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<tr>
<td>1</td>
<td>Syed Salim Raza</td>
<td>Chairman</td>
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<td>2</td>
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<td>Member</td>
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<td>3</td>
<td>Mr. Abdul Razak Dawood</td>
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<td>Mr. Mohsin Aziz</td>
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<td>Mr. Kamran Y. Mirza</td>
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<td>Mr. Iftikhar A. Allawala</td>
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<td>Mr. Zaffar A. Khan</td>
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<td>8</td>
<td>Mr. Tariq Sayeed Saigol</td>
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<td>9</td>
<td>Mr. Aftab Mustafa Khan</td>
<td>Corporate Secretary</td>
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</table>
Dear Mr. Chairman,

In accordance with Section 9A(f) of the State Bank of Pakistan Act, 1956, I submit herewith the Second Quarterly Report for the year 2008-09 of the Central Board of Directors of the State Bank of Pakistan on the State of the Economy.

With best regards,

Yours sincerely,

Syed Salim Raza

Mr. Farooq H. Naek
Chairman
Senate
Islamabad
April 04, 2009

Dear Madam Speaker,

In accordance with Section 9A(f) of the State Bank of Pakistan Act, 1956, I submit herewith the Second Quarterly Report for the year 2008-09 of the Central Board of Directors of the State Bank of Pakistan on the State of the Economy.

With best regards,

Yours sincerely,

Syed Salim Raza

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Muhammad Akmal (Prices)
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Sadia Badar (Private Sector Credit)
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Tasneem Alam (Team Leader, Fiscal Sector)
Muhammad Zeb (Fiscal developments)
Muhammad Idrees (Fiscal developments)
Mohib Kamal Azmi (Team Leader, External Sector)
Fayyaz Hussain (Balance of Payments)
Sabina Khurram Jafri (Trade)
Farrukh Mirza (Trade)
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1.1 Economic Outlook
Recent trends in most macroeconomic variables suggest that the disciplined implementation of the macroeconomic stabilization program is bearing fruit. With an improvement in fiscal discipline complementing the tightening of monetary policy, aggregate demand has seen a meaningful contraction. This has improved prospects for low inflation; while inflation is still very high, there is an expectation that it will decelerate sharply in the final quarter of the fiscal year. Also, there is a distinct improvement in the external sector, with a fall in the cumulative Jul-Feb FY09 trade deficit – the first reduction for this period in seven years. The narrowing trade deficit and robust remittances have also engineered a reduction in the current account deficit, allowing for a buildup of the country’s foreign exchange reserves.

Table 1.1: Selected Economic Indicators

<table>
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<tr>
<th>Indicator</th>
<th>FY07</th>
<th>FY08</th>
<th>FY09</th>
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<tr>
<td><strong>Growth rate (percent)</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>LSM</td>
<td>Jul-Jan</td>
<td>8.3</td>
<td>5.6</td>
</tr>
<tr>
<td>Exports (fob)</td>
<td>Jul-Feb</td>
<td>3.4</td>
<td>7.4</td>
</tr>
<tr>
<td>Imports (cif)</td>
<td>Jul-Feb</td>
<td>9.9</td>
<td>21.9</td>
</tr>
<tr>
<td>Tax revenue (FBR)</td>
<td>Jul-Feb</td>
<td>22.8</td>
<td>13.6</td>
</tr>
<tr>
<td>CPI (12 month MA)</td>
<td>Feb</td>
<td>7.7</td>
<td>8.4</td>
</tr>
<tr>
<td>Private sector credit</td>
<td>Jul-Feb</td>
<td>11.2</td>
<td>11.7</td>
</tr>
<tr>
<td>Money supply (M2)</td>
<td>Jul-Feb</td>
<td>8.4</td>
<td>7.4</td>
</tr>
<tr>
<td><strong>billion US dollars</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total liquid reserves</td>
<td>end-Feb</td>
<td>13.3</td>
<td>14.0</td>
</tr>
<tr>
<td>Home remittances</td>
<td>Jul-Feb</td>
<td>3.4</td>
<td>4.1</td>
</tr>
<tr>
<td>Net foreign investment</td>
<td>Jul-Feb</td>
<td>4.5</td>
<td>2.6</td>
</tr>
<tr>
<td><strong>percent of GDP^2</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fiscal deficit</td>
<td>Jul-Dec</td>
<td>1.9</td>
<td>3.4</td>
</tr>
<tr>
<td>Trade deficit</td>
<td>Jul-Feb</td>
<td>6.2</td>
<td>7.5</td>
</tr>
<tr>
<td>Current a/c deficit</td>
<td>Jul-Feb</td>
<td>4.1</td>
<td>5.2</td>
</tr>
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Notwithstanding this improvement, the short-term growth outlook is still difficult, with LSM growth in particular being hit (see Table 1.1) by a sharp reduction in demand from both domestic and international factors. Domestic industrial production particularly, has been badly affected by energy shortages, deterioration in the law and order situation, and constricted access to finance (as banks became increasingly risk averse). At the same time, while the direct impact of the international financial crisis on Pakistan has been relatively limited so far, there were significant indirect implications. These include a sharp pull back in some domestic asset markets (real estate and equities), constrained investment flows, and a fall in business confidence.
As the global economic environment continues to deteriorate (see Box 1.1), access to international capital markets looks to become even more difficult, and risks to both, exports and remittances, have increased. The changing economic environment thus has serious medium term implications, particularly for growth prospects, given the country’s diminished ability to finance even moderate fiscal and external account deficits.

The government has already made significant reductions in the fiscal deficit, bringing it down to 1.9 percent of (estimated annual) GDP for H1-FY09 from 3.4 percent of GDP in H1-FY08. Equally important is the capping of the monetization of the fiscal deficit at end-October 2008 level.  

This reduced an important source of inflationary pressures, rendering fiscal policy more consistent with the monetary stance. While certainly necessary in the short run, the reductions in the fiscal deficit seen so far are neither sustainable nor sufficient:  

- the sharp cut in development spending was probably justified and necessary in FY09. However, given the underdeveloped capital markets, the lack of a framework for public-private partnerships for infrastructure, and the country’s growing investment needs, it is simply not desirable for the government to keep development spending at low levels;  

- there are significant rigidities in government expenditures. In particular, defense spending and interest costs on the country’s rising debt absorb approximately three-fourths of revenues;  

- there is now a greater risk that even a lower fiscal deficit will crowd out private investment. This is because of the country’s sharply constrained access to international capital markets as well as the slower deposit growth in banks. Moreover, the recent shift to volume-based auctions of government papers means that domestic interest rates will be more sensitive to the government’s funding demands.

Thus far, the increased bank financing of the deficit has probably not impinged on the private sector’s ability to borrow from the banking sector. While the net growth in private sector credit has certainly slowed sharply, to a mere 4.6 percent in July-Feb FY09, from a robust 11.7 percent in the corresponding period last

1 Under Stand-By Arrangement end-June 2009 target for stock of government borrowing from SBP is Rs 1,181 billion, which is significantly lower than Rs 1,271 billion end-October 2008 level.
The State of Pakistan’s Economy

year, the deceleration owes to factors other than “crowding out” by government. These include a slowing economic activity, a sharp fall in cost of raw materials, bursting of asset-price bubbles in key markets, rising financing costs (stemming from high liquidity and credit risk premium as well as monetary tightening), etc. The slower growth in private sector credit, together with SBP measures to increase banking sector liquidity and support bank’s ability to lend by loosening capital requirements, allowed the government to increase borrowings from scheduled banks.

The risks to the external account are just as great a concern. If the feared slowdown in export growth and remittances proves serious then the government’s ability to implement counter-cyclical policies to support the domestic economy will be even more constrained. (1) The country’s ability to fund even short-term external deficits has already been hit by the severe depletion of FX reserves over the last 12 months; also, (2) despite meeting the targets under the Stand-By Arrangement, Pakistan is unlikely to received benefits at the same levels as in yester years. Typically, successful implementation of IMF program leads to increase investor confidence, thus encouraging international capital flows to the country. Unfortunately, the size and scope of the present international financial crisis suggests that such flows to Pakistan are unlikely to reach even (the relatively low) levels achieved by the country in recent years. To put this in perspective, the Institute of International Finance estimates that private capital flows to emerging markets are likely to fall to just US$ 165 billion in 2009, less than a fifth of the peak of US$ 929 billion recorded in 2007. This suggests that even a moderate external deficit could lead to a direct impact on the exchange rate. This would have negative consequences for inflation and growth.

It may be noted that the disinflationary process in Pakistan is already slow, and an accelerated depreciation could potentially sustain this trend. Though headline CPI inflation showed some signs of respite after reaching to its three decade high level of 25.3 percent in August 2008, it has remained above 20 percent throughout FY09. More importantly, core inflation has yet to see a meaningful decline.

Some key impediments to a deceleration in inflationary pressures are: (1) second-round effects of increase in cost of living amidst persistent high inflation for over a year, (2) absence of weakness in the prices of some key staples during harvesting period in the current fiscal year due to government’s policy decisions, \(^3\) (3) low

\(^2\) While these flows in Pakistan during FY07 were the highest ever recorded by the country, they were nonetheless low relative to that recorded by other emerging markets.

\(^3\) e.g., support price for wheat increased by 52 percent, and procurement of rice by public sector to support prices.
pass-through of decline in international prices, as well as, (4) an offsetting impact of renewed increase in prices of some key food staples (milk, meat, etc.). However, two important developments offer hope of significant relief late into FY09. The more supportive fiscal policy since November 2008, and lagged pass-through of the substantial decline in international commodity prices, is expected to contribute to a significant reduction in domestic inflation. This is already visible in a substantial decline in YoY WPI inflation from a peak of 35.7 percent in August 2008 to 15.0 percent in February 2009.

1.2 Looking Forward
The worsening outlook for the global economy, and drought in international capital markets mean that Pakistan’s economic revival strategy must perforce focus on fostering domestic and regional demand. Moreover, lowering inflation and limiting the twin deficits, in particular, would be key to enabling a transition in macroeconomic policy from a stabilization framework to one focused on reviving growth. The recent trends in key macroeconomic variables are therefore quite encouraging.

On an year-on-year basis CPI inflation, in particular, is expected to fall sharply in the final quarter of FY09, even though the annual average is expected to be quite high (see Table 1.2). Similarly, it is hoped that a continued compression in the imports, principally attributed to weakness in domestic demand, lower import unit values, as well as, depreciation of the rupee, will reduce the current account deficit, allowing Pakistan to build-up foreign exchange reserves. However, it is important to note that export earnings are also going down due to lower prices.4

#### Table 1.2: Projections of Major Economic Indicators

<table>
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<tr>
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<th>FY09 Annual plan targets</th>
<th>Projections</th>
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<tbody>
<tr>
<td><strong>growth rates in percent</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>GDP</td>
<td>5.8</td>
<td>5.5 - 3.5</td>
</tr>
<tr>
<td>Average CPI Inflation</td>
<td>12.0</td>
<td>11.0 - 19.5 - 20.5</td>
</tr>
<tr>
<td>Monetary assets (M2)</td>
<td>15.3</td>
<td>14.0 - 7.0 - 9.0</td>
</tr>
<tr>
<td><strong>billion US dollars</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Workers’ remittances</td>
<td>6.5</td>
<td>7.7 - 7.3</td>
</tr>
<tr>
<td>Exports (fob-BoP data)</td>
<td>20.1</td>
<td>22.9 - 18.5 - 19.5</td>
</tr>
<tr>
<td>Imports (fob-BoP data)</td>
<td>35.4</td>
<td>37.2 - 30.0 - 31.0</td>
</tr>
<tr>
<td><strong>percent of GDP</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Fiscal deficit</td>
<td>7.4</td>
<td>4.7 - 4.3 - 4.7</td>
</tr>
<tr>
<td>Current account deficit</td>
<td>8.4</td>
<td>7.2 - 5.8 - 6.2</td>
</tr>
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Note: Targets of fiscal and current account deficit to GDP ratios are based on Nominal GDP in the Budget document for FY09, while their projections are based on projected (higher) nominal GDP for the year.

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4 There is also a risk to remittances, which have hitherto grown strongly despite a global recession. It is possible that an income effect (due to recession and lower oil prices) has been offset by a reversal...
The realization of the expected sustained fall in domestic inflation, and increase in foreign exchange reserves would allow for easing of monetary policy. However, this is not necessarily expected to herald a recovery in manufacturing activity. Not only does monetary easing impact the real sector with a lag, industry will remain constrained by other bottlenecks such as energy shortages, high risk premiums on credit, etc. This means that real GDP growth will remain relatively weak in FY09, despite a reasonably good showing by both agriculture and the services sectors.

Any acceleration in growth in the following years too may require a supportive increase in development spending, as well as a targeted increase in spending on social safety nets. Unfortunately, this would not be possible without significant shifts in taxation and expenditure. The most important area for the government is to implement reforms in the country’s taxation system. As emphasized in the IMF SBA, an increase in tax-to-GDP ratio is necessary for fiscal sustainability. A focus on expanding the tax base rather than raising the tax rate is required. Most of the services (particularly trade, transport, professional services etc.) and agriculture sectors need to be taxed commensurately with their share in GDP. As such reforms bear fruit with time, it is important that they be initiated forthwith.

On the financing side, it will be important to accelerate the development of domestic capital markets. Not only will this reduce the government’s need to borrow from the banking system, a vibrant debt market could help ease credit access concerns, increase efficiency of the banks (as they would have to compete for funds), and help foster savings.

In the short to medium-term, it would be imperative for Pakistan to rely on concessional external assistance to finance development expenditure. The need for greater external assistance for Pakistan is underscored by the fact that the sources of domestic financing are either not available or remain risky due to its vulnerable external account position. Also, given the drying up of capital flows, official assistance seems to be the only option for countries like Pakistan to stimulate its economy to put it back on sustainable path of growth and development.

It should be remembered that the country achieved high growth, low inflation, low fiscal deficit and either surplus or a negligible current account deficit during...
FY03-FY07 period. All of these gains were wiped out mainly due to commodity price shock. This rapid deterioration in domestic economy raises concerns and reminds that stagnated structural transformation needs policy intervention to sustain growth and increase the economy’s ability to absorb shocks. Early restoration of structural reforms and second generation reforms is required here.

It is clear that outreach of financial services is still limited, despite some gains of earlier reforms in the sector. There is a dire need to develop financial sector and to increase intermediation, which is essential to raise rate of savings and sustained growth in the economy. It does not only means require focusing on increasing financial outreach in rural and far flung areas, but also that the development of long-term debt market, investment plans for pension funds, revitalization of mutual fund industry, and corporate bond markets are also necessary for efficient allocation of resources. Another benefit of financial depth would be in the form of more effective monetary policy transmission.

1.3 Executive Summary

1.3.1 Agriculture Sector
All indications are that agricultural growth will be reasonably good during FY09, despite the drag from 18.5 percent decline in sugarcane output during kharif FY09. This assessment is based on an anticipated record wheat harvest (that would significantly improve the contribution by major crops), above target performance of minor crops and a reasonably good outturn by the livestock sub-sector.

The improvement in the crops sub-sector appears to be helped by the significant gains to farmers in the previous cropping season amidst high commodity prices, as well as supportive government policies. The price signals were so clear in FY09 that farmers worked hard and invested to offset the impact of water shortages and non-availability of urea at controlled prices. These efforts were also supported by favorable weather conditions. This was particularly true for the rabi crops, which were helped by timely winter rains. Consequently, despite lower estimated water availability and urea shortages, the improvement in the performance of crops sub-sector during FY09 is remarkable. A decline in urea off-take also led to deceleration in agri-credit disbursement during Jul-Jan FY09.

1.3.2 Large Scale Manufacturing
Production in large scale manufacturing (LSM) witnessed a broad-based decline of 4.7 percent during Jul-Dec FY09 as against a 5.2 percent rise during the same period last year. In addition to greater energy shortages, a rise in input costs and
lower domestic and external demand, the following factors were also responsible for production decline; (a) upward adjustment in the prices of electricity, gas and diesel (b) prices of most of the industrial inputs remained relatively higher although international commodity prices started to ease somewhat from July 2008, (c) depreciation of rupee with a greater volatility also increased cost of inputs for a number of industries, as well as (d) global recession has also taken its toll on export driven industries (including textiles). Export-led industries also faced marketing problems due to security situation and country image, with attendant concerns over Pakistani producers’ ability to meet delivery deadlines.

1.3.3 Services
Initial data suggests that growth in services sector is likely to decelerate during FY09, though it would remain higher than the growth in the commodity producing sector. Upbeat growth prospects are supported by a sharp increase in foreign direct investment in services sector during H1-FY09 (a rise of 24 percent), despite global liquidity constraints. Similarly, improved growth prospects for the transportation & storage sub-sector, reflect the relatively better production in major crops. For the remainder, a strong contribution by finance & insurance sector and augmented administrative & defense related fiscal spending will provide support to the growth outlook of the services sector during FY09. However, this may be offset somewhat by a decline in LSM production, lower quantum of imports, and shrinking profits in telecommunication may drag growth in services sector during the year under review.

1.3.4 Prices
All price indices i.e. CPI, WPI and SPI, witnessed a clear downtrend in recent months. After showing a continuous acceleration since March 2008, CPI inflation (YoY) started easing from November 2008; it fell to 21.1 percent in February 2009 as against a peak of 25.3 percent in August 2008. However, this inflation is higher compared to 20.5 percent in the preceding month and 11.3 percent in the same month last year. The relative slowdown in domestic inflation since September 2008 was mainly driven by the deceleration in domestic food inflation as exhibited by the food groups of both CPI and WPI. While WPI non-food inflation dropped in tandem with international commodity prices, CPI non-food inflation showed stubbornness upto February 2009.

1.3.5 Money and Banking
SBP continued to maintain a tight monetary policy stance during FY09 under the macroeconomic stabilization program. In fact, the discount rate was sharply raised by 200 bps on November 13, 2008, taking the FY09 cumulative increase to
300 bps. The monetary measure was supported by constraints on deficit monetization, which in turn increased the consistency of the fiscal policy and the monetary tightening. Furthermore, monetary policy received substantial support from the sharp adjustments in the exchange rate during Mar-Oct 2008 period.

These measures seem to be bearing fruit as the persistent demand pressures in the economy have finally started to ease somewhat in recent months. This was obvious from (1) deceleration in domestic inflation as the YoY CPI inflation dropped to 20.5 percent in January 2009 from its peak of 25.3 percent in recorded August 2008. (2) a visible slowdown in import growth during Nov-Feb FY09 which helped to lower the current account deficit. This together with modest recovery in financial flows significantly reduced the pressure on country’s forex reserves. (3) a deceleration in private sector credit to 5.5 percent during Jul-Jan FY09 from 9.9 percent in the corresponding period of previous year. While some of the banks were reluctant to lend to private sector due to concerns on credit quality, credit demand from the private sector is also slowing down (4) weakening of demand stimulus from fiscal policy as fiscal deficit reduced and pace of government borrowing from the central bank declined sharply since December 2008 onwards.

The ease in demand pressures together with lowering of inflation expectations also had implications for domestic liquidity; market interest rates have already started softening. This means that the effect of tight monetary policy has eased considerably. The definitive easing of the monetary policy is however constrained by the developments on the external account and the stubbornly high core inflation.

In monetary aggregate terms, the YoY growth in broad money (M2) decelerated sharply to 9.8 percent as on 21st Feb FY09 compared to 18.2 percent in the corresponding period last year. The slowdown in M2 growth was essentially a reflection of strong contraction in net foreign assets (NFA) of the banking system. Net domestic assets (NDA) however increased by 23.2 percent on YoY basis on Feb 21, 2009.

The deposits mobilization by banks remained notably weak during Jul-Jan FY09 as overall deposits of the banking system declined by 1.8 percent on cumulative basis. This was in sharp contrast to deposit growth of 3.4 percent during the corresponding period of the previous year. Encouragingly, the recent trends suggest that the steep fall in YoY deposit growth seems to have bottomed out.

SBP had earlier increased its policy rate by 100 bps on 30th July 2008.
The asset quality of the banking system has shown considerable deterioration during Jul-Dec 2008. At the same time, the provisioning made by banks was relatively low probably as SBP allowed banks to avail the benefit of 30 percent of Forced Sale Value (FSV) of collateral while calculating provisioning requirement. As a result, net NPLs more than doubled and the coverage ratio weakened sharply during Jul-Dec 2008.

1.3.6 Fiscal Developments
Fiscal consolidation has been a major priority under the macroeconomic stabilization agenda for FY09. This seems to be having an impact; the fiscal deficit for H1-FY09 is estimated to have dropped to 1.9 percent of projected annual GDP compared to 3.4 percent in H1-FY08. The fiscal deficit for H1-FY09 thus appears to be in line with the annual target set in the budget FY09 as well as that agreed with IMF under the Stand-By Arrangement.

Understandably, the fiscal improvement thus far has largely been brought about by elimination of oil subsidies and a cut in development spending. Total revenues, as percent of GDP, recovered slightly during H1-FY09 after the sharp decline witnessed in H1-FY08. The marginal improvement came exclusively from increase in non-tax revenues. Stagnation of tax revenues, as a percent of GDP, yet again underscores the significance of fiscal prudence. While there is need for a line-by-line review of government budget outlays, long term sustainability of fiscal accounts would require expansion of total revenues, particularly by broadening the tax base.

Broadening the tax base is key to a sustainable macroeconomic framework, particularly as access to external financing is increasingly difficult. This forces greater reliance on domestic financing, with a concomitant high risk of crowding out of private investment.

The large drop in H1-FY09 fiscal deficit is clearly reflected in the negative growth of the sources of budgetary financing. The government received Rs 141.1 billion in gross external inflows in H1-FY09. However, Rs 104.1 billion external outflows on account of repayment of external debt left only Rs 37.0 billion, in net terms, for financing of budget deficit. With lesser availability of budgetary financing through external sources, government’s reliance on domestic financing increased sharply.

Within domestic sources of budgetary financing, non-bank’s contribution also witnessed a strong contraction. Consequently, banking system had to meet much
of the government’s budgetary requirements during H1-FY09. Thus, despite a 20.8 percent YoY decline in H1-FY09, the share of banking system in domestic sources of financing rose to 85.2 percent compared to 80.9 percent in the corresponding period last year.

1.3.7 Balance of Payments
After sharp deterioration in Jul-Oct FY09, overall external account balance improved noticeably in the ensuing months, aided by a sharp fall in the current account deficit and a modest recovery in financial inflows. Consequently, foreign exchange reserves increased and the rupee also recovered part of the losses suffered during Jul-Oct FY09. Thus, the aggregate 68.6 percent growth in overall external account deficit during the first eight months of FY09 was accrued essentially during the first four months of the period.

A significant part of the Jul-Oct FY09 deterioration in current account deficit owed to steep rise in import growth mainly on account of higher import price. The subsequent improvement owed to both the lower quantum of imports (as demand was compressed by monetary tightening and weaker rupee) as well as large fall in import prices. This contraction in import bill complemented the rise in remittances to contain the current account deficit. Thus current account deficit during Jul-Feb FY09 was lower (13.8 percent) compared with the same period last year.

On the financing side, though surplus in financial account during Jul-Feb FY09 period is considerably lower (50.0 percent) than the corresponding period of last year, modest revival in financial inflows was registered following the introduction of an IMF supported macroeconomic stabilization program in November 2008. In particular, foreign direct investment and the inflows categorized as other investment depicted considerable increase during November-Feb FY09 period.

1.3.8 Trade Account
For the first time in the last seven years, the trade deficit recorded YoY decline of 6.9 percent during the Jul-Feb FY09 period. This contraction was principally driven by imports compression, supported by fall in import prices and subsiding aggregate demand pressures. A moderate, increase in exports also helped in narrowing the trade deficit during the period. Almost all of this improvement emanated from November FY09 onward, after having deteriorated sharply during Jul-Oct FY09.

Expectation of continued decline in import prices and slowdown in aggregate demand pressures suggests further contraction in trade deficit in months ahead.
However, this contraction may be moderated by the further weakening in exports. In particular, fall in international demand in the wake of global recession and growing domestic problems e.g. energy crises pose downside risks to exports during the rest of FY09.

**Box 1: Global Economic Developments**

As was feared, the international financial crisis continued to worsen during H1-FY09 with devastating impact on the world economy. Most of the large economies face recession, with corollary negative impact on developing economies. With billions of dollars gone into various stimulus packages, policy makers are still not sure about the full extent of the losses. For example the IMF has now raised its estimate of the potential losses in U.S. originated credit assets held by banks and others from US$ 1.4 trillion in October 2008 to US$ 2.2 trillion.

In its January 2009 update to World Economic Outlook, IMF is now forecasting that the global recession will be much deeper and more protracted than previously envisaged. It may be pointed out that this is the 3rd downward revision in the world economic outlook by the IMF in the last four months.

Global growth is now expected to fall to 0.5 percent in 2009, with advanced economies expected to suffer their severest recession since World War II. Collectively, advanced economies are expected to contract by 2.0 percent in 2009, which is the first annual contraction in the post-war period.

Emerging economies are expected to slow sharply, growing by 3.3 percent in 2009. The IMF has also revised downward its economic growth forecast for China in 2009 by almost 2 percentage points to 6.7 per cent.

With markets remaining volatile, unemployment rising, and consumer and business confidence falling to record lows, policy makers are working on a two-pronged strategy. One part is to restore the health of the financial institutions to free-up the credit markets, while other part is to provide monetary and fiscal stimulus. Many central banks have taken strong actions to cut interest rates and improve credit provision. Similarly, many countries have also announced and are partially implementing sizeable stimulus packages.

While apparently workable, these remedial measures are not without downside risks. Restoring financial health may require nationalization of financial institutions with inherent inefficiencies. Fiscal stimulus packages would further widen fiscal deficits, which are already under strain because of the impact of asset price declines on revenues, as well as the cost of financial sector rescues.

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6 Source World Economic Outlook Jan 28, 2009.
Similarly as long as financial institutions remain cash strapped monetary easing may not be very effective.
2 Real Sector

2.1 Agriculture Sector Performance

All indications are that agricultural growth will be reasonably good during FY09, despite 18.5 percent decline in sugarcane output during kharif FY09. This assessment is based on an anticipated record wheat harvest (that would significantly improve the contribution by major crops), above target performance of minor crops and a reasonably good outturn by the livestock sub-sector.

Improvement in the crops sub-sector appears to be helped by the significant gains to farmers in the previous cropping season; amidst high commodity prices, as well as supportive government policies.¹ The price signals were so clear in FY09 (see Figure 2.1) that farmers worked hard to offset the impact of water shortages and non-availability of urea at controlled prices. These efforts were also supported by favorable weather conditions. This was particularly true for the rabi crops, which were helped by timely winter rains. The limited available data suggests that growth in minor crops

¹ In federal budget for FY09, some measures were announced including increase in subsidy on DAP fertilizer to promote balanced mix of fertilizers, exemption of excise duty for fertilizers and pesticides, increased allocation for maintenance of reservoirs and improve water network, for further details see Box 2.2.2, SBP Annual Report for 2007-08.
and livestock sub-sectors is also likely to improve during FY09 over the preceding year.

### 2.1.1 Cropping Sector

Despite many adversities in FY09, the country has already recorded its highest-ever rice production and wheat harvest is also expected to reach a record high. Both these bumper harvests resulted from increases in the area under cultivation as well as higher yields (see Table 2.1), amidst expectations of higher prices. This effect is most visible in the wheat crop, where the government announced a 52 percent increase in the support price, well ahead of the sowing season.

<table>
<thead>
<tr>
<th>Crops</th>
<th>FY07</th>
<th>FY08</th>
<th>FY08</th>
<th>FY09</th>
<th>FY09</th>
<th>FY09</th>
<th>% change in FY09 over FY08</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cotton</td>
<td>3,075</td>
<td>3,250</td>
<td>3,055</td>
<td>3,220</td>
<td>2,850</td>
<td>-6.7</td>
<td></td>
</tr>
<tr>
<td>Sugarcane</td>
<td>1,029</td>
<td>1,040</td>
<td>1,241</td>
<td>1,040</td>
<td>1,044</td>
<td>-15.9</td>
<td></td>
</tr>
<tr>
<td>Rice</td>
<td>2,581</td>
<td>2,594</td>
<td>2,516</td>
<td>2,594</td>
<td>2,916</td>
<td>15.9</td>
<td></td>
</tr>
<tr>
<td>Wheat</td>
<td>8,578</td>
<td>8,578</td>
<td>8,550</td>
<td>8,610</td>
<td>9,053</td>
<td>5.9</td>
<td></td>
</tr>
<tr>
<td>Gram</td>
<td>1,052</td>
<td>1,120</td>
<td>782</td>
<td>1,012</td>
<td>-</td>
<td>-</td>
<td></td>
</tr>
<tr>
<td>Maize</td>
<td>1,017</td>
<td>1,001</td>
<td>1,037</td>
<td>1,001</td>
<td>1,062</td>
<td>2.4</td>
<td></td>
</tr>
</tbody>
</table>

| Production (000 tons; cotton in 000 bales of 170.09 kg each) |
|-----------------------------|-----------------------------|-----------------------------|
| Cotton                     | 12,856                     | 14,140                     | 11,655                     | 14,110                     | 12,060                     | 3.5 |
| Sugarcane                  | 54,742                     | 55,871                     | 63,920                     | 56,516                     | 52,071                     | -18.5|
| Rice                       | 5,438                      | 5,721                      | 5,561                      | 5,721                      | 6,543                      | 17.7  |
| Wheat                      | 23,295                     | 24,045                     | 20,959                     | 25,000                     | 24,000                     | 14.5 |
| Gram                       | 838                        | 707                        | 554                        | 652                        | -                         | -     |
| Maize                      | 3,088                      | 3,221                      | 3,109                      | 3,279                      | 3,326                      | 7.0   |

| Yield (Kg/hectare)         |
|-----------------------------|-----------------------------|-----------------------------|
| Cotton                     | 711                        | 740                        | 649                        | 750                        | 720                        | 11    |
| Sugarcane                  | 53,199                     | 53,722                     | 51,507                     | 54,342                     | 49,876                     | -3    |
| Rice                       | 2,107                      | 2,205                      | 2,210                      | 2,205                      | 2,244                      | 2     |
| Wheat                      | 2,716                      | 2,803                      | 2,451                      | 2,904                      | 2,651                     | 8     |
| Gram                       | 797                        | 631                        | 708                        | 644                        | -                         | -     |
| Maize                      | 3,036                      | 3,218                      | 2,998                      | 3,276                      | 3,132                      | 5     |

P: Provisional; T: Target, E: Estimates, F: Forecast, Source: Ministry of Food & Agriculture

The increase in cotton output was more modest. Though the FY09 production increased, it remained significantly lower than the high FY05 levels, when farmers were encouraged by the record prices offered during FY04. A relative
improvement in cotton prices during recent months would probably provide some stimulus to farmers to increase cotton production in the next cropping season as well.

**Rice**

The rice harvest surpassed 6 million ton-mark for the first time during FY09. This output is significantly higher than estimated domestic rice consumption of about 2.5 million tons. It mainly reflects that farmers were encouraged by the sharp run-up in international prices in the previous year, when price stability concerns had led to the imposition of export restrictions by some major rice producing countries.

The attractive prices and lower competition in the international markets led to a surge in exports and a healthy 15.9 percent YoY increase in the cultivated area in FY09. Not only was area previously under sugarcane and cotton substituted with rice, the aggregate area under cultivation increased by 3.2 percent under major crops during FY09. Good luck, in the form of favorable weather\(^2\) also supported the rice crop during FY09. In addition, in some parts of Sindh, farmers cultivated rice twice during FY09 (in early *kharif* and again in late *kharif*),\(^3\) which is encouraging and indicates huge potential of the country to increase rice production going forward. Moreover, plantation of hybrid rice\(^4\) on approximately 122 thousand hectares also helped better yields.

