OVERVIEW OF THE ECONOMY

Fiscal year 2007-08 has been a difficult year for Pakistan's economy. Several political and economic events, both on domestic and external front, occurred unexpectedly. These events include: disturbed political conditions; an unstable law and order situation; supply shocks; soaring oil, food and other commodity prices; softening of external demand; and turmoil in the international financial market. All these events have adversely affected the key macroeconomic fundamentals of Pakistan during the fiscal year 2007-08. The most important aspect, however, has been the non-responsive stance on account of political expediency in addressing domestic and external challenges during most part of the fiscal year, further accentuating macroeconomic difficulties.

Notwithstanding these extraordinary developments Pakistan's economy posted a robust growth of 5.8 percent in 2007-08, as against 6.8 percent last year and this year's target of 7.2 percent. When viewed in the medium-term perspective, Pakistan's growth performance is still striking, with real GDP growing at an average rate of 7.0 percent per annum over the last five years (2004-08). The growth of this magnitude not only shows its resilience but also provides a source of optimism that regaining the growth momentum through a combination of adjustments and reforms is very much a plausible assumption.

Economic growth in 2007-08 is principally driven by the services sector, posting a growth of 8.2 percent as against 7.6 percent last year. The commodity-producing sector with agriculture and manufacturing, showing a dismal performance, has contributed to the slippage in growth for the year 2007-08. Within the commodity producing sector, agriculture, especially major crops, performed dismally. While overall agriculture grew by 1.5 percent, major crops infact, posted a negative growth of 3.0 percent. Livestock, accounting for 52 percent of agriculture, was the saving grace as it recorded a modest growth of 3.8 percent. The performance of the other component of the commodity producing sector, that is, manufacturing was hampered by a series of negative shocks; including soaring oil prices, severe energy shortages at home, and political unrest and social disruptions at regular intervals. Within manufacturing, large-scale manufacturing printed a relatively feeble growth on the back of domestic and external shocks. The cumulative impact of monetary tightening along with a weaker external demand, also played its role in dampening this year's large-scale manufacturing growth.

Unlike last year when three major components of the economy namely, agriculture, industry and services contributed adequately to growth, this year's growth is certainly not broad-based. Infact, three-fourth contribution to this year's growth came from the services sector alone with only one-fourth coming from the commodity producing sector. It is, therefore, safe to conclude that this year's growth is services sector-led-growth. The developments on the domestic and external fronts also influenced the growth patterns for the year. Unlike last year when consumption, investment and net exports contributed 38.3 percent, 45 percent and 16.7 percent, respectively; the growth pattern of this year prints a different picture. Economic growth for the year 2007-08 is entirely driven by consumption, particularly private consumption. The contribution of investment declined significantly from 45 percent last year to almost 12 percent this year. Net exports remained a drag this year with a 20 percent negative contribution. It would, therefore, be safe to describe this year's growth as a service/ consumption-led growth.

Fiscal year 2007-08 has however, been an extra-ordinary year in which many exogenous and endogenous shocks along with policy inactions during most part of the year, severely impacted the performance of the economy. Pakistan's economy is currently facing four major challenges, that is, deceleration in growth, rising inflation *(particularly food inflation),* a growing fiscal deficit, and the widening of trade and current account deficits. Among these, fiscal, trade and current account deficits are largely the outcomes of external shocks of extra-ordinary proportions accompanied by policy inaction during most part of the fiscal year.

Growth has decelerated to 5.8 percent principally on account of the poor performance of agriculture owing to the dismal performances of major crops such as wheat and cotton *(together they contribute over 20 percent and 4.2 percent to agriculture and GDP, respectively)* and the dismal performance of manufacturing, particularly large-scale manufacturing at the back of a series of domestic and external shocks *(political instability, a worsening security environment, severe power shortages, weaker external demand and the rising cost of doing business).*

Overall inflation, particularly food inflation, at 17.2 percent and 25.5 percent, respectively in April 2008 are the highest increases in over three decades. The oversized spike in inflation owes to an unprecedented rise in the prices of food, fuel and other commodities at the international level. Poor governance in managing the wheat crises and the lack of attention paid to minor crops and the livestock and dairy sector by successive governments, also contributed to the surge in the domestic price level. Signs of consumers' angst about the inflation outlook are emerging as prices of oil, food and other commodities are rising. Inflationary pressure is not likely to ease, at least, in the next two / three years owing to the continuing increase in global food and fuel prices, the second round effects of previous food / energy price shocks, a gradual removal of fuel and power subsidies, a weaker rupee, higher import prices and monetary overhang from the unprecedented government borrowing from the SBP for budgetary financing. A prolonged inflation overshoot will lead to a sustained deterioration in inflationary expectations, with a growing demand for wage hikes, in turn causing a wage-price spiral to gain strength. Such a scenario will ultimately require a more aggressive tightening in fiscal and monetary policies to bring inflation back to the targeted level.

The hard earned macroeconomic stability, underpinned by fiscal discipline, is under threat because of the large slippages in the Budget 2007-08. As against the target of 4.0 percent of GDP, fiscal deficit for the year is likely to be 6.5 percent *(based on information available till May 23, 2008)* because of the slippages in revenue and expenditures. Slower-than-the targeted real GDP growth and the adverse law and order situation resulted in lower-than-the targeted tax collection. Failure to pass on the increases in the international prices of oil and food to domestic consumers severely affected current expenditures as the government continued to finance these increases through the budget, with subsidies rising to an unsustainable level. A subsidized power tariff also added to the slippages. The extra-ordinary increase in development spending was not consistent with a stable macroeconomic framework. The increase in fiscal deficit coincided with a sharp decline in the external financing flows. Consequently, the government was forced to rely on SBP for budgetary financing. Government borrowing from the SBP has reached an all time high, leading to excessive monetary expansion and thus becoming one of the principal sources of inflationary build up in the country. In other words, financial indiscipline during the year, mainly on account of political expediency, has already caused severe macroeconomic imbalances, for which, Pakistan is likely to pay a heavy price in terms of deceleration in growth and investment, and the associated rise in poverty; the widening of current account deficit and the attendant rise in public and external debt; a loss of foreign exchange reserves and the associated pressure on the exchange rate, and most importantly, higher inflation and the accompanying rise in interest rates. There is no better way to explain the central importance of fiscal discipline in promoting growth and investment. Fiscal year 2007-08 has reminded us clearly that even one year of fiscal indiscipline is enough to damage several years of efforts to restore macroeconomic stability.

The slippages in the fiscal account as well as the unprecedented rise in the prices of oil and food items have contributed to the widening of both trade and current account deficits. The current account deficit during the first ten months of the fiscal year amounted to $ 11.6 billion – up by 75 percent over the same period last year. The impact of the rising current account deficit on the country's overall balance of payments was further compounded due to a decline in financial and capital account flows on account of a drop in net portfolio investment, delays in the planned floatation of a sovereign bond and Global Depository receipts (GDRs) and putting on hold the floatation of an Exchangeable Bond. Accordingly, the overall balance of payments is in deficit which is partly financed through reserves draw-down. Such a large current account deficit is not sustainable.

As stated early, fiscal year 2007-08 has been a challenging year for the economy of Pakistan. Even in the midst of the most difficult times the performance of some of the key economic indicators has been robust, reflecting the resilience of the economy. Firstly, though economic growth missed the target for the year, a growth of close to 6.0 percent on the back of extra-ordinary developments at home and abroad is by no means a small achievement. Secondly, the services sector continued to maintain a solid pace of expansion at 8.2 percent. Thirdly, the country produced 63.9 million tons sugarcane – the highest production level in the country's history. Fourthly, construction and banking and insurance – components of GDP, continued their stellar performance, posting growths of 15.2 percent and 17.0 percent, respectively. Fifthly, Pakistan's per capita income, in current dollar terms crossed the $ 1000 mark and stood at $ 1085, depicting an increase of 17.2 percent. Sixthly, despite continuous monetary tightening, private sector credit has grown consistently and has even outpaced last year's growth. In particular, credit to manufacturing has been steady. Seventhly, despite adverse domestic and external developments throughout the year, Pakistan's exports posted a decent growth (10.3%) compared to last year (3.6 %). Eighthly, at the back of political instability and adverse law and order conditions, workers' remittances recorded a commendable growth, up by 19.5 percent to $ 5.3 billion. Ninthly, at the backdrop of extreme political instability and heightened security concern, Pakistan succeeded in attracting $ 3.5 billion FDI in the first ten months *(July-April)* of the current fiscal year – almost $ 700 million less than last year. Another approximately $ 800 million FDI in financial business has been transacted in May 2008 which include a $ 680 million Maybank strategic investment in MCB bank and a $ 100 million investment by Barclays bank , reflecting continued investor's confidence in Pakistan's economy. The year is likely to end with a respectable amount of FDI.

