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THE STATE OF PAKISTAN'S ECONOMY
Third Quarterly Report for FY08

1.1 Economic Outlook

Pakistan's economy is showing increasing signs of stress by April 2008. A combination of adverse domestic and international developments is driving a broad deterioration in key macroeconomic indicators (see **Table 1.1**). Real GDP growth in FY08 is expected to drop below the 6 percent level for the first time in five years, annual inflation is poised to return to double digits, the fiscal deficit is forecast to rise substantially, and the annual current account deficit, as a percentage of GDP, is projected to be at an all-time high (see **Table 1.2**). The weakness in the external account is also reflected in weakening foreign exchange reserves (and a 7.3 percent YTD depreciation of the rupee by the first week of May 2008).

Table 1.1: Selected Economic Indicators

		FY06	FY07	FY08
	Growth rate (percent)			
LSM	Jul-Mar	8.0	9.0	4.8
Exports (fob)	Jul-Apr	17.2	2.9	10.2
Imports (cif)	Jul-Apr	40.4	8.9	28.3
Tax revenue (FBR)	Jul-Apr	21.3	20.0	16.3
CPI (12 month MA)	Jul-Apr	8.2	7.8	9.8
Private sector credit	Jul-10th May	19.9	12.5	14.9
Money supply (M2)	Jul-10th May	12.3	14.1	9.0
	billion US dollars			
Total liquid reserves[1]	end-Apr	13.1	13.7	12.3
Home remittances	Jul-Apr	3.6	4.5	5.3
Net foreign investment	Jul-Apr	4.0	5.9	3.6
	percent of GDP[2]			
Fiscal deficit	Jul-Dec	1.8	1.9	3.6
Trade deficit	Jul-Apr	7.5	7.8	10.7
Current a/c deficit	Jul-Apr	3.1	4.6	7.0

1. With SBP & commercial banks.
2. Based on full-year GDP in the denominator. For FY08 estimated full-year GDP has been used.

However, despite the deterioration, it is also important to note that as a result of structural reforms and liberalization measures over the last fifteen years, the economy has fundamentally gained resilience. This suggests that a policy focus on regaining macroeconomic stability through further reforms, and corrective measures could quickly reinvigorate the growth momentum of the economy.

The most recent data clearly indicates that the slowdown in the economy during FY08 is principally in the commodity producing sectors. For example, the disappointing performance of important major crops contributed significantly to slowdown in agricultural growth during FY08. This sector is globally vulnerable to weather conditions, but in Pakistan farmers also suffer from policy risk in the pricing of agri-produce, insufficient regulation on quality of inputs (pesticides,

seeds, etc.) and poor infrastructure (for water management, storage and processing facilities as well as lack of farm-to-market roads, etc.). Similarly, facilitation of institutional credit, as well as risk mitigation for farmers through active futures market and crop insurance, can allow a substantial increase in value-addition. Policy focus on the above areas can thus yield relatively quick returns in the form of higher productivity and lower post-production losses. Moreover, given that Pakistan is already a low-cost producer of many agri-commodities, and that international commodity prices seem likely to remain strong for years to come, agri-reforms offer broad-based gains in terms of income generation (and poverty reduction), support for lowering inflation, and higher exports. Interestingly, strategies to increase yield in agriculture also offer benefits for industry, raising hopes of low price inputs, and creating room for downstream value-added investment. This would also help diversify the country's manufacturing and export base, thus reducing output volatility.

Table 1.2: Projections of Major Economic Indicators

		FY08	
	FY07 P	**Original target**	**SBP projections**
Growth rates (percent)			
GDP	7.0	7.2	5.5 - 6.0
Inflation	7.8	6.5	11.0 - 12.0
Monetary assets (M2)	19.3	13.7*	17.0 - 19.0
billion US dollars			
Exports (fob-BoP data)	17.1	18.9	19.9
Imports (fob- BoP data)	27.0	29.6	34.0
Exports (fob-customs data)	17.0	19.2	18.3
Imports (cif-customs data)	30.5	32.3	39.0
Workers' remittances	5.5	5.8	6.2 - 6.7
percent of GDP			
Budgetary balance	-4.3	-4.0**	(-)6.5 – (-)7.0
Current account balance@	-5.3	-5.0	(-)7.3 – (-)7.8

*Announced in MPS Jul-Dec FY08; **Budget estimates.

@: without official transfers P: provisional

Note: Targets set by Government of Pakistan. SBP projections have been estimated outcome on the basis of information available by mid-May, 2008.

Productivity improvements can also be important in containing domestic inflation. Inflation is already a serious policy concern for Pakistan, with CPI inflation at 17.2 percent YoY for April 2008, the highest level in a month since April, 1995. At least a part of this is driven by domestic supply-shocks that have compounded the impact of strong aggregate demand, and high international commodity prices. The latter, in particular have continued to rise, and the pass-through to the domestic consumers is increasing; administered prices are increasing, wages are facing upward pressure, and imported inflation is on an uptrend. This clearly indicates that restoring price stability in the short-run may prove challenging. Even fiscal measures (tariff cuts and subsidies), aiming to at least

partially protect the broad populace from rising food and energy commodity prices, are likely to prove unsustainable, given the already large fiscal deficit. Any such measures need to be carefully targeted at only the very poor and vulnerable.

In this environment, it becomes all the more important that monetary policy be calibrated to squelch demand-led inflationary pressures in the economy. Over the last 6 months, expansionary fiscal policy has overshadowed and substantially weakened the impact of sustained monetary tightening by SBP. This impact of the heavy government borrowings has been particularly evident in FY08, with the borrowings rising to a record Rs 551.0 billion by 10th May, 2008 (compared to only Rs 45.7 billion in the corresponding period of FY07), almost doubling the total outstanding stock of borrowings to Rs 940.6 billion. This trend cannot be sustained without risking a substantial further acceleration in inflation.

In other words, the government has to urgently address the growth of the fiscal deficit as well as to diversify its financing away from the central bank. While information on fiscal developments is only available for H1-FY08, SBP assessment indicates that the Jul-Mar FY08 fiscal deficit (as a ratio of GDP) is likely to be greater than the FY07 annual figure. The new government has indicated an intention to broaden the tax base and rein-in expenditure growth in support of macroeconomic stability. It has also indicated an intention to diversify the financing of the deficit and reduce dependence on the central bank borrowings. For the economy to retain its high growth momentum, it is important that these goals are achieved.

Over time, the removal of the excessive fiscal stimulus, the increase in administered energy prices, the recent exchange rate adjustments and continued tight monetary stance[1] are also expected to help correct the substantial increase in the country's trade deficit. This correction is overdue. With food and petroleum imports constituting more than half of the rise in imports, there is a limited scope for import compression in the short-run. Moreover, it is likely that the country will need to raise imports to strengthen its infrastructure, particularly of power generation. Thus, policy focus needs to remain on addressing structural impediments to export growth in medium to long term. Typically subsidies do not incentivize efficiency, raise fiscal costs, and often lead to "gaming" to maximize rent seeking rather than increased productivity. Therefore, policies must instead

[1] Effective from May 23, 2008, SBP increased its policy discount rate by 150bps and reserve requirements by 100bps. At the same time, SBP imposed a cash margin requirement of 35 percent on selected imports. Furthermore, effective from June 1, 2008, banks are required to pay a minimum profit of 5 percent on PLS/Savings Accounts.

focus on structural reforms to reduce cost of doing business, ensure efficient provision of key inputs (water, power etc.), improvement of logistics chains, etc.

In addition significant gains in foreign exchange earnings may be achieved by boosting services exports such as IT services, tourism etc. and focusing on increasing remittances by benefitting from labor market opportunities in East Asian economies and the Middle East. Productivity gains likely to be accrued from skilled labor will have spillover effects in attracting FDI, enhancing workers' remittances as well as increasing exports of goods and services.

As of end-April 2008, the trade deficit recorded in the balance of payments has reached US$ 12.7 billion, contributing directly to the record current account deficit. The stress on the economy as a result of this has been compounded by the continuing problems in the international financial markets. While the country has largely been unaffected by the direct impact of these disruptions, investors are increasingly risk averse, with a reduction in liquidity flows to emerging economies. This makes financing the deficits more challenging.

In absence of hefty foreign investment inflows (both direct and portfolio) as evident in FY07, rising current account imbalance and weak performance of exports resulted in a depletion of foreign exchange reserves. A natural outcome of these developments is weakening of rupee against major currencies, which was further augmented due to appreciation of the US dollar in recent week.

1.2 Executive Summary

1.2.1 Real Sector

Agriculture

Recent information points to an increased risk of a decline in aggregate value-addition by important major crops in FY08 relative to the previous year. It was hoped that a wheat harvest close to the annual target would offset much of the drag from the disappointing aggregate performance of the FY08 kharif harvest. But some reports suggest that wheat production in FY08 may also turn out to be substantially below the target. If these concerns prove correct then a weak performance by major crops would drag the annual growth substantially below the annual target.

Given that commodity prices are likely to remain strong, it is imperative that policies be framed to support farmers' ability to raise productivity substantially in the years ahead. Key areas requiring policy intervention remain the transmission of price gains (establishment of futures markets), risk mitigation (crop insurance,

storage facilities), increasing investment in agri-sector infrastructure (water management, electricity, farm-to-market roads, etc.) and in value-addition chains (e.g. through processing).

The agriculture credit disbursement continued apace with its positive trends. The total agri disbursements amounting to Rs 157.6 billion during Jul-Apr FY08 - an increase of 34.9 percent YoY. The water shortage seen in rabi FY08 are likely to continue in first phase of *kharif* FY09, while improved water availability is anticipated from better monsoon rains during the second phase of *kharif* FY09 (June -September). Fertilizers off-take increased by 9.2 percent during July-March FY08.

Large Scale Manufacturing

Initial prospects of achieving a reasonable growth in LSM sector during FY08 were clouded by aggravating energy crisis coupled with high international commodity prices and political unrest through most of the year. As a result, the LSM sector posted a dismal growth of 4.8 percent in the first nine months of FY08 compared with 9.0 percent in the same period of FY07.

It appears that energy shortages had a broad-based impact on manufacturing activities. The impact was more pronounced on *metal* sub-sector which also faced a steep increase in international steel prices. Activities in *textiles* and c*hemicals* (especially caustic soda) industries were also affected by frequent energy disruptions as well as rising input cost.

Although a large number of industries (10 out of 15) delivered a weak performance; for some industries this was largely an outcome of short-term developments including poor FY08 cotton harvest (hurting textile and allied industries), political unrest through most of period (especially the economic losses in the aftermath of 27th December 2007), temporary closures of certain industrial units for maintenance and/or up-gradation (e.g., polyester fiber, paper and fertilizer), as well as power shortages (e.g., metal industries and manufacturers of caustic soda, among others).

Services

Information for the first nine months of FY08 suggests that the services sector is poised to achieve the annual targeted growth. The main contributors to this performance are wholesale & retail trade, transport storage & communication as well as public administration & defence sub-sectors. In addition, social & personal services seem well placed to contribute positively towards upbeat annual growth in services sector. However, growth in finance & insurance sub-sector

appears to slow due to weaker profitability of the commercial banks, nonetheless remain strong in FY08.

1.2.2 Prices

The impact of strong global inflationary pressures on domestic inflation has also been compounded by the adjustments of administered prices of key fuels and wheat. All price indices have moved up significantly so far in FY08 and are significantly higher than the annual averages for the preceding five years. Consumer Price Index (CPI) inflation accelerated to 17.2 percent YoY during April, 2008 contributed by both food and non-food sub-groups. In particular, CPI food inflation reached to 25.5 percent in April, 2008.

The desired impact of tight monetary stance of SBP has been neutralized by huge government borrowings. Core inflation, measured by 20 percent trimmed mean, accelerated to double digits (14.1 percent - record high level) in April 2008. Persistence of inflationary pressures is also evident from non-food non-energy (NFNE) based core inflation that increased to 10.8 percent in April 2008.

1.2.3 Money and Banking

The conduct of monetary policy has become increasingly challenging for SBP as the fiscal year has progressed, and inflationary pressures are gaining further strength.

The inflationary pressures have gained momentum, due to a number of factors, including supply shocks and continuing strong demand. The former include a sustained increase in global commodity prices (including unprecedented hikes in food and energy prices). The demand pressures, on the other hand, were mostly reflected in a sharp rise in the fiscal deficit that was largely monetized through a record increase in government borrowings from the central bank.

The pass through of high global commodity prices to domestic inflation is significant, and has increased in recent years as (a) the economy has become more open in recent years, and (b) the government began to gradually pass-on the rise in cost of key fuel (petrol and diesel), which was earlier frozen, to the domestic consumers.

Since the current higher prices in international markets are forecast to persist well above their historical averages in the foreseeable future, it is anticipated that the resulting inflationary expectations will be more lasting. There is also evidence that the erosion in purchasing power and squeeze in profit margins due to sustained increase in food and commodity prices is contributing to second round

of inflationary pressures. Without continued monetary tightening, the inflationary pressures may turn into a wage-price spiral.

At the same time, the already high fiscal deficit is not only limiting the scope for containing the pass through of global inflation through subsidies and tariff reduction, challenges for monetary policy have been compounded as the government is relying more on borrowings from the central bank – which is the most inflationary source of financing. Moreover, the liquidity injections from unpredictable government borrowings have weakened the transmission of policy interest rates to retail rates. In order to meet the above challenges, SBP is maintaining a tight monetary policy stance. However, this stance needs to be supported by fiscal prudence.

The overall credit demand is also strong despite a significant slowdown in credit growth to consumers, energy shortages and operational bottlenecks in major industries. This was mainly attributed to (1) rise in working capital requirements due to higher input costs; (2) the need for bridge financing to settle price differential claims of OMCs and IPPs; as well as (3) the higher fixed investment (visible in a few sectors, e.g. textile, refineries and power) in the month of March 2008.

1.2.4 Fiscal Developments

Although official statistics on public finance for July-Mar FY08 are not yet available, SBP forecast suggests that the budget deficit for Jul-Mar FY08 (as a percentage of the estimated FY08 GDP) is likely to be significantly higher than the full-year FY07 figure.

The growth in government revenues in Q3-FY08 is expected to recover from the low of 1.8 percent seen during H1-FY08 as: (1) FBR tax receipts, which contribute the bulk of government revenues, have increased by 31.3 percent in Q3-FY08 compared to 6.0 percent during H1-FY08, and (2) non-tax revenues have been bolstered with the disbursement of budgetary support grants of US$ 281.7 million and US$ 300 million from USA and Saudi Arabia respectively.

Government domestic borrowing during July-Mar FY08 grew strongly, reflecting a strong year-on-year increase in the deficit, and little change in external financing from FY07. Thus, with net retirements of borrowings from commercial banks and only Rs 1.7 billion in privatization proceeds (against Rs 75 billion budgeted for FY08), the government borrowings from the central bank continued to rise sharply. Indeed, incremental government borrowings from SBP as of May 10, 2008 have reached Rs 551.0 billion, pushing the outstanding stock of treasury bills

with SBP to Rs 940.6 billion. This development has significantly augmented inflationary pressures in the economy, and raised risks to macroeconomic stability.

After a sharp rise of 6.4 percent in second quarter, the growth in the domestic debt moderated to 5.5 percent in Q3-FY08. Although, government availed substantial financing from SBP in this quarter, growth in floating debt decelerated due to significant retirements by the commercial banks, resulting in a moderation in debt growth during Q3-FY08.

1.2.5 External Sector

Balance of Payments

The deterioration in Pakistan's overall balance of payment accelerated during Jul-Apr FY08. On the one hand, the current account deficit continued to expand while on the other, financial and capital account surplus shrank. Consequently, the country's foreign exchange reserves fell to US$ 11.5 billion and the rupee depreciated by 13.4 percent against US dollar by 22nd May, 2008.

A large part of the deterioration in current account deficit emanated Nov 2007 onwards on account of substantial increase in import bill. The rise in import bill, in turn, was driven by both high prices and demand factors, with former having the greater role. The rise in import bill was accompanied with rising freight charges which together overshadowed improvement in export growth and impressive increase in current transfers in the period under review.

The financial & capital account surplus declined during Jul-Apr FY08, mainly due to substantial fall in foreign portfolio investment[2], which resulted due to: (a) outflow from stock market, and (b) due to delay in floatation of Global Depository Receipts (GDRs) and (c) delay in issuance of euro bonds.

Trade Account

Pakistan's merchandise trade deficit widened to a record high of US$ 16.8 billion during Jul-Apr FY08, which is 37.8 percent higher than the annual trade deficit target. The deficit was fueled by a very strong surge in imports as well as below - target export growth. While the 10.2 percent YoY export growth during the Jul-Apr FY08 was an improvement over the previous year, it was nonetheless significantly lower than the 12.4 percent growth targeted for the period.[3] The surge in imports was caused by both higher aggregate demand and rising

[2] The foreign portfolio investment declined to US$ 118 million during Jul-Apr FY08 from US$ 1758 million in the same period of last year.

[3] The FY08 annual growth target for exports for was set at 13.1 percent in the trade policy.

international commodity prices. Growth in exports on the other hand was led by non textiles, while textile exports registered a fall in the period under review.

2 Real Sector

2.1 Agriculture Sector Performance

Recent information points to an increased risk of a decline in aggregate value-addition by important major crops in FY08 relative to the previous year. It was hoped that a wheat harvest close to the annual target would offset much of the drag from the disappointing aggregate performance of the FY08 *kharif* harvest. But some reports suggest that wheat production in FY08 may also turn out to be substantially below target. If these concerns prove correct, then the value addition by major crops would be negative during FY08 despite a record high sugarcane harvest (see **Table 2.1**). While the sector, on the whole, may post positive growth on the back of anticipated strong performance in livestock and minor crops, dismal performance by major crops would drag the annual growth substantially below the annual target.

Table 2.1: Estimation of Value Addition by Four Major Crops

	Real value addition (billion rupees)		percent growth
	FY07	**FY08**	
Rice	55.6	56.8	2.2
Cotton	93.8	84.8	-9.7
Sugarcane	44.5	50.6	13.9
Kharif sub-total	193.9	192.2	-0.9
Assumed wheat harvest (million tons**)**	**Value addition in FY08**		**Growth by 4-major crops**
	Wheat	**Major crops**	
22	147.5	339.7	-3.3
23	154.2	346.4	-1.4
24	160.9	353.1	0.5

The disappointing harvests of key cash crops are particularly troubling for Pakistan. What is worrisome is the fact that domestic producers could not take advantage of the incentive offered by record international prices for many agri-commodities, such as rice and wheat. Pakistan is a low-cost producer of many such commodities, and could, therefore have benefited substantially if productivity growth and output had remained strong.

Given that commodity prices are likely to remain strong, it is imperative that policies be framed to support farmers' ability to raise productivity substantially in the years ahead. Key areas requiring policy intervention remain the transmission of price gains (establishment of futures markets), risk mitigation (crop insurance, storage facilities), increasing investment in agri-sector infrastructure (water management, electricity, farm-to-market roads, etc.) and in value-addition chains (e.g. through processing).

Increased production of agri-commodities not only raise farm incomes and help reduce poverty (particularly as landless farmers' share in the crop), but also help narrow the country's current account deficit (through import substitution and higher exports), as well as help contain domestic inflation.

Table 2.2: Performance of Major Crop

Area under cultivation (000 hectares)						
Crops	**FY06**	**FY07^{T}**	**FY07^{P}**	FY08^{T}	FY08^{E}	% change in FY08 over FY07
Cotton	3,100	3,072	3,248	3,250	3,055	-5.9
Sugarcane	907	1,005	1,029	1,040	1,147	11.5
Rice	2,621	2,575	2,581	2,594	2,515	-2.6
Wheat	8,448	8,459	8,578	8,578	8,410	-2.0
Gram	1,029	1,051	1,074	1,120	-	-
Maize	1,042	1,001	1,038	1,001	1,055	1.6
Production (000 tons; cotton in 000 bales of 170.09 kg each)						
Cotton	13,019	13,820	12,856	14,140	11,655	-9.3
Sugarcane	44,651	50,500	54,871	55,871	62,300	13.5
Rice	5,547	5,693	5,439	5,721	5,559	2.2
Wheat	21,277	22,000	23,295	24,045	-	-
Gram	536	707	848	707	-	-
Maize	3,110	3,279	2,907	3,221	3,248	11.7
Yield (Kg/hectare)						
Cotton	714	724	720	740	649	-9.9
Sugarcane	49,229	50,249	53,325	53,722	54316	1.9
Rice	2,116	2,211	2,107	2,205	2210	4.9
Wheat	2,519	2,601	2,716	2,803	-	-
Gram	521	673	790	631	-	-
Maize	2,985	3,276	2,801	3,218	3079	9.9

Source: MINFAL

2.1.1 Crops

Wheat

Absence of the customary benchmark procurement price for wheat at sowing time in FY08 alongwith rising prices of fertilizers as well as delayed sugarcane crushing and extended cotton picking caused a reduction in area under wheat crop (see **Table 2.2**). Additionally, anticipated decline in water availability at the time of sowing discouraged farmers to bring more area under wheat cultivation (see **Figure 2.1**). While wheat crop benefitted from cold spell and winter rains at the initial stages, improvement in yield could not be realized due to stubbornly high prices of fertilizers, particularly DAP. Also, in some areas, wheat crop was partially damaged due to rains and hailstorms in early April 2008. Farmers

associations and government agencies estimated wheat crop size at around 21.8 million tons for FY08 compared with 23.3 million tons harvested last year.

This situation necessitates radical policy changes in incentive signals and market structures as well as development of infrastructure to increase productivity and reduce wastage. It is important to note that supportive policies and enabling environment have a positive impact on productivity (see **Box 2.1**). For example, cultivated area under wheat had almost always positively responded to announcement of rise in procurement prices before sowing period (see **Figure 2.2**). A market based solution may also be introduced by establishing forward markets, crop insurance and contract enforcement mechanism. The market then would be able to explore the equilibrium price by incorporating all information contents of domestic as well as international factors.

Figure 2.1: Area Under Wheat and Water Availibility

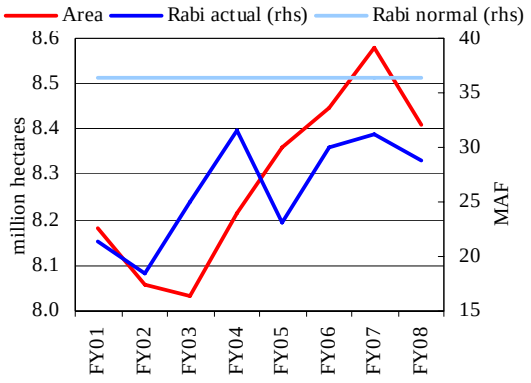
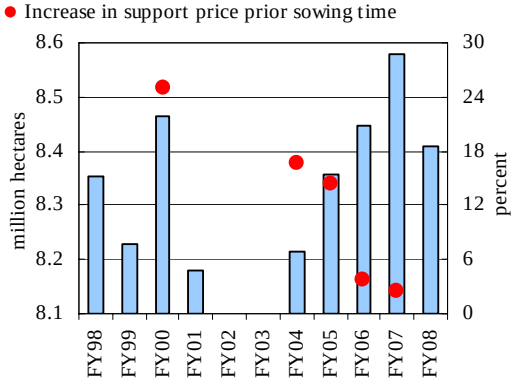


Figure 2.2: Wheat-Procurement Price and Area



Thus, farmers would have price benchmarks available at sowing time. In turn, government may also withdraw subsidies on fertilizer, electricity tariff etc. In contrast, the government's supportive role is required in facilitation of the working of markets as well as providing necessary infrastructure to ensure timely deliveries as well as to reduce post harvest wastages.[1] For instance, estimated wastage in

[1] Shamsher Khan (May 2007) paper is available at http://www.reliefweb.int

case of wheat is estimated at approximately 10 percent of the total production (see **Box 2.2**).

Other Crops

The maize harvest is higher by 11.7 percent during FY08 principally due to improved yield. Similarly, production of mung pulse also recorded a rise of 10.9 percent, despite a below target area under the crop. However, while heavy winter rains and cold weather were beneficial for wheat and other crops, gram and sunflower crops suffered due to frost and rain during their initial growth stages.

Anecdotal evidence suggests that the output of most of vegetables and fruits increased significantly during FY08. Thus, growth in minor crops is likely to be strong.

Box 2.1: A Paper[2] on the Policy Impacts on Long-term Agricultural Growth

A comprehensive study on Long-term Agricultural Growth and Agricultural Policy in India and Pakistan explored the performance of agriculture in the two regions (Pakistan & India) between 1900 & 2000 and associated it with changes in political institutions and agricultural policies. The study examined the growth records of agriculture production and changes in crop mix indices, which showed that institutional and policy changes have significant effects on agricultural growth in this region. The study concludes that farmers have responded to these changes, adjusting their crop mix and production technology. Growers have also responded to the changes in market conditions so that they not only adopted new technology with high-yielding potentials but also adjusted their land allocation toward high value crops. The study suggested that liberalization, deregulation and, privatization policies in agriculture in these countries led to an increased role of crop shifts in enhancing aggregate land productivity. The study further observed that the sustained growth during the post-colonial period was achieved when substantial public investment was implemented. With reduced public investment without simultaneous improvement in investment efficiency, the boom experienced during the 1990s in response to newly opened opportunities would not last long. The importance of production-oriented infrastructure in increasing productivity of agriculture and in reducing rural poverty cannot be overemphasized (Hayami 2003). Rather, considering the public-good nature of such investment, its importance should rise under the context of globalization and trade liberalization.

Box 2.2 Post Harvest Losses:

Improper postharvest handling of agriculture produce results into quantity and quality losses in addition to rise in consumer prices. These losses bring low return to growers, processors and traders and country also suffers in terms of foreign exchange earnings. Therefore, such losses cost in billions of rupees which could be avoided and can result in ensuring supply of sufficient food.

Postharvest loss in cereal, fresh fruits and vegetables is the result of disorders and infectious diseases, which varies greatly among commodities, production areas and seasons. Main causes of this loss, both in term of quality and quantity, are the result of stress related to excessive or insufficient heat or cold, improper mixtures of environmental gases (such as oxygen, carbon dioxide

[2] by Takashi Kurosaki: (December 2003), paper is available at ww.gdnet.org/pdf2/gdn_library/annual_conferences/fifth_annual_conference/kurosaki_paper.pdf

and humidity), poor nutrients and inadequate storage and transportation facilities. Further, loss may be caused by mechanical damages (such as bruising, cutting, excessive pooling or trimming). All these factors are not caused by disease organisms; however, these factors often weaken the natural defenses, especially of fresh produce, making it more susceptible to biotic diseases those that are caused by disease organisms.

Worldwide average food grain losses have been put at 5%. In the developed countries, losses have been generally at 1% while 10-30% losses have been reported for developing countries. However, worldwide post harvest losses in case of horticulture ranging between. 30-35%, are comparatively high with less difference between developed and developing countries[3] (see **Table 2.2.1**).

Table 2.2.1: Comparison of Cereals Oilseeds and Horticultural Crops

Cereals and oilseeds	**Horticultural crops**
Post harvest loss worldwide 5%	Post harvest loss worldwide 30-35%
Losses in • LDCs 10-20% • Pakistan 8-12% • India 10-15% • US 1-2%	Losses in • LDCs 15-50% • Pakistan 35-40% • India 30-40% • US 20-23%
Low moisture contents, typically 10-20 %	High moisture content, typically 70-90 %
Small unit size, typically less than 1 gram	Large unit size, typically 5 oz to 5 kg
Very low respiration rate with very small generation of heat	High to very high respiration rate
Heat production is typically 0.05 mega joule/ton/day for dry grain	Heat production is typically 0.5 -10 mega joule/ton/day at 0°C to 5 to 70 mega joule/ton/day at 20°C
Hard texture	Soft texture, easily bruised
Stable, natural shelf life is one to several years	Perishable, natural shelf life is a few days to several months
Losses usually caused by molds, insects and rodents sprouting, and bruising	Losses usually caused by rotting (bacteria, fungi), senescence

In Pakistan, out of 13.67[4] million tones of fruits and vegetables produced annually, it is estimated that about 35-40 percent goes to waste, losses varying from 6% each in almond and walnuts, to more than 50% in case of cherry, Mulberry and apricot[5], while 4 percent of exported horticulture of the country fetch 41 percent lower prices as compared to world average price due to below standard post harvest management. In India, this loss of fresh fruit and vegetable accounted for 40 percent. However, the loss in developed countries like US is not more than 25% (including plate waste: food not consumed by the purchaser)[6].

Post harvest loss in food grain production of Pakistan is, thought to be between 8-12 percent ranging from 10 percent in wheat to 15 percent in rice. Insect and mites cause 40-70 percent of the total post harvest loss in food grain depending on the type of food stored and pest involved. Similarly, other

[3] http://postharvest.ucdavis.edu/datastorefiles/234-528.pdf
[4] http://www.dailytimes.com.pk/default.asp?page=2008\03\18\story_18-3-2008_pg5_8
[5] http://www.apo-tokyo.org/00e-books/AG-18_PostHarvest/AG-18_PostHarvest.pdf
[6] http://postharvest.ucdavis.edu/datastorefiles/234-528.pdf

major crops like cotton and sugar are also exposed to significant postharvest losses. In case of fish, 10-15% of total catch go in to waste due to long voyage time and handling of fish catch on board (not including discard at sea)[7].

However, it is not economical or practical to aim for 0% losses, but an acceptable loss level for each commodity production area and season combination can be identified on the basis of cost-benefit analysis (return on investment evaluations) to ensure food requirement in the era of severe food scarcity.

2.1.2 Irrigation Water

The water shortage seen in *rabi* FY08 are likely to continue in *kharif* FY09[8] (see **Table 2.3**).[9] The carryover water balance for *kharif* 2008 from the ending *rabi* season was a negligible 0.013 MAF at Tarbela, Mangla and Chashma as on April 1, 2008. Carryover water balance was 1.5 MAF during the beginning of the corresponding *kharif* period. The water shortage is likely to impede sowing of the two major *kharif* crops - rice and cotton.

Indus River System Authority (IRSA) has estimated a 7.0 percent shortage for the first phase of *kharif* FY09, with the minimum daily average of only 5,100 cusecs available for Punjab and 3,500 cusecs for Sindh. Water shortages at the sowing time may lead to delay in sowing and shortfall in area under cultivation relative to target. It is important to note that delayed sowing results in lower yields.

Table 2.3: Water Availability
million acre feet (MAF)

	***Kharif* FY08**		***Kharif* FY09**
Province	**Anticipated**	**Actual**	**Anticipated**
Punjab	36.9	37.7	35.8
Sindh	33.6	30.3	32.7
Balochistan	2.5	1.7	2.5
NWFP	0.8	1.1	0.8
Total	73.9	70.8	71.9
Net (minus NWFP+Balochistan)	**67.2**	**65.7**	**64.7**

Source: IRSA

Water availability during the second phase of *kharif* FY09 *(*June 10-September 30) would largely depend upon monsoon rains in the catchment areas as well as the conducive high temperatures in the glacial belt- enough to precipitate the melting process. At present, water shortage for the full *kharif* season has been estimated at 3.7 percent relative to normal requirements for the season and 1.6 percent lower compared with the water availability during the preceding *kharif* season.

[7] http://www.nio.org/past_events/fisheries/session_II.jsp
[8] From April 1, 2008 to September 30, 2008.
[9] The sowing is undertaken in the first phase of *kharif* season that starts from April 1 and ends on June 10.

In contrast to predictable water availability in a canal fed area, water availability in barani areas is entirely dependent on rains. Therefore, yields of various crops are also based on the volume and timings of the rains in these areas. Asian Development Bank (ADB) has extended a loan to improve irrigation and drinking water facilities across the Potohar Plateau near Islamabad (see **Box 2.3**).

Box 2.3: Multiple Water Projects - Pakistan: Pakistan is to build multipurpose dams, irrigation canals, and drinking water supplies across the Potohar Plateau near Islamabad with US$75 million loan provided by the Asian Development Bank (ADB). The project will improve the livelihoods of about 22,000 farming households by bringing irrigation to 11,500 hectares of agricultural land that used to rely on irregular and unpredictable rainfall, as well as improving existing irrigation networks across another 10,000 hectares. The project will also increase supplies of water for domestic use to rural communities and small towns in Punjab province's districts of Attock, Rawalpindi, Jhelum, and Chakwal.

ADB rural development specialists believe that without secure water sources, farming in rain-fed '*barani'* areas usually have low productivity and carry high risk because crops often fail when there is drought. Farming is the traditional source of livelihoods across Potohar, but crop yields in the "*Barani*" areas have been typically less than half of those in areas with river-fed irrigation. The traditional crops in *barani* areas are wheat and gram in winter and sorghum, millet, groundnuts or maize in summer when rainfall is sufficient.

This project will give farmers a reliable water supply, which will increase crop and livestock productivity and therefore increase people's incomes. At the same time, it will increase households' access to cleaner water, therefore reducing sickness and mortality rates caused by waterborne diseases. The construction of dams across the Potohar Plateau started as early as the 1960s. But they were not as beneficial as had been hoped because local communities rarely participated in their development, farmers did not get the financial and technical support necessary to switch from rain-fed agriculture to irrigated farming, and there was no watershed management resulting in a high reservoir sedimentation rate.

