

PAKISTAN
ECONOMIC UPDATE
(JULY 2003 - JUNE 2004)

ASIAN DEVELOPMENT BANK

AUGUST 2004

Pakistan Resident Mission
Asian Development Bank

ASIAN DEVELOPMENT BANK

August 2004

Pakistan Resident Mission

OPF Building, Shahrah-e-Jamhuriyat

G-5/2, Islamabad, P.O. Box 1863

Islamabad, Pakistan.

Tel : (92-51) 2825011-16

Fax: (92-51) 2823324

(92-51) 2274718

E-mail: adbprm@adb.org

FOREWORD

The Asian Development Bank is a long-standing development partner of Pakistan, having provided a total of \$13.6 billion to the country in development assistance from 1968 to 2003. Of this amount, \$871 million were provided in 2003. The projected assistance for the period 2004-2006 amounts to \$2.7 billion. Historically, the major development sectors in which ADB has invested have included agriculture and rural development, energy, social sectors, finance and trade, and transport and communications. Under its Country Strategy and Program for Pakistan for 2002-2006, reduction of poverty is the central objective, which will be operationalized through promoting sustainable pro-poor growth, inclusive social development, and good governance, with governance being the key area of focus.

Together with this lending portfolio, the Pakistan Resident Mission (PRM) is actively engaged in Economic and Sector Work to develop an understanding of important economic policy and sector concerns, particularly with regard to poverty and governance issues. To bring this work to a wider audience, PRM published, in July 2002, a country poverty assessment titled “Poverty in Pakistan: Issues, Causes, and Institutional Responses”, after extensive consultations and dialogue with the key development partners. PRM has also started a working paper series on topical issues, and the first one titled “Escaping the Debt Trap: an Assessment of Pakistan's External Debt Sustainability” was published in December 2002. In addition, PRM published Pakistan: Sector Development Review in October 2003, which provides an overview of ADB's operations in Pakistan, particularly over the last five years.

In 2002, PRM initiated a quarterly series to provide a regular update on the state of the national economy. The first Pakistan Economic Update was published in April 2002. The present report provides an analysis of economic trends in Pakistan in fiscal year (FY) 2004, and presents outlook of the economy for FY2005. The report also reviews the progress in the area of poverty reduction, particularly with regard to public expenditure, and analyses the FY2005 federal budget and trade policy. We hope that the contents of this report will be of use to all stakeholders including the Government, civil society, donors, academia, media, and others. We look forward to receiving comments on the report, and also suggestions for improvement of future reports in this series.

M.ALI SHAH
Country Director, Pakistan

Contents

Foreword

I. Macroeconomic Developments	2
Domestic Sector	2
Growth	2
Investment and Saving	5
Prices	6
Monetary Management	7
Fiscal Situation	9
Stock Market	11
External Sector	12
Balance of Payments	12
Balance of Trade	12
Current Account	16
Capital & Financial Account	18
Foreign Exchange Reserves	18
Outlook	18
II. Economic Polices & Reforms	21
Analysis of Federal Budget 2004-05	21
Fiscal Outcome FY2004	21
Revenues	21
Expenditure	21
Federal Budget FY2005	24
Revenues	25
Current Expenditure	26
Public Sector Development Program	26
Key Policy Measures	27
Agriculture	27
Industry	28
Small & Medium Enterprises	28
Housing & Construction	28
Other Growth-oriented Measures	28
Tax Administration	29
Relief Measures	29
Overall Assessment	29
Trade Policy FY2005	30
Product Diversification of Exports	30
Geographical Diversification of Exports	30

Enhancing Competitiveness	30
Encouraging Investment	30
Trade Facilitation	31
III. Poverty Reduction	32
Decline in Incidence of Poverty	32
PRSP Expenditures	32

TABLES

Table 1: Sectoral Growth and Inflation	2
Table 2: Growth in Large-scale Manufacturing	4
Table 3: Consolidated Fiscal Position	10
Table 4: Financing of Overall Fiscal Deficit	11
Table 5: Changes in Prices & Quantities of Exports	14
Table 6: Structure of Exports	15
Table 7: Structure of Imports	16
Table 8: Balance of Payments	17
Table 9: Medium-term Outlook	19
Table 10: Summary of Federal Fiscal Indicators	22
Table 11: Revenue Receipts	23
Table 12: Federal Expenditures	24
Table 13: Federal Subsidies	25
Table 14: Budgetary PSDP 2004-05	27
Table 15: PRSP Budgetary Expenditures	33

FIGURES

Figure 1: Inflation	6
Figure 2: Composition of Monetary Assets	9
Figure 3: Stock Market Performance	12
Figure 4: Growth Rates of Exports & Imports	13

BOXES

Box 1: Reforms in Agriculture Sector Stalled	3
Box 2: Inflation Picks Up	7
Box 3: Sharp Increase in Agricultural Credit	8

PAKISTAN ECONOMIC UPDATE

(JULY 2003 - JUNE 2004)

Economic reforms of the last four years have started showing results in the form of strong recovery in the economy. The real GDP growth exceeded 6 percent after seven years, and macroeconomic fundamentals were better than at any time in decades. Investment in key sectors, like large-scale manufacturing, telecommunication, and oil and gas, also picked up. With sound macroeconomic fundamentals, pick up in investment, and improvement in relations with India, the Pakistan economy is poised to move to a high growth path in the medium term.

Structural reforms and macro-economic stabilization consistently pursued over the past four years have started showing results in the form of a strong recovery in the economy. The large-scale manufacturing sector achieved a record growth in FY2004.¹ With historically low interest rates and most industries having reached near full capacity utilization, there was also a sharp increase in investment in the large-scale manufacturing sector. Similarly, conducive regulatory and policy environment in the oil and gas and telecommunication sectors has attracted significant foreign direct investment.

Overall, the economy is poised to move to a high growth path in the medium term. However, with the economic recovery gaining momentum, prices, interest rates, and the exchange rate will come under pressure. Both inflation and interest rates have bottomed out and the Rupee has depreciated in recent months, as the trade deficit increased and the current account surplus declined sharply.

As economic recovery gains further strength, prices, interest rates, and exchange rate will come under greater stress. The management of the economy will become

more complex, as the Government moves away from a focused pursuit of macroeconomic stabilization to balancing the imperatives of growth and stabilization.

It will be a real challenge for the State Bank of Pakistan (SBP) to manage the rise in interest rates in such a way that it does not thwart the ongoing economic recovery. At the same time, the Government in financing the fiscal deficit, will have to find a balance between excessive domestic borrowing crowding out credit for the private sector, and excessive external borrowing eroding the gains of the last few years in debt management. The Government will also have to contain its borrowing requirements by mobilizing adequate revenues by consistently moving forward with taxation reforms, as well as improvements in tax administration. Finally, SBP will have to use the exchange rate to keep the growing deficit in the trade account under control, instead of the Government using tariff and non-tariff measures to restrict imports.

1. Fiscal year starts on 1 July and ends on 30 June.

I. MACROECONOMIC DEVELOPMENTS

Economic recovery gained further momentum in FY2004 and the overall performance of the economy turned out to be much better than forecast in the beginning of the year. The real GDP growth exceeded the initial Government target by a wide margin and the fiscal deficit was also lower than the target. The acceleration in growth was entirely due to the industrial sector, which posted the highest growth in last two decades. The services sector maintained its last year's growth, with the wholesale and retail trade sector giving an impressive performance, while growth of the agriculture sector was significantly lower. The current account of the balance of payments remained in surplus for the fourth consecutive year, but the magnitude of the surplus was greatly reduced. Also, inflation emerged as an area of concern, as it took a sharp upturn and the annual rate exceeded the target.

GDP growth exceeded the Government target by a wide margin and the fiscal deficit was also lower than the target.

Domestic Sector

Growth: The economy's overall performance improved further in FY2004, with the real GDP growth for the year estimated at 6.4 percent compared with 5.1 percent in FY2003 (see table 1).

Agriculture sector grew by 2.6 percent in FY2004 compared with 4.1 percent in FY2003. The deterioration in the performance of the sector was mainly due to a sharp decline in growth of output of major crops, which contribute more than one-third of the value-added in agriculture.

Unfavorable weather conditions damaged the wheat crop, and increase in its output (3.0 percent) was lower than last year. The cotton crop suffered a pest attack, which resulted in a 1.6 percent decline in its output. In the case of rice and sugarcane, the other two major crops, also output growth was much smaller than last year. As a result, value-added in the crop sub-sector increased

Table 1: Sectoral Growth and Inflation

	FY2002	FY2003	FY2004
% Growth Rates			
GDP	3.1	5.1	6.4
Agriculture	0.1	4.1	2.6
Industry	2.6	5.8	13.1
Of which:			
Large-scale Manufacturing	3.5	7.2	17.1
Services	4.8	5.3	5.2
GNP	5.1	7.9	5.2
Per-capita Income	3.1	5.8	3.3
Inflation	3.5	3.1	4.6
Contribution to GDP Growth			
Agriculture	0.0	1.0	0.6
Industry	0.6	1.3	3.0
Of which:			
Large-scale Manufacturing	0.4	0.8	1.8
Services	2.5	2.8	2.8

Source: Pakistan Economic Survey 2003-04, Finance Division, Government of Pakistan.

by 2.5 percent compared with 5.1 percent in the preceding year. Because of a setback suffered by the poultry business due to the bird flu, growth in value-added in the livestock sub-sector, at 2.6 percent, was also marginally lower than the preceding year.

However, despite the lower growth rate, higher prices of most major crops, particularly those of cotton, rice and wheat, resulted in a significant increase in farmers' cash income. Deregulation of agricultural output markets and removal of barriers to trade implemented in the past several years have more or less linked domestic agricultural commodity markets with international markets. As a result, prices of wheat, cotton and rice recorded significant increases, which greatly compensated the farmers for smaller growth in output. Higher prices of these commodities resulted in additional

cash income of Rs 60.0 billion for the farmers. However, the implementation of this deregulation policy has recently been marred by interventions by the Government (see box 1).

Manufacturing sector grew by 13.4 percent in FY2004, and the large-scale manufacturing (LSM) sub-sector recorded the highest growth achieved in last two decades (see table 2). With excess capacity available in most industries at the beginning of the year, manufacturing production increased as domestic demand surged due to an unprecedented increase in consumer credit, accelerating economic growth, higher cash incomes of cotton farmers, and continuing high level of remittances. Production data for LSM, available for the first three quarters of the year, shows that the quantum index of manufacturing, covering output of 100 large-scale

Large-scale manufacturing recorded the highest growth achieved in last two decades.

