1 An Overview and Executive Summary

1.1 Overview

The growth momentum of the economy continued to accelerate in FY04, with real GDP rising by a robust 6.4 percent, well above the 5.3 percent target for the year. As in the previous year, the growth was led principally by industry and in particular Large Scale Manufacturing (LSM), which benefited from a further acceleration in aggregate domestic demand as well as strong external demand. However, contrary to conventional wisdom, the acceleration in aggregate demand in FY04 (as in FY03) stemmed mainly from a strong rise in investment activities with a much smaller contribution of credit-led consumption demand. Investment growth rate has jumped to a record 22.3 percent–the highest ever in the recent history of Pakistan, pushing the investment-GDP ratio to 18.1 percent. This acceleration in investment, together with the sustained consumption growth, underpins SBP expectations of a continuation in the industrial growth momentum in the years ahead.[1]

However, the FY04 economic performance also highlighted the vulnerability of the economy to shocks; contrary to initial expectations the agri-sector growth proved disappointing as key crops suffered heavily from natural vagaries.[2] Similarly, other than *wholesale and retail trade*, growth in the services sector decelerated. Therefore, the quality of the FY04 growth is poorer compared to FY03, being quite concentrated in only a few sectors (*large-scale manufacturing*, *electricity & gas distribution*, *wholesale & retail trade* and *construction*).

As a result of the larger contribution of LSM in overall GDP growth, FY04 industrial output pulled ahead of agricultural output. This is the culmination of a medium-term trend, which if sustained, carries very significant implications for Pakistan's economy. In particular, it suggests an increasingly important role of monetary policy (especially given the increased sensitivity to interest rates movement implied in credit-driven growth), as well as the greater impact of external shocks (as industry is more dependent on imported inputs as well as on external demand).

This is already evident in the robust 18.1 percent growth in LSM in FY04, the highest in last three decades. This high growth in manufacturing (small scale manufacturing ought to have performed better than the assumed growth of 7.5 percent) is mainly a result of the combination of domestic aggregate demand expansion facilitated by accommodative monetary policy, and increased external demand aided by stable exchange rate and very low export financing rate. Government's higher public sector development expenditure in FY04 has also contributed to higher investment demand.

The greater dependence on LSM to sustain the growth momentum, as well as the perceived vulnerability of the sector to interest rate increases were key determinants of the SBP decision to only gradually increase interest rates in the face of rising inflationary pressures.

This said, the central bank was keenly aware of the rise in headline inflation, and the attendant increase in inflationary expectations through the economy, and tried to strike a balance between the growth and inflation management imperatives. Key comfort points for the SBP in continuing with its expansionary monetary policy were: (1) the fact that through most of FY04 inflationary pressures were caused by supply-side factors rather than excessive demand (which is supported by high food

[1] The sharp jump in investment that finally emerged in FY04, following steady increases in capacity utilization also offers the hope of increased employment generation in the economy in coming years.
[2] The saving grace for agriculture in FY04 was the relatively high prices of agri-produce, which helped increase farmers' incomes.

inflation in FY04), and (2) the expectation that inflationary pressures would begin easing early into Q2-FY05 (due to both, a projected decline in food inflation as well as initial expectations of a fall in oil prices, by October 2004).[3]

In this background, despite a gradual decline in net forex inflows, and a relative increase in government borrowing for budgetary support, the SBP largely maintained its easy monetary stance during FY04. This, in turn, underpinned the record credit expansion in FY04; to put this in perspective, the Rs 325 billion growth in net credit to the private sector was more than twice the *cumulative* net credit expansion in the preceding three years.

It is important to note the very significant changes in the economy that underlie the exceptional credit demand seen in FY04.

(1) One of the more significant (and more visible) results of the SBP's monetary policy in recent years has been the deepening of the consumer credit market. In FY04, consumer credit growth accelerated as banks aggressively sought to expand market share

(2) Another less visible but arguably equally important development in FY04 has been the increased competition in lending to the agricultural sector. As a result, not only has the volume of credit to the agri-sector increased significantly, the cost of funds has also declined.

(3) Finally, a very heartening development has been the increased access of small borrowers to the banking system credit. Both, the number of small loans taken, as well as the aggregate volume of these loans increased significantly.