In this new project, a more holistic approach is being used that is simultaneously looking at upstream watershed management and downstream irrigated area development. It will also involve local communities to ensure the project is demand driven. Out of the total loan package, $20 million will be concessional and will carry low interest rates, while the balance of $55 million will be provided from ordinary capital resources under ADB's London interbank offered rate-based lending facility.

2.1.3 Fertilizer off-take

The increased fertilizer off-take during July-March FY08 (see **Table 2.4**) was entirely due to an exceptional rise in urea demand that significantly offset the decline in DAP off-take in this period. The strong growth of urea off-take is a combined impact of a depressed base as well as substitution for DAP (as the international prices rose sharply).

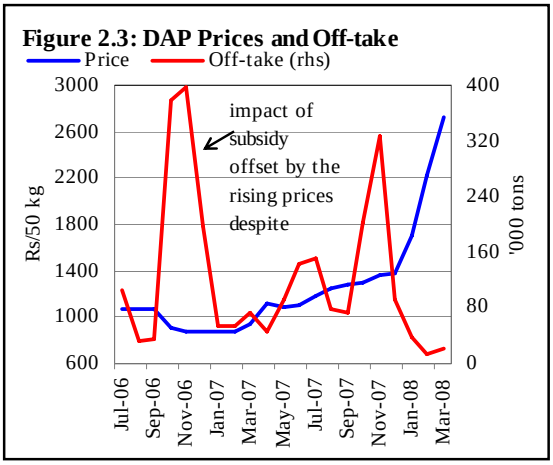
Domestic requirements of DAP are met by importing about 70 percent of DAP, therefore the rise in international prices of DAP have also translated into domestic prices. As a result, the DAP off-take in Jul-March FY08 decreased by 25 percent compared with13.8 percent rise in the same period of FY07. The impact of price effect is more evident in the second and third quarters of FY08, when DAP prices rose sharply and drop in its off-take was also more pronounced (see **Figure 2.3**).

A continuous increase in fertilizer prices is another source of concern (see **Box 2.4**). To increase the productivity in agriculture sector, there is a need to provide shelter to the farmers against the rising fertilizer prices. Since, the risk appetite of small farmers is limited and they are unable to invest heavily in agri inputs, there is possibility of a further decline in fertilizer off-take, if fertilizer prices would continue to follow a secular rising trend. This would lead to a decline in yields and degradation of soil quality due to a possible implementation of inappropriate mix of the nutrients.

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

Growth (%)	**FY06**	**FY07**	**FY08**
Urea	6.1	-15.5	22.1
DAP	3.8	13.8	-25.0
Total	**5.6**	**-9.1**	**9.2**
	Growth (in percent)		
Q1	0.4	-24.2	27.3
Q2	2.0	17.6	-13.9
Q3	18.6	-23.4	41.1

Figure 2.3: DAP Prices and Off-take

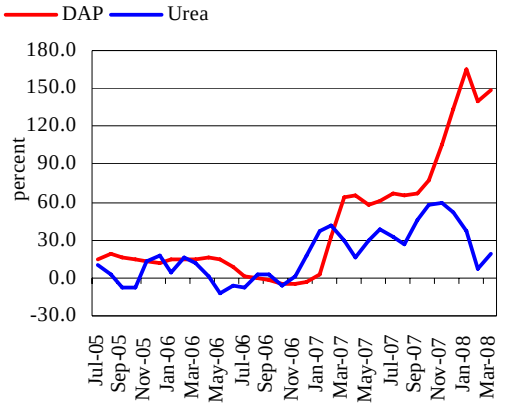


Box 2.4: Fertilizer Prices

Fertilizer prices are surging upwards around the world, causing decline in yields and income of farmers. International fertilizer prices rose steadily from 2004 through 2006 -then urea prices jumped by 41 percent in March 2008 relative to July 2007. The increasing trend in the price of urea since the start of 2007 did see a temporary reversal in Dec-Feb FY08, but resumed thereafter. DAP prices rose by 140 percent between January 2007 and March 2008 (see **Figure 2.4.1**), mainly denoting increases in prices of its essential raw material i.e. phosphoric acid and phosphate rock.

Main reasons for the enormous rise in the fertilizer price include: (1) bio-fuel- diverting farming land to energy crops, requires more fossil fuel, (2) additional land was brought under cultivation, 3) increase in freight charges, (4) rise in insurance rates, (5) increase in gas/energy prices (fertilizer is extraordinarily energy intensive), (6) increased per capita incomes in China, India, Brazil and other emerging economies, resulted in strengthening demand for grain-fed meat and dairy products, and (7) population increase (about 70 million people are added in the world per annum).

Figure 2.4.1: Change in Global DAP and Urea Prices



FAO[10] projected that global fertilizer consumption and supply to grow by 1.7 percent and 3.0 percent respectively upto 2012. Thus global supply of fertilizer is expected to fall short of demand. However, the global fertilizer supply constraints will start easing after 2010, when enhanced fertilizer industry by Gulf countries will start production.

2.1.4 Agriculture Credit

Agriculture credit disbursement continued apace with its positive trend. The total agri disbursements amounting to Rs 157.6 billion were achieved during July-April FY08 - an increase of 34.9 percent YoY (see **Table 2.5**). A part of this increase in the credit disbursements to farm sub-sector was attributed to rising prices of fertilizers and pesticides. The credit off-take in non-farm sub-sector also accelerated.

It is important to note that while commercial banks lending is more focused on production loans, specialized banks are supporting lending for developmental purposes. This is also evident during Jul-April FY08 numbers that rise in the developmental loans by ZTBL has partially offset the decline in these loans by the commercial banks. Since production loans are extended for a short period, the recovery ratio on such loans is better. This fact is also reflected in a higher growth of recovery by the commercial banks.

[10] FAO World Fertilizer Trend and Outlook 2011-12.

Table 2.5: Agriculture Credit (July-April)

billion Rupees

	Disbursement				Recoveries			
			percent change				percent change	
	FY07	**FY08**	**FY07**	**FY08**	**FY07**	**FY08**	**FY07**	**FY08**
Commercial banks	**72.5**	**107.8**	**11.7**	**48.6**	**67.1**	**102.8**	**26.4**	**53.2**
Five large commercial banks	54.5	74.3	3.5	36.1	52.7	74.7	21.5	41.5
Domestic private banks	17.9	33.5	47.1	86.9	14.3	28.1	48.8	96.2
Specialized banks	**44.3**	**49.7**	**20.7**	**12.2**	**39.8**	**45.2**	**16.6**	**13.3**
ZTBL	38.8	45.7	19.6	17.8	35.6	40.9	19.8	14.7
PPCBL	5.4	3.9	29	-27.1	4.2	4.2	-1.2	1.0
Total	**116.8**	**157.5**	**14.9**	**34.8**	**106.9**	**148.0**	**22.8**	**38.4**
	Production loans				**Developmental loans**			
			percent change				percent change	
	FY07	**FY08**	**FY07**	**FY08**	**FY07**	**FY08**	**FY07**	**FY08**
Commercial banks	**63.6**	**100.4**	**20.9**	**57.9**	**8.8**	**7.3**	**-27.8**	**-17.0**
Five large commercial banks	47.7	70.3	12.8	57.8	6.8	4.0	-34.1	-41.7
Domestic private banks	15.9	30.1	53.4	88.9	1.9	3.3	10.1	70.4
Specialized banks	**38.5**	**41.9**	**19.6**	**8.2**	**5.7**	**7.7**	**28.7**	**35.0**
ZTBL	34.9	38.7	21.6	10.7	3.8	7.0	4.2	84.2
PPCBL	3.6	3.2	3	8.5	1.8	0.7	151.4	-61.1
Total	**102.2**	**142.5**	**20.4**	**39.4**	**14.5**	**15.0**	**-12.6**	**3.4**

2.1.5 Crop Outlook FY09

Farmers are expected to bring more area under *kharif* crops, implement quality inputs in appropriate quantity with extra efforts to reap the benefits of prevailing higher prices of most of the agri-produce. In addition, improved nominal farm income during FY08 will also help boost the confidence and optimism of the farmers. Importantly, area under cotton crop, which has almost stagnated over a decade, is expected to increase amid rising cotton prices.

While water shortages are estimated to continue during *kharif* FY09, rains during April would have also likely to support the optimism amongst the farmers. In addition, availability of certified seed, certified Bt cotton seeds,[11] and effective pesticides are crucial factors to improve yield. Similarly, production of other two major *kharif* crops sugarcane and rice will also largely depends on sufficient monsoon rains, availability of irrigation water as well as efficient use of inputs.

[11] Bacillus Thuringiensis

Since 2005 cotton crop has been infested with mealy bug. This infestation has adversely impacted both the cotton yields and its quality.[12] It requires an early attention of all stakeholders to take preventive measures to ward off this menace (see **Box 2.5**). In FY08, CLCV and mealy bug incidences caused an estimated 16.4 percent loss (about 2.1 million bales) of the total production to the cotton crop.

Box 2.5: Mealy Bug – Threats and Management: Pakistan Agriculture[13]

The pink hibiscus mealy bug (PHM) - *Maconellicoccus hirsutus* (Green) - is a serious new threat to Pakistan agriculture. It is a small insect 1/5th of an inch size, gets its name from its appearance. Mealy bugs overwinter as eggs on stems, in soil, in cracks and crevices in the stem, and inside crumpled leaves. Freshly laid eggs are orange but turn pink just prior to hatch. The crawlers disperse from the ovisac by way of walking, wind, or ants. The nymphs feed and develop into adults in approximately 30 days. The insect has a life cycle of 24 to 30 days. The female mealy bug produces 10-15 generations per year in colonies of 500-600 eggs. It attacks more than 300 plant species world around, including Pakistan. These are: rice, sugarcane, cotton, fruits; papaya, carambola, avocado, citrus, sugar-apple, mango breadfruit, golden apple, cherry, plum, guava, pigeon pea, passion fruit ,grape, banana; vegetables, tomato, cucumber, pumpkin, peppers, okra, dasheen, lettuce cabbage, beans, squash; ornamentals hibiscus, bougainvillea, croton, oleander, allamanda, ixora, anthurium, ginger lily, heliconia, schefflera, lantana, ficus, seagrape, and numerous weeds etc.

It feeds on the sap of the plant and releases toxic substances causing injury, curling and drying of leaves which, damages fruiting and drastically decrease the yield. Mealy bug also attacks the roots just below the level of the soil, especially where the root and the stem meet. Root mealy bug lays their eggs in sacs of interwoven filaments that resemble cotton wool. Mealy bug also excretes large quantities of honeydew onto the plant that in turn attracts ants and sooty mould. Keep ants under control as they may distribute the pests to other plants. It is also spread by wind, or it can be stuck on clothing or on the hair of animals. Mealy bug can spread rapidly once introduced in an area. The mealy bug arrived in Egypt from India in 1912 and in Hawaii in 1984. It appeared in Grenada, Trinidad, and St. Kitts in the1990's and has spread to other islands in the Caribbean, where it attacks many hosts of economic importance. This pest is presently established in central and northern Africa, India, Pakistan, northern Australia, and southeastern Asia. In Pakistan, its significant presence viewed earlier as merely minor pests, was observed on the cotton crop in Gujarat in 2006 and, subsequently, in Punjab and the adjoining northern cotton-growing tracts in 2007. There have been reports of its growing populations from most other cotton-growing states as well. It caused a serious damage to the cotton crop in all major cotton growing districts in FY08. Similar or stronger damage is anticipated if, preventive measures were not taken.

[12] In Pakistan, 96-150 insect and mite pests attack cotton crop during its growth period. Their damage results in destruction of a large number of flower buds (square), tender shoots tips and immature bolls (green bolls) which reduces the yield. Aslam and others: (2004): J. Res. (Sci). B.Z. Univ., Multan, Pakistan 15:17-22. Insect pests cause heavy qualitative and quantitative losses in cotton yield varying from 39-50 percent. Chaudhry, G.Q. (1976) Seminar Esso Fertilizer Comp. Ltd., Pakistan. p. 114-118.

[13] USDA www.pakissan.com/english/advisory/mealy.bug.an.emerging.threat.to.cotton.crop.shtml and www.bugwood.org/factsheets/mealybug.html

One or more of the symptoms may be observed these includes: (1) Crinkled or twisted leaves and shoots, (2) Bunched and unopened leaves, (3) Distorted or bushy shoots, (4) White fluffy mass on buds, stems, fruit, and roots, (5) Presence of honeydew, black sooty mold, and ants, (6) Unopened flowers which often shrivel and die and (7) Small deformed fruits.

Integrated Control Options.

- Weeds serve as host plants, should be eradicated regularly,
- Severely infested plants must be cut and burnt immediately and field should be ploughed to kill immature stages available in the soil,
- Spray as strong a stream of soapy water solution as the plant can tolerate; this should dislodge most of the bugs. This is the easiest way to control mealy bugs. Repeat if you see new egg sacs,
- Spray with a soap/oil (Mix 1 tsp. detergent surf +100 ml neem oil, and 16 liter water in a spray tank) mixture may also give better results,
- The less affected crop at early growth stage should be sprayed with Imidacloprid (120 gram/acre) or Thiamethoxam and may be repeated after 5-7 days followed by water spray. The spray should be done at the crawler stage of mealy bugs, because it is the most fragile stage and the most susceptible to chemical control,
- The foliar spray of Chlorpyrifos, Triazophos, Profenofos, and Bifenthrin may be applied at later stage of crop. (i.e. after 100 days of sowing),
- Prior to the spray of Imidacloprid, Chlorpyrifos @ 2 Liter per acre should also be applied through irrigation as to control the root infestation and suppress the pest population in the soil, and
- Biological control offers the safest, most economical and long term solution to this problem. This strategy relies on producing sufficient numbers of tiny wasps (parasitoids) that attack and kill the mealy bug. A number of natural enemies are known, including the coccinellid predator Cryptolaemus montrouzieri and the parasites Anagyrus kamali and Gyranusoidea indica which suppress the mealy bug population. In Egypt and India, biological controls have been quite successful in suppressing the mealy bug. Other coccinellid predators have also been reported in India. At present, 21 parasites and 41 predators are known to attack this pest worldwide.

2.2 Large Scale Manufacturing

Initial prospects of achieving a reasonable growth in LSM sector during FY08 were clouded by aggravating energy crisis coupled with high international commodity prices and political unrest through most of the year. As a result, the LSM sector posted a dismal growth of 4.8 percent in the first nine months of FY08 compared with 9.0 percent in the same period of FY07 (see **Table 2.6**).

Table 2.6: Production of Selected LSM Items (Jul-Mar)

percent growth

	FY07	FY08
Overall LSM	**9.0**	**4.8**
Textile	9.8	2.8
Food, beverages & tobacco	6.4	11.0
Petroleum refining	-5.2	6.0
Pharmaceuticals	7.8	30.8
Chemicals	14.4	2.4
Non-metallic minerals	21.7	17.7
Leather	7.0	3.9
Paper & board	-1.7	-5.6
Tyres & tubes	23.6	-2.7
Wood	20.7	21.9
Automobiles	6.2	-0.2
Metal	34.3	-7.6
Fertilizers	-0.1	-16.9
Electronics	12.1	-4.7
Engineering goods	18.8	19.5

Source: Federal Bureau of Statistics

The operational constraints caused by energy shortages had a broad-based impact on manufacturing activities. However the impact was pronounced on *metal* subsector which also remained under the brunt of high international steel prices. Activities in *textiles* and c*hemicals* (especially caustic soda) sub-sectors were also affected by frequent energy disruptions as well as rising input cost.

Table 2.7: Monthly Growth Performance of LSM

March	FY06	FY07	FY08
Overall	10.0	14.7	2.7
Excl. Food	9.8	11.6	2.3
Excl. sugar	9.3	11.1	1.4
Cumulative Growth Performance of LSM			
Jul-Mar	FY06	FY07	FY08
Overall	8.0	9.0	4.8
Excl. food	8.2	9.6	3.5
Excl. sugar	8.6	8.8	3.3

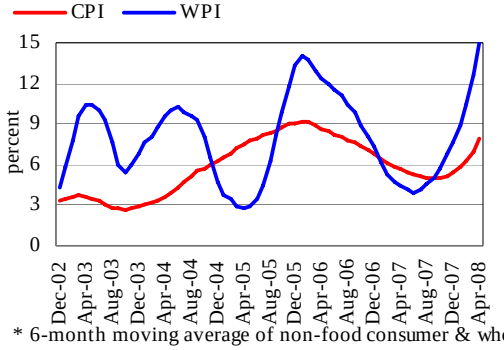
A closer look at the data provides a less comforting picture. An important contribution to the July-Mar FY08 growth is from the sharp rise in sugar production (though decelerated relative to Jul-Jan FY08). Excluding this sub-sector, LSM growth drops to only 3.3 percent during Jul-Mar FY08 (see **Table 2.7**). Sugar industry registered a phenomenal growth despite financial problems and stalemate with government and farmers (on start of crushing season and price of sugarcane). The record high growth in sugar production is primarily owed to record bumper crop during FY08.

It is important to mention here that the LSM showed some recovery in January 2008, after incurring huge economic losses in December 2007.[14] However, the recovery proved short-lived for a number of reasons:

(1) Growth in sugar production slowed to 34.0 percent in Jul-Mar FY08 compared with 51.6 percent in Jul-Jan FY08 as frost partially damaged the sugarcane crop.
(2) Although, import of cotton increased substantially during Feb-Mar FY08, Pakistan's textile industry is facing difficulties in procuring cotton due to rising prices.[15] Availability of cotton remained constrained in the domestic market with high average prices during the period.[16] More importantly, slowdown in US and Euro area would likely to put further pressures on the performance of textiles sector.
(3) The activities in edible oil/ghee industry could not gather pace during Feb-Mar FY08 reflecting ease in demand for the products due to rising prices. In addition, anecdotal evidence suggests that substitution of formal sector products with the informal sector products, particularly by small commercial users is a major contributory factor for slowdown in oil/ghee industry. Temporary suspension of palm oil supply from Karachi to the upcountry due to a row between ghee industry and truck owners for more than a week in April 2008, also hit the industry.
(4) Similarly, the production of fertilizers remained weak during Feb-Mar due to the closure of DAP plant for BMR up gradation.

Furthermore, the recovery in remaining months of FY08 also appears remote. High key commodity prices and steady depreciation of Rupee March 2008 onwards, further increased manufacturing

Figure 2.4: CPI and WPI Inflation*



* 6-month moving average of non-food consumer & whole prices.

[14] The LSM sector grew by 7.8 percent compared with 5.4 percent and 4.2 percent in Jan 2007 and Jan 2006 respectively.
[15] The quantum import of raw cotton during Feb-Mar FY08 registered a growth of 76.4 percent over Feb-Mar FY07.
[16] In Feb-Mar FY08, average cotton prices were 25.9 percent higher than Feb-Mar FY07 and 6.9 percent higher than Q2-FY08.

costs. More importantly, non-food wholesale prices are increasing faster than the non-food consumer prices; reflecting relative lower corporate margins (see **Figure 2.4**).

The latter factor in particular, could significantly weaken the prospects for LSM recovery in FY08. If the current trend in commodity prices is prolonged, producers have to choose between the two: (1) increase the consumer prices proportionately; and/or (2) absorb some cost increases either by raising productivity or compromise further on profit margins.[17,18] The impact on aggregate demand in the economy could only be mitigated through productivity gains.

Unfortunately, the crisis-like situation in domestic energy sector as well as in international commodity market does not appear to be settling down in the near future. Thus, the LSM sector is likely to remain under pressure in the short-term. However, the relative easing of a few commodity prices in international market (especially industrial metal including aluminum, copper, zinc, lead, etc) April 2008 onwards, if continued, may ease cost pressures from domestic manufacturers. Furthermore, presence of a still-strong demand in the economy may trigger a recovery in LSM. Specifically, aggregate demand has not yet weakened very substantially as:

(1) The worsening fiscal and current account deficits throughout the first nine months of FY08 are reflective of a strong (though moderated) domestic demand.
(2) The robust growth in exports of manufactured items (cement, chemicals and leather), during Jan-Apr FY08 hints at a strong external demand for domestic products.[19] and
(3) Although a large number of industries (10 out of 15) could not perform well; for some industries this was largely an outcome of non-economic factors. Most important among those were poor FY08 cotton harvest (hurting textile and allied industries), political unrest (especially the economic losses in the aftermath of 27th December 2007), temporary closures of certain industrial

[17] The detailed accounts of the corporate sector are yet to receive. However, the preliminary results of listed companies suggest decline in profit margins during FY08 in various sectors including, textile, fertilizer, cement and automobile industry.
[18] They are more likely to do this if demand is weak or because of competition. The degree of competition in markets can affect how much cost increases are passed on to consumers.
[19] Exports of major manufactured items grew by 12.1 percent during Jan-Apr FY08 over Jan-Apr FY07. Cement, chemicals, towels, petroleum products, etc. were some of the commodities showing robust growth in exports during Jan-Apr FY08.

units for maintenance and/or up-gradation (e.g., polyester fiber, paper and fertilizer), and power shortages (e.g., metal industries, among others).

Moreover, a rebound in LSM is expected in subsequent years especially driven by productivity gains following the BMR/up gradation activities in various industries, despite the risk of adverse impacts of rising commodity prices. Expectation of small recovery is also supported by the continuing expansions in a number of industries. Specifically, a number of capacity expansion plans are still underway especially in paper, tyres & tubes, petroleum refining, fertilizer and cement sectors. Since most of the expansion plans in domestic manufacturing sector are aimed at reducing import dependency (except cement), a positive impact of these expansions on domestic production seems likely.

From industrial policy perspective, de-bottlenecking would not only tend to improve the production going forward but may also aid in easing price pressures in related industries. Moreover, expansion of non-traditional industries will help in achieving diversification of manufacturing activities. This diversification will also reduce vulnerability to the crisis in a single sector. Sharp growth in the production of motorcycles, engineering goods, pharmaceuticals, etc. in recent years has already helped achieve some degree of diversification in LSM value addition.

The increasing focus on emerging industries, nevertheless, needs to be complemented by a focus on structural weaknesses in traditional sectors. Textile sector needs to consolidate to gain economies of scale and improve supply chain. The government can play an important role in enabling manufacturing firms to compete in the world market by facilitating technological up-gradation in production, investment, innovative capabilities and by providing most needed energy and infrastructure. In addition, policy stability and rationalization of tariff and taxes are important elements for industrial growth to address the dynamic global and domestic environment.

Moreover, the domestic LSM sector requires new skills to manage technical change. It also needs strong technical support agencies in standards, quality, testing, research & development to achieve the required productivity improvements. In addition, smooth and uninterrupted electricity and gas supplies to manufacturing firms and adequate infrastructure will prove instrumental in LSM future outlook. Sectors which are yet to show any notable mark in the export market must focus on measures to uncap the available potential. This is because export enables firms to diversify their product range and enable them to

withstand adversities in the domestic economy in addition to helping small firms grow and become more competitive.

2.3 Services

In contrast to an expected below-target performance of commodity producing sectors, information for the first nine months of FY08 suggests that the services sector is poised to achieve the annual targeted growth. The main contributors to this performance are wholesale & retail trade, transport storage & communication as well as public administration & defence sub-sectors. In addition, sub-sectors including ownership of dwellings and social & personal services seem well placed to contribute positively towards upbeat annual growth in services sector. However, growth in finance & insurance sub-sector appears to relatively slow due to weaker profitability of the commercial banks, nonetheless remain strong in FY08 (see **Table 2.8**).

Table 2.8: Services Sector Performance Indicators

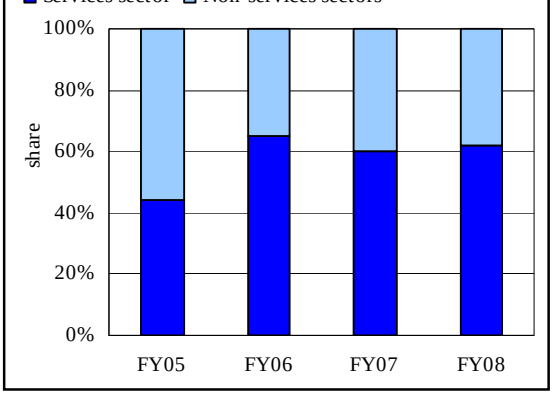
percent growth or mentioned otherwise

	FY06	FY07	FY07 Jul-Mar	FY08 Jul-Mar
Wholesale & retail trade				
Credit to wholesale and retail trade	8.1	-62.8	8.3	13.7
FDI in trade	126.4	46.0	57.0	15.1
Imports	38.8	6.9	8.4	25
Trade volume (imports & exports)	28.7	5.5	6.4	19.3
Transport storage & communication				
Credit to transportation storage and communication	-50.9	48.3	22.2	5.0
Petroleum crude imports	76.6	-4.9	-7.0	32.2
Commercial vehicles production (Jul-Feb)	16.1	7.9	3.7	2.5
Teledensity (percentage of population)	26.3	44.1	-	56.7
Cellular density (percentage of population)	22.2	39.9	-	52.2
Cargo handled at KPT	11.1	-5.6	-9.4	23.5
FDI in transport storage & communication	267.8	-0.5	35.0	-29.3
Finance & insurance				
Profit of commercial banks	24*	0.6*	-23.7 **	-34.4 **
FDI in financial business	22.2	182.6	162.2	-2.1
Public administration & defence				
Fiscal spending on public admin. and defence (Jul-Dec)	14.3	3.3	-3.5	14.7
Community, social & personal services				
FDI in social and personal services	162.5	23.8	39.1	12.2
Total FDI in services sector	181.5	27.4	59.5	-19.0

* : data pertains to CY; ** : data pertains to fourth quarter

Another important feature of services sector is a notable rise in its share in foreign direct investment in recent years (see **Figure 2.5**). In particular, liberalization and privatization policies helped finance and communication sub-sectors to fetch a major part of the rising FDI inflows in the country.

Figure 2.5: Foreign Direct Investment (Jul-Mar)



Value addition in wholesale retail trade sub-sector depends on the margins taken by merchants on the trade of domestic and imported commodities. While weakness in production of major crops and decline in growth of LSM may hamper growth in wholesale and retail trade, buoyant growth in imports and rise in the production of minor crops are expected to recompense that impediment. Specifically, since imports contribute more than half to wholesale & retail trade sub-sector, import growth of 28.3 percent during Jul-Apr FY08 compared with 8.9 percent growth in the same period last year is likely to support the performance of this sub-sector.

Transport, storage & communication sub-sector continues to benefit from the upbeat performance of telecommunication & broadcasting. In particular, cellular density in Pakistan increased by about 9 percentage points during Jul-Mar FY08 (see **Box 2.5**).

In addition to communication, a sharp surge in cargo handling and storage at Karachi Port Trust (KPT[20]) would also help to push up growth under transport & communication sub-sector during Jul-Mar FY08, despite mounting losses of PIA. The rise in cargo handling is principally owed to a jump in imports in this period.

Growth in finance & insurance appears to be slowing as profits of the commercial banks for CY07 increased by a mere 0.6 percent in comparison to a strong growth of 24 percent in CY06. However, the anticipated improvement in profitability of other financial institutions including insurance would likely to help achieve a reasonable growth by this sub-sector as well.

[20] KPT handles over 70 percent of total trade volume of the country

Social & personal services sub-sector are also positioned well to post strong growth given increased public sector focus on health and education as well as rising and active role of NGOs in the social sector of the country. Similarly, contribution of public administration & defence is expected to post a reasonable growth during FY08 mainly due to elections.

Box 2.5: Trends in Telecommunication

An important highlight of robust performance of cellular communication in Pakistan is the an impressive 109.7 percent compound annual growth (CAGR) over the preceding 7 years (2001-07) compared with Asian average of 27.4% **(**see **Table 2.5.1).** Other communication modes such as fixed line, wireless local loop (WLL) and broadband internet services [DSL, Wimax, Fiber to the home (FTTH)] are also picking up pace.

However, it is interesting to note that the rise in mobile phone users and revenue do not correspond the similar trend **(**see **Figure 2.5.1 and 2.5.2)**. A relatively slow rise in revenues of cellular providers is primarily attributed to:

1. Reduction in call rates due

Table 2.5.1: Mobile cellular subscribers and CAGR
(in million)

			CAGR (percent)	per 100 inhabitants
	2001	**2006**	**2001 - 06**	**2006**
Bangladesh	0.5	19.1	105.7	13.3
China	144.8	461.1	26.1	34.8
India	6.5	166.1	91	14.8
Indonesia	6.5	63.8	57.8	28.3
Iran (I.R.)	2.1	15.4	49.1	21.8
Malaysia	7.4	19.5	21.4	75.5
Nepal	0.0	1.2	131.8	4.2
Pakistan *	0.7	63.2	109.7	39.9
Saudi Arabia	2.5	19.7	50.7	78.1
Sri Lanka	0.7	5.4	52	25.9
Thailand	7.6	40.7	40.1	62.9
Viet Nam	1.3	15.5	65.4	18.2
Asia	341.2	1147.1	27.4	29.5

Source: World Telecommunication Indicators 2007

* Data pertains to year 2001-07

Figure 2.5.1: Trend in Cellular Services

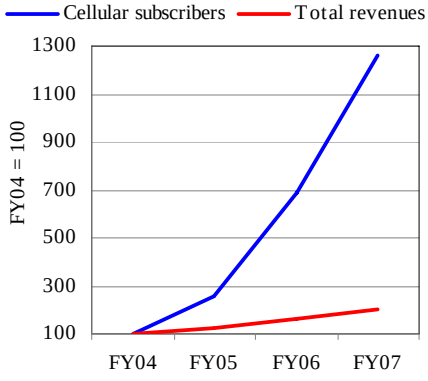
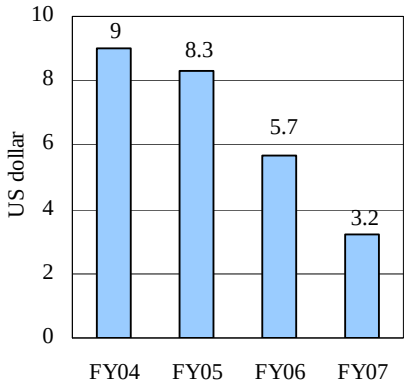


Figure 2.5.2: Average Revenue Per User



to intense competition as well as new technology reduced the cost of communication.

2. A majority, particularly low-income consumers are using the facility economically.
3. Most of the consumers have multiple connections, so subscribers are overestimated.
4. A large number of idle users.
5. It is important to note that information of active users and a single user in case of having multiple connections is needed to have a better analysis of the trends in the industry.

3 Prices

3.1 Global Inflation Scenario

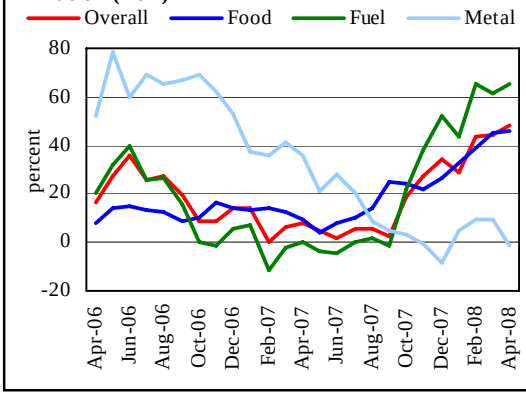
A number of factors are continuing to stoke up global inflationary pressures. Notably, these factors are: (1) sustained increase in global commodity demand, (2) supply issues, and (3) growing interest of investors in commodity markets on the back of a weak dollar[1] and falling interest rates. Prices of all key commodities have witnessed significant growth since July 2007 (see **Table 3.1**). The surge in commodity prices has been particularly strong in the last six months, with significant increase in global food and energy prices (see **Figure 3.1**).

Table 3.1: International Commodity Prices

Item	Unit	April 08	Percent change since July 2007
Crude oil	US$/barrel	109.0	48.0
Wheat	US$/MT	362.2	51.9
Rice	US$/MT	1015.2	205.3
Maize	US$/MT	246.6	67.9
Soybean	US$/MT	1292.1	57.7
Palm	US$/MT	1083.5	41.7
Iron ore	US cents/dmtu	140.6	66.0
Tin	US$/MT	2166	47.0
Dap	US$/MT	1200.6	175.2
Urea	US$/MT	471.3	75.9

Source: IMF and World Bank.

Figure 3.1: World Commodity Price Indices Inflation (YoY)



While increase in the prices of many key food commodities such as rice, wheat, and edible oil is mainly due to relatively disappointing harvests (which could improve in succeeding years), a significant contribution is also by factors that may not change. The

[1] The steady decline in the value of US dollar has been a key driver behind recent commodity price strength. Since July 2007, the US dollar has depreciated significantly against euro, yen and pound sterling that made dollar less attractive for investment and investors shifted their investments towards commodity markets.

latter include the increased demand from emerging economies (as income levels improve) and increased use of bio-fuel as an alternative energy source. The link of food prices with energy cost, is particularly troubling, given that energy prices are likely to remain significantly above historical norms in the foreseeable future.

The surge in global inflation has affected developing economies more than the developed economies. This is because the share of food in the consumption baskets of developing economies is significantly higher than developed countries. Moreover, the greater use of processed food in developed economies means that the impact of a rise in commodity prices is muted in food inflation for these economies, as (1) commodity prices account for only a small share of the prices of processed foods, and (2) many processed food industries either have long-term supply contracts, or hedge their price risk.

