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

1.1 Overview
Likelihood of achieving 7 percent growth target for FY07 remains strong despite visible challenges in meeting growth target of industry and agriculture. While an anticipated recovery in large scale manfacturing is likely to be realized, it seems that achieving the 13 percent growth target may prove difficult. Similarly, the weak performance by the three major *kharif* crops (cotton, rice and maize) had reduced the probability of a sharp rebound by agriculture, though even here, the value-addition is likely to be an improvement over the preceding year if the contribution from livestock and the wheat crop remain strong. This suggests that achievement of the annual growth target will require the services sector to turn in an above-target growth.

Encouragingly, although real growth remained strong and seems likely to exceed the FY06 levels, inflationary pressures eased somewhat during FY07 (see **Table 1.1**), suggesting the tight monetary policy is striking an appropriate balance, i.e., gradually removing excess stimulus from the economy, without dampening the growth momentum. However, this should not lead to complacency; on the one hand, the downtrend in the inflation over the past 12 months clearly shows a degree of instability, and on the other, reducing domestic inflation further is essential to improving the competitiveness of Pakistan's exports, and ensuring a better return to domestic savers.

Table 1.1: Selected Economic Indicators

		FY05	FY06	FY07
Growth rate (percent)				
Large scale manufacturing	Jul-Sep	26.9	8.8	9.7
Exports (FOB)	Jul-Nov	13.6	13.8	7.3
Imports (FOB)	Jul-Nov	51.5	33.2	13.9
Tax revenue (CBR)	Jul-Oct	22.5	20.8	17.9
CPI (12 month MA)	Jul-Nov	7.3	9.0	7.9
Private sector credit	Jul-Nov	12.9	10.9	5.9
Money supply (M2)	Jul-Nov	5.5	3.0	3.3
million US Dollars				
Total liquid reserves[1]	End-Nov	11,987	11,263	12,338
Home remittances	Jul-Nov	1,610	1,684	2,093
Foreign private investment	Jul-Nov	371	1,023	2,100
percent of GDP[2]				
Fiscal deficit	Jul-Sep	0.4	0.5	1.0
Trade deficit	Jul-Nov	1.48	2.81	3.10
Current a/c deficit	Jul-Nov	-0.60	-2.38	-2.69

1. With SBP & commercial banks.
2. Based on full-year GDP in the denominator.

It is also important to note that not all of the instability in inflation can be addressed through monetary policy. Core inflation has already dipped significantly and the present high levels of inflation and its greater variability are both principally driven by food inflation, which is largely determined by factors other than monetary policy. This does not imply that monetary policy cannot play any role in containing food inflation, but rather that the cost of monetary policy actions to contain it should be weighed cautiously. The food inflation pressures in Pakistan could be better controlled through by (1) improvement in supply of key staples, and (2) administrative measures as were taken in the month of *Ramadan*.

Another challenge to containing inflationary pressures is from the divergence between the expansionary fiscal policy and tight monetary policy, and the volatility in the government borrowings from the banking system (and particularly from SBP). The need to catalyze improvements in infrastructure and boost development (and particularly to reconstruct areas devasted by the October 2005 earthequake) means that it will be difficult to substantially reduce the fiscal stimulus in the near term. Unfortunately, the resulting added burden on monetary policy means that the offsetting monetary tightening will need to continue for a longer period.

Fiscal pressures have primarily originated from higher growth in development expenditure, although slowdown in revenue growth has also added to the stress. While weakness in non-tax receipts is not unexpected (and could potentially be reversed in H2-FY07), the slowdown in key CBR taxes is more of a concern. Specifically, the sharp deceleration in imports during FY07 appears to have impacted indirect tax collections, which have remained below target through the initial months of FY07.

It is noteworthy that aggregate collections have nonetheless been strong due to a welcome, but unexpected surge in direct tax receipts. It is hoped that CBR will be able to recoup the shortfall in indirect taxes from this recovery in direct taxes. However, if any revenue shortfalls do emerge, the impact on fiscal accounts should be sterilized through curtailing expenditure (particularly discretionary non-development spending). Such a clear demonstration of commitment to fiscal discipline would likely be crucial in reassuring international investors, thereby supporting a further improvement in the country's credit ratings, and helping domestic companies access international capital markets on more favorable terms.

Moreover, in order to reduce the impact of fiscal developments on monetary policy, it is important that government reduce the uncertaintyassociated with its borrowings (e.g., a start could be made by publishing its quarterly borrowing targets at the beginning of the period) and reduce its dependence on borrowings from the central bank. The government has indeed sought to do the latter by reversing its ban on institutional investments in NSS, but this mode of increasing non-bank borrowings has significant drawbacks (see **Special Section 1 on NSS**), and it is important that the government focus instead on raising funds through issuance of tradable long-term paper, i.e., PIBs.

Finally, while import growth has decelerated sharply in recent months, this has not relieved pressures on monetary policy given the puzzling decline also visible in export growth that has led to a further widening of the trade deficit. While some weakness in exports was not surprising given the increasingly competitive international markets, the reported slowdown was quite unexpected. Moreover, it is not entirely consistent with trends in associated variables, such as the US and EU statistics on textile imports from Pakistan, as well as the exchange record data of SBP (all of which show stronger export growth than given by FBS data). This raises hopes that at least a part of the strong deceleration in exports growth may be a statistical artifact due to unusual leads and lags in reporting (this view seems to be supported by the exceptional 23.9 percent YoY rise in November 2006 exports).

However, even if a part of deceleration is a statistical phenomenon, there is no denying that exports growth has been adversely impacted by competitive pressures, which, in turn, is a major contributer to the widening of the current account deficit in FY07. This is in sharp contrast to the import-led deterioration in the deficit over the preceding two years. It is in this context that the SBP seeks to support the govenrment and exporters by focusing on reducing domestic inflation in order to help curtail increases in the cost of business and to reduce any appreciation of the rupee's real effective exchange rate.

In the meantime, while persistent large current account deficits are clearly undesirable in the medium term, Pakistan's current account deficit is not yet a serious problem, as (1) the current account deficit is forecast at 4.5 percent of GDP, which is not unmanagable; (2) the country is in a position to comfortably finance the deficit through strong non-debt flows as well as by taking on debt at relatively favorable terms; (3) and given that this is without significantly increasing country risk, as the external debt to GDP ratio will continue to decline despite the rise in absolute debt levels. The latter view is supported by the continuing upgrades to Pakistan's sovereign credit rating by leading international credit rating agencies.

Looking Ahead

SBP forecasts based on initial data indicate that the FY07 annual growth target remains achievable, although risks to the downside have increased (see **Table 1.2**) following the below target harvests of key *kharif* crops (cotton, rice and maize), and the possibility of growth in large-scale manufacturing slowing a little in the months ahead as a result of power shortages, capacity issues (e.g., fertilizer production may drop as major units close temporarily to implement expansions), and a relative easing of demand due to the tight monetary policy, etc.

Table 1.2: Major Economic Indicators

	Provisional FY06	FY07 Original targets	FY07 SBP projection
Growth rates (percent)			
GDP	6.6	7.0	6.6 – 7.2
Inflation	7.9	6.5	6.7 – 7.5
Monetary assets (M2)	15.2	13.5	13.5 – 14.5
billion US Dollars			
Exports (fob-BoP data)	16.5	-	17.9
Imports (fob- BoP data)	24.9	-	27.2
Exports (fob-Customs data)	16.5	-	17.2
Imports (cif-Customs data)	28.5	-	30.7
Workers' remittances	4.6	5.0	5.0 – 5.4
percent of GDP			
Budgetary balance	-4.2	-4.2	-4.2
Current account balance	-3.9	-4.3	-4.5

However, M2 growth is forecast to be stronger than estimated earlier as the contractionary impact of net foreign assets of the banking system during Jul-Nov FY07 has been lower than anticipated, due to the unexpectedly robust net receipts in the external account. The latter is likely to overshadow the impact of the deceleration in private sector credit. The continued strength of aggregate demand, the unexpected strength in broad money and, most importantly, the recent uptrend in food prices reinforces the view that the inflation outcome for FY07 is likely to be higher than the annual target.

It is in this context that the SBP continues to stress the importance of retaining a tight monetary posture, in order to reduce the excessive monetary stimulus in the economy. The direction of monetary policy will need to be supported by the fiscal policy by avoiding any expansion in the targeted fiscal deficit (the target looks achievable; however some risks have emerged as a reuslt of the slowdown in import-based taxes), improving predictability in borrowings from banking system and raising non-bank borrowings through PIBs rather than NSS. The greater liquidity in larger market-based issues would also improve price discovery leading to improved long-term debt benchmarks, helping develop domestic debt markets. It should be kept in mind that healthy, liquid domestic debt markets are not only essential to long-term international investment in infrastructure projects etc, but can lead to an improvement in the balance of payments. To put this in perspective, it is important to realize that in order to remain competitive in the intenational markets and sustain economic growth, the country desperately needs to considerably augment and improve its infrastructure. This will only be possible by attracting significant private sector participation in these projects. This will be difficult without long-term debt markets.

1.2 Executive Summary

Agriculture

Hopes of a strong recovery in agricultural growth during FY07 on the back of improved water availability, continued access to credit, and ease in the prices of fertilizers have decreased following the lackluster performance of key major *kharif* crops. The initial production estimates of cotton, rice and maize posted a weak growth, which overshadowed the impact of the strong growth in sugarcane production during FY07 relative to the preceding year. As a result, realization of the FY07 agricultural growth target will be possible if the livestock sub-sector performance is well above target.

Large Scale Manufacturing

Growth in *large scale manufacturing* (LSM) accelerated in Q1-FY07, rising to 9.7 percent as compared with the 8.8 percent growth seen in Q1-FY06. This was primarily due to acceleration in the production in the *textile, electronics, chemicals* and *metal* industries. However, LSM growth acceleration is not broad-based.

The *electronics* sub-sector recorded an extraordinary 41.6 percent YoY growth during Q1-FY07 as against 9.2 percent YoY growth in the same period of previous year. Strong income growth, better access to credit, and the efforts of power utilities to modernize and extension in their distribution networks are the main factors behind the extraordinary performance of the electronics sub-sector.

As with electronics, the growth in the *textiles* sub-group also rose to 12.4 percent during Q1-FY07 as against a decline of 0.9 percent in the same period last year. This growth is the second highest for any first quarter during the last six years. The growth recorded in textile production appears to be supported by the acceleration in the growth of the *chemicals* sub-sector to 10.1 percent during Q1-FY07 as compared with 8.2 percent growth during Q1-FY06.

Metals sub-sector also grew by 14.5 percent during Q1-FY07 against the decline in the production by 4.1 percent during the same period last year. The improvement can be attributed to the streamlining of production by Pakistan Steel after completion of repairs of its coke oven batteries in the last quarter of FY06.

The *automobiles* sector registered a growth of only 11.1 percent during Q1-FY07, which is not only lower than the strong growth of 33.1 percent in the same period of the preceding year but also the lowest during the last six years.

The production of *fertilizer* also fell in Jul-Oct FY07, dropping by 1.7 percent as against a rise of 3.7 percent growth during the same period of the preceding year. This decline was mainly due to capacity constraints as well as lower demand on the back of untimely rain and an anticipated subsidy announcement by the government.

Prices

Although, on average, inflationary pressures appear to be weakening in the economy, the downtrend is unstable. This is evident in the benchmark Consumer Price Index (CPI) inflation, which jumped to 8.9 percent in August 2006 before dipping to 8.1 percent YoY during October 2006 and remained at the same level in November 2006, slightly higher than the 7.9 percent YoY in November 2005. The instability emerged essentially due to the volatility in food prices, particularly stemming from (1) supply-side disturbances on account of rains and floods, and (2) the impact of increases in international prices of some key food items.

A welcome development, from the monetary policy perspective, however, is that non-food inflation now appears to be trending downwards. This deceleration in non-food inflation is clearly mirrored in the easing of core inflation. The non-food non-energy (NFNE) measure of core inflation dipped to 5.6 percent YoY in November 2006 compared with 7.6 percent YoY for the corresponding month of 2005, suggesting that demand pressures in the economy are being reined-in by the continued tight monetary policy.

As with the core inflation, the Wholesale Price Index (WPI) inflation exhibited a steady downtrend, with the overall WPI inflation coming down to 7.5 percent YoY in November 2006 compared with 10.9 percent in November 2005. The major contribution to the decline in WPI is from the non-food group, which outweighed the acceleration in the food group prices.

Unfortunately, despite the moderation in inflationary pressures, CPI inflation is still close to the 8 percent levels by November 2006, which is significantly higher than the annual average inflation target of 6.5 percent for FY07. Given that core inflation is likely to remain contained through the remaining months of FY07 as a result of a tight monetary policy, it is important that its impact is supplemented by measures to address food inflation and high energy prices. Volatile, double-digit food inflation is particularly undesirable in view of its greater adverse impact on low-income groups. Moreover, it is a source of disquiet for monetary policy as well since inflationary expectations are based on overall inflationary trend. There is a need for effective administrative measures (as exercised in the month of Ramadan) to discourage profiteering on food items.

Money and Banking

The impact of monetary tightening pursued in FY06 as well as the policy signals through the FY07 changes, is already evident in the slowdown in private sector credit growth, which has dropped to 5.9 percent during Jul-Nov FY07 against the 10.9 percent growth witnessed in the corresponding period of FY06. Moreover, core inflation, as measured by non-food non energy inflation has slowed to 5.6 percent (YoY) in November 2006 from 7.6 percent (YoY) in November 2005.

However, the growth in monetary aggregates during Jul-Nov FY07 remained strong. This is because: (1) the deceleration in private sector credit has not been matched by an equally strong decline in government borrowings, which have remained significant; and (2) the contraction in NFA during Jul-Nov FY07 has been much lower than that in FY06.

The impact of continuing pressures on the external account was evident on the NFA of the banking system that showed a contraction of Rs 41.1 billion during Jul-Nov FY07, almost equally distributed between SBP and all commercial banks. However, it is important to note that the contraction in the NFA of the banking system during Jul-Nov FY07 was considerably lower than the sizeable reduction of Rs 90.5 billion witnessed during Jul-Nov FY06. This is largely because the NFA of commercial banks did not decline as sharply as in FY06.

The *government borrowings* from the banking system are higher and volatile. Although the government may be able to remain within the budgetary borrowing target of Rs 120 billion from the banking system for FY07, excessive borrowing during the course of the year is a source of concern for monetary policy, particularly because the government borrowing is entirely from the central bank, which is the most inflationary in nature as it contributes to reserve money growth.

The high government borrowings and the resulting rise in reserve money, has the potential of re-igniting inflationary pressures in the economy. If this happens, the time path for achieving a stable low inflation could be extended, as in the absence of low stable inflation, the central bank would have to keep interest rates high for a longer duration.

The government has however sought to increase its non-bank borrowings. Unfortunately, instead of raising these incremental funds entirely through PIB issues, the government has also re-allowed institutional investment in NSS. While the latter decision would, in theory, allow institutional investors to rollover large NSS maturities, this major policy reversal is likely to have significant negative implications for the development of the domestic debt market, and raise interest rate risk for the government.

In contrast to government borrowings, the private sector credit seems to be responding to interest rate signals from the central bank. Specifically, the growth in private sector credit during Jul-Nov FY07 has slowed down to 5.9 percent compared to 10.9 percent rise witnessed during the corresponding period of the previous year. However, so far, this slowdown in private sector credit growth is *not* a source of disquiet for SBP for the following reasons:

- The YoY growth in private sector credit remains very strong at 18.0 percent by 25th Nov 2006, although down from 31.9 percent last year.

- A review of monthly trends in private sector credit shows that the slowdown is largely concentrated in the month of September 2006. In fact, trends during October and November 2006 indicate presence of strong demand for private sector credit in the economy.

- The available evidence suggests that the slowdown in private sector credit is not broad-based as (1) the increased *net* retirement, particularly by the sugar manufacturers during Jul-Nov FY07 contained the growth in private sector credit; and (2) deceleration in bank credit against equities.

- More importantly, while the nominal lending rates are rising, the real lending rates are still very low. The real lending rates under export finance facility are even negative.

In sum, though the overall demand for credit by the private sector has decelerated, the slowdown is not broad-based. This suggests that monetary policy needs to remain tight.

However, while the transmission of the monetary policy on lending rates has improved over the last year, the impact on deposit rates has been less than desired, contributing to an unhealthy high banking spread. The available evidence shows that banks are mobilizing deposits at higher returns and the share of such deposits has been rising. Since the long-term deposits lower the maturity mismatch for banks and reduce liquidity risks, it was expected that the banking spread would decline. But in the meanwhile, lending rates have also risen thereby leading to a sharp rise in the banking spread (calculated on the basis of incremental loans and deposits) in recent months. Such a large spread can have a dampening effect on economic growth by discouraging savings.

Fiscal Developments

Developments in public finance during Q1-FY07 present a deterioration in the fiscal accounts. Fiscal deficit widened by 0.5 percent of GDP to 1.0 percent of GDP in Q1-FY07. The Q1-FY07 fiscal deficit (as percent of GDP) is not yet inconsistent with meeting the annual target of 4.2 percent of GDP. For example, the Q1-FY03 fiscal deficit had been 0.8 percent of GDP, but full year outcome was 3.7 percent of GDP. However, in that year the growth in CBR taxes had been exceptionally strong at 9.6 percent of GDP (a level achieved in FY97 but never since). The FY07 tax target is close to this level, at 9.5 percent of GDP, and attaining it will be important to meeting the overall fiscal deficit target for the year. Unfortunately, given the recent moderation in import growth, and the high dependence of tax receipts on import-based taxes, achievement of the CBR tax target may prove challenging.

This fiscal squeeze is attributable to both the lower revenue growth, as the total revenue to GDP fell from 3.1 percent in Q1-FY06 to 2.9 percent in Q1-FY07 and the rising expenditure. It is note worthy that the rise in expenditure to GDP ratio is only due to the unidentified expenditure that rose from 0.1 percent of GDP in Q1-FY06 to 0.4 percent of GDP in Q1-FY07. CBR though met its revenue target of Rs 236.2 billion with an actual collection of Rs 237.3 billion during Jul-Oct FY07 yet all the indirect taxes could not meet their respective targets. A moderate growth in imports and the large-scale manufacturing resulting in lower growth in tax collection by the CBR during first quarter, may keep the growth in indirect tax revenues relatively weak during FY07. Provincial governments, however, improved their position during first quarter. This better fiscal position stemmed from new formula of revenue sharing from federal divisible pool of tax revenue, except Balochistan, all the other provinces seem to be in a comfortable position.

Balance of Payments

Pakistan's overall external account position improved during Jul-Nov FY07 compared to the same period last year despite a worsening of the current account deficit. Specifically, while the current account deficit increased from US$ 3.1 billion to US$ 4.0 billion, an increase of 29.1 percent, the overall external account deficit shrank to US$ 0.73 billion in Jul-Nov FY07 compared to US$ 0.88 billion in Jul-Nov FY06.

As in the previous year, it was the surpluses in the *capital* and *financial* accounts that offset most of the deficit in the current account. The bulk of the 35.4 percent YoY increase in the aggregate surplus in the *capital* and *financial* accounts during Jul-Nov FY07 was contributed by foreign investment.

Although Pakistan was able to finance the Jul-Nov FY07 current account deficit relatively easily, the rise in the deficit nonetheless remains a source of some concern, particularly because unlike the previous years, it owed more to a substantial slowdown in the country's exports rather than an extraordinary rise in imports. Specifically, while the imports growth during Jul-Nov FY07 slowed substantially to 13.9 percent compared to 33.2 percent in the corresponding period last year, it was the unusual decline in the exports growth (that dropped to a mere 7.3 percent compared to 13.8 percent in the corresponding period last year), that drove the trade deficit up by 25.5 percent to US$ 4.5 billion.

In addition, the current account deficit was also adversely affected by an unusual rise in the income account deficit arising from a higher direct investment income outflows. The rise in the trade, services, and income account deficit was, however, mitigated to an extent by the increase in the current transfers, which increased by 13.4 percent during Jul-Nov FY07.

Due to substantial inflows, both on account of current transfers and foreign investment during Jul-Nov FY07, the impact of the widening current account on the country's reserves was relatively low. Pakistan's overall foreign exchange reserve declined by US$ 799.4 million during Jul-Nov FY07 compared to decline of US$ 1,321.6 million in the same period last year. Nevertheless, a result of the continuous pressures on the external sector, Pakistan's currency vis-à-vis US Dollar, depreciated by 1.1 percent during Jul-Nov FY07 as compared to the 0.1 percent in the corresponding period last year.

Foreign Trade[1]

The trade deficit continued to rise during Jul-Nov FY07, although the growth slowed substantially to 17.8 percent from the 147.5 percent YoY increase recorded during the corresponding period last year. This welcome deceleration in the growth of the trade deficit during Jul-Nov FY07 is principally due to the slowdown in the import growth.

Specifically, the moderation in import growth, which has been apparent since H2-FY06 further strengthened during Jul-Nov FY07 as all major imports categories other than *petroleum, machinery* and *other products*, recorded negative growth rates. As a result, the overall growth in imports fell to 10.4 percent during Jul-Nov FY07 against 54.3 percent rise in the corresponding period last year. Indeed, the trade deficit would have been even lower, had it not been for the unexpected sharp deceleration in export growth to 5.2 percent YoY during Jul-Nov FY07 compared to 22.3 percent YoY in Jul-Nov FY06.

A part of the decline in the exports growth is understandable given the more challenging economic environment as compared to a year earlier, both domestically and externally. Nevertheless, the magnitude of the slowdown in exports is still puzzling.

Specifically, while the FBS data shows a 3.3 percent decline in the textiles exports during Jul-Nov FY07, exchange records depict a growth of 11.0 percent. Furthermore, EU textiles and clothing imports from Pakistan also show a rise of 3.2 percent during Jul-Sep FY07,[2] and similarly, the US imports data show a rise of 8.8 percent in textile and clothing imports from Pakistan.[3] However, the November trade figures are some consolation; although detailed data is not yet available, the increase of 23.9 percent YoY in overall exports is nevertheless quite encouraging.

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

2 Real Sector

2.1 Agriculture

Hopes of a strong recovery in agricultural growth during FY07 on the back of improved water availability, continued access to credit, and ease in the prices of fertilizers have dimmed following the lackluster performance of major crops in *kharif* FY07. In particular, the impact of a strong sugarcane harvest has been overshadowed by declines in the harvests of cotton, rice and maize (see **Table 2.1**)

On the other hand, prospects for the *rabi* FY07 crops including wheat look good given favorable weather, satisfactory availability of all inputs, an increase in the wheat support price and the provision of a subsidy on non-urea fertilizers. However, even good *rabi* harvest may not be sufficient to push the growth in value-addition by major crops above the 4.3 percent annual target (see **Table 2.2**). As a result, realization of the FY07 agricultural growth target will be possible only if the livestock sub-sector performance is well above target.

Table 2.1: Value Addition by Major Crops

	million Rupees			Percent change	
	FY05	**FY06**	**FY07^{PE}**	**FY06**	**FY07**
Cotton	104.7	90.4	86.2	-13.6	-4.6
Rice	58.9	63.9	62.3	8.6	-2.5
Maize	15.9	19.8	18.6	24.1	-6.1
Sugarcane	38.3	35.9	41.6	-6.4	15.9
Sub-total	***217.9***	***210***	***208.7***	***-3.6***	***-0.6***
Wheat	144.7	144.2	152.5^{T}	-0.4	5.8
Total	**362.6**	**354.2**	**361.2**	**-2.3**	**2.0**

P: Provisional; E: Estimated

T: Target

Table 2.2: Composition of Agriculture Performance

percent

Sectors/Sub-sectors	FY06^{P}		FY07^{T}	
	Growth	**Share**	**Growth**	**Share**
Agriculture	**2.5**	**100**	**4.5**	**100**
Major crops	-3.6	35.2	4.3	35.1
Minor crops	1.6	12.3	2.3	12.1
Livestock	8.0	49.6	5.2	49.9
Fishery	1.9	1.3	4.0	1.3
Forestry	-9.7	1.6	3.5	1.6

P: Provisional; T: Targets Source: Annual Plan FY07

Crops

The initial production estimates for major crops of *kharif* FY07 indicate that the harvests of cotton, rice and maize declined relative to the preceding year.[1] This principally reflected a decline in the cultivated area under these crops (see

[1] The harvests of cotton and rice both were also short of their respective target for the year.

Table 2.3). Indeed the aggregate cropped area during *kharif* FY07 fell by 2.3 percent, despite the 13.9 percent increase in cropped area for sugarcane.

The only major *kharif* crop that performed well was sugarcane, where the cultivated area increased following exceptionally good prices garnered by sugarcane farmers in the previous season. This rise in area under sugarcane (and production) is a reversal of a declining trend witnessed for the last two years. Nonetheless, FY07 sugarcane crop size is still 3.7 percent lower than the level achieved in FY04 mainly due to continued dispute over prices between the growers and sugar mills. This indicates that a settlement of the perennial price disputes between growers and sugar mills needs to be resolved in order to improve the farmers' decision-making ability about the crop size.

Table 2.3: Planted Area of Major Crops

000' hectares

Crops	FY05 Actual	FY06 Actual	FY07 Target	FY07 Estimate	% change in FY07^{E} over FY06
Kharif crops					
Cotton	3,229	3,100	3,250	2,951	-4.8
Sugarcane	967	907	1,005	1,033	13.9
Rice	2,520	2,622	2,575	2,475	-5.6
Maize	945	1,030	1,001	1,027	-0.3
Rabi crops					
Wheat	8,358	8,448	8,459	--	--
Gram	1,109	1,066	1,051	--	--

E: estimate

The increased cultivation of sugarcane was one of the likely contributors to the relatively weak cotton harvest, as high prices for sugarcane and relatively weak cotton prices led farmers to switch crops. The impact of this may have been compounded by excessive rains at sowing time, and the late release of irrigation water in major cotton belt areas. As a result, the area under cotton fell short of both the target for FY07 and actual outcome in FY06.

Moreover, cotton yield also did not see a significant improvement in FY07, as the crop was hurt by: (1) rise in humidity, due to prolonged rains, fostered pest attacks and increased the incidence of Cotton Leaf Curl Virus (CLCV); and, (2) cotton fields were partly damaged by rain and flood in major cotton producing districts of Southern

Table 2.4: Production Estimates of Major Crops

(000 tons, cotton in 000 bales)

Crops	FY05 Actual	FY06 Actual	FY07 Target	FY07 Estimate	% change in FY07^{E} over FY06
Kharif crops					
Cotton	14,244	13,019	13,820	12,410	-4.7
Sugarcane	47,224	44,666	50,500	51,800	16.0
Rice	5,025	5,547	5,693	5,400	-2.7
Maize	2,797	3,110	3,279	2,918	-6.2
Rabi crops					
Wheat	21,612	21,277	22,000	--	--
Gram	868	480	610	--	--

E: estimate

Note: Wheat target revised to 22500 thousand tons and for gram to 707 thousand tons for FY07.

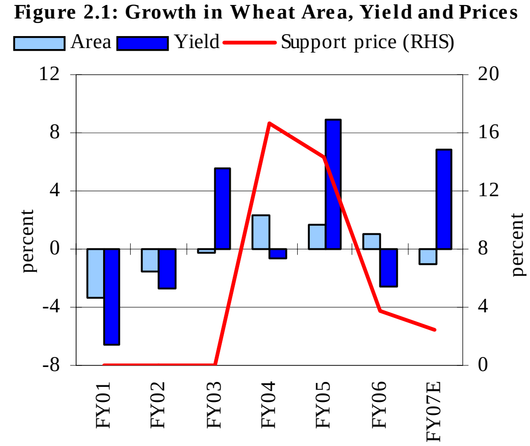
Sindh. As a result of these adverse developments, cotton harvests fell by 4.7 percent in FY07, continuing the decline (8.6 percent YoY) seen in the preceding year (see **Table 2.4**). Due to its greater impact on overall economy, this continued decline in the cotton harvest is a source of concern, and points to the need to develop more hardy varieties.

As with cotton, the decline in the area under rice may also have been impacted by extended untimely rains. As a result, the area under rice fell by 5.6 percent in FY07 against a sharp increase of 4.1 percent seen in FY06. Nonetheless, per acre yield witnessed an increase of 3.1 percent in FY07, suggesting that if targeted area under rice would have been achieved, FY07 would have seen another bumper crop.

The rising trend of rice yield is a result of (1) higher irrigation water availability, following monsoon rains, (2) efficient use of inputs, and (3) better crop management adopted by the growers on the hopes of better returns.

Following the below-target aggregate performance by the major crops in *kharif* FY07, only an exceptionally above-target wheat harvest will bring the aggregate value-addition by major crops close to the target. This looks challenging, particularly as widespread rains in November and December have reportedly delayed wheat sowing in some areas.