Notwithstanding these positive developments taking place in a most difficult circumstances during 2007-08, there are however several key macroeconomic indicators which have understandably missed their targets for the year. The key indicators that missed their targets are summarized as: (i) economic growth at 5.8 percent remained below the target of 7.2 percent, (ii) agriculture performed poorly at 1.5 percent against the target of 4.8 percent on the back of the less-than-targeted production of wheat and cotton and marginal increase in rice production. (iii) manufacturing in general and large-scale manufacturing in particular, after growing at a torrid pace in recent years, decelerated to 5.4 percent and 4.8 percent against the targets of 10.9 percent and 12.5 percent, respectively (iv) overall investment, after gaining a new height of 22.9 percent of GDP last year, declined to 21.6 percent against the target of 23.3 percent, (v) national savings as percentage of GDP declined sharply to 13.9 percent against the target of over 18.3 percent; (vi) government borrowing from the State Bank of Pakistan (SBP) reached an all time high of Rs.544 billion during the fiscal year until May 19, 2008 with stocks of borrowing from the SBP reaching at Rs.946 billion or 9.0 percent of GDP, the highest ever in Pakistan's history and more than double of last year's level; (vii) overall fiscal deficit is likely to be 6.5 percent of GDP against the target of 4.0 percent, with almost 80 percent of this year deficit financed from the SBP borrowing; (viii) under the Fiscal Responsibility and Debt Limitation Act 2005, the revenue deficit *(total revenue minus current expenditure)* was to become zero by end-June 2008. As a consequence of large fiscal slippages, the revenue deficit is likely to be Rs.287 billion or 2.7 percent of GDP – a violation of the Act; (ix) the Federal Board of Revenue (FBR) target *(Rs.1025 billion)* is likely to be missed by at least Rs.25 billion – first time a slippage in several years; (x) the overall CPI-based inflation is averaging 10.3 percent during the first ten months of the fiscal year, surpassing the target of 6.5 percent by a wide margin, whereas food inflation is averaging at 15 percent while non-food inflation stood at 6.8 percent; (xi) both trade and current account deficits deteriorated substantially against their targets, creating severe financial imbalances; (xii) until last year, Pakistan's debt profile continued to improve but is likely to deteriorate this year. The declining trend in the public and external debt burden is likely to be reversed this year; (xiii) the Fiscal Responsibility and Debt Limitation Act 2005 requires that public debt as percentage of GDP must decline by 2.5 percentage points. Instead of declining, the public debt is likely to increase over the last year - a clear violation of the Act; (xiv) external debt as percentage of GDP is likely to remain at last year's level, however, as percentage of foreign exchange earnings, this has already increased over last year; (xv) the exchange rate has come under severe pressure since December 2007 but more so during April 2008 onward on account of a widening current account deficit and an uncertain political environment in the country; (xvi) foreign exchange reserves witnessed significant depletion – declining from 30.6 weeks of import cover to 19.4 weeks; (xvii) domestic and external factors prevented Pakistan from launching sovereign and exchangeable bonds.

Global Economic Environment

While unsettled domestic political conditions and a heightened security environment have adversely impacted the performance of Pakistan's economy, the external developments have equally played an important role in accentuating Pakistan's macroeconomic imbalances.

The year 2007-08 has been a turbulent year for the world economy as well. This year has seen soaring energy prices, an unprecedented surge in food inflation and a financial market crisis to match the Great Depression. These developments have had adverse consequences of differing degrees for economies in different parts of the world. The global economy is in the midst of one of the biggest oil shocks in history. Since 2000, oil price has risen from \$ 15 /bbl to \$ 130 /bbl. The current oil shock is comparable in magnitude to that of 1970s that ushered in a period of stagflation. On the contrary, despite the surge in oil prices, there are scant signs that the current oil shock is affecting the global economy in a manner similar to the 1970s. A lot has changed since the 1970s. For example, energy efficiency has improved, the underlying global productivity growth has remained strong, and inflation expectations are better anchored today. As such, despite a surge in oil prices, the global economy continues to grow at a healthy pace.

Inflation is uncomfortably high in almost every corner of the world, creating serious difficulties for policy makers. Everywhere, the root cause is rising food and fuel prices underpinned by surging demand from fast growing developing economies like China and India. The longer food and energy prices keep pushing up overall inflation, the greater the chance that expectations of higher inflation would lead to bigger pay demands, thereby triggering a wage-price spiral, as witnessed in the 1970s.

The world stands on the brink as agricultural commodity prices surge, triggering food riots in countries from Haiti to Bangladesh. Food demand is rising as the world's population expands and a swelling middle class has emerged in countries such as China and India, consuming more proteins *(dairy and livestock)*. The development of the bio-fuel industry reduced the availability of food, leading to surge in their prices. Raising agricultural productivity at the global and national levels is the only viable solution to address this challenge. If there is no increase in yields there will be hunger and famine in most part of the world.

On the back of these developments, the world economy is still enjoying a period of healthy growth with every region doing well. The world economy posted a solid growth of 4.9 percent in 2007 – 0.5 percentage point lower than last year. The US economy is projected to grow by 0.5 percent in 2008 from 2.2 percent this year, primarily on account of the collapse of the sub-prime market. The Euro zone is projected to grow by 1.4 percent in 2008 compared with 2.6 percent in 2007, mainly on account of rising oil prices, appreciation of the Euro resulting in sluggish export growth, and the decline in real disposable income on account of the financial crisis leading to the deterioration of consumer and business sentiment.

Growth in the emerging and developing economies, though remaining strong, showed some signs of deceleration compared with last year. For emerging economies as a group, the performance has been encouraging as foreign exchange inflows, foreign exchange reserve growth, and FDI remained strong. The loss of trade due to the global financial crisis has been limited. Against this backdrop, developing and emerging economies have outperformed advanced economies by growing at a brisk pace of 7.9 percent in 2007 but likely to moderate to 6.7 percent in 2008.

The year 2007-08 saw China and India accounting for more than one-half of growth in world output. The performance of these two economies have been hampered by rising energy and food prices, supply-side shocks in the form of bad weather and a devastating earthquake in China, and a mild spill-over from the global financial crisis. A deliberate effort is also underway to avoid over-heating of the Chinese economy. On the other hand, the softening of external demand and the cumulative impact of monetary tightening will likely moderate growth in India. China's growth is likely to decelerate from 11.4 percent in 2007 to 9.3 percent in 2008. Similarly, India's growth is poised to decelerate from 9.2 percent to 7.5 percent during the same period. Other countries in developing Asia also recorded modest-to-strong growth in the range of 4.8 percent *(Thailand)* to 7.3 percent *(Philippines)* with Pakistan, Sri Lanka, Malaysia and Indonesia taking a middle ground.

An international economic crisis of such a nature has not been witnessed in the past. The fallout has been complicated further by ever increasing globalization and inter-linkages in modern day financial markets. The trend of disappointing data from the advanced economies continues sending shock-waves through markets in both developed and developing nations each time. Until transparency in financial markets is achieved, the credit crunch will continue. Policy responses to the slowdown are harder to achieve given the recent trend in energy and food prices, fueling inflation. Advanced economies are focusing on improving liquidity conditions and providing stimuli to the economy. There might be no quick fix to the current situation, as can be seen in the low growth projections for next year, but all efforts must be made to couple monetary and fiscal responses with reforms in the financial sectors, increasing transparency and providing borrowers and lenders with more information. Although growing at above average rates, developing countries need to keep a close eye on inflation, while guarding against any spill-over effects from the global slowdown.

GDP Growth: Real GDP grew at a robust rate of 5.8 percent in 2007-08 as against the revised estimates of 6.8 percent last year and the 7.2 percent target for the year. When viewed in the backdrop of major disruptions of extraordinary nature, economic growth in 2007-08 appears satisfactory. In the medium-term horizon, the real GDP has grown at an average rate of 7.0 percent per annum during the last five years (2004-08). Unlike last year, the growth for the year has not been broad-based as the performance of agriculture and manufacturing have been far from satisfactory. Agriculture grew by 1.5 percent at the back of a negative (-3.6 %) growth in major crops. The growth outcome of 1.5 percent for agriculture would have been higher if not for a decline in production of wheat and cotton and almost stagnant production of rice. Livestock, accounting for 52 percent of agriculture, failed to lift the growth in agriculture as it posted a modest growth of 3.8 percent. Major crops and livestock, contributing 86 percent to agriculture could not provide enough support to record a decent growth. Accordingly, the contribution of agriculture in real

GDP growth declined to 5.2 percent in 2007-08 as against 12 percent last year.

