OVERVIEW OF THE ECONOMY

Pakistan's economy continues to gain traction as it experiences the longest spell of its strongest growth in years. The outcomes of the outgoing fiscal year indicate that Pakistan's upbeat economic momentum remains on track. Economic growth accelerates to 7.0 percent in 2006-07 at the back of robust growth in agriculture, manufacturing and services. Pakistan's growth performance over the last five years has been striking. Average real GDP growth during 2003-07 was the best performance since many decades, and it now seems that Pakistan has decisively broken out of the low growth rut that it was in for more than one decade. Economic growth has been notably stable and resilient. With economic growth at 7.0 percent in 2006-07, Pakistan's real GDP has grown at an average rate of 7.0 percent per annum during the last five years (2003-07) and over 7.5 percent in the last four year (2004-07) in running. Compared with other emerging economies in Asia, this puts Pakistan as one of the fastest growing economies in the region along with China, India, and Vietnam. The good performance has resulted from a combination of generally sound economic policies, on-going structural reforms and a benign international economic environment. Based on the performance of half-a-decade of strong, stable, resilient and broad-based economic growth it appears that Pakistan's economy will continue to be a high mean, low variance economy over the medium-term.

Pakistan is in the midst of its strongest economic expansion phase and its growth momentum is broad-based. All the three major sectors, namely, agriculture, industry and services have provided support to strong economic growth. The commodity-producing sectors *(agriculture and industry)* contributed 2/5th and services sectors contributed remaining 3/5th to the real GDP growth of 7.0 percent in 2006-07. Within the commodity-producing sectors, the contribution of agriculture alone has been 15 percent *(or 1.1 percentage point)* while 25 percent *(or 1.8 percentage point)* contribution to this year's growth came from industry. Services sectors as a whole contributed almost 60 percent *(or 4.2 percentage points)* to this year's strong economic growth.

This year's economic growth is mainly driven by strong domestic demand with investment taking lead over consumption for the first time in the last three years. Net exports appear to have been a drag on overall growth in 2006-07. Almost 53 percent contribution to this year's growth came from investment while consumption contributed 50 percent. Net exports contributed negatively to the extent of 3.0 percent. This year's economic growth has benefited from higher consumption and investment demand owing to a growing middle class and favourable demographics. Increased contribution of investment to growth is a healthy development as it will engender employment growth which will support consumption demand and together they will play an important role in sustaining strong growth momentum in the medium-term.

Pakistan's economy continues to perform impressively and its economic fundamentals have gained further strength in the fiscal year 2006-07. The most important achievements of this year include: (i) a strong economic growth of 7.0 percent despite the pursuance of tight monetary policy resulting in interest rate increases; (ii) a strong recovery in overall agricultural growth at 5.0 percent and major crops at 7.6 percent at the back of highest ever production of wheat *(23.52 million tons)* in the country's history and an impressive 22.6 percent increase in sugarcane production *(54.7 million tons: the second highest production level in the history)*; (iii) large-scale manufacturing continue to grow robustly at 8.8 percent, *albeit* at a somewhat less torrid pace than last year; (iv) the overall services sector continue to maintain solid pace of expansion at 8.0 percent; (v) with strong average economic growth of over 7.5 percent during the last four years, Pakistan continues to maintain its position as one of the fastest growing economies in the Asian region; (vi) the real per capita GDP grew by 5.2 percent and has maintained an average growth of 5.5 percent per annum over the last four years; (vii) per capita income in current dollar term was up by 11.0 percent to $ 925; (viii) a sharp pick up in overall investment reaching at a new height of 23 percent of

GDP and most notably, private investment remained buoyant owing to the persistence of strong consumer demand, (ix) despite monetary policy tightening the credit to private sector continue to growth strongly (12.2%) at the back of improving investment climate; (x) a significant abatement of price pressure indicating a steady deceleration in core inflation *(non-food non-energy)* from an average of 7.7 percent last year to 6.0 percent this year owing to pursuance of tight monetary policy; (xi) on the fiscal side, the overall budget deficit target *(4.2% of GDP)* and revenue collection target of the Central Board of Revenue (CBR) are achieved; (xii) across all measures of vulnerability to external shocks, Pakistan's debt profile has improved significantly over the past year — public debt declined from 56.9 percent to 53.4 percent of GDP and external debt and liabilities declined from 29.4 percent to 27.1 percent; (xiii) highest ever workers remittances at around $ 5.5 billion, (xiv) highest ever foreign investment flows at around $ 6.5 billion, emerging as the single largest source of external finance after exports; (xv) exchange rate continues to remain stable despite widening of trade and current account deficits, clearly indicating strong inflows of external resources; and (xvi) the successful launch of a new $ 750 million 10-year 144 A sovereign bond in international debt capital market with seven times over subscription has been the defining moment in Pakistan's history as it reflected a strong vote of confidence by global investors on Pakistan's current economic prospects and future economic outlook.

While Pakistan's economy continues to gather momentum and its economic fundamentals are gaining traction the social sector indicators are also improving. According to the PSLM 2005-06 Survey released recently, the social sector indicators particularly gross and net enrolment at primary level and literacy rate show significant improvement over the last 5 years. The health indicators, particularly children immunization, incidence of Diarrhea and infant mortality rate have all improved significantly over the last 5 years. Most importantly, the contraceptive prevalence rate has increased substantially and accordingly the total fertility rate has declined from 4.5 to 3.8 over the last 7 years. While the incidence of poverty has declined significantly in Pakistan in recent years at the back of strong economic growth, some argue that income/ consumption inequality has also increased during the period. It is true that consumption inequality has increased only marginally during 2001-2005 and efforts are underway to reduce this gap, the consumption/ income inequality is far less in Pakistan compared with a variety of rich, middle and low income countries.

Notwithstanding these impressive gains in economic and social fronts in the outgoing fiscal year there remained some areas where results could not be achieved as planned for the fiscal year. First and foremost is the rate of inflation which has averaged 7.9 percent in the first ten months of the fiscal year – marginally lower than last year for the same period, but certainly above the target of 6.5 percent for the year. The average inflation for the year is expected to be around 7.5 percent — 100 bps above the target. This year's inflation has been fueled by a combination of global trends in the prices of several commodities and local supply-and demand-driven factors. Globally, higher prices of edible oil *(palm oil and soyabean)* and dependency on their imports transmitted higher international prices to domestic prices. Furthermore, shortfall in domestic production of pulses, rice, chilies, other vegetable items *(onion, tomato etc.)* and fruits forced the government and private sector to import some of these items *(pulses)*, also transmitted higher international prices to domestic prices. Resultantly, food inflation averaged 10.2 percent as against 7.0 percent last year, adversely affecting the low and fixed income groups. There are few food items which are widely consumed and whose prices remained high during the year and therefore contributed to the pick up in food inflation include: rice, masur and gram pulses, milk powder, vegetable ghee and cooking oil, red chilies, onion, tomato.

On the other hand, the prices of some essential food items were lower this year compared with last year. These items include: moong pulse, sugar, chicken, potato etc. The challenge for the government is therefore, to maintain a balance between the supply and demand of these essential commodities by enhancing production and augmenting supplies in the shortest possible time through import in the event of shortfall in the production. The key to addressing this challenge is to give due importance to minor crops *(vegetable items and fruits)* and livestock and dairy sector *(for meat and milk).* Currently there is a total disconnect between the importance given to these sub-sectors of agriculture *(they together account for 62% of the agricultural value-added)* and their relative roles in maintaining price stability in general and food inflation in particular. Marketing system also need to be improved for which several vegetable markets need to be established in each medium-to-large cities to minimize the role of middle man.

Notwithstanding the sharp pick up in prices of some of the food items it is equally true that the prices of essential commodities in Pakistan are still relatively cheaper in the region. For example the prices of wheat, wheat flour, chicken, and eggs are the lowest in South Asian region. Similarly, prices of all kinds of pulses and sugar are lowest in the region with the exception of Sri Lanka and India, respectively. However, this does not mean that we have to pause or rest in our efforts of keeping prices low and stable.

Secondly, on external side, while import growth slowed to a normal level in the current fiscal year after surging at an average rate of 29 percent per annum over the last four years, export growth witnessed abrupt and sharp deceleration to less than 4.0 percent after growing at an average rate of 16.0 percent per annum during the same period. Therefore, the benefits of normal growth of imports could not be achieved in terms of improving trade and current account deficits, mainly on account of less than satisfactory export performance. The capital account, meanwhile, remains solidly in surplus, Capital inflows have been dominated by foreign investment and other inflows the magnitude of which has overwhelmed the State Bank of Pakistan, and created difficulties for monetary policy. On net, strong inflows in capital account will not only more than offset the current account deficit but will help in building foreign exchange reserves. Nonetheless, trade and current account deficits require closer monitoring over the next few years.

Thirdly, while unemployment and poverty have declined substantially at the back of sustained high economic growth, consumption inequality, though far less in Pakistan as compared with many high, middle and low income countries has marginally increased during the period 2001-05. More attention will be required in skilled developments and improving the quality and delivery of education services in both urban and rural areas to address distributional issues. Reducing labour market rigidities could raise employment and growth. Such reforms in labour market will have beneficial effects on equity.

Global Economic Environment while sound macroeconomic policies and ongoing structural reforms have contributed in delivering yet another year of solid economic growth, Pakistan has also benefited from a benign international economic situation. The world economy is enjoying a remarkable period of broadly shared growth. In fact the world is in a period of economic expansion unmatched since the early 1970s, while inflation remains at low levels. Most importantly, every region of the world economy is now doing well. The world economy has expanded by 5.4 percent in 2006. The Euro zone at last managed a strong recovery with growth of 2.6 percent in 2006, up from 1.4 percent in 2005. While advanced economies grew by 3.1 percent, emerging and developing economies grew by an astonishing 7.9 percent. Developing Asia led the way with 9.4 percent growth; and china, India, Vietnam and Pakistan within the region growing in the range of 7.0 percent (Pakistan) to 10.7 percent (China) with India (9.2%) and Vietnam (7.4%) falling in between. But other regions have also done well. The Commonwealth of Independent State (CIS) grew by 7.7 percent with Russia growing at 6.7 percent. The four important economies of ASEAN region *(Indonesia, Malaysia, Thailand and Philippines)* have also grown at robust rate *(5.0 – 5.5%).* Saudi Arabia and Kuwait grew strongly at 6.3 percent and 6.2 percent at the back of equally strong oil revenue. All the countries in South Asia are witnessing stronger economic expansion and benefiting from growth in terms of reducing poverty in the region. Africa as a whole is growing at a modest pace of 5.5 percent.

Behind this widely share expansion lies the rapid growth in the volume of world trade *(up 9.2 percent in 2006)*, soaring capital flows with net private flows to emerging markets at $ 256 billion, robust external positions for the emerging market economies with a further accumulation of foreign exchange reserves, amounting $ 738 billion 2006, strong rises in commodity prices and, not least, a better distribution of growth among advanced economies.

The global economy is on track and expected to continue to grow robustly in 2007 and 2008 with somewhat less torrid pace than in 2006. Emerging market and developing countries of which, Pakistan is a member, are also likely to grow strongly in the next two years.

What factors could threaten the continuation of these strong trends? The current expansion phase of global economy owe heavily to global productivity growth. There is some concern that global productivity growth may decelerate in the period ahead if progress is not made in Doha Development Round. The protectionist forces could rise over time, imposing new barriers to trade and investment flows and reversing some of the gains from an increasingly integrated world economy. Second, crucial issue for maintaining productivity growth is the challenge posed by aging population, especially in advanced countries. The ratio of dependents to working age population will raise pension and healthcare costs, imposing fiscal strains. A central challenge will be to ensure that fiscal policy frameworks remain sustainable in the face of aging population.

GDP Growth Real GDP growth accelerated to 7.0 percent in 2006-07 as against the revised estimates of 6.6 percent last year and the 7.0 percent target for the year. The final estimate for 2004-05 has also been revised upward to 9.0 percent as against the revised estimate of 8.6 percent for the year. Thus, over the last four years the real GDP has grown at an average rate of 7.5 percent per annum. This year's growth has been broad-based as agriculture, manufacturing and services have grown robustly. Agriculture registered a sharp recovery from as low as 1.6 percent last year to 5.0 percent this year and therefore enhanced its contribution to real GDP growth from 6.0 percent *(or 0.4 percentage points)* to 15 percent *(1.1 percentage points).* Overall manufacturing grew at a somewhat more moderate pace at 8.4 percent in 2006-07 as against a strong growth of 10.0 percent last year. Accordingly, its contribution to this year's real GDP growth declined to 23 percent *(1.6 percentage points)* from 27 percent *(1.8 percentage point)* last year. Within overall manufacturing, large-scale manufacturing accounts for 70 percent and continues to post robust growth, although at somewhat less torrid pace than last year. This sector grew by 8.8 percent against the target of 12.5 percent and last year's achievements of 10.7 percent, perhaps exhibiting the signs of moderation on account of higher capacity utilization on the one hand and a strong base effect on the other. This year's real GDP growth was also powered by stellar growth in construction and banking and insurance sectors, respectively growing by 17.2 percents and 18.2 percent. Brisk pace of activities in housing and high rise buildings along with large public sector spending on physical infrastructure, and the on-going reconstruction activities in the earthquake affected areas contributed to the sharp pick up in construction value-added. The emergences of growing middle class along with strong buying power and on-going reforms in banking and financial sector have made this sector highly attractive to foreign investors. This sector is growing at an average rate of 27 percent per annum over the last three years and its contribution in overall GDP growth is increasing overtime. Electricity and gas distribution continues to be a drag on growth for third year in a row. This sector has registered a negative growth of 15.2 percent purely on account of high operating expenses of the WAPDA offsetting its gross value added.

The services sector continued to perform strongly for third year in a row and grew by 8.0 percent in 2006-07 as against 9.6 percent last. Services sector has grown at an average rate of 8.7 percent per annum during the last three years. Almost 60 percent contribution to this year's growth has come from services sector. All the components of services sector registered strong growth with the exception of ownership of dwellings which continues to grow at 3.5 percent for the last four years. Transport and communication, wholesale and retail trade, finance and insurance and public administration and defense have growth robustly in 2006-07.

Agriculture is still the single largest sector of the national economy. It has made a modest recovery from the dismal performance of last year. Overall agriculture grew by 5.0 percent in 2006-07 from 1.6 percent last year. Within agriculture, the major crops witnessed strong recovery by growing at 7.6 percent against a negative growth of 4.1 percent last year. The impressive growth in major crops owes partly to the bumper wheat and sugarcane crops and partly to the base effect as it is measured from a low base of last year. Wheat production was up by 10.5 percent to 23.5 million tons —the highest ever wheat production recorded in the country's history. The balanced use of fertilizer, availability of water during Rabi season, higher availability of agricultural credit and introduction of three new high yielding varieties of wheat have been responsible for record production of wheat this year. Sugarcane production, likewise, improved by 22.6 percent last year to 54.8 million tons — the second highest size of the crop in the country's history. Cotton production at 13.0 million bales remained at last year's level. The other two major crops, namely rice and maize did not perform well. Both rice and maize registered negative growth rates of 2.0 percent and 4.5 percent, respectively. Gram pulse, the other major crop, exhibited an impressive growth of 75.4 percent in 2006-07 to 0.842 million tons compared with 0.480 million tons last year. The performance of other components of agriculture such as minor crops, fishing, forestry and livestock has been lackluster at best. Livestock with almost 50 percent contribution to agriculture has performed reasonably well at 4.3 percent this year as against a strong growth of 7.5 percent last year. The performance of minor crops has a direct bearing on food inflation. Minor crops grew by only 1.1 percent this year as against an equally poor performance (0.4 %) of last year. The performance of this sector has been poor for third year in a row as it has grown at an average rate of 1.0 percent per annum. Lack of attention paid to minor crops by successive governments is responsible for its poor performance.

Manufacturing is the second largest sector of the economy accounting for 19.1 percent of GDP. The overall manufacturing continued to post robust growth in 2006-07, although at a somewhat moderate pace compared to last year as well the last three years. Overall manufacturing grew by 8.4 percent this year as against 10 percent last year. Large scale manufacturing (LSM), accounting for nearly 70 percent of overall manufacturing, also continued to post a robust growth in 2006-07, albeit at a somewhat less torrid pace than last year. The LSM sector grew by 8.8 percent against the target of 12.5 percent and last year's achievement of 10.7 percent. The relatively slower pace of expansion this year perhaps exhibits signs of moderation on account of higher capacity utilization, difficulties in the textile sector and lower than expected scale of operations of oil refineries. Several other factors have also contributed to the somewhat moderate pace of expansion of LSM such as: zero percent growth in raw cotton production which is a critical input in the textile industry thus limiting its growth; vegetable ghee and cooking oil which makes up nearly 5.5 percent of the LSM sector showed lackluster performance, most likely due to the unprecedented rise in international palm and soybean oil prices; and the performance of the automobile sector has been far less impressive this year as compared to previous five years due to the fall in domestic demand for cars on account of increasing auto financing rates. The high imports of used cars earlier in the fiscal year also dampened the performance of the domestic auto sector.