It is important to note that farmers could not realize gains at the scale anticipated, from bumper rice harvest due to an unexpected sharp fall in international rice prices. This disappointment may lead to a smaller crop size in FY10. However, recent move by Thailand and Vietnam (two major rice exporters) to fix export price is likely to help stabilize rice prices in international market. Stable prices would help farmers to make cultivation decision with some certainty.

**Cotton**

A 6.7 percent fall in cultivated area\(^5\) had initially raised expectations of a substantial decline in cotton output during FY09 cropping season but the output instead rose by 3.5 percent. Here too, it was an improvement in cotton prices that encouraged farmers to put extra efforts, resulting in a 10.9 percent gain in cotton

\(^2\) In particular, extended monsoon and winter rains.

\(^3\) Farmers took the advantage of smaller duration of crop as some varieties of rice matured in 90 days.

\(^4\) Plantation of IRRI and coarse varieties.

\(^5\) Besides lower cotton prices in the preceding season, water shortages at sowing period also led to drop in area under cotton during FY09.
yield which more than offset the decline in acreage. Another important reason for the substantial gains in yield is the increased plantation of Bt cotton during FY09. These results are promising and suggest that cultivation of Bt cotton should be encouraged in the country.

The broad continuing decline in cotton plantation since FY05 however, remains of concern. The trend is mainly attributed to relatively lower prices, which are remained below the levels seen in FY04 (see Figure 2.2), and inadequate increase in yields.

**Wheat**

The wheat production target was been revised upwards to 25.0 million tons for FY09, on the expectation that farmers would respond to a 52 percent increase in support price. An immediate impact of this was seen, as despite irrigation water shortages, wheat plantation target for the year was surpassed by 5.1 percent. This change was also helped by: (1) a switch from sugarcane crop to wheat, as price disputes between growers and sugar mills intensified last year, (2) early picking of cotton this year, as well as, (3) the westerly rain bearing systems encouraged farmers to sow more wheat in the major wheat producing districts of the country.

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6 Bt cotton is genetically modified by using a foreign gene (bacillus thuringiensis). This variety is resistant to diseases and pest attacks.
7 Earlier target was 24.0 million tons.
8 Cotton sowing has been completed earlier in the FY09 season (relative to customary trends) and as a result the crop matured earlier.
Area under wheat rose by 7.3 percent in the Punjab, 3.7 percent in Sindh, 0.7 percent in NWFP, and 0.2 percent in Balochistan during FY09\(^9\) over the preceding year. According to the crop reporting estimates, the sowing was 8.0 percent more in rain fed and 7 percent higher in irrigated areas of the Punjab (see Table 2.2). In addition, extended winter rains are also likely to have a positive impact on the wheat yield. It is important to note that while favorable weather and relatively lower fertilizer prices were supportive for FY09 wheat crop, better availability of urea at controlled prices would have helped further gains in yields.

**Sugarcane**

A sharp decline in the sugarcane harvest during FY09 was not surprising given the disappointment of farmers in materializing benefits from a record 63.9 million tons output in FY08. Not only purchase of sugarcane was delayed by mills it is alleged that, payments to farmers were also not made in time. As a result, area under sugarcane dropped by 15.9 percent and production fell by 18.5 percent (to 52.1 million tons) in FY09. This is also reflected in rising sugar prices, due to shortages of the commodity. The government needs to formulate an effective sugarcane policy by taking all stakeholders in confidence, which covers all the dynamics of the commodity (e.g., beginning of crushing season, credit requirements of sugar mills for working capital, payments to farmers, settlement of a market based price (since it has been observed that procurement price is unable to resolve marketing issues). One sustainable long-term solution of these problems lies in the introduction of effective futures market, with crop insurance\(^{10}\) and contract enforcement.

**Minor Crops**

A shortfall in domestic production relative to consumption was embedded in FY09 production targets for most of the minor crops (see Table 2.3). In addition, substitution of area under potatoes for wheat and damage to onions was due to unfavorable weather, and would probably lead to below target production of these two important vegetables in current season. However, overall performance of minor crops is likely to be

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\(^{9}\) Source: Ministry of Food and Agriculture.  
\(^{10}\) Crop insurance scheme is in its initial stages and likely to become popular among the farmers.
reasonable during FY09 given substantial improvements in plantation of oil seeds, mung pulse and other vegetables and fruits.

The surge in international prices of edible oil not only attracted farmers to reap the benefits of high prices, it also reinforced the need to raise the domestic output given burgeoning trade deficit. Initial reports suggest a substantial expansion in area under canola and sunflower has taken place in FY09 (see Table 2.4). In addition, Pakistan Oilseed Development Board is also making efforts to promote cultivation of palm oil and olives in the country. It is expected that these efforts will help sustain growth in minor crops and help reduce dependence on imported edible oil in future.

It is important to note that prices of most of the minor crops increased at a slower pace relative to rise in the grain prices in recent months. This is partly explained by rise in domestic output and partly by a substantial increase in the quantum of imports (see Table 2.5) of these items at relatively lower prices, from neighboring countries. For example, despite a possible decline in domestic potato output, country would have been able to produce more than domestic consumption requirement. However, as potato prices collapsed in India due to a bumper crop, a hefty rise in imports caused domestic prices to drop, despite imposition of import duty in January, 2009.

**Agriculture Inputs**

There was a remarkable improvement in the crops sub-sector despite lower water availability and urea shortages. Decline in urea off-take also led to deceleration in agri-credit disbursement during Jul-Jan FY09.
Fertilizers off-take

Aggregate fertilizer off-take declined by 10.1 percent during Jul-Jan FY09 compared with 5.6 percent increase in the corresponding period last year (see Table 2.6). This decline is attributed to market structure issues as well as prices of the fertilizers. DAP and urea registered decline of 33.0 percent and 3.6 percent respectively during this period. Farmers adopted a cautious approach in buying DAP due to a downtrend in DAP prices during the first quarter of FY09. This is evident from a sharp fall in DAP off-take in this period (see Figure 2.3), and a subsequent recovery.

A substantial increase in off take of DAP in Q2-FY09 followed ease in domestic prices and the fixation of a 52 percent higher wheat support price. Unfortunately, while international urea prices peaked off in August 2008, the benefit of this was not passed on to the farmers.11 Domestic urea prices witnessed a dip in October 2008, but then resurged amid strong demand and 6.0 percent rise in area under wheat cultivation. The rise in area under wheat was a clear indication of a strong demand for fertilizers during rabi FY09 season. However, it is alleged that, speculative hoarding created artificial supply shortages of urea in some parts of the country. The strong demand for fertilizer

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11 A slight up-tick in international urea prices during January 2009 may reverse a modest downtrend in domestic prices of the nutrient going forward.
should have been foreseen given a substantial increase in the wheat support price and adequate supply planned. In addition, government has to take administrative measures to discourage hoarding and ensure smooth supply of farm inputs.\textsuperscript{12}

**Water Availability**

In recent years, aggregate irrigated water availability continued to decline, mainly due to shortfalls in rabi season. Fortunately, above normal water availability during *kharif* FY09 supported rice and cotton crops and extended winter rains compensated the impact of 33.8 percent shortfall of irrigated water during *rabi* FY09.

It is important to note that the water shortages for *rabi* FY09 season were initially estimated at up to 39.0 percent, however, successive rain bearing systems in the major crop growing plains in Punjab, Sindh and NWFP during Dec-Jan FY09 helped improve water availability during the season. The overall reservoir level at the start of the *rabi* FY09 season decreased at 7.1 MAF against 9.7 MAF in the corresponding FY08 season (see Figure 2.5). The rain bearing systems have been instrumental in recent improvement in reservoirs’ water levels as well as share of un-irrigated (*barani*) cultivation in the key wheat crop sowing period.

\textsuperscript{12} Provincial Agriculture Departments may ensure availability of fertilizer at controlled prices. Dealerships of hoarders may be canceled. Supply of fertilizer through Utility Stores at district level is another option to discourage speculative hoarding.
Water shortfall during *rabi* FY09 was aggravated by the fact that the year-end average for Chenab was down to only 6,000 cusecs inflow during Dec-Jan FY09 against an average of 10,000 cusecs in Dec-Jan FY08. The retention of water resources upstream at Baglihar dam was probably responsible for the progressive cuts in the water inflows into the Chenab command areas. As a consequence, the deficit water has to be channeled through the Jehlum-Chenab link canal at Rasul downstream to make up for the inflow losses. Greater outflow of the Mangla reservoir have been thus triggered by the ‘Baglihar reservoir’ to supplement the Chenab and Ravi command areas in central and South Punjab (see Figure 2.6).

The westerly systems impact has been helpful in keeping the water inflows at the 2.0 MAF benchmark during the concluding months of the *rabi* FY09 season. The current situation calls for speedy completion of the dams along the major water courses, especially Indus; which is the major source of water resources for the irrigated canal systems in the country.

**Agri-credit**

Agriculture credit disbursement decelerated to 11.5 percent during Jul-Jan FY09, lowest in the preceding five years (see Table 2.7). At first look, this slowdown appears to be surprising given that increase in aggregate area under cultivation during FY09. A number of factors explain this apparent anomaly; (1) farmers delayed purchase of nutrients due to a declining trend in fertilizer prices, (2) relatively lower fertilizer prices in recent months led to lower

<table>
<thead>
<tr>
<th>Banks</th>
<th>FY06</th>
<th>FY07</th>
<th>FY08</th>
<th>FY09</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial banks (CBs)</td>
<td>45.8</td>
<td>49.7</td>
<td>73.0</td>
<td>80.6</td>
</tr>
<tr>
<td>Five large commercial banks</td>
<td>37.6</td>
<td>37.9</td>
<td>50.5</td>
<td>56.9</td>
</tr>
<tr>
<td>Domestic private banks (DPBs)</td>
<td>8.2</td>
<td>11.8</td>
<td>22.4</td>
<td>23.7</td>
</tr>
<tr>
<td>Specialized banks</td>
<td>25.9</td>
<td>31.2</td>
<td>31.8</td>
<td>36.2</td>
</tr>
<tr>
<td>ZTBL</td>
<td>22.6</td>
<td>27.2</td>
<td>28.1</td>
<td>32.9</td>
</tr>
<tr>
<td>PPCBL</td>
<td>3.3</td>
<td>4.0</td>
<td>3.7</td>
<td>3.3</td>
</tr>
<tr>
<td>Total</td>
<td>71.7</td>
<td>81.0</td>
<td>104.8</td>
<td>116.8</td>
</tr>
<tr>
<td>Growth (percent)</td>
<td>24.6</td>
<td>13.0</td>
<td>29.4</td>
<td>11.5</td>
</tr>
</tbody>
</table>
financing requirements, (3) farmers were not able to buy urea (at least at controlled prices) due to artificial shortages that also reduced their demand for financing, and (4) on the supply side, a temporary liquidity crunch during Q2-FY09 and rising overall NPLs also hindered extension in agri credit disbursement. The latter point is reinforced by the evidence that slowdown in agri-credit growth is entirely contributed by commercial banks as ZTBL witnessed a strong growth of 17.1 percent during Jul-Jan FY09 as against 3.4 percent increase seen in the corresponding period of FY08.

The drag in the performance of DPBs is also evident from the agri credit disbursement to annual target ratio, which dropped from 63.2 percent during Jul-Jan FY08 to only 45.1 percent in Jul-Jan FY09. It is in sharp contrast to an average of over 60 percent during the last five years.

It is also important to note that while growth in agri-credit disbursement for production purposes decelerated, growth in disbursements for developmental purposes accelerated during H1-FY09 (see Table 2.8). Major impetus to growth in developmental loans was from subsistence and above-economic farm holders. This probably reflects the farmers’ willingness and ability to undertake developmental work on the back of higher farm income amid better prices of most of agri produce.

In the non-farm sector, credit disbursements rose by a remarkable 68.5 percent YoY during Jul-Jan FY09 in the livestock, dairy & meat sub-sector. The number of borrowers in livestock sector also grew by 25.7 percent YoY during the first seven months of FY09 from 29 thousands to 37 thousands. This rise in disbursement and number of borrowers in livestock sub-sector indicates the success of small loans for the purpose. This would not only help to improve supply of dairy and meat products, but also help reduce poverty. The other major non-farm head, poultry, although registered almost the same growth in the number of borrowers, its share in disbursement dropped from 70.1 percent in Jul-Jan FY08 to 63.2 percent during Jul-Jan FY09 (see Table 2.9). A relatively slower growth

| Table 2.8: Agriculture Credit Disbursement (Jul-Jan) billion Rupees |
|------------------|----------|----------|----------|
| Farm             | FY07*    | FY08     | FY09     |
| Economic classification |
| Subsistence      | 40.8     | 46.5     | 51.3     |
| Economic         | 14.6     | 17.2     | 18.3     |
| Above economic   | 6.6      | 13.5     | 11.1     |
| Corporate        | 0.7      | --       | 1.6      |
| Purpose-wise     |
| Production       | 57.9     | 71.8     | 73.4     |
| Development      | 4.2      | 5.3      | 5.7      |
| Non-farm         | 9.7      | 27.6     | 36.1     |
| Small farms      | 5.1      | 4.8      | 6.9      |
| Large farms      | 4.5      | 22.7     | 29.2     |

*: Data for FY07 pertains to Jul-Dec. (--) Negligible
in disbursement in the poultry sector is probably a reflection of a conscious investment approach due to heavy losses in preceding seasons on account of recurrent episodes of bird flu virus. In this backdrop and significantly higher prices of poultry products, it is expected that the disbursement for poultry sector are likely to accelerate in the remaining months of FY09.

Table 2.9: Non-farm Sector (H1)

<table>
<thead>
<tr>
<th></th>
<th>FY08</th>
<th>FY09</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Number of borrowers</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Livestock</td>
<td>33,403</td>
<td>41,977</td>
</tr>
<tr>
<td>Poultry</td>
<td>955</td>
<td>1,172</td>
</tr>
<tr>
<td><strong>Amount disbursed-Rs billion</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Livestock</td>
<td>7.6</td>
<td>12.9</td>
</tr>
<tr>
<td>Poultry</td>
<td>17.8</td>
<td>22.1</td>
</tr>
</tbody>
</table>
2.2 Large Scale Manufacturing

Production in large scale manufacturing (LSM) saw a broad-based decline of 4.7 percent during Jul-Dec FY09 as against 5.2 percent rise during the same period last year (see Figure 2.7). A number of factors including intensified energy shortages, rise in input cost, as well as lower domestic and external demands are responsible for this decline.

First, both interruptions in energy supplies and upward adjustment in the prices of electricity, gas and diesel lowered the productivity and raised the cost of production in domestic industry. Second, though international commodity prices started to ease somewhat from July 2008 onwards, domestic prices of many industrial inputs remained relatively higher. Similarly, depreciation of rupee with a greater volatility also increased the cost of imported inputs. Third, global recession has also taken its toll; export driven industries (particularly textiles) suffered due to weakening external demand. Export-led industries also faced marketing problems as foreign buyers are avoiding travel to Pakistan due to security situation and country image, with attendant concerns over Pakistani producers’ ability to meet delivery deadlines. Fourth, dampening domestic demand, particularly of consumer durables, also contributed to a lackluster performance of the industry. The ease in consumer demand is attributed to both; high interest rates on consumer financing and commercial banks’ reluctance in providing consumer financing for consumer durables due to rising NPLs under this head (see Table 2.10), which has direct consequences for automobile and electronics industries.

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13 Excluding automobiles, electronics and sugar LSM growth comes to be 0.1 percent.
14 Industries with negative growth are considered as Bad; those with growth in the range 0-5 percent are categorized as Critical, while those with growth higher than 5 percent are labeled as Good.
15 The NPLs ratio (NPLs as percent of outstanding amount) at 7.2 is the highest for consumer durable by end September 2008 (for which the latest data is available). As a result, banks raised their credit risk premium for consumer financing for durables.
The uptrend in commodity prices was unprecedented and most of the analysts believed that it will continue for about a decade. Thus most of the firms which built inventories eying gains due to the expected rise in commodity prices; are now facing problems, as international commodity prices have plummeted. As a result, these domestic are unable to reduce prices with the same pace, resultantly facing stiff competition from relatively cheaper substitutes (either imports or produced by informal sector).

Due to these developments, the smaller sub-sectors (consumer durables, cement, metal, etc.), that were witnessing sustained growth (against volatile production behavior of agri based industries that form 66 percent of LSM) in recent years (see Figure 2.8), came under severe stress. The slowdown in these smaller industries is also attributed to their pricing policies and structural weaknesses (see Box 2.1). In particular, despite a substantial decline in international prices for metal, oil, chemicals, etc., July 2008 onwards, domestic prices of automobiles and electronics are showing a secular uptrend. Underutilization of production capacity is a major reason of the premium (own) being charged for immediate delivery of vehicles.

The automobile industry, all over the world, largely depends on institutional financing for sustained demand of its products. In Pakistan, consumer financing was relatively a new market segment in early 2000s and initially grew sharply. However as the economy slowed, NPLs in this market surged. Thus banks reduced lending; further pressuring demand for consumer durables. Furthermore,

<table>
<thead>
<tr>
<th>Table 2.10: Consumer Durables: Trends in Credit and Production</th>
<th>FY06</th>
<th>FY07</th>
<th>FY08</th>
<th>FY09</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit</td>
<td>Jul-Dec</td>
<td>Car</td>
<td>25.5</td>
<td>7.7</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Consumer durables</td>
<td>16.7</td>
<td>8.2</td>
</tr>
<tr>
<td>Production</td>
<td></td>
<td>Cars &amp; jeeps</td>
<td>29.1</td>
<td>15.8</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Electronics</td>
<td>17.6</td>
<td>8.2</td>
</tr>
</tbody>
</table>

Figure 2.8: Production Growth in LSM Sub-Sectors
local assemblers raised the prices of their products manifold, making it more difficult for middle class (already under stress of food and fuel inflation) to buy the new products.

Demand for vehicles is not picking up even with decline in prices of fuel. Electronics industry performed below potential, principally due to severe shortages of electricity and increased cost of financing.

Metal industry also registered a production decline of 10.6 percent during H1-FY09. This industry is suffering from the lagged impact of (high past) international commodity prices besides sluggishness in domestic construction activity amid lower public sector spending under PSDP. Capital flight towards once lucrative Middle East real estate as well as increased cost of construction due to high inflation also led to decline in domestic construction activities. Cement dispatches to the local market, which decreased by 14 percent during H1-FY09, also support the view that construction activity has slowed; hence metal production is facing paucity of demand. Energy shortages are also hindering growth in metals (see Figure 2.9). High inventory build up with the industry owing to slowdown in key demand generating industries is also contributing to sluggishness in production activity of metal sub-sector.

Sugar production, which had registered a record growth during FY08, is in doldrums this year due to an 18.5 percent decrease in sugarcane production. Gur making is also posing a challenge to sugar mills for procuring sugarcane. An ongoing conflict between farmers...
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and sugar mills over price and payments forced cane farmers to shift to gur making instead of selling their produce to sugar mills. At the same time, information from market sources suggest that farmers are getting good prices for gur on spot, and in some areas they are not even required to bear transportation cost as the middleman is ready to lift the produce where it is processed (the fields of farmers) on cash payment. While supplying sugarcane to mills even on increased rates involves transportation cost and delay in payment in many cases.

Vegetable ghee industry is also struggling to compete with the informal sector on prices as per kilogram difference between loose and tin packed ghee has increased in FY09 reaching to the level of Rs 50/kg (see Figure 2.10). Such a high price differential seems to have created a significant substitution effect especially in rural areas where people are more price sensitive.

POL is another sub-sector of LSM that recorded a decline in production during H1-FY09 (see Figure 2.11). Here, the widely discussed issue of circular debt is contributing to the problem as refineries are financially constrained. The fact that PSO owes about Rs 38 billion to different refineries, and it has receivables of about Rs 85 billion against IPPs, marks the severity of the problem. In addition, due to relatively high prices of POL and overall slowdown in economic activities, sales of POL dropped by 4.8 percent (YoY) during Jul-Dec FY09.

Textile sector, an export oriented industry of Pakistan, and thus more prone to international demand shocks, is under severe stress amid a global recession. Although textile production has declined slightly (0.4 percent) during Jul-Dec FY09, its exports recorded an increase of US$ 219.4 million, on a quantum basis during Jul-Dec period. A part of rise in exports may be on account of depreciation of rupee during 2008 (see Table 2.11). Recent decision of removal of antidumping duty on Pakistani bed wear is an encouraging development and increased the possibility of a modest recovery in domestic textiles industry. Textile sector, however, needs to find innovative ways of marketing, vertical integration,
mergers, product diversification, and maintain high quality of its products, for long-term survival, in an increasingly competitive international market.

Motor tyres & tubes industry is showing signs of resilience as it recorded a production growth of 11.2 percent when automobiles industry (the main demand creator) is in a bad shape. In fact, the number of automobiles has tremendously increased during the last six years, adding to the demand for replacement of tyres. The rising demand was met by mainly from BMR conducted by the General Tyres last year that has improved the quality of its products besides the capacity. In addition, a disproportionate higher increase in the prices of imported tyres also helped the domestic industry.

Fertilize is the only industry, having considerable weight in LSM (4.5 percent), that has registered a double digit growth of 23.9 percent during Jul-Dec FY09 owing to strong demand and low base effect due to last year’s closure of a phosphatic fertilizer plant for BMR and expansion purposes. Nonetheless, this sector still requires investment for capacity expansion as the existing capacity of both phosphatic (production of which depends on phosphate rock not available in Pakistan in abundance) and non phosphatic fertilizers (the production of which mainly depends on consistent supply of gas) is less than the domestic demand

### Table 2.11: Basis of Exports Earnings in Jul-Dec FY09

<table>
<thead>
<tr>
<th>Item</th>
<th>Quantum</th>
<th>Price</th>
</tr>
</thead>
<tbody>
<tr>
<td>Raw cotton</td>
<td>43.8</td>
<td>-2.5</td>
</tr>
<tr>
<td>Cotton yarn</td>
<td>-104.6</td>
<td>-10.7</td>
</tr>
<tr>
<td>Cotton fabrics</td>
<td>87.4</td>
<td>-35.5</td>
</tr>
<tr>
<td>Cotton carded or combed</td>
<td>-5.6</td>
<td>3.2</td>
</tr>
<tr>
<td>Yarn other than cotton yarn</td>
<td>-10.7</td>
<td>-0.4</td>
</tr>
<tr>
<td>Hosiery (Knitwear)</td>
<td>111.5</td>
<td>-103.9</td>
</tr>
<tr>
<td>Bed wear</td>
<td>12.1</td>
<td>-118.3</td>
</tr>
<tr>
<td>Towels</td>
<td>73.8</td>
<td>-23.4</td>
</tr>
<tr>
<td>Tarpaulin &amp; other canvas goods</td>
<td>-5.9</td>
<td>-4.8</td>
</tr>
<tr>
<td>Readymade garments</td>
<td>-50.7</td>
<td>-24.9</td>
</tr>
<tr>
<td>Art silk and synthetic textiles</td>
<td>68.3</td>
<td>-23.0</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>219.4</strong></td>
<td><strong>-344.3</strong></td>
</tr>
</tbody>
</table>

### Box 2.1: Structural Issues Faced by Industrial Sector: A Recent Report

Industrial sector in Pakistan faces many of the problems faced by developing economies around the world especially Asia. This set of problems can be categorized into; those prolonged by the negligence of industries themselves (R&D) and those where government support was insufficient (infrastructure) and others where collaboration was required but missing (skill base development). The comparative status of 25 developing economies around the world, based on these factors is ranked by Global production consultancy annually (see Table 2.1.1). According to which Pakistan’s potential for sustainable growth among all assessed economies is at the lowest as judged by R&D

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16 This heavily draws from [www.global-production.com](http://www.global-production.com). Global-production.com, Inc. is a business economics consultancy, based in Switzerland, which specializes in research and advice on emerging economies as locations for global production activities.
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abilities, level of skills developed in different fields, infrastructure development and government functionaries’ support for business activities.

Similarly selected performance indicators that reflect on the level of industrial value addition are not very encouraging. Pakistan’s export growth has remained lower than its competitors as was the share of high tech exports in total. The only hope is textile industry where we are ranked at the top for export specialization, irrespective of our export growth has remained comparatively low. This shows that policy makers and industrialists have to work really hard to maintain the competitive edge where we have, along with diversification of the industrial base. A special attention is required towards the basic industries like chemicals, electronics and machinery that are the base of modern day development of economies.

Table 2.1.1: Pakistan’s Ranking in Different Areas of Development and Industrial Advancement for 2008

<table>
<thead>
<tr>
<th>Industrial capability score value (0.000 – 1.000)</th>
<th>Pakistan</th>
<th>Pakistan</th>
<th>Indonesia</th>
<th>India</th>
<th>Philippines</th>
<th>China</th>
<th>Thailand</th>
<th>Malay</th>
</tr>
</thead>
<tbody>
<tr>
<td>Score</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Skill base</td>
<td>0</td>
<td>23</td>
<td>21</td>
<td>22</td>
<td>16</td>
<td>19</td>
<td>10</td>
<td>15</td>
</tr>
<tr>
<td>R+D capacity</td>
<td>0</td>
<td>25</td>
<td>24</td>
<td>21</td>
<td>22</td>
<td>10</td>
<td>20</td>
<td>11</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>0.083</td>
<td>19</td>
<td>21</td>
<td>20</td>
<td>23</td>
<td>13</td>
<td>11</td>
<td>8</td>
</tr>
<tr>
<td>Government</td>
<td>0</td>
<td>24</td>
<td>23</td>
<td>19</td>
<td>21</td>
<td>16</td>
<td>15</td>
<td>10</td>
</tr>
<tr>
<td>All indicators</td>
<td>0</td>
<td>25</td>
<td>24</td>
<td>23</td>
<td>22</td>
<td>18</td>
<td>14</td>
<td>12</td>
</tr>
</tbody>
</table>

| Avg. annual growth in exports (0.0 – 30.0%)   |          |          |           |       |             |       |          |       |
| Export growth                                | 7.9      | 23       | 24        | 7     | 21          | 1     | 9        | 17    |

| High-tech share in exports (0.0 – 80.0%)      |          |          |           |       |             |       |          |       |
| Hi-tech share                                | 0.7      | 25       | 12        | 18    | 1           | 7     | 6        | 2     |

| Export specialization index value (0.00 – 5.00) |          |          |           |       |             |       |          |       |
| Automotive                                   | 0.01     | 25       | 16        | 15    | 18          | 19    | 12       | 20    |
| Chemicals                                    | 0.4      | 22       | 10        | 5     | 25          | 21    | 11       | 17    |
| Electronics                                  | 0.01     | 25       | 10        | 20    | 1           | 7     | 5        | 2     |
| Machinery                                    | 0.07     | 25       | 20        | 16    | 17          | 19    | 11       | 21    |
| Text+cloth                                   | 9.09     | 1        | 6         | 4     | 9           | 7     | 8        | 19    |

Source: www.global-production.com

Box 2.2: Cars and Jeeps Production

A significant rise in production of cars and jeeps witnessed FY02 onwards on the back of rising income and low interest rate on newly introduced consumer financing (see Figure 2.2.1). Similar to other consumer durables, growth in automobile industry across the world depends heavily on economic growth and availability of financing from financial institutions at favorable terms.

Increased demand for automobile in Pakistan is also a reflection of this phenomenon. In response to surge in demand, automobile production units expanded their capacity and production touched new heights by FY07.
However, production of cars & jeeps registered a slight decline; dropping from 179,314 units in FY07 to 166,300 units during FY08. Importantly, this trend further worsened in FY09. The production of cars & jeeps reported at 49,553 units during Jul-Jul FY09 compared with 92,018 units in the corresponding period of FY08, is down by 46.1 percent. The production data reveals strong monthly seasonality (see Figure 2.2.2). If we take into account the seasonal factors of the preceding years when demand pressures were not strong, production of cars & jeeps is estimated to be around 92,000 units in FY08, a fall of about 44 percent. This decline is principally due to a number of factors including (1) increased cost of consumer financing amid tight monetary stance of SBP; (2) commercial banks cautious lending due to rising NPLs under consumer financing; (3) a surge in the prices of domestically produced automobiles, which increased in tandem with international prices of metal and chemicals but not adjusted downward as input cost lowered since July 2007 onwards; (4) continued premium (own) on immediate delivery, which shows that manufacturers are not utilizing their capacities to maintain demand-supply gap, (5) slowdown in income growth is also more pronounced in FY09.

In view of the above, ease in inflationary pressures and subsequent monetary easing will partly help in revival of automobile sector. However, to achieve earlier levels of production and to grow further, availability of institutional credit for consumer durables, appropriate pricing of domestic automobiles and waiving off of full advance and own money are some prerequisites. Industry has to increase its productivity to be competitive and realize the dream of exporting Made in Pakistan cars in near future.
2.3 Services
It is evident from half yearly data on key indicators of the services sector that though FY09 growth has decelerated, it is still likely to remain higher than the growth in the commodity producing sector for the year. Deceleration in services sector is not a surprise, as seen from the fact that the 6.1 percent FY09 target growth had been set substantially lower than the 8.2 percent achieved in the previous year. The expectations of a slowdown were based on a sharp decline in import growth and weakness in the domestic economy during FY09. These expectations have been realized during H1-FY09 with a decline in LSM growth, deceleration in import growth and lower profitability of commercial banks. However, a positive outlook of transport sector, increased profitability of the central bank, as well as, higher expenditures on defense provide a modicum of support of growth prospects in the services sector.

Sectoral analysis reveals that the strongest impact of domestic economic slowdown is more pronounced in wholesale & retail trade sub-sector during the first half of FY09. Lower growth in imports is a major drag on the contribution of wholesale & retail trade, since imports contribute about a quarter of the value addition in this sub-sector (see Figure 2.12).

Similarly, a decline in LSM production also has negative consequences for the trade sub-sector. In addition, a slowdown in credit off-take (see Table 2.12 and Figure 2.13) and decline in FDI\(^{17}\)

\(^{17}\)FDI dropped by 7.8 percent in trade during H1-FY09.
also point towards a deceleration in the contribution by trade sub-sector in GDP growth during FY09. However, a bumper rice harvest, a slight improvement in cotton output and an expected record wheat crop during FY09 are likely to offset some of the adverse impacts.

Unlike the trade sub-sector, most indicators suggest that the transport, storage & communication sub-sector is likely to exhibit an improvement in growth performance during FY09 relative to FY08 (see Table 2.13). This sector is expected to benefit primarily from a sharp decline in oil prices, increased production of light commercial vehicles (LCVs), higher storage activities amidst continued strong imports, and record high harvests of some major crops. The positive outlook of transport, storage & communication sector is also reflected in an increased credit off-take as well as a positive growth in FDI, despite global recession. Communications, on the other hand, exhibited signs of consolidation in H1-FY09. Mobile communications, for the first time, in December 2008 showed a slight contraction in subscriber base;\(^{18}\) this is primarily attributed to closure of undocumented cellular connections on account of PTA campaign. Encouragingly, despite the contraction in the subscriber base, revenue generation from mobile and WLL services is still increasing, indicating that most of the closed undocumented cellular connections were inactive ones.