Box 1: Reforms in Agriculture Sector Stalled

One of the objectives of economic reforms pursued by successive governments has been to curtail the role of public sector and encourage private sector participation in markets for agricultural outputs and inputs. Marketing of fertilizers and pesticides has been completely privatized, while both public and private sectors operate in the seed market. The Government has also got out of all output markets, except for wheat. Three years ago, it initiated reforms to encourage greater role of the private sector in marketing of wheat. However, recent policy actions have left the private sector participants guessing about the direction of official policy. At the beginning of the wheat-harvesting season, the Government of Punjab banned the inter-provincial and inter-district movement of wheat, and conducted raids on flourmills and storage facilities of traders and confiscated the wheat purchased by them. Midway through the season, SBP imposed a 50 percent cash margin requirement for bank loans to traders and flourmills against wheat. Both the actions were meant to increase public sector purchases of wheat at the expense of the private sector. These interventions depressed the price of wheat received by wheat growers in Punjab, and discouraged private traders and millers from making longer-term investment in badly needed areas such as storage and handling facilities. At the same time, it gave the signal to the market that shortage was much larger than expected and prompted hoarding and an excessive increase in market price of wheat in the Punjab, resulting in windfall gains for hoarders. Also, the price of wheat rose sharply in the wheat deficient provinces of Sindh, North West Frontier, and Balochistan. Thus despite the use of strong administrative measures, the Punjab Government failed to meet its procurement target. The objective of stabilizing the price of wheat in Punjab could have been easily achieved by timely announcement of the Government's intentions to import wheat to bridge the gap between consumption and domestic production of the commodity. Following the failure of the administrative measures, the Government has announced that it will import one million tons of wheat.

industries, increased by 17.1 percent compared with 6.7 percent in the same period of FY2003.² As is clear from table 2,

increase in production was broad-based. Particularly large increases were seen in the production of export products (cloth and

Table 2: Growth in Large-scale Manufacturing Production

	Weights (%)	% Change in July - March	
		FY2003	FY2004
Items			
Textiles	24.5	3.3	7.0
<i>Of Which:</i>			
Cotton Yarn	13.1	6.3	1.9
Cotton Cloth	7.6	0.9	15.6
Food, Beverages, and Tobacco	14.4	2.6	13.5
<i>Of Which:</i>			
Vegetable Ghee	4.2	-5.1	13.6
Sugar	4.2	12.3	14.8
Cigarettes	3.1	-7.2	9.9
Petroleum Products	5.2	2.5	1.7
Pharmaceuticals	5.0	1.8	14.1
Chemicals	4.8	0.9	28.3
Fertilizers	3.4	-12.0	51.2
Non-metallic Minerals	4.2	15.9	13.7
<i>Of Which:</i>			
Cement	4.1	15.3	13.7
Metal Products	3.5	8.0	7.0
Automobiles	4.0	48.7	52.8
<i>Of Which:</i>			
Cars and Jeeps	2.5	51.6	63.5
Tractors	0.7	16.4	42.4
LCVs	0.4	57.6	5.6
Electronics	2.5	46.8	45.8
Leather Products	2.3	-4.7	39.0
Paper and Board	0.6	16.5	7.9
Tires and Tubes	0.3	15.5	2.7
Engineering Goods	0.4	34.3	15.1
Others	24.9	5.6	18.1
Total	100.0	6.7	17.1

Source: www.sbp.org.pk

2. With the change in base from 1980-81 to 1999-00, the coverage of the quantum index of manufacturing was extended to eight more items (wheat, deep freezers, fans, soaps and detergents, toilet soap, starch and its products, matches, and synthetic rinse). As the output data for these additional items is not available for earlier years, increase in quantum index of manufacturing in FY2004 is not strictly comparable with growth in earlier years.

leather products), consumer durables (cars, motorcycles, air-conditioners, and refrigerators), intermediate goods (cement, glass sheets, fertilizers, and chemicals), and investment goods (tractors and engineering goods). Increase in manufacturing production in the past two years has mostly come from increased capacity utilization, although expansion of capacity also started in some industries, as is clear from revival of investment in large-scale manufacturing (see section on Investment and Saving). However, with most industries now operating at or near full capacity, there will be need for investment in capacity expansion across the board.

Electricity and gas distribution, and construction, the other two major sub-sectors included in the industrial sector, also exhibited marked improvement in their performance in FY2004. Value-added in generation and distribution of electricity and gas increased by 22.5 percent in contrast with a decline of 2.6 percent in FY2003. In electricity generation, the major contributor was increase in hydel generation, which increased by 30.0 percent due to Ghazi Barotha Hydel Project becoming operational. Gas production increased sharply by 21.8 percent as earlier investments came on stream. In the construction sector, growth was boosted by expanding public sector development program, increasing private sector investment, easy availability of housing finance from banks along with fiscal incentives given in the FY2004 budget. Value-added in construction increased by 7.9 percent, compared with a 3.1 percent growth in the preceding year.

Services sector growth was more or less the same as last year. Growth in public administration and defense, at 5.9 percent, was significantly less than last year's growth of 10.1 percent. However, value-added in wholesale and retail trade increased by 8.0 percent, reflecting recovery in domestic

economic activity, acceleration in imports, and continuing double-digit growth in exports. Growth in telecommunication services remained strong, and the number of cellular phone subscribers increased from 2.4 million as of end-June 2003 to 3.7 million in March 2004, while the number of fixed line connections increased to 4.3 million.

Investment and Saving: Investment picked up in FY2004, with Gross Fixed Capital Formation (GFCF) in constant prices increasing by 14.7 percent compared with 1.0 percent increase recorded in FY2003. The upsurge in GFCF was more pronounced in the public sector, where it increased by 40.8 percent. However, a part of the sharp increase in public sector GFCF was due to the base effect, as last year it had declined by 29.4 percent. GFCF in the private sector rose by 7.9 percent on the back of a 5.2 percent increase recorded last year. Within the private sector, sharp increases were seen in investment in LSM (25.4 percent), residential construction (25.0 percent), and other construction (15.0 percent). As most industries in LSM sector approached capacity limits during FY2004, there was pressure for expansion in capacity, which was facilitated by abundant availability of credit at low interest rates. In the public sector, investment in transport and communication, and electricity and gas increased sharply, as did investment by all the three tiers of general government. As a percentage of GDP, GFCF increased from 14.8 to 16.4 percent. Inclusive of accumulation of stocks, total investment increased from 16.7 percent of GDP to 18.1 percent.

Foreign direct investment (FDI) registered a significant increase for the third consecutive year in FY2004, increasing by 19.2 percent to \$951 million. In the preceding two years, FDI had increased by 50.2 percent and 64.5 percent, respectively. Exclusive of privatization proceeds, FDI

With most industries now operating at or near full capacity, there will be need for investment in capacity expansion.

Foreign direct investment increased to almost a billion dollars.

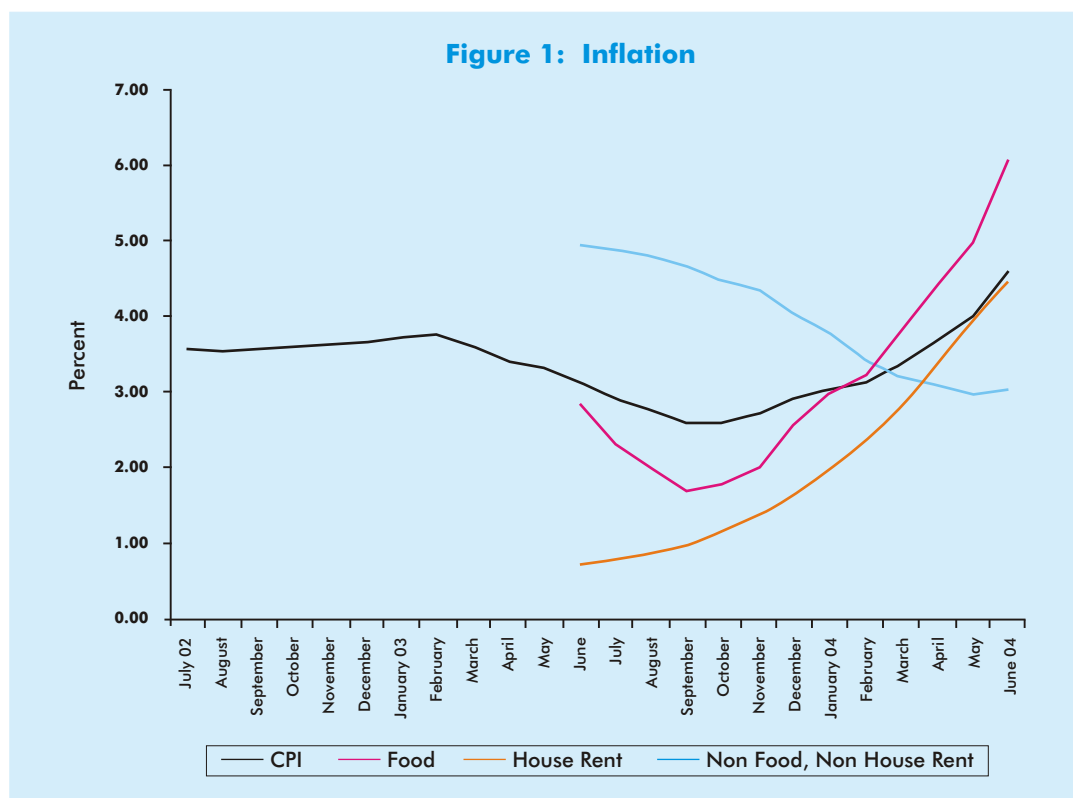
The upward trend in inflation, which started in October 2003, continued through June 2004.

increased by 22.5 percent to \$752 million.³ Oil and gas exploration remained the most attractive sector for foreign investors, followed by communications and financial services.⁴ In terms of sources, U.S.A. was the largest provider of foreign investment, accounting for one quarter of the total, followed by Switzerland, United Arab Emirates, and United Kingdom. These four countries together provided more than two thirds of total FDI in Pakistan. As regards foreign portfolio investment, there was an outflow of \$27.7 million in FY2004 compared with an inflow of \$22.1 million in FY2003.

Gross Domestic Savings (GDS) remained unchanged at 17.4 percent of GDP in FY2004. However, because of lower net factor income from abroad, Gross National

Savings (GNS) declined to 19.5 percent of GDP from 20.6 percent in FY2003. GNS exceeded total investment for the fourth consecutive year resulting in a surplus in the current account of the balance of payments (see section on Balance of Payments).

Prices: The upward trend in inflation, which started in October 2003, continued through June 2004, and the annual rate of inflation, based on a 12-month moving average of CPI, increased from 2.6 percent in September 2003 to 4.6 percent in June 2004 (see figure 1). Particularly sharp turnaround was seen in inflation in food and house rent, which together carry a weight of 63.7 percent in CPI. Non-food, non-rent inflation showed deceleration. The marginal rate of inflation, based on quarterly moving average of CPI, registered a sharper upturn,



3. Data on privatization proceeds is available only for the first ten months of the year.

4. Investment in the financial sector was in the form of privatization proceeds for the Habib Bank Limited.

increasing from 1.7 percent in August 2003 to 7.2 percent in June 2004. The WPI-based inflation also increased from 5.6 percent in FY2003 to 7.9 percent in FY2004. The impetus for the upturn in inflation has come mainly from supply-side factors so far (see box 2).

Monetary Management: The State Bank of Pakistan (SBP) continued to pursue an easy monetary policy through most of FY2004. Despite an upturn in inflation since the second quarter of the year, SBP did not reverse its monetary stance, lest it stall the nascent economic recovery. Also, as the upsurge in inflation was mostly confined to increases in food prices and house rent caused by supply constraints, tightening of monetary policy was not considered an appropriate policy. SBP by keeping its acceptances in treasury-bill (TB) auctions at

very low levels and proactively injecting liquidity in the market through open market operations ensured that the increase in short-term interest rates was gradual. The yield on 6-month TBs rose from 1.2 percent August 2003 to 2.1 percent in May 2004. Interest rate on the 10-year Pakistan Investment Board (PIB) increased from 5.6 percent in June 2003 to 6.2 percent December. The interest rate on 15-year and 20-year PIBs, first auctioned in January 2004, increased from 7.7 percent and 8.7 percent, respectively, to 8.99 percent and 9.99 percent in June 2004. Interest rate on 6-month TBs was also allowed to rise to 2.5 percent in the auction held on 21st July 2004.

Money supply increased by 17.6 percent in FY2004 compared with an increase of 17.4 percent recorded in

The State Bank of Pakistan continued to pursue an easy monetary policy, and ensured that the increase in interest rates was gradual.

Box 2: Inflation Picks Up

The two years preceding October 2003 was a period of low inflation. By September 2003, CPI-based annual rate of inflation had declined to as low as 2.6 percent — the lowest in the last three decades. Comfortable availability of essential food items, unutilized capacity in the large-scale manufacturing sector, declining interest rates, appreciating Rupee, and global price stability, all contributed to low inflation during this period.

In September 2003, the CPI-based annual inflation bottomed out. The upward trend in prices has been continuing since then, and it is likely to be sustained in FY2005. So far, the upsurge in inflation has been mostly driven by supply-side factors. Shortage of wheat, which emerged in the second quarter of FY2004, pushed up prices of wheat, wheat flour and other wheat-based products. As the wheat harvest in April and May 2004 fell short of the target, and the Government introduced extraordinary measures to procure wheat resulting in its hoarding by the private sector, the higher wheat price was sustained even after the harvest. The price of wheat flour rose by 15.1 percent in FY2004. Prices of mutton, beef, and poultry also rose sharply in the second half of the year. Many poultry farms went out of business in January-February 2004, when prices of poultry products plummeted in the wake of detection of bird flu in Karachi. Subsequently, the price of poultry meat recorded a sharp increase. Diversion of consumer demand to mutton and beef, initially caused by the bird flu scare and later sustained by shortage of poultry meat, put pressure on their prices, which increased by 23.3 percent and 23.1 percent, respectively, in FY2004. The food inflation, based on the 12-month moving average of consumer price index for the food group, increased from 1.7 percent in September 2003 to 6.0 percent in June 2004 (see figure 1 above). House rents started increasing in May 2003 in the wake of unprecedented increase in prices of real estate. The house rent inflation increased from 0.7 percent in June 2003 to 4.5 percent in June 2004.