Per capita income is regarded as one of the key indicators of economic well being of any country. It simply indicates the average level of prosperity in the country or average standard of living of the people in the country. Per capita income, defined as GNP at market price in dollar terms divided by the country's population, grew by 11 percent this year to US$925 up from US$833 last year. The per capita income in dollar terms has grown at an average rate of 13 percent per annum during the last five years, rising from US$ 586 in 2002-03 to US$ 925 in 2006-07. Per capita income grew at a much slower pace of 1.4 percent per annum in the 1990s. The main factors responsible for the sharp rise in per capita income in the recent years include: acceleration in real GDP growth, a stable exchange rate, and five fold increase in the inflows of workers remittances. Real per capita GDP is also an important indicator of the general well being of the people in the country. Real per capita GDP grew by 5.2 percent in 2006-07 and 5.5 percent on average during the last four years as against 1.4 percent in decade of the nineties.

Consumption Pakistan's economy is undergoing structural shift that are fueling rapid changes in consumer spending patterns. In particular, the middle class is becoming an increasingly dominant force. Pakistan's real per capita GDP has increased at an average rate of 5.5 percent per annum over the last four years, giving rise to the average income of the people. Such increases of this magnitude in real per capita income have led to a sharp increase in consumer spending during the last four years. As opposed to an average annual increase of 1.4 percent during 2000-03, the *real* private consumption expenditure has grown at an average rate of 7.4 percent per annum during the last four years. The extra-ordinary strengthening of domestic demand during the last four years points to several factors. Firstly, the higher consumer spending feeding back into economic activity is supporting the ongoing growth momentum. Secondly, it suggests the emergence of a strong middle class with growing purchasing power supporting domestic demand thus expanding domestic markets. Together with investment demand it is emerging as a critical driver of economic growth. Thirdly, Pakistan is currently witnessing changes in its demographic structure as the share of working age population has increased and the share of dependent population has declined, thus increasing disposable incomes and current consumption. Accordingly, the contribution of private sector consumption in real GDP growth, on average, has been 75 percent over the last four years. However, this year the contribution of private consumption expenditure has declined to 47 percent partly as a result of the tight monetary policy being pursued by State Bank of Pakistan to shave off excess demand.

Investment is a key determinant of economic growth. During the fiscal year 2006-07, the real gross fixed capital formation (real investment) grew by 20.6 percent as against 17.6 percent last year. Over the last three years, real fixed investment grew at an average rate of 17.3 percent. As percentage of GDP, total investment reached new heights touching 23 percent in 2006-07 increasing from 21.7 percent last year. Over the last four years, total investment has increased 6.4 percentage points of GDP, rising from 16.6 percent in 2003-04 to 23 percent this year, reflecting the buoyant mood of domestic as well as foreign investors. Real private investment grew by 19.6 percent this year as against 20.0 percent last year. Major private sector investment has taken place in mining and quarrying, manufacturing, construction, transport and communication, banking and finance and wholesale and retail trade. Real private investment in these sectors grew at a high double-digit levels. In the meantime, public sector investment grew by 31.7 percent this year as against 7.3 last year. Public sector investment has mostly been directed towards physical and human infrastructure for supporting the ongoing buoyant mood of the private sector. Foreign direct investment (FDI) has also emerged as a major source of private external flows in Pakistan as well as contributing to the growth of domestic fixed capital formation. FDI grew by almost 37 percent in the first ten month of the current fiscal year to US$ 4.16 billion as against US$ 3 billion in first ten month of last fiscal year. Almost 78 percent of FDI has come from five countries namely UAE, USA, China, UK and Netherlands. Nearly 80 percent of FDI was destined for four main sectors namely IT/Telecom sector, banking and financial services, energy sector including oil, gas and power and food, beverages and tobacco sector. Petroleum refining, chemicals and petrochemicals, textile and cement have also attracted FDI in the current fiscal year. This years economic growth is mainly driven by strong domestic demand with investment taking lead over consumption for the first time in the last three years. Almost 53 percent contribution to this year's growth came from investment. National savings also increased to 18 percent of GDP this year from 17.2 percent of last year contributing to 84 percent of financing of domestic fixed investment.

Inflation Stable inflation is recognized as an integral component of sound macroeconomic policies. Over the last decade, with a few exceptions, inflation around the world has been at retreat. More recently, with a pick-up in growth, inflation has started to rise again. Pakistan's economy exhibited a similar trend with a low inflation environment for last several years with a sharp pick-up in 2004-05 and a gradual abatement of price pressure thereafter. The rate of inflation averaged 7.9 percent in the first 10 months of the fiscal year – marginally lower than last year for the same period – but certainly above the target of 6.5 percent for the year. The average inflation for the year is likely to be around 7.5 percent – 100 bps above the target. Food inflation averaged 10.2 percent over the first ten months of fiscal year 2006-07 as against 7 percent last year. On the other hand, non-food inflation averaged 6.2 percent as against 8.8 percent of last year during the same period. The core inflation, which excludes food and energy costs from headline CPI based inflation, also exhibited a decline, averaging 6 percent over the first 10 months of the current year as against 7.7 percent during the same period last year. Likewise, increases in house rent index, second largest component of CPI (23.4 percent) after food (40.3 percent), averaged 6.7 percent as against 10.3 percent last year (first ten months). Further, change of transport component, accounting for 7.3 percent of CPI, decelerated sharply to 3.2 percent over the first 10 months of current fiscal year compared to 17.7 percent in the corresponding period of last year.

Based on the above facts it is clear that this year's inflation has largely been driven by higher food inflation as opposed to last year where the major culprit was non-food inflation. This year's food inflation has been fueled by a combination of global trends in the prices of several commodities and local supply – and demand – driven factors. Globally, higher prices of edible oil (palm oil and soybean) and dependency on their imports transmitted higher international prices to domestic prices. It may be pointed out that higher food inflation is now a global phenomenon as many countries around the world *(for example India and China)* are also experiencing higher food inflation. In fact, the global food price index is up by 16.1 percent this year as compared to last year. Furthermore, shortfall in domestic production of pulses, rice, chilies, other vegetable items (onion, tomato, etc) and fruits also contributed to the rise in domestic food prices. There are a few key food items which are widely consumed and whose prices remained high during the year and therefore contributed to the pick-up in food inflation. These items include: rice, masur and gram pulses, milk powder, vegetable ghee and cooking oil, red chilies, onions and tomato. On the other hand, the prices of some essential food items were lower this year compared with last year. These items include: moong pulse, sugar, chicken, potato etc. Non-food inflation in general and core inflation in particular have declined as a result of tightening of monetary policy during the year.

The challenge for the government is therefore to maintain a balance between the supply and demand for essential food items by enhancing domestic production and augmenting their supplies in the shortest possible time through imports in the event of shortfall in the production of these items. The key to addressing this challenge is to give due importance to minor corps, and livestock and dairy sectors which have been neglected by successive governments. The relative roles of these two sub-sectors, which together account for 62 percent of agricultural value added, in keeping food prices stable need to be emphasized and given due attention.

Monetary Policy The development of financial market world-wide over the past two decades has been revolutionary. In Pakistan, banking and financial sector has witnessed a broad based program of reforms since the early 1990s but the pace of reforms however has increased manifold since 2000. In particular, the banking industry in Pakistan has been transformed from a primarily state-owned sector to a vibrant private sector dominated industry. Banking industry in Pakistan has not only gained strength from the positive interplay of economic and political factors, but also has become and engine of growth for the economy. The State Bank of Pakistan has been taking number of steps in various areas to further enhance the effectiveness of banking industry in Pakistan. A strong and competitive financial system is, prerequisite for growth and a key element of macroeconomic stability. Financial innovation remains a major source of potential growth. Further, a weak financial sector can undermine efforts to achieve stability through prudent fiscal and monetary policies.

Monetary policy stance of the SBP has undergone considerable changes over the last 6-7 years gradually switching from an easy monetary policy to the current aggressive tight monetary stance. During the fiscal year 2006-07, the SBP took several additional policy measures in different phases as part of monetary policy tightening. In the first phase, the SBP raised the Statutory Liquidity Ratio (SLR) from 15 percent to 18 percent and Cash Reserve Ratio (CRR) for commercial banks from 5 to 7 percent. The SBP also raised the discount rate (policy rate) from 9 percent to 9.5 percent. The increase in interest rate was in line with the international rising trends in interest rates and prevailing inflationary pressures on the economy. The SBP, through its tight monetary policy, aimed at curbing strong domestic demand, which was one of the main driving forces fueling inflation, by curtailing the lending ability of the commercial banks to the private sector. As a result of tight monetary policy pursued during the year, the credit growth to private sector slowed considerably from 19.8 percent during July-May 12 last year to 12.4 percent in the same period of this year – the slowest credit growth in the last four years. The overall money supply (M2) increased by 14 percent as against 12.1 percent in the same period last year.

According to the Credit Plan for 2006-07, the SBP set the target for monetary expansion to the tune of Rs.460 billion or 13.6 percent higher than last year, on the basis of a growth target of 7 percent and an inflation target of 6.5 percent. The monetary expansion was kept marginally below the projected nominal GDP growth to absorb monetary overhang of the last few years. The projected monetary expansion during the year was expected to result primarily from the build up in the Net Domestic Assets (NDA) and a moderate rise in the Net Foreign Assets (NFA). Within the NDA, the government sector was estimated to avail bank credit of Rs.130.1 billion with budgetary borrowings at Rs.120.1 billion and commodity operations at Rs.10 billion. Credit to non-government sector was estimated at Rs.395 billion with private sector absorbing Rs.390 billion and public sector enterprises utilizing Rs.5 billion.

The money supply (M2) during July-May 12, 2006-07 expanded by Rs. 478 billion or 14 percent higher than the corresponding period last year. The high monetary growth during this period was caused mainly by a sharp rise in net foreign assets (NFA) of the banking system as the growth in the NDA of the banking system accelerated at a lesser pace. Pakistan has seen large foreign inflows during this period which has resulted in an expansion of the NFA to the tune of Rs. 88 billion as against the whole year target of Rs. 9.8 billion. The major factors responsible for large foreign capital inflows included a relatively higher growth in workers' remittances and foreign investment (both FDI and portfolio), foreign inflow through Global Depository Receipts (GDRs), PTCL privatization proceeds and relatively slower increase in trade related foreign currency payments.

While the increase in NFA reflects the improvement in country's external account, the higher growth in NDA was caused largely by a sharp increase in government sector borrowing that more than offset the deceleration in the credit to non-government sector. The credit to government for budgetary support swelled to Rs.212 billion against the annual target of Rs.120 billion. It is important to note that budgetary borrowing from banking sector till the July-February 2006-07 was less than half of that in the corresponding period of last year. It was March 2007 onward that this picture changed and budgetary borrowing exceeded those in the previous year. It is important to understand that during March-April of last fiscal year the realization of Eurobond issuance and PTCL privatization proceeds had enabled the government to retire most of the budgetary borrowing from the domestic banking system during the period. Such types of external inflows were not available to the government in March-April of this fiscal year consequently government had to finance its budgetary requirements through domestic bank borrowing. Within the banking sector, the scheduled banks provided the bulk of budgetary finance during July-May of this fiscal year; sharply in contrast with corresponding period of last year when the SBP was directly financing the budgetary need. However, with inflows of receipts from the issuance of Eurobond and other expected external inflows before the current fiscal year, the picture will change substantially and government borrowing for budgetary supports may come back to the target for the year.

Growth in private sector credit slowed from 19.9 percent during July-May last year to 12.5 percent during the same period of this year. This has been the slowest pace of private sector credit expansion in the last four years. The volume of credit also declined substantially in the said period showing that monetary policy has been reasonably successful in reducing excess demand in the economy. Apart from increase in interest rates as a result of tight monetary policy, other contributory factors for a slow down in private sector credit include: (i) the availability of non-bank finances to the private sector including credit from NBFI's, increase in foreign private loans and issuance of corporate bonds in international market by the private sector companies, (ii) Merger & Acquisition (M&A) in the banking industry and (iii) the SBP's continuous emphasis on monitoring the personal loans as well as under other schemes to ensure the minimum use of bank credit to finance speculative activities. In fact, a significant contribution to the realized credit growth was due to the provision of concessional financing facilities extended to the export sector by the SBP. The SBP's support to export sector also contributed to a relatively sharper increase in money supply during the year.

The tight monetary policy is also reflected in the rise of the weighted average lending rate. The average lending rate increased by 70 bps since June 2006 and until March 2007. Since the impact of monetary policy tightening on lending rate is generally realized with a lag, the lending rate since June 2005 has increased by 240 bps. During the same period the weighted average deposit rate increased by 200 bps. The spread - a measure of banking efficiency - remained in the range of 6.4 percent to 7.8 percent since June 2005.

Capital Market Pakistan's stock market is benchmarked through the Karachi Stock Exchange 100-index (KSE-100). This index stood at 9989 points at the end of the fiscal year 2005-06. The KSE-100 index rose by 24 percent since then to 12370 points until April 2007. During the same period total market capitalization increased by 28.6 percent rising from Rs 2801 billion ($ 46.5 billion) to Rs 3604 billion ($ 59.4 billion). The index reached all time high of 12961 points on 31st May 2007. Aggregate market capitalization also increased by 35.0 percent from Rs 2801 billion in June 2006 to Rs 3781 billion ($ 62.3 billion) as of 31st May 2007. This increase has been driven by a number of factors including: (i) continuous improvement in the country's economic fundamentals, (ii) government's commitment to maintain its economic reform and pro-market policies, (iii) stability in exchange rate as a result of strong build up in foreign exchange reserves, (iv) regionally cheap valuation driving foreign interest in Pakistan's stock market, (v) large-scale merger and acquisition in the banking, telecom and other sectors of the economy (vi) improving Pakistan's geo-political relationship with neighbours as well as globally, resulting in decline in political risk premium of the country, (vii) successful GDR offerings of the OGDC and MCB Bank, amounting US dollars 888 million and (viii) increase in Pakistan's coverage by large international brokerage firms and investment banks.

The outgoing fiscal year has witnessed concerted foreign investor's interest in Pakistan's stock market as a result of large-scale coverage of market by foreign brokerage houses. Brokerage houses providing research coverage on Pakistan are include: Merrill Lynch, JPMorgan, Credit Suisse, Citigroup, UBS. Lynch was the first to start active covering of Pakistan. The JPMorgan has expanded its operation in Pakistan during the outgoing fiscal year to expand into stock brokerage. The interest of foreign investors can also be gauged from the fact that JPMorgan is only catering to foreign clients as an initial way of doing business. JPMorgan's expansion has piqued foreign investors interest as well. Other investment banks such as Credit Suisse have also announced their intention of entering the Pakistan market, while others are looking to forge relationships with local brokerage houses. Several foreign banks have also organized road shows across the globe to introduce Pakistan to the community of foreign investors, interested in fast growing emerging markets.

Foreign portfolio investment in Pakistan's stock market during the first ten months of the current fiscal year amounted to $ 1.82 billion, which is the highest ever inflow of portfolio investment in Pakistan's history, as against $ 1.011 billion in the corresponding period of last year, thereby registering an increase of 80 percent. The growth in portfolio investment has been contributed to by issuance of GDR of Oil and Gas Development Corporation (OGDC) and MCB Bank. These GDRs are listed at the London Stock Exchange and are receiving strong investors' interest.

The outgoing fiscal year has also witnessed large-scale merger and acquisition, which provided support to stock market valuation. Several key takeovers have taken place in Pakistan's corporate sector during the outgoing fiscal year. These include: (i) acquisition of Union Bank Ltd. by Standard Chartered Bank, (ii) acquisition of Prime Commercial Bank Ltd. by ABN AMRO, (iii) acquisition of PICIC Bank by Tamasek of Singapore, (iv) acquisition of Crescent Commercial Bank by SAMBA, (v) acquisition of PakTel by China Mobile, (vi) acquisition of further stake in Lakson Tobacco by Philip Morris. This M&A activity, which has taken place at very attractive valuations has provided support to valuation in the stock market as well. Peer group companies' stock prices have also reacted as a result of these acquisitions.

Pakistan's privatization programme has also provided support to different sectors and corporate valuations. Even though no large privatization has taken place during July-May 2006-07, the government has still managed capital market transactions for OGDC. The GDR issuance of United Bank Ltd. (UBL) is also in the pipeline and is expected to be completed before the end of the current fiscal year. Several strategic sales are also in the pipeline, which continue to provide boost to investor sentiment in the stock market. Privatization of Pakistan State Oil, NIT, Pakistan Petroleum Ltd. etc. are all at advanced stages.

Fiscal Policy A sound fiscal position is an essential prerequisite for achieving macroeconomic stability which is increasingly recognized as a critical ingredient for promoting strong and sustained economic growth and lasting poverty reduction. The importance of sound fiscal policy cannot be overemphasized in the case of Pakistan as it's chronically high consolidated budget deficit (7 percent of GDP) and rising public debt burden (over 100 percent of GDP) have been the economy's Achille's heal in the 1990s. Pakistan has experienced serious macroeconomic imbalances in the nineties mainly on account of its fiscal profligacy and accordingly paid a heavy price in terms of deceleration in economic growth and investment and associated rise in the levels of poverty. Considerable efforts have been made over the last seven years to inculcate financial discipline by pursuing a sound fiscal policy. Pakistan has succeeded in reducing fiscal deficit from an average of 7 percent of GDP in the decades of 1980s and 1990s to an average of 3.5 percent during the last seven years. The associated public debt also declined sharply from over 100 percent of GDP to 53 percent of GDP by end-March 2007. Pakistan's hard earned macroeconomic stability is therefore underpinned by fiscal discipline.

