

# ECONOMIC UPDATE

## PAKISTAN

May 2006

Asian Development Bank

**Pakistan Resident Mission  
Asian Development Bank**

**ASIAN DEVELOPMENT BANK**

**May 2006**

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## FOREWORD

The first Pakistan Economic Update was published in April 2002. The present Report provides an analysis of economic trends in Pakistan during the first three quarters of fiscal year 2005/06, and presents an outlook of the economy for the whole year. The Report also discusses recent poverty trends in the country and reviews poverty reducing public expenditure during the first half of 2005/06. Economic growth decelerated in the first half of 2005/06, however the economy is expected to still post robust growth for the full year. The medium term outlook for the economy looks good.

The Asian Development Bank (ADB) is a long-standing development partner of Pakistan, having provided a total of \$15.0 billion to the country in development assistance from 1968 to 2005. Of this amount, \$1.5 billion were provided in 2005. The projected assistance for the period 2006-2008 amounts to \$4.4 billion. Major development sectors in which ADB has invested include energy, agriculture and rural development, finance and trade, transport and communications, social sectors, and governance. Under its Country Strategy and Program for Pakistan, reduction of poverty is the central objective, which has been operationalized through promoting sustainable pro-poor growth, inclusive social development, and good governance.

In addition to this assistance portfolio, the Pakistan Resident Mission is actively engaged in economic and sector work to develop a better understanding of important economic policy and technical issues. To share our work with a wider audience, PRM initiated a working paper series on topical issues. The most recent working paper titled “SME Sector Development in Pakistan” was released in October 2005. In addition, three papers titled “The Poverty-Health Relationship in Pakistan”, “Gender and Poverty in Pakistan”, and “The Impact of Global Cotton Markets on Rural Poverty in Pakistan”, were published by PRM in 2005. These papers will also serve as background for a Poverty Assessment Update that is currently in the process of preparation.

We look forward to receiving comments on the Report, and also suggestions for improvement of future reports in this series.

Peter L. Fedon  
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# PAKISTAN ECONOMIC UPDATE

(JULY 2005 - MARCH 2006)

*Economic growth decelerated and macroeconomic fundamentals were further strained in the first three quarters of 2005/06. The deficit in the current account of the balance of payments almost quadrupled and the fiscal deficit also increased. Despite decline, inflation remained high. GDP growth in 2005/06 is projected to be lower than last year, but still robust at 6.0–6.5 percent.*

Macroeconomic fundamentals, which had come under pressure last year, were further strained in the first three quarters of fiscal year 2005/06 (ending 30 June 2006). The current account deficit of the balance of payments increased sharply, as import growth continued to outstrip export growth. Despite a robust growth in revenues, the fiscal deficit increased due to a sharp increase in public expenditure. Inflation declined, but was still high. Commodity producing sectors experienced a slowdown, while the services sector maintained its robust growth.

## I. MACROECONOMIC DEVELOPMENTS

### Domestic Sector

**Growth:** Economic growth decelerated in the first half of 2005/06 with the two main commodity produc-

ing sectors experiencing a slowdown. In agriculture, cotton output is estimated to be 11.0 percent lower than its record level of 2004/05. Both the area sown with cotton as well as its yield declined compared with the last year. The production of sugarcane is also estimated to be significantly lower than last year. The rice crop is estimated to be larger (7.9 percent) than last year. Among the other summer crops, the output of maize increased by 30.0 percent.

Data on production of selected manufacturing items, as reported in the Second Quarter Economic Report of the State Bank of Pakistan, show significantly lower growth of most of these items in the first seven months of 2005/06 compared with the same period of 2004/05 (see Table 1)<sup>1</sup>. The slowdown is attributed to the high base effect and capacity constraints, as well as disruption of production due to the 8 October 2005 earthquake. Among individual industries, growth of the

textile industry declined to 7.7 percent in the first seven months of 2005/06, compared with 26.4 percent in the corresponding period of 2004/05. The production of cotton yarn and cotton cloth slowed down, with a particularly sharp decline in cloth production from 38.6 percent to only 3.0 percent. Sugar production witnessed a sharp decline of 29.1 percent due to a smaller sugarcane crop and a delayed start of the crushing season.

Cement production, which had grown rapidly last year, also showed significantly lower growth in the first seven months of the year, despite increased construction activities. Due to capacity constraints the growth of fertilizer production declined to 16.4 percent from 42.7 percent in the same period of last year. The production of iron and steel also declined sharply. Deceleration in these industries was partly offset by higher growth in the automobiles and paper and board industries. The assembly of cars of larger engine capacity (1300 cc and above) increased substantially.

Of the other two industrial sub-sectors, construction continued to expand at a rapid pace, as is reflected in the substantial increase in demand for cement and the resulting high prices. In view of the widening gap

1. The Federal Bureau of Statistics has not released production data of the large-scale manufacturing sector after the first quarter of 2005/06 (reported in ADB's Pakistan Economic Update December 2005).

**Table 1: Growth in Production of Selected Large-scale Manufacturing Items (% change)**

Items	July - January	
	2004/05	2005/06
<b>Textiles</b>	<b>26.4</b>	<b>7.7</b>
Cotton Yarn	17.7	11.9
Cotton Cloth	38.6	3.0
Jute Goods	-2.3	-3.5
<b>Food</b>	<b>16.8</b>	<b>9.0</b>
Of Which:		
Sugar	-1.4	-29.1
<b>Chemicals</b>	<b>12.2</b>	<b>4.4</b>
<b>Fertilizers</b>	<b>42.7</b>	<b>16.4</b>
<b>Non Metal Production</b>	<b>22.0</b>	<b>8.5</b>
Of Which:		
Cement	22.2	8.8
<b>Iron and Steel</b>	<b>-1.5</b>	<b>-62.3</b>
<b>Automobile Industry</b>	<b>N.A.</b>	<b>N.A.</b>
Cars (1300 cc and above)	25.8	83.4
Cars (1000 cc and Less)	-7.9	33.5
Jeeps and Vans	190.1	-23.2
Tractors	18.6	56.7
Motorcycles	38.4	31.3
<b>Paper and Board</b>	<b>4.5</b>	<b>11.7</b>

Source: The State of Pakistan's Economy April 2006. State Bank of Pakistan.