Not surprisingly, therefore, fiscal measures (tariff cuts and subsidies) aiming at, to partially protect the populace from rising food and energy commodity prices are more evident in developing economies. However, in countries where the fiscal deficit is already large, the fiscal measures to contain the impact of rising international food prices on domestic inflation are likely to prove unsustainable. The efforts to support poor by deterioration in fiscal balances, result in limiting sustainability of these measures. The latter concern is underlined by forecasts that the high food and energy prices are likely to remain.

A number of developing economies have introduced additional measures to rein in the rising food prices (see **Box 3.1**). For example, some major rice exporters have introduced export bans on rice (staple food of half of the world population) seeking to ensure availability (and low prices) in their domestic markets. Such measures have created supply disruptions in the world commodity market, and thus ultimately pushed up the food prices even higher across the globe.

The limitations of fiscal and administrative policies to contain inflationary pressures imply that the burden on monetary policy to contain inflationary pressures increases. Thus, monetary policy is tight in most of the emerging economies in the current spell of price hike. However, given that food inflation has taken less of a toll in developed economies, and that aggregate demand in these is already feared to be hit by the on-going financial crisis (which would help reduce inflation), monetary authorities in these economies have largely either loosened their monetary posture or are holding to a neutral stance.

Box: 3.1: Major Developments in International Food Commodity Markets
Following are the major developments that have led to a surge in food commodity prices in the international markets:

Wheat

- Rapid growth in emerging economies, importantly China and India, has resulted in increased demand for wheat, thus pushing its prices up.
- The number of wheat farmers switching to other crops such as maize and corn is growing due to increase in the preference for bio-fuel.
- Two years of drought in Australia has cut the global wheat stock to a level not seen since 1970s.
- Continued larger exports of wheat from USA led to depletion of wheat stocks to 60 years low level, creating panic.

Rice

- A ban from major rice exporters Vietnam, India, Egypt and Cambodia to ensure domestic availability aggravated supply concerns.
- Increase in rice demand as its consumption in Asia, Middle East and West Africa is rising due to higher per capita income.
- Short supplies due to reduction in acreage, rising cost of fuel and poor crop due to water shortages. As a result global current rice stocks are at the lowest levels since 1976.

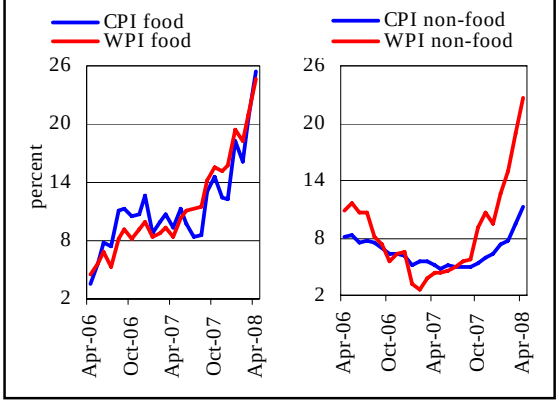
Edible Oil

- Expected lower rapeseed production in China because of bad weather and lowering of input tariff by Indian government has put pressure on vegetable oil prices in global market.
- US, EU and Russia have been showing high consumption of soybean oil for industrial use pushing its price in the international market.
- Increasing palm oil prices are also being supported by protectionist policies in major exporting countries like Indonesia where palm oil is politically sensitive as it is staple product.

3.2 Domestic Scenario

The impact of strong global inflationary pressures on domestic inflation has also compounded by the adjustments of administered prices of key fuels and wheat. All price indices have moved up significantly so far in FY08 and are significantly higher than the annual averages of the preceding five years (see **Table 3.2**).

Figure 3.2: Trends in CPI and WPI inflation YoY



It is important to note that trends of food inflation are similar in both CPI and WPI (see **Figure 3.2**). In contrast, there is a clear diversion in

non-food inflation in these indices[2].

Table 3.2: Inflation Trends
percent

	Year-on-Year[1]		12-month moving average		Avg. FY03-FY07 (YoY)
	April				
	2007	2008	2007	2008	
CPI	6.9	17.2	7.8	9.8	6.5
Food	9.4	25.5	9.7	14.3	7.5
Non-food	5.2	11.2	6.5	6.5	5.8
WPI	6.0	23.5	7.3	12.6	7.9
Food	8.4	24.6	8.1	15.8	7.7
Non-food	4.3	22.7	6.6	10.4	8.0
SPI	7.7	22.3	9.4	11.2	7.4
Core					
NFNE[3]	5.6	10.8	6.1	7.2	5.6
Trimmed mean	6.6	14.1	6.8	8.9	6.0

[1]e.g. change in April 2008 over April 2007
[2]e.g. change in 12-month average of April 2008 over April 2007
[3]Non-food non-energy

Source: Federal Bureau of Statistics

The initial diversion in non-food inflation in the two indices was primarily attributed to the fact that: (1) pass through of rising international oil prices was negligible in non-food CPI since the prices of key fuels remained unchanged in CPI basket. In contrast, pass through in WPI was significantly high as the prices of most of the POL items included in WPI are market based. (2) A large part of increased cost was probably absorbed by the producers to remain competitive in the market. Persistent rise in the commodity prices, however, forced producers to pass on some impact to consumers recently, which resulted in a sharp jump in CPI non-food inflation in April 2008, and (3) the impact of increase in the prices of various manufacturing inputs such as cotton and metals is only partially reflected in CPI non-food, while WPI non-food shows their full impact.

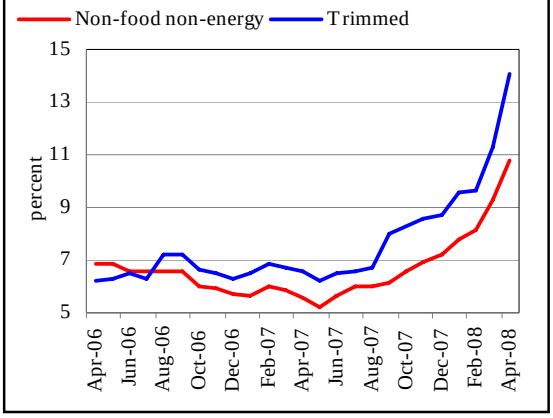
If inflationary pressures are, principally driven by rising food prices, a tight monetary posture may help contain second-round effects of high food inflation on CPI non-food inflation. But heavy government borrowing from SBP undermines its efforts to mitigate second-round effects of sustained high food inflation, which further fueled the inflationary pressures. As a result of large fiscal deficit, money growth remained well above the desired level and more than required growth in liquidity complicates monetary management.

The muted impact of monetary policy is also evident in rising core inflation

[2] CPI non-food inflation was only 6.3 percent YoY in December 2007, rose to 11.2 percent YoY by April 2008.

throughout FY08. Core inflation, measured by 20 percent trimmed mean, accelerated to double digits (14.1 percent -historic high level) in April 2008. Persistence of inflationary pressures is also evident from non-food non-energy (NFNE) based core inflation that increased to 10.8 percent in April 2008 (see **Figure 3.3**).

Figure 3.3: Core Inflation (YoY)



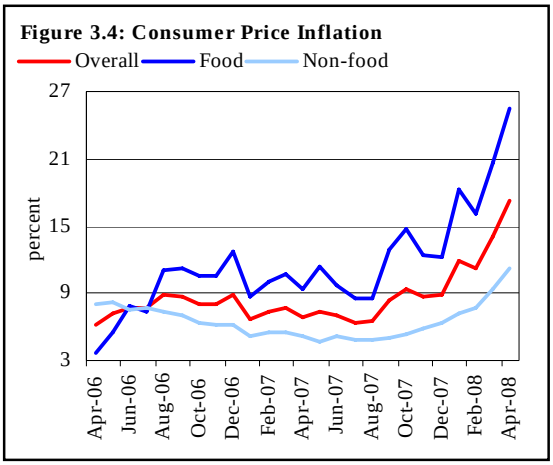
It should be kept in mind that the historic high food, energy, fertilizer and metal prices in international markets are the major causes of the strength in domestic inflation. Wheat, rice, edible oil, readymade food and milk prices have surged since July 2007. In perspective, a relatively lower domestic wheat flour prices encouraged smuggling to neighboring countries. Increase in wheat support price stimulated speculative hoarding. Low inventory stocks with the government, as well as, substantially higher input cost particularly fertilizers are the main reasons of the rising wheat prices. Procurement and import of sufficient quantity of wheat in order to stabilize flour prices will be a challenge for the government in coming months. Similarly, while Pakistan had sufficient surplus rice for export, rising international prices amid supply shortages attract Pakistani rice exporters, which resulted in increasing domestic prices of rice as well. Recently, in order to ensure domestic availability of rice, government has fixed a minimum export price for rice. Moreover, a tax on rice export would also help improve fiscal balance as well as ease domestic supply.

The unanticipated strength of food and energy prices is likely to continue in the medium-term. Such high inflation is not good for long-term growth and competitiveness. This suggests the need for a continuously tight monetary stance aiming at minimizing the second-round impact and pass through of administered prices. This is not easy task and requires effective support of fiscal authorities to reduce their borrowings from SBP. Further, depreciation of Pak rupee in recent months is also likely to generate inflationary pressures. Given the present inflationary pressures in the economy, SBP forecasts were revised upward with

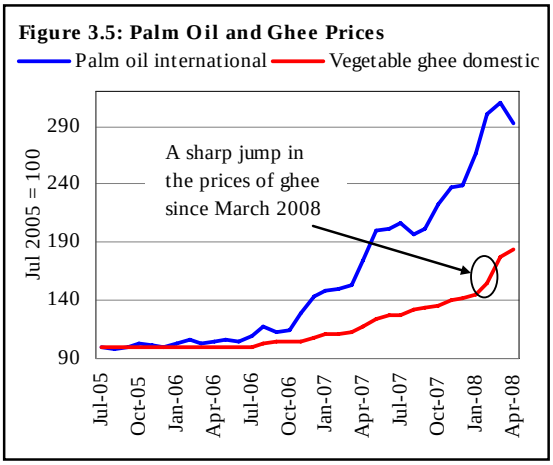
CPI inflation likely to fall between 10 to 11 percent during FY08, significantly higher than the 6.5 percent target for the year.

3.3 Consumer Price Index (CPI)

CPI inflation (YoY) remained in double digits during the third quarter of FY08. The acceleration in CPI inflation is contributed by both food and non-food components (see **Figure 3.4**).



Rising prices of key food staples (wheat, rice, edible oil and milk) continued to provide impetus to food inflation in recent months. It is also important to note that the pass through of rising international prices of palm oil has accelerated (see **Figure 3.5**).



The inflation outlook appears to be unfavorable given a sharp surge in wheat flour prices amid acute supply shortages in recent months, as well as, likely realization of upward revision in key fuel prices on food inflation[3]. Moreover, impact of depreciation of rupee is likely to fuel inflationary expectations in the times ahead.

Since the incidence of significantly high food inflation on the poor is disproportionately high, therefore, there is a need to take necessary administrative measures to protect low-income households by providing targeted subsidy to them

[3] In terms of higher transportation cost.

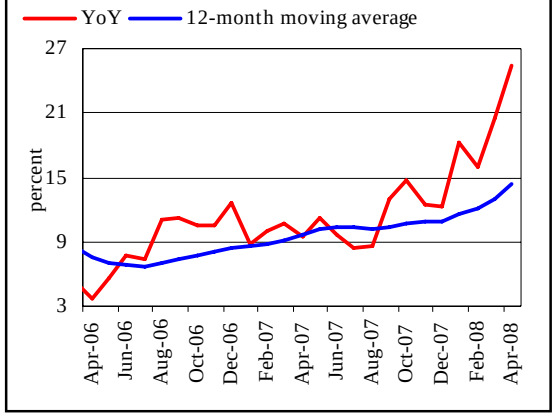
through ration cards, utility stores or through students of public schools[4]. Providing subsidy is, however, a short-term measure. In long-term, investment in agriculture sector to raise productivity is essential. This may be done by providing certified seeds, access to institutional credit, subsidy on fertilizer, reducing wastages, water reservoirs and investment in value addition chains. In addition, appropriate price signals to farmers and improve market structures are required to convince them that they will get a reasonable return for their labor. At the same time, strict check on illegal cross boarder movement of grains and a vigilant monitoring of domestic availability and timely imports in case of need to avoid crisis like situation will be crucial for domestic price stability.

It is important to note that non-food inflation is also likely to reach close to double digit levels by the end of current fiscal year. While, non-food group offsetting some of the impact of rising food inflation in FY07, it is contributing in strengthening inflationary pressures during FY08.

3.3.1 CPI Food Inflation

CPI food inflation increased significantly during the first nine months of FY08. CPI food inflation was 25.5 percent during April 2008, as compared to 9.4 percent in the corresponding month last year (see **Figure 3.6)**.

Figure 3.6: CPI Food Inflation



While the prices of most of the food items are rising, the dominant contribution to the sharp rise in CPI food inflation is from only a few items (see **Table 3.3**). Only seven food items with a total weight of 19.9 percent in CPI basket, contributed 47.1 percent in overall inflation during April 2008. Moreover, within the food group, only three items (wheat, vegetable ghee and fresh milk) contributed 56.1 percent of the food inflation during April 2008.

[4] It has been observed that drop out ratio from schools increases with rising incidence of poverty. Therefore, provision of basic food staple to public school students may probably help avoid increase in the drop out ratio as well as help the needy households.

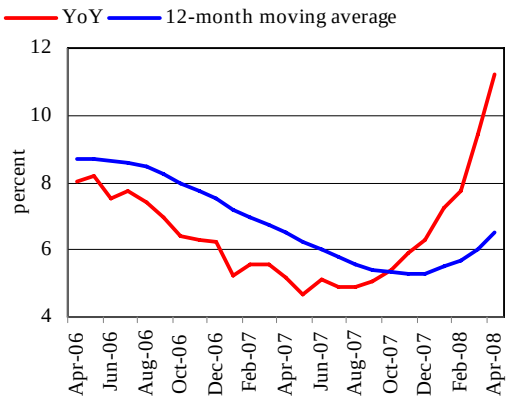
3.3.2 CPI Non-food Inflation

CPI non-food inflation (YoY) showed a sharp acceleration in FY08, though the pace of increase is slower than the food inflation. CPI non-food inflation rose to 11.2 percent in April 2008 compared with 5.2 percent in the same month last year (see **Figure 3.7**).

Table 3.3: Top Ten Contribution to YoY CPI Inflation in April 2008

	Items	Weights	YoY Change		Weighted contribution
			Apr-07	Apr-08	
1	Wheat flour	5.1	4.4	54.1	15.8
2	House rent index	23.4	6.2	11.4	15.4
3	Vegetable ghee	2.7	25.3	59.9	10.5
4	Milk fresh	6.7	11.2	21.0	8.7
5	Rice	1.3	28.4	60.2	5.2
6	Petrol	1.7	-6.9	28.2	3.5
7	Transport fare/charges	2.1	2.5	19.6	2.9
8	Cooking oil	0.7	18.2	59.1	2.5
9	Vegetables	1.8	7.9	18.6	2.2
10	Readymade food	1.7	6.4	20.7	2.2
	Total	**47.2**			**68.9**

Figure 3.7: CPI Non-food Inflation



The recent increase in non-food inflation is mainly attributed to jump in inflation in house rent index (HRI) and cleaning, laundry & personal appearance sub-groups during April 2008. Moreover, a trend reversal in sub-groups of transport & communication, as well as, fuel & lighting also put upward pressures on non-food inflation.

The rise in HRI is principally owed to increasing international metal prices and continued uptrend in domestic wages of construction workers. In contrast, increase in fuel & lighting and transport & communication sub-group is mainly a result of an upward revision in the domestic prices of key fuels amid record high international oil prices (see **Table 3.4**).

3.3.3 Income Group-wise Inflation

The contribution of food inflation in overall CPI remained high in the first nine months of FY08. This resulted in a larger incidence of inflation for the low-income groups, where food staples typically account for a greater proportion of total expenditure.

Table 3.4: CPI Non-food Inflation (YoY) by Groups

	Weights	Apr-07	Jun-07	Dec-07	Feb-08	Mar-08	Apr-08
Non-food group	59.7	5.2	5.1	6.3	7.8	9.4	11.2
Apparel, textile and footwear	6.1	7.3	7.2	8.7	6.7	6.9	8.4
House rent	23.4	6.2	6.7	8.8	10.0	10.6	11.4
Fuel & lighting	7.3	7.0	6.1	5.5	6.2	8.5	8.6
Household furniture & equip.	3.3	7.0	5.8	6.5	6.3	7.0	8.4
Transport & communication	7.3	-2.4	-3.1	-3.0	3.0	8.7	17.9
Recreation & entertainment	0.8	-0.2	0.1	0.4	0.7	0.9	1.0
Education	3.5	6.6	6.4	4.4	3.4	3.5	4.7
Cleaning, laundry & personal appearance	5.9	4.5	4.7	8.9	13.0	15.9	15.8
Medicare	2.1	10.1	9.9	7.6	7.9	6.5	7.4
Headline	**100**	**6.9**	**7.0**	**8.8**	**11.3**	**14.1**	**17.2**

Thus in April 2008, the lowest income group (income up to Rs. 3000 per month), middle income groups (income Rs. 3001 – 5000 per month) and upper middle income group (Rs. 5001 – 12000) witnessed highest inflation of 20.2, 19.9 and 18.1 percent, followed by 15.7 percent for the highest income group (with income above Rs. 12000 per month) (see **Figure 3.8**).

Figure 3.8: Incidence of CPI Inflation (YoY) Apr-08

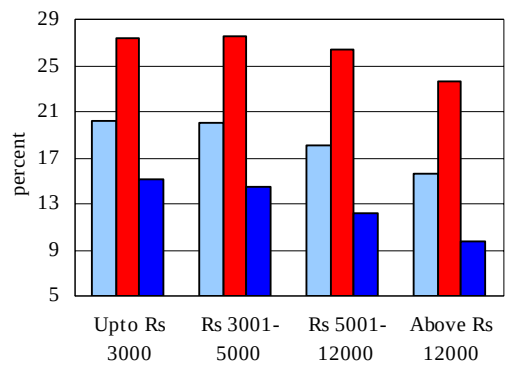
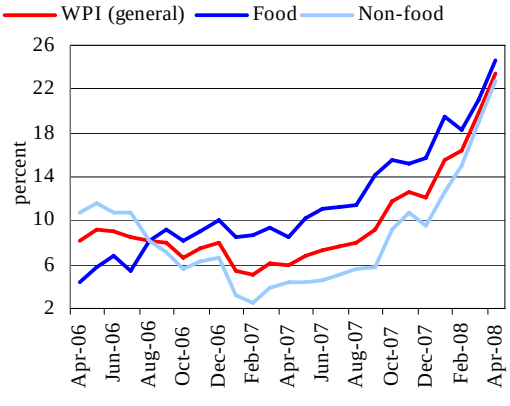


Figure 3.9: Wholesale Price Inflation (YoY)



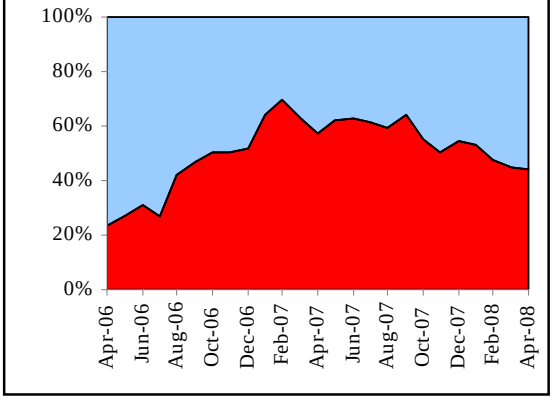
3.4 Wholesale Price Index (WPI)

Inflation measured by Wholesale Price Index continued its uptrend throughout the first nine months of FY08 and recorded 23.5 percent growth during April 2008, which is significantly higher than the 6.0 percent recorded in April 2007. Both, food and non

food groups of WPI contributed to the rise in WPI inflation (see **Figure 3.9**).

WPI food inflation reached 24.6 percent in April 2008 compared with 8.4 percent in the same month last year. Factors which drove CPI food inflation are also responsible for substantially high WPI food in recent months. WPI non-food inflation also rose to 22.7 percent in April 2008 compared to a subdued 4.3 percent during the same month last year. The strength of the rising pace of WPI non-food inflation is also evident from its rising weighted contribution (see **Figure 3.10**) in overall WPI inflation in recent months, despite continued double digit WPI food inflation in the current fiscal year.

Figure 3.10: Weighted Contributions in WPI

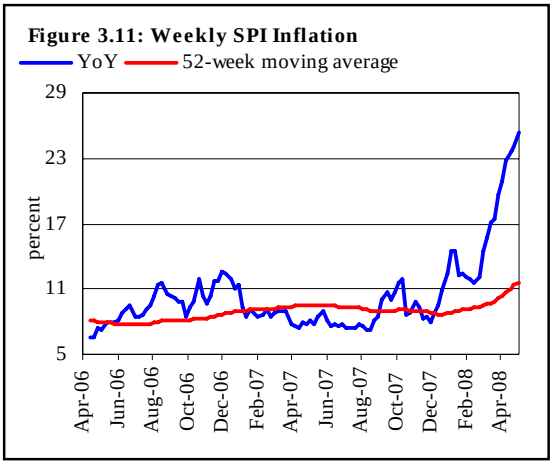


Within the non-food group of WPI, the fuel, lighting & lubricant sub-group showed a significant rise in its contribution during Q3-FY08 and has contributed more than 60 percent to non-food inflation in recent months, reflecting the impact of continuously rising international crude oil prices.

3.5 Sensitive Price Indicator (SPI)

Weekly inflation measured by SPI also increased considerably from 7.7 percent in the last week of FY07 to 25.4 percent in the first week of May 2008 (see **Figure 3.11**). Similarly the monthly SPI inflation reached to 22.3 percent (YoY) in April 2008 compared to 7.7 percent in the same month last year. This is mainly because almost 60 percent of the items included

Figure 3.11: Weekly SPI Inflation



in the SPI basket are from the food group, thus it largely exhibited the up trend of the CPI food component.

More than 60 percent of the items included in the SPI basket recorded double-digit YoY inflation during April 2008, with some of the items like rice, wheat, vegetable ghee, cooking oil, mustard oil, pulse masoor and tomatoes witnessing inflation of more than 50 percent.

4 Money and Banking

4.1 Overview

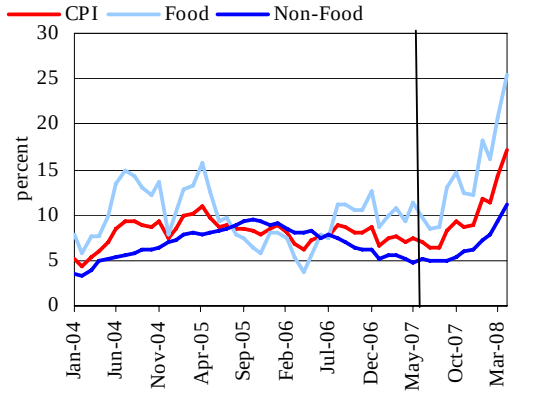
The SBP has continued with the tight monetary policy stance during FY08, raising the discount rate and increasing the reserve requirements of the banking system.[1] Other changes were also implemented to improve the transmission of policy signals, reduce the growth of reserve money, and drain liquidity from the market.[2] As a result, the overnight rates remained close to the discount rate and excess liquidity in the money market declined significantly (see **Table 4.1**).

Table 4.1: Liquidity Conditions in the Money Market (Jul-21st May)

	unit	FY07	FY08
Overnight rates (average)	percent	8.4	8.9
Volatility	percent	12	14
Credit/deposit ratio (end Apr)	percent	84.3	90.8
Credit/deposit ratio (end Apr, marginal)	percent	72.4	227.1
Discounting per visit	billion Rs	8.9	15.2
Absorptions through OMOs	billion Rs	789.3	1035.8
Injections through OMOs	billion Rs	72	190.6
WALR (end March, marginal)	percent	10.6	10.9

Despite sustained monetary tightening, inflationary pressures have persisted in the economy throughout Jul-Apr FY08 (see **Figure 4.1**). Specifically, the overall CPI reached a record high of 17.2 percent in April 2008 more than double from 6.4 percent recorded in July 2007. This was due to a number of factors, including supply shocks and continuing strong demand. The former was driven by disappointing harvests of key domestic crops, and a sustained increase in global commodity prices (including unprecedented hikes in food and energy costs). The demand pressures, on the

Figure 4.1: Price Movements in the Economy



[1] SBP increased its policy rate by 50 bps to 10 percent effective from August 1, 2007. To curb the aggregate demand pressures further, SBP again increased its policy rate by 50 bps to 10.5 percent and CRR by 100 bps effective from February 1, 2008. **Since the finalization of report SBP further raised its policy rate by 150 bps and reserve requirements by 100 bps.**

[2] See SBP's Monetary Policy Statements for Jul-Dec 2007 and Jan-Jun 2008 for details.

other hand, are reflected in a sharp rise in the fiscal deficit that was largely monetized through a record increase in government borrowings from the central bank. The impact of both supply and demand side factors was also reflected in the sharp widening of the current account deficit seen November 2007 onwards.

Thus, the conduct of monetary policy has become increasingly challenging for SBP as the fiscal year has progressed, and inflationary pressures appear to be gaining further strength.

Pass-through of international prices is increasing
Historic high prices of some of the key commodities in the international market (such as petroleum products, rice, wheat, palm and soybean oil etc) are exerting an upward pressure on domestic prices. This pass through is significant (see **Table 4.2**), and has increased in recent years as prices of many commodities in the domestic market are now more reflective of trends in the global markets (especially in fuel commodities, iron, selected food items, fertilizer sectors etc).[3] The impact on domestic inflation has recently become more pronounced as the government began to gradually pass-on the rise in cost of key fuel (petrol and diesel), which had earlier been frozen, to the domestic consumers.

Inflation expectations are becoming stronger
Since longer term structural price changes[4] are the major contributor to global inflation, the impact on inflationary expectations is likely to be more lasting. There are evidences that the erosion in purchasing power and squeeze in profit margins due to sustained increase in food and commodity prices are contributing to second round of inflationary pressures. The core inflation measures, which are reflective of underlying inflationary pressures in the economy, reached their historic highs in April 2008. Further, there is increasing risk that without continued monetary tightening, the inflationary pressures may turn into a wage-price spiral.

[3] It is important to note that the pass through of international prices to domestic consumers is not limited to imported goods only. In the case of exportables, higher prices in global markets will induce producers to sell their produce to foreign consumers, thereby exerting pressures on the local prices as well. The recent sharp increase in the prices of rice is the case in point where pressures on international prices were transmitted to domestic markets.
[4] Rising bio-fuels production in the US and EU accounts for almost half of the increase in consumption of major food crops in the past year. Growth in per capita income in emerging economies has brought robust demand growth. Higher energy and fertilizer costs have also contributed to higher prices for all agricultural commodities. Most of these factors are likely to be permanent (source: IMF Survey Magazine, March 2008).

Table 4.2: Empirical studies on impact of international prices on domestic inflation in Pakistan

Author	Data	Results
Khan and Qasim (1996)	1971-12 to 1994-95	One percent increase in import prices increase general price level of 0.46 percent.
Khan, Bukhari and Ahmed (2007)	1972-73 to 2005-06	One percent increase in import prices increases domestic inflation by 0.12 percent
Akbari and Rankaduwa (2005)	Quarterly 1992-2004	One percent increase in import prices increases the CPI inflation by 0.26 percent in the long run while increases the WPI inflation by 0.25 percent
Ahmad and Ali (1999)	1982-II to 1986-IV	One percent increase in import prices leads to 0.15 percent increase in domestic inflation
Hasan et al (1995)	1972-73 to 1994-95	One percent increase in external prices increases the manufacturing prices by 0.25 percent and raw material prices by 0.50 percent.
Ahmad and Ram (1991)	1960-61 to 1987-88	One percent increase in import prices leads to 0.20 percent increase in WPI and 0.14 percent in CPI respectively
Hyder, Zulfiqar and Sardar Shah (2004)	Jan 1988-Sep 2003	The exchange rate pass through is more pronounced in the case of WPI compared to CPI. The long-run pass through coefficient is 14.86 percent for WPI and 11.43 percent for CPI, whereas, short-run coefficient for WPI is 15.85 and for CPI is 10.27.

References:

Khan,A.H and M.A.Qasim (1996). "Inflation in Pakistan Revisited". *The Pakistan Development Review* 35:4 pp.747-757

Khan.A.A, Bukhari.K.H and Ahmad.Q.M. (2007). "Determinants of Recent Inflation in Pakistan". SPDC Research Report No. 66

Akbari.A.H and Rankaduwa.W (2006). "Inflation Targeting in Small Emerging Market Economy: The Case of Pakistan". *SBP Research Bulletin* 2:1 pp. 169-190

Ahmad.E and Ali.S.A. (1999). "Exchange Rate and Inflation Dynamics." *The Pakistan Development Review* 38:3 pp. 235-51

Hasan.A.M, Ashfaque K.H, Pasha.H.A and Rasheed.A. (1995)."What Explains the Current High Rate of Inflation in Pakistan?" *The Pakistan Development Review* 34:4 pp. 927-943

Ahmad.E and H.Ram (1991). "Foreign Price Shocks and Inflation in Pakistan: A Monetarist Approach" *Pakistan Social and Economic Review* 29:1 pp.1-20

Hyder, Zulfiqar and Sardar Shah (2004). "Exchange Rate Pass-Through to Domestic Prices in Pakistan." SBP Working Paper Series No.05

Weak fiscal space will inhibit government's ability to cushion impact

As the current higher prices in international markets are forecast to persist well above their historical averages for the foreseeable future, any effort by the government to absorb pass through of rising global prices to domestic consumers, would soon become unsustainable due to limited fiscal space. For Pakistan, the problem is compounded by the already high fiscal deficit.[5] Furthermore, the government is relying more on borrowings from the central bank, which is the most inflationary source of financing. To put this in perspective, as of May 10, 2008, the government budgetary borrowings from SBP have grown, by Rs 551.0 billion during the current fiscal year which has almost doubled the stock of

[5] The mounting-up of the fiscal deficit can contribute to the overall CPI inflation through two different channels: (1) rise in fiscal deficit due to high expenditures growth adds to the aggregate demand pressures in the economy, and (2) the composition of deficit financing also matters for the price stability.

MRTBs to Rs 940.6 billion. This fiscal indiscipline has complicated the monetary management. As evident from **Table 4.3**, the government sector has made significant contribution to overall M2 and aggregate demand pressures in the economy. Further, the liquidity injections from unpredictable government borrowings have weakened the transmission of policy rates to retail rates.

External current account deficit is also widening sharply

The impact of both the rising international commodity prices as well as the widening of fiscal deficit is being reflected in the overall worsening of balance of payments accounts.[6] This deterioration of the external account has implications for the monetary management because (1) it has put an upward pressure on the exchange rate of Pak rupee against major currencies that may add to the pass-through of imported inflation to the domestic economy;[7] (2) as a part of deterioration in external account is due to delays in the availability of external financing, it has resulted into increased reliance of the government sector borrowings on the central bank which is adding to the inflationary pressures; and (3) it has the potential to adversely impact the overall macroeconomic stability and economic growth.[8]

Table 4.3: Composition of M2 Growth by Sectors (Jul-Apr)

percent

	Contribution to M2 growth	
	FY07	**FY08**
NFA	**2.3**	**-7.3**
NFA govt.	4.2	4.1
NFA non-govt.	-1.9	-11.4
NDA	**9.9**	**15.7**
NDA govt.	3.5	8.9
NDA non-govt.	6.3	6.9
M2	**12.2**	**8.5**
Total govt. contribution	7.7	13.0
Total non-govt. contribution	4.5	-4.6

Given the mounting inflationary pressures, and the rising risk to macroeconomic stability and long-term growth, it was critical that the policy response be urgently formulated and implemented.

A survey of the monetary policy of various central banks clearly indicate that high global energy, food and commodity prices have substantially increased the upside risks to inflation for developing countries. Central banks of such economies

[6] During Jul-Apr FY08, balance of payments account turned into deficit of US$ 5.1 billion compared to the surplus of US$ 0.8 billion during the same period last year.

[7] By increasing the Rupee cost of imported goods, the exchange rate depreciation encourages more spending on domestic goods and services. Thus, in turn adds to demand pressure on domestic goods.

[8] The balance of payments problems severely hamper the growth prospects of an economy in the long-run through restraining the import demand which is essential for growth.

have decided either to further tighten their monetary policy or to maintain a status quo (despite clear indication of weakening aggregate demand – see **Box 4.1** and **Annexure 1**).

Box 4.1: Response of Selected Central Banks to Rising Fuel & Commodity Prices
A survey of monetary policy response of selected central banks to rising fuel and commodity prices reveals some interesting trends (see **Annexure 1** for details):

- In developing countries where the economic growth is strong, and risks to inflation and inflation expectations have increased considerably, the central banks have responded with more tightening (examples, India, China).

- In developing countries where the economic growth is strong, and domestic inflationary pressures are currently at low level, the central banks have kept their policy rate unchanged (example Malaysia).

- In developing countries where the aggregate demand is weakening, the central banks have kept their policy stance unchanged on anticipation that either disinflation would offset the pass through of higher international fuel and commodity prices (example, Turkey, Indonesia) or the inflation pressures would moderate with the slowdown in global economy (examples, Thailand, Philippines).