Figure 2.1: Growth in Wheat Area, Yield and Prices

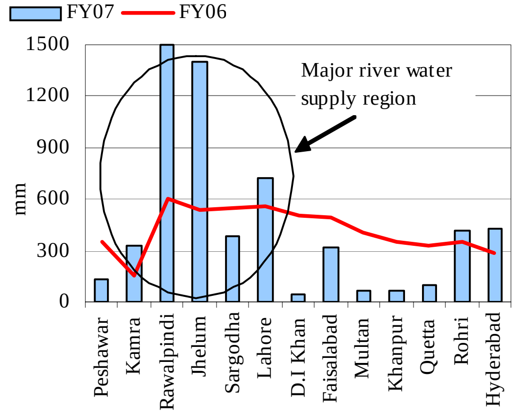


Nonetheless, the wheat target may be achieved given supporting factors, such as the subsidy given on phosphate and potash fertilizers, the 5.3 percent increase in water availability during *rabi* over the last year, and the fact that an increase in wheat support price (Rs 10.0 per 40 kg) was announced well in time and a vigorous media campaign was launched for balanced use of fertilizers to boost yields. Moreover, three new varieties of wheat (Fareed-06, Sehar-06, and TD1) were also distributed among wheat growers during FY07 season to achieve higher yield (see **Figure 2.1**).

Irrigation Water Availability

The higher monsoon rains during Jul-Oct FY07 relative to the comparable period of FY06 has increased the surface and underground water availability (see **Figure 2.2**). This in turn is likely to improve the prospects for crops, livestock and fisheries sub-sectors of the agriculture.

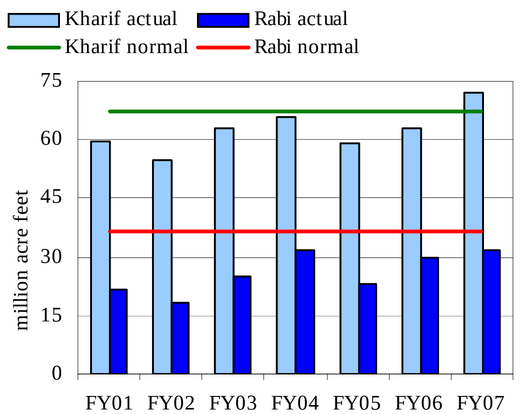
Figure 2.2: Monsoon Rains (Jul-Oct)



The irrigation water availability during FY07 seasons anticipated an increase of 11.2 percent to reach 103.5 million acre feet (MAF), which is considered as the normal level. If available water resources are well managed, there will be no severe shortfall as seen in the corresponding period of FY06.

Irrigation water availability was 13.9 percent higher in *kharif* and expected to increase by 5.3 percent in *rabi* FY07 season over last year (see **Figure 2.3**). Specifically, water availability in both, the Punjab and Sindh are expected to increase by 25,000-cusecs and Sindh 5,000-cusecs respectively during *rabi* FY07 season compared to the last *rabi* season.[2]

Figure 2.3: Irrigation Water



Moreover, in order to increase efficiency, under an ongoing *National Programme for Improvement of Water Courses in Pakistan*, 12000 water courses have been targeted to be improved in Punjab (7000) and in Sindh (5000) during FY07. On completion of this project, it

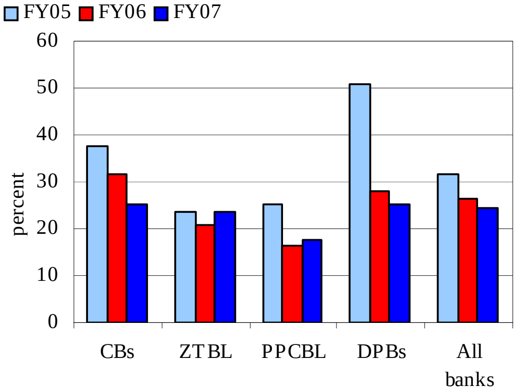
[2] Source: Indus River System Authority (IRSA).

will promote efficient use of water and improve irrigation efficiency at farm gate between 60 - 80 percent, resulting in large water savings.

Credit Disbursement

The credit disbursement target for FY07 was set at Rs 160.0 billion, compared to Rs 137.5 billion in FY06. This represents a strong 16.4 percent growth, nonetheless lower than the 26.4 percent growth seen in the previous year. The current pace of credit disbursement during Jul-Nov 2006 (32.3 percent of the annual target), suggests that FY07 target would be achieved (see **Figure 2.4**).

Figure 2.4: Credit as Percent of Target



Consistent with the target, agri-credit disbursement decelerated to 16.7 percent YoY during Jul-Nov FY07 compared with a robust 27.8 percent rise seen in the same period last year. While disbursement by the domestic private banks (DPBs) and specialized banks (ZTBL & PPCBL) remained strong, this deceleration is mainly from a slower rise by the big-5 commercial banks (CBs)[3] during this period. PPCBL witnessed an increase of 17.2 percent YoY in Jul-Nov FY07 against a decline of 27.4 percent YoY seen in the same period last year (see **Table 2.5**).

Table 2.5: Credit Disbursement Growth (Jul-Nov)
percent

Banks	FY06	FY07
CBs[1]	39.3	5.2
ZTBL	11.5	30.7
PPCBL	-27.4	17.2
DPBs	52.6	41.7
All banks	27.8	16.7

[1.] ABL HBP, MCB, NBP and UBL

All commercial banks except ABL and MCB witnessed deceleration in credit disbursement to the agri-sector during Jul-Nov FY07 compared with the same period of last year. This deceleration is attributed to (1) increase in lending rates, and (2) liquidity constraints faced by the banks. As a result, the CBs' market share in agri-credit fell by 5.7 percentage points to 52.2 percent during Jul-Nov FY07 over the last year. Consequently, ZTBL and DPBs gained market share in

[3] NBP, HBL, UBL, MCB Bank and ABL.

agri-credit by 3.2 and 2.5 percentage points respectively during this period (see **Figure 2.5**). Agriculture credit disbursement is likely to accelerate in months ahead as fertilizer off-take would increase at subsidized prices.

Figure 2.5: Market Share in Agri-Credit

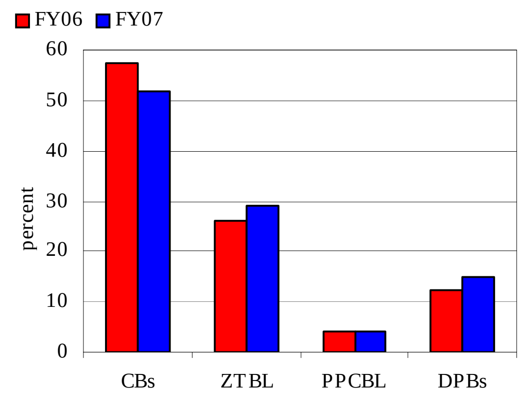
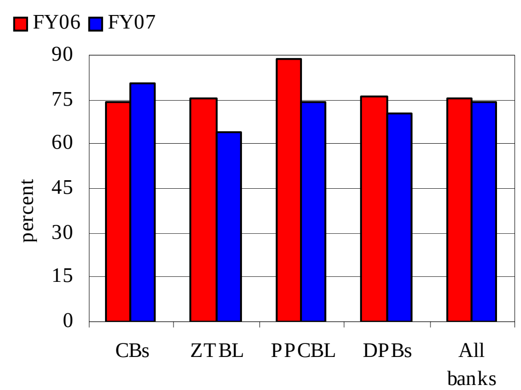


Figure 2.6: Credit Recovery Ratio



Credit Recovery

Despite losses caused by rains and flood during recent monsoon, the credit recovery as percentage of disbursement improved by 1.3 percentage points YoY during Jul-Nov FY07. However, this improvement is principally from a rise of 7.1 percentage points in the recovery ratio of CBs during this period. The other banking groups witnessed a relative deterioration in their respective recovery ratio. In particular, PPCBL witnessed a sharp decline of 15.1 percentage points during Jul-Nov FY07 (see **Figure 2.6**).

Fertilizers Off-take

To help boost the agricultural productivity and farm income, the government has announced a subsidy on 16 brands of Phosphate and Potash fertilizers during *rabi* FY07 season (see **Table 2.6**). This will entail an estimated cost of Rs 12.3 billion to budget. In addition, the government has launched a media campaign to guide farmers regarding the use of balanced mix of fertilizers to increase the yield of different crops.

However, farmers delayed the purchase of fertilizers for *rabi* FY07 season in anticipation of the subsidy announcement as well as due to continued rising prices of urea. As a result, fertilizers off-take fell by 21.2 percent YoY during Jul-Oct FY07 against 7.4 percent increase seen in the same period last year.

In particular, urea fertilizer off-take (the larger variety of fertilizer being used by the growers), fell by 23.4 percent YoY during Jul-Oct FY07 against 12.7 percent increase witnessed in the same period last year. Similarly, DAP off-take also witnessed a fall of 15.4 percent YoY in Jul-Oct FY07. However, a sharp rise is evident in DAP off-take during October 2006 following a decline in its prices (see **Figure 2.7**). Agri-scientists suggest that balanced use of fertilizers would help to increase the per unit yield. The subsidy given on other than urea fertilizers is also a part of the yield enhancing strategy. The recently announced subsidies and media campaign is also focused to improve the use of right combination of the fertilizers.

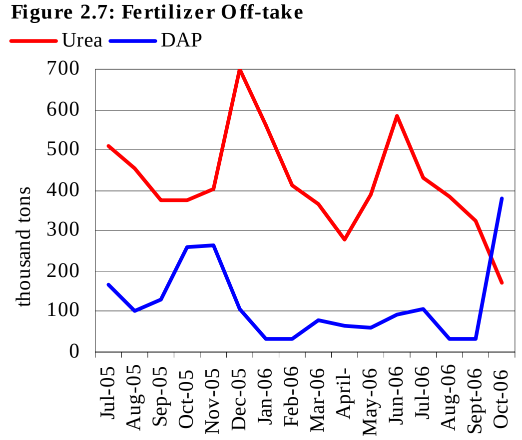
Table 2.6: Subsidy on Fertilizers

Brands of Fertilizers	Rs/50kg bag
DAP n18, po46	250
SSP (P) po18	98
SSP (G) po20	109
TSP po46	250
MAP*n11, po52	257
SOP ko50	250
MOP ko60	250
NP n20, po23	125
NP n23 po23	125
NPK (MOP) g n8, po23 ko 18	200
NPK (MOP) g no8, po23 ko 18 ko 20	181
NPK (MOP) grade n10 po28 ko10	194
NPK (MOP) grade n18 po9 ko18	124
NPK (MOP) grade n17 po17 ko17	163
NPK (SOP) grade n12 po15 ko20	182
NPK (SOP) grade n17, po17, ko17	177

*: 45.5 kg bag
Source: National Fertilizer Development Centre

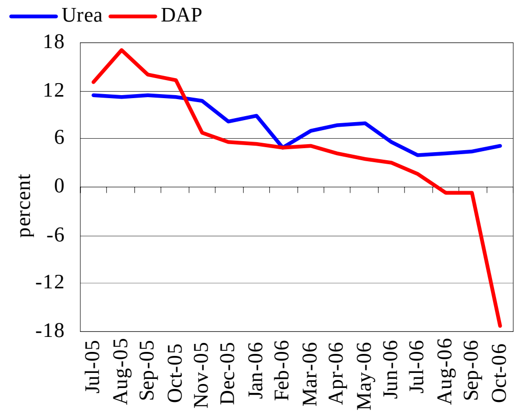
The subsidy has been announced in the range of Rs 109 to Rs 257 per 50 kg bag effective from 1st November, 2006, it is expected that fertilizers off-take would sharply increase in Nov-Dec 2006.

Figure 2.7: Fertilizer Off-take



Due to weak demand on the back of expected subsidy announcement, average urea prices rose by only 5.1 percent in October 2006 compared with 11.3 percent in the same period last year. The prices of DAP, which has been subsidized by Rs 250 per bag (effective for *rabi* season) decreased by 17.2 percent in October 2006 in contrast to 13.4 percent increase witnessed last year (see **Figure 2.8**).

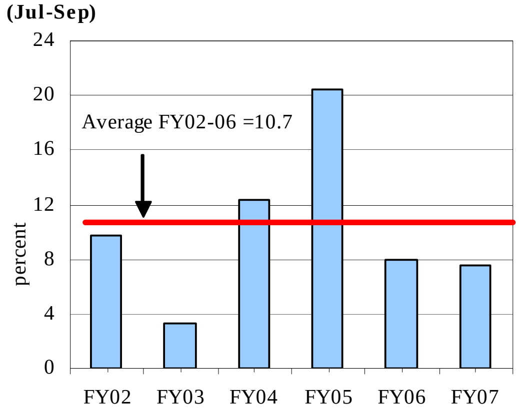
Figure 2.8: Changes in Fertilizer Prices



2.2 Industrial Production[4]

The *Index of Industrial Production* (IIP[5]), witnessed an increase of 7.6 percent during Q1-FY07, a little lower than the 7.9 percent rise seen during Q1-FY06 (see **Figure 2.9**). The slowdown is a reflection of growth deceleration in the *electricity generation* and *mining & quarrying* sub-sectors of the IIP, as growth in large scale manufacturing appears to be picking up during Q1-FY07. The lower growth in *mining & quarrying* was largely attributed to weaker growth in the production of natural gas during Q1-FY07, reflecting, in part, the disturbances in Balochistan.

Figure 2.9: Growth in Index of Industrial Production (Jul-Sep)



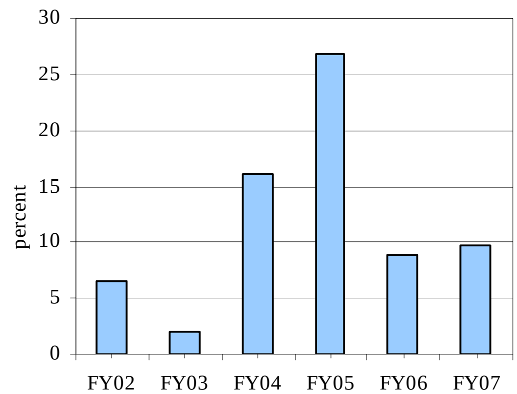
Large Scale Manufacturing (LSM)

Growth in *large scale manufacturing* accelerated in Q1-FY07, rising to 9.7 percent as compared with the 8.8 percent growth seen in Q1-FY06 (see **Figure 2.10**). The primary drivers of this improvement were textiles, electronics, chemicals and metals industries.

[4] This analysis is based on the provisional data on *large scale manufacturing* (LSM) supplied by the Federal Bureau of Statistics.
[5] IIP is used as a proxy for industry to estimate the industrial production.

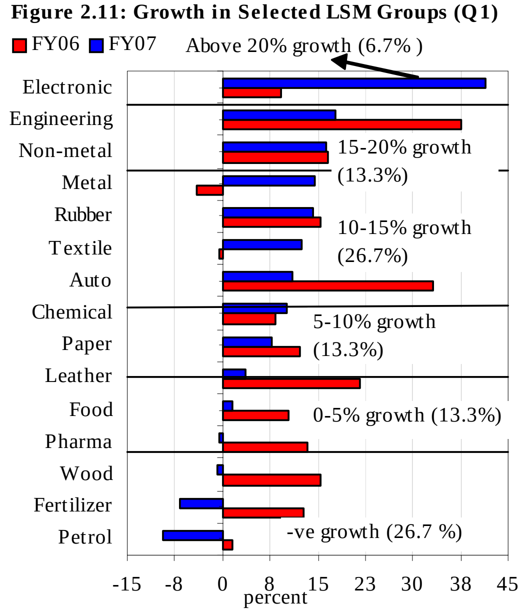
However, as shown in **Figure 2.11** the *LSM* growth acceleration is not broad based. Out of fifteen sub-sectors only five sub-groups (with 47.6 percent weight in total *LSM*) recorded acceleration, while four industries (having 18.2 percent weight) witnessed a decline in the production during Q1-FY07. The strongest contribution in *LSM* acceleration was from the *electronics* sub-sector in Q1-FY07; excluding this sector, LSM growth drops to only 7.4 percent from 8.7 percent in Q1-FY06 (see **Table 2.7**)

Figure 2.10: Growth in LSM during Q1



The *electronics* sub-sector recorded an extraordinary 41.6 percent YoY growth during Q1-FY07 as against 9.2 percent YoY growth in the same period of previous year. The continued strong demand for consumer electronics appears to reflect strong income growth, and better access to credit, while the impact of efforts by power utilities, KESC and WAPDA, to modernize and extend their distribution networks is reflected in the demand for electricity meters, transformers, etc.

Figure 2.11: Growth in Selected LSM Groups (Q1)



Figures in parentheses represent weights in LSM

Within consumer *electronics*, the highest 218.4percent growth was seen in the production of air conditioners during the first three months of the current fiscal year as against a decline of 6.1 percent in Q1-FY06.[6] This extraordinary performance is mainly a result of aggressive marketing by local companies as well as the increasing popularity of split type air conditioners due to efficiency in energy consumption as well as relatively lower prices.

Table 2.7: Summary of Growth Rates during Q1

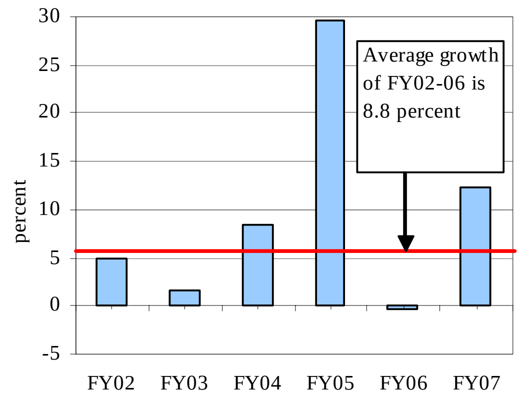
percent

	FY05	FY06	FY07
Overall	**26.9**	**8.8**	**9.8**
Excl. textile	25.6	13.0	8.7
Excl. electronics	24.2	8.7	7.4
Excl. automobiles	25.5	6.2	9.6
Excl. textiles & electronics	21.5	13.4	5.1
Excl. textile, electronics & autos	18.5	9.9	3.7

Source: Based on data from Federal Bureau of Statistics

As with electronics, the growth in the textiles sub-group also rose to 12.4 percent during Q1-FY07 as against a decline of 0.4 percent in the same period last year. This growth is the second highest for any first quarter during the last six years (see **Figure 2.12**). The rise in production in the backdrop of declining exports in key textile categories adds to the concerns over the quality of data.[7] The growth recorded in textile production statistics appears to be supported by the acceleration in the growth of the chemicals sub-sector to 10.1 percent during Q1-FY07 as compared with 8.2 percent growth during Q1-FY06. In particular, production grew strongly for textile-related chemicals such as *synthetic resins,* and *caustic soda.*

Figure 2.12: Growth in Textile Sector during Q1



Another significant contributor to the LSM growth acceleration was the *metals* sub-sector. This sub-group grew by 14.5 percent during Q1-FY07 against the decline in the production by 4.1 percent during the same period last year. The improvement can be attributed to the streamlining of production by Pakistan Steel after completion of repairs of its coke-oven batteries in the last quarter of FY06.

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[6] In absolute terms, the production of air conditioners reached to 102,390 units during Q1-FY07 from the aggregate production of 73,863 units during the first quarter of last six years (FY01-FY06).

[7] According to SBP trade data, the textile sector recorded 11.7 percent growth in Q1-FY07, while as per FBS data the exports of textiles sector fell by 9.3 percent during this same period.

Consequently, imports of *iron & steel*[8] products declined by 4.4 percent during Q1-FY07 as against a rise of 71.6 percent in Q1-FY06.

In contrast to the acceleration in the above mentioned sub-sector, production in the *automobiles* sub-group saw a deceleration during the first three months of FY07. Specifically, the *automobiles* sector registered a growth of only 11.1 percent during Q1-FY07, which is not only lower than the strong growth of 33.1 percent in the same period of the preceding year but also the lowest during the last six years (see **Figure 2.13**).[9] The capacity constraints, rise in interest rates, and import of used vehicles are the main reasons to slower growth in demand for local automobiles. In particular, the production of *cars & jeeps* slowed to 14.9 percent [10] in Q1-FY07 as against a high growth of 25.7 percent during the same period of the previous year (see **Figure 2.14**).

Figure 2.13: Automobile Sector Growth during Q1

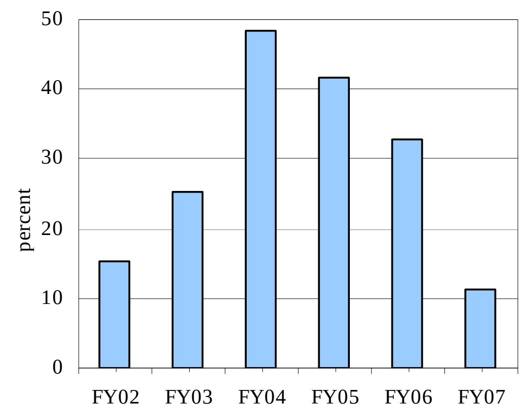
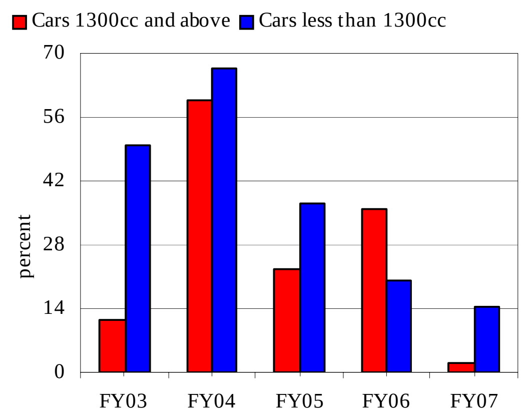


Figure 2.14: Growth in Car Industry (Jul-Oct)



In contrast, the production of *motor cycles* and *tractors* witnessed a fall of 18.0 percent in the first four months of FY07 compared with 37.5 percent rise during the same

[8] The import of *iron & steel* consist of *iron & steel* as well as *iron & steel scraps*.
[9] On the basis of information provided by PAMA for Jul-Oct, the growth rate of automobiles industry slowed further to 6.9 percent as compared with a high growth of 26.9 percent in the same period last year.
[10] The growth of cars & jeeps manufacturing further dipped to 9.1 percent during Jul-Oct FY07 significantly lower from 26.5 percent growth of Q1-FY06.

period of the preceding year. Under-reporting due to the rising market share of non-reporting producers (that are not members of the Pakistan Automobile Manufacturing Association) and a fall in farm incomes were the main factors for decline in the production of motor cycles.

Similarly, the production of *tractors* also fell to 0.3 percent in Jul-Oct FY07 from 18.6 percent growth during Q1-FY06. The monthly production data shows that highest decline was observed in the month of October 2006 (see **Figure 2.15**). This dip in production is attributable to the number of factors, including a slowdown in tractor financing, capacity constraints, shut down of plant by one of assemblers for annual maintenance (for ten days) during October 2006, import of Chinese tractors in the market after the government's budgetary decision of allowing import of tractors and work in progress to double the capacity of one manufacturer (which temporarily affected production capacity).

Figure 2.15: Growth in Tractor Industry (Jul-Oct)

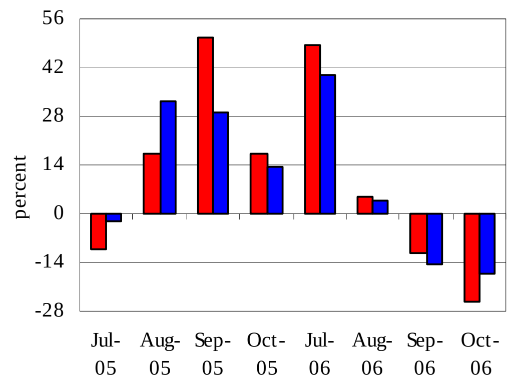
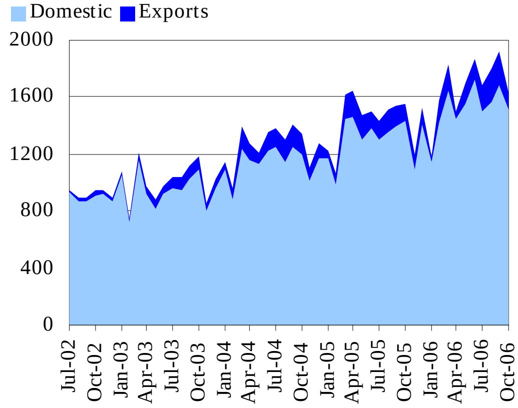


Figure 2.16: Cement Consumption (000 tons)



Another industry that recorded a slowdown in production growth during Q1-FY07 is *non-metal* industry. Within the non-metal sub-sector, the lower growth was seen in *cement* industry with 16.4 percent growth during Q1-FY07 as compared with 17.3 percent growth during the same period of previous year. The deceleration in the growth of cement production is also mirrored in the domestic cement sales[11] during this period (see **Figure 2.16**). The local cement dispatches rose by 4.4 percent in the first four months of FY07 as against a strong growth of 13.1 percent in the same period of last year. In sharp contrast, export demand for cement registered a robust increase of 41.5 percent during Jul-Oct-FY07 as against a fall of 5.8 percent in export during Jul-Oct-FY06. The decisions of the government regarding restoration of duty drawback on cement exports,[12] exemptions of federal excise duty and sales tax on exported cement as well as relatively moderate domestic demand, and more importantly lower domestic prices in Q1-FY07 relative to Q1-FY06 are key reasons for the rise in cement exports during the first four months of FY07.

The *paper & board* industry witnessed a slowdown in production growth during Q1-FY07 principally due to capacity constraints. Fresh investment in this industry is likely to accelerate its growth and lower imports of paper & board.

As with paper and board, the production of *fertilizer* also declined in Jul-Oct FY07, dropping by 1.7 percent as against a rise of 3.7 percent growth during the same period of the preceding year. This is partly attributed to supply problems due to capacity constraints (exacerbated by a shutdown by one of the producers for capacity expansion), as well as a slowdown in demand due to the impact of untimely rains and a temporary fall in demand for phosphatic fertilizer in anticipation of a subsidy announcement (the production of non-urea fertilizers dipped 5.1 percent YoY during the first four months of the current fiscal year in contrast with 14.4 percent growth recorded during Jul-Oct-FY06).

The high capacity utilization and continued strength of demand has attracted investment in the fertilizer industry. As a result, one major project is expected to begin operations in FY08 and another major project is likely to come online later. In the meantime, smaller expansions are also expected to be implemented in the current year, which implies that the production growth will slow temporarily in FY07 (necessitating a rise in imports) before resurging in FY08 onwards.

[11] The total (domestic and external) sales recorded growth of 18.7 percent, 15.6 percent and 48.0 percent respectively during Q1-FY07 as compared with 9.4 percent, 10.7 percent and a decline of 1.0 percent respectively during the same period last year.
[12] The Central Board of Revenue (CBR) has allowed duty drawback at the rate of Rs 25.08 per ton on export of cement through a customs notification by amending the SRO 840 of 2006. The facility is effective from September 27, 2006.

Table 2.8: Production of POL Products (Jul-Oct)

000 metric tons

	FY05	FY06	FY07
Jet fuel	356	421	402
Kerosene	55	65	66
Motor spirits	463	430	404
High speed diesel	1,256	1,187	1,002
Light speed diesel (n.o.s.)	77	47	49
Furnace oil	1,049	1,149	988
Lubricant oil	89	69	70
Jute batching oil	2	1	1
Solvent naphtha	238	262	263
Petroleum products (n.o.s.)	233	212	205
Total POL	*3,817*	*3,842*	*3,451*

Similarly, faltering demand for high distillates (e.g., motor spirits, kerosene), as well as storage and export bottlenecks led to a fall in capacity utilization in domestic refineries. This is reflected in the 4.9 percent decline in crude petroleum imports during FY07, and a simultaneous sharp 71.6 percent rise in imports of some refined products (principally furnace oil, to meet surging demand from domestic power utility for electricity generation). As a result, the production of *petroleum products* decliend by 10.2 percent during Jul-Oct-FY07 as compared with a negligible rise of 0.7 percent during the same period of the preceding year, and petroleum refineries capacity utilization fell to 74.3 percent, which is 12.3 percentage points less than the capacity utilization during the same period of last year. The production performance of different POL items is summarized in **Table 2.8**.

Analysis of Industries by End-Use (UBQI)[13]

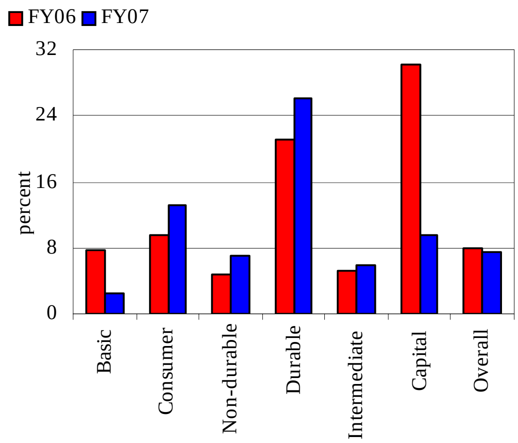
During Q1-FY07, deceleration was seen in the *User Based Quantum Index* (UBQI), which reflects the trend seen in the *electricity generation* and *mining & quarrying* sub-sectors of industry. While the two sub-indices (*basic goods* and *capital goods*) registered deceleration in output, the other two sub-components *consumer goods* and *intermediate goods* recorded acceleration in growth during Q1-FY07 (see **Figure 2.17**).