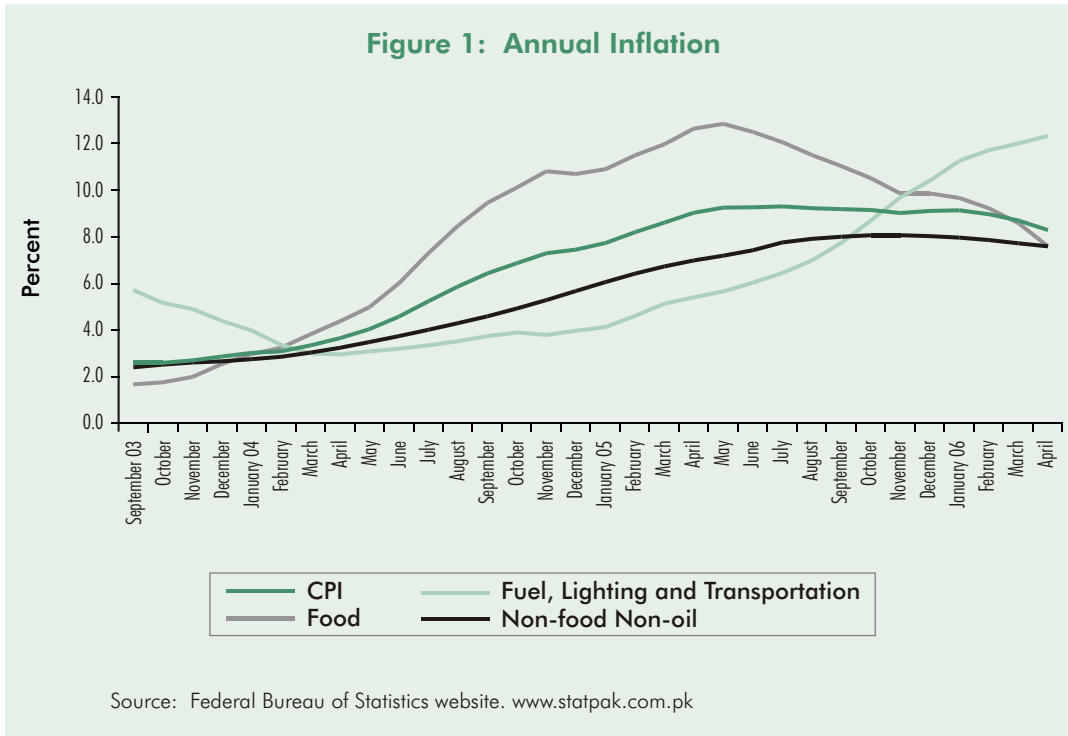
between demand and supply, the Government has recently allowed duty-free import of cement and announced freight subsidy on its import.

In the services sector, telecom services continued to expand rapidly, particularly mobile telephones. The two new companies granted licenses for the mobile telephone service last year competed aggressively for new subscribers and the total number of cellular phone subscribers increased to 29.6 million on 30 April 2006 from 12.5 million on 30 June 2005. In the last ten months, 1.7 million mobile telephone subscribers were added every month. Of the 18 licenses granted last year for the wireless local loop (WLL) telephone service, four companies have started operations and had provided 600,000 WLL connections by end of April 2006.

*In the last ten months, 1.7 million mobile telephone connections were added every month.*

Because of continued robust growth in both imports and exports, wholesale and retail trade also expanded rapidly. The financial sector maintained a high growth as income of banks increased with increased interest rates on advances.

**Prices:** Despite a significant decline in food inflation, annualized inflation based on consumer price index (CPI) declined by just one percentage point to 8.3 percent in the first ten months of 2005/06 (See Figure 1). The Government's policy of liberalizing imports of essential food items announced in the 2005/06 budget paid off and annualized food inflation declined to 7.6 percent in April 2006 from 12.5 percent at the beginning of the current fiscal year. This decline in food inflation was, however, largely offset by sharp increases in oil prices and subsequent



increases in transportation costs, which put pressure on all other prices. Inflation of the cost of fuel, lighting, lubricants, and transportation increased from 6.0 percent to 12.3 percent. Core inflation, defined as non-food non-oil inflation, which is more amenable to demand management policies, declined after November 2005, but is still somewhat higher than in June 2005. Overall, the CPI-based inflation, at 8.3 percent in April 2006, is still quite high compared with the below 5.0 percent inflation level during the five years ending June 2004.

**Monetary Management:** The State Bank of Pakistan (SBP) started aggressive tightening of monetary policy in April 2005, when it raised the discount rate from 7.5 to 9.0 percent. However, after raising the interest rate on 6-month treasury bills (TBs), which serves as benchmark for all other interest rates, by 259 basis points from 5.3 percent in March 2005 to 7.9 percent in June 2005, SBP allowed the TBs rate to only marginally increase to 8.29 percent in the first ten months

of 2005/06. Despite this increase, the real rate of interest on 6-month TBs is still zero and has remained more or less unchanged since November 2005. The interest rate on new bank loans increased by 200 basis points to 10.4 percent in the first three quarters of 2005/06.

Private sector credit continued to expand rapidly in the first ten months of 2005/06 (see Table 2). Together with a sharp pick-up in the Government's borrowing for financing the budgetary deficit, this resulted in an expansion of Rs 276.1 billion in domestic credit compared with Rs 265.2 billion in the corresponding period of 2004/05. However, due to a smaller expansion in net foreign assets of the banking system, the increase in the broad monetary aggregate in the first ten months of 2005/06 was lower than in the same period of the last year. Monetary expansion was also significantly lower than the projected growth of nominal GDP during the year, reflecting tightening of monetary policy by the SBP to combat inflation.

