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THE STATE OF PAKISTAN'S ECONOMY
Third Quarterly Report for FY07

1.1 Overview
Recent statistics indicate that the economy is likely to show robust growth for the fourth successive year, with real GDP growth now expected to exceed the 7 percent annual target in FY07. Moreover, the growth is expected to be quite broad based. The unexpectedly strong out turn by agriculture following the record wheat crop and upward revision in key *kharif* numbers means that agricultural growth is forecast to exceed the annual 4.5 percent growth target. The industrial growth is also expected to be stronger than that in the previous year, though it may not reach the FY07 target. Similarly, the services sector is expected to continue with its growth momentum for yet another year; while growth in the *wholesale & retail trade* sub-sector is likely to slow somewhat, reflecting the deceleration in imports, the remaining services sub-sectors are expected to continue to record high growth.

The strength of aggregate demand reflected in the growth figures clearly belies claims that the monetary tightening has stifled growth in the economy. Quite to the contrary, it seems that monetary policy has struck an appropriate balance by protecting the growth momentum of the economy, while attempting only to remove excessive monetary stimulus from the economy. Unfortunately, the impact of the latter in reducing inflationary pressures has been offset partially by the rise in food inflation, and supply-side pressures. Thus, even as non-food inflation weakened, overall CPI inflation declined only gradually, falling from 11.1 percent in April 2005 to 6.9 percent by April 2007 (see **Table 1.1**), however still above the 6.5 percent target for FY07.

Table 1.1: Selected Economic Indicators

Jul-Mar or as mentioned

		FY05	FY06	FY07
Growth rates (percent)				
LSM		18.7	9.9	9.8*
Exports (fob)		14.3	18.0	3.5
Imports (cif)		37.6	43.2	8.1
Tax revenue (CBR)		13.5	22.1	21.9
CPI (12m MA)	end-Apr	9.0	8.2	7.8
Private sector credit	Jul-Apr	28.6	20.2	13.0
Money supply (M2)	Jul-Apr	13.7	10.8	12.1
billion US Dollars				
Total liquid reserves[1]	end-Apr	13.0	13.1	13.7
Home remittances		3.1	3.2	3.9
Foreign investment		1.4	3.3	5.6
percent of GDP[2]				
Fiscal deficit	Jul-Dec	1.2	1.8	1.9
Trade deficit		3.8	6.7	6.8
Current account deficit		1.0	3.3	4.1

* September 2006 data point. More recent data is not available.
[1] With SBP & commercial banks.
[2] Based on full-year GDP in the denominator.

It needs to be recognized that food inflation is typically less responsive to monetary tightening and therefore monetary policy should not respond aggressively to *temporary* shocks in food prices. At the same time, it is also clear that a continuing focus on tight monetary policy will be critical so that the *second-round* impacts of the high food inflation do not add to underlying inflationary pressures in the economy. SBP depends more on market dynamics and government's administrative measures to contain food inflation while retaining a tightening bias to ensure that inflationary expectations are contained.

The challenge to the modulation of monetary policy is increased by the recent acceleration in the growth of monetary aggregates. Through most of FY07, even when seeking a broad reduction in aggregate demand, the SBP remained mindful of the pressures on the textile sector, and on exports, which faced rising competitive pressures. Thus, a substantial portion of the credit availed by these sectors in FY07 was provided on concessional terms by the central bank. This included a total of Rs 332.8 billion during Jul-April 28, FY07 as gross disbursement from refinancing facility (Rs 43.8 billion disbursed under the LTF-EOP[1] scheme and another Rs 289.0 billion through the export refinance scheme).

It must be recognized that the subsidy implicit in the provision of concessional re-financing by SBP is only part of the cost of supporting the strategic sectors; additional (less visible) costs include the downstream implications on reserve money growth and consequent lagged impact on inflation, fiscal costs (as SBP profits erode, reducing the pass through to government), as well as reducing the incentives for banks to generate deposits by raising returns.

Indeed, the concessional credit provided by the central bank was an important factor in the strong growth in reserve money during July-April FY07. The impact of this was compounded by the substantial increase in government borrowings from the banking system, and rising net foreign assets of the banking system. Partially, as a result, growth in broad money during the period rose to 12.1 percent by April 28, 2007, significantly higher than the 10.8 percent growth during the corresponding period of FY06.

Another important development in FY07 was the change in the credit growth profile.

- Firstly, even though the growth in private sector decelerated substantially during the first nine months of FY07, the bulk of the fall owed to a few specific sectors. Specifically while there was a sharp deceleration in

[1] Long-term financing for export oriented projects.

consumer credit, the business loans presented a mixed picture, with many businesses witnessing a strong increase in credit demand (including telecommunications, food processing industries, and apparel industries). In other words, there appears to be a healthy shift in the credit demand centers in the economy.

- Secondly, a part of the deceleration in credit demand owed to supply-side constraints, as a few large banks scaled down their credit activities either due to internal restructuring (e.g. to improve risk management, and credit extension services, etc.) or as a consequence of mergers & acquisitions. In fact, a substantial part of the deceleration in credit off-take is contributed by just a few institutions.
- Thirdly, while investment credit demand witnessed a decline, this essentially reflected lower demand in industries that had already substantially increased capacities in recent years (e.g. textiles and cement), as well as delays in the initiation of major infrastructure projects (e.g. power projects).

The above discussion suggests that at least a part of the deceleration in the private sector credit growth seen in FY07 may not persist in FY08. In other words, the high reserve money growth in FY07, together with the rising demand for private sectors credit, raises the risk to a strong resurgence in excess aggregate demand, and consequently inflationary pressures in FY08.

This makes it even more important that fiscal policy be aligned with monetary policy in months ahead. The rise in the fiscal deficit in recent years has been essentially an unavoidable function of the post-earthquake reconstruction activities and of the heavy development investments required to build up infrastructure and invest in human capital to enhance the productive capacity of the economy. At the same time the government has also tried to avoid the build-up in fiscal imbalances by committing to a 4.2 percent of GDP cap on the fiscal deficit target. However, despite significant success in increasing non-bank borrowings in FY07, particularly following the resumption of significant PIB issuances and a recovery in (net) NSS receipts, there is a worrying dependence on borrowings from the central bank. The risk to monetary stability posed by heavy budgetary borrowings is highlighted by the Feb-Apr FY07 fiscal financing activities, with the government raising Rs 195.7 billion from the scheduled banks, *net* of maturities, but retiring only Rs 58.4 billion of its central bank loans.

Another significant challenge to monetary stability stems, ironically, from the Pakistan's comfort in financing the country's growing current account deficit. While the growth in the current account deficit has decelerated sharply as FY07 progressed (mainly because of sharp compression in import growth), in absolute terms it has grown to US$ 6.0 billion by March 2007. While this was comfortably financed by even larger surpluses in the financial and capital account (with substantial non-debt components), the country's success in attracting international capital has led to a large jump in the NFA of the banking system, adding to liquidity in the domestic markets.

Table 1.2: Major Economic Indicators

	Provisional FY06	FY07 Original targets	FY07 SBP projection
Growth rates (percent)			
GDP	6.6	7.0	6.8 – 7.2
Inflation	7.9	6.5	7.5 – 7.8
Monetary assets (M2)	15.2	13.5	14.5 – 15.5
billion US Dollars			
Exports (fob)[1]	16.6	19.8	17.6
Imports (fob)[1]	25.0	27.4	27.2
Exports (fob)[2]	16.5	18.6	17.2
Imports (cif)[2]	28.6	28.0	30.2
Workers' remittances	4.6	4.5	5.3- 5.5
percent of GDP			
Budgetary balance	-4.2	-4.2	-4.2
Current account balance	-3.9	-4.3	-4.8

[1] BoP data, [2] Customs data

1.2 Looking Forward

Real GDP growth is now estimated to comfortably reach the annual growth target of 7.0 percent in FY07 (see **Table 1.2**), and could potentially exceed it, if LSM growth reaches double digits, livestock growth exceed targets and the services sector growth remains on target. However, the continued strength in aggregate demand, together with the resilience in food inflation, has meant that despite sustained monetary tightening the downtrend in inflation has been very gradual, and variable. As a result, domestic inflation is now forecast to remain in a relatively higher range than forecast earlier, and well above its annual target for FY07.

It is important that appropriate monetary policy be sustained as price stability is important to sustain long-term growth and for poverty reduction. In particular, it must be recognized that inflation has particularly adverse consequences for low-income groups, which generally have no means to hedge themselves from sustained high inflation, in contrast to high income groups that can partially offset the impact through investment in real assets.

The challenge to monetary policy is compounded by the unexpectedly strong resurgence in broad money in recent months, with M2 growth forecast to exceed the original 13.5 percent target, to fall in the range of 14.5 – 15.5 percent. A part of this is a consequence of the concessional re-finance to strategically important sectors of the economy, which significantly raised reserve money growth in FY07, and will consequently have knock-on impacts by raising monetary growth in subsequent periods.

The impact on reserve money growth of this development has been compounded by the heavy reliance on central bank borrowings by the government and the growth in NFA of the banking system. The impact of the former may be limited, if the government appropriately ensures that the SBP borrowings are retired as external and domestic non-bank receipts improve. However, the resurgence in NFA of the banking system poses an additional challenge – the country needs sustain these flows, but it is simultaneously imperative to sterilize the monetary impact of these flows in order to contain inflationary pressures.

The need to sustain the external flows is implicit in the growth of the current account deficit during FY07, which is now forecast to rise to 4.8 percent of GDP, up from the initial forecast of 4.5 percent of GDP. It is a source of comfort that the monthly growth in the current account deficit continues to decelerate, and that the current account deficit is likely to be comfortably financed in the short-run, particularly given strong international liquidity flows towards emerging markets.

However, it should also be kept in mind that international capital flows can be volatile, and are sensitive to a host of domestic and global factors (both economic as well as political). The long run health of the economy, however, requires a lower sustainable current account deficit, concurrent with a rise in the domestic savings rate and a gradual reduction in the fiscal deficit. For the latter to be sustainable, there is need to build upon the welcome growth in the tax receipts in July-March FY07. A graduated increase in the tax-to-GDP ratio, as proposed by CBR, is essential if the government is to sustainably finance the development spending required to raise the long-term growth potential of the economy.

1.3 Executive Summary

Agriculture

A record wheat harvest, and upward revision in the production figures for key *kharif* FY07 crops has raised the prospects of a strong recovery by the agriculture sector in FY07. Resultantly, it is estimated that growth for major crops could reach as high as 5.8 percent in FY07, significantly higher than the target growth of 4.3 percent for the year. In particular, the most significant contribution to the improvement in the agri-growth estimates was from the exceptional FY07 wheat harvest. The 23 million tons wheat harvest is not only well above the target of 22.5 million tons, it is the largest ever recorded in Pakistan.

On the expectations of higher irrigation water availability and continued policy support,[2] production targets for *kharif* crops for FY08 have been fixed higher as compared with the realized harvests in FY07. However, actual performance will depend critically on market prices and favorable weather conditions. On the former count, the FY07 increases in price of cotton and rice and persistently high sugarcane prices will be encouraging for the farmers in FY08.

The banking system provided its supportive role to agriculture sector by meeting the growing financial needs of the farming sector. Agriculture credit disbursement rose to Rs 111.2 billion during Jul-Mar FY07, up by 22 percent relative to the corresponding period of FY06. This growth is well above the 16.4 percent annual target, though 1.5 percentage points lower than seen in Jul-Mar FY06. The pace of agri-credit disbursement suggests that Rs 160 billion annual target for FY07 would be met comfortably.

Large-Scale Manufacturing (LSM)

The detailed LSM data of 100 items for Q1-FY07 and limited information for Q2-Q3 of current fiscal year implied that *LSM* growth may be higher during Jul-Mar FY07 as compared with the corresponding period of FY06, but suggests that the 13.0 percent growth target of *LSM* sector for FY07 may not be achieved.

Major industries supporting the recovery in LSM included textiles, sugar, cement and basic metals. The automobile industry, however, registered a slowdown in growth during Jul-March FY07 relative to the corresponding period of FY06. However, industries such as fertilizer, paper & board and engineering saw a decline in production during this period mainly due to weakness in demand and temporary shut down for maintenance as well as expansion.

Prices

Strong increases in food inflation continued to underpin inflationary pressures in the economy, and offset much of the gains from the abatement of non-food inflation through a tight monetary policy. Thus, principally due to rising food prices, CPI and SPI measures of inflation both recorded year-on-year increases in April 2007, after steep falls in the previous months (when food inflation had dropped sharply). The influence of food inflation is also evident in the WPI; although the WPI inflation has seen a year-on-year drop this is simply because a surge in its food component was largely offset by a sharper decline in its non-food elements.

[2] Continuity of subsidy on DAP fertilizers.

Inflationary pressures are particularly evident in headline CPI inflation which accelerated to 6.9 percent YoY in April 2007 compared with 6.2 percent YoY in April 2006, despite a significant ease in non-food inflation. The deceleration in non-food inflation is mainly attributed to slowdown in the sub-groups of *fuel & lighting, transport & communication* and *house rent*.

As a result of the unexpected resilience of food inflation and likely pressures in near term due to increases in the prices of milk and edible oil etc., SBP forecast for FY07 has been revised upwards from 6.7 – 7.5 percent to 7.5 – 7.8 percent.

Money and Banking

The key challenge for SBP monetary policy during FY07 has been to maintain a balance between sustaining strong economic growth and low and stable inflation. While the economic growth momentum remains intact, the headline CPI inflation has been stubbornly high at an average of 7.9 percent during Jul-Apr FY07. This is mainly due to continuing pressures on food inflation, as the slowdown in food inflation, expected during H2-FY07, did not materialize. SBP recognizes that food inflation is typically less responsive to monetary tightening and therefore the monetary policy should not respond aggressively to temporary shocks in food prices. Thus, SBP depends more on market dynamics and government's administrative measures to contain food inflation while retaining a tightening bias to ensure that inflationary expectations are contained.

A more challenging development has been the sharp increase in monetary aggregate (M2) growth. In fact, the M2 growth which has been showing gradual slowdown relative to the corresponding period till February 2007, [3]accelerated sharply afterwards to reach 12.1 percent during Jul-Apr FY07 compared to 10.8 percent rise during Jul-Apr FY06. Unfortunately, the underlying causes of the recent M2 growth (i.e., strong government borrowings and rise in net foreign assets) leave the central bank with a dilemma.

Specifically, the government borrowing from the banking system for budgetary support and net foreign assets (NFA) has been the key reasons for this sharp rise in M2 growth in recent months; these together contribute 3.6 percentage points to the total rise of 4.0 percentage points in M2 during Mar-Apr FY07.

Growth in credit to private sector slowed from 20.2 percent during Jul-Apr FY06 to 13.0 percent during Jul-Apr FY07, suggesting that the monetary policy has been

[3] The money supply has risen by 7.7 percent during the initial eight months of FY07 (i.e., Jul-Feb FY07) which was lower than 8.6 percent growth witnessed during the corresponding period of FY06.

reasonably successful in reducing excess demand in the economy. Nevertheless, the disaggregated data shows that the slowdown in private sector credit during Jul-Apr FY07 was concentrated in few business sectors, e.g., textiles, cement industries and commerce sector as well as in personal loans.

Fiscal Developments

Consolidated data on fiscal accounts will only be available by the end May but the government has indicated that it remains committed to achieving the fiscal deficit target of 4.2 percent of GDP. However, the relative slowdown in the CBR taxes January 2007 onwards (dipped from 26.7 percent in H1-FY07 to 12.3 percent in Q3-FY07) indicates that expenditure growth would need to be monitored closely.

The CBR significantly surpassed its tax collection target during Jul-Mar FY07 with actual collection of Rs 597 billion despite slowdown in growth of collections. Indirect tax collection stood at Rs 359.2 billion against the target of Rs 396.8 billion. This shortfall is the result of sharp decline in the import growth that fell from 43.2 percent YoY in Q3-FY06 to 8.1 percent YoY in Q3-FY07, reducing the import-related taxes substantially.

Another significant development is the sharp rise in domestic borrowing by the end of Q3-FY07, which mainly reflected the relatively lower availability of external financing compared to the corresponding period of FY06. The aggregate government borrowings for deficit financing from domestic sources stood at Rs 190.5 billion during Jul-Mar FY07, which was nearly four-times the Jul-Mar FY06 borrowings. However, external borrowings are expected to increase during Q4-FY07 due to an expected sovereign debt issue, which would reduce the government domestic borrowings.

An encouraging development was that, unlike the previous year, the government was able to substantially increase its non-bank borrowings in Jul-Mar FY07, as well as sourcing a greater proportion of its banking system borrowings from scheduled banks. The government also raised its non-bank borrowings as a result of PIB auctions and improved NSS receipts.

Balance of Payment

Pakistan's current account deficit continued to widen during Jul-Mar FY07, rising to a record US$ 6.0 billion, up sharply from the corresponding period of FY06. Encouragingly, the data also shows a distinct improvement in the pace of the growth of the current account deficit that has fallen sharply, with Q3-FY07 even witnessing a marginal (and probably temporary) year-on-year decline, largely reflecting the sharp deceleration in the trade deficit during the course of FY07.

Moreover, Pakistan continued to record large surpluses in the capital and financial account that comfortably offset the current account deficits. As a result, the overall external account recorded a surplus of US$ 373 million during the first nine months of the current fiscal year.

Pakistan's exchange rate remained broadly stable moving within a narrow band of 60.2-60.9 Rs/US$ during Jul-Mar FY07. However, the real effective exchange rate (REER) appreciated by 2.06 percent during this period primarily due to the rise in the relative prices compared to its trading partners.

Foreign Trade

During Jul-Mar FY07, imports and exports could record only 8.1 percent and 3.5 percent growth respectively, in contrast to high double- digit growth in the same periods of the preceding four years. Thus, while the trade deficit continued to widen, the pace of the increase was appreciably slower, falling to 14.6 percent during Jul-Mar FY07 as compared to an average growth of 88 percent during the corresponding period of the last four years.

Unfortunately, the gains from the (largely) anticipated deceleration in import growth have been offset by an unexpected weakness in export growth. The abrupt deceleration in export growth in FY07, after strong increases in the previous four successive years, is a source of some disquiet. The sluggishness in exports growth originated from a combination of factors, which include one-off supply shocks, EU-specific preferences & safeguards, as well as some competitive pressures.

Going forward, the rising trend of commodity prices in the international market, higher demand for furnace oil by the thermal power plants and anticipated increase in the import of power generating machinery may put upward pressure on the import bill. On the export side, Pakistan's textile industry needs to be more competitive as it would face increased competition in international markets after the abolishing of China specific textile and clothing safeguards in 2008 by the EU and the US.

In this backdrop, there is need to focus on devising a comprehensive export promotion strategy to narrow down the trade gap. Major issues to be addressed in the export strategy are: a) lack of exports diversification, b) supply side constraints, c) low labor productivity, d) relatively low quality of products, e) delay in the adoption of international standards, f) lack of scale economies, and g) inefficiencies caused by infrastructural bottlenecks.

2 Real Sector

2.1 Agriculture Sector Performance

A record wheat harvest, and upward revision in the production figures for key *kharif* FY07 crops has raised the prospects of a strong recovery by the agriculture sector in FY07. Resultantly, the growth for major crops could reach as high as 5.8 percent in FY07, significantly better than the target growth of 4.3 percent for the year (see **Table 2.1**). Similarly, the limited available information on minor crops also indicates a recovery in recent months after losses during the initial period of the fiscal year due to extended rains and snow. Thus, if the livestock sub-sector also performs well, the aggregate annual growth of the agriculture sector could surpass its annual target of 4.5 percent during FY07.

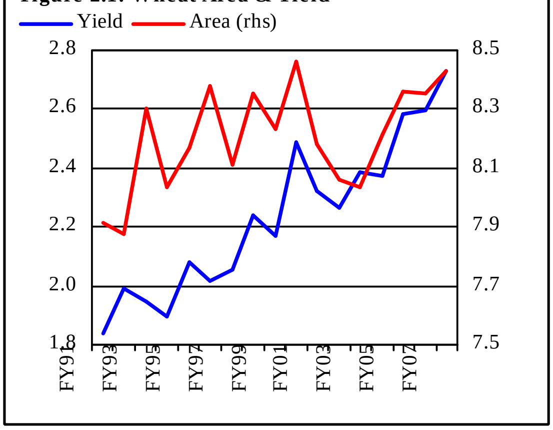
Table 2.1: Agriculture Value Added Growth
percent

Sector/sub-sectors	FY05	FY06	FY07[T]	FY07[E]
Agriculture	6.7	2.5	4.5	5.0
Major crops	17.8	-3.6	4.3	5.8
Minor crops	3.0	1.6	2.3	2.3
Livestock	2.3	8.0	5.2	5.2
Fishing	2.2	1.9	4.0	4.0
Forestry	-33.2	-5.7	3.2	3.2

T: Targets E: SBP estimates based on MINFAL data

The upward revision, in the production figures for cotton (the outcome of the third and final picking was better than earlier estimates) and sugarcane means that value addition by important major *kharif* crops grew 2.7 percent (in contrast to the marginal decline indicated by earlier figures). However, the most significant contribution to the improvement in the agri-growth estimates was from the exceptional FY07 wheat harvest. The 23 million tons wheat harvest is not only well above the target of 22.5 million tons, it is the largest ever recorded in Pakistan.

Figure 2.1: Wheat Area & Yield



A rise in the area under cultivation for wheat, higher irrigation water availability, policy support[1] as well as efficient use of inputs were the main reasons for the exceptional growth of 6.0 percent in FY07 wheat harvest. A strong contribution also came from favorable weather as good monsoon rains left sufficient moisture in non-canal areas and subsequently timely rains through the growth phases of the crop supported a rise in yields (see **Figure 2.1**).

However, there is a significant potential to further enhance yields, if growers emphasized on further improvement in soil management through laser leveling technology, planting of certified seed, improvements in weed & pest control.

Other Crops

The output of gram showed an exceptional growth of 58.2 percent in FY07 against 30.0 percent decline registered last year. This performance resulted from strong yield growth of 57.0 percent owing to higher monsoon rains, relatively better sowing practices, and winter rains that especially favored the non-canal areas. Further, the crop yield was well supported by the increased fertilizers mix use during FY07 following to the rising price signals from the market. The available data suggested that except maize, other crops posted strong production growth rates in FY07 than in the pervious year (see **Table 2.2**).

Table 2.2: Production of Other Crops

thousand tons

Crops	FY05	FY06^{P}	FY07^{E}	YoY change (%)
Gram	766	536	848	58.2
Maize	2,520	3,560	2,907	-18.3
Potato	2,025	1,568	2,470	57.5
Mung	130	114	138	21.1

P: Provisional, E: Estimates *Source: MINFAL*

Crop Outlook FY08

On the expectations of higher irrigation water availability and continued policy support,[2] production targets for *kharif* crops for FY08 have been fixed higher as compared with the realized harvests in FY07 (see **Table 2.3**). However, actual performance will depend critically on market prices and favorable weather conditions. On the former count, the FY07 increases in price of cotton and rice and persistently high sugarcane prices will be encouraging for the farmers in FY08.

Table 2.3: Targets of Major Kharif Crops

	Area (000 hectares)		Production (000 tons)	
Crops	**FY07**	**FY08**	**FY07**	**FY08**
Cotton*	3,250	3,250	13,820	14,140
Sugarcane	1,005	1,040	50,500	55,876
Rice	2,575	2,594	5,693	5,439
Maize	1,001	1,010	3,279	3,221

Source: MINFAL ; (*) 000' bales

[1] Fertilizers mix use technique was well utilized by the farmers, following subsidy on DAP.
[2] Continuity of subsidy on DAP fertilizers.

2.1.1 Agricultural Inputs

Irrigation Water Availability

The improved availability of water as a result of better monsoon and winter rains coupled with snowfall through February-March FY07 bodes well for water availability in FY08. Overall rains compounded a growth of 29.1 percent during July-March FY07 over the same period of last year and the increased water supply has not only helped to meet irrigation requirements for the *rabi* crops but would also fulfill the needs of *kharif* FY08 crops, leaving a reasonable water in the reservoirs for future use as well.

Indus River System Authority (IRSA) reported that canal flows are at full capacity and there would be no shortage through current *kharif* season.[3] However, farming sector has been advised to be careful in consumption of irrigation water, while losses between canal heads and farm gate need to be curtailed.

Kharif FY08 season will be facilitated with 6.8 MAF higher water availability (2.8 percent rise over *kharif* FY07), which may help to enhance the planted area as well as harvesting of *kharif* crops (see **Figure 2.2)**.

Figure 2.2: Irrigation Water Availability (*kharif*)

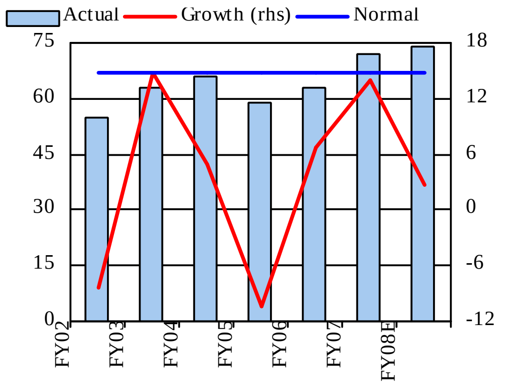
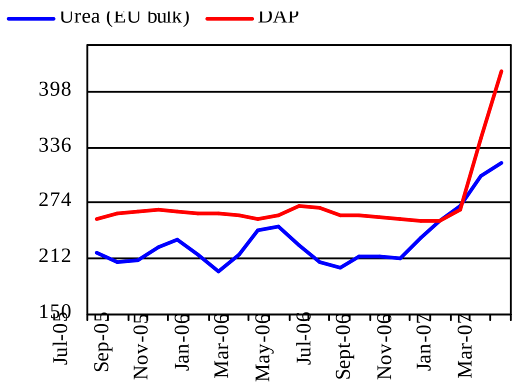


Figure 2.3: International Prices of Fertilizer



Fertilizer Off-take

The domestic prices of fertilizers increased during FY07 reflecting the rising international prices and soaring demand.

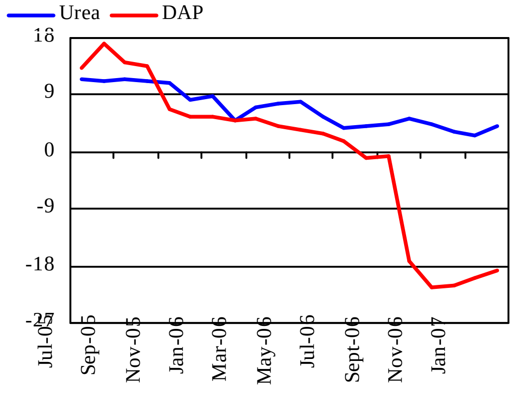
[3] *Kharif* FY08 season already started from 1st April, 2007.

International urea prices, in particular, have jumped 161.0 percent in March 2007 relative to July 2006, following the increases in energy cost (see **Figure 2.3**).

The subsequent increases witnessed in the international prices of DAP since January 2007 was even stronger, and forced domestic dealers to enhance the prices by end of March, 2007.

Partly as consequence of the higher prices (see **Figure 2.4**), fertilizer off-take dipped 9.1 percent YoY during July-March FY07 in contrast to 5.6 percent increase seen last year. The fall is essentially due to declining *urea* off-take; the demand for phosphatic fertilizers was strengthened due to a subsidy given by the government.

Figure 2.4: Change in Domestic Fertilizer Prices



The slowdown was more pronounced in the 1st and 3rd quarter of FY07 compared with the same periods of last year. However, second quarter of FY07 denoted a strong growth of 17.7 percent against 2.0 percent rise seen in last year; because of higher off-take for *rabi* crops (see **Table 2.4**).

Despite a record off-take i.e. 25.5 percent of total off-take between Jul-March FY07, in single month (839 thousand tons in Dec 2006),[4] *urea* off-take declined by 15.5 percent YoY Jul-March FY07 against 6.1 percent increase witnessed in the same period of last year. While its share in total national off-take declined by 5.5 percentage points on YoY basis. The declining trend of *urea* demand since July, 2006 did see a temporary reversal during November-December (the wheat sowing season), but continued thereafter.

Table 2.4: Fertilizer Off-take (Jul-Mar)

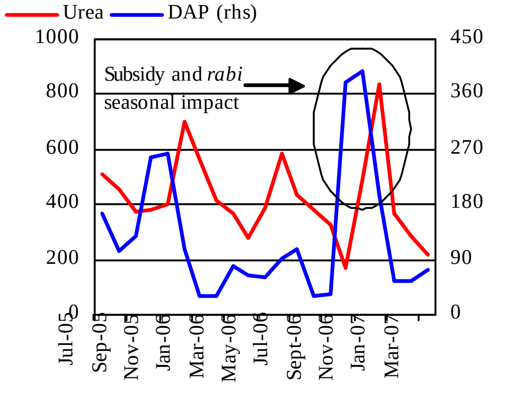
thousand tons

Period	FY05	FY06	FY07
Q1	1,727	1,735	1,315
Q2	2,065	2,107	2,480
Q3	1,249	1,481	1,046

[4] Urea off-take rose by 86 percent YoY in December due to complimentary effect of subsidy on DAP during wheat sowing period coupled with favorable weather conditions and water availability increased the prospects of a good wheat crop.

On the other hand, owing to the subsidy, and the Government's media campaign to promote usage of a balanced mix of nutrients, DAP demand growth picked up substantially after subsidy announced in October 2006. As a result July-March FY07 DAP off-take increased by 14.0 percent YoY compared with a rise of only 3.8 percent seen in July-March FY06 (see **Figure 2.5**). Consequently, the share of DAP in total fertilizers off-take jumped to 27.5 percent YoY in July-March FY07 compared with 21.9 percent in the corresponding period last year.

Figure 2.5: Fertilizer Off-take



The demand for fertilizers, particularly DAP is likely to remain strong, due to enhancement in subsidy on Phosphatic fertilizers and on going plantation of *kharif* FY08 crops.

Agriculture Credit

The growth in agri-credit disbursement slowed in FY07, after witnessing exceptional growth in the past three years. While this may partly reflect lower demand, as a result of better farming incomes given reasonable prices received from *kharif* FY07 crops, a significant contribution to the deceleration may also reflect rising cost of fund as well as some banks desire to limit exposure to this sector while they restructure to improve extension services, risk management, etc.

Table 2.5: Target Achievement Ratio (Jul-Mar)
percent

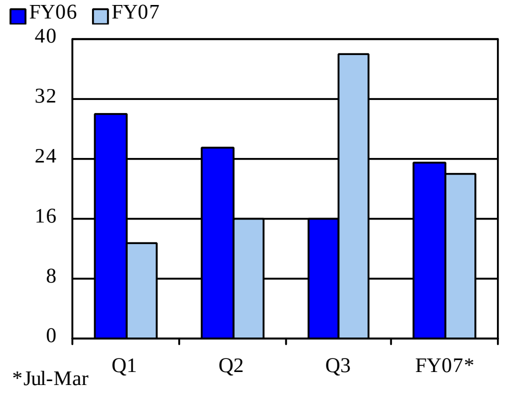
Banks	FY04	FY05	FY06	FY07
5 largest comm banks*	98.5	93.1	74.6	61.2
ZTBL	58.8	74.1	67.5	85.2
PPCBL	64.0	70.5	46.5	58.6
DPBs	62.4	151.6	73.2	69.9
Total Banks	**73.1**	**86.8**	**70.1**	**69.5**

*: NBP, HBL, MCB, UBL, and ABL

The latter is particularly reflected in the decline in the credit disbursement by the five largest commercial banks. Indeed, during July-March FY07 the agri-credit disbursement target to achievement ratio dropped for all banks except ZTBL (which recorded an increase of 17.7 percentage points YoY) and PPCBL (up by 12.2 percentage points YoY - see **Table 2.5**).

In aggregate growth in agri-credit disbursement decelerated by 1.5 percentage points YoY in July-March FY07 compared to the same period of FY06. Similarly, target achievement ratio also slipped by 0.6 percent during the period under review. The pace of credit disbursement was much slower in first and second quarters while its tempo picked up in 3rd quarter of FY07 mainly due to early purchase of inputs for *Kharif* FY08 season (see **Figure 2.6)**.

Figure 2.6: Credit Disbursement Growth



The slowdown during July-March FY07 was mainly caused by the five largest commercial banks[5] as their disbursement growth decelerated by 28.5 percentage points in July-March FY07 compared to July-March FY06 (see **Table 2.6**).

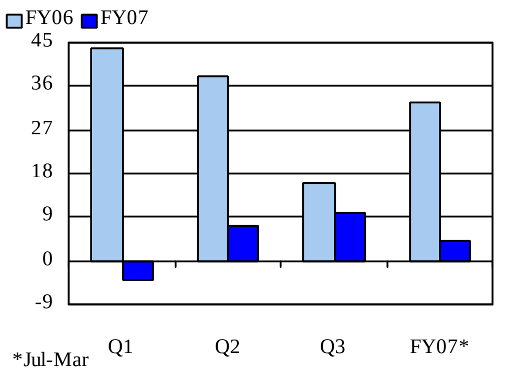
Table 2.6: Growth in Agri-credit Disbursement (Jul-Mar)

percent

Banks	FY05	FY06	FY07
ABL	82.9	25.6	22.6
HBL	90.3	40.7	-16.6
MCB	62.7	-4.9	31.1
NBP	51.2	24.8	13.8
UBL	14.1	90.6	3.2
Total	**60.4**	**32.7**	**4.2**

The five largest commercial banks witnessed a decline of 3.9 percent in agri-credit during the first quarter of FY07 compared to an increase of 43.9 percent in Q1-FY06 (see **Figure 2.7**). In contrast, agri-credit disbursement by specialized group of banks showed a

Figure 2.7: Growth in Agri-credit - 5 Large Commercial Banks



[5] ABL, HBL, MCB, NBP and UBL.

better performance compared to the five largest commercial banks during the first nine months of FY07. In aggregate these banks registered a strong growth of 40.8 percent YoY in July-March FY07 compared with 15.0 percent in the same period of last year (see **Table 2.7**).