The performance of the manufacturing sector remained subdued as it was hit hard by domestic and external factors. The overall manufacturing sector recorded a modest growth of 5.4 percent as against 8.2 percent last year. Accordingly, its contribution to this year's growth declined to 17.2 percent as against 22 percent last year. Large-scale manufacturing, accounting for 70 percent of overall manufacturing, suffered from a variety of factors including political instability, frequent eruptions of incidents detrimental to law and order and resulting in loss of working hours, incidence of violence causing damage to property and forcing industries to remain closed for many days, power shortages preventing industries from operating at their capacity level, and higher energy and capital costs. Accordingly, large-scale manufacturing recorded feeble growth of 4.8 percent, down from 8.6 percent last year.

This year's real GDP growth was also powered by stellar growth in the construction and banking and insurance sectors, respectively growing by 15.2 percent and 17.0 percent. Brisk pace of activities in housing and high-rise buildings, along with large public sector spending on physical infrastructure, and on-going reconstruction activities in the earthquake affected areas contributed to the sharp pick up in construction value-added. Construction has been growing at an average rate of 10.2 percent per annum over the last five year. The on-going reforms in the banking and financial sector have made this sector highly attractive to foreign investors. This sector has been growing at an average rate of 23 percent per annum over the last five years. Accordingly, its share in GDP has almost doubled in the same period. Electricity and gas distribution continues to be a drag on growth for the last four years. This sector is contracting at an average annual rate of 11.0 percent per annum and accordingly, its share in GDP has fallen by one-half during the period. Maintaining its past trend, electricity and gas distribution registered a negative growth of 14.7 percent in 2007-08 on account of high operating expenses of the WAPDA, offsetting its gross value added.

The services sector continued to perform strongly for the fourth year in a row with 8.2 percent growth in 2007-08. This sector has grown at an average rate of 7.3 percent per annum over the last five years. Major contributors to this year's services growth include: wholesale and retail trade, banking and insurance, public administration and defense, and social services. All these sectors have posted strong growth in 2007-08. As stated at the outset, this year's growth is not broad-based. Infact, three-fourth contribution to this year's growth alone came from the services sector while the remaining one-fourth contribution owed to the commodity-producing sectors *(agriculture and manufacturing)*

Agriculture: Notwithstanding its declining share in GDP, agriculture is still the single largest sector of the economy, contributing 21 percent to GDP. Agriculture performed poorly in 2007-08, growing at 1.5 percent against the target of 4.8 percent and 3.7 percent of last year. The poor performance of agriculture can be attributed to an equally poor performance in major crops and forestry, registering a negative growth of 3 percent and 8.5 percent, respectively. Livestock, minor crops and fishing have been the saving grace for agriculture as these sectors have performed reasonably well to compensate the poor performance of the major crops and forestry. Major crops, accounting for 34 percent of agriculture and 7.1 percent of GDP, suffered on account of poor showing of wheat and cotton and a less than satisfactory performance of the rice crop. Sugarcane and maize, being the other two major crops, performed impressively in 2007-08.

The cotton crop suffered for a variety of reasons, including heavy rainfall in May 2007 causing poor germination in Punjab, high temperatures during August and September 2007 causing more shedding of fruit parts and pest attacks, especially the dangerous mealy bug infestation. Consequently, cotton production declined to 11.7 million bales this year from 12.9 million bales last year – thus registering a negative growth of 9.3 percent. The wheat crop was also adversely affected by the 23.3 percent shortage of irrigation water over normal supplies during Rabi, and the sharp pick up in prices of DAP fertilizer.

Accordingly, production of wheat declined to 21.7 million tons from 23.3 million tons last year, thus registering a decline of 6.9 percent. In sheer contrast, the two other major crops performed better with sugarcane recording the highest ever production level of 63.9 million tons, 16.8 percent higher than last year. The production of rice witnessed a modest growth of 2.3 percent and stood at 5.6 million tons. The production of other major crops such as maize was up by 7.3 percent, while gram pulse registered a negative growth of 1.8 percent, mainly on account of a higher base effect as this crop grew by 75 percent last year.

Minor crops, accounting for 12 percent in agricultural value added, posted a growth of 4.9 percent against the negative growth of 1.3 percent last year. The performance of livestock, accounting for 52 percent of agricultural value added, was satisfactory at best as it grew by 3.8 percent this year. The performance of fisheries has been impressive as it grew by 11 percent in 2007-08 while forestry continued its traditional pattern of negative growth for the fifth year in a row.

The growth performance of agriculture over the last six years has been of a volatile nature- ranging from 1.5 percent to 6.5 percent. The volatility in agricultural growth is mainly caused by the crops sector which is associated with the vagaries of Mother Nature, pest attacks, adulterated pesticides etc. Such volatility is detrimental to income growth of farmers and hampers government efforts to reduce poverty.

For Pakistan, the notion of food security should move beyond a relatively static focus on food availability. Higher agricultural growth, particularly emanating from the crop sector, will provide food security by increasing supply, stabilizing prices, and raising incomes of poor farm households. While the current global food crisis is creating difficulties, primarily for net-food importing countries, it also provides an enormous opportunity to gain from recent food price hike. Pakistan can certainly benefit from the current global food crisis. What Pakistan needs is a change in policy orientation from the current practice of focusing exclusively on price to yield enhancement and simultaneously address structural issues such as poor crop management and skills of farmers; use of cheaper seeds; lack of agricultural infrastructure and higher post-harvest losses; limited research as well as the gap between available research and practical applications; and inadequate funding for research and development.

The emerging economies have become more affluent as they have sustained higher economic growth in recent years. Such affluence is impacting the consumption patterns of households, including a dietary change towards higher quality food such as meat and dairy products. As a result, the production of these items is rising globally. In Pakistan, however, the livestock and dairy sector has received little or no attention by the successive governments in the past despite the fact that it accounts for 52 percent of agriculture, 11 percent of GDP, and affects the lives of 30-35 million people in rural areas. It is an irony that the entire government machinery has focused its attention on major crops, that too on only four crops (rice, wheat, cotton, sugarcane), which accounts for only 34 percent to agricultural value added, while livestock, which accounts for 52 percent, has never received similar attention in the past. In order to achieve higher sustained growth in agricultural value added, it is absolutely necessary to give due attention to the livestock and dairy sector *(whose performance does not depend on Mother Nature)* to achieve multiple objectives of attaining food security as well as poverty reduction.

Manufacturing: Manufacturing is the second largest sector of the economy, accounting for 19 percent of GDP. This sector has recorded its weakest growth in a decade during fiscal year 2007-08. Overall manufacturing posted a growth of 5.4 percent during the first nine months (July-March) of the current fiscal year against the target of 10.9 percent and last year's achievement of 8.2 percent. When viewed in the medium-term perspective, the performance of the manufacturing sector has been impressive as it posted an average growth of 10.4 percent per annum during the last five years. Large-scale-manufacturing (LSM), accounting for almost 70 percent of overall manufacturing, registered a less-than-satisfactory growth of 4.8 percent in fiscal year 2007-08 against the target of 12.5 percent and last year's achievement of 8.6 percent. The less-than-satisfactory performance this year is a combination of structural as well as specific issues. The relatively slower pace of expansion this year perhaps exhibits signs of moderation on account of higher capacity utilization, difficulties in textile and other important sectors such as fertilizer, soap and detergent, vegetable ghee and cooking oil, automobile sector, paper and paper board, and billets.

This year's performance has also been adversely affected by domestic and international factors. Heightened political tension, frequent eruptions of incidents detrimental to law and order resulting in loss of working hours, incidence of violence causing damage to property and forcing industries to remain closed for many days, growing power shortages preventing industries from operating at their capacity level, higher cost of capital and the rising cost of doing business have been responsible for the less than satisfactory performance of LSM this year. This sector has been growing at an average rate of almost 12 percent per annum during the last five years; however, signs of deceleration have emerged since 2005-06 at the onset of the monetary policy tightening phase as well as saturation of the existing capacity level. Going forward, political stability, improved law and order situation, and the availability of power will be the key to regaining the lost growth momentum in LSM.

Per capita Income: Per capita income is treated as one of the foremost indicators of the depth of growth and general well-being of any country. Despite the array of recent and more sophisticated tools to measure growth, development and economic advancement, none match the historical importance and the simplicity of per capita income as a measure of the average level of prosperity of any country. Per capita income, defined as Gross National Product at current market price in dollar terms divided by the country's population, has grown at an average rate of above 13 percent per annum during the last five years rising from $586 in 2002-03 to $926 in 2006-07 and further to $1085 in 2007-08. Per capita income in dollar terms rose from $926 to $1085 in 2007-08 depicting an increase of 18.4 percent. *Real* per capita income in Rupee terms has also increased by 4.7 percent, on average, for the last five years. *Real* per capita income grew by 4.2 percent as compared to 4.8 percent last year. The main factors responsible for the rise in per capita income over the years include: acceleration in real GDP growth, a stable exchange rate and a more than five-fold increase in the inflow of workers' remittances.

