PAKISTAN
ECONOMIC UPDATE
(JULY - OCTOBER 2004)

ASIAN DEVELOPMENT BANK

DECEMBER 2004

Pakistan Resident Mission
Asian Development Bank

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December 2004
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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, and a seminar paper entitled Industrial Competitiveness: The Challenge for Pakistan in collaboration with ADB Institute in October 2004.

In 2002, PRM initiated a 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 the first four months of fiscal year (FY) 2005, and presents outlook of the economy for FY2005. The report also briefly discusses recent reforms in the telecommunication sector, and reviews poverty related expenditures in FY2004. 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.

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Contents

TABLES

FIGURES

BOX

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Performance of the economy in the first four months of FY2005 was impressive, and the outlook for the rest of the year looks good. Fiscal position improved significantly, as revenues exceeded the target, despite some revenue loss caused by increase in oil prices. However, high inflation was sustained due to strong domestic demand and shortages of essential food items, and rapid import growth led by oil imports turned the surplus in the current account of the balance of payments into a deficit.

High economic growth, recorded last year, was sustained in the first four months of FY2005, with both domestic and external sectors remaining buoyant. Because of strong domestic demand and shortages of essential food items, high inflation was sustained and external balance worsened, resulting in pressure on the Pakistan Rupee. Fueled by reforms, rapid growth in the telecommunication sector continued in FY2005. Poverty related public expenditure for the full FY2004 showed a substantial increase, reflecting the Government's commitment to poverty reduction. This report analyses macroeconomic developments in the first four months of FY2005 along with the outlook for the whole year in section I, briefly discusses reforms in the telecommunication sector in section II, and reviews poverty related expenditures in FY2004 in section III.

I. MACROECONOMIC DEVELOPMENTS

Performance of the economy in the first four months of FY2005 was impressive, and the outlook for the rest of the year looks good. Two of the three major summer crops showed growth over last year. Although prospects for winter crops are somewhat uncertain due to shortage of water, the early announcement of an increase in support price of wheat will help. The large-scale manufacturing sector (LSM) maintained a double-digit growth, and the large increase in private sector credit and double-digit growth in exports augur well for LSM growth during the rest of the year. Increases in tax collections and imports exceeded their respective targets by wide margins, reflecting continuing high economic growth. Import growth also exceeded export growth by a wide margin, resulting in a large trade deficit and the surplus on the current account of the balance of payments turning into a deficit. Inflation accelerated further in the first four months of FY2005.

Domestic Sector

Growth: The real sector of the economy showed a robust growth in the first four months of FY2005 and the outlook for the rest of the year looks good, despite continuing high international prices of oil and uncertain prospects of winter crops due to water shortage. A record cotton crop is expected, and official estimates have been revised upward to 12.1 million bales, or 21.0 percent larger than last year. The market expects that the crop output will be higher than even the latest official estimate. Ginneries had received 8.2 million bales of cotton by 15th November, or 44.0 percent higher than the corresponding period last

The cotton output is likely to be 2.5-3.5 million bales higher, which will add 1.7-2.4 percentage points to agriculture sector growth.

year. Each one million bales addition in cotton output directly adds 0.7 percentage points to the agriculture sector growth, and indirectly boosts the textile industry and exports. The actual cotton output is likely to be 2.5-3.5 million bales higher than last year, implying a 1.7-2.4 percentage points higher agriculture sector growth on account of cotton alone. Because of the timely announcement of the increase in the support price of wheat and prevailing high market prices, it is estimated that, despite water shortage, wheat target of just over 20 million tons may be achieved. As a result, the agriculture sector is expected to grow by 3.5 percent in FY2005.

Sustained high demand continued to boost production in the LSM sector. LSM production increased by 14.0 percent in the first quarter of FY2005 compared with the same period of FY2004. The growth was broad-based, with increases being particularly large in the case of cement, electronics, automobiles, and paints and varnishes (see table 1). In coming months, the bumper cotton crop and low cotton prices will provide a boost to the textile industry. Textile industry is also expected to benefit from the end of the quota regime in textile trade in January 2005. The other two sectors for which indicators of growth are available are construction and telecommunications. Robust double-digit increases in production and sale of cement and paints and varnishes indicate that high growth in construction continued in the first quarter of FY2005. Similarly, large increase in telephone connections shows that telecommunication services also contined to expand at a rapid pace (see section II).

Increases in food prices and house rent pushed up CPI-based inflation to 9.1 percent.

Prices: Shortages of essential food items like wheat, pulses, and potatoes, and rising house rents put further pressure on prices in the first four months of FY2005.[1] So far consumers have been insulated from higher oil prices and hence their impact on inflation is not seen. Increases in food prices and house rent, which together have a weight of 63.8 percent in the Consumer Price Index (CPI), pushed up CPI-based inflation to 9.1 percent compared with 2.2 percent in the first four months of FY2004. Food prices increased by 13.6 percent, and house rent by 9.9 percent. Non-food non-rent price index increased by only 3.4 percent in the period under review. The annualized CPI-based inflation was 6.9 percent in October 2004 compared with 4.6 in June (see figure 1). The Wholesale Price Index (WPI) increased by 8.2 percent in first four months of FY2005 compared with 4.4 percent in the same period of FY2004. The main contributors to rise in WPI-based inflation were higher prices of food items and fuel, lighting, and lubricants (weights of 42.1 percent and 19.3 percent, respectively), which increased by 11.2 percent and 10.3 percent. These increases were partly offset by lower prices of raw materials mainly due to a sharp decline in the price of cotton. Inflation may have started to decline after peaking in September. On the basis of a month-on-month comparison, increase in CPI in October 2004 (8.7 percent) was lower than in September (9.0 percent).