\(^{18}\) Cellular density fell from 55.9 percent in Q1-FY09 to 55.8 percent by end-December 2008.
period. Moreover, performance of commercial banks is likely to improve in later half of the fiscal year due to: (1) the issue of liquidity crunch, faced by commercial banks in H1-FY09, has been resolved through effective and appropriate measures by the central bank, and (2) SBP’s directive of providing the benefit of 30 percent cushion of forced sales value (FSV) of credit collateral to the commercial banks. These measures, as well as, increased FDI in financial sector in H1-FY09 may lead to increase in profitability of the financial institutions in general and commercial banks in particular.

Despite fiscal consolidation efforts, administrative & defense related spending during the current fiscal year has increased on account of unrest in the northern areas of the country and increased movements of troops along the Indian border in final months of 2008. Similarly, value addition by community & social services is expected to benefit from increased public spending towards social safety nets in terms of Benazir income support program during the final quarter of FY09. The budgetary allocations for the program doubled the federal government’s spending on social safety nets to 0.6 percent of GDP in FY09. Resultantly, this sub-sector is expected to exhibit strong growth in FY09.
### Table 2.13: Services Sector Performance Indicators

<table>
<thead>
<tr>
<th></th>
<th>FY06</th>
<th>FY07</th>
<th>FY08</th>
<th>FY07</th>
<th>FY08</th>
<th>FY09</th>
</tr>
</thead>
<tbody>
<tr>
<td>Wholesale &amp; retail trade</td>
<td>-2.4</td>
<td>5.4</td>
<td>6.4</td>
<td>H1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>FDI in trade</td>
<td>126.4</td>
<td>46.0</td>
<td>1.3</td>
<td>55.0</td>
<td>-0.4</td>
<td>-7.8</td>
</tr>
<tr>
<td>Imports</td>
<td>38.8</td>
<td>6.9</td>
<td>30.9</td>
<td>9.1</td>
<td>13.8</td>
<td>12.9</td>
</tr>
<tr>
<td>Trade volume (imports &amp; exports)</td>
<td>28.7</td>
<td>5.5</td>
<td>24.2</td>
<td>7.4</td>
<td>9.9</td>
<td>12.1</td>
</tr>
<tr>
<td>Transport storage &amp; communication</td>
<td>4.0</td>
<td>6.5</td>
<td>4.4</td>
<td>H1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Petroleum crude imports</td>
<td>76.6</td>
<td>-4.9</td>
<td>44.8</td>
<td>-1.8</td>
<td>3.6</td>
<td>35.7</td>
</tr>
<tr>
<td>Commercial vehicles production</td>
<td>16.6</td>
<td>-5.5</td>
<td>1.8</td>
<td>-6.7</td>
<td>1.6</td>
<td>7.7</td>
</tr>
<tr>
<td>Teledensity (percentage of population)</td>
<td>26.3</td>
<td>44.1</td>
<td>59.7</td>
<td>-</td>
<td>52.9</td>
<td>60.0</td>
</tr>
<tr>
<td>Cellular density (percentage of population)</td>
<td>22.2</td>
<td>39.9</td>
<td>54.7</td>
<td>-</td>
<td>48.6</td>
<td>55.8</td>
</tr>
<tr>
<td>Telecomm imports</td>
<td>-</td>
<td>15.2</td>
<td>4.0</td>
<td>22.3</td>
<td>2.2</td>
<td>-45.1</td>
</tr>
<tr>
<td>Transport group imports</td>
<td>-</td>
<td>9.2</td>
<td>-6.4</td>
<td>22.1</td>
<td>21.2</td>
<td>-46.2</td>
</tr>
<tr>
<td>FDI in transport storage &amp; comm.</td>
<td>267.8</td>
<td>-0.5</td>
<td>-11.0</td>
<td>52.4</td>
<td>49.2</td>
<td>4.2</td>
</tr>
<tr>
<td>Finance &amp; insurance</td>
<td>42.9</td>
<td>15.0</td>
<td>17.0</td>
<td>H1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>SBP profit</td>
<td>119.6</td>
<td>59.5</td>
<td>51.6</td>
<td>905.1</td>
<td>20.7</td>
<td>52.0</td>
</tr>
<tr>
<td>Profit of commercial banks</td>
<td>76.4 a</td>
<td>24 a</td>
<td>-1.8 a</td>
<td>75.9</td>
<td>12.9</td>
<td>1.3</td>
</tr>
<tr>
<td>FDI in financial business</td>
<td>22.2</td>
<td>182.6</td>
<td>72.4</td>
<td>340.0</td>
<td>-32.7</td>
<td>77.2</td>
</tr>
<tr>
<td>Ownership of dwellings</td>
<td>3.5</td>
<td>3.5</td>
<td>3.5</td>
<td>H1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cement Production</td>
<td>13.5</td>
<td>22.5</td>
<td>17.6</td>
<td>18.9</td>
<td>17.1</td>
<td>0.8</td>
</tr>
<tr>
<td>Metal production</td>
<td>5.3</td>
<td>10.7</td>
<td>-12.7</td>
<td>13.1</td>
<td>-3.3</td>
<td>-31.9</td>
</tr>
<tr>
<td>Public administration &amp; defense</td>
<td>10.1</td>
<td>9.1</td>
<td>10.9</td>
<td>H1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Defense</td>
<td>14.3</td>
<td>3.3</td>
<td>14.1</td>
<td>-3.4</td>
<td>14.7</td>
<td>12.1</td>
</tr>
<tr>
<td>Public order and safety services</td>
<td>32.8</td>
<td>8.8</td>
<td>17.8</td>
<td>18.4</td>
<td>8.7</td>
<td>17.5</td>
</tr>
<tr>
<td>Economic affairs expenditure</td>
<td>-7.7</td>
<td>46.9</td>
<td>226.1</td>
<td>-24.5</td>
<td>173.3</td>
<td>46.2</td>
</tr>
<tr>
<td>Community, social &amp; personal services</td>
<td>9.9</td>
<td>8.8</td>
<td>9.4</td>
<td>H1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>FDI in social and personal services</td>
<td>162.5</td>
<td>23.8</td>
<td>16.3</td>
<td>1.3</td>
<td>51.5</td>
<td>13.7</td>
</tr>
<tr>
<td>Total FDI in services sector</td>
<td>181.5</td>
<td>27.4</td>
<td>13.5</td>
<td>111.7</td>
<td>8.3</td>
<td>24.0</td>
</tr>
</tbody>
</table>

*a: data pertains to Calendar Year  
b: quarterly data relevant to Calendar Year  
c: Including light commercial vehicles, buses, trucks and tractors. Growth rate computed by using relative weights in LSM.*
3 Prices

3.1 Global Inflation Scenario

Inflationary pressures have eased significantly in almost all economies since October 2008 (see Figure 3.1), mainly due to a deepening global economic recession. The turmoil in the international credit markets has particularly hit consumer demand in the advanced countries, and the resulting slowdown in aggregate demand is compounding the impact of the declining credit availability, with negative spillovers for the entire global economy.

This is clearly seen in the sharp decline in key commodity prices. While the decline in oil, fuel and metal prices is principally attributed to ease in global demand for these commodities, the fall in food commodity prices is mainly due to: (1) increased supply, as farmers brought more area under cultivation to materialize the gains of higher prices of these commodities, as well as, (2) a sharp downturn in oil prices which made bio-fuels less attractive as a substitute of oil.

The pace of the downtrend is surprisingly strong. For example, the IMF Commodity Price Index, is down by 55.4 percent from peak level reached in July
2008. Moreover, oil prices\(^1\) alone have fallen sharply by 68.5 percent after reaching their monthly peak of US$ 132.5 per barrel in July 2008.

Declining commodity prices have had varying effects on different economies of the world. The plummeting fuel prices benefitted oil importing countries, particularly those with high oil consumption (this is generally the case for advanced economies). On the other hand, oil exporting countries have been severely hurt by the unexpected decline in oil prices. Similarly, net importers of grains, mostly developing countries, are benefitting from a decline in commodity prices and are now better placed to overcome macroeconomic imbalances that emerged as a result of the earlier steep rise in commodity prices.

Similarly on the policy front, concerns over growth and the possibility of a deflationary spiral have pushed central banks around the world to ease monetary policy and the governments are introducing fiscal stimulus packages to shore up the financial sector in order to boost demand.

3.2 Domestic Scenario

Although the disinflationary process in Pakistan has proved to be relatively slow, the

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\(^1\) Oil prices represented by simple average of three spot prices; Dated Brent, West Texas Intermediate, and the Dubai Fateh as reported by IMF.
Second Quarterly Report for FY09

underlying inflationary pressures have started retreating from Q2-FY09. All price indices i.e. CPI, WPI and SPI, witnessed a clear downtrend in recent months (see Figure 3.3).

The relative slowdown in domestic inflation since September 2008 was mainly driven by the deceleration in domestic food inflation as exhibited by the food groups of both CPI and WPI. While WPI non-food inflation dropped in tandem with international commodity prices, CPI non-food inflation showed stubbornness up to Feb-2009 (see Figure 3.4).

This difference in the trends of the two inflation indices is because: (1) pass through of declining global fuel and commodity prices to the wholesale prices has been quicker as compared to the retail prices. This is mainly because prices of most items included in the WPI basket are based on international prices,\(^2\) (2) the impact of decreases in prices of manufacturing inputs such as cotton and metals is fully reflected in the WPI non-food, whereas CPI non-food group exhibits their partial effect as CPI non-food items also incorporates labor wages which are impacted by second-round effects of persistent rise in cost of living, and finally (3) about 40 percent of CPI non-food constitutes of house rent index (HRI) which is being estimated by using 24-month geometric mean, which makes this large component relatively inflexible. Given that WPI non-food inflation has shown persistent downtrend, it is expected that it may also help bring down retail prices in the coming months.

It is important to note that a continued tight monetary stance of the central bank helped contain CPI non-food inflation, which is also evident from a substantial gap between WPI and CPI non-food inflation during most of 2008 (see Figure 3.4).

---

\(^2\) e.g. items like furnace oil, metals etc are reported in WPI but not in CPI, and these are linked with international prices.
The impact of continued tight monetary posture also yield dividend in terms of a relative ease in core inflation numbers during recent months.

Core inflation measured by 20 percent trimmed mean registered below 21 percent in January and February 2009 for the first time since July 2008 (see Table 3.1). It indicates a relative ease in inflationary expectations in the economy. Similarly, core inflation measured by Non-food Non-energy (NFNE) is hovering around 18.8 percent since October 2008, showing resilience in inflationary pressures. In fact, firmness in the NFNE measure of core inflation has been supported by a continued rising house rent index (HRI) during the recent months.

<table>
<thead>
<tr>
<th>Table 3.1: Inflation Trends</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>percent</strong></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>CPI</td>
</tr>
<tr>
<td>Food</td>
</tr>
<tr>
<td>Non-food</td>
</tr>
<tr>
<td>WPI</td>
</tr>
<tr>
<td>Food</td>
</tr>
<tr>
<td>Non-food</td>
</tr>
<tr>
<td>SPI</td>
</tr>
<tr>
<td>NFNE</td>
</tr>
<tr>
<td>Trimmed mean</td>
</tr>
</tbody>
</table>

| 1 e.g. change in Feb 2009 over Feb 2008 |
| 2 e.g. change in 12-month average of Feb 2009 over Feb 2008 |

It is important to note that an uptick in headline CPI inflation during February 2009, principally driven by a rise in food inflation, is not surprising. Generally, wheat prices decline during February each year due to pre-harvest seasonal impact. However, this year wheat prices did not decline as domestic prices are already aligned with the procurement price for FY09 wheat crop. This irregularity

1 Prices of most of the WPI items are based on international prices or determined by market forces. However, a weaker pass through to CPI non-food exhibits stress in demand stemming from monetary policy.
2 HRI has 23.4 percent weight in overall CPI basket and a dominating 45.9 percent weight in core inflation (NFNE). HRI inflation accelerated to 18.5 percent (YoY) in February 2009 compared to 12.4 percent in June 2008.
in wheat prices is reflected in higher food inflation during the month. However, food inflation is likely to decelerate at a faster pace from April onward when the impact of a bumper wheat and rice crops is likely to translate into lower consumer prices.

3.3 Consumer Price Index (CPI)
After showing a continuous acceleration since March 2008, CPI inflation (YoY) started easing from November 2008 and reached 21.1 percent in February 2009 as against a peak of 25.3 percent in August 2008. However, this inflation is higher compared to 20.5 percent in the preceding month and 11.3 percent in the same month last year.

The recent downturn in CPI inflation was mainly due to a relative ease in food inflation that has dropped from 34.1 percent in August 2008 to 22.9 percent by February 2009 (see Figure 3.5). Encouringly, CPI non-food inflation (YoY) showed a slight decline for the third consecutive month and recorded at 19.6 percent in February 2009 compared with a peak of 20.2 percent in November 2008 and 7.8 percent in February 2008.

It is imperative to note that the downward adjustment in domestic prices of key fuels in response to a decline in international oil prices is likely to further ease non-food inflation in months ahead. Moreover, given a significant decline in metal and other construction material prices, HRI is also likely to see a reversal in its rising trend going forward. Consequently, CPI non-food inflation would decelerate sharply.
3.3.1 CPI Food Inflation
CPI food inflation started decelerating from September 2008 after reaching a three decade high of 34.1 percent YoY in August 2008 and reached 22.9 percent YoY in February 2009. The prices of some key staples either showed a decline or stabilized in recent months (see Figure 3.6 and 3.7). More importantly, the pace of decline of food commodity prices is slower than the downtrend in international market, which points towards specific domestic factors or market structure issues. It is notable that a part of the gains was offset by the depreciation of the rupee during 2008.

In the case of wheat, the current ease in price level was mainly due to improved supply due to: (1) aggressive import of the wheat, (2) decline in illegal cross
border movement of the grain as lower international prices eroded incentives, and (3) anticipation of a bumper crop as farmers cultivated more area (due to higher support price and support from favorable weather). It is important to note that the procurement target of 6.5 million tons of wheat would be challenging for the government given (1) inadequate storage capacity with the public sector as a sufficient stock of imported wheat is also available, and (2) in case of substantially lower international wheat prices, domestic prices are also likely to ease further. In any case, government is likely to incur a cost. In case of aggressive procurement, wastage and losses are likely due to improper storage, and in case of latter government would have to extend a very large subsidy on the issue price to dispose of available stocks. Large-scale procurement operations would also reduce liquidity in the banking system. To avoid downward pressures on wheat prices (which is important to protect farmers and achieve repeat bumper harvests in FY10 onwards), it would be imperative to keep a strict check on smuggling of wheat and leakages from Afghan Transit Trade.

In case of edible oil and rice there is a risk of renewal of upward pressures on domestic prices due to recent gains in international prices. Similarly domestic price of sugar is likely to increase in months ahead due to lower domestic production in the season and speculative hoarding of the commodity. The country is likely to face a shortfall of around 0.4 million tons of sugar during FY09, which may increase further due to higher usage of sugarcane for gur manufacturing. However, the decision by the State Bank of

\[\text{Figure 3.8: CPI Non-food Inflation}\]

\[\text{percent\ YoY 12-month moving average}\]

\[\text{Fig. 3.8: CPI Non-food Inflation}\]

5 Wheat prices eased in international markets following an above expected wheat harvest estimates in Australia coupled with improved prospects for wheat crop in Argentina and some parts of wheat growing regions in China as a result of rains in these areas (source www.bloomberg.com).

6 International rice prices have recovered recently, indicating renewed pressures due to Thailand - Vietnam agreement on fixation of rice export price.
Pakistan to impose 50 percent cash margin for financing against sugar stocks is likely to discourage hoarding of sugar and restrict surge in sugar prices.

3.3.2 CPI Non-food Inflation
CPI non-food inflation started accelerating from H2-FY08. This trend has continued in FY09 and CPI non-food inflation has remained around the 20 percent YoY mark since September 2008 (see Figure 3.8).

The persistence in CPI non-food inflation (YoY) was contributed by all sub-indices in the non-food group as they have recorded double digit YoY inflation since September 2008 (see Table 3.2). In particular house rent index (HRI) has maintained an uptrend throughout FY09 reflecting the impact of increases in the prices of construction materials. Amongst other sub-groups, the transport & communication sub-index has shown the highest variability in FY09. This sub-index rose by 40.5 percent YoY in August 2008 before decelerating to 21.5 percent by February 2009. The initial increase in this sub-group was due to an upward price adjustment of key fuels and subsequent rise in transportation charges. However, downward adjustment in fuel prices and a slight decline in some transportation charges in response to a decline in

<table>
<thead>
<tr>
<th>Non-Food Group</th>
<th>Weight</th>
<th>Jul-08</th>
<th>Sep-08</th>
<th>Jan-09</th>
<th>Feb-09</th>
</tr>
</thead>
<tbody>
<tr>
<td>Apparel, textile</td>
<td>6.1</td>
<td>13.8</td>
<td>16.1</td>
<td>15.4</td>
<td>15.4</td>
</tr>
<tr>
<td>House rent</td>
<td>23.4</td>
<td>13.3</td>
<td>15</td>
<td>18.2</td>
<td>18.5</td>
</tr>
<tr>
<td>Fuel &amp; lighting</td>
<td>7.3</td>
<td>20.5</td>
<td>21.5</td>
<td>26.9</td>
<td>29.8</td>
</tr>
<tr>
<td>Household furniture</td>
<td>3.3</td>
<td>11.1</td>
<td>12.7</td>
<td>14.6</td>
<td>14.7</td>
</tr>
<tr>
<td>Transport &amp; com</td>
<td>7.3</td>
<td>37.2</td>
<td>39.9</td>
<td>25.2</td>
<td>21.5</td>
</tr>
<tr>
<td>Recreation &amp; enter</td>
<td>0.8</td>
<td>11.5</td>
<td>12.2</td>
<td>12.6</td>
<td>14.0</td>
</tr>
<tr>
<td>Education</td>
<td>3.5</td>
<td>10.0</td>
<td>16.0</td>
<td>17.1</td>
<td>18.0</td>
</tr>
<tr>
<td>Cleaning, laundry</td>
<td>5.9</td>
<td>18.2</td>
<td>19.3</td>
<td>19.4</td>
<td>18.3</td>
</tr>
<tr>
<td>Medicare</td>
<td>2.1</td>
<td>9.8</td>
<td>10.7</td>
<td>14.4</td>
<td>14.2</td>
</tr>
</tbody>
</table>

| Overall CPI          | 100    | 24.3   | 23.9   | 20.5   | 21.1   |

Figure 3.9: Income Group-wise Inflation (YoY)
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international fuel prices are the major contributory factors helping in the downward movement of transport & communication sub-index.

3.3.3 Incidence of inflation:
Income group-wise inflation during FY09 shows that the highest incidence of inflation has remained on the lowest income group. All income groups, except the highest income group (with earnings above Rs 12000), recorded higher inflation incidence than the overall CPI inflation (see Figure 3.9). However, the difference in inflation between the highest income group and lower income groups during the initial five months of FY09 has narrowed down since December 2008. This is because of a relative decline in food inflation which is normally expected to bring relief in inflationary pressures for the lower income groups, given that staple food accounts for a greater proportion of their total expenditure.

City-wise inflation data revealed that the inflation (YoY) in major cities, after declining from October to January FY09 picked up again in three out of five major cities during February 2009 (see Table 3.3).

3.4 Wholesale Price Index
After reaching the highest level of 35.7 percent YoY in August 2008, wholesale price index (WPI) inflation showed a sharp deceleration and reached 15.0 percent YoY in February 2009. This deceleration was evident in both food and non-food group inflation (see Figure 3.10). WPI food inflation YoY reached 22.0 percent during February 2009 compared to 33.5 percent in August 2008. Similarly, WPI non-food group inflation also showed significant decline after September 2008 and was

<table>
<thead>
<tr>
<th>Table 3.3: City-wise Inflation of Selected Cities</th>
<th>Nov-08</th>
<th>Dec-08</th>
<th>Jan-09</th>
<th>Feb-09</th>
</tr>
</thead>
<tbody>
<tr>
<td>Overall CPI</td>
<td>24.7</td>
<td>23.3</td>
<td>20.5</td>
<td>21.1</td>
</tr>
<tr>
<td>Islamabad</td>
<td>21.0</td>
<td>20.9</td>
<td>19.0</td>
<td>18.4</td>
</tr>
<tr>
<td>Lahore</td>
<td>22.5</td>
<td>21.8</td>
<td>18.9</td>
<td>18.1</td>
</tr>
<tr>
<td>Karachi</td>
<td>24.2</td>
<td>23.7</td>
<td>20.7</td>
<td>22.2</td>
</tr>
<tr>
<td>Quetta</td>
<td>26.9</td>
<td>26.5</td>
<td>23.2</td>
<td>25.1</td>
</tr>
<tr>
<td>Peshawar</td>
<td>27.8</td>
<td>26.8</td>
<td>22.8</td>
<td>23.9</td>
</tr>
</tbody>
</table>
recorded at 9.8 percent during February 2009 compared to its peak of 37.4 percent in August 2008. All sub-indices of the non-food group have shown a decline in YoY inflation during the same period, however, the decline in fuel, lighting & lubricants and building material sub-indices has been more significant.

An analysis of the distribution of price changes (YoY) of the WPI basket shows that the share of items showing double digit increases is still high (see Table 3.4). This implies that (1) a sharp decline in WPI inflation is principally a reflection of the ease in the magnitude of the price increases as evident in the percent of items recording more than 50 percent inflation have decreased in the recent months (2) despite a substantial fall in WPI inflation, inflationary pressures in wholesale prices are still broad based.

<table>
<thead>
<tr>
<th>Table 3.4: Distribution of WPI Price Changes (YoY)</th>
</tr>
</thead>
<tbody>
<tr>
<td>percent of items</td>
</tr>
<tr>
<td>Above 50%</td>
</tr>
<tr>
<td>Feb-08</td>
</tr>
<tr>
<td>Mar-08</td>
</tr>
<tr>
<td>Apr-08</td>
</tr>
<tr>
<td>May-08</td>
</tr>
<tr>
<td>Jun-08</td>
</tr>
<tr>
<td>Jul-08</td>
</tr>
<tr>
<td>Aug-08</td>
</tr>
<tr>
<td>Sep-08</td>
</tr>
<tr>
<td>Oct-08</td>
</tr>
<tr>
<td>Nov-08</td>
</tr>
<tr>
<td>Dec-08</td>
</tr>
<tr>
<td>Jan-09</td>
</tr>
<tr>
<td>Feb-09</td>
</tr>
</tbody>
</table>

3.5 Sensitive Price Indicator (SPI)
Following the trend of CPI and WPI, the sensitive price indicator (SPI) has also showed deceleration since October 2008 and reached 23.9 percent (YoY) in February 2009. However, this level of SPI inflation is still high as compared to the same month last year (see Figure 3.11). Weekly SPI, on the other hand, after witnessing a gradual fall in inflation since November 2008 has witnessed an increase in inflation from the second week of January 2009 (see Figure 3.12). However, a decrease in YoY inflation was witnessed in the first week of March 2009.
Box 3.1: Can movements in SPI Predict CPI?
Assessment of CPI inflation plays a key role in decision-making process of central banks. At times when inflation turns out to be high and volatile, the inflation projections based on econometric models may provide estimates that deviate from the original trend. For this SPI – another measure of inflation – can provide some support as it is reported on a weekly basis and is readily available at the end of every week. The selection of SPI as an alternative for projecting CPI inflation is based on:

1. SPI items are subset of CPI basket;
2. Prices of SPI items are available on a weekly basis (these items are also included in CPI basket); and
3. Out of total 53 items represented in the SPI, 34 fall under the category of food group while rest belong to non-food group;
As weights for SPI items are available, proxies for SPI food and non-food inflation can be calculated which can form necessary assessment of food and non-food components of CPI inflation.

The link between SPI and CPI inflation (YoY)
Graphical presentation of CPI and SPI inflation (YoY) shows that both are following a similar trend. Food and non-food SPI inflation can be used to project trend in CPI and SPI food inflation. The graph highlights the closeness in CPI and SPI food inflation, however there are some deviations in case of CPI and SPI non-food inflation (see Figure 3.1.1). This might be due to the presence of very limited number of items in SPI (only 19 non-food items in SPI compared to 250 non-food items in CPI basket).

Interdependence between SPI and CPI inflation is also visible from the correlation matrix. Overall CPI and SPI food inflation depicts strong positive correlation with overall SPI and SPI food inflation (see Table 1).

Table 1: Correlation Matrix YoY - Inflation

<table>
<thead>
<tr>
<th></th>
<th>SPI food</th>
<th>SPI non-food</th>
<th>SPI</th>
</tr>
</thead>
<tbody>
<tr>
<td>CPI food</td>
<td>0.98</td>
<td>0.73</td>
<td>0.98</td>
</tr>
<tr>
<td>CPI non-food</td>
<td>0.76</td>
<td>0.97</td>
<td>0.90</td>
</tr>
<tr>
<td>CPI</td>
<td>0.93</td>
<td>0.88</td>
<td>0.98</td>
</tr>
</tbody>
</table>

An analysis of 61 months consecutive inflation data for CPI and SPI verifies strong correlation (see Table 2). The above analysis portrays a clear picture about the co-movement of inflation not only for overall CPI and SPI but also for food and non-food groups and can thus support in providing better projections of inflation trends.

Table 2: Frequency of Movements in SPI and CPI (YoY Inflation)

<table>
<thead>
<tr>
<th></th>
<th>Food</th>
<th>Non-food</th>
<th>Overall</th>
</tr>
</thead>
<tbody>
<tr>
<td>Same direction</td>
<td>48</td>
<td>43</td>
<td>52</td>
</tr>
<tr>
<td>Opposite direction</td>
<td>13</td>
<td>18</td>
<td>9</td>
</tr>
<tr>
<td>Total observations</td>
<td>61</td>
<td>61</td>
<td>61</td>
</tr>
</tbody>
</table>
4 Money and Banking

4.1 Monetary Policy
Faced with serious macroeconomic imbalances, 1 Pakistan initiated an aggressive macroeconomic stabilization program in early FY09. As a part of this stabilization effort, SBP further tightened its monetary policy. The discount rate was sharply raised by 200 bps on November 13, 2008, taking FY09 cumulative increase to 300 bps. 2

The monetary measure was supported by constraints on deficit monetization, which in turn increased the consistency of the fiscal policy with the monetary stance. Furthermore, monetary policy received substantial support from the sharp adjustments in the exchange rate during Mar-Oct 2008 period.

These measures paid dividend as the persistent demand pressures in the economy finally started to ease somewhat in recent months (see Table 4.1). This was evident from a number of developments, for example:

1. **Slowdown in inflation pressure.** Domestic CPI YoY inflation dropped sharply to 21.1 percent in February 2009 from its peak of 25.3 percent recorded in August 2008 (see Figure 4.1). Similarly the food component of CPI witnessed a sharp downtrend. Though the inflation pressures were strong as YoY headline CPI inflation reached 25.0 percent and core inflation (20 percent weighted trimmed measure) touched 21.7 percent in October 2008. On the external front, robust growth in import bills resulted in worsening of current account deficit. Further, though fiscal deficit fell in Q1-FY09 as a result of reduction in oil subsidies and cut in developmental expenditure, the desirable impact on demand pressures was not materialize because of continuous monetization of deficit during Jul-Nov FY09 period.

2. SBP had earlier increased its policy rate by 100 bps on 30th July 2008.

---

1 Inflation pressures were strong as YoY headline CPI inflation reached 25.0 percent and core inflation (20 percent weighted trimmed measure) touched 21.7 percent in October 2008. On the external front, robust growth in import bills resulted in worsening of current account deficit. Further, though fiscal deficit fell in Q1-FY09 as a result of reduction in oil subsidies and cut in developmental expenditure, the desirable impact on demand pressures was not materialize because of continuous monetization of deficit during Jul-Nov FY09 period.

2 SBP had earlier increased its policy rate by 100 bps on 30th July 2008.
non-food component showed some resilience till February 2009, this was essentially due to an uptrend in House Rent Index (HRI). The sharp drop in global prices of key fuels and commodities had a significant role in moderating domestic inflationary pressures and it is expected that with economic slowdown, the downtrend in inflation would be steeper.

2. **Sharp drop in import demand particularly non-food non-oil imports.**
   Sharp fall in imports translated into a lower current account deficit which, coupled with modest recovery in remittances and FDI flows during Dec-Feb FY09 significantly, reduced the depletion of the country’s foreign exchange reserves, particularly of the central bank. In this perspective, it is encouraging that the SBP NFA even witnessed a net increase during Dec-Feb FY09 (see Figure 4.2).

3. **Deceleration in private sector credit growth.**
   The available data suggests that private sector credit grew by

<table>
<thead>
<tr>
<th>Table 4.1: Key Macroeconomic Indicators during FY09</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Jul-Sep</td>
<td>Oct-Feb</td>
</tr>
<tr>
<td>Current account deficit</td>
<td>65.9</td>
<td>-42.1</td>
</tr>
<tr>
<td>Imports</td>
<td>34.2</td>
<td>-19.4</td>
</tr>
<tr>
<td>Non-food non-oil</td>
<td>10.1</td>
<td>-16.9</td>
</tr>
<tr>
<td>Oil</td>
<td>92.5</td>
<td>-29.4</td>
</tr>
<tr>
<td>Private sector credit*</td>
<td>20.3</td>
<td>9.1</td>
</tr>
<tr>
<td>Inflation*</td>
<td>23.9</td>
<td>21.1</td>
</tr>
<tr>
<td>Broad money*</td>
<td>13.5</td>
<td>9.9</td>
</tr>
</tbody>
</table>

* end period basis

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3 HRI which constitute 23 percent of CPI or around 40 percent of CPI non-food inflation witnessed 18.5 percent YoY inflation in February 2009 compared with 15.0 percent in September 2008.
4 The fall in import demand, both for oil and non-food non-oil imports, primarily reflects quantum effect partly due to rupee depreciation against major currencies and rising interest rates. Besides fall in import quantum, lower international oil prices also contributed to drop in import bill during the period under review. Please see chapter on **Trade accounts** for detail.
4.6 percent during Jul-Feb FY09 compared with strong growth of 11.7 percent in the corresponding period last year. While some of the banks were reluctant to lend to private sector due to concerns on credit quality, credit demand from the private sector is also slowing down. Besides falling imports, economic slowdown in US and EU markets and structural issues of textile industry which led to fall in textile exports, and lower input costs in few categories, such as cotton and steel bar, also explained part of the lower demand for credit.

4. **Weakening of demand stimulus due to improved fiscal discipline during H1-FY09.** This is reflected in (1) fall in fiscal deficit to 1.9 percent of GDP in H1-FY09 compared with 3.4 percent in the corresponding period last year, and (2) pace of government borrowing from the central bank, which has been dampened since December 2008 -in line with the target set under the Stand-by Arrangement (see Figure 4.3). The government borrowed Rs 356.4 billion from SBP during Jul-Nov FY09, whereas during Dec-Feb FY09 period, net borrowings from the central bank were only Rs 56.9 billion (see Figure 4.4).

The ease in demand pressures together with the associated improvement in macroeconomic variables also had implications for domestic liquidity particularly

---

5 For detail see section on Private sector credit.
6 Though the demand for fixed investment in various industries witnessed robust growth, lower demand for working capital loans put downward pressure on total credit demand from the private sector.
7 Indeed, in the recent past besides contributing to demand pressures, the increased recourse to finance higher fiscal deficit from the central bank has diluted the impact of monetary tightening.
8 The reduction in borrowing from SBP was concentrated in the month of December 2008. In absolute term, government retired Rs 133.6 billion to SBP in the same month.
November 2008 onwards. A deceleration in credit demand from both the government as well as the private sector, along with a fall in pace of NFA depletion led to ample liquidity in the banking system. The availability of the rupee liquidity in the interbank market, banks’ changing preference in favor of risk-free debt instruments in view of increased concerns on credit quality, and market expectations that interest rates have peaked out, all encouraged a sharp rise in banks’ investment in government papers during Dec-Feb FY09 period. This in turn allowed the government to contain its borrowings from the central bank.