Table 2.7: Specialized Banks Credit Disbursement Growth
percent

Period	ZTBL	PPCBL	DPBs
Q1	43.2	4.5	36.1
Q2	16.7	48.2	46.5
Q3	71.2	29.2	55.6
FY07 (Jul-Mar)	**40.8**	**26.0**	**46.5**

Credit Recovery

Increased income of farming sector is truly reflected by the improvement in the agri-credit recovery, which grew by 22.5 percent YoY during July-March FY07 against 16.1 percent increase seen last year. This was entirely due to better recovery performance demonstrated by ZTBL, PPCBL, MCB and UBL. However, slow recovery was reported by domestic private banks and CBs (except MCB and UBL). Agri-credit recovery by the five largest commercial banks dropped by 3.1 percentage points in July-March FY07 compared to the pervious year, largely due to weaker performance of ABL, HBL and NBP (see **Table 2.8**).

Table 2.8: Agri-credit Recovery Performance

	Growth (%)		Share (%)	
Banks	**FY06**	**FY07**	**FY06**	**FY07**
Five largest commercial banks*	23.8	20.7	48.0	47.3
ZTBL	1.8	21.5	35.9	35.6
PPCBL	-17.4	-1.0	5.1	4.2
DPBs	86.0	44.2	11.0	12.9
Total	**16.1**	**22.5**	**100**	**100**

*: NBP, HBL, MCB, UBL, and ABL

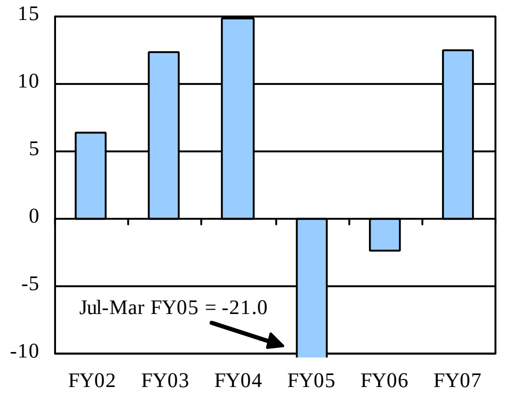
2.2 Large Scale Manufacturing (LSM)

The following analysis, which represents the developments in selected *large scale manufacturing* industries, is based on the limited information regarding production data collected by various associations and committees.[1] Due to non-availability of any aggregate manufacturing indicators,[2] this analysis may not be the true picture of growth in overall *LSM*, and it may also not be comparable with the trends reported in the earlier SBP reports. The detailed LSM data of 100 items for Q1-FY07 and limited information for the subsequent months of the current fiscal year indicate that *LSM* growth during July-March FY07 is probably higher than in the corresponding period of FY06, but suggest that 13.0 percent growth target of *LSM* sector for FY07 may not be achieved.

Sugar

Pakistan Sugar Mills Association's (PAMA) production data for the first nine months of the current fiscal year shows 12.5 percent growth in the *sugar* production, the second highest in the last six years. This is not only a strong reversal from the 2.4 percent decline during the same period of previous year, but is also significantly higher than the 3.0 percent annual growth target for FY07 (see **Figure 2.8**). This growth is largely due to the 22.9 percent rise in the sugarcane harvest during FY07 on the back of high sugarcane prices in previous season. The exceptional performance of *sugar* industry reduced the dependence on *sugar* imports, which fell to 315.0 thousand metric tons in Jul-Mar FY07, 58.8 percent lower than 764.6 thousand metric tons imported in the corresponding period of FY06. The robust growth in domestic production, together with falling international

Figure 2.8: Sugar Industry (Jul-Mar)



[1]These associations/committees included All Pakistan Cement Manufacturers Association, Pakistan Automobile Manufacturing Association, , Oil Companies Advisory Committee, National Fertilizer Development Corporation, and Pakistan Sugar Mills Association

[2] Traditionally, large scale manufacturing (LSM) data of 100 items is compiled and made available for public by the Federal Bureau of Statistics on a monthly basis. The item-wise data on 100 items is not available beyond the first three months (Jul-sep) of the fiscal year. Hence it is very difficult to assess the overall LSM performance for July-March FY07.

prices as global production also increased led to a decline in domestic sugar prices (see **Figure 2.9**).

Figure 2.9: Sugar and Gur Prices

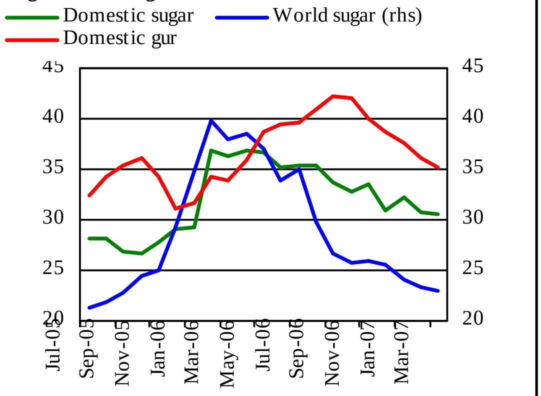
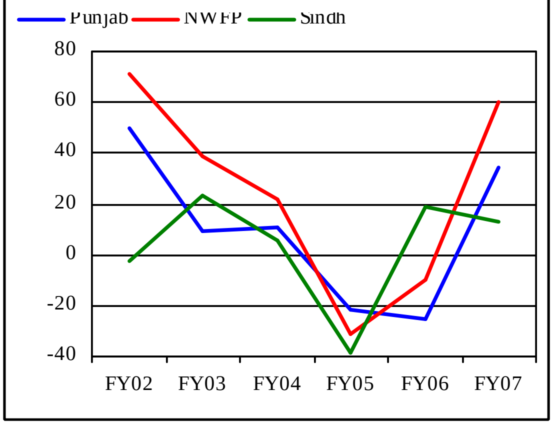


Figure 2.10 shows the performance of Punjab, Sindh and NWFP provinces[3] regarding *sugar* production, better sugar recovery from sugarcane was recorded in two provinces (the Punjab and NWFP), while a slowdown was observed in Sindh during FY07. The recoveries in first two provinces are largely due to an acceleration in the production of sugarcane with 29.6 percent growth and 8.1 percent growth respectively and deceleration in latter is contributed by relatively lower growth in crop production.

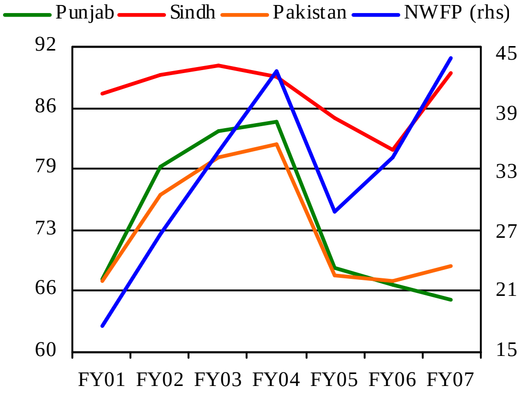
Figure 2.10: Sugar Industry in Provinces



The ratio of the sugarcane crushed to sugarcane production shows the cane utilization by the mills during the season. This ratio reflects the shifting of sugarcane from *sugar* production to *gur* processing. During the current season, this ratio increased by 1.7 percentage points as compared with a decline of 0.6 percentage points in the last crushing season (see **Figure 2.11**). Particularly, in Punjab (the share of Punjab in cane crushing is 64.8 percent), during FY07 sugarcane crushed and sugar cane production ratio, decline by 1.6 percentage points, which is mainly due to production of *gur* by farmers in un-organized sector. The rising trend of gur manufacturing is mainly attributed to relatively higher prices of *gur* in domestic

[3] According to PSMA, the share of Balochistan is negligible in the production of sugarcane as well as in sugar industry

Figure 2.11: Cane Utilization by Mills (percent)

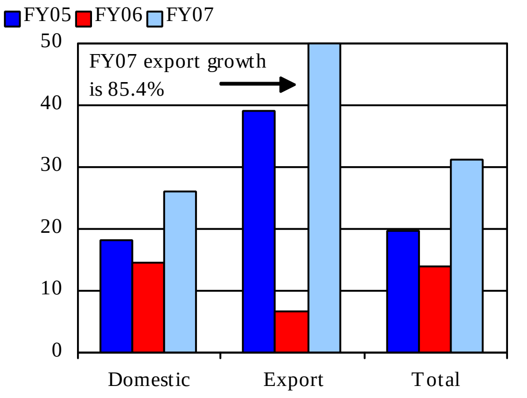


market, 32.7 percent rise in the exports of gur in Jul-Mar FY07 as against a fall of 16.7 percent during Jul-Mar FY06 and sugarcane price dispute between farmers and PSMA in current crushing season.

Cement

As in sugar industry, an acceleration was also observed in the *cement* production during the first nine months of FY07 with growth rising to 24.5 percent, significantly higher than this 18.6 percent seen in Jul-Mar FY06. The strong performance is mainly attributed to capacity expansions initiated[4] during the last five years, a rise in local demand as well as strong external demand (see **Figure 2.12**). During the first nine months of the current fiscal year, the total sales of *cement* recorded a growth of 31.3 percent which is significantly higher than 13.9 percent growth seen in Jul-Mar FY06.

Figure 2.12: Growth in Cement Sales (Jul-Mar)



Local *cement* dispatches rose by 25.0 percent in the first nine months of FY07 compared with 13.4 percent growth in the same period of FY06. The rise in local demand mirrored the boosting activity in *construction* sector (see **Table 2.1**) on the back of mega projects as well as continued large development spending on building infrastructure in the country and considerable rise in FDI in the sector.

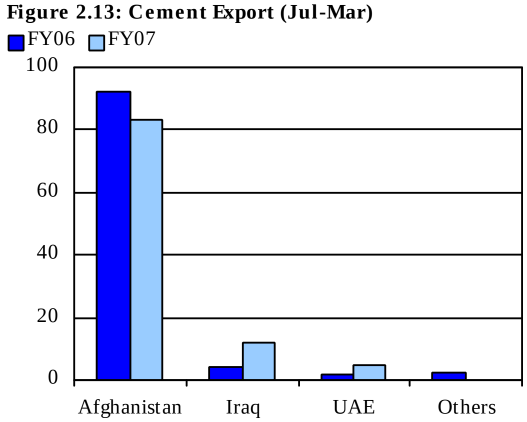
[4] The installed capacity in cement industry is more than doubled during the last five years.

Table 2.1: Construction Performance Indicators (Jul-Mar)

	Unit	FY05	FY06	FY07	
Development expenditures	billion Rs	138	204	149	3
Private credit for construction (flow)	billion Rs	9	9	10	
Foreign direct investment 1	million US$	22	93	136	
Production of steel	000 tons	2321	1188	1475	4
Import of iron & steel 2	000 tons	2122	3216	1922	
Import of construction & mining machinery	million Rs	6366	8254	8243	
Domestic cement dispatches	000 tons	10641	12193	15380	

1 It includes the FDI in construction, cement, metal, basic metal and ceramics groups
2 It includes the import of iron & steel as well as iron & steel scrap
3 Data pertain to Jul-Dec FY07
4 Data for Jul-Feb FY07

Figure 2.13: Cement Export (Jul-Mar)



The growth in exports was even stronger, reaching to 2.1 million tons during July-March FY07 against 1.2 million tons exported during the same period of FY06, an increase of 85.4 percent. Reconstruction activities in Afghanistan, Iraq and faster development work in UAE[5] (see **Figure 2.13**) have given rise to strong *cement* demand, and exports also benefited from fiscal measures[6] taken during FY07 are the main reasons for the rise in *cement* exports during the first nine months of FY07 (relative to the previous year). Export growth is expected to be sustained given the strong demand in India.

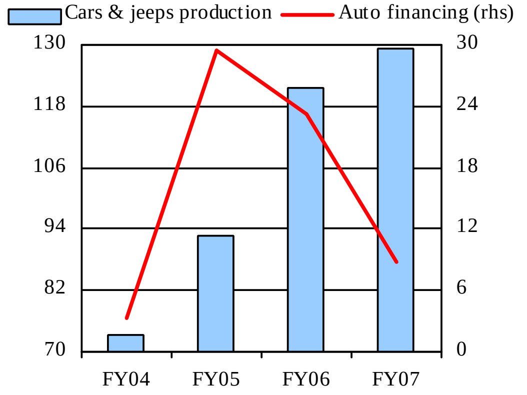
Automobile

As per data provided by Pakistan Automotive Manufacturers Association (PAMA), the *automobile* sector displayed 5.0 percent growth during the first nine

[5] In the first eight months of the current fiscal year, the share of Afghanistan, Iraq and UAE in Pakistan cement export reached to 99.9 percent as compared with 97.6 percent during the same period of the last year.
[6] Restoration of *duty drawback* and exemptions from *FED & sales tax* on exported cement.

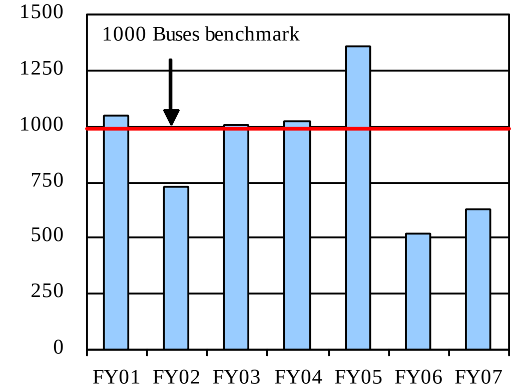
months of FY07, much lower than the 28.4 percent growth recorded during the corresponding period of FY06 (see **Figure 2.14**). The Jul-Mar FY07 growth in the production of *automobiles* is the lowest since FY03. This contributed by supply side as well as demand side factors. On the supply side, capacity constraints and failure to introduce new marketable models at affordable prices are the major factors. Concurrently on the demand side an increased number of substitutes in the shape of imported vehicles, increasing interest rates on bank financing combined with risk management efforts by banks, delay in delivery as well as premiums on local vehicles are the major factors for weakening demand.

Figure 2.14: Impact of Auto Financing (Jul-Mar)



Within the *automobile* sector, the production of rose by 21.0 percent during the first nine months of the current fiscal year, in contrast to a fall of 61.8 percent in the same period of previous year. This recovery in production is due to increased demand by government institutions for urban transport schemes, Punjab police as well as private sector transporters. Since FY01, the production of *buses* have remained less than a thousand in Jul-Mar for three times (FY02, FY06 and FY07) which shown the weak base of *buses* sub-group (see **Figure 2.15).**

Figure 2.15: Production of Buses (Jul-Mar)



A slowdown was observed in the output of *cars & jeeps* with 6.4 percent growth in Jul-Mar FY07, which is not only lower than 31.0 percent growth seen in the corresponding period of the preceding year but also the lowest since FY03 (see **Figure 2.16**). Specially the production of big *cars* with high capacity engine[7] (1300cc and above) fell by 14.4 percent in Jul-Mar FY07 as against a 35.4 percent increase during the same period of last year. A smaller deceleration was seen in the production of low capacity engine *cars* (less than 1300cc engines) with production rising17.2 percent in Jul-Mar FY07 as compared to 24.6 percent growth during the corresponding period of the previous year. Higher cost of auto financing, tough competition from imported cars, relatively higher prices of domestic assembled cars, reluctance of domestic assemblers to introduce new models are the main factors for the weak performance of this sub-sector of *automobiles* sector.

Figure 2.16: Production of Cars (Jul-Mar)

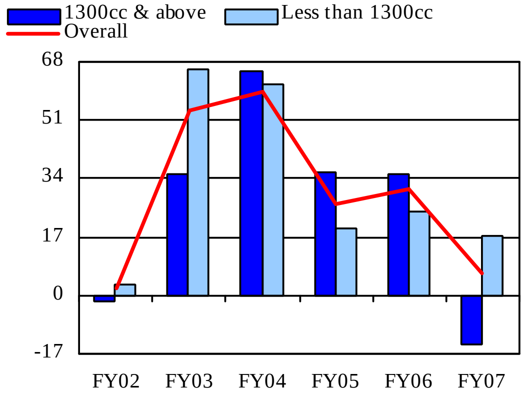
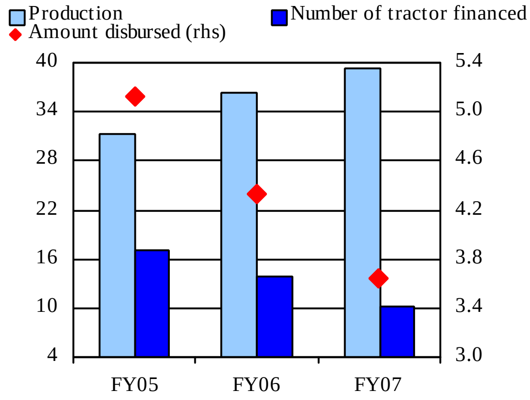


Figure 2.17: Tractors Output & Financing (Jul-Mar)



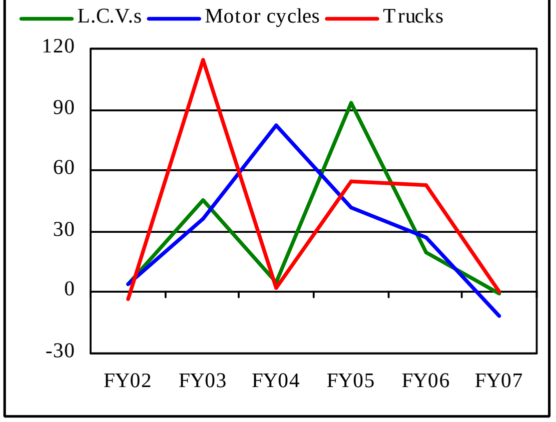
In the same way, a deceleration was also observed in the *tractors* production with 7.9 percent growth during the first nine months of the current fiscal years in contrast to the growth of 16.1 percent in the same period of FY06. Capacity constraints, lower availability of tractor financing and permission of the government to import *tractors*[8] are major reasons for the lower production growth during Jul-Mar FY07. During the first nine months of

[7] Amongst the big cars, Toyota Corolla and Suzuki Liana contributed positively with low pace in the growth of automobiles production in Jul-Mar FY07. While the output of all other assemblers declined during this period.

[8] During Jul-Feb FY07, the value of tractor imports reached to US$ 119.6 million, which is 35.6 percent higher than the same period of last year.

the current fiscal year, *tractor* financing declined in terms of number as well as in terms of amount disbursed (see **Figure 2.17**).

Figure 2.18: Auto Sub-groups (Jul-Mar)



Amongst the automobile industry three sub-sectors (*LCVs, motorcycles* and *trucks*) recorded negative growth in Jul-Mar FY07 (see **Figure 2.18**). The *motorcycles* sub-sector having a small share of 3.5 percent in *automobiles* sector, registered a decrease of 43304 units in production (negative growth of 11.3 percent) during Jul-Mar FY07 as compared with an increase of 82315 units produced during the same period of FY06. Rising market share of non-members of PAMA[9] (Chinese bikes assemblers) on the back of lower prices are the major factor for the lower recorded production of *motorcycles* during Jul-Mar FY07. Moreover, a decline in output of cotton and rice probably also made a negative impact on the sale of bikes in rural areas.

Another sub-group of automobiles sector, which registered a negative growth of 0.3 percent in Jul-Mar FY07, is *LCVs* (having 11 percent share in automobiles sector). This growth of Jul-Mar FY07 is not only lower than 19.3 percent growth in the corresponding period of the preceding year but also the lowest during the same periods in the last five years. The strong import of used *LCVs* is probably the main cause for the decline in the production of *LCVs* during this period.

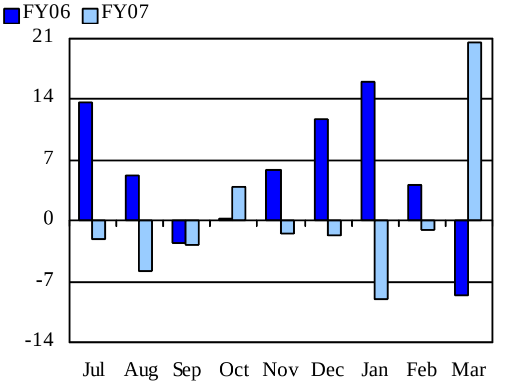
Fertilizer

The *fertilizer* industry registered 0.3 percent fall in output during Jul-Mar FY07 as against a growth of 4.8 percent during Jul-Mar FY06 (see **Figure 2.19**). Temporary closure (for maintenance and up- gradation), slowdown in demand due

[9] There are currently 43 Original Equipments Manufacturers (OEMs) in the motorcycles industry in Pakistan. Out of these, 6 OEMs are the members of Pakistan Automotive manufacturers Association (PAMA) and 37 OMEs who are not PAMA members. PAMA was formed in 1984, initially three motorcycles OEMs namely Atlas Honda, Dawood Yamaha and Suzuki Motorcycles Pakistan became the members of PAMA. In the 1990’s, three more OEMs joined PAMA, these were Fateh Motors, Pakistan Cycle Industrial Cooperative Society Limited and Siagol Qingqi Motors Ltd (subsequently renamed Qingqi Motors Ltd.)

to untimely rains and a considerable rise in the prices, mix of the fertilizers and expectation of a subsidy announcement by the government are the major factors for decline in the production of *fertilizer* (particularly in the production of *non-urea* during Jul-Mar FY07). During the first nine months of the current fiscal year, the import of *fertilizer* also declined by 60.1 percent as against a 69.7 percent rise during the corresponding period of preceding year, which reflects the slowdown in demand of fertilizer during Jul-Mar FY07. Within the *fertilizer* group, the decline in the production of non-urea fertilizer was more prominent with 3.8 percent in the first nine months of FY07 as compared with 6.4 percent growth in Jul-Mar FY06, which may be due to the impact of the delay in the purchases of *fertilizer* by the farmers in anticipation of subsidy announcement during Jul-Oct FY07.

Figure 2.19: Performance of Fertilizer Industry



Petroleum Products

The fall in the production of *POL* products was also declined in the first nine months of the current fiscal year, falling by 5.7 percent as against an increase of 2.3 percent in the corresponding period of the preceding year (see **Table 2.2**). However, the sale of *petroleum* products rose by 17.6 percent during Jul-Mar FY07, indicating that the fall in production did not reflect any weakness in demand for refined POL products. Contrary to the *crude oil*, the import of *petroleum* products recorded a growth of 57.5 percent in Jul-Mar FY07 in contrast with a decline of 5.2 percent during the same period of last year. Within *petroleum* products, the highest decline of 9.8 percent was recorded in furnace oil in Jul-Mar FY07 as

Table 2.2: Production of POL Products (Jul-Mar)

000 metric tons

	FY05	FY06	FY07
Jet fuel	847.6	968.2	898.6
Kerosene	143.0	160.8	154.6
Motor spirits	1,013.4	902.8	909.2
High speed diesel	2,574.2	2,503.0	2,314.9
Light speed diesel (nos.)	135.7	94.9	108.0
Furnace oil	2,370.1	2,546.1	2,297.5
Lubricant oil	154.1	152.4	155.4
Jute batching oil	4.6	2.9	2.9
Solvent naphtha	547.3	660.5	678.8
Petroleum products (nos.)	502.4	494.0	478.7
Total POL	8,292.4	8,485.6	7,998.8

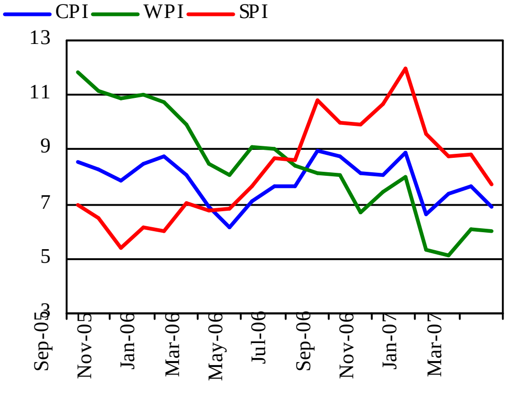
against 7.4 percent growth in the same period of the preceding year. As far as the sale of *furnace oil* is concerned, it reached to 5.3 million metric tons with 65.4 percent growth in Jul-Mar FY07. Similarly the sale of *light speed diesels* also increased by 19.3 percent in Jul-Mar FY07. The rising demand of electricity on the back of strength of economic activities and rising household demand may be the reasons for more demand for electricity in the economy and therefore, for furnace oil & diesel (used in the generation of thermal electricity). Similarly, the production as well as the sale of *jet fuel oil* recorded decline during the first nine months of current year mainly due to restriction on the country's national carrier PIA by the European Union on the back of international safety standard issues.

3 Prices

Overview

Strong increases in food prices continued to underpin inflationary pressures in the economy, offsetting much of the gains from the abatement of non-food inflation through a tight monetary policy. Thus, principally due to rising food prices, the CPI and the SPI measures of inflation both recorded year-on-year increases in April 2007 (see **Figure 3.1**). The influence of food inflation is also evident in the WPI; although the WPI inflation has seen a year-on-year drop, this is simply because a surge in its food component was largely offset by a sharper decline in its non-food elements.

Figure 3.1: Inflation Trends



Inflationary pressures are particularly evident in headline CPI inflation which accelerated to 6.9 percent YoY in April 2007 compared with 6.2 percent YoY in April 2006, despite an ease in non-food inflation (see **Table 3.1**). The deceleration in non-food inflation is mainly attributed to deceleration in the sub-indices for *fuel & lighting*, *transport & communication* and *house rent*. The relative improvement in non-food component also helped bring

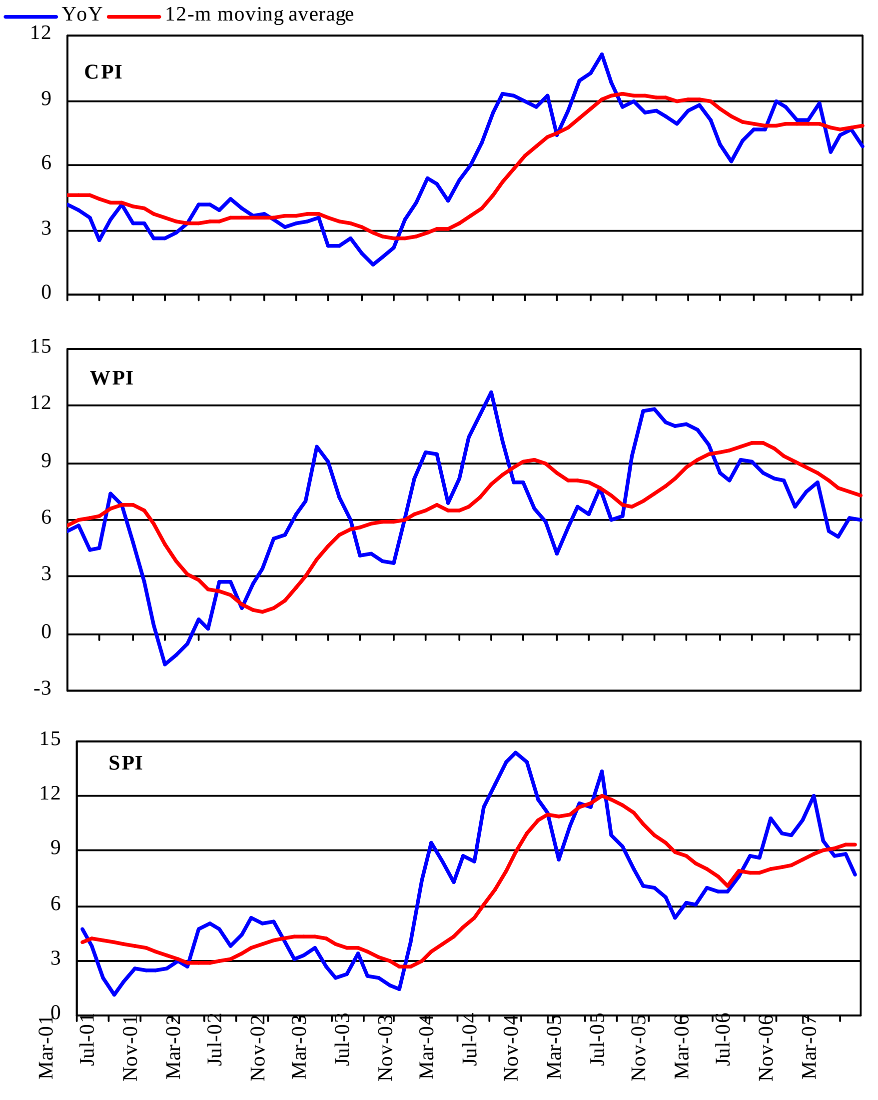
Table 3.1: Inflation Trends (End-April)

percent

	YoY		12-m moving ave[2]	
	FY06	**FY07**	**FY06**	**FY07**
CPI	6.2	6.9	8.2	7.8
Food	3.6	9.4	7.6	9.7
Non-food	8.0	5.2	8.7	6.5
House Rent	8.6	6.2	10.6	7.0
WPI	8.1	6.0	9.6	7.3
Food	4.5	8.4	7.5	8.1
Non-food	10.8	4.3	11.2	6.6
SPI[3]	6.4	7.7	8.1	9.4
Core- NFNE[4]	6.4	5.2	7.3	5.8
Core –trimmed[5]	6.0	6.1	6.9	6.7

[1] Change in Apr-2007 over Apr-2006
[2] Change in 12-m moving ave of Apr-2007 over Apr-2006
[3] Pertains to all income groups indices compiled by FBS.
[4] Non-food non-energy
[5] 20 percent trimmed CPI inflation.
Source: Federal Bureau of Statistics

Figure 3.2: Movements in Price Indices



down annualized CPI and WPI inflation (12 month moving average – see **Figure 3.2**).

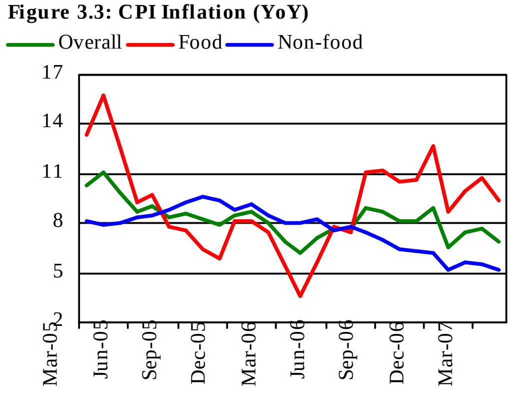
The impact of the unexpected resilience of food inflation and the likelihood of the continued upward pressures in near term due to increases in the prices of key staples such as milk and edible oil etc., SBP forecast for FY07 have been revised upwards from 6.7 – 7.5 percent to 7.5 – 7.8 percent.

In this backdrop, the instability and resilience in headline CPI inflation (particularly in food component) needs to be addressed more effectively. It is true that a part of the rise in food inflation is a reflection of rising seems international prices of key food items; however the dominant part of the increase seems attributable to domestic factors, including market failure and weak anti-trust practices.

The resilience in food inflation raises a policy dilemma. On the one hand, food inflation is relatively less responsive to monetary tightening and therefore it is generally (but not always) a less desirable policy option, particularly when non-food inflation is low and declining. On the other hand, a persistent increase in food inflation could lead to a rise in inflationary expectations.

It may also be noted that SBP also provided support to priority sectors by providing subsidized financing to keep the current growth momentum intact, which partially muted the impact of monetary tightening. These developments imply that SBP at least has to review its policy of subsidized financing so that the higher interest rates can impact aggregate demand more effectively. In addition, the fact that real GDP growth remains strong (and may be above target in FY07) suggests that the strength of aggregate demand is still unabated. Another factor, which may fuel inflationary pressures going forward, is a significant rise in reserve money growth during FY07 mainly on account of massive forex inflows. In the light of the above, at the very least, the central bank will need to retain an anti-inflation bias in its policies while carefully evaluating the second round impact of rising food prices on broader inflation in the country.

Figure 3.3: CPI Inflation (YoY)



3.2 Consumer Price Index

CPI inflation accelerated in April 2007 after registering a deceleration during the preceding two months. The CPI inflation (YoY) stood at 6.9 percent for April 2007, higher than the 6.2 percent inflation during the same month of FY06. The movement in CPI inflation was mainly driven by food inflation during the first ten months of FY07. The food inflation exhibited higher variability compared to non-food inflation which has shown relatively stable downtrend since September 2005 (see **Figure 3.3**). As a result, the contribution of food group in overall inflation increased significantly from 24.9 percent during April 2006 to 56.1 percent in April 2007; the non-food group's contribution declined accordingly in the month. Within the non-food group, the contribution of house rent index in overall CPI inflation also declined from 32.3 percent during the last fiscal year to 21.2 percent.