In the case of developed economies, the dominant response is the reduction in policy rate because (1) the recent tightening of credit conditions has considerably increased the downside risks to economic growth, and (2) the pass through of higher prices of food commodities is limited because of lower share of food items in the consumption basket. In Australia, which is commodity exporter, the improvement in terms of trade due to rising global commodity prices could potentially lead pressures on domestic spending. In view of rising risks to inflation, central bank further tightened its monetary policy.

4.2 Developments in Monetary Aggregates

Growth in broad money (M2) decelerated during Jul-10th May FY08 due to contraction in the net foreign assets (NFA) of the banking system; net domestic assets (NDA) of the banking system, on the other hand, expanded sharply during this period (see **Figure 4.2**). The YoY growth in M2 as on 10th May FY08 remained at 14.0 percent –still higher than FY08 target of 13.7 percent (see **Table 4.4**).

Table 4.4: Monetary Survey (as on 10th May)
flows in billion Rs and growth in percent

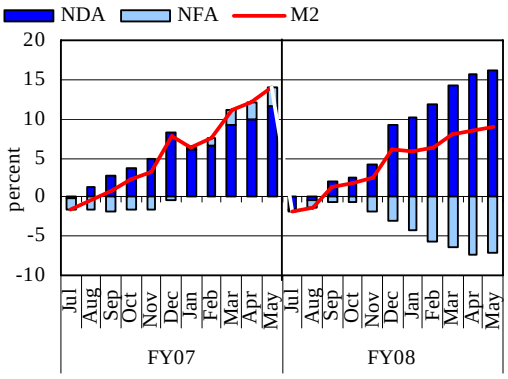
	Absolute flows since end-June		YoY Growth in Stock	
	FY07	**FY08**	**FY07**	**FY08**
Government borrowing	185.8	423.0	24.9	32.4
For budgetary support	212.4	362.1	27.8	27.3
SBP	34.8	551.0	28.9	104.4
Scheduled banks	177.5	-188.9	26.8	-42.7
Commodity operations	-26.4	60.9	3.1	96.0
Credit to Non-Govt Sector	274.0	414.4	15.9	21.3
Private sector	263.4	369.8	15.9	19.9
Credit to PSEs	10.2	44.3	21.1	75.6
OIN	-64.3	-180.7	31.2	53.9
SBP	44.3	-101.7	25.0	101.4
Scheduled banks	-108.6	-79.0	35.4	23.7
NDA	395.5	656.7	17.0	20.9
SBP	79.2	449.6	30.0	102.3
Scheduled banks	316.3	207.1	15.7	12.2
NFA	84.6	-289.8	16.8	-12.6
SBP	61.5	-221.7	11.3	-9.7
Scheduled banks	23.1	-68.1	42.7	-23.4
M2	480.1	366.9	16.9	14.0

Net Foreign Assets (NFA)

Contraction in NFA of banking system has been the result of widening trade deficit and lower net receipts of external financing.

Within the banking system, contraction in SBP's NFA has been higher compared to that of scheduled banks (see **Figure 4.3**). Higher SBP market support for oil payments, lower inflows on account of delays in privatization/ disinvestment transactions (including GDRs), and delays in logistic support receipts are the factors that explain most of the current decline in SBP's NFA (see **Figure 4.4**).

Figure 4.2: Contribution to M2 Growth (Jul-10th May)



The contraction in scheduled

banks' NFA[9] during Jul-10th May FY08 was due to a decline in foreign investments,[10] and lower receipts in foreign private loans.[11]

While the trade financing availed by importers (due to a rising interest rate differential between the Rupee and foreign currency loans) led to a sharp decline in the scheduled bank's NFA,[12] this was partially offset by a rise in resident foreign currency deposits during the period.[13]

Net Domestic Assets (NDA)
The sharp acceleration in NDA growth of the banking system is a source of concern for monetary policy. The SBP has contributed the most to the overall NDA expansion mainly due to strong growth in the government borrowings from central bank (see **Figure 4.5**). In the case of scheduled banks' NDA,

Figure 4.3: Net Foreign Assets (Cumulative Flows-Jul-10th May)

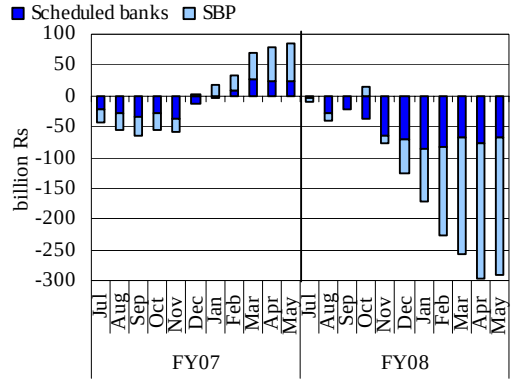
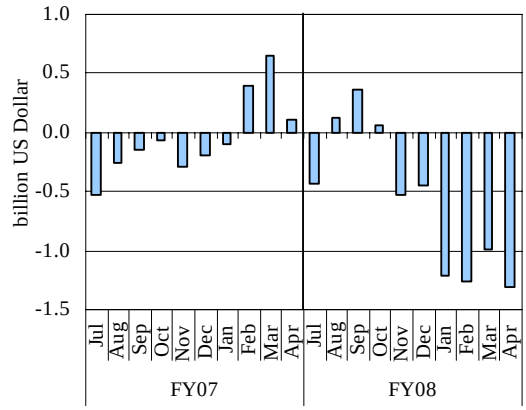


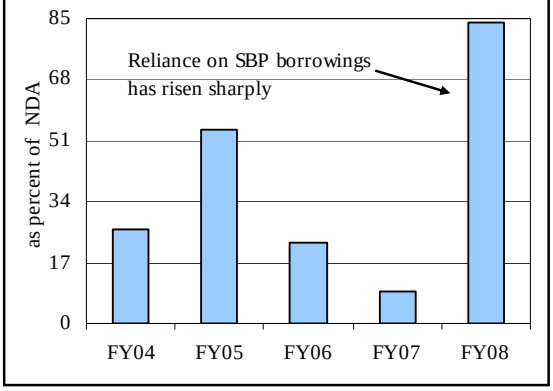
Figure 4.4: SBP's Forex Market Support (Net)



[9] This depletion in scheduled banks' NFA was despite a substantial rise of US$ 5.3 billion in workers' remittances during Jul-Apr FY08 compared to US$ 4.5 billion during the corresponding period last year. Foreign currency deposits also increased by Rs 19.0 billion during Jul-Apr FY08 compared to Rs 4.9 billion during the corresponding period last year.
[10] Foreign investment slowed down to US$ 3.6 billion during Jul-Apr FY08 compared to US$ 5.9 billion during the same period last year.
[11] Foreign private loans registered a major slowdown as the economy received net inflow of US$ 271 million only during Jul-Apr FY08 compared to US$ 465 million during the same period last year.
[12] Specifically, during Jul-Apr FY08, trade sector availed Rs 26.1 billion worth foreign currency loans compared to Rs 19.3 billion during the Jul-Apr FY07.
[13] Resident Foreign Currency Deposits witnessed an increase of Rs 21.2 billion during Jul-Apr FY08 against the increase of just Rs 2.8 billion during the same period last year.

the impact of expansion in private sector credit was partially offset by government's net retirement of borrowings from scheduled banks.

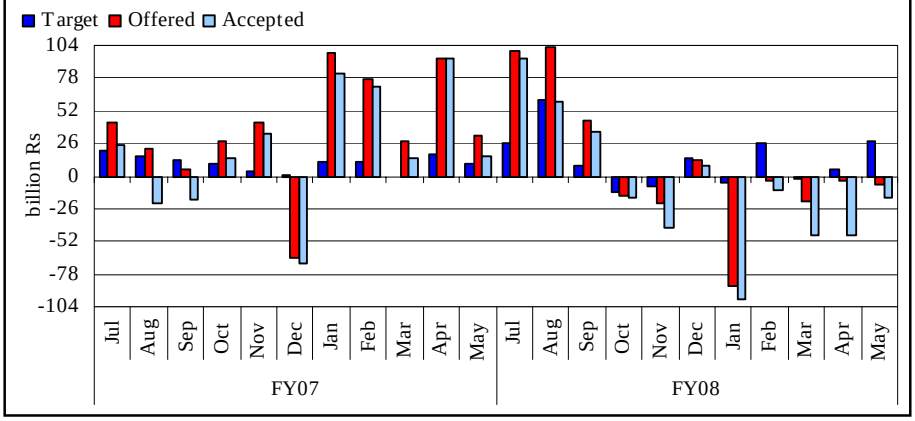
Figure 4.5: Budgetary Borrowings from SBP (Jul-10th May)



Government budgetary borrowings

On cumulative basis, as on May 10, 2008, government has borrowed Rs 551 billion from SBP during the current fiscal year, which has almost doubled the stock of MRTBs with SBP to Rs 940.6 billion. To put this in perspective, the Jul-10th May FY08 borrowings are twice the net borrowings seen during the preceding three years. The exceptional borrowings reflect more than budgeted expansion in the fiscal deficit against a slower growth in revenue mobilization and a shortfall in external financing receipts.

Figure 4.6: T-bill Auctions (Net of Maturities)

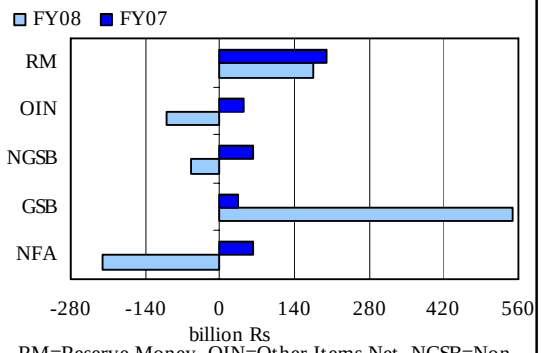


The reliance on central bank borrowing is partly an outcome of scheduled banks' reduced interest in government papers. This is because of tight liquidity conditions in the inter-bank market and strong credit demand from the private sector (which offers greater return). As a result, government is unable to mobilize substantial amounts in treasury auctions. In fact, there is a net retirement of

government debt to commercial banks (see **Figure 4.6**).

The growth in the credit to the PSEs, which also contributed to the current rise in NDA, is attributable to delays in settlement of oil price differential[14] claims of one public sector oil marketing company (OMC), and the credit extension to the electricity distribution companies.

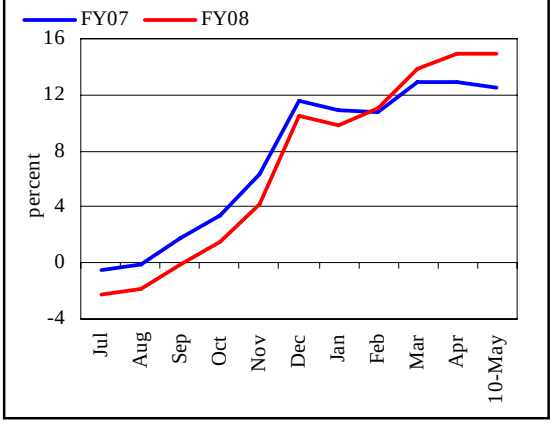
Figure 4.7: Composition of Reserve Money (Jul-10th May)



RM=Reserve Money, OIN=Other Items Net, NGSB=Non-govt sector borrowings, GSB=Govt sector borrowings

Despite substantially high government sector borrowings from the central bank, growth in the reserve money has slowed down in recent months (see **Figure 4.7**). This reflects (1) the contraction in NFA, net retirement in the amount of refinance provided by SBP,[15] and (3) open market operations.

Figure 4.8: Cumulative Growth in Private Credit



Private Sector Credit (net)[16]
Following a sharp rise since January 2008, the cumulative growth in private sector credit for the current fiscal year accelerated to 14.9 percent – 2.5 percentage points higher than that in corresponding period last year (see **Figure 4.8**).

[14] Differential is between the international oil prices and the domestic consumer prices.
[15] In order to contain excessive growth in reserve money, SBP capped the amount of export refinance for FY08 at 70 percent of the end-June 2007 level. This measure has led to net reduction in outstanding volume of export refinance.
[16] Private sector credit comprises of banks' investments and advances to the corporate sector. The data on private sector credit is based on monetary survey covering the period of Jul-10th May FY08.

The private sector credit, which had been growing at a slower pace till January 2008 compared to previous year, gathered momentum thereafter.

The key factors contributing to this recent acceleration in private sector credit growth were (1) rise in working capital requirements due to higher input costs; (2) the need for bridge financing to settle price differential claims of OMCs and IPPs; and (3) the higher fixed investment (visible in a few sectors, e.g. textile, refineries and power) in the month of March 2008 (see **Table 4.5**).

Table 4.5: Break-up of Private Sector Credit (FY08)
cumulative growth in percent

	Dec	Jan	Feb	Mar
Private sector credit	10.5	9.9	11.0	13.9
Of which:				
Fixed	3.4	0.5	1.3	7.0
Working capital	15.6	19.9	22.2	22.8

Figure 4.9:Contribution to Growth in Private Credit (Jul-Mar)

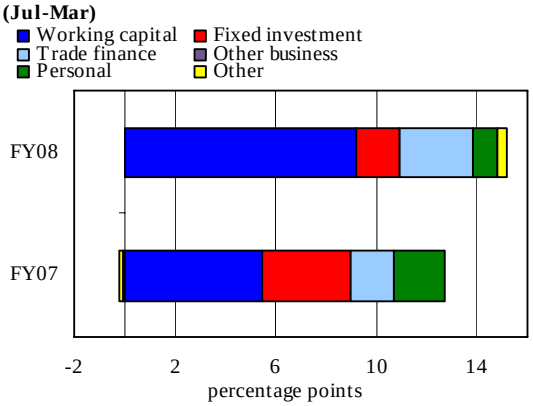
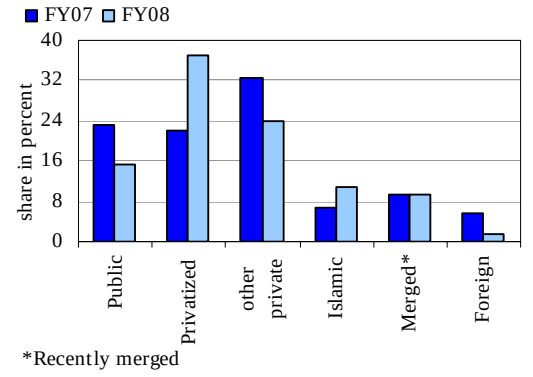


Figure 4.10: Skewed Incremental Credit Distribution (Jul-10th May)



Credit demand is stong

The acceleration in private sector credit growth during Jul-Mar FY08 was mainly reflected in credit extended to corporates. The overall credit demand is strong despite a significant slowdown in credit growth to consumers during the same period (see **Figure 4.9**).

At least, a part of the rise in credit demand is explained by continued strong surge in raw material prices in sectors such as agriculture, textile, commerce and trade. This suggests that the credit demand would have been even higher had energy shortages and operational

bottlenecks in major industries not have constrained the industrial growth during Jul-Mar FY08.

Bank's concentration in lending has risen amid supply side issues

The institutional concentration in the incremental lending activities increased during Jul-10th May FY08, compared to last year (see **Figure 4.10**). This was mainly due to a sharp rise in lending activity of one of the large privatized banks, which interestingly also experienced a higher deposit mobilization, particularly during the period of seasonal credit off-take.

The rising share of Islamic banks in incremental credit during Jul-10th May FY08 is reflective of the growing interest of public in the Islamic banking industry. Islamic banks are generating a healthy competition as they have been able to attract a significant share of credit demand from conventional banks.

The lower credit expansion in the remaining banking groups during the period under review stems from following reasons: (1) the process of merger in one of the domestic private bank (under the category of small domestic private banks) has prevented the entity from aggressive lending; and (2) deterioration in the quality of banks' assets, particularly in the category of consumer loans may have restrained a few banks to contribute significantly in the lending activities (see **Table 4.6**). The impact of the latter is more evident in foreign banks, since a large portfolio of foreign banks' credit comprises of consumer loans. Therefore, the lower demand for consumer loans and rising NPLs in this category has caused slowdown in foreign banks' credit expansion (see **Table 4.7**).

Table 4.6: Credit Quality Indicators (end Mar)

percent

	Mar-07	Mar-08
NPLs / loan (gross)	7.2	7.7
of which: Corporate	6.7	7.8
SME	9.2	8.9
Agriculture	23.7	19.8
Consumers	3.2	4.8

Lastly, the lower credit expansion in few banks is also explained by the liquidity constraints as gauged by their falling share in incremental deposit during Jul-Apr FY08. It may be noted that the average credit to deposit ratio

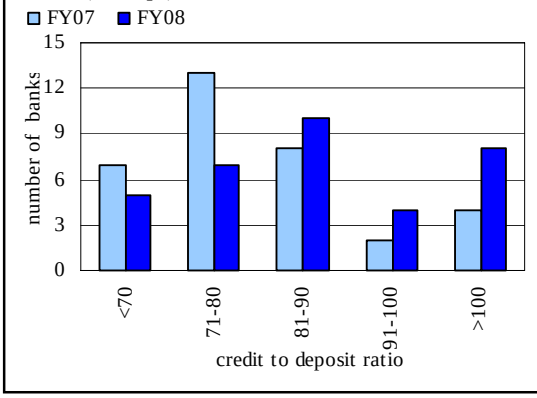
Table 4.7: Deceleration in Foreign Banks' Credit (Jul-Mar)

	FY07		FY08	
	Growth	Share*	Growth	Share*
Consumer credit	24.8	5.7	-7.8	-2.3
Business credit	13.9	10.7	13.1	9.2
Total	**16.4**	**-**	**6.9**	-

*Contribution to credit growth of foreign banks in percentage points

of the banking system reached to 108.4 percent by end-April 2008 compared with 86.1percent by end-April 2007. This shows banks' increasing inability to lend aggressively (**Figure 4.11**).[17]

Figure 4.11: Dwindling Banks' Ability to Extend Credit (Jul-Apr)



In this perspective, creating room for extending more credit is essential. But this is demanding as deposit growth of the banking sector has already moderated in recent months partly due to growing competition from non-bank financial institutions (NBFIs).

Table 4.8: Private Sector Advances Growth (Jul-Mar)

percent

	Trade financing		Working capital		Fixed investment	
	FY07	**FY08**	**FY07**	**FY08**	**FY07**	**FY08**
Business sector	**13.5**	**24.7**	**13**	**22.3**	**15.5**	**7**
A. Agriculture, hunting and forestry	-85.1	130	14.2	17.3	2	-12.2
B. Manufacturing	14.6	26.9	16.8	22.6	6.8	9.3
a. Textile	10.6	21.4	3.9	27.4	1.3	13.7
Spinning of fibers	21.8	32.5	5.1	29.6	-1.4	3.1
b. Sugar	-38.6	4.4	29.9	4.6	15.4	10.9
c. Fertilizer	273.3	18	34.2	10.2	57.5	41.8
d. Cement	139	138	30.5	78	13.2	-20.3
C. Electricity, gas and water	33	391	60.8	89.5	70	85
D. Construction	-36	297	17.6	35.5	49.6	3.7
E. Commerce and trade	8.2	9.1	5.5	19.8	38.9	-11.9
F. Transport, storage & communications	123.4	-53	34.5	2.8	19.4	8.3

Moreover, expanding credit growth remains challenging for banks as corporates are increasingly relying on private debt papers (Sukuk and TFCs), instead of

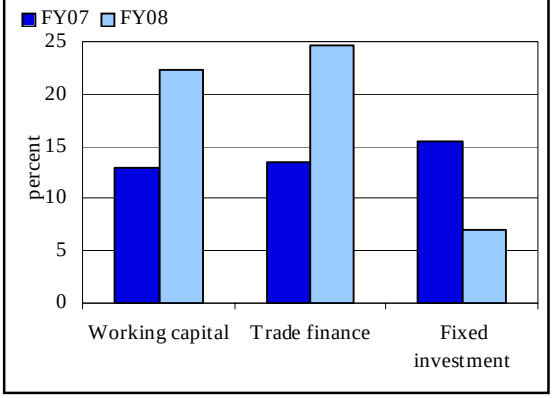
[17] Indeed, number of banks having credit to deposit ratio over 91 percent has increased substantially in Jul-Apr FY08.

raising finance through bank loans.[18] The level of substitution between bank and non-bank finance may increase further as these private debt instruments are traded informally in the secondary market. Indeed, selling of TFCs/Sukuks in secondary market by banks would depress the credit growth of the banking sector.[19]

Trend analysis of Sectoral Advances[20]

The growth in advances to the business sector accelerated to 17.7 percent during Jul-Mar FY08 from 13.6 percent in the corresponding period last year (see **Table 4.8**). A major contribution to this higher growth came from working and trade-related loans, whereas the growth in fixed investment demand has decelerated (see **Figure 4.12**). The personal sector loan on the other hand witnessed a slowdown during Jul-Mar FY08.

Figure 4.12: Growth in Private Sector Advances (Jul-Mar)



Lower demand for fixed investment does not reflect concerns for the economy

The substitution of expensive banks' advances with locally issued private papers (Sukuk and TFCs) resulted in deceleration in fixed investment loans during Jul-Mar FY08. In addition to substituting banks' loan, corporates are also increasingly using debt instruments to finance expansion activates (for example, in the chemical, cement, real estate and ship yard). Further, the slowdown in the fixed investment loans was anticipated to an extent, since few industries (e.g. cement, construction and textile) had expanded their capacities in recent years.

[18] As discussed in Q2-FY08, most of the private papers, especially Sukuk, were issued to refinance banks' debt. To the extent NBFIs investment in Sukuk is being used to substitute bank loans, this would depress the overall credit demand from the banking system.

[19] In case of liquidity shortages in the inter-bank market, banks may even choose to substitute their private debt paper holdings with the advances to the private sector.

[20] This section in based on data on private sector loans as per the classification under International Standard Industrial Classification and is available up to March 2008. The said data will not tally with the credit data reported in monetary survey as the latter includes banks' investments in equities of private business sector as well.

At the same time, higher demand for fixed investment loans from power, fertilizer and textile sectors is encouraging. It must be noted that a few power companies and refineries are in phase of finalizing their financial closures to undertake the expansion activities. Thus, banks are expecting higher credit demand in the next fiscal year.

Demand for trade related loans is high

Growth in trade related loans during Jul-Mar FY08 stemmed primarily from the import finance, which is in line with the rising import payments of the country during the period under review. The trade financing availed by the exporters on the other hand decelerated during Jul-Mar FY08 compared to that in corresponding period last year.

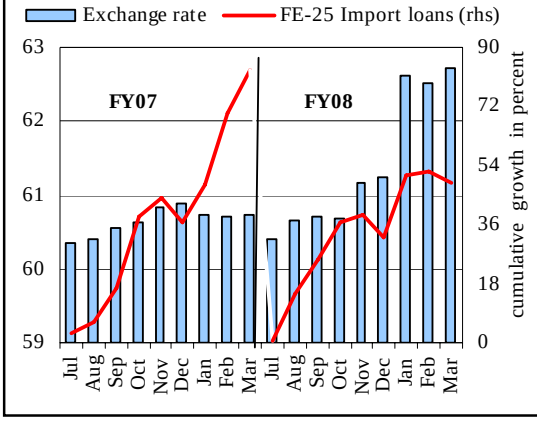
A further analysis of financing availed by the exporters depicts that it was the fall in growth of EFS that explains the slowdown in credit to exporters (see **Table 4.9**). Indeed, during FY07 exporters substituted their outstanding stock of FE-25 loans with that of EFS.[21] Interestingly, however, the gross disbursement under EFS recorded Rs 273 billion during Jul-Mar FY08 – slightly higher than the disbursement level of corresponding period.

Table 4.9: Export Finance Availed by Exporters (Jul-Mar)

	FY07		FY08	
	Growth	**Share***	**Growth**	**Share***
EFS	25.5	15.0	2.9	2.0
FE-25 Loans	-1.1	-0.3	23.1	6.0
Total	**9.6**		**7.6**	

*Contribution to growth in percentage points

Figure 4.13: Import Finance Against FE-25 Loans



The foreign currency loans, which had remained attractive for domestic importers during H1-FY08 largely due to stable exchange rate, became costlier following a depreciation of the Rupee in the latter half of FY08. This led to a slowdown in the demand for FE-25 loans by importers (see **Figure 4.13**).

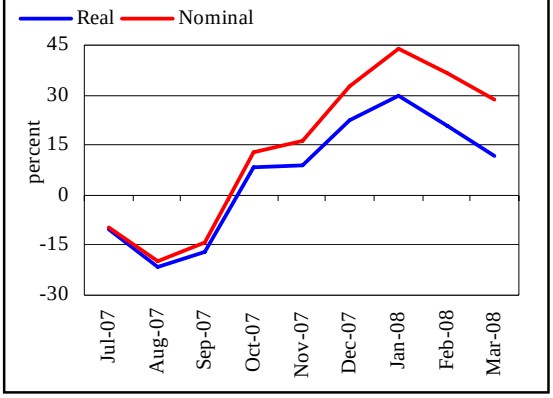
[21] This was because of increase in subsidy provided under EFS in July 2006.

Strong demand for working capital loans is despite lower industrial activity

The demand for working capital loans during Jul-Mar FY08 remained strong at 22.3 percent – the highest growth for Jul-Mar period in the last two years. Major contribution to growth came from the manufacturing sector, commerce and trade, power and other private business (see **Table 4.8**).[22]

The higher working capital advances to manufacturing sector[23] was remarkable given that the operational bottlenecks and supply-side concerns had caused a deceleration in the industrial growth during the said period. The sectoral analysis suggests that the sectors where the credit demand accelerated (such as cotton, rice processing, and construction) are also experiencing a surge in their raw material prices.

Figure 4.14: Working Capital Loans to Spinning Sector (Cumulative Growth)



For example, higher advances to the spinning industry were caused mainly by increased raw cotton prices during Jul-Mar FY08. The impact of this was more visible in the lower real demand for working capital loans in this sector (see **Figure 4.14**). Likewise, in the construction sector, the demand for working capital witnessed substantial growth mainly due to rising prices of building raw material.

In the cement sector, a part of the demand for working capital loans during Jul-Mar FY08 was attributed to rising exports. Similarly, higher trade related activity, specifically in Q3-FY08, explains demand for working capital loans in commerce and trade.

The demand for working capital increased also due to some industry specific

[22] Growth in other private business reflects bank advances under continuous funding system (CFS) to equity market largely mirroring the performance of local bourse.

[23] Unlike the previous year, working capital requirement from the manufacturing sector was concentrated in the textile sector during Jul-Mar FY08. This impact is more evident from 19.6 percent growth in working capital demand of manufacturing (excluding textiles) during FY08 compared with a strong growth of 27.5 percent in the corresponding period last year.

factors. For example, delays in settlement of claims with OMCs probably led to growth in working capital advances to refining petroleum products during Jul-Mar FY08. Similarly, the rising credit demand in the power sector was caused by the impact of delays in payment from WAPDA to IPPs.

Consumer loans are responding to rising interest rate

The increase in interest rate played a pivotal role in restricting the demand for consumer loans during Jul-Mar FY08. Besides this, rising NPLs to loans ratio in almost all categories of consumer loans (see **Table 4.10**) caused banks to become more vigilant while extending consumer credit. The impact of this restraint is more evident in auto loans, as one of the banks has even suspended the auto finance scheme.

Resultantly, growth in consumer loans decelerated to 4.8 percent during Jul-Mar FY08 compared with 11.8 percent in the corresponding period last year. More importantly, consumer credit recorded net retirement in Q3-FY08.

Table 4.10: NPLs to Loan (Gross)

(end-Mar position in percent)

	Mar-07	Mar-08
Consumers	**3.2**	**4.8**
Credit cards	3.7	3.7
Auto loans	2.6	5.9
Durables	3.2	14.8
Mortgage	2.3	4.2
Personal loans	4.0	4.5

Figure 4.15: Contribution to Growth in Consumer Finance (Jul-Mar)

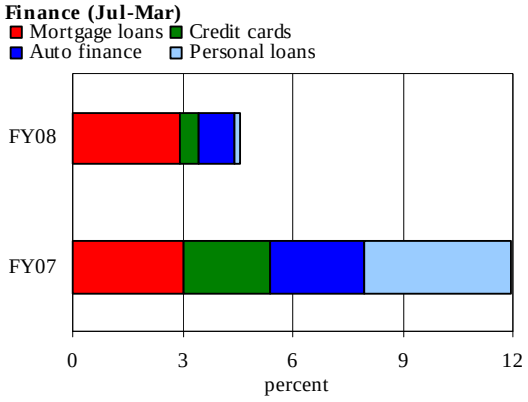
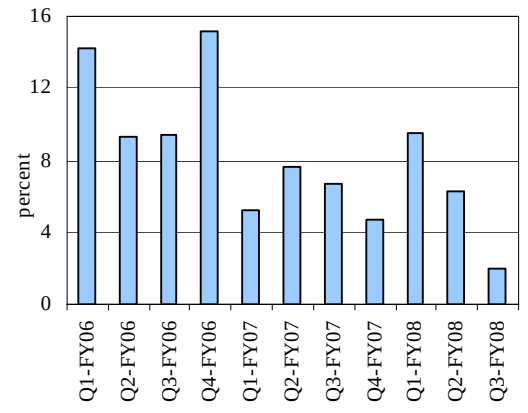
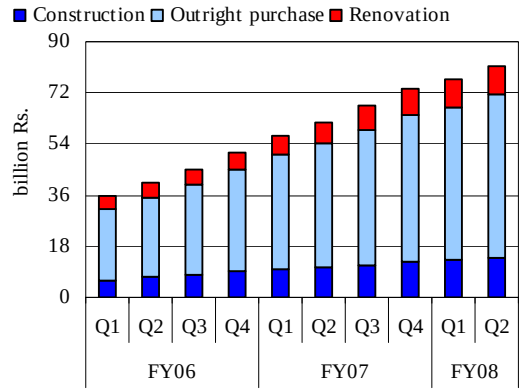


Figure 4.16: Quarterly Growth in Mortgage Finance



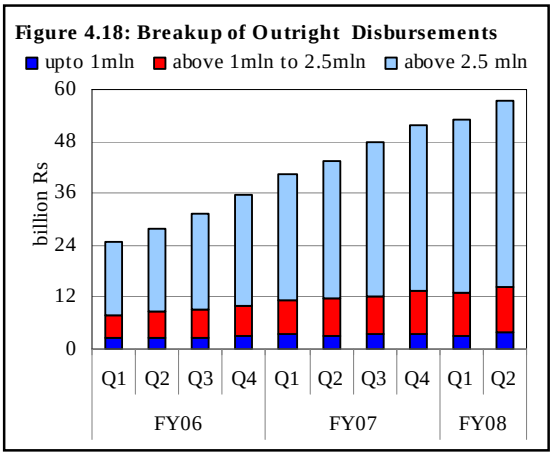
It is also worth noting that the share of consumer loans in the overall loans to private sector fell to 14.4 percent by end Mar 2008 compared to 15.4 percent in the corresponding period last year. This fact probably kept WALR from increasing sharply during Jul-Mar FY08, since consumer loans are high yielding advances.

Figure 4.17: Disbursement of Mortgage Finance



The slowdown visible in the consumer loans was broad-based as almost all categories, except mortgage finance, witnessed substantial deceleration, during Jul-Mar FY08 compared with the corresponding period last year (see **Figure 4.15**). The growth in mortgage finance also decelerated, but this still remains strong at 18.6 percent in Jul-Mar FY08. While the uptrend in mortgage finance appears to have tapered-off in recent quarters (see **Figrue 4.16**), this is mainly attributed to maturing of loans disbursed earlier. The quaterly disbursements, especially under outright purchase, are showing rising trend during the period of analysis (see **Figrue 4.17**).

Figure 4.18: Breakup of Outright Disbursements



Within outright purchase, a substantial portion of loans were disbursed under the loan category of above Rs 2.5 million (see **Figure 4.18**), which is probably reflecting the impact of rising real estate prices during the period under review.

Deposit Mobilization

The deposits growth of the banking system slowed to 5.9 percent during Jul-Apr FY08 from 9.4 percent during the corresponding period of last year (see **Figure 4.19**). A number of factors were responsible for this deceleration, such as:

(1) a sharp increase in current account deficit and the resulting foreign exchange outflows hold back the growth in deposit mobilization;
(2) the build-up of price differential claims of IPPs and OMCs led to downward pressures on their deposits; [24]
(3) a higher deposit base of FY07 due to one-off rise in foreign currency deposits of some commercial banks for import of machinery and network enhancement in the telecom sector. Not only such inflows were absent in FY08, the subsequent withdrawal of these funds restrained the growth in deposits base during the current period;
(4) an evident slowdown in the GDP growth from previous year; and
(5) a higher returns on investments in mutual funds that made deposits an inferior choice in the investment portfolio.

