1 Overview and Executive Summary

1.1 Overview

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. Also, despite strong aggregate demand, CPI inflation dipped slightly below the annual target.

However, sustained strong growth has contributed to increased stresses because of (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, (iv) widening of the external current account deficit. Sustainability of economic growth rates of over 6 percent in years ahead requires continued vigilance to ensure macroeconomic stability.

The real GDP growth for FY06 appears more impressive when viewed against the relatively weak performance of the commodity-producing sectors. In particular, agricultural growth decelerated with harvests of major crops such as cotton, sugarcane and wheat falling below target and inducing negative downstream impacts on the textile and sugar industries. The growth rate for large-scale manufacturing (LSM) was not only impacted because of this, but also due to capacity constraints in key industries (e.g. cement and fertilizer), infrastructure constraints and high energy costs and the high-base of strong growth in the preceding year. Private sector credit remained significantly buoyant although monetary tightening did curb its growth. All these factors combined to subdue aggregate industrial growth. However, the lackluster performance of commodity-producing sectors was more than offset by the continued strong growth in the services sector.

The unexpected weakness in the commodity producing sectors, particularly agriculture, probably also contributed to the revival of inflationary pressures late in FY06, compounding the impact of high energy costs and the strength of aggregate demand. Despite a decline through most of the fiscal year, CPI inflation remained relatively high, and its downtrend was also unstable. The persistent strength of non-food inflation, in particular, required continued emphasis on containment of excessive demand management pressures; consequently, SBP maintained a tight monetary stance. Effective monetary management, 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.

SBP's monetary posture to tighten demand management over the last 18 months, which was critical to curb the impact of years of expansionary monetary policy, has attracted economic debate. Some analysts advocate a reversal of the policy in order to support a perceived faltering domestic demand and slowing exports. Others contest that monetary tightening ought to have been more intense to curb the demand pressures more significantly, with a higher policy rate (3-day repo) combined with depreciation of the Rupee. Mindful of trade-offs between demand management and growth, SBP has calibrated monetary policy stance to balance these concerns by only modestly raising policy rate in July 2006 combined with continued flexible exchange rate management. The degree of monetary tightening adopted has successfully helped Government achieve its targeted FY06 CPI inflation rate, which has fallen by 1.4 percentage points relative to its peak level in June 2005. It was this performance that gave confidence to the Government to aim for lowering the inflation rate further, to 6.5 percent for FY07 and central bank's current policy positioning is shaped accordingly.

Table 1.1: Selected Macroeconomic Indicators

	FY02	FY03	FY04	FY05	FY06		FY07
					Targets P	Actual	Targets
					Growth rates (percent)		
Real GDP (at factor cost)[1]	3.1	4.8	7.5	8.6	7.0	6.6	7.0
Agriculture	0.1	4.1	2.2	6.7	4.8	2.5	4.5
Major crops	-2.5	6.8	1.9	17.8	6.6	-3.6	4.3
Manufacturing	4.5	6.9	14.0	12.6	11.0	8.6	11.0
Large-scale	3.5	7.2	18.2	15.6	13.0	9.0	13.0
Services sector	4.8	5.2	5.9	8.0	6.8	8.8	7.1
Consumer price index (FY01 =100)	3.5	3.1	4.6	9.3	8.0	7.9	6.5
Sensitive price indicator (FY01 = 100)	3.4	3.6	6.8	11.6	-	7.0	-
Monetary assets (M2)	15.4	18.0	19.6	19.3	12.8	15.2	13.5
Domestic credit	1.9	0.6	23.7	22.4	15.7	17.1	-
Exports (f.o.b.)	-0.7	22.2	10.3	16.9	18.0	14.4	13.0
Imports (c.i.f.)	-3.6	18.2	27.6	32.1	13.0	38.8	-2.0
Official liquid FE reserves[2] (million US$)	4,805	9,993	11,110	10,481	-	13,127	-
					As percent of GDP		
Total investment	16.8	16.9	17.3	16.8	18.1	20.0	-
National savings	18.6	20.8	18.7	15.1	15.9	16.4	-
Tax revenue	10.9	11.5	11.0	10.0	10.4	10.5	-
Total revenue	14.2	14.9	14.3	13.7	13.3	14.0	-
Budgetary expenditure	18.5	18.7	16.7	18.2	17.1	18.2	-
Budgetary deficit[3]	4.3	3.7	2.4	3.3	3.8	4.2	-
Current account balance (including official transfers)	4.0	4.9	1.8	-1.4	-2.1	3.9	-
Domestic debt	39.0	38.4	35.1	32.4	-	29.7	-
Foreign debt	45.6	40.0	35.0	31.0	-	-	-
Explicit liabilities[4]	1.4	0.9	0.6	0.4	-	-	-
Total debt (including explicit liabilities)	85.9	79.3	71.4	64.9	-	58.8	-

P: provisional; R: revised

[1] During FY06 sectoral shares in GDP were as follows: agriculture (21.6 percent), industry (26.0 percent) and services (52.3 percent).