Monetary Developments: To reduce inflationary pressure, the State Bank of Pakistan (SBP) changed its stance from an easy monetary policy of last year to a "measured tightening" of monetary policy in the first five months of FY2005. Interest rate on 6-month treasury bills, which serves as a benchmark for other interest rates, increased from 2.1 percent in May 2004 to 2.6 percent in August and further to 3.7

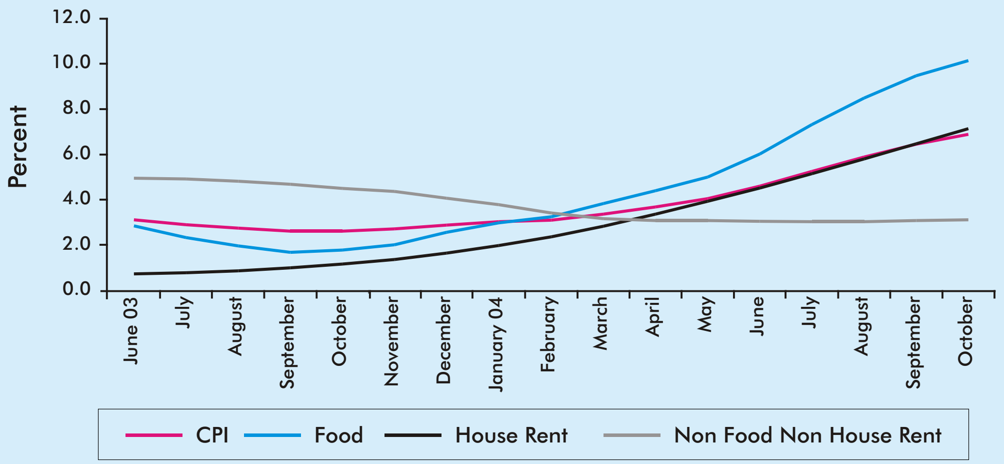
1. Reection of the shipment of wheat from Australia on ground of poor quality in January 2004 and subsequent ban imposed by the Punjab Government on inter-provincial movement of the commodity resulted in shortage of wheat in wheat-deficit provinces. Imported wheat entered the market only in October.

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

Items	Weights %	July - September FY2004	July - September FY2005
Textiles	**24.5**	**8.5**	**2.4**
Of Which:			
Cotton Yarn	13.1	2.5	0.1
Cotton Cloth	7.6	20.7	4.6
Food, Beverages, and Tobacco	**14.4**	**16.2**	**6.5**
Of Which:			
Vegetable Ghee	4.2	16.9	-6.9
Cooking Oil	1.3	18.3	35.6
Cigarettes	3.1	16.8	4.6
Petroleum Products	**5.2**	**1.0**	**17.2**
Pharmaceuticals	**5.0**	**23.3**	**1.9**
Chemicals	**4.8**	**16.6**	**5.3**
Fertilizers	**3.4**	**6.7**	**81.4**
Phosphatic Fertilizer	1.9	12.6	178.6
Nitrogenous Fertilizer	1.5	2.2	-0.2
Non-metallic Minerals	**4.2**	**17.2**	**22.0**
Of Which:			
Cement	4.1	17.4	22.0
Metal Products	**3.5**	**17.9**	**0.3**
Of Which:			
Pig Iron	1.6	18.7	2.9
Coke	1.4	22.5	3.4
Automobiles	**4.0**	**48.4**	**40.2**
Of Which:			
Cars and Jeeps	2.5	60.4	36.4
Electronics	**2.5**	**27.2**	**53.6**
Leather Products	**2.3**	**23.2**	**-8.9**
Paper and Board	**0.6**	**10.1**	**-1.1**
Engineering Goods	**0.5**	**13.4**	**14.0**
Overall Growth		**15.3**	**14.0**

Source: State Bank of Pakistan Website.

Figure 1: Annual Inflation



percent in November. SBP raised interest rate on its export refinance facility for banks by 50 basis points to 3.0 percent effective from 1st October 2004 and further to 3.5 percent from 1st December. Average interest rate on new loans disbursed by banks also increased to 6.2 percent in October from 5.1 percent in June.[2]

Growth in money supply slowed to 3.1 percent in the first four months of FY2005 compared with a 4.3 percent increase recorded in the corresponding period of FY2004 (see table 2). Expansion of the net domestic assets and net foreign assets of the banking system contributed more or less equally to growth in money supply. The

Table 2: Monetary Growth (Billion Rs)

	Monetary Impact during July-October	
	FY2004	**FY2005**
A. Net Borrowing by Government Sector	21.3	11.2
Of Which:		
Budgetary Support	29.0	11.0
Commodity Operations	-10.8	-1.8
B. Net Borrowing by Non-government Sector	45.6	112.2
(1) Borrowing by the Private Sector	70.8	123.5
(2) Borrowing by Public Sector Enterprises	-23.9	-11.4
(3) SBP Credit to NBFIs	-1.3	0
C. Other Items (net)	-26.8	-83.8
Net Domestic Assets of the Banking System (A+B+C)	40.1	39.6
Net Foreign Assets of the Banking System	49.2	37.6
Monetary Assets	89.3	77.3
% Growth in Monetary Assets	4.3	3.1

Source: SBP Website

2. Excluding zero interest loans.

major source of increase in net domestic assets was the accelerated flow of credit to the private sector, which increased by Rs 123.5 billion compared with Rs 70.8 billion last year, which itself was a record. Banks also continued their drive to lend to new sectors like consumer finance and agriculture. Gross disbursement of agricultural credit, at Rs 26.9 billion, in the first four months of FY2005 was 44.2 percent larger than the same period of FY2004. However, net borrowing by the Government for budgetary support was much lower than last year, i.e., only 37.9 percent of the amount borrowed in the same period of last year. This reflected better revenue position of the Government (see section on Fiscal Situation).

Fiscal Situation: Despite an adverse effect of a sharp increase in oil prices, fiscal situation improved significantly in the first quarter of FY2005 due to a surge in both tax and non-tax revenues and tight control on expenditure. Total revenue of the Federal and provincial governments increased by 22.2 percent, while expenditure increased by only 10.0 percent (see table 3). As a result, the overall fiscal deficit declined to 0.4 percent of GDP compared with 0.7 percent in the corresponding quarter of FY2004.

Fiscal situation improved significantly in the first quarter of FY2005.