However, the easy monetary policy also had some negative effects that need to be monitored closely. The most obvious of these was the increase in speculative activities in the economy, as borrowers sought to take advantage of soft credit terms and rising inflationary pressures. This was evident in a variety of markets, including wheat, automobiles, real estate, etc. While such non-productive activities certainly need to be discouraged, it is very important to note that this cannot be done by monetary policy alone. There is clearly a need for increased regulatory intervention as well as consumer resistance to unwarranted price hikes.

An important development in the credit regulation during FY04 was the amendment in the SBP prudential regulations introduced in FY04 to enable bank lending to the SMEs. This is not only expected to be a key driver of future credit growth, it could also significantly help improve employment generation and output in the economy. A positive side effect of the resulting increase in lending to the informal sector would be improved incentives for documenting economic activities, since the credit access to the SME sector will depend on demonstrable cash flows. In other words, these monetary policy changes could possibly initiate a virtuous cycle, whereby increased tax revenues resulting from the greater documentation could, in theory, lead to (1) lower average tax rates (further encouraging documentation); (2) lower dependence of government on bank borrowings (helping contain interest rates and facilitating private sector investment); and (3) further spurring credit demand (and documentation).

It should be noted that a strong fiscal position goes hand in hand with the ability of the central bank to prudently sustain low interest rates. The strong growth in government revenues and containment of fiscal deficit made important contributions to the SBP's ability to sustain low interest rates in the

[3] In the event, some evidence of a deceleration in food inflation has emerged since August 2004, but this gain may now be offset by the impact of the unexpectedly strong international oil prices (the government is expected to gradually pass on the impact of high oil prices to consumers in the months ahead).

economy. This was quite evident in FY04, when increased government borrowings from the banking system were a crucial driver of interest rate expectations. As long as the market was comfortable with the government's fiscal position, interest rate expectations were largely contained. Paradoxically, the government's increased borrowings from the banking system in FY04 stemmed not from a poor fiscal performance (the fiscal deficit actually shrank from Rs 184 billion in FY03 to Rs 173 billion in FY04), but as a result of exogenous factors – the decline in non-bank financing as well as lower availability of external financing (largely due to the termination of the Saudi Oil Facility), and the laudable desire to retire expensive external debt.

In fact, the termination of the SOF in December 2003 had multiple impact on the economy: (1) the current transfers fell sharply, exacerbating the impact on the BOP of the lower flows of logistic support payments, and net fall in aid inflows; (2) as a result the exchange rate came under pressure, even as (3) government borrowing rose. All of these raised expectations of a hike in interest rates, particularly in the final months of FY04.

Also the resulting increased sensitivity of the market to exchange rate pressures probably exacerbated the impact of the end to the SOF amidst rising oil prices, as importers rushed to lock-in the prevailing exchange rate, and the stock of outstanding export receivables climbed. Thus, it is no coincidence that the current account surplus recorded in FY04 was almost entirely garnered in H1-FY04, before these expectations took root.

It is important to note here that a decline in the current account surplus is not a problem for a developing country, as long as export growth remains strong, the rise in imports is driven principally by machinery and raw material, which add to domestic production, and the private remittances are able to finance trade deficit. This has been the case for Pakistan in FY04. The sustained rise in remittances greatly mitigated the risk of excessive exchange rate pressures. It should be noted that while "headline" remittances figures depicted an 8.6 percent YoY fall in FY04, in terms of foreign currency inflows into the economy this decline was illusory. The FY03 figure included the substantial conversion of forex deposits into Rupees. Adjusting for this figure and the impact of the termination of the Hajj Sponsorship Scheme, the foreign exchange sent into the country by expatriate Pakistanis fell by a mere US$ 31 million in FY04 (adjusted flows show a decline from US$ 3,838 billion in FY03 to US$ 3,807 million in FY04).

Looking Forward

Initial indications are that the growth momentum of the economy will continue into FY05. This is expected to be led principally by the continued strong performance of industry (particularly LSM) as well as a reasonable showing by agriculture, both of which are likely to support real GDP growth of over 6 percent. Similarly, the services sector too is expected to grow strongly on the back of the rise in the real sector as well as increased investment in key sub-sectors such as communications, etc. However, there are a number of factors that pose a significant threat to these expectations, chief amongst which is the anticipated water shortages that is likely to hit many major crops. In fact, the hopes of even the reasonable agri-sector performance in FY05 hinge on the anticipated exceptional cotton harvest, and good performance of minor crops.