[2] Foreign exchange reserves 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 include Special US dollar Bonds, FEBCs, FCBCs and DBCs.

Note: Targets are based on Annual Plan, Trade Policy, Credit Plan and Annual Budget Statement for FY07

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 modulated monetary tightening helped bring down aggregate demand pressures, as evident in the relative fall in the growth of private sector credit from 34.4 percent in FY05 to 23.5 percent in FY06. Despite this relative slowdown, aggregate demand remained strong as suggested by the fact that non-food inflationary pressures have persisted during FY06[1] and that the exceptional growth in imports has manifested itself in a record external current account deficit of US$ 5.2 billion for the year (a little over twice that seen in FY05).

The policy environment is likely to be even more challenging in FY07. 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. This challenge is compounded by a number of risks. Firstly, the large external current account deficit

[1] Encouragingly, non-food inflation, which was quite resilient in FY06, exhibited some signs of ease in the first quarter of FY07, suggesting that the tight monetary stance of SBP is started paying dividends.

seen in FY06 is to widen further in FY07; while the much-anticipated deceleration in import growth is already evident, it is accompanied by an unwelcome deceleration in exports. The resulting expansion in the trade deficit, and its consequent impact on the current account deficit requires a continued adherence to tight monetary policy, given that fiscal policy is expected to remain expansionary during the year.

The expansionary fiscal policy in FY07 has further compounded the risks to the economy. On the one hand, it adds to inflationary pressures by stimulating demand, and on the other hand, the Government's higher funding requirement induces more pressures to raise interest rates to curb incremental pressures on the economy. The probability of this risk materializing depends crucially on the nature of the expenditure growth,[2] and the manner in which Government finances its fiscal deficit. The fiscal deficit not only was higher in FY06 at 4.2 percent relative to 3.3 percent of GDP in FY05 but a significant part of the larger deficit was monetized through borrowings from the central bank. Both tendencies prevail in FY07, as evident from the first quarter trend, and need to be curtailed. On the other hand, a very encouraging development is that the FY06 deficit is principally due to a sharp rise in development expenditure. Development expenditures are sure to rise in FY07 as the government seeks to reinforce the country's infrastructure base in a bid to enhance economic productivity and attract investment. Moreover, it is heartening to note that the country's debt indicators showed an impressive improvement over the years. In fact, the debt-to-GDP ratio reach 60 percent; that was to be reached by 2013 under the Fiscal Responsibility Act 2005, has already been achieved in FY06. A lower debt-to-GDP ratio is a source of comfort in increased demands under current expenditure due to earthquake relief and rehabilitation.

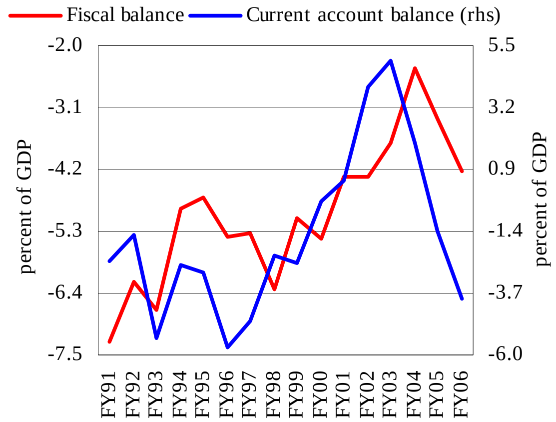
The key fiscal risk may emerge only if the necessary growth in expenditures is not matched by a commensurate increase in revenues, resulting in the loss of the hard-won fiscal space gained in recent years. Specifically, despite a small improvement, the revenue-to-GDP ratio remained low at 14.0 percent in FY06 and given the heavy dependence of tax revenues on imports, and the anticipated fall in import growth for FY07, it remains to be seen if the annual revenue target for the year will be met. Thus far, Q1-FY07 tax collection seems to be on target. Over the medium term, expansion in tax coverage by bringing exempted or lightly taxed sector of the economy into the tax net (including agriculture and the services sectors) and leveraging more provincial and local taxes is key to fiscal sustainability as public investment demands are likely to be high.