In Q1-FY07 *consumer goods* industries accelerated to 13.1 percent growth as compared with 9.5 percent rise seen in Q1-FY06, this rise is contributed by both durables as well as non-durables consumer goods. Within *consumer goods*, the growth in the production of *durables* accelerated to 26.3 percent YoY in the first three months of FY07, compared to the 21.1 percent YoY growth in the same period of the preceding year. The rise in the production of air conditioners, sewing machines and rubber products was the main contributory factors for the acceleration in this sub-group. Similarly, the production of *consumer non-*

[13] The UBQI covers about 62 percent of the industrial sector, with basic goods, consumer goods (durable & non-durables) and the capital goods.

durables (having 86.7 percent shares in consumer goods) also rose from 4.8 percent growth in Q1-FY06 to 7.0 percent in Q1-FY07. The major drivers for the high growth in the production of *consumer non- durables* included a large recovery in the production of *cotton cloth,* increase in the output of *electronics products (electric tubes)* and, some products of *pharmaceutical* industries.

Figure 2.17: Industrial Production by End-use (Q1)



Similarly, *intermediate goods* also showed the acceleration in production during Q1-FY07 with 5.9 percent growth as against a growth of 5.3 percent in the same period of last fiscal year. However, the fall in the output of *POL* products and *fertilizers* has partially offset the positive contribution of *cotton yarn* and *pig iron* during this period.

Contrary to *consumer* and *intermediate goods* indices, the *basic* goods industry (having over 25 percent weights in *UBQI*) recorded a lower growth of 2.4 percent in Q1-FY07 as compared with 7.8 percent growth seen in the Q1-FY06. The acceleration in the output of *crude oil, coal* and recovery in construction related minerals (gypsum, rock salt), was offset by relatively weaker growth of *electricity generation* and by fall in the production of *coke, marbles* and *acids*.

Similarly, the *capital goods* output registered a weaker growth of 9.6 percent during Q1-FY07 mainly as compared with substantially high increase of 30.1 percent recorded in Q1-FY06. It is interesting to note that the capital goods recorded single digit growth in Q1-FY07 for the first time since FY04.

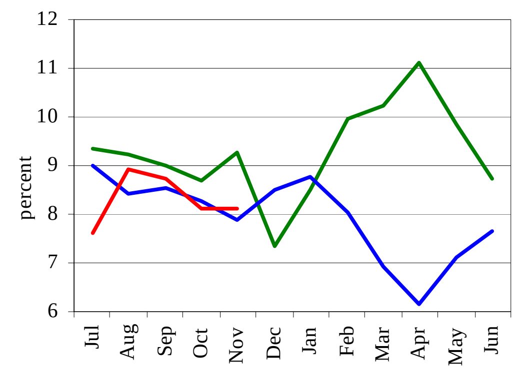
The analysis of UBQI suggests that domestic consumption demand remained strong. While aggregate growth in *basic* and *capital* goods industries is relatively weak, it is important to note that a number of these industries are facing capacity constraints. Increased investment in such industries could restore the growth momentum here as well.

3 Prices

3.1 Overview

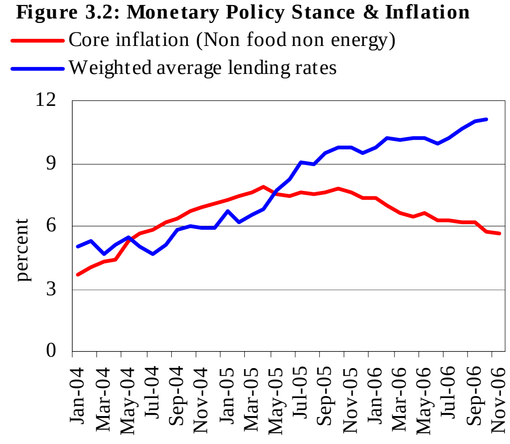
Although, on average, inflationary pressures appear to be weakening in the economy, the downtrend is unstable. This is evident in the benchmark Consumer Price Index (CPI) inflation, which jumped to 8.9 percent YoY in August 2006 before dipping to 8.1 percent YoY during October 2006 and remained at the same level in November 2006, slightly higher than the 7.9 percent YoY in November 2005 (see **Figure 3.1**). The instability emerged essentially due to the volatility in food prices, [1] particularly stemming from (1) supply side disturbances on account of rains and floods, and (2) the impact of increases in international prices of some key food items.

Figure 3.1: CPI Inflation - YoY



A welcome development, from the monetary policy perspective, however, is that non-food inflation now appears to be trending downwards. This deceleration in non-food inflation is clearly mirrored in the easing of core inflation. The non-food non-energy (NFNE) measure of core inflation dipped to 5.6 percent YoY in November 2006 compared with 7.6 percent YoY for the

Figure 3.2: Monetary Policy Stance & Inflation



[1] It is also evident from significantly higher standard deviation for food inflation at 3.2 during the last 28 months compared with 1.2 for non-food inflation in the same period.

corresponding month of 2005, suggesting that demand pressures in the economy are being reined-in by the continued tight monetary policy (see **Figure 3.2**). While the other important measure of core inflation, (i.e., 20 percent trimmed mean) witnessed a small rise in Q1-FY07, in each month it remained below that in the corresponding month of FY06. Further, it too also has dipped in November 2006 to 6.1 percent compared with 6.6 and 6.4 percent in the preceding months. The initial rise in this core inflation measure is explained mainly by the impact of energy charges (that are excluded in the NFNE measure).

In contrast to the volatility in CPI inflation, the WPI inflation exhibited a steady downtrend, with the overall WPI inflation coming down to 7.5 percent YoY in November 2006 compared with 10.9 percent in November 2005. The major contribution to the decline in WPI is from the non-food group, which outweighed the acceleration in the food group prices (see **Table 3.1**).

Table 3.1: Inflation Trends (November)

percent

	Year on Year[1]		12-month moving average[2]	
	FY06	**FY07**	**FY06**	**FY07**
CPI	**7.9**	**8.1**	**9.0**	**7.9**
Food	5.8	10.6	9.9	7.9
Non-food	9.4	6.3	8.4	7.3
House rent	10.8	6.6	11.7	7.6
WPI	**10.9**	**7.5**	**8.2**	**8.7**
Food	6.4	9.1	9.3	7.1
Non-food	14.3	6.3	7.3	9.9
SPI	**5.4**	**13.4**	**8.9**	**8.9**
Core[3]	**7.6**	**5.6**	**7.4**	**6.4**

[1] Change in Nov 2006 over Nov 2005
[2] Change in 12-month moving average of Nov 2006 over Nov 2005
[3] Non-food non-energy
Source: Federal Bureau of Statistics

Unfortunately, despite the moderation in inflationary pressures, CPI inflation is still close to the 8 percent levels by November 2006, which is significantly higher than the annual average inflation target of 6.5 percent for FY07.

Given that core inflation is likely to remain contained through the remaining months of FY07 as a result of a tight monetary policy, it is important that its impact is supplemented by measures to address food inflation and high energy prices. Volatile, double-digit food inflation is particularly undesirable in view of its greater adverse impact on low-income groups. Moreover, it is a source of disquiet for monetary policy as well since inflationary expectations are based on overall inflationary trend. There is a need for effective administrative measures (as exercised in the month of Ramadan) to discourage profiteering on food items.

In view of the above, SBP projections remained unchanged that CPI inflation is likely to remain slightly above than the 6.5 percent target for FY07 in the range of 6.7 – 7.5 percent during FY07.

3.2 Consumer Price Index

The CPI inflation exhibited a volatile trend during the last few months; this greater variability is mainly a result of fluctuations in food inflation. Non-food inflation however witnessed a relatively stable trend during the last two years (see **Figure 3.3**).

Figure 3.3: CPI Inflation - YoY

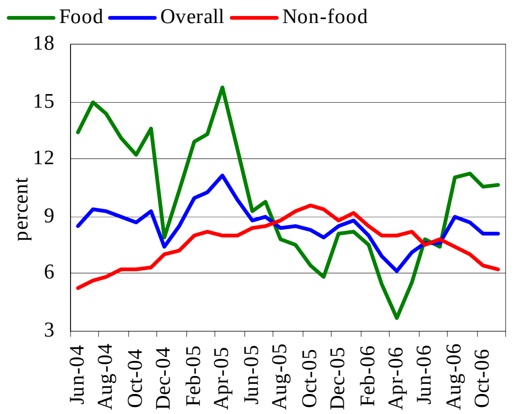
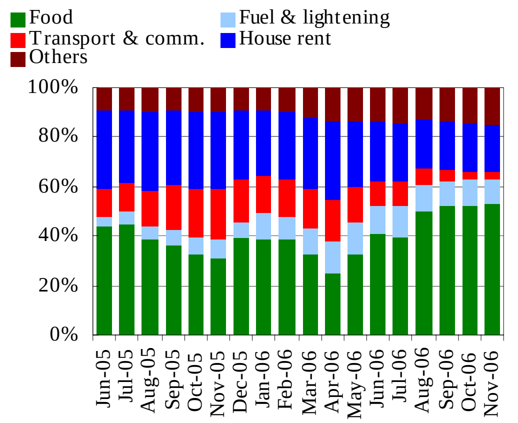


Figure 3.4: Contribution to CPI Inflation (YoY)

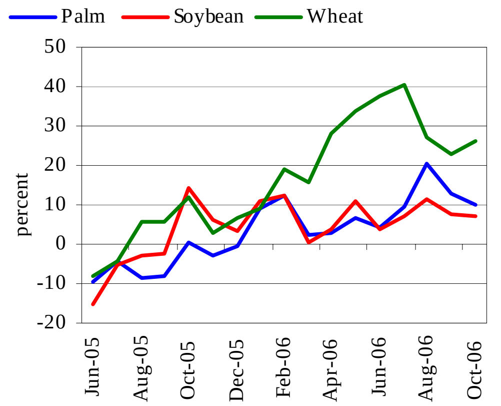


In contrast to FY06, inflation in the first five months of FY07 was mainly driven by food component of the CPI basket. Consequently, the contribution of food group to overall CPI inflation has increased from 31.2 percent in November 2005 to 53.1 percent in November 2006. On the other hand, the contribution of major non-food item, i.e., *house rent index* (having a weight of 23.4 percent in CPI) has declined significantly to 19.2 percent in November 2006 from 31.2 percent in the corresponding month of 2005. Moreover some reduction in the contribution of other sub-indices of non-food group to overall inflation has also been observed; e.g., contribution of *transport and communication* to overall inflation fell to 3.3 percent in November 2006 from its peak level of 20.7 percent in November 2005 (see **Figure 3.4**).

3.2.1 CPI Food Inflation

CPI food inflation, after declining to as low as 3.6 percent in April 2006 (despite pressures on the prices of sugar, milk and pulses), started rising in the subsequent months and increased significantly to 10.6 percent (YoY) in November 2006. The sharp acceleration is mainly attributed to supply disturbances for minor crops as well as sustained strong demand. Another important source of food inflation is the rising international prices of edible oil (see **Figure 3.5**); as a result, prices of ghee, cooking oil, prepared meal and bakery items registered increases.

Figure 3.5: Change in International Prices



The resurgence in food inflation since April 2006 is explained principally by reversal of the downtrend in wheat prices, which complemented the significant hike in the prices of some minor crops (vegetables, fruits) and meat, in the same period. **Table 3.2** shows that while a large number of food items witnessed a fall in the prices in April 2006, fewer food items showed a decline in prices during November 2006. In contrast, a larger number of food items exhibited a sharp rise of above 20 percent in November 2006 than the April 2006. Importantly, the number of items witnessed a rise in the range of 0 – 10 percent are almost unchanged during the both period. This analysis reflects that (1) food inflation is broad-based in November 2006 relative to April 2006; and (2) the impact of increase in the prices of a key staple (such as wheat or edible oil) influences the prices of a number of food items.

Table 3.2: Change in the Prices of Food Items

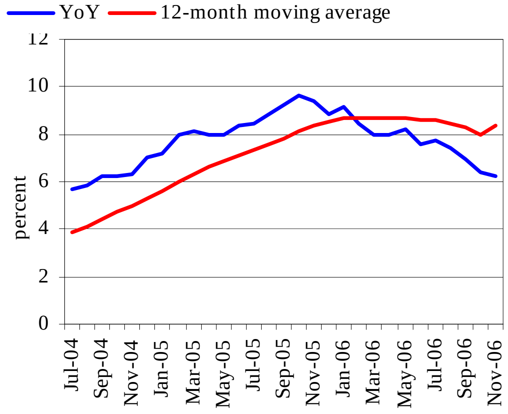
number of items

Inflation range	Apr-06	Nov-06
Decline in prices	36	11
0% to 5%	25	26
5% to 10%	23	24
10% to 15%	16	25
15% to 20%	1	10
20% and above	8	16
Total items reported	**109**	**112**

3.2.2 CPI Non-food inflation

CPI non-food inflation continued to decelerate, falling to 6.3 percent YoY in November 2006 as against 9.4 percent in November 2005. As a result, 12-month moving average of non-food inflation also decelerated to below 8 percent in November 2006 for the first time since October 2005 (see **Figure 3.6**). The deceleration was mainly due to lower increase in the *transport & communication* sub-index and persistent decline in HRI.

Figure 3.6: CPI Non-food Inflation

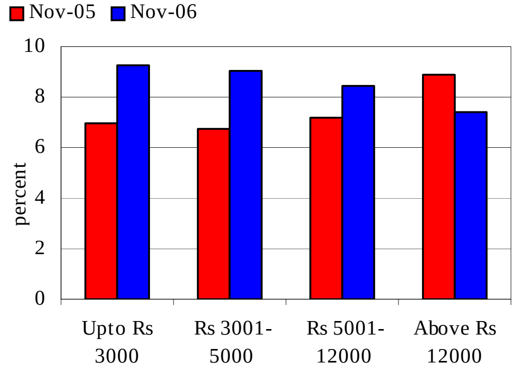


Some of the sub-indices of non-food group, nevertheless, showed higher growth in recent months of FY07 as compared with FY06. These include *fuel & lighting*, *household, furniture & equipment*, *recreation & entertainment*, *education*, and *medicare*. The most significant of these was in *medicare* inflation, which jumped from 1.6 percent in November 2005 to 9.8 percent in November 2006. The rise in *fuel & lighting* sub-index though eased somewhat since July 2006, it is higher in November 2006 relative to the same month of 2005. It may be noted that in the case of any downward adjustment in the domestic oil prices following an ease in international prices, the sub-index is likely to show a sharper decline in months ahead.

3.2.3 Income Group-wise Inflation

As mentioned earlier, the contribution of food inflation in overall CPI remained high in the first five months of FY07, which resulted into a larger incidence of inflation on the low-income groups where food staples typically account for a greater proportion of total expenditure. Thus, in November 2006, the lowest

Figure 3.7: Income Group-wise Inflation

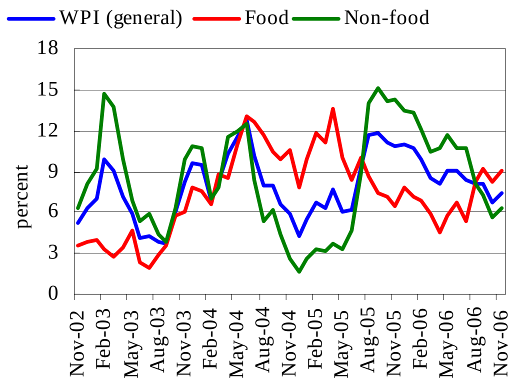


income group (income up to Rs 3000 per household per month) witnessed significantly higher than average inflation of 9.3 percent, followed by 9.0 percent and 8.4 percent for the two middle income groups (see **Figure 3.7**). As against the current pattern of inflationary incidence, all these income groups (lower income and middle income) witnessed below average inflation in November 2005. On the other hand, only the highest income group (with income above Rs 12,000 per month) witnessed lower than average inflation in November 2006, contrary to above average inflation in November 2005. This is because the driving force of inflation had been non-food prices in the FY06, while in FY07 the source of inflation has been food inflation.

3.3 Wholesale Price Index

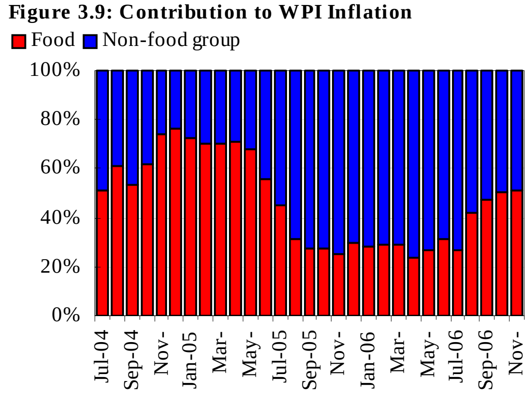
The Wholesale Price Index (WPI) maintained a downward trend throughout the first four months of FY07, reaching 7.5 percent YoY in November 2006, the lowest since April 2005. This slowdown is mainly attributed to a sharper deceleration in non-food component of WPI inflation (see **Figure 3.8**) on the back of weaker increase in *fuel, lighting & lubricants* sub-index.

Figure 3.8: Wholesale Price Inflation



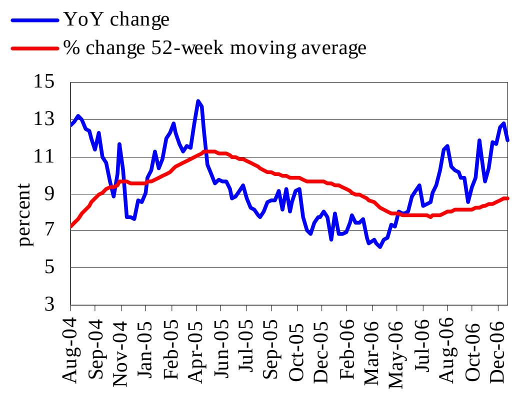
However, WPI food sub-group inflation accelerated to 9.1 percent in November 2006 compared with 6.4 percent in the same month of 2005. The rise in WPI food sub-index partially offset the lower inflation recorded by non-food sub-group. As a result, the weighted contribution of non-food inflation in WPI fell from 74.6 percent during November 2005 to 48.8 percent in November 2006 (see **Figure 3.9**).

Figure 3.9: Contribution to WPI Inflation



Interestingly, the food component is common in both CPI and WPI, however food inflation during November 2006 is relatively higher in CPI (10.6 percent YoY) than in WPI (9.1 percent YoY). The reason for the different pace of increase in the food sub indices in CPI and WPI is that some of the grains (bajra, maize and jowar) which recorded a decline in the prices are included in WPI but are not part of the CPI. Moreover, increases in the prices of wheat and its derivatives, pulses, milk and some other important food items are relatively higher in the case of CPI than the WPI. The latter fact is a reflection of increased profit margins at the retail level. This also reinforces the view that an effective price regulating system is required to discourage abnormal profit margins. Within the WPI non-food group, the sub-indices showed mixed trends in the first five months of FY07.

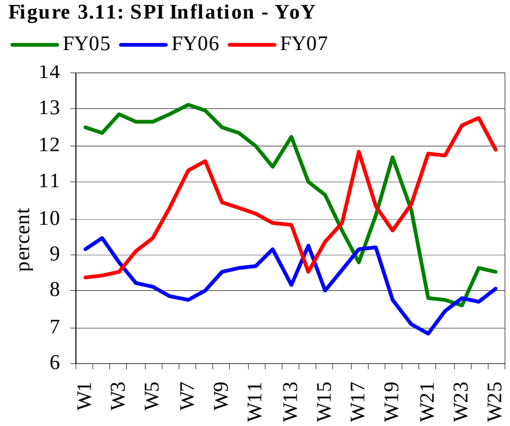
Figure 3.10: Weekly SPI Inflation



3.4 Sensitive Price Indicator

The SPI covers prices of 53 essential items of daily use (mostly kitchen items and some energy items e.g., petrol and diesel). In line with CPI food inflation, the SPI has followed increasing trends in the first five months of FY07. This is because more than 60 percent of the items included in the SPI basket are from the food group. During the period under review weekly SPI inflation YoY was generally high and remained around the 10 percent (see **Figure 3.10**). It may be noted that the inflationary pressures on food prices are persisting even by the second week of December 2006, when supply of fruits and vegetables usually improves (see **Figure 3.11**). This is

Figure 3.11: SPI Inflation - YoY

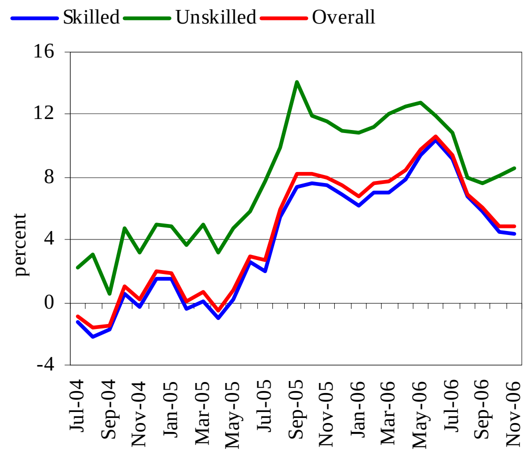


mainly attributed to supply shortages of vegetables due to unusual heavy winter rains.

3.5 Wage Inflation

The pace of increase in real wages eased during the initial months of FY07 after rising during the final months of FY06. However, the slowdown is more pronounced in the case of real wages for skilled workers (see **Figure 3.12**). It may be noted that despite the slowdown, the increase in average real wages during November 2006 remained strong at 4.9 percent YoY. Moreover, the rise in real wages for unskilled workers (which rose in recent months) is 8.6 percent YoY in this period. The significant increase in real wages implies that (1) demand for labor is strong, (2) a slower rise in real wages could potentially help reduce unemployment as well as (3) domestic consumption demand would accelerate further.

Figure 3.12: Change in Real Wages - YoY



In particular, strong labor demand appears to reflect increased construction activities in private sector as well as building infrastructure by the government.

4 Money and Banking

4.1 Overview

Although monetary tightening helped in reducing inflationary pressures in the economy during FY06, aggregate demand was still high as indicated by the strong growth in real GDP (that increased by 6.6 percent during FY06 despite losses relating to October 2005 earthquake and higher international oil prices), the high growth in private sector credit, sluggish decline in core inflation and large external account deficit. The FY07 monetary environment was rendered even more challenging by the need to balance the targeted rise in real GDP growth (i.e., 7 percent for FY07) and a further deceleration in inflation (from 7.9 percent in FY06 to 6.5 percent target for FY07).

The monetary policy also had to respond to the challenges posed by the expansionary fiscal policy and the continued pressures on the external account. In this regard, the use of exchange rate policy to address external imbalances was deemed unhelpful due to the pass through of exchange rate adjustments on domestic prices.[1] Thus, the charge of addressing macroeconomic imbalance fell disproportionately more on the monetary policy instruments. In this background, the Credit Plan for FY07 envisaged a slowdown in monetary expansion (M2) from 15.2 percent in FY06 to 13.5 percent in FY07; this target M2 growth was slightly lower than the nominal GDP growth target (14.0 percent for FY07), which would reduce excessive aggregate demand pressures in the economy while continuing to support the growth objective.

Consistent with this objective, SBP further tightened its monetary policy in FY07 by first raising the cash reserve requirements for banks on 22nd July 2006, and then increasing the discount rate by 50 basis points to 9.5 percent a week later. At the same time, SBP continued to drain excess liquidity from the inter-bank market. This combination of OMOs and increase in reserve requirement has exerted upward pressures on the overnight rates. Specifically, the overnight rates remained persistently close to the discount rate throughout H1-FY07.

[1] Given that the large external imbalance was due to sharp increase in imports, there are reasons to believe that the use of exchange rate policy to address external imbalances may not be desirable as a large share of imports comprises of raw material and capital goods, which are needed for capacity expansion and removing supply bottlenecks.

This is reflected in reduced volatility as the coefficient of variation for overnight rates has declined to 0.12 during Jul-Dec FY07 as compared to 0.16 during the same period last year. As shown in **Figure 4.1**, the overnight repo rate has been moving very close to the discount rate.

The impact of monetary tightening pursued in FY06 as well as the policy signals through the FY07 changes, is already evident in the slowdown in private sector credit growth, which has dropped to 5.9 percent during Jul-Nov FY07[2] against the 10.9 percent growth witnessed in the corresponding period of FY06. Moreover, core inflation, as measured by non-food non-energy (NFNE) inflation has slowed to 5.6 percent YoY in November 2006 from 7.6 percent YoY in November 2005 (see **Figure 4.2**).[3]

Figure 4.1: Overnight Repo Rate

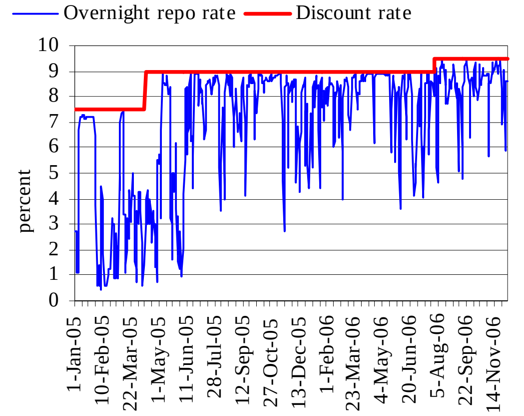
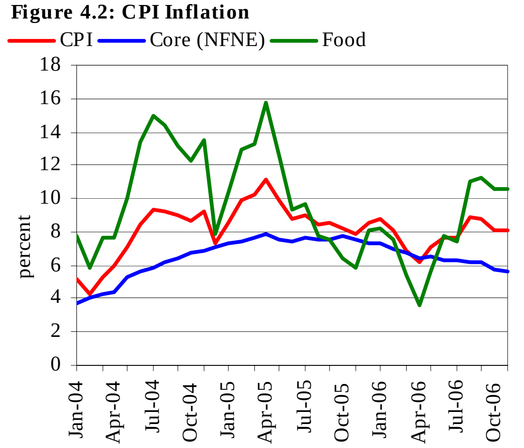


Figure 4.2: CPI Inflation



However, the growth in monetary aggregates during Jul-Nov FY07 remained strong (see **Figure 4.3**). This is because:

(1) the government borrowings showed a marginal deceleration, compared to the slowdown in the private sector credit; and

[2] Jul-Nov FY07 pertains to the period beginning from July 2006 to last Saturday of November (i.e., 25th Nov 2006).

[3] Both estimates of core inflation (i.e., non-food non energy as well trimmed) are showing deceleration, but the slowdown in the latter is relatively gradual.

(2) the contraction in NFA during Jul-Nov FY07 has been much lower than that in FY06.

While Jul-Nov FY06 figures show that *government borrowings* from the banking system have decelerated marginally (see **Table 4.1**), this reflects an exceptional receipts in this month. Adjusting for this, the borrowings are clearly higher, and volatile (see **Figure 4.4**). A large part of the variation in government borrowings from the banking system is a result of the uncertainty in the availability of budgetary financing from other sources (i.e., from external and non-bank).[4]

Although, the government may be able to remain within the budgetary borrowing target of Rs 120 billion from the banking system for FY07, excessive borrowing during the course of the year is a source of concern for monetary policy as this adds to the aggregate demand and in turn to the

Figure 4.3: Growth in Monetary Aggregates

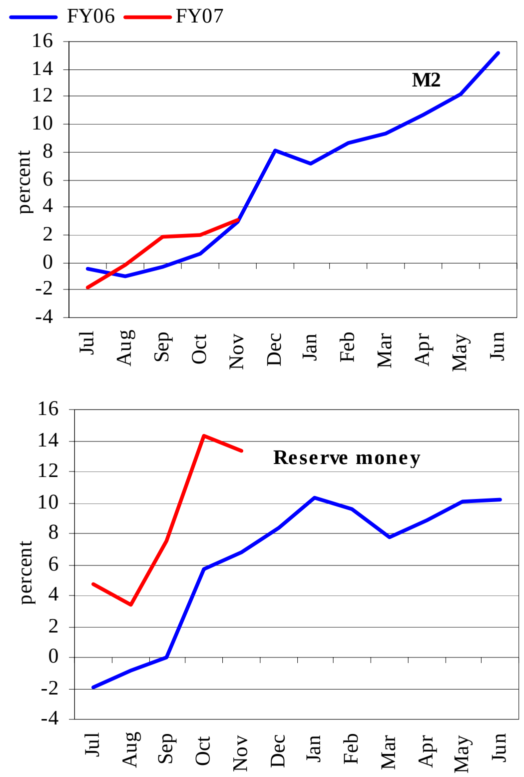


Table 4.1: Contribution to M2 Growth (Jul-Nov)

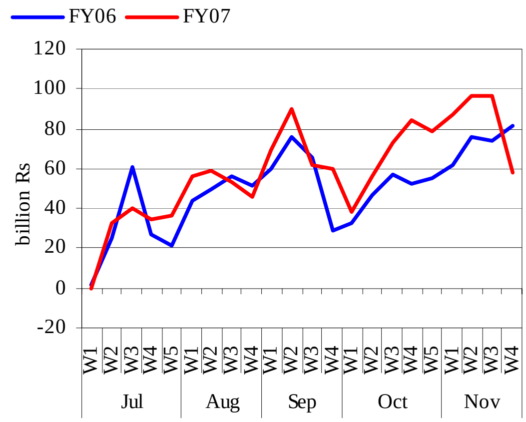
	Growth (percent)		**Contribution to Growth (percent)**	
	FY06	**FY07**	**FY06**	**FY07**
NDA	7.7	5.4	6.0	4.3
Credit to non-government	*10.2*	*5.5*	*6.2*	*3.5*
Government borrowing	*8.7*	*6.3*	*2.2*	*1.6*
Other items (net)	*33.7*	*8.6*	*-2.3*	*-0.8*
NFA	-14.2	-6.2	-3.1	-1.2
M2	**3.0**	**3.0**	**3.0**	**3.0**

[4] In April FY06, the government retired a large proportion of bank borrowing using the external receipts through privatization proceeds and Eurobond issue. Similarly, the sharp reduction in budgetary borrowing during the last week of November 2006 is largely the result of retirement of government debt owed to the banking sector through using proceeds from central bank's profits which were credited to the government account.

inflationary pressures in the economy.[5]

This is particularly unwelcome because the government borrowing is entirely from the central bank, which is the most inflationary in nature as it contributes to reserve money growth. Specifically, the reserve money sharply increased by 13.4 percent during Jul-Nov FY07 against 6.8 percent growth witnessed during the corresponding period of the previous year.[6] Given that SBP is targeting to bring down M2 growth to 13.5 percent in FY07 from 15.2 percent in the preceding year, this sharp increase in the reserve money is undesirable. The high government borrowing and the resulting rise in reserve money has a potential of re-igniting the inflationary pressures in the economy. If this happens, the time path for achieving a stable low inflation could be extended, as in the absence of low stable inflation, the central bank would have to keep interest rates high for a longer duration.