Figure 4.19: Cumulative Deposit Growth

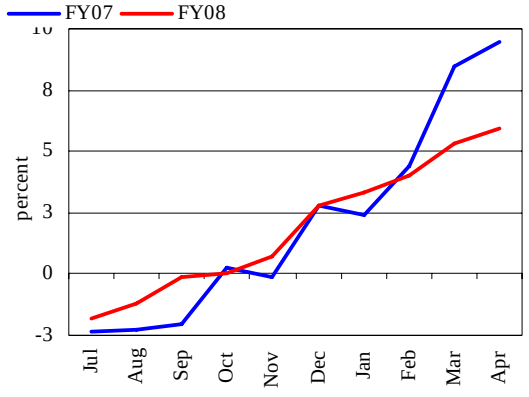


Table 4.11: Sector wise Deposit Growth and Contribution (Jul-Mar)

growth in percent; contribution in percentage points

	FY07		FY08	
	Growth	**Share**	**Growth**	**Share**
Total	**8.5**	--	**5.4**	--
of which				
Government	9.7	1.0	13.1	1.4
PSEs	-2.1	-0.2	7.5	0.6
NBFIs	50.4	0.9	14.3	0.4
Private sector	12.5	3.5	-3.4	-1.0
of which				
Textile	*-4.1*	*-0.1*	*-1.3*	*-0.01*
Construction	*-2.4*	*-0.04*	*-27.3*	*-0.5*
Telecom	*286.6*	*1.9*	*-53.9*	*-1.2*
Personal	7.8	3.1	7.2	2.8

A sector-wise analysis shows government as a significant contributor to overall deposit growth during Jul-Mar FY08 (see **Table 4.11**), which is quite surprising given the substantially high government borrowings from SBP and non-bank sources. The slowdown in deposits growth is due to net withdrawal in deposit

[24] Although the government provided guarantee on bank financing to settle a part of the claims of some OMCs, pressures on cash flows was hindering deposits mobilization.

base of the private sector. The deposit withdrawal in telecom sector largely due to payments for capital imports made significant contribution to contraction in the deposit base.

The currency-wise composition shows rising contribution of foreign currency deposits in overall deposit growth. This suggests that depositors, anticipating pressures on the Pak-Rupee, are preferring foreign currency deposits to local currency deposits (see **Figure 4.20**).

Within foreign currency deposits, the share of US Dollar deposits has witnessed a steep decline during FY08 (see **Figure 4.21**). This is predominantly because of weakening US Dollar against major currencies in the international markets.

Figure 4.20: Contribution to Deposit Growth

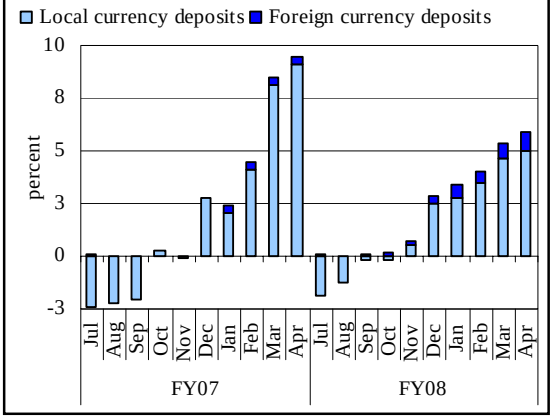
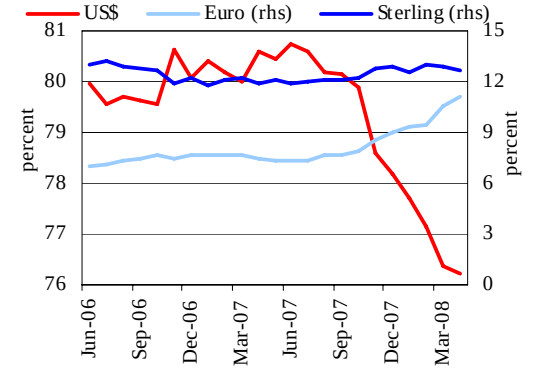


Figure 4.21: Share of US$ Denominated Deposits to Foreign Currency Deposits



Bank-wise distribution of deposits

Bank-wise distribution of deposits suggests that except for Islamic banks, all the banking groups have registered a slowdown in their deposit growth during Jul-Apr FY08 compared to the same period last year (see **Figure 4.22**). This decelerating deposit growth of these banking groups is inspite of an increased offered rates on deposits compared to the similar period of FY07 (see **Figure 4.23**).

It is expected that continued monetary tightening (which has led to a fall in excess reserves of commercial banks) and slowdown in deposit growth, would force banks to further raise their offered rates on deposits in order to meet continued strong growth in credit demand. At the same time, SBP is providing incentive in

Figure 4.22: Contribution in Deposit Growth (Jul-Apr)

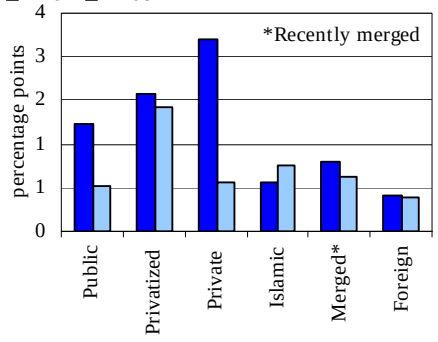
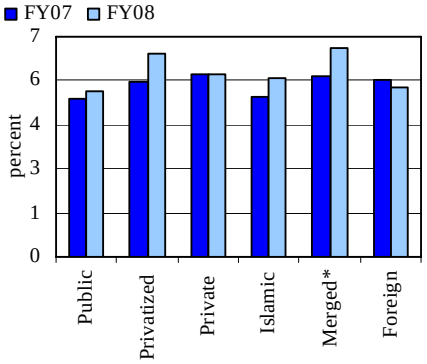


Figure 4.23: Incremental Deposit Rates (Avg Jul-Mar)



the form of zero rated CRR on term deposits of over one year maturity. It may be noted that deposits of one year and higher maturity are growing at a much faster pace compared to demand deposits. As a result, their share in total deposits has risen by 4.0 percentage points to 10.3 percent during August 4-May 10, FY08.

Annexure Table: How Various Central Banks Have Responded to Recent Rise in Fuel and Commodity Prices? – A Survey of Recent Policy Decisions (Updated on May 22, 2008)

Overall policy stance	Recent trends in inflation	Most recent policy change	Risk assessment by respective central banks
India The liquidity management assumes priority in the conduct of monetary policy. Since March 2004, the repo rate has risen by 175 bps to 7.75%, whereas the cash reserve requirement (CRR) has increased by 375 bps to 8.25%	Year-on-year WPI inflation, which was 3.83% on January 12, 2008, *i.e.*, at the time of the announcement of Third Quarter Review, increased to 7.41% on March 29, 2008 and rose further to 7.83% for the week ended May 03, 2008.	• On April 17, 2008, India increased CRR by 50 bps to 8% which would be effective in two stages, i.e., 25 bps on 26th April and another 25 bps from May 10, 2008. • The CRR was further increased to 8.25% effective from May 24, 2008. • **Last meeting:** April 29, 2008	• The recent rise in inflation has mainly emanated from supply-side pressures such as the one-off increase in domestic petrol and diesel prices to partially offset the global crude oil price increase over the year; continuous hardening of prices of petroleum products that are not administered, rising prices of wheat and oilseeds and the adjustment in steel prices in March 2008 due to the surge in international prices. • The upsurge in inflation in India has occurred at a time when global commodity prices have been volatile at historically elevated levels and central banks in mature and emerging economies alike have been articulating heightened inflation concerns. • There are concerns that demand pressures, which have been reasonably contained so far, are being coupled with supply-side factors which, if not temporary, could impact domestic inflation significantly.
Indonesia During the initial six months following the adoption of inflation targeting regime in July 2005, Bank Indonesia raised its policy rate by 425 bps. However, subdued inflation and growing economy allowed BI to reduce its policy rate by 475 bps on cumulative basis since April 2006.	Year-on-year inflation, which was 6.52% in Mar 2007, increased to 8.96% in Apr 2008.	• In December 2007, the BI rate was lowered by 25 bps to 8%. However, on May 6, 2008, central bank decided to raise the BI rate by 25 bps to 8.25%. • **Last meeting:** May 06, 2008	• The government commitment to ensure smooth distribution of foods and especially of staple goods considerably helped BI in achieving inflation targets during the past 2 years. The resulting downtrend in inflation together with steady improvement in economic growth allowed BI to cut its policy rate in December 2007. • The latest review of monetary policy suggests that the outlook for macroeconomic stability will face considerable challenges if the high level of international commodity prices and risk of global economic slowdown continue unabated. • The central bank will closely monitor economic developments and particularly any surge in inflationary pressure through identification of emerging sources of inflationary pressure. Bank Indonesia is resolutely committed to controlling inflation through more effective, simultaneous use of monetary instruments.

Malaysia The continued benign inflationary pressures have so far allowed the central bank to pursue growth supporting monetary policy stance.	The overall CPI inflation is moderate but rising. Year-on-year CPI inflation, which was 1.4% in Jun 2007, increased to 2.8% in Mar 2008. The YoY food inflation rose from 2.3% to 4.9% during the same period.	• Overnight policy rate unchanged at 3.5% since April 2006. • **Last meeting:** April 29, 2008	• While the slower external demand will have some moderating impact on the Malaysian economy, growth continues to be supported by an expansion in domestic demand. • Global energy and food prices have recently risen sharply from their already high levels. A major uncertainty at this stage is the extent of the moderation in global economic activity and the impact it will have in reducing global price pressures. • Domestic food prices have risen in response to the increase in global prices. The increase in food prices reflect a structural phenomenon requiring measures that ensure the adequacy of supply, create appropriate incentive structures that promote higher food production, and enhance the efficiency of the production and distribution chain. • The upside risks to inflation projection of 2.5-3% would be dependent on the degree to which (1) the increase in global prices have an impact on domestic prices and (2) administered prices are adjusted. • After evaluating the evidence on the downside risks to growth and the upside risks to inflation, the Bank has decided to maintain the current stance of monetary policy.
Thailand The central bank adopted inflation targeting in May 2000. The central bank considers the 0 - 3.5% target range for core inflation to be appropriate for the economy	Year-on-year CPI inflation, which was 1.8% in Apr 2007, increased to 6.2% in Apr 2008. The YoY food inflation also rose from 3.3% to 9.8%. However, the YoY core inflation rose marginally from 1.2% to 2.1% during this period.	• The last policy rate cut occurred in July 2007 when the rate was lowered by 25 bps to 3.25%. Since then, the rate is unchanged. • **Last meeting:** May 21, 2008	• While the Thai economy continued to grow strongly, exports have begun to show signs of moderation consistent with the slowdown in the global economy. In addition, rising costs of production and higher inflation could affect confidence and private spending going forward. • Risks to inflation increased markedly recently. Headline inflation accelerated as a result of the significant increase in energy and raw food prices. Core inflation rose by more than expected, mainly as a result of higher pass through of production costs, which could result in higher core inflation going forward. • The central bank realized that the risks to economic growth and inflationary pressures had risen. Though, the MPC decided to keep the policy interest rate, it would stand ready to adjust the monetary policy stance should inflation continue to accelerate.

Philippines A significant ease in inflation outlook and moderate demand-side pressure allowed the central bank to pursue monetary easing during second half of 2007. The average inflation of 2.8% for 2007 stood lower than 6.2% inflation realized in previous year and the target range of 4.0-5.0 %	Year-on-year CPI inflation, which was 2.3% in Apr 2007, increased to 8.3% in Apr 2008. This was the highest level since May 2005. The YoY inflation of food, beverage and tobacco rose from 8.2% in Mar 2008 to 11.4% in Apr 2008.	• The central bank gradually lowered the policy rate by 250 bps to 5 % during Jul 2007 to Jan 2008 period. • Since January 2008, the policy rate is unchanged. • **Last meeting:** April 24, 2008 • **Next meeting**: June 05, 2008	• The monetary policy admits that the balance of risks to the inflation outlook is tilted to the upside. Core inflation has drifted upward, with the March 2008 reading at its highest level since November 2006. The pending requests for wage and transport fare adjustments could raise the upside risks to inflation coming from demand-side pressures. • However, the offsetting factors include (1) relative appreciation of the peso that cushioned the impact of rising fuel and commodity process on domestic inflation; (2) oil import tariff reduction scheme would partially alleviate inflationary pressures stemming from possible continued surge in crude oil prices; and (3) weakness in global economic growth and its likely moderating impact on inflationary pressures in the international markets. • The central bank therefore decided to maintain the policy rate unchanged.
Turkey The target defined as the annual percentage change of the CPI has been set at 4% for 2008 (as well as for 2009 and 2010) with a symmetrical uncertainty band of 2 percentage points in both directions around the point target. The central bank failed to meet its inflation target in 2006 and 2007.	The Apr 2008 CPI inflation was 9.66% - more than double the year-end target.	• Following a strong monetary tightening of the past, a measured rate cut cycle was initiated in September 2007. The overnight borrowing rate was gradually lowered by 225 bps in total to 15.25% in Feb 2008. • The rate was however increased again by 25 bps to 15.75% in mid-May 2008. • **Last meeting:** May 15, 2008	• Lagged pass-through impact of the exchange rate movements and rising energy and processed food prices may lead to a temporary rise in inflation in the short term. • Difficulties in international credit markets continue to restrain the domestic demand, while external demand remains strong. • Overall, aggregate demand conditions will continue to support disinflation. • In the forthcoming period, monetary policy decisions will be geared towards keeping inflation close to these forecasts. Therefore, it is important that economic agents align their expectations with the Central Bank forecasts. The central bank will continue to take the necessary measures to prevent the potential second-round effects of the adverse developments in food and energy prices. Thus, the central bank will consider the possibility of a further measured rate hike in the next meeting.

Australia Under the inflation targeting framework, the RBA maintains CPI inflation between 2 and 3% range, on average, over the cycle.	The YoY CPI inflation rose to 4.2% in Mar 2008 from 2.4% in Mar 2007. The trimmed mean CPI also increased from 2.7% in Mar 2007 to 4.1% in Mar 2008.	• Since May 2002, RBA has been pursuing tight monetary policy. Until Mar 2008, the policy rate gradually increased by 300 bps to 7.25 percent. Since then the rate is unchanged. • **Last meeting:** May 06, 2008	• While domestic sources of inflationary pressure have clearly increased over the past year, the rise in inflation has been partly a result of global factors, notably a general increase in commodity prices. • There are evidences that the growth of domestic demand had moderated significantly. However, the prospects for growth and inflation are highly uncertain. On the one hand, the slowdown in the developed economies, the ongoing strains in world financial markets and tight domestic financial conditions were working to slow demand. On the other hand, there is the larger-than-expected stimulus to domestic incomes from the rising terms of trade. • Given the substantial tightening in financial conditions since mid 2007, and the extent of uncertainty surrounding the outlook, the RBA decided that it was appropriate to allow the current setting of monetary policy more time to work.
Korea BOK is following inflation targeting since May 1998. For 2007-9 period, CPI inflation of 3% with uncertainty band of 0.5% in both directions is the target for monetary policy.	The YoY CPI in March increased to 4.1% which is above the target range for the year and is the fastest pace in almost 4 years.	• Since October 2004, the BOK has been gradually raising its policy rate. During October 2004 to August 2007 period, the policy rate has risen by 175 bps. Since then, the central bank has maintained the policy rate at 5%. • **Last meeting:** May 08, 2008	• Despite some signs of adjustment in the pace of expansion in the domestic economy, the future economic performance faces a high degree of uncertainty largely due to international financial market turmoil and the US economic slowdown. • In the meanwhile, higher oil prices continued to push CPI inflation. • BOK therefore maintained its policy rate at 5%.

England BoE follows inflation targeting, aiming at 2% inflation without creating undue instability in the economy.	While the YoY CPI reached 3% in Apr 2008 from 2.5% in March. The RPI increased to YoY 4.2% in Apr 2008 from 3.8% in preceding month. .	• Towards the end of 2007, there were signs that growth has begun to slow, spending were expected to moderate, and credit market conditions had considerably tightened. These factors increased downside risks to the outlook for both output and inflation further ahead. In response, from Dec 2007 to Apr 2008, the BoE has reduced the policy rate by 75 bps to 5%. Since then the rate is unchanged. • **Last meeting:** May 08, 2008	• The Bank expects that increases in energy and import prices would push CPI inflation further above the target this year. However, trying to bring inflation to the target within this period would result in an undesirable degree of volatility in output. The central projection in the May *Inflation Report* implied that inflation would return to around the 2% target after two years. • The Bank continued to balance the upside and downside risks to inflation at this horizon. On the downside, a sharp slowing in the economy associated with weak growth of real disposable income and the tightening supply of credit could pull inflation below the target. The upside risk to the inflation outlook over the forecast period was that the period of above target inflation in the near term would, by affecting the expectations of those setting prices and wages, have a greater tendency to persist than had been assumed in the central projection. • In overall terms, though economic activity was likely to slow, the Bank had judged that some slowing in the growth rate of output was likely to be necessary for inflation to settle close to the target around two years ahead. A further reduction in policy rate this month could create the impression that the Bank was trying to stabilize output growth rather than maintaining its focus on the inflation target.

5 Fiscal Developments

5.1 Overview

Although official statistics on public finance for July-Mar FY08 are not yet available[1], SBP forecast suggests that the budget deficit for July-Mar FY08 (as a percentage of the estimated FY08 GDP) is likely to be significantly higher than the full-year FY07 figure. Moreover, the quality of Q3-FY08 fiscal performance can only be judged once consolidated fiscal accounts are released.

The growth in government revenues in Q3-FY08 was expected to recover from the low of 1.8 percent seen during H1-FY08 as: (1) FBR tax receipts, which contribute the bulk of government revenues, have increased by 31.3 percent in Q3-FY08 compared to 6.0 percent during H1-FY08, and (2) non-tax revenues have been bolstered with the disbursement of budgetary support grants of US$ 281.7 million and US$ 300 million from USA and Saudi Arabia respectively.

Government domestic borrowing during July-Mar FY08 grew strongly, reflecting a strong year-on-year increase in the deficit, and little change in external financing from FY07. Thus, with net retirements of borrowings from commercial banks and only Rs 1.7 billion in privatization proceeds (against Rs 75 billion budgeted for FY08), the government borrowings from the central bank continued to rise sharply. Indeed, incremental government borrowings from SBP as of May 10, 2008 have reached Rs 551.0 billion, pushing the outstanding stock of MRTBs with SBP to Rs 940.6 billion. This development has significantly augmented inflationary pressures in the economy, and raised risks to macroeconomic stability.

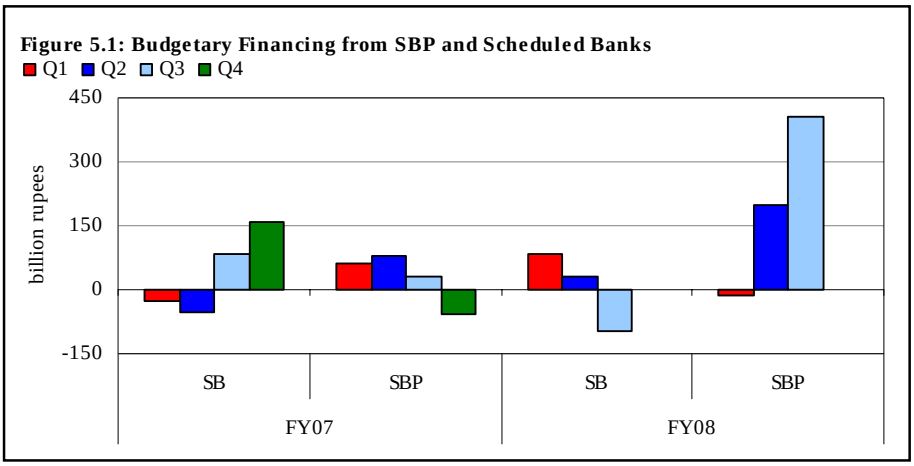
Realizing these concerns, the government has indicated its intention to broaden the tax base and rein-in expenditure growth for macroeconomic stability. The government has also indicated that it intends to diversify its financing base and reduce dependence on the central bank borrowings. For the economy to retain its high growth momentum, it is important that these goals are achieved.

[1] being scheduled for release by end-May 2008

5.2 Domestic Budgetary Financing[2,3]

Budgetary financing from domestic sources continued to rise, touching a record Rs 420.6 billion in Jul- Mar FY08. Also, the structure of financing remained a source of concern for the central bank as SBP solely had to finance the increased requirement in third quarter of FY08[4]. Commercial banks in this quarter, on the other hand resorted to net retirement of the government paper.

Figure 5.1: Budgetary Financing from SBP and Scheduled Banks



5.2.1 Financing from the Banking Sector

In Jul-Mar FY08 period SBP provided for budgetary financing Rs 404.8 billion, compared to Rs 33.1 billion in the same period of FY07 (see **Figure 5.1**). Analysis of borrowing from the SBP shows that Rs 371.2 billion were provided through issuance of new T-bills while the government availed Rs 33.5 billion from the deposit accounts including the 'other deposits' with the SBP. Commercial banks' retirement of government papers, (besides slowdown in the revenue growth) stretched the financing requirement from the SBP, as the central bank has to finance any shortfall in revenue between the issuance of new and the maturing bills in the T-bill auctions.

Debt retirement from commercial banks probably reflected (1) a slowdown in their deposit growth; and (2) better returns on alternative opportunities. Consequently,

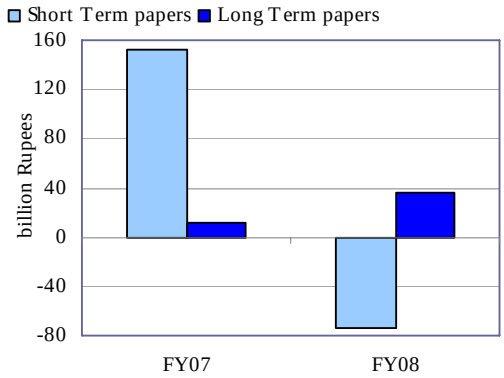
[2] The budgetary financing numbers do consider the impact of government deposits with the banking system whereas the debt numbers do not.
[3] This section is mainly based on SBP estimates, derived from Monetary Survey and outstanding stock of domestic debt as MoF numbers will only be available by end-May 2008.
[4] It is important to note that at the start of the fiscal year SBP advised the government to retire Rs 62.5 billion of government debt.

Rs 129 billion worth of government securities were retired in Q3-FY08 alone – the highest in any quarter since FY05. During July-Mar FY08 net retirement from the commercial banks stands at Rs 95.5 billion.[5] While commercial banks retired their holdings of short term instruments (T-bills), they continued to invest in the long term instruments (PIBs) (see **Figure 5.2)**.

5.2.2 Financing from the Non-banks

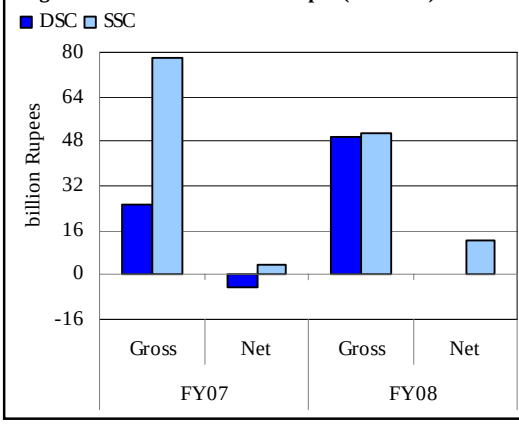
Non bank financing, with a large share of NSS, increased from Rs 73.9 billion during July-Mar FY07 period to Rs 111.3 billion in Jul-Mar FY08.

Figure 5.2: Commercial Banks' Financing (Jul-Mar)



Within NSS instruments, Behbood Saving Certificates (BSCs) and Pensioners Benefit Accounts (PBAs) continued to perform as a better financing source, due to their special interest rate structure[6]. Together the two instruments fetched Rs 47.8 billion for budgetary financing in Jul-Mar FY08.

Figure 5.3: SSC & DSC Reciepts (Jul-Mar)



Performance of the other active NSS instruments which offer returns competitive with the market based instruments, remained mixed in the period under review. For instance, investments in Defense Saving Certificates (DSC) remained subdued; showing a mere Rs 0.4 billion increase since June 2007 despite

[5] This figure incorporates the impact of Rs 47.9 billion added to government deposits with the commercial banks during Jul-Mar FY08.
[6] Both instruments offer highest profit rates (11.64 percent per annum) among NSS Instruments.

an increased gross receipt of Rs 49.6 billion. In Jul- Mar FY07 the gross receipt in DSCs was Rs 25.2 billion. High gross receipts but low net receipts probably reflect the pressure from the maturing high-yield DSCs issued a decade ago. Given that current yields are significantly lower, and the universe of competitive investments has expanded, not all of the maturing amounts would be reinvested.

In contrast, though the gross receipt in medium term Special Saving Certificate (SSC) declined to Rs 50.8 billion from Rs 78.1billion in Jul-Mar FY07, the instrument succeeded in fetching Rs 12.1 billion for budgetary financing in Jul-Mar FY08 (see **Figure 5.3**).

5.3 FBR Tax Collection

The FBR has formally abandoned the Rs 1025 billion revenue target set for FY08 but a new target has not been disclosed. Instead, media reports indicate that the tax authority is aiming at maximizing revenue collection for the remaining months of the fiscal year, hoping to cross the Rs 1 trillion mark by end-June 2008. Available data for the current fiscal year suggest a significantly large shortfall in tax receipts, indicating that achievement of Rs 1 trillion in tax collections for FY08 will be challenging.

Table 5.1: FBR Tax Collection
billion Rupees

	Annual target		Net collection (Jul-Apr)		YoY change (%)		% of Annual target	
	FY07	**FY08**	**FY07**	**FY08**	**FY07**	**FY08**	**FY07**	**FY08**
Direct taxes	264.7	405.0	252.9	284.6	50.9	12.5	95.5	70.3
Indirect taxes	570.3	620.0	403.6	479.0	6.4	18.7	70.8	77.3
Sales tax	343.8	375.0	245.8	293.7	7.5	19.5	71.5	78.3
Federal excise duty	69.0	91.0	54.7	70.6	20.7	28.9	79.3	77.5
Customs	157.5	154.0	103.1	114.8	-2.3	11.4	65.4	74.6
Total	**835.0**	**1,025.0**	**656.5**	**763.6**	**20.0**	**16.3**	**78.6**	**74.5**

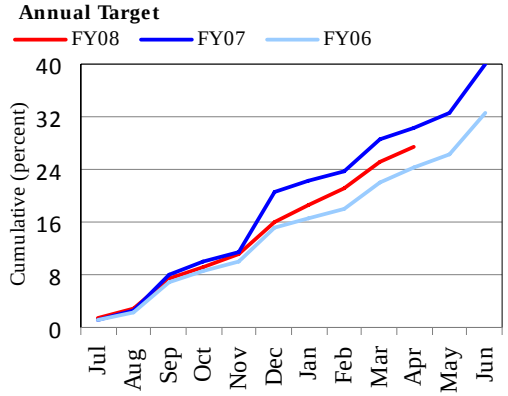
Source: Federal Board of Revenue

The severe shortfall in net tax collections during the current fiscal year is primarily caused by the unexpectedly poor performance of direct taxes (see **Table 5.1**). It may be recalled that the above-target tax revenue collection in FY07 was driven by direct tax receipts as well. In fact, direct tax receipts in FY07 remained substantially higher than the historical averages.

5.3.1 Direct tax collection

Since December 2007, direct tax collection has fallen behind the target path for FY07, resulting in massive shortfall in direct tax receipts (**see Figure 5.4**). During July-Apr FY08, direct tax receipts rose by 12.5 percent YoY to Rs 284.6 billion, compared to an impressive 50.9 percent increase during the corresponding period last year.

Figure 5.4: Contribution of Direct Taxes towards Annual Target



A break up of the direct tax collection, available for July-Mar FY08, reveals that despite a 360.8 percent growth in collection on demand, gross income tax increased by a mere 4.3 percent compared to a 48.6 percent rise during first nine months of FY07 (**see Table 5.2**).

Table 5.2: Direct tax collection during Jul-Mar

billion Rs

				% change	
	FY06	**FY07**	**FY08**	**FY07**	**FY08**
Gross Income tax	170.8	253.8	264.8	48.6	4.3
Collection on Demand	9.3	5.5	25.5	-40.8	360.8
Voluntary Payments	67.2	132.2	97.6	96.6	-26.2
Withholding taxes	94.2	116.0	141.6	23.2	22.1
Others	0.1	0.1	0.1	50.4	-17.5
Other direct taxes	6.1	9.7	12.1	59.7	25.0
Gross direct taxes	176.9	263.5	277.9	49.0	5.5
Refunds	24.2	25.7	20.2	6.1	-21.2
Net direct taxes	152.7	237.8	257.6	55.7	8.3

Source: Federal Board of Revenue

Voluntary payments dropped by 26.2 percent during Jul-Mar FY08, as compared to the incredible 96.6 percent rise in the corresponding period last year. However, it is important to remember that voluntary payments in FY07 were exceptionally high due to large profits booked by banks, telecommunication, and oil and gas sectors. The situation has not been repeated in FY08; for example banks' earnings during current fiscal year have been adversely affected by the forced-sale value regulation[7]. Similarly, PTCL has actually

[7] Earlier banks were allowed to avail benefit of forced-sale value of collateral held against loans and advances while making provisions against their assets portfolio. The forced sale value benefit of collateral was however restricted initially against financing of Rs 5 million and above effective November 01, 2005 and then against financing of Rs 10 million and above effective December 31,

booked a net loss (before tax) of Rs 8.3 billion for Jul-Mar FY08 due to huge expenses incurred on voluntary separation scheme (VSS).[8] Amid this sizeable fall in voluntary receipts, withholding taxes reclaimed its dominant share in gross income tax collections (see **Figure 5.5**).

Withholding tax receipts grew by a respectable 22.1 percent during Jul-Mar FY08 against 23.2 percent during the corresponding period last year. Together, imports and contracts (which relates mainly to projects and supply of goods and services) contributed nearly 50 percent in withholding tax collections during Jul-Mar FY08 (see **Table 5.3**). Other major heads contributing to withholding tax receipts include: telephone, electricity bills, salaries and securities. The withholding tax on profit on government securities declined by Rs 136 million during Jul-Mar FY08, probably reflecting the revenue cost of shift in budgetary financing from commercial banks to SBP, as SBP is exempt from payment of withholding tax on profit on government securities.

Withholding tax receipts from mobile phone subscribers recorded an increase of 57.8 percent during Jul-Mar FY08,

Figure 5.5: Share in Gross Income Tax (Jul-Mar)

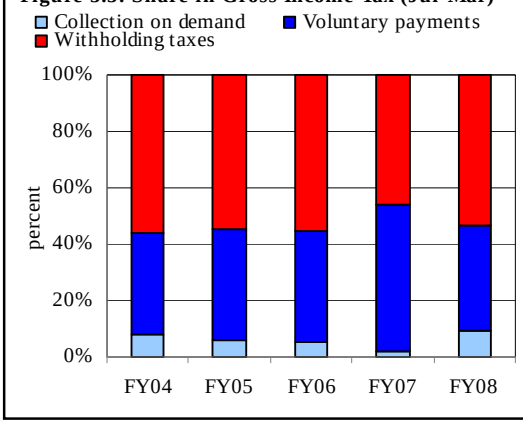


Table 5.3: Withholding tax collection during Jul-Mar

billion Rs

	FY07	FY08	Growth (%)
Imports	19.1	20.1	5.3
Salaries	11.4	14.5	27.2
Dividends	3.5	4.3	23.3
Securities	9.9	11.2	13.4
Technical fee	5.2	4.1	-20.8
Contracts	36.6	49.8	36.3
Exports	8.0	7.9	-1.8
Cash withdrawal from banks	3.4	4.2	23.8
Stock exchanges	2.0	1.8	-6.9
Electricity bills	3.8	4.4	16.4
Telephone	9.3	12.9	39.0
Others	4.0	6.5	60.1
Withholding tax (gross)	**116.0**	**141.6**	**22.1**

Source: Federal Board of Revenue

2006. The forced sale value benefit against all NPLs for calculating provisioning requirement was altogether abolished with effect from December 31, 2007.

[8] Excluding VSS, PTCL registered a before-tax profit of Rs 14.9 billion in the same period.

increasing from Rs 7.9 billion during Jul-Mar FY07 to Rs 12.5 billion in the corresponding period of FY08. Such high growth and the fact that almost 97 percent of withholding tax on telephone was collected from mobile phone subscribers indicate large growth potential of the cell phone market. Withholding tax receipts on account of cash withdrawal from banks stood at Rs 4.2 billion during first nine months of FY08 compared to Rs 3.4 billion in the same period last year. In contrast, with trading of shares subject to withholding tax rate of only 0.01 percent, Rs 1.8 billion was collected from stock exchanges during Jul-Mar FY08.

As a result of the FBR's recovery drive on the back of decline in voluntary payments, collection on demand was recorded at Rs 25.5 billion during Jul-Mar FY08 compared to Rs 5.5 billion in the corresponding period last year. Receipts under arrear demand increased to Rs 5.4 billion, up by 125.9 percent during Jul-Mar FY08 while receipts under current demand rose by 538.3 percent to reach at Rs 20.1 billion during Jul-Mar FY08.

5.3.2 Indirect tax collection

Indirect tax receipts grew by a handsome 18.7 percent during Jul-Apr FY08 as compared to 6.4 percent in the same period last year. Encouragingly, this particular performance was driven by strong growth in all the heads (see **Table 5.1**). Also, indirect tax collection during Jul-Apr FY08 comprised of 77.3 percent of annual target as compared to 70.8 percent collection of FY07 target during the same period of last year.

Sales tax

The Jul-Apr FY08 receipts from sales tax stood at Rs 293.7 billion, up by 19.5 percent as compared to a rise of 7.5 percent in corresponding period last year. The acceleration in the growth of sales tax collection is visible in the receipts from imports as well as in collection from domestic sources (see **Table 5.4**).