Because of continued high growth in domestic economic activity and a sharp increase in imports, tax receipts of the Central Board of Revenue (CBR) increased by 30.9 percent to Rs 124.7 billion in the first quarter of FY2005, compared with the same period of last year.[3] In addition, tax reforms implemented in the last 3-4 years have started paying off in the form of improved collection efficiency. Increase in tax receipts was broad-based, ranging from 19.8 percent in receipts from general sales tax (GST) on domestic production to 63.2 percent in income tax. The exceptionally large increase in income tax accounted for more than half of the total increase in tax receipts. Part of the increase was due to advance collection of the tax in September, which last year was collected in October.[4] Total receipts from GST (on both imports and domestic production) increased by 21.0 percent. Receipts from customs increased by 25.2 percent. Excise duties, which had been declining consistently over the last four years, also increased by 24.8 percent because of increases in the production of dutiable items such as cement, POL products, and natural gas.

CBR tax receipts increased by 30.9 percent to Rs 124.7 billion.

Non-tax revenues recorded a sharp increase of 36.2 percent in the first quarter of FY2005, as Pakistan Telecommunication Authority (PTA) transferred more than Rs 17.0 billion to the federal budget out of its receipts for issuing licenses for various types of telephone services. There was no such transfer from PTA in the first quarter of FY2004. The receipt of dividends from state-owned enterprises also increased from Rs 0.3 billion to Rs 7.2 billion. Receipts from defense and civil administration declined by 24.1 percent to Rs 17.6 billion, mainly because of a decline in payments from USA for logistic support for war in Afghanistan. However, these receipts exceeded the budget estimate by a wide margin.[5]

In contrast with the above-target collection of CBR taxes and non-tax revenues, receipts from development surcharge on petroleum products declined as the sharp increase in international prices

3. CBR tax receipts increased by 22.5 percent to Rs 166.6 billion in the first four months of FY2005.
4. The deadline for quarterly advance payment of income tax, which was 7th October last year, was changed to 15th September.
5. The budget estimate for receipts from defense and civil administration for the full FY2005 is Rs 13.6 billion.

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

	July - September		% Change
	FY2004	FY2005	
Total Revenue	165.6	202.3	22.2
Federal Revenue	151.3	188.5	24.6
Taxes	95.3	125.6	31.8
Of Which:			
CBR Taxes	95.3	124.7	30.9
Surcharges	15.9	8.3	-47.8
Non-tax Revenue	40.1	54.6	36.2
Provincial Revenue	14.2	13.7	-3.5
Total Expenditure	206.5	227.1	10.0
Current Expenditure	158.9	186.9	17.6
Federal Expenditure	116.8	133.6	14.4
Of Which:			
Interest	44.2	51.4	16.3
Of Which:			
Domestic	36.1	42.4	17.5
Foreign	8.1	9.0	11.1
Defense	45.7	46.1	0.9
Provincial Expenditure	42.2	52.7	24.9
Development Expenditure and Net Lending	33.1	33.4	0.9
Development Expenditure	24.9	32.0	28.5
Federal	14.6	21.1	44.5
Provincial	10.2	10.9	6.9
Unidentified Expenditure	14.5	6.8	-53.1
Budget Deficit	40.9	24.9	-39.1
As % of GDP	0.7	0.4	-42.9

Sources: Website of Ministry of Finance

of petroleum and petroleum products was not passed through (see box). If international oil price remains above $35 per barrel, the losses in petroleum surcharges are likely to continue, unless the Government decides to pass on the increase in the price to domestic consumers.

The slower increase in expenditure resulted from a sharp decline in unidentified expenditure, which in the first quarter of FY2005, at Rs 6.8 billion, was less than half of its level in the same quarter of FY2004. In the booked expenditure (i.e. expenditure classified under different heads), defense expenditure increased nominally by 0.9 percent, as improvement in relations with India started paying off. As a percentage of GDP also, it declined from 0.84 to 0.76. However, interest payments after declining in the last two years, increased sharply (16.3 percent), mainly because of rise in interest rates in both domestic and international markets.

Box : Impact of Oil Price Increase on the Economy

The recent hike in international oil prices had an adverse fiscal impact, as well as a negative impact on balance of payments. It will also put pressure on domestic prices, if and when increase in oil prices is passed on to consumers. In this box, we discuss the impact of higher oil prices on the Government budget, balance of payments, and prices.

Fiscal Impact: Taxes on oil products are a major source of Government revenues in Pakistan. Besides import duties and sales tax, oil products are subject to development surcharge, which contributed Rs 45 billion, or 7.3 percent of total tax revenues of the Government last year. In the past, the specific rate of surcharge was kept constant, and changes in international prices of oil products were passed on to consumers through fortnightly changes in domestic prices. However, the recent increase in international prices of oil was so large that the Government decided not to pass it on to consumers. Since 1st May 2004, domestic prices of petroleum products have been frozen and subsequent increases in international prices have been absorbed by lowering the surcharge, and in some cases, completely eliminating it. If the per barrel oil price remains around $44[1] and the increase in price is not passed on to consumers, the Government could lose Rs 30-35 billion in revenues.

The increase in oil prices has pushed up the cost of thermal electricity, which accounts for 70.0 percent of total power generation in Pakistan. As electricity tariffs have not been adjusted upward since oil prices started increasing, this increase in generation cost will increase the financial losses of the two state-owned power distribution companies. These losses will have to be covered from the budget, which will increase the budgetary expenditure on subsidies to WAPDA and the Karachi Electric Supply Corporation (KESC). According to a very rough estimate, the budgetary expenditure on subsidies to WAPDA and KESC will increase by about Rs 8 billion because of the increase in the price of furnace oil, if electricity tariffs are not increased. Thus total fiscal impact of the oil price increase may be 0.6-0.7 percent of GDP.

Balance of Payments Impact: Petroleum and petroleum products accounted for 20.3 percent of Pakistan's import bill in FY2004 and thus an increase in their prices has a significant impact on the country's balance of payments. In the last four months, the unit value of crude oil imports into Pakistan has increased by 23.6 percent. If the oil prices in FY2005 remain about 25.0 percent higher than last year, oil import bill will go up by about $800 million, or 0.8 percent of GDP.

Prices: So far, domestic consumers have been largely insulated from oil price increase. When these increases are passed on, there will be increases in the cost of transport and lighting. Also, industrial and commercial costs will go up, pushing up prices of a broad spectrum of goods and services. All in all, oil price increase could add 1.0-1.5 percentage points to annual inflaion in FY2005.