With economic recovery gaining further momentum, inflation in Pakistan is expected to rise further in FY2005. Also, with money supply having increased at a significantly higher rate than increase in nominal GDP in the last three years, price increases are likely to become more generalized in FY2005. In addition, most industries are now operating at or near full capacity, and, therefore, excess capacity, which earlier served as a dampener on prices, will not be there. The recent upturn in global inflation, and particularly the large increase in oil prices, will also put pressure on domestic prices in Pakistan.

Net flow of credit to the private sector was almost twice as large as that last year.

FY2003. In contrast with the preceding two years, when the bulk of the increase in money supply (over 90 percent) was due to increased net foreign assets of the banking system, in FY2004 domestic credit expansion accounted for almost nine-tenths of the increase in money supply. Within domestic credit, net flow of credit to the private sector, at Rs 301.2 billion, was almost twice as large as that last year, reflecting continuing recovery in domestic economic activity. Besides pick up in economic activity, banks' entry into non-traditional sectors like consumer lending and agricultural credit contributed to expansion in private sector credit (see box 3). There was also a large net expansion in bank lending to exporters in contrast to the small net retirement last year. In the public sector also, the Government's

bank borrowing for budgetary support increased by Rs 68.0 billion in sharp contrast with a retirement of Rs 44.0 billion last year. This happened despite lower borrowing requirements of the Government, because deposits in national saving schemes (NSS), the major source of non-bank borrowing, declined.⁵ Public sector enterprises (PSEs) managed to retire Rs 10.7 billion compared with retirement of Rs 8.1 million last year, reflecting improvement in their financial position.

During the last one and a half years, real interest rates on bank deposits have remained negative, which has impacted the composition of monetary assets. Because of its low opportunity cost, there has been a shift to liquid monetary assets, i.e. demand

Box 3 : Sharp Increase in Agricultural Credit

Due to conducive policy environment resulting from financial sector reforms implemented since 1997, as well as excess liquidity in the market, commercial banks have greatly expanded their lending operations in the agriculture sector in the last two years. The actual disbursement of agricultural credit exceeded the target set by the Government in FY2004 (see table). The increase was almost entirely due to higher lending by commercial banks, and for the first time ever they provided more agricultural credit than the Zarai Taraqati Bank Limited (ZTBL — formerly Agricultural Development Bank of Pakistan).

Gross Disbursement of Agricultural Credit (Billion Rs)

	FY2002		FY2003		FY2004
	Disbursement	Target	Disbursement	Target	Disbursement
Five Big Commercial Banks*	17.5	18.7	22.7	22.4	33.2
Other Private Commercial Banks	0.6	2.7	1.4	2.7	2.7
Total Commercial Banks	18.1	21.4	24.1	25.1	35.9
ZTBL	29.1	35.0	29.3	33.0	29.9
PPCBL**	5.3	6.3	5.5	7.5	7.7
Total	52.5	62.7	58.9	65.6	73.6

* National Bank of Pakistan, Habib Bank Limited, United Bank Limited, Muslim Commercial Bank, and Allied Bank Limited.

** Punjab Provincial Cooperative Bank Limited.

Source: State Bank of Pakistan.

5. In the first eleven months of FY2004, the Government retired Rs 666 million of its borrowing through NSS instruments, in contrast with a net borrowing of Rs 110 billion last year.

deposits. Their share in total money supply increased from 25 percent as of end-June 2002 to 29 percent at end-June 2003 and further to 31 percent on 26th June 2004. The share of time deposits, on the other hand, declined by 2 percentage points over this period (see figure 2). As more liquid monetary assets normally exert greater upward pressure on prices, in addition to monetary overhang of last three years, the change in composition of monetary assets may also add to inflation in FY2005 (see Box 2 above).

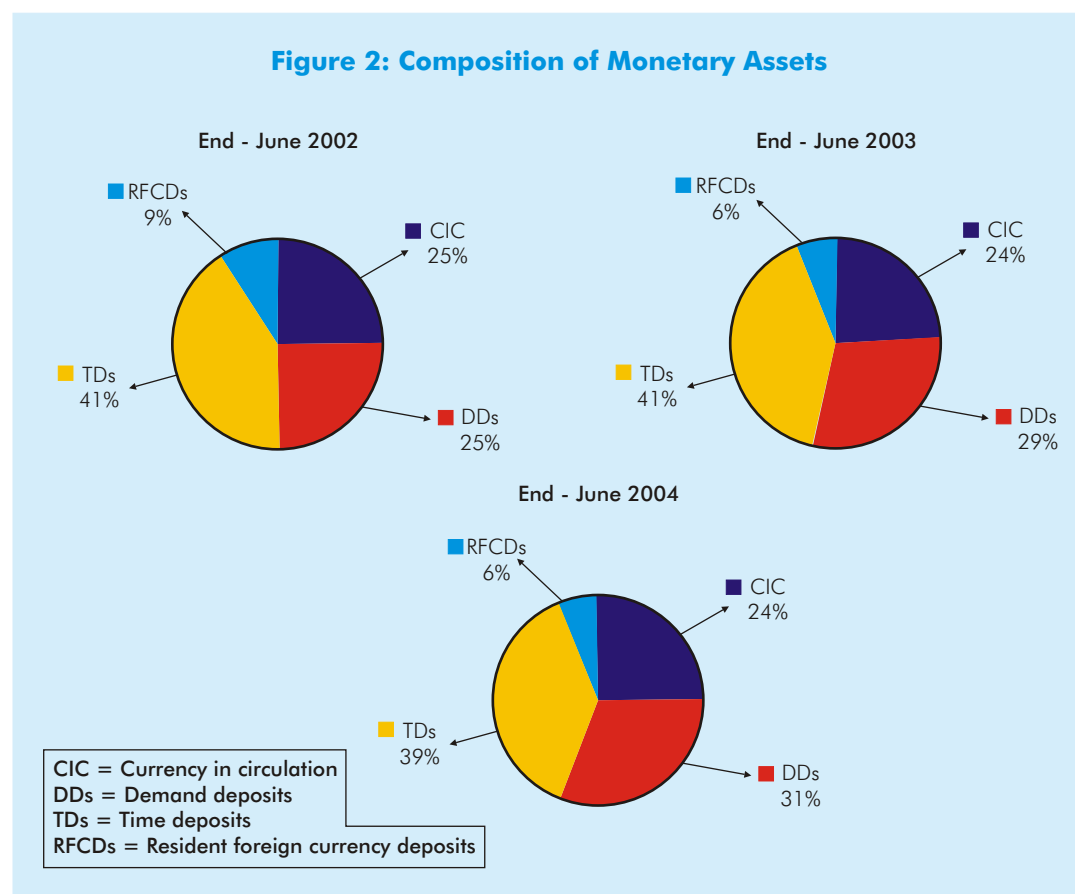
Fiscal Situation: The Government maintained a tight fiscal stance in FY2004 and the overall budget deficit declined

further to 3.3 percent from 3.7 percent in FY2003 (see table 3).⁶ The sharp improvement in the fiscal position during the year was the result of strong economic growth and a faster increase in revenues than in expenditures. Revenues increased by 8.3 percent, while increase in expenditure was kept at 6.6 percent, despite large increases in development and defense expenditures.

The current expenditure of federal and provincial governments in FY2004, at Rs 793.6 billion, was more or less the same as last year. This was made possible by interest payments remaining unchanged, thanks to lower domestic interest rates and the Government policy of pre-paying expensive

The Government maintained a tight fiscal stance and the overall budget deficit declined to 3.3 percent of GDP from 3.7 percent in FY2003.

Figure 2: Composition of Monetary Assets



6. These numbers are not comparable with earlier reports as in the calculation of the deficit to GDP ratio, GDP at current market prices with the base (1999 - 2000 = 100) has been used as denominator.

Table 3: Consolidated Federal and Provincial Fiscal Position (Billion Rs)

	FY2003 (RE)	FY2004 (MBE)	% Change
Total Revenue	720.8	780.3	8.3
Federal Revenue	673.6	726.9	7.9
Of Which:			
CBR Taxes	461.7	510	10.5
Surcharges	68.2	62.1	-8.9
Non-tax Revenues	139.6	152.2	9.0
Provincial Revenues	47.2	53.4	13.1
Total Expenditure	898.2	957.7	6.6
Current Expenditure	791.7	793.6	0.2
Federal	599.8	589.2	-1.7
Of Which:			
Interest	199.8	202.5	1.4
Defense	159.7	180.0	12.7
Running of Civil Administration	60.9	70.5	15.8
Provincial	191.9	204.4	6.5
Development Expenditure and Net Lending	106.5	164.1	54.1
Of Which:			
Development Expenditure	129.2	152.0	17.6
Statistical Discrepancy	3.2	0	
Budget Deficit	-180.6	-177.4	-1.8
As % of GDP	3.7	3.3	

RE = Revised estimates.

MBE = Modified budget estimates.

Source: 1) Pakistan Economic Survey 2003-04, Finance Division, Government of Pakistan.

2) www.finance1.finance.gov.org

international debt. As a percentage of GDP, interest payments declined from 4.7 to 4.1.⁷ Defense expenditure and expenditure on running civil administration recorded significant increases.

Consolidated development expenditure showed a sharp increase of 17.6 percent to Rs 152.0 billion. As a percentage of GDP, development expenditure increased from 2.7 to 2.8. There was a larger increase in development outlays by the Federal Government than by provincial governments.

Both tax and non-tax revenues recorded significant increases in FY2004. Receipts from taxes collected by provincial governments showed a sharp increase of 20.2. However, provincial tax receipts constitute only 4.3 percent of total tax collection. As a percentage of GDP, revenue receipts declined from 14.9 to 14.3. Tax receipts, excluding surcharges, also declined from 10.1 percent of GDP to 9.9 percent. Since FY2000, tax-to-GDP ratio has remained more or less constant at around 10.0 percent. However, this has been a period of tax reforms involving reduction of import

Development expenditure increased by 17.6 percent to Rs 152.0 billion.

7. In FY2000, interest payments were 6.9 percent of GDP.

duties, lowering of corporate tax rates for banks and private companies, and phasing out of excise duties on a number of items. Therefore, stagnancy of tax-to-GDP ratio is understandable. However, as major tax reforms have now been completed, the tax ratio should increase in coming years.

As a result of macroeconomic stabilization pursued by the Government, the overall fiscal deficit has declined over the last four years, and the deficit to GDP ratio in FY2004, at 3.3 percent, was 2.1 percentage points lower than its level in FY2000. Throughout this period, the budget has shown a robust primary surplus. With continuing primary surplus and GDP growth exceeding the average interest rate on public debt, public debt indicators are expected to improve further in the medium term.

Because of pre-payment of \$1.2 billion (about Rs 67 billion) of the Asian Development Bank loans in FY2004, net foreign financing of the budget deficit sharply declined to Rs 14.4 billion compared with Rs 113.0 billion in FY2003 (see table 4). Exclusive of the one-off pre-payment, net foreign financing would have declined to about Rs 82 billion. In the domestic sources of financing the budget deficit, there was a welcome shift from high-cost non-bank borrowing to low-cost

bank borrowing. This was made possible by the rationalization of interest rates on National Saving Scheme instruments (see box 2 in Pakistan Economic Update July - December 2003).

Stock Market: Except for a decline in September and October 2003, share prices continued their rising trend through most of the first ten months of FY2004, with the Karachi Stock Exchange (KSE)-100 index peaking at 5,621 on 19th April 2004 (see figure 3). Thereafter, equity prices declined amid fluctuations, and the KSE-100 index fell to 5,297 on 30th June 2004. For the year as a whole, the index rose by 55.2 percent. Stable exchange rate, low interest rates, higher economic growth, improved corporate profitability, and improvement in relations with India were the key factors contributing to buoyancy in the stock market in FY2004.