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 sources of borrowings and adopt a judicious mix of short-term and long-term borrowings. During FY06, the government relied heavily on borrowings from the central bank, and effectively ignored non-bank borrowings. The stock of long-term tradable bonds – PIBs and FIBs) alone fell by Rs 23 billion during the year, and the stock of long-term National Savings Schemes (NSS) instruments also declined.

Even when the government finally moved to increase long-term non-bank borrowings it has opted to do so through NSS instruments. The access of these non-traded bonds to institutional investors is expected to raise reliance of the government on non-bank borrowings, but will also have negative implications for the development of Pakistan's long term debt capital markets, and consequently for efforts to attract private capital for long-term investments for infrastructure, etc. In short, financial reforms, aimed at eradicating financial repression, have suffered a setback as a result of this decision.

[2] An increase in government spending (including development spending) can raise inflationary pressures. However, if the greater part of the higher expenditure is for developmental purposes, the long-term gains through crowding-in investment and increased economic productivity may outweigh the short-term cost of inflationary pressures.

Figure 1.1: Twin Deficit



Finally, it may be noted that often in emerging markets, fiscal imbalances are usually accompanied with external imbalances as well. This is also evident in Pakistan in the recent years, particularly in FY06 (see **Figure 1.1**), when strong aggregate demand (pushed, in part, by strong government spending) led to rising imports of capital goods and inputs. This, together with the rise in oil prices and a jump in food imports (as a result of shortages of key staples) pushed the external current account deficit to record highs. Fortunately, Pakistan has been able to finance the FY06 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, even as the improved investment climate and aggressive privatization program resulted in increased FDI and portfolio inflows. As a result, despite an average growth of almost 35.5 percent in the country's imports in the last two years, the country's foreign exchange reserves remain ample, equivalent to 25 weeks of imports cover, in line with prudent international norms. The country's improved economic prospects have been reflected in upgrades of Pakistan's sovereign rating.[3]

Strong economic performance should not engender complacency, as sustained large external imbalances typically introduce vulnerabilities in the economy. Forex reserves, a strong economy, and reasonably good macroeconomic fundamentals leave Pakistan reasonably well placed to sustain large external deficits in the short run. 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

Moreover, even in the short run, it would be preferable that external deficits be financed principally from stable non-debt sources, rather than taking on additional debt. Amongst the former, foreign direct investment (FDI) would be the preferred source of financing external deficits because these flows are typically long-term and often contribute positive technology and management spillovers. Pakistan has had considerable success in attracting FDI in FY06, however much can be done to improve on this performance in years ahead. In particular, it should be kept in mind that a large part of the FY06 FDI comprised receipts from privatization of public sector assets. Given that Pakistan has only a very small share in global FDI flows, there is considerable scope for improvement.

1.2 Looking Forward

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. The recovery in agriculture is expected to be underpinned by strong wheat and sugarcane harvests, which would offset the reported losses to the FY07 cotton harvest due to untimely rain. Similarly, a small resurgence in large-scale manufacturing is expected to pull-up industrial growth in FY07.

---

[3] Both Moody's as well as S&P have recently indicated that Pakistan's sovereign rating is under review for a possible further upgrade.

Table 1.2: Major Economic Indicators

growth rates (percent)	FY06	FY07 Original targets	FY07 SBP projections
GDP	6.6	7.0	6.8-7.2
Inflation	7.9	6.5	6.7-7.5
Monetary assets (M2)	15.2	13.5	13.5-14.3
Private sector credit incl. PSCEs	*23.5*	*18.4*	18.0-19.0
billion US Dollars			
Workers' remittances	4.6	5.0	4.8-5.4
Exports (fob-BoP data)	16.5	--	17.9
Imports (fob- BoP data)	24.9	--	27.2
Exports (fob-Customs data)	16.5	18.6	17.2
Imports (fob-Customs data)	28.5	28.0	30.7
percent of GDP			
Fiscal deficit	4.2	4.2	4.2
Current account deficit	3.9	4.3	4.2
Private investment	13.6	14.3	14.8

However, the continued strength of aggregate demand, together with the government's evident inability to reduce domestic prices of petroleum products indicates that average CPI inflation may remain above the 6.5 percent annual target (see **Table 1.2**). Key elements in this expectation include:

1. the risk of reversal of the downtrend in house rent index (HRI) inflation in H2-FY07 due to the high international commodity prices (e.g. steel) and sustained robust domestic demand for construction inputs (timber, metal, copper, etc.); and

2. the risk of a rise in food prices following strong domestic demand of some key staples such as milk, and an uptrend in international prices of key food items (such as edible oil and wheat). In particular, domestic wheat prices may rise despite an anticipated bumper crop if speculators seek to take advantage of the rising international prices. While the benefit of high prices should accrue to farmers, an excessive rise due to speculative activities can lead to a net welfare loss to the economy. Thus, it is important that the government deter speculators by ensuring the availability of sufficient buffer stocks with government agencies. Moreover, in order to facilitate this process, it may be necessary to defer exports of wheat, until the crop size is known and until buffer stocks are in place.