1. This was the average per barrel price of crude oil, West Taxas Int., for the first quarter of

There was also an increase of 28.5 percent to Rs 32.0 billion in development expenditure. As a percentage of GDP also, it increased from 0.46 to 0.53. Almost the entire increase was in federal development expenditure, which rose by 44.5 percent. The Federal Government succeeded in spending 14.2 percent of its annual development program compared with 12.9 percent in the first quarter of FY2004, which reflects efforts being made by the Government to expedite the execution of development projects.

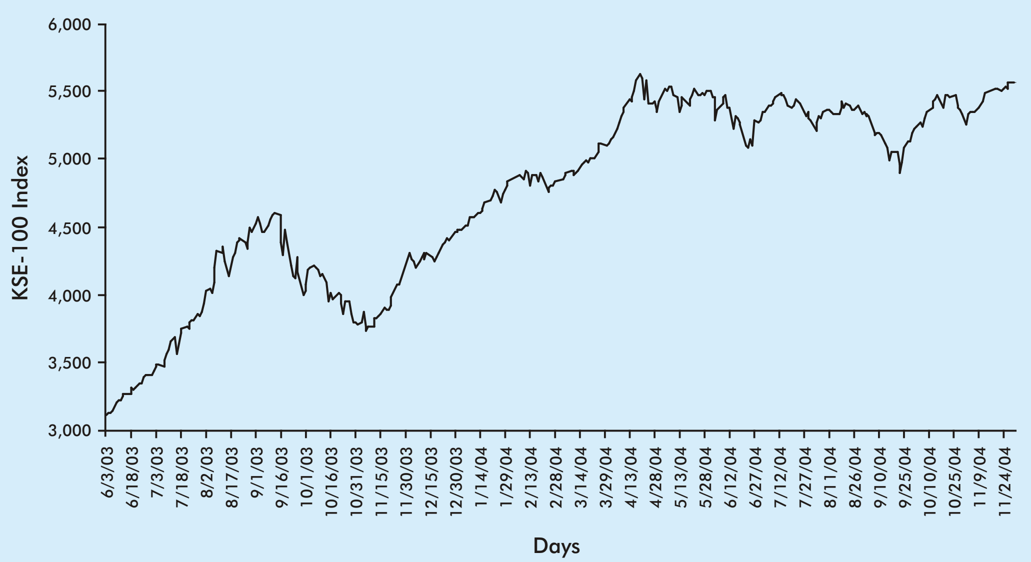
Expenditure on subsidies is not shown separately under the new classification of expenditure adopted with effect from the first quarter of FY2005. Therefore, it is not possible to analyze change in actual expenditure under this head. However, expenditure on subsidies is expected to increase substantially to cover additional losses of the two state-owned power companies, resulting from higher fuel prices as well as substitution of high-cost thermal for low-cost hydel electricity due to water shortage (see box). Additional subsidy will also be

Development expenditure increased by 28.5 percent in the first quarter of FY2005.

required to cover losses of the Trading Corporation of Pakistan (TCP) on account of its operations pertaining to import of wheat and urea and procurement of cotton.

Stock Market: Shares prices declined amid fluctuations in the first quarter of FY2005, mainly due to imposition of capital value tax on share transactions in the FY2005 budget, incidents of sectarian violence in some large cities, and flow of funds to foreign currency accounts in the wake of depreciation of the Rupee (see figure 2). The KSE-100 index declined from 5,279 on 30th June 2004 to 4,890 on 22nd September. Thereafter, share prices increased due to higher corporate earnings announcements. The KSE-100 index rose to 5,572 on 29th Novermber.

Figure2: Stock Market Performance



External Sector

Merchandise Trade: Imports continued to grow at a high rate in the first four months of FY2005. Export growth, which had decelerated sharply in the last quarter of FY2004, also picked up, although it was still only one-third of the import growth. Compared with the first four months of FY2004, imports increased by 37.4 percent to $5,894 million and exports by 12.3 percent to $4,462 million. Growth of imports in the first four months of FY2005 was much higher than the target set in the Trade Policy announced in July 2004, while export growth was on target.

Although, cumulative exports recorded a double-digit growth in the first four months of FY2005, there has been a sharp deceleration in their growth since July (see table 4). As a matter of fact, on a month-by-month basis exports actually declined in October. This is a matter of concern.

Growth in exports in the first four months of FY2005 was predominantly due to growth in volume in contrast with FY2004, when higher prices accounted for about three-fourths of the growth in exports. For 79.3 percent of exports for which quantity and price data are available, quantity increased by 6.2 percent, while prices increased by only 0.5 percent. In case of textiles, volume increased by 6.7 percent and prices by only 0.2 percent.

In the first four months of FY2005, imports increased by 37.4 percent.

Increase in textile exports lagged behind the overall export growth by a wide margin (see table 5).[6] Textile exports increased by 6.5 percent to $2,784 million and accounted for 34.8 percent of the total export growth. Knitwear recorded the largest increase (49.9 percent) and emerged as the largest item among textile exports. The entire increase in knitwear exports was due to higher volumes. Export of garments picked up and increased by 18.2 percent, also because of increase in volumes. This robust double-digit increase in export of garments in the first four months of FY2005 contrasts with decline in the same period of FY2004. On the negative side, export of bedwear continued to decline, possibly due to the 13 percent anti-dumping duty imposed by the European Union, which is currently the largest importer of Pakistani bed linen.

There has been a sharp deceleration in export growth since July, which is a matter of concern.

Export of non-textile manufactures increased by only 2.8 percent in the first

Table 4: Monthly Growth (%) of Exports July-October 2004

	July	August	September	October
Total Exports	**32.9**	**13.2**	**6.7**	**-1.3**
Of Which:				
Cotton Yarn	23.4	25.2	7.2	4.2
Cotton Cloth	48.4	25.0	-7.7	-14.2
Knitwear	44.9	49.3	58.8	26.9
Bedwear	1.6	-30.8	-41.4	-21.0
Readymade Garments	20.5	20.3	16.1	19.9

Sources: Website of Federal Bureau of Statistics (FBS).