The slowdown in the corporate bond market, seen in the fourth quarter of FY2003, continued through FY2004. There were only six issues worth Rs 4.3 billion in the first ten months of the year, down from nineteen issues for Rs 9.9 billion in the corresponding period of last year. The slow down in the corporate bond market reflected the impact of low interest rates and aggressive lending policies of commercial banks. However, with the change in interest rate

As major tax reforms have now been completed, the tax-GDP ratio should increase in coming years.

There was a shift in domestic sources of financing the fiscal deficit, from high-cost non-bank borrowing to low-cost bank borrowing.

Table 4: Financing of Overall Fiscal Deficit (Billion Rs)

	FY2002	FY2003	FY2004
Overall Fiscal Deficit	190.5	180.6	177.4
Financing			
External Borrowing (net)	83.1	113.0	14.4
Domestic Borrowing (net)	99.0	63.9	152.0
Non-bank Borrowing (net)	85.0	119.5	70.0
Bank Borrowing (net)	14.0	-55.6	82.0
Privatization Proceeds	8.4	3.7	11.0

Sources: Pakistan Economic Survey, Finance Division, Government of Pakistan.

In FY2004, exports increased by 10.0 percent and imports by 26.6 percent.

Growth of exports in FY2004 was mainly due to increase in prices; volumes increased by only 2.8 percent.

expectations toward the end of FY2004, the corporate bond market is likely to revive in FY2005.

External Sector

Balance of Payments

Balance of Trade: In FY2004, exports increased by 10.0 percent to \$12.3 billion and imports by 26.6 percent to \$15.5 billion. Imports maintained a double-digit growth throughout the year due to substantial increases in the import of machinery, chemicals and other raw materials (see figure 4). In the last quarter of the year, import growth sharply accelerated to 57.6 percent, partly due to import of aircrafts by the Pakistan International Airlines. Even after excluding the import of aircrafts, the last quarter growth was 40.2 percent, indicating a pick up in imports toward the end of the year. Export growth, on the other hand, decelerated sharply in the last quarter of the year, declining to 1.9 percent, compared with 13.3 percent in the first three quarters. However, the sharp decline in export growth was mostly due to the base effect, as there had been a large increase of

27.4 percent in the corresponding quarter of last year.

Growth of exports in FY2004 was mainly due to increases in prices. For four fifths of exports for which quantity and price data are available, prices increased by 8.7 percent, while volumes increased by only 2.8 percent (see table 5). The slow growth in volume of exports is a matter of concern, but it is possible that a part of the increase in prices of Pakistani exports may be due to a shift from lower to higher value-added items.

Like last year, textile manufactures led the growth in exports in FY2004 (see table 6). Textile exports increased by 12.0 percent to \$8.1 billion and contributed 77.7 percent of total export growth. Concentration of exports in textiles also increased to 65.9 percent from 64.7 percent last year. Export of bedwear suffered a setback in the last quarter of FY2004 due to the imposition of a 13.1 percent anti-dumping duty by the European Union, which is currently the largest importer of Pakistani bed linen. In the last quarter of the year, bedwear export declined by 11.8 percent compared with a 12.3 percent

Figure 3: Stock Market Performance

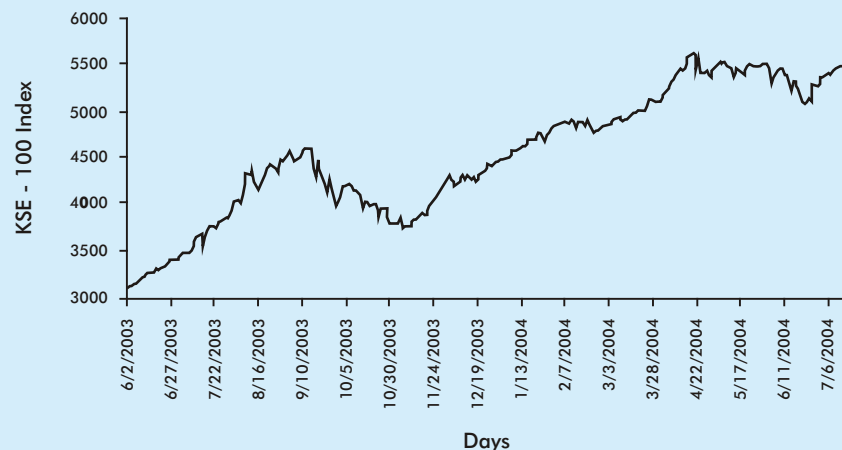
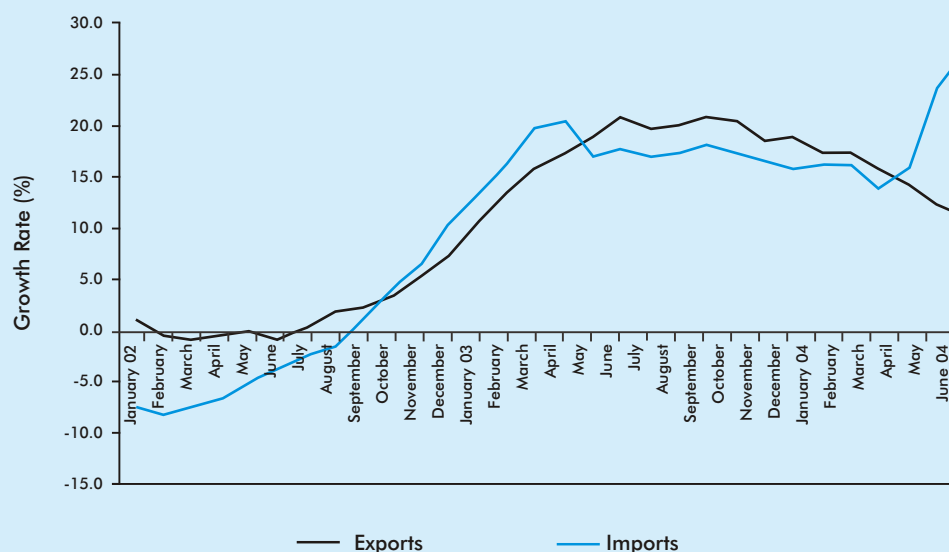


Figure 4: Growth Rates of Exports & Imports Based on 12-Month Moving Average



growth in the first three quarters. The decline (8.5 percent) in the export of artificial silk and synthetic textile seen in the first three quarters, accelerated in the last quarter to 43.3 percent. An 8.2 percent decline in the exports of garments in FY2004, due to 23.6 percent decrease in the volume, is also a matter of concern.

Export of non-textile manufactures, mainly comprising of leather and leather manufactures, sports goods, carpets, and petroleum products showed an increase of 1.9 percent. Within this category, there were wide variations in growth registered by individual items. For instance, export of footballs increased by 75.5 percent, leather garments increased by 34.9 percent, engineering goods by 30.1 percent, and petroleum products by 24.5 percent. The growth in export of engineering goods is particularly encouraging, as it took place on the back of 16.7 percent and 33.1 percent increases in the preceding two years. However, the total amount at \$74 million is still quite small. On the other hand, there

were sharp declines in the export of sports goods, other than footballs, surgical and medical instruments, and non-specified leather manufactures.

Export of primary goods in FY2004 featured a near disappearance of wheat export, which declined to only \$6 million from \$130 million in FY2003, as surpluses turned into shortages. Export of cotton also has declined in recent years, as more and more of it is being used up by the expanding domestic textile industry. Excluding wheat and raw cotton, there was an increase of 15.1 percent in primary commodities export. Export of fruits increased by 24.4 percent to \$104 million and among primary exports it emerged as the third largest export item after rice and fish. Substitution of better quality basmati rice for other varieties continued for the third consecutive year in FY2004, and the former now constitutes 67.0 percent of total rice exports, a substantial increase from 45.0 percent three years ago.

Export of fruits increased by 24.4 percent to \$104 million and among primary exports it emerged as the third largest export item after rice and fish.

Table 5: Changes in Prices and Quantities of Major Exports in FY2004

Commodities	% Change in Price	% Change in Quantity	% Change in Value
Primary Commodities	11.5	-10.4	0.0
<i>Of Which:</i>			
Basmati Rice	2.6	13.4	16.4
Other Rice	19.7	-11.1	6.5
Raw Cotton	43.7	-32.2	-2.4
Fish and Fish Preparations	3.2	12.6	16.2
Fruits	-11.9	41.3	24.4
Textile Manufactures	8.7	2.8	11.7
<i>Of Which:</i>			
Cotton Yarn	25.4	-2.0	22.9
Cotton Cloth	8.9	16.8	27.2
Knitwear	0.0	28.3	28.3
Beadwear	2.4	2.0	4.5
Readymade Garments	20.1	-23.6	-8.2
Towels	6.5	3.2	9.9
Art Silk and Synthetic Textiles	-1.7	-17.2	-18.6
Other Manufactures	8.3	0.0	8.2
<i>Of Which:</i>			
Carpets	6.7	-6.5	-0.3
Petroleum Products	16.7	6.7	24.5
Tanned Leather	2.3	1.1	3.4
Plastic Materials	21.5	-2.0	19.1
Total	8.7	2.8	11.7

Source: www.statpak.gov.pk

Non-food, non-oil imports increased by 30.6 percent in FY2004.

In imports, non-food and non-oil imports accelerated in FY2004, recording a growth of 38.0 percent on the back of 21.8 percent growth in FY2003 (see table 7). The sharp increase in these imports was partly due to import of aircrafts worth \$781 million in the fourth quarter. However, even after excluding aircrafts, non-food, non-oil imports increased by 30.6 percent in FY2004 compared with an increase of 22.3 percent in the preceding year. This reflected further strengthening of the ongoing economic recovery. Large increases were recorded in raw materials and intermediate goods for industry, like completely knocked

down automobile kits (26.2 percent), iron and steel (29.3 percent), aluminum (39.7 percent), plastic materials (25.0 percent), synthetic and artificial silk yarn (25.9 percent), and pesticides used in agriculture (104.2 percent). Import of machinery, excluding aircrafts, also increased by 16.4 percent.

Import of textile machinery, which is the single largest item in the machinery group, picked up in the second half of the year and increased by 10.0 percent to \$586 million in the full FY2004. This shows that investment for modernization of textile

Table 6: Structure of Exports (Million US\$)

Commodities	FY2003	FY2004	% Growth
Primary Commodities	1,007	1,007	0.0
<i>Of Which:</i>			
Rice	556	627	12.9
a) Basmati Rice	361	420	16.4
b) Other Rice	195	207	6.5
Raw Cotton	49	48	-2.4
Fish and Fish Preparations	135	156	16.2
Wheat	130	6	-95.4
Fruits	83	104	24.4
Textile Manufactures	7,225	8,090	12.0
<i>Of Which:</i>			
Cotton Yarn	928	1,141	22.9
Cotton Cloth	1,346	1,712	27.2
Knitwear	1,147	1,471	28.3
Bedwear	1,329	1,388	4.5
Towels	375	412	9.9
Readymade Garments	1,093	1,004	-8.2
Art Silk and Synthetic Textiles	574	468	-18.6
Other Manufactures	2,117	2,157	1.9
<i>Of Which:</i>			
Carpets	221	220	-0.3
Sports Goods	335	310	-7.7
Petroleum Products	206	257	24.5
Tanned Leather	235	243	3.4
Leather Manufactures	387	403	4.3
<i>Of Which:</i>			
Leather Garments	232	313	34.9
Chemical and Pharm. Products	261	263	0.9
<i>Of Which:</i>			
Plastic Materials	103	123	19.1
Surgical and Other Medical Instruments	150	124	-17.3
Others	812	1,020	25.7
TOTAL	11,160	12,274	10.0

Source: www.statpak.gov.pk

Table 7: Structure of Imports (Million US\$)

	FY2003	FY2004	% Change
Food Group	978	1,032	5.5
Of Which:			
Tea	173	197	14.0
Palm Oil	539	608	12.8
Pulses	116	74	-36.3
Machinery	2,942	4,099	39.3
Of Which:			
Power Generating Machinery	269	265	-1.1
Textile Machinery	532	586	10.1
Electrical Machinery and Apparatus	217	247	13.9
Non-classified Machinery	940	1,246	32.6
Vehicles	501	632	26.2
Petroleum	3,066	3,159	3.0
Petroleum Products	1,700	1,396	-17.9
Petroleum Crude	1,367	1,764	29.1
Textiles	222	255	15.1
Fertilizers and Other Chemicals	2,161	2,727	26.2
Of Which:			
Fertilizers	240	281	17.3
Plastic Materials	421	526	25.0
Medicinal Products	222	268	20.9
Non-classified Items	1,220	1,532	25.6
Metal Group	507	662	30.5
Of Which:			
Iron and Steel	450	582	29.3
Others	2,343	3,539	51.0
Total Imports	12,220	15,473	26.6
Non-oil, Non-food Imports	8,176	11,282	38.0

Source: www.statpak.gov.pk

Current account of the balance of payments maintained a comfortable surplus, although it declined to less than half of that in FY2003.

industry, which started four years ago, is still continuing.⁸ Among raw materials and intermediate products, the large increase in import of knocked down kits of automobiles reflected continuing high demand for automobiles fuelled by increased availability of consumer credit. Large increases in imports of iron and steel and plastic materials reflect the continuing expansion in the industrial and construction sectors.