In short, while inflation was principally driven by non-food component during FY06, inflationary pressures in FY07 are likely to stem from both food and non-food components.

Strong fiscal stimulus and a widening external 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.

Finally, since the growth of the current account deficit in recent years is largely due to an extraordinary rise in the trade deficit, this is obviously a starting point for corrective policy, with options revolving around a mix of reducing import growth and fostering strong export growth.

The practical import-reduction options included substantially raising interest rates (to reduce aggregate demand), or encouraging a depreciation of the rupee (raising the demand for domestic goods relative to imports). Both of the measures would, in the medium term, help exports by either reducing inflation (i.e. by holding down the cost of producing goods), or reducing the cost of local goods for foreign buyers. In the short run however, both have significant costs. On the one hand, given the prevailing tight monetary policy, a further sharp rise in interest rates could risk considerably slowing the growth momentum of the economy, and on the other hand, a sharp rupee depreciation could lead to self-fulfilling expectations that could de-stabilize the economy.

However, the central bank may have to make a difficult choice if large external imbalances persist. On the positive side, SBP projections suggest that the extraordinary import growth of FY06 will not be repeated in FY07 due to a combination of lower oil prices and a sharp fall in machinery imports. Unfortunately, SBP forecasts also indicate that this may not be enough to substantially reduce the trade deficit in FY07, given that the growth in exports is also forecast to decelerate.

This forecast of lower export growth is based on the trends evident in recent months that show that the increasingly competitive exports market has taken a toll in terms of lower prices as well as a fall in export volumes of some products. Clearly, there is a need to provide greater support to exporters. However, given that the provision of direct subsidies, as provided in some countries, carries significant economic costs in the long run, it seems desirable that the policy thrust be on reducing the cost of doing business, improving infrastructure (including removing transportation bottlenecks to lower delivery lags, and costs), enhancing labor skills, strengthening managerial capacity, reducing unit labor costs and more importantly, provide a reliable supply of energy at competitive prices relative to regional countries.

Indeed both, the cost and smooth supply of energy appear to be a major bottleneck for domestic manufacturing units. Moreover, energy shortages may become acute in the near future, unless urgent corrective polices are in place. In this background, the government is taking various initiatives from short-term to long-term perspectives. In the short-term, offering a clear policy with one-window implementation, appears an urgent necessity. Construction of reservoirs is a part of a medium to long-term solution, but these could be supplemented by also increasing reliance on a diversified mix of alternative sources including expanding on nuclear power capacity, negotiating multiple gas import options (including the pipeline from Iran) and developing the domestic coal resources (particularly the Thar deposits) in order to generate thermal power.

The realization of these developmental projects requires ample fiscal space. In FY06 a significant rise in government revenues allowed for a substantial increase in the development expenditures. This trend needs to be sustained by broadening the tax base. In addition, it must be kept in mind that a rise in development expenditure, by itself, is not a guarantee of an improvement in the country's productive capacity. It is even more important to ensure optimum allocation and efficient implementations so that improved infrastructure, extension in social services (health and education) and direct intervention in poverty reduction efforts lead to tangible and sustained economic gains.

1.3 Executive Summary

1.3.1 Economic Growth, Savings and Investment

Pakistan's economy overcame adverse pressures to achieve strong growth for the third successive year in FY06. Despite unexpectedly weak harvests of some key crops (cotton, sugarcane and wheat), the impact of the October 2005 earthquake, a tight monetary policy and an unprecedented rise in oil prices, real GDP growth remained strong at 6.6 percent during FY06. However, there was a visible deterioration in the quality of the economic performance, in the sense that the FY06 growth was more narrowly based as compared to preceding years. In contrast to a broad based growth in FY05, the impetus to the high growth in FY06 was principally from the above-target performance of the services sector, as both the key commodity-producing sectors, agriculture and industry saw growth fall well below the respective annual targets.

Agriculture

The decline in the FY06 production of sugarcane and cotton, together with the modest (below target) growth in wheat was the principal reason for the net 3.6 percent decline in the value addition by *major crops*, in sharp contrast to the 17.8 percent growth in the preceding year. The impact of this on the growth of the crops sub-sector was compounded by the below-target value-addition by *minor crops*.