6. This is in contrast with last two years, when textiles led the growth in exports.

Table 5: Growth in Exports (Million US$)

	July - October		% Change
	FY2004	FY2005	
Primary Commodities	**334**	**307**	**-8.1**
Of Which:			
Rice	205	200	-2.5
Fish and Fish Preparation	63	44	-29.3
Textile Manufactures	**2,614**	**2,784**	**6.5**
Of Which:			
Cotton Yarn	305	335	10.1
Cotton Cloth	509	550	8.0
Knitwear	482	723	49.9
Bedwear	483	375	-22.3
Towels	120	136	13.8
Readymade Garments	350	414	18.2
Art Silk and Synthetic Textiles	203	96	-52.8
Made-up Articles	144	145	0.5
Other Manufactures	**713**	**733**	**2.8**
Of Which:			
Carpets	67	71	5.8
Petroleum Products	74	129	74.4
Sports Goods	99	92	-7.3
Tanned Leather	76	77	2.0
Leather Manufactures	158	131	-16.8
Chemical and Pharm. Products	90	99	10.0
Others	**313**	**638**	**104.0**
Total	**3,974**	**4,462**	**12.3**

Source: FBS Website.

four months of FY2004. The export of other non-classified items more than doubled to $638 million and accounted for two-thirds of growth in total exports. However, as no breakdown of these exports is available, it is not possible to analyze them in depth.

Growth in imports was led by oil imports, which increased by 50.8 percent.

Growth in imports in the first four months of FY2005 was led by oil imports, which increased by 50.8 percent to $1,360 million and accounted for more than one-fourth of the total increase in imports (see table 6). Food imports increased by 26.7 percent. Non-food non-oil imports also increased sharply by 34.6 percent.

Due to a sharp increase in world prices, import of petroleum crude and petroleum products reemerged as the single largest item in country's import bill in the first four months of FY2005 (see box). Volume of petroleum products also recorded a sharp increase of 53.3 percent because of robust economic growth and additional demand for furnace oil for power generation to make up for decline in hydel generation due to water shortage. Volume of petroleum crude increased by 12.1 percent.

Large increases in import of machinery and raw materials and intermediate goods,

Table 6: Growth in Imports (Million US$)

	July - October		% Change
	FY2004	FY2005	
Food Group	**327**	**415**	**26.7**
Of Which:			
Edible Oil	225	249	10.7
Tea	60	73	22.3
Machinery	**1,045**	**1,348**	**29.0**
Of Which:			
Power Generating Machinery	107	101	-5.8
Textile Machinery	167	253	51.9
Vehicles	**197**	**255**	**29.2**
Petroleum Group	**902**	**1,360**	**50.8**
Petroleum Products	385	643	67.0
Petroleum Crude	517	717	38.7
Textile Group	**85**	**108**	**26.3**
Fertilizers and Other Chemicals	**891**	**1,183**	**32.8**
Of Which:			
Fertilizers	104	117	13.3
Plastic Materials	161	250	55.2
Metal Group	**202**	**308**	**52.5**
Of Which:			
Iron and Steel	178	281	57.5
Others	837	1,172	40.1
Total	**4,289**	**5,894**	**37.4**
Non-food Non-oil Imports	**3,060**	**4,119**	**34.6**

Source: FBS Website.

observed in the last two years, continued in the first four months of FY2005. Machinery imports were up by 29.0 percent. Particularly large increase was recorded in the import of textile machinery (it increased by 51.9 percent), which reflects the continuing modernization of the textile industry in anticipation of the end of the quota regime in January 2005. Import of construction and mining machinery and other machinery increased by 30.9 percent and 51.2 percent, respectively, which indicates a broad-based increase in investment. Raw materials and intermediate goods like completely knocked down automobile kits, iron and steel, plastic materials, fertilizers, and pesticides also recorded substantial increases, with particularly large increases being recorded in iron and steel (57.5 percent), plastic materials (55.2 percent), and synthetic fiber (50.9 percent).

Import of textile machinery increased by 51.9 percent, reflecting continuing modernization of the textile industry.

Almost two-fifths of the increase in food imports was contributed by imports of wheat and pulses required to make up for shortages in the domestic market. Pakistan imported 77 thousand tons of wheat for $21 million, and there are plans to import about 1.5 million tons of wheat in FY2005. At current prices, wheat imports will add about $400 million to the country's annual import bill. Import of pulses, which had declined in

The balance of payments position weakened significantly, as the current account went into deficit.

the last two years, increased sharply by 61.5 percent to $36 million compared with the first four months of FY2004.

Current Account: The balance of payments position weakened significantly in the first four months of FY2005, as the current account went into deficit of $80 million in contrast to a surplus of $1,492 million in the same period of FY2004 (see table 7). The reversal in the current account balance was mainly due to a burgeoning trade deficit and a more than nine-fold increase in deficit in the services account. Rapid import growth resulted in a trade deficit of $1,199 million compared with a small deficit of $27 million in the corresponding period of last year, while the services account recorded a deficit of $941 million compared with a deficit of $102 million last year. In addition, the Saudi Oil Facility, under which there was an inflow of $189 million in the first four months of FY2004, was no longer available. These developments were partly offset by the increase in inflow into foreign currency deposits and workers' remittances.

Capital and Financial Account: The capital account improved sharply,

Table 7: Balance of Payments (Million US$)

	July - October		% Change
	FY2004	FY2005	
Trade Balance	**-27**	**-1,199**	**--**
Exports	4,068	4,582	12.6
Imports	4,095	5,781	41.2
Services (net)	**-102**	**-941**	**822.5**
Income (net)	**-570**	**-707**	**24.0**
Of Which:			
Interest	261	246	-5.7
Current Transfers (net)	**2,191**	**2,767**	**26.3**
Of Which:			
Workers Remittances	1,292	1,312	1.5
Resident FCAs	153	264	72.5
Saudi Oil Facility	189	0	--
Current Account Balance	**1,492**	**-80**	**--**
Capital Account (net)	**24**	**529**	**--**
Of Which:			
Debt Forgiveness	0	495	--
Financial Account	**-926**	**-1,276**	**37.8**
Of Which:			
Foreign Direct Investment	170	275	61.8
Disbursement of Foreign Assistance	278	654	135.3
Amortization	-481	-903	87.7
Investment Assets of Banks	-289	-613	112.1
Errors & Omissions	**50**	**-212**	
Official Reserves	**10,044**	**9,775**	**-2.7**

Source: SBP Website.

showing a large surplus of $529 million compared with $24 million in the first four months of FY2004 -- primarily due to debt forgiveness of $495 million by the USA. The financial account, on the other hand, deteriorated and its deficit increased by 37.8 percent to $1,276 million, mainly because of a sharp increase in amortization (from $481 million to $903 million), largely because the Pak Arab Refinery (PARCO) repaid $347 million debt before time, and a large outflow of investment assets of banks. This was partly offset by higher disbursement of foreign assistance and an increase in foreign direct investment.