Current Account: Current account of the balance of payments maintained a comfortable surplus in FY2004, although it declined to less than half of that in FY2003 (see table 8). The main factors contributing to decline in the current account surplus were: (i) a four-fold increase in the trade deficit; (ii) a large deficit (\$1,347 million) in the services account compared with a negligible deficit last year; (iii) 8.6 percent

8. Import of textile machinery recorded an annual average growth of 36.2 percent in the last four years.

Table 8: Balance of Payments (Million US\$)

	FY2003	FY2004	% Change
Trade Balance	-359	-1,420	295.5
Exports	10,974	12,403	13.0
Imports	-11,333	-13,823	22.0
Services (net)	-2	-1,347	
Transportation	-669*	-769*	14.9
Of which:			
Freight	-753*	-944*	25.4
Travel	-329*	-1,044*	217.3
Of which:			
Personal	-328*	-1,008*	207.3
Logistic support	847*	753*	-11.1
Income (net)	-2,211	-2,205	-0.3
Of which:			
Interest	-1,277	-1,055	-17.4
Current Transfers	6,642	6,602	-0.6
Private	5,221*	5,443*	4.3
Of which:			
Workers' remittances	4,237	3,871	-8.6
Resident FCAs	-12	367	
Official	846*	493*	-41.7
Of which:			
Saudi Oil Facility	637	302	-52.3
Current Account Balance	4,070	1,630	-60.0
Capital and Financial Account (net)	-4	-1,109	
Of Which:			
Foreign direct investment	798	951	19.2
Disbursement of foreign assistance	1,389	1,124	-19.1
Amortization	-2,788	-2,744	-1.6
Debt forgiveness	1,000	0	
Errors and Omissions	523	334	-36.1
Exceptional Financing	620	-55	
Official Reserves (End-period)	9,529	10,564	10.9
(In months of merchandise imports)	9.4	8.2	

* For the first eleven months of the year.

Source: www.sbp.org.pk

Although remittances have declined in FY2004, they are still more than thrice the amount in FY2001.

decline in overseas workers remittances;⁹ and (iv) discontinuation of the Saudi Oil Facility, effective from January 2004. Despite a sharp increase in the trade deficit, it still does not fully reflect the gap between imports and exports shown by the trade data.¹⁰ This may be reflected in the next year's trade deficit. The services account deteriorated due to integration of payments on account of foreign travel into the formal system.¹¹ Although remittances have declined in FY2004, they are still more than thrice the amount in FY2001. Developments with negative impact on the current account were partly offset by lower interest payments on foreign debt and net inflow into resident foreign currency accounts in contrast with a net outflow last year.

Capital and Financial Account:

The capital and financial account also worsened in FY2004. There was a deficit of \$1,019 million in this account compared with only \$4 million last year, mainly because of absence of any debt forgiveness compared with \$1,000 million debt forgiven by the United States last year. Also, disbursement of foreign assistance declined to \$1,124 million compared with \$1,389 million in FY2003. These were partly offset by a bond issue of \$500 million, which resulted in a net increase of \$339 million in foreign investment in debt securities, whereas in the preceding year a net payment of \$261 million had been made for maturing debt. There was also higher foreign direct investment (\$951 million compared with \$798 million) and smaller amortization of

foreign debt (\$2,744 million compared with \$2,788 million).

Foreign Exchange Reserves:

Although growth in foreign exchange reserves was still at double-digit rate, it decelerated significantly in FY2004, when reserves with SBP increased by 10.9 percent to \$10.6 billion.¹² At their present level, reserves are sufficient to cover 8.2 months' imports. Slowdown in accumulation of reserves held by SBP reflects reduced purchases of foreign exchange by the central bank in the inter-bank market. The Rupee came under pressure in the last four months of FY2004, when it depreciated by 0.9 percent to Rs 57.91/US\$. For the whole year, the Rupee depreciated by 0.3 percent in contrast with an appreciation of 4.4 percent in FY2003.

Outlook

With sound macroeconomic fundamentals, private investment picking up, and the sharp increase in the Public Sector Development Program, the economy should grow by about 6.5 percent in FY2005 (see table 9). However, due to build-up of pressure on prices emanating from large liquidity overhang, surge in global prices, particularly oil prices, and most domestic industries approaching full capacity, inflation is expected to exceed the target of 5.0 percent. The balance of payments is likely to come under pressure, as imports grow faster than exports and official transfers decline.

The economy is expected to grow by about 6.5 percent, and inflation is likely to exceed the target of 5.0 percent in FY2005.

-
9. Net of one-off inflows under the Hajj sponsorship scheme, which has now been discontinued, and the 1991 Gulf War compensations, remittances in FY2004 were only 5.8 percent lower than FY2003.
 10. The full-year trade deficit based on the physical movement of goods across the border is \$3.2 billion compared with \$1.0 billion in FY2003.
 11. In the preceding years, travelers were asked to meet their foreign exchange requirements from the kerb market. Registered foreign exchange companies, which report all their transactions to SBP, have now started meeting travel requirements.
 12. Total reserves, including reserves held by commercial banks, as of end-June 2004 were \$12.3 billion compared with \$10.3 billion on 30th June 2003.

Table 9: Medium-term Outlook

	FY2003	FY2004	Projections
			FY2005
(Annual changes in percent)			
Real GDP	5.1	6.4	6.5
Agriculture	4.1	2.6	3.5
Large-scale Manufacturing	7.2	17.1	11.0
Other Sectors	5.1	6.1	6.6
Inflation (CPI)	3.1	4.6	5.5
Merchandise Exports	22.2	10.0	12.0
Merchandise Imports	18.2	26.6	15.0
(In percent of GDP)			
Budgetary Deficit*	3.7	3.3	3.5
Trade Balance	-0.5	-1.5	-4.0
Current Account balance	4.9	1.7	-1.3

* Consolidated budget deficit of Federal and Provincial Governments.

Sources: (1) *Pakistan Economic Survey 2003-04*, Finance Division, Government of Pakistan.

(2) *Annual Plan 2004-05*, Planning Commission, Government of Pakistan.

(3) ADB Staff Estimates.

Agriculture growth is likely to be higher than last year, but because of emerging water shortages, the prospects are fairly uncertain. Availability of water for summer crops is 20-30 percent lower than in FY2004. This is likely to hurt the rice and sugarcane crops. The area sown under sugarcane crop has declined by 11.3 percent, which will further reduce the crop output. Water level in two main reservoirs is also low which is expected to reduce availability of water for wheat and other winter crops. In the case of cotton, because of higher prices last year, sown area is higher by 6.7 percent. Also, the crop yield is likely to be positively impacted by the relatively dry weather, which reduces the intensity of pest attacks. Therefore, the cotton production is expected to increase by 7-9 percent over last year. Performance of the livestock sub-sector, which accounts for almost half of value-added in agriculture, is expected to be better, primarily because of recovery in the poultry sub-sector which

was hurt by bird flu last year. Keeping the above factors in view, the agriculture sector is expected to grow by about 3.5 percent, which is higher than last year, but less than the target of 4.0 percent set by the Government.

The growth in manufacturing in FY2005 will be lower than the record high achieved in FY2004, but is still likely to be in the double-digit range, given the strong recovery in investment in the sector seen last year. A number of incentives in the form of reduction in import duties on industrial raw materials and machinery, lowering of electricity tariffs, and liberalization of import of second-hand machinery and incentives for exports are expected to further boost investment and production in the manufacturing sector. Expected larger cotton crop and prevailing lower cotton prices will help the textile sub-sector. Anticipated increase in interest rates are not likely to adversely impact the manufactur-

Because of emerging water shortages, the prospects of agriculture in FY2005 are fairly uncertain.

The growth in manufacturing in FY2005 is likely to be in the double-digit range.

Significantly larger trade deficit could push the current account into a deficit in FY2005.

ing sector significantly, because interest rates will still be on the low side. Also, SBP in its Monetary Policy Statement for July-December 2004 has indicated that it will make sure that the process of increase in interest rates is gradual and does not adversely impact the ongoing growth.

In the services sector, telecommunication growth is likely to accelerate further with new licenses issued for mobile telephone, long distance international (LDI), fixed local loop, and wireless local loop (WLL) services, as well as new television and radio channels. Introduction of WLL will open up rural areas to telecom services, and facilitate the expansion of these services into new areas. The banking sector is also expected to register robust growth, as it has been strengthened through reforms and privatization.

With GDP growth expected to remain well above 6.0 percent and imports maintaining double-digit growth, tax revenues should grow by about 14 percent as budgeted. As public debt indicators are expected to improve further, debt servicing, the largest expenditure item, should remain under control. Similarly, defense expenditure should also remain on the target, given a significant improvement in relations with India. Hence the fiscal deficit target of 3.5 percent of GDP for FY2005 is likely to be achieved.

The fiscal deficit target of 3.5 percent of GDP is likely to be achieved.

With high economic growth continuing, imports are expected to grow by about 15 percent in FY2005. The planned import of one million tons of wheat during the year will also push up the import bill. Therefore, the import growth target of 7.7 percent given in the trade policy for FY2005 seems very much on the low side. With the phase-

out of textile and clothing quotas in January 2005, exports are expected to grow by about 12.0 percent. With imports increasing faster than exports, trade deficit will increase further. This, along with the discontinuation of the Saudi Oil Facility and anticipated lower receipts from USA for logistic support for war in Afghanistan, will push the current account of the balance of payments into a deficit after showing surplus in the last four years. This is likely to put pressure on exchange rate.

The medium-term prospects for the Pakistan economy are positive because of the substantial improvements in macroeconomic fundamentals over the last 3-4 years and a sharp pick up seen in investment in FY2004. Improved relations with India and possible increase in trade between the two countries will also help boost growth in the medium term.

There are a number of downside risks to economic projections given above. One, oil prices have been very volatile in recent months. If the oil prices continue to remain at current record levels, projections for imports, fiscal deficit, and inflation may have to be revised upward. Latest economic data indicate some slow-down in economic recovery in the USA, which is a major market for Pakistan exports. High oil prices could also dampen the global economic recovery. If this happens, Pakistan's export growth could be lower. On the domestic front, anticipated shortage of water in the two main reservoirs poses a major risk for winter crops, which mainly depend on canal irrigation. Possibility of increase in incidents of terrorism resulting from Pakistan's military action against foreign elements in the tribal areas is also a major downside risk.

II. ECONOMIC POLICIES AND REFORMS

The FY2005 Federal Budget and Trade Policy contain a number of policy measures, which reflect the Government's commitment to continue the structural reforms implemented in the last four years and to move on to second generation reforms to accelerate economic growth. The budget shows a clear shift in emphasis from macroeconomic stabilization to growth and the trade policy has a number of measures to promote trade by liberalizing imports and encouraging exports. The Federal Budget and Trade Policy are discussed in this section.

Analysis of Federal Budget 2004-05

The FY2005 Federal Budget, announced on 12th June 2004, has been formulated against a backdrop of an upswing in the economy. It marks a break with the past four years with a change in focus from fiscal consolidation to promoting growth. It takes full advantage of the fiscal space created by improvement in revenue generation and reduction in interest payments, to expand development expenditure and reduce business costs for the private sector. Allocation for development expenditure has been increased by over 38 percent, and import duties and sales tax on a number of raw materials and capital goods have been reduced. However, there is a concern about the Government's capacity to implement the expanded public sector development program.