This liquidity situation was in stark contrast to October 2008. At that time, the banking system was facing severe liquidity crunch which was exacerbated by heavy withdrawals of deposits following rumor-fed concerns over the stability of local banks in the backdrop of the international financial crisis. SBP responded by providing extensive liquidity support to banks so that (a) their lending ability remained intact, (b) confidence on the banking system was restored quickly.

The effect of SBP support to improve market liquidity, ease in demand pressures on rupee

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9 Net budgetary borrowing during Dec-Feb FY09 was Rs 102.8 billion compared with Rs 161 billion in the corresponding period last year.
10 As a result, the stock of T-bill holding by commercial banks increased to Rs 629.1 billion by end February 2009 from a low level of Rs 483.9 billion in November 2008.
liquidity and lowering of inflation expectations have led to softening of market interest rates (see Figure 4.5).\(^\text{11}\) This effectively means that the impact of the tight monetary policy stance of the central bank has eased considerably.

The definitive easing of the monetary policy is however constrained by the developments on the external account and the stubbornly high core inflation. Indeed, during Jul-Feb period, the gain from the lower import bill were somewhat offset by a slowdown in exports partly reflecting the effect of global slowdown which in turn have reduced the demand for country’s exports. Furthermore, there are risks that future remittances and foreign investments flows may face slowdown in wake of deepening recession in major economies. In particular, the slowdown in Dubai may adversely affect remittance inflows.

Nonetheless, if the current down trend on demand pressure continues and external inflows do not dry up, this will provide SBP room to review its current monetary policy stance.

4.2 Developments in Monetary Aggregates
The YoY growth in broad money (M2) decelerated sharply to 9.9 percent as on 28th Feb FY09 compared to 17.9 percent in the corresponding period last year. The slowdown in M2 growth resulted from a strong contraction in net foreign assets (NFA) of the banking system. Net domestic assets (NDA) however increased by 23.0 percent on YoY basis on Feb 28, 2009. Interestingly, a closer look at the components of M2 shows a trend reversal in the sources of deceleration in M2 growth towards the end of November 2008 (see Figure 4.6: YoY Growth in Components of M2 (in percent)).

\(^{11}\) The effect of excess rupee liquidity in the market was particularly strong on auction cut off rates. This was because the auction process has undergone two major changes: (1) cut off rates in the primary auction are now being decided (as a debt management function) by the Ministry of Finance, instead of SBP, and (2) cut off decision is now based on target volume, i.e., the cut off rate will be the one at which the government realizes the auction target volume.
4.6. Specifically, with a visible improvement in the overall external balance, net foreign assets (NFA) of the banking system have expanded by Rs 54.1 billion during Dec-Feb FY09 compared to an exceptionally strong contraction of Rs 356.3 billion in Jul-Nov FY09 (see Table 4.2). In parallel, YoY NDA growth experienced a sharp slowdown after attaining an unusually high 34.5 percent growth as on November 29, 2008. As government borrowing from the banking system continues unabated, the decline in the growth of NDA November 2008 onwards reflects deceleration in credit to the non-government sector during Dec-Feb FY09.

**Net Foreign Assets (NFA)**
The Stand-By Arrangement (SBA) signed with the IMF towards the end of November 2008 helped restore calm in the foreign exchange market by ensuring funding of FY09 financing gap of the overall external account. While the receipts of the first tranche of the IMF loan does not have any direct impact on net foreign...
assets, the depletion in NFA seen during Jul-Nov FY09 was arrested because of (1) a decline in trade deficit owing to sharp deceleration in import growth; (2) robust flows under workers’ remittances, and (3) financial flows from other multilateral and bilateral sources received once the SBA was signed. Consequently, foreign exchange reserves of the country began to recover. The expansion of Rs 54.1 billion in net foreign assets of the banking system since 29 Nov FY09 reduced the contraction in net foreign assets of the banking system to Rs 302.2 billion during Jul-Feb FY09.

The Jul-Feb FY09 contraction in NFA of the banking system is heavily dominated by changes in SBP NFA (see Figure 4.7). Till November 2008, imports grew sharply due mainly to considerably large price effect of higher international commodity prices. The largest impact was from the steep rise in prices of petroleum products. The increased provision of foreign exchange liquidity to meet oil payments led to sharp depletion in SBP’s reserves during Jul-Nov FY09. Pressures on SBP NFA mounted as external financing inflows slowed down. Hence, the net foreign assets of the SBP experienced an extraordinarily strong Rs 356.3 billion contraction during Jul-Nov FY09.

However, external financing inflows picked up from November 2008 onwards following the Stand-by Arrangement. In addition, the effect of decline in world oil prices on import growth started to get strength; in fact, the contribution of price effect in import growth turned negative since December 2008. Finally, the decision to partially meet foreign exchange requirement for payments of oil import from the interbank market effective February 2009 eased excessive pressure on

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This is because the IMF loan, which is essentially for balance of payment support, also creates a corresponding liability on the central bank.
central bank’s foreign exchange reserves. For these reasons, SBP’s NFA expanded by Rs 57.7 billion during Dec-Feb FY09.

Similarly, NFA of the scheduled banks registered a net expansion of Rs 3.0 billion during Jul-Feb FY09 compared to a contraction of Rs 80.9 billion during the corresponding period last year. Strong rise in workers’ remittances and substantial retirement of foreign currency loans (see Figure 4.8) were the major factors responsible for the expansion in NFA of the scheduled banks during Jul-Feb FY09. The net impact of the above factors was strong enough to also offset the decline in net foreign investment during the period under review.

**Net Domestic Assets (NDA)**

After attaining an unusually high YoY growth of 34.5 percent in end-November 2008, the growth in NDA of the banking system decelerated sharply in subsequent months. Despite the deceleration, NDA of the banking sector registered a strong YoY growth of 23.0 percent during Jul-Feb FY09, slightly higher than the increase of 21.7 percent during the corresponding period of FY08. A surge in credit extended for commodity operations and persistently high government budgetary borrowing from the banking sector, contributed towards the strong growth in NDA of the banking sector during the

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13 Specifically, purchase of foreign exchange related to the import of furnace oil and POL related foreign exchange purchases made on specific form ‘M’ against approvals issued by Exchange Policy Department of the SBP are to be made from interbank market. For the rest, SBP will continue to provide foreign exchange to the banks.
period under review. The sharp increase in credit financing for commodity operations since mid October is caused by procurement of large quantities of wheat, rice and fertilizer. This is in contrast to persistent contraction in credit financing for commodity operations during the same period in FY08 (see Figure 4.9). Interestingly, after the spike seen in end October 2008, financing for commodity operations have lingered around the same level, perhaps due to delays in retirement of loans taken by PASSCO for financing of fertilizer procurement.

Demand for credit, both from public sector enterprise (PSEs) and the private sector, remained rather strong up till the end of October 2008. Since then, there is perceptible deceleration in the credit to the non-government.

Notwithstanding the continued pressure on the banking sector to finance the budget deficit, the composition of government borrowing from the banking system has changed significantly since mid-October 2008. The government retired some of its debt held by SBP and financed its borrowings needs from the scheduled banks. Consequently, SBP financing, as a share of net budgetary borrowing from the banking system, declined to 82.7 percent as on 28th Feb FY09 from a high of 207.1 percent as on 8th October FY09.

4.2.1 Government budgetary borrowings
The government’s budgetary borrowing from the banking system during Jul-Feb FY09 rose by Rs 362.4 billion against an increase of Rs 306.4 billion
in the corresponding period of FY08 (see Figure 4.10). The sharp rise in borrowing from the banking system is despite the fact that fiscal accounts for H1-FY09 suggest a considerably lower budget deficit, in line with FY09 annual budget target.\textsuperscript{14} The apparent disconnect is explained by lesser availability of external financing,\textsuperscript{15} and a contraction in domestic non-bank receipts which forced greater reliance on bank financing.

Importantly though, the government’s reliance on budgetary borrowings from the SBP has declined since end November 2008. This was principally because: (1) in order to meet the end-December 2008 ceiling on borrowings from the central bank, the government used the proceeds from the transfer of SBP profits to retire its debt held by the SBP, (2) another Rs 22.7 billion worth of T-bills held by SBP were transferred to scheduled banks during Dec 26-31, 2008 under outright sale and OMOs (3) whereas external financing for H1-FY09 stands lower than the corresponding period last year, net external receipts to finance the deficit are larger than the Q1-FY09 inflows, and (4) banks’ increased participation in the T-bill auctions in the wake of fading demand for credit by the private sector and concerns over growing NPLs. Consequently, stock of market related treasury bills (MRTBs) with SBP, which rose to Rs 1,393.4 billion by November 29, 2008, declined to Rs 1,345.2 billion as on 28\textsuperscript{th} Feb 2009.

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure4.11.png}
\caption{T-Bill Auction (Net of Maturities)}
\end{figure}
During Jul-Nov FY09, scheduled banks were reluctant to provide financing to the government at the then prevailing auction cut off rates (see Figure 4.11). As a result, government was unable to even roll-over its maturing debt securities held by scheduled banks. This forced the government to retire Rs 93.3 billion of its budgetary borrowings from scheduled banks during Jul-Nov FY09. Since then, however, scheduled banks’ financing to the government has expanded by Rs 156.2 billion. Slowing credit demand amidst a weakening economy and lower risk appetite of banks increased interest in government securities. Moreover, banks sought to lock in yields ahead of an expected fall in interest rate for the reasons: (a) private sector credit has contracted following slowdown in real economic activity and (b) their expectations that interest rates have peaked out. Consequently, scheduled banks provided, on cumulative basis, to the government Rs 62.9 billion as on 28th Feb 2009 against net retirement of Rs 52.9 billion in the corresponding period of FY08.

Another contribution to the higher acceptance was the change in the auction process for government papers. First, instead of SBP, Ministry of Finance decides the cut off rates in the primary auction. Moreover, cut off decision are now based on target volume, i.e., the cut off rate will be the one at which the government realizes the auction target volume rather than one set by the borrower. This means that going forward, the yields on government papers will be more sensitive to volume of government borrowings.

The growth in the credit to the PSEs, which also contributed to Jul-Feb FY09 strong rise in NDA (see Figure 4.12), is attributable to continued delays in settlement of claims of one public sector oil marketing company (OMC) and the major power utility. Credit to PSEs rose by Rs 62.0 billion during Jul-Feb FY09 compared to an increase of Rs 31.5 billion in the corresponding period last year.
4.3 Credit to Private Sector (net)\textsuperscript{16}

Corporate demand\textsuperscript{17} for banks’ credit could not maintain the robust YoY growth seen in the first three months of FY09 and it decelerated sharply in the succeeding period (see Table 4.3).

Consequently, the cumulative private sector credit grew by 4.6 percent during Jul-Feb FY09 compared with strong growth of 11.7 percent in the corresponding period last year (see Table 4.4). Although the one-off credit demands, mainly from IPPs and OMCs, to fill the financing gap due to circular debt, somewhat inflated the credit growth in both fiscal years; the impact of this one-off demand on credit during FY09 was not as significant as in FY08.\textsuperscript{18}

Even adjusted for this phenomenon, it is seen that credit off-take, remains 6.1 percentage points lower in Jul-Feb FY09 than in the corresponding period last year (see Table 4.4).

\textsuperscript{16}The reported credit numbers comprises of banks’ investments and advances to the corporate sector. This data is based on monetary survey, while the sector-wise discussion covers the period of Jul-Jan FY09.

\textsuperscript{17}Credit demand from the businesses sector explains more than 85 percent of total private sector credit.

\textsuperscript{18}This was partly explained by a lower base of June-2007.
The sharp slowdown in private sector credit during Jul-Jan FY09 was entirely explained by a significant deceleration in working capital loans which witnessed the lowest growth in the recent past (see Figure 4.13).

In contrast, the growth in long term loans, mainly for expansion activities in various industries, remained strong and was largely evident during Jul-Nov FY09; as the monthly trend saw a deceleration in each of the next two months. On face value, the growth in fixed investment loans would appear quite puzzling given that business slowdown is visible in various industries. The explanation is that a part of acceleration in demand for fixed investment loans particularly in the power, construction and fertilizer, sectors primarily reflects their financial closures in the last two years.  

A closer look at the working capital requirements indicates that credit demand was exceptionally strong during Aug-Sep FY09. However, it slowed significantly after October 2008, probably reflecting the liquidity strains in the banking industry which limited the lending ability of a few banks. In addition to this, a sharp fall in raw material prices has also lowered the working capital requirements from corporates.

Though the liquidity pressures on the banking industry started to taper-off by end November 2008 due to number of measures undertaken by SBP, credit off-take remains sluggish. In specific terms, January 2009 witnessed a net retirement under working capital loans. Although the slowdown under working capital loans in the month of January is a common factor, the net retirement in

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19 Financial closure broadly defines the project financing pattern of a company mainly through bank and non-bank sources (such as corporate papers, external financing). In case of bank finance, after signing the loan agreements with corporates, banks are bound to provide loan according to the terms and conditions mention in the contract.

20 For detail see Q1-FY09.

21 For detail see Q1-FY09.
January 2009 was exceptionally strong (see Figure 4.14).

Some of the reduction in demand for running finance since October 2008 was not unexpected as a few IPPs and OMCs had exhausted their credit limits with banks by end September 2008. The continued slowdown in economic activity however exacerbated the situation (see Table 4.5). The impact of former on working capital loans was further compounded by the retirement of banks’ loan by some IPPs. Moreover, a decline in key asset markets reduced the speculative demand for credit. In addition, lower demand for credit was also explained by few sector specific issues.

For instance, economic slowdown in US and EU markets and structural issues of textile industry led to a fall in textile exports which in turn lowered the demand for working capital loans. Further, delays in settlement of textile export orders by importers resulted in piling up of stock of inventories.22 This has also led to lower demand for fresh working capital loans. Likewise, deceleration in import demand23 and lower input cost in few categories such as cotton and steel bar contributed to lower demand for working capital requirements.

Further, anecdotal evidence suggests that some corporates are also facing internal cash flow problems24 in meeting their loan obligations. Besides liquidity squeeze in various industries, deterioration in interest coverage ratio25 of a few corporates had also put significant downward pressure on credit demand (see Table 4.6).26

Table 4.5: Possible Factors For Slowdown in Total Working Capital Loans (including Trade Finance)

<table>
<thead>
<tr>
<th>FY08</th>
<th>FY09</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Jul-Jan</td>
</tr>
<tr>
<td>Industrial production</td>
<td>5.6</td>
</tr>
<tr>
<td>Imports</td>
<td>18.9</td>
</tr>
<tr>
<td>Exports</td>
<td>5.6</td>
</tr>
<tr>
<td>WPI non-food</td>
<td>12.7</td>
</tr>
<tr>
<td>Raw cotton</td>
<td>26.1</td>
</tr>
<tr>
<td>Steel bar</td>
<td>30.3</td>
</tr>
</tbody>
</table>

*end period basis

22 For detail see section on Trade Account.
23 Partly due to falling international oil prices and rupee depreciation against major currencies.
24 Probably due to freeze on redemption of open end mutual fund in October 2008 and stock market crisis.
25 Interest coverage ratio is defined as the ratio between the earnings before interest payment and taxes (EBIT) to interest expenses. This ratio evaluates a company’s ability to pay the interest expenses on its debt from available earning sources. A higher interest coverage ratio means that the company’s earnings is well above its interest requirements and thus company can withstand possible financial turmoil. By contrast, lower level of this ratio exhibits that the company barely manages to cover its interest costs and may easily fall into bankruptcy if its earnings suffer for even a single
A detailed analysis of selected sectors suggests that the lower interest coverage ratio in September 2008 was explained both by rising financial cost and fall in earnings before interest and tax (EBIT). It can be argued that part of private sector credit seems to be responding to interest rate channel of monetary policy. It may however be noted that a drop in EBIT of a few corporates reflects a mix of both fall in sale and increase in cost of goods sold.

Credit supply perspective suggests that during Jul-Sep FY09 banks had ample liquidity to fund credit demand as reflected in excess reserves with SBP over statutory requirements and maturing T-bill investments (see Figure 4.15). However, a continuous fall in excess statutory reserves with SBP and sudden withdrawal of deposits in mid October 2008 exerted significant pressures on period. It may be noted here that financial cost is used instead of interest expenses to calculate this ratio for selected companies, which mainly includes markup on long term and short term loan, finance lease and bank charges.

Table 4.6: Interest Coverage Ratio of Highly Leverage Selected Sectors*

<table>
<thead>
<tr>
<th>Sector</th>
<th>Sep-06</th>
<th>Sep-07</th>
<th>Sep-08</th>
</tr>
</thead>
<tbody>
<tr>
<td>Textile</td>
<td>2.5</td>
<td>2.5</td>
<td>1.8</td>
</tr>
<tr>
<td>Fertilizer</td>
<td>7.4</td>
<td>6.2</td>
<td>4.5</td>
</tr>
<tr>
<td>Auto</td>
<td>16.9</td>
<td>40.1</td>
<td>2.7</td>
</tr>
<tr>
<td>Pharmaceuticals</td>
<td>350.7</td>
<td>144.0</td>
<td>73.4</td>
</tr>
<tr>
<td>Chemicals</td>
<td>9.0</td>
<td>30.9</td>
<td>6.8</td>
</tr>
<tr>
<td>Paper &amp; Board</td>
<td>16.2</td>
<td>2.5</td>
<td>1.3</td>
</tr>
<tr>
<td>Leather &amp; Tanners</td>
<td>3.5</td>
<td>9.2</td>
<td>13.3</td>
</tr>
<tr>
<td>Food and Personal Care Products</td>
<td>7.7</td>
<td>9.2</td>
<td>1.9</td>
</tr>
<tr>
<td>Power Generation and Distribution</td>
<td>-2.1</td>
<td>-1.5</td>
<td>-0.1</td>
</tr>
<tr>
<td><strong>Overall</strong></td>
<td><strong>7.1</strong></td>
<td><strong>7.9</strong></td>
<td><strong>2.7</strong></td>
</tr>
</tbody>
</table>

* This information is based on quarterly audited balance sheets of 23 listed companies.

Figure 4.15: Incremental Credit Supply-FY09

- All banks
- Excl privatized

26 Resultantly, a few sectors also witnessed a relative increase in non-performing loans by end December 2008.

27 Banks were reluctant to rollover their investment in government papers mainly due to exceptional demand for private sector credit in the same period.
liquidity available with banks. This prevented a few banks from aggressive lending during Oct-Nov FY09.

Although most of the banks were hit by the deposits withdrawal, the lending ability of the large privatized banks\(^28\) remained intact, to an extent.\(^29\) This was because, except one of the large privatized banks, mostly banks in this group (1) were not much affected by the liquidity crunch of October 2008 and (2) reverted to their pre-crisis deposit level by early November 2008.\(^30\) On the other hand, the impact of deposit withdrawal was significant for some of the small private banks and thus their incremental lending fell sharply in Oct-Nov FY09\(^31\).

As discussed earlier, though the SBP measures eased-off tight liquidity conditions, to an extent, in the inter-bank market since November 2008 onwards, the effect on bank’s willingness to lend to private sector was weakened by number of factors such as rising concerns regarding deteriorating credit quality, delays in cash recoveries of loan proceeds and rising risk in sectors such as stock market and real estate. The concern regarding credit quality is also reflected by sharp increase in infection ratio particularly under working capital loans in December 2008 (see Table 4.7).

Moreover, the structure of loan portfolio of the banks has also changed significantly as by end December 2008, 78.2 percent of the total bank advances were

\[
\begin{array}{|c|c|c|}
\hline
\text{Dec-08} & \text{Dec-09} \\
\hline
\text{Fixed investment} & 11.3 & 12.7 \\
\text{Working capital*} & 6.6 & 9.2 \\
\hline
\end{array}
\]

* Excluding trade related loans

\(^28\) This category includes four banks namely; MCB, ABL, HBL, UBL.

\(^29\) It may be noted here that the incremental credit from large privatized banks during Oct-Nov FY09 was Rs 35.7 billion compared with Rs 24.9 billion in the Q1 FY09.

\(^30\) For detail see section on Deposits.

\(^31\) As their deposit withdrawal was significant when compared with their total deposit base. For detail see Box 4.2 in Q1-FY09.
lent at the rate of 12 percent and above. In comparison same month last year 70 percent of aggregate bank advances were extended at rates between 9 to 12 percent (see Figure 4.16). Besides reflecting effect of monetary tightening, the change in banks’ portfolio in terms of lending at a higher rate also indicates an increase in both the credit risk and return on government papers.

In view of the rising NPLs, a few banks followed more stringent credit criteria. For instance, it is cited that banks are focusing to finance mostly those projects that have ability to generate cash flows. In recent past, banks mainly focused on the value of collateral such as inventories, amount receivable and fixed assets, and less emphasis was given to corporates’ liquidity and cash flows. With rising default risks, banks are now also assessing the borrowers’ income level and their current obligations to determine their ability to service debt. Further, banks are also reluctant to lend in those sectors which have seen significant increase in inventories.

On the other hand, government appetite to raise funds from the banking system provides an avenue for banks to put their funds in T-bills. In specific terms, till September 2008, commercial banks were reluctant to lend to government as credit demand was exceptionally strong and banks were expecting higher interest rates due to rising inflationary trend in the economy. However, since October 2008 onwards, banks’ participation in T-bill auction increased significantly. Bank’s greater interest in government paper was explainable by a number of reasons, including: (1) ample loanable funds with banks32 (2) the interest rate differential between lending to private sector and to the government had narrowed33 (3) changing banks’ preference in favor of risk free instruments.

| Table 4.8: Liquidity Position of Banking Industry during FY09 (billion Rs) |
|-----------------------------|----------------|--------------------|----------------|----------------|
|                             | Jul-Sep | Oct-Nov | Dec-Feb | Total  |
| Net target                  | 32.9    | 40.4    | 93.3    | 166.5 |
| Net offered                 | 33.1    | 80.8    | 951.8   | 1,065.7 |
| Deposits                    | -129.0  | -17.3   | 124.3   | -22.3 |

| Table 4.9: Structure of Bank Lending during FY09 (billion Rs) |
|-----------------------------|----------------|--------------------|----------------|----------------|
|                             | Jul-Sep | Oct-Nov | Dec-Feb | Total  |
| Private sector              | 90.3    | 55.5    | -12.8   | 133.1 |
| PSE                         | 63.5    | -8.7    | 7.2     | 62.0 |
| Investment in GoP papers*   | -99.6   | 30.6    | 191.6   | 122.6 |

32 This is captured by banks’ excessive bidding in T-bill auctions during Dec-Feb FY09 period (see Table 4.8).
33 Difference between 6-month KIBOR and 6-month Repo rate declined from 152 basis points in September 2009 to 106 basis points in February 2009.
to avoid erosion of credit quality and (4) the market expectations that the overall interest rate in the economy have peaked out (see Table 4.9).

**Trend in Business sector Advances**
The growth momentum in business sector advances, which had witnessed strong growth in the last few years, slowed significantly, recording 7.6 percent growth during Jul-Jan FY09, i.e., 6.3 percentage points lower than the average growth in the preceding three years. Though fixed investment loans witnessed robust growth, a marked deceleration under working capital and trade loans had exerted significant downward pressure on overall demand for credit during Jul-Jan FY09. 34

**Factors explaining higher demand for fixed investment loans**
In contrast to deceleration in fixed investment loans visible since last three years, Jul-Jan FY09 posted a robust growth of 21.0 percent (see Figure 4.18). Monthly trend depicts that this significant rise in fixed investment loans was largely concentrated in Jul-Nov period, whereas moderation in demand was seen in the months of December and January FY09 (see Figure 4.19). More

34 It must, however, be noted that during Jul-Sep FY09, the contribution from working capital loans in advances growth was exceptional (see Figure 4.17).

64
importantly, demand for fixed investment remained broad-based as most of the sectors (such as fertilizer, power, commerce and trade, telecom and construction) recorded double digit growth. It must, however, be noted that FY08 marginal growth was an exception; as most of the corporates were issuing private papers to both (1) finance their expansion projects, and (2) retire long-term loans in some cases. \(^{35}\) Thus, the increase in demand under fixed investment loans for this year was expected to an extent, as corporate market saw no new issuance of corporate debt instrument in FY09. Further, it is also cited that disbursements in few sectors such as power, fertilizer and construction was anticipated as their financial closures were achieved in the last two years. In specific terms, while the fixed investment in power sector reflects expansion in power generating and distributing companies, demand in construction sector was principally for residential related projects by one large private construction company. In case of fertilizer sector, fixed investment demand was due to large fertilizer capacity expansion.

In addition, growth in fixed investment in telecom sector accelerated substantially from 35 For details see Q2-FY08
10.3 percent during Jul-Jan FY08 to 23.8 percent in Jul-Jan FY09. This was probably a reflection of expansion in the network of the wireless internet facility offered by different telecom companies.

Factors explaining lower demand for trade related loans
The growth in trade related loans fell sharply to 0.9 percent in Jul-Jan FY09 compared to robust growth of 21.0 percent in the same period last year. This was despite the strong contribution of EFS loans in total trade loans (see Figure 4.20). Although the loans under EFS recorded a robust growth of 14.8 percent in Jul-Jan FY09 compared with 5.1 percent in the corresponding period last year, the export loans other than schemes (mainly against FE-25 loans) witnessed substantial net retirement which had diluted the impact of higher growth under EFS loans.

Retirement under FE-25 loans was probably due to sharp depreciation of rupee against US dollar which had caused exporters to (1) substitute their FE-25 outstanding stock with EFS and (2) to meet their running finance requirement through EFS (see Figure 4.21).

A commodity-wise break up shows that most of the increase in EFS is recorded in rice and textile related products such as towel, and cotton fabrics. In specific terms, increase in loans extended to rice traders is consistent with bumper crop and remarkable increase in rice exports. Likewise, higher loans under towel and cotton fabrics primarily reflects higher export

![Figure 4.21: Substitution Between EFS and Other Than EFS-FY09](image)

![Figure 4.22: Import Finance (Jul-Jan)](image)
quantum in these commodities.³⁶

It must be noted here that to support exporters, SBP further enhanced the banks’ limit under EFS and LTFF.³⁷ As a result of this measure, more liquidity will be available with banks to facilitate exporters at a highly concessional rate. Recently, SBP has also issued performance based mark-up rates under EFS to further lower the rates for exports.³⁸

The fall in the import finance during Jul-Jan FY09 was visible in loans extended to importers against FE-25 and in local currency (see Figure 4.22). While the drop in import finance was in line with the deceleration in country’s import bills following a sharp fall in international oil prices, the upward pressure on exchange rate has further dragged down the demand for import finance.

**Factors explaining lower demand for working capital loans**

After recording robust growth in the past four years, demand for working capital loans decelerated substantially to 3.2 percent during Jul-Jan FY09, i.e., 18.6

<table>
<thead>
<tr>
<th>Table 4.10: Advances for Working Capital Loans</th>
<th>Jul-Jan FY08</th>
<th>Jul-Jan FY09</th>
<th>Oct-Jan FY08</th>
<th>Oct-Jan FY09</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Business Sector</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A. Agriculture, hunting and forestry</td>
<td>3.2</td>
<td>14.2</td>
<td>1.1</td>
<td>7.5</td>
</tr>
<tr>
<td>B. Manufacturing</td>
<td>20.3</td>
<td>11.8</td>
<td>30.6</td>
<td>5.1</td>
</tr>
<tr>
<td>a. Textile</td>
<td>33.7</td>
<td>16.1</td>
<td>42.5</td>
<td>14.1</td>
</tr>
<tr>
<td>Spinning</td>
<td>42.1</td>
<td>24.4</td>
<td>52.9</td>
<td>19.2</td>
</tr>
<tr>
<td>b. Cement</td>
<td>46.6</td>
<td>22.3</td>
<td>25.7</td>
<td>5.2</td>
</tr>
<tr>
<td>c. Fertilizer</td>
<td>-39.0</td>
<td>38.7</td>
<td>-1.2</td>
<td>-24.6</td>
</tr>
<tr>
<td>C. Power</td>
<td>35.7</td>
<td>-1.4</td>
<td>36.1</td>
<td>-15.7</td>
</tr>
<tr>
<td>D. Construction</td>
<td>32.4</td>
<td>-14.1</td>
<td>31.6</td>
<td>-4.7</td>
</tr>
<tr>
<td>E. Commerce and Trade</td>
<td>17.3</td>
<td>-4.7</td>
<td>17.7</td>
<td>-5.2</td>
</tr>
<tr>
<td>F. Transport, storage and communications</td>
<td>3.8</td>
<td>-21.4</td>
<td>68.9</td>
<td>-27.2</td>
</tr>
<tr>
<td>G. Other business activities*</td>
<td>54.2</td>
<td>8.5</td>
<td>38.3</td>
<td>-12.2</td>
</tr>
</tbody>
</table>

* Mainly includes loans extended to stock brokers/trade under CFS

³⁶ For detail see section on Trade.
³⁷ In Jan-Mar 09 Monetary Policy Statement, SBP increased the banks’ limit under EFS and LTFF by Rs. 35 billion. For detail see MPS Jan-Mar FY09.
³⁸ For details see SMFED circular # 06 dated March 09,2009.
percentage points lower than the average growth in the last four years. A detailed analysis of Jul-Jan period shows that the strong demand for working capital loans during Q1-FY09 begun to weaken sharply since October 2008 onwards. Thus, after witnessing exceptional growth in Q1-FY09, the growth under working capital loans dropped drastically in Oct-Jan FY09 (see Table 4.10).

A large number of sectors witnessed fall in demand for running Finance requirements in Oct-Jan FY09 which is in stark contrast to previous year’s trend. Besides, slowdown in economic activities, one of the major factors behind the significant slowdown in running finance requirements of corporates was a sharp fall in raw material prices in post Q1-FY09. For instance, drop in raw cotton prices since November 2008 onwards contributed to only 19.2 percent growth in demand for running finance in textile sector during Oct-Jan FY09 compared with strong growth of 52.9 percent in the corresponding period last year. Likewise, fall in credit extended to the construction sector partly recorded the impact of fall in steel bar prices during Oct-Jan FY09. The impact of this was further compounded by slowdown in domestic residential business activities as suggested by fall in real estate prices.

Further, freeze in stock market activity and resulting fall in valuation of shares lowered the incentives for stock brokers/agents to obtain advances under CFS. Resultantly, advances growth under loans to Stock Brokers/agents dropped drastically to 12.2 percent during Oct-Jan FY09 compared with 38.3 percent growth in Oct-Jan FY08.

Fall in demand from the power sector in Oct-Jan FY09 was partly due to retirement of bank loans by a few IPPs to avoid the rising financial expenses. The moderation in demand from power sector was further compounded by the fact that a few IPPs had already availed their credit limit till September 2008.

