

<i>Contents</i>	<i>Page No.</i>
1. Overview	1
2. Real Sector	10
2.1 Agriculture	
2.2 Large-scale Manufacturing	
3. Prices	24
3.1 Consumer Price Index	
3.2 Wholesales Price Index	
3.3 Sensitive Price Indicator	
4. Money and Banking	30
4.1 Overview	
4.2 Monetary Survey	
4.3 Reserve Money	
4.4 Components of Money Supply	
5. Fiscal Developments	43
5.1 Overview	
5.2 Revenue	
5.3 Expenditure	
5.4 Financing	
5.5 CBR Tax Collection	
6. External Sector	52
6.1 Balance of Payments	
6.2 Trade Account	
Special section 1: Differences in the Trade Data – FBS & SBP	91
Special section 2: Dynamics of Energy Consumption	95
Special section 3: Interest Rates and Banking Spread	98
Special section 4: Development of Microfinance Sector in Pakistan	107
Acronyms and Non-English Words	114

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THE STATE OF PAKISTAN'S ECONOMY Second Quarterly Report for FY06

1.1 Overview

While Pakistan's economy remains on a high-growth trajectory during FY06, the real GDP growth rate for the year seems increasingly likely to be lower than the 7 percent target. The expectation of the slowdown relative to the FY06 annual target owes principally to the (estimated) weakness in the commodity producing sectors of the economy, the impact of which will be partially offset by an anticipated above-target performance of the services sector.

It is important to understand here that the forecast deceleration in economic activity during FY06 does not presage a general weakening of the trend growth of the economy. With the substantial investments in the current (and preceding) year, strong domestic demand, buoyant exports and a relative improvement in FDI (even after excluding privatization receipts), the economy is poised to deliver real growth rates in excess of 6 percent through the decade, provided that progress is made towards removing infrastructural bottlenecks, implementing second generation reforms to improve institutions and governance, as well as to further liberalize the economy. Moreover, in the short-run, it would be necessary to address emerging macroeconomic imbalances while these are still small and not threatening.

Table 1.1: Major Macroeconomic Indicators

	July-December		
	FY04	FY05	FY06
<i>growth rates(percent)</i>			
Large-scale manufacturing	19.0	21.2	--
Exports	13.2	10.9	23.7
Imports	14.1	35.0	53.1
Tax revenues (CBR)	13.7	15.0	21.7
CPI (12-month moving average)	2.9	7.5	9.1
Private sector credit	13.2	22.3	17.4
Money supply (M2)	9.0	9.8	8.1
<i>million US\$</i>			
Total liquid reserves ¹	12,172	11,987	11,712
Home remittances	1,874	1,946	2,055
Foreign private investment	198	452	1,411
<i>percent of GDP²</i>			
Fiscal deficit	0.6	1.2	1.8
Trade deficit	0.8	2.2	4.5
Current a/c balance	0.9	-0.7	-2.3

¹ With SBP & scheduled banks. End December.
² Calculated by taking fiscal year GDP but variable numbers on half yearly basis. Projected GDP has been used for FY06.

Some of the key macroeconomic imbalances include the downtrend in savings that has led to a widening savings investment gap, the growth of the trade deficit (and concomitant rise in the current account deficit) and, a weakening in fiscal indicators (even after adjusting for exceptional earthquake related spending) (see

Table 1.1). Also, while inflationary pressures show a very welcome decline, the downtrend is still unsettled, and inflation remains at relatively high levels.

While inflation has declined from double-digit near term highs in FY05 and is expected to fall to the 8 percent levels by end-FY06, it must be recognized that reducing it further is necessary for a host of reasons. These include the need to encourage a rise in savings (by keeping real returns on savings positive), maintaining the purchasing power of incomes, making exports more competitive (by holding down the cost of production and thus lowering pressure on the exchange rate), etc.

It is important to realize here that while the tight monetary posture of the central bank, (supported by the government's administrative measures) has contributed to a reduction in inflationary pressures, aggregate demand remains strong. During July-Feb FY06, private sector credit growth was a very substantial 18.1 percent, albeit weaker than the 25.3 percent rise seen in the comparable period of FY05, and while growth in LSM also decelerated, this appears to owe more to factors other than a substantial weakness in demand (e.g. capacity constraints, high-base effects, technical problems, etc.). In this background, a reduction in the volatility of inflation and establishment of a clear downtrend will be important priorities for the central bank, and therefore, the possibility of a further monetary tightening cannot be ruled out.

However the monetary policy will need to be supported by fiscal prudence. While fiscal discipline had been good in recent years, there appears to be a trend deterioration in fiscal indicators during FY05 and FY06. The revenue balance is in deficit in both years, and even the primary balance deteriorated significantly in FY06. Going forward, not only does the government need to maintain low fiscal deficits, these should primarily be caused by developmental rather than current expenditure. While development spending generates economic activity to pay off the debt, current spending only adds to the debt burden.

Moreover, the mode of financing the fiscal deficit is also important. Borrowings from domestic sources other than SBP simply result in a shift of demand from the private sector to the government, but borrowings from SBP are more inflationary as they add to aggregate demand, and therefore financing of the deficit should be through a healthy mix of bank and non-bank borrowings. It should be recalled that the large Rs 178.2 billion increase in budgetary borrowing from SBP during July-Feb FY06 was an important driver of monetary expansion in the period. A part of the government's greater reliance on SBP borrowings was driven by weak non-bank receipts, but another contribution was also due to the non-issuance of

long-term treasury bonds; almost half of the Rs 31.0 billion net retirement of government borrowings from scheduled banks was due to maturities of these instruments. It is important that the government make fresh PIB issues to lower dependence on SBP borrowings and to provide a market driven benchmark, which is needed for the development of the corporate bond market.

While low inflation would help providing impetus to growth in years ahead, a disappointing level of national savings and low investment need immediate attention. Specifically, during FY03 and FY04, imports were financed through current account flows. Unfortunately, thereafter imports continued to grow; the growth in non-debt creating forex inflows was no longer keeping pace with the growing needs of the economy. This is reflected in the widening current account deficit, and resulting in a rising savings-investment gap. This means that in years ahead the country will be increasingly constrained in its ability to meet the growing consumption and investment needs without generating inflationary pressures and an accelerated growth in the country's debt stock, unless there are substantial policy revisions and sustained reforms to meet the challenge of increasing both investment (to increase productive capacity) and savings (to fund Pakistan's investment needs).

Unfortunately, the growth in the imports, and therefore the current account deficit, cannot be easily contained. Data suggests that much of the growth in imports comprises of either capital goods or input for industries. Curtailing these *directly* would therefore result in significant fall in economic activities. Moreover, some further growth in imports is inevitable for a developing economy such as Pakistan, particularly as it seeks to address infrastructural shortcomings.

The large current account deficit can be sustained in FY06, but hard choice will have to be made in future years, if it continues to persist. The policy options available will revolve around reducing the need for imports by containing the growth in aggregate demand, promoting exports, and attracting non-debt creating flows (e.g. FDI). Less desirable options would be to fund the current account deficits through a mix of privatization receipts and higher debt levels or a significant drawdown of the country's foreign exchange reserves.

Future Outlook

Current SBP forecasts indicate that real GDP growth will fall in the range of 6.3 - 6.8 percent during FY06 (see **Table 1.2**). Initial data suggests that the wheat crop may prove to be at (or slightly above) the 21 million tonnes target, but this will still not be sufficient to offset the drag of disappointing *rabi* harvests - cotton and sugarcane. The trends in Large Scale Manufacturing (LSM) growth are, however,

unclear, due to non-availability of adequate data from the Federal Bureau of Statistics. The SBP GDP estimate therefore incorporates the limited FBS data releases to date, and other available market information, and may be subject to revision when the complete FBS data set becomes available.

Headline inflation is projected to fall in the 7.7 – 8.3 percent range during FY06. While the deceleration is certainly welcome, the downtrend in inflation may prove unstable, and could pose a challenge to macroeconomic stability. SBP will therefore continue to retain a tight monetary stance. However, it is important to note that monetary policy alone will not be able to contain all of the rise in inflationary

Table 1.2: Major Economic Indicators

	Provisional FY05	FY06	
		Original targets	SBP projection
<i>growth rates (percent)</i>			
GDP	8.4	7.0	6.3-6.8
Inflation	9.3	8.0	7.7-8.3
Monetary assets (M2)	19.3	12.8	14.3
<i>billion US\$</i>			
Exports (fob-Customs record)	14.4	-	16.9
Imports (cif-Customs record)	20.6	-	28.8
Workers' remittances	4.2	4.0	4.3
<i>percent of GDP</i>			
Budgetary balance	-3.3	-3.8	-4.5
Current account balance	-1.4	-2.2	-4.7

pressures. In particular, there is an urgent need for the government to supplement its very laudable supply-side measures with policies to address market structure problems. Specifically, anecdotal evidence clearly suggests that in recent years, speculative hoarding and collusive price setting have been significant contributors to domestic inflationary pressures in markets for many key commodities. Such pressures respond more to legal and administrative measures, and are less sensitive to monetary tightening.

In contrast to the welcome decline in inflation, the external balance deteriorated significantly in FY06. Although remittances are expected to show reasonable growth and exports are likely to remain strong, the current account deficit is expected to swell to 4.7 percent of GDP by end-FY06. While this is not low, it is quite sustainable in the short run. In the longer run, however, large current account deficits cannot be sustained, as these would initiate a vicious circle of debt creation, exchange rate depreciation and inflation.

In summary, given the fast growing trends of aggressive globalization and increasing regional competition, Pakistan can ill afford to derail its macroeconomic stability which, besides political stability, has been the lynchpin of restoring both domestic and foreign investor confidence. Macroeconomic management today is complicated by Pakistan's need to continue growing which does require it to stretch its both financial and physical resource base, and the

country will have to carefully gauge its priorities in seeking to meet these challenges.

1.2 Executive Summary

Agriculture

The relative improvement in water availability and ample availability of agri-credit bodes well for the *rabi* FY06 crops. In particular, the wheat crop, which contributes the greater part of the value-addition by *rabi* crops, is expected to be a significant beneficiary, with better water availability offsetting the impact of delayed sowing in some key wheat growing districts. This is likely to be complemented by higher credit disbursements, enabling farmers to increase the use of quality inputs to increase productivity. Thus, with a little luck, wheat yields could surpass the record (2586kg/hectare) set last year. On the same lines, in aggregate, minor crops could also do significantly better than targeted during *rabi* FY06. However, even if this happens, the overall growth of the crops sub-sector may remain below target due to the considerable underperformance by two major *kharif* FY06 crops, i.e. cotton and sugarcane.

The overall performance of the agricultural sector could yet receive a significant boost, however, if growth in the livestock sector proves to be significantly above the 3.5 percent FY06 target. While there is little hard data to support this hope, anecdotal evidence suggests that above-target growth could be achieved.

Specifically, the dairy industry seems poised to deliver significant production increases in FY06 on the back of sustained government and private sector efforts in recent years.

Large-scale Manufacturing

Trends in large-scale manufacturing cannot be clearly established due to non-availability of data from Federal Bureau of Statistics (the last complete data set on LSM production is available for September 2005). However, there is some evidence that LSM growth has decelerated in Jul-Jan FY06 relative to the corresponding period of FY05.

Available information suggests that while the largest industrial group in LSM, the *textiles* witnessed a satisfactory growth of 7.7 percent YoY during the first seven months of FY06, it is far below the 26.4 percent YoY growth witnessed in the corresponding period of FY05. Growth in textiles, despite a high base set in the preceding year and higher prices of cotton, was achieved on the back of continued strong external demand. Similarly, despite rising construction activities, a slowdown was observed in *non-metal* industries largely because of deceleration in

the growth of the cement industry, where production growth slowed to 8.8 percent in Jul-Jan FY06, reflecting capacity constraints.

The *chemical* industry also recorded deceleration, posting only 4.4 percent YoY growth in output during Jul-Jan FY06 primarily due to capacity constraints, in caustic soda production, where capacity utilization reached above 130 percent. Similar to *chemical* industry, *fertilizer* industry also facing capacity constraints witnessed 16.4 percent growth YoY as compared with 42.7 percent growth in the same period last year.

Contrary to above, *automobiles* industry showed acceleration in growth, recording a 28.2 percent rise in production during Jul-Jan FY06 over the strong 27.9 percent YoY growth in the preceding year.

Similar to *automobile* industry, growth in the *paper & board* sub-sector accelerated to 11.7 percent during Jul-Jan FY06 as compared to 4.5 percent during the corresponding period of FY05, mainly, due to expansion in production capacity by some manufacturers.

Prices

Inflationary pressures in the domestic economy weakened during most of the first eight months of FY06 primarily due to tight monetary stance, administrative measures and favorable movements in international prices of key commodities. While the rate of increase in the consumer price index has been declining since last quarter of FY05, the same in the wholesale price index has also started deceleration with the beginning of the second half of the current fiscal year.

The reduction in CPI inflation is particularly notable as it dropped from 9.3 percent YoY in June 2005 to 8.0 percent in February 2006 despite sustained high oil prices and the supply shocks. This drop in inflation was more pronounced in food inflation as compared to the non-food inflation. The core inflation, both measured as non-food non-energy inflation in consumer prices and 20 percent trimmed mean, also maintained its declining trend throughout the first eight months of FY06. Inflation in wholesale price index remained high around 11 percent during the first half of the current fiscal year; however, it declined to below 10 percent by February 2006. The decline in WPI inflation is quite broad-based, with all the sub-groups of the index recording deceleration.

Keeping in view the current scenario of key economic indicators and macroeconomic policy environment, SBP forecasts suggest that the average annual inflation for FY06 is likely to be in the neighborhood of the 8 percent annual target.

Fiscal Developments

The government's fiscal position witnessed a moderate deterioration during H1-FY06 despite recording the strongest growth in tax revenues in recent years. Not only did the CBR surpass its tax collection target for the period by 4.7 percent, POL receipts and non-tax revenues also remained above budgetary expectations. Unfortunately, the impact of these gains was offset by the rising expenditures. Consequently, in addition to the decline in fiscal and revenue deficits, the primary balance also slipped into deficit after recording surpluses over the years.

The weakness in the fiscal indicators was primarily due to the spending required for relief and rehabilitation efforts for the earthquake struck regions of the country. However, this increased spending does not explain all of the deterioration; the Ministry of Finance has put the earthquake-related increase in spending at Rs 30 billion, and even after adjusting for this amount, the fiscal indicators for H1-FY06 continue to depict a weakening *trend*, relative to corresponding periods of the preceding two years.

The risk of a further deterioration in fiscal performance needs to be guarded against. Some key risks include: (1) an exceptionally strong rise in imports underpinned the H1-FY06 rise in CBR tax revenues, accounting for 48.0 percent of the share in collections (receipts could therefore slowdown if, as expected, import growth falls back to historical norms); and (2) dependence on potentially volatile non-tax revenues.

Thus, there is clear need for further tax effort to raise the tax-GDP ratio substantially over the next few years. In this context, the reported plan of the CBR to seek a one percentage point increase in the tax-GDP ratio in the next five years needs to be vigorously implemented. Particular attention needs to be given to the broad-basing of the tax net and improving collections from under-taxed areas of the economy such as agriculture, the services sectors, and equity markets

Money and Banking

Monetary policy remained tight throughout July-Feb FY06; while the benchmark 6-month T-bill rate was kept almost unchanged, SBP increased its interventions during the period to ensure that short-term inter-bank market rates remained close to the discount rate. The higher inter-bank rates, amidst declining market liquidity and rising credit-deposit ratio of the banking sector, contributed significantly to the 196 basis point increase in the weighted average lending rate during July-Feb FY06, and a consequent relative deceleration in non-government credit growth. Although credit growth to private sector remained strong at 18.1 percent during

Jul-Feb FY06, it was substantially lower than the very high growth of 25.3 percent during Jul-Feb FY05. Thus, the lower monetary expansion during the period was contributed principally by the slowdown in non-government credit growth, and depletion in banking system NFA.

Large government borrowing during Jul-Feb FY06, which contributed significantly to the M2 growth was mainly due to the relief spending needs of the earthquake affected areas, retirement of long-term government paper (PIBs and FIBs), and less than anticipated receipts from NSS instruments. However, when the anticipated external receipts (PTCL privatization, Euro bond etc) materialize, some of the decline in NFA of the banking system caused by the external account deficits will be reversed, and there will also be an offsetting fall in government borrowings from the banking system. Although, such a development would have no material change on overall M2 growth for the full year it would bring the government borrowing and the NFA close to annual targets. SBP estimates indicate M2 growth is likely to slow from 19.3 percent in FY05 to an estimated 14.3 percent in FY06,¹ which would be slightly below the rise in nominal GDP for the first time since FY02.

External Sector

Pakistan's overall external account deficit narrowed marginally during Jul- Jan FY06 to US\$ 0.58 billion from US\$ 0.61 billion in the corresponding period of FY05. While the current account deficit posted substantial deterioration of US\$ 2.4 billion during Jul-Jan FY06 on YoY basis, this was more than offset by a significant increase in the *capital & financial account* surplus.

This sharp deterioration in the current account was principally due to higher import related activities that include: (1) an exceptional 31 percent YoY rise in imports during Jul-Jan FY06 (based on exchange record), which overshadowed a reasonably strong 13 percent YoY growth in exports; and (2) higher import freight payments, which increased the services account deficit.

Approximately 28.0 percent² of the July-Feb FY06 growth in imports is due to the higher POL import bill, and even this owes mainly to rising international prices. Similarly, another substantial portion of the growth in imports during the period is due to a rise in machinery imports, most of which is catering to the economy's rising demand to increase productive capacity and improve infrastructure. It has been argued that the domestic economic growth has also stoked the import

¹ SBP projections

² Based on FBS data.

demand for some consumer durables as well, particularly of cell phone, personal cars, TV, refrigerator etc. However, this is not a consequential development as their share in overall imports growth during FY06 is very small.³

As the current transfers posted modest growth during Jul-Jan FY06, most of the deterioration in the trade deficit translated into the current account. However, a significant increase in the *capital & financial account* surplus more than offset the deterioration in the current account.

A further analysis of financial account inflows however highlights some concerns. While a substantial part of the improvement in financial flows was contributed by foreign private investment especially rising FDI, including a substantial sum of US\$ 255 million received as privatization proceeds that are one-time flow. Further, portfolio investment also saw a substantial rise during Jul-Jan F06; the volatile nature of this flow reduces its desirability as a source of financing.

Medium to long term policy options must therefore revolve around reducing the need for imports (e.g. reducing energy imports by promoting energy efficiency and raising domestic production), promoting exports, and attracting non-debt creating flows (e.g. FDI). Although the current account deficits could also be financed through a mix of privatization receipts and higher debt or a drawdown of reserves, these are less desirable options.

³The detailed FBS data available for up to October 2005 shows that the share of consumer imports (cell phone, personal cars, TV, refrigerator, air conditioners etc.) in total imports was only 5.7 percent during Jul-Oct FY06 compared to 3.2 percent during corresponding period last year.

2 Real Sector

2.1 Agriculture

While it is still too early to make a robust assessment, a relative improvement in water availability and ample availability of agri-credit bodes well for the *rabi* FY06 crops. In particular, the wheat crop, which contributes the greater part of the value-addition by *rabi* crops, is expected to be a significant beneficiary, with better water availability offsetting the impact of delayed sowing in some key wheat growing districts. This is likely to be complemented by higher credit disbursements, enabling farmers to increase the use of quality inputs to increase productivity. Thus, with a little luck, wheat yields could surpass the record (2586kg/hectare) set last year. On the same lines, in aggregate, minor crops could also do significantly better than targeted during *rabi* FY06.

However, even if this happens, the overall growth of the crops sub-sector may remain below target due to the considerable underperformance by two major *kharif* FY06 crops, i.e. cotton and sugarcane (see **Table 2.1**).

The overall performance of the agricultural sector could yet receive a significant boost, however, if growth in the livestock sector proves to be significantly above the 3.5 percent FY06 target. While there is little hard data to support this hope, anecdotal evidence suggests that above-target growth could be achieved. Specifically, the dairy

Table 2.1: Performance of Major Crops

Crops	FY05	FY06 ^T	FY06 ^E	% change in FY06 over FY05
<i>Area under cultivation</i> ; 000 hectares				
Cotton	3,229	3,247	3,120	-3.4
Sugarcane	967	955	900	-6.9
Rice	2,520	2,533	2,575	2.2
Wheat	8,358	8,415	8,310	-0.6
Gram	1,109	1,113	-	-
Maize	945	971	1,001	5.9
<i>Production</i> ; 000 tons; cotton in 000 bales of 170kg each				
Cotton	14,600	15,000	13,000	-11.0
Sugarcane	47,224	50,095	41,225	-12.7
Rice	5,025	5,000	5,422	7.9
Wheat	21,612	22,000	-	-
Gram	766	853	-	-
Maize	2,520	2,905	3,277	30.0
<i>Yield</i> ; Kg/hectare				
Cotton	770	785	709	-7.9
Sugarcane	49,000	52,500	45,806	-6.5
Rice	1,994	1,974	2,106	5.6
Wheat	2,586	2,614	-	-
Gram	769	771	-	-
Maize	2,667	2,992	3,273	22.7

T: Target; E: Estimates
Source: MINFAL

industry seems poised to deliver significant production increases in FY06 on the back of sustained government and private sector efforts in recent years.

Crops

With the cotton picking season all but over, the latest cotton crop estimate confirms fears of a significant decline in the FY06 harvest. The weak performance by both cotton and sugarcane crops offset the gains from a bumper rice crop to ensure that, in real terms, value addition by three major *kharif* crops¹ will be about 9.0 percent lower than the target for FY06. Therefore, as mentioned earlier, the fortunes of the crop sub-sector in FY06 will now depend crucially on the performance of the wheat harvest and minor crops

Wheat

Initial estimates show a 0.6 percent YoY decline in the area under wheat, which is consistent with the extended cotton picking season and delayed sugarcane crushing (due to price disputes between farmers and sugar mills). However, the impact of this could be offset by the increased use of quality inputs as a result of better water prospects and the increase in the support price for wheat announced ahead of the sowing season. Notwithstanding these positive dynamics, it should be recognized that wheat yield have to rise by almost 2.5 percent, compared to the all-time high recorded in *rabi* FY05, if the 22 million tons production target is to be met.

As with most crops, timely sowing is vital to maximizing yields, and the delayed sowing during *rabi* FY06 means that a good harvest will require continued use of quality inputs and, more importantly, favorable weather. The crop could also benefit from the impartment of the floods around the Indus River areas of the Punjab and Sindh, which increased soil moisture and fertility in these areas. Indeed the germination of standing wheat crop in these areas is reported to be satisfactory. Thus, while it is too early to make a reliable forecast about the size of the crop, field reports on the standing crop and higher input off-take coupled with timely rains in late February-early March support hopes that wheat production may be close to the target of FY06. If so, Pakistan would harvest a bumper wheat crop for the second successive year. A reasonably good wheat harvest, together with the carryover stocks of 4.66 million tons from the FY05 crops (and imports of 1.0 million tons), would be

¹ Cotton, sugarcane and rice.

sufficient to meet the estimated domestic consumption requirements of 20.30 million tons during FY06 (see **Table 2.2**).

Other Crops

The production of maize recorded a growth of 30.0 percent in FY06 over the final estimates of last year. This was the result of both, a rise in area under the crop (up 5.9 percent YoY) and a 22.7 percent YoY increase in per hectare yield, which has pushed the harvest to a record 3.28 million tons.

Reports suggest that growth of minor crops will be higher in FY06 as compared to the estimates of last year. Available data shows that area under *jowar* and *mash* is estimated to be higher by 8.2 percent and 0.8 percent (to 0.33 million hectares and 0.04 million hectares) respectively in FY06 over last year. On the other hand, the area under *mung* crop is reported to be lower by 1.6 percent, to 0.22 million hectares, during the period under review.

Inputs

The supply of irrigation water and off-take of major inputs like fertilizers and certified seeds were reported higher during HI-FY06 as compared to the same period last year.

Fertilizers

The growth in fertilizer consumption slowed in FY06; the total nutrient off-take rose by only 4.7 percent YoY during Jul-Jan FY06, as compared to a 6.3

Table 2.2: Wheat Supply and Use in World and in Pakistan

million tons					
Description	World		Pakistan		
	FY05	FY06 ^P	FY05	FY06 ^P	
Supply	Beginning stock	132.1	149.6	1.6	4.7
	Production	626.8	616.8	21.6	21.7
	Imports	109.8	106.6	1.4	0.8
	Overall supply	868.7	873	24.6	27.1
Use	Feed	106.8	113.66	0.4	0.4
	Consumption	609.2	623.77	19.5	20.3
	Exports	110.8	110.36	0.1	0.1
	Ending stock	149.63	142.62	4.66	2.8*
P: Projections		Sources:		1. MINFAL	
* As on 1st March 06				2. USDA	

Table 2.3: Fertilizers Off-take

000 tons		
Years	Urea	DAP
FY04	3,074	922
FY05	3,069	996
FY06	3,380	1,056
Growth (percent)		
FY05	-0.2	8.0
FY06	10.1	6.0

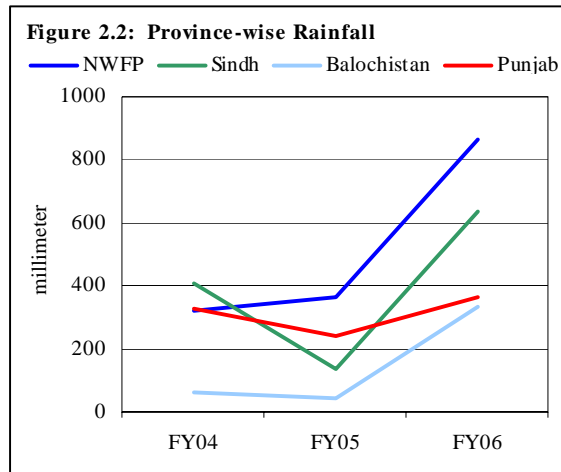
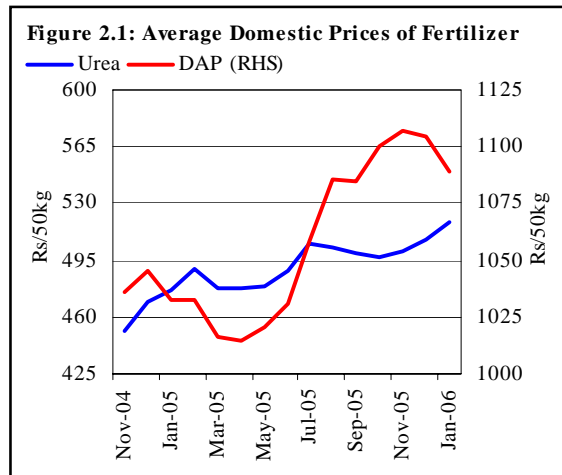
percent YoY rise in FY05. As seen in (see **Table 2.3**), the deceleration is entirely due to slower rise in DAP demand. The relatively slow growth in DAP sales during July-Jan FY06 appears to reflect both a high-base effect as well as a sharp increase in DAP prices (see **Figure 2.1**) as a result of higher international prices.

Domestic urea prices, on the other hand, rose by a much smaller margin, and consequently the demand for the commodity remained strong. Indeed, a part of the higher urea demand could simply reflect farmers increased usage of urea to partially compensate for the lower use of expensive DAP.

Water Availability

The weather, rains and snowfall were reported to be satisfactory during Jul-Jan FY06 compared to the preceding year. As a result, water availability for *rabi* FY06 was reported to be higher by 32.8 percent YoY (see **Figure 2.2**). While this availability is still 5.8 percent lower than normal *rabi* levels, this is not expected to be a major hindrance in achieving the FY06 *rabi* crop targets, as farmers appear to have significantly improved on efficiency of water usage in recent years (e.g. through greater use of laser land leveling). Indeed, the bumper wheat harvest in *rabi* FY05 was achieved in the face of even lower water availability than envisaged for FY06.

Provisional estimates on water



utilization by the provinces suggests 20.32 MAF² consumption from 1st October, 2005 - 31st January, 2006 compared to 14.96 MAF in the same period last year, showing 35.8 percent higher water utilization (see **Figure 2.3**).

Improved Seed

The usage of quality seed increases yield from 20-40³ percent over the traditional seeds used by the farmers. To attain the production target of major crops, in recent years, emphasis on the production of quality seed and distribution systems has been reinforced. Research institutes have given high priority to the development of new crop varieties and hybrid seeds.⁴ Moreover, eleven new seed testing laboratories are being established, in addition to the seventeen already in operation. Not surprisingly, the usage of certified seed increased for many important crops during FY06; this is particularly evident for wheat (see **Table 2.4**). Similarly, for the enhancement of the domestic supply of cotton through higher yield, the Government had allowed cultivation of virus resistance trans-genic Bt cotton⁵ for the cotton crop FY07.

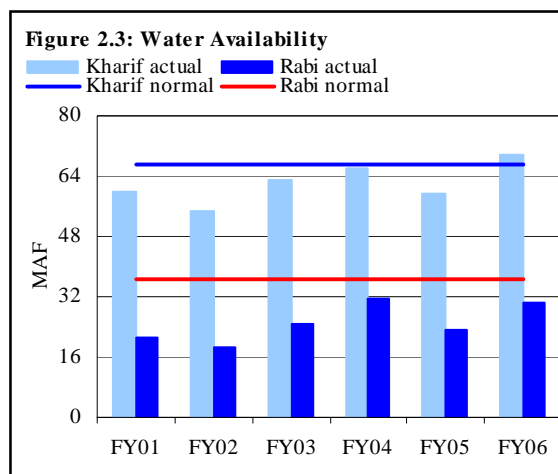


Table 2.4: Certified Seed Distribution
000 tons

Crops	FY05	FY06	Percent change
Wheat	171.2	266.9	55.9
Cotton	24.5	29.3	19.6
Rice	6.8	7.6	11.8
Maize	5.3	6.8	28.3

Source: Federal Seed Certification & Registration Department

² Million Acre Feet

³ Estimated by Pakistan Agricultural Research Council (PARC).

⁴ For example, a Foundation Seed Cell has been setup in each research institute to produce sufficient quantity seed to meet the needs of farmers.

⁵ Genetically enhanced varieties of cotton led to yield gains of between 30 and 35 percent. A type of cotton, disease resisting which carries a special gene derived from soil born bacterium "Baccillus thuringiensis".

Agriculture Credit

The growth of agricultural credit disbursement during Jul-Feb FY06 was healthy 24.1 percent YoY, but was significantly weaker compared with a robust 50.8 percent YoY during Jul-Feb FY05 (see **Figure 2.4**). The relative slowdown appears to reflect (1) a high base as well as (2) rising interest rates.

Encouragingly for the sustainability of the agri-credit market, the recovery of agri-loans has seen a broad improvement in FY06, as only two large institutions have seen the recovery-to-loan ratio decreased during July-Feb FY06, relative to the corresponding period last year.

A disaggregation of the credit disbursement (see **Table 2.5**)

shows that commercial banks have continued to raise their market share in this fast growing market segment, as have the smaller domestic private banks (DPBs), at the expense of the specialized banks, ZTBL and PPBCL. While most of the DPBs have aggressively increased their exposure in agri-disbursements in recent years, most of the rise in their market share is captured by just three of the 14 banks in this group, which jointly accounted for 80 percent of the total agri-credit disbursed during Jul-Feb FY06.

It is interesting to note that the share of development loans in total agri-credit disbursements has stayed around 18-20 percent in recent years, although the overall disbursements have increased significantly in absolute terms. Out of total Rs 80.99

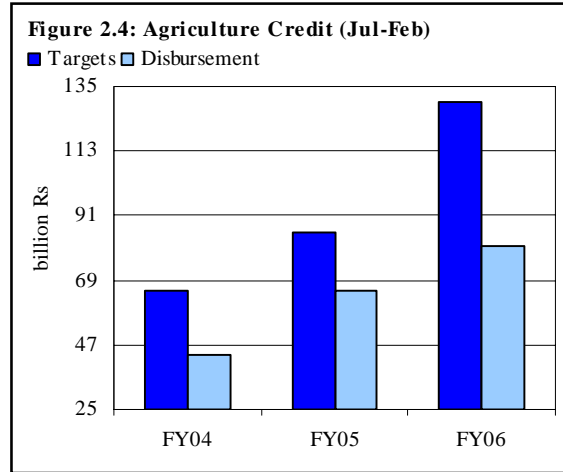


Table 2.5: Market Share (percent) in Agri-credit

Banks	FY04	FY05	FY06
CBs *	44.7	47.7	52.1
ZTBL	41.1	34.8	31.7
PPCBL	10.9	8.2	4.9
DPBs	3.4	9.3	11.2

*: ABL, HBL, MCB, NBP and UBL

billion agri-credit disbursements in Jul-Feb FY06, 5.3 percent has been utilized for tractor purchase, 27.4 percent for fertilizer purchases and 67.3 percent was disbursed for the other agriculture related activities.

The tractors financing increased by 8.9 percent YoY during H1-FY06 (see **Table 2.6**), with the 5 CBs and ZTBL jointly accounting for approximately 90.0 percent of the total tractor purchases financed during the period.

During Jul-Dec FY06 the land holding-wise share of credit disbursements stood at 68.3 percent for *subsistence* holdings, 22.4 percent for *economic* holdings and 9.3 percent for *above economic* holdings. Non-farm sector disbursements were shared by *small farmers* (53 percent) and *large farms* (47 percent) in Jul-Dec FY06. The total number of borrowers served both for farm and non-farm sectors fell by 11.4 percent to 488,241 during Jul-Dec FY06.

Approximately 93.1 percent of the agricultural credit disbursed during H1-FY06 was provided to the farm sector and 6.9 percent to the non-farm sector.