Fiscal Outcome FY2004

The Federal Government's fiscal position improved significantly in FY2004,

with its fiscal deficit declining to 3.2 percent of GDP compared to 3.9 percent in FY2003 (see table 10).¹³ The primary surplus of the Federal Government increased from Rs 11.0 billion to Rs 34.3 billion. The sharp improvement in the fiscal position was due to a 8.2 percent increase in revenues, while increase in expenditure was contained at 3.6 percent. Both CBR tax receipts and non-tax revenues showed increases, but surcharges on petroleum products and gas declined as the Government did not fully pass on the increases in the international price of oil in the latter part of the fiscal year.

Revenues: CBR tax receipts increased by 10.5 percent to Rs 510.0 billion in FY2004, and the increase was broad-based (see table 11). Receipts from custom duties recorded a substantial increase of 25.9 percent on the back of a 47.3 percent increase in the preceding year. As a result, their share in total tax revenues increased from 11.8 percent in FY2002 to 17.0 percent in FY2004. The general sales tax (GST) receipts, the largest source of tax revenues, increased by 11.9 percent and direct taxes by 5.6 percent. Substantial increase in imports, particularly imports that are subject to highest tariff rates, account for the bulk of the increase in collection from customs. Inclusive of non-CBR federal taxes and surcharges, total tax receipts showed an increase of 8.6 percent, which fell short of the 13.2 percent increase in nominal GDP. Therefore, as a percentage of GDP, federal tax receipts declined from 11.1 to 10.6 percent, after increasing in the preceding two years.

Expenditure: Total expenditure of the Federal Government declined from 14.5 percent of nominal GDP in FY2003 to 13.2 percent in FY2004 because of lower current expenditure, which was 2.1 percent lower

The budget shows a clear shift in emphasis from macroeconomic stabilization to growth.

The primary surplus of the Federal Government increased from Rs 11.0 billion to Rs 34.3 billion.

13. Fiscal deficit as a percentage of GDP has been calculated by using GDP at current market prices estimated with the new base (1999 - 2000).

Table 10: Summary of Federal Fiscal Indicators (Billion Rs)

	FY2003		FY2004		FY2005	
	(Billion Rs)					
	RE	BE	RE	BE		
Gross Revenue Receipts	701.4	728.5	761.1	796.8		
Less Transfer to Provinces	193.2	214.8	211.4	239.2		
Net Revenue Receipts	508.2	513.7	549.7	557.6		
Total Expenditure	697.0	728.6	721.8	806.1		
Current Expenditure	615.9	599.3	602.8	650.0		
Interest Payments	199.8	210.0	206.4	214.2		
Non-interest Expenditures	416.1	389.3	396.4	435.8		
Development Expenditure and Net Lending	81.1	129.3	119.0	156.1		
Of Which:						
Development Expenditure	90.0	113.0	106.9	148.0		
Federal Fiscal Deficit	188.8	-214.9	-172.1	-248.5		
Federal Primary Surplus/Deficit	11.0	-4.9	34.3	-34.3		
GDP (at current market prices)	4,821.3	5,458.1	5,458.1	6,051.8		
	% of GDP					
Federal Fiscal Deficit	-3.9	-3.9	-3.2	-4.1		
Federal Primary Surplus	0.2	-0.1	0.6	-0.6		
Gross Revenue Receipts	14.5	13.4	13.9	13.2		
Net Revenue Receipts	10.5	9.4	10.1	9.2		
Total Expenditure	14.5	13.4	13.2	13.3		
Current Expenditure	12.8	11.0	11.0	10.7		
Development Expenditure	1.9	2.1	2.0	2.5		

Sources: 1) *Pakistan Economic Survey 2003-04*, Finance Division, Government of Pakistan.
2) *Federal Budget 2004-2005*, Finance Division, Government of Pakistan.

The two public sector power companies received almost three-fifths of the total outlay on subsidies.

than FY2003 (see table 12). The reason for decline in current expenditure in FY2004 was that the large one-off expenditure of Rs 57 billion for write-off of the Government's equity in the Karachi Electric Supply Company (KESC) incurred in FY2003 had resulted in a high base year figure. Increases in all major items of current expenditure, except defense expenditure, were rather small. Interest payments, the largest item in current expenditure, increased by only 3.3 percent. Payment of interest on domestic debt, which accounts for almost three fourths of debt servicing, remained more or

less unchanged because of historically low interest rates in the domestic market.

Subsidies also increased by only 4.1 percent in FY2004, after showing a sharp increase in FY2003. Growth in subsidies slowed down mainly because of lower subsidies for WAPDA (see table 13), reflecting an improvement in its financial position. However, the two public sector power companies still received almost three-fifths (58.6 percent) of the total outlay on subsidies and the energy sector as a whole accounted for 70.4 percent.¹⁴

14. In FY2003, 91.6 percent of subsidies went to the energy sector.

Table 11: Revenue Receipts (Billion Rs)

	FY2003		FY2004		FY2005
	(Billion Rs)				
	RE	BE	RE	BE	
Gross Revenue Receipts	701.4	728.5	761.1		796.8
Tax Revenue (Gross)	465.8	516.4	515.7		589.5
CBR Tax Revenue	461.7	510	510.0		580
Direct Taxes	152.9	161.1	161.5		181.9
Indirect Taxes	308.8	348.9	348.5		398.1
Sales Tax	195.1	223.1	218.4		249.2
Customs Duties	68.8	78.1	86.6		103.2
Excise Duties	44.9	47.7	43.5		45.7
Federal Taxes other than CBR	4.1	6.4	5.7		9.5
Surcharges	68.2	61.1	64.4		65.3
Petroleum	47	46.1	46.4		47.5
Gas	21.3	15	14.2		15
Arrears of Surcharges	0	0	3.8		2.8
Non Tax Revenue	167.5	151	180.9		141.5
Of Which:					
Interest Receipts (Provinces)	28	27	26		26
Interest Receipts (Others)	25	41	41		28
Dividend	26.6	24	33		35
Royalty on Oil and Gas	12.6	17	15		17
Defence services	53.7	31	43		12
Less Transfer to Provinces	193.2	214.8	211.4		239.2
Net Revenue Receipts	508.2	513.7	549.7		557.6
Tax Revenue (inclusive of surcharges as % of GDP)	11.1	10.6	10.6		10.8

Sources: 1) Pakistan Economic Survey, Finance Division, Government of Pakistan.
2) www.finance1.finance.gov.pk
3) [Federal Budget 2004-2005](#), Finance Division, Government of Pakistan.

Substantial amounts of subsidies were also provided to the Pakistan Railways and Pakistan Agricultural Storage and Services Corporation (PASSCO).

Despite easing of tensions with India, expenditure on defense, the second largest item in the Federal Government's current expenditure, increased by 13.0 percent to Rs 180.5 billion, possibly due to military operations in tribal areas bordering Afghanistan. However, as a percentage of GDP, defense expenditure remained constant at 3.3 percent.

Development expenditure, as shown in revised estimates appearing in budget documents, showed a sharp increase of 18.8 percent to Rs 106.9 billion in FY2004. As a percentage of GDP, development expenditure increased from 1.87 to 1.96. However, the revised estimate of development outlay shown in budget documents may be overestimated. The reconciled accounts for the first three quarters of the year show that only Rs 54.9 billion (51.4 percent of total outlay) had been spent under this head. Although, there is a considerable bunching of expenditure in the last quarter of the fiscal

*Federal
development
expenditure
increased by 18.8
percent in FY2004.*

Table 12: Federal Expenditures (Billion Rs)

	FY2003	FY2004		FY2005
		(Billion Rs)		
	RE	BE	RE	BE
Expenditure and Net Lending	697.0	728.6	721.8	806.1
Current Expenditure	615.9	599.3	602.8	650.0
Of Which:				
Interest Payments	199.8	210.0	206.4	214.2
Domestic	160.5	170.5	161.5	170.2
Foreign	39.3	39.5	44.9	44.0
Defence	159.7	160.3	180.5	193.9
General Administration	55.1	52.5	57.1	59.2
Grants	50.3	62.1	65.0	65.4
Subsidies	49.0	71.8	51.0	68.0
Development Expenditure and Net Lending	81.1	129.3	119.0	156.1
Development Expenditure	90.0	113.0	106.9	148.0
Net Lending	-8.9	16.3	12.1	8.1
		(% of GDP)		
Interest Payments	4.1	3.9	3.8	3.5
Defence	3.3	2.9	3.3	3.2
Subsidies	1.0	1.3	0.9	1.1

Source: Federal Budget 2004-2005, Finance Division, Government of Pakistan.

year, it may be difficult for the Government to spend Rs 52.0 billion in the last quarter.

Federal Budget FY2005

While announcing the FY2005 federal budget, the Finance Minister, after reviewing economic performance and all round progress made in the last 4-5 years, stated that there were a number of formidable challenges still faced by the economy and the Budget addresses these challenges. The challenges include: (1) to raise the GDP growth rate to 8.0 percent; (2) reduce poverty and improve human development indicators; (3) improve implementation capacity of the Government; and (4) rehabilitate and expand economic and social infrastructure. The Budget addresses these challenges by: (i) promoting investment; (ii) generating employment; (iii) providing

relief to the common man; and (iv) increasing public sector development expenditure. The Finance Minister also highlighted the need to accelerate the reform process and to move on to the second-generation reforms, focusing on building the institutional and governance capacity and improving the competitive environment in the country, with civil service, police, judiciary, and devolution being the key areas for the second-generation reforms.

Reflecting a shift in focus from macro-economic stabilization to growth, the federal budget for FY2005 envisages total expenditure to increase by 11.7 percent to Rs. 806.1 billion, while net revenue is projected to increase by only 1.4 percent to Rs 557.6 billion. The slow growth projected for revenues is mainly due to a sharp decline in non-tax revenues because of a conserva-

The Finance Minister highlighted the need to move on to the second-generation reforms.

Table 13: Federal Subsidies (Billion Rs)

	FY2003		FY2004		FY2005	
	RE	BE	RE	BE	RE	BE
KESC Subsidy to pick up tariff differential	0	0	0		4.2	
KESC GST adjustment	2.0	1.5	2.1		2.3	
KESC Subsidy to pick up cash shortfall	0	11.7	9.6		6.5	
KESC on WAPDA arrears	8.0	0	0		0	
Total KESC	10.0	13.2	11.7		13.0	
Ad-hoc subsidy to WAPDA	0	0	2.4		1.0	
WAPDA GST Adjustment	10.4	12.1	13.3		13.3	
Subsidy to WAPDA - tariff differential AJK	1.0	1.0	1.0		1.1	
WAPDA arrears against AJK	0.5	0	0		0	
Subsidy to WAPDA on account of tariff differential on agri tubewells in Balochistan	2.0	1.5	1.5		1.7	
WAPDA for tubewells (PM directives)	0.5	0.5	0		0	
WAPDA pick up for cash shortfall	12.0	0	0		0	
Total WAPDA	26.4	15.1	18.2		17.1	
Subsidy to pick up inter-distribution cost tariff differential	0	0	0		19.6	
Subsidy to oil refineries and OMC claims	8.5	7.0	6.0		6.0	
Total Energy Related Subsidies	44.9	35.3	35.9		55.7	
Subsidy for Fuji Fertilizer Bin Qasim	0.7	1.1	1.1		1.0	
Shortfall in offsetting PSEs liabilities	0	21.5	0		0	
Subsidy to PASSCO on wheat export	2.3	3.5	4.5		1.3	
Subsidy to Punjab Govt for wheat export	1.0	1.6	0.5		0	
Subsidy to TCP on export of sugar	0	0.6	0.5		0.6	
Subsidy to Pak Railways for meeting their losses	0	7.9	8.0		9.1	
Others	0.1	0.4	0.5		0.2	
Total	49.0	71.8	51.0		68.0	

Source: Federal Budget 2004-2005, Finance Division, Government of Pakistan.

tive estimate of receipts from the United States for logistic support for war in Afghanistan; tax revenues will continue to show strong growth. The federal budget deficit is estimated at Rs. 248.5 billion, or 4.1 percent of the projected GDP, compared with 3.2 percent in FY2004.