Table 5.4: Sales tax collection (Jul-Apr)

				YoY change (percent)	
	FY06	**FY07**	**FY08**	**FY07**	**FY08**
Sales tax	228.6	245.8	293.7	7.5	17.6
Domestic	93.7	104.6	135.7	11.6	27.5
Import-related	134.9	141.2	158.0	4.7	10.2

Source: Federal Board of Revenue

Federal Excise Duty

The FED collection for Jul-Apr FY08 increased by a healthy 28.9 percent as compared to a rise of 20.7 percent in the corresponding period last year. A breakup of FED available for Jul-Mar FY08 reveal that major revenue contributions were made by cigarettes (30.6 percent), cement (16.9 percent),

natural gas (7.4 percent), POL products (3.6 percent), beverages (4.0 percent), and collection on account of 1% special excise duty (11.3 percent). In addition, services contributed Rs 8.4 billion (13.6 percent) during Jul-Mar FY08, of which Rs 6.0 billion came from FED on international travel by airlines.

Customs

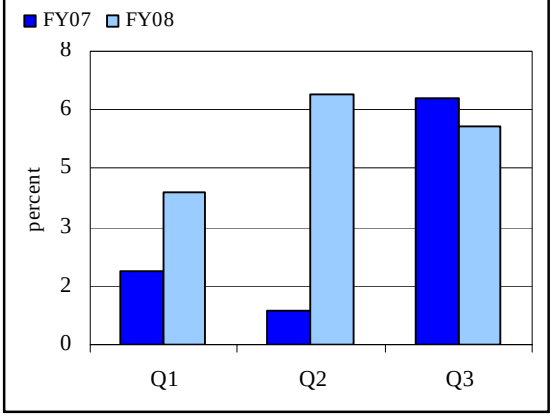
Customs duty added Rs 114.8 billion to the national exchequer during Jul-Apr FY08, up by 11.4 percent against a decline of 2.3 percent in the corresponding period last year.

Details of customs duty for Jul-Mar FY08 show that despite 11.9 percent decline, customs duty on vehicles remained the major source of customs receipts, contributing Rs 18.4 billion during Jul-Mar FY08 as compared to Rs 20.9 billion during Jul-Mar FY07. Other major sources of customs duty comprise of POL products (Rs 14.0 billion), edible oil (Rs 12.9 billion) and electrical machinery (Rs 9.2 billion).

5.4 Domestic Debt

After sharp rise of 6.4 percent in second quarter, the growth in the domestic debt moderated to 5.5 percent in Q3-FY08 (see **Figure 5.6**). Although government availed substantial financing from SBP in this quarter, growth in floating debt decelerated due to significant retirements by the commercial banks, resulting in a moderation in debt growth during Q3-FY08.

Figure 5.6: Growth in Domestic Debt



Another important development is the continued shift in the debt structure towards the shorter term instruments, and away from the longer term instruments. This raises interest rate risk, by increasing sensitivity of the cost of borrowing to short-term interest rates.

5.4.1 Components of Domestic Debt

A disaggregation of total domestic debt shows that the floating debt, characterized by the debt instruments of less than a year, continued to dominate the debt structure. During Jul-Mar FY08 the increase in floating debt substantially

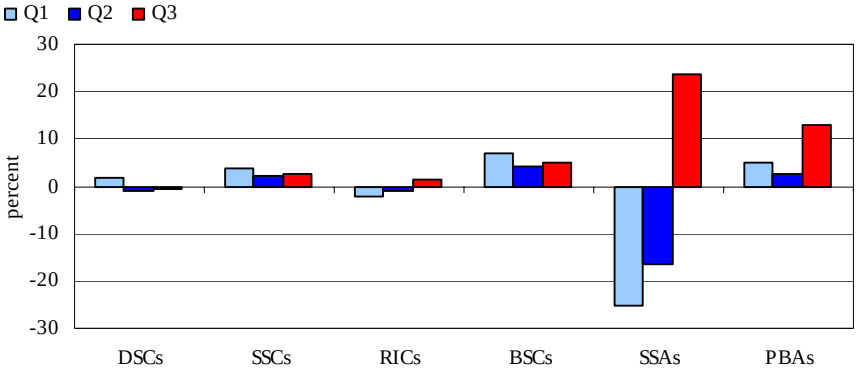
outpaced the rise in other components of domestic debt, resulting in 3.9 percentage points addition to its share in total debt (see **Table 5.5**).

Table 5.5: Domestic Debt (Jul-Mar)
debt in billion Rupees, growth and share in percent

	Debt		Growth rate		Share	
	FY07	**FY08**	**FY07**	**FY08**	**FY07**	**FY08**
Permanent	529	607	5.8	9.8	21.1	20.0
Floating	1,087	1,432	15.5	29.2	43.3	47.2
of which						
MTBs	557	584	28.6	-10.9	22.2	19.2
MTBRs	530	847	4.4	87.4	21.1	27.9
Unfunded	897	997	4.4	6.1	35.7	32.8
Domestic Debt	**2,512**	**3,036**	**9.2**	**16.7**	**100**	**100**

It is pertinent to note that in Q3 FY08 there was a sharp increase in the monetization of the deficit due to shift in the government borrowing from commercial bank to the SBP. The outstanding debt with SBP increased by 87.4 percent in Jul-Mar FY08, while the same with the commercial banks declined by 10.9 percent. The share of the external financing is expected to increase somewhat by end of the current fiscal year.[9]

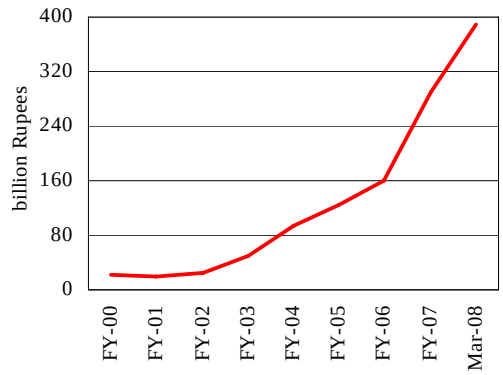
Figure 5.7: Quarterly Growth in Major NSS Instruments



[9] GOP has received budgetary support from China and KSA, and expecting the widening fiscal deficit of FY08 to narrow down as receipts due on account of the Logistic support would be received. Furthermore GoP is planning to float the Exchangeable Eurobond in FY08 that would also be providing the budgetary support.

In contrast, both permanent and unfunded debt, categorized with the medium and long term instruments, witnessed a decline in their respective shares. Specifically the share of the permanent debt reduced from 21.1 percent in Jul- Mar FY07 to 20.0 percent in FY08 while that of unfunded debt declined by 2.9 percent to 32.8 percent of the total debt in Jul- Mar FY08.

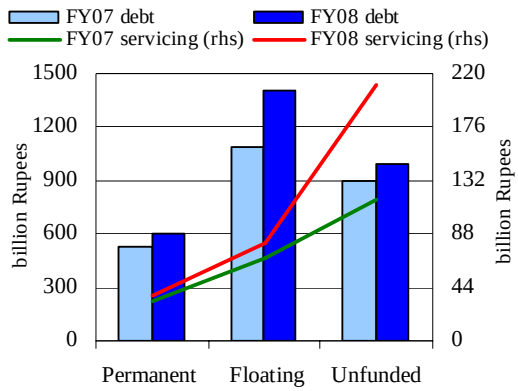
Figure 5.8: Aggregate Net Assets of Mutual Funds in Pakistan



The growth in the outstanding debt raised through the major NSS instruments is shown in **Figure 5.7**. The outstanding debt against all but DSC recorded positive growth. Furthermore, DSC and SSC, which compete with other market instruments like PIBs and corporate bonds, registered a fall of 0.5 percent and a paltry rise of 2.4 percent in Q3-FY08.

The major reason for the weak growth in receipts through these instruments probably include: (1) the increase in the market depth that has provided diversified investment opportunities, such as mutual funds, to the investors (see **Figure 5.8**); and, (2) the rigidities in profit payment structure of these instruments that penalizes investors seeking pre-mature encashment by denying them profit on the broken periods.

Figure 5.9: Debt servicing in Jul-Mar on Dom. Debt



***Debt Servicing*[10]**

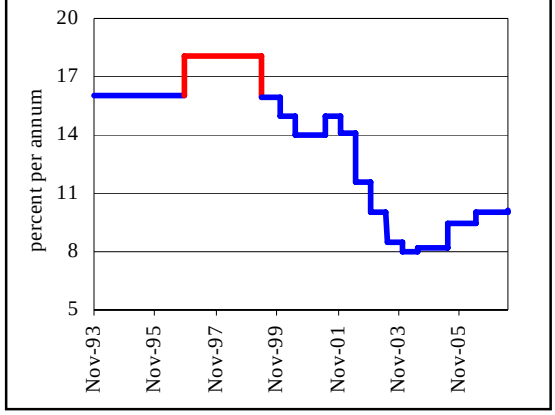
In July- Mar FY08 period, debt servicing cost of the domestic debt increased by 52.1 percent reaching to Rs 328 billion. A disaggregation shows that there is a sharp

[10] SBP estimates

increase in the unfunded debt servicing cost (see **Figure 5.9**).

A further break-up reveals Rs 172 billion costs being incurred against DSCs in debt servicing, more than half of the total servicing cost of the domestic debt for this period. In contrast in Jul-Mar FY07 the debt servicing of DSCs were Rs 80.44 billion.

Figure 5.10: Profit Rates on DSCs



The recent surge in debt servicing cost of DSCs is attributed to bullet maturities of high yield DCS issued in the later years of the 1990s. The profile of profit rates on DSCs reveal that, between November 1996 and May 1999, DSCs were sold at up to a rate of 18.04 percent (see **Figure 5.10**).

- *Outstanding bills* are added to SBP fob numbers, comprising all unrealized exports for which there exist customs records but no currency inflows to date.

- *Crude oil* represents the percentage of oil extracted in Pakistan which, by agreement, belongs to the foreign investors drilling here and is transported out of the country upon extraction becoming a physical 'export' for which no foreign exchange is forthcoming.
- *Land-borne exports* are similar to the entry in imports and refer to exports made to Afghanistan.

- *Export credit* refers to one-time bilateral trade credit offered by GOP to certain countries. Another such transient item is *samples*, which are the samples given to prospective buyers by domestic exporters.
- Finally, the exports from EPZs are also added in the SBP data.

Despite these adjustments to rationalize the differences in FBS and SBP figures, discrepancies still exist. This is primarily on account of leads and lags. Discrepancies in exports arise due to differences in valuations and commodity classification between SBP and FBS.

6 External Sector

6.1 Overview

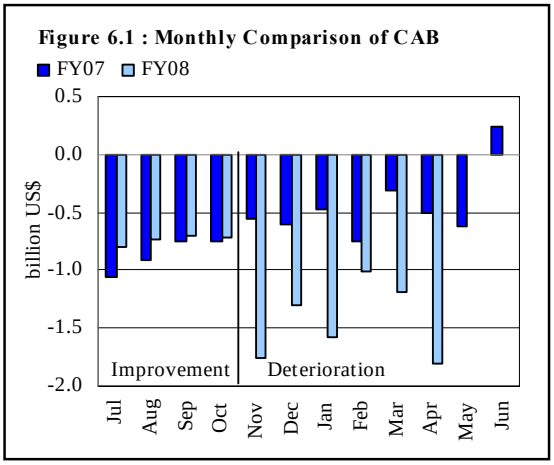
The deterioration in Pakistan's overall external balance accelerated during Jul-Apr FY08 as the current account deficit expanded further and financial & capital account surplus shrank (see **Table 6.1**). Consequently, the country's foreign exchange reserves dropped to US$ 11.5 billion and the rupee depreciated by 13.4 percent against US dollar by 22nd May, 2008.

Table 6.1: Summary of External Accounts (Jul-Apr)
billion US$

	FY06	FY07	FY08
A-C/A balance	-3.9	-6.6	-11.6
i) Trade balance	-6.5	-8.3	-12.7
ii) Invisible balance	2.5	1.7	1.2
B-Financial/capital balance	5.1	7.5	6.1
i) FDI	3.0	4.2	3.5
ii) FPI	1.0	1.8	0.1
iii) Other investment	1.0	1.4	2.5
C-Errors & omissions	0.2	-0.1	0.3
D-Overall balance	1.3	0.8	-5.2

Source: Statistics and Data Warehouse Department, SBP

Figure 6.1 : Monthly Comparison of CAB



A large part of the deterioration in current account deficit occurred Nov FY08 onwards, as is evident from more than US$ 1.0 billion year- on-year rise in monthly average import bill in the last six months (see **Figure 6.1 &Table 6.2).** This rise in import bill was contributed by both, record high prices of oil and other commodities in international market and increased import of wheat and cotton. Rise in import bill was accompanied by rising freight charges. The aforementioned factors overshadowed improvement in export growth and impressive increase in current transfers in the period under review.

On financing side, capitals & financial account registered lower surplus during Jul- Apr FY08 as compared to the same period last year. The decline in the

surplus mainly reflects: substantial decline in foreign portfolio investment,[1] on account of (a) outflow from stock market, and (b) delays in floatation of Global Depository Receipts (GDRs) and euro bonds.

The lower surplus in capital & financial account and expansion in current account deficit were reflected in the mounting pressures on foreign exchange reserves during the period. The country's overall foreign exchange reserves declined to US$ 12.3 billion at end Apr FY08 from US$ 15.6 billion at end June FY07.

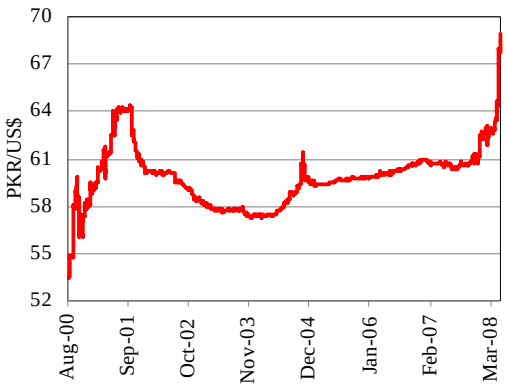
Table 6.2: Monthly Average of Current Account Balance and its Components

(billion US$)

	FY07		FY08	
	Jul-Oct	**Nov-Apr**	**Jul-Oct**	**Nov-Apr**
a-Trade balance	-0.92	-0.78	-0.84	-1.56
i)-Exports	1.36	1.42	1.55	1.66
ii)-Imports	2.28	2.20	2.39	3.23
b-Services balance	-0.41	-0.37	-0.53	-0.58
c-Income (net)	-0.28	-0.30	-0.30	-0.31
d-Current transfers	0.74	0.91	0.93	1.01
CAB(a+b+c+d))	**-0.87**	**-0.53**	**-0.74**	**-1.44**

Source: Statistics and Data Warehouse Department, SBP

Figure 6.2: Exchange Rate:A Historical Perspective



Not surprisingly, the rupee too came under pressure depreciating 6.4 percent against US dollar during Jul-Apr FY08 compared with nominal depreciation of 0.75 percent in the same period last year (see **Figure 6.2).** The pressure on exchange rate was partially attributed to weakening external account, and partially to speculative pressures as is evident from rise in kerb market premium and increase in foreign currency accounts.

It may be pointed out that surge in import growth (as was during FY03-FY06) remained the dominant factor behind worsening of current account during this fiscal year.[2] However, unlike previous years when extraordinary import growth

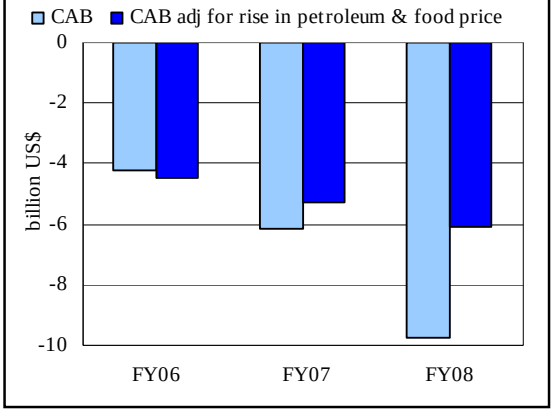
[1] The foreign portfolio investment declined to US$ 118 million during Jul-Apr FY08 from US$ 1758 million in the same period of last year.

[2] In FY07, slowdown in import growth was coincided with concurrent slowdown in export growth which deteriorated the current account deficit.

was mainly driven by demand pressures emanating from capacity expansion, the import growth in the current year was contributed by both high prices and demand factors, with former having a greater role. In particular, rise in petroleum and food imports, which contributed more than one half of the rise in overall imports, were mainly driven by higher prices.[3] Adjusting for rise in aforementioned groups, the current account deficit shows sizeable decline during the period under review (see **Figure 6.3).** The widening trade deficit suggests need for import curtailment, however, given that more than 50 percent rise in the imports is originating from food and petroleum imports; this strategy clearly has its limitations, leaving little option but to address structural problems (as mentioned in earlier quarterly reports) to boost exports earnings in medium to long term.[4]

Other than focusing on merchandize exports there is potential to enhance foreign exchange earnings by boosting services exports such as IT services, tourism etc. Increasing remittances from labor market opportunities in East Asian economies and the Middle East also needs attention to benefit from. Productivity gains likely to be achieved from skilled labor will have spillover effects in attracting FDI, enhancing workers' remittances and exports of goods and services.

Figure 6.3: Current Account Balance (Jul-Apr)



Looking ahead, persistently rising oil prices and poor performance of textile exports means that there is little room for a substantial decline in current account deficit in the remaining months of the year. However, relative easing of demand on account of rising prices, strong growth in remittances and expected inflows of logistic support are likely to slow down the pace of widening current account deficit to some extent. Likewise, inflows that can materialize from floatation of GDRs, issuance of sovereign bond,

[3] During Jul-Apr FY08, contribution of price rise in petroleum group imports was 70.3 percent while in food imports it was 86.2 percent.

[4] These problems have been discussed in various quarterly and annual reports of State Bank of Pakistan.

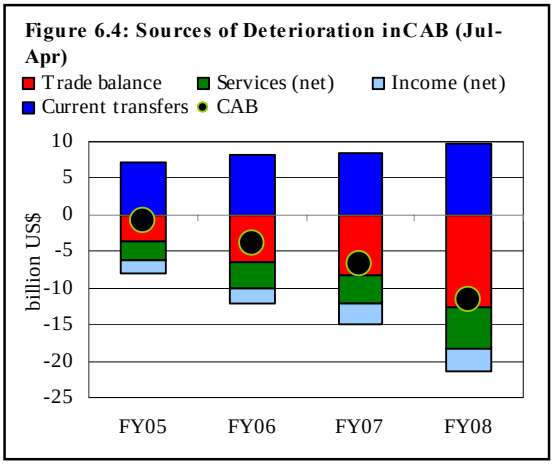
receipts of multilateral loans and disinvestment in the remaining months of the current year are likely to help in financing the current account deficit.

6.2 Current Account Balance

Current account deficit expanded by 74.8 percent during Jul-Apr FY08 on the top of a 67.9 percent rise during last year. Even when compared to the size of economy, CAD was substantially high at 7.0 percent of GDP during Jul-Apr FY08 against 4.6 percent for the same period last year.

Deterioration in the current account was caused by the widening trade and services account deficits (see **Figure 6.4).** The former increased due to surge in import growth and the latter due to rise in import related transportation costs and lower logistic supports receipts. Strong growth in workers' remittances and budgetary support from Saudi Arabia (US$ 300 million), however, provided some respite from widening current account deficit.

Figure 6.4: Sources of Deterioration inCAB (Jul-Apr)



Trade Account[5]

Trade deficit continued to worsen for the sixth year in a row (starting in FY03). During Jul-Apr FY08, substantial YoY increase of 29.4 percent in imports outstripped otherwise healthy export growth of 15.2 percent, thereby causing huge trade deficit.

Acceleration in import growth was largely contributed by inflated petroleum group imports and increased import of wheat and cotton owing to domestic supply shortage during the period. Welcome recovery in export growth, on the other hand, was chiefly driven by non-textile exports as textile exports continued to show poor performance. The weakness in textile exports is partly explained by slowdown in key textile export markets (particularly in H1-FY08) and partly by high cotton prices and power shortages plaguing domestic economy.

[5] This section is based on exchange record data compiled by SBP that does not tally with the Custom data compiled by FBS.

Services (net)

Services account deficit widened by 44.2 percent during Jul-Apr FY08 to reach US$ 5.6 billion. This deterioration is contributed by relatively high import growth and decline in export of services.

Table 6.3: Details in Trade in Services (Jul-Apr)

	Exports				Imports			
	Growth (percent)		Share (percent)		Growth (percent)		Share (percent)	
	FY07	FY08	FY07	FY08	FY07	FY08	FY07	FY08
Transportation	2.5	-5.6	29.6	32.0	11.9	14.4	37.8	36.3
Travel	31.5	-3.0	7.6	8.5	20.6	-5.2	20.4	16.2
Government services	-16.8	-26.5	38.3	32.3	2.7	17.7	3.8	3.8
Other business devices	19.4	-7.3	12.5	13.3	-10.3	41.1	30.4	36.1
Others	10.9	1.4	11.9	13.9	-8.8	18.6	7.6	7.6
Total	-2.0	-12.8	100.0	100.0	3.5	19.0	100.0	100.0
Adjusted for logistic support	6.3	2.1	-	-	-	-	-	-

Source: Statistics and Data Warehouse Department, SBP

During Jul-Apr FY08, 86 percent of services exports witnessed decline, particularly fall in government services is the strongest (see **Table 6.3**). Fall in government services exports was driven by lower logistic support receipts, while fall in transportation services was mainly result of lower passage earnings of Pakistani airlines facing stiff competition from foreign airlines. Worsening law & order situation and resultant decrease in foreign tourists proved major reasons for falling travel exports.

Higher import related transportation costs and outflow from other business services (mainly reflecting increased coverage of foreign transaction routed trough exchange companies) led to acceleration in services import growth during July-Apr FY08.[6]

[6] These outflows from foreign exchange companies have no impact on overall current account balance as these outflows are matched by receipts of foreign exchange companies.

Table 6.4: Current Account Balance

million US$

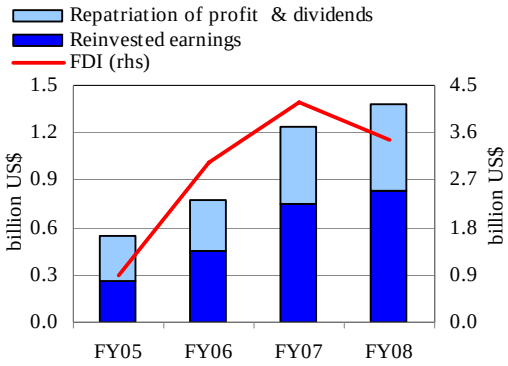
	Jul -Apr			YoY Change	
	FY06	**FY07***	**FY08***	**FY07**	**FY08**
1. Trade balance	**-6,458**	**-8,307**	**-12,740**	**-1,849**	**-4,433**
Exports	13,484	14,033	16,167	549	2,134
Imports	19,942	22,340	28,907	2,398	6,567
2.Services (net)	**-3,571**	**-3,867**	**-5,575**	**-296**	**-1,708**
Transportation	-1,453	-1,710	-2,139	-257	-429
Travel	-991	-1,176	-1,110	-185	66
Communication services	72	23	12	-49	-11
Construction services	-122	17	-13	139	-30
Insurance services	-94	-91	-92	3	-1
Financial services	-60	-55	-110	5	-55
Computer & information services	24	13	10	-11	-3
Royalties and license fees	-64	-69	-63	-5	6
Other business services	-2,029	-1,726	-2,621	303	-895
Personal & cultural & recreational services	-4	1	2	5	1
Government services	1,150	906	549	-244	-357
Of which logistic support	923	723	283	-200	-440
3. Income (net)	**-2,091**	**-2,900**	**-3,057**	**-809**	**-157**
Investment income(net)	-2,095	-2,905	-3,064	-810	-159
Direct investment	-1,635	-2,372	-2,592	-737	-220
Of which: profit & dividends	-325	-486	-543	-161	-57
Purchase of crude oil and minerals	-882	-1,163	-1,226	-281	-63
Portfolio investment	-123	-179	-157	-56	22
Of which : dividend	-75	-167	-189	-92	-22
IMF charges & interest on off. external long term debt	-430	-478	-502	-48	-24
Interest on private external debt	-71	-127	-181	-56	-54
Others (net)	168	256	375	88	119
4. Current Transfers (net)	**8,172**	**8,446**	**9,786**	**274**	**1340**
Private transfers	7,836	8,186	9,301	350	1115
Workers remittance	3,626	4,450	5,317	824	867
FCA - residents	268	59	351	-209	292
Others	4,000	3,720	3,700	-280	-20
Of which exchange companies	2,440	2,032	2,040	-408	8
Official transfers	336	260	485	-76	225
Current account balance	**-3,948**	**-6,628**	**-11,586**	**-2,680**	**-4,957**

* Provisional

Income (net)

Income account deficit deteriorated marginally by 5.4 percent during Jul-Apr FY08 against considerable expansion of 38.7 percent in comparable period last year. The substantial deceleration in deficit expansion during the period was result of a relatively smaller increase in repatriation of profit & dividends on investment income and decline in interest payment (net).

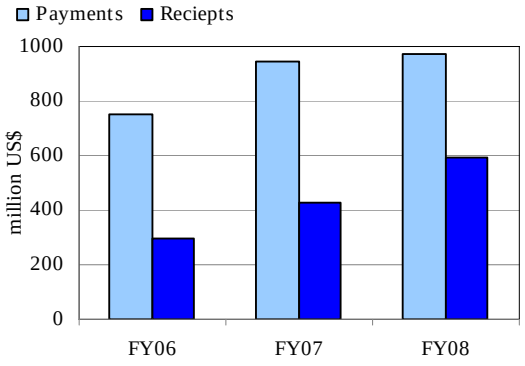
Figure 6.5: Impact of FDI on Current Account Deficits (Jul-Apr)



Slowdown in repatriation of profit & dividends on foreign investment during the current year probably reflects lower corporate profits during CY2007. Specifically, financial and telecommunication sector, which together account for more than one half of total foreign direct investment, repatriated lower amount of profit & dividend during Jul-Apr FY08 compared with the same period last year. In contrast the sectors with visible increase in profit & dividends during the period under review included thermal power generation and oil & gas exploration.

Encouragingly, amount of reinvested earning has been on the increase over the last four years in most of the sectors (see **Table 6.6**) which indicates that foreign investors are consolidating their business in Pakistan (see **Figure 6.5**).[7]

Figure 6.6: Interest Payment and Reciepts (Jul-Apr)



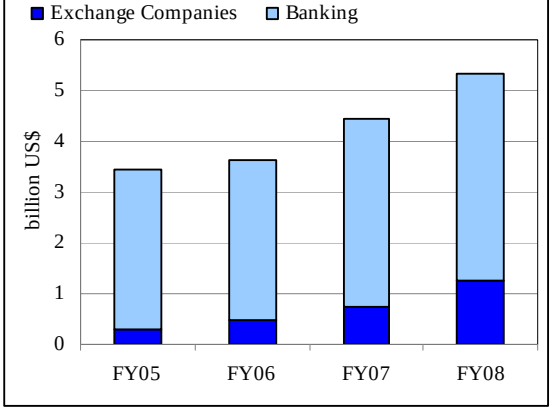
[7] Reinvested earnings are shown as outflow in current account balance and inflow in financial account balance. Hence they have no impact on overall external balance.

Decline in interest payment (net), on the other hand, is result of both increased interest earning and marginal decline in interest payments on external debt & liabilities during Jul-Apr FY08 (see **Figure 6.6)**.

Current Transfers

The 15.9 percent increase in current transfers during Jul-Apr FY08 reflects a significant increase in both the, private and official, transfers. Budgetary support of US$ 300 million from Saudi Arabia mainly explains the rise in official transfers while strong remittances growth and higher inflow in the resident foreign currency accounts explains rise in private transfers.

Figure 6.7: Workers Remmitances (Jul-Apr)



Workers' Remittances

As in the previous year, workers' remittances recorded impressive growth of 19.5 percent during Jul-Apr FY08. Remittances routed through exchange companies contributed 60.2 percent in the overall remittances growth. As a result, foreign exchange companies' share in overall remittances increased to 23.8 percent during Jul-Apr FY08 from 16.7 percent for the same period last year (see **Figure 6.7**).[8] Part of the strong growth in remittances is probably a consequence of rising costs of living at home.

Table 6.5: Country wise Workers Remittances (Jul-Apr)
million US$

	FY07	FY08	Absolute Change
Gulf region	2,111	2,704	593
USA	1,176	1,464	288
UK	355	379	24
Canada	70	83	13
Germany	65	63	-2
Others	672	624	-48
Total cash	**4,448**	**5,317**	**869**
Encashment & profits FEBC & FCBCs	2	2	0
Grand total	**4,450**	**5,319**	**869**

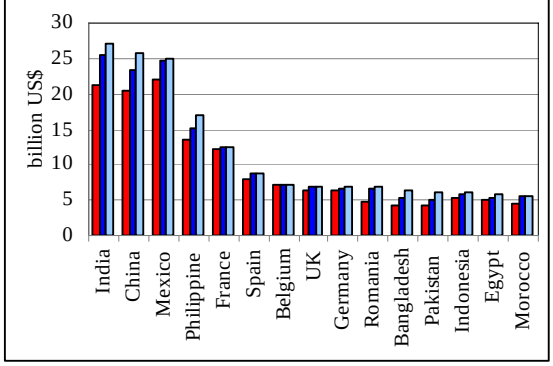
Source: Statistics and Data Warehouse Department, SBP

[8] For reason of rise in remittances through exchange companies see SBP 2nd Quarterly Report for FY08.

A greater share in remittances growth was that of the oil rich gulf region- Kuwait, Bahrain, Qatar, Oman, Saudi Arabia and United Arab Emirates- and from United State of America (see **Table 6.5).**

Increase in remittances to Pakistan in recent years is in line with the international trends. The world top fifteen remittances recipient countries have experienced increase in remittances in the last two years (see **Figure 6.8).** Pakistan registered the third highest growth (19.6 percent) in remittances during 2006 and the highest growth (19.1 percent) in 2007 among the top fifteen countries. As a result, Pakistan has become world's 12th largest remittance recipient country during 2007 from 17th in 2005.

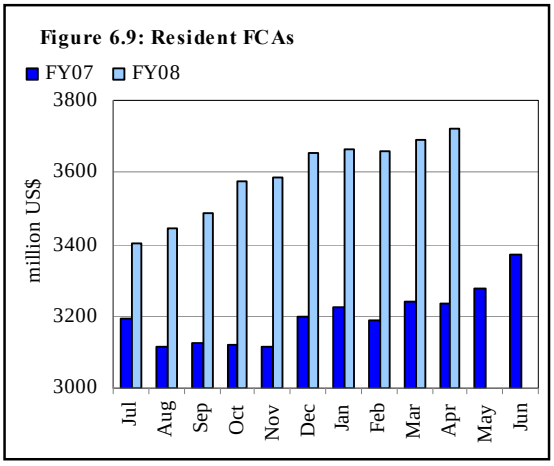
Figure 6.8: Remittances Inflows in World's Major recipient Countries



Resident FCAs

Historically, whenever expectation of depreciation in Pak Rupee take hold, the resident foreign currency account records considerable inflows. In line with this, the expectations of exchange rate depreciation in the recent months led to US$ 351 million inflow in resident foreign currency accounts during Jul-Apr FY08 compared with nominal inflow of US$ 59 million in the same period last year (see **Figure 6.9**).

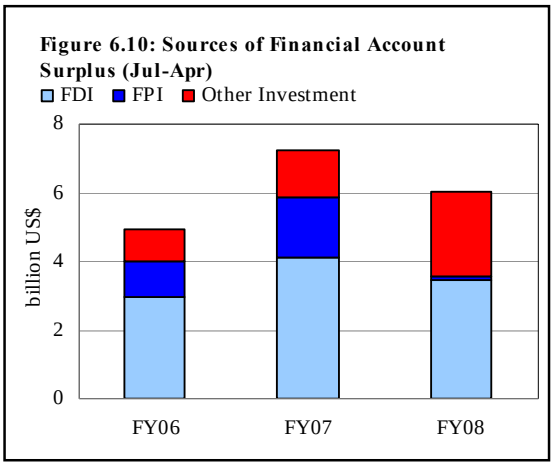
Figure 6.9: Resident FCAs



6.3 Financial Account

In sharp contrast to last two years, surplus in financial account declined sizably during Jul-Apr FY08 (see **Figure 6.10).** A large part of this decline was result of lower inflows in both foreign portfolio investment and foreign direct investment during Jul-Apr FY08 (as compared to substantial inflows in the same period last year). Other investments, however, recorded considerable inflows during Jul-Apr FY08 which mainly reflects higher inflows in earthquake loans (US$ 516 million) and receipts of short term loan (net) US$ 561 million from Islamic Development Bank (IDB).

Figure 6.10: Sources of Financial Account Surplus (Jul-Apr)



Net Foreign Investment

Overall net foreign investment declined by 39.2 percent during Jul-Apr FY08 as compared to 47.0 percent growth in the corresponding period previous year. This was mainly due to fall in foreign direct investment and portfolio investment. However, with 9.6 percent YoY growth during Jul-Jan FY08, fall in FDI entirely occurred in the last three months (Feb-Apr FY08).