Food Inflation

CPI food inflation accelerated significantly to 9.4 percent in April 2007, driven mainly by sharp increases in the prices of a few key staples. As a consequence, food inflation remained in double-digits, maintaining the trend since August 2006 (except for January and April 2007). The rise in food prices is not just a domestic phenomenon; the prices of major food items in international markets are also on the rise, contributing to high cost-push pressures.

Table 3.2: Top 10 Food Items Contribution in CPI Inflation

	Weighted contributions			
Items	**Jul-06**	**Dec-06**	**Feb-07**	**Mar-07**
Fresh fruits	0.58	1.53	9.28	12.16
Milk fresh	8.87	9.12	11.39	10.22
Onions	-0.06	13.50	11.26	6.25
Vegetable ghee	0.29	3.50	6.05	6.17
Meat	6.73	5.06	5.84	4.49
Chicken farm	1.88	-1.38	1.85	4.46
Rice	0.18	0.58	2.51	4.43
Eggs	-2.65	-0.06	1.52	3.20
Wheat flour	-1.05	0.98	2.35	1.95
Readymade food	2.14	2.25	2.27	1.91

A closer look at price movements of individual items included in the CPI food group reveals that prices of some important items such as wheat flour, milk rice and meat registered significant increases during April 2007 year on year. It is important to note that the combined weight of commodities with 10 percent or higher inflation is about 56 percent of the food group. On the other hand, prices of 12 commodities declined during the month of April 2007 as compared to fall in the prices of 36 items in April 2006, i.e., the normal seasonal deceleration in prices of many commodities was not strongly evident in FY07.

As regards the contribution of individual items in overall CPI inflation, fresh fruits, milk fresh and vegetable ghee were the top three contributors in the over CPI inflation in April 2007 (see **Table 3.2**).

Non-food Inflation

In contrast to food inflation, non-food inflation decelerated to 5.2 percent in April 2007 from 8 percent in the same month of FY06. The deceleration was primarily contributed by a decline in inflation recorded by the *fuel & lighting* and *transport & communication* sub-indices while supported the impact of the continued deceleration in the *house rent index*. In fact, the *transport & communication* sub-group actually showed deflation[1] mainly due to a decline in the market prices of automobiles (cars and motorcycle) on the back of softening demand. The long run trend (measured by the 12 month moving average) in non-food inflation also witnessed a continued deceleration.

Figure 3.4: House Rent Inflation

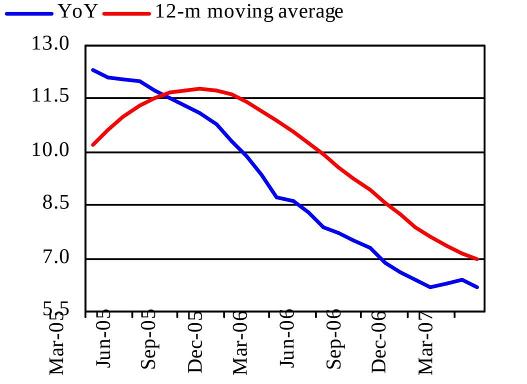
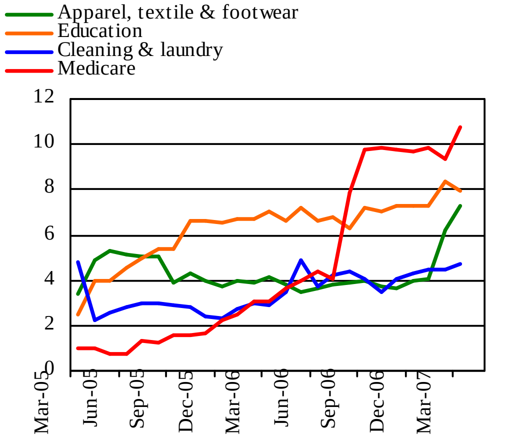


Figure 3.5: Non-food Subgroups' Inflation



The inflation measured by the *fuel & lightening* sub-index decelerated to 7 percent in April 2007 compared to 10.7 percent in April 2006. The fall in *fuel & lighting* inflation was mainly due to the impact of a downward revision in the domestic prices of key fuels in December 2006. Similarly, House rent index (HRI) maintained its declining trend which started after February 2005; it recorded a moderate increase of 6.2 percent in April 2007 which is lower than the 8.6 percent rise during the corresponding month last year. The long run trend of house rent

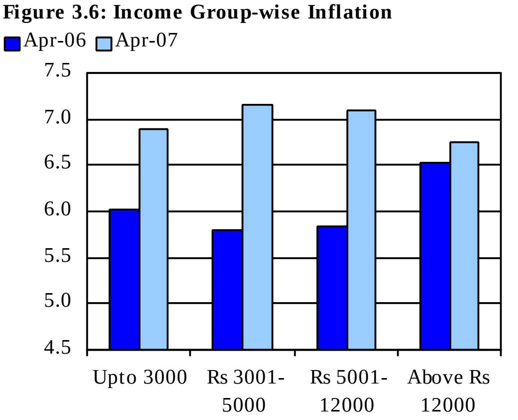
[1] In contrast to 2.4 percent deflation in April 2007, the transport & communication subgroup recorded 13.4 percent inflation during April 2006.

inflation also continued to decelerate (see **Figure 3.4**).

Other indices of non-food group that exhibited an increase in inflation during the month, included *apparel, textile & footwear, cleaning, laundry & personal appearance, household furniture & equipment* and *medicare*. The *medicare* sub index registered a significant double-digit increase of 10.1 percent in April 2007 compared to 3.7 percent growth in the same month last year (see **Figure 3.5**).

The latest published data reveals that the incidence of CPI inflation was the highest for the middle income groups during April 2007, in contrast to the April 2006 picture when the incidence of inflation was greatest for in the highest income bracket (of above Rs 12,000 - see **Figure 3.6**).

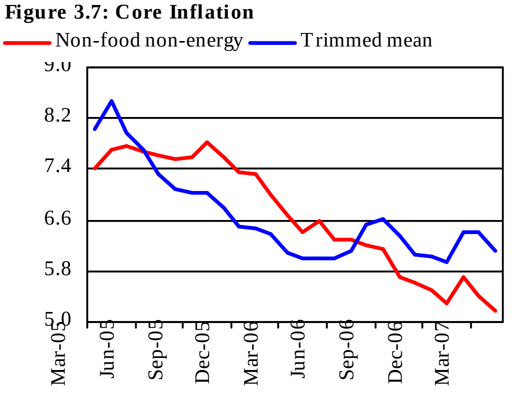
Figure 3.6: Income Group-wise Inflation



3.3 Core Inflation

Encouragingly, core inflation measured by excluding food and energy components from headline CPI inflation, witnessed a visible downtrend during FY07 (see **Figure 3.7**), indicating the impact of tight monetary stance of the central bank on underline inflationary pressures. However, this trend should not endanger complacency as core inflation has shown a little resilience in recent months. More importantly, central bank has to monitor the second round impacts on inflation due to sustained high food inflation, and be ready to act aggressively and pro-actively to minimize these impacts going forward.

Figure 3.7: Core Inflation



The caution is also warranted by the behavior of the other core inflation measure (core inflation measured by trimming method by excluding 20 percent most volatile changes, which are generally temporary) stagnated in a narrow range of 5.9 – 6.5 percent during the last 17 months. This resilience in core inflation measure suggests that inflationary pressures are persisting in the economy.

3.4 Wholesale Price Index (WPI)

WPI inflation, that started declining in October 2005, continued its downtrend in FY07. The WPI registered 6.0 percent increase in April 2007 compared to 8.1 percent during the same month last year (see **Figure 3.8**), as the strong deceleration in non-food component mitigated the inflationary pressures due to food component (see **Figure 3.9**). The *Fuel, lighting & lubricants* sub-index contributed in the deceleration of WPI non-food inflation during the first ten months of FY07. As a result, the contribution of *fuel, lighting & lubricants* sub-index dropped significantly from a positive 59.2 percent in April 2006 to a negative 6.1 percent by April 2007.

Figure 3.8: Wholesale Price Inflation

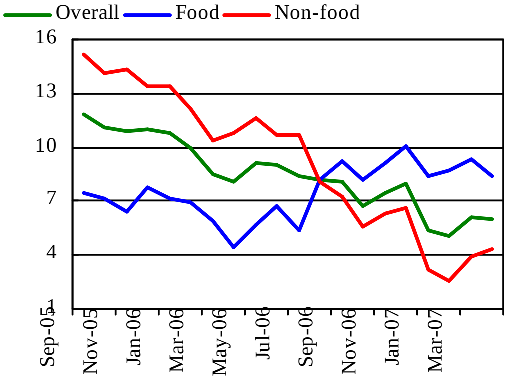
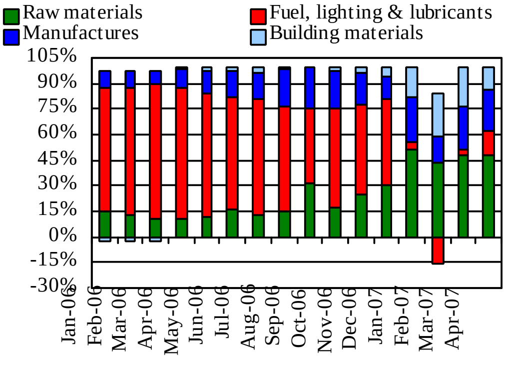


Figure 3.9: Contribution in WPI Non-food Inflation



The increase in WPI inflation was attributed to rise in wholesale prices of onions, fruits, poultry items, cotton seeds, wires & cables etc., which showed increases of varying magnitudes.

3.5 Sensitive Price Indicator

Like CPI inflation, the sensitive price indicator (SPI) remained high during the first ten months of FY07 due to rising inflation in food items.[2] The inflation under sensitive price indicator (SPI) accelerated to 7.7 percent in April 2007 compared to 6.4 percent seen in the same month last year. The long run trend indicated by 12-month moving average showed a slight increase due to continuously high SPI inflation during the current fiscal year.

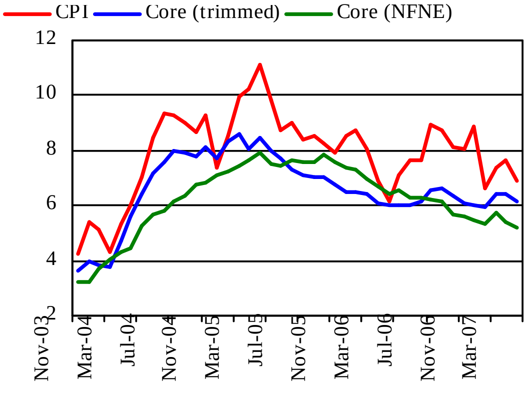
[2] The SPI covers prices of 53 essential items of daily use (mostly kitchen items and some energy items, e.g., petrol and diesel). As mentioned in the second quarterly report FY07 that the fluctuations in the prices food items therefore affect the SPI directly due to the fact that it consists of more than 60 percent food items.

4 Money and Banking

4.1 Overview

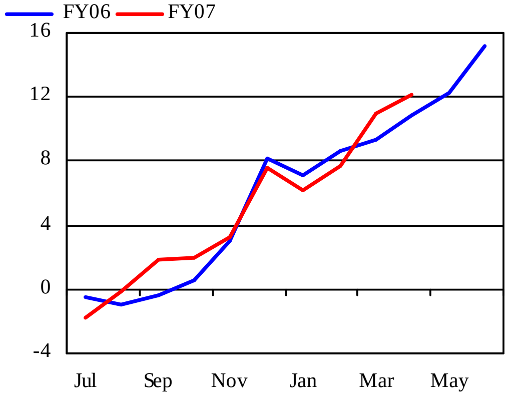
The key challenge for SBP monetary policy during FY07 has been to maintain a balance between sustaining strong economic growth and low and stable inflation. The recent available economic indicators suggest that while the economic growth momentum remains intact, the headline CPI inflation has been stubbornly high at an average of 7.9 percent during Jul-Apr FY07[1] (see **Figure 4.1**) and is projected to remain in the 7.5-7.8 percent range by end FY07.

Figure 4.1: CPI Inflation



The task of monetary management became more difficult in recent months with a sharp monetary expansion which accelerated to 12.1 percent during Jul-Apr FY07, exceeding the 10.8 percent growth realized during the corresponding period of FY06 (see **Figure 4.2**). More importantly, it is likely that the FY07 M2 growth would exceed the 13.5 percent growth target for the year.

Figure 4.2: Money Supply Growth (Cumulative)



Clearly, with (1) economic growth still substantially above the long term average, (2) the headline inflation, despite some decline, remaining persistently higher

[1] This is calculated as percentage change in average CPI for Jul-Apr FY07 over Jul-Apr FY06.

than the FY07 target, (3) the recent acceleration in M2 growth threatening to add to the inflationary pressures, and (4) so far, the slowdown in credit off-take essentially being visible mainly in textile units and consumer credit; the existing tight monetary stance appears appropriate.

While the headline CPI inflation is high, this is mainly due to continuing pressures on food inflation, as the expected slowdown in food inflation in the second half of FY07 did not materialize. Nonetheless, the demand-pull inflationary pressures as reflected in core inflation are weakening. Specifically the YoY core inflation (Non-Food Non-Energy – NFNE) has come down to as low as 5.2 percent in April 2007 from 6.4 percent in April 2006 and a local peak of 7.8 percent in October 2005. Similarly, core inflation measured by the trimmed mean has also decelerated, although not as sharply as in the first measure.

SBP recognizes that food inflation is typically less responsive to monetary tightening and therefore the monetary policy should not respond aggressively to temporary shocks in food prices. At the same time, it is also clear that a continuing focus on tight monetary policy is needed so that the *second-round* impacts of these shocks from high food inflation do not permeate to underlying inflationary pressures in the economy. As a result, SBP depends more on market dynamics and government's administrative measures to contain food inflation while retaining a tightening bias to ensure that inflationary expectations are contained.

In this perspective, the surge in M2 expansion in H2-FY07 is a more challenging development given that this has the potential to cause a resurgence in excess demand pressures in the economy. Unfortunately, the underlying causes of the recent M2 growth (i.e., strong government borrowings and rise in net foreign assets – see **Figure 4.3** and **Table 4.1**) [2] leave the central bank with a dilemma.

The budgetary borrowings from the banking system are largely a function of (1) the overall fiscal position of the government[4], and (2) availability of financing from other sources (external and domestic non-bank).

[2] These together contributed 3.6 percent to the total rise of 4.0 percent in M2 growth during Mar-Apr FY07.

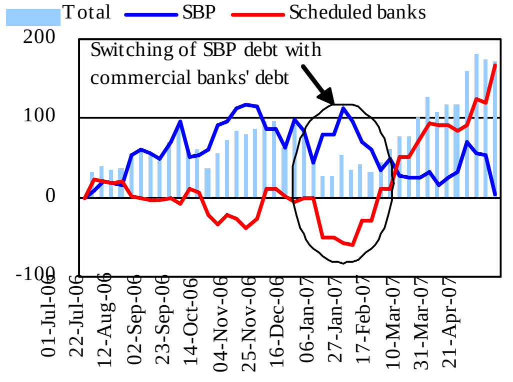
[4] It is also argued that the changes in government borrowings depend on the lead and lags in various payments and receipts of the government, which also induce unpredictability to the overall volume of budgetary borrowings from the banking system. For example, to the extent the recent sharp rise in government budgetary borrowings reflects lower external financing, it is expected that the forthcoming sovereign bond issue will enable the government to retire a part of its outstanding debt with the domestic banking system.

Table 4.1: Causative Factors for M2 Growth

in percent	Jul-Apr		Jul-Feb		Mar-Apr	
	FY06	FY07	FY06	FY07	FY06	FY07
M2 growth	10.8	12.1	8.7	7.7	2.0	4.0
Contribution from						
NFA	1.3	2.4	-2.7	1.2	3.7	1.1
NDA	9.5	9.7	11.4	6.5	-1.7	2.9
Government borrowing	0.7	3.5	4.0	1.2	-3.0	2.1
For budgetary support	*1.7*	*5.0*	*5.0*	*2.3*	*-3.0*	*2.5*
Credit to non-govt sector	11.7	8.1	10.5	6.5	1.1	1.5
Private sector	11.6	8.0	10.5	6.6	1.1	1.3
Other items (net)	-2.8	-2.0	-3.1	-1.2	0.2	-0.7

Given the government's commitment to increase development spending, and the fact that the monetary policy has already been successful in reducing excess aggregate demand, a further increase in policy rate raised the risk that an increase in government expenditures could seriously crowd out private investment.

Figure 4.3: Budgetary Borrowings from the Banking System

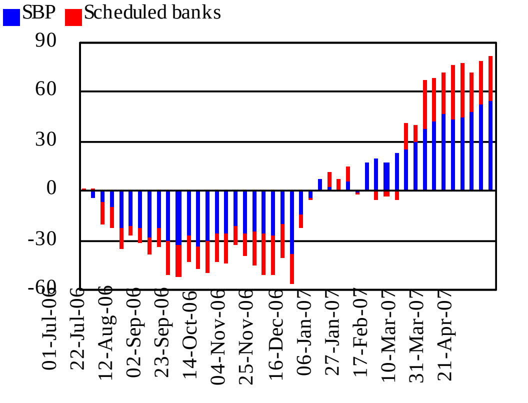


This raises two points: (1) the government needs to retire borrowings from the banking system, particularly from central bank. In particular, going forward, any rise in government receipts from external and non-bank sources must be mirrored by corresponding retirement of government debt with SBP in order to contain the reserve money growth; and (2) It is important that the fiscal deficit be contained in years ahead to reduce the risk of crowding out of the private investment.

The second major source of expansion in money supply during Mar-Apr FY07 is the large foreign exchange inflow (both in the government and the private sector) that has led to a significant increase in NFA of the banking system (see **Figure 4.4**). If excessive foreign exchange inflows are not mopped up, this would force the Rupee to appreciate against the foreign currency with adverse economic consequences. On the other hand, if the SBP seeks to purchase the foreign exchange in order to defend the Rupee appreciation; this could potentially further spur undesirable growth in reserve money.

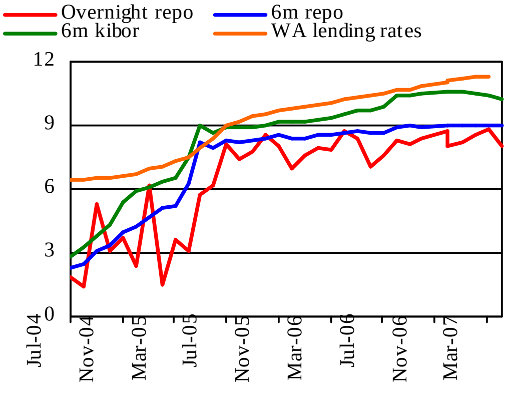
It must also be recognized that the increasing integration of the domestic financial market with international markets may render further interest rate hikes counter-productive. In other words, if the SBP attempts to sterilize the liquidity, the resultant rise in interest rates could lead to further foreign exchange inflows.

Figure 4.4: NFA of the Banking System



In light of the above, rather than raising the policy rate, the SBP focused on effective liquidity management. Indeed, the surplus liquidity in the inter-bank market (stemming from M2 expansion) could potentially stimulate the multiplier process by putting downward pressures on interest rates in coming months. This indeed was not desirable because, given the persistence of supply side pressures, a further increase in aggregate demand could only have exacerbated the inflationary pressures in the economy. To avoid this, the SBP has been monitoring closely the liquidity in the inter-bank market and has been intervening as and when required.[5]

Figure 4.5: Key Interest Rates

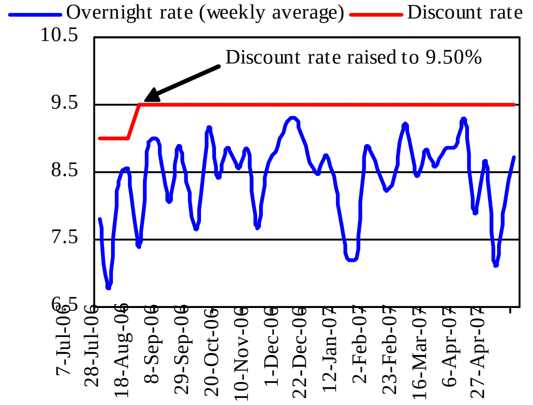


The effectiveness of liquidity

[5] The FY07 liquidity management was not only focused on the desired quantum of liquidity available in the inter bank but also took into account the efficient allocation of financial resources. In particular, the SBP has been directing banks on several occasions to closely monitor the use of the funds provided by them. This was done to ensure that the bank credit is not used to finance speculative activities in the economy.

management can be gauged from the fact that although the robust growth in deposit mobilization and the increased SBP purchases of US dollar from the inter-bank market added the Rupee liquidity in the banking system, there does not appear to be pressures for the softening of the weighted average lending rates (see **Figure 4.5**). Although the weighted average lending rates on gross disbursements (during the month) registered some decline in January and February 2007, this owed mainly to the impact of low interest rates applied on inter-bank lending (see **Box 4.1**).

Figure 4.6: Weighted Average Overnight Rate



It is true that the excess liquidity in the inter-bank market led to some temporary dips in the inter-bank overnight repo rate which resulted in large deviations from the discount rate. However, it is important to mention here that these deviations were of short duration (see **Figure 4.6**) and mainly reflect the unexpected inflows (especially from the external sector and government sector) that hamper the proactive conduct of liquidity management. More importantly, these deviations were inconsequential as the credit demand remained subdued throughout the period and given that despite the decline in kibor,[6] the lending rates kept following a rising trend.

The persistently high lending rates throughout Jul-Apr FY07 were instrumental in containing the aggregate excess demand in the economy. The impact of this on private sector credit growth was compounded by (1) the increase in credit from NBFIs; (2) more conservative credit assessments by banks given the expanded borrowers' data available through Credit Information Bureau (CIB); (3) internal restructuring as well as mergers and acquisitions in the banking industry; and (4) increase in capacity installations in manufacturing sector in recent years and delays in initiation of major infrastructure projects that led to subdued demand for fixed investment loans.

[6] The decline in Kibor is merely a rationalization of credit spreads over collateralized rates to historical norms, which had widened post reserve requirement and discount rate changes.

As a result, growth in private sector credit slowed to 13.0 percent during Jul-Apr FY07 compared to 20.2 percent during the corresponding period of FY06.

4.2 Monetary Survey

The growth in money supply (M2) during Jul-Apr FY07 accelerated to reach 12.1 percent compared with 10.8 percent during Jul-Apr FY06. The high monetary growth during Jul-Apr FY07 was caused mainly by a sharp increase in net foreign assets (NFA) of the banking system as the growth in net domestic assets (NDA) of the banking system strong, as in the previous year (see **Table 4.2**). While the increase in NFA reflects higher foreign exchange inflows, the strong growth in NDA was caused entirely by a sharp increase in government sector borrowings for budgetary support that more than offset the deceleration in the credit to non-government sector.

Table 4.2: Monetary Survey (Flows)
billion Rupees

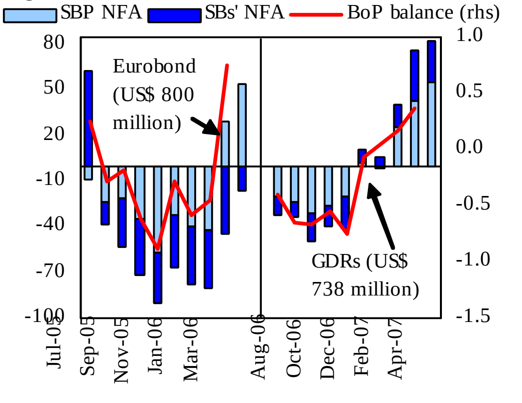
	Credit Plan FY07	Jul-Apr FY06	Jul-Apr FY07
Money supply (M2)	**459.9**	**320.8**	**412.2**
		(10.8)	(12.1)
NFA	**9.8**	**38.7**	**82.2**
		(6.1)	(11.9)
SBP		54.7	55.1
Scheduled banks		-16.0	27.1
NDA	**450.1**	**282.1**	**330.0**
		(12.11)	*(12.10)*
SBP		10.8	33.9
Scheduled banks		271.3	296.0
A. Government borrowing	**130.1**	**20.1**	**120.4**
Budgetary support	**120.1**	49.9	170.6
SBP		43.2	3.1
Scheduled banks		6.6	167.6
Commodity operations	**10**	-29.7	-50.4
B. Credit to non-govt. sector	**395**	**346.6**	**278.0**
Private sector	390	345.3	273.8
		(20.2)	*(13.0)*
PSEs	5	2.5	3.8
C. OIN	**-75**	**-84.5**	**-68.4**
SBP		-31.6	30.6
Scheduled banks		-52.9	-99.0

Note: Figures in parenthesis are growth rates

Net Foreign Assets

Following the slight improvement in the country's external account, the NFA of the banking system registered an expansion of Rs 82.2 billion during Jul-Apr FY07 (see **Figure 4.7**). This increase in NFA looks particularly high especially when compared with the Rs 9.8 billion initial estimates in the Credit Plan for FY07 and

Figure 4.7: Cumulative Flows in NFA



the low expansion of Rs 38.7 billion during the same period of FY06.

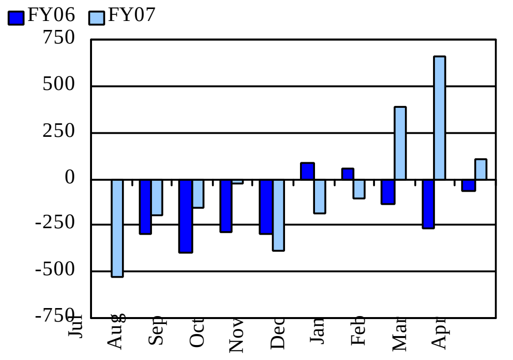
Major factors responsible for the current expansion in NFA include, influx of foreign exchange mainly through GDRs, a relatively high foreign investment (both FDI and Portfolio), foreign private loans and increase in loan disbursements from Asian Development Bank.[7]

Within the banking system, so far, the growth in NFA stemmed mainly from scheduled banks' NFA where most of the private sector foreign exchange flows were directed. The increase in SBP NFA of Rs 55.1 billion during Jul-Apr FY07 was only a little higher than the increase of Rs 54.7 billion in Jul-Apr FY06, despite the relatively lower government sector external inflows in the former period.

The major factors responsible for a slowdown in government sector inflows were: (1) delays in sovereign bond issuance during FY07; these had replenished the SBP NFA by US $ 799.0 million in Jul-Apr FY06; (2) lesser inflows under privatization proceeds (even after including inflows of foreign exchange through floatation of GDRs); and (3) relatively low logistic support receipts.

However, the impact of the slowdown in public sector external inflows on SBP's NFA was more than offset by the increase in the central bank's net US$ purchases from the inter-bank foreign exchange market during February and March 2007 (see **Figure 4.8**).[8]

Figure 4.8: SBP Net Purchases from the Inter-bank Foreign Exchange Market



Going forward, the expected issuance of a sovereign bond by the Government of Pakistan, and disbursements of loans from Asian Development Bank and Islamic Development Bank, are expected to result in a

[7] Net of total servicing, the ADB disbursed US$ 720.5 million during Jul-Mar FY07 compared with US$ 369.9 million in Jul-Mar FY06.

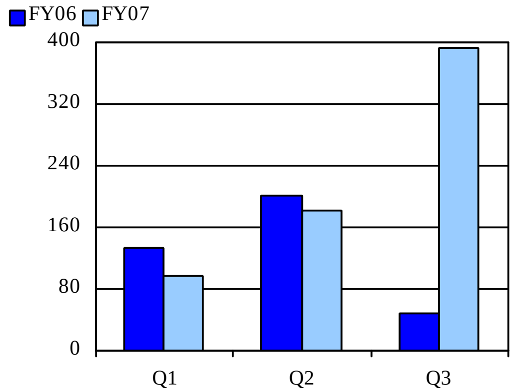
[8] As a result, the cumulative net selling reached to US$ 433.1 million (or Rs 26.3 billion) during Jul-Apr FY07; almost one-third of net selling of US$ 1.6 billion (or Rs 98.5 billion) in Jul-Apr FY06.

further rise in SBP's NFA during the remaining months of FY07.[9]

The NFA of the scheduled banks showed an expansion of Rs 27.1 billion during Jul-Apr FY07 compared to the net contraction of Rs 16.0 billion during Jul-Apr FY06.

This higher expansion is mainly explained by large foreign investment (both direct and portfolio), a relatively weak demand for FE-25 loans by the business sector[10] and significantly higher inflows of workers' remittances during Jul-Apr FY07.[11]

Figure 4.9: Quarterly Net Inflows in SCRA



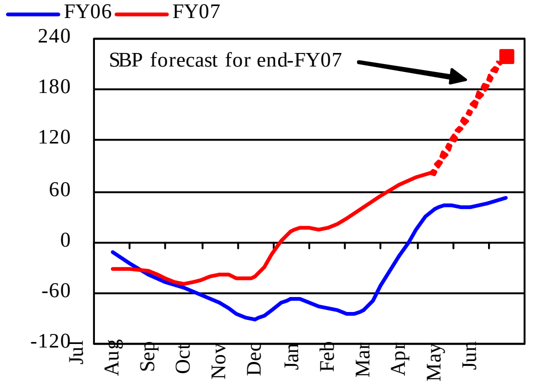
It is interesting to see that most of the increase in scheduled banks' NFA came during the Q3-FY07 when the overall external account balance turned into a surplus. In addition to a narrowing trade deficit and an increase in foreign direct investment, a noticeable increase was also observed in Special Convertible Rupee Accounts (SCRA) balances during Q3-FY07 which was even higher than the combined increase in SCRA during Q1 and Q2-FY07 (see **Figure 4.9**). Although SBP purchased a major part of foreign exchange from the inter-bank market during Q3-FY07, the volume of purchases was not sufficient to offset the impact of these inflows on scheduled banks' NFA.

Going forward, the expansion in NFA of the banking system is expected to continue apace and SBP forecasts suggest a cumulative expansion of Rs 220 billion by end-June FY07 (see **Figure 4.10**). The inflows in private sector are expected to continue, but their magnitude remains uncertain. In the wake of high

[9] Issuance of sovereign bonds worth US$ 500 million was projected in FY07 initial budget estimates.
[10] Business sector availed only US$ 309.2 million from FE-25 deposits during Jul-Apr FY07 compared to US$ 610.4 million during the same period last year. This relatively weak demand for foreign currency loans reflects the narrow spread between the cost of FE-25 loans and EFS loans, thereby making FE-25 loans unattractive for exporters. Importers on the other hand continued to avail the FE-25 loans which were cheaper compared to the rupee funding rate.
[11] During Jul-Apr FY07, workers' remittances grew by 22.6 percent compared to 5.2 percent during the same period last year.

inflation and reserve money growth pressures in the economy, sterilizing these huge foreign exchange inflows to minimize their impact on overall M2 growth will continue to be a challenge for SBP.

Figure 4.10: NFA of the Banking System



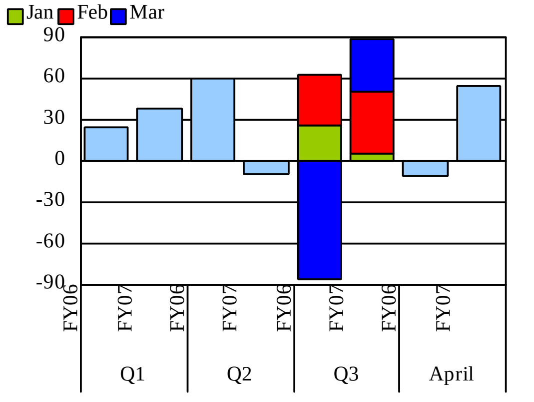
Net Domestic Assets

Growth in Net Domestic Assets (NDA) has remained more or less unchanged from the previous year during Jul-Apr FY07 to reach 12.1 percent. This was because the slowdown in credit to the non-government sector (from 19.4 percent in Jul-Apr FY06 to 12.7 percent in Jul-Apr FY07) offset the acceleration in credit to the government sector (from 2.7 percent in Jul-Apr FY06 to 14.3 percent in Jul-Apr FY07).

Government Borrowings for Budgetary Support

The *increase* in government's budgetary borrowings from the banking system during Jul-Apr FY07 was more than twice of that in Jul-Apr FY06. In specific terms, the budgetary borrowings recorded an increase of Rs 170.6 billion during Jul-Apr FY07 compared with Rs 49.9 billion in Jul-Apr FY06, despite the substantially large inflows in NSS.[12] The higher growth in the former period was caused mainly by (1) a rise in financing requirements; and (2) a relatively subdued financing

Figure 4.11: Quarterly Trends in Budgetary Borrowings

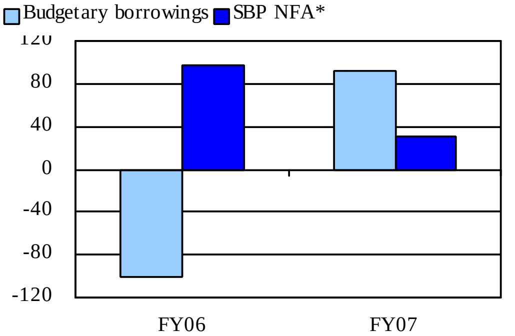


[12] The government mobilized Rs 42.1 billion through NSS during Jul-Mar FY07 compared with Rs 8.9 billion during Jul-Mar FY06. As a result, domestic non-bank borrowings reached to Rs 73.9 billion compared with net retirements of Rs 12.7 billion in corresponding period of previous year.

from external sector compared with Jul-Apr FY06.