In case of fertilizer sector, though the credit demand was strong in Jul-Sep FY09, it decelerated sharply in the subsequent months. It may be pertinent to mention here that the higher demand from the fertilizer sector in Q1-FY09 was partly due to delays in settlement of DAP subsidy claims with the government.39

39 In fact, to protect the farmers from hike in international DAP prices, government has been providing the DAP price differential (between the international DAP prices and the domestic DAP prices) to fertilizer companies. Since February 2008 the international DAP prices increased drastically and reaches to US$ 174.1 per mt in August 2008. Though government had raised the DAP subsidy in June 2008 from Rs 470/bag to Rs 1,000/bag which later on further increased to Rs...
4.4 Deposit Mobilization

Deposit mobilization by banks remained notably weak during Jul-Feb FY09 as overall deposits of the banking system declined by 0.6 percent on a cumulative basis. This was in sharp contrast to deposit growth of 4.0 percent during the corresponding period of the previous year. The unusually large withdrawal in deposits during the first two weeks after *Eid-ul-Fitr* in response to depositors’ concerns on stability of local banks, large scale redemptions by investors in mutual funds, shift in public preference away from deposits due to high inflation, high returns on NSS, effect of the slowdown in economic activity and continued external account pressures have contributed to the deceleration in deposit growth. Thus, the cumulative deposits growth, which generally attains positive levels around November each year, was still hovering in the negative range by February 2009 (see Figure 4.23).

2,200/bag, however, delays in settlement of subsidy claims a few fertilizer companies had to borrow from the banking system to meet the financing gap.

The discussion on deposits is based on total deposits of the banking system including government deposits.

It must be noted here that a part of fall in overall deposit growth during Jul-Feb FY09 emanates from the exceptional seasonal withdrawal in deposits seen in July 2008.
Encouragingly, the recent trends suggest that the steep fall in YoY deposit growth seems to have bottomed out. Further, the banking system on overall basis has at least recovered from abrupt large erosion in deposit base during October 2008 (see Figure 4.24). Indeed, it took banks more than three months to re-build their deposits to levels prevailing in mid-September 2008 (well before the panic had struck the depositors). A slower recovery in banks’ deposits was not surprising as depositors would take some time to overcome their concerns regarding the stability of local banks.

The recovery process is however not uniform across banks. While some of the banks recovered the loss in their deposit base rather quickly, other took more time, whereas a few of them are still struggling to recoup their deposits.

The bank-groupwise analysis of deposit growth after October 2008 suggests that both, public sector banks and private domestic banks have been able to recover most of the decline during June-October 2008 period in their stock of deposits (see Figure 4.25). Within public sector commercial banks, deposit growth is mainly concentrated in one large bank due to increase in deposits of government and public sector enterprises (PSEs). The growth in domestic private banks’ deposits is on account of a rise in deposits of PSEs, corporate and telecom sectors.
On the other hand, recovery of deposits is slower in privatized banks. Some of the banks, which had recently merged, continued to face difficulty in mobilizing deposits even after October 2008. This was primarily because of the maturing deposits of companies in the telecom and refineries sectors. It is important to note that the merged banks are facing problems in deposit mobilization, despite the significant rise in return on deposits offered by these banks.

The foreign currency deposits, (particularly in US$ denominated deposits), which faced heavy withdrawal in October 2008, are again becoming attractive. The share of US$ denominated deposits is also improving (see Figure 4.26), mainly due to rise in resident FCD accounts.

While almost all banks have increased return on their deposits, the interest rate spread for the banking industry rose by 100 basis points since June 2008, reaching 7.78 percentage points in January 09 – the highest level in recent years. It may be pointed out here spread had declined sharply in June 2008 following the introduction of 5 percent floor on savings/PLS deposits.

During Jul-Oct 2008, though both the lending as well as deposit rates were increasing, the response of lending rates to liquidity shortages was more pronounced, thereby leading to a rise in banking spread. On the contrary, the massive liquidity support by SBP during October 2008 and onwards.
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probably eased the compulsion on banks to aggressively mobilize their deposit base. As a result, deposit rates softened whereas lending rates remained almost unchanged, leading to a further rise in banking spread (see Figure 4.27).

4.5 Non-Performing Loans

The asset quality of the banking system has shown considerable deterioration during Jul-Dec 2008 as banks’ total non-performing loans (NPLs) increased sharply by 30.0 percent (i.e., Rs 72.3 billion) over the June 2008 level to reach Rs 313.7 billion as on end-Dec 2008 (see Figure 4.28). In the meanwhile, the provisioning made by banks was relatively low partly because SBP allowed banks to avail the benefit of 30 percent of Forced Sale value (FSV) of collateral while calculating provisioning requirement. As a result, net NPLs more than doubled

<table>
<thead>
<tr>
<th>Table 4.11: Sector wise NPL to Loan Ratio</th>
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<tbody>
<tr>
<td></td>
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<tr>
<td>Corporate sector</td>
</tr>
<tr>
<td>Chemical &amp; pharma</td>
</tr>
<tr>
<td>Agribusiness</td>
</tr>
<tr>
<td>Textile</td>
</tr>
<tr>
<td>Cement</td>
</tr>
<tr>
<td>Sugar</td>
</tr>
<tr>
<td>Shoes &amp; leather garments</td>
</tr>
<tr>
<td>Auto &amp; trans equipment</td>
</tr>
<tr>
<td>SMEs sector</td>
</tr>
<tr>
<td>Agriculture sector</td>
</tr>
<tr>
<td>Consumer sector</td>
</tr>
<tr>
<td>Credit cards</td>
</tr>
<tr>
<td>Auto loans</td>
</tr>
<tr>
<td>Consumer durable</td>
</tr>
<tr>
<td>Mortgage loans</td>
</tr>
<tr>
<td>Mort Commodity financing</td>
</tr>
<tr>
<td>Cotton</td>
</tr>
<tr>
<td>Rice</td>
</tr>
<tr>
<td>Sugarcane</td>
</tr>
<tr>
<td>Wheat</td>
</tr>
<tr>
<td>Total</td>
</tr>
</tbody>
</table>
and the coverage ratio weakened sharply during Jul-Dec 2008. This increase in net NPLs together with slowdown in advances growth, also led to a steep rise in the net NPLs to net loan ratio.

A sector wise analysis shows that NPL to advances ratio has increased for all sectors except for the agribusiness (see Table 4.11). In the corporate sector, textile, sugar and auto are the sectors facing rising NPLs-advances ratio. The economic slowdown and the resulting stress on balance sheet of corporates are probably driving the rising trends in bad loans. On the other hand, the infection ratio in shoes and leather, cement and agribusiness has declined.

Although the NPLs in consumer finance continued to grow during Jul-Dec 2008, their share in overall NPLs has fallen during Jun-Dec 2008. Furthermore, rise in NPLs in consumer loans during Jun-Dec 2008 was mainly concentrated in one bank which contributed around 50 percent of the rise in NPLs under consumer loans. Within consumer credit, the extent of NPLs is rising for all categories, except for loans extended for consumer durables (see Table 4.12).

Banks’ group-wise analysis shows that (1) both public and private banks are facing sharply increased burden of bad loans (see Figure 4.29), (2) more of the banks are now facing rising NPLs. This is evident from the fact that five banks with largest increase in NPLs accounted for 55 percent of the total rise in NPLs of the banking system during second half of CY2008. During first half, around 75 percent of the incremental NPLs were

| Table 4.12: Profile of Five Banks with Largest Increase in NPLs |
|----------------------|------------------|------------------|
| Percent share of 5 banks in | Dec07-Jun08 | Jun08-Dec08 |
| Total NPLs | 75 | 55 |
| Total assets | 32 | 41 |
| Total advances | 30 | 42 |

1. Assets as on Dec07 2. Assets as on Dec08 3. Advances as on Dec07 4. Advances as on Dec07

Figure 4.29: NPLs Stock by Bank-Group

![Figure 4.29: NPLs Stock by Bank-Group](image-url)
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centered in five banks (see Table 4.12). It is the relatively larger banks that are now facing greater increase in NPLs during second half of CY2008. This is evident from their share in total assets and advances.
5 Fiscal Developments

5.1 Overview
Fiscal consolidation has been a major priority under the macroeconomic stabilization agenda for FY09. This seems to be bearing fruits, as data for first six months of FY09 estimate overall fiscal deficit to have dropped to 1.9 percent of projected annual GDP compared to 3.4 percent in H1-FY08. The fiscal deficit for H1-FY09 thus appears to be in line with the annual target set in the budget FY09 as well as that agreed with IMF under Stand-by Arrangement (SBA).

Understandably, the fiscal improvement thus far has largely been brought about by elimination of oil subsidies and a cut in development spending (see Figure 5.1). Total revenues, as percent of GDP, recovered slightly during H1-FY09 after the sharp decline witnessed in H1-FY08. The marginal improvement came exclusively from increase in non-tax revenues (see Table 5.1). Stagnation of tax revenues, as percent of GDP, yet again underscores the significance of fiscal prudence. While there is need for a line-by-line review of government budget outlays, long term sustainability of fiscal accounts would require expansion in total revenues, particularly by broadening the tax base.

Broadening the tax base is key to a sustainable macroeconomic framework, particularly as access to external financing is increasingly difficult. This forces greater reliance on domestic financing, with a concomitant high risk of crowding out of private investment.

5.2 Fiscal Performance Indicators
All key fiscal performance indicators showed significant improvement in H1-FY09 (see Figure 5.2). Consistent with annual target for FY09, overall fiscal deficit, as a share of GDP, recovered to the H1-FY07 level. The large fiscal
slippage in FY08 resulted mainly from substantial deceleration in total revenues and unusually high subsidies, especially on petroleum products. Consequently, rationalization of subsidies has been an important ingredient of fiscal consolidation plan for the current fiscal year. Given fiscal rigidities in current expenditures and only slight improvement in total revenues, as percent of GDP, the government had to curtail its development spending during Jul-Dec FY09.

Encouragingly, primary balance (total revenues less total expenditures excluding interest payment) moved into

Table 5.1: Summary of Consolidated Public Finance

<table>
<thead>
<tr>
<th>Billion Rupees</th>
<th>Jul-Dec</th>
<th>YoY change (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>FY06</td>
<td>FY07</td>
</tr>
<tr>
<td>Total revenue</td>
<td>497.8</td>
<td>614.8</td>
</tr>
<tr>
<td>Tax revenue</td>
<td>343.3</td>
<td>433.4</td>
</tr>
<tr>
<td>Non-tax revenue</td>
<td>154.6</td>
<td>181.3</td>
</tr>
<tr>
<td>Development and net lending</td>
<td>127.8</td>
<td>147.9</td>
</tr>
<tr>
<td>Unidentified expenditure</td>
<td>-18.6</td>
<td>54.4</td>
</tr>
<tr>
<td>Budget balance</td>
<td>-136.7</td>
<td>-169.0</td>
</tr>
</tbody>
</table>

as percent of GDP

<table>
<thead>
<tr>
<th>Billion Rupees</th>
<th>Jul-Dec</th>
<th>YoY change (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>FY06</td>
<td>FY07</td>
</tr>
<tr>
<td>Total revenue</td>
<td>6.5</td>
<td>7.0</td>
</tr>
<tr>
<td>Tax revenue</td>
<td>4.5</td>
<td>5.0</td>
</tr>
<tr>
<td>Non-tax revenue</td>
<td>2.0</td>
<td>2.1</td>
</tr>
<tr>
<td>Development and net lending</td>
<td>1.7</td>
<td>1.7</td>
</tr>
<tr>
<td>Unidentified expenditure</td>
<td>-0.2</td>
<td>0.6</td>
</tr>
<tr>
<td>Budget balance</td>
<td>-1.8</td>
<td>-1.9</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance

Figure 5.2: Fiscal Performance Indicators (Jul-Dec)
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surplus during H1-FY09, the first such instance since H1-FY05. The emerging surplus in primary balance reflects the viability of current level of non-interest expenditures compared to total government resources, which could potentially lead to reduction in total debt stock. While the improvement in primary balance during H1-FY09 is considerable, the continued deficit in revenue balance suggests a still large growth of current expenditures compared to government’s resource envelope. Additionally, even though the deficit in revenue balance recorded a decline, this apparent improvement in revenue balance is unclear given the presence of large ‘unidentified expenditures.’

5.3 Revenues
The strong growth in total revenues recorded in Q1-FY09 further consolidated during second quarter of the current fiscal year. Specifically, total revenues rose to Rs 834.5 billion, registering an impressive YoY growth of 33.4 percent during H1-FY09 as compared to only 1.8 percent growth in H1-FY08. While this large acceleration in total revenues is due to substantial rises in both tax and non-tax revenues, the increase in tax receipts is just enough to keep these, as a share of GDP, unchanged at H1-FY08 level.

Category-wise performance of tax receipts reveals a large shortfall in collection of direct taxes for the second consecutive year. It is to be noted that direct tax receipts, contributing nearly 40 percent to the FBR tax revenues, play a key role in revenue trends. While the entire shortfall will be hard to replenish in the remaining months of FY09, the feared deceleration in direct tax receipts due to likely fall in corporate earnings, on account of realization of impairment losses arising from decline in value of financial assets, will now be staggered up to Q2-FY10, following the relaxation in IAS39 by SECP and SBP. Furthermore, consumption taxes and custom duties, which produced the strong rise in Q1-FY09 tax receipts, have started to weaken following a decline in international prices of POL inputs such as POL products.

1 The international accounting standard (IAS) 39 requires valuation of all financial assets and liabilities according to market price as on that day and recognition of any profit and loss arising from such valuation into the income statement. Realizing the unprecedented decline in market value of the stock exchanges and the fact that the market was effectively closed for nearly four months through imposition of price floor, SECP and SBP allowed all companies to defer the recognition of impairment loss as on 31st December 2008, if any, due to valuation of listed equity investment held as ‘available for sale’ to quoted market price on that day. Companies opting for this allowance are asked to show the impairment loss under equity. However, any such amount taken to equity will be routed to income statement on quarterly basis during the calendar year ending on 31st December 2009, provided the said decline in share prices is not reversed in coming quarters.
Non-tax revenues added Rs 148.3 billion to total revenues during Oct-Dec FY09 compared to Rs 77.8 billion in the corresponding period last year, registering an exceptionally strong YoY growth of 90.5 percent. This second-quarter large rise in non-tax revenues is in sharp contrast to a big deceleration witnessed in the growth of non-tax revenues during Q1-FY09, despite substantial inflows on account of logistic support reimbursements. The extraordinarily strong performance of non-tax revenues in Q2-FY09 is mainly attributable to a sharp increase in transfer of SBP profits and large collection of surcharge on petroleum products (see Table 5.2).

The ongoing large spread between international oil prices and domestic POL products prices has helped the government curtail its budgetary financing requirements. However, this needs to be a short term practice, as permanent reliance on such receipts to finance government expenditures is not without risks given the volatility in energy prices. Moreover, the failure to pass on the decline in energy prices raises the production costs. Also, SBP passed on another Rs 43.9 billion to the government during Q2-FY09, making its profit transfer to the government a cumulative Rs 71.9 billion in first six months of FY09. While this helped reduce H1-FY09 fiscal deficit, the government will now need to generate additional revenues or make further expenditure rationalization to meet its annual fiscal deficit target.

5.4 Expenditures
Elimination of oil subsidies and a pronounced absolute decline in development spending produced significant deceleration in growth of public expenditures during first six months of FY09. Specifically, consolidated public expenditure rose

<table>
<thead>
<tr>
<th>Table 5.2: Composition of Tax and Non-Tax Revenues</th>
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</thead>
<tbody>
<tr>
<td>billion Rupees</td>
</tr>
<tr>
<td>Jul-Sep</td>
</tr>
<tr>
<td>Tax revenues</td>
</tr>
<tr>
<td>215.6</td>
</tr>
<tr>
<td>Direct taxes</td>
</tr>
<tr>
<td>Taxes on property</td>
</tr>
<tr>
<td>Taxes on goods &amp; services</td>
</tr>
<tr>
<td>Taxes on international trade</td>
</tr>
<tr>
<td>Other taxes</td>
</tr>
<tr>
<td>Non-tax revenues</td>
</tr>
<tr>
<td>Profits from PTA/PO</td>
</tr>
<tr>
<td>Interest (PSE and others)</td>
</tr>
<tr>
<td>Dividends</td>
</tr>
<tr>
<td>SBP profits</td>
</tr>
<tr>
<td>Defence</td>
</tr>
<tr>
<td>Surcharges</td>
</tr>
<tr>
<td>Petroleum</td>
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<tr>
<td>Gas</td>
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<tr>
<td>Discount retained on crude oil</td>
</tr>
<tr>
<td>Royalty on oil/gas</td>
</tr>
<tr>
<td>Others</td>
</tr>
<tr>
<td>Total revenue</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance
to Rs 1085.0 billion during H1-FY09, up by 10.5 percent as compared to 25.3 percent rise in the corresponding period last year. During H1-FY09, development expenditures experienced a 41.1 percent YoY decline. Consequently, as a share of GDP, development spending dropped to 1.0 percent in H1-FY09, compared to 2.1 percent in H1-FY08.

Meanwhile current expenditures witnessed a particular deceleration in second quarter of FY09 (12.4 percent YoY in Q2-FY09 compared to 25.8 percent YoY in Q1-FY09), despite a significant increase in interest payments. As a result, current expenditures grew by 18.3 percent YoY during H1-FY09 compared to 33.3 percent in H1-FY08. The second quarter deceleration was made possible by declines in non-government grants and, surprisingly, in defense spending (see Table 5.3).

Although the strong YoY growth in current expenditures seen last year has decelerated, the H1-FY09 current expenditure growth is still quite strong and needs to be brought down for sustained fiscal consolidation. This becomes more important considering the expected rise in domestic interest payments in coming months on account of very high government borrowing from SBP. Additionally, H1 superannuation allowances and pensions have increased strongly for the second consecutive year following 20 percent rise in pensions in each of last two budgets. Finally, subsidy to oil refineries/OMCs in H1-FY09 on account of outstanding price differential claims from preceding year still constitute more than half of total current subsidies, reflecting on the grave consequences of one ill-advised decision.

Moreover, reducing development spending cannot be a sustainable feature of fiscal consolidation, particularly given the need to invest in infrastructure and building human capital. While private-public partnership can be an important supplement here, the role of the government cannot be supplanted. Also, it can hardly be overemphasized that increasing development expenditures would be

<table>
<thead>
<tr>
<th>Table 5.3: Composition of Current Expenditures</th>
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<tr>
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<tr>
<td></td>
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<tr>
<td><strong>Current expenditures</strong></td>
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<td><strong>of which</strong></td>
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<tr>
<td>Interest payments</td>
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<tr>
<td>Domestic</td>
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<tr>
<td>Foreign</td>
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<tr>
<td>Superannuation allowance</td>
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<tr>
<td>Grants (other than provinces)</td>
</tr>
<tr>
<td>Defence</td>
</tr>
<tr>
<td>Economic affairs</td>
</tr>
<tr>
<td>Health</td>
</tr>
<tr>
<td>Education affairs and services</td>
</tr>
<tr>
<td>Provincial</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance
crucial in dampening the negative effect of the global recession on Pakistan.

### 5.5 Budgetary Financing

The large drop in H1-FY09 fiscal deficit is clearly reflected in the negative growth of the sources of budgetary financing (see Table 5.4). The government received Rs 141.1 billion in gross external inflows in H1-FY09. However, Rs 104.1 billion external outflows on account of repayment of external debt left only Rs 37.0 billion, in net terms, for financing the budget deficit. With lesser availability of budgetary financing through external sources, government’s reliance on domestic financing increased sharply.

<table>
<thead>
<tr>
<th>Table 5.4: Sources of Financing (Jul-Dec)</th>
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<tbody>
<tr>
<td>billion Rupees</td>
</tr>
<tr>
<td>Total financing of budget</td>
</tr>
<tr>
<td>External resources (net)</td>
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<tr>
<td>Internal resources (net)</td>
</tr>
<tr>
<td>Banking system</td>
</tr>
<tr>
<td>Non-bank</td>
</tr>
<tr>
<td>Privatization proceeds</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance

1 Numbers in parenthesis represent share in domestic source of financing

Within domestic sources of budgetary financing, non-bank’s contribution also witnessed a strong contraction. Consequently, banking system had to meet much of the government’s budgetary requirements during H1-FY09. Thus, despite a 20.8 percent YoY decline in H1-FY09, the share of banking system in domestic sources of financing rose to 85.2 percent compared to 80.9 percent in the corresponding period last year.

Notwithstanding the continued pressure on the banking sector to finance the budget deficit, there is marked improvement in the composition of budgetary financing from the banking system in recent months. The share of SBP financing in total budgetary borrowing from the banking system fell to 114.1 percent at end-Dec 2008 compared to 187.0 percent in Q1-FY09 (see Figure 5.3). Government budgetary requirements from the central bank fell off as scheduled banks, being

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2 Budgetary financing from the banking system is worked out on cash basis and hence, these will differ from government borrowing numbers reported in the section on Money and Credit where data is measured on accrual basis.
hit by slow private credit demand and increased NPLs, were attracted towards risk-free government securities.

**Financing from the Banking sector**

January data on government borrowing reveal an expansion of Rs 51.6 billion in net budgetary financing from the banking sector. As a result, budgetary financing availed from the banking sector reached Rs 232.6 billion during Jul-Jan FY09 compared to Rs 188.8 billion in the same period of the preceding year.

During the first seven months of FY09, SBP provided Rs 249.5 billion, through issuance of fresh MRTBs, to the government for budgetary support. At the same time, government deposits with SBP (including other deposits) increased by Rs 13.0 billion that has pushed back the net budgetary financing in Jul-Jan FY09 to Rs 236 billion.

During Jul-Jan FY08, net financing from scheduled banks amounted to retirement of Rs 46.1 billion due to weak participation of the banks in government securities auction and expansion of government deposits with the banks. With perceived risks associated with credit to private sector during economic slowdown, banks’ interest in relatively risk-free government T-Bills has renewed since mid-November 2008. At the same time, government drew down a large part of its deposits held with scheduled banks during Jul-Jan FY09. As a result, net retirement from scheduled banks reduced to Rs 3.4 billion during Jul-Jan FY09 (see Figure 5.4).
**Financing from the Non Banks**

NSS, with net receipts of Rs 74.9 billion, remained the largest contributor in non bank sources of deficit financing. In an attempt to attract more resources through non-bank, the government revised the rate of return twice on some NSS instruments during the period under discussion. As a result, net receipts in NSS instruments grew at relatively faster pace in Jul-Jan FY09 compared to the same period last year. It is important to note that the Behbood Saving Certificate (BSC) and Pensioner Benefit Account (PBA) are called specialized investment instruments as these target the widows and pensioners and hence offer higher rates of return compared to other NSS instruments. Together these two instruments fetched Rs 49 billion for budgetary financing in Jul-JanFY09 (See Figure 5.5). The performance of other regular NSS instrument also improved in Jul-Jan FY09.

**5.6 FBR Tax Collection**

Growth in net tax collection during Jul-Jan FY09 accelerated to 23.0 percent against 10.8 percent during the same period last fiscal year (see Table 5.5). A break up of total tax collection shows that the double digit growth in all the four

<table>
<thead>
<tr>
<th>Table 5.5: FBR Tax Collection</th>
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<tbody>
<tr>
<td>billion Rupees</td>
<td></td>
</tr>
<tr>
<td>Net collection (Jul-Jan)</td>
<td>YoY change (%)</td>
</tr>
<tr>
<td>FY07</td>
<td>FY08</td>
</tr>
<tr>
<td>Direct taxes</td>
<td>185.2</td>
</tr>
<tr>
<td>Indirect taxes</td>
<td>277.5</td>
</tr>
<tr>
<td>Sales tax</td>
<td>171.0</td>
</tr>
<tr>
<td>FED</td>
<td>36.2</td>
</tr>
<tr>
<td>Customs</td>
<td>70.3</td>
</tr>
<tr>
<td>Total</td>
<td><strong>462.7</strong></td>
</tr>
</tbody>
</table>

Source: Federal Board of Revenue
taxes have helped accelerate this YoY growth in net tax collection.

Despite this strong growth, seven months tax collections for FY09 indicate a large shortfall in direct tax receipts. Though strong indirect tax collection during initial months of FY09 pull up the growth statistic for Jul-Jan FY09, monthly data show that receipts under sales tax and FED have started to weaken. Total tax collections (net) by FBR till January 2009 constitute 50.4 percent of Rs 1250 billion annual budget target and 48.5 percent of Rs 1300 billion revised IMF projections for FY09. At current levels of revenue collection, and given the severe economic slowdown in the country, FBR is likely to have hard time achieving even the Rs 1250 billion annual budget target for FY09.

**Direct Tax Collection**

Direct tax collection stood at Rs 235.3 billion during Jul-Jan FY09 against the FY09 annual budget target of Rs 499.0 billion. Although Jul-Jan FY09 direct tax receipts represent a growth of 22.8 percent YoY compared to 3.5 percent YoY in the same period last year, the increase is lower than the 28.7 percent YoY increase needed to achieve the annual budget target. Given that estimates for real GDP growth for FY09 indicate a big deceleration, the direct tax budget target for FY09 will be hard to achieve.

A break up of the direct tax collection, available for H1-FY09, reveals that more than half of net income tax came from “withholding taxes” followed by voluntary payments. The deceleration in advance tax payments witnessed in Q1-FY09 further deepened in Q2-FY09 reflecting weakening profitability of the corporate sector. With increased focus on audit and assessment of tax returns, FBR was able to collect a handsome Rs 29.9 billion on account of demand creation (see Table 5.6).

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<thead>
<tr>
<th>Table 5.6 : Major Components of Income Tax</th>
<th>Jul-Dec FY08</th>
<th>YoY % change</th>
<th>Share in Total FY09</th>
</tr>
</thead>
<tbody>
<tr>
<td>Voluntary payments</td>
<td>67.5</td>
<td>-35.8</td>
<td>42.8</td>
</tr>
<tr>
<td>Collection on demand</td>
<td>11.3</td>
<td>150.4</td>
<td>7.1</td>
</tr>
<tr>
<td>Withholding taxes</td>
<td>92.1</td>
<td>19.6</td>
<td>58.4</td>
</tr>
<tr>
<td>Others</td>
<td>0.1</td>
<td>-13.6</td>
<td>0.1</td>
</tr>
<tr>
<td>Gross collection</td>
<td>170.9</td>
<td>-8.4</td>
<td>108.4</td>
</tr>
<tr>
<td>Refund</td>
<td>13.2</td>
<td>-32.5</td>
<td>8.4</td>
</tr>
<tr>
<td><strong>Total net</strong></td>
<td><strong>157.2</strong></td>
<td><strong>-5.6</strong></td>
<td><strong>100.0</strong></td>
</tr>
</tbody>
</table>

Source: Federal Board of Revenue
Withholding tax (WHT) receipts grew by Rs 20.7 billion to reach Rs 112.8 billion during the first half of FY09, reflecting a YoY growth of 22.5 percent (see Table 5.7). Major heads contributing to withholding tax receipts were contracts (Rs 38.7 billion, up 23.4 percent YoY), imports (Rs 15 billion, up 19 percent) and salaries (Rs 12.0 billion, up 33.4 percent).

Indirect Taxes
Feeding on high international commodity prices and steep depreciation of Pak rupee, indirect taxes grew very strongly during the initial months of FY09, making up part of the shortfall in direct taxes. However, with sharp decline in world commodity prices and, consequently, in import growth, indirect tax receipts have started to weaken. Thus while Jul-Oct FY09 indirect tax receipts grew by 35.7 percent, the increase reduced to merely 7.4 percent YoY for Nov-Jan FY09. As a matter of fact, January 2009 receipts for the indirect taxes are Rs 0.9 billion less than January 2008 receipts, reflecting a contraction of 1.2 percent.

Sales tax receipts spearheaded the revenue effort during Jul-Jan FY09. During this period, net collections under sales tax grew by 25.5 percent YoY to reach Rs 250.0 billion, against annual budget target of Rs 470.0 billion. However, sales tax collections in recent months reveal a particular deceleration (see Figure 5.6). Detailed data related to the domestic source of sales tax, available for Jul-Dec FY09, depicts that POL products, telecom, natural gas and sugar were the main

<table>
<thead>
<tr>
<th>Table 5.7: Withholding Tax Collection (Jul-Dec)</th>
</tr>
</thead>
<tbody>
<tr>
<td>value in billion Rupees, change &amp; share in percent</td>
</tr>
<tr>
<td>Share in total</td>
</tr>
<tr>
<td>Imports</td>
</tr>
<tr>
<td>Salaries</td>
</tr>
<tr>
<td>Dividends</td>
</tr>
<tr>
<td>Securities</td>
</tr>
<tr>
<td>Contracts</td>
</tr>
<tr>
<td>Exports</td>
</tr>
<tr>
<td>Cash withdrawal from banks</td>
</tr>
<tr>
<td>Electricity bills</td>
</tr>
<tr>
<td>Telephone</td>
</tr>
<tr>
<td>Sub total</td>
</tr>
<tr>
<td>Others</td>
</tr>
<tr>
<td>Gross total</td>
</tr>
</tbody>
</table>

Source: Federal Board of Revenue

Figure 5.6: YoY Growth in Monthly Sales Tax

Monthly
Cumulative

<table>
<thead>
<tr>
<th>Month</th>
<th>Percent</th>
</tr>
</thead>
<tbody>
<tr>
<td>Jul</td>
<td>22.5</td>
</tr>
<tr>
<td>Aug</td>
<td>35.7</td>
</tr>
<tr>
<td>Sep</td>
<td>48.2</td>
</tr>
<tr>
<td>Oct</td>
<td>53.1</td>
</tr>
<tr>
<td>Nov</td>
<td>53.1</td>
</tr>
<tr>
<td>Dec</td>
<td>53.1</td>
</tr>
<tr>
<td>Jan</td>
<td>53.1</td>
</tr>
</tbody>
</table>
domestic sources of revenue (see Table 5.8).

Federal excise duty stood at Rs 61.7 billion during first seven months of current fiscal year showing a YoY growth of 33.1 percent. A break up of the FED, available for Jul-Dec FY09 shows that the major revenue came from the cigarettes (Rs 15.5 billion) followed by cement (Rs 8.6 billion). FED receipts from beverages were Rs 5.5 billion and that of natural gas stood at Rs 3 billion during H1-FY09. The collection of FED from services stood at Rs 8.2 billion during July-Dec FY09 against Rs 5.1 billion in the same period last fiscal year.

Adding Rs 7.9 billion more during Jul-Jan FY09 than the corresponding period a year earlier, net collections from custom duty reached Rs 83.4 billion against the annual budget target of Rs 169.0 billion.