Table 2.6: Tractors Financing by Banks

Banks	H1-FY05		H1-FY06	
	Tractors financed (Nos)	Amount disbursed (m/Rs)	Tractors financed (Nos)	Amount disbursed (m/Rs)
CBs *	3843	1220	4880	1671
ZTBL	4589	1140	4643	1256
PPCBL	686	235	255	91
DPBs	1200	404	703	247
Total	10318	2999	10481	3265

*: ABL, HBL, MCB, NBP and UBL

2.2 Large-scale Manufacturing (LSM)

Trends in large-scale manufacturing cannot be clearly established due to non-availability of data from Federal Bureau of Statistics (the last complete data set on LSM production is available for September 2005). However, there is some evidence that LSM growth has decelerated in Jul-Jan FY06 relative to the corresponding period of FY05 (see **Box 2.1**).

An attempt has been made here to cover developments in specific industrial groups, where data is available from sources other than the FBS. Due to this shift in coverage, methodology, etc, the analysis may therefore not be consistent with the trends reported in the preceding SBP reports.

Table 2.7: Production of Selected Textiles Items (Jul-Jan)

Items	Units	Weight	FY04	FY05	FY06
Cotton yarn	000 tons	13.1	1132.7	1332.8	1491.8
Cotton cloth	million sq.m.	7.5	386.3	535.4	551.3
Jute goods	000 tons	0.2	61.4	60.0	57.9

Available information suggests that despite a high base set in the preceding year and higher prices of cotton, *textile* industry witnessed a satisfactory growth of 7.7 percent YoY during the first seven months of FY06, though lower than the 26.4 percent YoY in the corresponding period of FY05. The main contributor for this relatively smaller growth was a moderate rise of 3.0 percent in the production of *cotton cloth* during the first seven months of FY06 as compared with 38.6 percent remarkable growth during the same period of previous year. During Jul-Jan FY06, *cotton yarn* industry saw 11.9 percent growth on the back of 21.3 percent rise in exports of *cotton yarn* in this period (see **Table 2.7**).

Table 2.8: Total Cotton Availability in Pakistan
million bales

	FY05	FY06
Carryover stock	2.0	4.3
Production	14.6	13.0
Imports	2.3	2.3 ¹
Exports	0.6	0.3 ¹
Total availability	18.3	19.3
Consumption	14.0	15.0 ²
End period stock	4.3	3.0

¹ Upto Jul-Feb FY06

² Based on the estimation of United States Department of Agriculture (USDA) for FY06

Contrary to common perception that the slowdown in *textiles* is attributable to lower cotton production, it is evident from **Table 2.8** that low cotton production is not an

Table 2.9: Automobile Industry (Jul-Jan)
numbers

	Production			Sale		
	FY04	FY05	FY06	FY04	FY05	FY06
Cars 1300cc and above	21,510	27,053	49,627	21,131	27,095	36,403
Cars less than 1000cc	40,519	37,329	49,849	31,610	39,154	63,235
Jeeps & vans	3,049	8,846	6,798	3,103	4,261	6,925
LCVs	4,222	8,293	14,995	4,197	8,241	14,739
Trucks	1,140	1,637	2,453	1,051	1,693	2,343
Buses	791	1,978	385	779	878	528
Tractors	20,131	23,884	37,424	19,989	32,987	28,028
Motorcycles	165,080	228,439	299,989	163,964	227,516	298,673

immediate source of concern for the *textile* sector. The performance of *textile* industry depends on the total availability of cotton in the country, which is estimated at 19.3 million bales for FY06, up 3.8 percent than the last year, on the back of strong carryover stock, and a relatively small rise in domestic consumption of cotton.

In contrast to *textile*, the *automobiles* industry saw an acceleration in production during the first seven months of the current fiscal year; the sub-group witnessed 28.2 percent growth in output as compared with a marginally lower 27.9 percent growth in the same period of the preceding year. Continued strong domestic demand on the back of credit availability as well as rising incomes was probably the major contributory factors to the extraordinary performance of the sector. All automobiles sub-groups except *buses* registered positive growth in output (see **Table 2.9**).

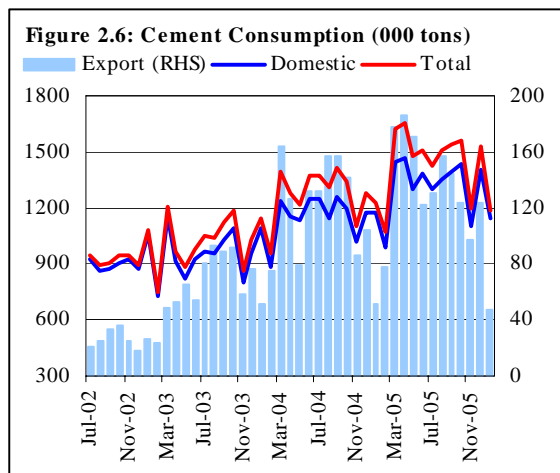
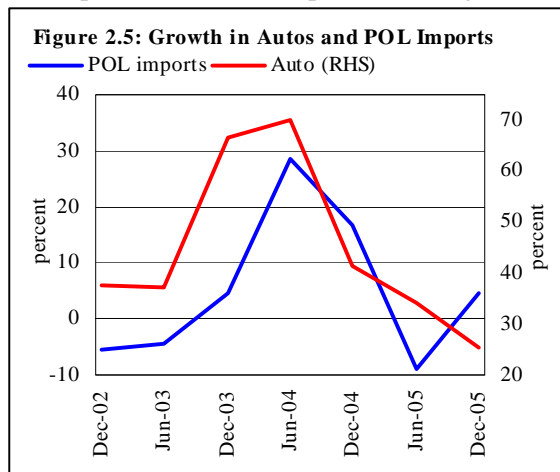
Within the *automobiles* industry, the *cars & jeeps* sub-sector recorded 45.1 percent growth during the first seven months of FY06 in contrast to the 12.5 percent growth recorded for the same period of the preceding year. In recent years the growth in the production of high capacity engine (1300cc and above) *cars* has been higher than that for the low capacity engine (below 1000cc) *cars*.⁶ Similarly, the production of *trucks* registered a noteworthy growth of 49.8 percent in Jul-Jan FY06 in contrast with 43.6 percent growth during Jul-Jan FY05. This performance was due to the initiation of production of Dongfeng trucks by Sindh Engineering (Pvt) Limited.

⁶ During Jul-Jan FY06, high capacity engine recorded 83.4 percent growth in production as compared with 25.8 percent growth in corresponding period of previous year.

However, output growth of *motorcycles & auto rickshaws* sub-group slowed to 31.3 percent in Jul-Jan FY06 as against the 38.4 percent rise in output during the first seven months of FY05. The production growth of *light commercial vehicles (LCVs)* was still very impressive 80.8 percent YoY compared with the 96.4 percent YoY growth seen in the same period of FY05. This sustained exceptional rise in the production of *LCVs* reflects both strong demand (with increasing economic activity and availability of institutional credit) as well as supply improvements following (1) the entry of two new producers; and, (2) capacity expansions by established manufacturers.

Despite a sustained rise in production, the domestic *automobile* industry is unable to meet the rising demand of *automobiles* in the economy, and therefore imports of *road motor vehicles* rose by 66.7 percent during H1-FY06 as against the 28.6 increase in imports during the corresponding period of the previous year. Not only are the heavy imports of road motor vehicles adding pressures on the trade account directly, the rising demand of *automobiles* has also led to rise in fuel consumption, which is met largely through imports. **Figure 2.5** shows that there is a direct relationship between growth in *automobiles* industry and imports of *petroleum* products.

As with the *automobile* industry, the *paper & board* sub-sector also observed an acceleration



with 11.7 percent growth in the production during Jul-Jan FY06 as compared with 4.5 percent during the corresponding period of FY05. An expansion in production capacity by some major players of industry were the main reasons for speeding up in *paper & board* output. To meet the robust domestic demand the imports of *paper & board* products increased by 18.7 percent YoY in Jul-Jan FY06 as against a 5.9 percent YoY rise in imports during the same period of the previous fiscal year.

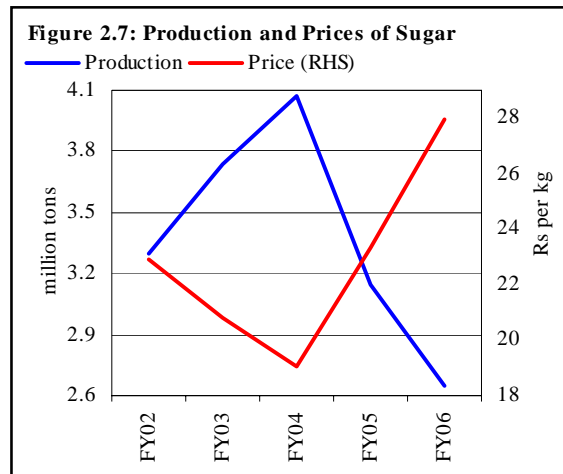
Despite rising construction activities, growth in *non-metal* production decelerated to 8.5 percent YoY during Jul-Jan FY06 substantially lower than 22.0 percent growth of Jul-Jan FY05. The bulk of this slowdown reflected a deceleration in growth of the cement industry, where production growth fell to 8.8 percent in Jul-Jan FY06, compared to robust 22.2 percent growth during the same period of FY05 (see **Figure 2.6**).

The local *cement* dispatches reached 9.1 million tons during the first seven months of FY06, from 8.2 million tons in Jul-Jan FY05, but external demand marginally declined by 0.8 percent during the first seven months of the current fiscal year from a robust 53.2 percent rise in Jul-Jan FY05.⁷ However, the prospects of the cement industry look good, as an expected surge in reconstruction activities following the earthquake in the northern areas, and the continuation of infrastructure development programs, disbursement of consumer loans for housing and rising construction activities in various housing schemes, are all likely to strengthen *cement* demand in months ahead. In the longer run, demand would also be augmented by the government's decision to build a number of large water reservoirs.

The *chemical* industry also recorded deceleration with growth falling to 4.4 percent during Jul-Jan FY06, which is significantly lower than 12.2 percent growth seen in Jul-Jan FY05. This deceleration was mainly due to capacity constraints. Specifically, capacity utilization reached above 130 percent in *caustic soda* industry, where 4.2 percent deceleration was witnessed in Jul-Jan FY06 in contrast to 13.2 percent growth during the first seven months of FY05. Within the *chemicals* industry, *soda ash* recorded 6.0 percent YoY production growth during Jul-Jan FY06 as compared with 3.0 percent growth in Jul-Jan FY05.

⁷ This is the first ever cumulative decline in cement exports since the country started cement exports.

The *Fertilizer* industry is also facing capacity constraints. During the first seven month of FY06, the *fertilizer* industry witnessed 16.4 percent growth YoY, which is significantly lower than 42.7 percent growth in the same period during last year. *Fertilizer* demand has been fundamentally strong on account of improved farm income, improved water availability and more credit availability to growers. In order to fill the supply demand gap, around 1.6 million metric tons of fertilizer was imported during Jul-Jan FY06, up 56.7 percent YoY. Given that no major capacity additions are currently underway, and that fertilizer plants have long gestation periods, demand growth in the next few years will be significantly met through imports, and possibly lead to higher prices (or greater government subsidies).



The positive growth contribution of the above mentioned industries were partially offset by fall in the production of three industries - *food*, *metal* and *rubber*. In Jul-Jan FY06, the output of *food* group registered a fall on account of deceleration in *cigarette* production and fall in the production of sugar. Specifically, *sugar* industry witnessed a 29.1 percent fall in the production during Jul-Jan FY06 as against a decline of 1.4 percent in Jul-Jan FY05. The fall in sugar production is mainly a function of (1) a 13.3 percent decline YoY in the production of sugarcane, and (2) an unwarranted delay in crushing season. These factors forced growers to shift to making other products such as “*gur*” (dehydrated sugar) which adversely affected the production of crystal sugar. The fall in the production of sugar, together with delays in imports, fostered perceptions of the shortage of sugar, which was further augmented by speculation, driving sugar price⁸ up sharply, by 39.5 percent YoY, during H1-FY06 (see **Figure 2.7**).

⁸ In retail market, the price reached to Rs. 42.0 per Kg.

As with the sugar industry, the *metal* industries also witnessed a decline in output. During Jul-Jan FY06, the production of *iron & steel* fell by 62.3 percent YoY as compared with only 1.5 percent YoY decrease seen in the first seven months of FY05. The fall in the production of *iron & steel* sector was mainly caused by the technical problems in Pakistan Steel.⁹ Thus the demand from the growing *automobile* industry, rise in *construction* activities (including the demand from reconstruction activities in earthquake affected northern areas) was met through imports for yet another year; imports of *iron & steel* recorded a 46.3 percent YoY rise during Jul-Jan FY06 compared to 40.0 percent YoY increase in the same period of FY05.¹⁰ Interestingly, foreign direct investment in the construction, *cement* and *metal* industries rose to US\$ 86.5 million in Jul-Feb FY06, up from US\$ 20.1 million during Jul-Feb FY05, indicating enhanced capacity that would allow accelerated growth in these sectors in years ahead.

⁹ Two Coke oven batteries of Pakistan Steel (PS) are out of order since April 2005. The PS has given tender for their repairing work in the first week of January 2006, in which 18 months are mentioned for the completion of task. This means that PS will start working at full capacity by the end of 2007.

¹⁰ The Ministry of Commerce has allowed the import of corrugated galvanized iron sheets from India for a period of one month commencing from December 14, 2005 to January 13, 2006 for exclusive use in rehabilitation of earthquake victims, subject to the verification and recommendation of the Federal Relief Commission.

Box 2.1: Need for Revision in LSM Data Compilation Methodology

It is a little puzzling that the LSM growth rates are trending downward while all other associated indicators are showing an improvement in the sector. First, country has imported huge amount of capital and raw material for capital goods during last three years. Similarly, a substantial amount of raw material was also imported to augment the requirements of the consumer product industries (see **Table B2.1**). Institutional credit and investment (including FDI) has also seen a significant rise during last three years.

Table B2.1: Imports of Different Economic Categories

million US\$

Economic category	FY03	FY04	FY05	Jul-Oct FY06
Consumer goods	1234	1439	2064	968
Raw material for consumer goods	6499	7670	9388	4290
Raw material for capital goods	705	995	1713	702
Capital goods	3782	5488	7433	2917
Total imports	12,220	15,592	20,598	8,866

Though, capacity constraints appear to be hitting LSM growth since FY05, it is possible that improved coverage of the industries may present a different picture. Similarly, weights of the existing industry are probably no longer representative; the current weights are based on FY01 data, and the industrial sector has undergone significant changes and new industries have been added (such as tetra milk, fruit juices, mineral water, value added textile products etc) the coverage of which is weak, and there has been massive growth in others (e.g. cars, consumer durables, etc. see **Box 2.3** in the *Third Quarterly Report of FY05*, p-29).

The present data set of 100 industries compiled by FBS captures only 75.1 percent weight in LSM on the basis of old survey. There is a need to re-allocate the weights and inclusion of some of the important large-scale manufacturing industries in the new survey based on their true contribution in the economy.

3 Prices

All major inflation measures continued to record a weakening in inflationary pressures through most of Jul-Feb FY06, suggesting that the tight monetary posture, administrative measures and favorable movements in key international commodity prices are reducing inflationary pressures in the domestic economy.

Particularly notable is the gradual reduction in CPI inflation despite sustained high oil prices and the supply shocks; CPI inflation has dropped from 9.3 percent YoY in June 2005 to 8.0 percent in February 2006 (see **Figure 3.1**). Moreover, while CPI inflation remained in high single-digits throughout the period, the volatility in the inflation rate is significantly lower than in the corresponding period last year. Also, core inflation, after clinging stubbornly in the range of 7.0 - 8.0 percent during the Jun FY04-Oct FY05 period is finally trending downwards, dropping to the 6.4 percent by February 2006 (see **Table 3.1**) for the first time in the last 20 months.

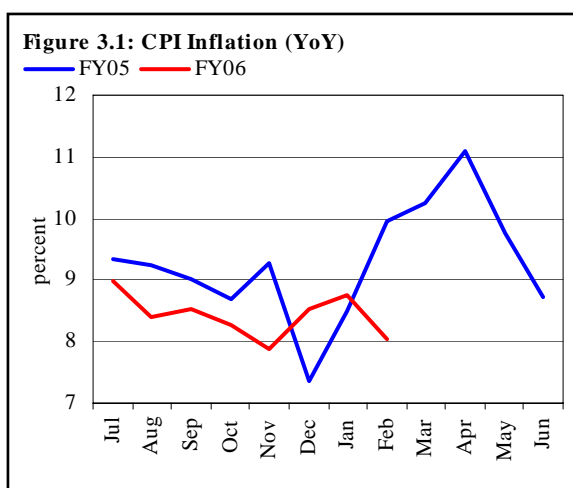


Table 3.1: Inflation Trends (end February)

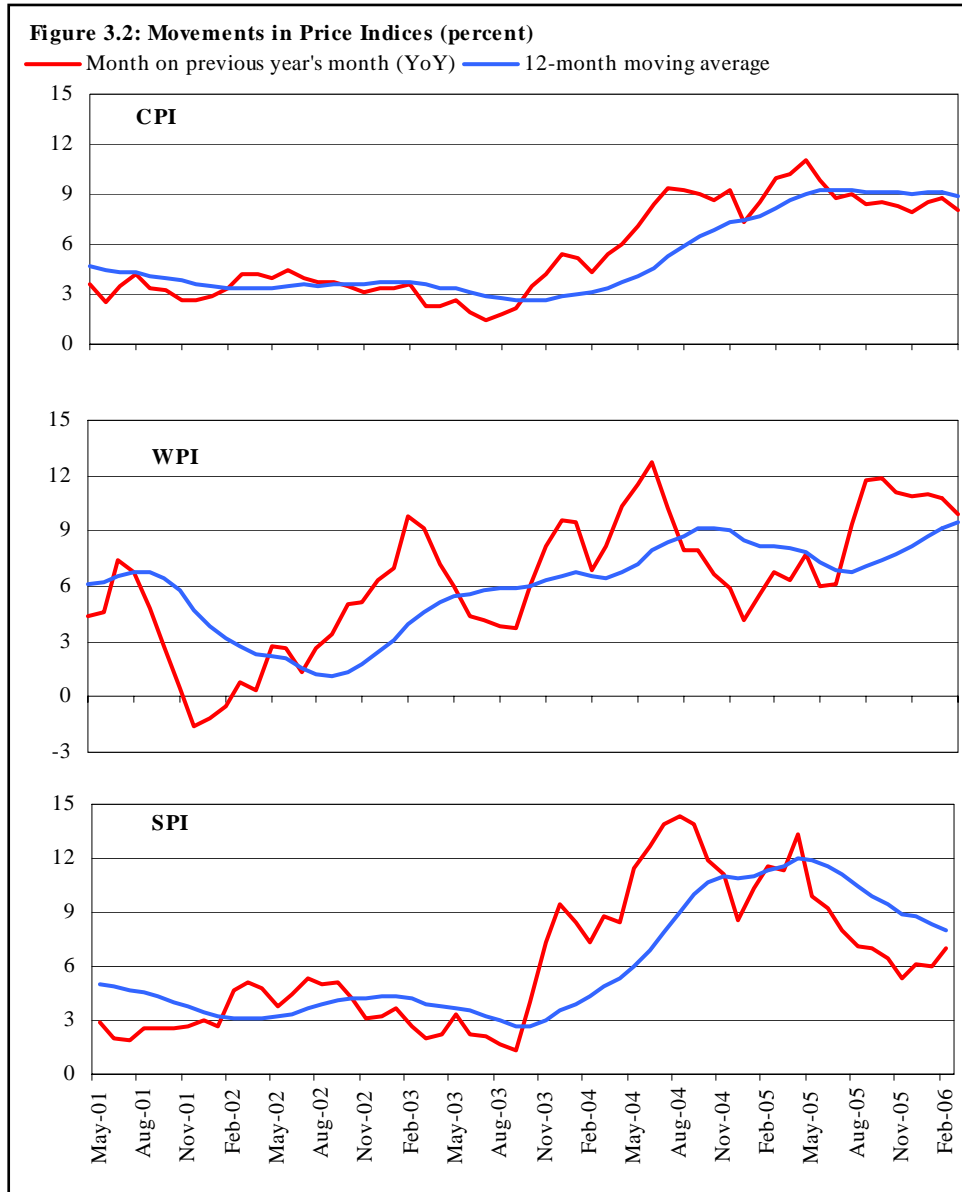
percent	Year on Year (YoY) ¹		12-m moving avg	
	FY05	FY06	FY05	FY06
CPI	10.0	8.0	8.2	8.9
Food	12.9	7.5	11.5	9.2
Non-food	8.0	8.4	6.0	8.7
H.Rent	12.3	9.4	9.7	11.2
WPI	6.7	9.9	8.1	9.4
Food	11.9	6.9	10.5	8.7
Non-food	3.3	12.5	6.4	10.0
SPI	11.6	7.0	11.4	8.0
Core inflation:				
• NFNE ³	7.4	7.0	6.1	7.5
• Trimmed mean ⁴	8.6	6.4	7.7	7.6

¹ Change in Feb 2006 over Feb 2005.

² Change in average of Mar 2005-Feb 2006 over the average of Mar 2004-Feb 2005.

³ Non-food, Non-energy inflation

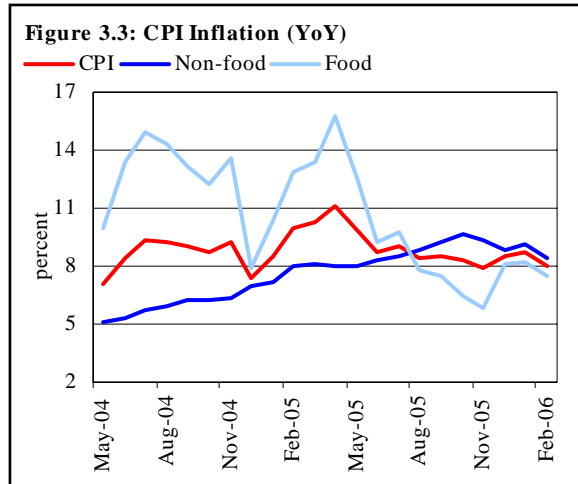
⁴ By trimming 20 percent of CPI items showing extreme changes
Source: Federal Bureau of Statistics



Similarly, the WPI inflation has decelerated, falling to 9.9 percent YoY in February 2006 after maintaining an average of more than 11 percent during the first half of the fiscal year (see **Figure 3.2**). As with the CPI, the contribution to

the decline in WPI inflation is quite broad-based, with all the sub-groups of the index recording a deceleration in price rises.

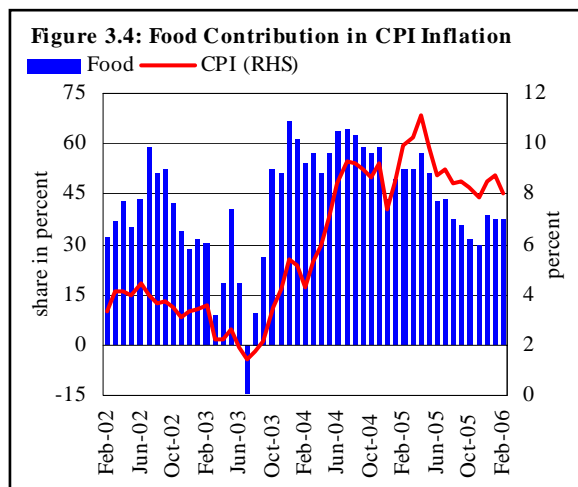
While there exists a possibility of a small rebound in food inflation¹, the impact of this should be mitigated by the impact on aggregate demand (and particularly non-food, non-oil demand), and lower volatility in energy prices. As a result, barring unforeseen supply shocks, SBP forecasts suggest that the average annual inflation for FY06 is likely to be in the neighborhood of the 8 percent annual target.



3.1 Consumer Price Index

As evident from **Figure 3.3**, and **Figure 3.4** it was the sharp decline in food price inflation² that contributed most to the deceleration in aggregate CPI inflation during Jul-Feb FY06.

Indeed, a larger deceleration in the CPI inflation was prevented only by the persistently high non-food inflation through most of this period. High energy prices, in particular, not only contributed directly to non-food inflation, but also forced a small resurgence in food

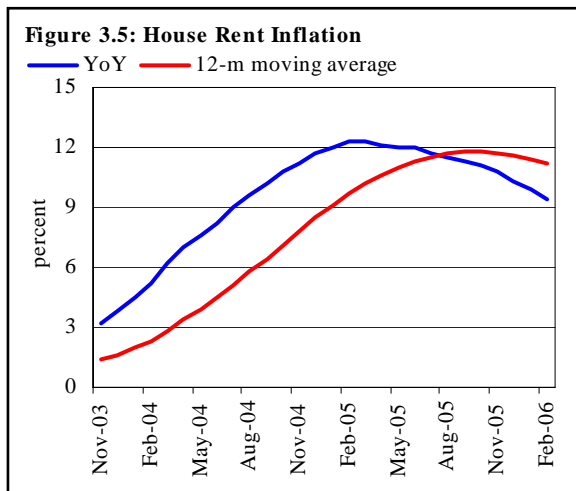


¹ As further increase in meat prices, as a substitution impact on the back of rising fears of bird flue; and in the milk prices due to high transportation cost is expected in the days ahead.

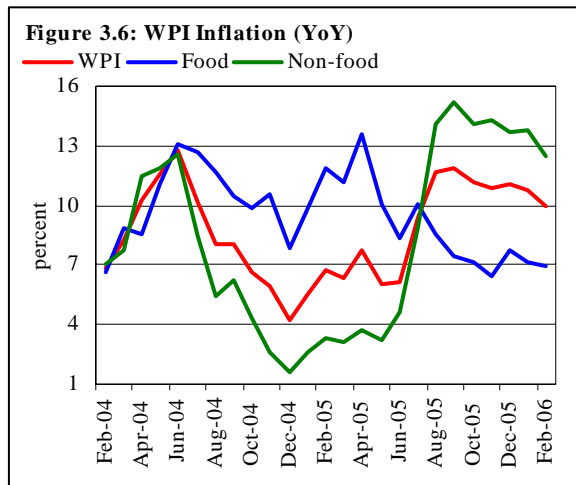
² Although the prices of some important commodities, such as sugar, fresh milk, pulses, etc. have increased sharply, their impact on aggregate food inflation has been offset by the deceleration in prices of some other key commodities, and a fall in wheat prices. For a more detailed analysis please see the SBP "Inflation Monitor" for February 2006.

inflation (through higher transportation costs and a general rise in inflationary expectations).

This trend is expected to change in the remaining months of FY06. On the one hand, the deceleration in food inflation is expected to taper off on the back of rising prices of pulses, sugar, meat and some vegetables, but on the other, the impact of this is expected to be offset by decline in poultry prices and a significant softening in non-food inflation. The latter is already evident in a disaggregation of the CPI inflation figure for February 2006 where: (1) the *fuel & lighting* and *transport & communication* sub-groups saw a sharp fall in their joint contribution to overall CPI inflation, and; (2) the house rent index (HRI) also decelerated substantially (see **Figure 3.5**).



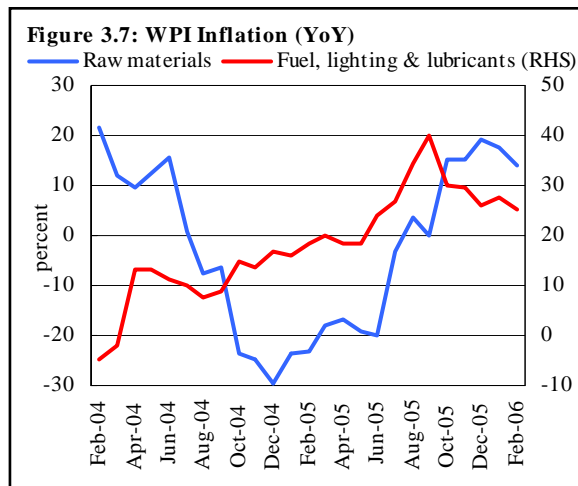
3.2 Wholesale Price Index
After being peaking off at 11.9 percent YoY in September 2005, wholesale price index (WPI) inflation decelerated to 9.9 percent YoY in February 2006. This deceleration was evident in both *food* and *non-food* group inflation (see **Figure 3.6**).



WPI *food* group inflation continued to decelerate through most of FY06, as the impact of significant rises in the prices of key commodities such as pulses, meat and sugar, were partially offset by a fall in the prices of wheat and its products, as well as weakness in the prices

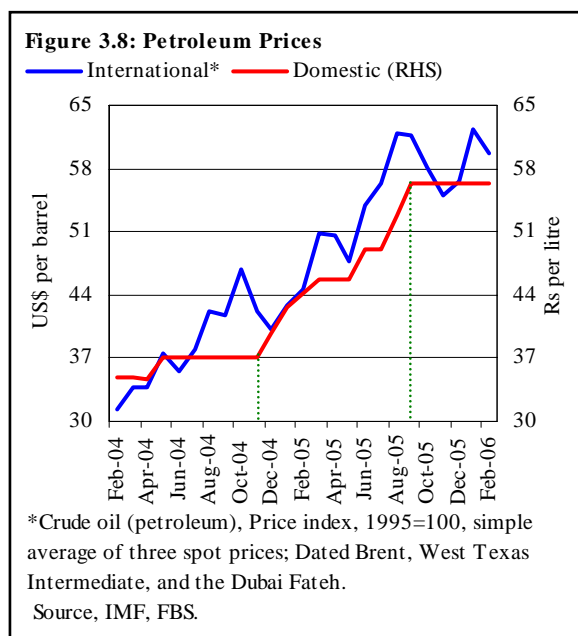
of some minor crops. As a result, WPI *food* inflation dropped to the 7 percent levels by Feb FY06.

Within the WPI *non-food* sub-group, inflation recorded by the *raw material* sub-index rose sizably, but the impact of this on overall WPI inflation was partially offset by the deflation in the *building material* index as well as a sharp deceleration in the WPI *fuel, lighting & lubricant* inflation.



The raw material sub-index of the WPI recorded an average inflation of 16.5 percent YoY during the second quarter of FY06 after witnessing average deflation of 17.6 percent YoY during FY05 (see **Figure 3.7**). The upsurge was primarily due to rising sugarcane and cotton prices; prices of both commodities rose sharply Oct FY06 onward when it became clear that the kharif FY06 harvest would be substantially below expectation.

By contrast, WPI inflation component of *fuel, lighting & lubricant* (19.3 percent weight in WPI) fell from 40.1 percent YoY in September 2005 to 25.2 percent YoY in February 2006. The deceleration in energy prices captured by the sub-index primarily reflects the relative stability in domestic oil prices despite some fluctuations in international oil prices (see **Figure 3.8**).

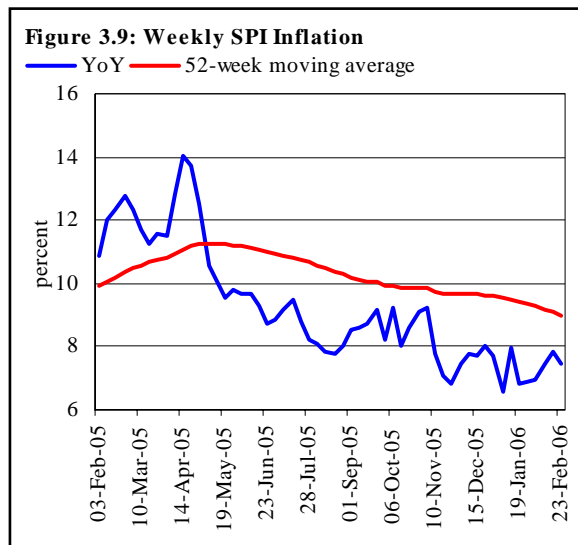


The *building material* is the only group of WPI items that has been recording a deflation since December 2005. This was mainly due to a decline in prices of iron and steel, primarily as a consequence of a reduction in the prices by Pakistan Steel, a reduction in the import duty, as well as declining steel prices in the international market. The impact of this would have been greater if not for the rising cement prices, which continued to move up despite the government's efforts to reduce prices by liberalizing the cement import policy.

3.3 Sensitive Price Indicator³

The Sensitive price indicator (SPI) exhibited, on average, a decelerating inflation trend during the first eight months of FY06 (see **Figure 3.9**).

Despite some volatility in some weeks of October (Ramadan effect), December (natural gas price effect) and February (sugar price effect), SPI continues to record a steady downward trend.



³ SPI is a sub-index of the CPI, constituting principally of key food staples and some important non-food items (including some fuels). Conceptually this indicator tracks the inflation in basic consumption items common to all income groups. The data for the SPI is provided by the FBS on a weekly basis, and higher frequency of the SPI makes it a useful leading indicator of inflationary trends.

4 Money and Banking

4.1 Overview

Monetary policy remained tight throughout July-Feb FY06; while the benchmark 6-month T-bill rate was kept almost unchanged, SBP increased its interventions during the period to ensure that short-term inter-bank market rates remain close to the discount rate (see **Table 4.1**).

	Jul-Feb	
	FY05	FY06
Number of OMOs	26	63
Number of injections	3	18
Number of absorptions	23	45
Average over-night repo rate	3.3	7.8
SBP repo (discount) rate	7.5	9.0
Coefficient of variation (overnight rates)	79	16

The higher inter-bank rates, amidst declining market liquidity and rising credit-deposit ratio of the banking sector, contributed significantly to the 196 basis point increase in the weighted average lending rate¹ during July-Feb FY06, and a consequent relative deceleration in non-government credit growth. Although credit growth remained strong at 18.1 percent during Jul-Feb FY06, it was substantially lower than the very high growth of 25.3 percent during Jul-Feb FY05. Thus, the lower monetary expansion during the period was contributed principally by the slowdown in non-government credit growth, and depletion in banking system NFA (see **Table 4.2**).