It is interesting to note that the budgetary borrowings from banking sector, during Jul-Feb FY07, were less than half of that in the corresponding period last year. It was only March 2007 onwards that this picture changed completely and the budgetary borrowings exceeded those in the previous year (see **Figure 4.11**). This change stemmed mainly from a sharp difference in the volume of external financing in the two periods.

Figure 4.12: SBP NFA & Budgetary Borrowings - A Comparison (Mar-Apr)

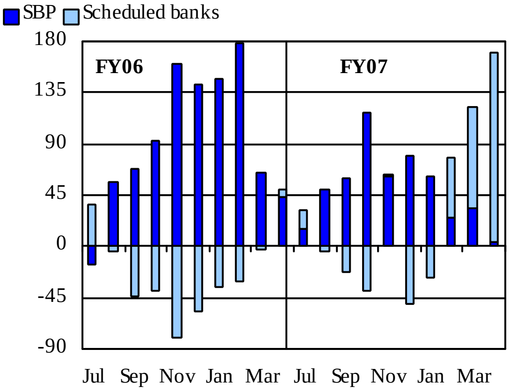


* The SBP NFA has been used because government sector external inflows are directed through SBP.

Specifically, during Mar-Apr FY06, the realization of Euro bond issuance and PTCL privatization proceeds had enabled the government to retire most of budgetary borrowings from the domestic banking system during the period (see **Figure 4.12**). As these external inflows were not available to the government in Mar-Apr FY07, government financed its budgetary requirements through domestic bank borrowings.

Nevertheless, it is worth mentioning that in Mar-Apr FY06, the net increase in budgetary borrowings was quite minimal as the government used the entire volume of external flows to retire domestic debt. In this perspective, the *increase* in budgetary borrowings of Rs 92.5 billion during Mar-Apr FY07 looks more disturbing.

Figure 4.13: Budgetary Borrowings (Jul-Apr)

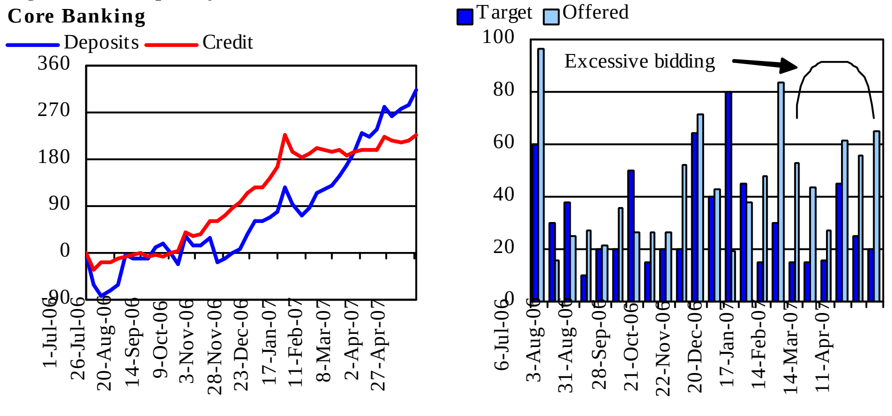


Within the banking sector, the scheduled banks provided the bulk of budgetary finance during Jul-Apr FY07.

This is sharply in contrast with Jul-Apr FY06 when the SBP was directly financing the budgetary needs. The monthly break up of the data, however, shows that up to the end-January 2007, the government was retiring the borrowings from scheduled banks (see **Figure 4.13**).

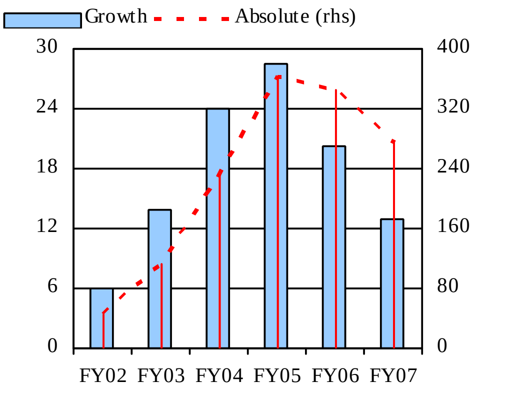
Figure 4.14: Liquidity Comfort from Core Banking

T-bill Auction Profile (all tenors)



This trend discontinued February 2007 onwards when the scheduled banks started investing heavily in government papers following the increase in Rupee liquidity at their disposal[13] (see **Figure 4.14**). The increase in offered amounts (net of maturity) in T-bill auctions, coupled with bid rates very close to the cut-off rates in previous auctions, provided government an opportunity to mobilize Rs 195.7 billion from scheduled banks during Feb-Apr FY07 and retire Rs 58.4 billion to the SBP in the same period. This helped SBP to contain the reserve money growth, in addition to absorbing additional liquidity from the inter bank market.

Figure 4.15: Private Sector Credit Flows (Jul-Apr)



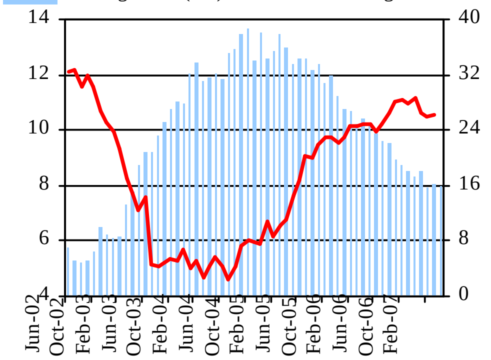
Private Sector Credit

Growth in credit to private sector slowed from 20.2

[13] The increase in liquidity stemmed mainly from a strong deposit growth, a slowdown in credit off-take and SBP's large US$ purchases from inter bank.

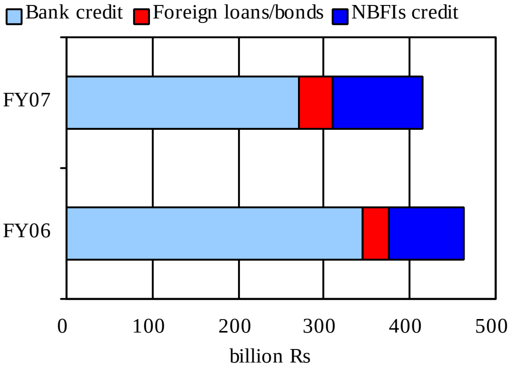
percent during Jul-Apr FY06 to 12.9 percent during Jul-Apr FY07; the lowest credit growth for Jul-Apr period in the last five years (see **Figure 4.15**). More specifically, the volume of credit also declined substantially in Rupee terms in the said period showing that monetary policy has been reasonably successful in reducing excess demand in the economy (see **Figure 4.16**).

Figure 4.16: Credit Growth and Lending Rates



Besides interest rates increase, other contributory factors to the slowdown in private sector credit (net) could include: (1) the greater availability of non-bank finance to the private sector, including credit from NBFIs, increase in foreign private loans and issuance of corporate bonds in international market by the private sector companies (see **Figure 4.17**); (2) banks following more conservative credit assessments given the expanded borrowers' data available through CIB and slightly increasing non-performing loans; (3) restructuring as well as mergers and acquisitions in the banking industry;[14] (4) the SBP's continuous emphasis on monitoring of the personal loans as well as under other schemes to ensure the minimum use of bank credit to finance speculative activities; and (5) large volume of loan write-offs during Jul-Mar FY07 compared with the Jul-Mar FY06.[15]

Figure 4.17: Comparison of Private Sector Credit (Jul-Mar)

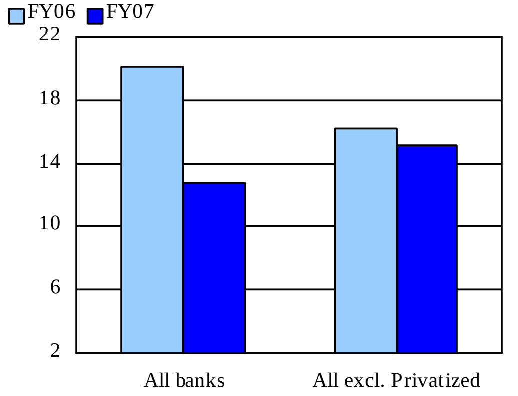


[14] The banks that merged during Jul-Apr FY07 registered an expansion of Rs 14.0 billion compared with Rs 30.1 billion in the corresponding period of previous year.

[15] In specific terms, loans amounting to Rs 16.1 billion were written off during Jul-Mar FY07 by commercial banks compared with Rs 6.9 billion in the same period of FY06.

In fact, a significant contribution to the realized FY07 credit growth was due to the provision of concessional facilities by the SBP. Excluding this, the credit growth drops to 10.1 percent in Jul-Apr FY07 from 19.3 percent in Jul-Apr FY06.

Figure 4.18: Credit to Private Sector Growth

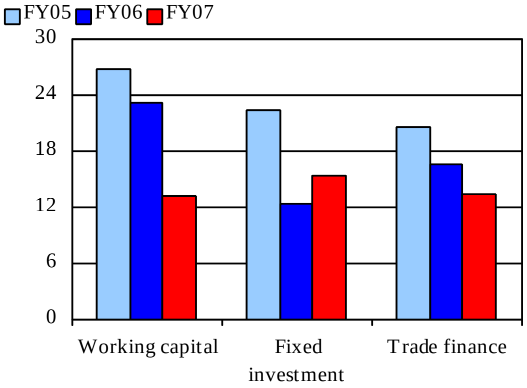


Nevertheless, the disaggregated data shows that the slowdown in private sector credit during Jul-Apr FY07 was not only concentrated in few sectors; but was concentrated in only a few banks as well. Specifically, while the major slowdown was registered in textiles, cement industries and commerce sector (within business sector) as well as in personal loans; the bank-wise data shows that excluding the privatized banks,[16] the credit to private sector has decelerated only slightly (see **Figure 4.18**).

Business sector loans[17]

The growth in aggregate business sector loans decelerated to 13.6 percent during Jul-Mar FY07 compared with 18.5 percent growth in the corresponding period of the previous year. A major contribution to this deceleration was from working capital loans and trade financing. In contrast, fixed investment loans registered a higher growth,

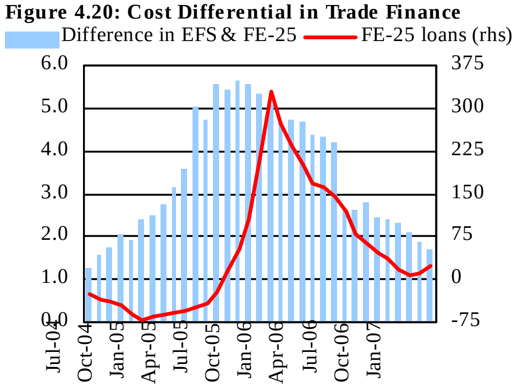
Figure 4.19: Advances to Private Sector (Jul-Mar)



[16] Privatized banks include HBL, MCB, ABL and UBL. Together, these banks constitute 35 percent in outstanding credit to private sector at end April 2007 (and 36.5 percent at end April 2006).

[17] Following sub-sections are based on data on private sector loans as per the classification under International Standard Industrial Classification and is available up to March 2007. The said data will not tally with the credit data reported in monetary survey as the latter includes banks' investments in equities of private business sector as well.

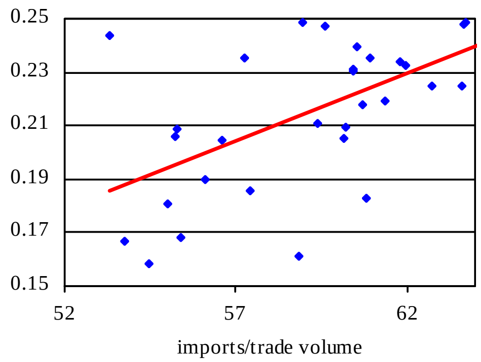
Figure 4.20: Cost Differential in Trade Finance



mainly to the telecommunication and power sectors (see **Figure 4.19**).

The slowdown in trade financing during Jul-Mar FY07 is in line with the deceleration in the growth of aggregate trade volumes from 21.9 percent during Jul-Mar FY06 to 7.9 percent in Jul-Mar FY07. However, the composition of trade finance during Jul-Mar FY07 is in stark contrast with Jul-Mar FY06. In specific terms, the EFS loans, that had registered a mere 0.7 percent growth during Jul-Mar FY06 constituted 71.3 percent of the increase in total trade finance during Jul-Mar FY07. This mainly reflected a decline of 150 basis points in the cost of such loans even as benchmark interest rates in the economy rose.[18]

Figure 4.21: Imports' Share in Trade Finance & Volume (Jul-04 to Mar-07)

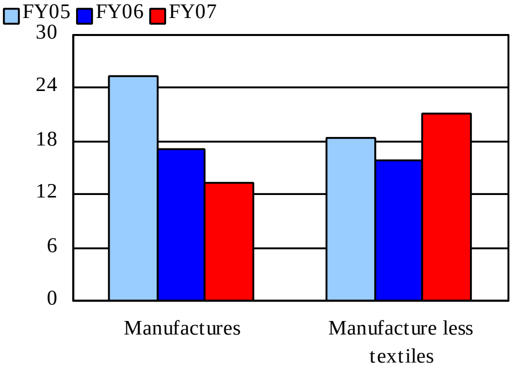


Foreign currency loans, on the other hand, lost their attractiveness for domestic exporters because of the dwindling spread between the cost of FE-25 loans and EFS loans (see **Figure 4.20**). However, it is interesting to see that the FE-25 loans for import financing and the share of import finance to total trade financing has increased substantially. This is a function of the relatively lower cost of FE-25 loans, as Rupee funding rate rose (see **Figure 4.21**).

[18] The SBP reduced the rate of refinance from 7.5 percent to 6.5 percent during July 2006. In addition, the SBP also capped the maximum margin/spread of banks at 1 percentage point from 1.5 percentage points earlier.

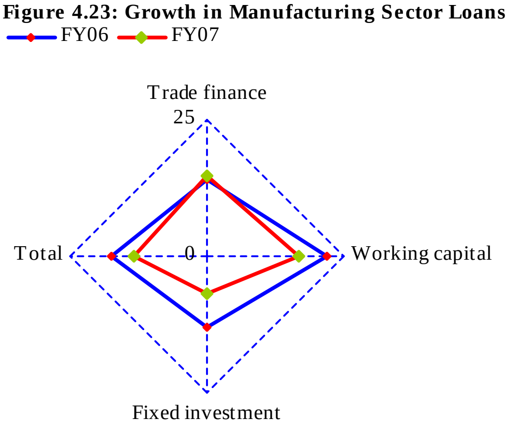
Manufacturing sub-sector
Growth in advances to the manufacturing sector decelerated to 13.2 percent during Jul-Mar FY07, compared with 17.1 percent rise in the corresponding period of FY06. However, it is pertinent to mention here that excluding the textile industry, the growth in advances to manufacturing sector has actually accelerated (see **Figure 4.22**).

Figure 4.22: Impact of Slowdown in Loans to Textiles on Loans to Business Sector



The slowdown was visible in both fixed investment loans and the loans for working capital (see **Figure 4.23**). Only trade financing registered a slight acceleration. A part of the slowdown in fixed investment loans is probably because many industries have already substantially increased their production capacities in recent years and have not borrowed aggressively in FY07. Moreover, delays in initiation of major infrastructure projects, e.g., power projects, have also led to subdued demand for fixed investment loans.

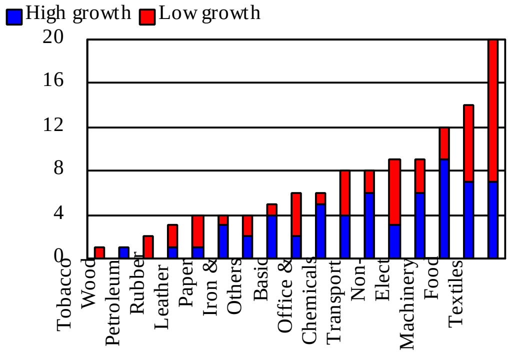
Figure 4.23: Growth in Manufacturing Sector Loans



However, it must be noted that the growth in working capital loans to manufacturing sector, though decelerated, has remained strong at 16.8 percent during Jul-Mar FY07.

In addition, a mixed trend in working capital loans was evident across various industries. Specifically, more than half of the manufacturing units registered a higher growth in off-take of working capital loans in Jul-Mar FY07 while others observed slower growth, compared with Jul-Mar FY06 (see **Figure 4.24**).

Figure 4.24: Growth Pattern of Working Capital Loans to Manufacturing Sector

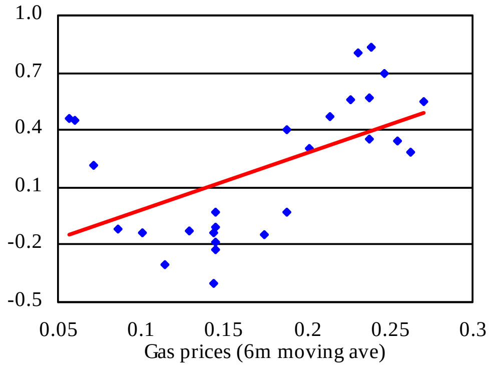


(1) Sectors registering high growth in advances

In most of the units that registered higher growth in advances during Jul-Mar FY07, the increase in raw material prices (both domestic and foreign) played an important role in raising the working capital requirements.

For example, advances to rice processing industries recorded a sharp growth of 26.8 percent during Jul-Mar FY07 compared with 6.1 percent growth during Jul-Mar FY06 (see **Table 4.3**). This growth was caused mainly by a surge in domestic prices of rice amidst rising international prices.[19] This, coupled with the higher demand for Pakistani rice in international market, increased the working capital requirements of the rice processing companies.[20]

Figure 4.25: Fertilizer Loans vis-à-vis Gas Prices (Dec-04-Feb-07)



Similarly, loans to the manufacture of electrical machinery and appliances registered a robust growth during Jul-Mar FY07 contributed mainly by domestic appliance industry and the manufactures of insulated wires and cables.

[19] The production of rice has dropped to 4.5 million tons in FY07 compared with 5.1 million tons in the preceding year. As a result, retail price of rice in the local market was increased from Rs 1100 per 40 kg in FY06 to Rs 1200 per 40kg in FY07.

[20] The demand for Pakistani rice in international market was due to a short supply of basmati rice caused by a sharp decline of 15 percent in the production of Indian rice.

While the growth in loans to former reflects a substantial growth of 30.6 percent in the unit prices of imported electrical machinery and apparatus during Jul-Mar FY07, the growth in latter is caused mainly by continued fixed investments in the telecommunication sector.

Fertilizer was another sector where the high growth in advances was driven entirely by increase in raw material prices. Specifically, the high growth in advances to fertilizer sector, despite a sharp slowdown in production, is explained mainly by a significant rise of 27.0 percent YoY in natural gas prices July 2006 onwards compared with a 14.5 percent rise in the same period last year (see **Figure 4.25**).[21]

Loans to the manufactures of wearing apparel registered a robust growth of 27.8 percent in Jul-Mar FY07 compared with only 5.1 percent growth during Jul-Mar FY06. Most of the increase was seen in trade financing as also evident in the 13.8 percent growth in exports of readymade garments, even over an already high growth of 24.8 percent during Jul-Mar FY06.

Table 4.3: Growth in Private Sector Credit (Jul-Mar)

	Change			
	percent		**billion Rs**	
	FY06	**FY07**	**FY06**	**FY07**
1. Private business	**18.5**	**13.6**	**230.9**	**203.2**
of which				
A. Agriculture and forestry	**-1.1**	**7.8**	**-1.4**	**10.5**
B. Manufacturing	**17.1**	**13.2**	**129.9**	**119.0**
of which				
a. Manufacture of food products	13.8	20.9	16.9	30.1
Rice processing	6.1	26.8	2.0	7.6
Feeding stuff for animals	70.6	395.8	1.3	9.9
Sugar	47.6	20.4	15.8	11.1
b. Manufacture of textiles	18.5	5.0	69.5	21.6
Spinning of fibers	15.6	5.4	31.7	11.8
c. Manufacture of wearing apparel,	5.1	27.8	1.4	8.0
d. Manufacture of refined petroleum	-2.0	69.7	-0.2	5.4
e. Fertilizers and nitrogen compounds	28.6	48.0	3.6	8.2
f. Cement	46.4	18.8	15.1	11.9
g. Manufacture of basic metals	23.1	43.7	3.4	7.9
Manufacture of iron & steel	23.7	64.6	2.2	7.9
h. Manufacture domestic appliances	21.6	85.6	1.4	6.9
i. Manufacture electrical machinery	12.6	29.4	1.7	4.4
Manufacture of electric motors	-4.6	3.6	-0.1	0.1
C. Electricity, gas and water supply	**15.4**	**65.3**	**2.4**	**12.3**
D. Construction	**28.7**	**24.6**	**9.0**	**10.3**
E. Transport and communications	**11.3**	**22.2**	**5.7**	**13.9**
Telecommunications	19.6	39.6	6.0	17.0
2. Personal loans	**27.0**	**11.3**	**67.2**	**38.8**

Finally, loans to basic metal industries registered a sharp growth during Jul-Mar FY07, compared with the preceding year. This was mainly due to a substantial rise in the international prices of pig iron and iron ores that increased the domestic

[21] However, the gas prices have been revised downwards January 2007 onwards.

prices of raw material of iron and steel industry, thus increasing the working capital requirements of the sector.

(2) Sectors registering low growth in advances
Spinning, weaving and finishing of textiles, made-up textiles, manufacture of knit wear and cement sectors were the major industries exhibiting a low growth in net advances. While the slowdown in textiles sector loans stemmed mainly from the sharp deceleration in working capital loans, the major contribution in slowdown in loans to the cement industry was from fixed investment loans (see **Figure 4.26**).

Figure 4.26: Contributions to the Slowdown in Loans to Cement & Textiles

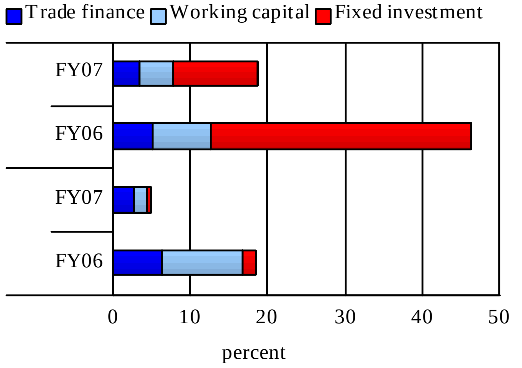
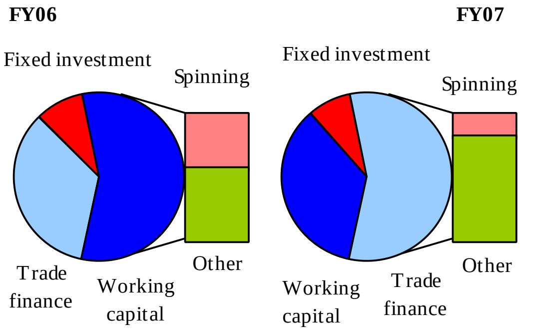


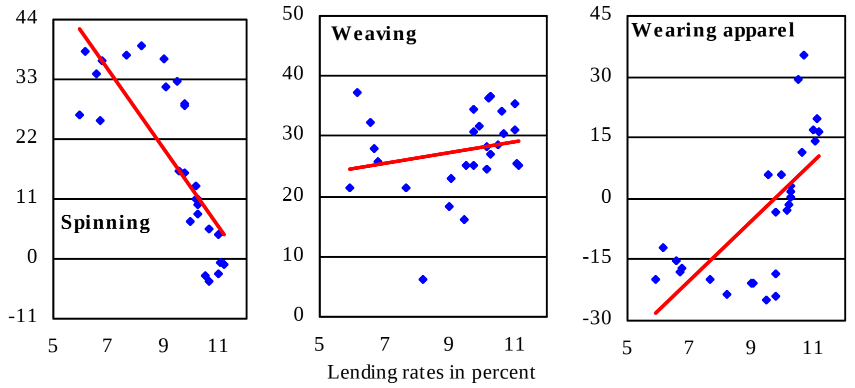
Figure 4.27: Composition of Loans to Textile Sector



Within textiles, most of the slowdown in credit off-take was evident in the spinning of cotton and synthetic fiber industries (see **Figure 4.27**). Major reasons for this slowdown were: (1) a deceleration in export growth; (2) a relatively stable cotton prices through FY07; and (3) increase in financing costs. It must be noted that due to the availability of concessionary export finance scheme to weaving of textiles and the manufactures of wearing apparel, growth in advances to these sub-sectors remained strong (see **Figure 4.28**).

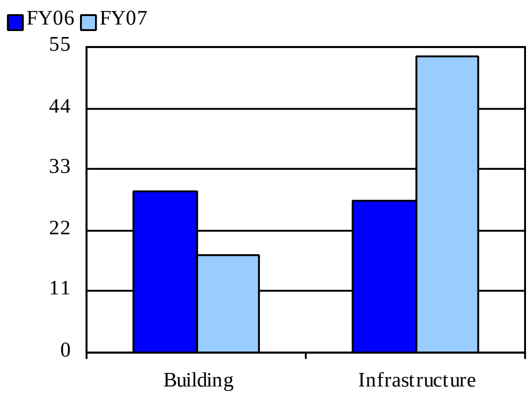
The slowdown in fixed investment loans to the textile sector was caused mainly by (1) substantial installation of new capacity in recent years (especially under Textile Vision 2005); and possibly (2) delayed off-take by industrialists in anticipation of textile sector relief package.

Figure 4.28: Loans to Textiles Sector vis-à-vis Interest Rates (Dec-04 to Mar-07)



Likewise, the slowdown in credit extended to the cement sector was caused mainly by the sharp fall in demand for fixed investment loans, following the huge capacity augmentations in the cement industry during the last five years.[22] In contrast, the working capital loans in cement industry, though decelerated, exhibited a robust growth of 30.5 percent during Jul-Mar FY07 as reflected in rising demand in domestic and external markets.

Figure 4.29: Loans to Construction Sector Growth



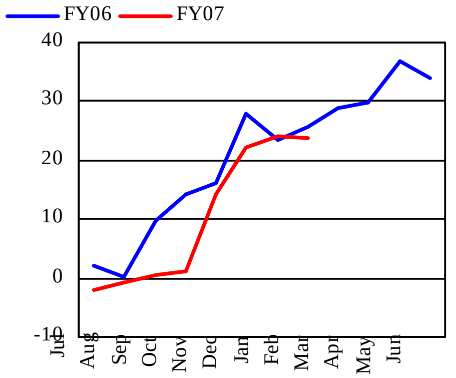
Construction sub-sector

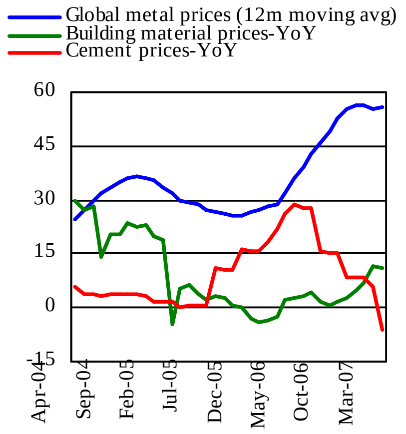
Growth in advances to the construction sector remained strong at 24.6 percent during Jul-Mar FY07, although a little lower than 28.7 percent in Jul-Mar FY06 (see **Figure 4.29**). This was caused primarily by the increased financing needs for infrastructure related construction activities.

In addition, the rise in raw material prices, especially the international metal prices, have also led to an increase in financing needs of the construction sector (see **Figure 4.30**).

[22] From FY02 to FY06, the installed capacity in cement industry increased by 41.9 percent.

Figure 4.30: Growth in Loans to Construction Sector and Raw Material Inflation



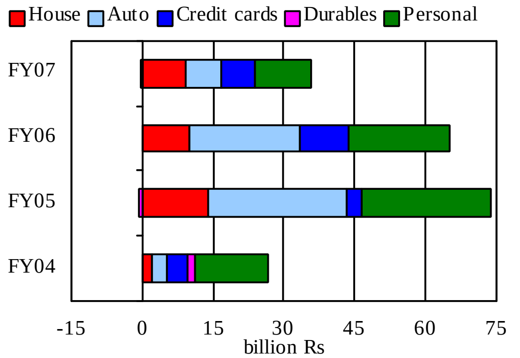


Consumer Loans

After registering an extraordinary growth of 70.5 percent in Jul-Mar FY05, the growth in consumer loans has been decelerating, dropping to 31.6 percent in Jul-Mar FY06 and further to 11.9 percent in Jul-Mar FY07 (see **Figure 4.31**).

While the Jul-Mar FY06 slowdown also incorporated the impact of higher base of FY05; the slowdown in Jul-Mar FY07 was caused primarily by the increase in interest rates as well as more restrained lending by banks.

Figure 4.31: Composition of Changes in Consumer Loans (Jul-Mar)

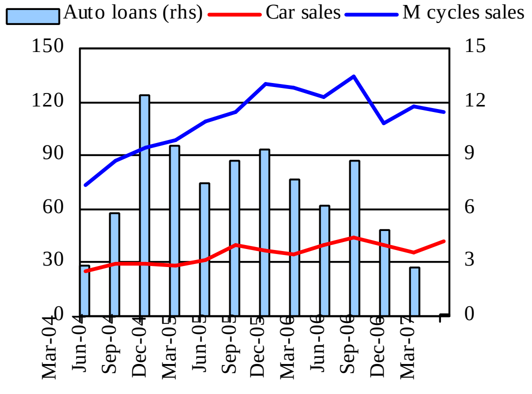


The deceleration in auto loans, in particular, has the largest contribution of 8.7 percentage points in the total 19.7 percentage points decline in the growth rate.

The deceleration in the growth of auto loans is attributable to four major factors: (1) the increase in interest rate; (2) low demand for automobiles as a result of increase in prices of domestic cars and low interest of consumers in imported cars (see **Figure 4.32**); (3) high insurance charges that have increased the effective cost of automobile financing;[23] and (4) increased number of bad debts due to interest rates increases that resulted in a relatively more cautious lending by banks.

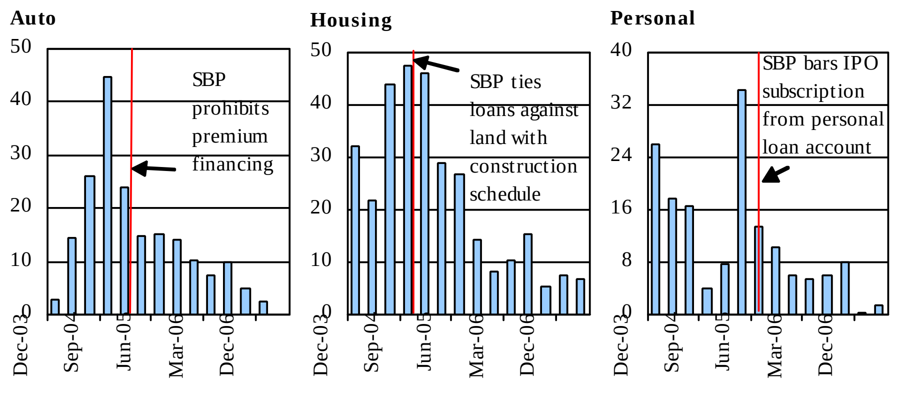
Growth in other personal loans witnessed a significant deceleration during Jul-Mar FY07. In addition to the increased cost of financing, the mandatory use of Credit Information Bureau (CIB) data by banks is also cited as a major reason in this slowdown. In specific terms, earlier banks were only required to set the credit limit to a certain borrower depending upon the aggregate take-home income. However, 2006 onwards, banks are required to set these limits after netting the aggregate take-home income by total financing already availed from other commercial banks.

Figure 4.32: Quarterly Expansion of Auto Loans



In addition, the SBP has given much emphasis on the need to ensure closed

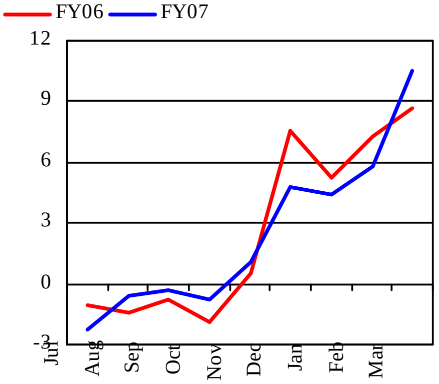
Figure 4.33: Consumer Finance (quarterly growth in percent)



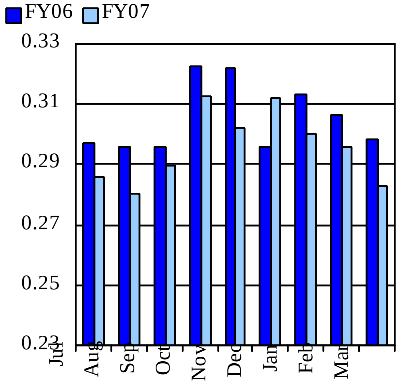
[23] Insurance is compulsory for auto financing from banks. Most of the car insurance companies have made it compulsory for the insurance holders to use costly car tracking devices.

monitoring of personal loans so that these loans are not utilized for speculative activities (see **Figure 4.33**). Housing finance, though decelerated, recorded a robust growth of 20.9 percent during Jul-Mar FY07.