*Monetary expansion was significantly lower than the projected growth of nominal GDP.*

**Table 2: Monetary Growth (Billion Rs)**

	Monetary Impact During 1 July to 29 April	
	2004/05	2005/06
<b>Monetary Assets</b>	<b>341.6</b>	<b>317.1</b>
% Growth in Monetary Assets	13.7	10.7
% Growth in Reserve Money	15.2	8.9
Net Foreign Assets of the Banking System	76.4	41.1
Net Domestic Assets of the Banking System	265.2	276.1
<b>Net Borrowing by Government Sector</b>	<b>13.3</b>	<b>15.8</b>
Of Which:		
Budgetary Support	7.9	45.6
1. Central Bank	128.8	43.2
2. Scheduled Banks	-120.9	2.4
Commodity Operations	3.3	-29.7
<b>Net Borrowing by Non Government Sector</b>	<b>344.0</b>	<b>346.6</b>
Of Which:		
Borrowing by the Private Sector	364.7	345.3
<b>Other Items (net)</b>	<b>-92.1</b>	<b>-86.3</b>

Source: State Bank of Pakistan website. [www.sbp.org.pk](http://www.sbp.org.pk)

**Fiscal Policy:** The Government continued to pursue an expansionary fiscal policy in the first half of 2005/06 and the fiscal deficit increased to 1.8 percent of GDP compared with 1.3 percent in the same period of 2004/05 (see Table 3). The primary balance turned into a deficit for the first time in the last three and a half years. The increase in public expenditure outstripped the growth in revenues, as the Government made payments for relief operations to help victims of the 8 October 2005 earthquake, as well as increased development expenditure sharply.

The consolidated expenditure of federal and provincial governments increased sharply by 26.1 percent in the first half of 2005/06, with current expenditure increasing by 22.9 percent and development expenditure by 57.2 percent. The current expenditure of the Federal Government increased by 21.6

percent, primarily because of higher grants to autonomous bodies, which almost doubled to Rs 61.9 billion. Defense expenditure increased by 17.8 percent—faster than provided in the budget, mainly due to the ongoing operations against militants in the tribal areas bordering Afghanistan and deployment of troops in areas affected by the earthquake. The current expenditure of provincial governments also rose sharply by 28.0 percent.

Both federal and provincial governments sharply increased their development expenditures in the first half of 2005/06, with federal expenditures increasing by 64.7 percent and provincial expenditures by 44.7 percent. The Government utilized 47.2 percent of annual public sector development program allocation, compared with 40.4 percent utilized in the first half of 2004/05. Among individual

*The Government increased development expenditures by 57.2 percent in the first half of 2005/06.*

**Table 3: Consolidated Fiscal Position (Billion Rs)**

	July - December		% Change
	2004/05	2005/06	
Total Revenue	423.8	497.8	17.5
Federal	397.6	462.5	16.3
Of Which:			
CBR Taxes	265.4	323.0	21.7
Surcharges	13.8	19.2	39.1
Non-tax Revenue	115.9	117.3	1.2
Provincial	26.1	35.2	34.9
Total Expenditure	503.3	634.5	26.1
Current Expenditure	427.5	525.3	22.9
Federal	309.5	376.3	21.6
Of Which:			
Interest	104.3	111.4	6.8
Domestic	83.0	89.8	8.2
Foreign	21.3	21.6	1.4
Defense	101.1	119.1	17.8
Provincial	116.4	149.0	28.0
Development Expenditure and Net Lending	86.3	127.8	48.1
Development Expenditure	81.6	128.3	57.2
Federal	50.7	83.5	64.7
Provincial	30.9	44.7	44.7
Net Lending	4.7	-0.4	
Unidentified Expenditure	-10.4	-18.6	78.8
Budget Deficit	-79.6	-136.7	71.7
As % of GDP	-1.3	-1.8	

Source: Ministry of Finance website. [www.finance.gov.pk](http://www.finance.gov.pk)

provinces, development expenditures of the Punjab Government increased by 63.9 percent and accounted for more than four-fifths of the increase in total provincial development expenditures. There was hardly any increase in development expenditures of the Sindh Government. Development expenditures of the NWFP Government increased by 7.6 percent, while those of the Balochistan government increased by 4.3 percent.

The consolidated revenue of federal and provincial governments increased by 17.5 percent in the first half of 2005/06 over the corresponding period of 2004/05. The increase in total revenues was more than the projected growth of nominal GDP. The taxes collected by the Central Board of Revenue (CBR), which account for 62.5 percent of total government revenues, increased at a fast pace (21.7 percent).<sup>2</sup> The increase in the CBR taxes

2. Figures recently released by CBR for the first ten months of 2005/06 show an increase of 21.3 percent over the same quarter of 2004/05. The pattern of growth in individual taxes remained more or less the same as in the first half of the year, except that the federal excise duty, after an initial decline, picked up in the last four months and recorded a cumulative increase of 9.0 percent in contrast with a decline in the first half of the year.

*The provinces' own revenues made up only 18.3 percent of their total revenues.*

was broad-based, with the three main taxes, namely sales tax, income tax, and customs, showing high double-digit growth. The federal excise duty, which as a matter of policy is being gradually limited to fewer items, declined by 2.7 percent. Losses in receipts from petroleum development surcharge in the first quarter of 2005/06 were more than recovered in the second quarter, as increases made in domestic oil prices in the first quarter were not reversed in the second quarter when international prices declined. Non-tax revenues showed a modest increase, mainly because of increases in non-tax revenues of provincial governments and receipts from the USA for logistic support for the war in Afghanistan.

The provincial governments are heavily dependent on the Federal Government for

their revenues, as most high yielding sources of revenue are with the Federal Government. The provinces' own tax and non-tax revenues made up only 18.3 percent of their total revenues in the first half of 2005/06, while the remaining 81.7 percent came from the Federal Government, mainly in the form of the provincial shares in the divisible tax pool. The provincial governments had been demanding an increase in their share for the last four years, but no agreement could be reached with the National Finance Commission (NFC), a constitutional body responsible for deciding the formula for revenue sharing. Recently, the President of Pakistan promulgated an ordinance to amend the 1997 NFC Award. The amended Award will be applicable for sharing revenues between the Center and the provinces in the 2006/07 budget due in June 2006 (see box 1).