Adequate level of revenue generation is *sine quo non* for the public policy to meet expenditure obligations. Inadequacy of revenue generation directly affects the government's resource position and the availability of socially desirable public goods. In Pakistan's economic history and until recently the mismatch between revenue collection and budgetary requirement was a norm rather than an exception. Since the situation required radical changes, broad-based tax policy and tax administration reforms were initiated by the Central Board of Revenue (CBR) to improve upon the resource mobilization effort and increase tax compliance by providing congenial environment to the taxpayers. The thrust of the reform has been at reducing tax rates, broadening the tax base to hitherto untaxed or under-taxed sectors and shifting the incidence of taxes from imports and investment to consumption and incomes. The tax and tariff reforms are aimed at simplification of tax system, improvement in resource mobilization, boosting economic activity to ensure robust economic growth, reducing the cost of doing business for trade and industry, reducing tax burden for lower income strata of the society and promoting a tax-payer friendly culture.

During the last six years from 2000-01 to 2006-07, tax collection by the CBR increased by 112.8%. The revenue deficit (the difference between total revenue and total current expenditure), a measure of government dis-saving, was at a deficit of 0.2% of GDP in 2005-06 compared to a deficit of 2.2% in 2000-01. It has further progressed towards a targeted revenue surplus of 0.6 percent of GDP in 2006-07. The revenue surplus has significance in inter-generational distribution of debt burden. Fiscal Responsibility and Debt Limitation Act 2005 envisages a revenue surplus starting from 2007-08. The structure of taxation has undergone considerable changes since the 1990s. Firstly, the share of direct taxes in total taxes (collected by the CBR) has increased from 18 percent to over 38.5 percent in July-April 2006-07. The share of indirect taxes declined from 82 percent to 61.5 percent during the same period. Even within the indirect taxes, dramatic changes have taken place. The collection from custom duty used to account for 45 percent of total tax collection and 55 percent of indirect taxes in 1990-91, its share has now been reduced to 18.6 percent and 32.3 percent, respectively. This is the consequence of the tariff reform implemented by successive governments since 1990-91. The share of sales tax increased at a relatively faster pace from 14.4 percent to 41 percent of total taxes and from 17.6 percent to 60.3 percent of indirect taxes during the same period. Central excise as a tax is loosing its importance and gradually being faded out. Its shares in total taxes and indirect taxes were 22.5 percent and 27.5 percent, respectively in 1990-91. These have now been reduced to 8.3 percent and 12.3 percent, respectively during the same period.

The total expenditure remains more or less stable in a narrow band of 17 to 18.8 percent of GDP during the last seven years. Substantial decline in interest payments from as high as 7.5 percent of GDP in 1998-99 to 2.7 percent of GDP in 2006-07, has provided fiscal space to re-orient expenditure in favour of development expenditure. Resultantly the share of current expenditure in total expenditure declined from 89 percent of total expenditure in 1998-99 to 72 percent in 2006-07. In addition, the share of development expenditure more than doubled from 11 percent to 28 percent in the same period. The development expenditure bore the brunt of structural adjustment of the 1990s as it declined from as high as 7.5 percent of GDP in 1991-92 to 2.5 percent of GDP by 1999-2000. During the last seven years the development expenditure improved from 2.2 percent of GDP in 2000-01 to 4.9 percent of GDP in 2006-07. Second largest component of the current expenditure, namely, defence spending remained stagnant at around 3.1 percent to 3.3 percent of GDP during the last seven years. This shows strong focus of the government on removing infrastructural bottlenecks and building physical assets. Non-defence-non-interest expenditure has improved from 7.8 percent of GDP in 1999-2000 to 11.9 percent of GDP in 2006-07.

Total revenues are budgeted at Rs. 1163.1 billion in 2006-07 compared to Rs. 1087.0 billion in 2005-06, showing an increase of 7.0%. The Central Board of Revenue (CBR) is targeted to collect Rs. 835 billion in 2006-07, which is 17.1 percent higher than last year's collection. CBR has exceeded the revenue target of Rs. 645.2 billion fixed for the first ten months of current fiscal year (July-April 2006-07) by Rs. 11.3 billion. The net collection stood at Rs. 656.5 billion as against Rs.547.0 billion in the comparable period of last year, thereby showing an increase of 20 percent. The direct taxes contributed most of the increase as they have surpassed the target by Rs.52.4 billion and recorded massive growth of 50.9 percent. This increase has compensated much of the revenue shortages on account of sales tax and customs duties by Rs. 22.5 billion and Rs. 19.0 billion, respectively owing to slowdown in imports. The massive than the anticipated slowdown in imports growth from 30.6 percent to 10.3 percent during July-April 2006-07, resulted in negative growth in dutiable imports with adverse implications for import related taxes.

Pakistan continues to maintain fiscal discipline for the last several years. *Total expenditure* is targeted at Rs. 1536.56 billion or 17.4 percent of GDP for the fiscal year 2006-07. Total expenditure was projected to be 8.6 percent higher than last year (2005-06). During the first nine month (July-March) of the current fiscal year total expenditure is estimated at Rs.1168.5 billion or 76 percent of the annual target. *Current Expenditure* is targeted at Rs. 1126.19 billion for the current fiscal year (2006-07) which means it would remain almost stagnant at the level of 2005-06. During July-March 2006-07, provisional estimates show current expenditure of Rs.925.3 billion which is 83.6 percent of the target. The higher increase in current expenditures during the last two years is mainly on account of earthquake-related spending amounting to 0.5 percent to 0.8 percent of GDP. Development expenditure is targeted at Rs.435 billion for the year 2006-07. During the first nine months *(July-March)* of 2006-07, development expenditure amounted to Rs.242 billion or 58 percent of the yearly allocation. This expenditure is likely to pick up in the last quarter of the year.

The *overall fiscal deficit* is targeted at Rs. 373 billion or 4.2 percent of GDP for 2006-07. The Government is well placed to meet this target as fiscal deficit during the first nine months remained at 3.1 percent of GDP or 73 percent of the yearly target. On the basis of the developments on revenue and expenditure front, the overall fiscal deficit during the first nine months (July-March) of the current fiscal year stood at Rs. 272.8 billion or 3.1 percent of GDP. Earthquake accounted for sizeable amount of fiscal deficit and underlying fiscal deficit excluding earthquake expenditure is targeted at 3.7 percent of GDP for 2006-07.

Public debt burden continues to decline sharply for the seventh year in a row on account of prudent fiscal management. Public debt was 85 percent of GDP in 1999-2000 but has declined sharply to 53.4 percent in end-March 2007 – a decline of 32 percentage points in just seven years is one of the significant achievements of the government. During the year, public debt has declined from 56.9 percent in 2005-06 to 53.4 percent of GDP – a decline of 3.5 percentage points in one year. Since public debt is a charge on the budget, its burden must be viewed in relation to government revenue. Public debt was 627 percent of total revenue in 1999-2000 but has declined to 400 percent in end-March 2007 – a decline of 227 percentage points in seven years is not a mean achievement.

External Sector Pakistan has recorded a laudable export performance during the last several years, with exports growing at an average rate of almost 16 percent per annum over the last four years (2002-06). Beside sound macroeconomic policies pursued by the government the strong and sustained growth in world economy also contributed to impressive export growth. Despite further improvements in the international trading environment, Pakistan's export growth witnessed abrupt and sharp deceleration to less than 4 percent in the first ten months of the current fiscal year after growing at an impressive rate of 16 percent per annum until June 2006. Pakistan's import growth on the other hand, slowed to a normal level in the current fiscal year after surging at an average rate of 29 percent per annum during the last four years. Four years of strong economic growth strengthened domestic demand which triggered a consequential pick up in investment. The rise in investment demand led to a massive surge in imports. Though Pakistan continued to maintain its strong growth momentum in the current fiscal year, import growth has decelerated to a trend level for a variety of reasons including the pursuance of tight monetary policy during the year. The slower growth imports are likely to improve trade deficit as percentage of GDP compared to last years.

Exports were targeted at $ 18.6 billion or 12.9 percent higher than last year. Exports during the first ten months (July-April) of the current fiscal year are up by 3.4 percent – rising from $ 13.46 billion to $ 13.9 billion in the same period last year. Export of food group declined by 3.5 percent. This decline is caused by a 2.6 percent and 14.3 percent decline in exports of rice and fruits. Export of rice declined due to lesser production caused by adverse weather condition which kept the domestic price higher. It was more profitable to sell within the country than to export. Exports of textile manufactures grew by 6.2 percent. Prominent among these are export of knitwear (13.9%), readymade garments (6.8%), made up articles (8.9%), cotton yarn (4.6%), and towels (2.6%). Exports of other textile materials registered a high double digit growth of 17.2 percent. Export of raw cotton, cotton cloth and bed wear on the other hand registered a decline. Exports of engineering goods increased by 6.7 percent while exports of petroleum products declined by 2.7 percent. In other manufactures' categories of exports, all items including carpets, rugs & mats, sports goods, leather products, surgical equipments and chemical & pharmaceutical products registered negative growth. Exports of most of these items have been on the decline for quite sometime. In absolute term the overall exports posted an increase of $ 452.1 million in the first ten months of the current fiscal year over the same period last year. Of this increase, 114.1 percent or $ 516.1 million was contributed by textile manufactures while 'all other items' increased by 64.8 percent or $ 293.2 million. This increase of $ 809 million was offset by a decline of exports of rice ($ 59.3 million) and other manufacturers ($ 296.6 million) leaving a net increase of $ 452 million.

The less than satisfactory export performance of textile manufacturers can be attributed to a variety of factors. First, it appears that Pakistan's textile exporters could not compete with its traditional competitors. Second, the discriminating and tied-dumping duty of 5.8 percent on the bed linen export also affected Pakistan's competitiveness. Third, poor quality of cotton on account of contaminated cotton issue has also adversely affected the export of spinning industry. Fourth, the rise in prima cotton price (a genetically modified version) which is imported from the US is a critical input for producing higher quality bed wear and fabrics, has made these items less competitive in the international market. Pakistan's export suffers from serious structural issues which need to be addressed primarily by textile manufacturers with government playing its role of facilitating and providing some financial support on temporary basis. Pakistan textile products are low value added and of poor quality therefore fetches low international price. The machinery installed in recent years are old relative to Pakistan's competitors therefore, these machines are power intensive, less productive and carry higher maintenance cost. Increased wastage of inputs also adds to their costs. Pakistan's labour are less productive because little or no efforts have been made to impart training or improving their skills. Pakistan's exporters spend little money on research and development. Pakistan export houses lack capacity to meet bulk orders as well as they are unable to meet requirements of consumers in terms of fashion and design. It is generally argued that Pakistan's exporters are uncompetitive in terms of adherence to contracted quality and delivery schedule. Pakistan's competitors are investing heavily and creating better economies of scale. These are structural issues and must be addressed by the industry itself with government playing its role of a facilitator and providing some temporary financial assistance to address short term issues mentioned earlier.

Pakistan's exports are highly concentrated in a few items namely, cotton, leather, rice, synthetic textiles and sports goods. These five categories of exports account for 77.2 percent of total exports during the first nine months of 2006-07 with cotton manufacturers alone contributing 61.5 percent, followed by leather (4.5%), rice (6.6%), synthetic textiles (3.0%) and sports goods (1.6%). The degree of concentration has changed little from last fiscal year. Pakistan's exports are highly concentrated in few countries including the US, UK, Germany, Japan, Hong Kong, Dubai and Saudi Arabia. These countries account for one-half of Pakistan's exports with US alone accounting for 28 percent. Pakistan needs to diversify its exports not only in terms of commodities but also in terms of markets. Heavy concentration of exports in few commodities and few markets can lead to export instability.

Imports were targeted to decline by 2.1 percent in 2006-07 to $ 28.0 billion from last year's level of $ 28.6 billion. As expected, growth in import decelerated to 8.9 percent during the first ten months (July-April) of the current fiscal year as against hefty increase of 40.4 percent in the same period last year. The deceleration in import growth is caused by several factors which include: the pursuance of tight monetary policy to shave off excess demand, softening of international price of oil, decline in imports of cars as a result of change in policy, decline in the imports of fertilizer because of large carryover stock of last year, and decline in the imports of iron & steel as Pakistan Steel coming back to its normal production level.

Disaggregation of total imports suggests that food imports grew by 5.3 percent - up from $ 2241.5 million to $ 2360.6 million. Imports of machinery rose by 18.6 percent – up from $ 3303 million to $ 3916 million. All categories machinery registered impressive growth with the exception of textile machinery and construction & mining machinery. Imports of petroleum group registered an increase of 12.0 percent. However, within the petroleum group, imports of petroleum products registered sharp increase of 38.6 percent on account of massive surge in furnace oil import, primarily for electricity generation purpose. Imports of crude petroleum declined by 6.7 percent because refineries were not operating at their full capacity. The import of crude petroleum in quantity term also registered a decline of almost 10 percent. It is important to note that since refineries were not operating at their full capacity, their import of crude was lower and accordingly their production of petroleum products was lower too. Low production of petroleum products within the country forced the government to import more petroleum products putting pressures on the country's balance of payments. Imports of consumer durables registered a decline mainly on account of lower imports of automobiles. Imports of electrical machinery & appliances (a component of consumer durables) however registered a hefty increase of 35 percent. Imports of raw materials registered a marginal (2.4%) decline mainly on account of 49.4 percent decline in the import of fertilizer. Import of fertilizer declined this year because of the large carryover stock of last year. Import of iron & steel also declined because Pakistan steel gradually came back to its capacity production level after the repair of coke oven battery. Telecom imports continue to maintain its momentum, though at a slower pace this year. Imports of telecom (cell phone as well as equipments, towers etc.) grew by 17.3 percent this year as cellular companies continue to expand their network.

Further analysis suggest that almost 31 percent contribution alone came from petroleum group, mainly on account of the surge in imports of petroleum products both in value and quantity. Imports of machinery contributed almost 30 percent to this year's rise in imports bills. This is followed by imports of telecom which accounted for 13 percent to the overall rise in imports. Almost three-fourth contribution came from three categories (machinery, petroleum and telecom) to this year's rise in imports. Interestingly, consumer durables' contribution was negative (-1.8%) mainly on account of a decline in the imports of cars. Therefore, contrary to the general perception, the contribution of consumer durables was negative.

Like exports, Pakistan's imports are also highly concentrated in few items namely, machinery, petroleum & petroleum products, chemicals, transport equipments, edible oil, iron & steel, fertilizer and tea. These eight categories of imports account for 75.5 percent of total imports during 2006-07. Among these categories machinery, petroleum & petroleum products and chemicals accounted for 57.7 percent of total imports. Concentration of imports remained, by and large, unchanged over the last one decade. Pakistan's imports are highly concentrated in few countries. Over 40 percent of them continue to originate from just seven countries namely, the USA, Japan, Kuwait, Saudi Arabia, Germany, the UK and Malaysia. Saudi Arabia is emerging as a major supplier to Pakistan followed by the USA and Japan.

Trade Balance Despite sharp deceleration in imports the merchandise trade deficit widen on the back of abrupt and sharp deceleration in exports. The merchandise trade deficit widen to $11.1 billion in the first ten months (July-April) of the current fiscal year as against $9.5 billion in the same period last year. However, as percentage of GDP, trade deficit is likely to be 9.0 percent in 2006-07 as against 9.5 percent last year. Thus, trade deficit is expected to improve this year despite less than satisfactory performance of exports.

Current Account Balance Pakistan's balance of payments shows a record increase in capital flows that has substantially offset a gradual widening of the current account deficit. The magnitude of the inflows has overwhelmed the State Bank of Pakistan and complicated monetary policy. Pakistan's current account deficit further widen to $ 6.2 billion (4.3% of GDP) in the first nine months (July-March) of the current fiscal year from $ 4.6 billion (3.6% of GDP) in the same period last year. A striking feature of this year's current account deficit is that it has widened even though the import growth has slowed to 10.2 percent but the performance of exports has been lack luster at best, resulting in widening of trade deficit.

Month wise trend in current account deficit suggests that much of the deterioration has taken place in the first quarter (July-September) of the current fiscal year when current account deficit averaged $ 935 million per month. During the remaining period (October-March) the current account deficit has narrowed to an average of $ 568 million per month – an improvement of 39.3 percent. If this trend continues, the current account deficit for the year is likely to be around 5.0 percent of GDP as against 4.4 percent last year. The strong inflows in capital account will more than offset the current account deficit and add to the stock of foreign exchange reserves.

Workers' Remittances Workers' remittances, the third largest source of foreign exchange inflows after exports and foreign investment, continue to maintain its rising trend. Workers' remittances totaled $ 4.45 billion in the first ten months (July-April) of the fiscal year as against $ 3.6 billion in the same period last year, depicting an increase of 22.6 percent. If this trend is maintained workers' remittances are likely to touch $ 5.5 billion for the year – the highest ever in the country's history.