Similarly, the sustained increase in international oil prices has multiple negative dimensions. First, there is a threat of a slowdown of the global economy, which could, in turn, hit Pakistan's export growth (hurting the textile industry in particular). Second, as the country's oil import bill expands, it will turn the current account surplus into deficit and put pressure on the Rupee. Third, the economy would likely also face increased inflationary pressures (particularly as the government may be not able to buffer local fuel prices for long). The resulting pressure on the exchange rate would also be hard to mitigate because of the increased integration of the domestic financial markets, with interest rate movements affecting the currency markets and vice versa. Any move to stabilize the currency would only create pressure for sharp interest rate hikes.

The oil prices, together with the decline in the non-structural flows such as the Saudi Oil Facility and the logistics support payments have already led to a weakening of the current account, but July-August 2004 data shows that the current account for the period is nonetheless in surplus (albeit by an almost negligible margin), aided by a continuation of the strong export growth, as well as an acceleration in remittances. If this favorable constellation of events extends throughout FY05, or even if only a small deficit materializes, it would obviously help the SBP in ensuring that the economy is not significantly disturbed by abrupt changes in the exchange rate.

Ironically, the pressure on the external account would help the SBP in managing the growth of reserve money in the economy, thereby holding down the rise in monetary assets within the limits set in the Credit Plan for FY05. It is important to note that monetary expansion in the preceding three years has been substantially higher than nominal GDP, and this overhang needs to be adjusted if rising inflationary pressures are to be contained to support long-term growth. Indeed, it is in this perspective that the planned 11.4 percent growth in the monetary assets during FY05 has been kept slightly below the projected 11.9 percent rise in nominal GDP for the year. Supply-side shocks, if they persist, will force inflation to exceed the postulated target of 5 percent. Although monetary policy stance will remain geared to subdue inflationary expectations, the initial momentum built up in the first quarter of FY05 will resist the reversal to the target.

A key determinant of the SBP's ability to meet its monetary targets would be the government's fiscal posture during the year. In particular, while tax revenue has seen robust growth so far in FY05, non-tax revenues have probably been hit by the government decision to squeeze the oil developments surcharge. Since only part of the resulting revenue shortfall is likely to be met from other sources (e.g. higher dividend receipts, etc.), the government's fiscal discipline is likely to be tested in FY05. In this regard it is important to stress the necessity of holding to fiscal discipline not only to the direct negative long-term consequences of fiscal laxity but also due to the risk of losing the hard-won credibility of Pakistan's economic managers in the eyes of the international investment community.

However, in addition to containing the rise in the deficit to the FY05 target levels, it is important that the government continue to protect development spending. While the government has indeed shown a very laudable desire to strongly increase investment in infrastructure and the social sector, it is imperative that the budgetary allocations are indeed materialized. It must be kept in mind that while FDI flows into Pakistan have certainly improved in FY04, the country's share in FDI to emerging market remains quite low. It will take both, sustained macroeconomic discipline as well as the availability of a skilled workforce in order to change this picture for the better.

To sum up, the outlook for growth rate of over 6 percent for GDP looks quite promising at this juncture but it is unlikely that the inflation target of 5 percent will be met. The risks to the FY05 prospects emanate mainly from exceptionally high escalation in oil prices that can adversely affect the current account and fiscal balance putting pressure on exchange and interest rates. This exogenous shock can be amplified if the water shortages: (1) reduce wheat output and other Rabi crops; and (2) raise demand for imported fuel oil to generate electricity.

These risks can be mitigated if the exports and remittances continue to show better than assumed results, government revenues exceed their target, wheat supplies are augmented through timely imports, development expenditure is not curtailed, and gas & coal are increasingly used for power.