Figure 4.4: Cummulative Budgetary Borrowings (On Weekly Basis)



Realizing the need to reduce reliance on bank borrowing (especially from SBP), the government has sought to increase its non-bank borrowings. Unfortunately, instead of raising these incremental funds entirely through PIB issues, the government has also re-allowed institutional investment in National Saving Schemes (NSS). While the latter decision would, in theory, allow institutional

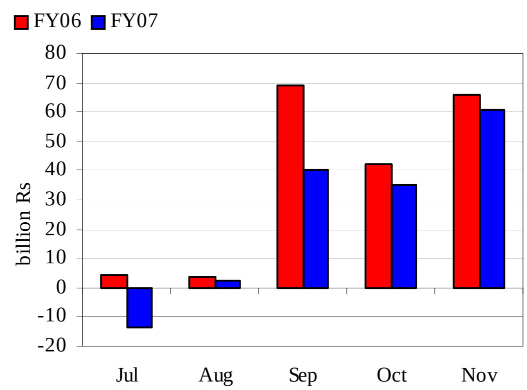
[5] The extent of the impact of government borrowing on inflation will depend on the sources of funding (i.e., SBP or commercial banks) and response of the central bank. The government borrowings from the commercial banks would lead to increase in M2 without expanding the monetary base (i.e., reserve money) through multiplier effect. This in turn will add to inflationary pressures in the economy. The borrowings from the central bank on the other hand would result into an increase in the reserve money and in turn to a rise in M2 which will be in addition to the increase in M2 through the multiplier effect. Thus, unless this impact on reserve money is neutralized by central bank through open market operations (OMOs), borrowings from the central bank are most inflationary in nature.

[6] Scheduled banks' deposits with SBP (which are part of the reserve money) saw an increase of Rs 42.6 billion in the month of July 2006 in which SBP raised the cash reserve requirement (CRR) for banks. Adjusting for this rise in deposits, the reserve money still shows an increase of 9.1 percent during Jul-Nov FY07.

investors to rollover large NSS maturities, this major policy reversal is likely to have significant negative implications for the development of the domestic debt market, and raise interest rate risk for the government (see **Special section on NSS**).

In contrast to government borrowings, the private sector credit seems to be responding to interest rate signals from the central bank. Specifically, growth in private sector credit during Jul-Nov FY07 has slowed down to 5.9 percent compared to 10.9 percent rise witnessed during the corresponding period of the previous year. However, so far, this slowdown in private sector credit growth is *not* a source of disquiet for SBP for the following reasons:

Figure 4.5: Credit to Private Sector (Monthly Incremental Flows)



- The YoY growth in private sector credit remains very strong at 18.0 percent by 25th Nov 2006, although down from 31.9 percent last year.

- A review of monthly trends in private sector credit shows that the slowdown is largely concentrated in the month of September 2006. In fact, trends during October and November 2006 indicate presence of strong demand for private sector credit in the economy (see **Figure 4.5**).

- The available evidence suggests that the slowdown in private sector credit is not broad-based as (1) the increased *net* retirement, particularly by the sugar manufacturers[7] and cotton spinning sector during Jul-Oct FY07 contained the

[7] With a view to discourage hoarding of sugar and to ensure stability in its prices, SBP on June 9, 2006 directed all banks to ensure that all advances against the security of sugar stock are fully adjusted latest by 31st October 2006. Further, all renewals/fresh disbursements were made subject to 50 percent cash margin requirement with the instruction that such advances are made only after a clean up period of at least one month. These restrictions were however withdrawn on 27th October 2006 (see BPRD Circulars # 4, 10, and 15 of 2006).

growth in private sector credit;[8] and (2) deceleration in bank credit against equities (see Section on **Private sector credit** for more details).

- More importantly, while the nominal lending rates are rising, the real lending rates are still very low (see **Figure 4.6**). The real lending rates under export finance facility are even negative.[9] The trade-related loaning activity is still very strong (see **Figure 4.7**).

- Further in order to help the textile sector that previously borrowed and at the floating KIBOR rates and are now feeling the pain of sharp rise in KIBOR due to monetary tightening, SBP announced debt swap option under Long Term Finance- Export Oriented Project (LTF-EOP) on September 04 2006. Interest rates on LTF-EOP facility is considerably lower than the weighted average rates of the

Figure 4.6: Lending Rates on Incremental Loans

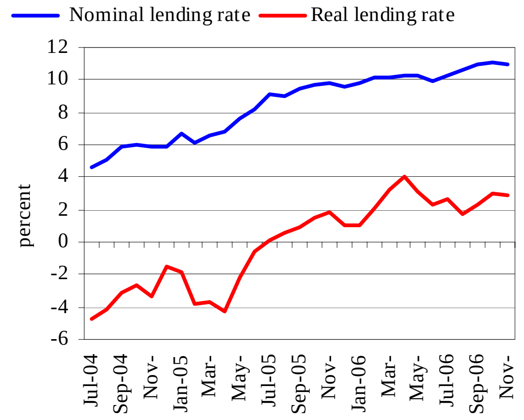
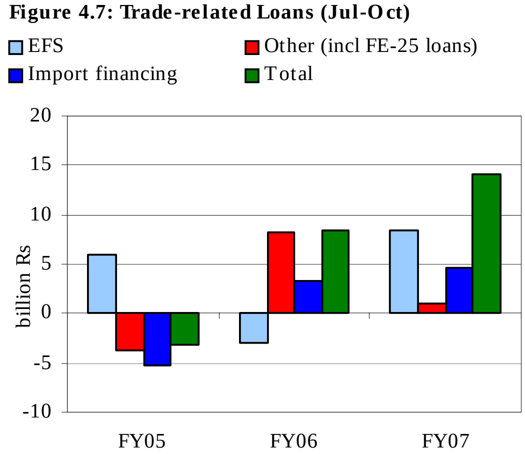


Figure 4.7: Trade-related Loans (Jul-Oct)



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[8] The *net retirement* by sugar manufacturers increased to Rs 18.3 billion during Jul-Nov FY07 period from Rs 1.8 billion during the corresponding period of FY06. The credit growth in cotton spinning sector remained sluggish at 2.8 percent during Jul-Nov FY07 period against the growth of 57.7 percent during the corresponding period of FY06.

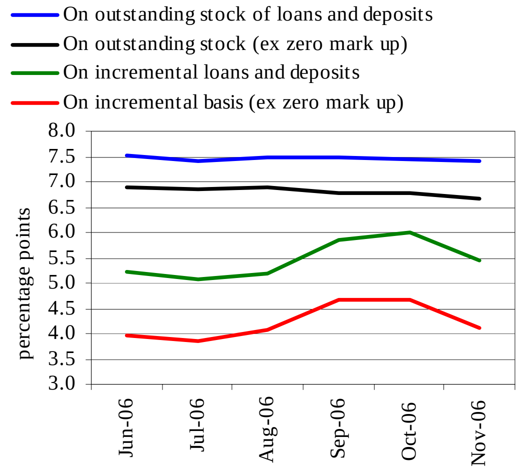
[9] Refinance under EFS is being offered at 6.5 percent, i.e., 4-4.5 percent below the 6-month KIBOR.

benchmark instruments,[10] thus leading to an efective subsidy in the range of 4.6-5.4 percent.[11]

In sum, though the overall demand for credit by the private sector has decelerated, the slowdown is not broad-based. This suggests that monetary policy needs to remain tight.

However, while the transmission of the monetary policy on lending rates has improved over the last year, the impact on deposit rates has been less than desired, contributing to an unhealthy high banking spread (see **Figure 4.8**).

Figure 4.8: Banking Spread



A part of the rise in the spread is explained by the changing maturity and risk profile of banks' assets and liabilities, and therefore SBP encouraged banks to mobilize longer term deposits by reducing cash reserve requirement on their time liabilities in July 2006. Encouragingly, the available evidence shows that banks are mobilizing deposits offering higher returns to customers and the share of such deposits has been rising (see **Figure 4.9**).

Table 4.2: Distribution of Banks in terms of Banking Spread

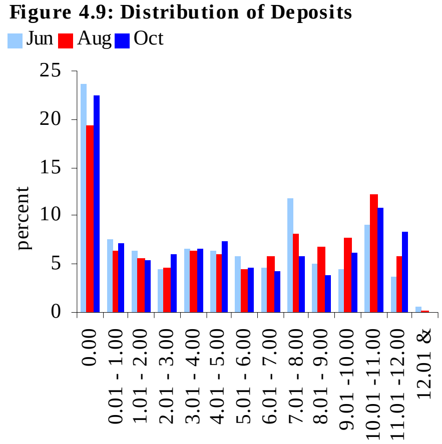
	Percentage of banks			
	Dec-05	**Mar-06**	**Jun-06**	**Oct-06**
Spread range	*On incremental basis*			
1-3 percent	19	24	21	23
3-5 percent	11	16	18	18
5-7 percent	28	24	23	18
7-9 percent	25	24	26	28
More than 9 percent	17	11	13	13
Spread range	***On incremental basis excl. zero mark up***			
1-3 percent	25	35	31	26
3-5 percent	19	19	23	23
5-7 percent	28	22	23	36
7-9 percent	14	16	18	10
More than 9 percent	14	8	5	5

[10] 12-month T-bills, 3-year PIBs and 5-year PIBs are used as benchmark instrument depending upon the tenor of financing.
[11] See **Box 5.7** in *SBP's Annual Report* for FY06.

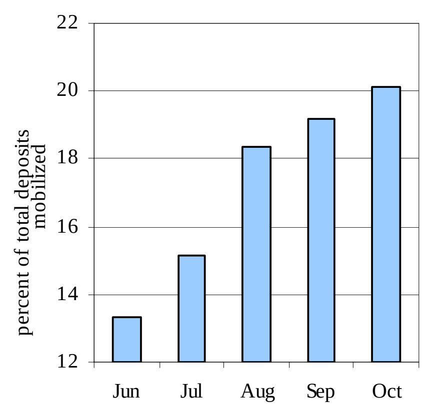
Since the mobilizations of long-term deposits lower the maturity mismatch for banks and reduce liquidity risks, it was expected that the banking spread would decline. But in the meanwhile, lending rates have also risen thereby leading to a sharp rise in banking spread (calculated on the basis of incremental loans and deposits) in recent months (see **Figure 4.8**).

Further, as evident from **Table 4.2**, while the concentration of banks earning more than 7 percent spread (on incremental basis excluding zero mark up deposits and advances) has declined from 28 percent in December 2005 to 15 percent in October 2006, 59 percent of banks are still charging spread in the range of 3-7 percent, which is quite high. Such a large spread can have a dampening effect on economic growth by discouraging savings.

Figure 4.9: Distribution of Deposits



Deposits Mobilized at Rate Above 10%



4.2 Monetary Survey

The broad monetary aggregate (i.e., M2) registered a growth of 3.0 percent during Jul-Nov FY07 period which was the same as achieved during the corresponding period of FY06 (see **Table 4.3**). As in the previous year, the expansion in money supply during Jul-Nov FY07 has been entirely contributed by the increase in net domestic assets (NDA) of the banking system as the net foreign assets (NFA) showed a contraction during the period, reflecting the continued pressures on country's external account.

Given that SBP is targeting to contain FY07 M2 growth at 13.5 percent against the actual growth of 15.2 percent in the preceding year, the acceleration in M2 during Jul-Nov FY07 is quite unwelcome and reinforces the need for a tight monetary stance.

4.2.1 Net Foreign Assets

The impact of continued pressures on the external account was evident on the NFA of the banking system that showed a contraction of Rs 41.1 billion during Jul- Nov FY07, almost equally distributed between SBP and

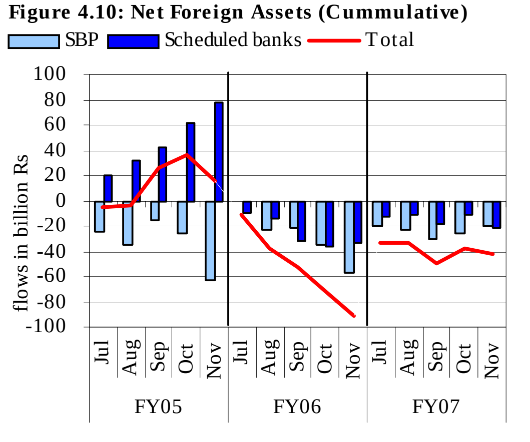
Table 4.3: Monetary Survey (Flows)

billion Rupees

	Credit Plan	Jul-Nov[1]	
	FY07	FY06	FY07
M2	**459.9**	**88.2**	**103.5**
	13.5%	*3.0%*	*3.0%*
NFA	**9.8**	**-90.5**	**-42.6**
SBP		-57.0	-20.4
Scheduled banks		-33.5	-22.2
NDA	**450.1**	**178.7**	**146.1**
	16.5%		
SBP		121.3	124.3
Scheduled banks		57.4	21.8
of which			
Government borrowing	**130.1**	**65.3**	**53.1**
For budgetary support	***120.1***	*81.6*	*57.6*
SBP		161.0	62.0
Scheduled banks		-79.4	-4.4
Commodity operations	**10.0**	**-15.5**	**-3.3**
Credit to non-govt sector	**395.0**	**182.6**	**119.4**
Private sector	390.0	185.8	125.4
PSEs	5.0	-1.6	-6.2
Other items (net)	**-75.0**	**-69.2**	**-26.4**
SBP		-38.1	63.4
Scheduled banks		-31.1	-89.9

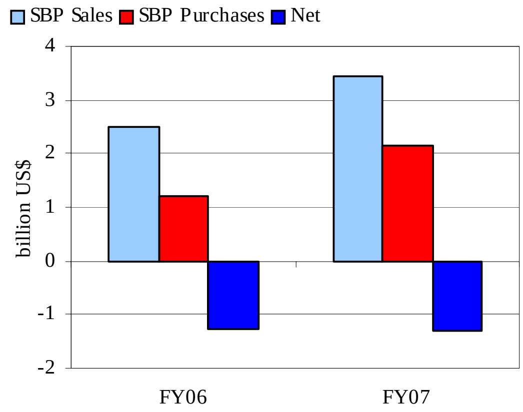
[1] Beginning of July to last Saturday of November (25 Nov 2006)

Figure 4.10: Net Foreign Assets (Cummulative)



commercial banks (see **Figure 4.10**).

Figure 4.11: SBP's Intervention (Jul-Nov)



However, it is important to note that the contraction in the NFA of the banking system during Jul-Nov FY07 was considerably lower than the sizeable reduction of Rs 90.7 billion witnessed during Jul-Nov FY06.

As in the previous year, the fall in SBP NFA during Jul-Nov FY07 reflected the worsening external account and SBP's decision to support foreign exchange market by providing foreign exchange to meet lumpy payments (see **Figure 4.11**) so that the extent of volatility in exchange rate could be contained. However, the lower depletion in SBP's NFA during Jul-Nov FY07 was on account of higher inflows (such as such privatization receipts of PTCL) during this period.

Table 4.4: FE-25 Loans (Jul-Nov)

million US Dollar

	FY06	FY07
Total FE-25 Loans	**491.9**	**120.6**
To exporters	306.7	-16.4
To importers	185.2	137.0

The depletion in commercial banks' NFA during Jul-Nov FY07 was low compared to the corresponding period of previous year. This mainly reflects the subdued demand of the foreign currency loans, which rose by only US$ 88 million during Jul-Nov FY07 against US$ 453.3 million during Jul-Nov FY06.[12] In particular, the foreign currency loans have become unattractive for exporters due to narrowing down of the differential between the EFS rate and the benchmark LIBOR rates, as well the increase in perceived exchange risk due to continuing pressures on the external account.

[12] The commercial banks may use the foreign currency funds mobilized under FE-25 deposit scheme either for placement outside Pakistan (in which case these foreign currency funds would add to the NFA of commercial banks) or for extending loans to exporters & importers (in such case, this would add to the NDA of the commercial banks as these loans are converted into Rupee and become liability of the domestic residents). Thus, with a given pool of FE-25 deposits, any increase in foreign currency loans, would lead to a corresponding decline in commercial banks' NFA and increase in its NDA. The opposite would happen when a foreign currency loan is retired or matures.

Since importers cannot take advantage of subsidized EFS loans, they are still interested in availing foreign currency loans due to the higher cost of the Rupee borrowing (see **Table 4.4**).

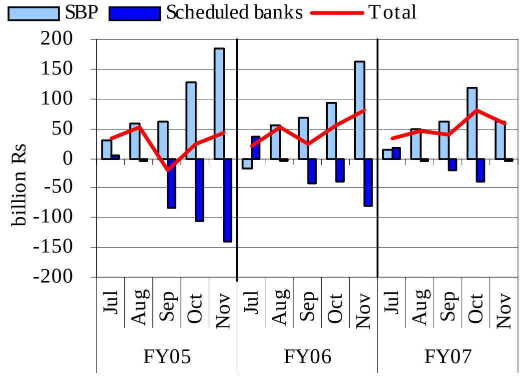
4.2.2 Net Domestic Assets

During Jul-Nov FY07, the growth in net domestic assets (NDA) of the banking system slowed down to 5.4 percent from 7.5 percent realized during the corresponding period of the previous year. The deceleration is evident in all major components of NDA viz. *government borrowing*, *credit to non-government sector*, and *other items (net)*.

Government sector borrowings

The government borrowings from the banking system decelerated to 6.3 percent during Jul-Nov FY07 from 8.1 percent during the corresponding period of FY06. However, this improved performance was the result of retirement of Rs 32.7 billion to the banking system in the last week of November 2006. The volatility in budgetary borrowing makes SBP's liquidity management more difficult.

Figure 4.12: Budgetary Borrowings (Cummulative Flows)



The high budgetary borrowing was mainly due to increased estimated budget deficit in FY07 (see **Table 4.5**). It is expected that the reliance of the budgetary borrowing on the banking system may fall following the recent decision of re-allowing institutional investment in National Saving Schemes since September 2006 and expected external flows on account of floatation of GDR.

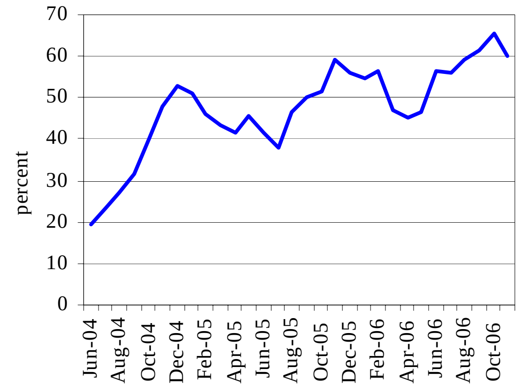
Table 4.5: Deficit Financing (Jul-Sep)

billion Rs

	FY06	FY07
Deficit	**37.7**	**86.7**
External	5.0	27.8
Domestic	32.6	58.9
Non-bank	14.3	24.4
Bank	14.8	34.5

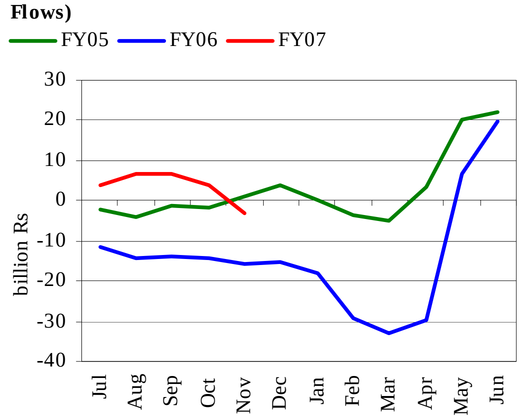
Unfortunately, share of the government's borrowing from the central bank has been rising steadily over time (see **Figure 4.13**). A key contributor to this rising trend has been the absence of any sizeable PIB issue in recent years. Certainly, such borrowings are the most inflationary in nature.

Figure 4.13: Budgetary Borrowings from SBP (Stock as Percent of Total Bank Borrowings)



Borrowings from commercial banks which had been witnessing net retirement during the Jul-Nov period of last two years also turned positive during FY07.

Figure 4.14: Commodity Operation (Cummulative Flows)



However, the credit under commodity operations slowed as the credit extended to Trading Corporation of Pakistan (TCP) during Jul-Nov FY07 for sugar-procurement related operations was offset by retirements on account of loans related to wheat, cotton and rice procurement operations (see **Figure 4.14**).

Credit to private sector

The private sector lending witnessed a sharp slowdown during Jul-Nov FY07, growing at 5.9 percent compared to the 10.9 percent growth realized during the corresponding period of last year. A close analysis of the data shows that this slowdown is concentrated in a few sectors:

1. The sugar manufacturer witnessed a sharp increase of 33.5 percent in *net retirement* from Rs 5.5 billion during Jul-Nov FY06 to Rs 18.3 billion in Jul-Nov FY07. This probably reflects the impact of the SBP's directive to banks to ensure that all advances against the security of sugar stock are fully adjusted latest by 31st October 2006. The resulting increase in net retirement pulled down the overall growth in private sector credit.

Table 4.6: Private Sector Credit (Jul-Nov)

	Absolute flows		% Growth	
(billion Rupees)	**FY06**	**FY07**	**FY06**	**FY07**
1. Private sector businesses	**144.0**	**106.2**	**11.6**	**7.1**
A. Agriculture	**9.5**	**11.7**	**7.3**	**8.7**
B. Manufacturing	**71.1**	**51.1**	**9.4**	**5.7**
Sugar	-1.8	-18.3	-5.5	-33.5
Textiles	59.2	33.3	15.7	7.6
Of which cotton	44.6	-5.0	18.3	-1.7
Coke and refined petro products	-2.5	5.0	-19.0	62.9
Chemicals and products	4.3	1.0	7.9	1.4
Non-metallic minerals	8.4	3.3	20.9	4.5
Of which cement	8.5	-3.2	26.1	-5.1
Basic metals	0.2	4.4	1.6	24.3
Machinery and equipments	2.0	3.6	19.7	32.2
C. Electricity, gas and water	**0.3**	**3.6**	**1.7**	**19.3**
D. Construction	**5.0**	**6.0**	**16.0**	**14.3**
E. Commerce and trade	**34.3**	**10.2**	**23.7**	**5.3**
F. Transport, storage & communications	**3.1**	**10.2**	**6.2**	**16.2**
G. Services	**16.0**	**5.8**	**22.4**	**6.2**
Of which other business activity	3.6	-0.2	63.0	-2.0
2. Personal	**38.7**	**32.1**	**15.6**	**9.4**
Of which consumer financing	37.9	29.6	18.3	9.9
Business + Personal	**182.8**	**138.3**	**12.2**	**7.5**

2. *Other business activities* witnessed a sharp drop in credit from Rs 14.5 billion in Jul-Nov FY06 to the retirement of Rs 1.6 billion during Jul-Nov FY07. This head includes bank advances under continuous funding system (CFS) to equity market which is closely related to performance of the stock market. During Jul-Nov FY07, the KSE-100 Index increased by 6.3 percent, sharply lower than 21.2 percent growth realized Jul-Nov FY06.

3. The credit to the cotton sector during Jul-Nov Fy07 was low at Rs 4.8 billion compared to the Rs 89.5 billion extended during the corresponding period last year. The slowdown is largely concentrated in cotton spinning sector.

As evident from **Table 4.7**, there is considerably higher retirement of Rs 23.5 billion in *agriculture machinery and equipment purchase* and *manufacturing of sugar* during Jul-Nov FY07 that contributed in slowing down the private sector credit. The lower credit to *other business activities* (mostly for CFS), *wholesale and commission trade* (that also includes part of FE-25 loans) and *cement manufacturer* further decelerated the growth in private sector credit.

Table 4.7: Profile of Credit to Private Sector Business (Jul-Nov)

	No of Sectors			Amount in Rs billion		
	FY05	**FY06**	**FY07**	**FY05**	**FY06**	**FY07**
Retirement of more than Rs 5 billion	1[1]	0	2[2]	-5.5	0.0	-23.5
Between Rs 3 to 5 billion	0	0	1	0.0	0.0	-3.0
Between Rs 1 to 3 billion	8	7	4	-15.2	-10.0	-6.2
up to Rs 1 billion	52	52	42	-16.1	-13.9	-7.7
Credit up to Rs 1 billion	68	69	77	25.4	18.0	20.3
Between Rs 1 to 3 billion	11	11	17	18.2	18.1	29.7
Between Rs 3 to 5 billion	7	6	7	28.8	22.5	27.7
Between Rs 5 to 10 billion	2	4[3]	1[4]	12.6	27.4	5.8
More than Rs 10 billion	4	3[5]	2[6]	143.2	114.5	29.1

1. Manufacturers of sugar
2. Agriculture machinery & equipment, and manufacturers of sugar
3. Major crop sector, auto sector (sales, maintenance and repair), and manufacturers of cement, domestic and wholesale
4. Manufacturers of refined petroleum and products
5. Cotton spinning sector, exports of finished products, other business activities
6. Major crop sector and post & telecommunication

Credit to agriculture sector increased by 9.1 percent during Jul-Nov FY07 mainly due to growing of major crops that showed an increase of 20.4 percent (Rs 16.3 billion) during the period. The rise in agri-credit was despite the retirement of Rs 5.21 billion (15.7 percent) under purchase of agricultural machinery and equipments.

While there is no doubt that the extraordinary growth in private sector credit (net) during the previous two years (largely reflecting the impact of historical low interest rates in the economy) has been receding, the credit demand is still quite strong. This is apparent in a strong 18.0 percent YoY growth in private sector credit by November 25, 2006.

Other items (net)

During Jul-Nov FY07, the *other items net* (OIN) had a contractionary impact on M2 growth. Most of the decline in OIN came from scheduled banks, which was partially offset by a fall in SBP other liabilities. The decline in SBP's liabilities was on account of reversal of the repo transactions and the allocation of SBP's profit.

5 Fiscal Developments

5.1 Overview

An expansionary fiscal stance and relatively low non-tax receipts are clearly reflected in the downtrend in key fiscal indicators during Q1-FY07. The fiscal deficit as a percent of GDP (mp),[1] doubled from the previous year to 1.0 percent of GDP, while the primary balance[2] moved from a surplus of 0.1 percent of GDP to a deficit of 0.3 percent of GDP. The revenue balance fares a little better, recording a surplus of 0.1 percent of GDP during Q1-FY07, only a little lower than that in Q1-FY06. However, even this positive may be deceptive, given the large size of "unidentified" expenditures. If the latter are included in current expenditures, even the revenue surplus would slip into a significant deficit (see **Figure 5.1a**).

Figure 5.1: Fiscal Balance Indicators During Q1

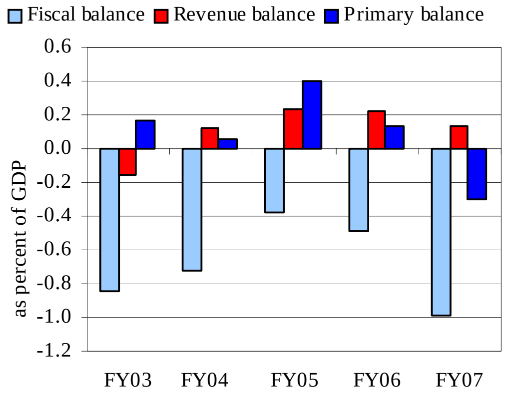
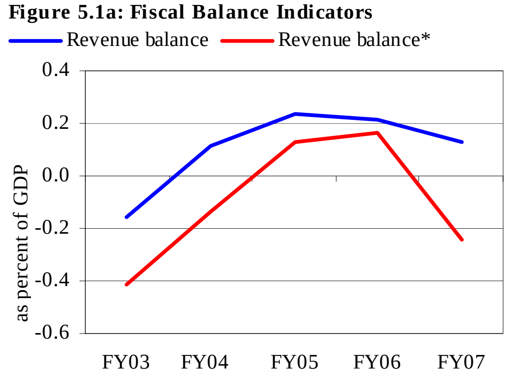


Figure 5.1a: Fiscal Balance Indicators



* Revenue balance after adding unidentified expenses

The Q1-FY07 fiscal deficit (as percent of GDP) is not yet inconsistent with meeting the annual target of 4.2 percent of GDP. For example, the Q1-FY03

[1] Figures for GDP (mp) for FY07 refer to estimated amount of Rs 8,808 billion as given in the Annual Plan 2006-2007.