Foreign Exchange Reserves Pakistan's total liquid foreign exchange reserves stood at $ 13,738 million at the end of April 2007, considerably higher than the end-June 2006 level of US$ 13,137 million. Of these, reserves held by the State Bank of Pakistan amounted to $ 11561.5 million and that by banks stood at $ 2,176.9 million. In terms of reserves adequacy, the amount of reserves as of end April 2007 is sufficient to meet over 6 months of imports. External inflows are likely to continue during the remaining three months of the fiscal year and as such the foreign exchange reserves are likely to cross $ 14 billion by end-June 2007. A number of factors contributed towards the accumulation of reserves. The most prominent among these are; private transfers that include remittances, floatation of bonds, higher foreign investment and privatization proceeds.

Exchange Rate Exchange rate remained more or less stable during the FY07. However, rupee depreciated only marginally (0.7%) from Rs.60.2138 per dollars as at end June 2006 to Rs.60.6684 as of end April 2007. In the open market, rupee traded at 60.655 to a dollar, that is at a discount of 0.02 percent as at end-April 2007. Euro continued to gain strength against Pak-rupees during Jul-April FY07. In July 2006, Euro on average traded at Rs.77.02, while in April 2007, the parity increased to Rs.82.76. Thus Pak-rupee depreciated vis-à-vis the Euro by 7.0 percent during Jul-April FY07, mainly due to strengthening of Euro against US dollar in the international market. The Real Effective Exchange Rate (REER) is used as an indicator of trade competitiveness that captures the behavior of the Pak-rupee against a basket of currencies. The REER showed a real appreciation of 2.06 percent during July-April FY07. The real appreciation resulted mainly due to higher domestic inflation compared to major competitors and trading partner countries. When viewed against the fact that the REER of some of the traditional competitors of Pakistan appreciated in the range of 7.0 percent to 13.5 percent during July-April 2006-07, Pakistan's appreciation of REER of 2.0 percent appears marginal at best.

External Debt Until few years ago, Pakistan was facing serious difficulties in meeting its external debt obligations. Not only was the stock of external debt and foreign exchange liabilities growing at an average rate of 7.4 percent per annum during 1990-99, but the debt carrying capacity of the country was weakening at a similar pace. Consequently, the debt burden *(external debt and foreign exchange liabilities as percentage of foreign exchange earnings)* reached an unsustainable level of 335 percent by 1998-99. Following a credible strategy of debt reduction over the last seven years, Pakistan has succeeded in not only slowing the pace of debt accumulation but also succeeded in reducing the country's debt burden in a substantial manner. Pakistan's external debt and liabilities stood at $ 38.86 billion at end-March, 2007. After 8 years of financing development programs Pakistan's external debt and liabilities reached to the level of end-June 1999 but at the same time the size of the economy, the levels of foreign exchange earnings and foreign exchange reserves have all increased manifold, thus reducing the country's debt burden significantly as well as increasing the country's debt carrying capacity.

A critical appraisal of the external debt and liabilities should not be focused on the variation in the absolute stock but it is the incidence of the debt burden which is important and meaningful from a policy perspective. The external debt and liabilities as percentage of GDP which stood at around 52 percent in end-June 2000, declined to 26.3 percent in end-March 2007. Similarly, the external debt and liabilities as percentage of foreign exchange earnings was reduced from 236.8 percent to 119.7 percent during the same period. It may also be pointed out that Pakistan's external debt and liabilities were 22 times of its foreign exchange reserves in 1998-99 but declined sharply to 2.8 times in just eight years. Interest payments on external debt were 7.8 percent of current account receipts in 2001-02 but declined to 3.2

percent by end-March 2007. The maturity profile also showed an improvement over the last five years as short-term debt was 1.4 percent of the total external debt and liabilities but declined to 0.1 percent by end-March 2007. Across all measures of vulnerability to external shocks, Pakistan's debt profile has improved significantly over the last seven / eight years.

The Privatization Program

Privatization is the cornerstone of the successful economic reforms of the Government. As a result of these reforms which also included liberalization and de-regulation accompanied by transparency, good governance and continuity and consistency of policies, the economy has been completely transformed and the country has been placed on the path of rapid and sustained growth. The government is fully committed to the implementation of its approved privatization program through an open, fair, transparent, and competitive process, as laid down in the Privatization Commission Ordinance 2000 and the rules and regulation presented there under. The government is pursuing privatization policy vigorously and has achieved unprecedented success during the past seven years. From 1999 to date, a total amount of US$ 6.1 billion have been realized from 61 transactions, which represents 87 percent of the total privatization proceeds of US$ 7 billion from 1991 to date (from 163 transactions).

During the period July 2006 to February 2007, the Privatization Commission completed five transactions that fetched an amount of Rs.67.664 billion. OGDCL's 10 percent listing and domestic offering was over subscribed yielding a total amount of $ 811 million, which reflected the confidence of investors in the policies of government. The privatization transactions of Pakistan State Oil (PSO), Roosevelt Hotel, New York, Services International Hotel, Lahore, National Investment Trust Limited (NITL), Genco-1 Jamshoro, Hazara Phosphate Fertilizers Limited are at various stages of processing and are likely to be brought to the bidding soon.

Foreign Investment: Foreign investment has emerged as a major source of private external flows for developing countries. Developing countries have attempted to liberalize their foreign investment regime and pursued investment-friendly economic policies for the last two decades. Pakistan, like many other countries, also undertook a wide-ranging structural reform in various sectors of the economy and pursued sound macroeconomic policies for the last seven / eight years. Pakistan has now emerged as a favourite destination for foreign investors, both direct and portfolio.

Total foreign investment during the first ten months *(July-April)* of the current fiscal year amounted to $ 6.0 billion which is almost 48 percent higher than last year in the same period. There are indications that total foreign investment would touch $ 6.5 billion *(or 4.5% of GDP)* by the end of the current fiscal year – over 13 to 14 times higher than seven / eight years ago.

Within total foreign investment, foreign direct investment (FDI) amounted to $ 4.16 billion which is 37 higher than last year. The remaining $ 1.8 billion is the portfolio investment which includes the proceeds from the GDRs of OGDC and MCB bank.

FDI has primarily come in four major areas: telecom, energy *(oil and gas, power, petroleum refineries)*, banking and finance, and food and beverages. These four groups accounted for over 80 percent of FDI inflows. Other areas such as textile, chemicals and petro-chemicals, automobiles, construction and trade are also attracting FDI.

Almost 78 percent of FDI has come from five countries, namely the UAE, US, UK, China and Netherlands. Pakistan's equity market is also attracting huge portfolio investment and has created brisk activity in stock markets of Pakistan. Foreign investment of this magnitude reflects the confidence of global investors on the current and future prospects of Pakistan economy.

Issuance of Sovereign Bond Pakistan has made a successful return to the international capital markets some three years ago *(February 2004)* by issuing $ 500 million 5-year Regulation-S Eurobond. This transaction attracted strong demand from high quality and diversified international investors resulting in four times oversubscription and consequent tightest possible pricing of the bond in comparison to similar rated sovereign offering for 5-year new issues. The success of this transaction reflected a vote of confidence by the international investor community on Pakistan's economic policies and reform agenda. This vote of confidence was a significant development as it happened at a time when Pakistan was in the middle of implementing a three-year's IMF Program. Since then, Pakistan has been in the market once in a year and has been continuously updating global investors about Pakistan's improving credit story. In January 2005, Pakistan issued $600 million 5-year Islamic bond (SUKUK) which attracted considerable interest from both conventional as well as Islamic investors across Asia, Middle East and Europe. This issue was over subscribed by over two times.

On March 23, 2006, Pakistan successfully issued $500 million new 10-year and $ 300 million new 30-year bonds. This transaction, which represented the first international 144 A bond issued by Pakistan since 1999, raised significant interest among US QIBs and international institutional investors. By issuing 10 and 30 year bonds, Pakistan completed its primary objective of establishing a full Pakistani international yield curve in record time. The issue was 2.5 times oversubscribed. This offering was the largest ever funding exercise of the government. It was the longest ever tenor achieved by Pakistan. Both the new 10 and 30 year offerings were debut offerings for Pakistan and the US dollar yield curve was extended out to 30 years in just 2 years. Most emerging market sovereign issuers had taken longer time to extend their yield curve from 5 to 30 years.

On May 24, 2007 Pakistan successfully issued $ 750 million 10-year 144 A sovereign bond. This was the largest 10 year deal to date, beating the previous deal of $ 500 million. This transaction was priced at an impressive US treasury + 200 bps, 40 bps tighter compared with last year's deal that was prices at US T+240 bps. This issue was highly oversubscribed with the largest ever order book amassed for Pakistan. The order book of $ 3.7 billion meant an over subscription of over 7 times on the original deal of $ 500 million. The transaction was announced and prices within 72 hours, an impressive feat and testament to investors' confidence in Pakistan. Furthermore, an astounding 60 percent of the deal went to first-time investors who had never bought Pakistan paper before and that 75 percent of investors met on the road show placed order. The offering was well balanced by geographically with an increase in US participation to 35 percent from 19 percent on previous transaction.

Poverty and Income Distribution Rapid and broad-based economic growth over a prolonged period is essential for poverty reduction and improving distribution. Many developing countries have succeeded in boosting growth for a short period but only those that achieved higher economic growth over a long period have seen a lasting reduction in poverty – East Asia and China are classic examples of lasting reduction in poverty.

Pakistan's growth performance over the last five years is enviable in many respects. Sound macroeconomic policies along with structural reforms have transformed Pakistan into a stable and resurgent economy. With economic growth at 7.0 percent in 2006-07, Pakistan's real GDP has grown at an average rate of 7.5 percent per annum in the last four years. The real per capita income has grown at an average rate of 6.6 percent per annum over the last four years.

The economic growth of such a pace for reasonably long period is bound to create jobs and therefore reduce unemployment and poverty. In recent years the role of remittances in reducing poverty has been acknowledged. Remittances allow families to maintain or increase expenditure on basic consumption, housing, education, and small business formation. Total remittances inflows since 2001-02 and until 2006-07 have amounted almost $ 24 billion or Rs.1413 billion. Such a massive inflow of remittances particularly towards the rural or semi-urban areas of Pakistan must have eased the liquidity constraints of their recipients, allowing them to increase consumption of both durables and non-durables, on education and health care, and on real estate. To the extent that the poorer sections of society depend on remittances for their basic consumption needs, increased flow of remittances would be associated with reduction in poverty.

Strong economic growth, large inflow of remittances and Rs.2217 billion spending on social sector and poverty-related program during 2001/02 and 2006/07 have succeeded in reducing poverty in Pakistan. At the national level, headcount decreased from 34.46 percent in 2000-01 to 23.9 percent in 2004-05, depicting a substantial reduction of 10.5 percentage points over this period. In absolute numbers the count of poor persons has fallen from 49.23 million in 2001 to 36.45 million in 2004-05. While rural poverty declined even more sharply *(11.13 percentage points)* urban poverty also declined by 7.75 percentage points. It is generally argued that though poverty has declined in Pakistan, the gap between rich and poor has widened. The result suggests that though consumption inequality in Pakistan has increased marginally during 2001-05, consumption/ income equality in Pakistan is far less compared with many high, middle and low income countries.

The results from PSLM 2004-05 on social indicators when compared with PIHS 2000-01 reveal interesting facts with respects access to various services of bottom 20 percent of population to top 20 percent of the population. The results show that not only access to services improved faster for the poor, the disparities in access between the poor and the rich has narrowed. The results from PSLM 2005-06 have been released recently. The new results suggest that most of the indicators pertaining to education such as gross and net enrollment at primary level and literacy rate have improved significantly over the last 5 years *(2001-2006)*. As regards, health indicators, children immunization, incident of diarrhea and infant mortality have improved appreciably. Infant mortality is down from 82 to 70 during 2001-06. Contraceptive prevalence rate has improved and consequently the total fertility rate has registered decline from 4.5 to 3.8 in 7 years.

Summing up! These are good times for the economy of Pakistan because policies have been relatively good. However, good times in the past also had led to policy short-sightedness which cost the nation heavily. It is essential for the sustainability of good times that we maintain a medium-to-long term focus in our policies and not let good times sidetrack us from addressing the enduring challenges that we face.

Going forward: Challenges and Opportunities Pakistan's economy is experiencing the longest spell of its strongest growth in years. The economic landscape of Pakistan has changed and therefore its challenges are also different today. How to sustain the ongoing growth momentum within the stable macroeconomic framework is the biggest challenge. Linked with this are the challenges of job creation, poverty alleviation, improving social indicators and strengthening the country's physical infrastructure to sustain the growth in the range of 7-8 percent in the medium-term. To convert the ongoing demographic transition into demographic '***dividend***' is another major challenge. This will require massive investment in human capital which will, in turn, enhance productivity. The rising average per capita income and the growing middle class along with higher inflows of workers' remittances will continue to fuel domestic demand which will, in turn, sustain growth momentum. The ongoing demographic transition is increasing the share of working age population and therefore, leading to a decline in dependency ratio. A decline in dependency ratio will increase savings and therefore, investment which will be a key determinant of strong economic growth and employment generation.

The supply side improvement will be critical to match growing domestic demand being fueled by demographic dividend. The supply side response can be improved through private sector development which will require strengthening of institutions, improving the competitiveness of our industry, strengthening of physical infrastructure, building a robust banking and financial system, further strengthening of tax administration, a continuing transparency in economic policy making, consistency and continuity in policies and removing irritants and impediments to private sector development. In other words, the pace of implementing second generation reforms would need to be accelerated.

It is in this background that the government has prepared a **new** Poverty Reduction Strategy. The new strategy will ensure that, as the country makes this inevitable demographic transition, clear cut priorities and sectoral strategies are in place.

Demographic Dividend and Emergence of Middle Class as Drivers of Growth

At the time of independence in 1947, Pakistan's population was 32.5 million. By 2006-07, the population is estimated to have reached 158.2 million. Thus in roughly two generations, Pakistan's population has increased by 125.7 million or has grown at an average rate of 2.7 percent per annum. While Pakistan has more mouths to feed, more families to house, more children to educate, and more people looking for gainful employment with millions migrating from the countryside to major cities in search of jobs and raising pressure on urban infrastructure, this large population on the other hand also represents a big opportunity for Pakistan to benefit from demographic dividend which can fuel Pakistan's economic growth for the next fifty years. Pakistan is witnessing changes in the age structure of the population with proportion of working age population increasing and offering a window of opportunity to turn this demographic transition into a demographic *dividend.*

What is demographic transition and demographic dividend? The demographic dividend is defined as transition from a largely rural agrarian society with high fertility and mortality rates to a predominantly urban industrial society with low fertility and mortality rates". Although demographic transition consists of three phases but in the case of Pakistan two phases are crucial. The third phase is relevant for the countries suffering from the issues of aging population. These phases result from the lag between changes in fertility and mortality. At an early stage of this transition (phase one) the fertility and mortality rates are high, resulting in the decline of the share of working age population and creating bulge in the young age groups. In other words, the share of dependent population is higher, freeing less resource for investment and growth. During the second phase, fertility rates decline, leading to fewer younger mouths to feed. On the other hand, the population bulge enters and stays in the working age. The working age population grows more rapidly than the population dependent on it, freeing up resources for investment and economic growth. Other things being equal, per capita income grows more rapidly, making more income available for dependents. Accordingly, the welfare of the family improves. This dividend period is quite long and lasts five decades or more.

Where exactly is Pakistan in this demographic transition? During the first phase when fertility rates were higher the share of young age (0-14 years) population continued to rise thereby creating a bulge in the young age population while the share of working age (15-59) continued to decline until 1972. Pakistan appears to have entered the second phase of demographic transition from 1981 onward.

As a result of decline in fertility rate from 6.0 percent to 3.8 percent during 1981 and until 2006, the share of working age (15-59 years) population continued to rise from 48.5 percent to 57.2 percent and accordingly the share of young age (0-14) continued to exhibit declining trend (from 44.5 percent to 36.8 percent). Thus, Pakistan is currently passing through the demographic transition phase during which, this transition can be converted into a demographic dividend. Empirical evidence supports the fact that Pakistan is in the second phase of demographic transition as more resources are available for investment, economic growth is accelerating and per capita income is rising at a faster pace. In other words, Pakistan has already started reaping its first dividend on the back of a large-scale spending on social sector (education, health vocational training, etc.) over the last several years.

The demographic dividend currently being offered to Pakistan is through the mechanisms of labor supply , saving and human capital in conjunction with rising per capita income , growing middle class, availability of consumer credit , inflows of workers remittance and rising exports (foreign demand) are fueling consumption demand leading to the expansion of domestic market . For example, the consumer items such as automobiles, motor cycles, refrigerators, air conditioners, television, cellular mobile, packaged milk etc. have been registering a high double-digit growth for the last four/five years. The growing domestic demand is being met through various booming sectors of the economy such as agriculture, manufacturing and services. As such, strong domestic demand leading to the expansion of domestic market, has emerged as a key driver of economic growth and is supporting the ongoing growth momentum. Realizing the significance of the phenomena of demographic dividend for an emerging economy like Pakistan, the government has already initiated a large number of employment generation programs to reap the benefits of the demographic transition. These programs include the recently launched National Internship Program, establishment of the National Vocational and Technical Education Commission (NAVTEC), increased budgetary allocation for social sectors, especially education (including higher education through the Higher Education Commission (HEC)), health, population etc. In addition, the Government has launched Rozgar Scheme (self employment scheme), Khushal Pakistan Program and many other initiatives. In this context, the impact of the development of mega cities as well as of rural infrastructure as sources of growth will be significant.