The 1.6 percent growth by minor crops during FY06 was lower than the 3.0 percent rise in output seen during FY05 and consequently the aggregate production of the crops sub-sector fell by 2.3 percent in FY06, compared to the growth of 13.7 percent in FY05. Similarly, the value-addition by forestry and fishing, both remained below target during FY06, but since each of these sectors has a very small share in agriculture, the net impact of these is not significant. Thus, the aggregate growth in agriculture during FY06 was contributed almost entirely by the exceptionally strong growth recorded by the livestock sub-sector, handsomely rewarding the increased policy focus in the area in recent years. The 8.0 percent growth recorded by the sub-sector in the period is strongest for the last decade, substantially outstripping the 2.3 percent growth seen in FY05.

Industry

The provisional number for FY06 indicates that industrial growth stood at 5.9 percent YoY, substantially lower than the 11.4 percent YoY growth recorded during the preceding year. However, the industrial growth estimates based on full year data is expected to be a little higher than the provisional number. In particular, 9.0 percent growth in large-scale manufacturing (LSM) could reach 10.7 percent during FY06, but this could still remain below the annual target (for the first time during the last four years) and also lower than the 15.6 percent growth recorded in FY05. This was mainly due to an unprecedented rise in oil prices, poor cotton and sugarcane harvests, capacity constraints in key industries as well as a tight monetary stance. However, despite rising interest rates, the electronics and automobile industries kept benefiting from the continued availability of consumer financing.

The only sub-group of industry to record negative growth during FY06 was electricity and gas distribution, with value addition declining by 8.4 percent during FY06, in contrast to the 3.5 percent rise registered in the preceding year. This fall was partly because of the increased cost of electricity generation and losses incurred by the gas distribution companies amidst unrest in Balochistan that offset even the impact of expansion in the distribution network of gas companies.

Finally, the overall capacity utilization during FY06 (adjusted for capacity in steel industry - which fell sharply due to temporary technical faults at Pakistan Steel), rose to 66.6 percent, exhibited an improvement of 1.8 percentage points during FY06. The highest increase of 15.1 percentage points was observed in automobiles in this period. Other industries showed enhanced capacity utilization are paper & board, ghee & cooking oil and fertilizer during FY06.

Services

Services sector performed remarkably well, witnessing 8.8 percent growth during FY06, surpassing its annual target for the year and well as the 8.0 percent growth registered in FY05. This robust growth was mainly contributed by *wholesale & retail trade*[4], *transport & communication* and *finance & insurance* sub-sectors. The acceleration in the services sector growth coupled with the unsatisfactory performance of the commodity-producing sector meant that the share of the services sector in GDP increased in FY06 after a gap of two years.

Although growth in both *wholesale & retail trade,* and *finance & insurance* slowed during FY06, it was nonetheless well above the target for both sectors. On the other hand, t*ransport*, *storage & communication* sub-sector has witnessed an acceleration, with growth rising to 7.2 percent during FY06 against 3.6 percent in FY05, mainly on the back of improved performance of *road transport* and *communication*, which was supplemented by the double-digit growth in *railway transport.* Similarly, growth in *public administration & defense* also accelerated to 4.7 percent in FY06, higher than the 3.5 percent target for the year and only 0.6 percent in the preceding year. Finally, the

[4] Contribution of *wholesale & retail trade* in growth of services sector has gone down to 41.2 percent in FY06 from 50.4 percent last year, nonetheless it still remains the highest in comparison to other sub-sectors.

accelerated growth in *community, social & personal services* was probably a reflection of the increased social service activities in Pakistan's Northern areas in the aftermath of the October 2005 earthquake.

Savings and Investment

Although national savings rose sharply by 16.5 percent during FY06 compared to the 7.5 percent growth in the preceding year, nonetheless this increase is lower than the rise in nominal GDP. As a result, the national savings to GDP ratio dropped slightly (by 0.1 percentage points) to 16.4 percent during FY06, the lowest level since FY01.

The reason why despite rising interest rates, national savings to GDP ratio did not improve could include to (1) prevailing negative real returns on deposits being offered by the banks, (2) rise in NSS rates was not in line with the expectations, (3) continued ban on institutional investment in NSS,[5](4) reluctance in issuing PIBs, and (5) continued consumption boom in the economy.

The total investment to GDP ratio rose to 20.0 percent during FY06 from 18.1 percent in the preceding year and an average of 17.1 percent in the last five years. Importantly, this is the highest level of the investment to GDP ratio in over a decade. The rise in the ratio is mainly attributed to (1) improved confidence of local as well as foreign investors on the back of a good showing of the economy and (2) a robust 22.3 percent growth in credit to private sector despite increasing interest rates.