Foreign Exchange Reserves: Foreign exchange reserves declined by $779 million to $9.8 billion in the first four months of FY2005, as balance of payments position worsened and SBP intervened in the inter-bank market to support the Rupee. Effective 1st November, SBP started providing foreign exchange directly for payments for oil imports, and reserves declined further to $9.3 billion by 27th November. At this level, reserves are sufficient to finance 8.2 months of merchandise imports. The Rupee depreciated by 5.0 percent in the first four months of FY2005, when the Rupee/Dollar parity increased from Rs 58.19/US$ to Rs 61.23/US$. In November the Rupee strengthened as a result of SBP intervention in the market and the Rupee/Dollar parity declined to Rs 59.78/US$ by 25th November.

Outlook

Economic growth forecast of 6.5 percent in FY2005 is likely to be achieved.

Robust growth in the real sectors of the economy in the first four months of the year, sharp increase in non-oil non-food imports, particularly machinery and industrial raw materials, and continuing high domestic demand all indicate that the earlier economic growth forecast of 6.5 percent in FY2005 is likely to be achieved (see table 8). Despite water shortages, the agriculture

Table 8: Outlook for FY2005

	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	12.0
Other Sectors	5.1	6.1	6.6
Inflation (CPI)	3.1	4.6	6.5
Merchandise Exports	22.2	10.0	11.0
Merchandise Imports	18.2	26.6	28.0
	(In Percent of GDP)		
Budgetary Deficit*	4.5	3.9	4.0-4.3
Trade Balance	-0.3	-1.3	-3.8
Current Account balance (including Official Transfers)	5.1	2.0	-1.4

* Consolidated Budget Deficit of Federal and Provincial Governments.
Sources: (1) Pakistan Economic Survey 2003-04, Government of Pakistan.
(2) Annual Plan 2004-05, Planning Commission, Government of Pakistan.
(3) Annual Report 2003 2004, State Bank of Pakistan.
(4) ADB Staff Estimates.

The manufacturing sector is likely to grow by about 12 percent in FY2005.

sector is expected to grow at 3.5 percent, as cotton output is estimated to reach a record level. Wheat, the largest crop in terms of value added, is expected to get a boost from the timely announcement of increase in its support price and prevailing high market prices. A sharp increase in gross disbursement of agriculture credit in the first four months of FY2005 also point to better prospects of the agriculture sector.

The growth in manufacturing in FY2005, while less than last year, is likely to be a robust 12 percent, given the strong recovery in investment in the sector seen last year and continuing high demand. 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, announced in the FY2005 budget, are expected to further boost investment and production in the manufacturing sector. Sharp increase in flow of credit to the private sector in the first four months of the current year, as well as large increase in receipts from sales tax and excise duty on domestic production, indicates that high growth of the manufacturing sector is being sustained. Continuing modernization of the textile industry, as reflected in a large increase in the import of textile machinery in the first four months, and cheaper and abundant availability of cotton, will boost the textile industry. Increase in interest rates is not likely to adversely impact the manufacturing sector significantly, as increase in lending rates in the first four months has been quite modest, and despite the further increase expected in coming months, lending rates will remain on the low side.

Inflation is likely to increase to 6.5 percent in FY2005.

Of the two other important sub-sectors in the industrial sector, expansion in construction will be sustained, as indicated by sharp increase in the off-take of cement in the first four months of FY2005. Electricity generation and distribution, on the other hand, is likely to suffer a setback due to shortage of water.

Services sector growth is also expected to increase in FY2005. The high growth in the telecommunication sector is likely to accelerate further, as companies given 193 licenses in the last 7-8 months for various types of telephone services, start their operations (see section II). The banking sector is also expected to register robust growth, as it has been strengthened through reforms and privatization, and is expanding its lending operations in new areas. And the large increase in imports will boost growth in wholesale and retail trade.

With large monetary overhang,[7] continuing high demand in the economy, and most industries operating at or near full capacity, inflation is likely to increase to 6.5 percent in FY2005. If the current high level of oil prices is sustained and the Government decides to pass on the higher oil prices to consumers, inflation could rise above 7.0 percent.

With GDP growth expected to remain well above 6.0 percent, imports maintaining very high growth, and tax reforms of the past several years beginning to pay off, CBR tax revenues should exceed the target of Rs 580 billion given in the budget. Non-tax revenues, like dividends from Pakistan Telecommunication Company Limited and Oil and Gas Development Corporation and license fees for telephone services are also expected to exceed the target. However, there will be a shortfall in receipts from surcharge on petroleum products (see box).

7. Money supply increased at a significantly higher rate than increase in nominal GDP in the last three year.

As regards expenditure, defense expenditure, the second largest expenditure item, should remain on target, given a significant improvement in relations with India. However, subsidies to the two state-owned power companies and TCP will be much larger than budgeted because of their additional losses. Much larger than budgeted increase in debt servicing in the first quarter of FY2005 indicates that it might also exceed the budget estimates due to increase in interest rates in domestic as well as international markets. The factors listed above could push the fiscal deficit by 0.3 percentage-points above the target of 4.0 percent of GDP, unless the Government passes on the increase in oil prices to consumers.

High economic growth, sharp increase in oil prices, additional requirement of furnace oil for thermal power generation, and the planned import of one and half million tons of wheat and additional 100,000 tons of urea during the year will result in rapid import growth. On the export side, consistent deceleration of growth in the last three months is a matter of concern. However, the phase-out of textile and clothing quotas in January 2005, together with large investment in modernization of the textile industry in the past several years and cheaper and abundant supply of cotton this year, should boost exports. 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 four years.