Table 1.1: Selected Macroeconomic Indicators

Description	FY00	FY01	FY02	FY03	FY04 Targets	FY04 Actual[P]	FY05 Targets
					Growth rates (in percent)		
Real GDP (FC)[1]	3.9	1.8	3.1	5.1	5.3	6.4	6.6
Agriculture	6.1	-2.2	0.1	4.1	4.2	2.6	4.0
Major crops	15.4	-9.9	-2.5	6.9	5.5	2.8	3.5
Manufacturing	1.5	9.3	4.5	6.9	7.8	13.4	10.2
Large-scale	0.0	11.0	3.5	7.2	8.8	17.1[5]	12.0
Services sector	4.8	3.1	4.8	5.3	5.0	5.2	6.2
Consumer price index (FY01 =100)	3.6	4.4	3.5	3.1	4.0	4.6	5.0
Sensitive price indicator (FY01 = 100)	1.8	4.8	3.4	3.6	-	6.8	-
Monetary assets (M2)	9.4	9.0	15.4	18.0	11.0	19.6	11.4
Domestic credit	9.0	3.7	1.9	0.6	8.3	23.7	13.1
Exports (f.o.b.)	10.1	7.4	-0.7	2.2	9.7	10.3	11.5
Imports (c.i.f.)	9.3	4.1	-3.6	18.2	5.0	27.6	8.7
Official liquid FE reserves[2] (million US$)	1,352	2,076	4,805	9,993	-	11,107	-
					As percent of GDP		
Total investment	17.4	17.2	16.8	16.7	16.8	18.1	18.8
National savings	15.8	16.5	18.6	20.6	16.8	19.8	19.1
Tax revenue	12.9	12.9	13.2	13.6	13.5	13.7	13.9
Total revenue	16.3	16.2	17.2	17.7	17.0	18.0	17.1
Budgetary expenditure	22.5	21.0	22.8	22.2	21.1	21.9	21.1
Budgetary deficit[3]	6.6	5.2	5.2	4.5	4.0	3.9	4.0
Current account balance (including official transfers)	-0.3	0.5	4.0	5.1	-	2.0	-
Domestic debt	41.6	41.6	39.0	38.4	-	36.2	-
Foreign debt	44.4	49.5	45.6	40.0	-	35.5	-
Explicit liabilities[4]	2.0	2.3	1.4	0.9	-	0.6	-
Total debt (including explicit liabilities)	88.0	93.4	86.0	79.3	-	72.3	-

[P] =Provisional : [R] =Revised

[1] During FY04, sectoral shares in GDP were as follows: agriculture (23.3 percent), industry (24.5 percent) and services (52.2 percent).

[2] Foreign exchange reserves for FY00 include FE-13 deposits with SBP, whereas since FY01, these include CRR/SLR on FE-25 deposits.

[3] For FY02, if one-off expenditure of Rs 52 billion incurred on KESC recapitalization (Rs 32 billion) and CBR bonds (Rs 20 billion) is accounted for, the fiscal deficit will be 6.6 percent of GDP.

[4] Explicit liabilities includes Special US dollar Bonds, FEBCs, FCBCs and DBCs..

[5]: LSM growth is recorded at 18.1 percent based on production index data for July-June 2004.

Note: Targets from Annual Plan 2004-05, Credit Plan and Annual Budget Statement 2004.

1.2 Executive Summary

1.2.1 Economic Growth, Savings and Investment

The robust 6.4 percent FY04 growth is not only substantially higher than the 5.1 percent increase recorded in FY03, it is also well above the 5.3 percent GDP growth target for the year. However, despite the strong increase in real output and the positive outlook for the year ahead, the profile of FY04 real GDP growth highlights certain weaknesses in the economy. Unlike the broad-based growth in FY03, the much of value-added in FY04 is concentrated in just three sectors, namely *LSM*, *wholesale & retail trade* and *electricity & gas distribution*.

Also, contrary to common perception, data shows that during FY04 the acceleration in aggregate demand was mainly driven by investment activities rather than consumption alone as total real investment grew by 12.4 percent[4] while real consumption demand grew by 5.5 percent during this period.

Agriculture

The agriculture sector witnessed a deceleration in the growth rate from 4.1 percent during FY03 to 2.6 percent in FY04. Other than *minor crops*, which showed a small recovery, all other sub-sectors showed a substantial slowdown in the growth rate, for example, *major crops* witnessed a growth of 2.8 percent during FY04 compared with 6.9 percent growth in FY03. *Livestock* also registered a lower growth of 2.6 percent in FY04 as against 2.8 percent growth in the preceding year. However, higher prices in FY04 partially compensated the farmers for lower output growth. Another important development was that the actual disbursement of agri-credit exceeded the annual targets by 12.2 percent during FY04, inducing higher input usage.