	Flows (billion Rs)		Contribution to M2 growth	
	FY05	FY06	FY05	FY06
1. Credit to non-government sector	305.6	310.8	12.3	10.5
2. Government borrowing	2.7	116.7	0.1	3.9
3. NFA	43.5	-80.8	1.8	-2.7
Sub total(2+3)	46.2	35.9	1.9	1.2
4. OIN	-80.3	-90.6	-3.2	-3.1
5. M2	271.5	256.1		

It should be noted that while there is a very large jump in government borrowings during the period significantly raising the impact on M2 growth relative to FY05, this was partly due to the relief spending needs of the earthquake affected areas, retirement of long-term government paper (PIBs and FIBs), and less than

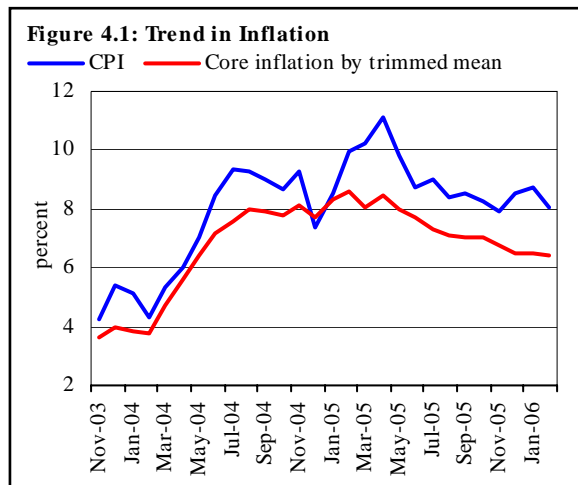
¹ One contribution to this will also be from changes in the profile of the credit growth. For example the increasing share of more expensive loans e.g. personal loans, agri-loans, etc. in total fresh disbursements would also push the weighted average lending rate for the period.

anticipated receipts from NSS instruments. All of the government borrowings for budgetary support were from the SBP.²

However, as seen in **Table 4.2**, the net contribution of government borrowings and changes in the NFA on M2 growth is little changed from the previous year. Moreover, as anticipated external receipts materialize, a part of the decline in NFA of the banking system caused by the external account deficits will reverse, and there will also be an offsetting fall in government borrowings from the banking system. Such a development would thus not have a material change on overall M2 growth for the full year.

Thus, it is anticipated that the dominant impact on the projected slowdown in overall FY06 M2 growth, from 19.3 percent in FY05 to an estimated 14.3 percent in FY06,³ will emerge from a relative slowdown in non-government (and particularly, private sector) credit. As a consequence, the FY06 money growth is projected to be slightly below the rise in nominal GDP for the first time since FY02.

Despite evidence of the slowdown in credit off-take relative to last year (which saw exceptionally high growth in net credit off-take) and a visible weakening in manufacturing growth, the SBP monetary policy stance has come under debate. Ironically, this centers on a very welcome weakness in inflationary pressures, and particularly the deceleration in core inflation (see **Figure 4.1**). On the one hand, some stakeholders (including manufacturers and exporters) point to the fall in inflation and stress the need to immediately lower interest rates to reduce the cost of production and investment in order to strengthen growth. On the other hand, the SBP is also exhorted by other stakeholders to tighten its monetary posture even further, by increasing rates immediately. It is argued that



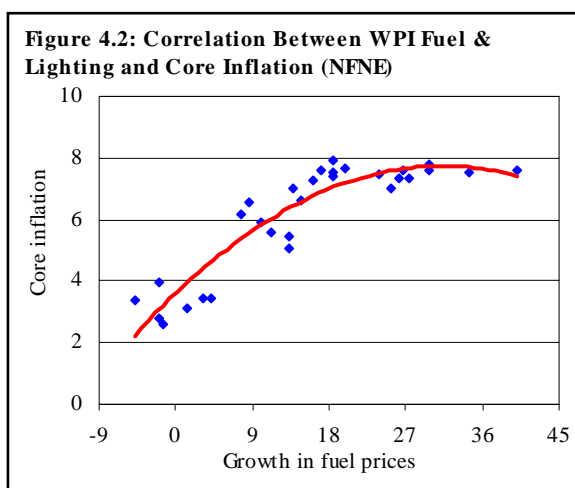
² A part of the higher borrowings from the banking system may also reflect lags in the realization of anticipated external receipts.

³ SBP projections

this is needed to reduce inflation to the low single digits, support long-term growth, and curb speculative pressures (alleging that asset bubbles have been created and need to be pricked), even at the risk of substantially depressing economic activities in the short-term. Both arguments merit some consideration.

The problem with the first argument is simply that despite the decline, domestic inflation rates remain relatively high and, while slowing, FY06 real GDP growth is also expected to remain strong, at over 6 percent. At present, it can be argued that given the monetary overhang of the preceding years, a premature easing of monetary policy runs the risk of reversing the downtrend in inflation, and that any financial savings as a result of lower interest rates could therefore be quickly eaten up by a rise in the cost of inputs. It must also be remembered that deposit growth (and indeed, the national savings rate) have already weakened in FY05 and FY06.⁴ In light of the above, and the emerging competition for deposits, it therefore seems prudent for the central bank to retain its tight monetary stance until inflationary pressures decline further.

The argument against a *further* immediate increase in interest rates is more nuanced, and the answers are less clear. A seemingly obvious answer would be that interest rates need not to be raised further given that inflation has fallen, and the trend seems likely to continue for some months ahead. However: (1) the resurgence in the CPI inflation during Dec-Jan FY06 was largely on account of the supply side factors and base affect, as the non-food non-energy inflation registered further deceleration during Jul-Feb FY06⁵. During February 2006, however, both the food and non-food inflation registered a downtrend and the overall CPI inflation declined to 8.05 percent; (2) although the core inflation has declined marginally from its peak level of 7.9 percent witnessed in April 2005 to 7.3 percent in



⁴ This means that the country will be hard pressed to meet its growing investment requirements through domestic savings, with attendant costs in terms of a widening current account deficit, slower growth, and eventually, higher inflation.

⁵ See SBP publication "Inflation Monitor" February 2006 for further details.

January 2006, this seems to be the result of lagged pass through of higher fuel prices on the core inflation. It may be pointed out that, although the core inflation excludes energy and food components, it shows strong correlation with fuel components in both the CPI and WPI (see **Figure 4.2**). Since domestic fuel prices have not changed since last few months it is likely that core inflation will show a more significant decline going forward, *ceteris paribus*.

However, given the potential for reigniting inflation (particularly as increasing trade and fiscal imbalance, as well as the persistent high fuel prices may not allow inflationary expectations to weaken significantly), and the potential buildup of asset bubbles, a decision to sustain the current monetary stance must center on the SBP's statutory responsibility to sustain both, price stability *and* growth, in the economy. Indeed, while there is some evidence of a slowdown in the commodity-producing sectors, and particularly large-scale manufacturing, this seems to be driven more by factors other than a very substantially slowdown in demand (e.g. capacity constraints). Finally, on the risk of asset bubbles, it must be recognized that these are notoriously hard to define *ex-ante*, and there is also a considerable controversy in economic literature on the appropriate policy response.⁶

On balance, based on the above discussion there seems to be little room for a reduction in the interest rates through the remaining months of FY06, and indeed there is some support for a policy bias towards a further tightening of the monetary stance. In accordance with the Monetary Policy Statement for Jan-Jul FY06, the SBP will therefore continue to monitor economic developments, particularly the trends in inflation, with a view to containing inflationary pressures without significant prejudice to growth.

4.2 Monetary Survey

Money supply registered an increase of Rs 256.1 billion during Jul-Feb FY06 compared with an increase of Rs 271.5 billion in the corresponding period of FY05 (see **Table 4.3**). The entire Jul-Feb FY06 increase was attributed to a strong growth of Rs 336.9 billion in the banking sector NDA as the NFA registered a net decline of Rs 80.8 billion due to rising trade imbalances and delay in external finance receipts

4.2.1 Net Domestic Assets

Net domestic assets registered a robust growth of 14.46 percent during Jul-Feb FY06 compared with the growth of 11.98 percent during Jul-Feb FY05 mainly due to a sharp rise in government sector borrowing. Expansion in credit to private

⁶ This is particularly true if the bubbles are restricted to small components of the economy.

sector (Rs 310.6 billion) was only slightly lower than Rs 322.5 billion witnessed in the corresponding Jul-Feb FY05.

Government Borrowing for Budgetary Support

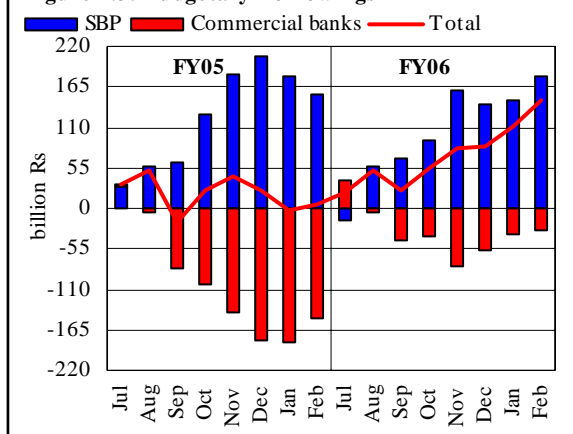
Government borrowing for budgetary support registered an increase of Rs 147.2 billion during Jul-Feb FY06 compared with an increase of Rs 5.0 billion in the corresponding period of the previous year (see **Figure 4.3**). The larger FY06 borrowings are explained mainly by: (1) increased government expenses on account of earthquake relief related activities; and (2) the shift in composition of budgetary finance.

Specifically, 54.2 percent of the full FY05 estimates of external finance were realized during H1-FY05 as the disbursements of loans from ADB and IDB and the receipts against the issuance of *sukuk* were realized during the period. This allowed the government to retire banking sector borrowings (see **Table 4.4**). In contrast, during H1-FY06 external finance receipts have been quite low, with 32.7 percent of the full year estimates being realized. As a result, the government borrowings from the banking sector have increased sharply, breaching the full year target by end-February 2006.

Table 4.3: Monetary Survey (Flows During Jul-Feb)
billion Rs

	Credit plan for FY06		
	FY06	FY05	FY06
M2 (I+II)	380.0	271.5	256.1
<i>growth in percent</i>		10.9	8.6
Reserve money	118.8	87.2	
<i>growth in percent</i>		15.4	9.6
I. NDA (A+B+C)	365.0	228.0	336.9
SBP		138.5	130.4
Scheduled Banks		89.5	206.5
<i>of which</i>			
A. Government borrowing	120.0	2.7	116.7
(i) Budgetary support	98.0	5.0	147.2
SBP		155.0	178.2
Scheduled Banks		-150.0	-31.0
(ii) Commodity operations	20.0	-3.5	-29.2
B. Credit to non-govt sector	320.0	305.6	310.8
Private sector	330.0	322.5	310.6
PSEs	-10.0	-10.8	1.4
C. OIN	-75.0	-80.3	-90.6
SBP		-10.8	-45.9
Scheduled Banks		-69.5	-44.7
II. NFA	15.0	43.5	-80.8
SBP		-31.7	-42.5
Scheduled Banks		75.2	-38.3

Figure 4.3: Budgetary Borrowings



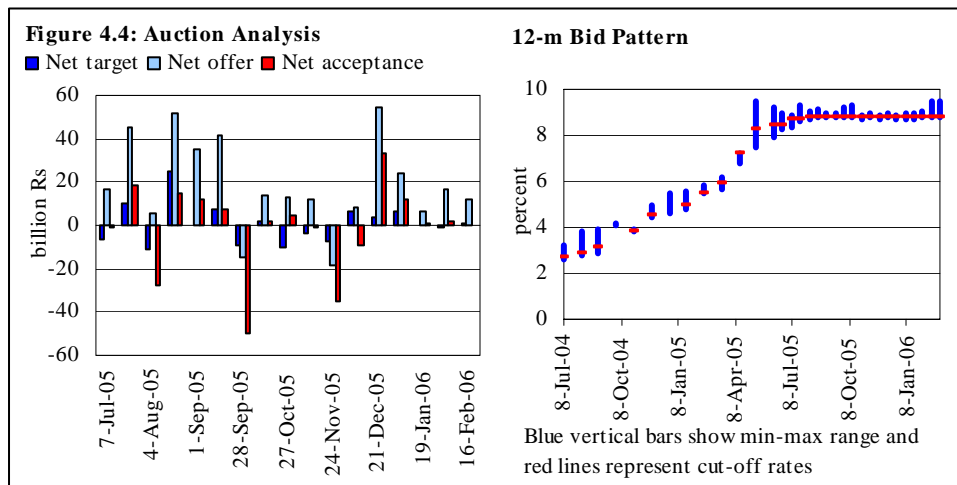
Going forward, however, the government sector borrowing from the banking sector is likely to witness some retirements as the external finance receipts are expected to rise sharply. As a result, government borrowing from the banking sector is likely to fall to the annual FY06 target by the year-end.

Table 4.4: Deficit Financing (Jul-Dec)¹

billion Rs	Budgetary		
	FY05	Est.FY06	FY06
External	40.4	121.6	39.8
Non-bank	15.7	55.4	-6.7
Privatization proceeds	6.8	20.0	18.7
Sub-total	62.8	197.0	51.8
Total financing requirement	79.6	285.0	136.7
Banking system	16.8	88.0	84.9

Source: Ministry of Finance (MoF), quarterly data.

¹ The MoF and SBP numbers differ due to differences in timings and definitions



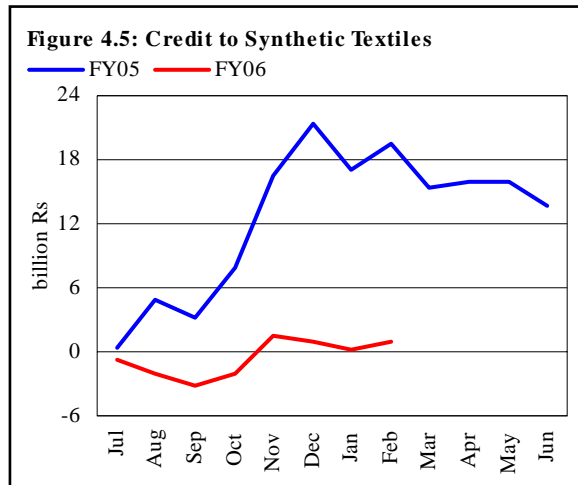
The composition of budgetary borrowings from banking system during Jul-Feb FY06 was similar to that of Jul-Feb FY05⁷. In both the periods, commercial banks registered net retirements, and the government’s budgetary requirements were funded by the SBP (see **Figure 4.4**).

Private Sector Credit

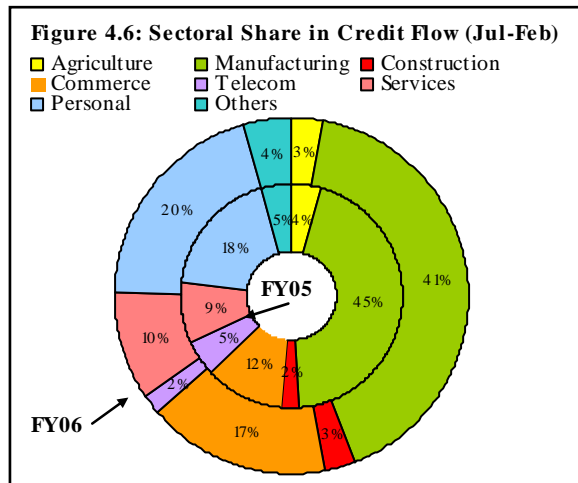
Private sector credit witnessed a deceleration during Jul-Feb FY06, increasing by Rs 310.8 billion (18.1 percent YTD) compared with Rs 322.5 billion (25.3 percent YTD) in the corresponding period of FY05.

⁷ However, it is imperative to mention here that the accounting practice of OMO transactions has been different during the two periods, i.e., Jul-Feb FY05 and FY06. In specific terms, in the older format, the OMO transactions used to shift the claims between SBP and commercial banks. However, from July 2005, these transactions are reflected only in other items net.

This slowdown looks a natural outcome of the constrained liquidity with the banks and the rising lending rates. However, some industry-specific factors also had a significant contribution. In specific terms, slowdown in credit growth was also contributed by; (1) the slowdown in credit off take by the local synthetics textile industry during Jul-Feb FY06 compared with Jul-Feb FY05 (see **Figure 4.5**)⁸. This was



because, during FY06, government reduced customs duties on fibers and man-made/blended yarns to promote the growth in textile industry⁹. As a result, imports of these products displaced local production¹⁰. This translated into a lower demand for credit by the domestic industry. (2) Slower growth in credit to telecommunication industry. This was because a multinational cellular company borrowed heavily from the banking sector during FY05 for fixed investment purposes to start its operations in Pakistan. With these one-off credit requirements absent in FY06, net credit disbursements to the telecommunication sector were understandably lower.



The sectoral distribution of the credit shows that personal and the commerce sector saw large increases in their respective share in incremental credit during Jul-Jan FY06 compared with that

⁸ January figures are the latest available.

⁹ Custom duties declined to 6.5 percent on fibers (from 10-20 percent on various categories) and 14 percent on fabrics of all man made yarns and blended yarns from 25 percent.

¹⁰ The import of synthetic fiber and synthetic yarn witnessed a growth of 64.3 and 55.0 percent during Jul-Jan FY06 over Jul-Jan FY05.

in the corresponding period of FY05 (see **Figure 4.6**).

While credit to commerce sector is reflective of the increase in trade related activities, the growth in consumer finance shows: (1) a weak responsiveness of consumer credit demand to interest rates; and (2) banks' interest in lending to this sector because of higher margins and a relatively low probability of default. Specifically, consumer loans have, at present, one of the smallest infection ratios as only 1.2 percent of total consumer credit portfolio is non-performing (see **Table 4.5**).

Although the manufacturing sector had the largest share in incremental credit in both the periods, its share has declined significantly during FY06.

The share of the construction industry has doubled in the incremental credit during FY06 reflecting the continuous growth in construction related activities in the country. Within the consumer finance sector, the major increases in incremental credit were registered in the credit cards and personal loans (see **Table 4.6**).

Similarly, while auto loans constituted the largest portion in the incremental consumer credit during Jul-Feb FY06, it registered a negative growth over Jul-Feb FY05. This slowdown seems partially the outcome of SBP's directive to banks (during January 2005) not to finance the premiums¹¹, and partially the impact of rise in lending rates. Interestingly, however, auto sales do not show any

Table 4.5: Segment-wise NPLs to Loan Ratio (percent)

	Sep-04	Dec-04	Mar05	Jun-05	Sep-05	Dec-05
Corporate	14.0	10.9	9.9	8.9	8.9	7.0
SME	10.9	10.6	10.2	13.1	13.1	11.6
Agriculture	38.1	38.2	34.3	37	33.3	31.1
Consumers	0.8	0.9	0.8	0.9	1.0	1.2
Credit cards	2.1	2.2	1.5	1.4	0.9	0.8
Auto loans	0.6	0.9	0.7	0.7	0.9	0.9
Durables	7.9	6.2	6.4	6.2	5.2	7.8
Mortgage	0.4	0.4	0.5	0.3	0.3	0.6
Personal	0.6	0.7	0.6	1	1.2	1.7
Commodity financing	1.0	1.1	1.3	1.2	1.3	1.2
Staff	1.4	1.4	1.4	1.4	1.3	1.0
Others	19.1	20.0	13.4	16.9	15.4	23.5

Table 4.6: Consumer Finance During Jul-Feb

	Increase (billion Rs)		
	FY04	FY05	FY06
House building	1.6	11.4	8.3
Auto finance	1.6	29.1	20.8
Credit cards	4.0	2.6	9.4
Consumer durables	1.0	-0.7	0.5
Personal loans	14.0	17.7	17.7
Others	6.5	-9.1	-0.1
Total	28.7	51.1	56.6

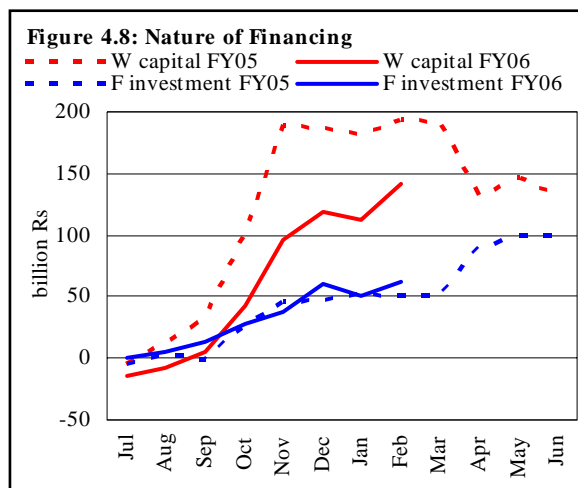
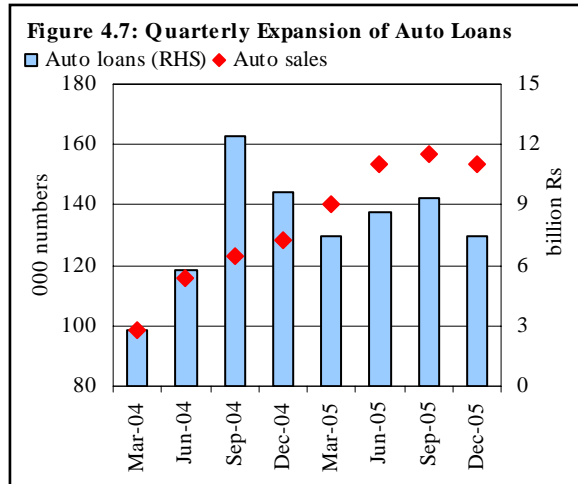
¹¹ This view perhaps can be strengthened by a sharp decline in incremental average auto loan size (increase in number of loans divided by increase in number of accounts) from Rs 1.31 million during Jul-Dec FY05 to 0.39 million during Jan-Jun FY05.

slowdown, possibly indicating a switch to cash purchases and increased car financing by NBFIs and other institutions (see **Figure 4.7**).

Most of the business sector credit growth has been for working capital requirements (see **Figure 4.8**). Indeed, it was the decline in working capital requirements, mainly of the synthetic textile industries that contributed to the lower rise in overall private sector credit growth during July-Feb FY06. The increase in fixed investment loans, on the other hand, was slightly larger than the corresponding period last year. Major sectors that registered an increase in fixed investment loans were cotton, woolen and made up textiles, sugar, cement, and domestic appliances industries.

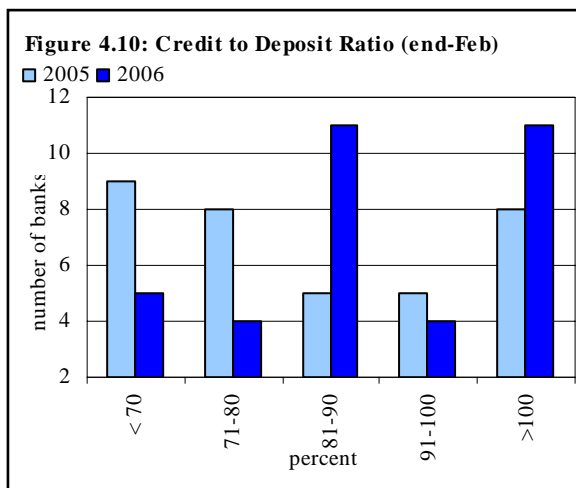
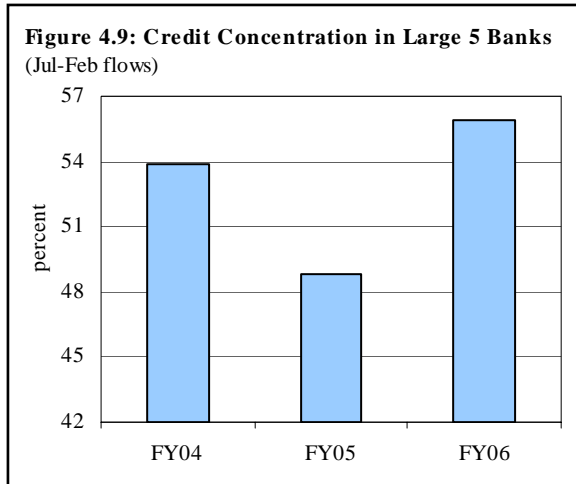
Banks' Concentration

Bank wise data shows that the share of the large five banks in the incremental credit has increased from 48.8 percent during Jul-Feb FY05 to 55.9 percent during FY06 (see **Figure 4.9**). As a result, the institutional concentration in lending activities has increased. This can be attributed to: (1) rising credit to deposit ratio, especially of the private sector banks and (2) the banks' response to capital requirements. Specifically, due to strong, sustained credit growth, the average credit to deposit ratio¹² of the banking industry has risen substantially in the preceding three years. The trend has



¹² Credit includes; (1) private sector credit; (2) private sector investment (banks' investment in stocks and private sector bonds); (3) loans for commodity operations; and (4) loans to PSEs and autonomous bodies. Whereas deposits include all bank deposits including the government sector deposits.

continued into Jul-Feb FY06 also, with the ratio rising to 82.0 percent on average. This translates into a weakening of banks' ability to lend aggressively, and is most evident in domestic private banks, some of which have credit to deposit ratio in excess of 100 percent (see **Figure 4.10**). While the credit to deposit ratio of the big five banks is still relatively lower, it should be noted that it too has also increased sharply during FY06 and, for the first time in last five years, is now close to the industry's average (see **Figure 4.11**).



In addition to the liquidity constraints, more stringent capital adequacy requirement might also have curtailed the ability of the smaller banks to contribute significantly in the credit expansion. In fact, as per the new requirements, banks have to maintain

capital to risk weighted assets between 8 to 14 percent depending upon their IRAF¹³ rating; and one approach to achieve the capital adequacy standards is to bring down the share of credit in total assets.

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¹³ Institutional Risk Assessment Framework.

Credit Quality

It should be noted that despite the aggressive lending to the private sector, there is little evidence of the deterioration in the quality of banks' assets (see **Table 4.7**). The ratio of non-performing loans to total advances has declined to 2.4 percent at end December 2005 compared with 3.0 percent as at end June 2005 and 3.6 percent as at end December 2004, possibly

suggesting the impact of better credit appraisal practices by the banks and favorable economic conditions.

4.2.2 Net Foreign Assets

The NFA of the banking system registered a decline of Rs 80.8 billion during Jul-Feb FY06 compared with the net increase of Rs 43.5 billion in the corresponding period of FY05. The FY06 decline in NFA has been the result of the widening trade deficit, that resulted in massive outflows of foreign assets from the domestic economy (see **Figure 4.12**), as well as the lower net receipts of external financing.

Within the banking system, both the SBP and the scheduled banks contributed to the overall decline in NFA.

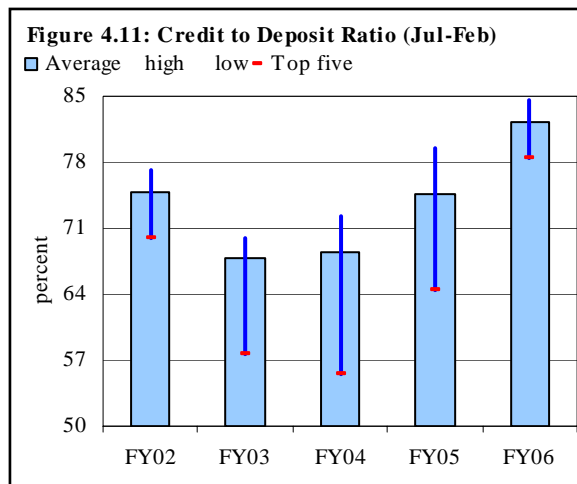
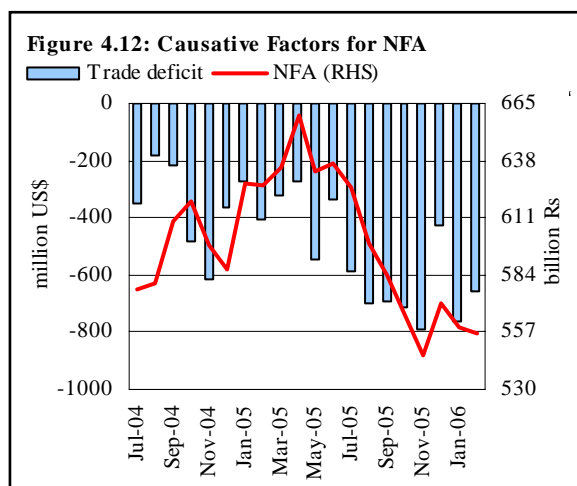


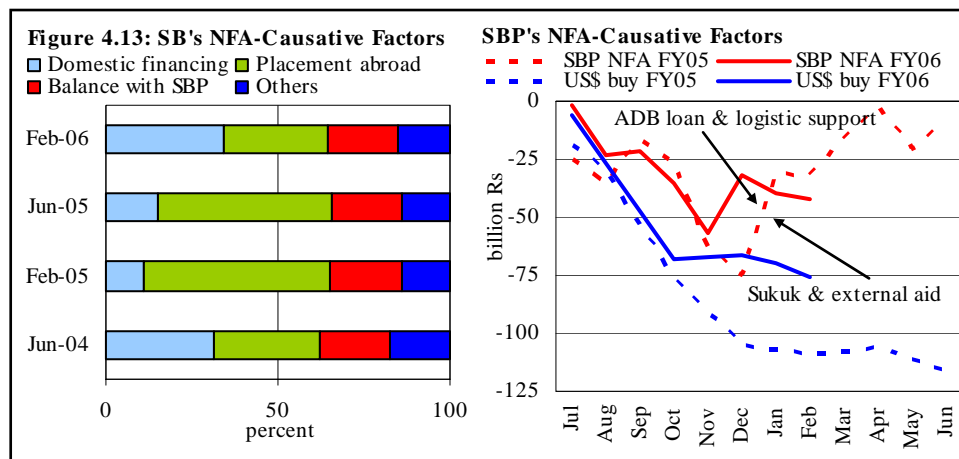
Table 4.7: Credit Quality Indicators (end-Dec)

percent	NPLs / loan (gross)		NPLs / loans (net*)	
	Dec-04	Dec-05	Dec-04	Dec-05
All banks	11.6	9.0	3.6	2.4
Commercial banks	9.1	6.7	2.7	1.5
Public sector banks	13.5	9.8	3.6	1.2
Private sector banks	9.0	6.5	2.8	1.8
Foreign banks	1.6	1.4	0.0	-0.6
Specialized banks	52.9	53.2	26.3	28.5

* net of provisioning



The decline in SBP NFA is quite in line with the volume of its interventions in the forex market to reduce exchange rate volatility, while the decline in scheduled banks' NFA is the outcome of the expectations of a stable exchange rate that resulted in a robust growth in trade related lending against FE-25 deposits (see **Figure 4.13**).



4.3 Reserve Money

Reserve money growth registered significant deceleration during FY06 and increased by Rs 87.2 billion (9.59 percent) during Jul-Feb FY06 compared with an increase of Rs 118.7 billion (15.37 percent) during Jul-Feb FY05. This deceleration is attributed to a slowdown in both SBP NDA and SBP NFA during the latter period.

In particular, the decline in SBP NFA during Jul-Feb FY06 was considerably larger than decline during Jul-Feb FY05. This was on account of lower inflows under program loans (mainly from ADB and World Bank) during Jul-Feb FY06 compared with Jul-Feb FY05. The slowdown in SBP NDA, despite higher government borrowings from SBP during Jul-Feb FY06, was attributed to a sharp decline in SBP OIN during Jul-Feb FY06 compared with Jul-Feb FY05.

4.4 Components of Money Supply

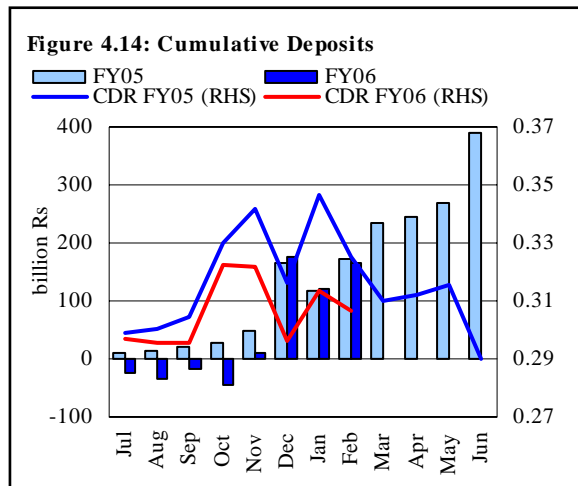
The slowdown in M2 during Jul-Feb FY06 is reflected in its components as the growth in total deposits of the banking sector and the currency in circulation has registered a slowdown during Jul-Feb FY06 compared with Jul-Feb FY05.

However, it is encouraging to see that the currency to deposit ratio has remained lower during the former period reflecting partially the increase in weighted

average deposit rates (from 1.6 percent on average during Jul-Feb FY05 to 3.9 percent during Jul-Feb FY06) (see **Figure 4.14**).

The slowdown in deposit growth was entirely due to the deceleration in growth of foreign currency deposits. Specifically, during most of Jul-Feb FY05, the upward pressures on exchange rate (on account of increased oil payments) and the

expectations of the Rupee depreciation made foreign currency deposits-FCDs rather attractive. Therefore, around 20.4 percent of total mobilization was comprised of FCDs during that period. However, during Jul-Feb FY06, FCDs constitute 8.3 percent of total deposit mobilization reflecting the expectations of exchange rate stability. Within the FCDs, the growth in deposits denominated in US dollars registered major slowdown whereas those denominated in Euro witnessed a sharp growth.