Private Sector Development and Enhancing Role of the Private Sector

The private sector will play an increasing role in driving growth and creating job opportunities. A strong Private Sector Development (PSD) strategy will therefore be a key element in enhancing the competitiveness of the private sector. The features of the strategy are: i) lowering the barriers to development of small and medium enterprises; ii) developing a modern financial sector with a view to providing a wide range of financial services; iii) removing irritants and impediments to private sector growth; iv) strengthening the country’s physical and social infrastructure, v) consistency and continuity of economic policies. All these measures are expected to significantly improve Pakistan’s investment climate, reduce the cost of doing business for the private sector, thus contributing to enhancing the competitiveness of the private sector.

A forward looking PSD strategy, supported by a vastly improved regulatory environment, processes and procedures will go a long way in freeing the private sector from constraints that impede its growth. This will create an enabling environment that will allow the private sector to focus on productivity, innovation and growth, responding to opportunities in the national and global markets. Private sector competitiveness is also being enhanced by taking into account the recent findings on the State of Pakistan’s Competitiveness Report by the Competitiveness Support Fund.

Enhancing Competitiveness and Productivity

Competitiveness relies on ensuring that the population is healthy, secure (in both civil and criminal aspects of society) and capable of sustaining the basic requirements of life through improved education, infrastructure and a stable macro-economic climate. It is further enhanced by the provision of world-class tertiary education and vocational skills training and the development of a knowledge economy based on a fully developed Information and Communications Technology (ICT) infrastructure. Improved competitiveness leads to sustained economic growth which has proven to be effective in generating employment and reducing poverty. Therefore, the Government recognizes improving competitiveness as a cornerstone of its economic growth strategy. The economy has responded well to the structural reforms carried out in the last 7 years and has emerged as one of the stronger growing economies of Asia. Although, as a result, Pakistan has significantly improved its position in the Global Competitiveness rankings of the World Economic Forum, much more needs to be done. The Government will therefore continue to implement its second generation reforms in addition to the private sector specific reforms listed above.

Special Economic Zones, Industrial Parks, IT Parks and SME Cluster Development

Pakistan's location already provides it with a competitive advantage that is unique. Situated strategically at the cross roads of Central Asia, Middle East and the Far East and its membership of growing organizations such as SAARC and ECO. Pakistan has access to all growing markets of the world. The Government intends to enhance the role of Special Economic Zones (SEZs), etc in attracting investment to achieve its goal of generating employment and further augmenting industrialization, modernization within a cohesive strategic plan. The SEZs and associated industrial parks and clusters will play an important role in increasing competitiveness. The SEZs are to be benchmarked with those of other countries to ensure that they are developed on the lines of best international practices.

There are already some excellent examples of industrial parks such as "Marble City", "Textile City", Pak-China Economic Zones near Lahore and the Lasbela Industrial Estate in Balochistan. The Government has also declared that the area around Gwadar Port city will be an SEZ. Cluster development in Punjab, e.g., around Sargoda has been extremely successful. Furthermore, the National Industrial Parks Development and Management Company (NIPDMC) has been established as a public-private partnership to foster this approach. These projects are aimed at fast pace industrialization that will generate employment in the country. The hallmarks of successful SEZs include high quality infrastructure, access to a productive labour pool, a critical mass of support industries, streamlined bureaucratic processes, and a suitable regulatory framework.

Financial Deepening and Economic Development

There has been a remarkable improvement in Pakistan's financial sector and this must be viewed against the backdrop of developments that took place over the last two decades. Pakistan initiated a broad-based program of reforms in the financial sector in the early 1990s. The pace of reforms, however, has increased manifold since 2000. Some of the key reforms included privatization of a number of financial institutions, rightsizing of banks and Development Finance Institutions (DFIs) through restructuring and improvement in corporate governance by promoting transparency and disclosure. Other reforms included strengthening of the legal framework to expedite recovery of stuck-up loans by promulgating a new recovery law, revision of Prudential Regulations (PRs) for Corporate/ Commercial banking to accommodate four separate categories viz. Risk management, Corporate Governance, Know Your Customer (KYC), Anti Money laundering and Operations as well as issuance of separate Prudential Regulations for SMEs, consumer and agriculture financing. In order to ensure that the depositors' money is protected, State Bank of Pakistan (SBP) is working to improve the banking system monitoring and risk management framework as well as strengthening the capital-base of the banking system.

World Class Infrastructure

The government's vision for economic growth and poverty reduction sets ambitious targets, which will require massive investment in quality and affordable infrastructure, to sustain high rates of private sector led growth, enhance the competitiveness of its economy and to optimize its locational advantage. This will be a primary objective during the PRSP II period and beyond. The magnitude of the investment is such that this will be only partially funded from the Budget. The large part of financing will be leveraged through public-private partnerships.

Second Generation Reforms

Pakistan has been implementing wide-ranging structural reforms in almost every sector of the economy to improve supply-side response by removing impediments to private sector development, improving the investment climate with the ultimate objective of strengthening the growth impetus and poverty reduction. The first generation reforms implemented so far include: financial sector reforms, capital markets reforms, tax and tariff reforms, reforms in tax administration, fiscal transparency, reforms in privatization programme, governance reforms, particularly with respect to devolution and capacity building, agricultural reform, and most importantly, the passage of the Fiscal Responsibility and Debt Limitation Act 2005. The second generation of these reforms, which will be implemented over the next five years, would focus on strengthening institutions, improving the competitiveness of domestic industry, building a robust financial sector in an environment of global financial restructuring, further strengthening of tax administration, promoting transparency in economic policymaking, further reform of capital markets and strengthening the country's physical and human infrastructure.

As part of institutional strengthening, major ongoing and planned government initiatives include reforms in judiciary, police, civil service, pension, the restructuring of the Central Directorate of National Savings (CDNS), restructuring of Federal Bureau of Statistics (FBS) into an autonomous institution, transforming the existing MCA into a Competition Authority Organization, and introduction and adoption of E-Government Strategy. Reforms aimed at improving competitiveness will work towards strengthening of the country's physical infrastructure, that is, the supply of gas, power, well functioning ports, roads, rail linkages, telecommunication network, and water availability. Second generation banking and financial sector reforms will include; voluntary mergers and consolidation of smaller banks into bigger more effective and stronger banks; further strengthening of the legal framework; formulation of new Banking Laws to deal with current and future challenges; a deposit insurance scheme to protect the small depositors; further liberalization of financial services in the context of the Agreement on Trade Related Investment Measures (TRIMs); promoting transparency and accountability in banking system; and observance of international standards, particularly legal and administrative measures to combat money laundering.

Concluding Remarks

As stated in the beginning, while Pakistan has made remarkable progress in its economic performance, undertaken wide ranging structural reforms, achieved both macroeconomic stability and strong growth, sharply reduced poverty, yet there is no room for complacency. Indeed the Government is far from complacent for the challenges are several, but then so are the opportunities. The important thing is that both challenges and opportunities have been identified. The new poverty reduction strategy attempts to bring these challenges and opportunities together within an integrated and holistic strategy. This strategy will be implemented jointly by all stakeholders, with the Government providing an enabling environment through both its policies and actions, all within a stable macroeconomic framework.

EXECUTIVE SUMMARY

01. GROWTH AND INVESTMENT

Pakistan’s economy continues to maintain its strong growth momentum for the fifth year in a row in the fiscal year 2006-07. With economic growth at 7.0 percent in the current fiscal year, Pakistan’s economy has grown at an average rate of almost 7.0 percent per annum during the last five years. This brisk pace of expansion on sustained basis has enabled Pakistan to position itself as one of the fastest growing economies of the Asian region. The growth that the economy has sustained for the last five years is underpinned by dynamism in industry, agriculture and services, and the emergence of a new investment cycle supported by strong growth in domestic demand. *Real GDP* grew strongly at 7.0 percent in 2006-07 as against the revised estimates of 6.6 percent for last year and 7.0 percent growth target for the year.

Growth of value addition in *Commodity Producing Sector (CPS)* is estimated to increase by 6.0% in 2006-07 as against 3.4% in 2005-06. Within the CPS, *agriculture* and *manufacturing* grew by 5.0 percent and 8.4

percent, respectively. *Large-scale manufacturing* registered a growth of 8.8% in 2006-07 against the target of 12.5.0% and last year's achievement of 10.7%. As a result of structural transformation, the share of agriculture in GDP has declined by 3.2 percentage points in the last 6 years alone and the share of the manufacturing sector has increased by 3.1 percentage points in the same period.

The performance of all the sub-sector of agricultural remained robust with the exception of minor crops and fishing. *Major crops* witnessed an impressive growth of 7.6 percent as against a negative growth of 4.1 percent last year. Livestock, a major component of agriculture, exhibited signs of moderation from its buoyant growth of 7.5 percent last year to 4.3 percent in 2006-07.

The services sector grew by 8.5% in 2004-05, by 9.6% in 2005-06 and by 8.0% in 2006-07. *Finance and insurance sector* spearheaded the growth in the services sector and registered stellar growth of 18.2 percent during the current fiscal year 2006-07 which is slightly lower than 33.0 percent of last year. Value added in the *wholesale and retail trade sector* increased by 7.1% in 2006-07 compared to 8.6% growth in 2005-06.

Value added in the *transport, storage and communications sector* grew by 5.7% from the previous year compared to 6.9% growth in 2005-06. *Public administration and defense* posted a growth of 7.0 percent while *ownership of dwellings* grew by 3.5 percent and *social services sector* improved its growth performance to 8.5 percent from 6.3 percent last year.

Pakistan's *per capita real GDP* has risen at a faster pace during the last four years (5.5% per annum on average in rupee terms) leading to a rise in average income of the people. Such increases in real per capita income have led to a sharp increase in consumer spending during the last three years. As opposed to an average annual increase of 1.4 percent during 2000-2003, *real private consumption expenditure* grew by 12.1 percent in 2004-05 but declined in the subsequent two years to 3.3 percent in 2005-06 and 4.1 percent in 2006-07. The *per capita income* in dollar term has grown at an average rate of 13.0 percent per annum during the last five years rising from $ 586 in 2002-03 to $ 833 in 2005-06 and further to $ 925 in 2006-07. The main factor responsible for the sharp rise in per capita income include acceleration in real GDP growth, stable exchange rate and four fold increase in the inflows of workers' remittances.

The *commodity producing sectors (agriculture and industry)* has contributed 30.2 percent or 2.9 percentage points to this year's growth while the remaining 59.8 percent or 4.2 percentage point's contribution came from *services sector*. Within the CPS, *agriculture* contributed 1.1 percentage points or 15.1 percent to overall growth while industry contributed 1.8 percentage points or 22.7 percent. The contribution of *wholesale and retail trade* has increased to19.4 percent or 1.4 percentage points to GDP growth in 2006-07. *Finance and insurance* has also contributed 13 percent or 0.9 percentage points to this year's growth. If we analyze the contributions from aggregate demand side for 2006-07, it emerged that *consumption* accounted for 49.8 percent or 3.2 percentage points to economic growth and while *investment* accounted for 52.7 percent or 3.4 percentage points to growth.

The *investment rate* is on the rise since 2004-05, reaching as high as 23 percent of GDP in 2006-07. This is the highest investment rate ever in recent economic history. This year's economic growth is largely investment-driven but ably supported which provides source of optimism that a growth of 6–8 percent in the next 5 years is quite achievable. *National savings* are financing a large part of this investment boom. The national savings rate is now at 18.0 percent of GDP.

Total investment has reached record level of 23.0 percent of GDP in the current fiscal year (2006-07) as against 21.7 percent of GDP last year. *Fixed investment* has increased to 21.4 percent of GDP from 20.1 percent last year. Total investment has increased from 16.9 percent of GDP in 2002-03 to 23.0 percent of GDP in 2006-07— showing an increase of 6.0 percent of GDP in five years. *Fixed investment* grew, on average, by 17.3 percent in real terms and 30.3 percent in nominal terms per annum during the last three years (2004-07). *Private investment* grew by 18**.**7 percent per annum in real terms and 32.0 percent per annum in nominal terms during the same period. The composition of investment between private and public sector has changed considerably during the last three years. The share of private sector investment in domestic fixed investment has increased from less than two-third (64.2%) to more than three-fourth (76.0%) in the last seven years clearly reflecting the growing confidence of private sector in the current and future prospects of the economy.

Private sector investment grew by 20.4 percent this year as against 37.5 percent increase in last year in nominal terms. Public sector investment has also increased by 25.7 percent per annum during the last three years and 25.7 percent during the current fiscal year in nominal terms. Major nominal growth in private sector investment is witnessed in manufacturing (27.0%), mining & quarrying (93.6%), construction (10.7%), transport and communication (20.8%), and wholesale and retail trade (25.4%). National Savings at 18.0 percent of GDP has financed 84 percent of fixed investment in 2006-07 as against 85.5 percent last year. National savings as percentage of GDP stood at 18.0 percent in 2006-07 fractionally higher than last year's level of 17.2 percent. Domestic savings has risen from 15.3 percent of GDP to 16.1 percent of GDP.

The *overall foreign investment* during the first ten months (July-April) of the current fiscal year has touched $ 6 billion — highest ever in the country's history. The overall foreign investment stood at $5979.2 million during the first ten months (July-April) of the current fiscal year as against $4048.9 million in the same period last year – an increase of 47.7 percent (See Table 1.8). *Public foreign investment* depicted modest 2.5 percent growth in Jul-April 2006-07 by moving to $671.4 million as against $655 million in the comparable period of last year. It is the private sector which took the major task of providing impetus to foreign investment. During July-April 2006-07, total foreign private investment reached $5307.8 million as against $3393.9 million in the comparable period of last year, thereby, depicting 56.4 percent increase. Total *foreign direct investment* has reached $4160.2 million as against $3038.2 million in the comparable period of last year, thereby, depicting 36.9 percent increase

Almost 78 percent of FDI has come from five countries, namely, the UAE, US, China, UK and Netherlands. Netherlands with 18.1 percent ($753.4 million) has topped the list of foreign investors followed by the UK (17.4% or $724.4 million), China (17.0% or $708.9 million), US (16.3% or $676.7 million), and UAE (8.8% or $364.2 million). If we look at sectoral break-up, the communication sector (including Telecom) spearheaded the FDI inflows by accounting for 34.2 percent stake during July-April 2006-07 followed by financial business (20.9 percent), energy including oil & gas and power (14.1 percent), and food, beverages and tobacco (11.8 percent). These four groups accounted for almost 80 percent of FDI inflows in the country.

02. AGRICULTURE

Agriculture continues to be the single largest sector, a dominant driving force for growth and the main source of livelihood for 66 percent of the country's population. It accounts for 20.9 percent of the GDP and employs 43.4 percent of the total work force. As such agriculture is at the center of the national economic policies and has been designated by the Government as the engine of national economic growth and poverty reduction. Agriculture contributes to growth as a supplier of raw materials to industry as well as a market for industrial products and also contributes substantially to Pakistan's exports earnings. Thus any improvements in agriculture will not only help country's economic growth to rise at a faster rate but will also benefit a large segment of the country's population.

The agriculture growth has experienced mixed trends over the last six year. The country witnessed unprecedented drought during the first two years of the decade i.e. (2000-01 and 2001-02) which resulted in contraction of agricultural value added. Hence agriculture registered negative growth in these two years. In the following years (2002-03 to 2004-05), relatively better availability of irrigation water had a positive impact on overall agricultural growth and this sector exhibited modest to strong recovery. The performance of agriculture remained weak during 2005-06 because its crops sector particularly major crops could not perform up to the expectations. Growth in the agriculture sector registered a sharp recovery in 2006-07 and grew by 5.0 percent as against the preceding year's growth of 1.6 percent. Major crops posted strong recovery from negative 4.1 percent last year to positive 7.6 percent, mainly due to higher production of wheat and sugarcane. Wheat production of 23.5 million tons is highest ever in the country's history, registered an increase of 10.5 percent over last year. Sugarcane production likewise improved by 22.6 percent over last year to 54.8 million tons, both being record high production.

Cotton production at 13 million bales remained mostly unchanged in comparison to 13.02 million bales of last year. Rice production at 5.4 million tons was marginally less than 5.5 million tons produced last year. Despite the lower yield, higher demand abroad for Pakistan Basmati rice and high international prices are expected to surpass the last year's export earning from Basmati Rice. Amongst the other major crops, gram crop, exhibited an impressive growth of 75.4 percent in 2006-07 due to the increase in intervention price of the crop and good rains in "*Thal*" area where the gram crop is mainly concentrated. Minor crops registered a weak growth of 1.1 percent while it was 0.4 percent last year. However, amongst the minor crops, production of potato increased by 67.2 percent, mung and masoor pulses improved by 21.5 percent and 17.9 percent respectively. Livestock registered a strong growth of 4.30 percent over the last year's impressive growth of 7.5 percent due to increase in the livestock and poultry products. Fishery performed positively at 4.2 percent though the previous year's growth stood at 20.5 percent. Forestry has decreased by 3.8 percent in 2006-07 while it had decreased by 43.7 percent last year.

Pakistan's agricultural output is closely linked to the supply of irrigation water. Against the normal surface water availability at canal heads of 103.5 million-acre feet (MAF), the overall (both for Kharif and Rabi) water availability has been less in the range of 5.9 percent (2003-04) to 29.4 percent (2001-02). However, it remained less by 2.6 percent in 2005-06 against the normal availability. Relatively speaking, Rabi season faced more shortage of water than Kharif during these periods.