Industry

The industrial sector witnessed a robust 13.1 percent growth in during FY04. The major impetus to this rise came from *electricity & gas distribution* and *large-scale manufacturing* (LSM). The remarkable performance of industry pushed up its share in GDP from 23.1 percent during FY03 to 24.5 percent in FY04. Similarly, *construction* sector recorded the highest growth rate since FY87 due to increase in housing finance, supportive government policies and increase in government expenditures. A substantial growth in gas distribution was the main contributor for the strong growth of *electricity & gas distribution* in FY04. The broad-based growth of LSM pulled the annual growth rate for the sector to a remarkable 18.1 percent,[5] which is the strongest growth recorded in the last three decades.

This remarkable LSM performance is principally derived from the accommodative monetary policy, global recovery that fueled export growth, changes in government regulations and rising development spending. The direct impact of the monetary policy is most evident in sub-sectors such as *automobiles*, *electronics* and *construction*. The availability of cheap export finance, rising international demand and supportive government policies accounted for the growth in export-led industries such as textiles, leather, and pharmaceuticals. Government's regulation and tariff structure changes also helped the *vegetable ghee & cooking* oil and *beverages* industries. Public sector industries recorded a lower growth rate of 6.1 percent against 9.5 percent in FY03.

Services

The services sector experienced a slight slowdown as its sectoral growth rate fell to 5.2 percent in FY04 compared to 5.3 percent in FY03. This was the result of a deceleration in almost all sub-sectors except *wholesale & retail trade*, which grew at an impressive 8.0 percent due to increased volume of external trade. *Transport, storage & communication* witnessed a slight decline in growth from 4.0 percent in the preceding year to 3.9 percent in the current year, largely due to the poor performance of Pakistan Railways. Increased investment in this sector, especially in *telecommunications*, was encouraging as it was among the priority areas of government policies. *Finance and insurance* sector continued to perform poorly in FY04 as breakeven by SBP compared to large profits in FY03 overshadowed the profitability of domestic banks.

Saving and Investment

Contrary to a double-digit growth in national savings in the last 10 years, the rise in national savings decelerated to only 9.0 percent during FY04, well below the nominal GDP growth. As a result, the ratio of *national savings to GDP* fell to 19.8 percent from a record high of 20.6 percent in FY03. The

[4] Nominal total investment witnessed a sharp rise of 22.3 percent during FY03.
[5] Source: Federal Bureau of Statistics. LSM production index data pertains to July-June FY04.

deceleration in the growth of national savings during FY04 is attributed to (1) a substantial *decline* of 12.7 percent in the *private savings*; and (2) negative growth in *net factor income from abroad*.

The improvement in the economy is also visible in the strong revival in the investment activities during FY04. In nominal terms, total investment rose by an impressive 22.3 percent during FY04 as against an average of 7.0 percent in the preceding three years. As a result, the *total investment to GDP* ratio witnessed a trend reversal during FY04, to reach a remarkable 18.1 percent compared with 16.7 percent in the preceding year. The substantial rise in real investment reinforces the view that the present economic recovery is sustainable, at least in the medium term.

1.2.2 Prices

FY04 witnessed a sharp resurgence of inflationary pressures, with CPI inflation ending a seven-year downward trend. After bottoming out at all-time low of 1.4 percent in July 2003, marginal (YoY) CPI inflation witnessed a steep rise through most of FY04 to close at 8.5 percent, taking the average CPI inflation for the year to 4.6 percent.

While the rise in domestic CPI inflation was indeed influenced by international prices, the impact of these was mitigated, to an extent, through fiscal measures.[6] As a result, in contrast to trends in most regional economies, the rise in Pakistan's CPI inflation during FY04 largely stemmed from domestic sources, reflected principally in the leading roles of the *food* and *house rent* sub-groups respectively.

The CPI *food* inflation witnessed a sharp rise of 13.4 percent (YoY) in June 2004 as compared to a quite subdued 0.9 percent in June 2003, taking annualized *food* inflation to 6.0 percent for FY04. The acceleration in CPI *food* inflation, October 2003 onwards, was largely attributed to artificial supply shortages of wheat that were probably due to the realization that Government's capacity to intervene was hampered by depleted wheat reserves.