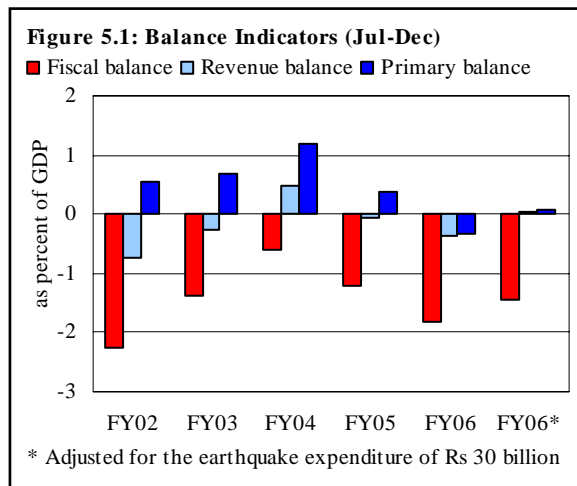


5 Fiscal Developments

5.1 Overview

The government's fiscal position witnessed a moderate deterioration during H1-FY06 despite recording the strongest growth in tax revenues in recent years. Not only did the CBR surpass its tax collection target for the period by 4.7 percent, POL receipts and non-tax revenues also remained above budgetary expectations.

Unfortunately, the impact of these gains was offset by the rising expenditures, and therefore key fiscal indicators all recorded deterioration during the first half; alongside the decline in fiscal and revenue balances, the primary balance also slipped into deficit after recorded surpluses over the years (see **Figure 5.1**).



The weakness in the fiscal indicators latter was primarily due to the spending required for relief and rehabilitation efforts for the earthquake struck regions of the country. However, this increased spending does not explain all of the deterioration; the Ministry of Finance has put the earthquake-related increase in spending at Rs 30 billion, and even after adjusting for this amount, the fiscal indicators for H1-FY06 continue to depict a weakening *trend*, relative to corresponding periods of the preceding two years.

Going forward, not only does the government need to maintain low fiscal deficits, these should primarily be caused by developmental rather than current expenditure. While development spending generates economic activity to pay off the debt, current spending only adds to the debt burden. Moreover, the mode of financing the fiscal deficit is also important. Borrowings from domestic sources other than SBP simply result in a shift of demand from the private sector to the government, but borrowings from SBP are more inflationary as they add to aggregate demand, and therefore financing of the deficit should be through a healthy mix of bank and non-bank borrowings. It should be recalled that the large

Rs 178.2 billion increase in budgetary borrowing from SBP during July-Feb FY06 was an important driver of monetary expansion in the period. A part of the government's greater reliance on SBP borrowings was driven by weak non-bank receipts, but another contribution was also due to the non-issuance of long-term treasury bonds; almost half of the Rs 31.0 billion net retirement of government borrowings from scheduled banks was due to maturities of these instruments.

Some key risks in the fiscal management include:

- The high dependence on import-based taxes, accounting for 48.0 percent of the share in collections. Receipts could therefore slow if, as expected, import growth falls back to historical norms in future periods.
- Potentially volatile non-tax revenues.

Thus, there is clear need for further tax effort to raise the tax-GDP ratio substantially over the next few years. In this context, the reported plan of the CBR to seek a one percentage point increase in the tax-GDP ratio in the next five years needs to be vigorously implemented. Particular attention needs to be given to the broad-basing of the tax net and improving collections from under-taxed areas of the economy such as agriculture, the services sectors, and equity markets.

5.2 Revenues

The growth in total revenues accelerated during H1-FY06, with both tax collections and non-tax receipts contributing to the improvement. Given that the larger part of annual tax collections have traditionally been recorded in the second half of the fiscal year, it seems likely that aggregate FY06 revenues will exceed the Rs 990.3 billion budgetary target.

The improvement in the growth of tax revenues during H1-FY06 was due to above target CBR receipts, as well as a substantial improvement in surcharges. CBR tax receipts grew 21.6 percent during the period, accounting for 64.9 percent of the total revenues (see **Table 5.1**). However, the acceleration in the revenue growth was mainly due to the recovery in the Petroleum Development Levy (PDL)¹ which accounts for the bulk of the surcharge collections (see **Table 5.2**). PDL receipts had declined sharply in FY05 as increases in domestic oil prices failed to keep pace with the rise in international prices, and the subsequent partial recovery in these collections during FY06 reflects the increase in domestic prices as well as a decline in international prices. The continuation of the FY06 recovery

¹ The PDL is a tax, levied on key fuels, the value of which essentially reflects the difference between the cost of these products (including other taxes and distribution costs etc.) and the domestic sales price.

Table 5.1: Consolidated Fiscal Operations (Jul-Dec)
billion Rs

Head	FY02	FY03	FY04	FY05	FY06	YoY change	
						FY05	FY06
Revenues	263.9	332.9	379.1	423.8	497.8	11.8	17.5
Tax Revenue	209.0	253.2	277.7	298.2	362.5	7.4	21.6
Non-Tax Revenue	54.9	79.7	101.4	125.6	135.3	23.9	7.8
Expenditure	363.8	398.6	412.8	503.3	634.5	21.9	26.1
Current	296.7	345.1	352.5	427.5	525.3	21.3	22.9
Development	50.9	51.5	56.8	81.6	128.3	43.7	57.2
Net Lending to PSEs	6.8	2.7	7.0	4.7	-0.4	-32.9	-108.9
Un identified	9.4	-0.8	-3.4	-10.4	-18.6	205.9	79.3
Fiscal Balance	-99.9	-65.7	-33.7	-79.6	-136.7	136.0	71.8
As percent of GDP*							
Revenues	6.0	6.9	6.9	6.5	6.7	-	-
Tax Revenue	4.7	5.2	5.0	4.6	4.9	-	-
Non-Tax Revenue	1.2	1.7	1.8	1.9	1.8	-	-
Expenditure	8.3	8.3	7.5	7.7	8.5	-	-
Current	6.7	7.2	6.4	6.5	7.0	-	-
Development	1.2	1.1	1.0	1.2	1.7	-	-
Net Lending to PSEs	0.2	0.1	0.1	0.1	0.0	-	-
Un identified	0.2	0.0	-0.1	-0.2	-0.2	-	-

Source: Ministry of Finance
* GDP Base 2000

as well as an expected rise in the gas development surcharge from January 2006 onwards² suggests that the aggregate receipts of surcharges during FY06 will remain substantially above the annual target.

Finally, the improvement in the contribution of the non-tax revenues was also substantial. This was mainly on account of *logistic support* receipts that rose to Rs. 46.5 billion against the budgetary projection of Rs 12.1 billion in FY06. Inflows under other major revenue heads such as interest income and dividend payments declined as compared to H1-FY05.

² Oil and Gas Regulatory Authority, Ordinance, 2002 and Natural gas tariff rules, 2002, Decision November 21, 2005 & November 18, 2005, that shows an increase in gas tariffs along with an overall increase of 15.5 percent in gas prices effective from Jan 01, 2006.

5.3 Expenditure

H1-FY06 recorded an exceptional expenditure growth of 26.1 percent as compared to the 21.9 percent growth during H1-FY05. However, this higher growth is not too disquieting in as much as it came from the 57.2 percent

growth in development expenditure during the period (see **Table 5.1**), and that a part of rise in the current spending probably pertained to earthquake relief efforts and therefore does not reflect a loosening of fiscal discipline.

Table 5.2: Surcharges During H1
billion Rs

	FY04	FY05	FY06	YoY change	
				FY05	FY06
Surcharges	33.2	13.8	19.2	-58.5	39.7
Gas	8.9	9.0	9.9	1.6	9.4
Petroleum	24.3	4.7	9.4	-80.5	97.6

Source: Ministry of Finance

Table 5.3: Composition of Current Expenditure (Jul-Dec)

billion Rs

	FY04	FY05	FY06	YoY change	
				FY05	FY06
Current Expenditures	352.5	427.5	525.3	21.3	22.9
<i>Of which</i>					
Interest Payments	98.8	104.2	111.4	5.5	6.9
Domestic	76.3	82.9	89.776	8.6	8.3
Foreign	22.5	21.3	21.635	-5.2	1.4
Defence	87.3	101.1	119.05	15.8	17.8
Development and Net Lending	63.7	86.3	127.8	35.4	48.2
PSDP	56.8	81.6	128.3	43.7	57.2
Net Lending	7.0	4.7	-0.4	-32.6	-108.9

Source: Ministry of Finance

The composition of current expenditure reveals that neither the interest payments nor the defense posed an issue for the government during H1-FY06 (see **Table 5.3**). The interest payment stood at 111.4 billion, up only 6.9 percent YoY as compared to the 5.5 percent YoY increase seen in H1-FY05. While defense expenditure accelerated to 17.8 percent YoY as compared to the 15.8 percent YoY growth during H1-FY05, the major contribution to this probably reflects the fiscal impact of the Army's substantial role in relief,³ reconstruction and rehabilitation activities in the earthquake-affected areas.

³ Grant payments during H1-FY06, even crossed the full year budgetary target of Rs. 38.4 billion by a wide margin (61.1 percent).

A very encouraging development in H1-FY06 is the strength of the development expenditures; these rose by 57.2 percent YoY even over the exceptional 43.7 percent YoY growth in the corresponding period last year. Finally, for the first time in the last five years, lending to Public Sector Enterprises (PSEs) shows a net retirement, falling by Rs 0.42 billion during H1-FY06.

5.4 Financing

In contrast to the preceding year, the major part of the H1-FY06 financing requirement was met through the internal resources, and particularly the banking sector (see **Table 5.4**). In fact, the net borrowings of Rs 84.9 billion are very close to the Rs 88 billion annual targets. Moreover, all of the growth in the government borrowings has been through SBP; borrowings from scheduled banks witnessed a net retirement of Rs 57.5 billion, even as those from the SBP rose by Rs 142.2 billion.

The higher budgetary borrowing from the central bank is certainly not desirable, but it remains to be seen to what extent the higher borrowings reflect lags in external funding receipts. If, as expected, external receipts surge in the second half of the fiscal year, and significant planned

Table 5.4: Financing of Budget Deficit (Jul-Dec)
billion Rs

			Percent share	
	FY05	FY06	FY05	FY06
Financing through	79.6	136.7	100.0	100.0
External resources (net)	40.4	39.8	50.7	29.1
Internal resources	39.2	96.9	49.3	70.9
Domestic non-bank	15.7	-6.7	19.7	-4.9
Banking system	16.8	84.9	21.1	62.1
Privatization proceeds	6.8	18.7	8.5	13.7

Source: Ministry of Finance

privatization/disinvestment transactions are completed, the monetization of the deficit through SBP debt could be significantly reduced.

However, at least a part of the government's rising dependence on borrowings from the banking system is due to the failure to issue long-term bonds (PIBs). The absence of PIB issues probably reflects a reluctance to raise the cost of funding the deficit, particularly as the yields on these instruments act as a benchmark for returns on the government's National Savings Schemes. The last 10-year PIB issue was at 8 percent, and is quite likely that any current issue would be at significantly higher yields, with a consequent impact on NSS returns.

Indeed, failure to raise return on NSS instruments, together with the prohibition of sales from banks, has probably been an important reason for the government's failure to raise non-bank borrowings. The government could only generate a meager amount of Rs 3.6 billion from the National Savings Scheme, during H1-

FY06, and since the Public debt account stood at Rs - 18.0 billion, non-bank borrowings saw a net retirement of Rs 6.7 billion during H1-FY06.

In contrast to non-bank borrowings, privatization proceeds rose sharply, contributing approximately Rs 18.7 billion during H1-FY06 as against the annual budget of Rs 20 billion.

These receipts are expected to rise further due to forthcoming privatization transactions⁴ in the latter half of FY06 (SSGC, Pakistan Steel, a further 5 percent public offering of the UBL shares, and the delayed PTCL receipts).

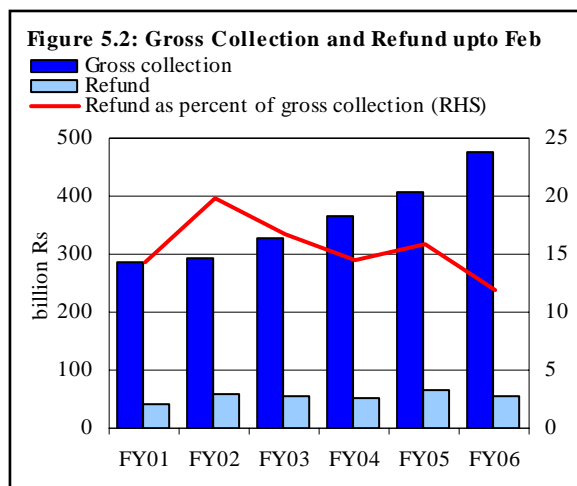


Table 5.5: Tax Collection

billion Rs

Head	Target	Net tax collection up to Feb		Percent of target		
	FY06	Feb	FY05	FY06	Annual	Feb
Direct taxes	214.0	115.6	96.3	124.9	58.4	108.0
Indirect taxes	476.0	293.0	244.7	294.4	61.9	100.5
Sales tax	276.5	172.0	145.2	178.5	64.6	103.8
Federal excise duty	59.5	36.1	31.5	34.4	57.8	95.2
Customs	140.0	84.9	68.0	81.5	58.2	96.0
Total	690.0	408.6	341.0	419.3	60.8	102.6

Source: Central Board of Revenue

5.5 CBR Tax Collection⁵

The performance of CBR remained up to the mark during the first eight months of FY06, as it collected Rs 419.3 billion, up 102.6 percent of the Jul-Feb target. Except for federal excise duty and customs duty, all the taxes surpassed their revenue targets for the Jul-Feb FY06 period (see **Table 5.5**). This implies that CBR will probably comfortably meet the revenue budget target of Rs 690 billion

⁴ According to the Economic Outlook document of the MoF, privatization receipts for FY06 are projected to be around Rs 60 billion.

⁵ Jul-Feb data is used in overall CBR tax analysis, while due to unavailability of the breakup on various taxes, the detailed analysis is limited to H1-FY06 collection.

for FY06, though collections of custom duty and federal excise duty may fall short of target.

Table 5.6: Major Components of Income Tax (Jul-Dec)

	FY01	FY02	FY03	FY04	FY05	FY06	YoY change	
							FY05	FY06
Voluntary payments	16.6	26.7	24.2	26.5	35.9	48.8	35.4	35.9
Collection on demand	3.5	4.7	4.5	5.6	3.7	5.6	-33.5	50.1
Withholding taxes	36.8	35.1	37.0	42.2	46.8	60.3	10.9	28.9
Others	5.9	3.1	2.5	0.6	0.4	0.1	-30.3	-75.0
Gross total	62.8	69.6	68.3	74.9	86.9	114.7	15.9	32.1
Refund/rebate	4.5	6.9	6.6	4.9	10.5	15.3	113.4	45.9
Total (net)	58.3	62.8	61.7	70.0	76.4	99.5	9.1	30.2

Source: CBR

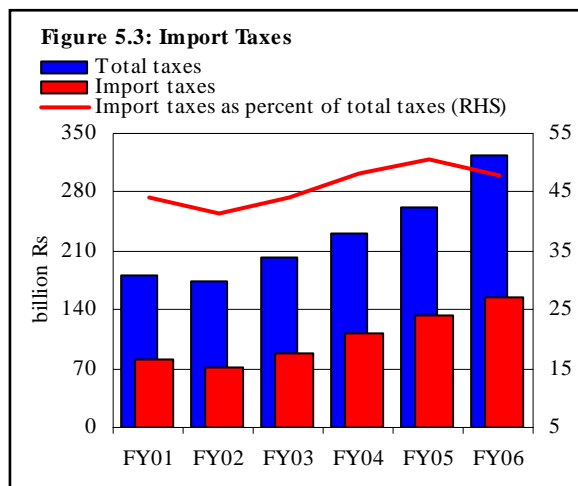
5.5.1 Gross and Refund Collection

Gross collection during Jul-Feb FY06 rose to Rs 476.0 billion as compared to Rs 405.3 billion during Jul-Feb FY05, while the refunds declined to Rs 56.7 billion as compared to Rs 64.3 billion during the corresponding period last year. The 11.8 percent YoY decline in refunds probably reflects the zero rating on same key export products, particularly textiles, that was introduced in FY05.

5.5.2 Direct Taxes

The direct tax collection stood at Rs 104.2 billion during H1-FY06 as compared to Rs 78.4 billion in the corresponding period of FY05 with an impressive growth rate of 33 percent, of which income tax contributed Rs 99.5 billion (see **Table 5.6**).

The composition of income tax demonstrates a big recovery in *collections on demand* which had deteriorated during FY05. However, this improvement is mainly on account of *arrear demand* reflecting a strong arrear collection drive by the CBR; the receipts under current demand



remained almost unchanged from the corresponding period of the preceding year. More encouraging is the 35.9 percent YoY rise in *voluntary* payments that corresponding to an increase in the filing of tax returns in December 2005. Other major heads contributing to the rise in income taxes were imports (Rs 13.2 billion, up 22percent YoY), contracts (Rs 18.0 billion, up 30 percent YoY), and salaries (Rs 6.4 billion, up 11 percent YoY). Apart from this strong tax collection, the refunds of Rs 15.3 billion during H1-FY06 also showed a YoY growth of 45.9 percent.

5.5.3 Indirect Taxes

Indirect taxes contributed Rs 218.9 billion to the over all tax collection effort during the first six months of FY06, registering a 18.9 percent increase over the same period last year. Almost half of the tax revenue is generated from the import-related taxes - Rs 155.4 billion in the total CBR tax collection of Rs 323.7 billion in H1-FY06 (see **Figure 5.3**). The impressive growth in import related taxes is in line with the 53.1 percent growth in imports during the half year.

Sales Tax

With a net collection of Rs 132.1 billion, sales tax surpassed the overall target of Rs 126.7 billion; however, the domestic sales tax collection of Rs 68.5 billion fell short of its gross target of Rs 70.5 billion. Sales tax on import-related products reached at Rs 80.7 billion with a growth of 16.5 percent over the year. Accordingly, almost 61 percent of the sales tax revenue came from import-related sales taxes.

Federal Excise Duty

Federal excise duty, a dying tax, could not meet its target of Rs 26.6 billion and recorded collection of Rs 25.3 billion during H1-FY06. Just six products accounted for almost 95 percent of the total FED collection (see **Table 5.7**).

Customs Duty

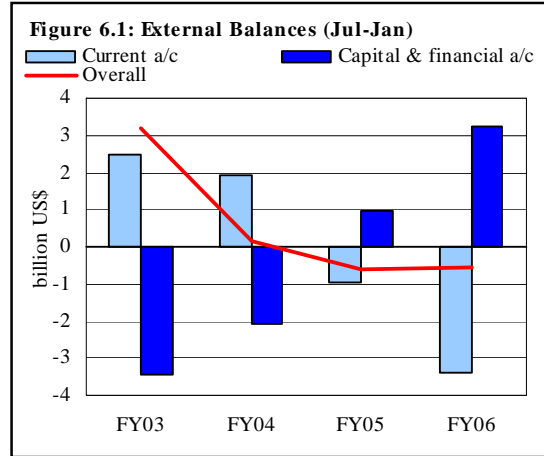
Customs duty receipts remained up to the mark with the collection of Rs 61.5 billion against the target of Rs 61.4 billion for H1-FY06, and up approximately 20 percent YoY. Major revenue spinner remained vehicles (Rs 15.7 billion), POL (Rs 6.9 billion), and mechanical appliances (Rs 5.6 billion).

Table 5.7: Collection from Federal Excise Duty During H1					
billion Rs					
	FY04	FY05	FY06*	Share	
				FY05	FY06
Locally produced goods					
<i>Major commodities</i>					
Beverages	1.06	1.23	1.2	5.6	5.5
Beverages concentrate	0.50	0.86	0.9	3.9	3.9
Cigarettes & tobacco	7.51	9.04	9.0	41.3	40.7
Cement	4.32	5.19	5.2	23.7	23.4
Natural gasses	2.32	2.66	2.7	12.1	12.0
POL products	1.63	2.05	2.1	9.4	9.3
<i>Sub total</i>	<i>17.34</i>	<i>21.03</i>	<i>21.0</i>	<i>96.1</i>	<i>94.8</i>
Miscellaneous	1.08	0.86	1.2	3.9	5.2
Gross total	18.42	21.89	22.2	100.0	100.0
<i>Refund and rebate</i>	<i>0.06</i>	<i>0.01</i>	<i>0.0</i>	<i>0.1</i>	<i>0.1</i>
FED from domestic goods	18.36	21.88	22.2	99.9	99.9
FED from imported goods	0.63	1.38	1.4	-	-
Total gross (imported + domestic)	19.05	23.27	23.6	-	-
Grand total (net)	18.99	23.26	23.6	-	-
*Provisional				Source: CBR	

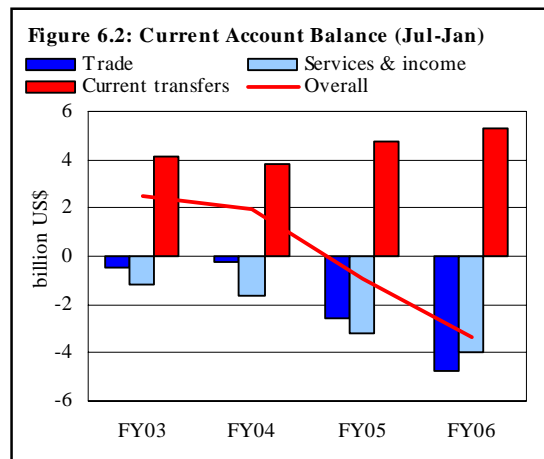
6 External Sector

6.1 Balance of Payments

Pakistan's overall balance of payments deficit narrowed only marginally during Jul-Jan FY06, falling to US\$ 0.58 billion from US\$ 0.61 billion in the corresponding period of FY05 (see **Figure 6.1**). This was because the impact of the substantial US\$ 2.4 billion YoY increase in the current account deficit in the period was offset by a sharp rise in the *capital & financial account* surplus. The spot buying exchange rate of the Pak Rupee averaged Rs 59.75 per US\$ during Jul-Jan FY06, moving in a narrow range of 31 paisa.

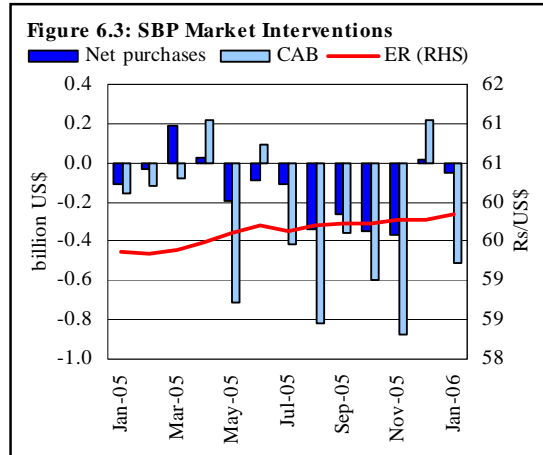


The sharp deterioration in the current account deficit emanated largely from import related activities, i.e., (1) an exceptional surge in imports that outpaced the reasonably strong rise in exports; and (2) higher import freight payments, which increased the services account deficit. Moreover, the current transfers saw modest growth. This combination, i.e., an acceleration in the trade and services deficits together with a deceleration in growth of



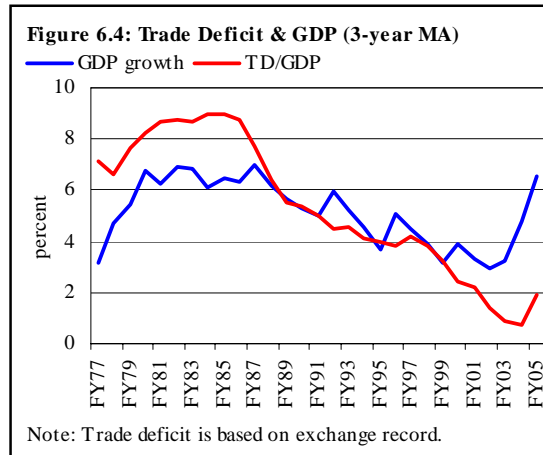
net transfers, translated into a higher growth of the current account deficit during Jul-Jan FY06 relative to the corresponding period of FY05 (see **Figure 6.2**).

As in the preceding year, a part of the current account deficit was financed through long-term non-debt capital flows and drawdown of reserves; the liquid reserves of the central bank fell by US\$ 746.8 million during Jul-Jan FY06, reflecting pressures on the current account (see **Figure 6.3**). However, FY06 financing also included privatization receipts of US\$ 255 million.



The strong import-driven rise in the current account deficit in FY06 has given rise to considerable debate on the ability of the economy to sustain this trend. Specifically, concerns have been expressed on the composition of the import growth, the impact on the country's foreign currency reserves, and the potential for a rise in external debt levels.

Unfortunately, the growth in imports cannot be easily contained, as much of it comprises of either capital goods or input for industries. Curtailing these directly would therefore result in a significant fall in economic activities. Indeed, it should be noted that the trade deficit as a percentage of GDP, has traditionally moved in line with growth trends in the economy (see **Figure 6.4**).



In the longer term, however, sustained large current account deficits and the consequent increasing dependency on capital and financial flows could add to the country's external risk. This can be better understood by analyzing the financing

of Pakistan's current account deficit during July-January period of FY05 and FY06 (see **Table 6.1**).

Interestingly, the financial flows were *negative* during Jul-Jan FY05, suggesting a substantial reliance on SBP's reserves to support the current account deficit.¹ The situation however changed during Jul-Jan FY06 when the dependence on SBP's reserves was relatively low compared to the size of the current account deficit. This was possible because the financial flows were positive and financed a significant portion of the current account deficit.

Table 6.1: Pattern of Financing
million US\$

	Jul-Jan	
	FY05	FY06
Current account balance	-967	-3,368
Financial account balance	-295	2,529
<i>of which</i>		
FDI	515.0	1,226.0
<i>of which</i>		
Privatization proceeds		255.0
Portfolio investment	638.0	310.0
Foreign ILT loans	297.0	323.0
Private loans	-234.0	-22.0
Trade financing	-531.4	672.4

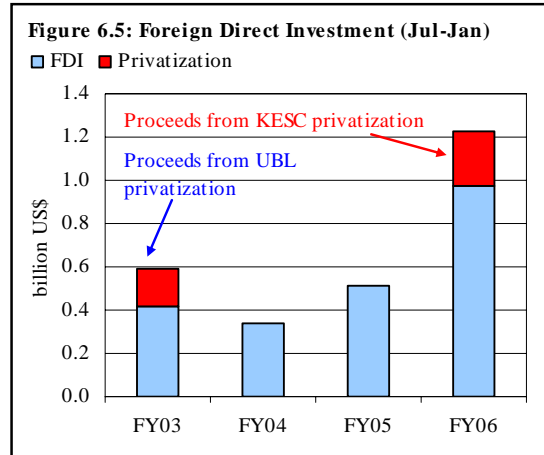
Source: Statistics Department, SBP

A detailed analysis of the capital & financial flows however raises some concerns on the medium term sustainability of the higher trade deficit.

- (a) A substantial part of the improvement in financial flows came from foreign private investment, a large share of which was contributed by rising FDI. While the rise of US\$ 711 million in FDI during Jul-Jan FY06 over corresponding period of previous year is a welcome sign, this however includes a significant amount of US\$ 255 million of the privatization proceeds which are one-off inflows. Further, as evident from **Figure 6.5**, the investment flows during Jul-Jan FY06 diverge significantly from their historical norms. Historically, though the FDI flows have been persistent, their levels were very low (see **Box 6.1**).
- (b) The portfolio investment increased by US\$ 308 million during Jul-Jan FY06 over Jul-Jan FY05. These investments (realized mainly in telecommunication, banks and oil & gas sectors) are the outcome of impressive growth performance in these sectors in recent years. However, as the portfolio investment is volatile in nature, these flows may reverse very easily. This raises the vulnerability of the external account of the country to sudden outflows.

¹ Some of the pressures on external account during Jul-Jan FY05 were absorbed through exchange rate depreciation.

(c) The fresh disbursements of the long-term loans witnessed a fall during Jul-Jan FY06 over the corresponding period last year. As a matter of fact, a total of project assistance and non-food aid fell from US\$ 1,536 million during Jul-Jan FY05 to US\$ 929 million in Jul-Jan FY06. The long-term loans during Jul-Jan FY06 also include some disbursements to support relief operation in earth quake affected areas.² Unfortunately the pace of loan disbursement committed for the earthquake financing is still very slow.



(d) Finally, there has been considerable reliance on foreign currency trade loans. These foreign currency loans extended by commercial banks may not have a significant impact on the overall balance of payments position of the country as these banks are simply switching one type of foreign currency assets (i.e., foreign currency holdings) with other assets (i.e., loan assets). However, they have some implication for the inter-bank market, given that these loans can be retired pre-maturely.

Medium to long-term policy options must therefore revolve around reducing the need for imports (e.g. reducing energy imports by promoting energy efficiency and raising domestic production), promoting exports, and attracting non-debt creating flows (e.g. FDI). Less desirable options would be to fund the current account deficits through privatization receipts and even worse, through higher debt or a drawdown of reserves.

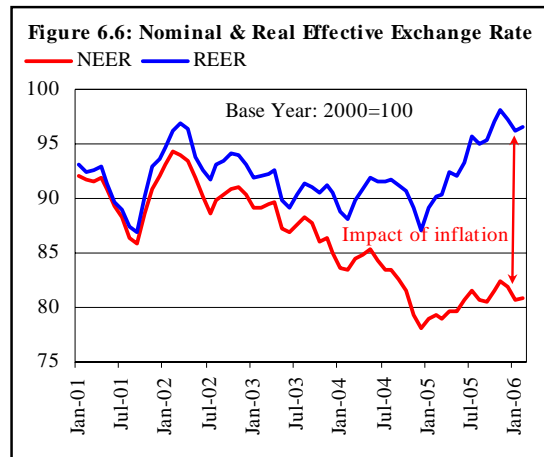
One seemingly obvious path to controlling trade imbalances would be an exchange rate adjustment. In theory, this would result in higher exports and reduced imports (by making them more expensive). However, such adjustments typically have only temporary impacts, and in any case, there are doubts whether

² In Jul-Jan FY06, IDA disbursed US\$ 200 million as earthquake financing whereas from ADB this financing amounted to US\$ 84.5 million.

exchange rate adjustments *alone* are appropriate given indications that capital imports may be more elastic than consumption imports to exchange rate adjustment (see **Box 6.3**).³

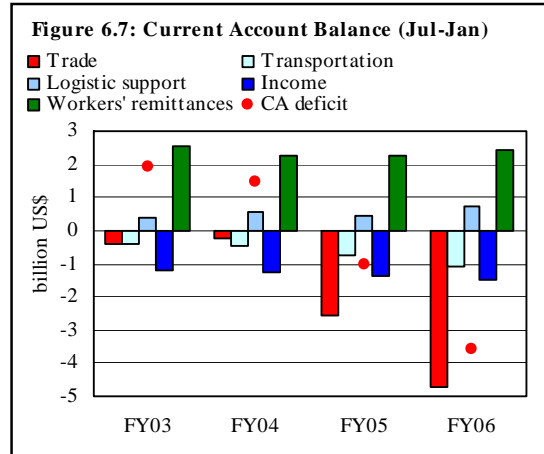
Moreover, this option needs to be exercised with care as it could destabilize the inter-bank markets, with heavy consequent costs, as well as feeding into inflationary pressures. In particular, large

and/or abrupt exchange rate adjustment would not be desirable. A better option could be to enhance competitiveness of exports, e.g., by containing inflationary pressures (see **Figure 6.6**), improving better transportation infrastructure (lowering delivery lags, and costs), etc.



6.1.1 Current Account

The current account posted a deficit of US\$ 3.4 billion during Jul-Jan FY06, worsening sharply from US\$ 0.96 billion in corresponding period last year. More than 80 percent of this US\$ 2.4 billion increase in the current account deficit stems from a steep US\$ 2.2 billion YoY rise in the trade deficit during Jul-Jan FY06.



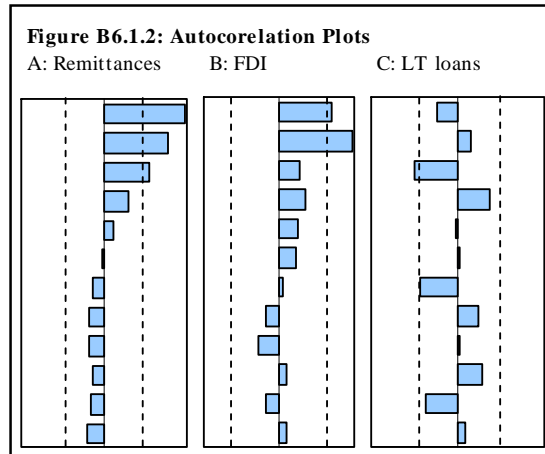
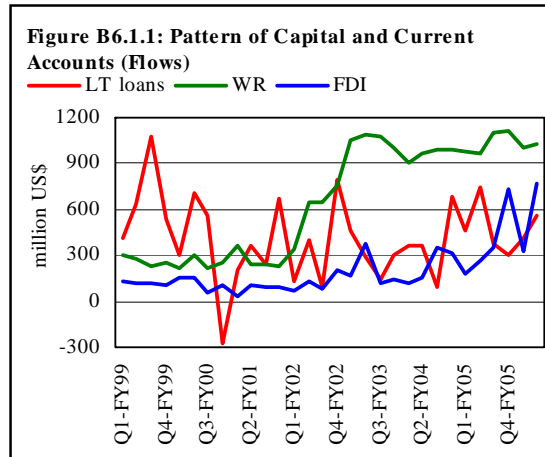
³ While downward adjustment of the exchange rate would contain the overall import growth, its impact could be more severe on the import of raw material & capital goods than on consumer good imports. This could be true particularly when (a) there are comfortable profit margins in the import of personal cars and cellular phones (relative to import of raw material & capital goods) so that importers are ready to bear the cost of exchange rate changes; (b) consumer loans are easily available; (c) vehicle import rules are relatively relaxed.