Revenues: The Budget estimates CBR tax revenue for FY2005 at Rs. 580 billion, compared with revised estimates of Rs. 510

billion for FY2004. This implies an increase of 13.7 percent, which is more than the projected increase of 10.9 percent in nominal GDP. Receipts from direct taxes are budgeted to increase by 12.6 percent, while those from indirect taxes by 14.2 percent. Of indirect taxes, revenues from customs are expected to increase by 19.2 percent (on the expectation of a continued robust growth in imports) and sales tax by 14.1 percent.

The budget deficit is to increase to 4.1 percent of GDP from 3.2 percent in FY2004.

The Federal Public Sector Development Program is to increase by 31.0 percent in FY2005.

Receipts from surcharges on petroleum and gas are projected to increase by 3.1 percent to Rs 62.5 billion. Small increase in receipts from surcharges may be attributed to the recent policy of the Government not to pass on the entire increase in international oil prices to consumers.

Non tax revenue is projected to decline by 21.8 percent, from Rs. 181 billion in FY2004 to Rs. 142 billion in FY2005. This is mainly due to a 73.0 percent projected decrease in receipts from defense services, the bulk of which comes from payments by the United States for logistic support for war in Afghanistan. Interest receipts from public sector enterprises are also projected to decline by 31.7 percent.

Current Expenditure: Current expenditure is expected to increase from Rs. 602.8 billion in FY2004 to Rs. 650.0 billion in FY2005. Within current expenditure, interest payments on debt are to increase by 3.8 percent to Rs 214.2 billion. Defense expenditure is budgeted to increase by 7.4 percent to Rs. 193.9 billion. The share of interest payment in current expenditure will decline from 34.2 percent to 33.0 percent, while that of defense expenditure will remain more or less constant. Expenditure on the running of civil administration is expected to register a 3.7 percent increase in FY2005.¹⁵ Expenditure on subsidies is projected to increase by 33.3 percent to Rs 68.0 billion. As in the past, bulk of the subsidies will go to the two power utilities (WAPDA and KESC).

Infrastructure accounts for 54.5 percent of federal development program.

Public Sector Development

Program: The Federal Public Sector Development Program (PSDP) has been budgeted at Rs 148.0 billion, or 31.0 percent larger than the FY2004 Federal PSDP (see table 14).¹⁶ This shows that the Government intends to use the available fiscal space to increase development expenditure.

The bulk of the Federal PSDP (54.5 percent) is allocated for improving infrastructure. Expenditure on infrastructure is projected to increase by 21.1 percent to Rs 80.6 billion in FY2005. Within infrastructure, expenditure on transport and communication is projected to increase by 10.4 percent, water by 41.4 percent, and power by only 1.0 percent. Social sectors have been accorded the second highest priority and account for 21.1 percent of the Federal PSDP. Development expenditure on social sectors is expected to increase by 37.1 percent to Rs 31.3 billion. Federal expenditure on education and health, the two main social sectors, is projected to increase by 63.9 percent and 38.2 percent, respectively.¹⁷ Among other sectors, there is an almost five-fold increase in allocation for agriculture and over 50.0 percent increase in allocation for governance.¹⁸ Allocation for the Taamir-e-Watan Program, under which members of the National Assembly and the Senate can identify small development schemes for execution in their constituencies, has also been increased by 38.0 percent to Rs 5.4 billion.

-
15. It is not clear whether 15 percent dearness allowance and 8-16 percent increase in pensions announced in the Budget is reflected in this or not.
 16. Including the provincial development programs, the total size of PSDP has been increased by 26.2 percent to Rs 202 billion.
 17. It may be noted that education, health and other social sectors are a provincial subject, and the bulk of expenditure on these sectors appears in provincial budgets.
 18. These include allocations of Rs 1.8 billion for Agriculture Sector Development Loan II and Rs 2.4 billion for the Access to Justice Program.

Table 14: Budgetary PSDP 2004-05 Ministry/Division-wise Summary (Billion Rs)

Ministry/Division/Agency	Allocation for 2003 - 04	Allocation for 2004 - 05	% Increase
Infrastructure	66.5	80.6	21.1
of which:			
Water & Power Division (Water Sector)	14.7	20.8	41.4
WAPDA	13.6	14.2	4.0
Communication Division (including NHA)	21.5	23.4	9.0
Railways Division	8.1	9.3	15.0
Social sectors	22.8	31.3	37.1
of which:			
Education Division	3.1	3.4	8.1
Higher Education Commission	4.5	9.1	103.0
Health Division	4.4	6.0	38.0
Governance	4.9	7.3	51.0
Interior Division	2.7	4.9	81.0
Law,Justice, Human Rights	2.1	2.4	13.0
Others	18.8	28.8	53.0
of which:			
Information Technology and Telecommunications Division	2.0	2.7	37.0
Ministry of Science and Technology	1.3	1.9	52.0
Food,Agriculture and livestock Division	1.5	7.3	386.0
Total	113.0	148.0	31.0

Source: Public Sector Development Program 2004-2005, Planning Commission, Government of Pakistan.

Key Policy Measures: The FY2005 Federal Budget is a growth-oriented budget, and contains a number of policy measures aimed at accelerating investment and lowering the cost of doing business in various sectors of the economy. The budget proposes a number of measures for improving the tax administration, which aim at increasing tax collection by facilitating payment of taxes. The budget also provides relief to salaried persons and pensioners. Some of the main growth-enhancing measures are listed below by sectors, followed by measures for improvement of tax administration and relief measures.

Agriculture: A number of measures were announced in the budget to boost investment and accelerate growth in agriculture. Specifically, import duty on tractors of sizes which are not manufactured locally, will be reduced (to 10 percent) and no sales tax or withholding tax will be levied on these imports. Import of specified agricultural machinery and implements, not manufactured locally, will be allowed without any import duty or sales tax. Also agricultural machinery manufactured locally will be exempted from sales tax. Through adjustments in taxes, the price of Di-Ammonium Phosphate (DAP) fertilizer

The 2005 Federal Budget contains a number of policy measures aimed at accelerating investment and lowering the cost of doing business.

Multiple GST rates ranging from 15 percent to 23 percent have been converted to one standard rate of 15 percent.

will be reduced by Rs. 100 per bag. Withholding tax on the import of certain types of fertilizers has been reduced from 6.0 percent to 1.0 percent. Interest rate on agricultural loans given by ZTBL has been reduced from 14.0 to 9.0 percent. In addition, farmers whose loans from ZTBL have been in arrear since 31st December 2000 have been offered an easy settlement scheme, whereby they can settle these loans by paying only a part of their outstanding loan liability.

Industry: To help industry meet the challenges of the WTO regime, the cost of investment will be reduced by lowering the custom duty on import of plant and machinery not manufactured locally to 5 percent. In addition, 15 percent sales tax and 6 percent import duty have been abolished. To expose local engineering industry to competition, tariff protection to locally manufactured capital goods has also been reduced. This will also lower the cost of locally manufactured machinery for investors. Custom duty on 469 items of industrial raw materials has been reduced by 5 to 20 percent. Reduction in import duties will benefit such key sectors as iron and steel, plastics, precision equipment, locally manufactured plant and machinery, and chemicals and dyes. Multiple GST rates ranging from 15 percent to 23 percent have been converted to one standard rate of 15 percent. GST on ginned cotton, raw hides, and leather has been abolished, which will reduce cash flow problems for processors, as well as export-related refunds and the associated interaction with the Government machinery. To reduce the cost of production and also to make GST a truly value-added tax, adjustment will be allowed for input tax on almost all items, including diesel used in generators for producing electric power by registered persons. Electricity tariff for industrial users has also been reduced.

The threshold for the turnover tax has been raised to Rs. 5 million.

Small and Medium Enterprises

(SMEs): To encourage SMEs, the threshold limit for the turnover tax for manufacturers and retailers has been raised from Rs. 0.5 million and Rs. 1 million, respectively, to Rs. 5 million. Also the SME Bank will reduce its interest rate from 11 percent to 9 percent for those borrowers who meet their repayment obligations in time.

Housing and Construction:

Housing and construction has been identified as one of the four priority sectors for growth and poverty alleviation for two reasons: one, because it is labor intensive, and two, because it has backward and forward linkages with at least 40 other industries. To encourage investment in this sector, excise duty on paints has been abolished, and import duties on a number of building materials, including steel and its products, and construction machinery have been reduced. Sales tax and withholding tax on construction machinery has also been abolished. The Government is going to undertake a major effort to remove ambiguities in urban land titles to remove uncertainties from the real estate market.

Other Growth-oriented Measures:

To reduce harassment of the business community, the provincial governments have been asked to reduce interventions by a number of departments such as inspectors of shops, labor department, and electricity. The visits to industrial units will be pre-announced with appropriate notice. In addition, the GST refund system is being reformed to make prompt and full payment of refund. For this purpose, refund claims will be categorized as reliable, average, and risky based on the past history, and prompt and full payments will be made in the case of claims categorized as reliable. A pilot project for round-the-clock and automated

clearance of export and import consignments is being started in Karachi. There will be only selective examination of goods based on the concept of risk management.

Tax Administration: To facilitate tax payment by large- and medium-sized taxpayers, one more Large Taxpayers' Unit (LTU) is being established in Lahore and five more Medium Taxpayers' Units at Karachi, Quetta, Faisalabad, Rawalpindi, and Peshawar.¹⁹ These units will provide a taxpayer friendly environment for large- and medium-sized taxpayers. To simplify the legal framework for sales tax and encourage tax compliance, a major effort has been made to update and consolidate all notifications and instructions related to sales tax into a single document, which will be easily accessible.

Relief Measures: To provide relief, the exemption limit for personal income tax has been increased from Rs 80,000 to Rs 100,000. All government employees will be given a dearness allowance of 15 percent of their current basic salary. Pensions of retired government servants have been increased by 8-16 percent depending on their date of retirement, and the income ceiling for tax rebate for senior citizens aged 65 years and above has been increased. The maximum limit for investment in Bahood Certificates, a saving instrument provided by the Government exclusively for retired and senior citizens and widows, has been increased from Rs 1 million to Rs 2 million. Withholding tax of 10 percent on income on these certificates has also been abolished.

Overall Assessment: The budget represents a change of direction from a focus on fiscal consolidation to promoting economic growth. Allocation for develop-

ment expenditure has been increased substantially, and taxes and other business costs for the private sector have been reduced. Thus it should provide a significant boost to the economy, without jeopardizing the fiscal stability achieved through the policies of the last few years.

The Federal Government has substantially increased the size of its development program. However, there are serious concerns about its capacity to implement this large program. In the first nine months of the outgoing year, only 48 percent of the Federal PSDP allocation had been spent. In the past, development spending has consistently fallen short of the budgeted allocations, reflecting poor implementation capacity. Also there has been a pattern of spending a large part of development allocations in the last quarter of the year, which undermines the quality of expenditure. Hence there is an urgent need to strengthen institutions and improve implementation capacity of the Government.

Certain measures contained in the budget, like lowering interest rate to be charged by ZTBL and raising the maximum limit for investment in Bahood Certificates are not in line with the ongoing reforms of the financial sector. Lowering the rate of interest rate on ZTBL loans will discourage the participation of commercial banks in the agriculture credit market, which increased substantially last year. With ZTBL rates of interest being below market rates, ZTBL credit will be allocated on other than economic considerations. Large landowners may get more than their proportionate share of subsidized loans, while the small farmers are left out. The increase in the ceiling for investment in Bahood Certificates, which carry higher interest rate

The exemption limit for personal income tax has been increased from Rs 80,000 to Rs 100,000.

There are serious concerns about the Government's capacity to implement the enlarged Public Sector Development Program.

19. One Large Taxpayers' Unit has been functioning successfully in Karachi since 1st July 2002 and a Medium Taxpayers' Unit in Lahore for the last one year.

To diversify exports, the trade policy contains a number of measures aimed at promoting non-traditional exports.

than available on other saving instruments, will add to the interest rate distortions. Also, there will be greater incentive for misuse of the scheme.