Consumption: Pakistan's economic growth is historically characterized as consumption-led growth and this is also found true for the year 2007-08. In recent years, Pakistan's economy has undergone a structural shift which fuelled rapid changes in consumer spending patterns. Pakistan's real per capita GDP has increased at an average rate of 5 percent per annum over the last five years, giving rise to the average income of the people. A more than five-fold increase in inflows of workers' remittances have also influenced the domestic consumption patterns as they have enhanced local purchasing power, especially in rural areas, and provided an important hedge against higher domestic inflation. These two factors have led to a sharp increase in consumer spending during the last five years. The *real* private as well as total consumption expenditure have grown at an average rate of 7.5 percent per annum during the last five years and played an important role in sustaining a growth of 7 percent per annum during the same period. Against an average growth of 7.5 percent, the real private consumption expenditure grew by 8.5 percent in 2007-08 and accordingly, its contribution to overall GDP growth has been more than 100 percent which was only neutralized by the negative contribution of net exports to the extent of 21 percent. Investment contributed approximately 12 percent to this year's growth as compared to 45 percent last year. This year's economic growth, therefore, is largely consumption driven and support from investment has declined substantially. National savings have shown their inadequacy for financing the new investment as it witnessed a sharp decline from 17.8 percent of GDP last year to 13.9 percent this year, thereby portraying a sharp increase in the current account deficit.

Investment: After reaching a record level of 22.9 percent of GDP in 2006-07, total investments declined to 21.6 percent - a decline of 1.3

percentage points. *Fixed investment* decreased to 20 percent of GDP from 21.3 percent last year. While public *sector investment* remained at last year's level of 5.7 percent, *private sector investment* however, registered a decline of 1.4 percentage points - declining from 15.6 percent to 14.2 percent. Investment is a key determinant of growth. Total investment has increased from 16.6 percent of GDP in 2003-04 to 21.6 percent this year, showing an increase of 5 percent of GDP in the last five years. In fiscal year 2007-08, gross fixed capital formation or domestic fixed investment grew by 12.5 percent in nominal terms as against 18.6 percent last year. In real terms, it grew by 3.4 percent as against 16 percent last year. The composition of investment between public and private sector has remained unchanged over the last five years as the former continues to account for approximately 72 percent despite continuous monetary tightening during the period.

Private sector investment was broad based. The energy sector has played a key role in attracting private sector investment. The overall fixed investment destined to the energy sub-sectors, namely mining and quarrying and electricity and gas distribution, witnessed their highest increases by growing at 29.4 percent and 12 percent respectively in real terms. Other major contributors to overall fixed investment growth are: wholesale and retail trade (9.3 %); services (10.6 %); public sector and general government investment collectively grew by 9.7 percent in real terms while public sector investment alone registered a growth of 16.1 percent in real terms. Barring transport and communication, public sector investment in all other sectors rose sharply at high double-digits, thus enabling overall public sector investment to grow at 16.1 percent this year in real terms.

The contribution of national savings to domestic investments is indirectly the mirror image of foreign savings required to meet investment requirements. The requirement of foreign savings needed to finance the saving-investment gap simply reflects the current account deficit in the balance of payments. National savings, at 13.9 percent of GDP, is the lowest since 1999-2000 and was able to finance only 69.5 percent of fixed investment in 2007-08 as against 83.6 percent last year. Domestic savings also declined substantially from 16 percent of GDP last year to 11.7 percent this year.

Foreign direct investment has also emerged as the major source of private external flows in Pakistan as well as contributing to the growth of domestic fixed capital formation. Fiscal year 2007-08 has been a difficult year for foreign investment in developing countries because of the crisis in the international financial markets. Overall foreign investment in Pakistan was affected not only by the difficult external environment but also domestic political developments and security concerns. In a most difficult domestic and external environment, Pakistan succeeded in attracting \$3.6 billion worth of foreign investment in the first ten months of the current fiscal year as against \$5.9 billion in the same period last year. It may be pointed out that last year was an extraordinary year as Pakistan attracted \$8.4 billion of total foreign investment. Additionally, in the month of May, two more transactions in the financial business sector have been completed. These include Maybank of Malaysia buying shares of Muslim Commercial Bank amounting to \$680 million and Barclays bringing in approximately \$100 million of investments. These numbers will appear once the account for the entire fiscal year is completed.

Almost 57 percent of FDI has come from three countries, namely the U.A.E, US and UK. The United States, with 33.4 percent share, is the single largest investor in Pakistan, followed by U.A.E (15.4 %), UK (8.7%), Norway (4.4%), Switzerland (4.1%), Hong Kong (3.5%), and Japan (2.9%). The communications sector, including Telecom, was the most attractive sector for FDI inflows, accounting for 30.4 percent followed by financial businesses (22.6%), energy including oil and gas and power (16.6%) and trade (4.9%). The three groups, namely communication, banking, and oil and gas exploration, accounted for over two thirds of FDI inflows in the country.

Inflation: A stable inflation not only gives a nurturing environment for economic growth but also uplifts the poor and fixed income citizens who are the most vulnerable in society. Over the last decade, with a few exceptions, inflation around the world had been at a retreat. However, with buoyant global growth, along with higher population growth, rapid industrialization and urbanization in emerging markets, and strong per capita income growth, inflation has started veering its ugly head in many parts of the world including Pakistan. Inflation is uncomfortably high in almost every corner of the world including Pakistan, creating extraordinary difficulties for policy-makers. The culprit everywhere is rising food and energy prices underpinned by surging demand from the fast growing developing countries.

There is a general consensus that the era of cheap food is over. Soaring food prices over the last year have helped propel inflation all around the world, sparking protests and even riots in some countries. The high price of food in the global arena as well as short-sighted policy responses threatens to push millions into poverty. Rising food prices have pushed up overall inflation not only in Pakistan, but across the region, particularly during 2007 and mid-2008. This is worrisome given that food price inflation is the most regressive of all taxes, hurting the poor and fixed income groups the most. Additionally, this explosion in international food prices is a threat to macroeconomic stability through inflation, the rising fiscal cost of food subsidies, and the negative impact on the exchange rate for net food/energy importing countries like Pakistan.

The CPI-based inflation during July-April 2007-08 averaged 10.3 percent as against 7.9 percent in the same period last year. The single largest component of the CPI is the food group, which makes up 40.34 percent of the CPI, and it showed an increase of 15.0 percent. This was higher than the 10.2 percent food inflation observed over the corresponding period of last year. A further breakdown of food inflation into perishable food items and non-perishable food items reveals some interesting facts. The rise in the price of perishable food items stood at 8.7 percent whereas non-perishable food items stood at 13.6 percent. Based on the current trend observed, the contribution of food inflation to the overall CPI is estimated at 59 percent and non-food inflation at 40 percent as against 52.4 percent and 47.2 percent, respectively in the comparable period last year. On the other hand, the non-food prices grew at a slower pace compared to last year. Non-food inflation averaged 6.8 percent during July-April 2007-08 while it stood at 6.2 percent in the corresponding period last year. The non-food-non-energy inflation (core inflation) was also higher at 7.5 percent in first ten months of the fiscal year 2007-08 as against 6.0 percent in the same period last year, on account of the rising house rent and Medicare sub-indices.

The current fiscal year inflation on a year-on-year (y-o-y) basis exhibits a significant increase in price pressures. This year's inflation started with 6.4 percent in July 2007 but continued to accelerate, reaching a peak of 17.2 percent in April 2008. Food inflation was close to 8.5 percent at the beginning of the year but accelerated sharply to 25.5 percent in April 2008, recording one of the highest increases since 1974-75, when it peaked at 27.8 percent. The exceptionally high trend in food inflation during the current fiscal year indicates that prices of a few (18) essential food items registered sharp increase particularly during the second half of the fiscal year. The high food inflation adversely affects the low and fixed income groups as a majority of their total monthly expenditure is on food items. Thus, sharp increases in prices of some key food items puts a lot of pressure on the poor segment of society. Other significant contributors to this year's upward inflationary trend include house rent, which is the index that measures the cost of construction in Pakistan, racing to 11.4 percent by April 2008. Transport and communication also contributed a heavy chunk by peaking at 17.9 percent in April 2008, given the unprecedented hike in global oil prices, translating to domestic oil and transportation costs. Rounding up, fuel and lighting stood at 8.6 percent whereas Medicare stood at 7.4 percent in April 2008 (y-o-y).