Box 6.1: Persistence of Capital and Current Account Flows – The Case of Pakistan

The degree of permanence of key foreign exchange inflows provides a measure of the vulnerability of the external account to adverse economic shocks, since a sudden fall in forex flows during times of stress may accentuate adjustment costs. In this background, this section attempts to gauge the degree of permanence for foreign direct investment, official long term loans, and worker remittances.

The autocorrelation – the correlation between the observations of a time series – provides a measure of persistence, i.e., a higher degree of correlation among the observations of a series implies higher degree of permanence in the variable.⁴ While the trends in foreign direct investment, official long term loans, and worker remittances are provided in **Figure B6.1.1**, autocorrelation patterns for these variables are shown in **Figure B6.1.2**. It is clear that workers remittances depict the strongest persistence, followed by FDI and long-term loans.

Thus, worker remittances are a reliable cushion for financing trade deficit. Further, though the FDI flows were also persistent in the period of analysis, their levels have been quite low. Finally, the lack of persistence of official long term loans highlights the risks of relying on these flows as a source of financing the trade deficit.



⁴ Source: A Study on balance of Payments and structure of External Trade Indicators, Joseph Antonio R. Tan III, URL: www.policy.com.ph

While the worker remittances and logistic support inflows showed some improvements, these were offset by: (1) substantial hike in the transportation charges due to higher imports; and (2) higher *net income* outflows (see **Figure 6.7**).

Trade Balance

The trade balance deteriorated sharply from US\$ 2.6 billion in Jul-Jan FY05 to US\$ 4.7 billion during Jul-Jan FY06 as a very strong import growth of 31 percent outpaced a reasonable 13 percent growth in exports during the period under review. In fact, imports have been witnessing a sharp rise since FY05 on the back of a hike in oil prices as well as rising machinery and industrial raw material imports.

It may be pointed out that the rise of US\$ 2.2 billion during Jul-Jan FY06 in trade deficit is based on the exchange record data. On the other hand, the trade deficit based on FBS data shows an increase of US\$ 3.6 billion in Jul-Jan FY06 over Jul-Jan FY05. This variance in these two data sources is due to the difference in the data compilation method. **Special Section 1** reconciles the trade numbers obtained from these two data sources.

Services (Net)

The services account deficit continued to widen during Jul-Jan FY06, rising further by 36 percent YoY (US\$ 651 million) during the period to reach US\$ 2.5 billion (see **Table 6.2**). The major factors responsible for this worsening were:

- (1) rising transportation outflows that reflect higher freight charges following the sharp growth in imports;⁵
- (2) higher outflows under business services due to the improved coverage of foreign exchange transactions routed through foreign exchange companies (FECs);⁶ and

⁵ *Transportation* generally reflects receipts/payments on account of shipment services. The net outflow under this head suggests that payments to foreign companies against shipping services are higher than the receipts of Pakistan's shipping company. The rising trade volume generally leads to more outflows under *transportation*.

⁶ It has been mentioned in the earlier reports that these outflows have no impact on the overall current account balance as it is matched by the receipts of the FECs (appearing as current transfer inflows under *private transfers*).

(3) an unusual rise of US\$ 175 million in *other* outflows mainly due to the payments relating to the construction of Ghazi Brotha Dam (that had been deferred earlier).

Items	FY04	FY05	Jul-Jan		Change FY06 over FY05
			FY05	FY06	
1. Trade balance	-1,279	-4,514	-2,564	-4,731	-2,167
Exports	12,459	14,482	8,085	9,172	1,087
Imports	13,738	18,996	10,649	13,903	3,254
2. Services (net)	-1,316	-3,293	-1,812	-2,463	-651
Transportation	-890	-1,218	-717	-1,085	-368
Travel	-1,034	-995	-604	-723	-119
Communication services	166	272	161	49	-112
Other business services	-332	-2,217	-1,132	-1,303	-171
Government services	905	1,041	579	873	294
of which logistic support	754	831	448	756	308
Other	-131	-176	-99	-274	-175
3. Income (net)	-2,207	-2,386	-1,359	-1,496	-137
Investment income(net)	-2,208	-2,387	-1,360	-1,498	-138
Direct investment	-1,215	-1,622	-893	-1,135	-242
of which: Profit & dividend	-338	-376	-215	-254	-39
Purchase of crude oil & minerals	-678	-951	-504	-577	-73
Portfolio investment	-201	-154	-95	-69	26
of which: Profit & dividend	-109	-146	-54	-45	9
IMF charges & interest on off. external debt	-708	-656	-369	-376	-7
Interest on private external debt	-131	-108	-71	-47	24
Others	47	153	68	129	61
4. Current transfers (net)	6,614	8,659	4,768	5,322	554
Private transfers	6,102	8,409	4,732	5,128	396
Workers remittance	3,871	4,168	2,267	2,446	179
FCA - residents	367	521	445	295	-150
Others	1,864	3,720	2,020	2,387	367
Official transfers	512	250	36	194	158
Saudi oil facility	302	0	0	0	0
Cash grants	202	231	17	117	100
Current account balance	1,812	-1,534	-967	-3,368	-2,401

Source: Statistics Department, SBP

However, these large outflows were substantially compensated by higher inflows against logistic support provided by Pakistan to coalition forces. Specifically, the receipts under this head posted a YoY rise of US\$ 308 million to reach US\$ 756 million during Jul-Jan FY06.

Income Account

The outflows under *income account* reached US\$ 1.5 billion during Jul-Jan FY06, going up by 10 percent (US\$ 137 million) on YoY basis. This was mainly caused by higher repatriation of profits on foreign direct investment (FDI) during Jul-Jan FY06, which was partially offset by savings on interest payments on the external debt, and higher earnings on country's foreign exchange reserves during the same period.

The repatriation of profits on FDI increased by US\$ 242 million due to more outflows of dividends and return on reinvested earnings; possibly reflecting increased holding of Pakistani assets by foreigners. The repatriation of dividend and return on reinvested

earnings together with the fall in profit outflows probably shows expectations of continued growth in corporate profitability. Further, the purchase of crude oil & gas⁷ also remained significantly large during this period on account of higher prices (see **Table 6.3**).

Table 6.3: Returns on Direct Investment (Jul-Jan)
million US\$

	FY05	FY06	Change
FDI	900	1143	243
Profits	58	22	-36
Dividend	155	232	77
Purchase of oil & gas	503	577	74
Reinvested earnings	184	312	128

Source: Statistics Department, SBP.

The outflows of investment return were however partially compensated by higher earnings on country's international reserves (see **Table 6.4**).

In the case of interest payments, the higher outflows on euro bonds and *sukuk* during Jul-Jan FY06;⁸ and the final payment for foreign currency bonds

⁷ Purchase of crude oil & gas reflects the amount paid by the government for its share in the crude oil & gas extracted in Pakistan by foreign companies.

⁸ These interest payments are accrued on Eurobond of US\$ 603 million launched in FY98 (and subsequently restructured) and US\$ 500 million issued in FY04, and the *sukuk* of US\$ 600 million launched in FY05. With the rising stock of sovereign issues, the interest payments are also swelling.

rescheduled in 1999,⁹ were more than offset by savings due to lower interest payments to private creditors.

Further the interest payments on long-term loans rose only marginally during the period under review largely due to lower interest payments particularly to Paris club creditors. These lower interest payments were the result of the re-profiling of Paris club debt, substantial write-off of US debt stock and prepayment to the ADB and private foreign creditors.

In addition, the interest payments for external liabilities also remained higher during Jul-Jan FY06 relative to the corresponding period of FY05, largely due to a rise in foreign currency loans extended to traders during this period¹⁰ as well as the interest payments made by the foreign companies for the working capital requirements.

These outflows however were more than offset by higher interest receipts on country's international reserves during Jul-Jan FY06, resulting in net savings of US\$ 84 million during the period (see **Table 6.4**).

Current Transfers

Current transfers recorded a YoY 12 percent (US\$ 554 million) improvement during Jul-Jan FY06. The higher inflows during the period under review were due to rise of US\$ 179 million in worker remittances, the receipt of US\$ 117 million as cash grant from Saudi Arabia for the budgetary support purposes as well as

Table 6.4: Details of Interest Payments and Receipts
million US\$

	Jul-Jan		Saving
	FY05	FY06	
Payments (I+II)	539	571	-32
I. <u>Total external debt</u>	<u>475</u>	<u>478</u>	<u>-3</u>
Public & publicly guaranteed	<u>392</u>	<u>421</u>	<u>-29</u>
Long-term	342	348	-6
Military	11	8	3
Euro bonds	35	55	-20
Commercial loans/credits	4	4	0
IDB	0	6	-6
Private loans/credits	71	47	24
IMF	12	10	2
II. <u>External liabilities</u>	<u>64</u>	<u>93</u>	<u>-29</u>
Foreign currency deposits	9	12	-3
Special US\$ bonds	19	19	0
Central bank deposits	11	21	-10
Others	25	41	-16
Receipts	111	176	65
Interest on reserves	79	132	53
Others	32	44	12
Net payments	-428	-395	84

Source: Statistics Department, SBP

⁹ A total of US\$ 7.7 million final coupon payment was made in December 2005 for the foreign currency bond that was rescheduled in 1999.

¹⁰ Outflows under this head are equally off set by the inflows in the *other receipts*.

US\$ 45 million as earthquake grants. This improvement was partially offset by lower inflows into resident FCAs that showed a significant fall of US\$ 150 million during Jul-Jan FY06 over Jul-Jan FY05.

Workers' Remittances

Worker remittances (cash) recorded a US\$ 179 million rise in Jul-Jan FY06 over Jul-Jan FY05. The bulk of this improvement came from

rising remittances from Saudi Arabia, Qatar, UK and Canada. The rise in remittances from Canada is of particular interest. Though the absolute level of remittances from Canada is still relatively low, these have risen substantially in the last two years with a YoY growth of around 100 percent in each quarter. This is probably attributable to the higher number of Pakistani immigrants into Canada. As a matter of fact, the number of Pakistani residents is substantially expanding since late 1990s, and Pakistan is the third largest source of migrants to Canada after China and India.¹¹

On the other hand, though the remittances from UAE and the USA slightly recovered in Q2-FY06 (probably to support earthquake-related relief efforts in Pakistan), in overall terms these still remained lower than the total remittances in Jul-Jan FY05 (see **Figure 6.8**).

While the workers' remittances are growing very modestly, various policy measures undertaken by SBP have resulted in expanded documentation of the forex flows under private transfers. For example, the central bank

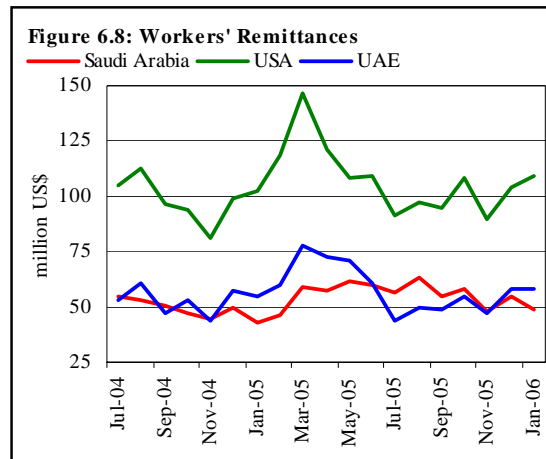


Table 6.5: Expanding Documentation of Forex Flows
billion US\$

	Remittances	FCAs	Kerb purchases	FECs	Total
FY01	1.1	0.5	2.2		3.8
FY02	2.4	0.3	1.4		4.1
FY03	4.2	0	0.4	0.3	4.9
FY04	3.9	0.4	0	1.2	5.5
FY05	4.2	0.5	0	3.1	7.8
Jul-Jan FY05	2.3	0.4	0.0	1.7	4.4
Jul-Jan FY06	2.4	0.3	0.0	1.9	4.7

Source: Statistics Department, SBP

¹¹ Source: www.cic.gc.ca

has been gradually increasing the coverage of FECs transactions by streamlining the reporting system and by shifting more payments to these companies. As a result, during FY05, FECs reported transactions amounting to US\$ 3.1 billion compared to US\$ 1.2 billion in FY04 (see **Table 6.5**). During Jul-Jan FY06, the foreign exchange flows transacted through FECs increased to US\$ 1.9 billion against US\$ 1.7 billion during corresponding previous year.

Resident FCAs

FCAs (resident) recorded a lower inflow of US\$ 295 million in Jul-Jan FY06 compared to the US\$ 445 million inflow during Jul-Jan FY05. The substantial FCA inflows during Jul-Jan FY05 were largely one-off and were observed in the deposits of a government institution and a new telecommunication company. In the absence of such one-off developments, the level of inflows remained lower in Jul-Jan FY06.¹²

6.1.2 Financial Account

The financial account balance witnessed a surplus of US\$ 2.5 billion during Jul-Jan FY06 compared to the US\$ 0.3 billion deficit during Jul-Jan FY05.¹³

The major contribution to this improvement of US\$ 2.8 billion in the financial account came from rising FDI and portfolio investment. In addition, rising trade loans along with higher inflows of private loans added to the surplus in the financial account.

Table 6.6: Adjusted Financial Account Balance (Jul-Jan)
million US\$

	FY05	FY06	Change
Financial account balance	-295	2,529	2,824
<u>One-off flows</u>	<u>595</u>	-	-
Debt write-off	495	-	-
PARCO loans	100	-	-
Adjusted balance	300	2529	2,229

Source: Statistics Department, SBP

Net Foreign Investment (NFI)

The net foreign investment recorded a substantial YoY rise of US\$ 399 million during Jul-Jan FY06. A significant share of this increase was contributed by rising FDI flows. Further, the country experienced a substantial rise of US\$ 308 million in the equity part of the portfolio investment during Jul-Jan FY06 over Jul-Jan FY05, approximately 67.5 percent of which was from the USA.

¹² The monthly analysis shows that the month of December showed a divergence from the preceding months, as some inflows of one-off nature were witnessed during this period. These included inflows into the deposits of a government agency and of a foreign bank.

¹³ Financial outflows during Jul-Jan FY05 included non-structural outflows, such as (1) notional outflows as a result of debt write off; and (2) repayment of PARCO loans. After excluding these outflows, net financial account shows a surplus of US\$ 0.3 billion during Jul-Jan FY05 (see **Table 6.6**).

Table 6.7: Financial Account

million US\$

	FY04	FY05	Jul-Jan		Change FY06 over FY05
			FY05	FY06	
Financial account (1 through 4)	-1335	446	-295	2529	2824
1. Direct investment abroad	-45	-66	-34	-18	16
2. Direct investment in Pakistan	951	1525	515	1226	711
<i>of which: Equity capital</i>	763	1211	333	913	580
Reinvested earning	183	314	182	313	131
3. Portfolio investment	314	620	638	310	-328
<i>of which: (Stock markets)</i>	-28	151	92	400	308
<i>Special US Dollar bonds</i>	-137	-130	-56	-96	-40
<i>Euro bonds</i>	496	596	598	0	-598
<u>Net foreign investment</u>	1220	2079	1119	1518	399
4. Other investment	-2555	-1633	-1414	1011	2425
Assets	-670	-1352	-1096	385	1481
<i>i. Outstanding exports bills (exporters)</i>	-335	-248	-132	-173	-41
<i>ii. Outstanding exports bills (DMBs)</i>	-120	-149	-21	62	83
<i>iii. Currency & deposits</i>	-215	-955	-943	496	1439
<i>of which :Bank</i>	-100	-837	-901	453	1354
Liabilities	-1885	-281	-318	626	944
<i>i. Foreign Long-term loans / credits (net)</i>	-1449	458	531	345	-186
<i>of which :Project assistance</i>	434	591	374	337	-37
Food aid	0	0	0	0	0
Non-food aid	536	1301	1162	592	-570
Amortization	2419	1434	1005	584	-421
<i>ii. Private loans</i>	-109	-351	-234	-22	212
<i>of which: Suppliers credits/MNCs</i>	503	20	12	167	155
Supplier Credits Repayments	612	371	246	189	-57
<i>iii. ST Capital, (official)</i>	-317	147	18	-61	-79
<i>of which: Commercial banks (net)</i>	-133	-116	-116	-116	0
IDB (net)	-184	263	134	55	-79
<i>iv. Currency & deposits</i>	-26	-302	-408	354	762
<i>of which: Trade financing</i>	-210.2	-356.0	-531.4	672.4	1204
<i>v. Other liabilities</i>	16	-233	-225	10	235

Source: Statistics Department, SBP

Note= LT: Long-term, DMBs: Deposit Money Banks, ST: Short-term.

Foreign Direct Investment

FDI flows recorded a substantial rise of US\$ 711 million to reach US\$ 1,226 million during Jul-Jan FY06. Even after adjusting the KESC privatization proceeds amounting to US\$ 255 million, the FDI flows demonstrate a substantial rise of US\$ 456 million (see **Table 6.8**).

Table 6.8: Adjusted FDI Flows

	million US\$			
		Jul-Jan		
	FY04	FY05	FY05	FY06
FDI	949.4	1524	515	1,226
Privatization proceeds	199	363	0	255
Adjusted FDI	750.4	1161	515	971

Source: Statistics Department, SBP

Further breakup of these flows reflects that a large share of this increase came from rising investment in equity capital, the bulk of which was in the sectors of telecommunication; financial business services, oil and gas exploration, power and trade. Encouragingly, the country has been witnessing a gradual rise in the FDI flows in recent years. While there

Table 6.9: Countries' Share in Global FDI Inflows

	percent			
	2001	2002	2003	2004
Singapore	1.71	0.81	1.47	2.48
India	0.41	0.48	0.67	0.82
Malaysia	0.07	0.45	0.39	0.71
Thailand	0.47	0.13	0.31	0.16
Bangladesh	0.01	0.01	0.04	0.07
Sri Lanka	0.02	0.03	0.04	0.04
Pakistan	0.05	0.11	0.08	0.15

Source: World Investment Report 2005

has been some improvement in the investment climate of the country, much remains to be done in order to deepen these flows sustainably (see **Box 6.2**). It must be noted that despite the gradual rise in foreign investment, Pakistan still receives a meager share (less than one percent) of the global FDI flows. A comparison with some other countries of the region shows that Pakistan's share in the global FDI flows, though rising, is still less than the other large countries (see **Table 6.9**).

Outstanding Export Bills (OEBs)

The outstanding export bills held by exporters increased by US\$ 173 million during Jul-Jan FY06 as compared to the US\$ 132 million rise of Jul-Jan FY05. This rise is attributable to high volume of exports during Jul-Jan FY06. On the other hand, the OEBs held by banks recorded a fall of US\$ 62 million during this period due to higher realization (see **Figure 6.9**).

Box 6.2: Investment Climate in Pakistan

According to the Ease of Doing Business Index 2006, published by the World Bank, the investment climate in Pakistan is better than that in many regional competitors, e.g. India and Bangladesh. The Index incorporates two types of indicators: (1) measures of actual regulations—for example, the number of procedures to register a business; and (2) measures of regulatory outcomes, such as the time and cost to register a business, enforcement of a contract, or bankruptcy related procedure. The methodology is based on detailed assessments of laws and regulations, and surveys of in-country government officials, lawyers, legal consultants, and other professionals. Survey results show that doing business in Pakistan is relatively easy (see **Table B6.2**).

Table B6.2: Ease of Doing Business in Pakistan

	Pakistan	India	Bangladesh		Pakistan	India	Bangladesh
Starting a business				Protecting investors			
Procedures (number)	11	11	8	Extent of disclosure index (0-10)	6	7	6
Time (days)	24	71	35	Extent of director liability index (0-10)	6	4	7
Cost (% of income per capita)	18.6	62	81.4	Ease of shareholders suits index (0-10)	7	7	7
Dealing with licenses				Strength of investor protection index (0-10)			
Procedures (number)	12	20	13	Paying taxes			
Time (days)	218	270	185	Payments (number)	32	59	17
Cost (% of income per capita)	1170.7	678.5	291	Time (hours per year)	560	264	640
Hiring and firing workers				Total tax payable (% of gross profit)			
Difficulty of hiring index (0-100)	67	56	11	Trading across borders			
Rigidity of hours index (0-100)	40	40	40	Documents for exports (number)	8	10	7
Difficulty of firing index (0-100)	30	90	20	Signatures for exports (number)	10	22	15
Rigidity of employment index (0-100)	46	62	24	Time for export (days)	33	36	35
Hiring cost (% of salary)	12	12	0	Documents for import (number)	12	15	16
Firing cost (weeks of salary)	90	79	47	Signatures for imports (number)	15	27	38
Registering property				Time for import (days)			
Procedures (number)	5	6	11	Enforcing contracts			
Time (days)	49	67	363	Procedures (number)	46	40	29
Cost (% of income per capita)	3.2	8.9	11	Time (days)	395	425	365
Getting credit				Cost (% of income per capita)			
Strength of legal right index (0-10)	4	5	7	Closing a business			
Depth of credit information index (0-6)	4	2	2	Time (years)	3	10	4
Public registry coverage (% of adults)	0.3	0	0.4	Cost (% of estate)	4	9	8
Private bureau coverage (% of adults)	0.9	1.7	0	Recovery rate (cents on the dollar)	44.3	12.8	24.2

Source: Doing Business in 2005; International Finance Corporation, World Bank.

Currency and Deposits

Currency and deposit assets recorded a US\$ 496 million fall during Jul-Jan FY06, compared to a US\$ 943 million rise observed in Jul-Jan FY05. The fall was caused by a slowdown in fresh FCA inflows together with the large expansion in trade financing.

Foreign Long-term Loans

Official long term loans recorded a lower inflow of US\$ 345 million during Jul-Jan FY06 as compared to the US\$ 1,038 million inflow in Jul-Jan FY05 (see **Table 6.10**).¹⁴ Lower inflows of program loans from both ADB and the World Bank were responsible for this fall in the net inflows. These flows would have been even lower, were it not for earthquake related disbursement of US\$ 200 million & US\$ 84.4 million by IDA and ADB respectively.¹⁵

Private/Short-term Loans

Private loans inflows remained higher during Jul-Jan FY06, recording a US\$ 155 million rise during this period. Most of these inflows were directed to the transport, storage and communication sectors. The short term loans inflows on the other hand remained lower during this period due to low disbursement of IDB financing for oil imports.

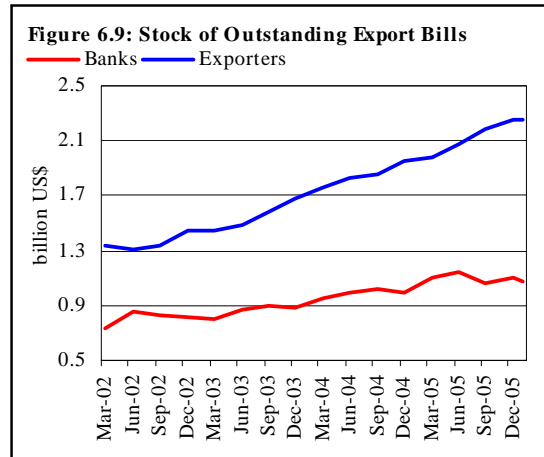


Table 6.10: Adjusted Official LT Loans (Jul-Jan)
million US\$

	FY05	FY06
Receipts	1548	929
Amortization	510	584
Net inflows	1038	345

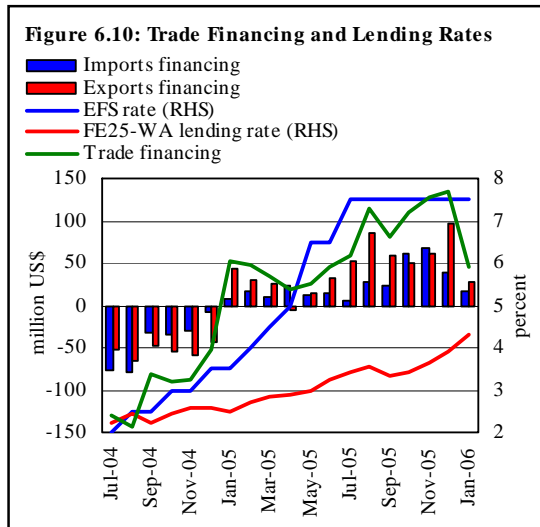
Source: Statistics Department, SBP

¹⁴ The net inflow during Jul-Jan FY05 is adjusted for the US\$ 495 million debt write off during that period.

¹⁵ The ADB has pledged a sum of US\$ 1 billion as earthquake assistance. Out of this amount, US\$ 80 million will be disbursed as grant and the remaining will be in the form of loans.

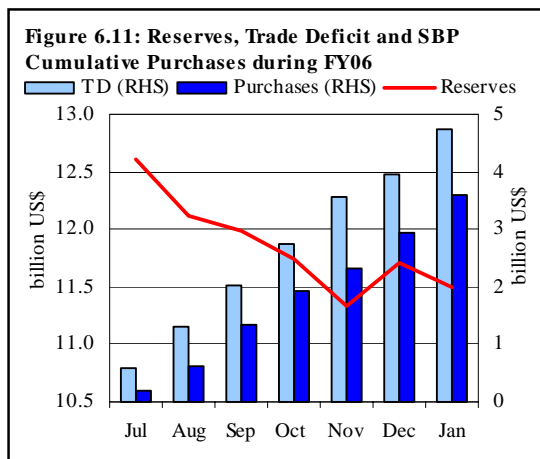
FE-25 Related Trade Financing

The trade financing against FE-25 deposits recorded a substantial rise of US\$ 672 million against the net retirement of US\$ 531.4 million in the same period last year (see **Figure 6.10**). As a matter of fact, during Jul-Jan FY05 due to the expectations of a substantial depreciation of the rupee, there was a net retirement of trade loans. However, during Jul-Jan FY06 both due to a stable rupee as well as the widened gap between EFS and FE-25 weighted average lending rates, the loans against FE-25 deposits remained more attractive for exporters.¹⁶



Foreign Exchange Reserves

While Pakistan's trade account balance deteriorated sharply by US\$ 2.2 billion during Jul-Jan FY06 and the central bank continued to provide liquidity for key commodity imports with net sales of US\$ 1.5 billion during this period, SBP's reserves fell no more than by US\$ 746.7 million during Jul-Jan FY06. Adding to this a US\$ 369 million fall in commercial banks' reserves, the Pakistan's total foreign exchange reserves showed a decline of US\$ 1,114.7 million during Jul-Jan of FY06 to reach US\$ 11,502.2 million by end January 2006 (see **Figure 6.11**).



¹⁶ A large share of the trade loans is for financing exports.

million US\$	Q1 FY05	Q2 FY05	Q3 FY05	Q4 FY05	FY 05	Q1 FY06	Q2 FY06	Jul- Dec FY 05	
Opening Balance	12,389	12,458	12,141	12,855	12,389	12,621	12,061	12,621	12,389
Inflows	7,386	8,191	8,441	8,538	32,556	8,760	9,632	18,392	15,577
Exports of goods	3,393	3,553	3,751	3,785	14,482	3,870	4,043	7,913	6,946
Export of services	865	812	788	854	3,319	1,074	930	2,004	1,677
Of which logistic support	280	168	202	181	831	474	282	756	448
Income	58	59	79	241	437	142	194	336	117
Workers' Remittances	983	963	1,104	1,118	4,168	1,002	1,053	2,055	1,946
Foreign Direct Investment	159	252	246	444	1,101	321	515	836	411
Foreign Portfolio Investment	21	38	48	44	151	145	214	359	59
Euro / Sukuk Bond	0	0	600	0	600	0	0	0	0
Loan Disbursements	828	745	526	339	2,438	737	565	1,302	1,573
<i>Official</i>	<i>818</i>	<i>743</i>	<i>518</i>	<i>339</i>	<i>2,418</i>	<i>570</i>	<i>565</i>	<i>1,135</i>	<i>1,561</i>
Long-term loans	721	743	381	302	2,147	407	559	966	1,464
Program loans	596	521	300	139	1,556	246	346	592	1,117
IMF	255	0	0	0	255	0	0	0	255
IDA/IBRD	310	115	300	0	725	96	200	296	425
AsDB	31	406	0	139	576	150	146	296	437
Project & food loans	125	222	81	163	591	161	213	374	347
Short-term including IDB	97	0	137	37	271	163	6	169	97
Private un-guaranteed	10	2	8	0	20	167	0	167	12
Privatization proceeds	0	0	103	260	363	0	255	255	0
Official grants	32	60	64	235	391	38	155	193	92
Other receipts	1,047	1,709	1,132	1,218	5,106	1,431	1,708	3,139	2,756
Outflows	7,317	8,508	7,727	8,772	32,324	9,320	9,986	19,306	15,825
Imports of goods	4,175	5,047	4,801	4,973	18,996	5,899	5,978	11,877	9,222
Imports of services (excl. interest)	1,449	1,669	1,764	1,730	6,612	1,931	2,051	3,982	3,118
Interest payments	225	281	152	379	1,037	258	371	629	506
Amortization of official loans	362	365	259	353	1,339	345	303	648	727
IMF	108	139	68	85	400	48	42	90	247
IDA/IBRD	124	86	134	92	436	127	78	205	210
AsDB	41	80	50	71	242	46	58	104	121
Others actual paid	89	60	7	105	261	124	125	249	149
Profit and Dividends	164	246	139	287	836	234	317	551	410
Purchase of crude oil /Gas	195	225	258	272	950	231	269	500	420
Principal repaid on private loans	103	70	111	88	372	94	69	163	173
Foreign exchange liabilities liquidated	27	50	27	50	154	115	51	166	77
PTMA & comm.. loans-actual paid	0	16	0	0	16	0	16	16	16
IDB (Short Term)	0	8	0	0	8	97	0	97	8
Special US\$ bonds	27	26	27	50	130	18	35	53	53
Other Payments	617	555	216	640	2,028	213	577	790	1,172
Gross reserves at end of period	12,458	12,141	12,855	12,621	12,621	12,061	11,707	11,707	12,141
CRR	587	637	645	682	682	680	713	713	637
Sinking fund	235	0	0	200	200	45	0	0	0
Net reserves of SBP	10,079	9,182	10,062	9,805	9,805	9,504	9,226	9,226	9,182
DMB Reserves without sinking fund & includes CRR	2,144	2,959	2,793	2,616	2,616	2,512	2,481	2,481	2,959

Source: Statistics Department, SBP

A further analysis of factors causing changes in SBP's reserves during Jul-Jan FY06 period suggests the presence of substantial non-structural inflows such as receipts from logistic support, privatization proceeds, cash grants etc. Further, the loan disbursements were lower during Jul-Jan FY06 compared to the corresponding period last year.

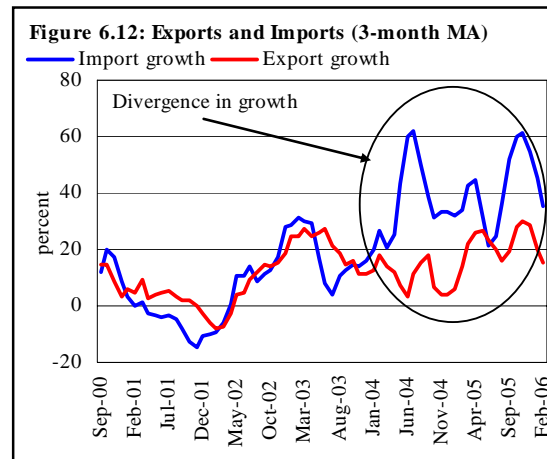
Indeed, even as the SBP continued support for oil payments and some other commodities, it was also able to purchase foreign currency from the market. This led to a net injection of US\$ 1.5 billion during Jul-Jan FY06, translating into net average monthly sales of US\$ 207.9 million during the period, as compared to net average sales of US\$ 277.4 million during corresponding period of FY05.

SBP reserves also benefited from inflows of US\$ 2,580 million from donor agencies, logistic support and privatization during Jul-Jan FY06. Encouragingly, most of the total inflows are non-debt creating in nature. Such inflows include US\$ 756.1 million as logistic support from the US and US \$ 455.0 million in privatization proceeds.

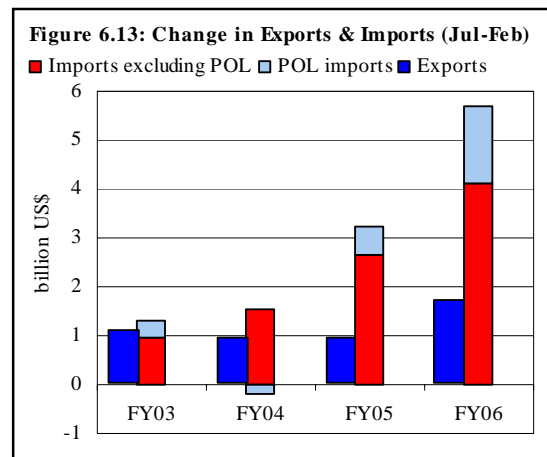
6.2 Trade Account¹

The divergence between the growth rates of exports and imports that emerged in the second half of FY04, continued in FY06 as well (see **Figure 6.12**).

Specifically, during the Jul-Feb FY06 period, the extraordinary 46.3 percent YoY growth in imports outpaced the strong export growth of 19.7 percent (on YoY basis). As a result, the trade deficit continued to widen sharply, touching US\$ 7.4 billion compared to US\$ 3.5 in the corresponding period last year.