[2] Primary deficit measures the effects of current discretionary policy by excluding interest payments from the conventional measure of the fiscal deficit. Generally, total interest payments are subtracted from total expenditure to calculate the primary balance, which indicates how the recent fiscal actions of the government affect the government's net debt and therefore is important in assessing the sustainability of the government deficit.

fiscal deficit had been 0.8 percent of GDP, but full year outcome was 3.7 percent of GDP. However, in that year the growth in CBR taxes had been exceptionally strong at 9.6 percent of GDP (a level achieved in FY97 but never since). The FY07 tax target is close to this level, at 9.5 percent of GDP, and attaining it will be important to meeting the overall fiscal deficit target for the year. Unfortunately, given the recent moderation in import growth, and the high dependence of tax receipts on import-based taxes, achievement of the CBR tax target may prove challenging.

Nonetheless, it is very important that the fiscal deficit target for FY07 is achieved, as it would send a strong signal of the government's commitment to fiscal

Table 5.1: Summary of Consolidated Public Finance During Q1

billion Rupees

						YoY change	
	FY03	**FY04**	**FY05**	**FY06**	**FY07**	**FY06**	**FY07**
Total revenue	153.5	165.6	202.2	236.5	255.7	17.0	8.1
Tax (Net)	115.6	119.7	142.5	164.8	191.6	15.6	16.2
Non-tax	38.0	45.8	59.7	71.7	64.1	20.1	-10.7
Total expenditure	194.5	206.5	227.1	274.3	342.4	20.8	24.8
Current	161.2	158.9	186.9	219.8	244.2	17.6	11.1
Development and net lending	21.1	33.1	33.4	50.6	65.2	51.3	28.8
Unidentified expenditure	12.3	14.5	6.8	3.9	33.0	-43.1	751.5
Budget deficit	-41.0	-40.9	-24.9	-37.7	-86.7	51.5	130.0
Financing	41.0	40.9	24.9	37.7	86.7	51.5	130.0
External	34.6	4.9	19.6	5.0	27.8	-74.3	453.2
Domestic	5.6	34.0	5.3	32.7	58.9	512.8	80.3
Bank	-14.1	9.9	-19.9	14.9	34.5	-174.7	132.4
Non-bank	19.7	24.1	19.1	14.3	24.4	-25.0	70.1
Privatization proceeds*	0.8	2.0	6.1	3.5	14.4	-42.8	313.0
As percent of GDP							
Total revenue	3.2	2.9	3.1	3.1	2.9	--	--
Tax (net)	2.4	2.1	2.2	2.1	2.2	--	--
Non-tax	0.8	0.8	0.9	0.9	0.7	--	--
Total expenditure	4.0	3.7	3.5	3.6	3.9	--	--
Current	3.3	2.8	2.8	2.8	2.8	--	--
Development and net lending	0.4	0.6	0.5	0.7	0.7	--	--
Unidentified expenditure	0.3	0.3	0.1	0.1	0.4	--	--
Budget deficit	-0.8	-0.7	-0.4	-0.5	-1.0	--	--
Financing	0.8	0.7	0.4	0.5	1.0	--	--
External	0.7	0.1	0.3	0.1	0.3	--	--
Domestic	0.1	0.6	0.1	0.4	0.7	--	--
Bank	-0.3	0.2	-0.3	0.2	0.4	--	--
Non-bank	0.4	0.4	0.3	0.2	0.3	--	--
Privatization proceeds	0.0	0.0	0.1	0.0	0.2	--	--

* Privatization proceeds are the part of non-bank financing from FY07

Source: Ministry of Finance

discipline and macroeconomic stability, particularly given the perception in some quarters that expenditure control may be difficult in an election year. This means that in case revenues prove to be below target, FY07 expenditures will need to be scaled accordingly. Such a clear demonstration of commitment to fiscal discipline would likely be crucial in reassuring international investors, thereby helping further improve the country's credit ratings, and help domestic companies access international capital markets on more favorable terms.

5.2 Revenues

Total revenue increased to Rs 255.7 billion, rising 8.1 percent YoY during Q1-FY07 as compared to the impressive growth of 17.0 percent in Q1-FY06. This deceleration is basically due to a dip in non-tax revenues that partially offset the impact of a small acceleration in the growth of tax revenues (see **Table 5.1**).

The acceleration in the growth of tax revenues largely owes to a 38.0 percent[3] increase in the direct tax collections by the CBR, which helped compensate for the weakness in indirect tax receipts and relatively low non-tax revenues. The decline in the latter stems from a steep fall in both, defence receipts (that plummeted from Rs 28.9 billion in Q1-FY06 to just Rs 0.6 billion in Q1-FY07), and profits from PTA (which dropped from Rs 10.2 billion to Rs 0.1 billion). The decline in both is consistent with budgetary expectations.

A significant change in public policy was witnessed when government decided that Petroleum Development Levy would not form part of its revenues from FY07, as this remained a major source of revenue for federal government previously. This levy was to be used only to subsidize the prices of petroleum products, but surprisingly, the revenue from this head (a sub-set of non-tax revenues) still stood at Rs 7.6 billion during Q1-FY07.

5.3 Expenditure

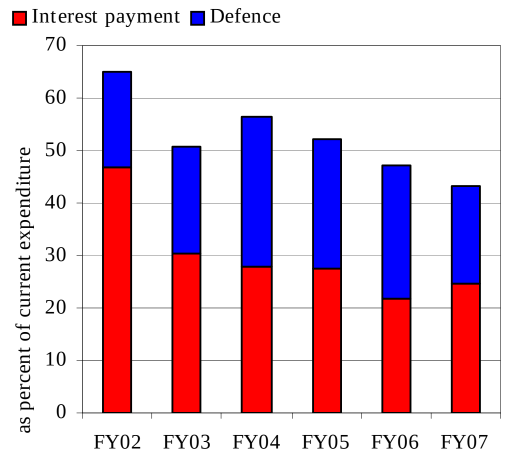
The consolidated public expenditure in the first quarter of FY07 jumped to Rs 342.4 billion, up by 24.8 percent YoY as compared to a rise of 20.8 percent YoY in Q1-FY06. Development expenditure in particular, grew by a welcome 28.8 percent YoY.

However, the classification of 0.4 percent of total Q1-FY07 expenditures in "unidentified expenditure" hampers a more meaningful analysis. To put this in perspective, a rise of 11.1 percent on current expenditure during Q1-FY07 seems quite reasonable, particularly if compared with the 17.6 percent growth seen in

[3] This growth is up till September 2007.

Q1-FY06 (see **Table 5.1**). However, if unidentified spending comprises current expenditures, this growth would jump to a disturbing 23.9 percent.

Figure 5.2: Major Components of Current Expenses



Within Q1-FY07 current expenditures, the impact of a strong increase in interest payments was mitigated by the decline in defense spending (see **Table 5.2**). As a result, the aggregate share of defence and interest payments in total current expenditure continued to drop, falling from 47.3 percent in Q1-FY06 to 43.4 percent in Q1-FY07, thus creating additional fiscal space for development spending (**Figure 5.2**). The increase in interest cost reversed a downtrend visible in the previous five years, and reflects both an increase in the absolute value of the debt stock, as well as rising interest rates.

A sharp increase of 28.8 percent in the development expenditure (net lending) is in line with the government's commitment to provide better infrastructure to the economy, and to reconstruct the areas hit by the October 2005 earthquake.[4] It is also noteworthy that of the development expenditure of Rs 67.5 billion, there was a net negative lending of Rs 2.3 billion from public sector.

Table 5.2: Composition of Current Expenditure During Q1
billion Rupees

				YoY change	
	FY05	**FY06**	**FY07**	**FY06**	**FY07**
Current expenditures	**186.9**	**219.8**	**244.2**	**17.6**	**11.1**
Of which					
Interest payments	51.5	48.0	60.3	-6.7	25.6
Domestic	42.4	39.8	49.1	-6.3	23.5
Foreign	9.0	8.2	11.2	-8.9	36.2
Defense	46.1	55.9	45.6	21.4	-18.5
Provincial	52.7	67.0	83.1	27.1	24.1

Source: Ministry of Finance

[4] While the development expenditure has been raised from 4.7 percent of GDP in FY06 to 4.9 percent of GDP in FY07, the figure for the latter year includes earthquake relief and reconstruction expenditure. On a comparable basis, excluding earthquake related spending the FY07 development expenditure dips to 4.4 percent GDP.

5.4 Financing

Financing requirements surged from Rs 37.7 billion in Q1-FY06 to Rs 86.7 billion during Q1-FY07. These requirements were largely met from financial resources generated domestically. However, external financing was also substantially higher than in the previous year (see **Table 5.3**).

Table 5.3: Financing of Budget Deficit During Q1

billion Rupees

			Percent share	
	FY06	FY07	FY06	FY07
Financing through	**37.7**	**86.7**	**100.0**	**100.0**
External resources (net)	5.0	27.8	13.3	32.1
Internal resources	32.7	58.9	86.7	67.9
Banking system	14.9	34.5	39.5	39.8
Non-bank	17.8	24.4	47.2	28.1
Privatization proceeds	3.5	14.4	9.3	16.6

Source: Ministry of Finance

Government raised Rs 34.4 billion through bank borrowing and Rs 24.4 billion from the non-bank to fill the budgetary gap. The bank borrowing was entirely from the SBP, as borrowings from commercial banks saw a net retirement (essentially reflecting the maturity of long-term paper, i.e., PIBs and FIBs). The share of non-bank borrowings through the National Savings Scheme (NSS) also declined, and investors' interest remained concentrated in a few schemes that offered preferential (higher) rates. Moreover, privatization proceeds of Rs 14.4 billion significantly contributed to non-bank financing of the fiscal deficit.

5.5 CBR Tax Collection

The overall CBR tax collection surpassed the target of Rs 236.2 billion by a margin of Rs 1.1 billion during Jul-Oct FY07 (see **Table 5.4**). However, this was possible only because considerably above-target direct tax receipts offset shortfalls in indirect tax receipts.

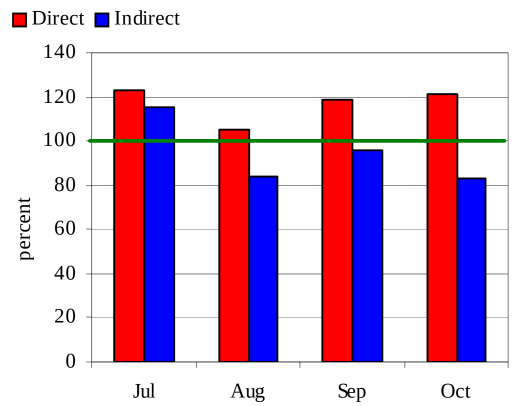
Table 5.4: CBR Tax Collection (Jul-Oct)

billion Rupees

	Targets FY07		Net Tax Collection			As % of target		YoY Change	
	Annual	Jul-Oct	FY05	FY06	FY07	Annual	Jul-Oct	FY06	FY07
Direct taxes	264.7	70.1	48.5	59.3	82.5	31.2	117.7	22.3	39.2
Indirect taxes	570.3	166.1	118.1	141.9	154.7	27.1	93.1	20.1	9
Sales tax	343.8	101.7	70.1	86.6	97.6	28.4	95.9	23.5	12.7
FED	69	19.8	15.5	16.9	19.5	28.2	98.3	8.9	15.3
Customs	157.5	44.6	32.6	38.5	37.7	23.9	84.5	18.2	-2.1
Total taxes	**835**	**236.2**	**166.6**	**201.2**	**237.3**	**28.4**	**100.4**	**20.8**	**17.9**

Source: Central Board of Revenue

Figure 5.3: Collection as Percent of Target



Direct taxes exceeded targets in each of the first four months of FY07 by significant margins, which compensated for the continuing below-target receipts on indirect taxes since August 2006. In particular, the collections from customs duty and federal excise duty fell short of the respective targets throughout Jul-Oct FY07 (see **Figure 5.3**).

The below target performance in sales tax and the customs duty receipts is mainly due to the deceleration in the growth of imports, that fell from 53.9 percent in Q1-FY06 to 7.7 percent in Q1-FY07. Not surprisingly, therefore the sales tax collections on imports for the period declined by 3 percent YoY, while customs duty collections fell by 2.1 percent.

Box 1: CBR Tax Performance and the Impact of Target Revision

During FY06 CBR tax collection marked an improvement in all heads except sales tax and the federal excise duty. The above-target collection in customs was noticeable (suggesting that the growth was driven by the upsurge in imports), while, sales tax collection fell short of the targets by Rs 2.1 billion (see **Table 1**).

However, the data received from CBR[1] shows that the modified budget targets have been revised *ex post facto* to show the outstanding performance of CBR to have an above target collection. Also the target of sales tax collection stands revised; the new target is set just below the achieved collection. These revised targets do not represent any indicator of performance.

Table 1: Revision of Targets by CBR During FY06

	Initial Targets	Revised Targets*	Ex post facto Revision	Collection
Direct taxes	214.0	217.6	215.0	225.0
Indirect taxes	476.0	492.5	475.0	488.5
Sales tax	276.5	296.7	282.5	294.8
Federal excise	59.5	58.8	57.5	55.3
Customs	140.0	137.0	135.0	138.4
Total	**690.0**	**710.1**	**690.0**	**713.4**

Source: Central Board of Revenue

* Source: Economic Survey 2005-06

Similarly, the government's hopes of increasing revenue from federal excise duty, through the new FY07 budgetary measures did not materialize, as key contributing industries either saw production decline (e.g., POL production that fell by 9.5 percent YoY) or saw growth deceleration (e.g., cement, natural gas).

On the other hand, there is significant increase of 17.9 percent in total tax collection YoY when compared with the actual collection in Q1-FY06 (see **Table 5.4**). Component-wise analysis shows that the 39.2 percent growth of direct taxes in this period helped increasing its share in total tax collection from 29.5 percent in Jul-Oct FY06 to 34.8 percent in Jul-Oct FY07, while lower growth of 9.0 percent in indirect taxes is worrisome factor if compared with the 14.2 percent estimated growth of nominal GDP set for the FY07.

Trends in the latest available information (upto October FY07) reveal that CBR has to make enormous efforts to meet the tax targets for the year in the light of slower activity in key manufacturing industries and a sharp deceleration in the growth of imports.

Refunds and Gross Collection

Gross collection increased by 19.4 percent during Jul-Oct FY07, to reach Rs 270.4 billion, as compared to the 15.4 percent growth in the corresponding period last year. However, while the refunds had declined by 14.8 percent in Jul-Oct FY06, these increased by 31.1 percent in Jul-Oct FY07. This rise is however due to the increased refund on domestic sales tax that rose from Rs 11.1 billion to Rs 15.3 billion in this period, leading to an increase of 1.1 percent in refunds to gross collection ratio.

5.6 Provincial Fiscal Operations

An improvement in the provincial public finance is visible during Q1-FY07 as the total revenue increased to Rs 98.7 billion compared to Rs 76.7 billion in Q1-FY06 with a YoY increase of 28.7 percent, while the growth in expenditure relatively slowed down during the quarter, exhibiting a prudent fiscal management.

Better provincial fiscal position stemmed from new formula of revenue sharing from the federal divisible pool of tax revenue (see **Box 2**) that has increased provincial share from 37.5 percent to 41.5 percent. As a result, federal tax assignments during Q1-FY07 rose by 42.3 percent. Under provincial tax heads, property tax dropped drastically from Rs 2.0 billion in Q1-FY06 to Rs 1.5 billion in Q1-FY07 with a decline of 24.6 percent, while this decline is offset by an increase in other revenue that increased from Rs 2.1 billion to Rs 3.5 billion. It is encouraging to note that the agriculture tax increased from Rs 0.09 billion to Rs

0.12 billion, while all the provinces made net repayment of loans to the federal government.

Table 5.5: Summary of Consolidated Provincial Finance During Q1
billion Rupees

	FY03	FY04	FY05	FY06	FY07	YoY Change FY06	YoY Change FY07
Total Revenue	**57.4**	**58.9**	**65.9**	**76.7**	98.7	16.3	28.7
Provincial share in Federal revenue	35.7	39.4	46.0	55.2	78.5	19.9	42.3
Provincial taxes	5.9	8.5	8.7	8.9	9.8	2.3	10.3
Provincial non-tax	3.9	5.7	5.1	5.7	4.9	11.7	-14.5
Federal Loans and transfers/grants	11.9	5.2	6.1	6.8	5.4	12.8	-20.7
Total expenditure	**59.3**	**59.1**	**70.1**	**90.4**	111.7	29.1	23.5
Current expenditure	52.2	48.9	59.2	72.6	88.2	22.7	21.4
Development expenditure	7.1	10.2	10.9	17.8	23.5	63.4	31.9
Overall balance	**-1.9**	**-0.3**	**-4.1**	**-13.8**	**-13.0**	**232.5**	**-5.7**
Financing	**2.9**	**3.4**	**-1.3**	**6.9**	**-6.9**		
Domestic	2.9	3.4	-1.3	6.9	-6.9		
Bank	2.9	3.4	-1.3	6.9	-6.9		

Source: Ministry of Finance

Table 5.6: Provincial Finance up to Q1
billion Rupees

	Punjab		Sindh		NWFP		Balochistan	
	FY06	FY07	FY06	FY07	FY06	FY07	FY06	FY07
Total Revenue	**35.7**	**45.5**	**23.4**	**31.8**	**9.4**	**12.5**	**8.2**	**8.9**
Provincial share in Federal revenue	26.5	37.2	17.3	26.2	6.4	8.7	5.0	6.4
Provincial taxes	5.0	5.2	3.1	3.9	0.6	0.6	0.2	0.2
Provincial non-tax	2.2	3.0	1.1	0.9	0.5	0.9	1.9	0.1
Total expenditure	**46.3**	**59.5**	**22.8**	**29.5**	**14.8**	**13.8**	**6.6**	**8.8**
Current expenditure	33.7	41.9	20.3	27.7	12.6	10.7	6.1	7.8
Development expenditure	12.6	17.6	2.5	1.8	2.2	3.1	0.5	1.0
Overall balance	**-10.6**	**-14.0**	**0.6**	**2.2**	**-5.4**	**-1.3**	**1.6**	**0.1**

Source: Ministry of Finance

A breakup of the provincial public statistics shows that overall balance deteriorated in case of the Punjab and Balochistan, while Sindh and NWFP saw an improvement (see **Table 5.6**); this improvement is mainly due to the rise in provincial revenue receipts. However, looking at the deterioration in fiscal balance of Balochistan, it is worrisome to note that Balochistan is persistently breeching its OD limits[5] that may be alarming in the next quarters. The premature retirement of expensive Cash Development loans not only impacted the interest

[5] Balochistan persistently breeching its OD limits, and by the end of Q1-FY07 the outstanding position of Balochistan stood at Rs 8.6 billion against the OD limit of Rs 1.7 billion.

payments of the provinces but also helped in creating more fiscal space for development projects.

Box 2: Revenue Sharing

The National Finance Commission (NFC) Award is a mechanism for the distribution of financial resources among the federation and the provinces (Punjab, NWFP, Sindh and Balochistan) of Pakistan by the federal government on annual basis. Since the Constitution governs the relationship between the federation and provinces with respect to the distribution of a divisible pool of revenue, therefore, after every 5 years the President of Pakistan forms a National Finance Commission (NFC) which consists of finance ministers of the federal and provincial governments and other appointees by the President.

Main objectives of the commissions are:

- The distribution of net proceeds of the taxes between the federation and provinces
- Making of grants-in-aid by the federal government to provincial governments
- Payment of royalties on crude oil and of surcharge on natural gas
- Distribution of share of taxes between the federal government and provincial governments

The last NFC Award announced in 1996 went into effect in July 1997 for a 5 years time span. It is still in force despite expiration of the specific period because consensus could not be created among all the concerned parties over the proposed formula. According to the Constitution of Pakistan, the President has powers to amend or modify the distribution of revenues. Whereas NFC could not submit its recommendations with regard to distribution, the President promulgated "Distribution of Revenues and Grant-in-Aid (amendment) Order 2006" effective from July 1, 2006.

Under this Order, the percentage share of the provinces from the net proceeds of taxes and duties in each year shall be as under:-

2006-07	41.50%
2007-08	42.50%
2008-09	43.75%
2009-10	45.00%
2010-11 and onward	46.25%

Allocation of shares to the Provincial Governments: Out of the sum assigned to the provincial governments, an amount equal to the net proceeds of 1/6th of Sales Tax shall be distributed amongst the provinces at the following ratio and the provincial governments shall further transfer the whole of such amounts to the district governments and cantonment boards without retaining any part of this amount:-

The Punjab	50.00%
Sindh	34.85%
The NWFP	9.93%
Balochistan	5.22%
Total	**100.00%**

The balance shall be distributed amongst the provinces on the basis of their respective population in the percentage specified against each:-

The Punjab	57.36%
Sindh	23.71%

The NWFP	13.82%
Balochistan	5.11%
Total	**100.00%**

Grants-in-Aid to the Provinces: Rs 27.75 billion shall be charged upon the Federal Consolidated Fund each year as Grants-in-Aid of the revenues to be distributed amongst the provinces according to following shares:

The Punjab	11.00%
Sindh	21.00%
The NWFP	35.00%
Balochistan	33.00%
Total	**100.00%**

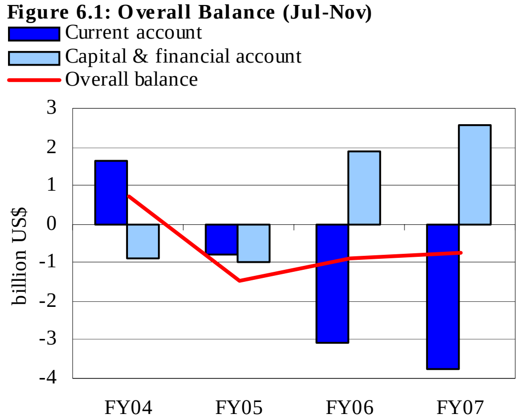
The Grants-in-Aid will be increased annually in line with the growth of net proceeds of divisible taxes for each year. However, the provinces had demanded that the federal government increase the provincial share of the Federal Divisible Pool (FDP) to 50 percent, in addition to special grants and subvention pool. According to federal budget 2006-07, the royalty on crude oil & development surcharge on natural gas after deducting 2 percent collection charges is transferred to the provinces on the basis of well head production. The royalty and excise duty on natural gas after deducting 2 percent collection charges is also transferred to the provinces in accordance with article 161(1) of the Constitution. The GST on services (provincial) is also transferred to the provinces after deducting 2 percent collection charges.

6 External Sector

6.1 Overview

Pakistan's overall external account position improved during Jul-Nov FY07 compared to the same period last year despite a worsening of the current account deficit. Specifically, while the current account deficit increased from US$ 3.1 billion to US$ 3.8 billion, an increase of 22.3 percent, the overall external account deficit shrank to US$ 0.74 billion compared to US$ 0.88 billion in Jul-Nov FY06.

Figure 6.1: Overall Balance (Jul-Nov)



As in the previous year, it was the surpluses in the *capital* and *financial* accounts that offset most of the deficit in the current account. The bulk of the 35.6 percent YoY increase in the aggregate surplus in the *capital* and *financial* accounts during Jul-Nov FY07 was contributed by foreign investment (see **Figure 6.1**).

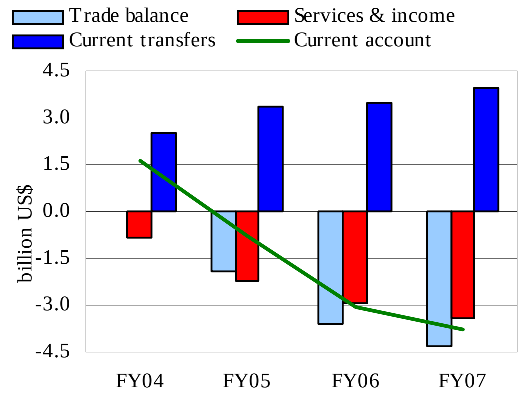
Foreign direct investment inflows increased to US$ 1.5 billion during Jul-Nov FY07 as compared to US$ 752 million in Jul-Nov FY06. Key FDI inflows included: (1) US$ 195 million on account of acquisition of Union Bank by Standard Chartered Bank, (2) US$ 133 million installment of PTCL privatization proceeds, and (3) US$ 175.7 million of a mobile phone company. Portfolio investment of US$ 591 million during Jul-Nov FY07 was also significantly higher than US$ 245 million recorded in the same period in FY06. This increase in portfolio investment was mainly on account of the Muslim Commercial Bank's Global Depository Receipts (GDR) of US$ 150 million, US$ 148 million on account on Mobilink bonds, and US$ 50 million foreign investment in Term Finance Certificates issued by Mobilink.[1]

[1] Mobilink floated US$ 250 million worth of International Bonds, out of which US$ 148 million was received till November 2006.

Although Pakistan was able to finance the Jul-Nov FY07 current account deficit relatively easily, the rise in the deficit nonetheless remains a source of some concern, particularly because unlike the previous years, it owed more to a substantial slowdown in the country's exports rather than an extraordinary rise in imports. Specifically, while the imports growth during Jul-Nov FY07 slowed substantially to 11.8 percent compared to 33.2 percent in the corresponding period last year, it was the unusual decline in the exports growth that dropped to 7.8 percent compared to 13.8 percent in the corresponding period last year, which drove the trade deficit up by 18.8 percent to US$ 4.3 billion.

In addition, the current account deficit was also adversely affected by an unusual rise in the income account deficit arising from higher direct investment outflows. The rise in the trade, services, and income account deficits was, however, mitigated to an extent by the increase in the current transfers by 13.4 percent during Jul-Nov FY07 (see **Figure 6.2**).

Figure 6.2: Current Account Balance (Jul-Nov)



Due to substantial inflows, both on account of current transfers and foreign investment during Jul-Nov FY07, the impact of the widening current account deficit on the country's reserves was relatively low. Pakistan's overall foreign exchange reserve declined by US$ 799.4 million during Jul-Nov FY07 compared to decline of US$ 1,321.6 million in the same period last year.

Interestingly, despite lower depletion of reserves and significant slowdown in the imports growth, some speculations about exchange rate were witnessed due to incorrect conclusions drawn from IFI reports and reported by some local papers that called for a large adjustment of the exchange rate.

This forced central bank to aggressively correct these misperceptions in order to avoid unnecessary market volatility. Specifically, the central bank pointed out that: (1) the exchange rate continued to be set in the inter-bank market; and (2) the SBP interventions remained limited to the provision of liquidity for lumpy oil payments in order to dampen excessive market volatility.

It is important to realize that the exchange rate adjustment is not an end in itself but a means to an end. If the aim is to curtail imports, then there is already a broad based slowdown apparent in the imports since H2-FY06, which seems to have strengthened during Jul-Nov FY07. As impact of monetary tightening measures

taken during July 2006 take effect (due to time lag in monetary transmission mechanism), the imports are likely to be constrained further. Thus, adjustment in the exchange rate to curtail imports seems unnecessary.

The argument for devaluations to boost exports is debatable, as analysis of the past 30 years data show no consistent relationship between exports growth and devaluation. One risk is that excessive volatility in exchange rate would adversely raise domestic cost of production, thus rendering exports uncompetitive instead of boosting them and could also deter foreign investment. Past experience also shows persistent large exchange rate adjustments can also generate self fulfilling expectations that could lead to added pressures on the exchange rate and inflation, as well as on the country's foreign exchange reserves and encourage dollarization of the economy.

Thus, in short, best policy option is to let the market determine the exchange rate in light of supply and demand pressures, and the macroeconomic fundamentals at large. Indeed the data reveals that by Nov 2006, in nominal terms, Pak Rupee against basket of currencies has depreciated by 6.7 percent since July 2005, and it is only due to the increase in the relative price index that has not allowed similar depreciation in real terms. Thus, if exports competitiveness is to be enhanced, the appropriate channel in this scenario is through controlling domestic inflation.