High global prices of food, fuel and other commodities driven by a weaker Pakistani rupee, high import prices and gradual removal of fuel, food and power subsidies along with monetary overhang on account of excessive borrowing from the SBP to finance fiscal deficit have been mainly responsible for sharp pick up in prices this year. These factors will continue to exert upward pressure on overall prices in the next two/ three years. The longer the higher inflationary pressure persists, the greater is the chance for wage-price spiral to gain a firm hold. Pursuance of tight monetary policy will be necessary to prevent the wage-price spiral from gaining strength.

The government is fully aware of the developments taken place on the inflationary scene, both within and outside the country. The government is also aware of its responsibilities to maintain price stability, particularly with respect to essential commodities. It is in this perspective that the State Bank of Pakistan has further tightened the monetary policy to curtail aggregate demand. On the other hand the government is making efforts to ensure adequate supplies of essential food items through encouraging domestic production as well as imports. It is in this perspective that the government has increased the support price of wheat from Rs.425 per 40 kg to Rs.625 per 40 kg for the current wheat season with a view to providing right price to Pakistani farmers so that they can grow more wheat. Furthermore, a higher support price of wheat will also help in discouraging smuggling, therefore ensuring the availability of the commodity in the country. The government has also imported 1.7 million tons of wheat last year and will also be importing 2.5 million tons this year to ease supply pressures. The government has also allowed the private sector to import wheat for which the custom duty was reduced to zero. In order to stabilize the price of rice in the country, the government negotiated an agreement with the Rice Exporter Association of Pakistan. The association will provide adequate quantity of rice at a subsidized rate to the Utility Stores Corporation as well as ensure an adequate supply of rice in the country. The government has also used the facilities of the Utility Stores Corporation for providing relief to the people by selling wheat flour, pulses, and edible oil at reduced rates. The government is also working to set up an ***Income Support Fund*** through which the deserving segments of society will be protected from the rising cost of food items.

Monetary Policy: Monetary policy stance of the SBP has undergone considerable changes over the last seven years, gradually switching from an easy monetary policy to the current aggressive tight monetary policy stance depending on the inflationary situation in the country. During FY08, the SBP continued with a tight monetary policy stance, thrice raising the discount rate and increased the Cash Reserve Requirement (CRR) and Statutory Liquidity Requirement (SLR). During the first half of FY08, the SBP raised the policy rate by 50 bps to 10 percent effective from August 1st, 2007. Furthermore, the SBP zero rated the CRR for all deposits of one year and above maturity to encourage greater resource mobilization of longer tenor and 7 percent CRR for other demand and time liabilities. In the second half of FY08, the SBP further tightened monetary policy by raising the discount rate by 50 bps to 10.5 percent. Furthermore, the CRR was raised for deposits up to one year maturity by 100 bps to 8 percent while leaving term deposits of over a year zero rated. The objective was to give incentives to commercial banks to mobilize long-term deposits. In the light of a continued inflationary buildup and increasing pressures in the foreign exchange market, the SBP announced a package of monetary measures on May 21, 2008 that includes; (i) an increase of 150 bps in discount rate to 12 percent; (ii) an increase of 100 bps in CRR and SLR to 9 percent and 19 percent, respectively for banking institutions (iii) introduction of a margin requirement for the opening of letter of credit for imports (excluding food and oil) of 35 percent, and (iv) establishment of a floor of 5 percent on the rate of return on profit and loss sharing and saving accounts.

In order to improve the effectiveness of monetary policy and avoid ambiguities in sending out policy signals, the SBP has abolished the Annual Credit Plan (ACP). This was a long awaited measure, following the removal of credit ceilings which made the Credit Plan redundant. For 2007-08, the SBP had assumed that with real GDP growth target of 7.2 percent and inflation target of 6.5 percent, broad money (M2) supply growth should grow by 13.7 percent. The money supply growth during July- May 10th 2007-08 *(henceforth July-May)* of the current fiscal year slowed to 9 percent compared to 14 percent during the corresponding period of FY07. The FY 08 growth in M2 is entirely attributable to a rise in the net domestic assets (NDA) of the banking system due to high government borrowings for budgetary support, as the NFA registered a contraction during the period, mainly reflecting the weaknesses in country's external balance of payment. The monetary tightening has been successful in moderating the exceptional rise in private sector credit growth seen in recent years to levels consistent with its long term trends. However, the impact of this desirable moderation in private sector growth on M2 was more than offset by continued strong budgetary borrowings of the government from the banking system. The NDA of the banking system registered an expansion of Rs.656 billion during Jul-May FY08 compared with an expansion of Rs.395 billion during the corresponding period of last year.

In the current fiscal year, domestic and external shocks of extra-ordinary proportions caused large slippages on the fiscal side. The financing plan of the fiscal deficit was also affected by these shocks. The overall fiscal deficit of Rs.398 billion was to be financed by external sources (Rs.193 billion), and domestic sources (Rs131 billion).The remaining Rs.75 billion was to come from privatization proceeds. Within domestic sources, Rs. 81 billion financing was to come from banking sources while the remaining Rs. 50 billion was to come from non-banking sources. The domestic and external shocks not only increased the size of the fiscal deficit but they also changed the composition of financing. The borrowing requirements increased from Rs. 324 billion *(the net of privatization proceeds)* to Rs. 683.4 billion *(with no privatization proceeds)* - an increase of 111 percent *(based on information until May 23, 2008)*. External resource inflows were adversely affected by these shocks and against the budgeted level of Rs.193 billion, only Rs.119.4 billion is likely to materialize. Pakistan could not complete the transaction of GDRs of the National Bank of Pakistan and could not launch sovereign and exchangeable bonds either. Furthermore, some of the lending from the multilateral banks could not be materialized. These developments had adversely impacted the external resource inflows which remained far below the budgeted level. Thus, the brunt of adjustments on the financing side fell on domestic sources. Against the budgeted financing of Rs. 131 billion from domestic sources, it increased to Rs. 564 billion. Within domestic sources, the bulk *(82.2 percent)* of financing came from banks while the remaining Rs. 100 billion or 17.8 percent came from non-bank sources. Most importantly, the borrowings from the State Bank of Pakistan reached an alarming level which is posing serious complications for the conduct of monetary policy. On cumulative basis, as on May 10 2008, the government has borrowed Rs.551 billion from SBP during the current fiscal year, which has almost doubled the stock of MRTBs with SBP to Rs.945.9 billion. To put this in perspective, the July-May FY08 borrowings are twice the net borrowings seen during the preceding three years. The reliance on central bank borrowing is partly an outcome of scheduled banks' reduced interest in government papers. In addition, the expectations regarding changes in the discount rate in the monetary policy statement for the second half of FY08 also limited the scheduled banks' participation in the auctions of government securities.

Credit to private sector grew by 14.9 percent during July-May FY08 as against 12.2 percent in the same period of last year. Credit to private sector as percent of GDP is continuously rising since 2001-02. The key factors contributing to this year's acceleration in private sector credit growth include: (i) rise in working capital requirements due to higher input costs; (ii) the need for bridge financing to settle price differential claims of the OMCs and IPPs; and (iii) the higher fixed investment in the month of March 2008.

In order to develop the bond market, and to reduce the cost of funds for financing the fiscal deficit in the long run, Government has started PIB auctions since December 2000. In FY07, the supply of long term government paper started to pick up pace as the government started to hold primary auctions of PIBs in a more regular and predictable manner. Regarding long-term interest rates, an important development in FY07 was the extension of the yield curve to 30 years. Interest rates of long term government securities also registered an increase due to the upward revision of the discount rate, and the yield curve moved in an upward direction in the range of approximately 81 to 110 basis points. The SBP mopped up Rs.68 billion from the primary market of PIBs during the first nine months of FY08 as compared to Rs.37 billion in the same period of FY07. The market offered a total amount of Rs.133 billion in the first nine months of FY08 as compared to Rs.100 billion in the same period of last year. In the first nine months of FY08, heavy investment was in 10 year PIBs which constituted 33.5 percent of the total accepted amount.

The tight monetary policy for the year 2007-08 is also reflected in the rise of the weighted average lending rate. The weighted average lending rate increased by 60 bps since June 2007 and until March 2008. During the same period the weighted average deposit rate increased by 20 bps. The spread - a measure of banking sector efficiency/inefficiency - increased from 6.3 percent to 6.7 percent during the same period. It is in this perspective that the State Bank of Pakistan in its Interim Monetary Policy Measures announced on May 21 2008, mandated the commercial banks to pay a minimum interest rate of 5 percent on savings deposit products with a view to not only encouraging people to save more, but also to bringing the spread down to a reasonable level.