### Box 1: Interim NFC Award 2006

The NFC Award, which determines the revenue sharing arrangements between the Center and the provinces, is formulated every five years. The new NFC Award was due in 2002, but it could not be agreed because of differences on: (1) division of revenues between the Federal Government and provincial governments; and (2) distributing the provincial share in the divisible pool among the four provinces. The President on 19 January 2006 issued an ordinance to amend the NFC Award 1997. The amended award de-facto is the new NFC Award, with the following main features:

1. The share of the four provincial governments, taken together, in the divisible tax pool was increased from 37.5 percent to 41.5 percent for 2006/07. In the subsequent four years, the provincial share is to be increased to reach 46.25 percent in 2010/11. Inclusive of grants-in-aid (see paragraph 4 below), the provinces' share in revenues will rise to 50.0 percent in 2010/11. As before, the divisible tax pool consists of all CBR taxes other than the federal excise on gas and GST on services.
2. In the distribution of the provincial share in the federal divisible pool among the four provinces, collection has been made the basis for distributing one-sixth of GST (i.e. 2.5 percent GST out of 15.0 percent) among provinces, as demanded by the Sindh province. Thus Sindh, where disproportionately large tax collection takes place, will get a larger share than warranted by its population.
3. The remaining part of the divisible tax pool is to be distributed on the basis of population (1998 census), as was the case in the 1997 NFC Award.
4. The Federal Government will provide grants-in-aid to provinces, which will be distributed among all four provinces according to their level of development. The amount of grants-in-aid, projected at Rs 27.7 billion in 2006/07, will increase every year at the same rate as the size of the divisible tax pool. Under the 1997 NFC Award, grants were provided to only the two smaller and less developed provinces of NWFP and Balochistan, and the amount of these grants was only about one-third of the amount specified under the new arrangement. As the level of development is the basis for inter-provincial sharing of these grants-in-aid under the new arrangement, the two smaller provinces will still get a much larger share than warranted by their population (see table below).

Province	Share in Grants-in-aid (%)
Punjab	11
Sindh	21
NWFP	35
Balochistan	33

5. As it was the case under the 1997 NFC Award, 100 percent of receipts from GST on services, surcharge on gas, excise duty on gas, and royalty on gas and oil are to be transferred to provinces after deducting 2.0 percent collection charges, and their inter-province distribution will be on the basis of collection in the individual provinces.

## External Sector

**Merchandise Trade:** The expansion of external trade seen in the last three years continued in the first three quarters of 2005/06, with both exports and imports increasing at a high double-digit rate. Imports increased by 43.2 percent to \$20.7 billion and exports by 18.6 percent to \$12.1 billion. However, growth of both exports and imports has decelerated in recent months (see Figure 2).

*Imports increased by 43.2 percent and exports by 18.6 percent in the first three quarters of 2005/06.*

The increase in exports in the first nine months of 2005/06 was mainly due to increased volume. For about three-fourths of total exports for which quantity and price data are available, quantity increased by 17.7 percent while the prices increased by only 2.8 percent. The buoyant global economy and the end of the quota regime for textile and clothing exports since January 2005 were the main factors responsible for the sharp increase in the volume of exports.

The growth in exports in the first nine months of 2005/06 was broad-based, with all

major categories showing double-digit growth. Textile and clothing exports (T&C) grew by 19.2 percent and accounted for 61.4 percent of the total increase in exports (see Table 4). The export of primary commodities also recorded a robust growth, mainly because of continued high growth in the export of rice. The variety-wise breakdown of growth of rice exports shows that the increase in export of non-basmati rice was much larger than that of basmati rice, marking a break with the pattern observed in the preceding three years. Non-textile manufactures also grew at a high double-digit rate, with sharp increases in export of petroleum products and leather garments.

All major T&C items recorded robust increases in the first three quarters of 2005/06, mainly because of sharp increases in quantity, which ranged from 31.9 percent for towels to 72.0 percent for bedwear. Of the major T&C exports, only knitwear experienced stagnation in volume. The prices of most T&C items declined because of increased competition among exporters after the end of the quota regime. The sharp

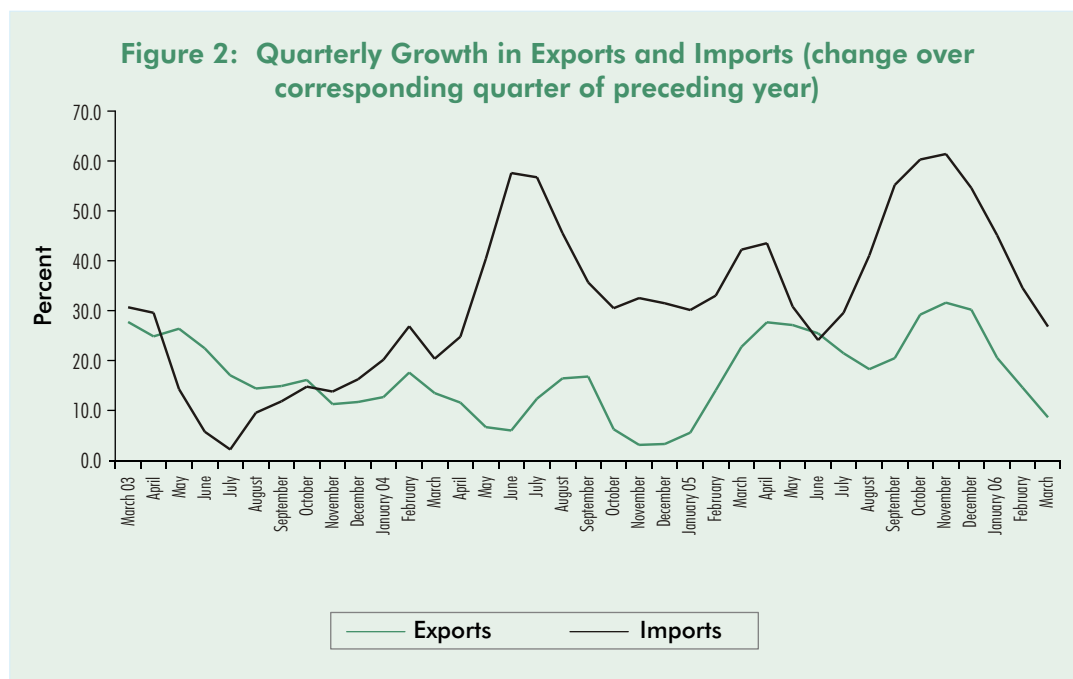


Table 4: Growth in Exports (Million US\$)