On the other hand, CPI *non-food* sub-group witnessed a YoY increase of 5.3 percent in June 2004, while annualized non-food inflation recorded a rise of 3.6 percent in FY04. CPI *non-food* inflation was quite benign before setting for an upward trend in March 2004 onward. The rising pressures mainly stemmed from sub-group of *house rent index* (HRI). The role of HRI was critical in accelerating the overall CPI inflation, as this component has a 23.43 percent weight in the CPI basket. Specifically, HRI rose by 8.2 percent on year-on-year basis in June 2004 compared with only 1.2 percent in June 2003.

The concentration of inflation in *food* and other essentials also raises concerns over the impact on low-income groups. People in the low income group (Rs 3000 per month or less) suffered at 10.4 percent YoY inflation in June 2004 against the average CPI inflation of 8.5 percent for the period.

1.2.3 Public Finance and Fiscal Policy

In FY04, the fiscal consolidation drive of the government produced a second successive reduction in the budgetary deficit. It not only managed higher revenue collection but was also able to contain expenditures to bring down the fiscal deficit to 3.9 percent of GDP from 4.5 percent in FY03.

The consolidated revenue receipts in FY04 stood at Rs 798.8 billion, showing an increase of Rs 81.5 billion over FY03 largely due to higher tax collections and larger non-tax receipts. The consolidated

[6] For example, the impact of strong international steel prices was partially offset by the reduction in import taxes. Similarly the rising cost of *some* petroleum product imports was mitigated by the government's decision to absorb the higher cost through lowering implicit taxes. However, it is important to note that this was mainly affected the fuels prices; the increase in the cost of other petroleum derivatives such as lubricants, greases, etc. did impact the domestic economy.

expenditures however increased at a slower pace compared to FY03 and rose by Rs 70.8 billion in FY04.

Developmental expenditures again showed under utilization of Rs 5.6 billion during FY04. Since development expenditures are important for generating future economic growth and employment, it is imperative that their full utilization must be ensured. It is expected that these expenditures for FY05 will overtake defense expenditure after a long time. Even assuming that the entire allocation of Rs 202 billion is not fully utilized, the overall growth over the previous year's actual outlay is likely to be above 25 percent.

A significant shift was witnessed in the financing profile during FY04. External financing (net) and borrowing from non-bank sources declined during the year while borrowing from the banking sector surged as compared to the net retirement in recent years.

1.2.4 Money and Banking

FY04 witnessed the evident impact of the accommodative monetary stance pursued by the central bank since last few years. On the one hand this easy monetary stance was instrumental in instigating a massive increase in aggregate demand, which drove the real GDP growth to over 6 percent for the first time since FY96, but on the other hand it also contributed to rising inflationary pressures in the economy.

Although, SBP was confronted with a number of conflicting objectives in FY04, it consistently indicated its desire to use monetary policy to stimulate economic activity in the country, and its willingness to accept some modest rise in inflationary pressures as a cost for accelerating economic growth.

This policy stance proved extremely helpful in achieving a broad based recovery of the economy led by the manufacturing sector. The private sector fully exploited the low interest rates as is evident from a record growth in the private sector credit of Rs 325.2 billion. Increasing share of personal loans in this credit expansion also suggests that, hitherto inaccessible bank credit is now within the reach of the small borrowers, thus making the banking system much more effective in terms of its benefits to the common man.

The Banking sector on its part consolidated the tremendous improvements it made during FY03. Bank deposits and credit in FY04 recorded strong increases on the back of robust economic recovery. This performance was helped by both, the falling burden of outstanding non-performing loans as well as by stemming inflows of fresh NPLs.

Keeping in view the developments of FY04, the central bank is likely to continue balancing between the objectives of sustaining the growth momentum, managing the pressures on the exchange rate and containing inflation through FY05, but the FY05 monetary policy is unlikely to be as accommodative as in FY04. This is implicit in the SBP's monetary policy statement, which clearly indicates the SBP's concerns over the monetary overhang in the economy, and states that the SBP would only seek to avoid a "significant" weakening of the economy.

1.2.5 Domestic and External Debt

The country's debt profile improves further for the third successive year during FY04. Not only did the debt bearing capacity of the economy increase but the growth in outstanding debt stock was insignificant.