Both public and private investment contributed in the rise of total investment during FY06, however, increase in the latter was more pronounced. It is important to note that a significant rise in public investment in infrastructure during past three years also resulted in a trend reversal in private investment as well.

Foreign direct investment in the economy more than doubled for FY06 reaching as high as US$ 3.5 billion which suggests the improved macroeconomic fundamentals and relative policy stability of the economy is attracting investor interest. Although half of this FDI represented to privatization proceeds on account of PTCL privatization, sale of shares of KESC and receipts on account of HBL, but even adjusting for these FDI has registered a rise of 70.6 percent. Disaggregated analysis suggests that these flows are mainly concentrated in the *telecommunications, power, finance & insurance* and *oil & gas exploration* sectors. In terms of geographical origin of FDI, a significant shift in favor of Middle East is evident in recent years and resultantly, the share of North America (mainly USA), Europe (mainly UK) and East Asia Pacific (mainly Japan) regions has shrunk considerably since FY03.

1.3.2 Prices

While Pakistan's economy suffered due to the rising commodity prices, inflationary pressures eased somewhat in the domestic economy as headline Consumer Price Index (CPI) witnessed a deceleration from a peak of 9.3 percent (average annual inflation) in FY05 to 7.9 percent during FY06, mainly due to monetary tightening to soften demand pressures as well as administrative measures to counter supply shocks. Moreover, while the sharp acceleration in CPI inflation during FY05 was equally contributed by *food* and *non-food* components, the FY06 deceleration is solely a result of ease in food inflation. Even though, *house rent index* (HRI) sub-group contributed to a slowdown in *non-food* component, a strong surge in *fuel & lightning* and *transport & communication* sub-groups more than offset the impact of the moderation in HRI during this period.

Indeed, the persistence in non-food inflation, coupled with a rising trend in inflation measured by both Wholesale Price Index (WPI) and GDP deflator, indicates that inflationary pressures persist in the

[5]Institutional investment in NSS was relaxed recently during FY07.

economy. The major impetus to WPI inflation stemmed from the *raw material* and *energy* sub-groups. Similarly, the rise in the GDP deflator also witnessed primarily due to increase in *industrial* sub-index following a surge in the cost of energy and raw materials.

Given (1) high levels of CPI inflation and core inflation, (2) resilience in non-food inflation, which is still at high levels, (3) acceleration in broader measures of inflation and (4) a lower inflation target of 6.5 percent for FY07, SBP is likely to continue with its tight monetary policy in months ahead. In this background, cetris paribus, current SBP forecasts suggests that CPI inflation is likely to be in the range of 6.5 – 7.5 percent during FY07, a little above the annual target.

1.3.3 Public Finance and Fiscal Policy

In the wake of 19.6 percent growth in revenue collection, unprecedented in the recent years, the government continued to pursue pro-cyclical fiscal policy for yet another year pushing the fiscal deficit to 4.2 percent of the GDP as compared to the previous year's 3.3 percent. The above-target CBR tax collection of Rs.712.6 billion, owing much to the strong economic activity and extraordinary growth of imports, enabled the government to follow an expansionary fiscal policy. As a result of this, development spending witnessed an exceptional growth of 60.3 percent. Although the current expenditure grew by nearly 19 percent YoY, this was principally owed to the rehabilitation activities in the earth-quake hit areas. Adjusting for this expenditure of Rs 65.8 billion, the total deficit stands at 3.4 percent of the GDP. However there remain structural weaknesses in the fiscal system, including a narrow tax base and over-reliance on import-related taxes.

The analysis of provincial finance depicts weakness in their revenue mobilization efforts as their overall contribution to the GDP is not more than 0.8 percent in FY06. Provinces have tremendous scope for tapping the revenue potential given that the taxation of the major sectors of the economy (agriculture and services) rests with the provinces. Also the tax collecting capacity of the provinces needs to be strengthened to improve the overall tax-to-GDP ratio of Pakistan.

Looking ahead, the federal budget FY07 has taken various measures to increase the tax-to-GDP ratio and broadening of the tax base (for example, by subjecting certain financial services to the sales tax and federal excise duty, and the marginal increase in the CVT on capital gains).

1.3.4 Money and Banking

As in the previous year, the SBP continued to maintain a tight monetary policy throughout FY06, even though the principal policy variable, the discount rate remained unchanged at 9.0 percent during the period, in contrast to the 150 basis point rise seen in FY05. Instead, during FY06 the SBP focused essentially on improving the transmission of the policy rate, by draining excess liquidity from the inter-bank market and driving the overnight repo rates very close to the discount rate. This approach proved to be very effective.