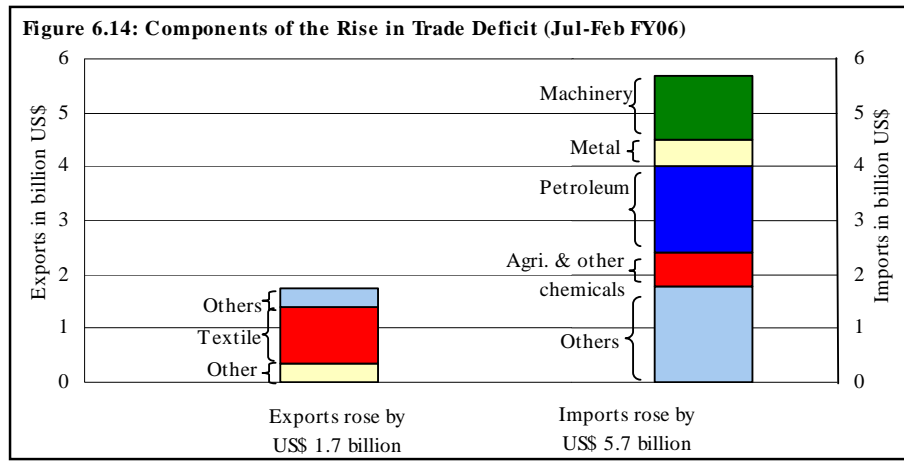
The exceptionally strong growth in the trade deficit during FY05 and FY06 has led to demands for corrective policy actions, and the focus has often been on the need to compress imports. However, the growth in the imports cannot be easily contained. The available data suggests that much of the growth in imports comprises of either machinery or input for industries, curtailing which would result in a significant fall in economic activities.



As seen in **Figure 6.13**, approximately 28 percent of the July-Feb FY06 growth in imports is due to the higher POL import bill, and even this owes mainly to rising international prices.²

¹ The discussion in this section is based on customs data provided by the Federal Bureau of Statistics (FBS) which differs from trade numbers compiled by SBP (see Special section 1 for details).

Similarly, another substantial portion of the growth in imports during the period is due to a rise in machinery imports, most of which is catering to the economy's rising demand to increase production as well as productive capacity and to improve infrastructure. Imports of agricultural & chemical group, metal group and food group also increased sharply but their contribution in overall imports is relatively small (see **Figure 6.14**).



It has been argued that the domestic economic growth has also stoked the import demand for some consumer durables as well, particularly of cell phone, personal cars, TV, refrigerator etc. However, this is not necessarily a negative development, provided that the larger part of the demand is contributed by domestic industry.³ Indeed, the strong growth in domestic consumption has been a major boost to domestic manufacturing, with consequent positive impacts on employment and income levels.

6.2.1 Exports

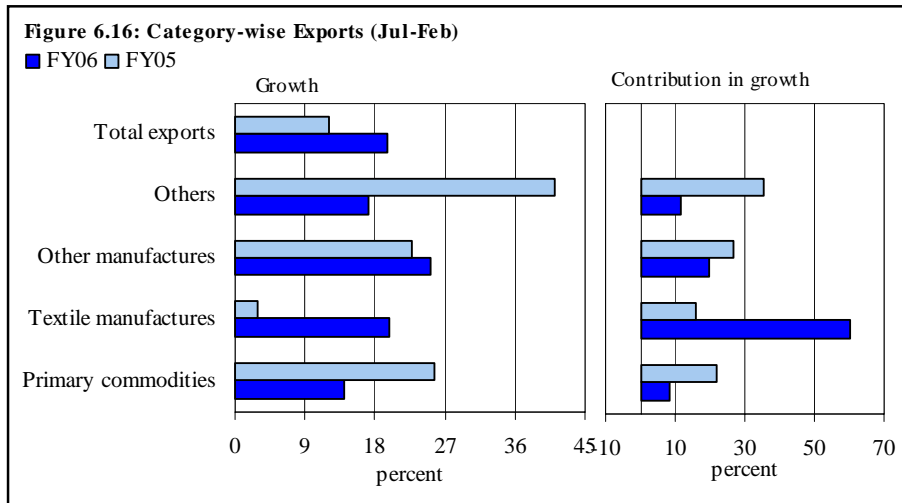
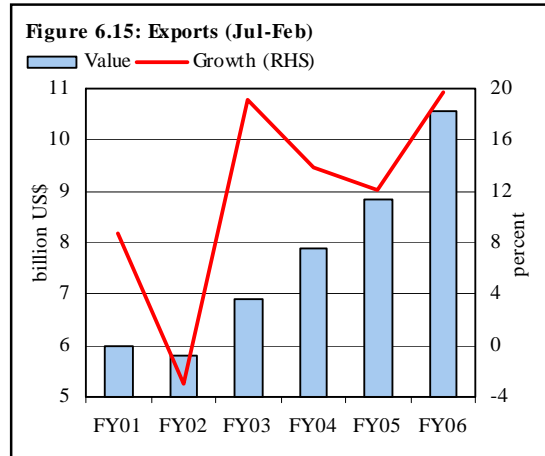
Overall exports posted a remarkable growth of 19.7 percent YoY during Jul-Feb FY06, substantially higher than the 12.1 percent YoY export growth in the corresponding period of last year (see **Figure 6.15**). In fact, in absolute terms, the rise in exports during Jul-Feb FY06 was only slightly lower than the combined

² The POL imports during Jul-Feb FY06 increased by US\$ 1.6 billion (66.1 percent) on YoY basis, which was mainly due to higher oil prices in the international market as import quantum of POL increased only marginally during this period.

³ Moreover, the detailed FBS data available for up to October 2005, shows that the share of cell phone, personal cars, gold, TV, telephone sets, refrigerator, air conditioners and video camera in total imports was only 5.7 percent during Jul-Oct FY06 compared to 3.2 percent during corresponding period last year.

increase in exports realized during the corresponding period of the previous two years.⁴

Moreover, this impressive export performance was realized despite negative developments in exports to the EU market, including continuation of antidumping duty on the bed linen exports, the loss of preferential access under GSP and the significant appreciation of the rupee against Euro. As customary, textile exports contributed over 60 percent of the export growth followed by *other manufactures* and *primary commodities* (see **Figure 6.16** & **Table 6.12**).

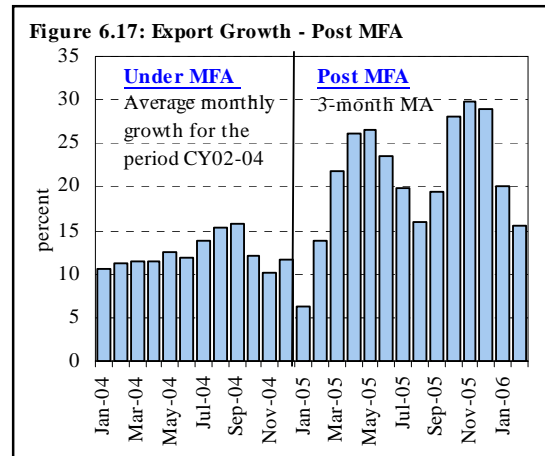


The performance of textile exports during the post MFA regime is particularly remarkable. As evident from **Figure 6.17**, the monthly export growth during the

⁴ Exports increased by US\$ 960.8 million and US\$ 954.6 million during Jul-Feb periods of FY04 and FY05 respectively.

period after the complete phase out of the MFA has been considerably higher than the average growth realized in the corresponding month during the previous 3 years.

Specifically, the average monthly export growth has been 21.1 percent during post-MFA period (i.e., Jan 2005-Feb 2006) against monthly average growth of 10.3 percent during CY02-04.



Part of the explanation probably lies in the slower textile export growth during corresponding months of FY05 amidst uncertainty due to the scheduled removal of global textile quotas under MFA from January 2005 and onward. This suggests that the growth in textile exports could see a relative slowdown in the months ahead.

Primary Commodities

The primary commodities witnessed growth of 14.1 percent YoY during Jul-Feb FY06 as compared to 25.7 percent YoY growth in the corresponding period of FY05. The major contributors to the growth in primary commodity exports were *rice* and *fish & fish preparations*, but the impact of strong exports in these categories was partially offset by the fall in raw cotton exports.

The rice export performance was remarkable, rising by 41 percent YoY during the period, against the 24.8 percent YoY growth realized during the corresponding period last year. This substantial increase was mainly driven by higher export quantum as well as an increase in unit values.⁵

Similarly, the increase in unit values and quantum enabled the *fish and fish preparation* to register 27.8 percent YoY growth during the period as compared to negative growth of 11.7 percent in the corresponding period of last year.

⁵ The rice crop recorded production of 5 million ton during the current year.

Table 6.12: Major Exports (Jul-Feb)

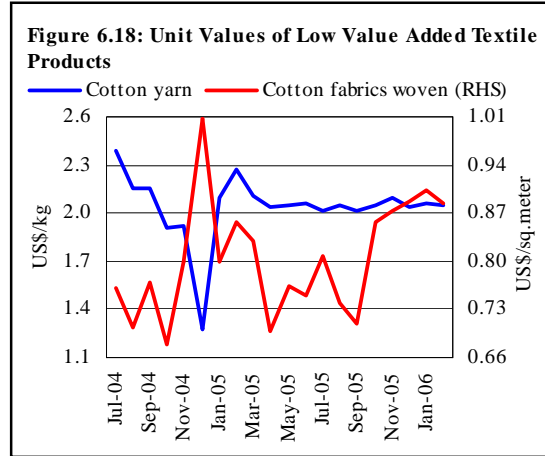
Value: million US\$; Unit value: US\$

	Unit	FY05		FY06		Abs chg. In value	% change in Jul-Feb FY06/ Jul-Feb FY05		
		Value	Unit value	Value	Unit value		Qty	Value	Unit value
A. Primary commodities		1024.1		1168.9		144.8		14.1	
1 Rice	MT	503.9	337.9	710.7	402.7	206.8	18.3	41.0	19.2
2 Raw cotton	MT	89.3	938.8	48.1	1019.1	-41.2	-50.4	-46.2	8.6
3 Raw wool (excluding wool tops)	MT	0.5	1593.4	0.4	1371.3	-0.1	0.0	-13.9	-13.9
4 Fish & fish preparations	MT	92.2	1497.9	117.9	1663.5	25.6	15.1	27.8	11.1
5 Leather	SQM	198.3	16.3	169.0	16.7	-29.4	-17.1	-14.8	2.8
6 Guar and guar products	MT	17.8	1198.5	7.6	1124.9	-10.2	-54.6	-57.4	-6.1
7 Fruits	MT	68.8	314.6	78.3	367.9	9.5	-2.7	13.8	16.9
8 Vegetables	MT	23.0	302.1	20.0	338.7	-3.0	-22.4	-13.0	12.1
9 Crude animal material	MT	11.2	3570.3	6.5	4283.2	-4.7	-51.6	-41.9	20.0
10 Oil seeds & nuts etc.	MT	18.9	784.0	10.4	711.8	-8.6	-39.6	-45.2	-9.2
B. Textile manufactures		5285.1		6334.9		1049.7		19.9	
12 Cotton yarn	MT	654.8	1926.8	844.4	2036.4	189.6	22.0	29.0	5.7
13 Cotton fabrics (woven)	SQM	1151.7	0.8	1374.0	0.8	222.3	17.0	19.3	2.0
14 Hosiery (knitwear)	DOZ	1099.1	24.2	1120.5	23.3	21.4	5.7	1.9	-3.5
15 Bed ware	MT	802.6	5436.2	1330.1	5512.9	527.5	63.4	65.7	1.4
16 Towels	MT	324.7	3734.4	365.9	3675.5	41.2	14.5	12.7	-1.6
17 Cotton bags and sacks	MT	8.8	4066.4	4.4	4120.3	-4.4	-50.6	-49.9	1.3
18 Readymade garments	DOZ	655.1	31.8	872.3	35.9	217.2	17.8	33.1	13.1
19 Tarpaulin & other canvas goods	MT	45.2	2600.2	12.9	2254.5	-32.3	-67.0	-71.4	-13.3
20 Tule, lace, embroidery etc.	(-)	8.4	---	3.2	---	-5.2	---	-61.8	---
21 Synthetic textiles	SQM	207.5	0.7	128.3	0.8	-79.2	-43.1	-38.2	8.6
22 Other textile made up	(-)	320.8	---	274.7	---	-46.0	---	-14.4	---
23 Waste material of textile fibers/fabrics	MT	6.4	616.1	4.2	948.5	-2.3	-57.9	-35.2	54.0
C. Other manufactures		1370.8		1714.9		344.2		25.1	
24 Carpets, carpeting rugs & mats	SQM	171.9	59.2	176.9	61.1	5.0	-0.2	2.9	3.1
25 Petroleum and products	MT	264.4	367.8	453.1	486.1	188.6	29.7	71.3	32.2
26 Sports goods	(-)	178.8	---	193.7	---	14.9	---	8.3	---
27 Leather manufactures	(-)	330.5	---	484.0	---	153.6	---	46.5	---
28 Surgical & medical instruments	NO	117.6	---	104.4	---	-13.1	---	-11.2	---
29 Cutlery	GR	20.2	18.5	22.6	44.8	2.5	-53.7	12.2	142.4
30 Onyx manufactured	MT	5.4	1701.4	8.0	1634.2	2.6	54.1	48.0	-3.9
31 Chemicals and pharmaceuticals	(-)	222.8	---	244.7	---	21.9	---	9.8	---
32 Molasses	MT	49.1	56.9	17.9	44.8	-31.2	-53.8	-63.6	-21.2
33 Sugar	MT	10.1	285.7	9.5	386.5	-0.6	-30.3	-5.7	35.3
Others		1155.9	---	1354.6	---	198.8	---	17.2	
Total exports		8835.9		10573.4		1737.5		19.7	

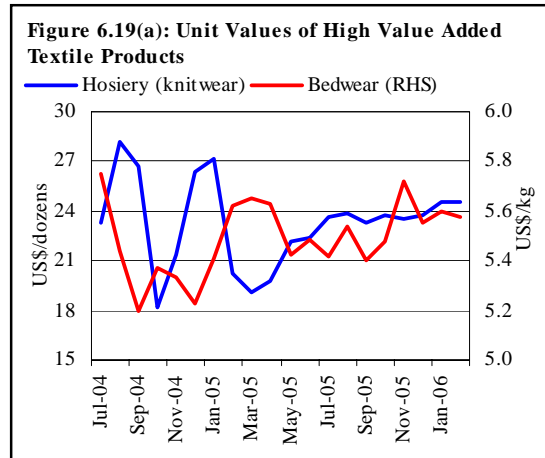
Source: Federal Bureau of Statistics

Textile Manufactures

Exports of textile manufactures grew by 19.9 percent YoY during Jul-Feb FY06 as compared to the negligible growth of 3 percent during the corresponding period last year. A low base effect together with the relatively stable prices of most of the textile products in the international market led to remarkable textile export growth rates during the period under review. In this regard, the key contribution came from bedware, readymade garments, cotton fabrics and cotton yarn.

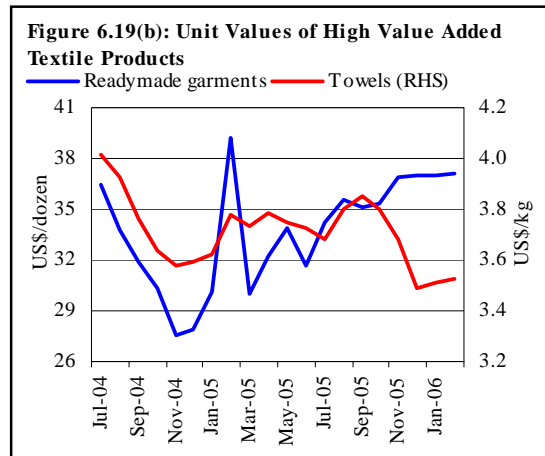


The low value-added textile products recorded remarkable 22.8 percent YoY growth during Jul-Feb FY06 as compared to nominal growth of 3.3 percent in the corresponding period of last year. Within this category, cotton yarn and cotton fabrics witnessed 29 percent YoY and 19.3 percent YoY growth respectively during Jul-Feb FY06 as compared to growth rates of minus 5.4 percent YoY and 9.1 percent YoY in the corresponding period of the previous year. Encouragingly, this increase was contributed by a rise in both, the unit values and quantities (see Figure 6.18).



The impact of rising unit values and low base effect of the previous year was also visible within high value added textile product (see Figure 6.19(a)). For example, the bed ware exports registered 65.7 percent YoY growth during Jul-Feb FY06 as compared to a decline of 9 percent YoY in the corresponding period of the previous year (subsequent to the imposition of the antidumping duty on bed ware

export to EU). The improved performance during FY06 suggests that Pakistan has been able to withstand the adverse impact of anti dumping duty through market diversification. The expected reduction in the antidumping duty on bed ware exports from Pakistan from 13.1 percent to 5.8 percent expected to be enforced from mid-April, 2006 is likely to have positive impact on exports.



Likewise, the export of *readymade garments* witnessed YoY growth of 33.1 percent during Jul-Feb FY06 against a decline of 0.1 percent YoY in Jul-Feb FY05 (see **Figure 6.19(b)**). The 6 percent subsidy to the sector might have given additional support to the readymade garments export.⁶

However some of the value added textile exports experienced decline in unit values as well as high base effect. For example, *towels* export increased by 12.7 percent during Jul-Feb FY06 as compared to impressive growth of 34 in the corresponding period of last year. The knit wear exports on the other hand registered a nominal growth of 1.9 percent during the period in comparison to 19.8 percent growth in same period last year.

Textile Sector under post-MFA regime

An analysis of Pakistan’s textile exports in the US market one year after the complete phase-out of the MFA provides some interesting insights.

In overall terms, Pakistan’s textile export growth to the US did not experience any major change in its trend. In fact, despite a marginal slow down in export growth (from 13.9 percent in CY04 to 13.4 percent during CY05), Pakistan’s share in US market expanded slightly to 3.2 percent in CY05 against 3.0 percent during CY04 (see **Table 6.13**). In comparison, China was the major beneficiary of the post-

⁶ The government is providing research and development support to the textile garment units manufacturing and exporting textile garments to EU and USA subject to certain conditions. This support is applicable to shipment made on or after April 12th 2005.

MFA regime as its textile exports to US increased by 42.8 percent during CY05 as compared to 22.7 percent growth during the corresponding period of last year. Moreover, its share in the US market has increased to 27.6 percent from 20.6 percent a year earlier.

Table 6.13: Textile Imports in USA

	million US\$			% YOY Growth	
	CY05	CY04	CY03	CY05	CY04
Pakistan	3,230.8	2,850.2	2,503.4	13.4	13.9
<i>% Share</i>	3.2	3.0	2.9		
China	27,750.2	19,437.2	15,846.0	42.8	22.7
<i>% Share</i>	27.6	20.6	18.1		
Bangladesh	2,658.9	2,244.9	2,094.8	18.4	7.2
<i>% Share</i>	2.6	2.4	2.4		
Sri Lanka	1,804.8	1,701.4	1,594.0	6.1	6.7
<i>% Share</i>	1.8	1.8	1.8		
India	5,518.4	4,417.5	3,912.1	24.9	12.9
<i>% Share</i>	5.5	4.7	4.5		
Vietnam	2,971.5	2,819.5	2,591.8	5.4	8.8
<i>% Share</i>	3.0	3.0	3.0		
Thailand	2,281.6	2,316.6	2,160.6	-1.5	7.2
<i>% Share</i>	2.3	2.5	2.5		
Total US Textile Imports	100,531.1	94,388.9	87,372.9	6.5	8.0

Source: US Census Bureau

The growth of Indian textile exports to the US market almost doubled to 24.9 percent during CY05 from 12.9 percent during CY04. As a result, India's textile exports succeeded in increasing their market share in US from 4.7 percent during CY04 to 5.5 percent during CY05.

Detailed analysis suggests that Pakistan was successful in increasing its share in the textile mill products (middle value added range) whereas its share in the high value added products of apparel and accessories remained unchanged. On the other hand, the textile and fabric exports witnessed negative growth, with a consequent fall in market share (see **Table 6.14**).

China on the other hand increased its share in the US market, in all the categories, ranging from value added to high value added products. However, the increase was more pronounced in case of high value added products. Finally, while, India was able to increase its share in the high value added product, its share in the low value added product and middle value added product remained unchanged.

A further analysis of Pakistan’s textile exports to the US indicates that except non-woven fabrics all the other items depicted negative growth in the low value added products (see **Table 6.15**). However, all the items in the middle value added range witnessed positive growth. The major contribution in textile mill products came from other household textile product and textile sacks and bags. The high value added items showed mix trend.

The analysis suggests that Pakistan has been successful in increasing its share in the middle value added product and maintaining its share in the high value added products. However, the low value added products seems to be uncompetitive as Pakistan has lost its market share to India and China.

Table 6.14: Category Wise Textile Imports of the US

	Amount (million US\$)			% YOY Growth	
	CY05	CY04	CY03	CY05	CY04
Pakistan					
Textiles and Fabrics	438	536	440	-18	22
<i>% Share</i>	6	7	6		
Textile Mill Products	1,347	991	862	36	15
<i>% Share</i>	9	8	8		
Apparel and Accessories	1,446	1,323	1,201	9	10
<i>% Share</i>	2	2	2		
China					
Textiles and Fabrics	1,061	725	582	46	25
<i>% Share</i>	13	9	8		
Textile Mill Products	6,195	4,828	3,626	28	33
<i>% Share</i>	43	38	34		
Apparel and Accessories	20,494	13,884	11,638	48	19
<i>% Share</i>	26	19	17		
India					
Textiles and Fabrics	321	283	266	13	6
<i>% Share</i>	4	4	4		
Textile Mill Products	1,812	1,582	1,324	15	19
<i>% Share</i>	13	13	13		
Apparel and Accessories	3,385	2,553	2,322	33	10
<i>% Share</i>	4	3	3		

Source: US Census Bureau

	million US\$		%
	FY05	FY04	YOY Growth
313-Textile and fabrics			
Nonwoven fabrics	0.0	0.0	38
Narrow fabrics	0.3	0.4	-11
Knit fabrics and lace	2.1	3.2	-34
Yarns	122.1	137.9	-11
Broad woven fabrics	310.2	390.8	-21
Coated fabrics	2.8	3.9	-29
314-Textile mill product			
Ropes, cordage, and twine	0.9	0.9	3
Textile sacks and bags	1.8	0.8	123
Other household textile products	1116.9	786.1	42
Carpets and rugs	129.6	114.9	13
All other miscellaneous textile products	40.1	35.6	13
Curtains and draperies	57.5	51.7	11
Canvas and related products	0.5	0.7	
315-Apparel and accessories			
Women's and girls' other outerwear	136.2	93.7	45
Men's and boys' trousers, slacks, and jeans	122.6	98.6	24
Gloves & mittens	51.0	42.4	20
Men's and boys' suits, coats, and overcoats	3.2	2.7	18
Hosiery and Socks	85.6	76.8	11
Men's and boys' shirts (except work shirt)	576.9	523.2	10
Women's and girls' suits, coats, tailored jackets, and skirts	41.0	38.2	8
Men's and boys' underwear and nightwear	58.3	54.6	7
Women's and girls' lingerie, loungewear, and nightwear	61.0	59.5	3
Men's and boys' other outerwear	125.2	128.3	-2
Women's and girls' blouses and shirts	105.4	109.9	-4
Infants' apparel	6.1	6.5	-7
Fur and leather apparel	43.6	50.1	-13
Other apparel accessories	13.8	16.3	-15
Men's & boys neckwear	0.0	0.0	-17
Women's and girls' dresses	14.8	19.9	-25
Hats and cap	1.1	2.4	-54

Source: US Census Bureau

Textile Exports to the EU Market

Pakistan’s textile export to the EU market in the post-MFA regime showed relatively unsatisfactory performance as compared to its major competitors. Specifically Pakistan’s textile share in the EU market contracted from 1.98 percent in CY04 to 1.67 percent during Jan-Nov CY05. In contrast, export share of China rose from 11.36 to 15.41 percent making her the largest share holder in the EU market; similarly the export share of India increased from 3.59 percent to 4.0 percent during period under review (see **Table 6.16**).

The detailed analysis shows that Pakistan gained market share in some of the low value added or middle value added products (see **Table 6.17**). Within this category, the increase in the share of cotton yarn and cotton cloth was more significant. The loss in market share is more visible in higher value added products, particularly made up textile articles (e.g. bedware) followed by apparel articles and accessories (readymade garments and knit wears).

China expanded its share in the EU market in almost all the categories ranging from low value added to high value added products. However, market gains for China are more concentrated in higher value added products. The India however posted mix trend under post MFA regime. The gains in market share for India were limited in exports of low value-added textile products, whereas in the high value added products (bedware in particular) India succeeded in increasing its market share in almost all the categories. Conversely, Bangladesh lost its market share in the EU market in both the low value added and high value added products.

Table 6.16: Percentage Share of Selected Countries Exports in EU-25 Total Textile Imports

	CY03	CY04	Jan-Nov 05
Bangladesh	2.56	2.93	2.64
China	10.57	11.36	15.41
Egypt	0.62	0.60	0.56
Indonesia	1.61	1.45	1.24
India	3.58	3.59	4.00
Iran	0.17	0.16	0.13
South Korea	1.46	1.31	0.99
Sri Lanka	0.59	0.64	0.59
Myanmar	0.24	0.28	0.14
Mexico	0.08	0.08	0.08
Malaysia	0.39	0.36	0.34
Philippines	0.27	0.29	0.18
Pakistan	1.87	1.98	1.67
Thailand	0.98	0.94	0.85
Turkey	15.07	15.06	14.86
Total EU	100.0	100.00	100.00

Table 6.17: Category- wise Share of Major Textile Exporters to EU Market.

percent	Pakistan			China			India			Bangladesh		
		Jan-			Jan-			Jan-		Jan-		
Pakistan	CY03	CY04	Nov-05	CY03	CY04	Nov-05	CY03	CY04	Nov-05	CY03	CY04	Nov-05
Cotton	7.1	8.4	10.3	5.9	5.9	9.3	10.6	11.3	12.4	0.2	0.2	0.1
Veg Text Fib;Veg Fib & Paper Yns	0.0	0.0	0.1	11.3	12.6	31.3	16.5	14.0	13.7	12.1	10.9	10.3
Man Made Filaments	1.2	1.3	1.2	20.7	22.5	20.4	3.6	3.5	4.0	0.0	0.0	0.0
Man Made Staple Fibers	6.0	6.4	5.1	4.2	5.0	7.0	4.2	4.4	3.5	0.0	0.0	0.0
Wadding, felt and non woven; special yarn	0.2	0.1	0.1	3.4	4.4	6.1	0.6	0.6	0.7	0.0	0.0	0.0
Carpets and other textile floor coverings	3.8	4.0	3.7	5.1	5.5	6.3	14.9	15.6	16.0	0.0	0.0	0.0
Special Woven Fabrics	0.5	0.4	0.6	14.8	16.7	21.9	4.1	4.6	5.2	0.0	0.0	0.0
Impregnated etc textile fabrics and textile articles for industrial use	0.1	0.1	0.2	2.5	3.8	6.0	1.0	1.0	1.1	0.0	0.0	0.0
Knitted or croacheted Fabrics	0.1	0.1	0.1	3.5	5.4	8.3	2.0	2.1	1.2	0.0	0.0	0.0
Apparel articles and accessories knitted or croacheted	0.8	1.0	0.7	8.9	9.6	14.2	2.6	2.8	3.1	4.3	4.9	4.5
Apparel articles and accessories not-knitted or croacheted	0.9	0.9	0.7	12.3	13.1	17.5	2.5	2.3	2.9	2.5	2.8	2.3
Other made up textile articles	7.6	7.3	6.2	12.2	13.6	17.8	6.3	6.5	7.3	0.9	1.3	1.3

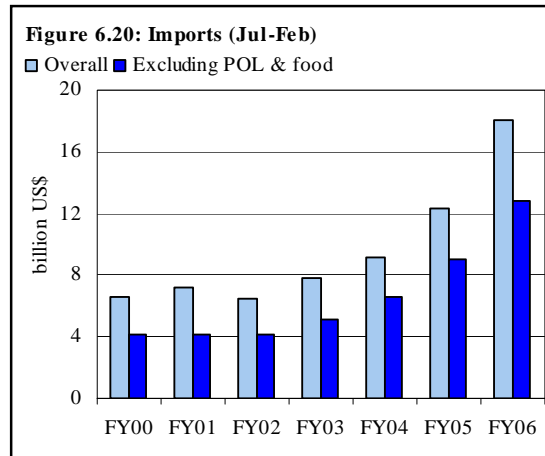
Other Manufactures

Exports of *Other manufactures* performed well during Jul-Feb FY06, rising by 25.1 percent YoY during Jul-Feb FY06, as compared to a 22.7 percent YoY rise during the same period last year. The major contributor in this section were petroleum & petroleum products and leather manufactures, which recorded growths of 71.3 percent YoY and 46.5 percent YoY growth respectively during the period under consideration.

6.2.2 Imports

The overall imports rose sharply by 46.3 percent YoY during Jul-Feb FY06 as against 35.4 percent YoY in the corresponding period of previous year. The strong contribution to the increase was from the persistent rise in international oil prices as well as the need to improve the domestic supplies of essential food items. However, even excluding POL and food, imports still showed a strong growth of 43 percent YoY during Jul-Feb F06 compared to 37 percent YoY in Jul-Feb FY05 (see **Figure 6.20**).

The petroleum group imports rose by 66.1 percent YoY during Jul-Feb FY06 as compared to 30.2 percent YoY increase in the corresponding period of FY05. The rise in POL imports stemmed mainly from rising prices (contributing 98 percent of the rise in the petroleum imports). In comparison, the increase in petroleum imports during the corresponding year was contributed by both price (63 percent) and quantity (37 percent).



The government efforts to improve the supply of food items, particularly sugar, also contributed to the inflated import bill. Specifically, the imports of sugar and wheat contributed 79 percent of the total YoY growth in food imports during Jul-Feb FY06.

As far as the non-oil non-food imports are concerned, there has been some criticism on the manner in which these imports are classified. In particular, some

concerns have been raised about the composition of import of capital goods as this category also includes cellular phones, personal cars, TV, refrigerator, etc. As long as these imports are being used in the production of goods & services and increasing jobs, there is no harm in classifying such imports under capital goods. However, a sharp increase in imports of these goods does raise concerns on the quality of capital goods imports. In order to address these concerns, it would be necessary to determine their weightage in overall imports.

Table 6.18: Imports Economic Category-wise

Economic Category	Import share (customs record)			Import share (exchange record)		
	Jul-Oct-FY05	Jul-Oct-FY06	% share in growth	Jul-JanFY05	Jul-JanFY06	% share in growth
Consumer goods	10.2	10.9	13.2	12	12	13
Raw material for consumer goods	52.0	48.3	38.6	48	49	51
Raw material for capital goods	7.9	7.9	7.9	9	8	6
Capital goods	29.9	32.9	42.0	31	31	30
Total imports	100.0	100.0	100.0	100	100	100
Capital goods (adjusted)*	26.8	27.1	28.1	26	26	23

Source: Federal Bureau of Statistics and State Bank of Pakistan

*Adjusted for cellular phones, gold, small cars, telephones sets, television & refrigerators, video cameras and window/wall type ACs

Unfortunately further analysis is hampered by the considerable time lags in the availability of detailed information on imports; as of February 2006, the Federal Bureau of Statistics (FBS) has released detailed data up to October 2005 only.

In order to address these data limitations, we have used

imports based on exchange record which is available up to January 2006.⁷ As evident from **Table 6.18 & 6.19**, the share of various economic categories in overall imports during Jul-Jan FY06 follows the similar trends that were observed during Jul-Oct FY06 period in the custom record data.

Table 6.19: Some of the Imports Included in Capital Goods

million US\$	SBP		FBS	
	Jul-Jan FY05	Jul-Jan FY06	Jul-Oct FY05	Jul-Oct FY06
Cellular phones	186.7	303.6	53	193
Gold (monetary & non-monetary)	0.0	0.0	0	108
Vehicles personal usage	262.7	357.2	101	188
Televisions & refrigerators	35.7	26.9	12	10
Telephone sets	23.3	25.2	5.0	0.3
Others (window/wall type ACs and video cameras)	-	-	11.1	9.8
Total	508.5	715.7	182	510

⁷ For discussion on the difference between custom record and exchange record data, see **Special Section 1**.

A detailed analysis of capital good imports confirms that this category includes some durables items, but their share is very small, i.e., capital goods imports adjusted for selected durables still enjoy 27.1 percent share in total imports during Jul-Oct FY06, up by 0.3 percentage points over the corresponding period of last year. More importantly, these adjusted capital goods still contribute around 28.1 percent of the increase in total imports. Thus, the share of cellular phones or personal cars in total imports is not very significant. Further, it should be noted that the sharp growth in these durables may be treated as an outcome of a structural change following the opening up of these sectors.⁸ In this case, we may expect that the imports of cell phone and personal cars would adjust to new levels once the economic agents absorb the impact of policy change in these sectors. In fact, as discussed earlier, there are fair chances that any exchange rate adjustment to counter these imports may prove ineffective (see **Box 6.3**).

Food Group

The food group recorded YoY growth of 39.7 percent during Jul-Feb FY06 as against 25.7 percent growth in the corresponding period last year (see **Table 6.20**). The sugar import to bridge the domestic consumption and production gap contributed almost 66.5 percent in the growth of total food group imports. The other major imports were the wheat, pulses and palm oil contributing 12.4 percent, 12 percent and 6 percent in the food imports respectively. As a result the food group contribution in total import growth has increased to 6 percent during Jul-Feb FY06 from 5 percent in the same period of last year.