Capital Markets: Pakistan's stock market has emerged as one of the fastest growing markets in emerging economies in recent years. Local and foreign investors' confidence in the investment environment of Pakistan has boosted the index to peak highs. Pakistan's benchmarked stock market index - the Karachi Stock Exchange - KSE-100 index has increased from 1,521 points on June 30, 2000 to 12,130.5 points on May 30, 2008 – a rise of over 10,610 points or an increase of 698 percent. Similarly, Aggregate Market Capitalization (AMC) has increased from Rs. 392 billion ($ 7.6 billion) on June 30, 2000 to Rs. 3,746 billion ($ 56 billion) on May 30, 2008, showing a rise of over Rs. 3,354 billion ($ 48.4 billion) or an increase of 856 percent.

Notwithstanding the difficult domestic and external environments, the fiscal year 2007-08 has witnessed large-scale merger and acquisition activities. Several key takeovers have taken place in Pakistan's corporate sector during the year. These include: (i) acquisition of 65 percent strategic stake and management control in Worldcall Telecom by OmanTel, (ii) sell-off of 68 percent shares in Saudi-Pak Commercial Bank to an international consortium consisting of Bank Muscat, IFC and Nomura European Investment Limited, (iii) acquisition of 15 percent strategic stake in Muslim Commercial Bank (MCB) by Malaysia's largest financial institution, Maybank, with a right to increase its stake to 20 percent after one year, (iv) and acquisition of 95 percent shares of ABN AMRO Bank worldwide by the Royal Bank of Scotland (RBS). These M&A activities, which have taken place at very attractive valuations, have provided support to the valuation in the stock market. Peer group companies' stock prices have also reacted as a result of these acquisitions. The Initial Public Offerings (IPO's) of Habib Bank Limited (HBL) and Arif Habib Bank Limited both came in 1.5x and 5.8x oversubscribed, which is an encouraging development.

The Karachi Stock Exchange (KSE) is the biggest and most liquid exchange in Pakistan. The premier equity market is benchmarked through the KSE-100 index. The KSE-100 index closed at 12,130.5 points on May 30, 2008, a decrease of 1,642 points or about 11.9 percent in comparison to end June index position of 13,772.5 points, after touching its all-time high of 15,676 points on April 18, 2008. On the other hand, the Aggregate Market Capitalization (AMC) settled to close at Rs. 3,746 billion ($ 56 billion), about Rs. 273 billion ($ 10.4 billion) or 6.8 percent less than the end-June 2007. A series of domestic and external shocks impacted the performance of Pakistan's stock market in the fiscal year 2007-08. Political uncertainty, less than satisfactory security environment, and a disturbed law and order situation on the domestic front, an international financial market crisis and the downgrading of Pakistan's credit rating by Standard & Poor's and Moody's on the international front, have played major roles in dampening the investors' sentiments.

Fiscal Policy: Fiscal year 2007-08 proved to be a difficult year for Pakistan, with several political and economic events transpiring unexpectedly. These events include heightened political tensions, soaring global oil prices, the international and domestic food inflation phenomena, a slowdown in global economic activity, and the troubled law and order situation prevalent in the country. However, the most important aspect was the non-responsive stance on account of political expediency, that is, not responding to the policy challenges emerging on Pakistan's economic scene during most part of the fiscal year 2007-08. All these events have had adverse consequences for fiscal discipline. Because of the instability experienced at the onset of 2007-08, the fiscal deficit is expected to miss the target of 4.0 percent of GDP this year by a wide margin. The hard earned macroeconomic stability underpinned by fiscal discipline is under threat.

A sound fiscal position is vital for achieving macroeconomic stability, which is increasingly recognized as being critical for sustained economic growth and poverty reduction. The sooner Pakistan improves its fiscal position by making sharp fiscal adjustments, the lesser the price it is likely to pay for its fiscal indiscipline. A sharp fiscal adjustment can reduce large external current account imbalances, restore the confidence of global investors, ease financing constraints, support growth and contain inflation.

The total revenue collected during FY 2007-08 stood at Rs. 1545.5 billion, higher than the targeted level of Rs 1476 billion *(based on information till May 23, 2008)*. This increase of Rs 69.5 billion from the budgeted revenues was mainly due to higher-than-targeted non-tax collections. Tax revenues however, exhibited a disappointing performance. Political disturbances and a less than satisfactory law and order situation seriously hampered the revenue collection efforts of the FBR. There are expectations that the FBR may fall short of its targeted level, and the year is most likely to end with tax collection amounting to Rs. 1.0 trillion—Rs. 25 billion less than the original target. Notwithstanding the shortfall, the government has made an extraordinary effort to collect more resources from the non-tax revenue side. There are expectations that the government may collect an additional Rs. 103 billion in non-tax revenues, reaching to Rs. 483 billion. Slippages in provincial tax revenues amount to Rs. 8 billion.

The FBR was assigned an ambitious revenue target of Rs. 1,025 billion for FY 2007-08, and to reach this target a reasonably high growth of 21 percent was required over the last year collection of Rs. 847 billion. However, revenue collection efforts were seriously hampered due to political unrest in the country during most of 2007-08. The incidents of December 2007, accompanied with a severe energy crisis and long hours of load shedding, adversely affected industrial production. Resultantly, FBR also suffered a revenue loss of Rs. 35 billion. At the end of April 2008, the net collections had reached Rs. 763.6 billion, higher by 16.3 percent over the net collection of previous fiscal year, but short of the assigned target of Rs. 787.7 billion. Thus, revenue collection has so far achieved 97.0 percent of its target, which was Rs.1025 billion at the beginning of the year.

A detailed analysis reveals that the gross and net collection has increased by 12.3 percent and 16.3 percent, respectively. In absolute terms, the gross and net collections have gone up by Rs. 89.9 billion and Rs. 107.1 billion, respectively. The overall refund/rebate payments during the first ten months of the current fiscal year amounted to Rs. 55.8 billion relative to Rs. 73.0 billion paid during the corresponding period of the last fiscal year. Among the four federal taxes, the highest growth of 28.9 percent was recorded in the case of federal excise receipts, followed by sales tax (19.5%), direct taxes (12.5%) and customs (11.4%).

The total expenditure for 2007-08 was budgeted at Rs. 1875 billion -- 11.9 percent higher than last year. Current expenditure on the other hand was budgeted at Rs. 1378 billion (almost equivalent to last year's level), of which, Rs. 862 billion was earmarked for the federal government and the remaining Rs. 416 billion was allocated for provincial governments. Development expenditure (after adjusting for net lending) was targeted at Rs. 496 billion – 16.7 percent higher than last year. On the basis of revenue and expenditure projections, the overall fiscal deficit was targeted at Rs. 398 billion or 4 percent of GDP as against 4.3 percent last year.

Fiscal Year 2007-08 has been a tough year for Pakistan's economy. This year began in the backdrop of challenges emanating from domestic and external front. Surging oil, food and commodity prices accompanied by the turmoil in international financial markets and the disturbed domestic political conditions had an adverse impact on Pakistan's budgetary position. Furthermore, inaction on account of political expediency for most part of the fiscal year in addressing the challenges, accentuated the budgetary imbalances.

Large slippages have occurred on the expenditure side mainly on account of subsidies on oil, power, fertilizer, wheat and other food items. In addition to this, the interest payment significantly surpassed their targeted level. Oil subsidy was budgeted at Rs. 15 billion and the price of oil in the international market was $50-55 per barrel (Arab Gulf Mean) during the time of the preparation of the budget 2007-08. It was also assumed that the government would pass on the rise in international price of oil to domestic consumers. Two factors had a significant impact on the budgetary outlook for the year. Firstly, oil prices continued to rise at a greater pace, reaching as high as $ 115 per barrel in May 2008--- an increase of over 116 percent during the fiscal year. Secondly, the lack of action on the part of the government aggravated the fiscal situation as the high international price of oil was not passed on to the domestic consumers. Consequently, the oil subsidy is projected to rise to Rs. 175 billion— surpassing the targeted level by Rs. 160 billion. Similarly, the higher cost of furnace oil used in power generation was not allowed to pass through to domestic consumers of electricity. Therefore, against the budgeted subsidy of Rs. 52.9 billion the projected power subsidy is likely to be Rs. 113 billion --- an excess of Rs. 60 billion.

At the time of the preparation of the Federal Budget 2007-08, the government never thought of importing wheat as there was a bumper wheat crop (23.3 million tons) in 2006-07. Hoarding, smuggling and mismanagement of wheat operations forced the government to import 1.7 million tons of wheat at all time high prices. Since the government imported wheat at higher prices and sold it in the domestic market at a cheaper price, the difference of Rs. 40 billion had to be picked up by the government. Similarly, the government had to make extra payments on research and development (R&D) in the textile sector, subsidy on imported fertilizer etc. which were not part of the 2007-08 federal budget.