Figure 4.34: Cumulative Deposits Growth



Currency to Deposit Ratio

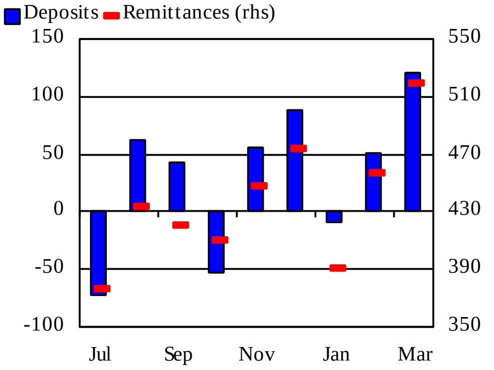


Deposit Mobilization

The deposit base of the banking industry during Jul-Apr FY07 registered a growth of 11.7 percent, slightly higher than the 10.5 percent seen during Jul-Apr FY06 (see **Figure 4.34**). Despite a sharp rise in investments in NSS instruments and increase in deposits of non-bank financial institutions (NBFIs), including aggressive retailing from mutual funds, the double digit growth in bank deposits is impressive.

More importantly, the currency to deposit ratio has remained low throughout Jul-Apr FY07 compared to the same period in the preceding year reflecting the increased

Figure 4.35: Monthly Deposit Mobilization vis-à-vis Workers' Remittances



intermediation of the banking sector.

The higher growth in the deposits during Jul-Apr FY07 was caused mainly by a high growth in workers' remittances (see **Figure 4.35**), more aggressive marketing of deposit products by banks, increase in weighted average deposit rates, and the expansion in the network and usage of Automated Tellers Machines (ATMs) (which limits precautionary cash holdings).[25]

Private Banks Continued to Lead

Within the banking sector, the domestic private banks (excluding large privatized banks and also those banks that merged during FY07) continued to outperform other banking groups in deposit mobilization, although their deposit growth slowed somewhat from the previous year. However, due to a low growth base, the share of private banks in total increase in bank deposits slightly declined during Jul-Apr FY07 compared with Jul-Apr FY06 (see **Figure 4.36**).[26] The high returns offered by domestic private banks are the key contributors in high deposit mobilization of these banks (see **Figure 4.37**).

Further, as a result of SBP efforts to raise the rate of returns on deposits, the

Figure 4.36: Group-wise Deposit Mobilization

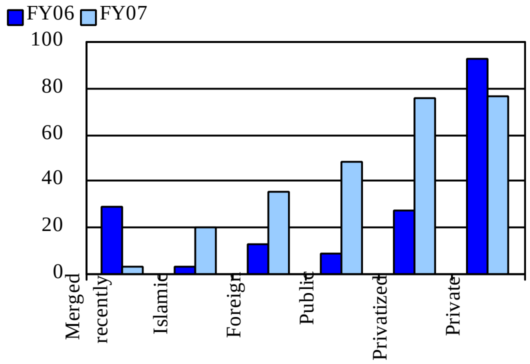
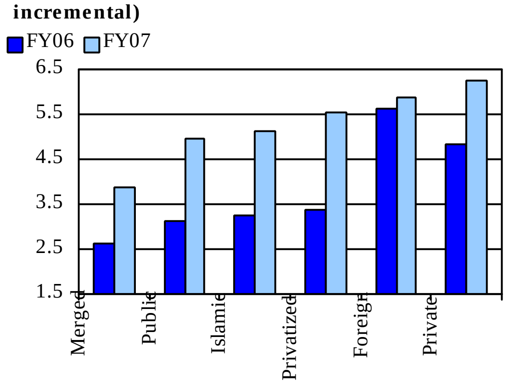


Figure 4.37: Group-wise Deposit Rates (average incremental)



[25] The increased use of electronic transactions, especially for cash withdrawals and funds transfer implies that the deposits remain within the banking system for longer periods.
[26] The Figure includes all customer deposits including government deposits. As such, this will not tally with the deposits reported in monetary survey since the latter excludes government deposits.

deposit rates of rest of the banking industry rose sharply during Jul-Mar FY07 compared with Jul-Mar FY06.[27] The only exception to this was the recently merged banks where the deposit mobilization decelerated during Jul-Mar FY07.

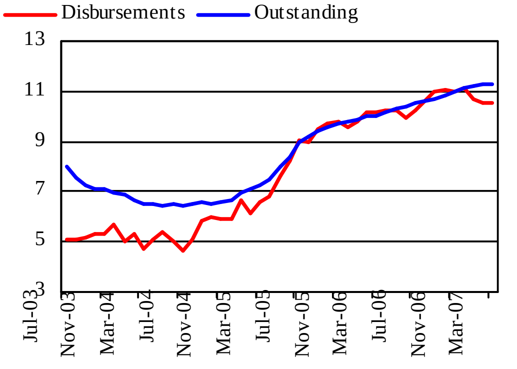
The currency wise decomposition of the deposits shows that within the overall deposits of the banking system, the share of foreign currency deposits is declining mainly due to expectations of a stable exchange rate stemming from continued massive forex inflows in the economy.

[27] The data on weighted average deposit rates is available up till March 207.

Box 4.1: Factors Providing a Downward Bias to Weighted Average Lending Rates

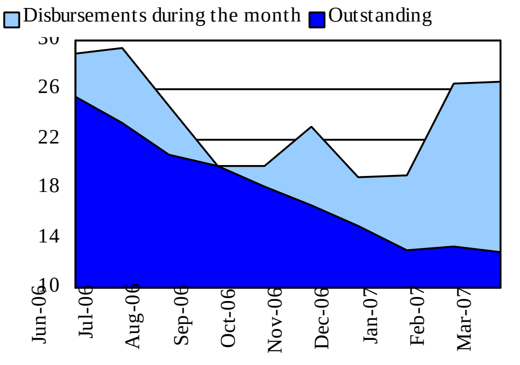
It may be important to mention that the weighted average lending rates include the returns applied on inter-bank lending as well. Since the volume of these lending is usually quite substantial; their impact on overall lending rates is also quite significant. Thus, when overnight rates are high, these provide an upward bias to weighted average lending rates and vice versa. However, as the maturity of inter-bank lending is usually quite short (for overnight, for instance), the impact of the returns applied on these lending gets diluted in outstanding data. Therefore, while the weighted average lending rates on gross disbursements (during the month) show a dip January 2007 onwards; the weighted average lending rates on outstanding loans continued the increasing trend (see **Figure 4.1.1**).

Figure 4.1.1: A Comparison of WALR on Disbursements and Outstanding Loans



Since the decomposition of data on weighted average lending rate is not available with respect to the kind of transactions (i.e., customer lending and inter-bank lending); the impact of rates applied on inter-bank transactions can not be gauged. However, the advances given at returns between 8 percent to 10 percent can be used as a crude proxy for inter-bank lending. A look at the share of these advances in gross disbursements (during a month) and outstanding advances seconds the view that the impact of inter-bank lending is relatively lower in outstanding data (see **Figure 4.1.2**).

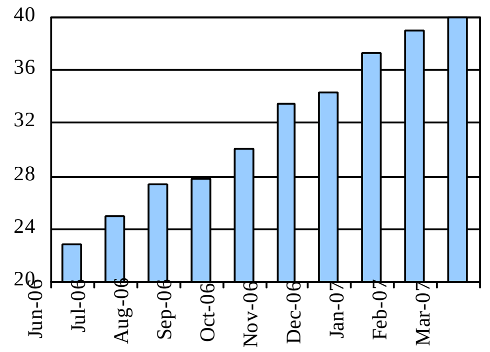
Figure 4.1.2: Share of Advances Lent at 8 to 10 Percent Returns



Therefore, to check whether the lending rates in the economy have actually increased, it will be more meaningful to analyze the share of loans extended at various rates of return. The advances extended at returns 12 percent and above has increased tremendously during Jul-Feb FY07 registering a robust growth of 85 percent (see **Figure 4.1.3**). As such, the share of these advances in total advances also increased tremendously from 22.8 percent at end-June 2006 to 39.1 percent at end February 2007. The data on gross disbursements during the month, however, shows that the average share of high cost loans during Jul-Feb FY07 period has been 28.6 percent.

In addition to inter-bank lending rates, a sharp increase in private sector lending on subsidized rates has also provided a downward bias to the weighted average lending rates. In particular, a sharp rise in loans under EFS and conversion of fixed investment loans on market based returns to subsidized LTF-EOP scheme has increased the share of low return lending in total lending. This is evident from a sharp growth of 89 percent in the share of loans extended at the rate 7.01-8.00 percent during Jul-Feb FY07 with an absolute increase of Rs 59.9 billion.

Figure 4.1.3: Share of Outstanding Loans Disbursed at 12 Percent & Above



Box 4.2: SBP Measures to Increase the Supply of Bank Credit
At first, the SBP, on the suggestion of Pakistan Banks' Association (PBA) removed the cap on aggregate exposure of banks against all their clean facilities with the amount of their equity. [1] The existing instructions require the banks to restrict their *Aggregate Clean Exposure* at the level of their equity. However, banks have now been advised that they may take higher exposure on unsecured basis provided the SBP is satisfied with the level of their risk management processes, loan default ratio and other allied factors.

Moreover, during April 2007, the SBP amended the Regulation R-17 of Prudential Regulations for Consumer Financing with which the banks restricted to cap their *housing exposure* at 10% of their total net advances. However, this restriction was withdrawn to enable the banks to expand the housing portfolio reasonably. [1]

Further, the SBP changed the definition of subordinated loans during FY07. Specifically, the borrowers are allowed to include sub-ordinated loan in their equity, which consequently enable them to have higher exposure limit (borrowing limit) from the financial institutions. However, the borrowers were earlier allowed to include only those sub-ordinated debts in their equity, which were taken from the sponsors of the borrowing companies, i.e. the borrowers enjoyed restricted choice to generate subordinated debts. However, with the amendment in March 2007, the companies can also generate subordinated loans from other than the sponsors. This amendment will enable the companies to have larger number of avenues to generate subordinated debts, that will consequently enable them to avail higher financing limits from the financial institutions. [1]

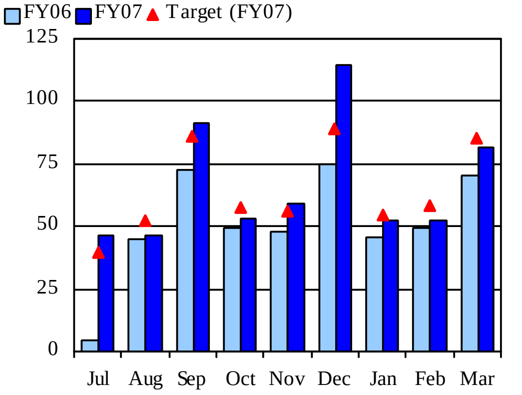
[1] See BPD Circular NO. 02 dated June 02, 2006 for details.
[1] See BPRD Circular Letter No. 14 dated April 21, 2007 for details.
[1] See BPRD Circular Letter NO. 09 dated March 26, 2007 for details.

5 Fiscal Developments

Overview

Data on consolidated fiscal accounts will only be available by end-May 2007 but the government has indicated that it remains committed to achieving the fiscal deficit target of 4.2 percent of GDP for FY07. The strong growth in direct taxes seen in the first half of FY07 lends confidence that fiscal deficit would be within limits, however, the relative slowdown in the CBR taxes January 2007 onwards (see **Figure 5.1**) indicates that expenditure growth would need to be monitored closely.

Figure 5.1: Monthly Tax Collection vs Targets

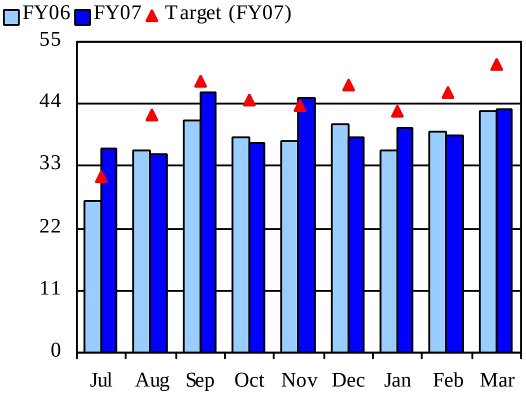


The growth in CBR taxes (which contribute the bulk of government revenues) has dipped from 26.7 percent in H1-FY07 to 12.3 percent in Q3-FY07. It may be noted that H1-FY07 receipts had been bolstered by an exceptional (unanticipated) 65.6 percent rise in direct taxes that more than offset the below- target indirect tax receipts. The resulting exceptionally strong revenue growth helped contain the fiscal deficit during H1-FY07.

Another significant development is the sharp rise in government borrowings from the domestic sources during Jul-Mar FY07, which mainly reflected the relatively lower availability of external financing compared to the corresponding period of FY06. However, external borrowings are expected to increase in future due to an expected sovereign debt issue later in FY07, and the government is planning to retire a part of the outstanding stock of domestic debt. An encouraging development in FY07 was that, unlike the previous year, the government was able to substantially increase its non-bank borrowings during Jul-Mar FY07, as well as sourcing a greater proportion of its banking system borrowings from scheduled banks.

5.1 CBR Tax Collection

Figure 5.2: Indirect Tax Collection (monthly)



The CBR significantly surpassed its tax collection target of Rs 579.8 billion during Jul-Mar FY07 with actual collection of Rs 597.0 billion (21.9 percent YoY growth). However, the fact that monthly collections from indirect taxes continued to fall below the target, except for two months, during Jul-Mar FY07 is a point of disquiet (see **Figure 5.2**). Indeed, were it not for the substantially above-target direct taxes in December 2006, aggregate collection would have been below target by Q3-FY07.

The shortfall in the indirect taxes was principally due to weak growth in the customs duty and the sales tax receipts (see **Table 5.1**). This volatility in collections is essentially caused by a narrow tax base, and underlines the need to diversify the tax base so that aggregate receipts are not disproportionately impacted by adverse developments in any segment of the economy.

Table 5.1: Tax Collection (Jul-Mar)
billion Rupees

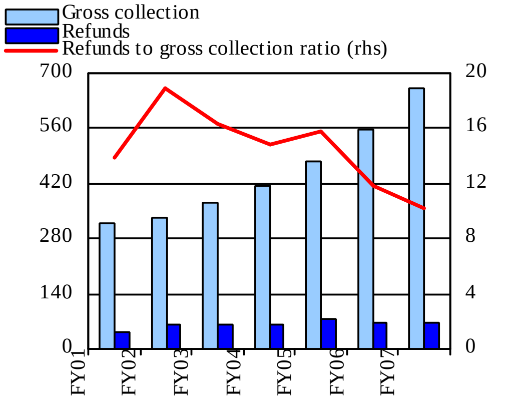
	Target		Net tax collection		Percent of target		Growth	
Head	**FY07**	**Up to Mar**	**FY06**	**FY07**	**Annual**	**Mar**	**FY06**	**FY07**
Direct taxes	264.7	183.03	152.7	237.8	89.8	129.9	27.8	55.7
Indirect taxes	570.3	396.8	337.1	359.2	63.0	90.5	19.6	6.5
Sales tax	343.8	238.8	202.4	218.8	63.6	91.6	22.4	8.1
FED[1]	69.0	47.7	39.6	47.7	69.2	100.0	9.1	20.4
Customs	157.5	110.3	95.1	92.7	58.8	84.0	18.7	-2.5
Total	835.0	579.8	489.8	597.0	71.5	103.0	22.1	21.9

Source: Central Board of Revenue, [1] Federal Excise Duty
Figures may not tally due to separate round off.

5.2 Gross Collections and Refunds

Jul-Mar FY07 gross tax collections reached Rs 664.2 billion, up 19.6 percent YoY from the Rs 555.2 billion collected during the corresponding period of FY06, but refunds increased by merely 2.9 percent. Consequently, the ratio of refunds to gross tax collections dropped from 12 percent at end-March 2006 to 10 percent by end-March 2007, continuing the downtrend seen in recent years (see **Figure 5.3**).

Figure 5.3: Gross Collection and Refunds



5.3 Direct Tax Collection

Direct tax collection stood at Rs 237.8 billion during Jul-Mar FY07 against the target of Rs 183 billion showing a growth of 55.7 percent YoY. Moreover, the direct tax collection remained above the target in all months, but the December 2006 receipts were exceptionally strong, up 118.7 percent from that in December 2005, and accounting for 32.5 percent of the overall direct tax collections during Jul-Mar FY07.

Almost half of the direct tax revenue was under the head of "*voluntary payments*" that were nearly doubled during Jul-Mar FY07 as compared to the same period last year. On the other hand, collection "*on demand*" declined during the said period.

5.4 Indirect Tax Collection

Indirect tax collection stood at Rs 359.2 billion against the target of Rs 396.8 billion during Jul-Mar FY07. This shortfall is the result of a sharp deceleration in the import growth, which fell from 43.2 percent YoY during Jul-Mar FY06 to 8.1 percent YoY during Jul-Mar FY07, reducing the import-related taxes substantially.

Sales Tax

The cumulative Jul-Mar receipts from *General Sales Tax* (GST) stood at Rs 218.8 billion, 8.4 percent (Rs 20 billion) short of the target for the period. The sharp deceleration in the growth of GST collections is visible in

Table 5.2:Sales Tax Collection (Jul-Mar)

billion Rupees

	FY05	FY06	FY07
Sales Tax	165.4	202.4	218.8
Domestic	59.4	81.3	93.0
Import-related	106.0	121.1	125.7

Source: Central Board of Revenue

Figures may not tally due to separate round off.

the receipts from imports as well as in collection from domestic sources (see **Table 5.2**), and is evident in all but three months of the period.

Of the sales tax from domestic sources, the major revenue came from telecom (Rs 26.4 billion), POL products (Rs 20.1 billion), electrical energy (Rs 11.5 billion), natural gas (Rs 8.7 billion), sugar (Rs 8.4 billion) and cigarettes (Rs 4.6 billion), while POL products, vehicles, iron and steel, plastic remained major revenue spinners of import related sales tax.

The biggest drag on the year-on-year growth of sales tax through imports was from vehicle and iron & steel imports. The revenue from the former fell by 23.2 percent YoY (Rs 3 billion), while that from the latter dropped 26.9 percent YoY during Jul-Mar FY07.

Federal Excise Duty (FED)

Of the indirect taxes, only the federal excise duty met its revenue target. The collections for the Jul-Mar FY07 stood at Rs 47.7 billion, showing a YoY growth of 20.4 percent (see **Table 5.1**). The major revenue came from the cigarettes (Rs 17.5 billion), cement (Rs 11.0 billion), natural gas (Rs 4.4 billion), beverages (Rs 4.3 billion) and POL (3.4 billion).

Customs

Due to a deceleration in import growth, customs duty receipts fell short of the target by 16.0 percent, adding Rs 92.7 billion to the national exchequer during Jul-Mar FY07 against the target of Rs 110.3 billion (see **Table 5.1**).

Despite 19.2 percent YoY decline in duty on vehicles, it remained the major source of custom duty collection, contributing Rs 20.9 billion during Jul-Mar FY07 as compared to Rs 25.8 billion last year. Among the other major sources, edible oil contributed Rs 12.3 billion, POL products Rs 9.9 billion, and electrical machinery Rs 7.5 billion during Jul-Mar FY07.

5.5 Government Budgetary Borrowings

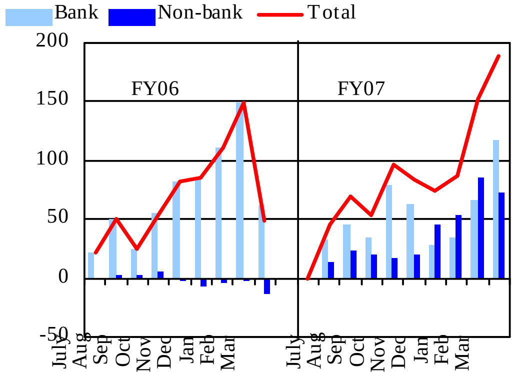
The aggregate government borrowings for deficit financing from domestic sources stood at Rs 190.5 billion during Jul-Mar FY07, which was nearly four-times the Jul-Mar FY06 borrowings (see **Figure 5.4**).

Primarily, this sharp increase seems to be the result of lower availability of external financing during the first nine months of FY07 compared to the same period of FY06, which led the government to increase reliance on domestic resources.[1]

Non-bank Borrowings

Non-bank borrowings (net) rose by Rs 73.9 billion during Jul-Mar FY07 in contrast to a (net) repayment of Rs 12.7 billion in the corresponding period of the previous year. The trend reversal owed to renewed issuance of PIBs during FY07, as well as a resurgence in NSS receipts.

Figure 5.4: Bank and Non-bank Borrowings



The government mobilized Rs 15.9 billion[2] through PIB auctions, from non-bank sources, during Jul-Mar FY07. This is in sharp contrast to net repayments of Rs

Table 5.3: Gross and Net Mobilization through Major NSS Instruments (Jul-Mar)

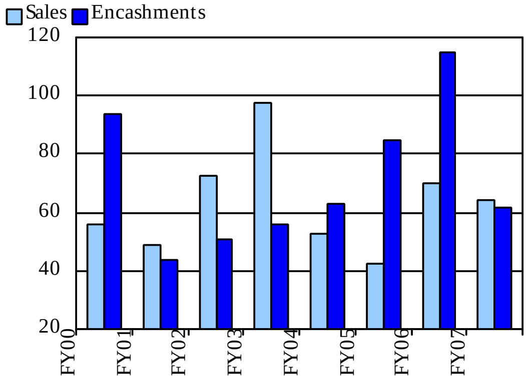
million Rupees

	FY06		FY07	
	Gross	Net	Gross	Net
NSS Instruments	**293,649.0**	**8,922.2**	**356,964.2**	**42,102.2**
Defence Saving Certificates	13,807.7	-5,200.1	25,227.2	-4,528.1
Special Saving Certificates	69,862.9	-45,274.9	78,090.4	3,738.3
Regular Income Certificates	12,982.9	-11,440.0	14,548.0	-12,435.7
Bahbood Savings Certificates	61,044.0	50,121.9	73,298.0	38,793.7
Saving Accounts	25,019.4	-1,887.8	51,563.8	499.9
Special Saving Accounts	19,395.9	-911.5	24,159.8	3,191.8
Mahana Amdani Accounts	94.5	12.5	110.1	51.3
Pensioners' Benefit Accounts	18,760.0	13,997.4	23,571.3	9,403.5
Prize Bonds	65,258.9	3,312.2	66,391.3	4,620.4

[1] External Financing is expected to gain momentum in coming months of the fiscal year which is discussed in Money & Banking in detail)

0.2 billion in corresponding period of FY06, when no PIB auctions were held.[3]

Figure 5.5: Special Saving Certificates (Jul-Mar)



The recovery in the net receipts from NSS reflects both, a decline in the outflows, as well as high gross sales, (the later probably owes to an increase in offered yields), and possibly the return of institutional investment (as the government ended a ban on institution investment in NSS instrument in September 2006). Specifically the government mobilized Rs 42.1 billion through the NSS during Jul-Mar FY07, which is substantially higher than Rs 9.7 billion borrowed during Jul-Mar FY06 (see **Table 5.3**).

Net mobilization through *Special Savings Certificates* (SSCs) and *Special Savings Accounts* was Rs 6.9 billion during Jul-Mar FY07, against a net retirement of Rs 46.2 billion during the corresponding period last year (see **Figure 5.5**). Also while the *Bahbood Saving Certificates* (BSCs) and *Pensioners Benefit Accounts* (PBAs) together witnessed a substantial rise in gross inflows, the net inflows were relatively lower during the Jul-Mar FY07 compared to the corresponding period of FY06 as earlier issues of these instruments started maturing during FY07.

Banking System Borrowings

Bank borrowings (net) reached Rs 116.6 billion[4] during Jul-Mar FY07, which is significantly higher than the Rs 61.2 billion borrowed during Jul-Mar FY06[5]. Moreover, while the government borrowed essentially from the SBP during FY06, the FY07 borrowings included non-bank borrowings as well as government borrowings from commercial banks.

[2] Gross amount of PIBs issued during Jul-Mar FY07 is Rs 53.8 billion while after adjustment of repayments, net amount realized through PIBs remained Rs 28.9 billion. Out of this, Rs 15.9 billion is from non-bank and Rs 12.7 billion is from banks.
[3] FY06 witnessed only one PIB auction in May 2006
[4] This includes the impact of government deposits. Borrowing from banking system works-out to be at Rs 138.9 billion excluding the impact of government deposits.
[5] Jul-Apr 28 FY07 data show that borrowing from banking system reached Rs 170.6 billion.

Borrowings from the scheduled banks showed a substantial increase to reach Rs 83.5 billion during Jul-Mar FY07 against a net retirement of Rs 3.0 billion in the corresponding period of FY06 (see **Figure 5.6**). As a result, borrowings from the SBP dropped sharply to Rs 33.1 billion during Jul-Mar FY07 compared to Rs 64.2 billion during Jul-Mar FY06. A declining trend in borrowing from SBP is quite visible over the period (see **Figure 5.7**).

Figure 5.6: Composition of Scheduled Banks Borrowings (cumulative)

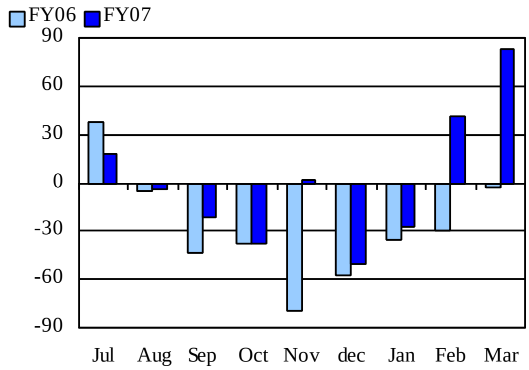
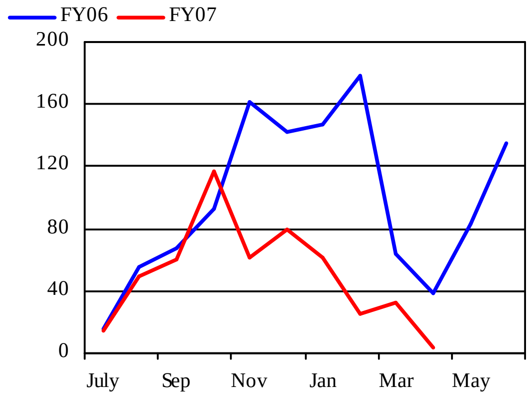


Figure 5.7: Government Borrowings from SBP



5.6 Domestic Debt Developments

The Jul-Mar FY07 period witnessed few important changes in domestic debt growth pattern. First, there was significantly higher growth in the stock of domestic debt instruments during Jul-Mar FY07 compared to the corresponding period last year. Second, the government borrowed a substantial amount from long-term debt instruments. Third, the ownership composition of short-term debt saw a shift, with a fall in SBP holding (see **Table 5.4**).

The higher growth in domestic debt seems to be the result of significantly lower availability of external sector financing, which forced the government to rely more on domestic sources. However,

Table 5.4: Key Developments of Domestic Debt

	Jul-Mar	
	FY06	**FY07**
Growth in domestic debt (percent)	5.4	9.3
Contribution of LT debt (billion Rs)	-12.0	66.5
Contribution of SBP debt holding (billion Rs)	119.6	22.4

following an expected increase in external receipts during the later months of FY07, the growth in domestic debt is expected to decelerate.

A break up of the debt instruments data reveals that the government issued PIBs of Rs 53.8 billion during Jul-Mar FY07 through three successful auctions, which was more than offset the impact of maturing PIB/FIB in the period (see **Table 5.5**).

Table 5.5: Rise in Domestic Debt
billion Rupees

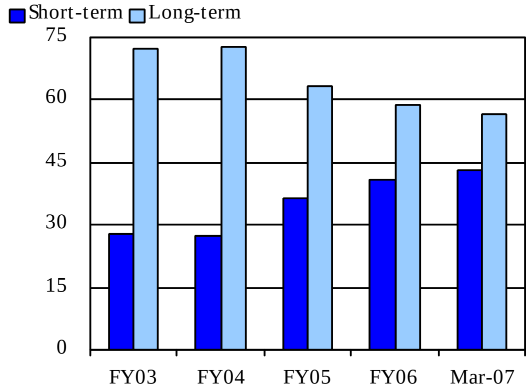
	Jul-Mar	
	FY06	**FY07**
PIB/FIB	-19.0	25.4
T-bills	128.1	146.3
NSS	5.6	37.5
Domestic Debt	116.1	212.8

In addition to the net increase in PIB stock, the stock of NSS instruments[6] also recorded an increase of Rs 42.1 billion during Jul-Mar FY07, in contrast to a rise of only Rs 9.7 billion during the same period of FY06. Not only the gross sales of NSS instruments during Jul-Mar FY07 recorded a YoY increase, but also the encashment witnessed a decline in this period.

The greater issuance of LT debt (PIBs and NSS instruments) meant that the growth in the stock of ST debt instrument fell marginally to 15.6 percent during Jul-Mar FY07 compared to 16.5 percent in the corresponding period of FY06, however, share of LT instruments in total domestic debt continued to decline (see **Figure 5.8**).

Another significant development was the change in the composition of T-bill holdings in the Jul-Mar periods of FY06 and FY07. In the former period, there was a net increase of Rs 8.5 billion in T-bills holding of scheduled banks and non-bank compared to a substantial net increase of Rs 123.9 billion during Jul-Mar FY07.
The SBP T-bill holding (on

Figure 5.8: Composition of Domestic Debt



[6] Including Prize Bonds

net basis) increased by Rs 119.6 billion during Jul-Mar FY06. In contrast, it increased by only Rs 22.4 billion during Jul-Mar FY07. However, the relatively larger maturities during Jul-Mar FY07 resulted in higher gross issuance of SBP T-bills for replenishment (see **Table 5.6**).

Table 5.6: Gross Payments and Receipts of T-bills (Jul-Mar)

billion Rupees

	FY06		FY07	
	Payments	**Receipts**	**Payments**	**Receipts**
MTBs	641.0	649.5	529.3	653.1
MRTBs*	729.9	849.5	879.2	901.6
Totals	1,370.9	1,499.0	1,408.5	1,554.7

* MRTBs are used for replenishment and MTBs are issued in auctions.

While the growth of ST debt instrument declined to 15.6 percent during Jul-Mar FY07 from 16.4 percent recorded in Jul-Mar FY06, the servicing of its stock of over Rs 1 trillion is still vulnerable to upward movements in ST interest rates. It is probably desirable to increase reliance on LT debt instruments in order to reduce the risks associated with ST interest rate movements.

6 External Sector

6.1 Balance of Payments

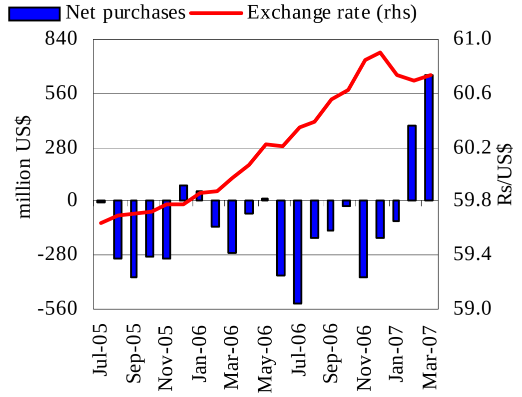
Pakistan's current account deficit continued to widen during Jul-Mar FY07, rising to a record US$ 6.0 billion, up sharply from the corresponding period of FY06 (see **Table 6.1**). Encouragingly, the data also shows a distinct improvement in the pace of the growth of the current account deficit that has fallen sharply, with Q3-FY07 even witnessing a marginal (and probably temporary) year-on-year decline. The improvement largely reflects the sharp deceleration in the growth of the trade deficit during the course of FY07. Moreover, Pakistan continued to record large surpluses in the capital & financial account that comfortably financed the current account deficits; and generated an external account surplus of US$ 373 million during the first nine months of the current fiscal year. Encouragingly, only 30.2 percent of the *capital & financial account* receipts[1] during Jul-Mar FY07 were debt creating compared with 52.4 percent last year.[2] Moreover, the impact of one-off flows in the form of privatization proceeds was also limited to US$ 133 million in Jul-Mar FY07 as against US$ 919 million during the same period last year.

Table 6.1: External Account Position (Jul-Mar)

	FY06	FY07	YoY percent
Current A/c	-4,247	-6,015	41.6
Q1	-1,585	-2,753	73.7
Q2	-1,292	-1,905	47.4
Q3	-1,370	-1,357	-0.9
Financial & capital A/c	4,633	6,352	37.1
Errors & omission	359	36	-90.0
Overall Balance	**745**	**373**	**-49.9**

Pakistan's exchange rate as witnessed during the last few years remained broadly stable and moved within a narrow band of 60.2-60.9 Rs/US$ during Jul-Mar FY07.

Figure 6.1: SBP Purchases and Exchange Rate



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[1] These capital inflows include: FDI, portfolio investment and official & private loans.

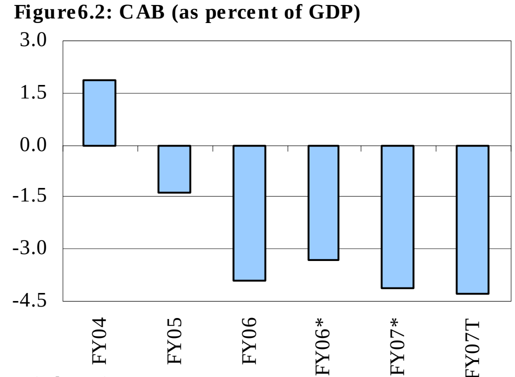
[2] The main debt creating inflows during Jul-Mar FY06 were the two new Euro bond issues worth US$ 800 million.