### 5.7 Provincial Fiscal Operations

Notwithstanding the apparent deceleration in total revenues, consolidated provincial public finance recorded a substantial surplus in overall balance during H1-FY09 as total expenditures witnessed 8.7 percent YoY decline to reach Rs 294.4 billion (see Table 5.9). Province-wise details show that while the other three provinces recorded surpluses in their respective overall balance Sindh experienced a deficit in H1-FY09 (see Table 5.10). However, the large

---

**Table 5.8: Major Revenue Spinners of Sales Tax (domestic) (Jul-Dec)**

<table>
<thead>
<tr>
<th></th>
<th>FY08</th>
<th>FY09</th>
<th>% change</th>
<th>Share in total</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>%</td>
<td></td>
<td></td>
<td>FY08</td>
</tr>
<tr>
<td>Telecom services</td>
<td>21.8</td>
<td>23.5</td>
<td>7.9</td>
<td>24.6</td>
</tr>
<tr>
<td>POL products</td>
<td>9.2</td>
<td>39.6</td>
<td>331.7</td>
<td>10.4</td>
</tr>
<tr>
<td>Natural gas</td>
<td>8.1</td>
<td>10.0</td>
<td>23.1</td>
<td>9.1</td>
</tr>
<tr>
<td>Sugar</td>
<td>5.1</td>
<td>4.5</td>
<td>-11.1</td>
<td>5.8</td>
</tr>
<tr>
<td>Cigarettes</td>
<td>4.0</td>
<td>4.0</td>
<td>1.1</td>
<td>4.5</td>
</tr>
<tr>
<td>Cement</td>
<td>1.7</td>
<td>1.8</td>
<td>4.7</td>
<td>2.0</td>
</tr>
<tr>
<td>Tea</td>
<td>1.3</td>
<td>1.6</td>
<td>17.9</td>
<td>1.5</td>
</tr>
<tr>
<td>Beverages</td>
<td>1.8</td>
<td>1.6</td>
<td>-14.2</td>
<td>2.0</td>
</tr>
<tr>
<td>Auto parts</td>
<td>1.0</td>
<td>0.7</td>
<td>-26.1</td>
<td>1.1</td>
</tr>
<tr>
<td>Food products</td>
<td>0.5</td>
<td>0.7</td>
<td>43.1</td>
<td>0.6</td>
</tr>
<tr>
<td>Sub total</td>
<td>54.5</td>
<td>88.1</td>
<td>61.5</td>
<td>61.5</td>
</tr>
<tr>
<td>Others</td>
<td>34.1</td>
<td>38.0</td>
<td>11.4</td>
<td>38.5</td>
</tr>
<tr>
<td>Total (gross)</td>
<td>88.6</td>
<td>126.1</td>
<td>42.3</td>
<td>100.0</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: Federal Board of Revenue
overall balance in H1-FY09 does not necessarily indicate an improvement in fiscal performance of the provinces as the decline in total expenditures was produced mainly through 52.6 percent cut in development spending. As a result, the share of development spending in total expenditures nearly halved from the H1-FY08 level (see Figure 5.7).

On the other hand, current expenditures registered only a slight deceleration during H1-FY09. Specifically, current expenditures stood at Rs 245.0 billion during H1-FY09, with an increase of 12.2 percent compared to a rise of 16.6 percent in the corresponding period last year.

<table>
<thead>
<tr>
<th>Table 5.9: Summary of Consolidated Provincial Finance</th>
<th>Jul-Dec</th>
<th>FY07</th>
<th>FY08</th>
<th>FY09</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total revenue</td>
<td>215.7</td>
<td>285.2</td>
<td>326.4</td>
<td></td>
</tr>
<tr>
<td>Provincial share in federal revenue</td>
<td>170.2</td>
<td>187.4</td>
<td>250.6</td>
<td></td>
</tr>
<tr>
<td>Provincial taxes</td>
<td>17.0</td>
<td>18.2</td>
<td>22.0</td>
<td></td>
</tr>
<tr>
<td>Property taxes</td>
<td>1.7</td>
<td>2.0</td>
<td>2.5</td>
<td></td>
</tr>
<tr>
<td>Excise duties</td>
<td>1.0</td>
<td>1.3</td>
<td>1.5</td>
<td></td>
</tr>
<tr>
<td>Stamp duties</td>
<td>4.7</td>
<td>5.3</td>
<td>5.0</td>
<td></td>
</tr>
<tr>
<td>Motor vehicle tax</td>
<td>3.9</td>
<td>3.9</td>
<td>3.5</td>
<td></td>
</tr>
<tr>
<td>Others</td>
<td>5.8</td>
<td>5.8</td>
<td>9.4</td>
<td></td>
</tr>
<tr>
<td>Provincial non-tax</td>
<td>18.3</td>
<td>34.2</td>
<td>24.7</td>
<td></td>
</tr>
<tr>
<td>Interest</td>
<td>0.1</td>
<td>9.8</td>
<td>0.1</td>
<td></td>
</tr>
<tr>
<td>Irrigation</td>
<td>0.9</td>
<td>1.0</td>
<td>1.2</td>
<td></td>
</tr>
<tr>
<td>Others</td>
<td>17.3</td>
<td>23.1</td>
<td>23.5</td>
<td></td>
</tr>
<tr>
<td>Federal loans and transfers/grants</td>
<td>10.3</td>
<td>45.4</td>
<td>29.2</td>
<td></td>
</tr>
<tr>
<td>Loans (net)</td>
<td>-4.4</td>
<td>3.7</td>
<td>1.8</td>
<td></td>
</tr>
<tr>
<td>Grants</td>
<td>14.7</td>
<td>16.3</td>
<td>19.2</td>
<td></td>
</tr>
<tr>
<td>Grant for dev. expenditure</td>
<td>0.0</td>
<td>25.4</td>
<td>8.2</td>
<td></td>
</tr>
<tr>
<td>Total expenditure</td>
<td>242.7</td>
<td>322.4</td>
<td>294.4</td>
<td></td>
</tr>
<tr>
<td>Current expenditure</td>
<td>187.2</td>
<td>218.3</td>
<td>245.0</td>
<td></td>
</tr>
<tr>
<td>Development expenditure</td>
<td>55.4</td>
<td>104.2</td>
<td>49.4</td>
<td></td>
</tr>
<tr>
<td>Overall balance</td>
<td>-26.9</td>
<td>-37.2</td>
<td>32.1</td>
<td></td>
</tr>
</tbody>
</table>

Source: Ministry of Finance

<table>
<thead>
<tr>
<th>Table 5.10: Provincial Finance during Jul-Dec</th>
<th>Punjab</th>
<th>Sindh</th>
<th>NWFP</th>
<th>Balochistan</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>FY08</td>
<td>FY09</td>
<td>FY08</td>
<td>FY09</td>
</tr>
<tr>
<td>Total revenue</td>
<td>144.1</td>
<td>159.8</td>
<td>78.4</td>
<td>89.9</td>
</tr>
<tr>
<td>Provincial share in federal revenue</td>
<td>94.2</td>
<td>124.0</td>
<td>56.8</td>
<td>76.7</td>
</tr>
<tr>
<td>Provincial taxes</td>
<td>9.8</td>
<td>10.2</td>
<td>7.0</td>
<td>10.4</td>
</tr>
<tr>
<td>Provincial non-tax</td>
<td>22.8</td>
<td>19.7</td>
<td>3.9</td>
<td>1.8</td>
</tr>
<tr>
<td>Federal loans and transfers/grants</td>
<td>17.3</td>
<td>6.0</td>
<td>10.6</td>
<td>1.0</td>
</tr>
<tr>
<td>Total Expenditure</td>
<td>173.9</td>
<td>148.9</td>
<td>86.1</td>
<td>94.0</td>
</tr>
<tr>
<td>Current expenditure</td>
<td>102.3</td>
<td>120.2</td>
<td>71.9</td>
<td>83.1</td>
</tr>
<tr>
<td>Development expenditure</td>
<td>71.6</td>
<td>28.7</td>
<td>14.2</td>
<td>11.0</td>
</tr>
<tr>
<td>Overall balance</td>
<td>-29.8</td>
<td>10.8</td>
<td>-7.7</td>
<td>-4.1</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance
Growth in total revenues decelerated during H1-FY09 due to declines in both non-tax revenues and federal government loans and grants to the provinces. However, this was more than offset by Rs 63.1 billion increase in federal tax assignments to the provinces during H1-FY09. The high growth in provincial share in federal revenues during H1-FY09 was caused by larger divisible pool following strong growth in indirect taxes.

5.7 Domestic Debt
Despite sizeable reduction in fiscal deficit in H1-FY09, domestic debt recorded net addition of Rs 341.0 billion till January 2009. This strong growth in domestic debt reflects non-realization of privatization proceeds and reduced availability of net external financing due to increase in external debt repayments on maturing stock of foreign currency bonds. Notwithstanding the large increase in domestic debt, and the stock of domestic debt at Rs 3.6 trillion, the ratio of domestic debt to estimated FY09 GDP declined to 27.0 percent after rising slightly in FY08 (see Figure 5.8).

Composition of Domestic Debt
Although growth in short term debt decelerated during Jul-Jan FY09, the increase of 16.3 percent in the outstanding stock of short term debt is still quite strong (see Figure 5.9). As a result, despite the deceleration, the share of short term debt in total domestic debt strengthened by 6.9 percentage point to reach 52.8 percent due to an even weaker growth in long term debt.
The breakup of the domestic debt data reveals that the outstanding stock of permanent debt stood at Rs 609.1 billion at the end of January 2009 (see Table 5.11). In contrast to a substantial rise of Rs 44.5 billion during Jul-Jan FY08, the stock of PIBs depleted by Rs 12.5 billion during H1-FY09. With short term interest rates on the rise during Jul-Jan FY09, only Rs 3.6 billion (gross) were collected in the single PIB auction held during the current fiscal year. In the meantime, maturities of Rs 16.1 billion during this period resulted in contraction of PIB stock as on January 2009. On the other hand, the government fetched Rs 12.5 billion through two successful GoP Ijara Sukuk bond auction during Jul-Jan FY09. The inflows through Ijara Sukuk bond offset the repayment on the matured stock of PIB, leaving the overall stock of permanent debt almost unchanged.

Floating debt rose by 16.3 percent in Jul-Jan FY09, compared to 21.2 percent in corresponding period last year. The stock of T-bill holdings by SBP still constitute a major share in floating debt, reflecting government’s heavy reliance, in the past 16 months, on the central bank to finance the budget deficit. The outstanding stock of MRTBs went up by 18.3 percent in Jul-Jan FY09 compared to a rise of 56.3 percent in the same period last year. However a notable development was seen when the government retired MRTBs of worth Rs 80.8 billion in December 2008. This was made possible by renewed interest of commercial banks in T-bill auctions.

Unfunded debt showed increase of 7.2 percent to reach Rs 72.9 billion during Jul-Jan FY09. Gross receipts from sale of NSS instruments stood at Rs 687.0 billion in the period under discussion (see Figure 5.10). Gross sales of major NSS

<table>
<thead>
<tr>
<th>Table 5.11: Gross Receipts and Payments (Jul-Jan)</th>
</tr>
</thead>
<tbody>
<tr>
<td>billion Rupees</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>FY08</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Permanent</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>of which</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>PIB</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Ijara Sukuk</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Floating</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>of which</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>MRTBs*</td>
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<tr>
<td></td>
</tr>
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<td>MTBs</td>
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<td></td>
</tr>
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<td>Total</td>
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<td>Permanent</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>of which</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>PIB</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Ijara Sukuk</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Floating</td>
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<tr>
<td></td>
</tr>
<tr>
<td>of which</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>MRTBs*</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>MTBs</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Total</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>* Inclusive of outright sale of MTBs to commercial banks</td>
</tr>
</tbody>
</table>

- Gross receipts
- Repayments
- Debt (end Jan)

<table>
<thead>
<tr>
<th>FY08</th>
<th>FY09</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross receipts</td>
<td>Repayments</td>
</tr>
<tr>
<td>Permanent</td>
<td>123.3</td>
</tr>
<tr>
<td>of which</td>
<td></td>
</tr>
<tr>
<td>PIB</td>
<td>54.6</td>
</tr>
<tr>
<td>Ijara Sukuk</td>
<td>0.0</td>
</tr>
<tr>
<td>Floating</td>
<td>1170.9</td>
</tr>
<tr>
<td>of which</td>
<td></td>
</tr>
<tr>
<td>MRTBs*</td>
<td>819.2</td>
</tr>
<tr>
<td>MTBs</td>
<td>351.7</td>
</tr>
<tr>
<td>Unfunded</td>
<td>257.5</td>
</tr>
<tr>
<td>Total</td>
<td>1551.7</td>
</tr>
</tbody>
</table>
The State of Pakistan’s Economy

instruments, i.e., Behbood Saving Certificate (BSC), Special Saving Certificate (SSC) and Pensioner Benefit Account (PBA) went up significantly during the period. However, massive encashment of these instruments (including early encashment) has pushed the net receipts to a much lower level. The less than expected inflow through NSS instruments has forced the government to twice revise upwards the rate of return on major NSS instruments, in a span of three months. Recently, the government has provided the facility of free conversion toward higher rate of return for existing holder of the BSC and PBA. These steps are expected to help the government in mobilizing more funds through NSS instruments in the remaining months of the current fiscal year.

**Domestic Debt Servicing**

During Jul-Jan FY09, the debt servicing cost of the domestic debt increased to Rs 288.2 billion (see Figure 5.11). The breakup of domestic debt servicing data reveals that there is a sharp increase in floating debt servicing cost. The surge in the floating debt stock to finance the large budget deficit in FY08, coupled with the hikes in the interest rates, pushed the share of interest payment on floating debt in total domestic debt servicing to 44.4 percent in Jul-Jan FY09 from 22.4 percent in the same period of the preceding year. Even as interest payments on unfunded debt declined during Jul-Jan FY09 compared to the same period last year, debt servicing cost of the unfunded debt still constitutes a major share in total domestic debt servicing.

**Figure 5.10: Gross & Net Receipts of NSS (Jul-Jan)**

- Gross receipts
- Net receipts

**Figure 5.11: Domestic Debt Servicing (Jul-Jan)**

- Permanent debt
- Floating debt
- Unfunded debt
The recent decline in interest payments on unfunded debt indicates easing of payment pressure on account of maturities of high-interest rate DSCs of late 1990s. On the other hand the debt servicing cost of BSC and PBA is expected to increase in future due to their nature of coupon payments and relatively better interest rate structure among others schemes.
6 External Sector

6.1 Overview
After a sharp deterioration in Jul-Oct FY09, Pakistan’s overall external account balance improved noticeably in the ensuing months, (see Table 6.1) aided by lower current account deficits and a modest revival of financial inflows. Consequently, foreign exchange reserves increased and rupee also recovered part of its losses suffered during the Jul-Oct FY09 period (see Figure 6.1). Thus the aggregate 83.9 percent growth in overall external account deficit during the first eight months of FY09 accrued essentially during the first four months of the period.

Table 6.1: Summary of External Accounts

<table>
<thead>
<tr>
<th></th>
<th>FY08 Jul-Feb</th>
<th>FY08 Nov-Feb</th>
<th>FY09 Jul-Feb</th>
<th>FY09 Nov-Feb</th>
</tr>
</thead>
<tbody>
<tr>
<td>A-Current A/c balance</td>
<td>-8.6</td>
<td>-5.7</td>
<td>-7.5</td>
<td>-1.5</td>
</tr>
<tr>
<td>i) Trade balance</td>
<td>-9.3</td>
<td>-5.9</td>
<td>-8.9</td>
<td>-3.0</td>
</tr>
<tr>
<td>Exports</td>
<td>12.5</td>
<td>6.3</td>
<td>13.0</td>
<td>5.9</td>
</tr>
<tr>
<td>YoY growth (%)</td>
<td>13.8</td>
<td>14.3</td>
<td>4.3</td>
<td>-7.0</td>
</tr>
<tr>
<td>Imports</td>
<td>21.8</td>
<td>12.2</td>
<td>21.9</td>
<td>8.9</td>
</tr>
<tr>
<td>YoY growth (%)</td>
<td>20.8</td>
<td>37.6</td>
<td>0.5</td>
<td>-27.6</td>
</tr>
<tr>
<td>ii) Invisible balance</td>
<td>0.6</td>
<td>0.3</td>
<td>1.4</td>
<td>1.5</td>
</tr>
<tr>
<td>Remittances</td>
<td>4.1</td>
<td>2.0</td>
<td>4.9</td>
<td>2.6</td>
</tr>
<tr>
<td>B-Financial/cap balance</td>
<td>4.9</td>
<td>1.8</td>
<td>2.5</td>
<td>1.9</td>
</tr>
<tr>
<td>i) FDI</td>
<td>2.5</td>
<td>1.2</td>
<td>2.8</td>
<td>1.5</td>
</tr>
<tr>
<td>ii) FPI</td>
<td>0.1</td>
<td>-0.2</td>
<td>-0.9</td>
<td>-0.7</td>
</tr>
<tr>
<td>iii) Other investment</td>
<td>2.2</td>
<td>0.7</td>
<td>0.5</td>
<td>1.2</td>
</tr>
<tr>
<td>C-Errors &amp; omissions</td>
<td>0.7</td>
<td>0.9</td>
<td>-0.2</td>
<td>-0.3</td>
</tr>
<tr>
<td>D-Overall balance</td>
<td>-3.1</td>
<td>-3.0</td>
<td>-5.2</td>
<td>0.1</td>
</tr>
</tbody>
</table>

A significant part of the Jul-Oct FY09 deterioration in the current account owed to a steep rise in import growth mainly on account of higher import prices. The subsequent improvement owed to both, a lower quantum of imports (as demand was compressed by monetary tightening and a weaker rupee) as well as large fall in import prices (see Table 6.2). Specifically, the import bill registered a 27.6 percent YoY decline during Nov-Feb FY09 against an extraordinary growth of 37.6 percent in the comparable period last year (see Table 6.1).

The contraction in the import bill complemented the rise in remittances to contain the current account deficit. However, weakening in exports growth and lower earnings on foreign exchange reserves offset some of the gains.
Similarly, financial inflows which had dried up in Jul-Oct FY09 period revived to some extent following the availability of IMF support for Pakistan’s macroeconomic stabilization program in November FY09 (see Figure 6.1). IMF support encouraged the foreign inflows in two ways. On the one hand it helped stabilize exchange rate which, in turn, decelerated the retirement of FE-25 loans and discouraged holdings of outstanding export bills. On the other hand, it helped somewhat in restoring foreign investor’s confidence and led to the release of bilateral and multilateral loans. As a result, the surplus in the financial account increased to US$ 1.9 billion during Nov-Feb FY09 period from a meager amount of US$ 0.5 billion during Jul-Oct FY09.

**Potential Risks to Future Outlook**

On the flip side, falling export prices and decline demand, amid of a recession in Pakistan’s major export markets compounded by the impact of domestic power

---

1 S&P upgraded Pakistan’s credit rating from CCC to CCC+ on December 18, 2008.
2 Support from IMF is not included in capital and financial account inflows.
shortages have adversely impacted Pakistan’s exports in the recent months. Specifically, during Nov-Feb FY09, Pakistan’s exports have declined by 7.0 percent compared with 14.3 percent YoY growth in the comparable months of the previous year.

Moreover, workers’ remittances which showed impressive growth so far may be hurt by world economic recession in the medium to long term (see Table 6.3). For instance, sharp fall in oil prices may reduce the demand for additional migrants in the oil rich gulf region which accounts for more than 50 percent of Pakistan’s overall remittances receipts. Likewise, deep recession in US, which contributes close to one third of Pakistan’s remittances, could also hurt remittances flows to Pakistan in the months ahead. However, in the short run, remittances are expected to show resilience to recession in the source countries (see Box 1). Similarly, notwithstanding the modest revival in foreign direct investment, overall foreign investment declined during Jul-Feb FY09 (mainly on

<table>
<thead>
<tr>
<th>Table 6.3: Potential Risk for Pakistan’s External Accounts</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
</tr>
<tr>
<td>-------</td>
</tr>
<tr>
<td>World GDP growth**</td>
</tr>
<tr>
<td>US**</td>
</tr>
<tr>
<td>EU**</td>
</tr>
<tr>
<td>Advance economies import growth**</td>
</tr>
<tr>
<td>World unemployment rate*</td>
</tr>
<tr>
<td>Developed economies and European Union*</td>
</tr>
<tr>
<td>Middle East*</td>
</tr>
<tr>
<td>Sugarcane production (million ton)***</td>
</tr>
<tr>
<td>Global liquidity (TED spread)†</td>
</tr>
</tbody>
</table>

* International Labor Organization report on global employment trends January 2009
** World Economic Outlook Update January 2009
*** Fiscal Year p projected
† TED spread is a measure to summarize credit strain in the financial markets. Usually the TED spread is less than 0.5%. The higher the spread, the greater the perceived credit risk.

<table>
<thead>
<tr>
<th>Table 6.4: Major Inflows Vulnerable to US Recession</th>
</tr>
</thead>
<tbody>
<tr>
<td>million US$</td>
</tr>
<tr>
<td>Jul-Jan FY08</td>
</tr>
<tr>
<td>Total</td>
</tr>
<tr>
<td>-------</td>
</tr>
<tr>
<td>Exports BOP</td>
</tr>
<tr>
<td>Remittances</td>
</tr>
<tr>
<td>Foreign private investment</td>
</tr>
<tr>
<td>of which:</td>
</tr>
<tr>
<td>Direct investment</td>
</tr>
<tr>
<td>Portfolio investment</td>
</tr>
<tr>
<td>Total Inflows</td>
</tr>
</tbody>
</table>
account of net outflow from portfolio investment) in the wake of sluggish performance of stock market, euro bond payment, poor law and order situation and liquidity crunch in the international market. With more than one third of foreign investment inflows originating from US, which is worst hit by the ongoing financial crises, the chances of considerable improvement in these inflows in the coming months remain dim (see Table 6.4).

In this backdrop, maintaining growth in foreign exchange inflows would be challenging going forward. Therefore, there is an urgent need to devise a strategy to mitigate the downside risks to Pakistan’s external inflows. For instance, efforts to raise productivity, address power shortages and trade diplomacy to get preferential market access are critical factors for protecting export market shares.

In the same way, workers’ remittances can be promoted by facilitating international travel documents, providing investment advisories services at migrants’ hometowns, strengthening financial sector infrastructure, and making efforts for greater labor mobility under the mode four of General Agreement on Trade in Services (GATS). Regarding foreign investment, efforts to improve law & order situation, better infrastructure

<table>
<thead>
<tr>
<th>Table 6.1.1: Cross Country Comparison of Remittances Flows Stability Against Other Capital Flows</th>
</tr>
</thead>
<tbody>
<tr>
<td>(measured by Coefficient of Variation)</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Q1-1980-Q4-2007</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Q1-1980-Q4-1989</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Q1-1990-Q4-1999</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Q1-2000-Q4-2007</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

1 Indian data is available up to Q4-2006.  
2 Indian Investment data is available from Q1-1991 onward.  
3 Srilankan portfolio investment data is available from Q1-1991 onward.  
4 Foreign investment data is available from Q1-1983 onward.
and controlling the factors that increase start-up costs might encourage foreign direct investment.

**Box-6.1.1: Workers’ Remittances as a Stable Source of Foreign Inflows**

After exports, worker’s remittances are the second largest source of foreign exchange earnings in Pakistan. In recent years, its impressive growth has moderated the widening of current account deficit as it more than offset the deficit in services and income account. However, there are downside risks to remittances growth in the wake of ongoing recession in the source countries. In this backdrop, a comparison is made between the stability of remittances and other capital inflows over the longer period of time to business cycles in home and host countries.

To conduct this exercise, quarterly data on workers’ remittances, foreign direct investment, foreign portfolio investment and other investments from 1980 to 2007 is taken from IMF balance of payment statistics. The countries chosen are Pakistan, Philippine, India, Sri Lanka, and Bangladesh. The coefficient of variation is used as measure of dispersions as it is more appropriate when comparing between data sets with widely different means.

The comparison of different capital flows show that remittances are one of the least volatile sources of foreign exchange earnings in almost all of these countries. Moreover, remittances have shown remarkable stability over time (see Table 6.1.1). Thus, it may be argued that remittances react less violently to economic cycles (both in source and recipient countries) than the other form of capital flows.

The relative stability of workers’ remittances to economic down turn in source countries may be attributed to the following factors: a) remittances are small part of the workers income and migrants continue to send remittances even hit by adverse income shock, b) if migrants return, they are likely to take back accumulated savings and c) developed countries may offer some income protection to migrant workers during economic downturns.

In this scenario, Pakistan’s remittances flows are likely to increase in the short run. Apart from the above mentioned factors, the recent action against the informal transfer of funds may also divert a part of the informal flows to formal channel. Moreover, migrants are likely to remit more to meet the increasing cost of living of their families at home in the wake of strong inflationary pressures. Likewise, predominant proportion of remittances is intended for consumption purposes which are less volatile than those intended for investment.

**6.2 Current Account Balance**

In sharp contrast to extraordinary YoY expansion of 47.6 percent in the comparable period last year, current account deficit contracted by 13.8 percent during Jul-Feb FY09. This contraction entirely stemmed from the Nov-Feb FY09 period (see Figure 6.2), during which current account deficit declined by 74.3 percent compared with the same period last year.

---

3 Doing Business Report for 2009 shows that Pakistan’s ranking in starting a business has deteriorated from 64th in 2008 to 77th in 2009.
The improvement in the current account deficit in the latter period was contributed by both, a substantial contraction in the trade deficit and a surplus in the invisibles account. The contraction in the former was mainly the result of substantial fall in import bill on the back of lower import prices, subsiding demand pressures and exchange rate depreciation while improvement in the latter emanated from decrease in freight charges, receipt of logistic support payments and impressive growth in worker’s remittances (see Figure 6.3).

While falling global commodity prices, amid world economic recession, benefitted Pakistan in the form of lower import bill it has also lowered Pakistan’s export earnings and poses risk to remittances growth in the medium to long term. In particular, if the global recession prolongs, the aforementioned risks may hamper improvement in current account deficit going forward.

6.2.1 Trade Account
Trade deficit showed YoY contraction of 4.6 percent during Jul-Feb FY09 against a 31.5 percent expansion in the comparable period of last

---

4 This section is based on exchange record data compiled by SBP that does not tally with the Custom data compiled by FBS due to inclusion of freight and insurance costs in the latter imports, difference in coverage, times leads and lags involved in recording etc.
year, largely reflecting extraordinary slowdown in import growth. However, what is worrisome is the concurrent slow down in export growth which slowed to 4.3 percent during Jul-Feb FY09 from reasonable growth of 13.8 percent in the same period last year.

Slowdown in export growth during Jul-Feb FY09 period is mainly explained by decline in textile exports on the back of shrinking demand in Pakistan’s major export markets as a result of ongoing global economic recession. Unfortunately, there are also signs of slowdown in non textile exports in the last four months which were hitherto showing strong growth. 5

As mentioned earlier, YoY growth in imports slowed down to only 0.5 percent during Jul-Feb FY09 from 20.8 in the corresponding period last year.

6.2.2 Services (net)
In sharp contrast to Jul-Feb trend of last six years, the deficit in services trade declined by 36.0 percent during Jul-Feb FY09. Lower outflow from foreign exchange companies 6, logistic support receipts and deceleration in freight related charges on account of slowdown in import growth were the major contributory factors behind this decline.

In this regard, close to three fourth of this decline was witnessed during Nov-Feb

<table>
<thead>
<tr>
<th>Table 6.5: Services Account Balance</th>
<th>Jul-Feb</th>
<th>Absolute change</th>
<th>Nov-Feb</th>
<th>Absolute change</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>FY08</td>
<td>FY09</td>
<td></td>
<td>FY08</td>
</tr>
<tr>
<td>Transportation</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>of which freight</td>
<td>-1,628.0</td>
<td>-1,625.0</td>
<td>3.0</td>
<td>-911.0</td>
</tr>
<tr>
<td>Travel</td>
<td>-1,705.0</td>
<td>-1,752.0</td>
<td>-47.0</td>
<td>-963.0</td>
</tr>
<tr>
<td>of which exchange companies</td>
<td>-872.0</td>
<td>-675.0</td>
<td>197.0</td>
<td>-502.0</td>
</tr>
<tr>
<td>Other business services</td>
<td>-1,937.0</td>
<td>-837.0</td>
<td>1,100.0</td>
<td>-976.0</td>
</tr>
<tr>
<td>of which exchange companies</td>
<td>-1,653.0</td>
<td>-476.0</td>
<td>1,177.0</td>
<td>-843.0</td>
</tr>
<tr>
<td>Government services</td>
<td>407.0</td>
<td>621.0</td>
<td>214.0</td>
<td>387.0</td>
</tr>
<tr>
<td>of which logistic support</td>
<td>282.0</td>
<td>465.0</td>
<td>183.0</td>
<td>282.0</td>
</tr>
<tr>
<td>Others</td>
<td>-207.0</td>
<td>-197.0</td>
<td>10.0</td>
<td>-113.0</td>
</tr>
<tr>
<td>Services(net)</td>
<td>-4237.0</td>
<td>-2713.0</td>
<td>1524.0</td>
<td>-2115.0</td>
</tr>
</tbody>
</table>

---

5 For detail, please see section on foreign trade.
6 The outflows from exchange companies have been declining since May-2008 when exchange companies outflows for legal transactions were restricted to 75 percent of the home remittances mobilized by them during the preceding month (FE circular No. 04, dated May 09, 2008).
FY09 period. This relatively larger decline during this period mainly owed to significant decline in import related freight charges and sharp fall in outflows from foreign exchange companies in the aftermath of action against undocumented fund transfer (see Table 6.5).

<table>
<thead>
<tr>
<th>Table 6.6: Current Account Balance</th>
<th>FY08</th>
<th>FY09*</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Jul-Feb</td>
<td>Nov-Feb</td>
</tr>
<tr>
<td>1. Trade balance</td>
<td>-9,293.7</td>
<td>-5,938.0</td>
</tr>
<tr>
<td>Exports</td>
<td>12,482.0</td>
<td>6,297.0</td>
</tr>
<tr>
<td>Imports</td>
<td>21,775.7</td>
<td>12,235.0</td>
</tr>
<tr>
<td>2. Services (net)</td>
<td>-4,237.0</td>
<td>-2,115.0</td>
</tr>
<tr>
<td>Transportation</td>
<td>-1,628.0</td>
<td>-911.0</td>
</tr>
<tr>
<td>Travel</td>
<td>-872.0</td>
<td>-502.0</td>
</tr>
<tr>
<td>Communication services</td>
<td>19.0</td>
<td>-4.0</td>
</tr>
<tr>
<td>Construction services</td>
<td>-13.0</td>
<td>-11.0</td>
</tr>
<tr>
<td>Insurance services</td>
<td>-88.0</td>
<td>-35.0</td>
</tr>
<tr>
<td>Financial services</td>
<td>-81.0</td>
<td>-63.0</td>
</tr>
<tr>
<td>Computer &amp; information services</td>
<td>5.0</td>
<td>11.0</td>
</tr>
<tr>
<td>Royalties and license fees</td>
<td>-49.0</td>
<td>-11.0</td>
</tr>
<tr>
<td>Other business services</td>
<td>-1,937.0</td>
<td>-976.0</td>
</tr>
<tr>
<td>Personal &amp; cultural &amp; recreational services</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Government services</td>
<td>407.0</td>
<td>387.0</td>
</tr>
<tr>
<td>Of which logistic support</td>
<td>282.0</td>
<td>282.0</td>
</tr>
<tr>
<td>3. Income (net)</td>
<td>-2,428.0</td>
<td>-1,201.0</td>
</tr>
<tr>
<td>Investment income (net)</td>
<td>-2,433.0</td>
<td>-1,205.0</td>
</tr>
<tr>
<td>Direct investment</td>
<td>-2,047.0</td>
<td>-982.0</td>
</tr>
<tr>
<td>of which: profit &amp; dividends</td>
<td>-423.0</td>
<td>-161.0</td>
</tr>
<tr>
<td>purchase of crude oil and minerals</td>
<td>-971.0</td>
<td>-485.0</td>
</tr>
<tr>
<td>Portfolio investment</td>
<td>-149.0</td>
<td>-61.0</td>
</tr>
<tr>
<td>Of which: dividend</td>
<td>-134.0</td>
<td>-91.0</td>
</tr>
<tr>
<td>IMF charges &amp; interest on off. external debt</td>
<td>-436.0</td>
<td>-294.0</td>
</tr>
<tr>
<td>Interest on private external debt</td>
<td>-115.0</td>
<td>-60.0</td>
</tr>
<tr>
<td>Others (net)</td>
<td>319.0</td>
<td>196.0</td>
</tr>
<tr>
<td>4. Current transfers (net)</td>
<td>7,314.0</td>
<td>3,602.0</td>
</tr>
<tr>
<td>Private transfers</td>
<td>7,259.0</td>
<td>3,566.0</td>
</tr>
<tr>
<td>Workers remittance</td>
<td>4,124.0</td>
<td>2,045.0</td>
</tr>
<tr>
<td>FCA - residents</td>
<td>287.0</td>
<td>84.0</td>
</tr>
<tr>
<td>Others</td>
<td>2,848.0</td>
<td>1,437.0</td>
</tr>
<tr>
<td>of which exchange companies</td>
<td>1,526.0</td>
<td>782.0</td>
</tr>
<tr>
<td>Official transfers</td>
<td>55.0</td>
<td>36.0</td>
</tr>
<tr>
<td>Current account balance</td>
<td>-8,644.7</td>
<td>-5,652.0</td>
</tr>
</tbody>
</table>

* Provisional
6.2.3 Income (net)
Deterioration in income account deficit accelerated to 20.4 percent during Jul-Feb FY09 from a benign growth of 3.3 percent in the comparable period of last year. While a rise in investment income outflow also contributed to this deterioration, a large part of the acceleration was driven by an increase in interest (net) payments during the period under review.