Foreign Direct Investment

After recording average growth of 100.2 percent in last three years (FY05-07), the foreign direct investment declined by 16.7 percent during Jul-Apr FY08. A part of decline is attributed to high base set last year and a part to increased country risk.

Sector wise analysis reveals that investment in telecommunication, power, petroleum refining and financial business declined whereas cement, oil & gas exploration and trade recorded increase. Major companies which received foreign inflows include: Pakistan Cement Company Limited (Chakwal cement), Warid telecom, Telenor, Lasmo Oil Pakistan Ltd, Saudi Pak Bank and Metro cash & carry.

Moreover, almost entire decline in overall foreign direct investment during Jul-Apr FY08 resulted from a decline in cash investment, as reinvested earnings grew by considerable rate of 12.0 percent during the period under review. Major sectors

which registered increase in reinvested earning during Jul-Mar FY08 include: financial business, oil & gas exploration, cement and trade. Higher reinvested earnings mainly reflect profitability of these sectors and investors confidence in Pakistan economy in the long run.

Table 6.6: Sector wise Foreign Direct Investment (Jul-Apr)
million US dollar

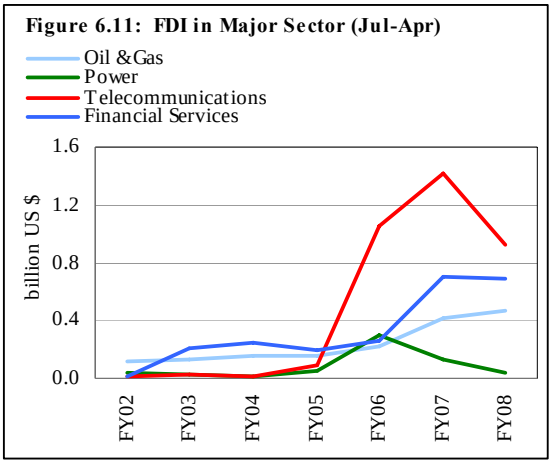
	FY07			FY08		
	Cash	**Reinvested Earnings**	**Total**	**Cash**	**Reinvested Earnings**	**Total**
Chemical	-10	41	31	29	37	66
Petroleum refining	17	98	115	11	56	67
Oil & gas exploration	346	106	452	326	178	504
Cement	-2	18	16	59	35	94
Trade	103	17	120	123	40	163
Cars	3	31	34	14	53	67
Power	49	88	136	45	6	51
Telecommunication	1,303	57	1,360	959	73	1,033
Financial business	687	191	877	471	269	740
Other	913	103	1,016	607	90	697
Total	**3,407**	**751**	**4,158**	**2,645**	**837**	**3,482**

It may be pointed out that during the last few years a substantive part of foreign direct investment was concentrated in a few sectors: financial business, oil & gas, power and telecommunications (see **Figure 6.11**). As these sectors mature the scope for further FDI in these sectors would decline, therefore it is important to create conducive environment to attract FDI in other sectors of the economy. The major impediments to FDI in other sectors are lack of skilled labor, inadequate infrastructure and poor law & order situation.

Portfolio Investment

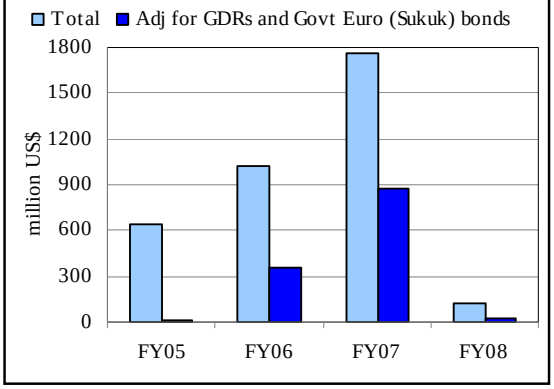
Unlike previous years (FY03-07), foreign portfolio investment witnessed substantial decline during Jul-Apr FY08. Changing international financial environment together with adverse developments at home were the major factors behind these capital outflows.

Figure 6.11: FDI in Major Sector (Jul-Apr)



Pakistan has had very low level of portfolio investment four to five years back. However, in the last three years (FY05-07) foreign flows in portfolio investment picked up sharply on the back of a combination of factors. On the one hand, liquidity comfort in international market along with political and economic stability at home enabled Pakistan to raise funds from international capital market, in the form of euro (sukuk) bonds and GDRs, at favorable rate. On the other hand, remarkable performance of stock market also attracted sizeable amount of foreign investment in the last two years (see **Figure 6.12)**.

Figure 6.12: Foreign Portfolio Investment (Jul-Apr)



The congenial international and domestic environment, however, changed for worst during Jul-Apr FY08. International financial market was hit by subprime crisis which led to capital flight from emerging economies stock markets and also increased the risk premium of raising funds from international market. The effect of adverse developments on external front was further compounded by political uncertainty and widening imbalances in the domestic economy which increased country risk as was reflected by Moody's and Standard & Poor's downward revision (from stable to negative) of Pakistan outlook on the long term foreign and local currency sovereign credit rating.[9]

In this backdrop, a larger part of the extraordinary fall, during Jul-Apr FY08, is not surprising which is attributed to delay in floatation of Global Depository Receipts (GDRs), delay in issuance of euro bond and capital outflow from the stock market.

Outstanding Export Bills (OEBs)

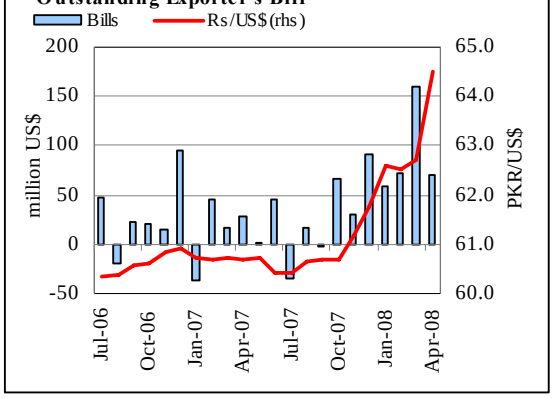
During Jul-Apr FY08, stock of outstanding export bill increased by US$ 428 million. This increase is more than double of the increase of US$ 210 million in the comparable period last year. Like the previous year, the entire increase in the

[9] For detail see 2nd Quarterly Report of State Bank of Pakistan for FY08.

stock resulted from outstanding export bills held by the exporters as the bills held by the commercial bank recorded decline during the period.

The increase in OEBs held by exporters was more pronounced in the last five months (Dec-Apr FY08) which coincided with the relatively sharp depreciation in exchange rate (see **Figure 6.13**). This correlation strengthens the view that exporters hold back their proceeds when they expect exchange rate to depreciate.

Figure 6.13: Exchange Rate and Increase in Outstanding Exporter's Bill



Currency & Deposits

Commercial banks' FE-25 nostros declined by US$ 915 million during Jul-Apr FY08 compared with nominal fall of US$ 9.0 million in the same period last year. Increase in lending against FE-25 deposits is the probable factor behind this decline in FE-25 nostros.

Official Long Term Loans

Net inflows in the official long term loans were higher during Jul-Apr FY08 against the same period of last year. This increase mainly reflects higher earthquake related inflows (US$ 516 million) during Jul-Apr FY08 compared with the same period last year (US$ 235 million).

Official Short term Loans

Official short term loans witnessed net inflows of US$ 561 million compared with the net outflows of US$ 58 million in the corresponding period last year. This increase entirely reflects higher gross inflows of US$ 602 million from Islamic Development Bank during the period under review. Importantly, this amount is disbursed for less than one year term which means; it is not only expensive but will also be reflected as capital outflow in the following fiscal year.

Table 6.7: Financial Account

million US$

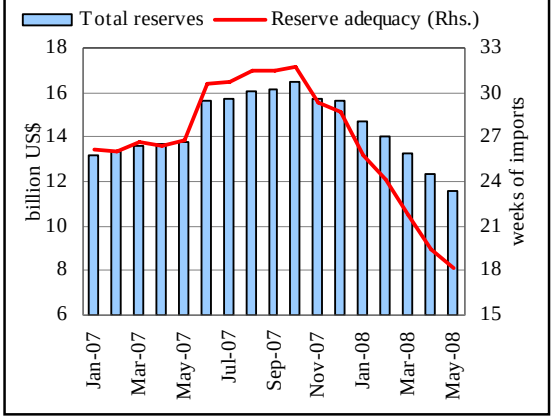
	Jul - Apr			YoY Change	
	FY06	**FY07***	**FY08***	**FY07**	**FY08**
Financial account (net)	**4,938**	**7,244**	**6,037**	**2,306**	**-1,207**
Direct investment abroad	**-79**	**-80**	**-35**	**-1**	**45**
Direct investment in Pakistan	**3,038**	**4,181**	**3,482**	**1,143**	**-699**
Equity capital	2,591	3,430	2,645	839	-785
Reinvested earnings	447	747	837	300	90
Portfolio investment	**1,027**	**1,758**	**118**	**731**	**-1,640**
Equity securities	372	1,579	97	1,207	-1,482
Debt securities	655	179	21	-476	-158
Net foreign investment	**3,986**	**5,859**	**3,565**	**1,873**	**-2,294**
Other investment	**952**	**1,387**	**2,472**	**435**	**1,085**
Assets	169	-82	607	-251	689
1-Outstanding export bills (exporters)	-241	-235	-527	6	-292
2-Outstanding export bills (DMB s)	-29	25	99	54	74
3-Currency and deposits	438	127	1,035	-311	908
Of which banks	403	9	915	-394	906
Liabilities	662	1,384	1,725	722	341
1-Foreign long-term govt. loans / credits (net)	530	604	784	74	180
Project loans	549	728	913	179	185
Non- project loans	838	692	776	-146	84
Amortization	857	816	905	-41	89
2-Private loans	234	465	271	231	-194
Of which supplier credits	502	796	529	294	-267
Suppliers credit repayments	268	331	258	63	-73
3-Short term capital (official)	-195	-58	561	137	619
Of which IDB (net)	-79	58	561	137	503
4-Currency and deposits	296	348	415	52	67
Other liabilities	-82	110	-166	192	-276

* Provisional

6.4 Foreign Exchange Reserves[10]

Deterioration in the external accounts of the country took toll on its reserves. Pakistan's reserves declined quite sharply October onwards, mirroring sharp rise in the current account deficit. The overall reserves of the country stood at US$ 11.6 billion by mid May 2008; down by US$ 4.8 billion from the peak of US$ 16.4 billion in Oct 2008.

Figure 6.14: Foreign Exchange Reserves



Depletion in foreign exchange reserves has also eroded the reserve adequacy of the country, in terms of weeks of imports. Import coverage ratio declined to 18.1 weeks from 30.6 weeks in June FY07 (see **Figure 6.14**).

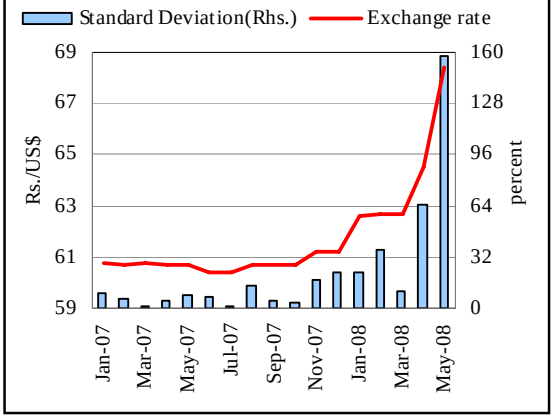
Almost all the decline in the country's reserves was due to depletion of SBP reserves as the commercial bank's reserves remained stable at around US$ 2.3 billion throughout Jul-mid May FY08 period.

Pressures on SBP reserves are likely to ease in the coming months due to rise in the inflows. Saudi Arabia has provided US$ 300 million to Pakistan while ADB has also pledged US$ 650 million for budgetary support. Besides, inflows are also expected from the acquisition of 15 percent stake in MCB by Malaysia's Maybank.

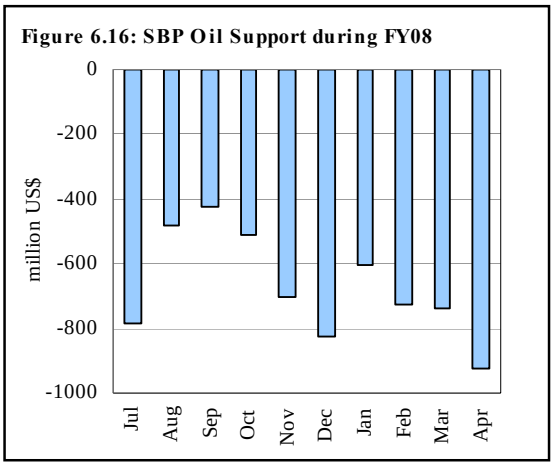
6.5 Exchange Rate

Pak rupee after remaining stable for more than four years, lost significant value against the US dollar depreciating by 13.4 percent during Jul-21st May 2008.

Figure 6.15: Exchange Rate and its Volatility

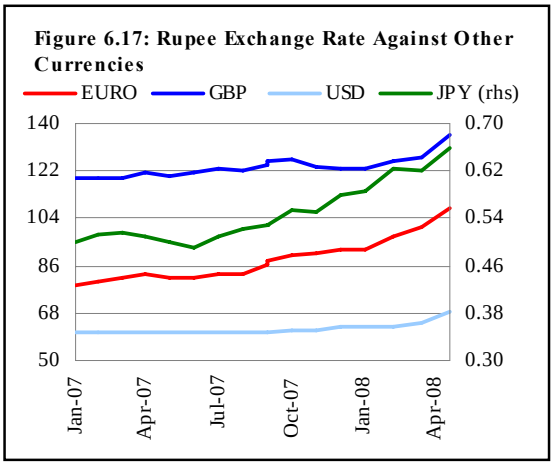


[10] May data corresponds to May 21, 2008.



Most of the depreciation in the value of rupee was recorded post November 2007. This depreciation appears to be due to a mix of flight to safety following the political unrest, trade related outflows and speculative activities. Other than sharp depreciation, rupee dollar exchange rate also remained quite volatile during the last six months (Dec-May) (see **Figure 6.15**). Although, SBP continued to provide US$ liquidity both for oil support (as per policy) and to check the excess volatility(see **Figure 6.16)**, the pressure on market persisted on the back of political uncertainty and build up of speculative positions, consequently exchange rate kept weakening trend besides fluctuating significantly**.**

The steep decline in value of rupee as well as the high volatility in the market prompted SBP to take some stringent steps including issuance of guidelines to banks and exchange companies regarding the foreign exchange dealings (see **Box 6.1**) followed by some interim policy measures. These include, among others, a rise in discount rate by 150 basis points, and imposition of margin requirement for import L/C to 35 percent. These measures appear to have dented the market sentiments as rupee regained some of its lost value following the interim monetary measures announced on 22nd May. Going forward, these measures coupled with expected inflows are likely to provide further support to the weakening rupee.

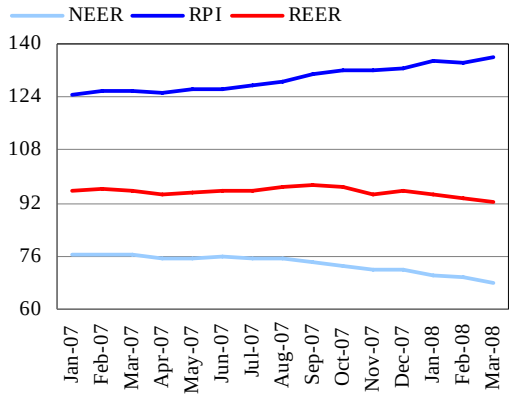


As against dollar, rupee also depreciated against other major currencies, with depreciation against Euro and JPY being more pronounced. This mirrors the dollar depreciation against these

currencies, besides rise in rupee exchange rate against US$ (see **Figure 6.17**).

During Jul-mid May 2008, rupee depreciation against JPY, Euro and Pound sterling amounted to 25.4, 24.0 and 10.4 percent respectively. Due to steep depreciation against Euro, rupee to Euro exchange rate crossed Rs. 100/Euro mark reaching Rs. 108 per Euro by mid May 2008.

Figure 6.18: Effective Exchange Rate Indices



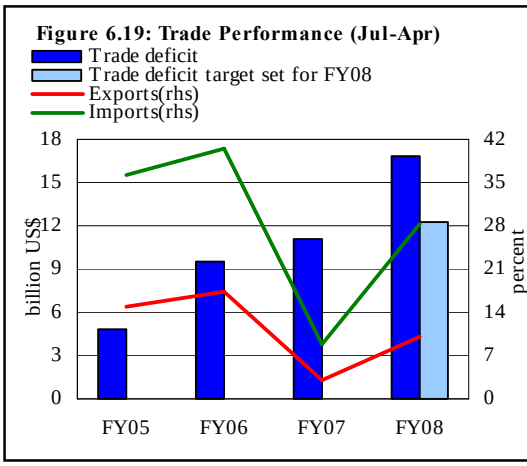
Real Effective Exchange Rate

Despite consistent rise in inflationary pressures evident in 8 percent rise in relative price index (RPI), real effective exchange rate index depreciated by 3.2 percent during Jul-Mar FY08(see **Figure 6.18)**.[11] This real depreciation and hence improvement in Pakistan's competitiveness owes to steep weakening of Pak rupee against major competing currencies reflected by 10.3 percent depreciation of the Nominal Effective Exchange Rate (NEER) during Jul-Mar 2007.

6.6 Trade Account

Pakistan's merchandise trade deficit widened to a record high US$ 16.8 billion during Jul-Apr FY08, 37.8 percent higher than the annual trade deficit target (see **Figure 6.19**). The deficit was fueled by a very strong surge in imports, as well as, below - target export growth. While the 10.2 percent YoY export growth during Jul-Apr FY08 was an improvement over the previous year, it was

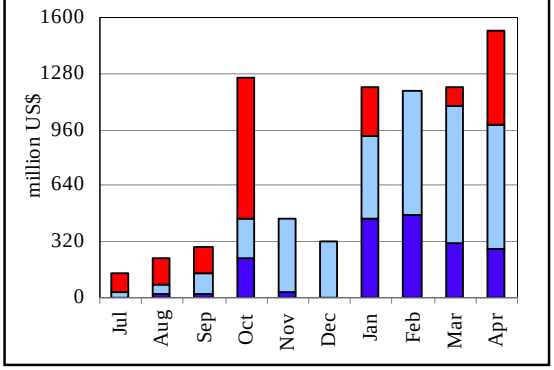
Figure 6.19: Trade Performance (Jul-Apr)



[11] The latest data on Real Effective Exchange Rate is for end-March 2008.

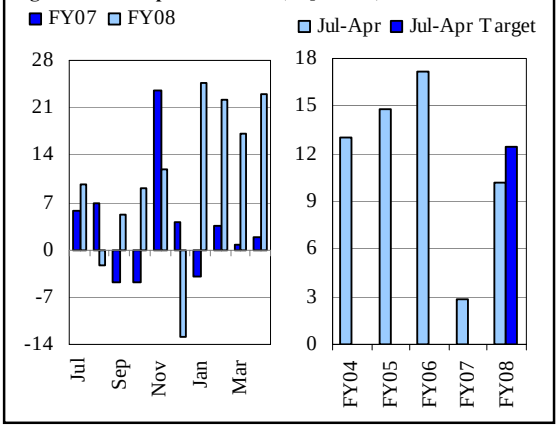
nonetheless significantly lower than the 12.4 percent growth target for the period.[12]

Figure 6.20: Source of Increase in Imports FY08



The surge in the imports during Jul-Apr FY08 was driven by both rising demand pressures and increase in the international commodity prices. Demand pressures were especially evident in Jan-Apr FY08 during which around 70 percent of the total increase in imports was concentrated (see **Figure 6.20**). In overall terms non-food non-oil imports witnessed a sharp 18.8 percent YoY increase during Jul-Apr FY08.[13] The impact of higher demand was further compounded by a sharp surge in international commodity prices[14] Q2 onwards.

Figure 6.21: Export Growth (in percent)



The growth in exports was led by the non-textile sectors whereas textiles registered a fall during the period under review. Within the non-textiles exports, performance of the *other manufactures* is indeed very encouraging, particularly given the continued bottlenecks facing the exporters in the form of energy and skilled labor shortages, political

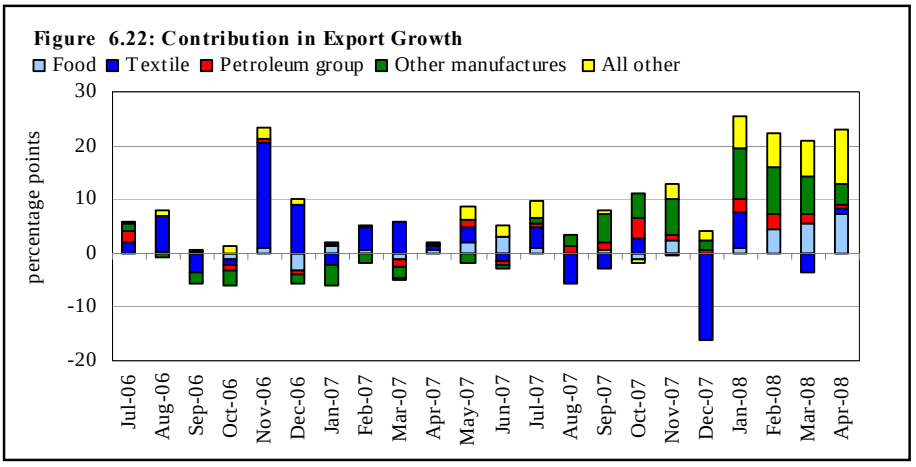
[12] The FY08 annual growth target for exports was set at 13.1 percent in the trade policy.
[13] After excluding the price impact and cotton imports however this YoY growth decreases to 13.7 percent.
[14] For around 52.2 percent of the total imports, detailed data on price and quantum was available during Jul-Apr FY08. According to this data 46..3 percent of the total increase in imports during this period, was caused by price impact.

disturbances, etc. Poor show of the textile sector exports on the other hand is partly attributable to growing competitive pressures and partly to slowdown in textile imports in the key EU and US markets (particularly during H1-FY08).

Going forward both exports and imports are expected to undergo a seasonal expansion. In case of imports, however, the seasonal surge will be amplified by expected continuation of the trend increase in international commodity prices particularly *oil* and rising demand pressures as witnessed in Q3. This suggests the possibility of further widening of country's trade deficit in the remaining months.

Exports

Exports growth staged a sound recovery during Jul-Apr FY08 as compared to the same period last year, though it remained short of the growth target set for the period (see **Figure 6.21**). This recovery had two important features 1) a large



share of the total increase in exports during Jul-Apr FY08 was concentrated in the period Jan-Apr;[15] 2) growth in exports originated from non-textile sector, while the textile sector export growth experienced fall during this period.

A part of the surge in export growth during Jan-Apr FY08 is explained in terms of the delayed fulfillment of export orders due in December FY08. Reportedly the month of December FY08 witnessed delays in fulfillment of export orders, particularly of textile exports due to a wide-scale disruption of economic activity (see **Figure 6.22**).

[15] In absolute terms the YoY increase in exports during Jan-Apr FY08 had 83.4 percent share in the total rise in exports during Jul-Apr FY08

Table 6.8: Export Growth Comparisons -FY08

											Number of	
	Jul	**Aug**	**Sep**	**Oct**	**Nov**	**Dec**	**Jan**	**Feb**	**Mar**	**Apr**	**High**	**Low**
Rice	0	0	1	0	1	0	0	1	1	1	5	5
Basmati	1	1	1	1	1	1	0	1	1	1	9	1
Others	0	0	0	0	1	0	1	1	1	1	5	5
Fruits	1	1	1	1	0	0	0	1	1	1	7	3
Sugar	-	-	-	-	-	-	1	1	1	1	4	6
Readymade garments	1	1	1	1	0	0	1	1	1	1	8	2
Art silk / synthetic textiles	1	1	0	0	0	0	0	1	1	1	5	5
Petroleum products	0	0	1	1	1	1	1	1	1	1	8	2
Chemicals/ pharmaceuticals	0	0	1	0	1	1	1	1	1	1	7	3
Cement / cement products	1	0	1	1	1	1	1	1	1	0	8	2
Percentage point contribution in growth	**7.8**	**2.2**	**3.8**	**2.2**	**7.4**	**1.0**	**11.5**	**15.7**	**16.4**	**19.3**		
Export growth	**9.7**	**-2.3**	**5.1**	**9.2**	**11.9**	**-12.9**	**24.6**	**22.3**	**17.3**	**23.1**		

Besides this, the growth witnessed during the period was based on fundamentals 1) – sharp rise in international *rice* prices that offered a strong incentives to exporters, along with the availability of exportable surplus in domestic market, unlike the shortages in some of the competitor countries 2) – higher *sugar* production during FY08 leading to higher *sugar* and *ethanol* exports 3) – increasing world demand for *synthetic textiles* 4) – capacity enhancements and improved demand in the *cement* sector, etc.

This is also supported from the comparison of monthly YoY export growth of the strong performing categories during Jul-Apr FY08. It shows that growth in most of these categories [16] remained higher than in Jul-Apr FY07 (see **Table 6.8**). In addition, the performance of some of the categories, which were not performing well in H1-FY08 e.g., *other varieties of rice, sugar* also started to improve in H2-FY08.

This analysis shows strong growth potential of the major export categories. In overall terms during the remaining months of FY08, the growth trajectory of exports is likely to remain unchanged.

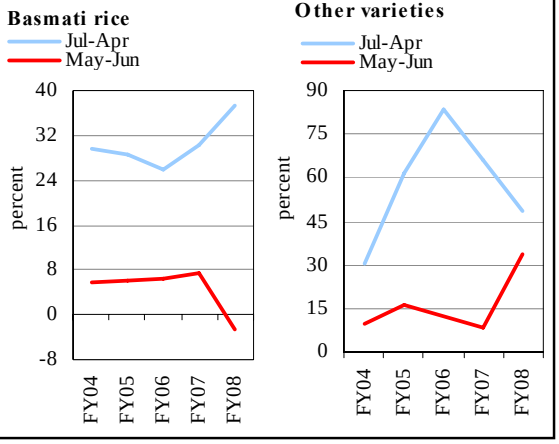
[16] Basmati rice, petroleum products, chemicals & pharmaceuticals and cement, etc.

Particularly the rise in *rice* exports was seen due to 1) - rising quantum of *basmati* exports and 2) - rising international prices of rice (see **Table 6.9**). With the production of basmati rice almost at the same level as previous years, the surge in export quantum of this category implies that exporters are selling larger quantum of this category abroad, taking advantage of the sharp rise in international prices. This fact is also supported by sharp rise in the domestic prices of *basmati rice* during the same period.[17]

Table 6.9: Rice Production and Exports (Jul-Apr)

	FY06	FY07	FY08
Quantum (000MT)			
Rice	3,108	2,690	2,431
Basmati	680	751	914
Other varieties	2,427	1,939	1,517
Unit Value (US$/MT)			
Rice	310	350	488
Basmati	571	600	691
Other varieties	237	254	365
Production (million tones)			
Rice	5.6	5.4	5.6
Basmati	2.6	2.5	2.5
Other varieties	2.9	2.9	3.1

Figure 6.23: Rice Export Quantum Share in Production



The faster than usual pace of *basmati rice* export has led to relatively earlier depletion in its export surplus this year compared to previous years, if the share of *basmati rice* exports in total production stays at the average level of last three years (see **Figure 6.23**). [18]

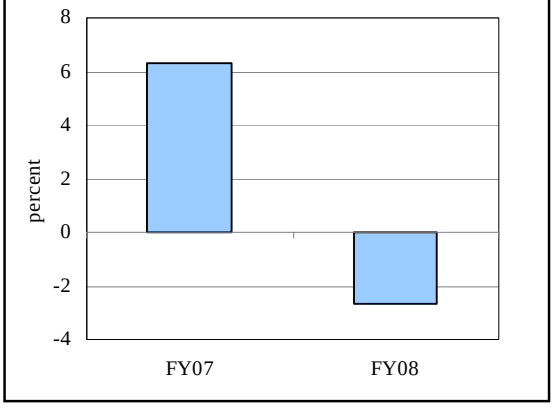
Fall in exports of *other varieties of rice* during Jul-Apr FY08 is probably attributable to a combination of electricity shortages (that curtailed working of rice mills) and higher domestic demand (and prices) due to persistent wheat shortages in the country, creating increased domestic demand for rice. In addition, anecdotal

[17] Average domestic prices of basmati rice recorded 56.5 percent YoY rise during Jul-Mar FY08 as compared to the same period last year.
[18] During Jul- Apr FY05-FY07 around 28.7 percent of the total basmati rice production was exported, which is lower than the current 37.3 percent basmati rice exported during Jul-Apr FY08.

evidence also suggests possibility of rice smuggling to Iran, as domestic banks are not accepting letters of credit from Iranian banks for imports because of the shortage of dollars in that market. However, since January 2008, the export quantum of this category has started to recover, because of availability of imported wheat in the market. In view of the rising international prices of rice and higher export surplus of the category, this rise is likely to continue in going forward (see **Figure 6.23**). [19]

Improvement in *textile* export performance on the other hand, seems to be difficult in the short run. Textile exports staged a small recovery during Q3-FY08; however, the overall export level for Jul-Apr FY08 remained significantly below the mark for the same period last year (see **Figure 6.24**). Recovery in Jan- Apr FY08 was largely concentrated in ready-made garments and synthetic textiles exports. In fact synthetic textile was almost the only sector that recorded rise in export quantum during Jul-Mar FY08, whereas ready-made garments showed a small fall in export quantum (see **Table 6.11**).

Figure 6.24: Textile Export Growth (Jul-Apr)



This under performance of textile sector is caused by structural issues hurting its competitiveness. Some of the important issues are rising domestic cost of production due to higher electricity tariffs, increased power shortages and lack of skilled

Table 6.10: Textile and Apparel Exports Growth- Major Markets
in percent

	Textile		Apparel	
	FY07	**FY08**	**FY07**	**FY08**
EU (H1-FY08)				
Pakistan	9.9	8.4	5.3	0.6
World	8.0	4.1	7.5	3.3
US (Jul-Feb FY08)				
Pakistan	-3.9	-6.2	12.7	-0.5
World	4.0	5.2	7.8	-0.9

[19] Government has imposed Minimum Export Price for the export of rice. However in view of the rising trend of international rice prices and availability of domestic surplus the value of export earning is likely to remain unaffected because of this measure.

resources resulting in lower productivity, low quality of products due to the use of contaminated cotton produced domestically, etc. In addition the deteriorating law and order situation in the country also resulted in the reported diversion of export orders to other countries.

These factors are hampering the production capacity of this sector leading to fall in textile and apparel exports in the US market where country's exports have to face tough competition, whereas in the EU market where the country has access to the general GSP scheme these exports fared relatively better (see **Table 6.10**). In addition the slowdown in the US market is also hurting country's apparel exports to this destination. Persistent appreciation in the currencies of some major competitors like India and Vietnam might give some relief to country's exports. Also, the textile industry would probably benefit from consolidation to generate economies of scale.