⁸ One can even argue on the logic of excluding *all* cellular phones or personal cars from the capital goods category as some of the cell phone might have been used in the business activity.

Box 6.3: Disaggregated Import Elasticities for Pakistan⁹

While sufficient evidence is available suggesting that overall imports are generally insensitive to price and exchange rate changes in Pakistan, little attention has been paid on understanding how the disaggregated imports respond to changes in relative prices, exchange rate and income. In order to analyze the response of disaggregated imports to various policy changes, we have estimated disaggregated real import demand functions with following specifications:

$$\begin{aligned} \text{Capital imports} &= f(\text{ER}_t, \text{RP}_t, \text{IMP}_t) && \text{(A)} \\ \text{Raw material imports} &= f(\text{ER}_t, \text{RP}_t, Y_t) && \text{(B)} \\ \text{Consumer imports} &= f(\text{ER}_t, \text{RP}_t, Y_t) && \text{(C)} \end{aligned}$$

Where ER is nominal exchange rate, RP is relative prices defined as the ratio of USA GDP deflator/Pakistan GDP deflator, IMP is the index of manufacturing production used as a proxy to income and Y is real GDP.¹⁰ It is expected that the higher domestic economic activity (represented by GDP) would lead to higher imports demand. However, the higher relative prices would discourage imports. Finally the exchange rate depreciation would increase the price of imports in domestic currency and thus decrease the import demand.¹¹

The estimation results are reported in **Table B6.3**. As expected, the exchange rate and relative prices have negative influence for both capital and industrial raw materials. However, for consumer imports the impact of exchange rate and relative prices changes are positive with statistical significance. These results can be justified as the imports of consumer goods consist of essential items that are insensitive to the exchange rate devaluation and increase in relative prices level.

Finally, it may be pertinent to note here, a one percent depreciation of the exchange rate would decrease the imports of capital goods in a range of 2.2 to 1.5 percent, which is much higher in magnitude compared to raw materials estimates.

On the other hand, the consumer imports have exchange rate elasticities mostly between +0.71 and +0.64 percent. Thus, the result shows that the imports of capital and industrial raw materials are relatively more elastic to exchange rate devaluation than consumer imports. These regression results are robust for different samples and reflect a range of relevant policy variables.

Table B6.3: Import Elasticities

	Ranges	
	Upper	lower
Log of capital imports		
Log of exchange rate	-2.20	-1.50
Log of relative prices	-1.70	-1.10
Log of IMP	+1.11	+0.97
Log of raw material imports		
Log of exchange rate	-0.72	-0.69
Log of relative prices	-0.88	-0.85
Log of GDP	+1.16	+1.14
Log of consumer imports		
Log of exchange rate	+0.71	+0.64
Log of relative prices	+0.88	+0.70
Log of GDP	+0.87	+0.84

⁹ Based on provisional results of the forthcoming SBP working paper by Sadia Badar, Analyst, Research Department.

¹⁰ In economic literatures, relative price of imports is defined as the index of the unit values of imports in domestic currency/GDP deflator. However, due to high multicollinearity between nominal exchange rate and unit values of imports in domestic currency, it is suggested to use unit values index of world prices as a proxy variable. Finally, the above regression estimates the imports demand function by using USA export prices index as well as the USA GDP deflator as a proxy to unit values index of imports in domestic currency.

¹¹ All these variables are in log form and the data span covered is 1973-2005.

Table 6.20: Major Imports (Jul-Feb)

Value: million US\$; unit value: US\$

Commodities	Units	FY05		FY06		Abs chg. In value	% chg in Jul-Feb FY06/Jul-Feb FY05		
		Value	Unit Value	Value	Unit Value		Qty	Value	Unit value
A. Food group		843.0	---	1,177.7	---	334.7	---	39.7	---
1. Milk & cream	MT	19.9	1,946.5	32.7	2,653.2	12.8	20.4	64.2	36.3
2. Wheat un-milled	MT	53.0	204.9	94.6	176.7	41.6	-	-	-
3. Dry fruits	MT	24.8	682.7	35.8	513.1	11.0	91.8	44.2	-24.8
4. Tea	MT	147.6	1,672.5	152.8	1,659.3	5.2	4.3	3.5	-0.8
5. Spices	MT	34.0	824.3	35.0	677.2	1.0	25.2	2.8	-17.9
6. Edible oil	MT	488.3	487.5	489.3	476.3	1.0	2.5	0.2	-2.3
<i>Soya bean</i>	MT	29.4	971.1	10.6	719.3	-18.8	-51.4	-64.0	-25.9
<i>Palm oil</i>	MT	458.8	472.4	478.7	472.8	19.8	4.2	4.3	0.1
7. Sugar	MT	2.1	312.8	224.7	348.2	222.5	9306.9	10370.6	11.3
8. Pulses	MT	73.2	308.0	112.9	383.7	39.7	23.8	54.3	24.6
B. Machinery group		---	3379.2	---	4572.0	---	1192.9	---	35.3
1. Power generating	---	240.3	---	348.0	---	107.7	---	44.8	---
2. Office machinery	---	168.5	---	171.9	---	3.4	---	2.0	---
3. Textile	---	616.3	---	585.2	---	(31.2)	---	(5.1)	---
4. Construction & mining	---	96.9	---	101.5	---	4.6	---	4.7	---
5. Electrical machinery & apparatus	---	209.4	---	304.6	---	95.3	---	45.5	---
6. Railway vehicles	---	37.1	---	37.5	---	0.4	---	1.1	---
7. Road motor vehicles	---	591.2	---	851.5	---	260.3	---	44.0	---
8. Aircraft, ships and boats	---	128.1	---	72.8	---	(55.3)	---	(43.2)	---
9. Agricul machinery & implements	---	35.5	---	81.0	---	45.5	---	128.1	---
10. Other	---	1255.9	---	2,018.0	---	762.1	---	60.7	---
C. Petroleum group	MT	2415.6	263.7	4012.1	432.6	1596.5	1.2	66.1	64.0
1. Petroleum products	MT	1013.9	272.2	1550.4	455.9	536.5	-8.7	52.9	67.5
2. Petroleum crude	MT	1401.7	257.9	2,461.7	419.0	1,060.0	8.1	75.6	62.5
D. Textile group	MT	212.5	---	359.5	---	147.0	---	69.2	---
1. Synthetic fiber	MT	98.5	1828.0	166.7	1745.5	68.2	77.2	69.2	-4.5
2. Synthetic & artificial silk yarn	MT	87.8	1818.0	160.8	1,843.0	73.0	80.6	83.1	1.4
3. Worn clothing	MT	26.1	321.9	31.9	343.4	5.8	14.6	22.2	6.7
E. Agri and other chemicals	MT	2302.6	---	2924.4	---	621.8	---	27.0	---
1. Fertilizer	MT	258.0	239.7	457.3	283.4	199.3	49.9	77.3	18.2
2. Insecticides	MT	102.7	3453.8	85.1	3471.5	-17.6	-17.5	-17.1	0.5
3. Plastic materials	MT	493.0	1133.0	678.7	1,264.0	185.6	23.4	37.7	11.6
4. Medicinal products	MT	178.6	24917.7	213.5	32,446.5	34.8	-8.2	19.5	30.2
5. Others	---	1270.3	---	1,489.9	---	219.6	---	17.3	---
F. Metal group	MT	726.0	---	1226.6	---	500.6	---	69.0	---
1. Iron and Steel Scrap	MT	133.1	205.8	241.1	269.5	108.0	38.4	81.2	30.9
2. Iron and Steel	MT	529.7	457.1	910.2	562.6	380.6	39.6	71.8	23.1
3. Aluminum wrought & Worked	--	63.3	---	75.3	---	12.0	---	19.0	---
G. Miscellaneous group		297.3	---	377.4	---	80.1	---	26.9	---
1. Rubber crude	MT	57.2	1077.5	69.5	1180.5	12.3	11.0	21.6	9.6
2. Rubber tyres & tubes	No.	86.4	26.3	104.9	26.4	18.6	21.4	21.5	0.1
3. Wood & cork	---	18.4	---	23.8	---	5.3	---	29.0	---
4. Jute	MT	21.0	301.8	28.4	357.0	7.5	14.6	35.6	18.3
5. Paper/ paper board & manufac	MT	114.4	634.4	150.8	721.4	36.4	15.9	31.8	13.7
H. Others		2134.7	---	3358.3	---	1223.6	---	57.3	---
Total imports:		12310.9		18008.0		5697.1		46.3	

Source: Federal Bureau of Statistics

Machinery Group

The machinery group imports depicted relatively lower growth of 35.3 percent YoY during Jul-Feb FY06 as compared to the extraordinary growth of 56 percent YoY in the corresponding period of FY05. As a result, its share in the total imports growth has decreased from 37.5 percent during Jul-Feb FY05 to 21 percent in Jul-Feb FY06. The deceleration in import growth of machinery was mainly driven by decline in import of power generating machinery coupled with nominal growth in the import of textile machinery (see **Table 6.21**).

Table 6.21: Analysis of Machinery Group (Jul-Feb)

	FY05		FY06	
	%YoY Growth	% Share	%YoY Growth	% Share
Machinery group	56	100.0	35	100.0
Road motor vehicles	41	17.5	44	18.6
Textile machinery	68	18.2	-5	12.8
Power generating machinery	31	7.1	45	7.6
Office machinery	24	5.0	2	3.8
Electrical machinery & apparatus	35	6.2	46	6.7
Construction & mining machinery	59	2.9	5	2.2
Railway vehicles	-30	1.1	1	0.8
Aircraft, ships and boats	15	3.8	-43	1.6
Agricultural machinery & implements	96	1.1	128	1.8
Other machinery	88	37.2	61	44.1

Source: Federal Bureau of Statistics

However, road motor vehicles and electrical machinery and apparatus continued to depict strong import growth. Unlike the previous year when the group import was primarily driven by the textile machinery, construction machinery, road motor vehicles and other machinery, the machinery, import growth this year was mainly driven by other machinery, road motor vehicles and electrical machinery and apparatus.

Electrical Machinery and apparatus

The electrical machinery and apparatus imports depicted a robust growth of 46 percent YoY during Jul-Feb FY06 on the top of the 35 percent YoY growth in the corresponding period of last year. Consequently the category share in total machinery imports has increased to 6.7 percent from that of 6.2 percent in the corresponding period of last year. The major contributors in this group were discs for laser reading system, other electrical appliances such as switches, incorporated electronics, networking equipments and energy saving lamps.

Road Motor Vehicles

The import growth of road motor vehicles was 44.0 percent YoY during Jul-Feb FY06 as compared to 41 percent YoY growth in the same period of FY05. However according to information available up to October 2005, the share of the

vehicles which are directly contributing in generating the economic activity is almost 49.5 percent, while the share of seemingly unproductive or indirectly productive motor cars,¹² bicycles & other delivery tri cycles and baby carriages & parts thereof, are 50.5 percent (see **Table 6.22**). The rise in road motor vehicles imports may be attributed to higher demand on the back of auto leasing finance facility and duty free imports of used cars under gift scheme, transfer of residence scheme and personal luggage scheme.

Other Machinery

Other machinery observed substantial growth of 61 percent during Jul-Feb FY06 as against 88 percent growth in the previous year. Resultantly, the share of *other machinery* in the total machinery imports increased considerably to 44.1 percent during Jul-Jan FY06 from 37.2 percent in the corresponding period of last year. The major contributors in this group were telecom & sound recording equipments, general industrial machinery & equipments/ parts and metal working machinery. The transmission apparatus and cellular mobile phones has the dominant share in the telecom and sound recording equipment imports on the back of fast growing telecommunication industry in Pakistan and expanding bank credit to this sector.

Table 6.22: Analysis of Road Motor Vehicles

	% Share in total vehicles imports	
	Jul-Oct FY05	Jul-Oct FY06
Other tractors	2.07	8.01
Motor vehicles (10 persons or more)	6.01	3.61
Motor cars & other motor vehicles	47.75	50.35
Motor vehicles for transport goods	14.70	15.62
Special purpose motor vehicles	1.58	2.04
Parts/accessories motor vehicle	12.58	12.66
Work trucks, self-propelled, parts	0.16	0.16
Motor cycle, cycle fit auxil motor	6.99	3.41
Bicycles, other delivery tricycle	0.18	0.13
Invalid carriages motorized/mech	0.02	0.03
Part accessories vehicle	7.91	3.83
Baby carriages & parts thereof	0.01	0.04
Trailers & semi trailer, parts	0.06	0.10
	100.00	100.00

Source: Federal Bureau of Statistics

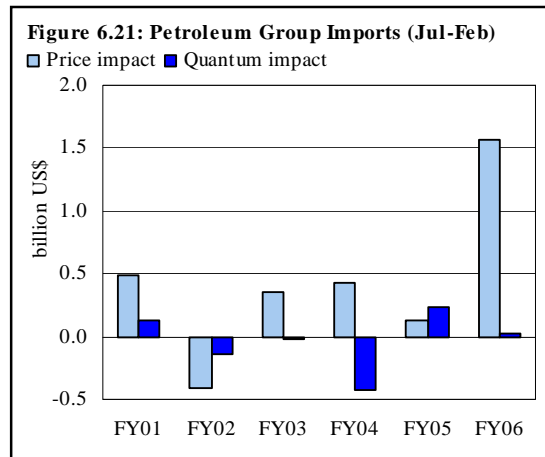
¹² The motor cars include the Completely Buildup Units and CKDs / SKDs. The import of CKDs and SKDs also helps in generating the economic activity.

Petroleum Group

Against a 30.2 percent YoY increase during Jul-Feb FY05, petroleum group imports increased by 66.1 percent during the corresponding period of FY06 mainly because of an increase in the international oil prices. Although the increase in petroleum product was mainly driven by the high global oil prices, the 75.6 percent YoY increase in the petroleum crude was contributed by both price (98 percent) and quantum (2 percent) impact. The analysis suggests that effects of increase in the international oil prices on the petroleum import bill depicted gradual increase since FY03. However, the price impact in Jul-Feb FY06 is the largest in absolute value term so far (see **Figure 6.21**).

Metal Group

The metal group imports witnessed a 69 percent YoY growth during the period under consideration against 71.1 percent YoY in the corresponding period of previous year. The iron & steel scraps and iron & steel were the major contributor in this group recording 81.2 percent and 71.8 percent import growth respectively. The demand for iron and steel scraps may have emerged from the low production of Pakistan Steel mill probably because of some technical fault and low ship breaking in Pakistan. Where as the increased demand for iron and steel may be attributed to higher growth of automobiles and consumer durables.



Other Imports

The significant increase in import of oil seeds & oleaginous fruits, gold (monetary & non-monetary), manufactures of metal, synthetic & regenerated fiber, professional, scientific & control and iron ores & concentrates pushed the other import to 57.3 percent during Jul-Feb FY06 as against 16.2 percent growth in the corresponding period of last year.

Special Section 1

Differences in the Trade Data – FBS & SBP

Recently, the difference in trade data reported by the FBS and the SBP has begun to widen significantly. While exchange record data shows a rise of US\$ 2.47 billion in trade deficit during Jul-Feb FY06 over Jul-Feb FY05, the deficit based on FBS data depicts an increase of US\$ 3.96 billion during the same period. The major reason for this difference is that while the FBS records data on the physical movement of goods; the trade figures compiled by SBP are based on the exchange record data depending on actual payments of foreign exchange.

In order to address the confusion generated by these differences, this section provides explanation for the variance between the two datasets.¹

Imports

The imports reported by banks are a mixed of ‘free on board’ (f.o.b.) and ‘cost, insurance & freight’ (c.i.f.) basis. In order to make these imports comparable with the FBS imports, the cost of freight and insurance is subtracted from both the SBP record and FBS import data.²

The variance between custom record and exchange record arises also due to difference in coverage. Specifically some of imports which are reported in the customs data are not included in imports reported by banks. Such imports are *added* to imports based on exchange record. For example,

- The non-repatriable investment (NRI) that consists of (a) small investments made by expatriate Pakistanis transporting machinery into the country that has been bought and paid for abroad; and (b) the purchases made from the *duty-free shops*
- The imports of wheat, sugar, urea and some other commodities done by TCP are added to the SBP imports under the title of unclassified imports.
- FEA (foreign economic assistance) is project-specific and materializes as physical transfer of development or investment goods, such as machinery, rather than a direct inflow of foreign exchange.

¹ It may be pointed out that this section draws heavily from the *Special Section 3 of Q1-FY01*.

² In the case of exchange record, actual value of freight and insurance reported by banks is subtracted from imports. However, since the information on freight and insurance is not available for FBS data, a fixed proportion of 9 percent is subtracted from the FBS imports as the cost of freight & insurance.

- Goods carried over Pakistan's borders from Afghanistan are classified as *land borne imports*, which do not directly enter the exchange record, as cash payments made in Rupees do not go through authorized dealers.
- The purchases of spare parts and other imports made by Pakistan International Airlines (PIA) and Pakistan National Shipping Corporation (PNSC) at foreign airports or seaport for which payments are made are also added in the SBP import numbers.

Table S1.1: Reconciliation of Imports Compiled by FBS & SBP

million US\$

FBS data			SBP data		
	Jul-Feb			Jul-Feb	
	FY05	FY06		FY05	FY06
FBS imports (c.i.f)	12,311	18,010	SBP imports (c.i.f)	12,007	15,444
Less freight & insurance	1,120	1,639	Less freight & insurance	960	1,236
FBS (adjusted)	11,191	16,371	SBP imports (adjusted)	11,047	14,209
			<i>Plus</i>	1,038	1,238
			a) Unclassified imports	338	484
			<i>of which wheat\sugar\urea</i>	212	228
			b) Imports NRI, sale of duty free shops	25	73
			c) Imports under foreign assistance	438	530
			d) Land borne imports with Afghanistan	16	44
			e) PIA & PNSC	104	54
			f) Imports through exchange companies	137	4
			g) Imports by EPZ	0	85
			h) Refund & rebate	-19	-36
FBS total imports	11,191	16,371	SBP total imports	12,085	15,446
Difference				894	-925

Source: Statistics Department, State Bank of Pakistan

- The value of imports for which forex is provided by the exchange companies and imports made by EPZ are also added in the SBP imports.

Finally the refunds and rebates made to importers are subtracted from the SBP imports.

Exports

In order to make export figures comparable, SBP figures are adjusted for freight and insurance, while FBS records are corrected for double counting (due to short shipments, cancellation, etc). *Short shipments* refer to customs-registered export shipments that are not shipped out in the total amounts recorded due to transport shortages, last-minute clearance issues, etc. In addition, FBS numbers must be adjusted for cancellations of registered export orders, as well as *ship stores*, which refers to export consignments that lie in warehouses after registration, due to unanticipated delays.

The SBP exports on the other hand are adjusted for the following factors:

- *Outstanding bills* are added to SBP fob numbers, comprising all unrealized exports for which there exist customs records but no currency inflows to date.
- *Crude oil* represents the percentage of oil extracted in Pakistan which, by agreement, belongs to the foreign investors drilling here and is transported out of the country upon extraction becoming a physical 'export' for which no foreign exchange is forthcoming.
- *Land-borne exports* are similar to the entry in imports and refer to exports made to Afghanistan.
- *Export credit* refers to one-time bilateral trade credit offered by GOP to certain countries. Another such transient item is *samples*, which are the samples given to prospective buyers by domestic exporters.
- Finally, the exports from EPZs are also added in the SBP data.

Despite these adjustments to rationalize the differences in FBS and SBP figures, discrepancies still exist. This is primarily on account of leads and lags in data. Discrepancies in exports also arise due to differences in valuations and commodity classification between SBP and FBS. Agency charges not remitted through ADs further interfere with SBP's tracking of export revenues. Efforts to harmonize classification differences between SBP & FBS are being made, while SBP is also trying to track agency charges more closely.

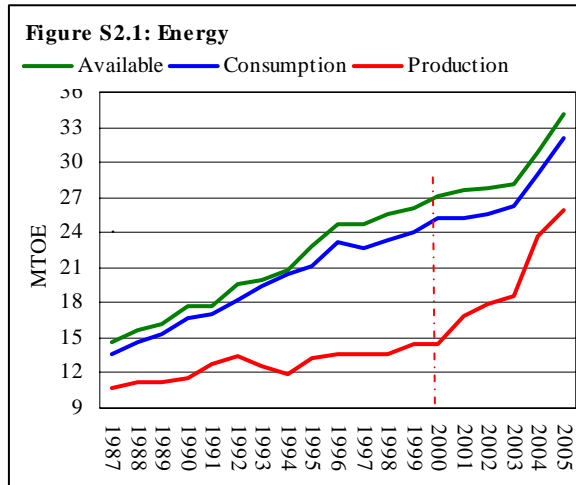
Table S1.2: Reconciliation of Exports Compiled by FBS & SBP					
million US\$					
FBS Data			SBP Data		
	Jul-Feb			Jul-Feb	
	FY05	FY06		FY05	FY06
FBS exports	8,836	10,578	SBP exports	9,037	9,753
			Less freight & insurance	315	335
			SBP exports (adjusted)	8,722	9,418
Less			Add	483	915
a) Shorts shipment	124	154.3	a) Outstanding export bills	181	170
b) Cancellation	50	42.3	b) Crude oil	0	0
c) Ship stores	0	0	c) Land borne exports	300	641
			d) Exports credit	-	-
			e) Export of sample	2	0
			f) Export by EPZ	0	104
FBS total exports	8,662	10,381	SBP total exports	9,205	10,333
Difference				543	-48

Source: Federal Bureau of Statistics

Special Section 2

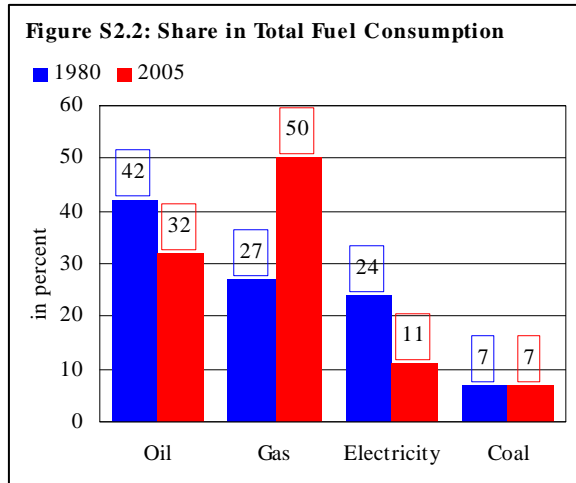
Dynamics of Energy Consumption

Pakistan has been facing severe imbalances in energy demand and supply for the last couple of decades. During early 1980s domestic supply of energy was fulfilling almost 86 percent of total domestic energy demand; a gap of 14 percent was being filled by imports. However, the demand – supply gap started increasing since then and reached to almost 47 percent by the year 2000 (see **Figure S2.1**).



The domestic supply position of energy, nevertheless, improved after 2000 and the gap shrank to 18 percent in 2005; this was mainly due to steady expansion in the supply of natural gas. Currently, the total supply of energy from all sources is about 34 MTOE (million ton oil equivalent) and total consumption is 32 MTOE.¹

Traditionally, oil has been the largest source of energy, but its share in total consumption has declined from 42 percent of the total consumption in 1980 to 32 percent in 2005 (see **Figure S2.2**). The share of electricity has also declined significantly in the total fuel consumption in the economy. Correspondingly, natural gas has become the most popular source of energy, almost doubling its share in fuel



¹ Total supply includes domestic production and imports excluding exports and feed stocks; the difference between total supply and consumption is line losses.

consumption during this period.

It is important to note that the pattern of energy consumption has changed over time in favour of natural gas primarily due to its enhanced availability² and upward changes in relative prices of other fuel sources, especially oil. **Figure S2.3** shows that the domestic oil price has been increasing faster relative to the gas price since early 1990s. The relative prices index of oil is 1:1.8; i.e per unit cost of oil was 1.8 times higher than that of gas during 2005.³ Resultantly, there has been a continuing shift from oil consumption to gas consumption.

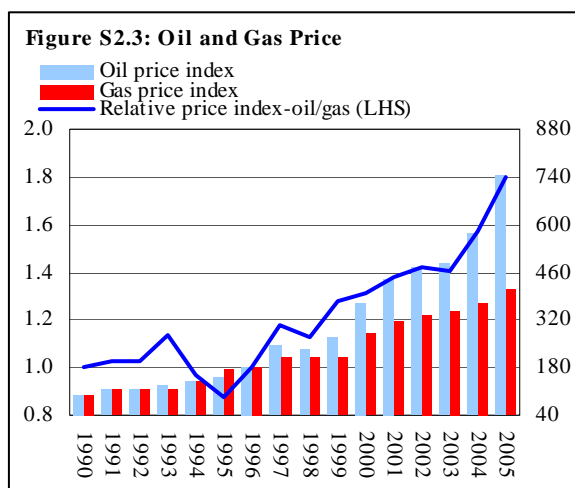


Table S2.1: Energy Distribution by Fuel Type (percent)

	1980's				1990's				2000's			
	Oil	Gas	Elect	Coal	Oil	Gas	Elect	Coal	Oil	Gas	Elect	Coal
Household	35.5	25.5	38.4	0.5	39.3	39.1	21.6	0.0	5.8	62.4	31.8	0.0
Agriculture	29.9	0.0	70.1	0.0	38.8	0.0	61.2	0.0	32.9	0.0	67.1	0.0
Industry	12.9	53.6	19.9	13.6	30.5	54.0	6.2	9.3	28.8	56.2	5.4	9.6
Services:	86.2	5.7	8.1	0.0	92.5	4.9	2.6	0.0	88.2	9.2	2.6	0.0
Transport	100.0	0.0	0.0	0.0	99.9	0.0	0.0	0.0	96.8	3.2	0.0	0.0
Commerce	3.0	40.2	56.9	0.0	7.8	61.0	31.2	0.0	0.0	71.3	28.7	0.0
Others/Govt.	66.1	0.0	33.3	0.6	65.2	0.0	34.8	0.0	51.9	0.0	48.1	0.0

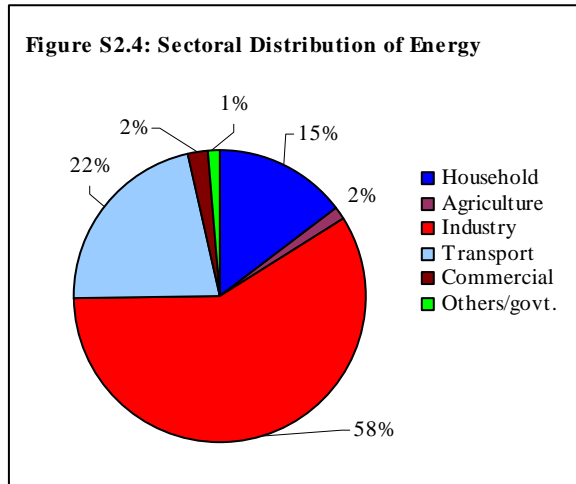
Besides changes in the overall energy mix in the economy, the composition of energy basket of different consumer groups has also changed over time. **Table S2.1** shows the share of different fuels in total usage of energy by consumers. The household sector that consumes 15 percent of the total energy consumption was deriving 35.5 percent of its energy needs from oil, 25.5 percent from gas and 38.4 percent from electricity in 1980s. This composition changed radically in the next two decades; the share of gas increased to 62.4 percent in total household energy consumption during 2000s and consequently the shares of oil and electricity

² During the period 1996-04, 50 new reserves of natural gas were discovered, ever high since 1950.

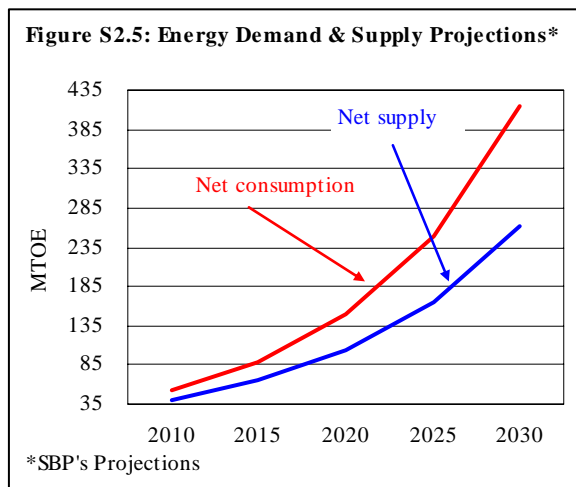
³ 1990 is the base year.

declined. The industrial and services sectors also altered their consumption mix of energy by reducing substantially the usage of electricity and increasing the gas consumption; however, unlike household sector, they increased their oil consumption as well.

Although there are significant changes in intra-sector pattern of energy consumption, the inter-sectoral distribution of energy has not changed much. The industrial sector is still the largest consumer of energy with 58 percent share followed by transport sector with a share of 22 percent (see **Figure S2.4**).



Going forward, if the current growth trend in the energy supply and demand continues then it is estimated that energy consumption in Pakistan would be about 150 MTOE and the net supply from indigenous sources would be 103 MTOE by the year 2020 (see **Figure S2.5**). Thus the country would be facing a shortage of 31 percent of energy in the foreseeable future which will seriously affect the balance of payment position of the country and would make it difficult for the economy to continue moving on the present growth trajectory.

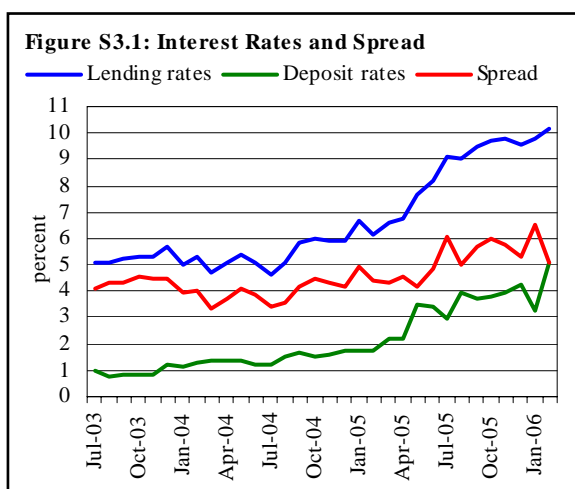


Thus it is very important to take concerted efforts for capacity building to increase the supply of energy from diversified sources; particularly the most neglected sources of energy, i.e. coal, need more attention of the policy makers.

Special Section 3

Interest Rates and Banking Spread

After remaining at historic low during FY03 and most of FY04, interest rates have been moving steadily upwards since the end of Q3-FY04. However, as the weighted average deposit rates were increasing at a relatively slower pace compared with the weighted average lending rates, the banking spread (measured as the difference between weighted average lending and



deposit rates) has been moving upwards throughout FY05 and FY06 (see **Figure S3.1**). This rise in spread is a source of concern for the policy makers since it is generally associated with deterioration in banking sector efficiency¹.

Usually, the banks are impelled to raise the spread in order to maintain the profitability when the intermediation expenses increase. This said, gone are the days in Pakistan, when the significant provisioning against the non-performing loans and the unfavorable tax structure in

Table S3.1: Earnings & Asset Quality Indicators

percent	2001	2002	2003	2004	Jun-05	Sep-05
NPLs to loan	23.4	21.8	17	11.6	10.6	10.5
Net NPLs to loan	12.1	9.9	6.9	3.6	3.0	2.7
ROA (after tax)	-0.5	0.1	1.1	1.2	1.4	1.7
NII/gross income	70.4	67.1	60.5	64	71.1	71.7
Cost/income	62.4	59.1	49.1	51.6	48.2	43.8

banking system used to increase the operating expenses and banks had to raise the spread to remain profitable. However, in the recent years, both, the asset quality and the profitability of the banks have improved significantly (see **Table S3.1**), and therefore, the current rise in the banking spread is rather intriguing and calls for identifying the causative factors.

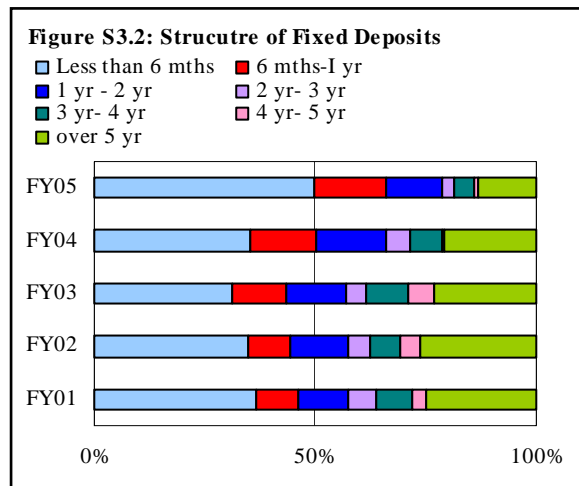
¹ However, it should be noted that in a market based mechanism, banks are allowed to determine the retail interest rates and the central bank does not direct banks for setting up a specific interest rate structure.

At the onset, it should be realized that the business of banking industry has undergone significant structural changes during the preceding three years. In particular, the nature of banks' lending and deposit taking activities has experienced a shift in terms of both, outreach and the diversification of banking services. New products have been introduced and a healthy competition among banking institutions has appeared that enabled customers to avail banking services at a more competitive rates. In this scenario, the dynamics of banking spread has also changed and therefore the rising spread may not necessarily be depicting the operating inefficiencies in the sector; rather it may be reflecting the shift in structure of deposits and advances portfolio.

Maturity Profile of Deposits

The structure of bank deposits, for instance, has changed significantly during FY05 compared with the preceding years. In particular, the maturity profile of bank deposits has shifted towards shorter tenure as the current and savings deposits registered a growth of 31.1 and 13.1 percent respectively during FY05².