Commodities	July - March		% Change
	2004/05	2005/06	
<b>Primary Commodities</b>	<b>951.3</b>	<b>1,160.9</b>	<b>22.0</b>
<i>Of Which:</i>			
Rice	625.0	835.2	33.6
a) Basmati	318.5	395.6	24.2
b) Others	306.4	439.6	43.5
Raw Cotton	96.8	53.9	-44.3
Fruits	74.8	90.3	20.6
<b>Textile Manufactures</b>	<b>6,041.0</b>	<b>7,201.5</b>	<b>19.2</b>
<i>Of Which:</i>			
Cotton Yarn	760.0	983.5	29.4
Cotton Cloth	1,336.3	1,556.5	16.5
Knitwear	1,217.2	1,269.8	4.3
Bedwear	943.2	1,494.3	58.4
Towels	376.1	421.1	12.0
Readymade Garments	765.1	1,002.1	31.0
Art Silk & Synthetic Textiles	232.0	146.3	-37.0
<b>Other Manufactures</b>	<b>2,064.3</b>	<b>2,460.0</b>	<b>19.2</b>
<i>Of Which:</i>			
Carpets, Rugs & Mats	198.2	199.8	0.8
Petroleum Products	311.6	563.3	80.8
Sports Goods	216.1	228.4	5.7
Tanned Leather	219.7	196.8	-10.5
Leather Manufactures	375.3	540.5	44.0
<i>Of Which:</i>			
a) Leather Garments	244.4	387.3	58.5
b) Leather Gloves	113.4	107.6	-5.1
Surgical Goods and Medical Instruments	136.5	117.3	-14.1
Chemicals and Pharma. Products	282.5	299.6	6.1
Engineering Goods	122.8	135.4	10.3
<b>Non-classified Items</b>	<b>1,126.1</b>	<b>1,250.6</b>	<b>11.1</b>
<b>Total</b>	<b>10,182.7</b>	<b>12,072.9</b>	<b>18.6</b>

Source: Federal Bureau of Statistics website. [www.statpak.gov.pk](http://www.statpak.gov.pk)

increase in volume of bedwear exports happened despite the anti-dumping duty imposed by the European Union, which reflects the diversification of the export of this item to other markets. As a result, the value of

bedwear exports increased by 58.4 percent in the first three quarters of 2005/06. The export of readymade garments, cotton yarn, and cotton cloth also recorded substantial increase in value terms.

*Export of most textile and clothing items decelerated in recent months.*

The bulk of the increased export of most T&C items took place in the early part of 2005/06. Lately their export has sharply decelerated, mainly because of the high base effect. For example, the export of bedwear increased by 75.9 percent in the first seven months of the year; however, its growth plummeted to only 15.5 percent in the last two months. Similarly, growth in export of readymade garments declined to only 9.5 percent in the last six months from 105.9 percent in the first quarter of the year. On the other hand, the export of knitwear picked up in the last two quarters and increased by 27.0 percent after declining by 20.5 percent in the first quarter of the year.

The growth of imports in the first nine months of 2005/06 was led by petroleum and petroleum products, which together increased by 64.5 percent to \$4.6 billion and accounted for 29.0 percent of growth in total imports (see Table 5). Food imports increased sharply by 34.6 percent mainly because of the large import of sugar compared with the negligible amount imported in the first nine months of 2004/05. Non-food and non-oil imports also increased sharply by 38.3 percent, reflecting the continued strong domestic demand.

*Petroleum and petroleum products led the growth of imports.*

The sharp increase in the petroleum import bill in the first three quarters of 2005/06 was due to a 76.6 percent increase in the unit value of petroleum crude and 62.9 percent in that of petroleum products. The increase in unit values of petroleum crude and petroleum products was much larger than the increase in the international oil price (37.1 percent) during the period. As Pakistan buys crude oil and products from countries in the Middle East under contracts, effects of changes in international oil prices on the country's import prices show up with a time lag, but more sharply. In the corresponding period last year, the unit value of crude oil imports increased by only 11.8 percent and that of petroleum products by 13.4 percent

despite a 44.0 percent increase in the international oil price.

The import of consumer durables increased by 41.8 percent reflecting strong domestic demand fuelled by consumer credit as well as rising incomes in the last two years. In this regard, the import of motor vehicles was also encouraged by significant liberalization of import of both new and second-hand fully assembled cars announced in the 2005/06 budget. The import of motor vehicles, in the form of completely knocked down kits for local assembly and completely assembled vehicles, increased by 41.0 percent, and constituted almost three-fourths of the total increase in consumer durable imports. However, there was a deceleration in the import of motor vehicles in the last six months ending March 2006 to 21.7 percent, from 97.8 percent in the first quarter of 2005/06.

The buoyant economy continued to push up imports of machinery and raw materials, both of which increased at very high rates. A particularly large increase (109.2 percent) was seen in the import of agricultural machinery that was supported by higher cash incomes of farmers from last year's bumper cotton crop and greater availability of credit. Import of other non-classified machinery increased by 51.7 percent. The import of textile machinery, however, declined by 6.5 percent, after increasing by 55.3 percent in 2004/05. Among raw materials, import of synthetic and artificial silk increased by 77.6 percent and that of synthetic fiber by 72.6 percent, reflecting a policy change, whereby the tax for protecting the International Chemical Industries (ICI) in Pakistan has been withdrawn. It also shows the increasing requirements of the textile industry. The import of fertilizers increased by 77.4 percent, due to lower growth of domestic production and increasing demand of the agriculture sector.

**Table 5: Growth in Imports (Million US\$)**

	July - March		% Change
	2004/05	2005/06	
<b>Food Group</b>	<b>990.7</b>	<b>1,346.7</b>	<b>35.9</b>
Of Which:			
Wheat Unmilled	70.11	94.577	34.9
Tea	174.4	180.1	3.3
Edible Oil	560.4	551.9	-1.5
Sugar	11.0	275.1	
Pulses	83.2	125.9	51.3
<b>Machinery Group</b>	<b>3,034.6</b>	<b>3,970.6</b>	<b>30.8</b>
Power Generating Machinery	275.3	398.6	44.8
Office Machines	194.0	197.9	2.0
Textile Machinery	700.0	654.2	-6.5
Construction & Mining Machinery	107.4	138.5	29.0
Aircrafts, Ships and Boats	132.8	90.9	-31.5
Agricultural Machinery	43.9	91.7	109.2
Other Machinery	1,581.3	2,398.7	51.7
<b>Petroleum Group</b>	<b>2,806.6</b>	<b>4,615.8</b>	<b>64.5</b>
Petroleum Products	1,195.4	1,834.2	53.4
Petroleum Crude	1,611.2	2,781.6	72.6
<b>Consumer Durables</b>	<b>957.7</b>	<b>1,358.2</b>	<b>41.8</b>
Electrical Machinery & Appliances	238.5	344.1	44.2
Roadmotor Vehicles	719.2	1,014.1	41.0
<b>Raw Materials</b>	<b>1,972.0</b>	<b>3,017.8</b>	<b>53.0</b>
Synthetic Fiber	109.1	188.3	72.6
Synthetic & Artificial Silk Yarn	100.3	178.2	77.6
Fertilizers	275.3	488.5	77.4
Insecticides	107.1	91.8	-14.3
Plastic Materials	587.0	757.1	29.0
Iron and Steel	793.2	1,314.0	65.7
<b>Others</b>	<b>4,684.5</b>	<b>6,384.2</b>	<b>36.3</b>
<b>Total</b>	<b>14,446.1</b>	<b>20,693.2</b>	<b>43.2</b>
<b>Non Food Non Oil Imports</b>	<b>10,648.8</b>	<b>14,730.8</b>	<b>38.3</b>