6.2 Current Account Balance

The current account balance worsened further in the first five months of FY07. The deficit reached to US$ 3.8 billion during Jul-Nov FY07 as compared to US$ 3.1 billion recorded in the corresponding period of FY06. The increase in deficit was contributed by goods and income deficit along with services deficit. However, current transfer inflows showed improvement of US$ 465 million over the corresponding period, mainly due to higher remittances inflows. It is worth mentioning that despite persistent current account deficit since FY05, Pakistan's debt to GDP ratio is continuously improving (see **Table 6.1**).[2]

[2] see **Section 6.3** on External Debt in *SBP Annual Report FY06*

Table 6.1: Current Account Balance(Jul-Nov)

million US$

Items	FY06	FY07	Change FY07 over FY06
1. Trade balance	**-3,624**	**-4,304**	**-680**
Exports	6,415	6,917	502
Imports	10,039	11,221	1,182
of which: petroleum group	2,364	3,325	961
2.Services (net)	**-1,778**	**-1,871**	**-93**
Transportation	-791	-828	-37
Travel	-462	-550	-88
Communication services	57	22	-35
Other business services	-879	-839	40
Government services	532	458	-74
Of which: logistic support	474	425	-49
Other	-235	-134	101
3. Income (net)	**-1,147**	**-1,524**	**-377**
Investment income(net)	-1,148	-1,527	-379
Direct investment	-842	-1,197	-355
Of which: profit & dividend	-217	-274	-57
Purchase of crude oil & minerals	-408	-590	-182
Portfolio investment	-56	-85	-29
Of which: profit & dividend	-30	-81	-51
IMF charges & interest on off. external debt	-315	-336	-21
Interest on private external debt	-37	-39	-2
Others	102	130	28
4. Current transfers (net)	**3,481**	**3,946**	**465**
Private transfers	3,407	3,844	437
Workers remittance	1684	2093	409
FCA - residents	110	-61	-171
Others	1613	1812	199
Official transfers	74	102	28
Cash grants	17	33	16
Current account balance	**-3,068**	**-3,753**	**-685**

Source: Statistics and Data Warehouse Department, State Bank of Pakistan

Trade Balance[3]

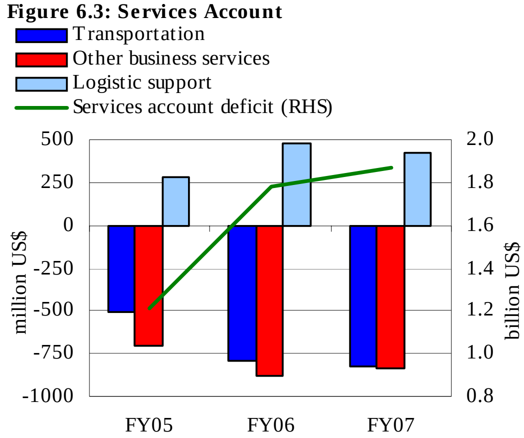
The trade balance deteriorated further during Jul-Nov FY07, though the growth was limited to 18.8 percent against 90.6 percent recorded in the same period last year. The rise in the trade deficit during the last three years was mainly driven by extraordinary jump in the imports. This rise was understandable given the increase in the economic activity after a prolong period of recession. The imports were therefore not discouraged, as they were deemed necessary to enhance the productive capacity of the economy. It was also assumed that as economy's productive capacity increases the imports would gradually fall. This has exactly been the case. The imports growth which started declining in H2-FY06, further fell to 11.8 percent during Jul-Nov FY07 compared to 33.2 percent in the corresponding period last year, with all major heads except for food and transport recording significantly lower growth than last year.

Unfortunately, the desired growth in exports has not been sustained. Contrary to expectations, the exports have decelerated at a much faster pace than the imports, thus widening the trade deficit by 18.8 percent during Jul-Nov FY07 (for a more detailed discussion (see **Section 6.6** on Foreign Trade).

Services (Net)

The services account deficit recorded an increase of 5.2 percent during Jul-Nov FY07 to reach US$ 1.9 billion as compared to 46.5 percent rise in the corresponding period last year (see **Figure 6.3**). An unusual lower growth in services account deficit was largely due to the absence of one-off outflow for construction services. The payments for construction services declined by US$ 77 million during Jul-Nov FY07 as compared to the same period in FY06. The higher payments for construction services during Jul-Nov FY06 were related to

Figure 6.3: Services Account



[3] This section is based on exchange record compiled by the SBP that does not tally with more detailed custom data used in **sub-Section 6.2**. In BoP, the trade data is recorded on accrual basis (after the realization of actual receipts and payments), while in the trade section, trade data is based on customs records, which is compile on the basis of physical movement of goods).

the deferred construction payments for the Ghazi Brotha Dam. Similarly, the net outflow under other business services also recorded YoY fall of 40 percent during Jul-Nov FY07. Thus the saving on construction services and other business services partially offset the routine outflows on account of transportation and travel account.

Income (Net)

Income account deficit recorded YoY expansion of US$ 377 million during Jul-Nov FY07, mainly due to higher investment income outflows.

The net direct investment outflows recorded a rise of US$ 355 million, mainly due to higher payments for the *purchase of oil & gas* (see **Table 6.2**).

Table 6.2: Returns on Direct Investment (Jul-Nov)
million US$

	FY06	FY07	Change
Direct investment (net)	842	1197	355
Profits	22	10	-12
Dividend	195	264	69
Reinvested earning	223	348	125
Purchase of oil & gas	408	590	182

Source: Statistics and Data Warehouse Department, SBP

During Jul-Nov FY07 net interest payments on external debt and liabilities decreased by US$ 13 million. The rise in interest payments on external debt and liabilities by US$ 49 million was partially offset by a US$ 36 million increase in receipts during the period.

Table 6.3: Details of Interest Payments and Receipts
million US$

	Jul-Nov		
	FY06	**FY07**	**Savings**
Payments (I+II)	**472**	**521**	**-49**
I. Total external debt	399	449	-50
Public & publicly guaranteed	356	402	-46
Long-term	294	310	-16
Military	7	7	0
Euro bonds	47	74	-27
Commercial loans/credits	3	4	-1
IDB	5	7	-2
Private loans/credits	37	39	-2
IMF	6	8	-2
II. External liabilities	73	72	1
Foreign currency deposits	4	9	-5
Special US$ bonds	11	4	7
Central bank deposits	17	12	5
Others	41	47	-6
Receipts	**159**	**195**	**36**
Interest on reserves	111	149	38
Others	48	46	-2
Net Payments	**-313**	**-326**	**-13**

Source: Statistics and Data Warehouse Department, SBP

Interest payments on external debt increased to US$ 402 million during Jul-Nov FY07 from US$ 356 million in the corresponding period in FY06 (see **Table 6.3**). This increase was mainly due to higher interest payments on Euro bonds, which increased to US$ 74 million during Jul-Nov FY07 from US$ 47 million in the same period during FY06.

On the receipts side, the YoY increase of US$ 36 million during Jul-Nov FY07 was due to higher interest earnings on reserves and other investments. The returns on reserves improved from US$ 111 million during Jul-Nov FY06 to US$ 149 million during Jul-Nov FY07.

Current Transfers (net)
Current transfers registered 13.4 percent YoY rise during Jul-Nov FY07.[4] This was mainly due to 12.8 percent YoY increase in net private transfers during the period.

Within the net private transfers of US$ 3.8 billion, US$ 2.09 billion were contributed by workers' remittances and US$ 1.81 billion by other private transfers (remittances through exchange companies). However, residents' FCAs declined by US$ 61 million during Jul-Nov FY07 (see **Figure 6.4**).

Workers' Remittances
Workers' remittances (cash) recorded 24.3 percent YoY increase reaching US$ 2,093 million during Jul-Nov FY07 as compared to only 4.6 percent growth observed

Figure 6.4: Composition of Foreign Private Transfers (Jul-Nov)

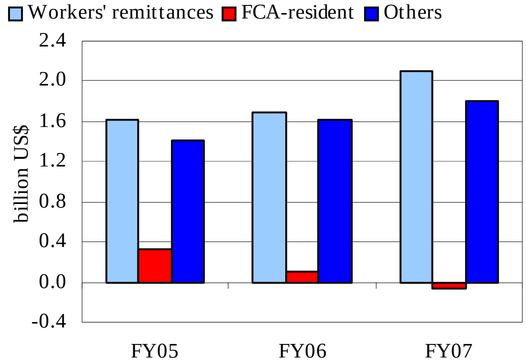


Table 6.4: Workers' Remittances
million US$

	Jul-Nov		
	FY06	**FY07**	**Change**
I. Gulf region	**752**	**1,009**	**256**
Bahrain	41	52	10
Kuwait	92	114	22
Qatar	43	62	19
Saudi Arabia	281	399	118
Sultanat-e-Oman	52	64	12
U.A.E.	243	318	75
II. U.S.A.	**482**	**533**	**52**
III. Other than Gulf & US	**442**	**550**	**107**
Canada	32	35	3
Germany	24	33	10
Japan	3	2	-1
Norway	7	8	1
U.K.	173	180	7
Other	203	291	87
Total	**1676**	**2,092**	**416**
Encashment of FEBCs & FCBCs	**8**	**1**	**-7**
Grand total	**1684**	**2,093**	**409**

Source: Statistics and Data Warehouse Department, SBP

[4]This head comprises of private and official transfers.

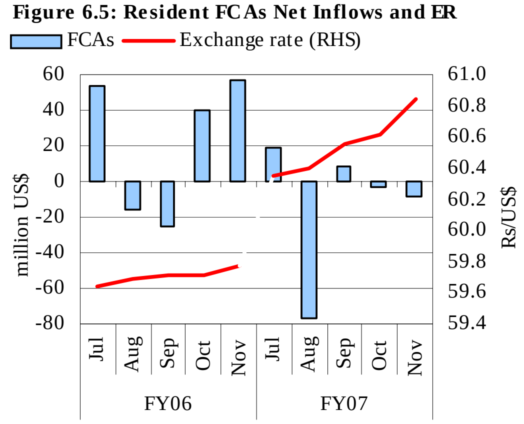
during Jul-Nov FY06.

The increase in the workers' remittances stemmed largely from the traditional sources; USA, Saudi Arabia and U.A.E (see **Table 6.4**). The increase in the remittances from the Gulf region is probably due to the booming regional economies, particularly in the wake of high international oil prices.

Resident FCAs

During Jul-Nov FY07, resident FCAs recorded net outflow of US$ 61 million as compared to net inflow of US$ 110 million during Jul-Nov FY06. This outflow in FE-25 deposits was mainly observed in the month of August FY07 (see **Figure 6.5**).

Figure 6.5: Resident FCAs Net Inflows and ER



Movements in the foreign currency accounts usually reflect the changing expectations with regard to domestic currency. However, with exchange rate more or less stable, the changes in the FCA have been limited and reflect mostly one-time transactions.

6.3 Financial Account

The financial account posted a net surplus of US$ 2.5 billion during Jul-Nov FY07 as compared to US$ 1.8 billion surplus in Jul-Nov FY06 (see **Table 6.5**). The main contributing factor to the increase in the financial account surplus was higher net foreign investment of US$ 2.0 billion during Jul-Nov FY07 as compared to US$ 984 million in Jul-Nov FY06.

Net Foreign Investment

The net foreign investment registered a significant YoY rise of US$ 1.0 billion during Jul-Nov FY07 due to high foreign direct investment as well as foreign portfolio investment inflows.

Foreign direct investment inflows increased to US$ 1.5 billion during Jul-Nov FY07 as compared to US$ 752 million in Jul-Nov FY06. The leading sources of FDI inflows during Jul-Nov FY07 were UK, USA and UAE.

Table 6.5: Financial Account

million US$

	Jul-Nov		Change FY07 over FY06
	FY06	FY07	
Financial account (1 through 4)	**1,814**	**2,466**	**652**
1. Direct investment abroad	**-13**	**-51**	**-38**
2. Direct investment in Pakistan	**752**	**1,476**	**724**
of which: Equity capital	529	1,126	597
Reinvested earning	223	348	125
3. Portfolio investment	**245**	**591**	**346**
of which: (stock markets)	271	426	155
Special US Dollar bonds	-29	-43	-14
Euro bonds	-2	-	2
Net foreign investment	984	2,016	1,032
4. Other investment	**830**	**450**	**-380**
Assets	427	200	-227
i. Outstanding exports bills (Exporters)	-141	37	178
ii. Outstanding exports bills (DMBs)	77	-49	-126
iii. Currency & deposits	491	212	-279
of which: Bank	463	147	-316
Liabilities	403	250	-153
I. Foreign long-term loans / credits (net)	233	113	-120
of which: Project assistance	267	367	100
Food aid	-	-	-
Non-food aid	446	211	-235
Amortization	480	465	-15
II. Private loans	21	5	-16
of which: Suppliers credits/MNCs	166	128	-38
Supplier credits repayments	145	123	-22
III. ST capital, (official)	-28	-42	-14
of which: Commercial banks (net)	-100	-100	-
IDB (net)	72	58	-14
IV. Currency & deposits	220	186	-34
of which: Trade financing	492	121	-371
V. Other liabilities	-43	-12	31

Source: Statistics and Data Warehouse Department, SBP

The increasing trend in the FDI inflows in a capital deficient country like Pakistan is indeed a healthy development. It not only helps in funding the current account deficit but at the same time, it brings in new technology and management skills. During the past few years, while telecommunications, financial business services and oil and gas exploration remain the major recipients of the FDI, other sectors such as; trade, power, textiles, personal services have also witnessed increased foreign investment (see **Table 6.6**).

Table 6.6: Top Ten Recipients of Foreign Direct Investment
million US$

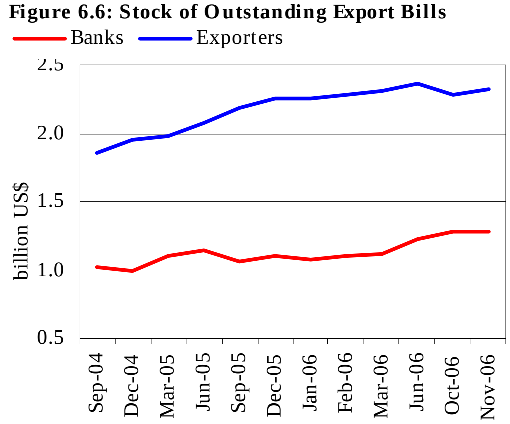
	Jul-Nov	
Economic group	**FY07**	**FY06**
Total Foreign Investment	**1,476.0**	**752.1**
of which:		
Chemicals	24.2	24.2
Financial business	393.7	59.7
Oil & gas explorations	221	114.5
Personal services	32.6	23.5
Petroleum refining	35.3	11.8
Power	76.1	281.2
Telecommunications	392.3	157.4
Textiles	28.5	13.4
Trade	84.4	49.3
Transport equipment (Automobiles)	19.6	13.2

Source: Statistics and Data Warehouse Department, SBP

More than half of the total FDI inflows of US$ 1.5 billion during Jul-Nov FY07 came in the month of September including: (1) US$ 197.6 million from Standard Charted Banks' acquisition of Union Bank; (2) US$ 133 million installment of PTCL privatization proceeds; and, (3) US$ 98.4 million reinvested earnings by Telenor Company.

Portfolio investment also registered a substantial increase of US$ 591 million during Jul-Nov FY07 as compared to US$ 245 million in Jul-Nov FY06. During Jul-Nov FY07, US$ 426 million foreign investment was recorded in the stock market as compared to only US$ 271 million in Jul-Nov FY06. Out of this, US$ 150 million was received on account of MCB Bank's Global Depository Receipts (GDRs) from UK, and US$ 50 million investment in Mobilink TFCs, both during the month of October FY07.

Figure 6.6: Stock of Outstanding Export Bills



Outstanding Export Bills (OEBs)

The stock of outstanding export bills held by exporters and commercial banks recorded a US$ 12 million rise during Jul-Nov FY07 as compared to the US$ 64 million increase during Jul-Nov FY06.

OEBs held by exporters witnessed a decline of US$ 37 million during Jul-Nov FY07 against US$ 141 million rise in Jul-Nov FY06 (see **Figure 6.6**).

On the other hand, the OEBs with commercial banks recorded a rise of US$ 49 million during Jul-Nov FY07 as compared to US$ 77 million decline in Jul-Nov FY06.

Currency and Deposits

This head comprises of currency & deposits held by monetary authorities, general government, commercial banks and other sectors. During Jul-Nov FY07 the currency and deposits observed a decline of US$ 212 million as compared to US$ 491 million fall in Jul-Nov FY06. Comparitively lower fall in currency and deposits during Jul-Nov FY07 was due to lower trade financing of US$ 121 million as compared to US$ 492 million in Jul-Nov FY06.

Foreign Long-term Loans

The long-term official loans witnessed a net inflow of US$ 113 million during Jul-Nov FY07 as compared to the US$ 233 million net inflow in Jul-Nov FY06. High net inflows in the latter are explained by program loan receipts (non-food aid) including World Bank loan of US$ 296 million and US$ 150 million loan from ADB. On the other hand, during Jul-Nov FY07 program loan receipts were only US$ 211 million received from ADB. The amortization of loans declined to US$ 465 million during Jul-Nov FY07 as compared to US$ 480 million in the same period during FY06.

Private/Short-term Loans

Private loans recorded net inflow of US$ 5 million during Jul-Nov FY07 as compared to US$ 21 million in Jul-Nov FY06. Credit repayments of US$ 123 million off set a large portion of the US$ 128 million inflows.

Short-term loans witnessed net outflow of US$ 42 million during Jul-Nov FY07 as compared to the US$ 28 million outflows during Jul-Nov FY06.[5] Further analysis shows that US$ 58 million net inflows from IDB during Jul-Nov FY 07, was offset by repayment of US$ 100 million by commercial banks, thus leading to net outflow of US$ 42 million.

FE-25 Related Trade Financing

Trade financing against FE-25 deposits recorded a rise of US$ 121 million during Jul-Nov FY07 as compared to US$ 492 million during Jul-Nov FY06. In contrast

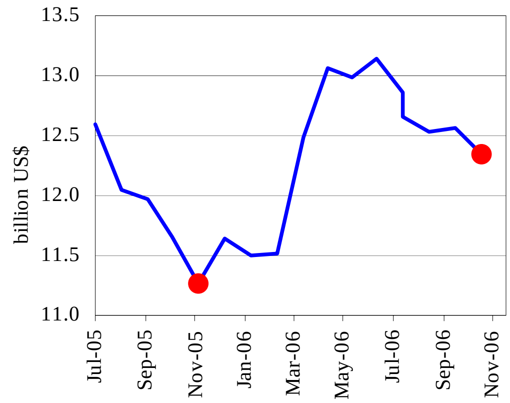
[5] Short term loans contain commercial loans along with the IDB financing for oil imports.

to US$ 307 million rise during Jul-Nov FY06 a decline of US$ 16 million in exports financing from FE-25 deposits was observed during Jul-Nov FY07. However, US$ 137 million rise in imports financing from FE-25 deposits was recorded during Jul-Nov FY07 as compared to US$ 185 million rise observed in the same period in FY06.

6.4 Foreign Exchange Reserves

Pakistan's foreign exchange reserves declined by US $ 0.8 billion during Jul-Nov FY07 due to persistent and rising current account deficit. However, this fall in reserve was comparatively lower than the US$ 1.32 billion recorded in the corresponding period last year. The reserve position during Jul-Nov FY07 benefited from substantial increase in the financial inflows emanating from foreign investment. Unlike the previous year, when bulk of the inflows were concentrated at the end of the fiscal year, in FY07 these inflows appear to be more evenly distributed. As a result not only the depletion of reserves during Jul-Nov FY07 was lower than the corresponding period last year, but on aggregate the reserves were also higher by a billion US dollar compared to the same period last year (see **Figure 6.7**).

Figure 6.7: Foreign Exchange Reserves



As a result of increased inflows in the inter-bank on account of financial receipts as well as the remittances and higher outflow due to rising trade deficit, SBP market intervention increased substantially during Jul-Nov FY07 compared to the corresponding period last year. SBP market support for oil payments increased from US$ 2.4 billion in Jul-Nov FY06 to US$ 3.3 billion in Jul-Nov

Table 6.7: SBP Reserves
million US$

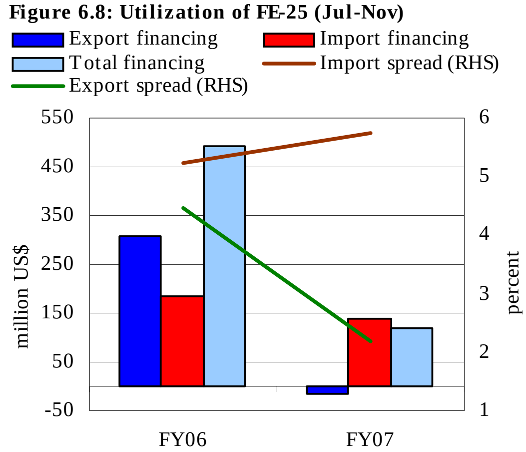
	Jul- Nov	
	FY06	**FY07**
SBP Reserves (end Nov)	**8,890.9**	**10,086.0**
Change	*-900.7*	*-674.2*
Inflows	**4,226.1**	**5,123.1**
SBP Purchases	1,204.7	2,136.1
Donor Agencies and Others	3,021.4	2,987.0
Outflow	**5,126.8**	**5,797.3**
Oil payments	2,394.6	3,318.5
External Debt Servicing	1,207.1	1,474.2
Others	1,525.1	1,004.6

FY07. Similarly, SBP purchases from the inter-bank increased by almost a billion US dollar (see **Table 6.7**).

While the depletion in the SBP reserves was arrested due to rise in the financial inflows and SBP market purchases, the lower depletion in the commercial banks' reserve was mainly due to fall in the lending against FE-25 deposits.

Trade financing against FE-25 deposit declined to US$121.0 million during Jul-Nov FY07 against US$ 492 million in the corresponding period last year (see **Figure 6.8**). The fall was witnessed in both the import as well as export related financing. This fall appears to be the function of interest rate differential between the foreign currency loans and alternate financing modes.

Figure 6.8: Utilization of FE-25 (Jul-Nov)



With the fall in the Export Finance Scheme (EFS) rates from 7.5 to 6.5 percent with further narrowing of the bank's spread by 0.5 percent and rise in the LIBOR rates, the difference between EFS rate and LIBOR rate substantially declined (see **Figure 6.8**).[6] With exchange risk further eroding any benefits, financing through the EFS became more attractive. Consequently, while foreign currency loans for export financing witnessed retirement of US$ 16.4 million, the loans under EFS increased by Rs 17 billion during Jul-Nov FY07.

Unlike the exporters the importers borrow at non-concessional rates, with rise in domestic interest rates, foreign currency loans for imports are still attractive as the differential between the Weighted Average Lending Rates (proxy rate for lending) and 6-month LIBOR appears to have increased since Jul-Nov FY06. However, with concerns over the stability of the domestic currency the exchange risk has probably increased. As a result, although importers utilized the foreign currency loan, nevertheless, the volume of these loans was lower in Jul-Nov FY07 compared to the same period last year.

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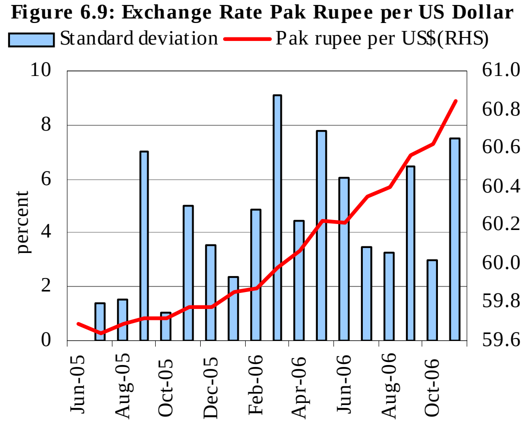
[6] See SMED Circular No.14 of July 14, 2006.

6.5 Exchange Rate

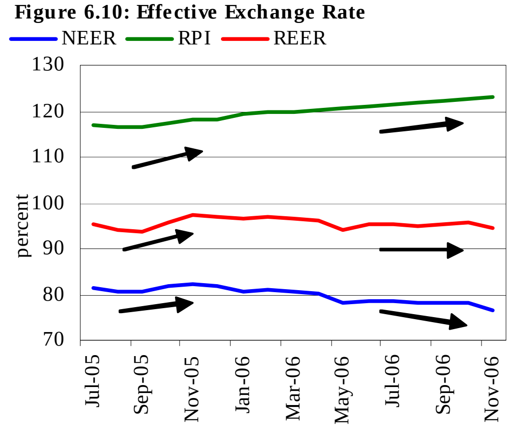
Owing to the pressures on the external sector, Pakistan's currency, vis-à-vis US$ depreciated by 1.05 percent during Jul-Nov FY07 as compared to the 0.13 percent in the corresponding period last year.

Figure 6.9: Exchange Rate Pak Rupee per US Dollar



Not only the rupee depreciated continuously throughout Jul-Nov FY07, but the volatility in the exchange rate within each month was also significant. Standard deviation of the average interbank market exchange rate on occasions was as high as 9 percent (see **Figure 6.9**). On average, standard deviation for the Jul-Nov FY07 was 4.73 percent compared to 3.19 percent in the same period of FY06. The continuous depreciation of the rupee and significant volatility in the exchange rate within each month indicates that, while SBP considers it important to remove the volatility, it is not aiming at any targeted rate.

Figure 6.10: Effective Exchange Rate



As against US$, the exchange rate against the basket of currencies as measured by the Nominal Effective Exchange Rate (NEER) also showed 2.77 percent depreciation during Jul-Nov FY07 against appreciation of 2.06 percent during the same period last year (see **Figure 6.10**).

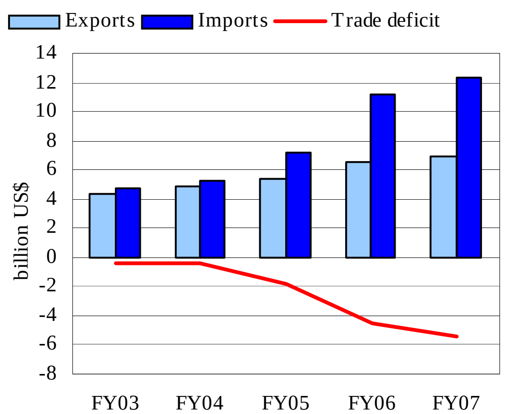
However, the depreciation in the Real Effective Exchange Rate (REER) was limited to 0.87 percent due to continuous rise in the Relative Price Index (RPI) that is due to higher domestic inflation compared to the trading partner countries. In contrast, REER appreciated 4.4 percent during Jul-Nov FY06.

6.6 Foreign Trade[7]

The trade deficit continued to rise during Jul-Nov FY07, although the growth slowed substantially to 17.8 percent from the 147.5 percent YoY increase recorded during the corresponding period last year (see **Figure 6.11**). This welcome deceleration in the growth of the trade deficit during Jul-Nov FY07 is principally due to the slowdown in the import growth.

Specifically, the moderation in import growth, which has been apparent since H2-FY06 further strengthened during Jul-Nov FY07 as all major imports categories other than *petroleum*, *machinery* and *other products*, recorded negative growth rates. As a result, the overall growth in imports during the period fell to 10.4 percent during Jul-Nov FY07 against the 54.3 percent rise in the corresponding period last year. Indeed, the trade deficit could have been lower, had it not been for the unexpected sharp deceleration in export growth during Jul-Nov FY07 that dropped to a mere 5.2 percent compared to the 22.3 percent in the corresponding period last year.

Figure 6.11: Trade Deficit (Jul-Nov)



A part of the decline in the exports growth is understandable given the more challenging economic environment as compared to a year earlier, both domestically and externally. On the one hand, export prices are under pressure due to increased competition post-MFA, and on the other hand, high domestic costs (especially for energy), and slow progress in relieving infrastructural bottlenecks and improving productivity hamper improvements in competitiveness. Nevertheless, the magnitude of the slowdown in exports is still puzzling. Adding to the confusion is the inconsistency of FBS (customs record) data with that of the SBP (exchange record data) as well as with the import data of EU and the US.

[7] The analysis is based on the provisional data provided by Federal Bureau of Statistics, which is subject to revisions. This data will not tally with the exchange record numbers reported in the section on *Balance of Payments*. Data differences are due to different methodologies for customs-based trade data by FBS and exchange-based BoP data by SBP. For details see **Special Section 1** in the SBP 2nd *Quarterly Report on the State of the Economy for FY0*6.

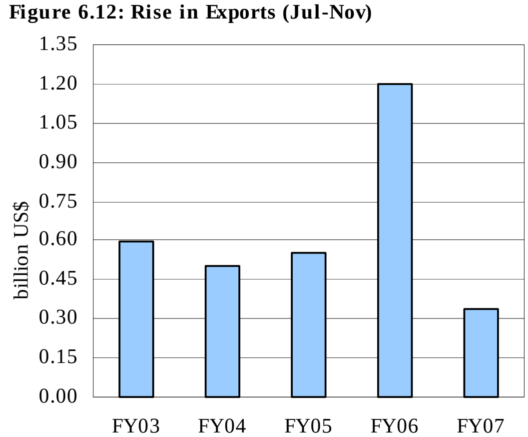
Specifically, while the FBS data shows a 4.2 percent decline in the textiles exports during Jul-Nov FY07, exchange records show 11.0 percent growth. Furthermore, EU textiles and clothing imports from Pakistan show a rise of 3.2 percent during Jul-Sep FY07,[8] and similarly, the US imports data show a rise of 8.8 percent in textile and clothing imports from Pakistan.[9]

It is therefore not surprising that some quarters have shown skepticism over the low export growth figures. However, trade figures for the month of November are some consolation; although detailed data is not yet available, the increase of 23.9 percent YoY in overall exports is nevertheless quite encouraging. Further data points and details on the export data will be required to assess policy implications.