Trade Policy FY2005

The trade policy for FY2005, announced on 22nd July 2004, sets the export growth target for the year at 12.3 percent and the import growth target at 7.7 percent. The policy contains a well worked out strategy aimed at diversification of exports, enhancing competitiveness, enabling exporters to meet international standards and requirements, and trade facilitation. Also, it aims to encourage investment and promote industrial growth in general. Some of the important measures are discussed below.

Product Diversification of Exports:

Pakistan's exports have an extremely narrow base, with textiles accounting for 65.9 percent of total exports. To diversify exports, the Government aims to promote non-traditional exports. The trade policy contains a number of measures to promote horticultural exports. These include payment out of Export Development Fund of the first 6 percent of the interest rate on investment loans taken for setting up green houses and cool chain infrastructure, provision of services of hired cool vans to flower exporters on experimental basis, and a freight subsidy on horticultural products for exporters complying with standards developed by the Pakistan Horticulture Development and Export Board. A 25 percent freight subsidy will also be provided to exporters of finished products of granite and marble and furniture produced in factories located beyond 250 kilometers from the port.

The trade policy has provided incentives for development of testing facilities and obtaining international certification.

Geographical Diversification of Exports:

Pakistan's exports to USA, European Union, and Japan account for almost 60.0 percent of the total. To geographically diversify the exports, two Suppliers' Credit Funds of \$10 million each are being established to develop markets in Africa and Central Asian Republics. Also targeted strategies to increase exports to these regions will be formulated through consultations with envoys and commercial officers posted in these regions.

Enhancing Competitiveness and Meeting International Requirements:

To improve the quality of exports and meet international standards, the trade policy has provided incentives for development of testing facilities, obtaining international certification, and establishment of facilities to meet environment requirements. These include: (i) payment of 100 percent of the cost of consultancy services acquired by the private sector parties to develop accredited testing facilities of international standard; (ii) payment of first 6 percent of interest rate on loans for new investment in quality testing and research and development equipment; (iii) subsidy for exporters obtaining ISO-1400, ISO-17025, HACCP, WRAP, and Eco Labeling certification²⁰; (iv) reduction in import duty on effluent treatment plants to 5 percent; and (v) zero import duty on raw materials needed for producing these plants locally.

Encouraging Investment: In view of the ongoing global industrial restructuring, particularly in the textile industry as a result of proposed elimination of the quota regime from January 2005, the trade policy includes measures to facilitate the relocation of such plant and equipment to Pakistan. Relocation of projects from abroad has been

20. These certificates pertain to social accountability (labor rights and eliminating child labor) and environment protection.

liberalized to cover almost all industrial sectors, and import of machinery and equipment under relocation scheme has been allowed even if it is produced in the country. However, a prescribed pre-shipment inspection (PSI) company will have to certify that the machinery is in good working condition and has a remaining life of at least ten years. In addition, the trade policy has allowed import of certain specialized second-hand machinery for use in installation, periodic repairs, and refurbishing of plants and machinery by gas and mining companies.²¹ The Government has also lifted the ban on the import of a number of second hand machinery, including automatic specialized mobile trolleys used in wet processing textile industry, vending machines for postage stamps, food

and beverages, and money changing machines.

Trade Facilitation: To reduce turnaround time and transportation cost, trade policy includes measures aimed at facilitating investment in concerned areas. Airlines operating in Pakistan, airport authorities, approved ground handling agencies, seaport authorities, dry port authorities, agencies operating border crossing infrastructure at custom posts, and operators of inland container depots have been allowed to import used equipment required for their operations, subject to certification by a prescribed internationally recognized PSI company that the equipment is in good condition and has remaining life of at least ten years.

Relocation of projects from abroad has been liberalized to cover almost all industrial sectors.

21. Oil exploration/production and construction companies are already allowed to temporarily import such machinery under the existing trade policy.

III. POVERTY REDUCTION

Decline in Incidence of Poverty:

Strong economic growth and substantial increase in poverty-related public expenditure in the last two years should have had a positive impact on poverty. However, as Pakistan Integrated Household Survey (PIHS) has not been conducted since 2000-01, it is difficult to measure with confidence the impact of these developments on poverty. The Government did conduct a Survey of Household Consumption Expenditure covering 5,046 urban and rural households from 19th April to 6th May 2004. The survey showed a significant reduction in poverty since 2001. However, these numbers are only indicative of the trend, because they cover only about two weeks in 2004, and are based on one-third the PIHS 2000-01 sample.

PRSP Expenditures: PRSP expenditures at Rs 157.9 billion in the first three quarters of FY2004 represented an increase of 23.7 percent over the same period of FY2003 (see table 15). As a percentage of GDP, PRSP expenditures increased from 2.6 to 2.9.²² Their share in total public expenditure also increased from 21.6 percent to 25.2 percent. The Finance Minister in his budget speech said that the target of Rs 278.0 billion poverty-related expenditures for the full FY2004 would be realized. In that case, FY2004 PRSP expenditure will be 5.1 percent of GDP, compared with 4.3 percent in FY2003.

PRSP expenditure has been grouped under the following heads: improving access of the poor to market and community services, fostering human development,

accelerating development of rural areas, improving governance, and providing safety nets. In the first three quarters of FY2004, the sharpest increase was seen in expenditure on improving access to markets and community services (64.0 percent), followed by expenditure on safety nets (50.7 percent), human development (29.7 percent), and governance (11.1 percent). Only expenditure on rural development, including irrigation and land reclamation, suffered a decline of 6.0 percent.²³

Among individual expenditure heads, education, health, population planning, water supply and sanitation (WS&S), and social security and social welfare may be considered as the core areas. Expenditure on these sectors, taken together, at Rs 99.7 billion, represented an increase of 20.2 percent over the same period of FY2003, which was lower than increase in overall PRSP expenditure. Slower growth in expenditure on core sectors was due to a sharp decline of 40.5 percent in rural development. Expenditure on other core sectors, taken together, increased by 32.1 percent, which was much larger than increase in overall PRSP expenditure. Particularly sharp increases were recorded in expenditure on social security and social welfare, WS&S, and population planning. Expenditure on WS&S increased by 50.9 percent in contrast with declines seen in the preceding two years. Under devolution the responsibility for WS&S is with the tehsil governments, and the upturn in expenditure indicates that the transition problems may finally have been overcome. Expenditure on education and health services also registered robust increases of 29.7 percent and 27.1 percent, respectively.

PRSP expenditures increased by 23.7 percent in the first three quarters of FY2004.

Expenditure on water supply and sanitation increased by 50.9 percent in contrast with declines seen in the preceding two years.

22. In computing these percentages, GDP for full year has been used as denominator and poverty related public expenditure for only three quarters of the year as numerator.

23. Expenditure on rural electrification has been excluded to make expenditure data for the two years comparable.

Table 15: PRSP Budgetary Expenditures (Billion Rs)

	FY2002	FY2003	(% Change	July - March		(% Change
				FY2003	FY2004	
Market Access and Community services						
Roads, Highways & Bridges	6.3	13.1	107.3	5.0	8.5	69.1
Water Supply & Sanitation	4.6	3.4	-26.3	2.0	3.0	50.9
Sub-total	11.0	16.6	50.8	7.0	11.5	64.0
Human Development						
Education	66.3	78.6	18.6	51.3	66.5	29.7
Health	19.2	22.4	16.4	13.5	17.1	27.1
Population Planning	1.3	3.1	134.4	1.8	2.7	50.6
Sub-total	86.8	104.1	19.9	66.5	86.3	29.7
Rural Development						
Irrigation	10.1	15.5	53.3	8.2	12.1	48.0
Land Reclamation	1.8	1.8	-4.3	1.1	1.3	19.6
Rural Development	12.3	16.9	37.0	13.7	8.1	-40.5
Village Electrification				NA	1.4	
Sub-total	24.3	34.2	40.7	22.9	23.0	0.2
Governance						
Law and Order	31.0	36.3	17.1	23.3	25.8	10.4
Access to Justice	2.0	2.2	13.4	1.4	1.7	23.4
Sub-total	33.0	38.5	16.8	24.7	27.5	11.1
Safety Nets						
Low Cost Housing		0		0	0.4	1082.9
Food Subsidies	5.5	10.9	97.0	3.2	4.3	34.4
Food Support Program	2.0	2.2	10.9	2.0	2.2	9.6
Social Security & Social Welfare	3.7	1.3	-64.0	0.8	2.3	184.2
Natural Calamities & Other Disasters	0.2	0.4	124.3	0.3	0.4	25.9
Tawana Pakistan	0.8	0.6	-26.3			
Sub-total	12.2	15.5	1.9	6.3	9.6	50.7
Grand Total	167.3	208.9	20.52	127.6	157.9	23.7
Total PRSP Expenditure as % age of						
Total Public Expenditure	20.2	23.3		21.6	25.2	
Total PRSP Expenditure as % age of						
GDP	3.8	4.3		2.6	2.9	
GDP (Current MP)	4,401.7	4,821.3		4,821.3	5,458.0	

Sources: (1) Accelerating Economic Growth and Reducing Poverty: The Road Ahead, Government of Pakistan. December 2003

(2) www.finance1.finance.gov.pk

Acceleration in expenditure on primary and secondary education is welcome from the perspective of poverty reduction.

Within the education sector, expenditure on primary education, which had declined by 4.4 percent in FY2003, increased by 36.0 percent in the first three quarters of FY2004. Similarly, expenditure on secondary education increased by 16.8 percent after a very slow growth (4.1 percent) in FY2003. On the other hand, growth in expenditure on general college and university education slowed down from 51.2 percent last year to 24.2 percent, which is still quite a robust increase. Acceleration in expenditure on primary and secondary education is welcome from the perspective of poverty reduction, as basic education indicators for the poor, who benefit the most from primary and secondary education provided by the public sector, are extremely low.

In the health sector, large increase in expenditure on preventive health facilities was sustained in the first three quarters of FY2004. Growth in expenditure on these facilities accelerated from 21.8 percent last year to 46.4 percent, which far exceeds the increase in expenditure on other health services, reflecting a desirable shift in emphasis from curative to preventive health facilities.

Despite large increase in expenditure on health services, there was a marked deterioration in intermediate health indicators in the first three quarters of FY2004. Utilization of first level health care facilities declined to 86.0 percent from 94.0 percent in the same period of FY2003 and immunization coverage of children declined from 67.0 percent to 65.0 percent and that of pregnant women from 44.0 percent to 38.0 percent. Similarly, births attended by skilled birth attendants declined from 13.0 to 11.0 percent. The decline in intermediate health indicators simultaneously with

There was a marked deterioration in intermediate health indicators in the first three quarters of FY2004.

increase in health expenditure needs to be investigated further.

Among non-budgetary income transfer programs, disbursement of Zakat increased by 22.2 percent to Rs 3.8 billion in the first three quarters of FY2004, compared with the same period of FY2003. There was a sharp increase in one-off rehabilitation grants of up to Rs 50,000 provided for setting up a small-scale business that can generate a steady flow of income. The average amount of grant provided to beneficiaries, however, decreased from Rs 14,913 to Rs 12,222. Disbursement for Guzara (subsistence) allowance for poor households, which is currently the second largest use of the Zakat Fund, declined by 26.4 percent to Rs 1.1 billion. Assistance for education in the form of stipends for poor students, studying in mainstream educational institutions, and grants to Madaras²⁴ increased from Rs 67 million to Rs 204 million.

Disbursement of micro credit through Khushali Bank (KB), Pakistan Poverty Alleviation Fund (PPAF), and ZTBL increased by 50.3 percent to Rs 2.1 billion in the first three quarters of FY2004 compared with the corresponding period of FY2003. There was a sharp pick up in disbursement of micro-credit by ZTBL, which recorded an almost three-fold increase. However, ZTBL still remains the smallest of the three institutional sources of micro-credit. The Pakistan Poverty Alleviation Fund (PPAF), which disburses 61.0 percent of total micro-credit, also increased its disbursement by 76.3 percent to Rs 1.3 billion on the back of a 128.2 percent increase last year. Growth of micro-credit disbursed by KB slowed down to only 12.6 percent after increasing by 149.4 percent last year. The number of borrowers

24. Institutions imparting education in Islamic Studies.

from the three institutions increased by 24.2 percent to 187,826 and the average size of the loan increased from Rs 9,151 to Rs 10,914. Although there has been a large

increase in the disbursement of institutional micro credit in the last two years, its coverage of poor households is still relatively low.