Source: Federal Bureau of Statistics website. [www.statpak.gov.pk](http://www.statpak.gov.pk)

**Current Account:** The balance of payments weakened further in the first nine months of 2005/06 as increase in import payments outstripped export receipts by a wide margin. The current account deficit<sup>3</sup> swelled to \$4.7 billion compared with a deficit of \$1.2 billion in the same period of 2004/05 (see Table 6). Import payments increased by 30.0 percent while export receipts increased by 12.2 percent, resulting in a trade deficit of \$6.2 billion 87.4 percent larger than in the

corresponding period of last year. Despite a sharp increase (40.5 percent) in receipts from the USA for logistic support for the war in Afghanistan, the deficit on the services account increased by 39.6 percent mainly because of large increase in payments for shipping services. The deficit in the income account was also larger than last year. These deficits were only partly offset by a surplus on current transfers, which was 13.5 percent larger than last year.

**Table 6: Balance of Payments (Million US\$)**

	July - March		% Change
	2004/05	2005/06	
Trade Balance	-3,326	-6,232	87.4
Exports	10,697	12,005	12.2
Imports	14,023	18,237	30.1
Services	-2,417	-3,374	39.6
Income	-1,689	-1,891	12.0
Of Which:			
Interest	658	875	33.0
Current Transfers	6,271	7,117	13.5
Of Which:			
Workers' Remittances	3,050	3,228	5.8
FCAs (Residents)	426	198	-53.5
<b>Current Account</b>	<b>-1,161</b>	<b>-4,380</b>	<b>277.3</b>
<b>Current Account (excl. official transfers)</b>	<b>-1,198</b>	<b>-4,728</b>	<b>294.7</b>
<b>Capital Account</b>	<b>625</b>	<b>125</b>	<b>-80.0</b>
Of Which:			
Debt Forgiveness	495	0	
<b>Financial Account</b>	<b>-50</b>	<b>4,609</b>	
Of Which:			
Foreign Direct Investment	793	2,224	180.5
Portfolio Investment (Liabilities)	622	1,076	73.0
Equities	107	406	279.4
Debt Securities	515	670	30.1
Disbursement of Foreign Assistance	1,824	1,498	-17.9
Amortization	1,290	1,140	-11.6
Errors & Omissions	357	392	9.8
<b>Overall Balance</b>	<b>-229</b>	<b>746</b>	
<b>Official Reserves (end-period)</b>	<b>10,062</b>	<b>10,282</b>	<b>2.2</b>

Source: State Bank of Pakistan website. [www.sbp.org.pk](http://www.sbp.org.pk)

3. Excluding official transfers.

### Capital and Financial Accounts:

The weakening of the current account in the first nine months of 2005/06 was largely offset by a sharp turnaround in the financial account. The financial account turned into a large surplus of \$4.6 billion in the first nine months of 2005/06 from a deficit of \$50 million in the same period of last year. The improvement in the financial account was mainly due to the almost tripling of foreign direct investment to \$2.2 billion and a sharp increase in inflow of foreign funds into the stock market. On the other hand, disbursement of foreign assistance in the first nine months of 2005/06 was lower than in the corresponding period of last year. The amortization of foreign loans was also smaller than last year. The capital account weakened, with its surplus shrinking to \$125 million from \$625 million in the first three quarters of 2004/05. Due to higher inflows under the financial account, particularly as a result of the higher foreign direct investment,

the overall balance of payments had a surplus of \$746 million compared with a deficit of \$229 million in the same period of 2004/05. However, some inflows, which are responsible for improvement in the overall balance of payments, may not be sustainable (see Box 2).

### Foreign Exchange Reserves and Exchange Rate:

The foreign exchange reserves held by SBP increased by \$477 million to \$10.3 billion in the first three quarters of 2005/06, despite a sharp increase in the current account deficit. The entire increase in reserves took place in March due to the inflow of substantial privatization proceeds (\$565 million) and proceeds of the new sovereign bond (\$800 million). At their current level, reserves are sufficient to finance 4.2 months of projected imports in the current year. The exchange rate remained more or less stable and the Rupee/Dollar parity depreciated slightly from Rs 59.67/US\$ in

*The sharp increase in the current account deficit was largely offset by a large surplus in the financial account.*

### Box 2: Financing Trade and Current Account Deficits

Despite a sharp increase in the trade deficit and the current account deficit, the overall balance of payments improved in the first three quarters of 2005/06, mainly because of higher foreign direct investment, including privatization proceeds, portfolio investment, receipts from the United States for logistic support for the Afghanistan war, and official transfers. Together, these inflows amounted to \$3.7 billion and were more than twice as large as last year (see table below).

	(Million US\$)	
	<b>July - March</b>	
	<b>2004/05</b>	<b>2005/06</b>
1. Receipts for Logistic Support	650	756
2. Official Transfers	37	348
3. Foreign Direct Investment	793	2,224
Of Which:		
Privatization Proceeds	103	919
4. Portfolio Investment in Equities	107	406
<b>Total</b>	<b>1,587</b>	<b>3,734</b>
<b>Current Account Deficit (Excl. 1&amp;2)</b>	<b>1,848</b>	<b>5,484</b>

However, continued dependence on such inflows to finance the trade and current account deficit is not sustainable. This is because privatization proceeds are one-off receipts, and receipts for logistic support will continue only as long as the US and NATO forces are in Afghanistan and in need of Pakistan's civil aviation and other facilities. At the same time portfolio investment in equities is highly volatile. For example, in one month (March 2006), \$64 million of portfolio investment flew out of the country.