However, there were some upward pressures on Pak rupee due to the substantial rise in forex inflows during Q3-FY07.[3] As a result, a slight appreciation in rupee was witnessed even as SBP purchases from the inter-bank market increased substantially Jan 2007 onwards. In fact, SBP became a net purchaser of forex in the months of Feb and Mar 2007 (see **Figure 6.1**). If this trend continues, it would pose a serious challenge to SBP's monetary and exchange rate policies (see **Section 4.1** on **Money and Banking** for details).

However, the appreciation in Pakistan's real effective exchange rate (REER) since Jun 2006 has been primarily due to the rise in the relative prices compared to its trading partners, while the nominal (NEER) depreciation in rupee of 4.04 percent has kept the real appreciation limited to 2.06 percent.

This real appreciation would be significantly higher if the rupee had appreciated in nominal terms. Since Jan 2007, rupee appreciation has been limited and only against the US, Canadian dollar and Japanese Yen, and therefore its impact is not evident in the REER.[4]

Figure6.2: CAB (as percent of GDP)



* (Jul-Mar)
T: Annual Plan Target

Current Account Balance (CAB)

The current account deficit (CAD) soared to US$ 6.0 billion during the first nine months of FY07 as compared to US$ 4.2 billion in Jul-Mar FY06 (see **Table 6.2**). This caused the CAD to GDP ratio to increase to 4.1 percent compared with the corresponding FY06 level of 3.3 percent. If current trend persists, the current account deficit is likely to breach the Annual Plan target of 4.3 percent of GDP for FY07 (see **Figure 6.2**).[5]

The principal factors responsible for the widening of the CAD during Jul-Mar FY07 include: a widening trade deficit by US$ 1.3 billion and a US$ 730 million

[3] Pakistan received substantial capital flows in FDI, SCRA and worker remittances during Q3-FY07.
[4] Due to depreciation of the rupee against Euro and other currencies during Q3-FY07, the extent of rupee's appreciation against the US$ was largely offset.
[5] SBP projections for FY07 put the annual current account deficit at 4.8 percent of GDP.

Table 6.2: Current Account Balance
million US Dollars

	Jan-Mar		Jul-Mar		YoY change
	FY06	**FY07**	**FY06**	**FY07**	
1. Trade balance	**-2,135**	**-2,199**	**-6,237**	**-7,581**	**-1,344**
Exports	4,126	4,156	12,023	12,506	483
Imports	6,261	6,355	18,260	20,087	1,827
2. Services(net)	**-1,372**	**-1,012**	**-3,350**	**-3,469**	**-119**
Transportation	-409	-474	-1,342	-1,539	-197
Travel	-285	-366	-900	-1,074	-174
Other business services	-731	-538	-1,808	-1,533	275
Government services	92	386	957	839	-118
of which logistic support	0	298	756	723	-33
Others	-39	-20	-257	-162	95
3. Income (net)	**-532**	**-806**	**-1,880**	**-2,610**	**-730**
Investment income(net)	-532	-808	-1,882	-2,616	-734
Direct investment	-463	-654	-1,469	-2,115	-646
of which: Profit & dividend	-54	-85	-300	-421	-121
Purchase of crude oil & minerals	-284	-338	-784	-1,050	-266
Portfolio investment	-25	-38	-98	-133	-35
Other (net)	-44	-116	-315	-368	-53
4. Current transfers (net)	**2,669**	**2,660**	**7,220**	**7,645**	**425**
Private transfers	2,545	2,610	6,879	7,414	535
Workers' remittances	1,173	1,368	3,228	3,937	709
FCA-residents	-21	41	198	65	-133
Others	1,393	1,201	3,453	3,413	-40
Official transfers	124	50	341	231	-110
Current account balance (1+2+3+4)	**-1,370**	**-1,357**	**-4,247**	**-6,015**	**-1,768**

rise in the income deficit.[6] The increase in the current transfers of US$ 425 million, on the other hand, helped in curtailing the deficit to an extent.

An encouraging aspect with regard to the CAD during Jul-Mar FY07 is the broad monthly declining trend in both, the trade deficit and the CAD (with few exceptions in Dec and Feb FY07). Specifically, from US$ 1.1 billion deficit in Jul FY07, the monthly CAD fell to its lowest level of US$ 263 million in Mar FY07 (see **Figure 6.3**).

One prominent exception to the declining trend was in Feb 2007, when the fall in

[6] Trade deficit has contributed approximately 76.0 percent in the absolute rise in CAD during Jul-Mar FY07, while the share of income deficit is 41.3 percent.

net inflows in invisible account (that is, the difference between exports and imports of services, receipts and payments of income and unilateral transfers) reversed the monthly declining trend in CAD-by US$ 180 million.[7] The lower net inflows under invisible account were primarily due to sharp rise in services and income deficits.

Figure 6.3: CAB (monthly position)

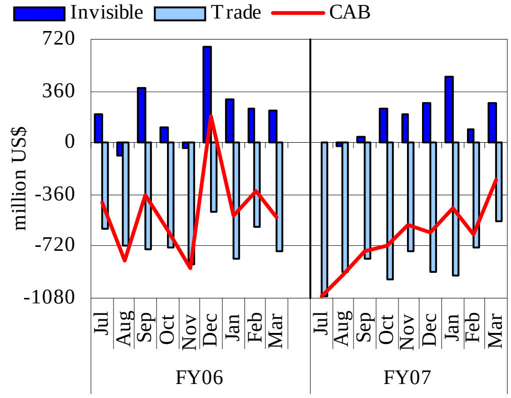
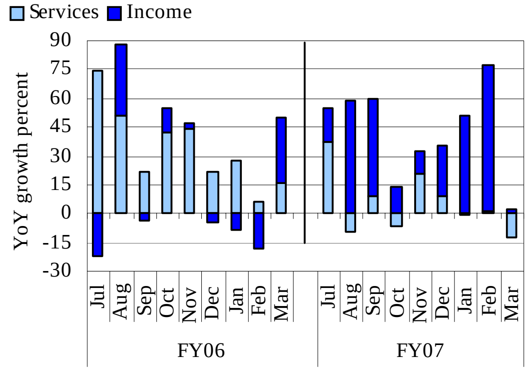


Figure 6.4: Compositional Change in Services & Income Deficits



Since the re-emergence of the CAD in FY05, the rise in the services account deficit, which mainly reflects the transportation charges related to imports, has come down as import growth declined. On the other hand, the income account deficit, which primarily reflects the repatriation of the profits and dividends and purchase of crude oil by the foreign companies operating in Pakistan, has continued to rise. Consequently, year-on-year growth in the adjusted[8] income account deficit was much higher than the adjusted growth in the services account deficit throughout Jul-Mar FY07 (see **Figure 6.4**).

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[7] It may be pertinent to note here that the contribution of net invisible balance in CAD was almost negligible during Q1-FY07; however, the CAD still recorded a decline primarily due to sharp decline in trade deficit.

[8] Income account is adjusted for the reinvested earnings as it has an offsetting credit entry in FDI under financial account, thus having no cash impact in BoP. Similarly, the services account is adjusted for the one-off payment under construction services in Aug FY05 and a non-structural flow related to logistic support. In fact, Pakistan received approximately US$ 650 to 700 million per annum on account of services provided to the UN troops, which is unequally disbursed among

Thus, while the trade deficit is showing a declining trend even as exports growth remains nominal; the rising trend in the income account deficit continues to exert pressure on the current account. There is a likelihood of the trade deficit narrowing in the months ahead as exports pick up, however, the income account deficit would continue to rise due to increase in the repatriation of profits and dividends resulting from increased investment inflows.

Trade Deficit[9]

The exchange record data on Pakistan's trade depicts a US$ 1.3 billion increase in the trade deficit during Jul-Mar FY07 to US$ 7.6 billion (see **Table 6.2**). This deterioration in country's trade account was despite a precipitous decline in import growth, as export growth also fell sharply.

Import growth slowed down to 10.0 percent during Jul-Mar FY07 as compared to 30.2 percent growth seen in Jul-Mar FY06. This was mainly due to a deceleration in petroleum imports on account of declining international oil prices; and a sharp deceleration in the growth of machinery imports. On the other hand, exports grew by only 4.0 percent in Jul-Mar FY07 as against a healthy growth of 12.4 percent during Jul-Mar FY06.[10]

Services Account

Growth in the services account deficit, adjusted for one-off payment of Ghazi Brotha dam in Aug FY06, slowed down to 6.7 percent during Jul-Mar FY07 as compared with 34.5 percent growth in the corresponding period of FY06 (see **Table 6.2**).[11] This improvement was mainly attributed to 4.6 percent services payment growth in Jul-Mar FY07, much lower than 22.4 percent recoded during Jul-Mar FY06.

The main contribution to the lower growth in payments was from the fall in freight charges caused by a slowdown in imports (see **Figure 6.5**). In addition, payments under other services and other business also remained subdued during Jul-Mar FY07. However, the travel payments routed through exchange companies recorded an expansion of US$ 195 million during this period.

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different months in a year, therefore to remove the sharp jump, the services account is adjusted for logistic support.

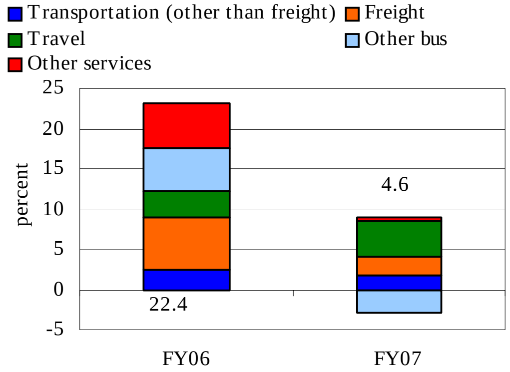
[9] This section is based on exchange record data compiled by SBP that does not tally with the Customs data compile by the FBS, and used in sub-section 6.3.

[10] For detail, see section 6.3 on **Trade**.

[11] Even this nominal growth was mostly due to relatively higher deficit in H1- FY07, while the deficit dropped in Q3-FY07.

It is worth mentioning that the impact of deceleration in the growth of services payment on the net services balance would have been more pronounced, had the services exports performed better. Unfortunately, during Jul-Mar FY07, services export grew by only 2.0 percent as compared to 10.5 percent growth in the corresponding period last year.

Figure 6.5: Contribution in Services Payments Growth

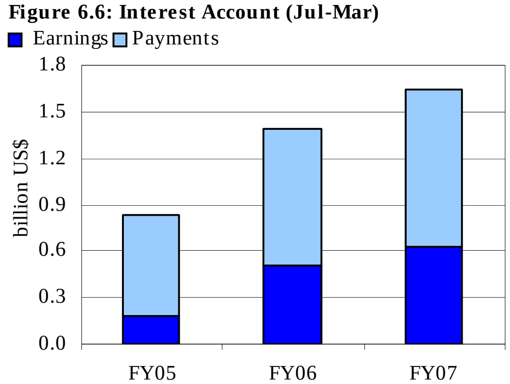


The lower services export growth during Jul-Mar FY07 was primarily due to a US$ 122 million YoY fall in government services, which emanated from lower receipts in logistic support and lower remittances to the embassies operating in Pakistan from their home countries. Another factor was the US$ 45 million YoY fall in communication exports, particularly telecom services; which may have resulted due to extensive use of international calling cards (offering concessional rate) by the Pakistani residents that has possibly reduce the inward international calls (and thus net earnings).

Income Account[12]

The income account deficit widened to US$ 2.6 billion during Jul-Mar FY07 compared to US$ 1.9 billion in the same period last year (see **Table 6.2**). The 38.8 percent YoY growth in the income account deficit was caused by a substantial increase in outflows under investment income, attributed to profit remittances and purchase of crude oil by foreign investors. Net interest payments, were also

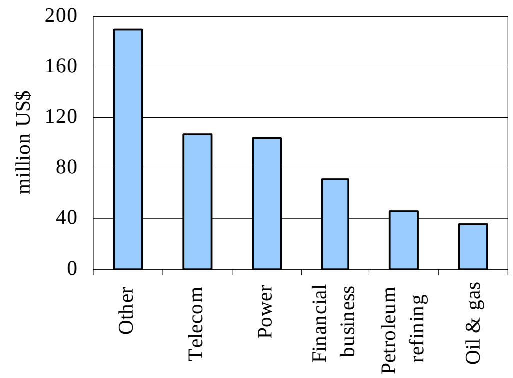
Figure 6.6: Interest Account (Jul-Mar)



[12]The income account balance can be broadly split into interest paid on loans and returns earned by the investors.

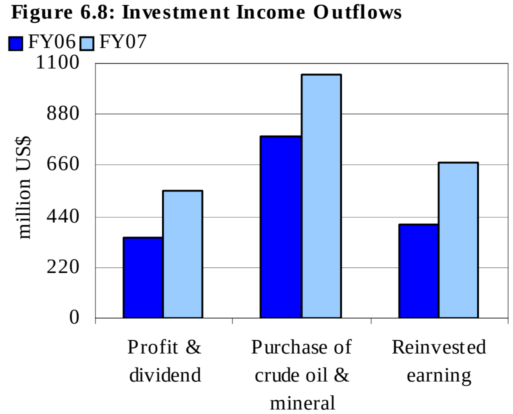
slightly higher at US$ 368 million during Jul-Mar FY07 as compared to US$ 315 million in Jul-Mar FY06. On the positive side a continuing rise in interest earnings, particularly on the country's international reserves, partially offset the impact of a marginal rise in interest payments owed to external creditors in the same period (see **Figure 6.6**).

Figure 6.7: Repatriation of Profit & Dividend (Jul-Mar FY07)



Under the net investment income (outflows)[13] (excluding interest payments) repatriation of profit earned on both direct as well as portfolio investment depicts a 56.1 percent YoY growth during Jul-Mar FY07 as compared to 12.5 percent growth in Jul-Mar FY06. The hefty outflows under profit & dividend in the first nine months of FY07 was visible mainly in the telecom, power, petroleum refining, and banking sectors (see **Figure 6.7**).

Figure 6.8: Investment Income Outflows



Since most of the businesses that received FDI are in the process of consolidation, the outflows under this head could potentially to grow unless they decide to reinvest their earnings. Encouragingly, the reinvested earnings have also witnessed a sharp increase during this period (see **Figure 6.8**).

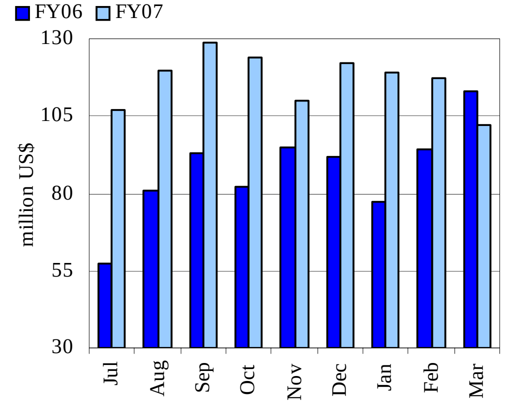
In addition, the payments made by the government to the foreign companies exploring crude oil & mineral in Pakistan also increased by US$ 266 million

[13] Investment income outflow comprises of outflows under profit & dividend, reinvested earning and purchase of crude oil.

during Jul-Mar FY07.[14] However, the monthly trend is quite encouraging, as it appears to be falling (see **Figure 6.9**).

It is pertinent to note that there is no noticeable change in the production of crude oil and mineral, thus the recent hike in outflow under this head was probably a reflection of higher prices.[15]

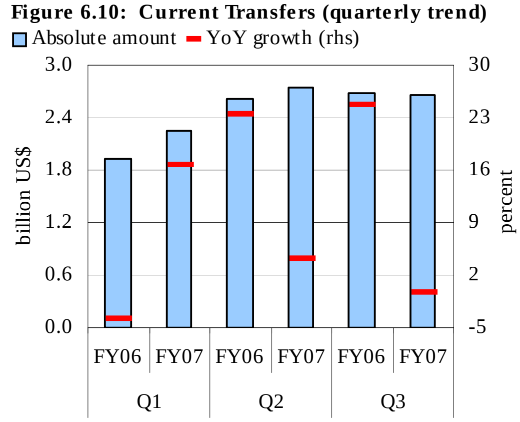
Figure 6.9: Purchase of Crude Oil & Minerals



Current Transfers

Despite an impressive growth of 21.9 percent in worker's remittances, current transfers reflect a marginal 5.9 percent rise during Jul-Mar FY07 as against a more pronounced growth of 15.1 percent in Jul-Mar FY06. In absolute terms, current transfers recorded a US$ 425 million YoY increase during Jul-Mar FY07 reaching US$ 7.6 billion (see **Table 6.2**). This growth was witnessed mostly in Q1-FY07, while the YoY growth in the remaining quarters of FY07 declined substantially (see **Figure 6.10**). The stronger growth in the first quarter was mainly due to the fact that 23.1 percent growth in remittances was compounded by the YoY 11.3 percent growth

Figure 6.10: Current Transfers (quarterly trend)

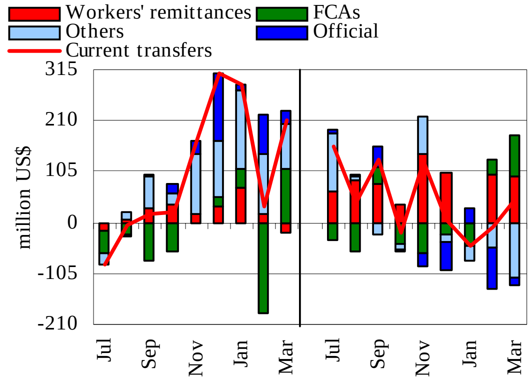


[14] In fact, it is the foreigner's share in total exploration of oil & gas, other than the government's share, which they can sale to government of Pakistan or export it.

[15] The international oil prices started to decline gradually since Aug 2006, however, average international oil prices during Jul-Mar FY07 (US$ 61.66 per barrel) is still higher than the corresponding average prices (US$ 59.17 per barrel) during Jul-Mar FY06; thus possibly explains the higher purchase of crude oil & mineral outflow during Jul-Mar FY07.

in other private transfers during Q1-FY07. In the next two quarters of FY07, growth in remittances was partly offset by the fall in other private transfers.[16]
Thus apart from the rise in worker's remittances all other components of current transfers had no significant contribution to the rise in current transfers during Jul-Mar FY07 (see **Figure 6.11**).[17]

Figure 6.11: Composition of Current Transfers (YoY change)



Workers' Remittances

Workers' remittances of US$ 3.9 billion proved an important cushion to contain the growth in CAD during Jul-Mar FY07 (see **Table 6.3**). The 21.9 percent YoY rise (US$ 709 million) in Jul-Mar FY07's remittances was mainly on the back of significant increases from Middle East and the USA. It is encouraging to see that country recorded a historic peak of US$ 520 million in the month of Mar FY07 (see **Figure 6.12**). SBP projections show that this

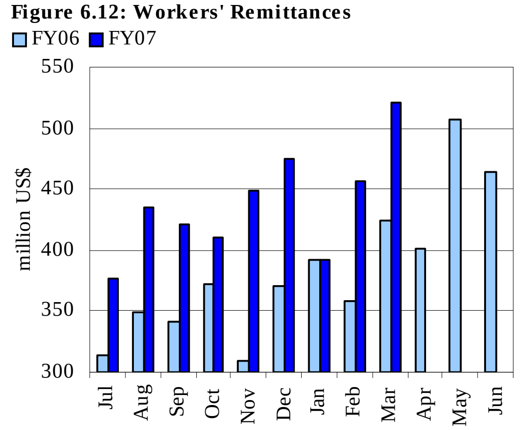
Table 6.3: Workers' Remittances
million US Dollars

	Jul-Mar		Change
	FY06	FY07	
I. Gulf region	**1436**	**1868**	**432**
Bahrain	76	93	18
Kuwait	176	206	30
Qatar	82	120	38
Saudi Arabia	516	733	218
Sultanat-e-Oman	95	118	23
U.A.E.	491	596	105
II. U.S.A.	**894**	**1035**	**141**
III. Other than Gulf & US	**1379**	**1032**	**-347**
Canada	58	62	4
Germany	43	58	15
Japan	5	3	-2
Norway	12	14	3
U.K.	305	319	14
Other	956	575	-381
Total	**3218**	**3935**	**717**
of which: Exchange companies	450	659	209
Encashment of FEBCs &	11	2	-9
Grand total	**3228**	**3937**	**709**

[16] It may be important to note here that after workers' remittances, the second largest component in the current transfers is other private flows which mainly comprises of unclassified private transfers, private donations, withdrawal from the residents FCAs and receipts of exchange companies.
[17] The higher inflows in official transfers during Jul-Mar FY06 was mainly due to US$ 144 million received on account of earthquake grant and US$ 144 million of cash grant for budgetary support, while these flows were limited to US$ 81 million in Jul-Mar FY07. The lower inflow of US$ 65 million in FCAs during Jul-Mar FY07 as compared to an inflow of US$ 198 million in Jul-Mar FY06; was mainly a result of relatively stable rupee and widening spread between rupee and FCAs.

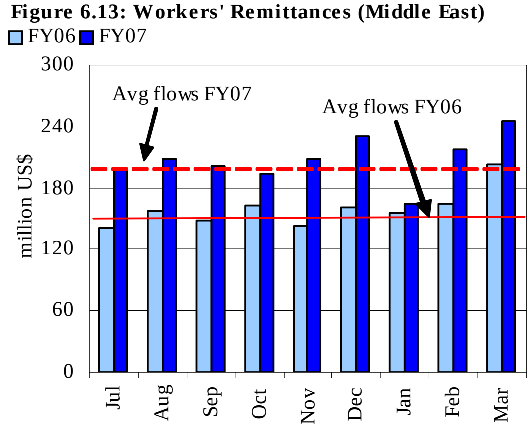
rising trend will continue in the upcoming months of FY07; bringing the FY07 total of approximately US$ 5.5 billion.

Figure 6.12: Workers' Remittances



Break up of remittances by source shows that flows from Middle East, particularly Saudi Arabia and Dubai, during Jul-Mar FY07 were substantially higher, with a monthly average of US$ 207.5 million, as compared with US$ 159.6 million in the corresponding period of FY06 (see **Figure 6.13**).

Figure 6.13: Workers' Remittances (Middle East)



Apart from the Middle East, remittances from USA have also been rising strongly during Jul-Mar FY07. The average monthly level from this particular region reflects a YoY increase of US$ 15.7 million during this period. However, in case of UK, growth in remittances slowed down to 4.6 percent during Jul-Mar FY07 as compared to 12.8 percent in Jul-Mar FY06.

Financial Account

The financial account witnessed a surplus of US$ 6.2 billion during Jul-Mar FY07 as compared to a US$ 4.5 billion surplus in the same period of FY06 (see **Table 6.4**).

The decomposition of the financial account reveals that, this surplus was mainly on account of foreign direct investment (excluding privatization proceeds) and the

Table 6.4: Financial Account
million US Dollars

	Jan-Mar		Jul-Mar		YoY change
	FY06	**FY07**	**FY06**	**FY07**	
Foreign direct investment	1,121	1,986	2,242	3,859	1,617
of which: equity capital	987	1,746	1,840	3,189	1,349
Reinvested earning	134	240	402	668	266
Portfolio investment	779	394	1,091	1,697	606
of which: Equity securities	48	306	407	1,466	1,059
Debt market	729	85	670	236	-434
1. Net foreign investment	**1,833**	**2,352**	**3,254**	**5,480**	**2,226**
2. Other investment	**280**	**163**	**1,216**	**681**	**-535**
Assets	40	170	396	12	-384
i. Outstanding export bills (exporters)	-38	-113	-219	-150	69
ii. Outstanding export bills (DMBs)	-34	115	13	14	1
iii. Currency & deposits	112	168	602	148	-454
of which: Banks	103	99	567	148	-419
Liabilities	240	-7	820	669	-151
i. Official loans	177	70	515	577	62
ii. Private loans	259	6	257	175	-82
iii. Short-term loans	-137	0	-181	-58	123
iv. Currency & deposits	24	232	310	328	18
of which: trade financing	65	145	693	245	-448
v. Other liabilities	-83	-315	-81	-353	-272
Financial account	**2,113**	**2,515**	**4,470**	**6,161**	**1,691**

portfolio investment in equity securities (due to issuances of public and private GDRs and sizeable investment in stock market).

However, the contribution of privatization proceeds to the surplus dropped sharply in FY07 in contrast to FY06 when the financial account surplus was almost equally contributed by FDI, privatization proceeds; portfolio investment and other investment (see **Figure 6.14**).

In the remaining months of FY07, financial account surplus is likely to remain strong on account of (1) floatation of new GDRs both private as well as public; (2) private sector bonds in international capital market; and (3) the issuance of Euro bond worth US$ 800 to 1000 million by the government.

Foreign Investment (net)

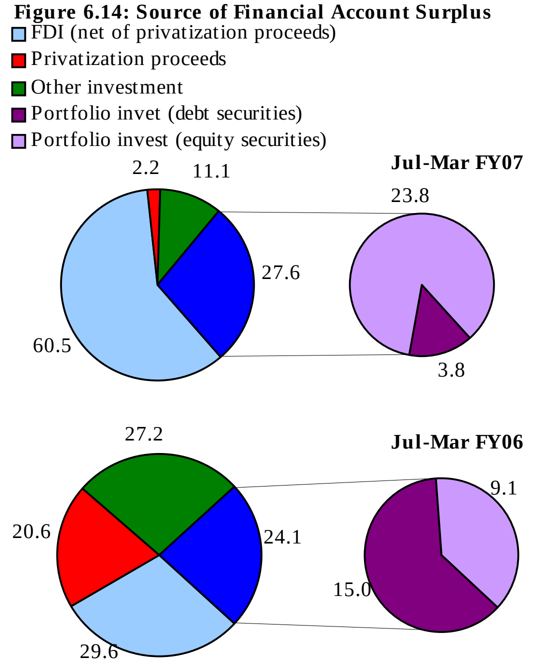
The net foreign investment recorded a substantial YoY rise of US$ 2.2 billion in Jul-Mar FY07 to reach US$ 5.5 billion. This sizeable increase was mainly possible due to continued increase in foreign direct investment. At the same time, an impressive growth in portfolio investment further strengthened the country's investment position (see **Figure 6.15**).

Foreign Direct Investment

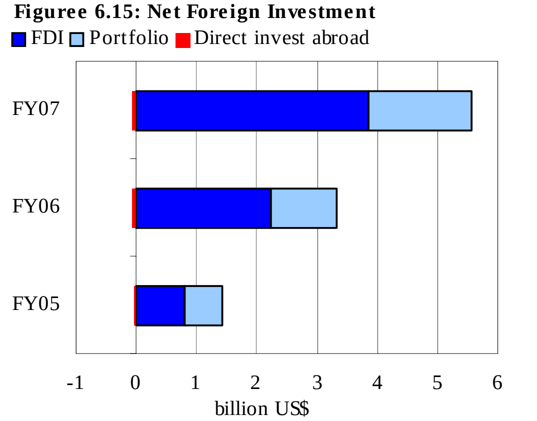
Foreign direct investment recorded a significant expansion of US$ 1.6 billion during Jul-Mar FY07. As stated earlier, in Jul-Mar FY07 the contribution from privatization proceeds in FDI was limited to US$ 133 million as compared to US$ 919 million during Jul-Mar FY06. Indeed, after adjusting for privatization proceeds FDI inflows reflects an impressive rise of US$ 2.4 billion in this period. Moreover, the average monthly FDI jumped to US$ 428.8 million during Jul-Mar FY07 from US$ 249.2 million in Jul-Mar FY06.

Interestingly, the quarterly data during Jul-Mar FY07 shows that half of the FDI inflows-US$ 2.0 billion were realized in the third quarter alone (see **Figure 6.16**).

Figure 6.14: Source of Financial Account Surplus

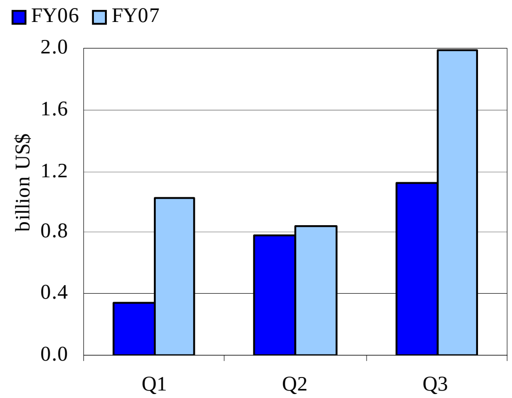


Figuree 6.15: Net Foreign Investment



This was mainly because of the huge inflows of US$ 704 million in telecom sector as a result of acquisition of Paktel by the China mobile company, and a US$ 382 million investment in Lakson Tobacoo from the Philip Morris International (PMI). PMI has recently acquired the Lakson Tobacco Company by increasing its stake in company from 40 percent to 91 percent. In terms of attracting FDI Tobacco & Cigarettes became the forth largest recipient of FDI after communication, financial, oil & gas exploration sectors.

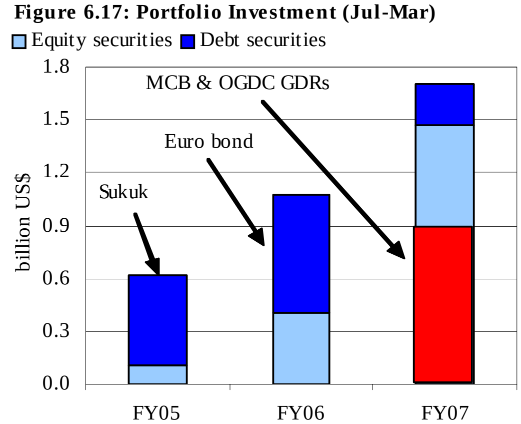
Figure 6.16: Foreign Direct Investment



FDI in the communication sector during Jul-Mar FY07 excluding privatization proceeds of PTCL (US$ 133 million) and China mobile proceeds totaled US$ 513 million for business expansion. FDI of US$ 107 million was also received in oil & gas exploration sector.

Mergers and acquisitions in financial sector also contributed significantly in FDI during Jul-Mar FY07. Specifically, Pakistan received US$ 195.4 million from Standard Chartered Bank's acquisition of Union bank; US$ 99 million for the stake of Crescent Commercial Bank acquired by the Samba group of Saudi Arabia and US$ 68 million in Habib Metropolitan Bank.

Figure 6.17: Portfolio Investment (Jul-Mar)

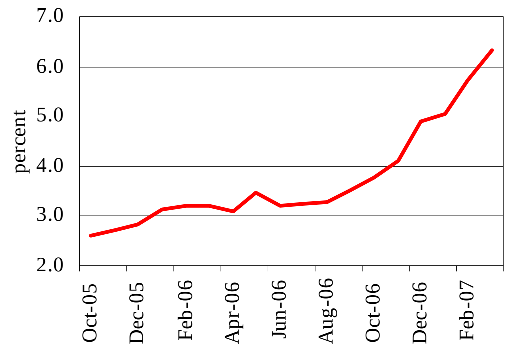


Portfolio Investment

Foreign portfolio investment depicted a substantial growth of 55.5 percent YoY during Jul-Mar FY07 to reach US$ 1.7 billion (see **Table 6.4**). This increase was caused by the rising investment in equity securities, partly from the sale of Global Depositary Receipts (GDRs) by the government oil exploration company and a private sector bank (see **Figure 6.17**). Adjusting for the GDRs of US$ 888 million, portfolio investment in equity securities reflects US$ 578 million in the country's stock market, especially from USA and UK. While Special Convertibility Rupee Account (SCRA) depicts a higher net inflow of US$ 671 million during Jul-Mar FY07.[18] This apparent difference is primarily explained by the foreign investment in money market through SCRA (see **Box 6.1.1**).

The recent surge in portfolio investment, particularly in the stock market, has both positive and negative implications. On the one hand, these flows helped finance the country's current account deficit, but on the other hand, there are some concerns in terms of volatility attached with these flows since their abrupt withdrawal can adversely affect the domestic stock prices and the stability of the domestic currency.

Figure 6.18: Foreign Stake on Domestic Stock Market (as percent of agg. market capitalization)



Analyzing the extent of foreign stake on country's stock market-gauged by the outstanding market value of foreign shares to aggregate market cap-reflects a sharp jump from 3.2 percent in Jun FY06 to 6.3 percent by end Mar FY07 (see **Figure 6.18**). This impact is more pronounced from the flow data; the foreign holdings as percent of market cap increased to 35 percent during Jul-Mar FY07 as compared to 4.7 percent in Oct-Mar FY06.

In the context of GDRs, Pakistan saw two GDRs issues-OGDC of US$ 738 million and MCB of US$ 150 million-in the London stock market against ordinary shares during Jul-Mar FY07.[19] The MCB GDRs incorporates a one-way convertibility guarantee available to the foreigners to hedge risk. Through the one-way convertibility, foreign investors have the option to convert their GDRs into ordinary shares and thus can trade (or dis-invest) in the local market. Similarly, the OGDC GDRs have two-way convertibility options. Indeed, this

[18] In Pakistan, non-residents are allowed to investment in the domestic stock market by maintaining a "Special Convertible Rupee Account" with any authorized dealer.
[19] Global Depository Receipts is an instrument through which a listed firm/investor raises money from the foreign equity markets. Through GDRs foreign investors actually avoid exchange risk, which is apparent if they invest in domestic stock market.