During the current fiscal year (2006-07), the availability of water for Kharif 2006 (for the crops such as rice, sugarcane and cotton) has been 6.0 percent less than the normal supplies and 10.8 percent less than last year's Kharif. The water availability during Rabi season (for major crop such as wheat), as on end-March 2007 was estimated at 31.2 MAF, which was 14.3 percent less than the normal availability, and 3.7 percent more than last year's Rabi. Sufficient water supplies coupled with timely winter rains in Rabi season had a good impact on Rabi crops particularly on gram, masoor and wheat as production of these crops increased by 75.4, 17.9 and 10.5 percent, respectively.

Amongst major crops, cotton production estimated at 13.0 million bales for 2006-07 remained mostly same at the last year's production of 13.02 million bales. Wheat production is estimated at 23.5 million tons in 2006-07, as against 21.3 million tons last year, showing an increase of 10.5 percent. Rice production has, however, decreased by –2.0 percent in 2006-07 from 5.547 million tons last year to 5.438 million tons in 2006-07. Sugarcane production increased from 44.666 million tons in 2005-06 to 54.752 million tons in 2006-07, showing an increase of 22.6 percent. As regards the minor crops, the production of potatoes, mung and masoor increased by 67.2 percent, 21.5 percent and 17.9 percent, respectively. The production of chillies, onion and mash decreased by 49.6 percent, 14.3 percent and 3.6 percent, respectively. Lesser production over last year is due to shortfall in area. Agriculture credit disbursement of Rs 104.844 billion during July-March, 2006-07 is higher by 15 percent, as compared to Rs 91.161 billion over the corresponding period last year. The fertilizer off-take stood at 2825 thousand nutrient tons in July-March 2006-07 or lower by 5.6 percent, as compared to 2991 thousand nutrient tons for the corresponding period last year. The offtake pattern of nutrients has changed in the country because of subsidy factor on phosphatic and potassic fertilizers. Nitrogen offtake has decreased by 12.0 percent while that of phosphate and potash increased by 14.2 and 63.6 percent, respectively during July-March 2006-07. However, the share of phosphate and potash is low as compared to nitrogen in total offtake, so the overall offtake reduced. Moreover, erratic rainfall pattern in the Kharif 2006 also negatively affected the offtake.

According to the Livestock Census 2006, the share of livestock in agriculture growth has jumped from 25.3 percent in 1996 to 49.6 percent in 2006. The higher growth in the livestock sector was mainly attributed to growth not only in the headcount of livestock, which is commercially important but also in the milk production. The population of total animals registered a significant increase of 30 percent in 2006 when compared with 1996. Overall, the milk production increased by 35.6 percent in 2006 over 1996. Likewise, the total number of animals slaughtered registered 36.7 percent increase in 2006 over 1996.

03. MANUFACTURING AND MINING

The overall manufacturing sector continued on its strong positive trend during the current fiscal year. Overall manufacturing recorded an impressive and broad based growth of 8.45 percent, against last year's growth of 9.9 percent. Large-scale manufacturing, accounting for 69.5 percent of overall manufacturing registered an impressive growth of 8.75 percent in the current fiscal year 2006-07 against last year's achievement of 10.68 percent. There has been a slight decline in growth in the manufacturing sector due to multiple reasons like reduced production of cotton crop, sugar shortage, steel and iron problems and the last but not the least global oil prices. All of these reasons contributed to reduced growth in 2006-07 but high levels of liquidity in the banking system, an investment friendly interest rate environment, a stable exchange rate, low inflation, comfortable foreign exchange reserves, stronger domestic demand for consumer durables and high business confidence among other things will again boost the manufacturing sector growth rate up to a reasonable level.

The main contributors to this impressive growth of 8.75 percent in July-April 2006-07 over last year are cotton cloth (7.0 percent) and cotton yarn (11.9 percent) in the textile group; cooking oil (6.8 percent), sugar (19.6 percent) and cigarettes (4.14 percent) in the food, beverages and tobacco groups; cement (21.11 percent) in the non-metallic mineral products group and Jeeps & Car (3.0 percent), LCV's (17.04 percent), motorcycles/scooters (12.30 percent) and tractors (11.40 percent) in the automobile group. The individual items exhibiting negative growth include; both nitrogenous and phosphatic fertilizers (0.08 percent and 3.10 percent), petroleum products (5.59 percent) and galenicals (24.49 percent).

The Government is fully committed to making the mineral sector in Pakistan one of the most profitable for the country. During the current fiscal year the mining and quarrying sector has registered a growth rate of 5.6 percent as against 4.58 percent of last year. This increased growth rate was propelled by strong positive growths recorded in magnetite, dolomite, limestone and chromites.

During the period July 2006 to February 2007, the privatization commission completed five transactions that fetched an amount of Rs. 67.664 billion. OGDCL's 10 percent listing and domestic offering was over subscribed yielding a total of $ 811 million, which reflected the confidence of investors in the policies of present government. The privatization transactions of Pakistan State Oil (PSO), Roosevelt Hotel, New York, Services International Hotel, Lahore, National Investment Trust Limited (NITL), Genco-1 Jamshoro, Hazara Phosphate Fertilizers Limited are at various stages of processing and are likely to be brought to the bidding soon.

Given the significance of the SME sector, recent years have witnessed increasing government/ private sector focus. Studies have been undertaken to identify the constraints the SMEs face, an SMEs policy has been announced, commercial banks are now enhancing their to lending to SMEs, some universities are offering programs in Entrepreneurship and SME Management . In its endeavors, Pakistan like some of the other developing countries has received support from the Asian Development Bank.

Non-availability of financing has been recognized as a major impediment to SME development. To meet the financing needs of the SME sector, the SME Bank was formed by converting the Regional Development Finance Corporation in 2002, with loans beings extended for working capital and medium to long term financing, programs lending and leasing through its subsidiary, SME leasing. The SME Bank has lent to areas like CNG station, health development, surgical instrument, fan manufacturers, power looms, carpet manufacturer, gems & jewelry etc.

Small & Medium Enterprise Development Authority (SMEDA) is another institution dedicated solely to the promotion of SMEs in the country. During FY07 SMEDA has started establishing on ground demonstration projects and Common Facility Centres to enable the private sector catch up with fast changing global trends in technology and management processes with enhanced productivity and quality standards. These include projects in sports, agro based industry, leather and light engineering sectors. These projects are spread all over the country.

04. POVERTY AND INCOME DISTRIBUTION

As Pakistan’s economy entered the fourth year (FY 2006-07) of above 7.0 percent growth, its poverty headcount had fallen from one-third to less than one-fourth of the population. The confluence of growth accelerating government policies, nature’s blessings and annual growth of 21% in pro-poor expenditures during the period contributed to approximately 13 million people moving out of poverty. In the immediate to short-run the challenge is to maintain the hard won improvement in poverty levels and even improve upon it through sustained growth (a necessary condition) in the range of 6-8 percent per annum. However growth alone does not suffice to reduce poverty levels. It has to be reinforced by job creation. Since FY 02, the economy created 10.62 million jobs, thereby reducing the open unemployment rate to 6.2 percent by FY 05-06. Foreign inflows in the form of remittances also have salutary impact on poverty. Development expenditure as a ratio of GDP, increase in human capital base, and openness of the economy are some of the other important factors that reduce the absolute poverty levels in Pakistan. On the debit side, food inflation increases poverty levels. The economy has witnessed a gradual increase in all the former set of determinants, while food inflation remained benign till 2004-05.

An appreciable decline in poverty rates has occurred between 2000-01 and 2004-05. At the national level, headcount decreased from 34.46 percent in 2000-01 to 23.94 percent in 2004-05, depicting a substantial reduction of 10.52 percentage points over this period. In absolute numbers the count of poor persons has fallen from 49.23 million in 2001 to 36.45 million in 2004-05. The absolute fall in poverty headcount in rural areas from 39.3 percent in 2001 to 28.1 percent in 2005 was much higher than in urban areas. However in percentage terms, urban poverty fell by 34 and rural poverty by 28 percent during the period.

The percentage of population (1.0% of total population) classified as “extremely poor” remained unchanged between the two periods, the proportion of “ultra poor” and “poor” have declined appreciably during the same period. At the higher end, the percentage of “quasi non-poor” and “non-poor” has increased notably.

Pakistan’s poverty reduction strategy has yielded handsome result in the shape of sharp reduction in poverty. Although, poverty has declined but the fact remains that 23.9 percent people of Pakistan still live below the poverty line. Further reduction in poverty is a major challenge for the government. A clear lesson from the past five years of Pakistan and from other countries’ experience is that sustained growth on a consistent basis is needed to reduce poverty. Macroeconomic stability is, of course, a prerequisite for the sustained economic growth that brings the poverty reduction and rising living standards that we all want to see. But macroeconomic stability is not sufficient. Rather, it is the foundation on which to build a thriving economy. Successfully targeted social programs, fair and broad based fiscal regimes, labour markets that promote job creation, and high quality education opportunities for the neediest, are also the key to permanent and sustained reduction in poverty.

05. FISCAL DEVELOPMENT

A sound fiscal position is an essential pre-requisite for achieving macroeconomic stability, which is increasingly recognized as a critical ingredient for promoting strong and sustained economic growth and lasting poverty reduction. Considerable efforts have been made over the last seven years to inculcate financial discipline by pursuing a sound fiscal policy. Pakistan has succeeded in reducing fiscal deficit from an average of 7.0 percent of the GDP in the 1990s to an average of 3.5 percent during the last seven years. The associated public debt accumulation also declined sharply from over 100 percent of GDP to 53 percent this year. Pakistan’s hard earned macroeconomic stability is therefore, underpinned by fiscal discipline.

The underlying fiscal deficit is targeted at 3.7 percent of GDP (excluding earthquake spending) for the current fiscal year (2006-07) which is slightly higher than the deficit level of the previous year (3.4% of GDP). Higher deficit was targeted to finance higher public sector development program (PSDP), particularly towards financing infrastructure projects. Pakistan needs to strengthen its physical and human infrastructure to sustain growth momentum.

Total revenues are budgeted at Rs. 1163.1 billion in 2006-07 compared to Rs. 1087.0 billion in 2005-06, showing an increase of 7.0%. This was primarily due to a rise of 15.5 percent in tax revenue on the back of increases in federal tax revenues are projected to rise by 17.5 percent. Provincial tax revenue is projected to decline by 12.6 percent. Non-tax revenue are targeted to decline by 13.3 percent by moving to Rs.277.3 billion in 2006-07 as against Rs.320.0 billion last year.

The wide-ranging tax and tariff reforms as well as reforms in tax administration have started paying dividends. During the last seven years tax collection by the Central Board of Revenue (CBR) has increased by 112.8 percent. During the current fiscal year (2006-07), CBR has exceeded the revenue target of Rs. 645.2 billion fixed for the first ten months of current fiscal year (July-April) by Rs. 11.3 billion. The net collection stood at Rs. 656.5 billion as against Rs.547.0 billion in the comparable period of last year, thereby showing an increase of 20 percent. The direct taxes contributed most of the increase as they have surpassed the target by Rs.52.4 billion and recorded massive growth of 50.9 percent. This increase has compensated much of the revenue shortages on account of sales tax and customs duties by Rs. 22.5 billion and Rs. 19.0 billion, respectively owing to slowdown in imports, resulted in negative growth in dutiable imports with adverse implications for import related taxes.

The gross and net collection has increased by 17.9% and 20.0% respectively during July-April 2006-07. The overall refund/ rebate payments during first ten months of current fiscal year have been Rs. 73.0 billion relative to Rs. 71.9 billion paid back during the corresponding period of past fiscal year. Among the four federal taxes, the highest growth of 50.9% has been recorded in the case of direct tax receipts, followed by FED (20.7%) and sales tax (7.5%). On the other hand, customs duties have witnessed a negative growth of 2.3%. The share of direct taxes in total taxes (collected by the CBR) has increased from 18 percent to over 38.5 percent in July-April 2006-07. The share of indirect taxes declined from 82 percent to 61.5 percent during the same period. The collection from custom duty used to account for 45 percent of total tax collection and 55 percent of indirect taxes in 1990-91, its share has now been reduced to 18.6 percent and 32.3 percent, respectively. The share of sales tax increased at a tremendous pace from 14.4 percent to 41 percent of total taxes and from 17.6 percent to 60.3 percent of indirect taxes during the same period.

Total expenditure is targeted at Rs. 1536.6 billion or 17.4 percent of GDP for the fiscal year 2006-07. Total expenditure was projected to be 8.6 percent higher than last year (2005-06). During the first nine month (July-March) of the current fiscal year total expenditure is estimated at Rs.1168.5 billion or 76 percent of the annual target.

Current Expenditure is targeted at Rs. 1126.2 billion for the current fiscal year (2006-07) which means it would remain almost stagnant at the level of 2005-06. During July-March 2006-07, provisional estimates suggest an expenditure of Rs.925.3 billion which is 83.6 percent of the target. The higher increase in current expenditures during the last two years is mainly on account of earthquake-related spending amounting to 0.5 percent to 0.8 percent of GDP. The major components of current expenditure include interest payments and defense spending which also show increases. *Interest payments* are targeted at Rs. 239.5 billion for the current fiscal year which are slightly lower than Rs. 241.2 billion but during July-March 2006-07, it already exceeded the target. *Defense spending* for the year is targeted at Rs. 250.2 billion — 3.8 percent higher than last year and during July-March 2006-07, the spending has reached Rs.172.8 billion which is 69 percent of the full year target.

Development expenditure is targeted at Rs. 435 billion for the year 2006-07 as against revised estimate of Rs.313.7 billion in 2005-06. During the first nine months (July-March) of the current fiscal year 2006-07, development expenditure amounted to Rs.241.8 billion or only 58.3 percent of the yearly allocation. This expenditure is likely to pick-up in the last quarter of the year. The size of the federal PSDP was budgeted at Rs.270 billion and provincial PSDP was estimated at Rs.115 billion; totaling Rs.385 billion. An amount of Rs.50 billion was budgeted for earthquake related spending; therefore, the total size of the PSDP was budgeted at Rs.435 billion. However, an operational shortfall of Rs.20 billion in PSDP was anticipated in 2006-07. During the last seven years the development expenditure improved from 2.2 percent of GDP in 2000-01 to 4.9 percent of GDP in 2006-07.

The *overall fiscal deficit* is targeted at Rs. 373 billion or 4.2 percent of GDP for 2006-07. The Government is well placed to meet this target as fiscal deficit during the first nine months remained at 3.1 percent of GDP or 73 percent of the yearly target. On the basis of the developments on revenue and expenditure front, the overall fiscal deficit during the first nine months (July-March) of the current fiscal year stood at Rs. 272.8 billion or 3.1 percent of GDP. Earthquake accounted for sizeable amount of fiscal deficit and underlying fiscal deficit excluding earthquake expenditure is targeted at 3.7 percent of GDP for 2006-07. *Revenue balance* (revenue minus current expenditure) — a measure of government's savings or dis-savings, was targeted to be in surplus to the extent of 0.6 percent of GDP. During the first nine months (July-March) of the current fiscal year, the revenue balance has remained in deficit to the extent of Rs.29.6 billion or 0.3 percent of GDP. The primary balance (total revenue minus non-interest total expenditure) remained in surplus for the last seven years. However, primary balance turned negative for the first time in 2005-06.

The public debt- to-GDP ratio, which stood at almost 85 percent in end June 2000, declined substantially to 56.9 percent by the end of June 2006 — 28.0 percentage points decline in country's debt burden in 7 years. By end March 2007, public debt further declined to 53.4 percent of the GDP for the year. In absolute terms public debt grew by 7.6 percent during July-March 2006-07. Public debt was 562.5 percent of revenue by the end of the 1990s. Following the debt reduction strategy in which raising revenue was one of the key elements, the public debt burden in relation to total revenue has declined substantially to 401.0 percent by end-June 2006 and further to 400 percent by end-March 2007

By end-June 2006 total domestic debt stood at Rs. 2312 billion which was 30 percent of GDP. The outstanding stock of domestic debt rose by Rs 211.8 billion and domestic debt stock stood at Rs.2523 billion by end-March 2007 which is 28.4 percent of GDP. It has risen by 9.1 percent by end-March 2007 over end-June 2006.

06. MONEY AND CREDIT

The development of financial markets and institutions is a critical and inextricable part of the economic growth. In countries with better financial development, an efficient financial system ameliorates market distortions and reduces information and transaction costs. It thus identifies and funds good business opportunities, mobilizes domestic savings, monitors the performance of businesses, enables the trading, hedging and diversification of risk and facilitates the exchange of goods and services. There has been a remarkable improvement in Pakistan's financial sector as it initiated a broad-based program of reforms in the early 1990s.The pace of reforms; however, has increased manifold since 2000. As a result of successful reforms in the financial sector the M2/GDP ratio, which is an indicator of financial deepening and development has been showing rising trend since 1990-91.M2/GDP ratio has increased from 39.3 percent in 1990-91 to 45 percent in 2005-06.Credit to private sector/GDP ratio is also rising from 21.7 percent in 1990-91 to 27.4 percent in 2005-06.

During the fiscal year 2006-07, the SBP took several additional policy measures in different phases as part of monetary policy tightening. In the first phase, the SBP raised the Statutory Liquidity Ratio (SLR) from 15 percent to 18 percent and Cash Reserve Ratio (CRR) for commercial banks from 5 to 7 percent.