The current account of the balance of payments will go into a deficit after four years.

There are a number of downside risks to the economic projections given above. If the oil prices increase further, projections for imports, fiscal deficit, and inflation may have to be revised upward. High oil prices could also dampen the global economic recovery, which would adversely impact Pakistan's export growth. 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. Increase in incidents of terrorism is also a risk.

II. ECONOMIC POLICIES AND REFORMS

The number of cellular phone subscribers has doubled every year since FY2000.

Reforms in Telecommunication Sector: Although reforms in the telecommunication sector were started in the early 1990s, they picked up in the last 2-3 years. Consequently, today this sector is probably the fastest growing sector in the economy having a significant impact on the investment and employment in the country. In this section, we discuss these reforms.

Deregulation of the telecom service got a big push after the announcement of the Telecom Deregulation Policy on 13th July 2003. The policy aims at promoting the availability of high quality, efficient, and cost effective telephone services in a competitive market. Under the new policy, fixed-line telephone service was also opened to private sector in December 2003. In 2004, the Pakistan Telecommunication Authority (PTA) has issued 12 licenses to various national and international companies for long-distance international (LDI) service and 73 fixed-line local loop (FLL) licenses for providing service in 14 regions of the country. To provide telecom services to remote rural areas, 106 wireless local loop (WLL) licenses have been awarded to 28 companies through open bidding. Two licenses have also been issued for cellular service, both going to foreign companies, one from Norway and the other from United Arab Emirates.[8]

As a result of deregulation, telecommunication sector, particularly the cellular phone and internet services, has expanded at a phenomenal speed in recent years, with the number of cellular phone subscribers doubling almost every year since FY2000 (see table 9). In FY2004, their number exceeded the fixed-line subscribers. However, penetration of both cellular and fixed-line phone service (measured by the proportion of telephone subscribers in total population) is still low compared with other countries with similar per-capita income. Hence, there is a vast scope for further expansion of telecommunication services. When the companies given licenses recently for cellular, fixed-line local loop, and wireless local loop roll out their services, there will be further acceleration in growth in this sector.

Table 9: Expansion of Telephone Services

	Number of Telephone Subscribers	
Year	**Fixed Line**	**Cellular**
FY1997	2,557,619	135,027
FY1998	2,660,898	196,096
FY1999	2,874,234	265,612
FY2000	3,053,460	306,493
FY2001	3,252,518	742,606
FY2002	3,655,474	1,238,602
FY2003	3,982,781	2,404,400
FY2004	4,500,000	5,000,000
September 2004	N.A.	6,500,000

Sources: (1) Pakistan Economic Survey 2003 - 04
(2) Pakistan Telecommunication Authority

8. Four licenses for cellular phone service had been issued earlier during the 1990s.

III. POVERTY REDUCTION

Poverty Reducing Public Expenditure: The pro-poor budgetary expenditure in FY2004, at Rs 254.0 billion, was 21.8 percent higher than FY2003, and also 6.4 percent more than the target (see table 10). As a percentage of GDP, the pro-poor expenditure increased from 4.3 in FY2003 to 4.7 in FY2004, reflecting a continuing strong commitment of the Government to poverty reduction. The share of pro-poor expenditure in total expenditure also increased from 23.1 to 26.1 percent.

Table 10: PRSP Expenditure (Billion Rs)

	FY2003	FY2004	% Change
	Access to Market and Community Services		
Roads	13.1	16.5	25.2
Water Supply & Sanitation	3.4	4.2	22.1
Sub-Total	**16.6**	**20.6**	**24.5**
	Human Development		
Education	78.4	98.0	24.9
Health	22.4	26.6	18.8
Population Planning	3.1	4.9	57.5
Sub-Total	**103.9**	**129.5**	**24.6**
	Development of Rural Areas		
Irrigation	15.5	22.9	47.7
Land Reclamation	1.7	2.0	15.2
Rural Development	16.9	18.4	8.9
Village Electrification	0	2.0	-
Sub-Total	**34.2**	**45.3**	**32.6**
	Social Safety Nets		
Social Security & Welfare	1.3	4.1	218.4
Natural Calamities/Disasters	0.4	0.5	32.4
Food Subsidies	10.9	7.8	-27.8
Food Support Program	2.0	2.8	39.0
Low Cost Housing	0.0	0.4	-
Tawana Pakistan	0.8	0.4	-50.0
Sub-Total	**15.4**	**16.2**	**5.0**
	Governance		
Courts and Justice	2.2	2.4	11.3
Law and Order	36.3	40.0	10.2
Sub-Total	**38.5**	**42.4**	**10.3**
Grand Total	**208.5**	**254.0**	**21.8**
Total PRSP Expenditure as % of GDP	4.3	4.7	
Total PRSP Expenditure as % of Total Public Expenditure	23.1	26.1	

Source: PRSP Progress Report 2003-04, PRSP Secretariat, Finance Division, Government of Pakistan.

Expenditure on education increased from 1.6 percent of GDP in FY2003 to 1.8 percent in FY2004.

Pro-poor 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. Expenditures under all these heads recorded increases in FY2004, with the sharpest increase being in expenditure on development of rural areas (32.6 percent), followed by human development (24.6 percent), and improving access to markets and community services (24.5 percent). Expenditure on social safety nets showed the lowest increase of 5.0 percent.

Of the 17 sectors identified for pro-poor expenditure, education, health, population planning, social security and social welfare, water supply and sanitation (WSS), and rural development may be considered core areas. Total expenditure in these sectors, at Rs 156.2 billion, represented an increase of 24.4 percent compared with FY2003, which was higher than the increase in overall pro-poor expenditure. Of individual sectors, growth in expenditure on social security and social welfare, population planning, education, and WSS exceeded the increase in total poverty reducing expenditure. While expenditures on health and rural development recorded smaller increases than that in overall pro-poor expenditure.

Development expenditure on higher education increased by almost six times in the last two years.