*The bond issued by Government in international market in March 2006 was heavily oversubscribed.*

June 2005 to Rs 60.01/US\$ in March 2006. The slow depreciation of the nominal exchange rate, along with much higher domestic inflation than in major trading partners, has resulted in an appreciation of the real exchange rate, which could be an added causative factor for slower growth in exports and the widening trade gap.

### **External Debt and Liabilities:**

Pakistan's external debt and liabilities declined by \$589 million to \$35.2 billion in the first half of 2005/06, mainly because of a decline in the bilateral debt owed to members of the Paris Club. This was partly offset by an increase (\$314 million) in low-cost multilateral debt.

**Issue of Sovereign Bond:** Pakistan has been raising funds in the international capital market since 2003 through bond issues.<sup>4</sup> The country floated the third such bond for \$500 million in New York on 23 March 2006 with tenures of 10 years and 30 years. The bond was heavily oversubscribed, and received total bids of \$2 billion: \$1.3 billion for the 10-year bonds with a coupon rate of 7.1 percent and \$700 million for the 30-year bonds with a coupon rate of 7.9 percent. Out of these bids, the Government accepted \$500 million for the 10-year bonds and \$300 million for the 30-year bonds.

### **Economic Outlook**

The growth of the two commodity producing sectors so far has been lower than last year. The higher-than-anticipated oil prices will further depress economic growth, and so could the 8 October earthquake, although its adverse impact on the economy has been estimated to be small (see Special Section in ADB's Pakistan Economic Update of December 2005). The economy is expected to post a lower-than-last year, but still a robust growth of 6.0-6.5 percent in 2005/06.

*Growth of the LSM sector is expected to be lower than last year, but still quite robust at 10.0 percent.*

The agriculture sector is at best expected to post no growth in 2005/06, due to the significantly smaller cotton crop, which accounts for 10.5 percent of the value-added in agriculture. Wheat, which is the largest crop contributing 13.9 percent to agriculture value-added, is also expected to be lower, or best equal to last year's harvest. The growth of the livestock sub-sector is expected to be lower than last year because of the setback to the poultry business due to bird flu, as well as the damage caused by the earthquake in five districts of NWFP, where the main economic activity is rearing livestock.

As indicated by its performance in the first seven months, growth of the large-scale manufacturing (LSM) sector in 2005/06 is expected to be lower than last year, but still quite robust at about 10.0 percent. Although complete information on production in manufacturing sector is not available, the sharp increase in imports of raw materials and capital goods and the robust growth in private sector demand for credit, despite the higher interest rates, indicate that the manufacturing sector has sustained high growth so far. Textile and clothing as well as leather manufactures have been boosted by substantial increases in export volumes in the first three quarters of the year (see Section on Merchandise Trade). However, the current high oil prices can depress manufacturing production by raising the cost of production. Similarly, capacity constraints emerging in a number of manufacturing industries could also affect the performance of the industrial sector.

Of the other two other sub-sectors of the industrial sector, construction is expected to sustain high growth in 2005/06 because of the larger public sector development program and the reconstruction work in the earthquake affected areas. The duty-free import of cement from India has improved the supply of cement and lowered its price, which should further

4. Pakistan had earlier issued a Euro bond for \$500 million in 2003 and an Islamic bond, commonly known as 'Sakuk' for \$600 million in 2005.

encourage construction activity in the last quarter of the year.

In the services sector, the rapid expansion of mobile telephone service and wireless local loop connections witnessed in the last ten months, is expected to continue in the remaining two months of the year. The privatization of the Pakistan Telecommunication Company Limited will give an additional boost to the telecom sector. The banking sector is expected to continue with rapid growth, as increase in interest rates will help increase incomes of banks. The wholesale and retail trade will benefit from double-digit growth in imports and exports. Hence the services sector is likely to expand by 7-8 percent in 2005/06.

The import of sugar, wheat, and other food items has already improved the food supply situation and significantly reduced food inflation in the first ten months of 2005/06. The tight monetary policy has also somewhat dampened core inflation. However, the continued increase in domestic prices of petroleum products is likely to put pressure on prices of fuel, lighting, and lubricants, transport charges, and the cost of production. Also, continuing rapid expansion in domestic credit and no further increase in short-term interest rates since November 2005, may further impact inflation. The full-year inflation for 2005/06 is not expected to be lower than its current level of 8.3 percent.

With robust growth and a sharp increase in imports, particularly of items subject to high tariff rates, the budget target for tax revenues is likely to be surpassed. The non-tax revenues may also exceed the target because of the higher than budgeted receipts from the USA for logistic support for the war in Afghanistan. However, total expenditure may also exceed the budget estimate by a wide margin because of expenditures for rehabilitation and reconstruction in the earthquake affected areas. GDP growth in 2005/06 is now expected to be lower than the original projection. As a result, the budget deficit could rise to 4.2 percent of GDP compared with the target of 3.8 percent.

Imports are projected to increase by 30.0 percent as high oil prices and continued strong domestic demand will continue to exert upward pressure on imports in the last quarter of 2005/06. The liberalization of imports of fully built up cars, both new and second hand, import of sugar and wheat, and the recently allowed duty-free import of cement will further increase the import bill. On the other hand, the robust growth in the global economy, particularly that of the European Union, USA, and Japan, and the end of the quota regime, augur well for exports which are expected to increase by 14.0 percent. However, because of the much larger growth in imports relative to exports, the trade deficit is projected to increase to over \$8.0 billion, and the current account deficit to \$6.0-6.5 billion or 4.9-5.3 percent of GDP.

The medium-term outlook of the economy looks reasonably good. The substantial public sector investment in the irrigation infrastructure and private investment in mechanization of agriculture in the last four years would boost growth of the agriculture sector. The end of the quota regime for textiles and clothing (T&C) exports, as well as the large investment in the T&C industry in the past several years, will continue to catalyze the manufacturing sector. Improved relations with India and the expected increase in trade with regional countries, including China, will also help the economy. The boom in the services sector, particularly telecoms and banking, is likely to continue. The banking system is well positioned to support economic growth by channelizing savings to productive uses as it has been significantly strengthened through reforms and privatization.

The growing imbalance in the external sector poses a risk to the country's medium-term economic prospects. Continued policy action would be required to deal with the external imbalance and the monetary overhang. In the longer run, the continuing low level of investment could depress economic growth.