Interest payments surpassed their targeted level by a significant margin. A sum of Rs. 375 billion was budgeted for interest payments in 2007-08. The year is likely to end with interest payments of Rs. 503.2 billion — surpassing the target by Rs. 128.2 billion, mainly due to two reasons. Firstly, there was a slippage on account of the National Savings Scheme (NSS) particularly with respect to Defence Savings Certificates (DSCs), amounting to Rs. 54 billion. There was a massive maturity of DSCs that were issued in 1997-98 which were due for payment in 2007-08 (this is a ten year paper). The NSS is still ill-equipped to determine how many of these certificates were encashed prematurely and how many were held till maturity. Secondly, there was a slippage on account of floating debt and permanent debt mainly due to the substantial rise in the volume of borrowing as well as the rising interest rates. Therefore, a combination of underestimating the extent of maturity of the NSS instruments as well as substantial rise in the government's borrowing requirements (because fiscal deficit was high: Rs. 683 billion vs Rs. 398 billion) and the consequential rise in interest rates of various instruments were responsible for the slippages in interest payments.

In order to counter massive gaps between budgeted and estimated targets in current expenditure, the government made efforts to mobilize more resources on the one hand, and postpone development spending on the other. An adjustment of Rs. 100 billion was made in development expenditure. All these efforts were made to bring the budget deficit at an acceptable level in the wake of a difficult domestic and external environment.

The above developments on the revenue and expenditure sides resulted in massive slippages in the overall fiscal deficit for the year 2007-08. Against the target of Rs. 398 billion or 4 percent of GDP the overall fiscal deficit is *likely* to be Rs. 683.4 billion or 6.5 percent of GDP--- the highest in the last ten years.

Public debt is the outcome of the developments taking place on the fiscal and current account deficits. A larger gap in these two deficits would cause the public debt to grow at a faster pace. Exchange rate depreciation would also cause the public debt to grow even if the government does not borrow a single dollar. Low fiscal and current account deficits, along with stability in the exchange rate, are critical in keeping the public debt at a sustainable level. Public debt as a percentage of GDP (a critical indicator of the country's debt burden), which stood at 85 percent in end-June 2000, has declined to 55.2 percent by end-June 2007 – a reduction of almost 30 percentage points of GDP in seven years. The declining trend in public debt is likely to be reversed in 2007-08, mainly on account of a widening of the fiscal and current account deficits and a sharp depreciation of the rupee vis-à-vis the US dollar. By end-March 2008, the public debt as percentage of full year GDP stood at 53.5 percent. More damage has however, been done to public debt in the last quarter (April-June) of the current fiscal year, that is, a further widening of the fiscal and current account deficits, increased borrowing from domestic and external sources to finance the deficits, and a sharper adjustment to the exchange rate. The year 2007-08 is likely to end with public debt at around 56 percent of GDP – marking the first time in a decade to see a reversal in trends. Public debt in rupee terms has increased by 15.8 percent in the first nine months (July-March) of the fiscal year 2007-08. Public debt is a charge on the budget and therefore, it must be viewed in relation to government revenues. Public debt stood at 589 percent of total revenues by end-June 2000 but declined to 363 percent by end-March 2008 – a reduction of 226 percentage points of revenue.

Fiscal year 2007-08 has also witnessed violation of various elements of the Fiscal Responsibility and Debt Limitation Act 2005. Under the act, the revenue deficit (*total revenue minus current expenditure*) was to become zero by end-June 2008. As a consequence of large fiscal slippages, the revenue deficit is likely to be Rs. 287 billion or 2.7 percent of GDP- a violation of the Act. Similarly, the Act also requires that public debt as percentage of GDP must decline by 2.5 percentage points each year. Instead of declining, public debt is likely to increase over the last year- once again a clear violation of the Act.

Going forward, the key to the success of reducing public debt burden includes: a reduction in fiscal and current account deficits and maintaining stability in the exchange rate. A declining public debt would release government resources for public sector investment, would enable private sector to borrow more (crowding-in) for investment, and thus promote growth.

External Sector: Both the domestic and external environments play an important role in shaping the country's trade with rest of the world. The outgoing fiscal year 2007-08 witnessed a series of developments, both on the domestic and external front, which adversely affected the country's overall balance of payments, including the trade balance. Pakistan's export performance has been impressive in recent years (2002-03 to 2005-06) registering an average growth of 16 percent per annum. Pakistan's export performance was dismal in 2006-07 as it witnessed abrupt and sharp deceleration to less than 4 percent. When viewed in the back of last year's performance, exports did manage to recover somewhat this year but its performance has remained far short of the average growth of 16 percent achieved during 2002-03 to 2005-06.

Pakistan's exports suffer from serious structural issues which need to be addressed primarily by the industry itself, with government playing its role of a facilitator. Textile is the backbone of Pakistan's exports but bears various tribulations. These include: (i) low value added and poor quality products fetching low international prices; (ii) the machinery installed in recent years has depreciated considerably relative to Pakistan's competitors; (iii) these machines are power-intensive, less productive and carry high maintenance cost; (iv) augmented wastage of inputs adding to the cost of production; (v) little or no efforts on the part of industry to improve their workers' skills; (vi) industry spending less money on research and development; and (vii) export houses lacking capacity to meet bulk orders as well as meeting requirements of consumers in terms of fashion, design and delivery schedule.

Pakistan's imports grew at an average rate of 29 percent per annum during 2002-03 to 2005-06 on the back of strong economic growth which triggered a consequential growth in investment and imports. However, import growth slowed to a normal level in the fiscal year 2006-07 but registered a sharp pick up once again in the current fiscal year 2007-08 on account of an unprecedented rise in oil import bills and some one-off elements in the shape of imports of wheat and fertilizer. As a result, Pakistan's trade and current account deficits have widened substantially in this year contributing to serious macroeconomic imbalances. Correction of imbalances through shaving off aggregate demand by appropriate policies should be the top most priority of the government.

Exports: Overall exports recorded a growth of 10.2 percent during the first ten months (July- April) of the current fiscal year against a growth of 3.6 percent in the same period last year. In absolute terms, exports have increased from $ 13.8 billion to $ 15.3 billion. Broad categories of exports suggest that with the exception of textile manufactures, all other categories of exports registered stellar growth. For example, exports of food group were up by 22.4 percent; petroleum group exports registered an increase of 38 percent; exports of other manufactures and *'other items'* posted a handsome growth of 33.2 percent and 59.5 percent, respectively. Textile manufactures, accounting for almost 57 percent of total exports, performed poorly as it registered a decline of 2.5 percent. The government has provided financial support to the textile sector through R & D during the current fiscal year. Even this financial support could not help improve the performance of textile exports. It is therefore, clear that the problems are structural in nature and cannot be resolved through financial support of the government.

Exports of the food group, accounting for 13.2 percent in total exports, grew by 22.4 percent and contributed 26.1 percent in overall exports growth. Within food group, rice, accounting for 60 percent, registered an impressive growth of 28.5 percent. Pakistan clearly benefited from the unprecedented rise in international price of rice and this is likely to continue in coming years since Pakistan is a net exporter of rice. This will also encourage farmers in Pakistan to grow more rice and benefit from the current hike in international prices. Export of textile manufactures, accounting for 57 percent of total exports, not only registered a negative growth of 2.5 percent but also was a drag on the overall performance of exports. With the exception of raw cotton and other textile materials, all other major components of textile manufactures registered negative growth in the current fiscal year. It is important to note that the unit value of all the major components of textile manufactures were up substantially but exports in quantum terms registered a sharp decline across the board with the exception of raw cotton. In other words, Pakistan's textile exports could not benefit from higher international prices. The dismal performance of textile exports can be attributed, beside their structural issues, to rising cost of production owing to increase in domestic cotton prices and stifling power shortages; the deteriorating law and order situation in the country resulting in reported diversion of export orders to other countries; poor quality of cotton on account of contaminated cotton issue has also adversely affected the export of the spinning industry. Furthermore, textile exports appear to have also suffered from the slow down in the US economy which has been the largest destination for Pakistani exports during the last few years. Export of the petroleum group, accounting for 6 percent of total exports, contributed 18.2 percent in the overall exports growth for the year. Export of petroleum products and Naphtha registered an impressive growth of 83 percent and 16 percent, respectively.

Unlike textile manufactures, exports of other manufactures, accounting for 19 percent of total exports, posted a stellar growth of 33.2 percent in the current fiscal year. Accordingly, it contributed over 50 percent to this year overall exports growth. The major performers under this category of exports include leather tanned; leather manufacturer; surgical goods; chemical and pharmaceutical products. Performance of all broad categories of exports is indeed encouraging when viewed at the back of power and skilled labor shortages and political disturbances in the country.