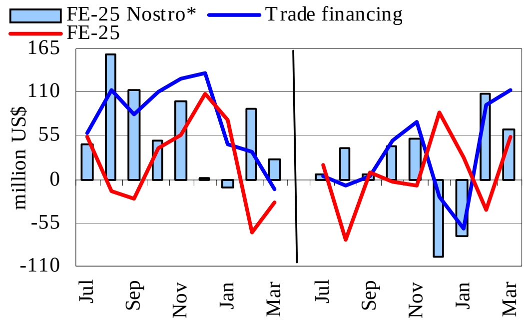
facility is in addition to one way convertibility, under this any foreigner can also reconvert its ordinary shares into GDRs, given the available "*headroom*".[20]

Investments in debt securities also contributed to portfolio investment inflows. The Jul-Mar FY07 flows included US$ 250 million Mobilink bond in the international market and another US$ 50 million foreign investment in Mobilink TFCs; as compared to US$ 670 million in the corresponding period of FY06.[21] Thus the US$ 236 million receipts are essentially private sector flows, while the US$ 670 million inflows during Jul-Mar FY06 largely represented two sovereign Euro bonds.

Currency and Deposits

A lower fall in FE-25 Nostro deposits[22] caused currency and deposit assets to decline only by US$ 148 million during Jul-Mar FY07 as compared to a significant drop of US$ 602 million in Jul-Mar FY06 (see **Table 6.4**).[23] This was mainly due to lower net disbursements against FE-25 loans in Jul-Mar FY07. However, the deceleration in growth of FCA deposits has offset part of the gain from the lower trade financing during Jul-Mar FY07 (see **Figure 6.19**).

Figure 6.19: Causative Factors of FE-25 Nostro Deposits



* Positive values of the FE-25 Nostro deposit assets imply reduction in their level

Official loans

Net official loans recorded a marginal US$ 62 million YoY rise in inflows during Jul-Mar FY07. However, these net inflows after adjusting for earthquake loans, reflects a significant increase of US$ 423 million in Jul-Mar FY07 (see **Table 6.5**).

[20] Headroom is simply the number of GDRs available, as a result of any cancellation.
[21] Out of US$ 250 million private bond, US$ 101 million was utilized in loan repayment of the company; reflected as debit entry in other liabilities of financial account, thus have no impact on BoP.
[22] FE-25 nostros deposits constitute the placements by domestic commercial banks with their foreign counterparts out of FE-25 deposits mobilized by these banks.
[23] In fact, the FE-25 Nostro deposits declined by US$ 148 million during Jul-Mar FY07 as compared to US$ 567 million fall in Jul-Mar FY06.

Table 6.5: Adjusted Official Long-Term Loans (Jul-Mar)
million US Dollars

	FY06	FY07
Receipts	1,321	1,332
of which: Earthquake	522	161
Amortization	806	755
Net adjusted inflows	-7	416

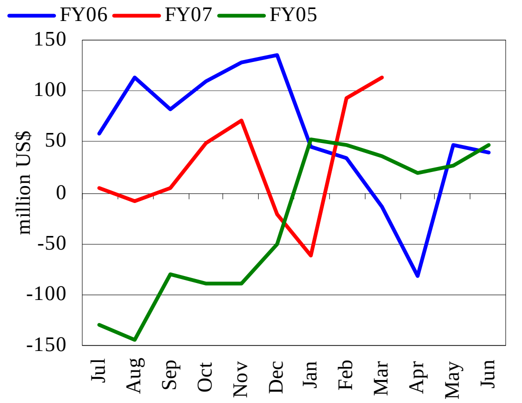
A breakup of the foreign loans shows that during Jul-Mar FY07 Pakistan received US$ 685 million from the ADB and US$ 168 million from the World Bank under program loans. While the project loans amounted to US$ 479 million during Jul-Mar FY07.[24]

Private/Short-term Loans

Private loans registered a net inflow of US$ 175 million in Jul-Mar FY07 as against of US$ 257 million net inflows during Jul-Mar FY06. This was primarily due to higher amortization of US$ 310 million in Jul-Mar FY07 as compared to US$ 245 million in the same period last year. The FY07 loan inflows remained almost unchanged from the previous year.[25]

On the other hand, the short-term loans witnessed a lower net outflow of US$ 58 million as compared to net outflows of US$ 181 million in the same period of FY06. This was primarily because of lower loan amortization of US$ 283 million in Jul-Mar FY07 as against of US$ 350 million during Jul-Mar FY06.[26] The disbursement of loans reflects a marginal rise of US$ 56 million YoY in this same period.

Figure 6.20: Trade Financing



Trade Financing

The trade financing against FE-25 loans witnessed a rise of US$ 245 million during Jul-Mar FY07 as compared to substantial increase of US$ 693 million in Jul-Mar FY06. This was mainly a reflection of widening spread between the cost of FE-25 and

[24] For detail see **Second Quarterly Report** FY07.
[25] During Jul-Mar FY06, the communication sector received substantial loan proceeds of US$ 164 million, while this year the disbursement under communication was US$ 136 million.
[26] The repayments on short-term loans include US$ 116 million to commercial credits in both periods. Out of this US$ 100 million is a rollover amount which has an offsetting entry in the exceptional financing.

(concessional) EFS loans, which made FE-25 financing unattractive for the exporters during this period.[27] However, importers continue to avail financing through this mode, as these loans are still cheaper than the market-based rupee financing.

Table 6.6: Appreciation/Depreciation of Pak rupee Against Major Currencies

	FY06	Jul-Apr*	
		FY06	FY07
US Dollar	-0.87	-0.62	-0.76
GB Pound	-2.39	-1.71	-9.69
Euro	-6.12	-5.20	-8.14
JP Yen	3.08	2.48	3.13

*End period buying selling averages

The monthly trend shows that these loans were largely disbursed during Q3-FY07; which is in contrast to a seasonal fall in the disbursement of FE-25 loans (see **Figure 6.20**).

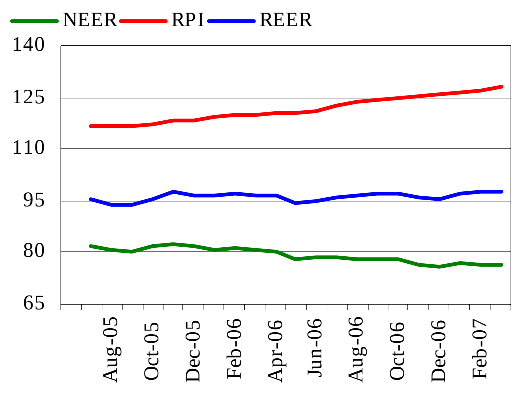
6.2 Exchange Rate

The rupee depreciated against most major currencies other than Japanese Yen during Jul-Apr FY07. While the decline vs. the US dollar was nominal 0.76 percent, the weakness of dollar was reflected in larger depreciations against Euro and Pound Sterling (see **Table 6.6**).

Effective Exchange Rate

Despite relatively lower depreciation against the US dollar and an appreciation against the Japanese yen, Pak rupee's nominal effective exchange rate (NEER) index depicted a cumulative depreciation of 4.04 percent during Jun-Apr FY07. Such an aggregate depreciation occurred because rupee depreciated by larger magnitudes against most of the other basket currencies. However, on account of relatively higher domestic inflation (RPI) compared to the trading partner/competitor countries, the REER index appreciated by 2.06 percent during Jul-Apr FY07, although it shows some improvement compared to a higher appreciation of

Figure 6.21: Trend in NEER, REER and RPI Indices



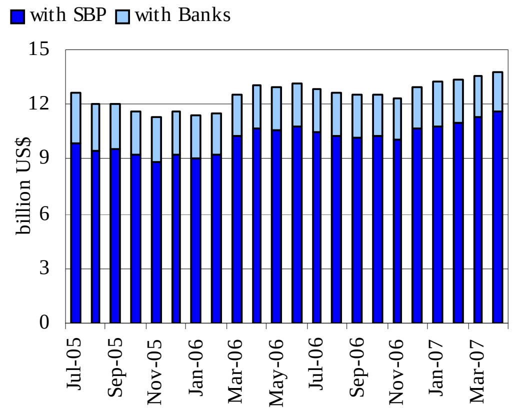
[27] For detail see section 4.1 on **Money & Banking**.

2.51 percent in Jun-Mar FY07 (see **Figure 6.21**). The appreciation of Pak rupee, in real terms, underlines the importance of containing inflation to maintain the competitiveness.

Foreign Exchange Reserves

Pakistan's total foreign exchange reserves grew by US$ 616 million to reach US$ 13.74 billion at end-April 2007, compared to a level of US$13.12 billion at end-June 2006. The growth in reserves was essentially due to a rise in the SBP reserves (see **Figure 6.22**).

Figure 6.22: Liquid Foreign Exchange Reserves



In the Jul-Apr-FY07 period SBP reserves increased by US$ 796.5 million while the banking sectors reserves declined by US$ 180.1 million. In the corresponding period of FY06 the SBP reserves had increased by US$ 877 million largely due to the sovereign Eurobond and PTCL privatization proceeds.

Interestingly, SBP reserves had declined by US $126 million during H1 FY07, when it had been supporting the market through net injections (principally reflecting the position of liquidity for oil payments) before recovering in subsequent months, as ample market liquidity allowed SBP to repurchase a substantial portion of its net injections. Therefore, in Jan-Apr FY07 the SBP reserves increased by US$922 million when the SBP absorbed the forex liquidity through net purchases.

Table 6.7: Causative Factors for Changes in SBP Foreign Exchange Reserves

(million US $)

	FY07	
	Jul-Dec	**Jan- Mar**
Inflows	***5632.3***	***4127.4***
Purchase	2478.1	2711.5
Loan & grants	1075.2	299.3
ADB	658.6	169.6
Others	2079.0	1116.6
Logistic supports	423.9	298.1
Privatization proceeds	133.2	0.0
Sale of OGDC	731.1	0.0
Outflows	***5758.3***	***3204.9***
Sale	3961.8	1766.4
Oil support	*3842.8*	*1681.4*
Debt servicing	622.3	219.2
Others	1174.2	1219.3
Net change in reserves	**-126.0**	**922.5**

Source: DM&MMD, SBP

The accumulation in SBP reserves during Jul-Apr FY07 was contributed primarily to the floatation of OGDC GDRs, receipt of the part payments for the PTCL privatization proceeds, ADB's support for various projects, receipts under logistic support and other inflows. However, these inflows were partly offset by outflows on account of oil and other payments for necessary items. Resultantly, the SBP reserves recorded an increase of US$ 796.5 million during the ten months of current fiscal year. A summary of the causative factors is given in **Table 6.7**.

6.3 Foreign Trade[1]

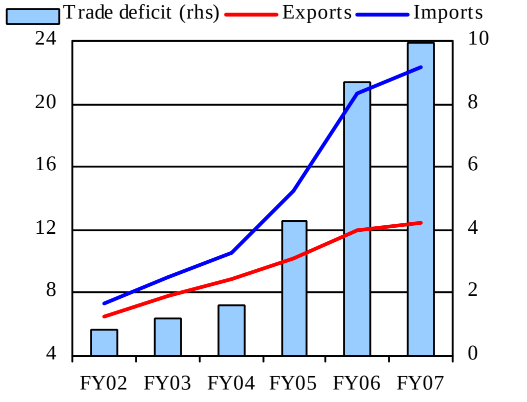
Table 6.8: Summary of Trade Balance (Jul-Mar)

	FY03	FY04	FY05	FY06	FY07
Export Growth	20.2	13.4	14.3	18.0	3.5
Import Growth	22.8	16.3	37.6	43.2	8.1
Trade Deficit (US$ billion)	1.2	1.6	4.3	8.7	9.9
Trade Deficit (%Change)	43.7	35.6	167.8	103.5	14.6

Source: Federal Bureau of Statistics

During Jul-Mar FY07, the import and export could record only 8.1 percent and 3.5 percent growth respectively, in contrast to high double- digit growth in the same periods of the preceding four years (see **Table 6.8**). Thus, while the trade deficit continued to widen, the pace of the increase was appreciably slower, falling to 14.6 percent during Jul-Mar FY07 as compared to an average growth of 88 percent during the corresponding period of the last four years.

Figure 6.23: Foreign Trade (Jul-Mar)



The decline in the import growth is not unexpected and reflects a number of factors, including the return to normal levels of investment by the textiles sector after a surge ahead of the end of export quotas, the absorption of one-off demand created by economic liberalization measures (e.g. in the telecom and media sectors), a moderation in aggregate demand as a result of monetary tightening (most visible in the fall of automobile imports), as well as a fall in oil prices (that limited the growth of oil import bill).

Unfortunately, the gains from the (largely) anticipated deceleration in import growth have been offset by an unexpected weakness in export growth. The abrupt deceleration in export growth in FY07, after strong increases in the previous four successive years, is a source of some disquiet, and has been the source of speculation, with the decline being variously attributed to (1) a conspiracy by exporters to force exchange rate adjustments, (2) to a fall in "spurious" exports

[1] The analysis is based on the provisional data provided by Federal Bureau of Statistics, which is subject to revisions. This may not tally with the trade data based on exchange record reported in the section on *Balance of Payments*.

following a reduction in rebates, as well as (3) to the loss of competitiveness as a result of high domestic inflation and rising funding costs. However, there is little evidence for any of these claims.

While Pakistan's competitiveness has certainly been hurt in recent years, it remains to be seen if this was sufficient to account for the scale of the deceleration in export growth, particularly given the additional incentives provided to exporters. Indeed, there is some evidence also that a significant part of the export deceleration is due to one-off elements (e.g. the decline in raw cotton, rice and citrus fruit exports mainly reflected relatively poor harvests), or due to sector specific issues (i.e. petroleum products, leather manufactures, sports goods, carpets, etc.).

The textile exports also present a mixed picture. While many categories saw export growth weaken somewhat and some have seen growth accelerate, most of the items depicted positive growth except cotton fabrics and bedwear. Interestingly, while cotton fabric exports declined, the exports of synthetic fabrics saw a much strong jump, and as a result the aggregate growth in fabric exports saw only a small deceleration to 7.2 percent YoY during Jul-Mar FY07 compared to 9.2 percent YoY during Jul-Mar FY06. Similarly, even the decline in bedwear exports may be attributed to competitive pressures in the EU market only (on account of loss of GSP and an anti-dumping duty) - exports to the US market have strengthened (see **Table 6.9**).

Table 6.9: Pakistan's Bedwear exports market value share (%) in US and EU

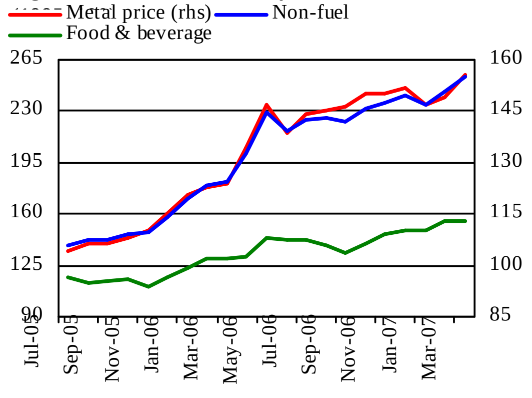
	2004	2005	2006
[1]US*	15.5	25.3	27.3
[2]EU	29.0	23.2	24.2

* The bedwear included pillow cases, cotton sheets and bedspreads
1) Source: US Department of Commerce- office of textile and apparel
2.) Source: Eurostat

Finally, non traditional exports appear to be strengthening, as evident in the 37.8 percent rise in "other exports" during July-March FY07, as compared to a decline of 1.7 percent in the corresponding period last year. These exports include, cement, and ethanol (see **Box 1**).

The above analysis suggests that the sluggishness in exports growth originated from a combination of factors, which include one-off supply shocks, EU-specific preferences & safeguards, as well as some competitive pressures. In any event, whatever the causes, there is no denying that the magnitude of the slowdown in export growth is worrisome.

Figure 6.24: IMF Commodity Price Index



Going forward, the rising trend of commodity prices in the international market, higher demand for furnace oil by the thermal power plants and anticipated increase in the import of power generating machinery may put upward pressure on the import bill (see **Figure 6.24**). On the export side, Pakistan's textile industry needs to be more competitive as it would face increased competition in international markets after the abolishing of China specific textile and clothing safeguards in 2008 by the EU and the US.

In this backdrop, there is need to focus on devising a comprehensive export promotion strategy to narrow down the trade gap. Major issues to be addressed in the export strategy are: a) lack of exports diversification, b) supply side constraints, c) low labor productivity, d) relatively low quality of products, e) delay in the adoption of international standards, f) lack of scale economies, and g) inefficiencies caused by infrastructural bottlenecks (see **Box 2**).

In a more liberalized and competitive world, Pakistan's exports prospects will depend heavily on the adaptability of its industry to the fast changing dynamics of international markets. Pakistan has got the opportunity of duty free access in the fast growing and biggest market of the world by entering into a free trade agreement (FTA) with China to be effective from July 1, 2007. Given that China has such a free trade arrangement only with Chile and Pakistan; therefore, it is a window of opportunity for Pakistani exporters to exploit this market to the maximum. Moreover, similar opportunities of duty free market access are opening up through FTAs with Malaysia and Sri Lanka.

6.3.1 Exports

During Jul-Mar FY07, the exports could only register a nominal growth of 3.5 percent as compared to healthy growth of 18 percent during the same period last year. The export growth, after declining since January FY06, has begun to recover somewhat from November FY07 (see **Figure 6.25**). Specifically, the monthly

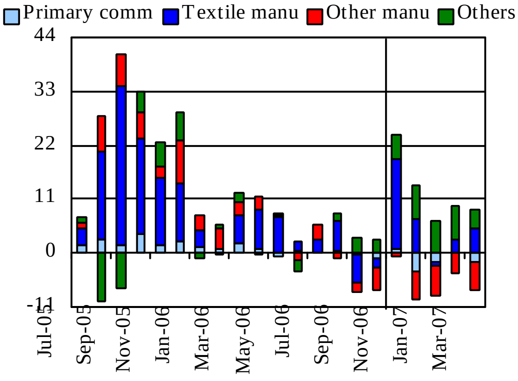


Figure 6.25: Contribution in Export Growth

average export growth of 6.5 percent during Nov-Mar FY07 was higher than the monthly average growth of 0.8 percent during Jul-Oct FY07.

The increased exports of high value added textile items and other exports were the main factors behind this welcome increase in export growth in the later part of Jul-Mar FY07 period. This export growth may be attributed to various incentives given to the exporters as well as the recovery in prices of high value added exports. In fact, the overall export growth could have recovered considerably had it not been for the dip in exports of primary commodities and other manufactures.

Primary Commodities

The exports of primary commodities declined by 7.6 percent YoY during Jul-Mar FY07, sharply down from the growth of 17.1 percent YoY during the same period of FY06. The significant contribution to this deceleration in growth was accounted for by the relatively poor rice, cotton and citrus fruit crops.

However, fish & fish preparations, vegetable and oil seeds & nuts registered positive growth during the period under review. The exports growth of fish & fish preparation and vegetable was entirely contributed by the increase in unit prices, which offset the impact of lower export volumes while growth in the export of oil seeds & nuts was contributed by both volumes and price (see **Table 6.10**). Going forward, the EU ban on the fish & fish preparation from Pakistan with effect from April 12, 2007 will be drag on export growth in this category (see **Box 3**), but the growth rate should nonetheless improve as wheat exports pick up[2].

Textile Manufactures

The textile group exports have recovered somewhat from Q1-FY07, to record 5.8 percent growth during Jul-Mar FY07 in contrast to the robust growth of 19.4

[2] Wheat exports have reportedly already commenced in April 2007, and significant quantities are anticipated to be exported in the remaining months of FY07 and the early months of FY08.

Table 6.10: Major Exports (Jul-Mar)

Value: million US$; Unit value: US Dollar

			FY06		FY07p		Abs chg. in value	% change in Jul-Mar FY07/Jul-Mar FY06		
		Unit	Value	Unit value	Value	Unit value		Qty	Value	Unit value
	Primary Commodities		**1,401.6**		**1,295.3**		**-106.4**		**-7.6**	
1	Rice	MT	846.2	312.6	818.2	362.6	-28.0	-16.7	-3.3	16.0
2	Raw cotton	MT	52.4	1,084.5	44.8	1,078.6	-7.6	-14.0	-14.5	-0.5
3	Raw wool (excl wool tops)	MT	1.4	895.5	0.8	505.6	-0.6	0.0	-43.5	-43.5
4	Fish & fish preparations	MT	133.2	1,493.4	139.4	1,725.0	6.2	-9.4	4.7	15.5
5	Leather	SQM	208.8	16.9	185.2	16.8	-23.6	-10.9	-11.3	-0.5
6	Guar and guar Products	MT	17.9	1,152.3	12.2	1,176.7	-5.6	-33.0	-31.6	2.1
7	Fruits	MT	95.3	281.9	39.3	193.4	-56.0	-39.9	-58.8	-31.4
8	Vegetables	MT	25.9	293.1	37.1	450.3	11.2	-6.7	43.3	53.6
9	Crude animal material	MT	12.5	3,765.1	4.1	2,847.7	-8.4	-56.9	-67.4	-24.4
10	Oil seeds & nuts etc.	MT	8.1	625.1	13.0	714.5	4.9	40.2	60.2	14.3
11	Wheat	MT			1.2	--	1.2			
	Textile Manufactures		**7,244.6**		**7,662.1**		**417.5**		**5.8**	
1	Cotton yarn	MT	1,002.0	2,049.5	1,036.2	2,092.6	34.2	1.3	3.4	2.1
2	Cotton fabrics (woven)	SQM	1,567.0	0.8	1,458.2	0.9	-108.9	-14.7	-6.9	9.1
3	Hosiery (knitwear)	DOZ	1,275.9	21.2	1,469.2	22.1	193.3	10.6	15.1	4.1
4	Bedwear	MT	1,494.0	5,451.0	1,435.6	5,399.8	-58.3	-3.0	-3.9	-0.9
5	Towels	MT	431.3	3,736.4	440.4	3,777.5	9.1	1.0	2.1	1.1
6	Cotton bags and sacks	MT	10.4	4,130.1	4.4	3,318.9	-6.0	-47.1	-57.5	-19.6
7	Readymade garments	DOZ	968.5	34.6	1,052.2	35.1	83.7	6.9	8.6	1.6
8	Tarpaulin & other canvas goods	MT	25.3	2,231.8	59.1	2,448.4	33.8	112.6	133.2	9.7
9	Tule, lace, embroidery etc.	(-)	6.2	---	1.2	---	-5.0	---	-80.5	---
10	Synthetic textiles	SQM	145.8	0.7	377.9	0.8	232.2	130.7	159.3	12.4
11	Other textile made up	(-)	309.1	---	324.2	---	15.1	---	4.9	---
12	Waste material of textile fibres/fabrics	MT	9.1	701.8	3.5	756.4	-5.6	-64.5	-61.7	7.8
	Other Manufactures		**2,089.4**		**1,715.5**		**-373.9**		**-17.9**	
1	Carpets, rugs & mats	SQM	193.2	60.2	168.1	63.4	-25.1	-17.4	-13.0	5.3
2	Petro and petro products	MT	591.6	519.5	583.7	840.7	-7.9	-39.0	-1.3	61.8
3	Sports goods	(-)	232.0	---	193.9	---	-38.1	---	-16.4	---
4	Leather manufactures	(-)	556.5	--	351.8	---	-204.7	---	-36.8	---
5	Surgical & medical instru	NO	119.2	---	86.6	---	-32.6	---	-27.3	---
6	Cutlery	GR	24.9	21.8	26.4	38.3	1.5	-39.6	5.9	75.4
7	Onyx manufactured	MT	9.4	1,604.5	10.9	1,889.1	-0.8	16.8	17.7	-0.8
8	Chemicals & pharmaceuticals	(-)	311.0	---	271.3	---	---	-12.8	---	---
9	Molasses	MT	28.7	84.4	22.9	75.9	-11.2	-20.1	-10.1	-11.2
10	Sugar	MT	23.0	422.5			-	-	-	-
	Others		**1,278.1**		**1,761.6**		**483.5**	**---**	**37.8**	**-**
	Total		**12013.7**		**12434.5**		**420.8**		**3.5**	

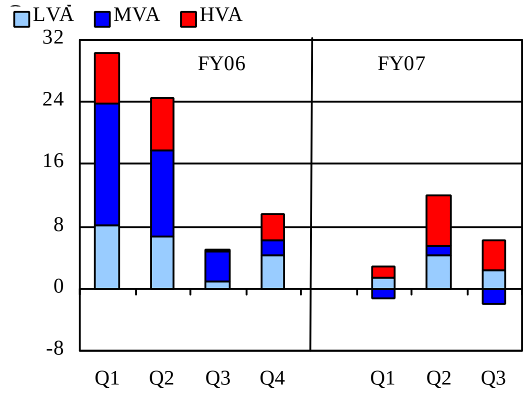
Source: Federal Bureau of Statistics

P : Provisional

percent during the same period of last year.

It may be pointed out that after showing a remarkable performance in H1-FY06, the export growth of textile manufactures started deceleration since Q3-FY06 onward. However, after recording the lowest growth during Q1-FY07 of the last two years, textiles exports have started picking up from Q2-FY07 onward probably because of an increase in unit prices (see **Figure 6.26**). Importantly, the increasing exports of high value textile items seem to be the driving force behind the export growth of textile group, although the exports of low value added textile exports also contributed in the overall growth of textile exports.

Figure 6.26: Contribution in Textile Exports



1) Low Value Added Exports

Cotton yarn and cotton fabrics constitute around 36 percent of the total textile exports, and the growth in the exports of both decelerated sharply during Jul-Mar FY07. Exports of the former recorded a nominal growth of 3.4 percent during Jul-Mar FY07 as compared to impressive growth of 31.8 percent during the same period of last year. Similarly, the cotton fabrics exports declined by 6.9 percent during Jul-Mar FY07 against 17.3 percent growth in the same period of last year despite the considerable increase in its unit price and provision of a 3 percent Research and Development (R&D) subsidy (see **Figure 6.27)**.

Figure 6.27: Cotton vs. PSF Price in Pakistan

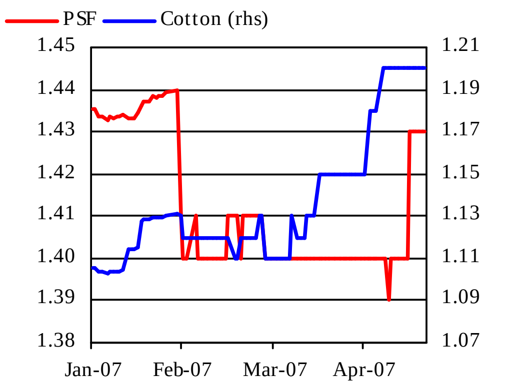
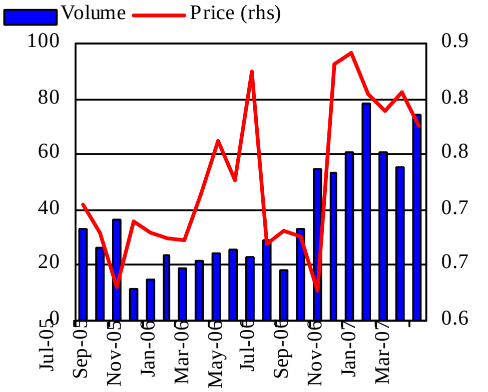


Figure 6.28: Volume and Unit Value of Synthetic Textile



It may be mentioned here that decline of US$ 108.9 million in cotton fabrics exports was more than offset by US$ 232 million increase in the synthetic textile exports (mainly fabrics of synthetic textile) during the same period. The synthetic textile exports recorded extraordinary growth of 159.3 percent during Jul-Mar FY07 as compared to a decline of 37.2 percent in the same period of last year. With the increasing pricing of cotton and falling prices of polyester staple fiber in Pakistan, the local producers might have substituted cotton with the polyester staple fiber, thereby increasing the exports of fabrics of synthetic textile. This extraordinary growth in exports was contributed by both the increase in unit price and the quantum from September FY07 onward (see **Figure 6.28**).

2) Middle Value Added Exports

The textile made ups (middle value added) has traditionally been the main strength of Pakistan's textile exports. The bedwear and towels are the important items in the group which have significant share in the two dominant markets of the world, i.e. EU and the USA. The decline in export growth in both categories is a little puzzling as the bedwear exports declined despite the reduction in antidumping duty from 13.1 percent to 5.8 percent in May 2006 and the grant of R&D subsidy of 5 percent with effect from August 2006. The bedwear exports declined by 3.9 percent during Jul-Mar FY07 against the strong growth of 58.4 percent in the same period of last year.[3] The decline in bedwear exports may partially be explained by the slight decline in unit price.

Driven by both the increase in price and volume, the towel exports registered a nominal growth of 2.1 percent during Jul-Mar FY07 on the top of 14.7 percent increase in the same period of last year (see **Figure 6.29**).

[3] During Jul-Mar FY06, the bedwear exporters were paying 13.1 percent antidumping duty and no R&D was allowed.

3) High Value Added Exports

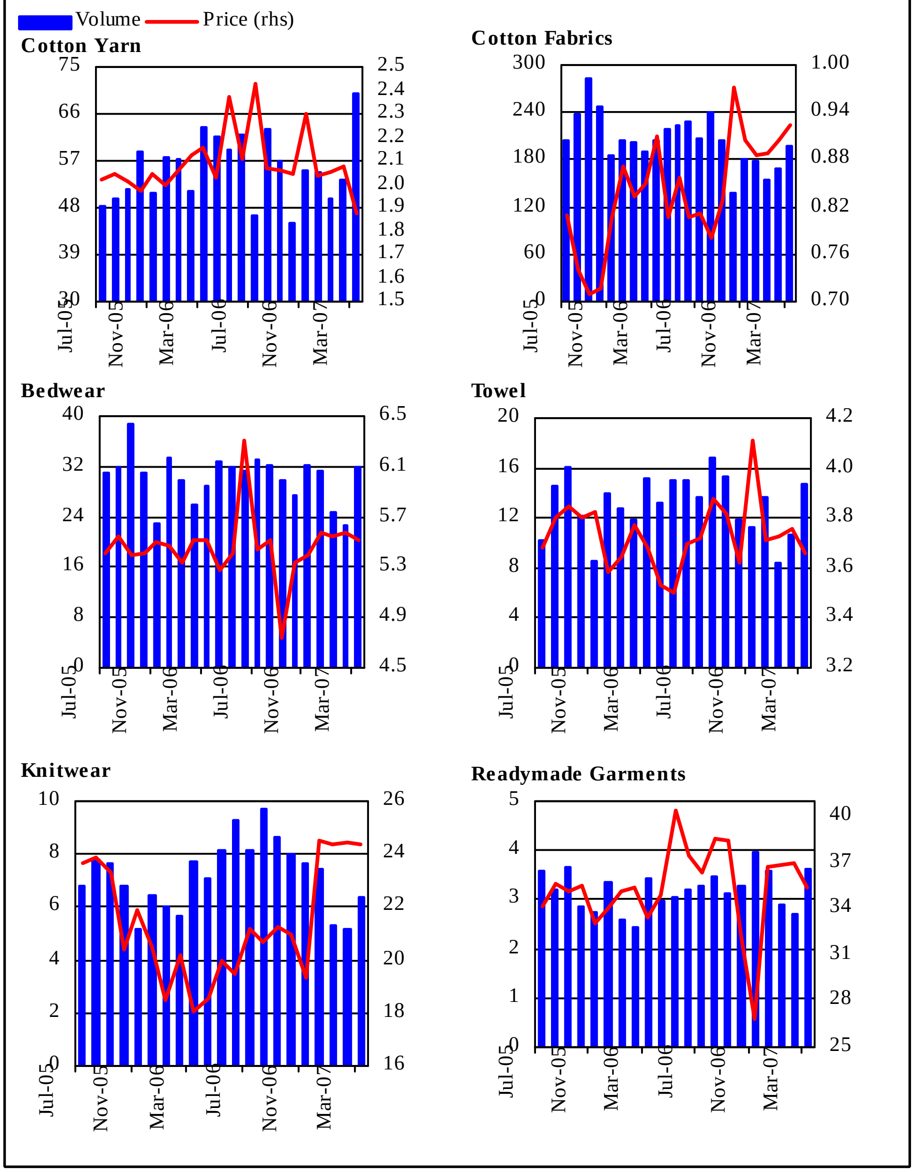
The high value added textile items i.e. hosiery and readymade garments constitute around 30 percent of the total textile exports of Pakistan, which are facing stiff competition from China, India, Bangladesh and Sri Lanka in both the US and the EU markets. In the EU market, Bangladesh and Sri Lanka enjoy duty free access under GSP plus facility whereas Pakistan is at a disadvantageous position in this market. Moreover, unit prices of Pakistan's high value added textile items are lower than that of its major competitors.