Exports

According to the FBS data, exports growth dropped to 5.2 percent during Jul-Nov FY07 compared to 22.3 percent in the corresponding period last year. Exports rose by only US$ 339.9 million during Jul-Nov FY07, which is significantly lower than the increases in the preceding four years (see **Figure 6.12**). The exports also fell short of the target by US$ 318 million during the period under review.[10]

Figure 6.12: Rise in Exports (Jul-Nov)



It may be pointed out that 16 percent average growth during the last four years was the outcome of an extraordinarily congenial export environment. On external front, Pakistan gained increased market access through favorable GSP provisions and increase in quotas (that were finally ended in January 2005), and the world demand was also on a rise. On the domestic front, domestic inflation was relatively low and real interest rates were negative

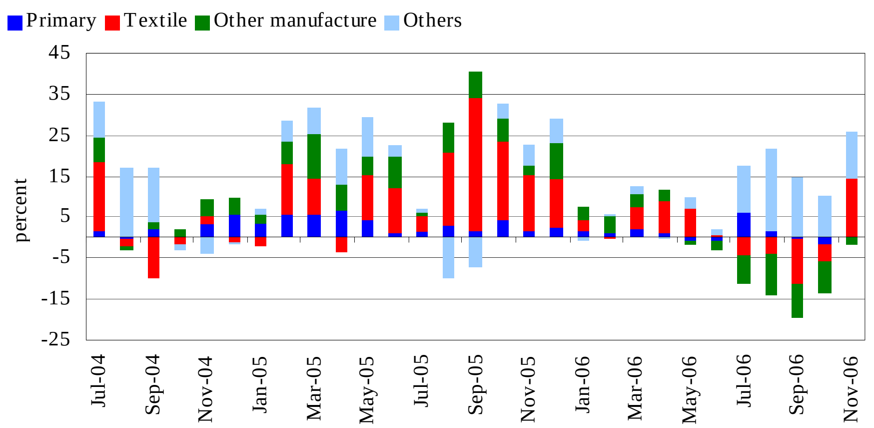
8 Source: Eurostat
9 Source: US Census Bureau
10 Jul-Nov FY07 Export Target was US $ 7.246 billion against which actual exports realized were US$ 6.928 billion. Monthly export targets are available at Trade Development Authority (former Export Promotion Bureau) website: www.epb.gov.pk

or very low, energy costs had yet to rise, and competitive pressures were lower.[11]

However, this congenial environment has gradually become more challenging. The quotas regime has ended (thereby increasing competition, particularly in textile commodities), Pakistan has lost some of the gains under GSP (which some key competitors continue to enjoy)[12], and the world demand is slowing. On the domestic front, inflation remains high (despite having declined significantly in recent months), and real interest rates have also increased (although they still remain below regional norms). The rise in the international oil prices has also added to cost pressures.

Given the above developments, some slowdown in exports growth was to be expected. However, the magnitude of the slowdown is puzzling, especially when taken in light of auxiliary information (as mentioned earlier). Nonetheless, it is clear that the country has to address structural issues urgently, with regard to increasing efficiency and productivity of our export industry, which is principally the domain of the private sector. Unfortunately, it appears that our exporters continue to rely heavily on government interventions to boost their competitiveness. However, the government also has a role in facilitating exporters by providing improved infrastructure, supportive policy environment and negotiating better market access.

Figure 6.13: Contribution in Monthly Export Growth



[11] Average inflation for FY03, FY04 and FY05 was 5.65 percent compared to average inflation of 8.1 percent during FY06 and Jul-Nov FY07

[12] Countries with least developed status enjoy special market access.

The dismal export performance during Jul-Nov FY07 is attributed to the decline in exports of both the textile and non-textile manufacturing sectors. It was rice and other exports which helped the overall exports to record the positive growth, however during the month of November textile exports indicate substantial growth of 24.5 percent YoY, which is a good omen for overall exports growth (see **Figure 6.13**).

Primary Commodities

The major non-textile foreign exchange earner, rice exports, helped commodity exports register a reasonable growth of 8.5 percent during Jul-Nov FY07 as compared to 43.1 percent growth in same period last year (see **Table 6.8**). Helped by a bumper crop, rice exports increased by 42.8 percent during the period under review. The exports of basmati rice contributed almost 65 percent in the total rice exports. By contrast, *raw cotton*, *fish and fish preparations* exports declined by 29.2 percent and 2.4 percent respectively during the period, as against -52.8 percent and 32.7 percent growth respectively recorded in Jul-Nov FY06. The raw cotton exports declined on account of the smaller cotton crop and consequent higher domestic prices.

Textile Manufactures

After showing a remarkable performance in 2005, the growth in the exports of textile manufactures decelerated from the very beginning of 2006, probably reflecting both increased competition and rising costs of business. Moreover, aggressive marketing and export subsidies by China, India and Bangladesh to their textile sectors might also have been a contributing factor for slowdown in Pakistan's textile export.[13]

The group's export, which constitutes almost 57.0 percent of the total exports, recorded a negative growth of 4.2 percent during Jul-Nov FY07 in contrast to robust growth of 29.3 percent in the same period of last year.[14]

Moreover, the decline in group export was broad based as exports of all the major textile items except cotton yarn and knitwear decline during the period under review mainly because of fall in their quantum (see **Figure 6.14**).

[13] To promote the investment in the high tech-textile units, under the Technology Up- gradation Fund Scheme (TUFTS), the Indian Government provides 5 percent interest reimbursement on the loans to textile industry. Moreover, for processing sector, 10 percent capital subsidy is also given in addition to the 5 percent interest subsidy.

[14] However, as noted earlier, SBP data shows that textile exports grew by 8.9 percent during Jul-Oct FY07.

Table 6.8: Major Exports (Jul-Nov)

Value: US$ million: unit value: US$

			FY06		FY07			% change Jul-Nov-FY07 over Jul-Nov-FY06		
		Unit	Value	Unit value	Value	Unit value	Abs chg. In value	Qty	Value	Unit value
A.	**Primary commodities**		**709.5**		**769.7**		**60.1**		**8.5**	
1	Rice	MT	382.8	463.6	546.8	507.6	164.0	30.5	42.8	9.5
2	Raw cotton	MT	25.5	1,456.6	18.1	1,722.3	-7.5	-40.1	-29.2	18.2
3	Raw wool (excluding wool tops)	MT	0.5	833.0				---	---	---
4	Fish and fish preparations	MT	82.0	2,030.7	80.1	2,117.3	-1.9	-6.4	-2.4	4.3
5	Leather	SQM	120.5	21.0	90.7	20.4	-29.9	-22.5	-24.8	-3.0
6	Guar and guar products	MT	9.3	1,377.0	10.6	1,845.1	1.3	-14.5	14.5	34.0
7	Fruits	MT	52.8	377.4	10.5	156.0	-42.2	-51.7	-80.0	-58.6
8	Vegetables	MT	23.9	359.3	7.2	642.0	-16.6	-83.1	-69.7	78.7
9	Crude animal material	MT	7.8	5,136.6	0.0	---	-7.8	---	---	---
10	Oil seeds & nuts etc.	MT	4.5	754.8	5.7	1,390.7	1.2	-31.5	26.3	84.3
B.	**Textile manufactures**		**4,104.8**		**3,932.4**		**-172.4**		**-4.2**	
1	Cotton yarn	MT	522.7	2,510.2	586.6	2,520.8	63.9	11.8	12.2	0.4
2	Cotton fabrics (woven)	SQM	870.5	0.9	731.7	1.1	-138.7	-32.0	-15.9	23.6
3	Hosiery (knitwear)	DOZ	778.1	26.8	793.7	30.5	15.6	-10.6	2.0	14.1
4	Bed wear	MT	849.0	6,383.0	738.7	7,085.9	-110.3	-21.6	-13.0	11.0
5	Towels	MT	234.1	4,406.5	228.6	4,632.7	-5.5	-7.1	-2.4	5.1
6	Cotton bags and sacks	MT	5.3	4,963.5	0.0	---	-5.3	---	---	---
7	Readymade garments	DOZ	560.1	41.9	535.0	45.6	-25.2	-12.2	-4.5	8.8
8	Tarpaulin & other canvas goods	MT	12.9	2255.0	28.5	3,141.3	15.6	58.5	120.8	39.3
9	Tulle, lace embroidery etc.	---	3.8	---	0.0	---	-3.8	---	---	---
10	Synthetic textiles	SQM	82.7	0.8	146.1	1.6	63.4	-15.6	76.6	109.1
11	Other textile made up	---	180.3	---	143.4	---	-36.9	---	-20.5	---
12	Waste material of textile fibers/ fabrics	MT	5.1	1,162.9	0.0	---	-5.1	---	---	---
C.	**Other manufactures**		**1,062.1**		**616.2**		**-445.9**		**-42.0**	
1	Carpets, Carpeting Rugs & Mats	SQM	111.3	74.1	83.6	84.3	-27.6	-34.0	-24.8	13.8
2	Petroleum and Petroleum Products	MT	270.6	628.2	90.3	789.6	-180.3	-73.5	-66.6	25.7
3	Sports Goods	---	119.0	---	75.7	---	-43.3	---	-36.4	---
4	Leather Manufactures	---	312.6	---	176.7	---	-135.9	---	-43.5	---
5	Surgical and Medical Instruments	No	67.1	---	38.2	---	-28.9	---	-43.1	---
6	Cutlery	Gr	15.3	30.3	11.1	---	-4.2	-100.0	-27.3	---
7	Onyx Manufactured	MT	5.5	1,893.4	4.9	2,228.9	-0.6	-23.9	-10.4	17.7
8	Chemicals and Pharmaceuticals	---	142.5	---	125.4	---	-17.1	---	-12.0	---
9	Molasses	MT	7.9	79.1	10.3	165.4	2.4	-37.4	30.8	109.0
10	Sugar	MT	10.3	417.0	0.0	---	-10.3	---	---	---
11	Others		715.5		1,613.5		898.0	---	125.5	---
	Total exports		**6,591.9**		**6,931.8**		**339.9**		**5.2**	

The exception of the cotton yarn exports may be explained by the fact that 47 percent of the total investment of US$ 5.5 billion during 1999-2005 under textile vision 2005 went into the spinning sector (see **Table 6.9**).

The decline in the exports of high value added textile products is more pronounced as compared to the low value added textile products. Within the low value added textile products, the cotton yarn exports increased by 12.2 percent as compared to the increase of 37.8 percent in the same period of last year while the cotton fabrics exports declined by 15.9 percent against the increase of 27.7 percent in the same period of last year.

Figure 6.14: Textile Exports (Jul-Nov)

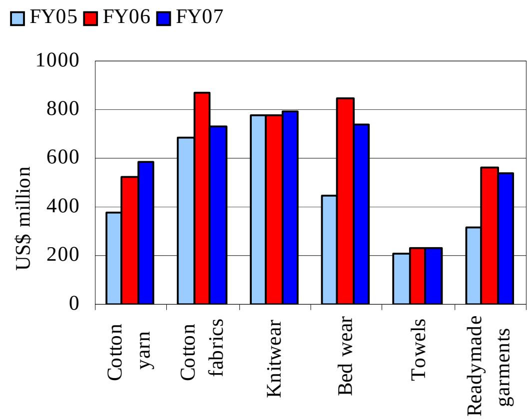


Table 6.9: Investment in Textile Under the Textile Vision 2005

	As percent of total
Spinning	47
Weaving	26.3
Knitwear and Garments	4.8
Made ups	7.7
Synthetic Textile	5.2
Textile processing	10.5
Total Investment (1999-2005) in billion US $	**5.5**

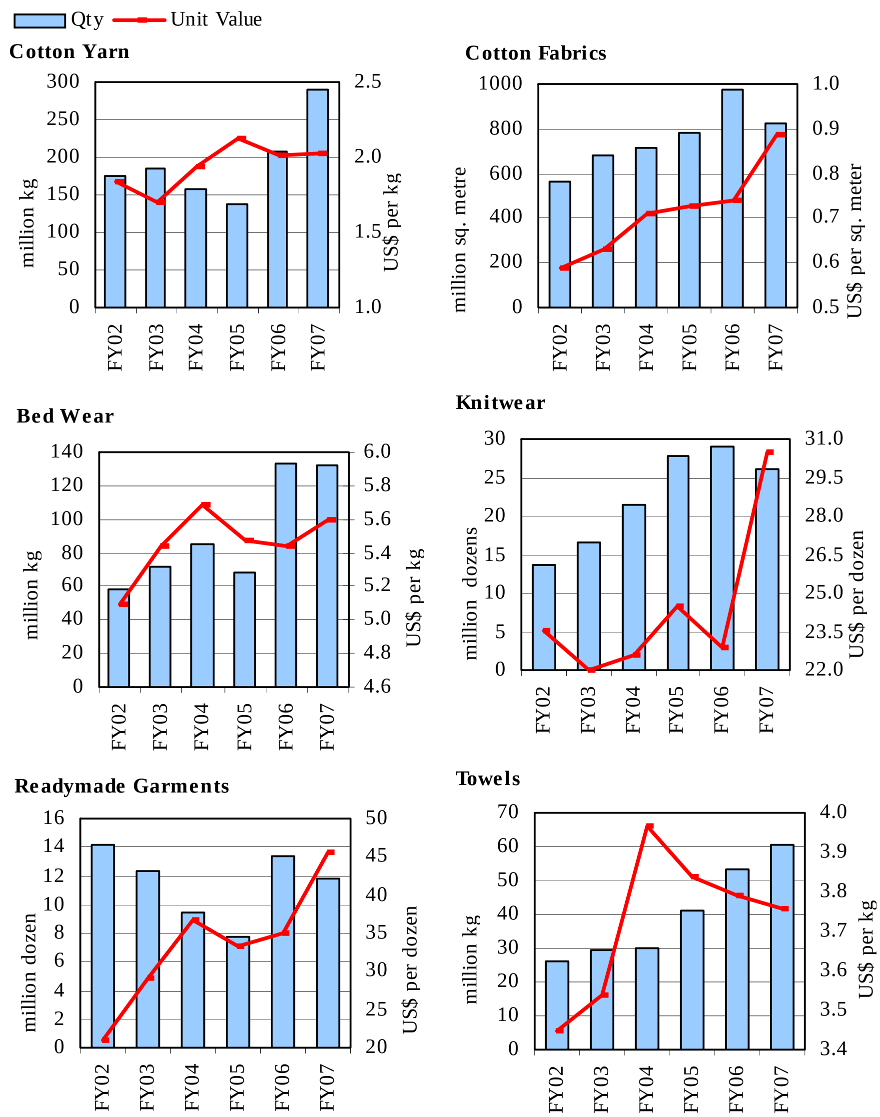
Source: EPB/ E Survey

Within the high value added textile products, the bed wear export performance was most disappointing; with exports declining by 13.0 percent despite the reduction of antidumping duty in the EU market from 13 to 5.8 percent from May 2006. Moreover, almost the entire decline was quantum driven as its unit values registered a nominal increase of 3 percent during the period.

The prices of towel in the international market remained under pressure for the third successive year, which in turn lead to a decline of 2.4 percent in exports of towel during the period under review. The decline in towel export was also contributed by the fall in the quantum (see **Figure 6.15**).

Knitwear export after recording a negative growth during Jul-Oct FY07 registered a slight increase of 2.0 percent during Jul-Nov FY07. The slowdown in the knitwear exports from the very beginning of the quota phase out, suggests that this sector has been facing stiff competition in the post MFA regime.

Figure 6.15: Major Textile Manufactures- Export Quantums and Unit Prices (Jul-Nov)



Despite the 6.0 percent research and development subsidy provided by the government and around 5.7 percent increase in its prices, the exports of ready made garments declined by 4.5 percent during Jul-Nov FY07 as compared to the extraordinary growth of 76.5 percent in the same period last year. It may be noted that by Dec 19 2007, absolute amount of Rs 10.2 billion has been disbursed as subsidy on research and development which is quite huge.

Other Manufactures

The other manufactures exports declined by 42.0 percent during Jul-Nov FY07 as compared to 27.1 percent growth in the corresponding period of last year. All sub-groups under other manufactures including: leather manufactures (leather garments), sport goods, chemical and pharmaceutical products, petroleum products and engineering goods etc recorded negative growth during Jul-Nov FY07, with only molasses showing a positive growth of 30.8 percent.

Imports

The overall imports growth decelerated sharply to 10.4 percent YoY during Jul-Nov FY07 as against strong growth of 54.3 percent YoY in the corresponding period of previous year. The decline in the imports was broad based with all major groups recording negative growths with the exception of petroleum group, machinery and other imports (see **Table 6.10**).

Moreover, the bulk of the rise in the Jul-Nov FY07 imports was registered in the first two months of FY07, when imports of *petroleum* and *other imports* categories increased, on average, by 53.5 and 46.2 percent, respectively. Although the imports showed a declining trend throughout Jul-Oct FY07, they staged a strong comeback in the month of November recording growth of 20.6 percent YoY. The main contributors to this rise were petroleum products, machinery and food group imports (see **Figure 6.16)**.

Figure 6.16: Contribution in Monthly Import Growth

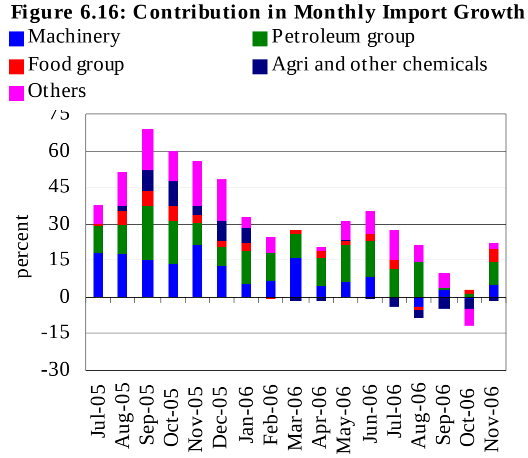


Table 6.10: Major Imports (Jul-Nov)
Value: US$ million: unit value: US$

			FY06		FY07			% change in Jul-Nov-FY07/Jul-Nov-FY06		
		Unit	Value	Unit value	Value	Unit value	Abs chg. In value	Qty	Value	Unit value
A.	**Food group**		**800.0**	--	**753.1**	---	**-46.9**	--	**-5.9**	---
1.	Milk & cream incl. milk food	MT	20.1	1,913.1	21.4	3,049.6	1.3	-33.3	6.3	59.4
2.	Wheat un-milled	MT	44.7	160.2	29.0	228.9	-15.8	-54.7	-35.2	42.9
3.	Dry fruits	-MT	20.8	463.5	17.8	415.7	-3.0	-4.8	-14.6	-10.3
4.	Tea	MT	85.2	1,655.4	88.6	1,842.4	3.3	-6.6	3.9	11.3
5.	Spices	MT	20.8	628.9	22.9	736.4	2.1	-5.9	10.2	17.1
6.	Edible oil	MT	331.6	433.8	335.1	455.4	3.5	-3.7	1.0	5.0
	Soybean	MT	6.7	713.5	*15.9*	783.6	9.2	115.9	137.1	9.8
	Palm oil	MT	324.9	430.3	*319.2*	446.1	-5.7	-5.2	-1.8	3.7
7.	Sugar	MT	200.5	338.7	130.5	430.3	-70.0	-48.7	-34.9	27.0
8.	Pulses	MT	76.3	355.1	107.9	474.0	31.7	6.0	41.5	33.5
B.	**Machinery group**	---	**2,986.0**	---	**3,055.6**	--	**69.6**	--	**2.3**	---
1.	Power generating machinery	--	209.8	--	247.0	---	37.2	--	17.7	---
2.	Office machinery	---	110.6	---	121.4	--	10.8	---	9.8	---
3.	Textile machinery	---	351.1	---	231.9	---	-119.3	--	-34.0	---
4.	Construction & mining machinery	--	63.2	---	64.0	---	0.8	---	1.2	---
5.	Electrical machinery & apparatus	---	189.9	---	246.0	---	56.1	---	29.5	---
6.	Railway vehicles	--	47.8	---	20.3	--	-27.5	---	-57.5	---
7.	Road motor vehicles	--	574.8	---	526.8	---	-47.9	---	-8.3	---
8.	Aircraft, ships and boats	---	42.3	---	103.5	---	61.2	--	144.5	---
9.	Agri machinery & implements	--	58.5	---	58.4	---	-0.1	--	-0.1	---
10.	Other machinery	---	1338.0	--	1,436.3	---	98.3	---	7.3	---
C.	**Petroleum group**	**MT**	**2,581.4**	**431.9**	**3,383.8**	**461.2**	**802.5**	**22.8**	**31.1**	**6.8**
1.	Petroleum products	MT	1,036.6	455.8	1,768.4	452.0	731.8	72.1	70.6	-0.9
2.	Petroleum crude	MT	1,544.8	417.2	1,615.4	471.8	70.7	-7.5	4.6	13.1
D.	**Textile group**	**MT**	**230.5**	---	**206.0**	---	**-24.6**	---	**-10.7**	---
1.	Synthetic fibre	MT	98.3	1,587.1	89.4	1,977.2	-8.9	-27.0	-9.0	24.6
2.	Synthetic & artificial silk yarn	MT	112.5	1,517.4	93.9	1,540.1	-18.6	-17.8	-16.5	1.5
3.	Worn clothing	MT	19.8	330.3	22.7	339.5	2.9	11.6	14.7	2.8
E.	**Agricultural and other chemicals**	**MT**	**1,884.8**	---	**1,509.0**	---	**-375.8**	---	**-19.9**	---
1.	Fertilizer	MT	375.2	279.0	155.8	314.1	-219.5	-63.1	-58.5	12.6
2.	Insecticides	MT	67.7	3,409.4	43.3	3,600.4	-24.3	-39.3	-35.9	5.6
3.	Plastic materials	MT	428.6	1193.5	398.6	1,359.7	-30.0	-18.4	-7.0	13.9
4.	Medicinal products	MT	140.1	31485.3	130.0	3,097.2	-10.1	-11.7	-7.2	5.1
5.	Others	--	873.2	---	781.3	---	-91.9	---	-10.5	---
F.	**Metal group**	**MT**	**737.3**	---	**582.1**	---	**-155.2**	---	**-21.0**	---
1.	Iron and steel scrap	MT	139.6	250.3	85.2	294.7	-54.4	-48.2	-39.0	17.7
2.	Iron and steel	MT	551.5	488.2	439.7	652.0	-111.8	-40.3	-20.3	33.6
3.	Aluminum wrought & worked	-	46.2	-	57.2	---	11.0	---	23.8	---
G.	**Miscellaneous group**		**242.4**	---	**242.3**	---	**-0.1**	---	**-0.1**	---
1.	Rubber crude	MT	44.6	1,190.8	44.4	1,207.2	-0.3	-2.0	-0.6	1.4
2.	Rubber tyre & tubes	No.	70.1	21.1	63.4	33.1	-6.6	-42.2	-9.5	56.7
3.	Wood & cork	--	14.9	---	14.6	-	-0.4	---	-2.4	---
4.	Jute	MT	14.7	329.3	14.7	404.2	0.0	-18.8	-0.3	22.7
5.	Paper paper board & manufactures	MT	98.1	708.9	105.2	763.0	7.2	-0.3	7.3	7.6
H.	**Others**		**1,713.7**		**2,601.8**		**888.1**	---	**51.8**	---
	Total imports:		**11,176.2**		**12,333.8**		**1157.6**		**10.4**	

Going forward, along with the petroleum products, machinery imports on account of expansion in the power generation capacity, and imports of textile related inputs like cotton and textiles chemicals would continue to exert pressure on imports.

Food Group

The food group imports declined by 5.9 percent during Jul-Nov FY07 as against a strong growth of 59.0 percent in the same period last year. Imports of this group demonstrated a mix trend during the period, with wheat (un-milled), sugar, and dry fruits recoding substantial decline. Sugar imports probably declined due to large domestic stocks and prospects of a substantial rise in production following a good sugarcane harvest in FY07. As a result, the share of this group's imports in the total imports decreased to 6.1 percent during Jul-Nov FY07 from 7.1 percent in the same period of last year.

Machinery Group

Against the extraordinary 71.1 percent YoY increase during Jul-Nov FY06, the machinery group imports recorded a nominal growth of 2.3 percent during the corresponding period of FY07.

Resultantly, the group share in the total imports has decreased to 24.8 percent during Jul-Nov FY07 from 26.7 percent during Jul-Nov FY06. While the textile, railway vehicles, and road motor vehicles show decline in imports during Jul-Nov FY07, the nominal growth in the imports appears to be largely due to one off items of aircraft ships and boats, which show 144.5 percent growth during the period. (see **Table 6.11**)

Table 6.11: Analysis of Machinery Imports (Jul-Nov)

	FY06		FY07	
	Share	**Growth**	**Share**	**Growth**
Machinery group		**71.1**		**2.3**
Power generating machinery	7.0	48.1	8.1	17.7
Office machinery	3.7	25.9	4.0	9.8
Textile machinery	11.8	7.4	7.6	-34.0
Construction & mining machinery	2.1	-0.7	2.1	1.2
Electrical machinery & apparatus	6.4	83.3	8.1	29.5
Telecom	1.6	127.0	0.7	-57.5
Road motor vehicles	19.2	80.6	17.2	-8.3
Aircraft, ships and boats	1.4	35.7	3.4	144.5
Agricultural machinery & implements	2.0	256.4	1.9	-0.1
Other machinery	44.8	111.0	47.0	7.3

Besides this one off item, power-generating machinery, electrical machinery, apparatus, and the office machinery also contributed positively to the group's import growth.

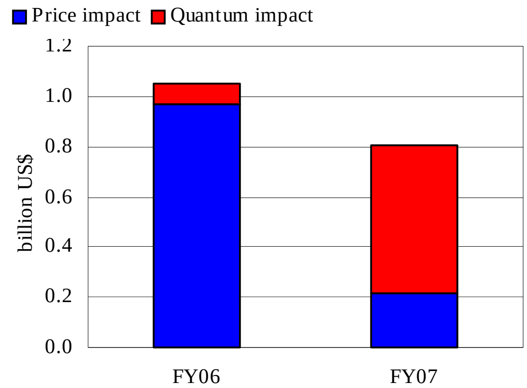
After depicting strong import growth of 80.6 percent during Jul-Nov FY06, the road motor vehicles imports declined by 8.3 percent during the corresponding period of FY07. However, almost the entire decline in the imports in this category was contributed by a fall in the imports of Completely Knock Down (CKD) or Semi Knock Down (SKDs) kits; in contrast, imports of Completely Built Units (CBUs) rose by 34.0 percent during Jul-Nov FY07. Within CBU imports, the entire increase was contributed by the motorcar imports. However, anecdotal evidence suggests that surge in the demand of imported cars has also eased, and the contribution to import growth could fall in months ahead.

The telecommunications equipment imports depicted an increase 17.2 percent YoY during Jul-Nov FY07 against an extraordinary import growth of 253.8 percent in the same period of last year. The decline in imports of transmission apparatus was the dominant factor behind the group imports slowdown.

Petroleum Group

The petroleum group imports portrayed a relatively low growth of 31.1 percent YoY during Jul-Nov FY07 as compared to the robust import growth of 68.7 percent YoY in the same period of the pervious year. Unlike the Jul-Nov FY06 period, when the increase in these imports was largely driven by the rising prices (up 90 percent), the rise in these imports during the corresponding period of FY07 was largely contributed by the rising export volumes (up 63.4 percent YoY see **Figure 6.17**). Within the group, almost the entire increase was contributed by the petroleum products imports as the petroleum crude imports increased by only 4.6 percent during Jul-Nov FY07. This was principally because of prevailing low prices of refined products, which were lower than the cost of crude petroleum.

Figure 6.17: Rise in Petroleum Group Imports (Jul-Nov)

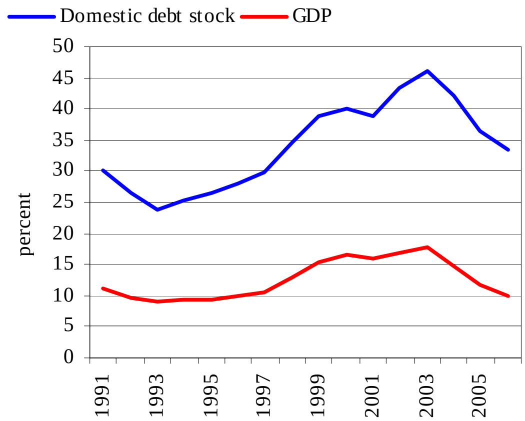


Metal Group

During Jul-Nov FY07, the metal group imports declined by 21.0 percent on account of the lower imports of iron and steel and iron and steel scraps. The imports of iron & steel and iron & steel scraps declined, due to increased domestic production of steel. Anecdotal evidence also suggests that there are stocks available that were imported before the recent hike in the international metal prices. If correct, metal imports could rise in months ahead.

Special Section 1: National Saving Schemes in Pakistan

Figure 1: NSS as Percent of



Following the offer of exceptionally high (and above-market returns), the National Saving Schemes attracted significant investment throughout the 1990s. This led to a number of problems, such as: (1) a sharp rise in the government cost of financing its deficit; (2) as the instruments were available 'on tap', the flows were not predictable and made the government funding cost volatile;[1] (3) the inherent volatility in these flows, and consequent uncertainty over the government funding requirement from the banking system added difficulty in formulating stable monetary policies; (4) the administered nature of NSS profit rates was a major source of distortion in the term structure of interest rates;[2] (5) as these instruments were not traded (i.e., price discovery was not possible), these did not form benchmarks for corporate debt; and finally (6) the implicit put option (the bonds could be substituted at any time) meant that corporate issues would have to be priced at much higher yields to compete with NSS instruments. In effect, this ensured that the domestic debt market would remain moribund.