The State bank of Pakistan prepared the Credit Plan for the year 2006-07 with a view to maintain price stability and promoting economic growth. The money supply during Jul-May 12'2007 of the current fiscal year expanded by Rs.477.9 billion or 14 percent as against an expansion of Rs358.2 billion or 12.1 percent in the same period last year .The high monetary growth during this period was caused mainly by a sharp rise in the net foreign assets of the banking system as the growth in the net domestic assets of the banking system accelerated only slightly. Pakistan has seen large foreign inflows during the period which has resulted in an expansion of the NFA of the banking system. The NFA portrayed an expansion of Rs.88.1 billion as against the target of Rs.9.8 billion .The major factors responsible for large foreign exchange inflows included a relatively higher growth in workers' remittances and foreign investment (both FDI and portfolio), foreign inflows through Global Depository Receipts (GDRs), PTCL privatization proceeds and relatively slower increase in trade-related foreign currency loans.

While the increase in the NFA reflects the improvement in country's external account; the higher growth in the NDA was caused entirely by a sharp increase in government sector borrowings that more than offset the deceleration in the credit to non-government sector. The NDA of the banking system registered an expansion of Rs.389.68 billion Jul-May FY 07 compared with Rs.314.38 billion expanded during the corresponding period of the preceding year. The sustainability of private sector credit take-off (Rs.273.9 billion) and sizable government borrowings for budgetary support (Rs.212 billion) were the major factors responsible for the current hefty buildup in NDA. However, with the inflows of receipts from the issuance of Euro bond and other expected external inflows before the current fiscal year, the picture will change substantially and government borrowings for budgetary support may come back to the target for the year.

Consistent with its objective of shaving off domestic demand with a view to reducing inflation, the SBP not only raised reserve requirements for banks with effect from July 22, 2006 but also increased the discount rate by 50bps to 9.5 percent from 9 percent. In addition, SBP continued its frequent open market operations (OMO's) to drain excess liquidity from the inter-bank market. In addition, SBP also raised the cut-off yield on 6 months and 12 months treasury bill**s** which had increased gradually by 41 and 29 basis points to 8.9%and 9.07% respectively during July-April FY 07. Interest rates of 3, 5 and 10 years maturities of the Pakistan Investment bonds (PIBs) exhibit an increase in the range of the 14 basis points to 33 basis points during the FY 07 over last year. The weighted average lending rate has increased by 240 basis points in a period of 21 months from June 2005 to March 2007 from 8.2 percent in June 2005 to 10.6 percent in March 2007.

The banking sector of Pakistan is regarded as one of the best performing sectors in the region Microfinance sector in Pakistan has recorded substantial growth over the past six years as an outcome of a conducive policy and regulatory framework as well as supportive investments undertaken by the Government of Pakistan towards the development of the sector. Khushali Bank continues to lead and is the largest microfinance Institution in the country in term of its network, clients and portfolio. The bank has a presence in 85 districts of the country through a network of 110 service outlets and processed over a million loans worth Rs.10 billion across 550,000 households with a portfolio that is pre-dominantly rural.

The importance of Small and medium Enterprise Sector in achieving and sustaining higher levels of growth in the economy is now well recognized based upon the fact that SMEs are a source of low cost employment. SME Bank responds to the need of Small and Medium Entrepreneurs by providing them with the necessary financial assistance in the form of medium to long term funds.The bank and its leasing company both financed 1402 SMEs during the year 2006 by extending to them record credit of Rs.1.95 billion.

07. CAPITAL MARKETS

Pakistan's capital and stock markets have witnessed impressive growth over the last several years on account of market-friendly and investment-friendly policies pursued by the government. The KSE-100 index (Pakistan's benchmarked stock market) has increased from 1521 points in June 2000 to 12370 points in April 2007 – a rise of over 10,800 points or an increase of 713 percent. Similarly aggregate market capitalization has increased from Rs 392 billion ($ 7.6 billion) in June 2000 to Rs 3604 billion ($ 59.4 billion) in April 2007, showing a rise of over Rs 3200 billion (or $ 53 billion) or an increase of 819 percent. The KSE 100-index reached all time high of 12961 points on 31st May 2007. Aggregate market capitalization also increased by 35.0 percent from Rs 2801 billion in June 2006 to Rs 3781 billion ($ 62.3 billion) as of 31st May 2007. Portfolio investment has increased from a negative $ 140 million in fiscal year 2000-01 to $ 1819 million during July-April 2006-07.

The impressive performance in the stock markets during the current fiscal year has been driven by a number of factors including: (i) continuous improvement in the country's economic fundamentals, (ii) government's commitment to maintain its economic reform and pro-market policies, (iii) stability in exchange rate as a result of strong build up in foreign exchange reserves, (iv) regionally cheap valuation driving foreign interest in Pakistan's stock market, (v) large-scale merger and acquisition in the banking, telecom and other sectors of the economy (vi) improving Pakistan's geo-political relationship with neighbours as well as globally, resulting in decline in political risk premium of the country, (vii) successful GDR offerings of the OGDC and MCB Bank, amounting US dollars 888 million and (viii) increase in Pakistan's coverage by large international brokerage firms and investment banks. Extraordinary performance in the stock markets during the current fiscal year was driven by some major sectors of the economy including banks and other financial institutions, transport and communication, engineering, fuel & energy and auto & allied.

Large-scale merger of banks and a telecom company (PakTel) along with continued momentum of privatization programme have promoted growth of Pakistan's stock markets during the current fiscal year. Over the past few years, the Securities & Exchange Commission of Pakistan (SECP) has taken measures to restore confidence of both foreign and domestic investors. In the current fiscal year the SECP in consultation with the stock exchanges, has introduced significant capital market reforms in the fields of risk management, governance, transparency and investor protection.

08. INFLATION

During the first ten months (July–April) of the current fiscal year 2006-07, the average inflation rate as measured by the change in consumer prices index (CPI) stood at 7.9 percent compared with 8.0 percent last year. Food inflation during this period increased to 10.2 percent from 6.9 percent in the same period last year whereas the non-food inflation is estimated at 6.2 percent against 8.8 percent in the comparable period of last year. The core inflation which represents the rate of increase in cost of goods and services excluding food and energy prices also subdued from 7.7 percent to 6.0 percent. The major contributors to the high pick up in food inflation and there by overall (CPI) inflation include the rise in prices of vegetable ghee, various kinds of pulses, rice, poultry, meat, milk, fresh vegetables and fruits on account of imbalance in demand and supply of these commodities. Besides, the soaring global price of key importable food items such as edible oil, milk powder, tea, medicine and food related components have boosted domestic inflation. The government attaches high priority to controlling inflation in the country owing to its impact on the economy as well as its implications on the purchasing power and monthly budgets of the low income and poor households. A number of measures were initiated during the current year 2006-07 to contain the price hike in the country including easing of imports for commodities facing supply shortage, reforms geared towards increase in agricultural output and improvement in marketing mechanism. It may be pointed out that although inflationary pressure has been eased considerably and the current level of inflation at 7.9 percent is within manageable limits, it is still above the target of 6.5% set for fiscal year 2006-07. However, due to a bumper crop of wheat and steps taken by government to ease the pressure on supply side factors it is expected that inflation will decelerate in coming months.

09. TRADE AND PAYMENTS

Pakistan has recorded laudable export performance during the last several years, with exports growing at an average rate of almost 16 percent per annum over the last four years (2002-03 to 2005-06). Despite improvements in the international trading environment. Pakistan's export growth witnessed abrupt and sharp deceleration to less than 4.0 percent in the first ten months (July-April) of the current fiscal year after growing at an impressive rate of 16.0 percent per annum in recent years.

Exports were targeted at $ 18.6 billion or 12.9 percent higher than last year. Exports during the first ten months (July-April) of the current fiscal year are up by 3.4 percent – rising from $ 13457.0 million to $ 13909.0 million in the same period last year.

After growing at an average rate of 29 percent per annum during 2003-2006 Pakistan's import growth slowed to a moderate level in the current fiscal year. Pakistan's imports grew by 8.9 percent or $ 2047 million in the first ten months of the current fiscal year. Imports were targeted to decline by 2.1 percent in 2006-07 to $ 28.0 billion from last year's level of $ 28.6 billion. As expected, growth in import decelerated to 8.9 percent during the first ten months (July-April) of the current fiscal year as against hefty increase of 40.4 percent in the same period last year. The deceleration in import growth is caused by several factors which include: the pursuance of tight monetary policy to shave off excess demand, softening of international price of oil, decline in imports of cars as a result of change in policy, decline in the imports of fertilizer because of large carryover stock of last year, and decline in the imports of iron & steel as Pakistan Steel coming back to its normal production level.

Almost 31 percent contribution alone came from petroleum group, mainly on account of the surge in imports of petroleum products both in value and quantity. Imports of machinery contributed almost 30 percent to this year' rise in imports bills. This is followed by imports of telecom which accounted for 13 percent to the overall rise in imports. Almost three-fourth contribution came from three categories (machinery, petroleum and telecom) to this year's rise in imports. Interestingly, consumer durables' contribution was negative (-1.8%) mainly on account of a decline in the imports of cars. Therefore, contrary to the general perception, the contribution of consumer durables was negative.

Pakistan's balance of payments shows a record increase in capital flows that has substantially offset a gradual widening of the current account deficit. The magnitude of the inflows has overwhelmed the State Bank of Pakistan and complicated monetary policy. Pakistan's current account deficit further widen to $ 6.2 billion (4.3% of GDP) in the first nine months (July-March) of the current fiscal year from $ 4.6 billion (3.6% of GDP) in the same period last year. A striking feature of this year's current account deficit is that it has widened even though the import growth has slowed to 10.2 percent but the performance of exports has been lack luster at best, resulting in widening of trade deficit. Deficit in services account also widened and as such even a robust growth of 7.8 percent in private transfers could not narrow the current account deficit

The current account deficit for the year is likely to be around 5.0 percent of GDP as against 4.4 percent last year. The strong inflows in capital account will more than offset the current account deficit and add to the stock of foreign exchange reserves. The flow under long-term capital (net) has surged to $ 5.7 billion in the first nine months (July-March) of the current fiscal year as against $ 3.1 billion in the same period last year, showing an increase of 82 percent.

Exchange rate remained more or less stable during the FY07. However, rupee depreciated only marginally (0.7%) from Rs.60.2138 per dollars as at end June 2006 to Rs.60.6684 as of end April 2007. In the open market, rupee traded at 60.655 to a dollar, that is at a discount of 0.02 percent as at end-April 2007.

Workers' remittances, the third largest source of foreign exchange inflows after exports and foreign investment, continue to maintain its rising trend. Workers' remittances totaled $ 4.45 billion in the first ten months (July-April) of the fiscal year as against $ 3.6 billion in the same period last year, depicting an increase of 22.6 percent.

Pakistan's total liquid foreign exchange reserves stood at $ 13,738 million at the end of April 2007, considerably higher than the end-June 2006 level of US$ 13,137 million. A number of factors contributed towards the accumulation of reserves. The most prominent among these are; private transfers that include remittances, floatation of bonds, higher foreign investment and privatization proceeds.

10. EXTERNAL DEBT AND LIABILITIES

Due to a credible debt reduction strategy and successive high growth rates, Pakistan has reduced its public debt burden (including Rupees debt and foreign currency debt) from 100.3 percent of GDP in end-FY99 to 53.4 percent of GDP by end-March FY07. The external debt component of public debt (excluding private non-guaranteed debt and liabilities) has decreased from 40.8 at end-FY02 to 24.6 at end-March FY07.

External debt and liabilities (EDL) at the end of March FY07 were US$ 38.86 billion. This is an increase of US$ 1.6 billion which represents a 4.3 percent increase over the stock at the end of FY06. Pakistan has succeeded in reducing the country's debt burden by ensuring that the growth in EDL is less than the GDP growth. Consequently, the burden of the debt has declined substantially during the same period. The external debt and liabilities (EDL) declined from 50.9 percent of GDP at the end of FY02 to 26.3 percent of GDP by end-March 2007. Similarly, the EDL were 236.8 percent of foreign exchange earnings but declined to 119.7 percent in the same period. The EDL were nearly 5.8 times foreign exchange reserves at the end of FY02 but declined to 2.8 by end March 2007. Interest payments on external debt were 7.8 percent of current account receipts but declined to 3.2 percent during the same period.

Continuing the credible debt policy, Pakistan successfully issued a US$ 750 million 10 year note at a fixed rate of 6.875% on May 24, 2007 lead managed by Deutsche Bank, Citi Group and HSBC. This was the largest 10 year deal to date, beating the previous deal of US$ 500 million. The transaction has provided a true liquid benchmark for other issuers to follow. The transaction priced at an impressive UST (US Treasury) +200 basis point which is 40 bps (basis points) tighter compared to last year's deal that priced at UST +240 basis points. The deal priced at the tight end of a revised price guidance of 6.875-7.00 percent. The issue was highly oversubscribed with the largest ever order book amassed for Pakistan. The order book of US$ 3.7 billion meant an oversubscription of over 7 times on the original deal of US$ 500 million. The resounding demand allowed Pakistan to upsize the deal by 50% to US$ 750 million. The transaction was announced and priced within 72 hours, an impressive feat and testament to investor confidence in Pakistan. Furthermore, an astounding 60% of the deal went to first-time investors who had never bought Pakistan paper before and that 75% of investors met on the roadshow placed orders. The offering was well balanced by geographically with an increase in US participation to 35% from 19% on previous transaction.

11. EDUCATION

Education is the driving force of growth and progress in an increasingly interconnected and globalizing world. The multifaceted impact of education on every aspect of human existence makes it an essential area for policy framework especially for developing countries. Developing countries where majority of the world's population resides need to maximize on productivity and capabilities of the advanced human capital. Today's global economy and the demographic shift towards a large bulge of working-age population provide Pakistan with a perfect opportunity towards growth and development.

In the recent years, the literacy levels in Pakistan have improved over time *albeit* at a moderate pace. The overall literacy rate (10 years & above) was 45 percent in 2001 which has increased to 54 percent in 2005-06, indicating a 9.0 percentage points increase over a period of only five years. The literacy rate for non-poor went up from 51 percent in 2001 to 59 percent in 2005 whereas for poor it improved from 30 percent to 40 percent in the same period. The rate of improvement is higher for poor as compared to non-poor. Males literacy rate (10 years & above) increased from 58 percent in 2001 to 65 percent in 2005-06 while it increased from 32 to 42 percent for females during the same period highlighting the gender gaps that still persist in access to education. The percentage of children aged 10-18 that left before completing primary level has decreased from 15 percent in 2001 to 10 percent in 2005. This underlines the government's effort to improve the access and quality of education.

The government has taken several strong initiatives to improve and overhaul the existing system of education. It has taken prudent step towards streamlining the education sector at the national level. *Education sector reform Action Plan 2001-2005* is one of the examples of this multi-pronged strategy which envisage in it the devolution of responsibility of the delivery of the education to local governments along with improving the overall literacy, enrollment and access to education. Also, the *National Education Policy 1998-2010* is currently under review to include to participation of all the stakeholders and ensuring ownership of the policy by federating units and other stakeholders.

According to 2005-06 PSLM Survey data there is a marked difference in literacy rate as recorded in PIHS (2001-02) and PSLM (2005-06). A 9 percentage point increase has taken place over a period of just five years. Thus, showing a sharp and substantial rising trend in all the three indicators that is; literacy, Gross Enrolment rates (GER) and Net Enrolment Rates (NER). Within the literacy rates sex wise division shows that, as expected, literacy among males is higher. However, the rate of increase in literacy for females is faster as compared to the males. Province wise literacy data for PSLM (2005-06) as against PIHS (2001-02) show Punjab to be on the top (56% Vs 47%) followed by Sindh (55% Vs 46%), NWFP (46% Vs 38%) and Balochistan (38% Vs 36%).

According to the Education Census 2005, there are currently 227791 institutions in the country. The over all enrolment is recorded at 33.38 millions with teaching staff of 1.357 million. As shown in Fig.1, out of the total institutions 151,744 (67 percent) are in public sector catering to 22 million (64 percent) of enrolled students and 0.723 million (53 percent) of the teaching staff. In case of private sector, there are 76047 institutions (33 percent) catering to 12 million student and 0.632 (47 percent) of the teaching staff. In terms of physical infrastructure out of the total covered institutions 12737 (5 percent) have been found non-functional. From the covered institutions 12737 (11589 schools and 1148 others) almost all in the public sector have been reported as non- functional.

12. HEALTH AND NUTRITION

Access to essential health care is a basic human need and a fundamental human right. A healthy population is not only valued in its own right, but it also raises the human capital of a country thereby positively contributing to the economic and social development. This recognition of health and human development is reflected in cohesive agenda of Millennium Development Goals (MDGs) to which Pakistan is one of the signatories. The Constitution of Pakistan ensures the provision of basic necessities of life including health and medical relief for all citizens, irrespective of sex, caste, creed or race. The public health sector has been a priority area of the Government activities and the current health sector reforms focus on equitable, efficient and effective health interventions. The Government's commitments regarding health sector are spelled out in the form of MDGs, PRSP and MTDF.