Although, fixed/term deposits also witnessed a growth of 39.8 percent during FY05; but the fixed deposits with the maturity within six months registered a growth of 96 percent. As a result, the share of short term deposits (maturity within six months) in total fixed deposits has increased from 35.4 percent at end FY04 to 49.7 percent at end FY05 (see **Figure S3.2**).

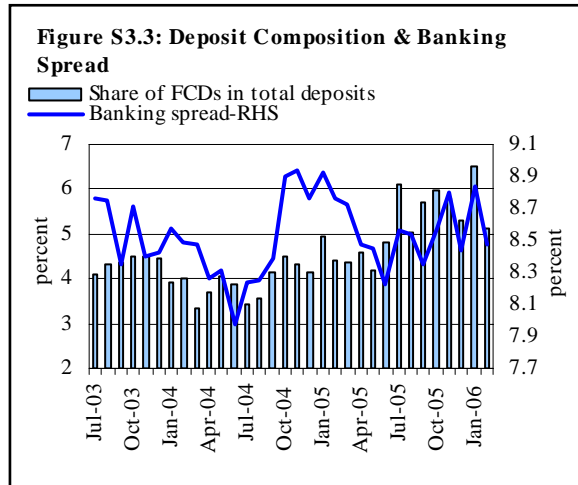


Currency Profile of Deposits

In addition to the deposit structure, the currency composition of deposit mobilization may also impact banking spread, since; the rate of return on deposits denominated in foreign currency (especially US dollar) is lower compared with those denominated in Rupee. **Figure S3.3** shows that the higher share of FCDs in total deposits tends to drag down the over all deposit rates.

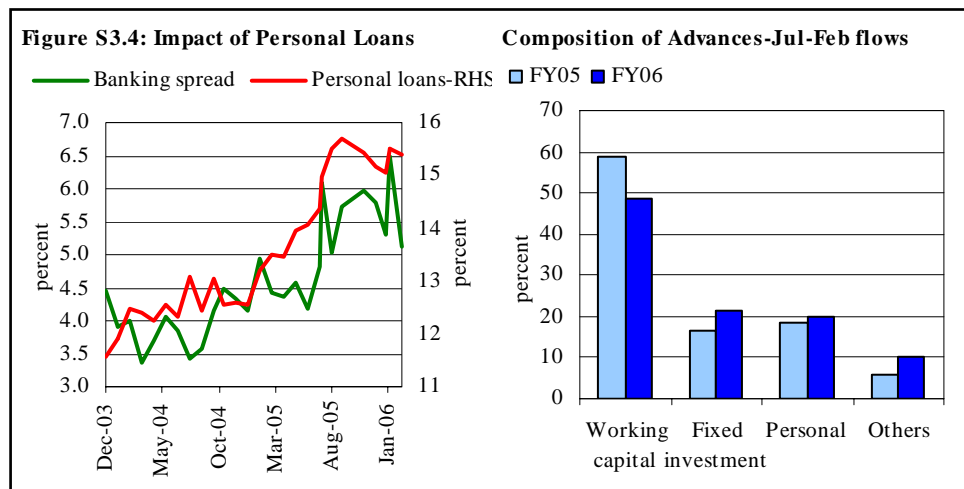
² This data has been taken from half-yearly accounts of banks. The data for end-December 2005 is not yet received

Although the divergence in the return offered on rupee deposit and foreign deposits is quite significant,³ the share of FCDs in total deposits has gone down from almost 34 percent in April 1998 to mere 8 percent by end-February 2005. As such FCDs presently do not create a significant impact on the overall weighted average deposit rates and banking spread.



Lending Profile

The structure of loan portfolio of the banks has also witnessed significant changes since FY02 in terms of clientele and the nature of loans. In particular, banks have been lending to new sectors like consumer and SMEs that are relatively riskier in nature (and in some cases have relatively longer maturities) and thus yield higher returns. Furthermore, the credit to corporate sector also witnessed a shift in structure in the form of rising share of fixed investment loans with relatively longer maturity compared with the working capital loans. As shown in **Figure**

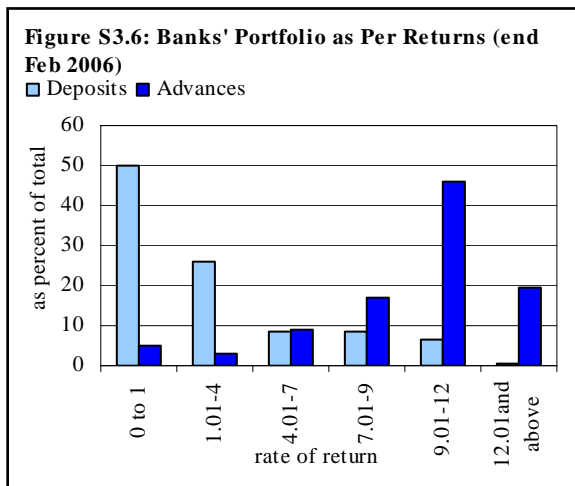
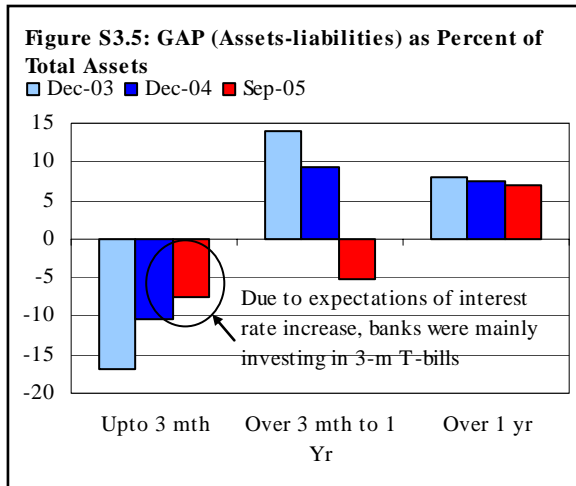


S3.4, the banking spread is moving in direction of the share of fixed investment loans in total advances and the share of consumer loans in total advances.

Impact of Product Mix

The new product mix with concentration of fresh deposits in shorter tenure and lending in longer tenure is also reflected in the banks' gap analysis (maturity gap is measured by the difference between assets and liabilities, adjusted by total assets). As shown in the **Figure S3.5**, the difference between assets and liabilities (as a percent of total assets) with maturity of over 3 months and between 3 months and a year is negative. Although, the gap has improved slightly for maturities up to 3 month (mainly due to banks' heavy investments in 3 month T-bills during Dec-04 to Sep-05); the gap for maturities between 3 month and a year has deteriorated significantly and has turned negative at end September 2005. In the longer-term basket, however, banks are operating with large positive gap as the assets of banks have longer maturities compared with their liabilities.

This contrast in the incremental advances and deposit profile has moved the distribution of returns in a



³ As of end- Feb the weighted average returns on foreign currency deposits was 1.62 percent against 5.35 percent offered on the rupee deposits.

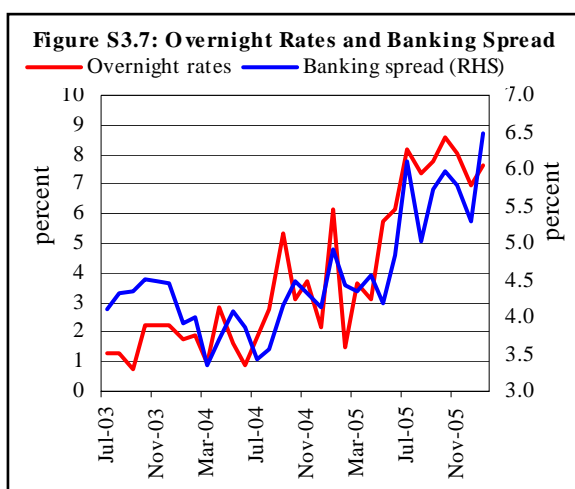
direction that is favorable to banking sector profitability⁴.

As shown in **Figure S3.6**, at end December 2005, 50.9 percent of the total bank deposits were placed at rate between 0 to 1 percent followed by 27.8 percent deposits placed at the rate between 1 to 4 percent. On the other hand, 44.5 percent of total bank advances were placed at the rate between 9 to 12 percent. This distribution of returns against deposits and advances is itself an indication of higher spread.

Impact of Inter-bank Lending

Another important determinant of the movements in banking spread has been the impact of the cost of interbank lending. Specifically, during July 2003, the interbank lending and deposit rates were also included in the weighted average lending and deposit rates. Further, it should be noted that throughout FY04 and most of FY05, the interbank money market remained fairly liquid as a result of which overnight lending rates were providing a downward stimulus to the banking spread⁵ (see **Figure S3.7**).

Contrarily, during the ending months of FY05 and throughout FY06, SBP has kept the inter bank market quite short of liquid. In addition, during April 2005, the discount rate was also increased from 7.5 to 9.0 percent and hence, the overnight lending rates were providing an upward stimulus to the banking spread. This can be seen from the fact that since July 2003, there has been a correlation of 0.84 in the movements of incremental spread and the overnight rates.



Price Rigidities in Deposit Rates

The above discussion fairly explains that the recent rise in banking spread is reflective of its structure and the change in the product mix of the banking

⁴ Although the difference in the nature of incremental advances and deposits is a serious question mark on the maturity and liquidity risk that the banks are undertaking.

⁵ The volume of interbank lending is quite substantial compared to the volume of interbank deposit.

industry. However, it is important to mention here that in a changing interest rate scenario, the interpretation of the trend in banking spread becomes all more complicated given the price rigidities in the banking products.

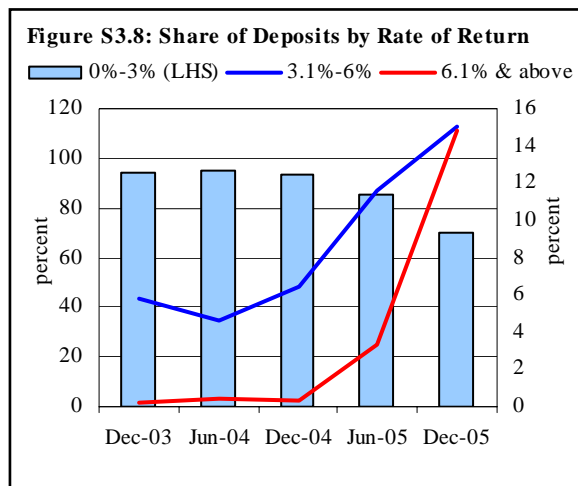
In particular, the rigidities in the retail deposit rates have been amply discussed in the economic literature (see **Box S3**). For instance, the findings of Hannan and Berger (1991) are that the deposit rates are significantly more rigid when the stimulus for a change is upward, rather than downward. In addition, there are a number of studies explaining the trend and pace of change in interest rates as a function of the market concentration and interest elasticity of deposit and advances (Neumark and Sharpe 1992). Similarly, there are findings that the spread tends to widen when interest rates rise and narrow when interest rates fall (Hutchison 1995). Here it is essential to recall that when in Pakistan the benchmark interest rates were falling, i.e., during FY03 and FY04, the banking spread was squeezing as the fall in lending rates was sharper compared with the fall in deposit rates⁶.

Conclusion

In sum, the dynamics of banking spread has changed overtime and therefore the trend in banking spread should be seen in perspective of the changes in product mix of the banks in terms of maturity and risk profile, the structure of banking industry, monetary policy transmission mechanism, monetary and overall macroeconomic

developments and other bank specific factors. With the stable banking soundness indicators related to earnings, asset quality and managerial efficiencies, and given the structural changes in the composition of lending and deposit rates, it may be too early to warrant an immediate policy response.⁷

Nonetheless, if the widening persists, then it will raise a serious concern because the continuous widening spread



⁶ For details, please see **SBP Annual Report for FY03**.

⁷ Rather, banks have to focus more on the liquidity coverage, especially asset based, in the shorter tenure as the maturity profile of liabilities has been shortened.

can have a dampening effect on economic growth as a continuous high spread discourages both investments and savings.

Going forward, it is expected that the completion of monetary transition and the pass through on lending and deposit rates would help banks in narrowing the spread somewhat. It is also likely that banks, with an aim to lower the maturity mismatch and the resultant liquidity risk, will focus on mobilizing longer tenure deposits in months to come. In this regard, the latest data on distribution of deposits by rate of return is quite encouraging as it shows that banks have already started making efforts to mobilize the deposits at higher returns and the share of deposits with higher rate of returns (more than 6 percent) has increased tremendously during Jun-05 and Dec-05 (see **Figure S3.8**).

Box S3: Theoretical Explanation of Rigidity in Pricing Deposits and the Case of Pakistan

A number of theories have been presented to explain the existence of price rigidity in the banking sector. The structure of the banking industry has mostly been explained as one of the determinants of rigidity in deposit rates;

- (1) The structure performance hypothesis suggests that high institutional concentration in the banking industry leads to non-competitive pricing which results in low deposit rates.
- (2) Even in the presence of competitive pricing, it is not necessary, that the deposit rates are adjusted with every single change in policy rate or the improvements in profitability. For banks it is costly to make rapid adjustments in deposit rates given the non-trivial menu costs; and the depositor may also find it costly to shift funds from one bank to another.
- (3) The existence of collusive arrangements in the banking industry where banks mutually decide to keep deposit rates low.
- (4) Incomplete information regarding the returns offered by various banks also impedes the depositors' decision to switch banks.

The banking industry in Pakistan in the pre-reform structure was although characterized by a high level of concentration in a few banks; however, this hardly had any impact on the deposit rate structure since the SBP used to control the deposit rates till 1985. From 1st July 1985 onwards, banks were disallowed to mobilize interest based deposits as a result of the measures to transform the conventional banking system to a non-interest based system. However, banks were required to obtain prior clearance from SBP for declaring profit rates under PLS system (profit and loss sharing). During 1988-92, although, the returns on deposits were based on PLS system, still the interest rate restrictions were at place in the form of floors on deposit rates.

With the liberalization process of the banking industry, banks were allowed to set the rate of return on deposits and all the earlier restrictions were dispensed with. At present, banks announce half yearly the rate of return on deposits based on the PLS system. However, it should be noted that although the profitability of banks has increased manifold in preceding three years; still the returns on deposit show no sign of improvement. This is reflective of the fact that there exist price rigidities in the domestic banking industry arising out of (1) incomplete information; and (2) the absence of competition.

Specifically, local depositors do not have a complete access to the information regarding the returns offered by banks under various schemes as no network system is at place where banks upload such information. Similarly, banks do not have to offer highly competitive prices given the absence of alternative modes of savings especially for institutional investors. This is because; (1) during March 2000, the institutional investors were disallowed to invest in National Savings Schemes-NSS instruments effective from March 2000; and (2) the decline in secondary market activities in PIBs given the low supply as banks have shifted most of the available stock to the 'held to maturity' category and there were no new PIB issuances since June 2004.

However, it should be noted that in the preceding three years, banks have been enjoying a robust deposit growth given a sharp rise in workers' remittances, decline in the profit rates on NSS instruments and the overall increase in economic activity in the economy. With the introduction of two new NSS instruments with a relatively higher profit rates, the additional liquidity that the banks were enjoying has been constrained somewhat. This can be reflected in a substantial decline in net outflows from these schemes during H1-FY06 and the highest gross mobilization in last six years. If this trend persists, then banks will have to raise the deposit rates significantly to compete with the NSS instruments, especially to fund the extended maturity of bank advances.

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- (2) Hutchison E. David, Retail Bank Deposit Pricing: an inter temporal asset pricing approach, *Journal of Money Credit and Banking* Vol. 27 No.1, (Feb 1995) pp 217-231.
- (3) Neumark David and Sharpe S. Steven, Market Structure and the Nature of Price Rigidity: evidence from the market for customer deposits, *Quarterly Journal of Economics* (1992).

Special Section 4

Development of Microfinance Sector in Pakistan

Microfinance (MF) is the provision of financial services, usually in the form of small sized financial transactions to people who are unable to access such services from commercial banks. After the inception of Grameen in Bangladesh in 1984, the first formal microfinance bank of the world, MF has widely been recognized as an important tool for poverty reduction. Successful experience of Grameen Bank, in serving the financial needs of the poor segment of the society on sustainable basis, made the bank a role model for private and public sector institutions in other countries to follow. During 1990s, the importance of microfinance has been recognized at international forums; more importantly International Financial Institutions (IFIs) started providing funds for development of MF sector. Presently, development of MF sector has become one of the main pillars in poverty reduction strategies of many developing countries.

In Pakistan, MF has started gaining importance, as a tool of social mobilization and poverty reduction, since late 1990s. Indeed the enhanced international emphasis, in particular the increased funding from IFIs for MF, encouraged both public and private sector to develop microfinance sector in the country.

The objective of this special section is to revisit the developments of microfinance in Pakistan since 2000, particularly the experience of Microfinance Banks (MFBs) in the country. A brief review on evolution of microfinance in Pakistan is presented in the next section, followed by scope and current market structure in third section. The fourth section covers the growth, loans classification and sustainability of Microfinance Banks (MFBs) in Pakistan. The last section concludes the study.

Evolution of Microfinance Sector in Pakistan

As mentioned above, following the rising focus at international level, microfinance started getting importance in Pakistan¹ towards the end of 1990s. The significant increase in the international funding enabled Non Government Organizations (NGOs) to expand their operations and was also a major driving force for establishment of specialized microfinance institutions in the formal sector i.e. MFBs.

¹ Microfinance sector was present since long but informally and at very small level, for example Rural Support Program (RSP) by NGOs and the government were providing small loans to farmers since 1980s (see SBP First Quarterly Report for FY05 for the further details).

Realizing the need and importance of MF, as a tool of poverty reduction and social mobilization, the government has accelerated its efforts to establish strong foundations of MF in formal sector and extended a considerable support to the informal sector (NGOs) as well. In order to promote the MF in formal sector, the most significant step taken by the government was the launching of Microfinance Sector Development Programme (MSDP) in 2000. The main objective of this program was to broaden and increase the pace for the development of the sector to provide the financial services to poor on sustainable basis. Moreover, the government has recognized microfinance as an important tool of poverty reduction in its Poverty Reduction Strategy Paper (PRSP). Khushali Bank (KB), the first specialized microfinance bank, was established in 2000 under a special ordinance. Then MFI Ordinance 2001 was put in place to provide separate regulatory framework exclusively for MF.

While these measures by the government provided the enabling infrastructure for the MF development, the regulatory and promotional services were undertaken by the State Bank of Pakistan (SBP) (see **Box S4** for details). SBP is the executing agency for MSDP and has also been responsible for monitoring of formal microfinance institutions (MFIs). Focus of SBP policies remained on providing conducive environment to the private sector and increasing the coordination between public and private sector for the speedy growth of the MF sector. As a result, within the four years of MFI ordinance 2001, four specialized MFBs (excluding KB) have started their operations. First Microfinance Bank Limited (FMFBL) and Tameer Microfinance Bank Limited are operating at national level, while Rozgar Microfinance Bank Limited (RMFBL) and Network Microfinance Banks Limited (NMFBL) are serving at district level.²

In order to support the informal sector, the government has established the Pakistan Poverty Alleviation Fund (PPAF), apex institution, in 1999 to ensure availability of funds on continuous basis. PPAF can finance any legally established entity in the government or private sector.³ PPAF is also working for the capacity building of its partner organizations (see **First QR 2004-05** for further details). Moreover informal group, at its own, has established Pakistan Microfinance Network (PMN) in 2001 for capacity building of institutions in this

² FMFBL and Tameer has started their operations in 2002 and 2005, respectively. While both the district level MFBs became operational since 2004.

³ The criteria for selection depends upon the strength of the organization by analyzing its past trends and the proposal submitted to PPAF

group. PMN is also providing a platform for coordination between formal and informal sectors for the development of MF in Pakistan.⁴

Scope and Coverage of Microfinance in Pakistan

There is no unanimous international standard to estimate the potential market of microfinance; every country estimates the market size according to its own objectives and focus of the sector. In Pakistan, the potential market for MF is generally being considered around 6 to 7 million household, which is approximately one third of total household in the country. A little is known about the methodology to come up on this market size, though practitioners in this area explain that the potential market is roughly the population below the poverty line.

Box S4: Role of SBP in MF Sector Development

Considering MF as a growing sector, as an effective tool for poverty reduction and financial deepening, SBP has accepted the dual responsibility of supervision and development of MF in the country. In order to effectively perform these functions, SBP has undertaken several steps for its own capacity building, including: (a) a separate division has been established within SBP; (b) extensive trainings is being imparted to a pool of officers at SBP, to get them equipped with the techniques and information required to fulfill their jobs efficiently in this specialized area; (c) International consultant groups have also been hired to provide assistance in the development of on-site and off-site surveillance manuals for MFBs.

As a supervisor, SBP is monitoring and regulating MFBs and has taken various policy measures to provide the operational infrastructure such as: (a) licensing criteria for establishing Microfinance banks has been set; (b) prudential Regulations for MFBs have been issued; (c) guidelines for the Mobile Banking and transformation of NGO/ RSPs / Cooperative into MFBs have been provided; (d) Fit and Proper Criteria for Board of Directors has been defined, etc. SBP has adopted a consultative mechanism for designing policies.

In order to create conducive environment for the MF sector growth and development, SBP is frequently interacting with stakeholders. In this regard, in December 2004 a two day international conference on “*Microfinance in Pakistan-innovating and Mainstreaming*” has been arranged by SBP in collaboration with PPAF, PMN and KB.

However the potential market can actually be much larger in size, as it is important to target the household just above the poverty line, especially the household in Transitory Vulnerable and Transitory Non-poor categories.⁵ This is because experiences from other countries suggest that a significant portion of

⁴ A study by Tameer Bank Limited on “Microfinance Market Assessment in Pakistan, 2004”, explained the role of PMN.

⁵ In the standard definition transitory non-poor are defined as households that were not above the poverty line for most of the defined period but not always, while transitory vulnerable are transitory non-poor that have high probability of getting poor

transitory groups fall back into poverty due to seasonality in their income and lack of appropriate income smoothing mechanism available to them. Moreover the MF Ordinance 2001 considers people below taxable income eligible for microfinance,⁶ which reinstates that the potential market size of MF could be larger than what is generally being considered in Pakistan.⁷

Table S4.1: Microfinance Outreach -- Number of Borrowers

numbers in thousand, shares in percent

	2003		2004		2005	
	Numbers	Shares	Numbers	Shares	Numbers	Share
NGOs & RSPs	228.8	70.6	262.3	58.7	na	-
MFBs	95.2	29.4	184.7	41.3	270.9	-
Total	324.0	100.0	447.0	100.0	-	-

na: not available

Nevertheless, even admitting the 7 million as potential market the coverage of MF is very low at present. The most recent available data (2004) indicates that the total coverage of MF sector (including NGOs, RSP, and MFBs) was hardly 7 percent of this market size.⁸ As shown in **Table S4.1**, NGOs and RSPs were contributing the major share i.e., 58.7 percent of the overall coverage of the market.⁹ It is important to note the rapid growth in share of MFBs in market coverage, which has gone up from below 30 percent in 2003 to above 40 percent in 2004.

Experience of MFBs in Pakistan

As mentioned earlier, presently, five specialized microfinance banks are operating in the country; three are operating at the national level and the two at the district level. The assets of MFBs are highly concentrated in one bank, i.e. KB; specifically, at the end of 2005, share of KB in overall assets of MFBs was around 79 percent. As Tameer Bank has recently started its operation, analysis in rest of the section is based on the remaining four banks.

Since the inception of the KB, in 2000, the MFBs saw substantial growth. The total number of branches of these banks increased from 4 in 2000 to 91 at the end

⁶ Presently Rs. 100,000 is the taxable income

⁷ The rough estimation based on the Labor Force Survey of 2000-01, the household below the taxable income were between 14 to 15 million around 70 percent of the total households.

⁸ But one element should be kept in mind that want is equally important as access is implying that not necessarily every household would be in need of credit. So the problem of coverage is not only from the supply side but from the demand side as well.

⁹ No of borrowers has been taken as the coverage indicator.

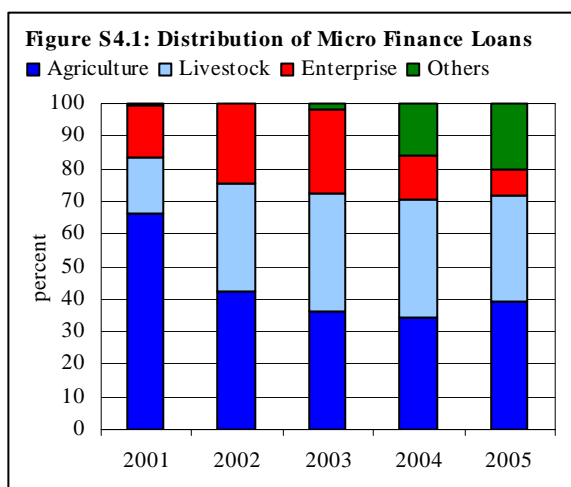
of 2005 and total assets of MFBs have increased from 1.7 billion at end-December 2000 to 7.9 billion in December 2005 (see **Table S4.2**), showing a compound annual growth rate of 35.5 percent. As expected, MFBs also saw significant changes in their assets composition; the share of advances in total assets has jumped from below one percent in 2000 to almost 29 percent in 2005.¹⁰ During the same period advances of MFBs increased from hardly Rs 0.1 billion to Rs 2.3 billion, showing a compound annual growth rate of 184 percent.

Table S4.2: MFBs Growth

	Unit	2000	2001	2002	2003	2004	2005
Assets	million Rupees	1734.7	1885.7	3066.0	4334.6	5686.7	7908.9
Advances	million Rupees	12.3	108.1	493.1	736.3	1538.8	2271.7
Deposits	million Rupees	0.0	0.0	64.4	392.0	469.0	707.8
Branches	Numbers	4	30	39	56	75	91
Borrowers	numbers in '000'	n.a	12.8	56.3	95.2	184.7	275.21
Advances	numbers in '000'	n.a	21.1	87.9	192.6	380.1	647.3
Savers	numbers in '000'	0	0	0	10.2	18.6	32.5

Note: Data of Tameer Microfinance Bank Limited is not included here.

The sectoral composition of loans suggests that the most of MF loans are extended to Agriculture and Livestock sectors (see **Figure S4.1**). At the end of 2005, together these two sectors were sharing above 70 percent of total advances extended by MFBs. This distribution is justified as majority of the population, especially the poor, is associated with these two sectors.



¹⁰ In the initial period a larger proportion of MFBs was coming from investment, as their client base is increasing the share of advance is increasing rapidly.

An important objective of MF, as defined in MSDP, is to increase the access of females to financial services. Providing MF facilities to female group is expected to improve women empowerment in the country.¹¹ At the end of

Table S4.3: Gender -wise Distribution of Loans

	percent share				
	2001	2002	2003	2004	2005
Male	70	70	71	72	76
Female	30	30	29	28	24
Total	100	100	100	100	100

2001, loans extended by MF were distributed in proportion of 30 to 70 percent among female and male groups, respectively. However in their efforts to increase coverage to remote areas in rural sector, where people have strong social and cultural views on women participation in economic activity, MFBs failed to maintain this proportion and share of females in total loans declined to 24 percent by end December 2005 (see **Table S4.3**). It is important to mention here that informal sector (NGOs and RSPs) has got better coverage of female¹² as compared to MFBs. In fact some of the NGOs are predominantly providing MF services to females group.¹³ MFBs can learn from experiences of these NGOs to overcome the social and cultural gender biases against female participation.

In order to fund their assets growth, MFBs are primarily dependent on borrowings. However, while the largest MFB, KB has not even begun deposit mobilization yet, is relying on external sources to finance its assets¹⁴, during the CY02-CY05 period, deposits of other MFBs increased by more than 10 times to reach Rs 679.2 million at the end of CY05. On average, the loan to deposit ratio for MFBs (excluding KB) was at 58.2 percent in December 2005. The experience of the MFBs (ex-KB) suggests that there exists a demand for saving products even from the poor.¹⁵

Although it is too early to reach at any strong conclusions, asset quality of MFBs is reasonably good. At the end of 2005, Gross Non Performing Loans (NPLs) to gross advances ratio was 4.3 percent. Moreover a substantial part of NPLs have been provisioned. In December 2005, net NPLs (net of provision) to net advance ratio was even below one percent level.

¹¹ Improving women empowerment is one of the main objectives in the government Medium Term Development Framework (MTDF) for 2005-2010.

¹² On average female constitute 56 percent share (2004). 200620648

¹³ For example, KASHF & DAMEN is extending MF facilities only to female.

¹⁴ High reliance on external funding raises question about the long term sustainability of the institution

¹⁵ Although, irrespective of income level, any body can deposit his saving with MFBs, anecdotal evidence suggests that, in practice, only the people with low income (also eligible for credit) are also depositing with these banks.

Conclusion

In Pakistan, microfinance is relatively less developed sector and a large scope is available to increase the financial services to poor people in the country. Realizing the importance of MF in social mobilization and poverty reduction, the Government has geared up its efforts to provide support to both formal and informal sector. Currently informal sector, i.e. NGOs and RSPs, is contributing major share towards the coverage of the market, however, MFBs saw a rapid growth during the last four years and have captured a significant share in overall coverage of MF sector in the country.

Although the MFBs have recently started their business, Pakistan's experience also confirmed the increasingly establishing fact at international level that poor can repay their loans on time and also has ability to save a part their income. However it is important for MFBs to increase focus on deposit mobilization to sustain their operations in future as presently mainly dependent on external funding.

While high performing loans is a healthy sign, it is more important to analyze the impact MF have on the wellbeing of clientele. Unfortunately, an independent study in this area is missing in Pakistan case, though MF institutions have done some studies.¹⁶ In order to perform the social impact analysis, there is a dire need of independent survey.

¹⁶ These studies concluded positive effect of MF on their customers' welfare.

Acronyms

ADs	Authorized Dealers
ADB	Asian Development Bank
AGRSP	Agha Khan Rural Support Programme
bftd	billion cubic feet per day
BOK	Bank of Khyber
BoP	Balance of Payments
CBR	Central Board of Revenue
c.i.f	Cost, Insurance & Freight
CKDs	Completely knock down system
CPI	Consumer Price Index (2000-01=100)
CY	Calendar Year; from January 1 to December 31
DAP	Di-Ammonium Phosphate
D-D	Difference and difference
DMBs	Deposit Money Banks
DPBs	Domestic Private Banks
EFS	Export Finance Scheme
ECC	Economic Co-ordination Council
EPZs	Export Processing Zones
EU	European Union
FBS	Federal Bureau of Statistics
FCAs	Foreign Currency Accounts
FCD	Foreign Currency Deposits
FDI	Foreign Direct Investment
FECs	Foreign Exchange Companies
FE-25	Foreign Exchange Cir.No.25
FIB	Federal Investment Bond
FMFBL	First Micro Finance Bank Limited
f.o.b	Free on Board
FY	Fiscal Year (from July 1 to June 30)
GDP	Gross Domestic Product
GSP	Generalized System of Preferences
HRI	House rent Index
HBL	Habib Bank Limited
IDA	International Development Agency
IDA	International Development Association
IDB	Islamic Development Bank
IFIs	International Financial Institutions
IIP	Index of Industrial Production
IMF	International Monetary Fund

IRAF	Institutional Risk Assessment Framework
IT	Information Technology
KB	Khushali Bank
LCVs	Light Commercial Vehicles
LSM	Large Scale Manufacturing
MA	Moving Average
MF	Microfinance
MFA	Multi Fiber Arrangement
MFBs	Microfinance Banks
MFI	Microfinance Institutions
MNCs	Multi National Corporations
MoM	Month on Month
MSDP	Microfinance Sector Development Programme
NBFIs	Non-Bank Financial Institutions
NDA	Net Domestic Asset
NFA	Net Foreign Asset
NFI	Net Foreign Investment
NFNE	Non-food, non-energy
NGOs	Non Governmental Organizations
NMFBL	Network Micro Finance Bank Limited
NRSP	National Rural Support Programme
NSS	National Savings Scheme
OEBs	Outstanding Export Bills
OIN	Other Items Net
OMOs	Open Market Operations
PARCO	Pak-Arab Oil Refinery Company
PESRP	Punjab Education Sector Reforms Program
PIB	Pakistan Investment Bond
PMN	Pakistan Microfinance Network
POL	Petroleum, Oil and Lubricants
POL	Pakistan Oilfields Limited
PPAF	Pakistan Poverty Alleviation Fund
PPBCL	Punjab Provincial Cooperative Banks limited
PRSP	Poverty Reduction Strategy Paper
PRSP	Punjab Rural Support Programme
PSEs	Public Sector Enterprises
PSLM	Pakistan Social and Living Standards
PTA	Pakistan Telecommunication Authority
Pvt.	Private
REER	Real Effective Exchange Rate

RHS	right hand side
RSPs	Rural support Programmes
SBP	State Bank of Pakistan
SKDs	Semi Knock down System
SMEs	Small and Medium Enterprises
SPI	Sensitive Price Index
SRSP	Sarhad Rural Support Programme
STARR	Sales Tax Automated Refund Repository
TCP	Trading Corporation of Pakistan
UAE	United Arab Emirates
UBQI	User Based Quantum Index
USA	United States of America
US\$	United States Dollar
WAPDA	Water and Power Development Authority
WPI	Whole Price Index
YoY	Year on Year
YTD	Year to Date
ZTBL	Zarai Taraqiati Bank Limited

Non-English Words

Rabi crops	Winter crops with sowing season starting from October to December, and harvesting season starting from April to May
Kharif crops	Summer crops with sowing season starting from April to June and harvesting season starting from October to December
Jawar	Sorghum, one of the major crops in Pakistan
Mash	A kind of pulses
Mung	A kind of pulses
Bt cotton	Baccillus thuringiensis cotton: Genetically enhanced and disease resistant variety of cotton which carries a special gene derived from soil born bacterium "Baccillus thuringiensis"