Table 6.11: Major Exports (Jul-Apr)

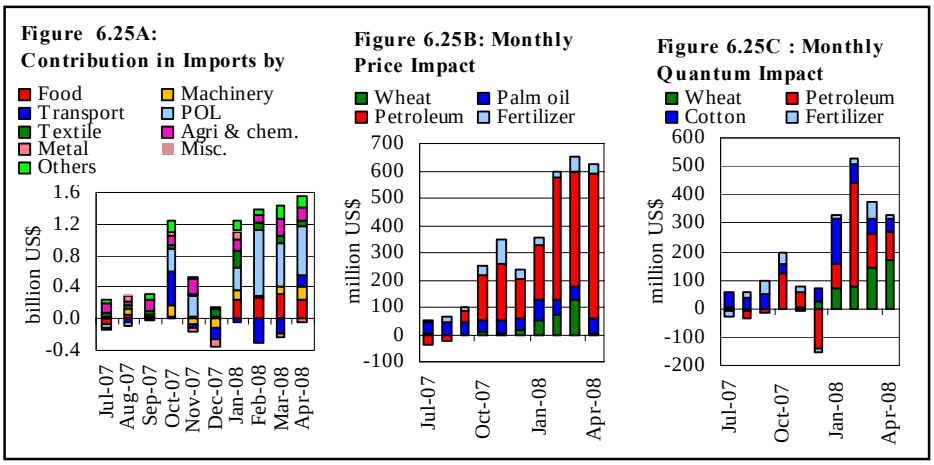
million US$

		FY07		FY08(P)		Abs.Δ value	% YoY Δ		
		Value	**Unit value**	**Value**	**Unit value**		**Qty**	**Value**	**Unit Value**
A. Food group		**1,643.3**		**1,954.2**		**310.9**		**18.9**	
Of which									
Rice	MT	942.0	350.3	1,185.2	487.6	243.2	-9.6	25.8	39.2
Fish and fish preparations	MT	158.2	1,523.5	165.9	1,700.1	7.7	-6.0	4.9	11.6
Fruits	MT	95.2	329.6	124.6	422.9	29.5	2.1	31.0	28.3
Vegetables incl. roots and	MT	48.6	269.9	41.0	369.7	-7.6	-38.4	-15.6	37.0
Oil Seeds & nuts etc.	MT	13.8	744.1	35.3	880.2	21.4	115.2	154.6	18.3
Meat and meat preparations	MT	33.6	2,737.3	42.0	2,949.7	8.4	16.0	25.0	7.8
B. Textile group		**8,875.3**		**8,638.0**		**-237.3**		**-2.7**	
Of which									
Cotton yarn	MT	1,176.5	2,142.4	1,066.6	2,246.8	-109.9	-13.6	-9.3	4.9
Cotton fabrics	SQM	1,717.3	904.0	1,529.8	1,017.8	-187.5	-20.9	-10.9	12.6
Hosiery (knitwear)	DOZ	1,604.9	20.1	1,477.0	21.2	-127.9	-12.7	-8.0	5.4
Bed wear	MT	1,634.7	5,380.2	1,550.0	5,683.3	-84.7	-10.2	-5.2	5.6
Towels	MT	498.0	3,835.8	491.9	3,981.5	-6.0	-4.8	-1.2	3.8
Readymade garments	DOZ	1,125.8	33.3	1,227.9	36.9	102.1	-1.5	9.1	10.7
Art silk and synthetic Textiles	SQM	310.5	0.8	451.3	0.9	140.8	20.6	45.3	20.5
C. Petroleum group		**674.1**		**909.9**		**235.9**		**35.0**	
D. Other manufactures		**2,147.0**		**2,844.7**		**697.7**		**32.5**	
Of which									
Sports goods excl. toys	---	234.0	---	241.7	---	7.7	---	**3.3**	---
Leather exc. reptile Leather	SQM	252.8	16.8	339.5	17.4	86.7	29.6	34.3	3.6
Leather manufactures	---	461.2	---	563.3	---	102.1	---	22.1	---
Foot wear	Pair	94.7	7.6	97.8	8.7	3.1	-9.2	3.3	13.8
Chemicals and pharmaceuticals	---	315.8	---	520.3	---	204.5	---	64.7	---
Engineering goods	---	191.6	---	164.5	---	-27.0	---	-14.1	---
Jewelry	---	30.8	---	133.0	---	102.3	---	332.3	---
Cement and cement products	MT	110.4	52.0	295.3	61.0	185.0	128.5	167.6	17.1
All other items		507.6		925.5		417.9		82.3	
E. Total exports		**13,847**		**15,256**		**1,408**		**10.2**	

provisional

Imports

Country's imports surged October FY08 onwards, causing the import bill for Jul-Apr FY08 to reach a historic peak of US$ 32.1 billion. A large share of the total increase in the import bill during this period was observed in Jan-Apr FY08 mainly due to higher *petroleum, food, textile* and *machinery* group imports (see **Figure 6.25A)**. A part of this rise was caused by a surge in the international prices of *oil, wheat* and *palm oil* that caused the unit values of these categories to increase (see **Figure 6.25B**). Especially the rising international *oil* prices alone resulted in 27.6 percent of the total increase in the import bill during Jul-Apr FY08.

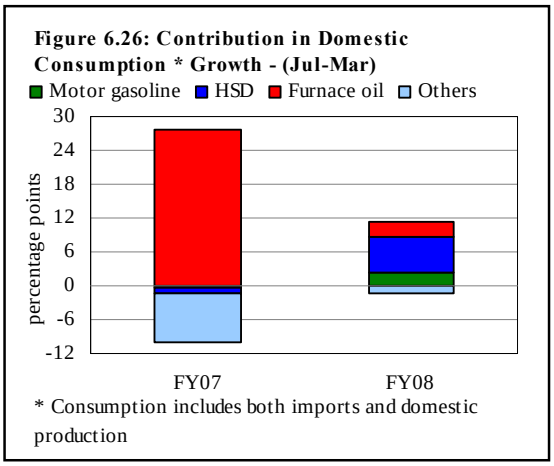


Rise in international prices of these commodities is based on strong fundamentals and is likely to continue at least in the short run. Palm oil is witnessing surge in international demand from China and India. In case of wheat the price rise is caused by lower global wheat production in 2006-07 because of the substitution of wheat with other lucrative crops used for bio fuels as well as drought in Australia, a major wheat producer, resulting in *wheat* shortages in the international market.[20]

Further, domestic shortages of *wheat* and *raw cotton* also led to sizeable widening in import bill (see **Figure 6.25 C**). The pace of *wheat* imports is not likely to slow going forward in view of the government decision to continue wheat import for the coming fiscal year. *Raw cotton* imports started to surge from January FY08

[20] According to the USDA report on Grains: World Markets and Trade, April 2008, the global wheat production recorded 4.6 percent YoY fall during 2006-07 crop year that resulted in international wheat shortages, leading to rise in prices.

after government allowed import of this category through land routes from India and are likely to continue till the availability of new crop in the market.



As expected from the rising trend of international oil prices, petroleum group had the highest share in the overall import growth during Jul-Apr FY08.[21] Apart from prices, rising quantum of petroleum products also led to a sizeable increase in the petroleum group imports (see **Table 6.12**). The rise in quantum of petroleum products came from; rising *motor gasoline, high speed diesel* and *furnace oil* imports (see **Figure 6.26**). The rise in quantum for *motor gasoline* and *HSD* despite rising prices was not unexpected, and reflects the reduced opportunity for smuggling of petroleum products from Iran July FY08 onwards. On the other hand, the rise in furnace oil imports was caused by higher power generation needs in the country.

Table 6. 12: Price and Quantum Impact of Petroleum Group Imports (Jul-Apr)

million US$

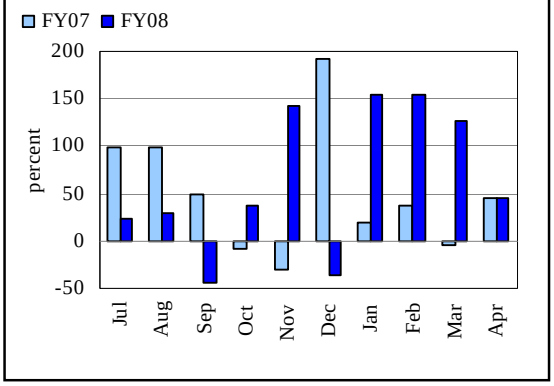
	FY07			FY08		
		Change in Value due to			Change in Value due to	
	Abs Δ	Quantity	Price	Abs Δ	Quantity	Price
Petroleum group	650.8	702.7	-51.9	2,770.2	822.4	1,947.9
Petroleum products	857.4	1,069.3	-211.8	1,622.7	612.9	1,009.8
Petroleum crude	-206.7	-303.1	96.4	1,145.1	206.2	938.8

Rising power generation needs in the country also led to a surge in the *power generating machinery* imports (see **Table 6.13**). A large part of growth in these imports was seen in Q3-FY08 to cater to the needs of the IPPs that achieved financial closure in Jul-Jan FY08[22] (see **Figure 6.27**). Besides, imports of generators for domestic use also rose due to rising power shortages in the country

[21] The average prices for Arabian light oil rose from the average of US$58.3/barrel in Jul-Apr FY07 to US$ 92.2/barrel in Jul-Apr FY08.
[22] Some eight IPPs achieved financial closure in Jul-Jan FY08.

ahead of the summer season. However, government has removed tariff concession on this machinery given in the Power Policy 2002, for the IPPs attaining financial closure after April FY08, in order to boost the domestic engineering goods sector.[23] This measure might prove helpful in curtailing the import of this category in the medium term.

Figure 6.27: Power Generating Machinery YoY Import Growth



Another important component of the import bill was *agriculture* and *other chemicals group* that witnessed expansion due to rising *fertilizer, plastics* and *other chemicals* imports; with the share of the former being the greatest (see **Table 6.13**). To fill the domestic supply and demand gap, the country imports on average 1.9 million tones *fertilizers* annually, a large share of phosphate fertilizer, DAP. To fill this gap, a domestic fertilizer plant has undergone major expansion in Q3-FY08[24]. As a result the DAP import is likely to fall by around 220 thousand tones annually from FY09. During the remaining FY08, however, the current pace of imports is likely to continue, since, a large quantum of DAP is being imported for the *kharif* season.

The rise in *plastic materials* and *chemicals* imports signals expansion in some of the industries. *Iron and steel scrap* imports also increased due to higher constriction activity in the country. In view of the continued rise in the international prices along with persistent domestic shortages and rising demand of non-food and non-oil imports, the current ratio of increase in the import bill is likely to continue in the remaining months of FY08.

[23] Power Policy for 2002 allowed the import of power generating machinery not manufactured locally at a concessional rate of 5 percent. However, recently this concession has been removed for the power plants that will achieve financial closure after April 30, 2008.

[24] As a result of the BMR program in this plant its production capacity is expected to rise by around 150 percent.

Table 6.13 : Major Imports (Jul-Apr)

million US $

		FY07		FY08(P)			% YoY Δ		
		Value	Unit Value	Value	Unit Value	Abs Δ	Qty	Value	Unit Value
Food group		**2370.8**		**3523.1**		**1152.2**	**--**	**48.6**	**--**
Of which									
Wheat un-milled	MT	41.5	305.4	812.1	494.3	770.6	1108.9	1856.2	61.8
Palm oil	MT	736.1	512.0	1215.8	858.1	479.7	-1.4	65.2	67.6
Machinery group		**5438.2**		**5892.8**		**454.6**	**---**	**8.4**	---
Of which									
Power generating machinery	-	592.5	--	**851.5**	--	**259.1**	**---**	**43.7**	---
Textile machinery	-	428.3	--	359.9	--	-68.5	---	-16.0	---
Telecom									
Mobile phone		729.4		639.1	---	-90.3	---	-12.4	---
Other apparatus		1106.7		1251.3	---	144.6	---	13.1	---
Transport group		**2058.0**		**1885.5**		**-172.5**	**---**	**-8.4**	**---**
Of which									
Road motor Vehicles	-	1164.2	---	1062.4	---	-101.8	---	**-8.7**	---
Air crafts, ships and boats	-	871.3	---	799.0	---	-72.3	---	**-8.3**	---
Petroleum group		**5902.3**	**434.8**	**8672.5**	**560.7**	**2770.2**	**13.9**	**46.9**	**29.0**
Petroleum products	MT	3027.7	431.3	4650.3	550.9	1622.7	20.2	53.6	27.7
Petroleum crude	MT	2874.5	438.5	4019.6	572.2	1145.1	7.2	39.8	30.5
Textile group		**1249.1**		**2032.1**		**783.0**		**62.7**	
Of which									
Raw cotton	MT	504.7	1392.0	1166.1	1525.3	661.3	110.8	131.0	9.6
Agricultural and other chemical Group		**3117.7**	**3491.9**		**4754.6**		**1262.7**		**36.2**
Of which									
Fertilizer manufactured	MT	280.8	278.2	822.9	414.4	542.1	96.8	193.1	48.9
Plastics	MT	951.1	1425.8	1068.3	1578.2	117.2	1.5	12.3	10.7
Other chemicals	-	1829.3	---	2355.4	---	526.2		28.8	
Metal group		**2146.5**		**2133.9**		**-12.6**		**-0.6**	
Miscellaneous group		**550.8**		**594.1**		**43.3**		**7.9**	
All other Items		**1788.1**		**2573.7**		**785.5**		**43.9**	
Total imports		**24993.0**		**32061.1**		**7068.1**		**28.3**	

An Explanatory note on differences between FBS and SBP trade data

Table 1: Reconciliation of Imports Compiled by FBS & SBP

million US$

	Jul-Apr	
	FY07	**FY08**
A-Imports (c.i.f.) FBS	**24,993.1**	**32,061.1**
Less Freight & Insurance	2,274.4	2,917.6
B- Imports FBS (fob)	**22,718.7**	**29,143.5**
C-Import Payments (Banks)	**19,626.0**	**24,247.0**
Less Freight & Insurance	1,741.6	2,201.9
Add subtotal of	1,991.6	3,264.0
a) Unclassified imports	761.8	1,411.9
b) Imports NRI, sale of DFSs	126.2	95.6
c) Imports under foreign assistance	642.4	1,148.0
d) Land borne imports (Afghanistan)	52.0	93.8
e) PIA & PNSC	401.1	380.8
f) Capital equipment	3.6	0.0
g) Cost of imports (Ex. Cos.)	13.1	0.9
h) Refund & rebate	-96.9	-62.8
i) Import from EPZ	88.3	195.7
D-Import SBP	**22,020.2**	**28,585.7**
Difference (B-D)	**698.5**	**557.9**

As customary, the trade data compiled by the SBP and FBS displayed large differences during Jul-Apr FY08 – the SBP data showed a trade deficit of US$ 12.6 billion for Jul-Apr FY08, while the deficit based on FBS data amounted to US$ 16.8 billion during the same period. The origin of this difference lies in the different uses of the trade statistics compiled by these sources – BoP data compiled by SBP is used to see the amount of the total monetary exchanges of an economy with the rest of the world, while FBS data provides detailed information regarding quantum, value and unit value of traded goods. Therefore, BoP trade data is based on the actual receipt and payments of foreign exchange for the trade of goods, while FBS records data on the physical movement of goods. It may be pointed out that the difference between BoP and FBS trade figures is not a Pakistan specific feature and can be found in countries around the world. For instance, according to the customs data EU's trade deficit for CY07 stood at 185.5 billion Euros, while EU's BoP statistics reported the trade deficit for the same period as 153.4 billion Euros.[25]

The difference in the trade statistics compiled by the SBP and the FBS arise due to following reasons:

Imports

The imports by banks are variably reported either on a 'free on board' (f.o.b.) basis or on 'cost, insurance & freight' (c.i.f.) basis. In order to make these imports comparable with the FBS imports, the cost of freight and insurance is subtracted from both the SBP record and FBS import data.[26]

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

[25] Source: Eurostat

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

- The non-repatriable investment (NRI) that consists of (a) small investments made by expatriate Pakistanis transporting machinery into the country that has been bought and paid for abroad; and (b) the purchases made from the *duty-free shops.*

- The imports of wheat, sugar, urea and some other commodities done by TCP are added to the SBP imports under the title of unclassified imports.

- FEA (foreign economic assistance) is project-specific and materializes as physical transfer of development or investment goods, such as machinery, rather than a direct inflow of foreign exchange.

- Goods carried over Pakistan's borders from Afghanistan are classified as *land borne imports,* which do not directly enter the exchange record, as cash payments made in Rupees do not go through authorized dealers.

- The purchases of spare parts and other imports made by Pakistan International Airlines (PIA) and Pakistan National Shipping Corporation (PNSC) at foreign airports or seaport for which payments are made are also added in the SBP import numbers.

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

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

Exports

In order to make export figures comparable, SBP figures are adjusted for freight and insurance, while FBS records are corrected for double counting (due to short shipments, cancellation, etc).

Short shipments refer to customs-registered export shipments that are not shipped out in the total amounts recorded due to transport shortages, last-minute clearance issues, etc. In addition, FBS numbers must be adjusted for cancellations of registered export orders, as well as *ship stores,* which refers to goods provided to foreign ships, for carrying out repairs replenishment of kitchen stores when they are anchored at Pakistani port.

Table 2: Reconciliation of Exports Compiled by FBS & SBP
million US$

Exports	Jul-Apr	
	FY07	FY08
A-Exports FBS	**13,847**	**15,255.5**
Less subtotal of	227.5	224.3
a) Shorts shipment	181.1	177.9
b) Cancellation	46.4	46.4
c) Ship Stores	0.0	0.0
B- Export FBS (fob)	**13,619.8**	**15,031.1**
C-Export receipts (Banks)	**13,289.2**	**14,909.9**
Less Freight on export	415.2	321.0
Add subtotal of	1,029.5	1,402.1
a) Land borne exports	573.0	746.9
b) Sample	2.6	3.3
c) EPZ	247.9	235.8
d) Outstanding export bills	208.9	426.9
e) Refund & Rebate	-2.9	-10.8
D-Export (Adjusted) SBP	**13,903.5**	**15,991.0**
Difference (B-D)	**-283.7**	**-959.9**

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

- *Outstanding bills* are added to SBP fob numbers, comprising all unrealized exports for which there exist customs records but no currency inflows to date.

- *Crude oil* represents the percentage of oil extracted in Pakistan which, by agreement, belongs to the foreign investors drilling here and is transported out of the country upon extraction becoming a physical 'export' for which no foreign exchange is forthcoming.
- *Land-borne exports* are similar to the entry in imports and refer to exports made to Afghanistan.

- *Export credit* refers to one-time bilateral trade credit offered by GOP to certain countries. Another such transient item is *samples*, which are the samples given to prospective buyers by domestic exporters.
- Finally, the exports from EPZs are also added in the SBP data.

Despite these adjustments to rationalize the differences in FBS and SBP figures, discrepancies still exist. This is primarily on account of leads and lags. Discrepancies in exports arise due to differences in valuations and commodity classification between SBP and FBS.

Box 6.1 SBP Measures for Stabilizing Exchange Rate

Recently, SBP has made some amendments in its guidelines to exchange companies and authorized dealers regarding their foreign exchange operations. These steps are aimed to stabilize the foreign exchange markets. These include:

- Exchange companies are now required to surrender a minimum of 15%, instead of earlier 10%, of foreign currencies received by them from home remittances to the interbank markets.

- Limits on advance payments that were relaxed last year have been tightened. Now advance import payments will only be allowed against letter of credits and that too only to the extent of 50%. Advance payments against contracts are now not allowed.

- Exchange companies have been directed to transfer foreign currency from their Nostro accounts held outside Pakistan to commercial banks in Pakistan and henceforth exchange companies will have to close all Nostro accounts abroad by May 31, 2008.

- Exchange companies have been encouraged to focus on promoting home remittances and companies can only affect outward remittances to the extent of 75% of the home remittances mobilized by the respective company during the preceding month.

- In order to meet the demand of foreign currencies within Pakistan, the Exchange Companies have been directed to surrender their surplus foreign currency to State Bank – earlier exchange companies were exporting most of the foreign currency, except dollars abroad exchange companies, besides dollar, will not be able to export Pound Sterling, Euro and UAE Dirham's.

- Some reforms of the forward hedging mechanism available to importers / exporters have also been introduced to ensure that there is no misuse of the facility other than true hedging.

- State Bank of Pakistan has increased the frequency of 'surprise inspections' on banks and exchange companies in relation to their compliance of all foreign exchange related regulations.

Reference:

FE circular No. 2 and 3 dated April 29, 2008. FE circular No. 4 and 5 dated May 09, 2008

Special Section: An Introduction to Social Protection

1. Introduction

The idea of Social Protection (SP) relates with the concept of a welfare state. The purpose of SP (see **Box 1** for goals of SP) is to promote dynamic, cohesive and stable societies through increased equity and security in the face of shocks and life cycle events.[1] In order to ensure basic livelihood standards for all citizens, developed countries started to promote social assistance and social insurance programs since the beginning of 20th century. Developing nations followed this lead and despite their limited resources have been trying to provide relief to their citizens through various social protection initiatives. SP[2] is argued to be necessary in order to:

- ensure social justice and equity and hence making growth more efficient and equitable
- protect citizens against risk (including financial crises)
- promote investment in human capital for poor households and communities
- enable people to take economic risks to pursue livelihoods
- compensate for declining effectiveness of traditional and informal systems for enhancing livelihood security

Box 1: Goals of Social Protection

The **United Nations** Economic and Social Commission for Asia and Pacific (UNESCAP) describes SP as 'the mix of policies and programmes aimed at reducing poverty and vulnerability for individuals unable to work owing to chronic illness, permanent disabilities or old age, and to protect the majority of the population against some of the unexpected downturns of life (sickness, unemployment, depth of breadwinner, etc.).

The **World Bank's** Social Protection & Labor Sector has mission to assist WB country clients to alleviate poverty and promote equitable and sustainable growth through expanding opportunities, providing security and enhancing equity.

According to Asian Development Bank **(ADB)**, "Social protection consists of policies and programs designed to reduce poverty and vulnerability by promoting efficient labor markets, diminishing people's exposure to risk, enhancing their capacity to protect themselves against hazards and interruption/loss of income".

The realization by countries that government intervention was required to provide decent standard of living to their citizens and ensure inclusive growth, has made social protection programs an integral part of socioeconomic development. Social protection tools are one of the key measures used by the governments to protect their citizens against recent high global commodity prices.

[1] Source: Norton A., T. Conway, and, M. Foster (2001), "Social Protection Concepts and Approaches: Implications for Policy and Practice in international Development". Working Paper 143, Center for Aid and Public Expenditure, Overseas Development Institute, London, UK.
[2] Ibid

Despite being a developing country with limited resources, the government of Pakistan is aware of the significance of social protection programs. Inclusion of pro poor programs in the Medium Term Development Framework (MTDF 2005-10) and Poverty Reduction Strategy Paper is a reflection of that awareness.

This special section provides an insight into various mechanisms of social protection and briefly discusses the SP initiatives introduced in Pakistan.

2. Mechanisms of Social Protection

Social protection mechanisms are classified into two main categories: (i) Informal Social Protection (ISP) and (ii) Formal Social Protection (FSP).

ISP is provided to individuals or groups by themselves, family, relatives, neighbors, non-governmental organizations, and community based groups. On the other hand, FSP is provided by government to the poor and vulnerable segments of the society. Following is a brief explanation of mechanisms through which informal and formal social protection is extended.

A. Informal Social Protection

Instruments of ISP mainly include use of savings, sale of assets, loans, and remittances among family, neighbors, and friends.[3] Besides these personal arrangements, there are a few institutionalized informal mechanisms like credit cooperatives, rotating savings and credit associations (ROSCAS) and group lending.

Credit cooperatives borrow from bank and lend to its members. ROSCA[4] is the mechanism where groups pool their funds that go to one member by lot or bidding every period. Group lending involves lending to a group that becomes mutually responsible to pay back. These mechanisms with their limited outreach have proved to be effective to an extent in providing social protection especially in developing countries.[5]

[3] See, Skoufias, E., and A. R. Subsuming (2004), "Consumption Insurance and Vulnerability to Poverty: A Synthesis of the Evidence from Bangladesh, Ethiopia, Mali, Mexico and Rusia. Social Protection Discussion Paper No. 401. The World Bank, Washington, DC.
[4] ROSCAS are very popular in Asia (e.g., India, Pakistan, Republic of Korea; Taipei, China).
[5] Sipahimalani-Rao, V. (2006), "Income Volatility and Social Protection in Developing Asia", ERD Working Paper No. 88, Asian Development Bank.

B. Formal Social Protection

Formal social protection mechanisms involve public programs designed to support the poor and vulnerable segments of the population against shocks. These shocks may be natural (earthquake, floods etc), social (death in a family, injury, health problem), or economic (crop failure, unemployment, high inflation).

There are four major forms of FSP: a) social safety nets; b) social security; c) human development and child protection; and, d) microfinance (see **Table 1**).

Table 1: Social Protection in Pakistan

Type of SP	Instruments	Objectives
a) Social Assistance/Safety Nets	Cash transfers; food related programs; price and other subsidies; public works programs	Safety nets protect individuals from falling below a given standard of living.
b) Social Security	Social insurance: unemployment insurance; health insurance; funeral assistance and disaster insurance	These interventions focus on instruments that can prevent employed people falling into poverty. These programs also aim at promoting decent working conditions as declared by International Labor Organisation (ILO) mission statement*.
	Labor market intervention establishing minimum wage; abolition of child labor; elimination of forced labor; changes and implementation of labor legislation	
c) Human Development and Child Protection Measures	Targeted fee waivers and exemptions, and life line tariffs; school feeding programs; child care and child nutrition; micro-nutrient supplementation programs; and, child support grants.	Certain kind of shocks make the poor people to take their children out of school, reduce their food consumption or limit health services to their children. So these instruments are designed to prevent those shocks from destroying human capital.
d) Microfinance	Microcredit, savings, micro-insurance	Income and consumption smoothening, protection against shocks

* ILO's main aims are to promote rights at work, encourage decent employment opportunities, enhance social protection and strengthen dialogue in handling work-related issues.

a) Social Safety Nets: Social safety nets or social assistance programs are noncontributory[6] transfers to prevent poor from falling below a certain living standard. These programmes are helpful in reducing income inequality.

[6] Receiver of assistance is not required to contribute for getting the benefit.

Instruments of social safety nets include cash transfers, food related programs, price and other subsidies, and, public works programs.

Cash Transfers: Cash transfers are regular or occasional assistance in the form of cash to increase real income of those facing risk of falling into poverty in absence of any support. In certain cases, cash transfers are made conditional that the receivers will bring change in their social behavior towards education, health, savings, environment or gender related issues depending on the nature of the implemented program by donor.

Effectiveness of this instrument depends on appropriate selection of needy, the choice of payment modalities and adequate infrastructure for implementation. The major supporting point of cash transfers is the cost efficiency as it does not require transportation, storage or monitoring problems as embedded in kind transfers.

Food-related Programs: Food-related programs are designed to ensure a minimum food consumption of the receivers or to ensure certain level of livelihood of the poor households in the wake of a shock. These transfers usually constitute targeted food transfers to individuals or households, food stamps[7] and price subsidy on food items used by poorest population.

Price and Other Subsidies: Price or tax subsidies are provided to change or protect certain consumption pattern of certain commodities. These subsidies are preferred by government due to ease in administration as compared to other transfers. However, these untargeted subsidies are costly and have incidence of benefits proportional to purchases which may benefit the wealthier population. These subsidies are more beneficial for poor if provided on inferior goods for which consumption declines with increase in incomes.

Public Work: Programs: These public interventions are made to provide employment to unskilled workers through projects like construction of canals, dams, roads and reforestations. Besides enhancing income through employment creation, these projects also provide infrastructure for economic growth. In designing such projects, ensuring quality of the asset and its second round employment generation capacity are considered as one of the important aspects for policy makers.

[7] A Federal program which supplements the food-purchasing ability of low-income households through the distribution of coupons which can be used to purchase food for human consumption. Source: www.lmic.state.mn.us/datanetweb/healthDemDefs.html

b) Social Security

Social Insurance: Social insurance schemes are contributory programs, where beneficiaries pay a certain fee over a period of time in order to be eligible for financial assistance later on. In some cases contributions are supplemented by the state. Social insurance programs generally comprise of unemployment insurance, health insurance, pension schemes, and insurance against the loss in case of a disaster.

Labor Market Intervention: Labor market instruments are designed to prevent employed people falling into poverty. These instruments include establishing minimum wage standards, abolition of child labor; elimination of all forms of forced labor, and changes and implementation of labor legislation to safeguard the laborers from exploitation.

c) Human Development and Child Protection Measures

These measures are designed to save human capital by preventing poor people from taking children out of school in case of any shock. These measures may include targeted fee waivers and exemptions, lifeline tariff/social tariff[8], school feeding programs[9], child care and child nutrition, micro-nutrient supplementation programs and child support grants.

User fee exemptions/subsidized health insurance cover chronically poor groups (children, older people, pregnant women, and disabled people) and are suitable in presence of well established administrative system.

d) Microfinance

Microfinance[10] is the provision of financial services (credit, savings, insurance) to low-income and self-employed mainly those ignored by formal financial sector. These services can help poor people to increase their incomes and smoothening of their consumption patterns. The saving component can play a part of buffer to absorb shocks, and can also provide assistance in financing investments. Similarly, micro-insurance protects poor people from unanticipated incidents like crop failure, injury, and health shocks.

[8] Lifeline tariff/Social tariff is a pricing strategy designed to provide minimal amounts of water at low prices to households.

[9] School feeding programs ensure that food contains nutrients missing in children's daily diet. These programs are helpful in reducing poverty if rates of school attendance are high and majority of children do not miss school due to hunger.

[10] The term microfinance got prominence in the literature with the success of Grameen Bank established by Dr. Muhammad Younas.

3. Social Protection in Pakistan

Social Protection was initiated in Pakistan in the decade of 1970's when the very first Employee Social Security Scheme was introduced to provide medical services and cash allowances to public sector employees and their dependants. Other schemes like the Workers Welfare Fund Scheme and the Workers' Children Education Ordinance were also initiated during the early 70s. In 1976, the Employees Old Age Benefits Institution (EOBI) was established as a federal scheme to provide old age benefits, and survivor's pensions as well as old age grants. Targeting the lowest segments of the society, Zakat and Ushr Ordinance was promulgated and implemented in the 80's at federal as well as at the province and district level. Bait ul Mal was established in the beginning of 90's to provide assistance to the needy not covered by Zakat especially the minorities. According to an estimate 7 million[11] households are eligible for Zakat but the coverage is only one tenth of the needy population.

All the above mentioned programs were unable to produce desired impact of poverty alleviation due to problems in their implementation. The government of Pakistan is spending almost 1.4 percent of GDP [12](FY 2005-06) on SP; it is lower than its neighboring countries like India (4.7 percent) and Sri Lanka (3.1 percent).

Though it is important to target poor and vulnerable population without disturbing macroeconomic stability of the country but it will be a great challenge for the government due to limited fiscal space. However due to its commitment to the social uplift of its citizens, the government of Pakistan continues to introduce social protection programs, formulation of National Social Protection Strategy currently in process being one of them.

Due to the complex nature of issues faced by the country a multi pronged approach regarding social protection programs will be more effective in improving the socioeconomic status of the country. The multi pronged approach can ideally comprise of short term measures like targeted transfers (ration cards, cash transfers) supported by proper identification of poor and vulnerable, transparent delivery system, an efficient allocation of resources and ensured access to the poor. In the medium to long-run, sustainable pro-poor employment creating projects can be initiated in collaboration with donor agencies. A well structured and coordinated social protection framework will indeed help Pakistan in improving the socioeconomic indicators of the country.

[11] Chapter IV, Responses to Poverty, "Poverty in Pakistan: Issues, Causes and Institutional Responses", *Asian Development Bank Report*, 2002

[12] "Pakistan Social Protection in Pakistan, Managing Household Risks and Vulnerability", Report No. 35472-PK, Human Development Unit, World Bank

Acronyms

ADB	Asian Development Bank
BI	Bank Indonesia
BMR	Balancing Modernization and Replacing
BoE	Bank of England
BoP	Balance of Payments
bps	basis points
BSC	Bahbood Saving Certificate
CAD	Current Account Deficit
CBs	Commercial Banks
CFS	Continuous Funding System
Cif	insurance & freight
CLCV	Cotton Leaf Curl Virus
CPI	Consumer Price Index
CRR	Cash Reserve Requirement
CY	Calendar Year
DAP	Di-Ammonium Phosphate
DMB	Deposit Money Banks
DPBs	Domestic Private Banks
DSC	Defence Saving Certificate
EFS	Export Finance Scheme
EOIBI	Employees Old Age Benefits Institution
EPZ	Export Processing Zones
EU	European Union
FAO	Food and Agriculture Organization
FBR	Federal Board of Revenue
FBS	Federal Bureau of Statistics
FCAs	Foreign Currency Accounts
FCBC	Foreign Currency Bear Certificates
FDI	Foreign Direct Investment
FE-25	Foreign Exchange Circular No.25
FEA	foreign economic assistance
FEBC	Foreign Exchange Bear Certificates
FED	Federal Excise Duty
Fob	free on board
FPI	Foreign Portfolio Investment
FSP	Formal Social Protection
FY	Fiscal Year
GDP	Gross Domestic Product
GDR	Global Depository Receipt

GoP	Government of Pakistan
GSP	Generalized System of Preference
HRI	House Rent Index
HSD	High Speed Diesel Oil
IDB	Islamic Development Bank
ILO	International Labor Organization
IPP	Independent Power Producer
IRSA	Indus River System Authority
ISP	Informal Social Protection
IT	Information Technology
JPY	Japanese Yen
KPT	Karachi Port Trust
KSA	Kingdom of Saudi Arabia
LSM	Large Scale Manufacturing
MAF	Million Acre Feet
MCB	Muslim Commercial Bank
MoM	Month on Month
MTDF	Medium Term Development Framework
NBFI	Non Bank Financial Institution
NDA	Net Domestic Asset
NEER	Nominal Effective Exchange Rate
NFA	Net Foreign Asset
NFNE	Non-food non-energy
NGO's	Non Governmental Organization
NPL	Non Performing Loan
NRI	Non-repatriable investment
NSS	National Saving Scheme
OEBs	Outstanding Export Bills
OIN	Other Items Net
OMC	Oil Marketing Company
OMO	Open Market Operation
Oz	Ounce
PBA	Pensioners Benefit Account
PHM	Pink Hibiscus Mealy Bug
PIA	Pakistan International Airline
PIB	Pakistan Investment Bonds
PNSC	Pakistan National Shipping Corporation
POL	Petroleum, Oil and Lubricants
PPCBL	Punjab Provincial Co-operative Bank Limited
PSE	Public Sector Enterprises
PTCL	Pakistan Telecommunication Company Limited

RBA	Reserve Bank of Australia
REER	Real Effective Exchange Rate
rhs	right hand side
RM	Reserve Money
ROSCA	Rotating saving and credit association
RPI	Relative Price Index
SBP	State Bank of Pakistan
SP	Social Protection
SPI	Sensitive Price Indicator
SSC	Special Saving Certificate
UK	United Kingdom
US	United States
VSS	voluntary separation scheme
WALR	Weighted Average Lending Rate
WAPDA	Water and Power Development Authority
WB	World Bank
WPI	Wholesale Price Index
YoY	Year on Year
YTD	Year to date
ZTBL	Zarai Taraqiati Bank Limited

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