In the light of these issues, the government finally initiated NSS reforms in 2000 and onwards: (1) in March 2000, government barred all types of institutional investment in NSS; (2) in the same year, government issued the long-term debt instrument, i.e., Pakistan Investment Bonds (PIBs);[3, 4] and finally, (3) the government linked the NSS rates with the rates on PIBs.

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[1] This could theoretically even lead to a situation where a sharp increase in relatively expensive NSS finance could compel government to retire its relatively cheaper bank credit.

[2] The differential between the returns on bank deposits and the NSS, in addition to tax free status of NSS profit and 'implicit put option', had led to massive dis-intermediation in the economy and weakening of SBP's role as a monetary authority.

[3] In December 2000 government issued the 3-, 5- and 10-year Pakistan Investment Bonds (PIBs) and effectively extended the yield curve to 20-years in January 2004.

[4] It was also likely that resources mobilized through PIBs would be used to mitigate the impact of expected large maturities of NSS instruments in the absence of institutional investment. In fact, the

While the NSS rates were related to the PIB rates, the linkage was weak due to considerable lags in the adjustment of rates of return.[5] In a falling interest rate scenario, rate of return on NSS instruments becomes relatively attractive,[6] but becomes less so when rates are expected to rise.

Thus, as a result of the combined impact of the ban on institutional investment, fall in returns on NSS and checks on arbitrage opportunities, the growth in NSS investments fell and eventually became negative in FY05. Thus, the need to fund NSS outflows put further pressures on the budget financing.

In the meanwhile, the long-term issues by the government were few and of limited size (except for Jumbo issues of FY05). It appears that the government was reluctant to increase long-term interest rates inline with market expectations (probably to reduce the cost of its borrowing). In fact, the lack of government's enthusiasm to borrow through PIBs was evident even when the short-term interest (in T-bills auctions) stabilized and market interest in the long-term paper re-emerged in FY06.[7] It seems that the government's apparent objective of reducing interest cost (even at the cost of increased interest rate risk) triumphed over the need to develop long term debt market (and attendant gains by encouraging a vibrant institutions investors market and derivative market).[8]

Thus, the unwillingness on the part of the government to issue long-term PIBs led to a situation where the government was unable to generate sufficient resources to meet upcoming large NSS maturities. Furthermore, since PIBs provided a much needed funds to the government for the financing of its budgetary gap (particularly in the face of net outflows under NSS), the limited supply of PIB issues unnecessarily increased the government's reliance on the short-term bank borrowings, particularly from the central bank. Indeed, the rise in government borrowing from the central bank in FY06 essentially mirrors the net maturities of long term FIBs/PIBs.

PIBs, particularly 10-year bonds were successful as the major demand came from maturities of (10-year maturity) Defense Saving Certificates issued by NSS.

[5] NSS rates are reviewed on half yearly basis; once in January and then in July every year.

[6] It was one of the reasons that despite restriction on institutional investment in NSS, inflows remained strong in this scheme during FY02 and FY03 reflecting mainly the arbitrage opportunities that emerged as an outcome of wide interest rate differential between NSS rates and banks' lending rates on loans secured against NSS instruments.

[7] Only one auction with a target of Rs 10 billion was conducted during the year.

[8] This is also evident from the pace of reforms (aimed at strengthening institutions such as Employees Old Age Benefit Institutions (EOBI), Provident funds, insurance companies) which remained very gradual.

Indeed even the limited reforms of the late 1990s and early 2000 in NSS have not been sustained. Instead, the government chose to increase the non-bank borrowing by removing the restriction on institutional investment in NSS.

Nonetheless, this decision is a major policy reversal and has significant implications for the banking industry and domestic debt market. It is likely that, over time, institutional investors would prefer the NSS instruments over terms deposits with banks as NSS instruments are risk free, and have implicit put option, i.e., institutions can avoid revaluation losses under rising interest rate as these instrument can be easily liquidated and reinvested at higher yields. Thus, institutional investment in NSS will shift medium term funds away from the banking sector, which in turn may exert an upward pressure on market interest rates. Further, this also has implications for the volatility in government funding cost and expectations for interest rate changes.

This decision also has significant implications for the development of long-term debt market. As mentioned earlier, facilitating growth of long-term debt market was one of the key motives for putting ban on institutional investment in NSS as this was likely to shift institution's demand for long-term debt instruments[9] towards private corporate sector bonds [10] and long-term financing products by banks. Thus, the removal of ban on institutional investment in NSS, not only restricts the development of long term products by banks but also adversely impacts the corporate debt market.[11]

Ostensibly, one of the motives for this decision was to reduce the government reliance on borrowing from the central bank. It can however be argued that the dependence on SBP borrowings would have been reduced even by frequent issues of tradable instruments (such as PIBs) which would have also acted as a benchmark for corporate debt.

In conclusion, the decision to re-allow institutional investment in NSS is a setback to financial sector reforms. Further, there is a risk that this decision will not add substantially to an immediate increase in NSS net receipts even as it hurts the prospects of developing the domestic debt market.

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[9] The government had already stopped issuing the long-term Federal Investment Bonds in June 1998

[10] NSS instruments had been offering zero risk yields that were much higher than corporate borrowing rates. On the other hand, issuance of corporate bonds involved relatively high issuance and taxation costs.

[11] Efforts to develop long-term debt market get set back due to limited issues of long-term PIB instruments during FY05 and FY06 that rendered benchmark rate for longer-end of the yield curve non-representative.

Special Section 2: The Role of ICTs in Growth & Poverty Alleviation
The world today is revolutionized by information technology. It plays a key role in every sector, be it economic or social. This section discusses how Information & Communication Technology (ICT) contributes towards poverty alleviation and overall growth of the economy. ICT-based initiatives are only a tool that will be effective to pace up the process of poverty reduction; though given an environment of prudent policies and careful management according to the requirements of the economy. A few success stories and major government initiatives for Pakistan also form part of the discussion.

1.1 Introduction
Information and Communication and Technology (ICT) commonly refers to the newer technologies of computers, internet and phones and also believed to incorporate media such as radio, television and libraries, due to their role in the transmission of information. The Information Society represents an era where productivity and competitiveness for firms, regions and countries depend more than ever on information. Its creation, processing and dissemination are the most significant economic activity of today's global economy. In his works of 1969 Peter Drucker identified knowledge as foundation of the modern economy, and a shift from a goods' economy to a modern economy. ICTs have been the leading enabler of this transformation.

In order to better understand the impact of ICTs on Growth and Poverty Reduction it is important to understand the channels through which ICTs shape an economy. The two major channels are as follows;

1. **ICT-as a sector of the economy:** ICTs as an industry and its value addition to other industries contribute towards the growth of the economy at large.

2. **ICT-as enabler of socioeconomic development:** ICTs enhance the social impact of developmental projects. This facilitating and enabler role becomes apparent by looking at the following sub-categories
    - ICTs aid in enhancing human productivity and creating resource efficiencies by extending tools for optimizing contribution.
    - By providing access to information and shrinking time and space ICTs have opened up a wide new range of opportunities for their users.

However, the impact of ICTs in a country or a region depends on its nature, the purpose of its deployment and spatial spread, besides the economic, administrative and social environment backing up the strategy of its diffusion.

1.2 ICTs a Catalyst for Growth:
A historical correlation exists[1] between higher rate of economic growth and technological innovation. The real contribution of ICTs remained debatable till recently when computers themselves enabled researchers to analyze large amounts of data, providing some more definitive answers (see **Box 1** for success stories). Current world economic growth is primarily driven by innovation in processes, value chains and business models. Services have become a major part of economic activity and an increase in production is paramount for competitiveness.

Box 1: Success Stories

- Microfinance is an important tool for helping the poor. Smart card technology is helping Swayam Krishi Sangam(SKS), a microfinance institution in Andhra Pradesh in India to reduce transaction costs. IT has been a solution to high cost of delivery, with potential savings of 18 percent in SKS operations.
- 'Auto Bank E' of South Africa has developed a fully automated saving system aimed at poor depositors. An account can be opened with only US$8 and provides customers with a range of electronic banking services. The system is highly popular with 2.6 million depositors and 50,000 more being added each month.
- Naushad Trading Company; Kenya, a producer of wood-carvings, pottery and baskets saw its revenues growing from US$10,000 to over US$2 million in two years since going online.
- Chile Compra, a public online system for purchasing and hiring achieved great success since its inception in 2000. It is the largest business to business site in Chile with 900 purchasing organizations, including public services, hospitals, municipalities, universities, and the military. On an average 130,000 companies get registered each month and 70,000 business negotiations transacted. There were 270,000 operations with US$1.9 billion in transactions, reaching to US$2.5 billion in 2005.
- Chile's Inland Revenue's site launched in 1995 was a big success. Over 96 percent of Chilean taxpayers pay their income taxes through the internet. This has also led to high taxation compliance in the country.

Recent econometric studies have found strong evidence of a causal link between telecommunication development and economic growth. According to a study in 2002 on "Elasticity of Productivity with respect to Information Technology (IT)" by Kevin Stiroh[2], IT appeared to be strongly associated with higher firm level productivity. His research results showed that doubling the IT capital stock led to a 5 percent rise in productivity. Despite this relationship, various studies highlight huge variations in the average impact of IT on firm productivity. One of the significant reasons for this variation is the different environment into which IT is introduced.

[1] The Global Information Technology Report 2005-06, Leveraging ICT for Development, World Economic Forum.
[2] Federal Reserve Bank of New York.

The International Monetary Fund (IMF) noted[3] that between 1995 and 2000, ICTs contributed to an average increase in total factor productivity (TFP) growth of about one-third of a percentage point per year in industrial countries and that the contribution of ICTs can be significant to productivity growth in Asian economies as well. Within this background, India introduced major reforms that led to a dramatic increase in IT's growth from 3 percent per annum in 1991 to the present[4] average of 6.1 percent annually

Moreover, India is operating the largest[5] telecom network in Asia and is the 10th largest in the world measured in terms of number of phones. The annual growth rate of India's software exports has been consistently over 50 percent since 1991 and the revenue has increased from US $150 million in 1991-92 to over US $2.15 billion in 2003-04. The country has been able to expand its industry-related employee base to over one million in 2004-05. While many have benefited from the use of ICTs, Pakistan was a little late in joining the bandwagon. However the current regime, realizing this lag, has undertaken various initiatives to gain from opportunities offered by ICTs.

Table 1: Pakistan ICT Competitiveness FY06

Networked readiness index rank	67
Environment component index	76
Market environment	58
Political & regulatory environment	79
Infrastructure environment	101
Readiness component index	67
Individual readiness	79
Business readiness	73
Government readiness	41
Usage component index	61
Individual usage	109
Business usage	64
Government usage	35

Source: The Global Information Technology Report 2005-06

According to Networked Readiness Index (NRI) [6] of FY06, Pakistan has been ranked[7] 67th amongst the group of 115 countries. Though this is an improved position as compared to 76th in FY 04 amongst the group of 102 countries, still the penetration of ICTs in the economy remains low. Detailed analysis of the index explains that the penetration of ICTs is the lowest in the government's category as indicated by

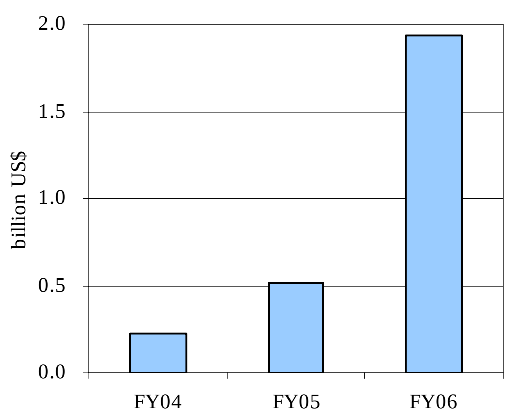
[3] The Global Information Technology Report 2005-06, Leveraging ICT for Development, World Economic Forum.
[4] Uptill 2005-06
[5] Source: www.indiacore.com
[6] NRI is benchmark of the overall success of a country in participating and benefiting from ICT. This index is the combination of three indices i.e. Environment, Readiness and Usage.
[7] The Global Information Technology Report (2005-06), Leveraging ICT for Development, World Economic Forum

Government Readiness and Government Usage (see **Table 1**) while Individual Usage (109th position) of ICTs is substantial. The position of the country in the category of Infrastructure Environment (101st position) represents a conducive environment for penetration of ICTs into the economy.

Better position of Infrastructure Environment can be associated with significant growth of the IT sector over the last five years. An integrated IT policy focusing on human resource, infrastructure, and software industry development was implemented in August 2000.

Investment incentives like income tax exemption for 15 years on income from export of software, zero custom duty on imports of software and hardware were introduced. Exporters can now retain 35 percent of foreign exchange earnings, and have a permission of opening Internet Merchant Account[8]-a move to promote e-commerce. Regulations are being legislated for venture capital companies and funds. Pakistan Software Export Board (PSEB) has been established to ensure the developments and implementation of a national policy framework. Telecom Deregulation Policy and Cellular Phone Policy were announced in 2003 and 2004 respectively. To enhance the rural Teledensity and to provide basic telecom services to under and un-served area of the country, the government has brought legislation for developing Universal Service Fund (USF) framework.

Figure 1: Trends of FDI in Communication



A considerable rise in foreign direct investment (FDI) can be observed in IT sector as a result of a conducive and liberalized environment in the country. FDI has jumped (see **Figure 1**) from US $ 0.22 billion in FY04 to US $ 1.94 billion in FY06. Global System for Mobile Communication (GSM) [9] Association has awarded Pakistan its prestigious Government Leadership Award for introducing successful reforms in the country's telecommunication sector. Mobile phone

[8] State bank has granted this permission.
[9] GSM is the global trade association that exists to promote, protect and enhance the interests of mobile operators globally.

subscribers have shown a growth of 98 percent over the last five years and reached 16 million in FY05 from almost 0.3 million in FY00. Teledensity has been improved from 2.4 percent in FY00 to 13.7 percent in FY05. Internet users at growth rate of 76 percent increased over 2 million in FY05 as compared to 0.5 million (see **Table 2**) in FY00. Given these positive trends, there is still room for Pakistan to explore various dimensions of ICTs leading towards economic growth and poverty alleviation.

Table 2: Penetration of ICTs

Years	No. of payphone companies	Internet users (millions)	Cellular subscribers (millions)	FL+WLL subscriber (millions)	Total density (percentage)*
2000	32	0.5	0.3	3.1	2.4
2001	64	0.8	0.7	3.3	2.8
2002	99	1	1.7	3.7	3.7
2003	164	1.6	2.4	4.0	4.3
2004	281	2	5.0	4.5	6.3
2005	364	2.1	12.8	5.5	11.89

* Teledensity is for Fiscal Year

Source: Pakistan Telecommunication Authority(PTA) Web site

1.3 ICTs a Tool for Poverty Alleviation:

Poverty is generally understood as individuals living below subsistence income levels. According to this definition, the World Population Data Sheet[10] 2006 report that of the world's 6555 million people, 3474 million are living below the poverty line of US $ 2 per day with 36 percent residing in South Asia. Over time policy makers have broadened the definition of poverty by including in it the state of malnutrition, lack of shelter and inaccessibility to health and education services, unemployment, powerlessness and lack of freedom. According to this redefinition, the figure for the world's poor population has automatically become greater than the above mentioned number.

Many would argue that lack of access to ICTs is not as serious as malnutrition, inadequate shelter, access to medical facilities and clean drinking water- the basic survival needs. However the majority now believe that ICTs have the potential to enable countries that missed out on opportunities of agriculture and industrial revolutions, leapfrog stages of growth. Now the establishment of the World Summit on the Information Society (WSIS) would help in mainstreaming of ICTs

[10] World Bank Publication

for development that would help to curtail excessive enthusiasm and skepticism for ICTs.

ICTs can play an effective role in poverty alleviation but reducing poverty through ICTs is not guaranteed. ICTs can enhance poor people's opportunities by improving their access to markets, health care and various government services. Progressive technologies not only contribute towards a pro-poor growth by increasing production in IT sector (as a sector of economic activity) but also through their strategic use in others areas (as an enabler for enhancing Human Productivity & the Choice of opportunities). The Millennium Declaration 2000; a unanimous resolution adopted by the world community against poverty, has also highlighted the importance of ICTs towards poverty alleviation by making it a part of the Millennium Development Goals (MDGs)[11]. Few countries[12] have defined ICTs as a strategic component of poverty reduction and refer to it as an independent item in their PRSPs. Although most countries have not included ICTs as an independent strategic component, but they still refer to the telecommunication sector development as a major contributor towards the growth of the economy.

ICTs can facilitate achieving of MDGs by enhancing livelihoods, optimizing delivery of services, and empowering the local in planning processes e.g. Major ICTs based reforms in Chile have reduced the percentage of people below poverty line from 40 percent[13] to 17 percent. Similarly continuation of prudent policies in Taiwan over the last few decades, have resulted in a dramatic reduction in poverty and the country joining the ranks of progressive competitive economies.

The use of technology for poverty reduction varies from country to country depending upon country's limitation towards implementation of modern technology. Pro-poor ICT policy demands for a greater investment on infrastructure development which complements already prevailing flow of infrastructure to have a multiplying effect of technology and modernism on poverty reduction and growth. However, most of the developing countries[14] lack resources and are unable to direct sufficient funds for infrastructure development and thus remain short of exploiting the true potential of ICTs. With these obstacles, developing countries can depend mainly on widely available technology

[11] Goal 8,Target 18, "to make available the benefits of new technologies, especially information and communications"

[12] 12 out of the 29(Aug'2003)

[13]By 2005 Chile was able to increase its foreign direct investment to US $ 74.6 billion, an 88.5 percent increase as compared to the beginning of 1990s.

[14] With larger number of poor population

like television and radio that can reach a larger portion of population at relatively lower cost. Moreover the use of technology like television and radio requires very low level of skills and in this way also covers the hurdle of low literacy in developing countries. **Box 2** provides an insight of few international success stories where developing countries have adopted traditional technology depending upon their resources and economic growth to improve the socio-economic conditions.

1.3.1 ICT's Based Initiatives in Pakistan:

The Pakistan government widely recognizes the role of ICTs and is adopting the policies to maximize the benefit from them. ICTs are being used for human development with their penetration in education, health and employment. However, a matter of concern remain that ICTs require prudent policies and careful project designing, because even if IT infrastructure reaches the poor there is no assurance that they are going to access or benefit from it. The government of Pakistan is trying to enhance the coverage by offering maximum possible opportunities in almost all major sectors of the economy. Following are the major initiatives taken by the government to capture all the possible aspects of poverty (see **Box 2** for International stories).

Pakissan (www.pakissan.com) is the first portal of its kind providing comprehensive information about agriculture in Pakistan in both the languages English and Urdu as larger portion of population linked to this profession is not highly educated. This portal does not only act as a point of contact for farmers and the communities related to agriculture but also provides useful information like corporate financing techniques and marketing techniques. Moreover this information portal contains the details of all government rules, policies, procedures and incentives to facilitate the farmers. However, lack of infrastructure limits the scope of this kind of projects.

The government is trying to increase e-commerce business revenues. In this regard the most significant step is the establishment of Pakistan's first B2B (business-to-business) portal, "Industrial Information Network" (IIN). IIN is serving as the largest source of exchanging and disseminating business information in the country.

The major initiatives of the government in the education sector involve establishment of seven IT universities (including one virtual university as a distance learning and information portal). Allama Iqbal Open University (AIOU) is the largest distance learning institute in South Asia. IT and telecommunications ministry is in the process of making 25 existing universities specialize in IT discipline.

Considering language as the main barrier in accessing ICTs, the government is trying to introduce and develop tools like Urdu fonts, proprietary software for Urdu on Windows XP and commercially developed Urdu word processors. Grants have been awarded to develop software commercially in local languages.

Telemedpak, and PAkmedinet are two main websites providing telemedicine services (data bank of doctors, medicines, online consultation) to the public. In this regard, two major projects in Taxila and Gilgit are having significant impact by providing online services and are creating awareness about telemedicine. TelMEDPAK along with the help of Allahtuwakkal network (ATN) Group, is also trying to establish 50 telemedicine centers in rural areas of Pakistan

IT sector is providing considerable employment opportunities (o.68 million) in the country. Moreover the government has established an Overseas Employment Corporation (OEC) that holds a data bank of information about skilled labor force and the availability of job opportunities abroad.

ICTs have the potential of empowering people by providing them access to information. An example of this can be utilization of information kiosks at various government offices like NADRA, Passport Office providing information to the citizens. This would help masses to save money they used to end up giving to the private agents for information available to them through these kiosks.

Government of Pakistan is promoting E-Government projects to enhance public participation and make procedures more transparent. Central Board of Revenue (CBR) and the Export Promotion Bureau (EPB) have an on-line interaction with the public, providing them with necessary information and receiving feed back on government policies.

Given that ICTs bring tremendous opportunities with them, their implementation remains complicated. Infrastructure development plays a key role in the implementation of pro-poor ICT policy and like many other developing countries Pakistan is unable to dedicate required level of resources to infrastructure development. Moreover the diffusion of benefits of ICTs for poor also suffers from widespread illiteracy[15]. These problems undermine the utility of ICTs though the negative impact of all these can be minimized by exploiting benefits of

[15] 47 percent of population(2004-05) is illiterate in Pakistan

suitable technologies. Keeping these hurdles into consideration the role of widely available technologies like television and radio can help in enhancing access to information at relatively lower cost, requiring lower skills. Radio, one of the most accessible technologies[16]can be used as an effective tool making maximum population benefit from advantages of technology. Through the more readily available technologies like radio and television, government can disseminate already existing information on portals like Pakissan to a much larger segment of population. This does not undermine the potential of new technologies like computers and internet however reinforces the pragmatism and adaptability required in technology transfer and its utilization in developing nations.

1.4 The Way Forward

According to the International Labor Organization (ILO), ICTs have the potential to contribute towards socio-economic development but investment in them alone is not sufficient for development. Technology is just a tool for development not a goal. It is vital for people involved in developmental work to consider ICTs as a means for achieving development and not as an end in itself. An integrated approach having a focus beyond technology; including contemporary and earlier ICTs- radio in particular - can add in poverty eradication. Prudent policies, careful planning, government support and community participation are necessary for any ICT-based initiative to reduce poverty. The debate has now moved from substituting to complementing, therefore rather than making choices, ICTs should be used to lift people from the slums. There is a dire need to capitalize on the true potential of ICTs in areas of economic growth, empowerment, education, health, and environment. Lack of resources should not become an impediment in using ICTs to improve socio-economic conditions. The government should follow a pragmatic approach and use all available technologies for growth enhancement and poverty reduction. Pakistan has taken steps in the right direction; however it has an extra mile to go.

[16] Radio is the cheapest form of mass media, can easily penetrate into remote geographical regions and does not require high level of skills or education as well

Box: 2 Role of ICT in Poverty Alleviation

Education

- In China where only one out of 20 young people receive higher education, distance learning has facilitated the education process and provided access to the masses because traditional universities can not meet the demand. China Central Radio and Television University has 1.5 million students and lectures are broadcasted through radio and television.
- In Mexico over 700,000 secondary school students in remote villages have access to the *Telesecundaria Program*. Based on comprehensive course curriculum, lectures are delivered through close-circuit television, and teleconferencing between students and teachers.
- Committee to Democratize Information Technology (CDI) of Brazil has created 110 sustainable self managed community-based schools. These schools with limited funds and voluntary assistance train more than 25,000 young students per year in ICT skills which provides them better opportunities for jobs.
- Distance learning based National Open University of Taiwan was able to reach 30 percent more students than the National Taiwan University while spending less than one third of its budget.

Health

- Radio-based awareness is increasingly playing a crucial role in the fight against HIV/AIDS, tuberculosis and other diseases.
- In Andhra Pradesh India, handheld computers have enhanced auxiliary nurse midwives efficiency by eliminating cumbersome data entry and related paper work. One nurse is generally responsible for 5,000 people's immunization, family planning, and mother child education. Handheld computers have approximately reduced the time spent on these activities by almost 40 %.
- In Ginnack a remote island village on the Gambia river nurses use digital camera to take pictures of symptoms for examination by a near-by doctor. Data such as X-rays are compressed and sent to various parts of the world for a more specialized opinion.
- ICTs played an important role in the creation and implementation of programs to control river blindness in West Africa. Data collected along the 50,000 km of rivers with aid of sensors was fed into the computers and beamed to a network of entomologists by satellite radio. These efforts have protected 30 million rural people and eliminated river blindness in seven countries.

Employment:

- ILO notes that some developing countries have been able to create employment for thousands of women and men through community access points and telecentres. A group of ladies in Kizhur village Pondicherry established an incense-sticks firm. Initially they started of as subcontractors however their confidence grew by utilizing a telecentre. By acquiring necessary skills today they are seeking more distant clients using the telecentre.
- Grameen Bank in Bangladesh has provided around 1,100 telephones to the rural poor women through micro credit loans. These women are now making profit by reselling airtime to the others in village.
- ICTs empower small farmers and artisans in the rural areas. In Gujarat India computerized milk collection centers with integrated electronic weights, fat testing machines and plastic card readers ensure fair prices to the dairy farmers. Because of the new system farmers now not only benefit from a more transparent and efficient system but are also paid on the same day of delivery as compared to the earlier 10 days wait period.
- In Ghana radio the cheapest form of mass media has helped farmers increase their revenues and improve their farming practices by making information on regional market developments accessible to them.

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Acronyms

ABL	Allied Bank Limited
ADB	Asian Development Bank
AIOU	Allama Iqbal Open University
ATN	Allahtuwakkal Network
bfcd	billion cubic feet per day
BoP	Balance of Payments
CBs	Commercial Banks
CBR	Central Board of Revenue
CBU	Completely Built Units
CDI	Committee to Democratize Information Technology
CFS	Continuous Funding System
CKD	Completely Knock Down
CLCV	Cotton Leaf Curl Virus
CPI	Consumer Price Index
CRR	Cash Reserve Requirement
DAP	Di-Ammonium Phosphate
D-D	difference and difference
DMBs	Deposit Money Banks
DPBs	Domestic Private Banks
EFS	Export Finance Scheme
ECC	Economic Co-ordination Council
EOBI	Employees Old Age Benefit Institutions
EPB	Export Promotion Bureau
EU	European Union
FBS	Federal Bureau of Statistics
FCAs	Foreign Currency Accounts
FDI	Foreign Direct Investment
FDP	Federal Divisible Pool
FECs	Foreign Exchange Companies
FE-25	Foreign Exchange Cir.No.25
FIBs	Federal Investment Bonds
FY	Fiscal Year
GDP	Gross Domestic Product
GDR	Global Depository Receipts
GSM	Global System for Mobile Communication
GSP	Generalized System of Preferences
GST	General Sales Tax
HRI	House rent Index
HBL	Habib Bank Limited

ICT	Information & Communication Technology
IDA	International Development Agency
IDB	Islamic Development Bank
IIN	Industrial Information Network
IIP	Index of Industrial Production
ILO	International Labor Organization
IMF	International Monetary Fund
IT	Information Technology
KESC	Karachi Electric Supply Corporation
KIBOR	Karachi Inter Bank Offer Rate
LIBOR	London Inter Bank Offer Rate
LCVs	Light Commercial Vehicles
LSM	Large Scale Manufacturing
LTF-EOP	Long Term Finance-Export Oriented Project
MAF	Million Acre Feet
MDGs	Millennium Development Goals
MFA	Multi Fiber Agreement
MNCs	Multi National Corporations
MoM	Month on Month
NADRA	National Database and Registration Authority
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
NRI	Networked Readiness Index
NSS	National Savings Scheme
OEBs	Outstanding Export Bills
OEC	Overseas Employment Corporation
OIN	Other Items Net
OMOs	Open Market Operations
PAMA	Pakistan Automotive Manufacturers Association
PARCO	Pak-Arab Oil Refinery Company
PESRP	Punjab Education Sector Reforms Program
PIBs	Pakistan Investment Bonds
POL	Petroleum, Oil and Lubricants
PPCBL	Punjab Provincial Cooperative Banks limited
PSEs	Public Sector Enterprises
PSEB	Pakistan Software Export Board
PSLM	Pakistan Social and Living Standards

PTA	Pakistan Telecommunication Authority
PTCL	Pakistan Telecommunications Company Limited
Pvt.	Private
REER	Real Effective Exchange Rate
rhs	right hand side
RPI	Relative Price Index
SBP	State Bank of Pakistan
SKD	Semi Knock Down
SMEs	Small and Medium Enterprises
SPI	Sensitive Price Index
STARR	Sales Tax Automated Refund Repository
TCP	Trading Corporation of Pakistan
TFCs	Term Finance Certificates
TUFTS	Technology Up-gradation Fund Scheme
UAE	United Arab Emirates
UBQI	User Based Quantum Index
UK	United Kingdom
USA	United States of America
USF	Universal Service Fund
WAPDA	Water and Power Development Authority
WPI	Whole Price Index
WSIS	World Summit on Information Society
YoY	Year on Year
YTD	Year to Date
ZTBL	Zarai Taraqiati Bank Limited

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