In terms of GDP, the burden of debt and its servicing has significantly declined in FY04. Specifically, overall debt to GDP ratio has dipped to 72.3 percent by end-FY04 from 79.3 percent in the FY03 and 85.9 percent in FY02. Similar improvement is witnessed in respect of debt servicing to GDP and revenues ratios.

Another noteworthy feature of debt situation is that the substitution of expensive debt with cheaper borrowings is changing its profile, i.e., the average cost of holing debt stock is declining. This was visible for both: external debt (e.g. the pre-payment of expensive ADB loans were partly substituted by soft loans), and domestic debt (e.g. lower flows into the expensive NSS instruments were compensated by higher borrowings from relatively cheaper PIBs).

These favorable changes in debt profile in the recent few years are largely attributable to: (1) increased repayment capacity of the country due to strong economic recovery, (2) subdued growth in debt resulting from prudent debt management and improving fiscal discipline, and (3) low domestic interest rates.

1.2.6 Balance of Payments

The overall balance though still in surplus at US$ 887 million, experienced a sharp fall of 80 percent YoY over the preceding year, resulting from a deterioration in both, the current account and capital account. The deterioration under capital account is mainly due to a one-off large pre-payment of expensive external debt. Excluding this one – off pre-payment the overall balance recorded a US$ 2,424 million surplus in FY04.

The current account surplus at US$ 1.8 billion was substantially lower than US$ 4.2 billion witnessed in the preceding year. Interestingly, adjusting for conversion of foreign currency deposits, it is clear that the FY04 remittances are very close to FY03 remittances.

The sharp jump in trade deficit is clearly caused by the strong 27.6 percent growth in imports, which overshadowed the robust 10.3 percent jump in exports during FY04. Although the rising international prices of major imports especially oil was a major concern during FY04, petroleum import bill rose by US$ 100.1 million YoY basis in FY04. This relatively low increase is deceptive. Had the average FY03 oil prices been sustained, Pakistan's oil bill would have been significantly reduced during FY04.

The export volume reached US$ 12.3 billion during FY04, recording a 10.3 percent rise over preceding year, and also surpassing the annual export target by 1.7 percent. This high export growth was mainly textile driven as earnings from the four major categories namely: cotton fabrics, knitwear, bed wear and cotton yarn crossed US$ 1 billion each.

The changes in the current account have significant impact on the exchange rate. The Rupee strengthened through most of H1-FY04 when the YoY decline in the current account surplus was low, and when SBP was also lowering its net purchases from the inter-bank forex market. However, the Rupee posted depreciation during H2-FY04 as the monthly current account surpluses diminished sharply and then turned into deficit by May 2004. In fact, the depreciation in the Rupee would have been even steeper had the central bank not defended the Rupee aggressively, so as to allow the economy to adjust gradually to the changing exchange rate environment.

Pakistan's total liquid reserves rose to US$12,328 million at end-June FY04 compared with US$ 10,719 million last year. However, the increment of US$ 1,609 million in FY04 was lower than US$ 4,287 million in FY03. This slowdown was not unexpected given the SBP continued focus on liberalization of the exchange regime, the recovering economy (and attendant expectations of a rise in imports) as well as the anticipated pre-payment of expensive external debt.

In overall terms, the erosion in the external account in FY04 is primarily driven by exceptional outflows and less from weakness in foreign exchange inflows; overall inflows, at US$ 25.6 billion during FY04 were higher than the US$ 25.2 billion experienced last year.

1.2.7 Socioeconomic

With an estimated population of around 148.7 million in 2004, Pakistan is the sixth most populous country in the world and faces a daunting challenge of poverty reduction and human development. The high proportion of working-age population through their additional productivity can produce a "demographic dividend" in the form of faster economic growth, higher employment generation and thus poverty reduction. This demographic change can be an asset, if the large pool of labor is transformed into productive human capital. It offers an opportunity for faster economic growth rate, which can only be possible if an adequate investment in human capital is made. Notably, a better educated workforce will be better equipped to compete in this age of competition and globalization. Thus, the increased fiscal space resulting from the higher economic growth in FY04 should be utilized for enhancing spending on education and health further in FY05 accompanied by improved governance and better management in the delivery of these services at the grassroot level.