etc. These measures, coupled with the exchange rate appreciation in neighboring countries, should provide an opportunity to regain the export momentum. Recognizing access issues, Pakistan has signed off on a few free trade agreements, including one with China, which should augur well for future export growth.

Pakistan's re-entry in international financial markets augurs well for deepening of financial markets, better integration with world markets and supplementing and diversifying sources of financing. Besides floatation of three debut issues of GDRs for OGDC and two banks (MCB and UBL), some corporates (such as Mobilink) accessed the international corporate debt markets taking advantage of interest rate differential between local rupee and foreign currency loans. Sovereign bond issuance has facilitated setting pricing for the debt issuance, while investors are getting a strong feel for the underlying dynamics of the economy that has shown resilience not only by withstanding domestic political developments but also exogenous shocks such as the hike in oil prices. Different types of inflows would help Pakistan's integration with world financial markets, while helping meet financing requirements, on competitive terms, for corporates that have exhausted bank limits of corporate exposures. The central bank has recently also liberalized external commercial borrowings within limits and has set in place a monitoring system to ensure debt sustainability.