*The full year inflation is not expected to be lower than its current level of 8.3 percent.*

*The current account deficit is projected to increase to 4.9-5.3 percent of GDP in 2005/06.*

## II. POVERTY REDUCTION

Based on latest data, the Government has announced that there has been a significant decline in the incidence of poverty between 2000-01 and 2004-05. The high economic growth in the last three years, as well as the significant increase in pro-poor public expenditure since 2001/02, appears to have had a positive impact on poverty reduction. The robust growth also generated additional job opportunities, with 5.5 million jobs created in the last two years. As a result, the unemployment rate declined from 8.3 percent in 2001/02 to 7.7 percent in 2003/04 and further to 6.5 percent in the first half of 2005/06. The literacy rate and primary school enrollment also showed improvements in the past four years.

**Poverty Reducing Public Expenditures:** Over the last four years, the Government has consistently increased pro-poor public expenditure under its poverty reduction strategy initially spelled out in the Interim Poverty Reduction Strategy Paper released in February 2001 and later in the Full Poverty Reduction Strategy Paper (PRSP) issued in December 2003. PRSP has identified 17 sectors, expenditure on which is assumed to have the greatest positive impact on poverty reduction.<sup>5</sup> Public expenditure in these sectors increased from 3.8 percent of GDP in 2001/02 to 4.8 percent in 2004/05.

The PRSP expenditure continued to increase rapidly in the first half of 2005/06 to Rs 167.0 billion which represents a 34.0 percent increase over the first half of 2004/05 (see Table 7). As a percentage of GDP, PRSP expenditures increased from 1.9 to 2.2 during this period. The share of poverty related expenditure in total public expenditure also recorded an increase from 24.8 percent to 26.3 percent.

Pro-poor expenditure has been grouped under the following heads in the PRSP: improving access of the poor to market and community services; fostering human development; accelerating development of rural areas; improving governance; and providing safety nets. Expenditures under all these heads recorded sharp increases in the first half of 2005/06, ranging from 18.6 percent in expenditure on governance to 139.1 percent on social safety nets. The expenditure on human development, which accounts for 45.4 percent of total PRSP expenditure, increased by 18.7 percent.

Of the 17 sectors identified to cover pro-poor expenditure, education, health, population planning, social security and social welfare, water supply and sanitation (WSS), and rural development, including village electrification, may be considered the core sectors. Currently, more than half of the total poverty related expenditure is incurred in these sectors. However, total expenditure in these core areas, at Rs 90.0 billion, represented an increase of 19.8 percent compared with the first half of 2004/05, which was lower than the overall increase of 34.0 percent in PRSP expenditure. In 2004/05 too, expenditure in core areas for poverty reduction increased at a slower pace than the overall PRSP expenditure.

Expenditure on education, which accounts for 34.8 percent of the total pro-poor expenditure, increased by 16.0 percent to Rs 58.1 billion in the first half of 2005/06. The expenditure on primary and secondary education recorded a double-digit growth, while that on general university and college education more than doubled. The expenditure on other non-classified education fell sharply.

The expenditure on health increased by 21.5 percent to Rs 14.9 billion in the first half

*There was a significant decline in poverty between 2000-01 and 2004-05.*

*Pro-poor public expenditure increased by 34.0 percent to Rs 167.0 billion in the first half of 2005/06.*

5. These sectors are: education, health, population planning, water supply and sanitation, social security, food subsidies, food support program, Tawana Pakistan, natural calamities, roads, irrigation, land reclamation, rural development, village electrification, low-cost housing, administration of justice, and law and order.

Table 7: PRSP Expenditures (Rs Million)

	July - December		% Change
	2004/05	2005/06	
<b>Access to Market and Community Services</b>			
Roads	9,630	13,946	44.8
Water Supply & Sanitation	2,160	3,665	69.7
<b>Sub-Total</b>	<b>11,790</b>	<b>17,611</b>	<b>49.4</b>
<b>Human Development</b>			
Education	50,038	58,068	16.0
Health	12,274	14,915	21.5
Population Planning	1,567	2,871	83.2
<b>Sub-Total</b>	<b>63,879</b>	<b>75,854</b>	<b>18.7</b>
<b>Development of Rural Areas</b>			
Irrigation	12,516	23,810	90.2
Land Reclamation	1,076	971	-9.8
Rural Development	6,709	7,398	10.3
Village Electrification	371	969	161.2
<b>Sub-Total</b>	<b>20,672</b>	<b>33,148</b>	<b>60.4</b>
<b>Social Safety Nets</b>			
Social Security & Welfare	1,989	2,085	4.8
Natural Calamities/Disasters	242	8,487	
Food Subsidies	1,060	1,125	6.1
Food Support Program	2,053	1,598	-22.2
Low Cost Housing	229	172	-24.9
Tawana Pakistan	59	0	
<b>Sub-Total</b>	<b>5,632</b>	<b>13,467</b>	<b>139.1</b>
<b>Governance</b>			
Administration of Justice	1,386	1,508	8.8
Law and Order	21,322	25,428	19.3
<b>Sub-Total</b>	<b>22,708</b>	<b>26,936</b>	<b>18.6</b>
<b>Grand Total</b>	<b>124,681</b>	<b>167,016</b>	<b>34.0</b>
Total PRSP Expenditure as % of GDP	1.9	2.2	
Total PRSP Expenditure as % of Total Public Expenditure	24.8	26.3	

Source: Ministry of Finance. Website: www.finance.gov.pk

*Expenditure on water supply and sanitation increased by 69.7 percent to Rs 3.7 billion.*

of 2005/06. While there was a high double-digit growth in expenditure on general hospitals, and mother and child health services, there were only modest increases of expenditure on preventive health measures and other health services.

The provision of clean drinking water is high among the priorities of the Government, and it has provided increased allocations for this sector. In the first half of 2005/06, both current and development expenditure on water supply and sanitation continued to increase rapidly.

Among other categories of pro-poor budgetary expenditure, the sharp increases in expenditure on irrigation in the last two years

continued in the first half of 2005/06, with provisions for mega water projects, such as the Thal Canal and a number of irrigation dams, as well as higher outlays for repair and maintenance of the canal systems. The expenditure on irrigation was up by 90.2 percent in the first half of 2005/06, with development expenditure more than doubling to Rs 18.1 billion. The expenditure on roads also continued to increase rapidly in the first half of 2005/06. In this case also, mega projects such as the Coastal Highway between Gwadar and Karachi accounted for the bulk of the expenditure. Greater expenditure on irrigation and transport infrastructure will promote economic growth and poverty reduction.