The impact of the improvement in the transmission channel is clearly evident in the sharp deceleration of major monetary aggregates during FY06. Although the overall money supply growth for the year reached well above the 12.8 percent target, it was nonetheless significantly lower than the growth witnessed in FY05. The fall in reserve money growth was even steeper. Similarly, the growth in credit to the private sector slowed very sharply, even though it exceeded the initial target. As a result during FY06, for the first time in 6 years, the growth in broad money dropped below that of nominal GDP.

Thus, it would appear that the central bank was successful in modulating monetary policy to contain inflation within the 8 percent annual target, without prejudice to the country's long term growth momentum. However, the continued tight monetary policy attracted debate throughout FY06 with some arguing that the monetary policy has not done enough and that the policy rate should be increased along with the Rupee depreciation.

From SBP's perspective , however, the decision to keep the policy rate unchanged was guided by a number of factors, including: (1) the concern that attempts to hasten the pace of disinflation ran the risk of destabilizing the growth momentum of the economy; (2) it was felt that the impact of aggressive policy rate increases in FY06 would have been exaggerated by the lagged impact of earlier tightening, raising the risk of an economic slowdown; (3) the moderate target reduction in inflation, together with evidence that inflation was finally responding to monetary policy; (4) the signs of deceleration in trends in monetary aggregates, including M2, reserve money and private sector credit for FY06 as suggested in initial estimates; and finally (5) while the external account imbalance was certainly troubling, it was hoped that the import growth would moderate significantly during H2-FY06.

As a result of above factors, the SBP focused instead on improving the transmission of its monetary signals through increased money market operations (OMOs) during FY06, concentrating on raising the lower end of the yield curve. These OMOs were aimed at reducing volatility in the short-term rates so as to define an implicit band within which the SBP wanted the interest rates to move.

Given the challenges faced by the SBP in shape of widening external imbalances and expansionary fiscal policy, achieving the inflation target of 6.5 percent for FY07 appeared ambitious. As a response, the SBP has again increased the extent of monetary tightening FY06 onwards; re-committing itself to achieve the objective of price stability. In doing so, the SBP has raised the reserve requirements during July 2006 to drain significant volume of liquidity from the inter bank market. Further, in order to accommodate the short term rates to signal the liquidity tightening; the SBP also moved the discount rate up by 50 basis points, a week later.

1.3.5 Domestic and External Debt

The outstanding stock of Pakistan's total debt and liabilities (TDL) witnessed moderate growth for yet another year in FY06. Specifically, the TDL rose by 6.3 percent during FY06, only marginally higher than the 6.1 percent growth in FY05. The modest rise in TDL coupled with the strong growth in nominal GDP meant that the country's debt to GDP ratio fell significantly to 57.8 percent during FY06 from 63.7 percent in the preceding year, reflecting the continual improvement in the economy's ability to sustain debt.

This is the fifth successive year that the debt to GDP ratio has improved. More significantly, this is the first time in more than two decades that the ratio has fallen below 60 percent. In fact, "The Fiscal Responsibility and Debt Limitation Act, 2005" envisaged a debt to GDP ratio at 60 percent by FY13. Since this target has already been surpassed in FY06, there is a need to set a lower target for future.

The improvement in the debt to GDP ratio in FY06 was contributed by both domestic and external debt. However, the growth in domestic debt has been relatively faster than that of external debt. As a result of a stronger rise in domestic debt relative to external debt, the share of domestic debt in total debt & liabilities (TDL) increased further from 50.9 percent in FY05 to 51.3 percent by end FY06.

During FY06, Pakistan acquired US$ 3.4 billion fresh long-term loans, of which US$ 1.7 billion reflects the long-term flows from ADB and the World Bank. Of the total disbursement from the ADB and World Bank, US$ 673 million were specifically earthquake related loans.[6] Besides loans from

[6] During FY06 approximately US$ 1.7 billion of loans were committed by the international donors for earth quake fund, while the actual disbursement was limited to US$ 768 million.

ADB and World Bank, Pakistan also received grants for earth quake relief from other sources, including mainly China (US$ 33 million), and Turkey (US$ 30 million).[7]

Moreover, Pakistan once again accessed the global bond market to rise funding through the issuance of the Euro Bonds in FY06. Pakistan not only successfully generated inflows of, US$ 800 million from this issuance, but also established a long-term sovereign benchmark that would help local corporates access global markets. The FY06 issuance consists of 10-year bonds of US$ 500 million, and US$ 300 million in 30-year bonds. Finally, in FY06 the private sector also registered fresh loan of US$522 million primarily on account of the long-term loans to the communication sector, and to Pakistan International Airline (PIA) for the purchase of aircraft.