A considerable improvement in health sector facilities over the past year is reflected in the existing vast network of health care facilities which consist of 4712 dispensaries, 5,336 basic health units/sub health centers (BHUs/SHCs) , 560 rural health centers(RHCs) ,924 hospitals, 906 maternal and child health centers(MCHs), and 288 TB centers(TBCs). Available Human resource for the fiscal year 2006-07 turns out to be 122798 doctors, 7388 dentist and 57646 nurses which make the ratio of population per doctor as 1254, population per dentist as 20839 and population per nurse as 2671. The new health facilities added to overall health services include construction of 87 new facilities(63 BHU and 24 RHCs) ,upgrading of 65 existing facilities(20 RHCs and 45 BHUs) and addition of 5000 new doctors, 2300 nurses and 14000 lady health workers. The total outlay on health sector is budgeted at Rs. 50 billion which shows an increase of 25% over the last year and turns out to be 0.57 % of GDP. To reduce incidence of disease and to alleviate people's suffering and pain so as to improve their health status, various health programmes remained operative during fiscal year 2006-07. These include the national programs for the prevention and control of tuberculosis, malaria, HIV/AIDS, hepatitis, blindness and program on maternal, neonatal and child health etc.

During the fiscal year 2006-07 the caloric availability per day is likely to increase from 2423 to 2425.

13. POPULATION, LABOUR FORCE & EMPLOYMENT

At the time of independence in 1947, 32.5 million people lived in Pakistan. By 2006-07, the population is estimated to have reached 156.77 million. Thus in roughly three generations, Pakistan's population has increased by 124.27 million or has grown at an average rate of 2.6 percent per annum. While Pakistan has more mouths to feed, more families to house, more children to educate, and more people looking for gainful employment, the high population also represents an abundance of labour which can be used for productive purposes. The large population also represents a large potential market for goods and services. This large consumer base with increasing disposable income may attract even more foreign investment. The large population therefore represents a big opportunity for Pakistan to benefit from demographic dividend which can fuel Pakistan growth for the next fifty years. The interest in relationship between population change and economic growth has reignited in Pakistan which is experiencing declining fertility and mortality rates and therefore declining growth in population. Consequently, Pakistan is witnessing changes in age structure with proportion of working age population increasing and offering a life time window of opportunity to turn demographic transition into demographic dividend.

Where exactly is Pakistan in this demographic transition? The Population Census data depicts two phases of demographic transition. During the first phase when fertility rates were higher the share of young age (0-14) population continued to rise thereby creating bulge in young age population while the share of working age (15-59) continued to decline until 1981. Pakistan appears to have entered the second phase of demographic transition from 1981 onward. As a result in decline in fertility rate from 6 percent to 3.8 percent during 1981 and until 2006 the share of working age (15-59) population continued to rise from 48.5 percent to 57.2 percent and accordingly the share of young age (0-14) continued to exhibit declining trend (from 44.5% to 36.8%). Thus, Pakistan is currently passing through the demographic transition phase which provides a lifetime window of opportunity to convert this transition into demographic dividend. Empirical evidence support the fact that Pakistan is in the second phase of demographic transition as more resources are available for investment , economic growth is accelerating and per capita income is rising at a faster pace. In other words, Pakistan has already started reaping its first dividend on the back of a large-scale spending on social sector (education, health vocational training, etc.) over the last several years.

In Pakistan, The labor force participation rate is measured on the basis of Crude Activity Rate (CAR) and Refined Activity Rate (RAR). The CAR is the percentage of the labor force in the total population while RAR is the percentage of the labor force in the population of persons 10 years of age and above. The labor market in Pakistan demonstrates a lower labor force participation rate (LFPR). It has been in the range of 28.6% -32.3% over a decade; even the RAR is low and hovered at 43% over a decade (see Table-13.6). It is nevertheless important to point out that both these ratios are increasing in recent years. This is mainly attributed to increasing economic activities that are fairly diversified and thus are not only generating employment opportunities but also motivating others to join workforce. The crude activity rate has stayed roughly constant since 1980, but has started to rise in the last few years: from 29.6% in year 2001-02 to 32.3% in 2005-06. Similarly, the RAR has also started to increase from past trend of 43.3% in 2001-02 to 46% in 2006-07. Participation rates are highest in Punjab and lowest in NWFP. These rising rates of participation point towards an increasing optimism in the labor market.

Agriculture remains the dominant source of employment in Pakistan. The share of agriculture in employment has increased from 43 percent in 2003-04 to 43.37 percent by the year 2005-06 however it has decreased from 47.5 percent in 1990, with manufacturing and trade and services absorbing a growing share of the work force. Targeting of labor intensive livestock and dairy sectors proved to be an important strategy for employment augmentation in rural areas. These are complemented by public sector funded small area development schemes. These strategies have successfully expanded rural employment, particularly at the local level. Agriculture is followed by wholesale and retail trade, community and social services and manufacturing sector. These sectors employ 14.67%, 14.35% and 13.84% workforce, respectively. An increase in the share of agriculture and manufacturing sector, however, is an indication that employment opportunities are created in both rural and urban dominated sectors. The policy of deregulation, privatization and liberalization helped in increasing the participation of private sector in the economy.

14. TRANSPORT AND COMMUNICATION

A well functioning Transport and communication system is a critical pre-requisite for a country's development. Investment in the infrastructure directly affects economic growth through many changes such as allowing producers to find the best markets for their goods, reducing transportation time and cost and generating employment opportunity. In addition, efficient transport and communication systems also have network effects and allow adoption of latest production techniques such as just-in time manufacturing.

Infrastructure development has been a priority area for Pakistan as evidenced by a number of projects completed or in progress. Major infrastructure projects completed during the last seven years include: Islamabad-Lahore Motorway (M-2), Makran Costal Highway, Nauttal-Sibi section including Sibi Bypass, Dera Allah Yar-Nauttal Section, Khajuri-Bewata Section N-70, Kohat Tunnel and Access Roads, Mansehar-Naran Section, Karachi Northern Bypass, Qazi Ahmed & Shahpur Jehania road, Ratodero-Shahdadkot-Qubo Saeed Khan, Pindi Bhattian-Faisalabad Motorway (M-3), Lahore-Sahiwal Section, Rahim Yar Khan-TMP Section, Baberlo-Pano Aqil Section, Torkham-Jalalabad road, rehabilitation of Band Road Lahore and inauguration of Gwader Port etc. Major on-going projects including, Islamabad-Peshawar Motorway (M-1), Lakpass Tunnel, Gwadar-Turbat-Hoshab (M-8), Khuzdar-Shahdadkot Section, Kalat-Quetta-Chaman Section, Sibi-Dhadar Section, Lyari Expressway, D.I. Khan-Mughalkot Section, Islamabad-Murree Dual Carriageway and R.Y. Khan-Bahawalpur Section. In the long term the transport system is likely to experience tremendous improvement with the implementation of the National Trade Corridor (NTC) programme.

The total length of roads in Pakistan was 259,197 Km, including 172,827 Km of high type (67 percent) and 86,370 Km of low type roads (33 percent) by the end of March, 2007. During the outgoing fiscal year, the length of high type roads has increased by 3.2 percent over the last year but the length of low type roads has declined by 5.6 percent.

The Pakistan Railways have carried 66 million passengers and 4.5 million tons freight. Its gross earnings stood at Rs.14.1 billion during July-March 2006-07.

PIA carried 4.2 million passengers during July-March 2006-07 as against 4.3 million in the same period last year showing decrease of 2.3 percent. Its fleet consists of 39 aircrafts of various types. Along with PIA, there are three private airlines are operating in the country and providing both domestic and international services.

Karachi Port has handled 22,427 thousand tons of cargo during July-March, 2006-07, compared to 24,572 thousand tons during the same period last year, showing decrease of 8.7 percent. The Port Qasim has handled 19.7 million ton of cargo during July-March 2006-07 as against 16.8 million cargo handled during corresponding period last year, registering a growth of 17 percent. The Gawader Port was inaugurated on 20th March 2007.

In 1999-2000, there were only 0.3 million cellular mobile subscribers in Pakistan which jumped to 2.4 million by 2002-03 as a result of introduction of cord pay phone (CPP) regime and addition of more mobile operator. Mobile subscribers continued to rise at an unprecedented pace, reaching 34.5 million by 2005-06. In a short period of 9 months in the outgoing fiscal year, more than 24 million new subscribers have been added to the list, reaching over 58.6 million by end April 2007. In other words more than 70 percent increase in subscribers in just 9 months. Accordingly, the total teledensity (Fixed + Cellular + WLL) has jumped form 3.7 percent in 2001-02 to 40.2 percent by end March 2006-07.For promotion of Information Technology, 2444 cities/towns/villages have been provided Internet facility, upto March, 2007.

15. ENERGY

Pakistan's economy has been growing at an average rate of over 7.6 percent per annum over the last three years and the government is making efforts to sustain the momentum going forward. Knowing well that there exists strong relationship between economic growth and energy demand government is making efforts to address the challenges of rising energy demand. These include, import of piped natural gas from Iran and Turkmenistan, import of LNG; increase in oil and gas exploration in the country; utilizing 175 billion tones of Thar coal reserves; setting up of new nuclear power plants; exploiting the affordable alternate energy resources and overhauling existing power generation plants to enhance their generation capacity. In addition to increasing supply, there is a need to promote efficient use of energy resources as well.

Production of crude oil per day has increased to 66,485 barrels during July-March 2006-07 from 65,385 barrels per day during the same period last year, showing an increase of 1.7 percent. The overall production of crude oil has increased to 18.2 million barrels during July-March 2006-07 from 17.9 million barrels during the corresponding period last year, showing an increase of 1.7 percent. On average, the transport sector consumes 50.7 percent of the petroleum products, followed by power sector (32.1 percent), industry (11.4 percent), household (2.2 percent), other government (2.3 percent), and agriculture (1.3 percent) during last 10 years i.e. 1996-97 to 2005-06.

The average production of natural gas per day stood at 3,876 million cubic feet during July-March, 2006-07, as compared to 3,825 million cubic feet over the same period last year, showing an increase of 1.3 percent. The overall production of gas has increased to 1,062,124 million cubic feet during July-March 2006-07 as compared to 1,048,190 million cubic feet daily in the same period last year, showing an increase of 1.3 percent. On average, the power sector consumes 36.4 percent of gas, followed by fertilizer (21.6 percent), industrial sector (19.1 percent), household (17.8 percent), commercial sector (2.7 percent) and cement (1.1 percent) during last 10 years i.e. 1996-97 to 2005-06.

The total installed capacity generation witness no change during July-March 2006-07, it was 19,440 MW in first nine months of current financial year. Total installed capacity of WAPDA stood at 11,363 MW during July-March 2006-07 of which, hydel accounts for 56.9 percent or 6,463 MW, thermal accounts for 43.1 percent or 4,900 MW. During first three quarters of current fiscal year 71,033 GWh electricity has been generated as against 66,110 GWh were produced in the same period last year showing an increase of 7.4 percent. The number of villages electrified increased to 113,605 by March 2007 from 103,231 up to 2005-06, showing an increase of 10 percent.

Presently, some 1414 CNG stations are operating in the country in 85 cities and towns. By March 2007 about 1.35 vehicles were converted to CNG as compared to one million vehicles during the same period last year, showing an increase of 35 percent. On average 29,167 vehicles are being converted to CNG every month. With these developments Pakistan has become the leading country in Asia and the third largest user of CNG in the world after Argentina and Brazil.

16. ENVIRONMENT

Pakistan recognizes the importance of incorporating environmental concerns as a cross-cutting theme in its sustainable development strategy. In Pakistan, environmental degradation is intrinsically linked to poverty because of the overwhelming dependence of the poor on natural resources for their livelihoods—whether agriculture, forestry, fisheries, hunting etc. Poverty combined with a burgeoning population and rapid urbanization, is leading to intense pressures on the environment.

Pakistani cities are facing problems of urban congestion, deteriorating air and water quality and waste management while the rural areas are witnessing rapid deforestation, biodiversity and habitat loss, crop failure, desertification and land degradation. The Government has initiated the National Environment Action Plan (NEAP) in 2001 as an umbrella programme to address these environmental concerns in a holistic manner. The United Nations Development Programme has been supporting the implementation of this initiative though the NEAP Support Programme (NEAP-SP). In March 2007, NEAP-SP programme entered its second phase. The NEAP-SP Phase-II will be guided from the experiences gained in Phase-I and help translate the NEAP into action, while enhancing the poverty-environment nexus aspects in operational terms.

The Government has also committed itself to achieving the Millennium Development Goals (MDGs) as adopted by the UN member states in the year 2000. The MDG target for "land area to be protected for the conservation of wildlife" is 12 percent by 2015. Pakistan already has 11.3 percent of its area under protection for conservation of wildlife. Thus, it is very likely that this target can be met by 2015. The Government's MDG target for number of vehicles using CNG (which previously used diesel and petrol) is 920,000 whereas the current estimate for 2005-2006 is 1.4 million. Therefore, Pakistan has already met its MDG target well in advance. This achievement has been made possible because of the tremendous growth in the number of vehicles that are converting to CNG due to the Government's resolve regarding the development of the CNG sector as a cleaner and economical energy alternative. The MDG target of environmental sustainability aims to "halve, by 2015, the proportion of people without sustainable access to safe drinking water and basic sanitation". It is also concerned with improvement of the lives of slum dwellers. In Pakistan, this target has been adapted to mean proportion of katchi abadis that have been regularized. The major cities of Pakistan have been suffering from deteriorating air quality due to a relatively higher population growth; absence of public transport services and tremendous increases in the number of privately owned vehicles.

Pakistan's steady economic growth has been accompanied by rising urbanization, higher income and affluence, and an increase in the private ownership of motor vehicles. In the absence of any urban transport policies and sustained investments in public transport, most urban citizens rely either on their private motor vehicles or the informal transport sector for urban transport. The resulting urban congestion is straining the capacity of the Government to resolve the urban transport issues and fund sustainable solutions. As a consequence, urban areas of Pakistan are experiencing a deterioration in air quality. The Government's response to vehicular pollution and to improve ambient air quality has been to promote CNG as a cleaner alternative. Currently, 1,450 CNG stations were operational throughout the country while another 1,000 are under construction. To date, Oil and Gas Regulatory Authority (OGRA) has issued more than 5700 provisional licenses for the establishment of CNG Stations in the country. Pakistan's CNG fleet is the largest in Asia and the third largest in the world after Argentina and Brazil. The sector has already attracted the investment of Rs. 60 billion and more is expected. The tremendous growth in this sector has led to job creation and till date approximately 60,000 new jobs have been created. In line with a Cabinet directive, the Federal Government is providing incentives in the form of payment of the markup (either complete or partial) of the loans required to purchase new CNG vehicles. In this regard, the cities of Karachi, Hyderabad, Lahore, Rawalpindi, Islamabad, Peshawar and Quetta are phasing out diesel vehicles in favour of CNG buses for intra-city transportation. All new buses, mini buses and wagons will be dedicated CNG – or dual fuel vehicles. Provincial governments are also taking initiatives to promote CNG conversions. For example, the Punjab Government is giving 20 percent of the capital cost for purchasing new CNG vehicles.

The increased groundwater utilization for domestic and agricultural use has adversely affected groundwater quality particularly in the irrigated areas with almost 70 percent tube wells now pumping hazardous sodic water. Due to greater dependence on this resource for meeting the ever-growing agricultural requirements, water table decline has also been observed in many areas. Despite the generally arid nature of Pakistan's climate, 10 percent (780,000 ha) of the total surface area of the country is covered by wetlands, which are of global importance. In addition, almost all of Pakistan's wetlands are inhabited by people. Due to growing population pressures and habitat loss induced by climate change, the wetlands are facing increasing pressures. It is feared that these wetlands may not be able to take on much additional pressure and their productivity needs to be preserved, enhanced and sustained. Target 10 of MDG 7 deals with sustainable access to safe drinking water and basic sanitation. Currently, only 54 percent of the population of Pakistan has access to safe sanitation and 66 percent to safe drinking water, whereas the targets for 2015 are 90 percent and 93 percent respectively. Even though there has been an improvement in water supply coverage from 53 percent in 1990 to 66 percent in 2005, however, the MDG target of 93 percent poses a considerable challenge. Pakistan has committed to increasing forest cover to 5.7 percent by 2011 and to 6 percent by the year 2015. An increase of 1.2 percent implies that an additional

1.051 m.ha area has to be brought under forest cover within the next ten years. This will include all state lands, communal lands, farmlands, private lands and municipal lands. In terms of the MDG target with respect to protected areas established to conserve rapidly declining wildlife species in their natural environment, Pakistan has committed to improve and enhance its existing network of protected areas in terms of quality and quantity from 11.25 percent in 2001 to 12 percent by 2015.

To address the various challenges mentioned above, the Government is implementing various policies and programmes; many of which have come out of the National Environment Action Programme of the Ministry of Environment. In this regard, the National Environment Policy prepared under NEAP serves as an overarching framework for various interventions in the environment sector. Some of the key policies and programmes that have stemmed from NEAP are: Air and water Quality Monitoring, Clean Drinking Water for all, Pakistan Wetlands programme, National Sanitation Policy, Sustainable Land Management to Combat Desertification in Pakistan, Environmental Rehabilitation and Poverty Reduction through Participatory Watershed Management in Tarbela Reservoir and Energy Efficiency and Renewable Energy etc.

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