Expenditure on education, which accounts for 38.6 percent of the total pro-poor expenditure, increased by 24.9 percent to Rs 98.0 billion in FY2004. As a percentage of GDP, it increased from 1.6 to 1.8. While this increase is most creditable, the percentage is still quite low by international norms. Within the education sector, in FY2004 there was a discernable shift in expenditure towards primary education. Expenditure on primary education increased by 31.4 percent, and that on secondary education and general college and universities increased by 13.3 percent and 18.5 percent, respectively. In FY2003, expenditure on primary education had declined by 4.4 percent and that on general college and university education had increased by 51.2 percent. Therefore, higher increase in expenditure on primary education and lower increase in expenditure on colleges and universities may be partly due to the base effect. Development expenditure on general college and university education has increased very rapidly in the last two years (from Rs 873 million in FY2002 to Rs 5,125 million in FY2004) and now accounts for more than one third of total expenditure on college and university education. This reflects the Government's commitment to expand higher education to increase the supply of trained manpower required for knowledge-based development of the economy in coming years.

Expenditure on health increased by 18.8 percent to Rs 26.6 billion. Growth in expenditure varied substantially between various levels of health services. While expenditure on hospitals increased by 20.5 percent, that on preventive health facilities and mother and child health services increased by only 10.0 percent and 13.1 percent, indicating a shift from basic and preventive health facilities to tertiary and curative facilities. The lower priority accorded to basic health care will make it difficult to achieve the Government's objectives with regard to the millennium development goals.

Among non-budgetary income transfer programs, disbursement of Zakat, which had increased sharply in FY2003, declined back to more or less the FY2002 level in FY2004.[9] Zakat disbursement, at Rs 5,330 million, is 33.4 percent lower than the amount disbursed in FY2003, and signifi-

9. Disbursement of Zakat in FY2004 was only 1.4 percent more than FY2002.

cantly less than the target of Rs 9,650 million given in the Full Poverty Reduction Strategy Paper released in December 2003. There was decline in all the uses of the Zakat Fund, except support for religious schools. The largest decline was in one-off rehabilitation grants provided for setting up a small business, which declined to Rs 2,427 million, almost half of the amount disbursed in FY2003. Disbursement of subsistence allowance also declined by 7.7 percent to Rs 1,923 million. The number of beneficiaries of the Zakat Fund declined by 6.6 percent to 1,639,000.

Total disbursement of micro credit through Khushali Bank, Pakistan Poverty Alleviation Fund (PPAF), and Zari Taraqqiati (Agricultural Development) Bank increased by 20.5 percent to Rs 3,034 million in FY2004. The growth of micro credit provided by these three institutions slowed in FY2004; in the preceding two years, it had grown by 81.8 percent and 140.0 percent, respectively. Each one of the three institutions extended the geographical coverage of its operations. PPAF, the largest provider of micro-finance, extended its operations to 75 districts compared with 72 districts in FY2003.

Last year, Gallup Pakistan evaluated the impact of micro credit operations of PPAF through a survey of 1700 borrower and non-borrower households from 17 districts in all the four provinces of the country. According to the findings of the survey, borrowing households were better off than households who had not borrowed. On the average, their income, consumption, and personal and business assets had increased. The mean return on investments financed through loans was approximately 30 percent per annum.

Intermediate Human Development Indicators: Data on intermediate indicators, available for education and health, is used for assessing the impact of increased public expenditure on these services in the short run. In education, the number of functional primary and middle schools and their proportion with four basic facilities (i.e., water, latrine, electricity, and boundary wall) are used as intermediate indicators. The number of functional primary schools increased by 1.0 percent to 135,365 in FY2004 (see table 11). The number functional middle schools also increased by 1.0 percent to 13,873. The percentage of schools with water and sanitation facilities increased in FY2004. For the other two facilities, comparison is not possible as numbers are not available for FY2003.

Households borrowing from PPAF were better off than households who had not borrowed.

Intermediate health indicators show that there was deterioration in all indicators except coverage of lady health workers (LHWs). The utilization rate of first level health care facilities (FLCFs), immunization coverage, percentage of births attended by skilled birth attendants, percentage of FLCFs not experiencing stock outs of any of the five essential supplies (ORS, cotrimoxazole, foalte tablets, chloroquine, and syringes), and the percentage with supplies of contraceptives, all declined in FY2004. Only the percentage of population served by LHWs increased from 44 to 50.

The system for collecting and reporting data on intermediate human development indicators is quite weak, making the quality of the data somewhat suspect. For instance, deterioration in intermediate health indicators, while expenditure on basic health facilities increased, is difficult to explain. Numbers for education indicators for FY2004 are only estimates. Given the poor quality of data on intermediate human development indicators, it is difficult to say something with confidence about the impact of increased expenditure on these services. There is an urgent need to improve the monitoring of intermediate/output indicators.

Almost all intermediate health indicators declined in FY2004.

Table 11: Intermediate Human Development Indicators

	FY2003	FY2004	% Change
Education			
Primary Schools			
No. of Functional Schools	134,027	135,365	1.0
% of Schools with:			
Water	48.0	50.0	4.2
Latrine	46.0	47.0	2.2
Electricity	N.A.	27.0	
Boundary Wall	N.A.	46.0	
Middle Schools			
No. of Functional Schools	13,736	13,873	1.0
% of Schools with:			
Water	68.0	71.0	4.4
Latrine	67.0	70.0	4.5
Electricity	N.A.	58.0	
Boundary Wall	N.A.	62.0	
Health			
Utilization Rate for FLCFs (Curative -- average number of cases per day per facility)**	115.0	110.0	-4.3
LHW Coverage (% of population)	44.0	50.0	13.6
Immunization Coverage (% of target population)			
DP III	69.0	65.0	-5.8
TT II **	48.0	38.0	-20.8
Births Attended by Skilled Birth Attendants (%) **	14.0	12.0	-14.3
Number of Skilled Birth Attendants**	96,354	NA	-
FLCFs not Experiencing Stock-out**	35.0	27.0	-22.9
FLCFs Meeting Staffing Norms (%)**	30.0	NA	-
Availability of Contraceptive at FLCFs (%)**	85.0	68.0	-20.0

* * Data is available only for the first three quarters of the year.
Source: PRSP Progress Report 2003-04, PRSP Secretariat, Finance Division, Government of Pakistan.