In this backdrop, the robust exports growth of high value added textile items during Jul-Mar FY07 is really commendable. The exports of readymade garments increased by 8.6 percent during Jul-Mar FY07 against a 26.6 percent growth in the same period of FY06. More impressively, exports growth in hosiery items accelerated to 15.1 percent during Jul-Mar FY07 against a nominal growth of 4.8 percent in the same period of last year. The appreciable increase in the exports of these two items was contributed by increases in both the price and the volumes. However, the positive effect of unit price was more pronounced in case of hosiery than that of readymade garments. The continuation of R&D subsidy of 6 percent for the readymade garments might have provided additional support to the product's exports. The increase in the high value added textile items is important for two reasons, firstly, it fetches good price in the international market and secondly, there are better prospects for the expansion of high value added textile items. However, the abolishing of China specific safeguards in the year 2008 imposed by the US and EU against textile and clothing imports may pose a challenge for Pakistan's high value added textile items.

Other Manufactures

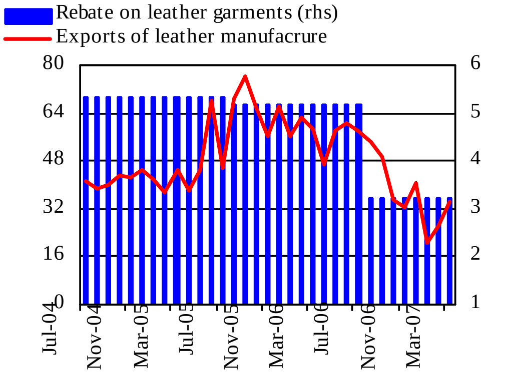
The exports of other manufacture declined by 17.9 percent during Jul-Mar FY07 in contrast to a robust growth of 29 percent in the same period of last year. Exports of almost all the major items such as carpets & rugs, sports goods, leather manufactures, petroleum & petroleum products and chemical & pharmaceuticals declined during Jul-Mar FY07.

Figure 6.29: Major Textile Manufactures- Export Volume and Unit Prices



This decline in exports is attributed to industry specific issues.[4]

Figure 6.30: Leather Manufacture Exports Agiants Rebate

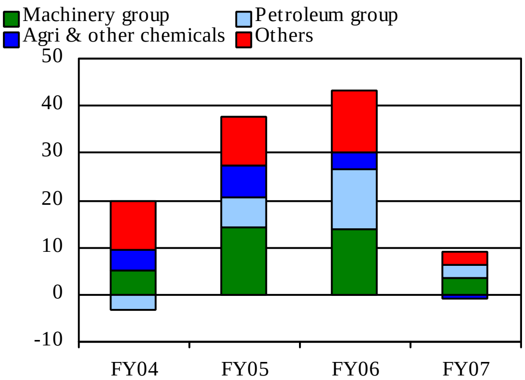


The leather garment exports, which constitutes almost 73 percent of the total leather manufacture exports, was the dominant factor behind the decline of leather manufacture exports. Interestingly, the leather manufactures exports decline coincided with the decline in rebate on leather garments from 5.17 percent during JulyFY07 to 3.22 percent during August FY07 (see **Figure 6.30**). Also given the claim of the leather manufactures of dubious leather garment exports last year and one off high exports to Iran lends some credence to the arguments that leather exports growth last year may have been overstated due to the rebate.[5]

6.3.2 Imports

After depicting extraordinary growth of 30 percent, on average, during the last four years, the imports growth sharply declined to 8.1 percent during Jul-Mar FY07 (see **Figure 6.31**). This was contributed by a significant deceleration in the import of all major groups such as machinery, petroleum group, agriculture & other chemicals group and other imports. For example the lower oil prices

Figure 6.31: Contribution in Import Growth (Jul-Mar)



[4] See *SBP 2nd Quarterly Report FY07*, Section 6.2, Page 93

[5] The Federal Bureau of Statistics suggests that Pakistan's exports to Iran under the head of special transaction used to be around US$ 0.3 million to US$ 0.8 million during FY03 to FY05, however the exports under this head touched US$ 35.77 million during FY06 out of which US$ 33.993 million were of leather manufacture exports.

in the international market decelerated the oil bill growth during the period. Specifically, the unit prices contributed only 4 percent to the additional oil imports bill during Jul-Mar FY07 as compared to 96 percent contribution in the same period of last year.

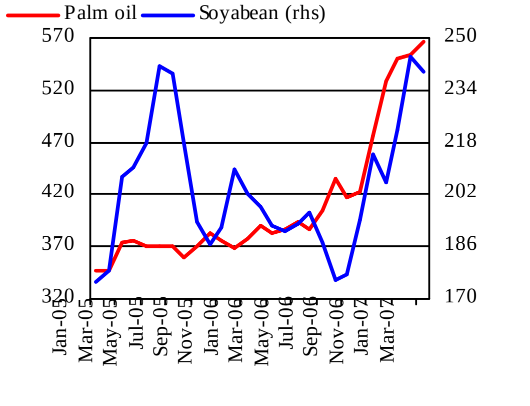
The absorption of one-off impact of structural changes in the telecommunication and automobile sectors together with slowdown in credit for fixed capital and consumer loans have paved the way for deceleration in growth of machinery import.

Food Group

Food imports increased by 6.7 percent during Jul-Mar FY07, as compared to extraordinary growth of 40.5 percent in the same period of last year (see **Table 6.11**). Even this modest growth, despite the positive impact of a bumper wheat harvest and strong domestic sugar production, was caused by an increase in the prices of almost all food items in the international market. The price impact was quite pronounced in the import of pulses as around 70 percent of the total increase in pulses imports growth of 60.8 percent during Jul-Mar FY07 was contributed by an increase in prices.

However, the biggest contribution to the growth in the food import bill was by the sharp increase in the prices of edible oils, on account of strong global demand, and supply constraints. The price hikes contributed significantly to the 107 percent increase in the import bill of soybean oil, and 19 percent increase in the palm oil import during Jul-MarFY07 (see **Figure 6.32).**

Figure 6.32: International Market Edible Oil Prices



Machinery Group

After an extraordinary import growth of 50 percent during Jul-Mar FY06, the import growth of machinery has dropped to 11.7 percent during Jul-Mar FY07. The deceleration in import growth of textile machinery and road motor vehicles together with deceleration in import growth of telecom, electrical and other machinery were main driving forces behind the slowdown of overall machinery import growth (see **Figure 6.33**).

Table 6.11: Major Imports (Jul-Mar)

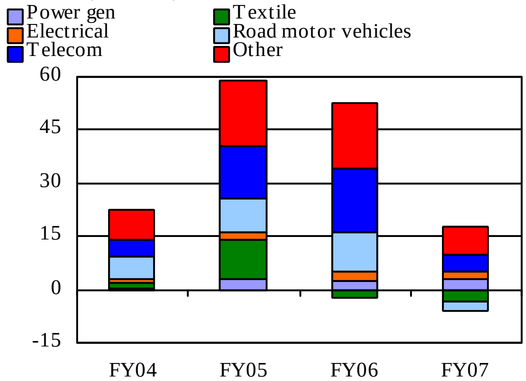
Value: US$ million; unit value US$

		Jul-Mar FY06		Jul-Mar FY07p		Abs chg. In value	% chg in Jul-Mar FY07/Jul-Mar FY06		
Commodities	**Units**	**Value**	**Unit Value**	**Value**	**Unit Value**		**Qty**	**Value**	**Unit value**
A. Food group		**1392.3**	**---**	**1485.4**	**---**	**93.1**	**---**	**6.7**	**---**
1. Milk & cream incl. milk food for infants	MT	41.3	1761.8	53.2	2362.2	11.9	-11.6	28.8	34.1
2. Wheat un milled	MT	126.8	159.2	32.6	277.1	-94.2	-75.9	-74.3	74.1
3. Dry fruits	MT	39.8	551.6	49.4	494.9	9.6	28.9	24.1	-10.3
4. Tea	MT	173.8	1693.3	167.4	1922.3	-6.4	-13.7	-3.7	13.5
5. Spices	MT	39.6	630.8	40.8	674.9	1.2	-10.7	3.0	7.0
6. Edible Oil	MT	566.7	432.9	687.3	479.2	120.6	-1.1	21.3	10.7
Soyabean	MT	14.4	654.5	30.0	850.1	15.6	89.0	108.3	29.9
Palm Oil	MT	552.3	429.1	657.3	469.9	105.0	-2.4	19.0	9.5
7. Sugar	MT	278.9	364.7	253.0	773.0	-25.9	-50.5	-9.3	112.0
8. Pulses	MT	125.4	372.2	201.7	503.9	76.3	18.9	60.8	35.4
B. Machinery group	**---**	**5989.2**	**---**	**6687.9**	**---**	**698.7**	**---**	**11.7**	**---**
1. Power generating machinery	---	362.2	---	526.9	---	-5462.3	---	45.5	---
2. Office machinery	---	209.5	---	233.4	---	-128.8	---	11.4	---
3. Textile machinery	---	598.8	---	392.8	---	183.3	---	-34.4	---
4. Construction & mining machinery	---	138.0	---	139.8	---	-459.0	---	1.3	---
5. Electrical machinery & apparatus	---	349.2	---	479.0	---	341.0	---	37.2	---
6. Railway vehicles	---	65.0	---	7.0	---	-342.2	---	-89.2	---
7. Road Motor vehicles	---	1176.4	---	1009.8	---	944.8	---	-14.2	---
8. Aircraft, ships and boats	---	398.1	---	802.5	---	-373.9	---	101.6	---
9. Agricultural machinery & Implements	---	110.3	---	129.7	---	-268.4	---	17.6	---
10. Other machinery	---	2581.7	---	2967.0	---	2856.7	---	14.9	---
C. Petroleum group	**MT**	**4630.6**	**435.4**	**5224.5**	**437.2**	**2642.8**	**14.4**	**12.8**	**0.4**
1. Petroleum products	MT	1849.0	459.7	2639.1	433.1	790.1	59.6	42.7	-5.8
2. Petroleum crude	MT	2781.6	420.7	2585.5	441.6	-196.1	-12.2	-7.0	5.0
D. Textile group	**MT**	**399.6**	**---**	**382.1**	**---**	**-17.5**	**---**	**-4.4**	**---**
1. Synthetic fiber	MT	186.1	1598.5	169.8	1863.0	-16.3	-26.0	-8.8	16.5
2. Synthetic & artificial silk yarn	MT	179.2	1629.9	173.0	2199.2	-6.2	-31.9	-3.5	34.9
3. Worn clothing	MT	34.4	335.2	39.4	339.4	5.0	11.6	14.5	1.3
E. Agricultural and other chemicals group	**MT**	**3199.3**	**---**	**3020.9**	**---**	**-178.4**	**---**	**-5.6**	**---**
1. Fertilizer	MT	543.6	278.7	258.9	281.3	-284.7	-56.5	-52.4	0.9
2. Insecticides	MT	88.7	3435.7	73.3	3592.1	-15.4	-28.2	-17.4	4.6
3. Plastic materials	MT	765.6	1225.2	843.8	1403.6	78.2	-8.4	10.2	14.6
4. Medicinal products	MT	250.9	31549.6	296.9	33949.9	46.0	1.7	18.3	7.6
5. Others	---	1550.5	---	1548.0	---	-2.5	---	-0.2	---
F. Metal group	**MT**	**1412.8**	**---**	**1242.7**	**---**	**-170.1**	**---**	**-12.0**	**---**
1. Iron and steel scrap	MT	274.6	251.9	217.1	274.9	-57.5	-37.0	-20.9	9.1
2. Iron and steel	MT	1049.7	493.8	893.8	615.4	-155.9	-38.3	-14.9	24.6
3. Aluminum wrought & worked	---	88.5	---	131.8	---	43.3	---	48.9	---
G. Miscellaneous Group		**436.3**	**---**	**481.9**	**---**	**45.6**	**---**	**10.5**	**---**
1. Rubber crude	MT	77.6	1223.7	82.0	1344.0	4.4	-2.4	5.7	9.8
2. Rubber tyres & tubes	No.	116.3	21.6	116.0	22.1	-0.3	-25.5	-0.3	2.3
3. Wood & cork	---	26.7	---	28.9	---	2.2	---	8.2	---
4. Jute	MT	32.9	368.8	33.9	412.5	1.0	-13.0	3.0	11.8
5. Paper, paper board & manufacture	MT	182.8	701.8	221.1	720.9	38.3	9.3	21.0	2.7
H. Others		**3227.4**		**3846.7**		**619.3**	**---**	**19.2**	**---**
Total imports		**20687.6**		**22372.1**		**1684.5**		**8.1**	

Source: Federal Bureau of Statistics, p: provisional

On the other hand, the one-off items such as power generating machinery, aircrafts, ships and boats, and agriculture machinery contributed significantly in the overall machinery import growth.[6]

Figure 6.33: Contribution in Machinery Import Growth (Jul-Mar)



Power Generating Machinery

The import of power generating machinery increased by 45.5 percent during Jul-Mar FY07 on the top of 31.6 percent growth in the same period of last year. The import of power generating machinery is likely to increase further with the rapidly growing appetite for the power in the country. A large number of power generating plants are under process, which are importing electric power generators for their projects.[7]

Road Motor Vehicles

After depicting an extraordinary import growth in the last three years, the road motor vehicle imports declined by 14.2 percent during Jul-Mar FY07. This decline was contributed by both the decline in imports of Completely Built up Units (CBUs) and Completely Knocked-Down Systems. The imports of CBUs of all the categories declined (except of motor cycles whose share in the total CBUs imports is negligible). The imports of CKDs of busses, trucks, other heavy vehicles and motor cycles also increased while that of motor cars declined.

Telecom Group

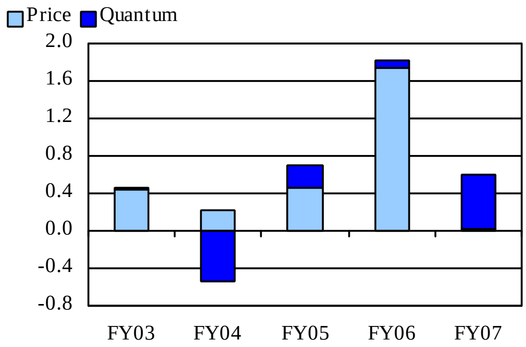
In line with expectations, the growth of telecom group imports decelerated to 18.5 percent during Jul-Mar FY07 as compared to 104.8 percent growth in the same period of last year. The mobile phones imports increased by 32.3 percent while the other telecom apparatus imports increased by 10.7 percent during Jul-Mar FY07.

[6] After adjusting for the one-off imports of Aircraft, Ships and Boats, the growth in machinery imports drops to 5.3 percent during Jul-Mar FY07.

[7] Some of the power generating projects includes 220 Mega Watt (MW) power in Korangi, 1800 MW power consortium near Port Qasim, 225 MW power plants in Shaikhupura, Bhikki.

Petroleum Group

Figure 6.34: Rise in Petroleum Group Imports (Jul-Mar)



The import growth of petroleum group decelerated to 12.8 percent during Jul-Mar FY07 as compared to 65 percent increase in the same period of last year. With the relatively low global oil prices, 96 percent of the increase in the petroleum group was contributed by rising import volumes during Jul-Mar FY07. In contrast increase in prices were the dominant contributor (96 percent) to import growth during the same period of FY06 (see **Figure 6.34**).

Within the petroleum group, almost all the increase was contributed by the petroleum products, as petroleum crude imports declined by 7.1 percent during the period on account of the lower demand of oil refineries that continued to operate at the lower capacities relative to preceding years. The import growth of petroleum products was entirely driven by the quantum as the demand for the furnace oil was increased by the power generation units.[8] With the growing need for power in the country, the dependence on the thermal power generation and thereby on the furnace oil is on increase which may put further pressure on the petroleum group imports in future.[9]

Metal Group

Against a robust growth of 62.7 percent during Jul-Mar FY06, the metal group imports declined by 12 percent during Jul-Mar FY07. One of the major contributory factors behind this decline was increase in the metal prices in the international market. Moreover, the improvement in the domestic steel production and revival of ship breaking industry were the other factors behind the decline of metal group imports.

[8] The demand for furnace oil originates mainly from WAPDA, KESC, IPPs and few captive power plants. It also originates from industries which mainly include cements, fertilizers and sugar.

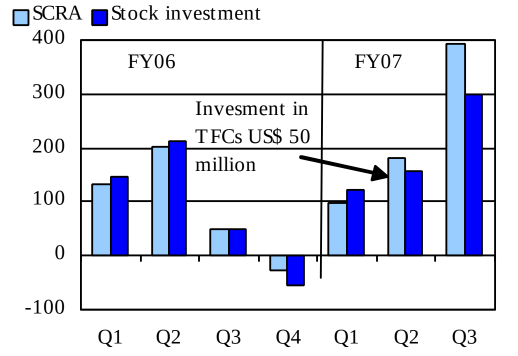
[9] The probable reasons behind the increased dependence on the thermal power generation includes i) controlled water outflow from the dams for agriculture and ii) decrease in gas fired power generation.

Box 6.1: Differences in Foreign investment in stock market and SCRA balance

Non-residents are allowed to invest in the local stock market through Special Convertibility Rupee Account (SCRA).[1] Generally, the foreign investment in stock market that appears in the financial account under portfolio investment is reflection of SCRA flows.[2] However, differences can arise in a given period.

This could be due to number of factors, including (1) non-residents' investment in money market securities through SCRA (2) the fact that non-resident can invest through non-SCRA means as well such as remitting dollars in their brokerage account and withdrawal of rupee from resident enterprises FCAs for stock market investment. However, it is also pertinent to mention here that the larger part of foreign investment in the local bourses is routed through SCRA.

Figure 6.1.1: Foreign Investment in Stock Market and SCRA



At a glance, quarterly trends in SCRA flows and stock market investment reveal that the difference between the two accounts has customarily been negligible. However during Jul-Mar FY07, the difference between the SCRA flows and stock market investment has increased (see **Figure B1**). Specifically, in Q2-FY07 foreign investors purchased Mobilink TFCs of worth US$ 50 million through SCRA; which was not reflected in the stock investment. Similarly, in Q3-FY07 the foreign investment in the stock market reflects US$ 299 million, while the SCRA balance shows US$ 393 million of net inflow. In fact, a difference of US$ 94 million is partly due to the reason that PMI, bought back 5 percent shares of Lakson Tobacco Company Limited (worth of US$ 43 million). Although this amount is routed through SCRA, however, this is not part of stock market investment. As stated earlier that by acquiring 51 percent share of Lakson Tobacco, PMI now become major share holder in the company therefore this amount is recorded in FDI. While the remaining balance of US$ 51 million was kept in SCRA balances with the authorized dealers, and was not invested during Q3-FY07.

[1] Investors are bound to surrender dollars with the authorize dealers and the equivalent rupee amount has being credited in their SCRA balance, which can be replenished through fresh remittances from abroad or by transferring from their foreign currency account maintained in Pakistan.

[2] Equity securities in the portfolio investment are adjusted for GDRs.

Box 6.2 Pakistan's Ethanol Exports

Ethanol is used for three major purposes a) industrial use i.e., for perfumes, after shaves, and cleaners, b) beverages (drinking) and c) fuel (It is blended with gasoline to increase the fuel blend's octane or to produce a cleaner burning fuel). While Ethanol can be made from any commodity containing starch or sugar, including vegetable, sorghum, barley, grasses, and even paper; sugarcane has the highest output level of ethanol per pound of matter. With the rise in global oil prices, the use of ethanol as an alternative fuel is rising as compared to its other uses.

In terms of the market, the USA is the fast growing and largest world market for ethanol followed by Germany and Korea (see **Table 6.2.1**). As a result of better prospects for ethanol markets expansion, countries are producing ethanol to meet the growing demand for ethanol. In particular, Brazil which is the single largest exporter of ethanol is directly converting the sugarcane into ethanol for domestic use and export. Brazil began producing ethyl alcohol from sugar to cut petroleum imports after petroleum prices rose in 1973. The Brazilian Government specifies the percentage of alcohol to be included in gasoline, depending on sugar prices, and encourages the production of automobiles that run on alcohol. As a result, Brazil was the largest share holder (73.5 percent) of ethanol in the world market followed by South Korea and USA during 2006 (see **Table 6.2.2**).

In Pakistan, major source of ethanol is molasses which is byproduct of sugar manufacturing. Until recently, due to lack of awareness, the sugar industry was focused on producing refined sugar while the molasses was exported. However, during the last two years there is considerable rise in the ethanol exports.

Table 6.2.1: World Major Importers of Ethanol

Value in US$ million and Share in percent

	2005		2006	
	Value	**Share**	**Value**	**Share**
World	**2371.4**	**100.0**	**2440.6**	**100.0**
USA	374.6	15.8	1705.8	69.9
Germany	216.7	9.1	279.1	11.4
Belgium	219.3	9.2	112.2	4.6
Korea	87.4	3.7	107.8	4.4
Finland	31.2	1.3	48.7	2.0
Japan	212.6	9.0	n.a	n.a
India	142.7	6.0	n.a	n.a
Others	1086.9	45.8	186.9	7.7

Source: com trade

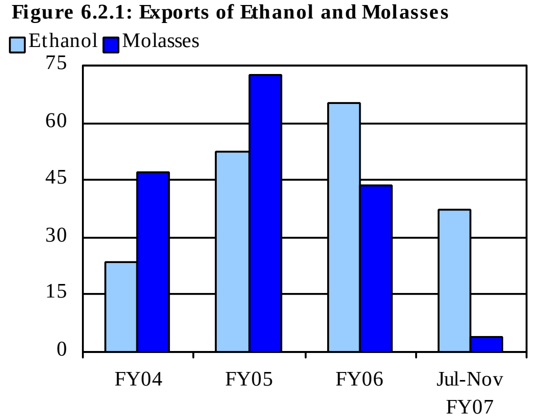
Table 6.2.2: World Major Exporters of Ethanol

Value in US$ million and Share in percent

	2005		2006	
	Value	**Share**	**Value**	**Share**
World	**2328.4**	**100.0**	**2183.6**	**100.0**
Brazil	765.6	32.3	1604.8	73.5
South Africa	139.1	5.9	112.1	5.1
USA	141.1	5.9	108.6	5.0
Germany	94.9	4.0	106.8	4.9
Belgium	49.4	2.1	80.6	3.7
France	221.2	9.3	n.a	n.a
U.K	161.3	6.8	n.a	n.a
Others	755.8	31.9	170.7	7.8

Source: com trade

Figure 6.2.1: Exports of Ethanol and Molasses



Pakistan's sugar industry is now converting larger volume of molasses into ethanol which fetch far higher price in the international market as compared to molasses .[1] It can be observed from the **Figure 6.2.1** that ethanol exports is increasing consistently while molasses exports are falling.

EU had been the major market for Pakistan's ethanol exports. For instance during 2002-04 period, Pakistan was holding almost 20 percent share of the EU total ethanol imports, mainly because of duty free access to EU market under Everything But Arms (EBA) initiative. Importantly, Pakistan has been successful in diversifying its markets for ethanol products as is depicted by the increased share of ethanol exports to USA, Korea, Japan, Jamaica, Nigeria and Philippines (see **Table 6.2.3**).

With the greatest focus on USA, which is the world largest and fast growing market for Ethanol, along with Korea, Philippines and Japan, Pakistan can increase its foreign exchange earnings. Moreover, the unit price of ethanol in USA, Japan and Philippines is higher than average price in the EU market.

Table 3: Major Markets for Pakistan's Ethanol Exports

Value in US$ million and Share in percent

	2003		2004		2005		2006	
	Value	**Share**	**Value**	**Share**	**Value**	**Share**	**Value**	**Share**
World	**23.6**	**100.0**	**20.7**	**100.0**	**56.9**	**100.0**	**64.8**	**100.0**
Netherlands	0.7	2.8	0.8	3.6	13.8	24.2	28.0	43.2
USA	0.0	0.0	0.0	0.0	0.0	0.0	7.1	11.0
Turkey	0.0	0.0	0.0	0.0	1.6	2.8	6.8	10.6
Spain	0.0	0.0	0.0	0.0	0.0	0.0	4.4	6.8
Korea	0.0	0.0	0.0	0.0	2.6	4.6	3.6	5.6
Italy	16.6	70.0	13.8	66.4	32.3	56.7	3.3	5.1
Japan	0.0	0.0	0.0	0.0	0.0	0.0	3.2	4.9
France	1.5	6.2	2.0	9.8	6.0	10.6	2.2	3.4
Jamaica	0.0	0.0	0.0	0.0	0.0	0.0	2.1	3.2
Nigeria	0.0	0.0	0.0	0.0	0.0	0.0	1.4	2.2
Philippines	0.0	0.0	0.0	0.0	0.0	0.0	1.0	1.5
Switzerland	2.5	10.7	1.9	9.0	0.0	0.0	0.8	1.2
Others	2.4	10.3	2.3	11.2	0.7	1.1	0.9	1.3

Source: com trade

1) According to the market sources the ethanol is being quoted around US$ 550 per ton against the molasses price of US$ 61 per ton.
2) According to Federal Bureau of Statistics data, during FY06 per liter price of Pakistan's ethanol exports in US is US$ 0.60, in Japan US$ 0.57, in Philippines US$ 0.58 as compared to EU average price of US$ 0.56 per liter.

Box 6.3: Export's Concentration in Textile Sector

Pakistan's exports are highly concentrated in the textile sector. Pakistan's share of textile exports in total exports (60 percent) is higher than that of India (29 percent), Sri Lanka (47 percent) and China (20 percent) during CY05. Thus a downturn in this single sector may have significant impact on the overall export performance. Since the major input of the textile industry is cotton which heavily depends on the vagaries of nature, the overall performance of export remains uncertain.[1]

Table 6.3.1: World merchandise exports by product group, 2005

(Annual Growth and Share in percent)

	Share	Growth
Fuels	15.8	41
Ores & minerals	1.7	26
Iron and steel	3.6	18
Non-ferrous metals	2.2	16
Other chemicals	9.4	13
Scientific and controlling instruments	2.4	12
Office & telecom. equip.	14.3	11
Other semi manufactures	8.0	10
Pharmaceuticals	3.1	10
Other machinery	14.3	9
Agricultural products	9.6	8
Automotive products	10.3	6
Clothing	3.1	6
Textiles	2.3	4

Source: WTO International Trade Statistics

Moreover, the textile and clothing exports have relatively low prospects for market expansion as compared to other products (see **Table 6.3.1**). The products which have greater share in the world exports and whose market is expanding fast include office & telecom equipments, other machinery, agricultural products, automotive products and pharmaceuticals. The expanding market of these products provides Pakistan an opportunity to diversify its exports by moving to the exports of the engineering products, agricultural products, pharmaceuticals and other chemicals.[2]

[1] After textile, rice is the second largest foreign exchange earner for Pakistan whose exports are also climate dependant and hence volatile.
[2] In chemical Pakistan has the potential to capture the expanding ethanol market while in agricultural products such as milk, meat, seafood and fruits have the potential for exports.

Box 6.4: EU-27 Ban on Pakistan's Fish and Fish Preparation Exports

The EU 27-nations block of European Union is the largest market for Pakistani sea food as is evident from the fact that during FY06 almost 22.4 percent of our total fish and fish preparations exports were destined for this market. Importantly, Pakistan exports of fish and fish preparations were fetching the highest price (US$ 3/ kg) in EU market as compared to other markets. However, EU countries were showing their concern on the processing condition of seafood since last couple of years. For instance, Pakistan government had self-imposed a ban on seafood exports to the EU in 2005 after the EU experts had pointed out lapses at the facilities and for which the government of Pakistan had also submitted guarantees with the EU to improve the conditions at the harbor.

During January 2007, an EU team visited Karachi fish harbor and other seafood processing facilities to check seafood quality. The visit led EU to impose a ban on exports from all Pakistani processing factories on lack of Hazard Analysis and Critical Control Point (HACCP) implementation, lack of traceability of raw materials and poor fish processing.[1] The initial letter from EU has informed Pakistan that no consignments of fishery products will be accepted to enter into the EU after April 12, 2007.

Table 6.4.1: Destination of Pakistan's Fish and Fish Preparation Exports

	FY06			FY05		
	Share (%)		US$/kg	Share (%)		US$/kg
Countries	Vol	Val	Price	Vol	Val	Price
Total	100	100	1.5			1.4
EU-27	11.3	22.4	3.0	8.9	19.1	3.1
China	23.4	15.5	1.0	24.6	16.4	1.0
Thailand	18.6	11.4	0.9	8.2	4.9	0.9
UAE	5.0	9.2	2.8	7.2	13.5	2.7
Malaysia	8.7	5.6	1.0	13.0	7.9	0.9
Japan	2.9	5.6	2.9	3.9	9.2	3.4
Singapore	3.0	5.3	2.7	0.5	0.7	1.8
Korea	5.1	4.6	1.4	7.1	6.9	1.4
Hong Kong	3.5	4.6	2.0	4.3	6.2	2.1
Saudi Arabia	2.8	3.1	1.7	2.9	2.3	1.1
Sri Lanka	7.0	2.8	0.6	11.3	3.9	0.5
Kuwait	2.6	2.6	1.5	2.9	3.2	1.6
U.S.America	0.6	0.9	2.4	0.5	1.0	3.0
Others	5.4	6.3	1.8	4.7	4.7	1.4

This ban has serious repercussions for the fish and fish preparation exports. Firstly, Pakistan has lost its largest market for seafood exports. Secondly, the per unit price in the other market is relatively lower as compared to EU, thirdly, the EU ban is having fallout on the other major international importers from Pakistan. As a result prices of Pakistani seafood have nosed-dived in the international market. According to the World Trade Review report, within a week after April 12, 2007 prices of Pakistani seafood in the international market have declined by almost 20 per cent.

With ban on exports to EU, the other potential markets that can be explored and where seafood fetches relatively good price are: United Arab Emirates, Japan, Singapore, Hong Kong and U.S. America. Along with finding the new markets, both the public and private sector need to make all out efforts to improve the quality of seafood, as it will not only boost our exports but it will also ensure better quality for the domestic consumers.

1 HACCP is a systematic preventative approach to food safety that addresses physical, chemical and biological hazards as a means of prevention rather than finished product inspection.

Acronyms

ABL	Allied Bank Limited
ADB	Asian Development Bank
AIDP	Auto Industry Development Program
BoP	Balance of Payments
CBs	Commercial Banks
CBR	Central Board of Revenue
CBU	Completely Built Units
CDL	Cash Development Loan
CKD	Completely Knock Down
CNG	Compressed Natural Gas
CPI	Consumer Price Index
DAP	Di-Ammonium Phosphate
DFIs	Development Finance Institutions
DMBs	Deposit Money Banks
DPBs	Domestic Private Banks
DPCO	Debt Policy Coordination Office
DPS	Debt Policy Statement
DSCs	Defence Saving Certificates
EFS	Export Finance Scheme
EOBI	Employees Old Age Benefit Institutions
EU	European Union
FBS	Federal Bureau of Statistics
FCAs	Foreign Currency Accounts
FCBCs	Foreign Currency Bearer Certificates
FDI	Foreign Direct Investment
FE-25	Foreign Exchange Cir.No.25
FEBCs	Foreign Exchange Bearer Certificates
FRDL	Fiscal Responsibility and Debt Limitation
FY	Fiscal Year
GDP	Gross Domestic Product
GDR	Global Depository Receipts
GSP	Generalized System of Preferences
GST	General Sales Tax
HBL	Habib Bank Limited
IDB	Islamic Development Bank
KESC	Karachi Electric Supply Corporation
KIBOR	Karachi Inter Bank Offer Rate
LIBOR	London Inter Bank Offer Rate
LCVs	Light Commercial Vehicles

LPG	Liquefied Petroleum Gas
LSM	Large Scale Manufacturing
LTF-EOP	Long Term Finance-Export Oriented Project
MAF	Million Acre Feet
MDGs	Millennium Development Goals
MFA	Multi Fiber Agreement
MoF	Ministry of Finance
MRTB	Market Treasury Bills (for Replenishment)
MTB	Market Treasury Bills
MTBF	Medium Term Budgetary Framework
NAM	New Accounting Model
NBP	National Bank of Pakistan
NDA	Net Domestic Asset
NEER	Nominal Effective Exchange Rate
NFA	Net Foreign Asset
NFC	National Finance Commission
NFI	Net Foreign Investment
NFNE	Non Food Non Energy
NSS	National Savings Scheme
OCAC	Oil Companies Advisory Committee
OGDC	Oil and Gas Development Company
OIN	Other Items Net
OMOs	Open Market Operations
PAMA	Pakistan Automotive Manufacturers Association
PCT	Pakistan Customs Tariff
PDs	Primary Dealers
PIBs	Pakistan Investment Bonds
POL	Petroleum, Oil and Lubricants
PPCBL	Punjab Provincial Cooperative Banks limited
PPIB	Private Power and Infrastructure Board
PSDP	Public Sector Development Program
PSEs	Public Sector Enterprises
PSMA	Pakistan Sugar Mills Association
PSMEA	Pakistan Sports Manufacturers and Exporters Association
PTA	Pakistan Telecommunication Authority
PTCL	Pakistan Telecommunications Company Limited
Pvt.	Private
REER	Real Effective Exchange Rate
RPI	Relative Price Index
SBP	State Bank of Pakistan
SECP	Securities and Exchange Commission of Pakistan

SKD	Semi Knock Down
SMED	Small and Medium Enterprises Department
SPI	Sensitive Price Index
SSAs	Special Saving Accounts
SSCs	Special Saving Certificates
TFCs	Term Finance Certificates
UAE	United Arab Emirates
UBL	United Bank Limited
UK	United Kingdom
USA	United States of America
WPI	Whole Price Index
YoY	Year on Year
ZTBL	Zarai Taraqiati Bank Limited

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