The modest rise in investment income outflows was entirely explained by higher purchase of crude oil and minerals whereas the repatriation of profit and dividends registered decline during the period under consideration. This latter largely reflects sharp fall in repatriation of profit and dividends by the telecommunication sector on account of PTCL’s lower profits owing to its Voluntary Separation Scheme (VSS). Moreover, lower profitability of banks on the back of increased non-performing loans also contributed to decline in repatriation of profit and dividend during the period under review.

On the other hand, oil & gas exploration, petroleum refining and power sector registered small increase in repatriation of profit and dividends during the period under consideration (see Figure 6.4).

Unlike the previous years when growth in interest income on foreign reserves

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7 The repatriation of profit and dividends by PTCL declined to US$ 1.2 million during Jul-Jan FY09 from US$ 47.0 million during same period last year.
offset a significant part of the increase in interest payments, substantial fall in these earnings during Jul-Feb FY09 increased net interest payments (see Figure 6.5). Specifically, net interest payment increased by US$ 207 million during Jul-Feb FY09.

### 6.2.4 Current Transfers

Against the respectable growth of 11.4 percent last year, current transfer declined by 3.7 percent during Jul-Feb FY09. With the robust growth in workers’ remittances during the period, this decline was largely driven by fall in other inflows from foreign exchange companies. Moreover, outflow from resident foreign currency account also contributed to this decline (see Table 6.6).

Nonetheless, current transfers have registered a nominal increase of 10.8 percent during Nov-Feb FY09 period on the back of extraordinary growth (25.9 percent) in workers’ remittances and inflow in resident foreign currency accounts during the period.

### Worker’s Remittances

As in the previous two years, workers’ remittances grew remarkably during Jul-Feb FY09. Specifically, workers’ remittances registered 19.3 percent growth during Jul-Feb FY09 on the top of 21.3 percent average growth in the same period of the previous two years.

During Jul-Feb FY09, channel of remittances growth can be categorized into two distinct periods i.e. Jul-Oct FY09 and Nov-Feb FY09. During the first period, more than three fourths of the increase in remittances was contributed by higher inflows in exchange companies whereas in the second period around 60 percent of

<table>
<thead>
<tr>
<th>Channel</th>
<th>Jul-Oct</th>
<th>Nov-Feb</th>
<th>Jul-Feb</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banks</td>
<td>9.7</td>
<td>59.9</td>
<td>43.1</td>
</tr>
<tr>
<td>Exchange companies</td>
<td>78.3</td>
<td>32.5</td>
<td>47.8</td>
</tr>
<tr>
<td>Post offices</td>
<td>12.0</td>
<td>7.6</td>
<td>9.0</td>
</tr>
<tr>
<td>Overall growth</td>
<td>12.7</td>
<td>25.9</td>
<td>19.3</td>
</tr>
</tbody>
</table>
the rise in remittances growth was contributed by higher inflows in banks (see Table 6.7). Monthly data on remittances suggests that this compositional change in remittances growth coincided with the FIA action against the undocumented fund transfers during October 2008. This coincidence gives credence to the view that a part of the remittances earlier being transmitted through undocumented channel diverted to banking channels after this action. Moreover, growth of remittances flows routed through exchange companies witnessed a deceleration suggesting that prospective customers might have withheld funds for the time being owing to the possibility of a further crackdown against other exchange companies.

Country-wise data on the remittances suggests that a major part of the increase in remittances through banking channel in the post FIA action period was recorded from United Arab Emirates, while slowdown in remittances through exchange companies was largely attributed to fall in remittances from United States (see Table 6.8), which accounted for 58.5 percent of the overall remittances routed through the companies during Jul-Oct FY09.

During Nov-Feb FY09, a steep rise in remittances through banking channel relative to exchange companies from UAE (see Figure 6.8) may be attributed to a) action against undocumented transfer of funds, b) wide network of Pakistan’s banks available in
the region, c) negligible differences between costs of remitting through banking channel and money transfer operators (MTOs) and d) possible reverse capital flight of some of the money earlier transferred to Dubai in the wake of recession in the real estate activities in the region.

Regarding US, it may be pointed out that remittances routed through exchange companies were continually rising while that through banking channel were continuously falling till October 2008 (see Figure 6.9). Specifically, share of workers’ remittances routed through exchange companies in overall remittances increased to 64.7 percent in October 2008 from 48.8 in July 2007. This shift was taking place probably because of considerably low cost of remitting funds through Money Transfer Operators (MTOs) compared to banks (see Table 6.9) and scarce

### Table 6.8: Monthly Average of Workers’ Remittances

<table>
<thead>
<tr>
<th></th>
<th>Jul-Sep FY08</th>
<th>Oct FY08</th>
<th>Nov-Feb FY08</th>
<th>Jul-Sep FY09</th>
<th>Oct FY09</th>
<th>Nov-Feb FY09</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total</strong></td>
<td>500.2</td>
<td>580.2</td>
<td>510.8</td>
<td>466.1</td>
<td>643.1</td>
<td></td>
</tr>
<tr>
<td><strong>US</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Banks</td>
<td>370.6</td>
<td>429.2</td>
<td>376.9</td>
<td>420.0</td>
<td>306.7</td>
<td>456.2</td>
</tr>
<tr>
<td>Exchange Companies</td>
<td>116.7</td>
<td>134.6</td>
<td>118.3</td>
<td>184.1</td>
<td>140.0</td>
<td>161.4</td>
</tr>
<tr>
<td>Post Offices</td>
<td>12.9</td>
<td>16.4</td>
<td>15.5</td>
<td>22.5</td>
<td>19.4</td>
<td>25.5</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>500.2</td>
<td>580.2</td>
<td>510.8</td>
<td>466.1</td>
<td>643.1</td>
<td></td>
</tr>
<tr>
<td><strong>UAE</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Banks</td>
<td>77.7</td>
<td>95.4</td>
<td>75.5</td>
<td>59.1</td>
<td>44.9</td>
<td>60.3</td>
</tr>
<tr>
<td>Exchange Companies</td>
<td>62.6</td>
<td>74.5</td>
<td>66.9</td>
<td>107.4</td>
<td>82.3</td>
<td>72.1</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>140.3</td>
<td>169.9</td>
<td>142.4</td>
<td>166.6</td>
<td>127.3</td>
<td>134.0</td>
</tr>
<tr>
<td><strong>UK</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Banks</td>
<td>63.0</td>
<td>78.1</td>
<td>70.8</td>
<td>83.0</td>
<td>60.3</td>
<td>133.4</td>
</tr>
<tr>
<td>Exchange Companies</td>
<td>11.9</td>
<td>13.9</td>
<td>10.7</td>
<td>14.4</td>
<td>9.6</td>
<td>18.3</td>
</tr>
<tr>
<td>Post Offices</td>
<td>4.2</td>
<td>5.4</td>
<td>5.3</td>
<td>6.7</td>
<td>6.1</td>
<td>10.2</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>79.1</td>
<td>97.4</td>
<td>86.8</td>
<td>104.1</td>
<td>75.9</td>
<td>161.9</td>
</tr>
<tr>
<td><strong>KSA</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Banks</td>
<td>24.3</td>
<td>30.7</td>
<td>20.5</td>
<td>23.5</td>
<td>17.6</td>
<td>15.3</td>
</tr>
<tr>
<td>Exchange Companies</td>
<td>15.7</td>
<td>13.9</td>
<td>11.6</td>
<td>16.0</td>
<td>13.6</td>
<td>33.3</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>40.0</td>
<td>44.6</td>
<td>32.1</td>
<td>39.5</td>
<td>31.2</td>
<td>48.6</td>
</tr>
</tbody>
</table>

During Jul-Oct Khanani & Kalia accounted for around 19 percent of the remittances received through exchange companies. During Jul-Oct around 53 percent of Khanani & Kalia remittances were received from US alone.
availability of Pakistani banks branches in the US. The exchange companies which captured the major share of these inflows during Jul-Oct FY09 period included Zarco (28.9 percent), Pakistan’s currency exchange (28.5 percent) and Khanani & Kalia (K&K) (17.0 percent). With the action against one of these exchange companies (K&K), the remittances routed through these companies fell sharply during Nov-Feb FY09 period (see Figure 6.9).

In addition, deepening recession in US economy may also have decelerated the remittances inflows from US. Other countries which contributed to rise in remittances during Jul-Feb FY09 included Saudi Arabia, other gulf countries and United Kingdom.

**Resident FCAs**

Resident foreign currency accounts registered a net outflow of US$ 142 million during Jul-Feb FY09 against inflow of US$ 287 million during the comparable period of last year. Almost all of this decline occurred during the Jul-Oct FY09 period, when individuals withdrew funds from foreign currency accounts on the back of substantial depreciation in exchange rate and rumors of bank defaults and possible freezing of foreign currency accounts during October 2008. The outflow peaked at
The State of the Pakistan’s Economy

US$ 315 million at end October, 2008. However, some of this outflow was recovered in subsequent months (Nov-Feb) with the stability in exchange rate.

6.3: Financial Account
Worsening law and order situation, large economic imbalances, sluggish performance of stock market and risk averse behavior of foreign investors amid liquidity crunch in the international market hampered capital flows to Pakistan during Jul-Feb FY09. In particular, portfolio investment and other investment\(^8\) which are most volatile in nature (see Box 1) were severely impacted by these developments during the period (see Figure 6.10). Consequently, surplus in financial account shrunk by 52.6 percent during Jul-Feb FY09 against 14.2 percent decline in the corresponding period last year.

Encouragingly, foreign inflows have revived modestly in the aftermath of IMF support for macroeconomic stabilization program. On the one hand, stability in exchange rate decelerated the retirement of FE-25 loans and encouraged the repatriation of export proceeds, on the other hand, IMF support lowered the default risk and encouraged loan inflows from other sources. The latter was chiefly attributed to increased inflows from Islamic Development Bank, Bank of China and other private sector loans.

6.3.1 Net Foreign Investment
Overall net foreign investment declined by 34.2 percent during Jul-Feb FY09 on the top of around 25.0 percent decline in the corresponding period of last year. As in the previous year, the entire decline resulted from outflow of portfolio investment (on account of euro bond payment and outflow from stock market) as the foreign direct investment registered a nominal growth of 0.2 percent during the period under review. Substantial fall in inflows from US, which constituted more than 50 percent of the overall investment in Pakistan during Jul-Feb FY08, was the major driving force behind decline in investment inflows during Jul-Feb FY09 (see Table 6.10).

Foreign Direct Investment
During Jul-Feb FY09, foreign direct investment increased slightly by 0.2 percent against a decline of 6.1 percent in the corresponding period of last year. The weak FDI growth largely owes to absence of privatization proceeds, decline in reinvested earnings on account of lower corporate profitability and tighter liquidity conditions in the international market.

\(^8\) The major components of other investment inflows to Pakistan are the official and private loans.
Major sectors which registered either decline or deceleration in FDI growth during Jul-Feb FY09 included communication, financial business, personal services, trade, construction and transport equipments. On the other hand, food packaging, petroleum refining, oil & gas explorations and, power sectors witnessed higher growth in investment inflows during Jul-Feb FY09 compared with the same period of last year (see Table 6.11). In food packaging almost the entire increase was due to investment in Tetrapak Pakistan Limited while higher investment in power was received by Uch power projects and KESC.

### Portfolio Investment

In line with the trend in emerging economies stock markets, foreign

<table>
<thead>
<tr>
<th>Table 6.10: Net Foreign Investment in Pakistan</th>
</tr>
</thead>
<tbody>
<tr>
<td>Million US$</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td><strong>July-Feb FY08</strong></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td><strong>FDI</strong></td>
</tr>
<tr>
<td>I. Private investment</td>
</tr>
<tr>
<td>U.S.A</td>
</tr>
<tr>
<td>Mauritius</td>
</tr>
<tr>
<td>U.A.E</td>
</tr>
<tr>
<td>U.K</td>
</tr>
<tr>
<td>Japan</td>
</tr>
<tr>
<td>Switzerland</td>
</tr>
<tr>
<td>Germany</td>
</tr>
<tr>
<td>Netherlands</td>
</tr>
<tr>
<td>Norway</td>
</tr>
<tr>
<td>Malaysia</td>
</tr>
<tr>
<td>Singapore</td>
</tr>
<tr>
<td>Hong Kong</td>
</tr>
<tr>
<td>II. Public investment</td>
</tr>
<tr>
<td>-29.5</td>
</tr>
<tr>
<td>Total (I+II)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Table 6.11: Sector-wise Foreign Direct Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Million US$</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td><strong>July-Feb</strong></td>
</tr>
<tr>
<td>FY08</td>
</tr>
<tr>
<td>Food packaging</td>
</tr>
<tr>
<td>Petroleum refining</td>
</tr>
<tr>
<td>Oil &amp; gas Explorations</td>
</tr>
<tr>
<td>Transport equipments</td>
</tr>
<tr>
<td>Power</td>
</tr>
<tr>
<td>Construction</td>
</tr>
<tr>
<td>Trade</td>
</tr>
<tr>
<td>Communications</td>
</tr>
<tr>
<td>Financial business</td>
</tr>
<tr>
<td>Personal services</td>
</tr>
<tr>
<td>Others</td>
</tr>
<tr>
<td><strong>Total</strong></td>
</tr>
<tr>
<td><strong>Total without Privatization</strong></td>
</tr>
</tbody>
</table>
investors are taking their investment out from Pakistan’s stock market. Outflow of the foreign investment, which decelerated with the imposition of artificial floor on prices on end August, 2008, accelerated again with the removal of this floor in mid December, 2008 as around 58 percent of the outflow from equity securities during Jul-Feb FY09 was concentrated in Dec-Feb FY09 (see Figure 6.11).

Moreover, outflow from public sector debt securities on account of euro bond payment worth US$ 500 million further added to the outflow from portfolio investment during the period under review.

6.3.2 Outstanding Export Bills
Aggregate stock of outstanding export bills declined by US$ 467 million during Jul-Feb FY09 compared with increase of US$ 156 million in the same period of last year (see Table 6.12). Partly, this decline may be attributed to slowdown in export growth and partly to the Central Bank tight monitoring of overdue outstanding exports bills. Moreover, slight appreciation in exchange rate after the IMF support for macroeconomic stabilization program may have also encouraged repatriation of export proceeds.

6.3.3 Currency and Deposits (Assets)
In sharp contrast to decline of US$ 858 million during the Jul-Feb period of last year, currency and deposits increased by US$ 83 million during Jul-Feb FY09. This increase is largely attributed to increase in FE-25 nostros on account of retirement of FE-25 loans by exporters and importers.

Official Long Term Loans
As a result of lower inflows and higher amortization, net inflow in long term loans worth US$ 444.4 million during Jul-Feb FY09 were considerably lower than US$
731 million received during the corresponding period of last year. The inflows during the current year mainly reflected US$ 693 million receipts from Asian Development Bank. Relatively higher amortization, on the other hand, mainly emanated from payments of Islamic Development Bank (US$ 200 million), Asian Development Bank (US$ 116 million) and IBRD (US$ 120 million) loans during the period under review.

6.3.4 Official Short Term Loans
The short loans recorded net outflow of US$ 114 million during Jul-Feb FY09 compared with net increase of US$ 367 million in the comparable period of last year. This net outflow mainly reflects US$ 590 million payment to Islamic Development Bank during the period. However, in the Nov-Feb FY09, short-term loans recorded net inflow of US$ 223 million on account of receipts from Islamic Development. This loan is for less than one year and would be reflected as an outflow next year.

6.3.5 Private Loans
Net inflow in the private loans increased to US$ 379.0 million during Jul-Feb FY09 from US$ 157.0 million in the comparable period of last year. This inflow largely reflects US$ 556 million loan received by Warid Telecom during the period.

6.3.6 Currencies and Deposits (liabilities)
Decline in trade financing on account of retirement against FE-25 loans led the currency and deposits to register sizable decline during Jul-Feb FY09. It may be pointed out that retirement of FE-25 loans was mainly driven by exchange rate depreciation which makes these loans costlier for exporters and imports. However, with the stabilization in exchange rate during Nov-Feb FY09, retirement of these loans slowed down significantly (see Figure 6.12).
### Table 6.12: Financial Account

<table>
<thead>
<tr>
<th></th>
<th>FY08</th>
<th>FY09*</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Jul-Feb</td>
<td>Nov-Feb</td>
</tr>
<tr>
<td>Financial account (net)</td>
<td>4,811.00</td>
<td>1,705.00</td>
</tr>
<tr>
<td>Direct investment abroad</td>
<td>-36</td>
<td>12</td>
</tr>
<tr>
<td>Direct investment in Pakistan</td>
<td>2,532.00</td>
<td>1,213.00</td>
</tr>
<tr>
<td>Equity capital</td>
<td>1,867.00</td>
<td>869.00</td>
</tr>
<tr>
<td>Of which: privatization receipts</td>
<td>133</td>
<td>133</td>
</tr>
<tr>
<td>Reinvested earnings</td>
<td>665.00</td>
<td>344.00</td>
</tr>
<tr>
<td>Portfolio investment</td>
<td>82.00</td>
<td>-229.00</td>
</tr>
<tr>
<td>Equity securities</td>
<td>111.00</td>
<td>-231.00</td>
</tr>
<tr>
<td>Debt securities</td>
<td>-29.00</td>
<td>2.00</td>
</tr>
<tr>
<td>Net foreign investment</td>
<td>2,578.00</td>
<td>957.00</td>
</tr>
<tr>
<td>Other investment</td>
<td>2,233.00</td>
<td>748.00</td>
</tr>
<tr>
<td>Assets</td>
<td>702.00</td>
<td>291.00</td>
</tr>
<tr>
<td>1-Outstanding export bills (exporters)</td>
<td>-297.00</td>
<td>-252.00</td>
</tr>
<tr>
<td>2-Outstanding export bills (DMBs))</td>
<td>141.00</td>
<td>114.00</td>
</tr>
<tr>
<td>3-Currency and deposits</td>
<td>858.00</td>
<td>429.00</td>
</tr>
<tr>
<td>of which banks</td>
<td>761.00</td>
<td>400.00</td>
</tr>
<tr>
<td>Liabilities</td>
<td>1,531.00</td>
<td>457.00</td>
</tr>
<tr>
<td>1-Foreign long-term Govt loans / credits ( net)</td>
<td>731.00</td>
<td>207.00</td>
</tr>
<tr>
<td>Project loans</td>
<td>767.00</td>
<td>243.00</td>
</tr>
<tr>
<td>Non-project loans</td>
<td>643.00</td>
<td>299.00</td>
</tr>
<tr>
<td>Amortization</td>
<td>679.00</td>
<td>335.00</td>
</tr>
<tr>
<td>2-Private loans</td>
<td>157.00</td>
<td>54.00</td>
</tr>
<tr>
<td>of which supplier credits</td>
<td>331.00</td>
<td>168.00</td>
</tr>
<tr>
<td>suppliers credit repayments</td>
<td>174.00</td>
<td>114.00</td>
</tr>
<tr>
<td>3-Short term capital (official)</td>
<td>367.00</td>
<td>303.00</td>
</tr>
<tr>
<td>of which IDB (net)</td>
<td>483.00</td>
<td>319.00</td>
</tr>
<tr>
<td>4-Currency and deposits</td>
<td>337.00</td>
<td>106.00</td>
</tr>
<tr>
<td>5-Other liabilities</td>
<td>-111.00</td>
<td>-213.00</td>
</tr>
</tbody>
</table>

* provisional
6.4 Foreign Exchange Reserves

After a substantial fall in Jul-Oct FY09 period, foreign exchange reserves increased considerably in ensuing months. Specifically, foreign exchange reserves increased to US $10.2 billion by 13th March, 09 from end October 2008 level of US $6.8 billion. A significant part of the increase in the latter period is attributed to IMF support for Pakistan’s macroeconomic stabilization program. In addition, noticeable improvement in overall external balance on the back of substantial reduction in current account deficit coupled with modest revival in capital flows also contributed to increase in the post October 2008 reserves position (see Figure 6.13). Improvement in reserves brought relative stability in the exchange rate and subsequent increase in foreign currency deposits, these factors in-turn further eased pressures on the foreign exchange reserves during the period.

The breakup of foreign exchange reserves indicates that while commercial banks’ reserves also increased, improvement in overall reserves during Nov-Jan FY09 period largely owed to increase in the Central Bank’s reserves (see Figure 6.14). As mentioned earlier, increase in central bank reserves during the period mainly owed to inflow from IMF (US$ 3.0 billion) and the subsequent revival of capital inflows from ADB (US$761 million), IDB (US$ 517 million), and China (US$ 500 million) (see

---

**Figure 6.13: Foreign Exchange Reserves**

```
<table>
<thead>
<tr>
<th>Date</th>
<th>SBP reserves</th>
<th>DMBs reserves</th>
<th>Total reserves</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nov-07</td>
<td>3.0</td>
<td>0.0</td>
<td>3.0</td>
</tr>
<tr>
<td>Feb-08</td>
<td>2.3</td>
<td>0.8</td>
<td>3.1</td>
</tr>
<tr>
<td>May-08</td>
<td>1.5</td>
<td>1.2</td>
<td>2.7</td>
</tr>
<tr>
<td>Aug-08</td>
<td>0.8</td>
<td>1.5</td>
<td>2.3</td>
</tr>
<tr>
<td>Nov-08</td>
<td>1.2</td>
<td>0.8</td>
<td>2.0</td>
</tr>
<tr>
<td>Dec-08</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Jan-09</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
<tr>
<td>Feb-09</td>
<td>0.0</td>
<td>0.0</td>
<td>0.0</td>
</tr>
</tbody>
</table>
```

**Figure 6.14: SBP Reserve Flows**

```
<table>
<thead>
<tr>
<th>Date</th>
<th>SBP reserves</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nov-07</td>
<td>1.5</td>
</tr>
<tr>
<td>Feb-08</td>
<td>2.3</td>
</tr>
<tr>
<td>May-08</td>
<td>1.5</td>
</tr>
<tr>
<td>Aug-08</td>
<td>0.8</td>
</tr>
<tr>
<td>Nov-08</td>
<td>1.2</td>
</tr>
<tr>
<td>Dec-08</td>
<td>0.0</td>
</tr>
<tr>
<td>Jan-09</td>
<td>0.0</td>
</tr>
<tr>
<td>Feb-09</td>
<td>0.0</td>
</tr>
</tbody>
</table>
```
However, higher payments for oil support and euro bond (US$ 517 million) exerted downward pressure on the central bank reserves.

Table 6.13: SBP Reserves (million USD)

<table>
<thead>
<tr>
<th></th>
<th>Jul-Feb FY08</th>
<th>Jul-Feb FY09</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Inflows</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Purchases</td>
<td>3,676.0</td>
<td>4,415.0</td>
</tr>
<tr>
<td>Loans and grants</td>
<td>1,890.0</td>
<td>4,709.0</td>
</tr>
<tr>
<td>ADB</td>
<td>975.0</td>
<td>866.2</td>
</tr>
<tr>
<td>IMF</td>
<td>5.0</td>
<td>3,057.1</td>
</tr>
<tr>
<td>IDB</td>
<td>303.0</td>
<td>516.5</td>
</tr>
<tr>
<td>Others</td>
<td>4,361.0</td>
<td>12,514.0</td>
</tr>
<tr>
<td>Forward maturities</td>
<td>2,480.0</td>
<td>9,204.0</td>
</tr>
<tr>
<td>Logistic supports</td>
<td>281.7</td>
<td>466.0</td>
</tr>
<tr>
<td>Privatization proceeds</td>
<td>644.0</td>
<td>0.0</td>
</tr>
<tr>
<td><strong>Outflows</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>7,021.0</td>
<td>8,800.0</td>
</tr>
<tr>
<td>Inter-bank sales</td>
<td>1,962.0</td>
<td>1,176.0</td>
</tr>
<tr>
<td>Oil support</td>
<td>5,059.0</td>
<td>7,624.0</td>
</tr>
<tr>
<td>Debt servicing</td>
<td>724.0</td>
<td>1,448.0</td>
</tr>
<tr>
<td>Others</td>
<td>3,952.0</td>
<td>13,321.0</td>
</tr>
<tr>
<td>Forward maturities</td>
<td>1,972.0</td>
<td>10,031.0</td>
</tr>
<tr>
<td>Wheat L/C - TCP</td>
<td>325.0</td>
<td>690.0</td>
</tr>
<tr>
<td><strong>Net Change in reserve</strong></td>
<td>-1,770.0</td>
<td>-1,930.0</td>
</tr>
</tbody>
</table>

Source: DMMD

As against the SBP reserves, commercial banks’ reserves recorded an increase of US $ 652.3 million during Jul-13 Mar FY09 and stood at US $ 3.5 billion.

Commercial banks’ reserves were recording healthy rise till September, 2008, however, adverse developments in October 2008 resulted in sharp fall in their reserves. Not only remittances fell sharply in October, but heavy withdrawals were also witnessed from the foreign currency accounts in the wake of heightened volatility in the exchange rate. Fortunately, fall in the trade deficit and increased inflows on account of remittances are likely to mitigate to a large extent the adverse impact of this decision on the exchange rate.

uncertainty amid sharp depreciation in exchange rate and rumors of possible freezing of foreign currency accounts.

However, as Pakistan’s external position improved in the subsequent months so did the reserves of the commercial banks. By March 13 2009, commercial banks’ reserves were slightly over their pre-October, 2008 level of US$ 3.2 billion.

**Reserve Adequacy**
Both reserve adequacy ratios; reserves to weeks of imports and reserves to short term debt and liabilities recovered slightly in Q2-FY09 after continued deterioration for almost a year (see Figure 6.15 & Figure 6.16).

Reserves to weeks of imports ratio in particular, declined to as low as 9.1 weeks in October, 2008 before recovering to 14.5 weeks as on March 13, 2009. This owes both to improvement in the reserves as well as fall in the imports bill in Q2-FY09. Likewise, reserves to short term debt and liabilities ratio recovered to 4.6 at end December 2008, from 4.1 during September, 2008.

**6.5 Exchange Rate**
After falling steeply by 16.3 percent during July-Oct FY09, rupee recovered some of its lost grounds November 2008 onwards. The recovery of the exchange rate owes to improvement in Pakistan’s external accounts, especially improvement in the financial account following the Stand-By Arrangement with the IMF. The inflows from the IMF not only stemmed
depletion of reserves but also improved market sentiments. In the following months, as trade deficit shrank and inflows from other sources increased, the pressure on the rupee further subsided. As a result rupee exhibited relative stability against US dollar during Nov-Feb FY09. The value of standard deviation that indicates fluctuations, also declined considerably from 1.41 in October to 0.35 in Feb FY09. (see Figure 6.17)

**Global Recession and Exchange Rates**

The recent economic turmoil not only resulted in global slowdown, but it also altered the stance of central banks; as a result massive rate cuts were witnessed worldwide. The Fed set the rate to record lows, while the Bank of Japan has the lowest rate around the globe. The European central bank and the Bank of England also changed their stance and opted for sharp rate cuts in order to foster economic growth (see Table 6.14). The financial turmoil and rapid rate cuts brought sharp movements in every major currency. During H1-FY09, while Dollar strengthened against its counterparts, the Euro and Pound lost ground against other currencies. Emerging-market currencies, along with commodity currencies 11 Canadian, Australian, and New Zealand dollars also lost value against the US dollar.

<table>
<thead>
<tr>
<th>Table 6.14 : Interest Rates Comparison</th>
</tr>
</thead>
<tbody>
<tr>
<td>USA</td>
</tr>
<tr>
<td>UK</td>
</tr>
<tr>
<td>Eurozone</td>
</tr>
<tr>
<td>Japan</td>
</tr>
<tr>
<td>Pakistan</td>
</tr>
</tbody>
</table>

11 Commodity currencies is a name given to currencies of countries which depend heavily on the export of certain raw materials for income. In the foreign exchange market, commodity currencies generally refer to the Australian Dollar, Canadian Dollar, New Zealand Dollar, and the South African Rand.
The rupee showed relatively better performance against other major currencies. Rupee’s appreciation against the Euro and Pound was primarily driven due to the weakness in the respective currencies during H1-FY09. Both Pound and Euro weakened against the US dollar due to deteriorating economic conditions in UK and Euro-zone. Owing to relative strength of Japanese yen against the US dollar, Pak rupee depreciated by 21.4 percent against its Japanese counterpart (see Figure 6.18).

The exchange rate against basket of currencies as measured by Nominal Effective Exchange Rate (NEER) showed 7.1 percent depreciation during Jul-Jan FY09 as compared to the depreciation of 7.2 percent during the same period last year, however, due to continuous rise in inflationary pressures as evident from the 9.4 percent rise in Relative Price Index (RPI), Real Effective Exchange Rate (REER) appreciated by 1.6 percent during Jul-Jan FY09 (see Figure 6.19).
6.6 Trade Account
The cumulative trade deficit for the Jul-Feb FY09 was recorded at US$ 11.6 billion, down by 6.9 percent YoY – the first time in seven years that the trade deficit for the July-February period has declined. This improvement was led principally by a compression of imports. Imports recorded substantial YoY growth in Q1-FY09, but a pronounced weakening of aggregate demand, and a sharp fall in import prices November 2008 onwards caused the import bill to shrink, with a corresponding impact on the trade deficit (see Figure 6.20). While the resilience in exports also played a role in narrowing the trade deficit, this was small, as the modest YoY increase in Jul-Feb FY09 exports was largely concentrated in Q1-FY09.

The Q1-FY09 rise in imports was almost entirely due to higher prices. International commodity prices had started to weaken since the beginning of FY09, but this was reflected in Pakistan’s import prices with a lag, and the import bill saw an accelerated reduction Q2-FY09 onwards (see Figure 6.21 & 6.22). This trend was also helped by declines in the quantum of imports, which probably reflected the combined impact of a coordinated tightening of both monetary and fiscal policies and a sharp depreciation of the Pak rupee,\(^{12}\) energy shortages, etc.

\(^{12}\) Rupee exchange rate vs. US Dollar recorded 14.5 percent depreciation during Jul-Feb FY09.
The slowdown in aggregate demand is likely to continue through FY09, while import prices are also expected to weaken. Consequently, as chances are that the trade deficit will decline further in the months ahead. However, the extent of the compression of the overall trade deficit for FY09 will depend upon the trends in export growth during Mar-Jun FY09.

So far, while exports have shown weakness, the decline has been relatively modest. In the wake of global recession and the resultant fall in international demand, slowdown in the country’s export growth was expected. However, the situation has been worsened by growing domestic problems, such as the energy shortage. Moreover, export growth during Jul-Jan FY09 was narrowly based, as almost all of the increase in exports during this period came from rice and cement sectors and there is a risk to the growth momentum in both sectors.