1.3.6 Balance of Payments

The external account of Pakistan continued to remain under pressure during FY06 due to increase in aggregate demand, coupled with the rise in international oil and commodity prices. The country witnessed highest ever current account deficit of US$ 5.0 billion during FY06 as compared to deficit of US$ 1.5 billion in the previous year. This rise in the current account deficit was mainly contributed by huge trade deficit of US$ 8.4 billion as compared to the US$ 4.5 billion in the preceding year. The expansion in the trade deficit was primarily due to a significant 31.3 percent YoY growth in imports that outpaced the 14 percent growth in exports.

The persistently rising international oil prices and the broad-based increase in the aggregate demand led to a sharp rise in import bills to US$ 24.9 billion during FY06. The exceptional import growth and accompanying rise in services account payments (principally for freight payments for imports), contributed to a sharp widening of the country's current account deficit, from a relatively manageable 1.4 percent of GDP in FY05, to a more threatening 4 percent of the GDP in FY06. However, the strong growth in remittances from expatriates and gains from the lower net interest payment on external debt & liabilities partially offset the impact of the large trade gap.

The large current account deficit was however, easily financed through the improvement in the financial account. Specifically, financial account surplus increased substantially, from a meager US$ 0.45 billion in FY05, to a sizeable US$ 5.9 billion in FY06. The improvement in the financial account was quite broad based, contributed by higher FDI of US$ 3.5 billion (including privatization proceeds of US$ 1.54 billion); rise in portfolio investment on account of floatation of Euro bonds of US$ 800 million and other receipts. In addition to this, higher receipts of long-term concessional loan from ADB and World Bank, and net inflow of supplier's credit also helped in swelling the financial account surplus. Hence, despite the unprecedented YoY deterioration in trade account in FY06, the overall balance recorded a surplus of US$ 1.33 billion during the period.

After remaining under pressure during the better part of FY06 due to a burgoning trade deficit, Pakistan's overall foreign exchange reserves rose by US $ 520 million in FY06. The entire rise in the country's reserves during FY06 was attributable to a US $ 969 million increase in the SBP reserves, which was partially offset by a decline of US $ 449 million in the commercial bank reserves. The fall in commercial bank reserves was mainly due to the rise in trade loans against FE-deposits resulting from both exchange rate stability and rise in the domestic interest rates. Although all reserve adequacy indicators deteriorated by end-June FY06, they were nevertheless at comfortable levels.

The surplus in the overall external balance, that led to a net US$ 520 million increase in the country's forex reserves (to reach US$ 13.137 billion by end-June 2006) during FY06 also helps explain, in part, the relative stability of the rupee during the year. The rupee traded within a narrow band of 74

[7] The total grant committed under earth quake was US$ 273.5 million during FY06, however, country actually received US$ 144 million in the same period.

paisa for most part of FY06, depreciating only 0.84 percent during the period, to close at Rs 60.1238/US$. However, due to comparatively higher domestic inflation in relation to the trading partner countries and relative stability of the domestic currency, the rupee appreciated in real terms by around 1.9 percent.

Foreign Trade

Pakistan's trade deficit almost doubled to US$ 12.1 billion during FY06 relative to the FY05 level. The exceptionally high deficit was the outcome of higher increase of 38.8 percent in imports as compared to a moderate increase of 14.4 percent in exports during the period.

The unprecedented high oil prices in the international market along with increased demand for machinery and raw material were the contributory factors behind the strong import growth. Specifically, while import of machinery and raw material together contributed almost 42 percent in the additional import bill, oil imports alone accounted for 33.5 percent or one third of the rise in imports (of which, around 87 percent was due to rise in the oil prices).

The extraordinary rise in import seems to be moderating, as evident from the H2-FY06 data. Specifically, imports growth slowed to 27.8 percent in the latter half of FY06 from 53.1 percent during the first half of the year. The slowdown is more pronounced in the non-oil imports growth, particularly, in the machinery group, where the growth has slipped from 66 percent during H1FY06 to 18 percent during H2FY06. With oil prices declining substantially in recent months, and aggregate demand being constrained by the tight monetary policy, it is hoped that import growth will decelerate significantly in FY07.

Unluckily, the export growth also show sign of weakness in the second half of FY06 on account of increased competitive pressure from China, India and Bangladesh in textile and clothing items in the post-MFA regime. Thus imports moderation may not help substantially in reducing the trade deficit.