Exports
Exports recorded a modest 4.3 percent YoY growth during Jul-Feb FY09 as compared to 7.4 percent YoY growth posted during the same period last year. In view of the long range of issues facing exporters - the continued severity of the domestic energy crisis, political uncertainty in the country and law and order issues – this performance was appreciable. However this growth pattern does not seem to be sustainable in the coming months, as from Nov-FY09 exports are recording a steady YoY decline (see Figure 6.23). The weakness in export
performance is broad based. Not only there is a continuing decline in textile exports, there is now an appreciable weakness even in the hitherto strong performing categories of non-textile exports (see Table 6.15).

This situation needs immediate attention from government. In particular, the energy shortages need to be addressed on priority. According to APTMA sources the textile (spinning and weaving) sector was provided with only 33 percent of its total gas requirement during the winter season (Nov-Jan FY09), while during the whole of Jul-Jan FY09 this sector obtained 70 percent of its total power supply needs. In addition, the country’s exports are also being affected by a variety of
structural and sector specific issues in various sectors, which should be addressed aggressively.

**Major non-textile exports**

*Rice* exports were the largest contributor in the total YoY increase in exports during Jul-Feb FY09. A large share of this surge was witnessed during Q1-FY09, as the rice export growth has started to decelerate since Q2-FY09 (see Figure 6.24). This is attributable to a number of factors:

1) A part of this slowdown in Q2-FY09 may be attributed to problems faced by rice mills on account of frequent power shortages.

2) In the case of basmati rice, situation has been complicated by India’s decision to remove duty on the export of basmati rice from January FY09, as this has increased competition for Pakistan’s basmati rice export.

3) The supply of new crop has led to a sharp fall in the international rice prices. In this situation despite a bumper domestic rice crop, for attracting demand, Pakistan’s exporters have to be price competitive. The situation in the domestic rice market, however, is not completely in line with that in the international market, where the fall in the domestic rice prices is not as sharp as that in the international market (see Figure 6.25).

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**Figure 6.24: Rice Exports Quantum - YoY Growth**

* Basmati  ■ Others

**Figure 6.25: Trends in Rice Prices**

* FAO rice price index
This could partly be attributed to the intervention of Trading Corporation of Pakistan (TCP) in the rice trade. This decision by government has caused uncertainty in the domestic market, as growers are reportedly not willing to sell their produce to exporters in the hope of getting better rates from TCP. The resultant stagnation in domestic rice prices is hurting competitiveness of the country’s rice exports.

**Other manufacture exports** recorded 9.5 percent YoY growth during Jul-Feb FY09. Though large, this growth was substantially less than the 35.4 percent YoY growth recorded by this category during the same period last year. Almost all major export categories in this group are witnessing deceleration or fall since Q1-FY09 (see [Figure 6.26](#)).

Among other manufactures *cement* was the largest contributor in overall export growth during Jul-Feb FY09. In fact this sector recorded high growth rates throughout FY08 led by increase in external demand and domestic capacity enhancements. However, recently some adverse developments in the major cement export markets, are posing serious challenges to the ability of this sector to sustain the high growth pattern witnessed in FY08. For instance;

1) From January 2009, India which is one of Pakistan’s large export markets that accounts for 12-14 percent of cement exports, has imposed 12 percent duty on its cement imports.

2) The slowdown in construction activities in UAE (14 percent share) may also hamper export demand from this market;

3) An increase in Saudi Arabia’s cement production capacity might also divert demand from Middle Eastern countries away from Pakistan.

[Figure 6.26: YoY Contribution in Other Manufactures Export Growth](#)

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All these factors might cause some downward pressure on country’s cement exports in the coming period. However, on a positive note, African countries have emerged as a potential market for Pakistani cement since FY08.

*Leather manufactures* exports recorded a 13.5 percent YoY fall during Jul-Feb FY09. This was caused by a fall in external demand led by global recession as well as a long range of domestic structural issues. Most of the countries’ leather manufactured exports comprise luxury items such as leather jackets and articles of apparel\(^{14}\), with EU, and US being the major markets, which are in the grip of economic recession. On the supply side, like other sectors, this sector is faced with the issue of power shortages, rising cost of production, unskilled labor force and obsolete machinery.

Given the availability of raw leather in the country the exports of leather manufactures have a potential to increase once the structural issues are addressed properly. However, in the coming period these problems are likely to persist, which implies slowdown in export of this category in the short run. In addition, the fall in leather manufactures demand has also reduced the raw leather demand from some of the major leather goods producing countries. This has resulted in a large 22.5 percent YoY fall in raw leather exports as well during Jul-Feb FY09.

*Chemicals and pharmaceuticals* exports also recorded a slight YoY deceleration and recorded a 14.5 percent YoY rise during Jul-Feb FY09 as compared to 41.9 percent rise witnessed during the same period last year. This was observed due to a slowdown in exports of major categories of plastics and other chemicals.

A large (around 55 percent) share of plastic exports comprises PET bottle grade resin, which is a derivative of crude oil. With a sharp decline in international oil

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\(^{14}\) Leather manufactures contain 75 percent of leather garments, and together leather jackets and articles of apparel comprise 90 percent of leather garments exports.
The State of the Pakistan’s Economy

prices the unit values of PET are also declining since Jul-FY09 leading to falling price impact and thus deceleration in overall plastic exports (see Figure 6.27).

The fall in exports of *petroleum products* during Jul-Feb FY09 may be attributed to lingering circular debt problem that is hindering the ability of refineries to import crude and resulting in lower petroleum products export. This fact is also supported by lower production of petroleum products, such as naphtha, HSD and Jet fuel, as compared to the same period last year (see Figure 6.28).

**Textile** exports have largely witnessed a steady monthly decline since May FY08 and this trend has continued into FY09. During Jul-Feb FY09 exports from this sector recorded 5.6 percent YoY fall. In view of the ongoing global recession and resulting fall in demand for textile and apparel products, this slowdown in textile exports is not unanticipated.

In addition to falling international demand, domestic supply side issues, especially power and gas shortages are also affecting the export performance of this sector (see Figure 6.29). Due to the large intensity of the adverse effects of the current energy crisis on country’s largest exports sector i.e., textile, this situation demands some immediate attention from the government. In addition, this sector is also facing cash flow problems due to low credit availability from the banks. As a result of building up of large inventories on account of sluggish response from buyers, and rising NPLs in the textile sector, banks have become more conservative in extending loans to this sector. This belief is also strengthened by a deceleration in net credit flow to the textile sector from 14.1 percent in H1-FY08 to 5.1 percent in H1-FY09. Further, the anecdotal evidence suggests that due to the ongoing international recession international buyers are demanding extension in payment period, which is further aggravating cash flow problems faced by the textile sector.

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15 Graph is based on information provided by All Pakistan Textile Mills Association.
16 For details see Chapter 4 on Money & Credit.
This said, however, a substantial depreciation of Pak rupee has increased the competitiveness of this sector vis-à-vis its competitors. This is also reflected from country’s relatively better position in the major exports to EU and US in both textile and apparel categories (see Table 6.16). In fact in rupee terms textile exports recorded a large 19.3 percent YoY increase during Jul-Feb FY09. The large depreciation is helping textile sector in many ways; 1) this has increased the ability of exporters to quote lower prices, which is evident from falling unit prices of a number of textile products during Jul-Feb FY09.

2) Given the fact that around more than half of the raw material used by this sector is domestically produced, textile exporters are now well positioned to offset some of the impact of rising domestic cost of production. Importantly, the prices of one of the important raw material i.e., raw cotton are recording a continued decline since August FY09. Further, with the fall in international oil prices, the prices of synthetic fibre are also falling. In this situation the important rising costs to be borne by this sector are electricity tariffs and wages (see Figure 6.30).

Pak rupee recorded 14.5 percent depreciation against US dollar during Jul-Feb FY09.
Financial costs are also an important part of the cost structure of this sector; however, the availability of concessional financing through EFS has to some extent protected the textile industry from the effect of rising lending rates. In this connection SBP has given further incentives to textile sector which include one year extension in mark-up subsidy for spinning sector, provision of 100 percent financing to banks against export finance provided to exporters provision of one year moratorium on loans availed under the Long Term Financing Facility (LTFF) and extension in the period of refinancing under EFS.

In this scenario with the persisting external demand side weakness and domestic energy shortages, the depreciation of Pak rupee is likely to stem a large fall in textile sector exports to some extent. Resultantly, textile exports are expected to record a small YoY fall in the remaining months of FY09.

Table 6.16: Textile & Apparel Export Growth - Market Analysis

<table>
<thead>
<tr>
<th>CY07 Textile Apparel</th>
<th>CY08 Textile Apparel</th>
</tr>
</thead>
<tbody>
<tr>
<td>Pakistan -10 4.2 -5.2 -0.5</td>
<td></td>
</tr>
<tr>
<td>Bangladesh 3 5.3 7.5 11.3</td>
<td></td>
</tr>
<tr>
<td>China 10.9 17.2 0.6 -0.8</td>
<td></td>
</tr>
<tr>
<td>Indonesia -2.4 7.7 -5.5 1.1</td>
<td></td>
</tr>
<tr>
<td>India 2.1 -1.7 1.7 -2.7</td>
<td></td>
</tr>
<tr>
<td>Sri Lanka 3.1 -7 -22.5 -5.9</td>
<td></td>
</tr>
<tr>
<td>Mexico 5.9 -15 -15.5 -10.5</td>
<td></td>
</tr>
<tr>
<td>Turkey 2.4 -22.4 -9.9 -28.4</td>
<td></td>
</tr>
<tr>
<td>World 3.5 2.2 -4.1 -3.5</td>
<td></td>
</tr>
</tbody>
</table>

Source: US Census Bureau & Euro stat

19 SMEFD Circular No. 03 of 2008, SBP.
Imports
During Jul-Feb FY09, imports recorded a 1.5 percent YoY fall as compared to the 21.9 percent YoY growth witnessed during the same period last year. The deceleration in import growth has been evident since Q2-FY09, due to both, a sharp fall in international commodity prices and falling demand pressures in the economy (see Figure 6.31 & 6.32).

The contractionary impact of both these factors was more pronounced during Q2-FY09. During Q1-FY09, despite a fall in most of the international commodity prices as compared to their H2-FY08 levels, imports recorded a higher price impact due to lower base.

Demand led compression in imports
A tight monetary policy by SBP, sharp depreciation of Pak rupee, fall in domestic real income levels, increase in import duties and sales tax on luxury goods, circular debt issue and a general slowdown in the economic activity substantially compressed import demand during Jul-Jan FY09 (see Table 6.17 & 6.18). While the non-food and non-oil imports remained weak during Jul-Feb FY09, from Nov FY09 food & oil imports have also started to record a YoY fall (see Figure 6.33).
In overall terms petroleum group imports recorded a large 9.2 percent YoY increase during Jul-Feb FY09, though almost all of this increase was caused by prices lower. In terms of quantum, petroleum crude recorded a moderate increase whereas petroleum products imports continued to decline in Jul-Feb FY09 (see Table 6.18).

The slowdown in POL group import quantum is attributable to the circular debt issue that limited the ability of refineries and OMCs to import. In the case of petroleum crude, refineries were also facing problems in opening LCs, probably due to a deterioration in Pakistan’s external account position prior to IMF support. With an agreement with IMF and a steep fall in international oil prices, this situation has improved which is also evident from a YoY quantum rise in petroleum crude import during Dec-Jan FY09. The circular debt issue, however, is still keeping petroleum product imports depressed (see Figure 6.34 A&B).

Table 6.17: Quantum impact – Top 12 import Categories

<table>
<thead>
<tr>
<th></th>
<th>FY08</th>
<th>FY09</th>
<th>FY09</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Q1</td>
<td>Q2</td>
<td>Q3</td>
</tr>
<tr>
<td>Fertilizer manufactured</td>
<td>50.4</td>
<td>109</td>
<td>73.7</td>
</tr>
<tr>
<td>Raw cotton</td>
<td>141.9</td>
<td>93.6</td>
<td>353</td>
</tr>
<tr>
<td>Petroleum products</td>
<td>-136.9</td>
<td>344.2</td>
<td>337.9</td>
</tr>
<tr>
<td>Iron and steel</td>
<td>77.7</td>
<td>-26.2</td>
<td>6.5</td>
</tr>
<tr>
<td>Iron and steel scrap</td>
<td>78.9</td>
<td>88.5</td>
<td>47.9</td>
</tr>
<tr>
<td>Palm oil</td>
<td>1.8</td>
<td>-39.8</td>
<td>27.1</td>
</tr>
<tr>
<td>Plastic material</td>
<td>-3.4</td>
<td>6</td>
<td>11.9</td>
</tr>
<tr>
<td>Soybean oil</td>
<td>17.3</td>
<td>5.1</td>
<td>18.6</td>
</tr>
<tr>
<td>Paper/ board &amp; Manuf.</td>
<td>-9.4</td>
<td>1</td>
<td>6</td>
</tr>
<tr>
<td>Rubber tyres &amp; tubes</td>
<td>1.5</td>
<td>0.9</td>
<td>4.8</td>
</tr>
<tr>
<td>Wheat</td>
<td>0</td>
<td>-3.7</td>
<td>547.7</td>
</tr>
<tr>
<td>Petroleum crude</td>
<td>93.4</td>
<td>-163.8</td>
<td>220.3</td>
</tr>
<tr>
<td>Total</td>
<td>313.2</td>
<td>414.8</td>
<td>1655.4</td>
</tr>
</tbody>
</table>
Fertilizer manufactured imports also recorded a steep quantum decline during Jul-Feb FY09 (see Table 6.17 & 6.18). This fall resulted from very high domestic fertilizer prices, especially for DAP, which led to a lower DAP offtake during the period under review.\(^{22}\) In addition large domestic inventories were also present from excessive imports of FY08, which also reduced the need for further imports.

Fall in iron and steel import quantum is reflective of lower construction activity and a fall in automobiles production\(^{23}\) during Jul-Feb FY09. Telecom sector imports also witnessed a large 49.8 percent YoY fall during the period of analysis. This is attributable to declining purchasing power along with higher custom and regulatory duties on mobile sets\(^{24}\).

Raw cotton import recorded fall on account of good domestic cotton crop\(^{25}\). The fall in palm oil imports could be attributed to improved domestic oil seeds crops\(^{26}\) during FY08 as well as falling domestic demand both from households and from industry on account of the sharp rise in prices. Falling industry demand is also evident from 4.8 percent YoY fall in cooking oil production during H1-CY09.

Wheat imports recorded substantial YoY quantum increase during Jul-Feb FY09 (see Table 6.18). This was done according to government’s decision to import around 2.5 million tonnes of wheat during FY09 to 1) overcome domestic shortages and 2) to build one million tonnes strategic reserves of this commodity to ensure ample domestic supply on sustained basis. The wheat shortages in FY08 also made government to announce a very high support price i.e., Rs 950/40kg for

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\(^{22}\) DAP offtake recorded 6.2 percent YoY fall during Jul-Dec FY09.

\(^{23}\) Automobiles production recorded a large 35 percent YoY fall during Jul-Dec-FY09.

\(^{24}\) In the FY08 budget the federal government imposed Rs500 customs duty per set and later imposed Rs250 regulatory duty (R&D) in August 2008.

\(^{25}\) Cotton production recorded 3.5 percent YoY rise during FY09 reaching 14.1 million bales.

\(^{26}\) Sunflower production recorded 48 percent YoY rise during FY08.
the FY09 crop. This has led to a reported increase in area under cultivation and a bumper production is expected from the current crop.

<table>
<thead>
<tr>
<th>Table 6.18: Major Imports (Jul-Feb)</th>
</tr>
</thead>
<tbody>
<tr>
<td>million US Dollar</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td><strong>Units</strong></td>
</tr>
<tr>
<td><strong>Food group</strong></td>
</tr>
<tr>
<td>of which</td>
</tr>
<tr>
<td>Wheat</td>
</tr>
<tr>
<td>Palm oil</td>
</tr>
<tr>
<td><strong>Machinery group</strong></td>
</tr>
<tr>
<td>of which</td>
</tr>
<tr>
<td>Power generating machinery</td>
</tr>
<tr>
<td>Telecom</td>
</tr>
<tr>
<td><strong>Transport group</strong></td>
</tr>
<tr>
<td>of which</td>
</tr>
<tr>
<td>Road motor vehicles</td>
</tr>
<tr>
<td>Aircrafts, ships and boats</td>
</tr>
<tr>
<td><strong>Petroleum group</strong></td>
</tr>
<tr>
<td>Petroleum</td>
</tr>
<tr>
<td>Petroleum products</td>
</tr>
<tr>
<td>Petroleum crude</td>
</tr>
<tr>
<td><strong>Textile group</strong></td>
</tr>
<tr>
<td>of which</td>
</tr>
<tr>
<td>Raw cotton</td>
</tr>
<tr>
<td><strong>Agricultural and chemical group</strong></td>
</tr>
<tr>
<td>of which</td>
</tr>
<tr>
<td>Fertilizer</td>
</tr>
<tr>
<td>Other chemicals</td>
</tr>
<tr>
<td><strong>Metal Group</strong></td>
</tr>
<tr>
<td>of which</td>
</tr>
<tr>
<td>Iron and steel scrap</td>
</tr>
<tr>
<td><strong>Miscellaneous group</strong></td>
</tr>
<tr>
<td>All other items</td>
</tr>
<tr>
<td><strong>Total imports</strong></td>
</tr>
</tbody>
</table>
However, this has also created certain issues pertaining to the handling of FY09 wheat crop. Due to sharp fall in international wheat prices\textsuperscript{27}, unit values of imported wheat have also come down significantly as compared to the support price level announced for the FY09 crop (see Figure 6.35). In this situation the procurement of current wheat crop at the stated support price will require large subsidies to the growers and hence, a huge financial burden for government.

The surge in \textit{power generating machinery import} recorded during Jul-Feb FY09 is attributable to rising demand for generators in anticipation of large power shutdowns in the forthcoming summer season. Further, the government’s decision to exempt duty on temporary imports of power generating plants by WAPDA, Pepco and KESC might also be contributing in the rise of this category’s import.\textsuperscript{28} In addition, these imports also increased due to the ongoing work on various IPPs.

During Jul-Feb FY09 a marginal amount of \textit{sugar} worth only US$ 14.1 million was imported. However, from Q4-FY09 onwards sugar import is likely to witness a surge due to a large YoY fall in the FY09 sugarcane crop\textsuperscript{29}. Government has directed TCP to start import process to curb rise in domestic sugar prices, which are witnessing a continuous rise since May FY08 (see Figure 6.36). Given, the fact that FY08 crop recorded a large 14.4 percent YoY increase, the rise in domestic sugar prices might not be associated with depletion of sugar stocks in the country as early as in May 2008. In fact this points towards the possibility of hoarding and smuggling of this commodity to some neighboring countries. To curb this tendency SBP imposed the condition of 50 percent cash

\textsuperscript{27}International wheat prices after crossing the level of US$ 440/MT in April FY08 have come down to almost US$ 240/MT in Jan FY09.

\textsuperscript{28}From June 11, 2008 Wapda and Pepco were allowed duty free import the power plants with the condition of re-export the same. Now from January 2, 2009 KESC will also be treated like Wapda and Pepco under the same conditions (source: FBR).

\textsuperscript{29}According to estimates sugar production recorded 18.5 percent YoY fall during FY09.
margin on sugar trade financing in February FY09 which was afterwards removed.\textsuperscript{30}

The above discussion hints at a fall in import growth during the remaining months of FY09. This is because of the following three factors:

1) The fall in price impact in total imports that started in January FY09 is likely to continue through FY09 due to significantly high levels of international commodity prices in H2-FY08 as compared to their current levels.

2) The large quantum surge recorded in wheat is also likely to cease in the remaining FY09 with the availability of domestic wheat.

3) The general depression in imports due to a slowdown in economic activity is also likely to continue through FY09.

The imports of power generating machinery, sugar, petroleum crude and other chemicals, however, are likely to rise but the surge in these categories imports is expected to be offset by the above mentioned factors. This scenario hints at the possibility of a large YoY fall in overall imports for FY09.

\textsuperscript{30} BPRD Circular No. 02 of 2009, SBP
<table>
<thead>
<tr>
<th>Acronyms</th>
<th>Full Form</th>
</tr>
</thead>
<tbody>
<tr>
<td>ADB</td>
<td>Asian Development Bank</td>
</tr>
<tr>
<td>ARPU</td>
<td>Average Revenue per User</td>
</tr>
<tr>
<td>BMR</td>
<td>Balancing Modernization and Restructuring</td>
</tr>
<tr>
<td>BoP</td>
<td>Balance of Payments</td>
</tr>
<tr>
<td>BSC</td>
<td>Behbood Saving Certificate</td>
</tr>
<tr>
<td>CELSS</td>
<td>Controlled Ecological Life Support System</td>
</tr>
<tr>
<td>CLCV</td>
<td>Cotton Leaf Curl Virus</td>
</tr>
<tr>
<td>CPI</td>
<td>Consumer Price Index</td>
</tr>
<tr>
<td>CRR</td>
<td>Cash Reserve Requirement</td>
</tr>
<tr>
<td>DAP</td>
<td>Di-Ammonium Phosphate</td>
</tr>
<tr>
<td>DMBs</td>
<td>Deposit Money Banks</td>
</tr>
<tr>
<td>DMMD</td>
<td>Domestic Market and Monetary Management Department</td>
</tr>
<tr>
<td>DPBs</td>
<td>Domestic Private Banks</td>
</tr>
<tr>
<td>DSC</td>
<td>Defense Saving Certificate</td>
</tr>
<tr>
<td>EBIT</td>
<td>Earning Before Interest and Taxes</td>
</tr>
<tr>
<td>EFS</td>
<td>Export Finance Scheme</td>
</tr>
<tr>
<td>EPD</td>
<td>Exchange Policy Department</td>
</tr>
<tr>
<td>ER</td>
<td>Exchange Rate</td>
</tr>
<tr>
<td>EU</td>
<td>European Union</td>
</tr>
<tr>
<td>FAO</td>
<td>Food and Agriculture Organization</td>
</tr>
<tr>
<td>FBR</td>
<td>Federal Board of Revenue</td>
</tr>
<tr>
<td>FBS</td>
<td>Federal Bureau of Statistics</td>
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<tr>
<td>FCAs</td>
<td>Foreign Currency Accounts</td>
</tr>
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<td>FCBCs</td>
<td>Foreign Currency Bearer Certificates</td>
</tr>
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<td>FDI</td>
<td>Foreign Direct Investment</td>
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<td>Foreign Exchange Bearer Certificates</td>
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<td>FED</td>
<td>Federal Excise Duty</td>
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<tr>
<td>FE-25</td>
<td>Foreign Exchange Cir.No.25</td>
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<tr>
<td>FPI</td>
<td>Foreign Portfolio Investment</td>
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<td>FSV</td>
<td>Forced Sal value</td>
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<tr>
<td>FY</td>
<td>Fiscal Year</td>
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<tr>
<td>GCC</td>
<td>Gulf Cooperation Council</td>
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<tr>
<td>GDP</td>
<td>Gross Domestic Product</td>
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<tr>
<td>GDR</td>
<td>Global Depository Receipts</td>
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<tr>
<td>GST</td>
<td>General Sales Tax</td>
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<td>HRI</td>
<td>House Rent Index</td>
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<tr>
<td>HSD</td>
<td>High Speed Diesel Oil</td>
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<tr>
<td>IBRD</td>
<td>International Bank for Reconstruction and Development</td>
</tr>
<tr>
<td>IDB</td>
<td>Islamic Development Bank</td>
</tr>
</tbody>
</table>
### The State of the Pakistan’s Economy

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
</tr>
</thead>
<tbody>
<tr>
<td>IFIs</td>
<td>International Financial Institutions</td>
</tr>
<tr>
<td>IMF</td>
<td>International Monetary Fund</td>
</tr>
<tr>
<td>IPPs</td>
<td>Independent Power Projects</td>
</tr>
<tr>
<td>IRSA</td>
<td>Indus River System Authority</td>
</tr>
<tr>
<td>KAPCO</td>
<td>Kot Addu Power Company Limited</td>
</tr>
<tr>
<td>KESC</td>
<td>Karachi Electric Supply Corporation</td>
</tr>
<tr>
<td>KIBOR</td>
<td>Karachi Inter Bank Offer Rate</td>
</tr>
<tr>
<td>KYC</td>
<td>Know Your Customer</td>
</tr>
<tr>
<td>LIBOR</td>
<td>London Inter Bank Offer Rate</td>
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<tr>
<td>L/C</td>
<td>Letter of Credit</td>
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<tr>
<td>LSM</td>
<td>Large Scale Manufacturing</td>
</tr>
<tr>
<td>LT</td>
<td>Long Term</td>
</tr>
<tr>
<td>LTFF</td>
<td>Long Term Financing Facility</td>
</tr>
<tr>
<td>MINFAL</td>
<td>Ministry of Food, Agriculture and Live Stock</td>
</tr>
<tr>
<td>MNCs</td>
<td>Multi National Corporations</td>
</tr>
<tr>
<td>MPS</td>
<td>Monetary Policy Statement</td>
</tr>
<tr>
<td>MRTB</td>
<td>Market Related Treasury Bills</td>
</tr>
<tr>
<td>MT</td>
<td>Metric Ton</td>
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<tr>
<td>NDA</td>
<td>Net Domestic Asset</td>
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<tr>
<td>NASA</td>
<td>National Aeronautics and Space Administration</td>
</tr>
<tr>
<td>NEER</td>
<td>Nominal Effective Exchange Rate</td>
</tr>
<tr>
<td>NFA</td>
<td>Net Foreign Asset</td>
</tr>
<tr>
<td>NFNE</td>
<td>Non Food Non Energy</td>
</tr>
<tr>
<td>NPLs</td>
<td>Non Performing Loans</td>
</tr>
<tr>
<td>NSS</td>
<td>National Savings Scheme</td>
</tr>
<tr>
<td>NWFP</td>
<td>North-West Frontier Province</td>
</tr>
<tr>
<td>OCAC</td>
<td>Oil Companies Advisory committee</td>
</tr>
<tr>
<td>OGRA</td>
<td>Oil and Gas Regulatory Authority</td>
</tr>
<tr>
<td>OICCI</td>
<td>Overseas Investors’ Chamber of Commerce &amp; Industry</td>
</tr>
<tr>
<td>OMCs</td>
<td>Oil Marketing Companies</td>
</tr>
<tr>
<td>OMOs</td>
<td>Open Market Operations</td>
</tr>
<tr>
<td>OPEC</td>
<td>Organization of the Petroleum Exporting Countries</td>
</tr>
<tr>
<td>PBA</td>
<td>Pensioners Benefit Account</td>
</tr>
<tr>
<td>PET</td>
<td>Polyethylene Terephthalate</td>
</tr>
<tr>
<td>PIA</td>
<td>Pakistan International Airlines</td>
</tr>
<tr>
<td>PIBs</td>
<td>Pakistan Investment Bonds</td>
</tr>
<tr>
<td>POL</td>
<td>Petroleum, Oil and Lubricants</td>
</tr>
<tr>
<td>PPCBL</td>
<td>Punjab Provincial Cooperative Banks limited</td>
</tr>
<tr>
<td>PSDP</td>
<td>Public Sector Development Program</td>
</tr>
<tr>
<td>PSEs</td>
<td>Public Sector Enterprises</td>
</tr>
<tr>
<td>PTA</td>
<td>Pakistan Telecommunication Authority</td>
</tr>
</tbody>
</table>
REER     Real Effective Exchange Rate
RFCAs    Residents Foreign Currency Accounts
RHS      right Hand Side
RIC      Regular Income Certificate
RPI      Relative Price Index
S&P      Standard & Poor’s
SA       Saving Account
SBA      Stand-By Arrangement
SBP      State Bank of Pakistan
SECP     Securities and Exchange Commission of Pakistan
SMEFD    Small and Medium Enterprises Finance Department
SPI      Sensitive Price Index
SQM      Square Meter
ST       Short Term
SSA      Special saving Account
SSC      Special saving certificate
TBs      Treasury Bills
TCP      Trading Corporation of Pakistan
TFCs     Term Finance Certificates
UAE      United Arab Emirates
UK       United Kingdom
USA      United States of America
WAPDA    Water and Power Development Authority
WEO      World Economic Outlook
WPI      Wholesale Price Index
YoY      Year on Year
ZTBL     Zarai Taraqiati Bank Limited
April 04, 2009

Dear Madam Speaker,

In accordance with Section 9A(f) of the State Bank of Pakistan Act, 1956, I submit herewith the Second Quarterly Report for the year 2008-09 of the Central Board of Directors of the State Bank of Pakistan on the State of the Economy.

With best regards,

Yours sincerely,

Syed Salim Raza

Dr. Fehmida Mirza
Speaker
National Assembly
Islamabad
April 04, 2009

Dear Mr. Chairman,

In accordance with Section 9A(f) of the State Bank of Pakistan Act, 1956, I submit herewith the Second Quarterly Report for the year 2008-09 of the Central Board of Directors of the State Bank of Pakistan on the State of the Economy.

With best regards,

Yours sincerely,

Syed Salim Raza

Mr. Farooq H. Naek
Chairman
Senate
Islamabad
State Bank of Pakistan

**CENTRAL BOARD OF DIRECTORS**

(As on 25-03-2009)

<table>
<thead>
<tr>
<th></th>
<th>Name</th>
<th>Position</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Syed Salim Raza</td>
<td>Chairman</td>
</tr>
<tr>
<td>2</td>
<td>Mr. Salman Siddique</td>
<td>Member</td>
</tr>
<tr>
<td>3</td>
<td>Mr. Abdul Razak Dawood</td>
<td>Member</td>
</tr>
<tr>
<td>4</td>
<td>Mr. Mohsin Aziz</td>
<td>Member</td>
</tr>
<tr>
<td>5</td>
<td>Mr. Kamran Y. Mirza</td>
<td>Member</td>
</tr>
<tr>
<td>6</td>
<td>Mr. Iftikhar A. Allawala</td>
<td>Member</td>
</tr>
<tr>
<td>7</td>
<td>Mr. Zaffar A. Khan</td>
<td>Member</td>
</tr>
<tr>
<td>8</td>
<td>Mr. Tariq Sayeed Saigol</td>
<td>Member</td>
</tr>
<tr>
<td>9</td>
<td>Mr. Aftab Mustafa Khan</td>
<td>Corporate Secretary</td>
</tr>
</tbody>
</table>
The Team

Team Leader
Mohammad Mansoor Ali

Researchers
Moinuddin (Team Leader, Real Sector)
Muhammad Sharif Khawaja (Agriculture)
Muhammad Naqi Akbar (Agriculture)
Shabbir Ahmed (Large Scale Manufacturing)
Mian Abdullah Tahir (Services)
Dr. Mian Farooq Haq (Team Leader, Prices)
Saghir Pervaiz Ghauri (Prices)
Muhammad Akmal (Prices)
Muhammad Usman Abbasi (Prices)
Syed Sajid Ali (Team Leader, Money & Banking)
Tasneem Alam (Monetary Survey)
Sadia Badar (Private Sector Credit)
Reeba Nasim (Banking)
Muhammad Zeb (Banking)
Tasneem Alam (Team Leader, Fiscal Sector)
Muhammad Zeb (Fiscal developments)
Muhammad Idrees (Fiscal developments)
Mohib Kamal Azmi (Team Leader, External Sector)
Fayyaz Hussain (Balance of Payments)
Sabina Khurram Jafari (Trade)
Farrukh Mirza (Trade)
Tosif Hussain (Exchange Rate and Reserves)

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Sabahat

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