The performance of textile manufacturers has been far from satisfactory during the fiscal year 2007-08. This point's to the fact that a natural diversification of exports is underway and Pakistan appears to be moving away from conventional textile products to new non-conventional items such as other manufactures, petroleum products and food group. However, the pace of diversification is painfully slow. The current food price hike at the global and national level provides window of opportunity for Pakistani farmers to grow more wheat and rice and thus emerge as a major exporter of these agricultural produce.

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 72.4 percent of total exports during the first nine months of 2007-08 with cotton manufacturers alone contributing 54.7 percent, followed by rice (7.1%), leather (6.1%), synthetic textiles (2.9%) and sports goods (1.6%). The degree of concentration has changed little from the last fiscal year. Like the concentration of Pakistan's exports in a few items, the country's exports are also highly concentrated in only few countries. USA, Germany, Japan, UK, Hong Kong, Dubai and Saudi Arabia alone account for almost one-half of Pakistan's export. Continuing the past trend, these seven markets remained the major destinations for Pakistani export during the current fiscal year. US remained by far the major destination for Pakistan's exports accounting for 26.4 percent.

Imports: Imports during the first ten months (July-April) of the current fiscal year (2007-08) grew by 28.3 percent to $32.1 billion on the back of an extraordinary surge in the imports of petroleum products as well as imports of food group and raw material. Non-oil imports were up by 22.5 percent and non-oil and non food imports surged by 18.8 percent during the same period. Imports of food group were up by 48.6 percent in the current fiscal year mainly on account of unanticipated imports of wheat amounting to $ 819 million and an extraordinary surge (70.4%) in the imports of edible oil due to the sky-rocketing price of palm oil in the international market. Imports of food group accounted for 11 percent of total imports but contributed 16.3 percent in the overall growth of imports in the current fiscal year.

Imports of machinery posted a modest increase of 6.9 percent in the first ten months (July-April) of current fiscal year reaching to $4.2 billion. Within machinery group, imports of power generating machines; construction and mining machines and other machinery showed a substantial increase of 38.2 percent, 33.1 percent and 9.9 percent, respectively. The rise in the import of these different categories of machines is attributed to ongoing work on various power and construction projects in the country. Machinery group accounts for 13.2 percent of total imports but contributed only 3.8 percent in the overall import growth of this year.

Imports of the petroleum group witnessed an extraordinary surge at 47 percent, amounting to $8.7 billion. Petroleum group accounts for 27 percent of total imports but contributed 39 percent in the overall import growth for the year. The surge in imports of petroleum group has been the result of an extraordinary increase in the prices of POL products.

Unlike in previous years, the imports of consumer durables registered a decline of 1.6 percent in the first ten months (July-April) of the current fiscal year. The share of consumer durables in total imports stood at 5.3 percent in 2007-08 while its contribution to this year's import growth has been nil at best.

Imports of raw material, accounting for 16.6 percent of total imports, grew by 38.6 percent in the first ten months (July-April) of the current fiscal year. Fertilizers, plastic material, iron, steel and scrap, amounting for 45 percent of total raw material imports, grew respectively by 193.1 percent, 12.3 percent and 74 percent. The extraordinary increase in the import of fertilizer was surprising at a time when the price of fertilizer in the international market was up by almost 50 percent. As against 1 million tons last year, Pakistan imported almost 2 million tons in the first ten months of current fiscal year, registering a growth of 97 percent. Why such large quantities of fertilizer were imported when its off-take within the country did not grow compared to last year, is not clear. Nevertheless, the country had to pay an additional $542 million in imports on account of the extraordinary increase in the import of fertilizer which cannot be explained by looking at the performance of this year's agricultural crops. Imports of raw material contributed 21 percent to the overall growth of imports this year.

Unlike in the recent past, imports of telecom remained more or less at last year's level of $1.9 billion, suggesting that the expansion phase of various cellular companies appears to have saturated for the time being. Imports of telecom accounts for 5.9 percent of total imports but contributed only marginally (0.3%) to this year's overall imports growth.

It is important to note that the surge in imports during 2003-06 was on the back of strong economic growth which strengthened the domestic demand and consequently a pick up in investment. In contrast, the surge in this year's import is not because of any structural shift in demand but because of rising international commodity prices such as crude oil and palm oil and one–off increases in the import of wheat and fertilizer. Imports of petroleum products and edible oil alone contributed 47 percent to the rise of this year's import. Additional 18.7 percent contribution came from import of wheat and fertilizer. Together these four items accounted for two-thirds growth in this year's import.

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 accounted for 75.5 percent of total imports during the first nine months (July-March) of current fiscal year. Pakistan's imports are also highly concentrated in few countries. USA, Japan, Kuwait, Saudi Arabia, Germany, the UK and Malaysia have been the major sources of Pakistan's imports since last ten years. Over 40 percent of Pakistan's imports continue to originate from these seven countries. During first nine months (July-March) of the current fiscal year, Saudi Arabia, followed by USA and Japan have been the major supplier of our imports.

Trade Balance: During the first ten months of the current fiscal year (July- April), the merchandise trade deficit worsened sharply to $ 17 billion as compared to $ 11 billion in the same period last year. The surge in merchandize trade deficit owes to an outsized increase of 28.3 percent in imports that more than offset a modest export growth 10.2 percent. On the basis of existing trends, the trade deficit is likely to touch $ 20.5 billion or 12.3 percent of GDP during 2007-08.

Current Account Balance: Pakistan's current account deficit further widened to US$ 11.6 billion *(including official transfers)* during Jul-Apr FY08 against US$ 6.6 billion in the comparable period of last year, showing an increase of 75.6 percent. Even when compared to the size of the economy, the current account deficit was substantially high at 6.9 percent of GDP during Jul-April FY08 as against 4.6 percent for the same period last year. Given the trend so far, the year is likely to end with a current account deficit of over 8.0 percent of GDP. The deterioration in the current account deficit mainly emanated from the sharply rising trade deficit along with increase in net outflows from the services and income account. The strong growth in current transfers on the back of impressive growth in remittances almost entirely offset the deficit in the services and income account thereby leaving the trade deficit as the fundamental source of expansion in current account deficit. The current transfers witnessed an impressive increase of 16.4 percent during Jul-April FY08 on the back of strong growth in private transfers.

A month-wise trend in current account deficit can be categorized into two distinct periods. In the initial four month (Jul-Oct) of FY08, the current account deficit averaged $737.5 million and depicted almost 15 percent ($518 million) improvement over the same period last year on the back of a small recovery in exports (non-textile) and slowdown in import growth. However, this improvement could not be sustained in the subsequent months with current account deficit averaging $1439 million during Nov-Apr FY08- almost doubled compared to the initial four months. This deterioration in the current account deficit can also be viewed from the fact that Pakistan faced a high average price of crude oil, rising from $69 per barrel in July to $75 per barrel in the month of October 2007 but surged to $106 per barrel in April 2008. Such a massive surge in oil prices caused the monthly oil import bill to rise from $762 million in July 2007 to $1.3 billion in April 2008. These developments, along with imports of wheat and fertilizer, worsened the trade deficit as well as current account deficit. Financing of current account deficit witnessed some compositional shift during Jul-Apr FY08 compared to previous years. Specifically, unlike Jul-Apr FY07, when current account deficit was comfortably financed from surpluses in the financial account, during Jul-Apr FY08 the deficit was financed through a mix of surplus in the financial account and a drawdown of foreign exchange reserves.

Workers' Remittances: Workers' remittances registered commendable growth during Jul-Apr FY08, growing by 19.5 percent to $5.3 billion on top of 22.7 percent growth in the corresponding period of last year. Remittances routed through exchange companies contributed 60.2 percent in the overall remittances growth. As a result, foreign exchange companies share in overall remittances increased to 23.8 percent during Jul-April FY08 from 16.7 percent for same period last year. Higher remittances have two favorable effects for the economy. Firstly, these inflows enhance local purchasing power, especially in rural areas and provide an important hedge against higher levels of domestic inflation. Secondly, they limit the deterioration in the current account deficit due to the worsening merchandise trade deficit caused by the high international price of oil. A major share in remittances growth came from United States, Saudi Arabia, United Arab Emirates, and other GCC countries. Together they accounted for over 78 percent of remittances, with the US taking the lead with 27.5 percent. Pakistan has emerged as the world's 12th largest remittances recipient country during 2007.

Foreign Exchange Reserves: Pakistan's total foreign exchange reserves stood at $ 12.3 billion as of end-April 2008, significantly lower than end June 2007 level of $15.6 billion. During the current year, movement in foreign exchange reserves can be divided into two distinct periods. In the first period, reserves peaked to $ 16.4 billion at end Oct-2007 while the second period showed significant depletion of $ 4.1 billion during Nov-Apr FY08. During Jul-Oct 2007, reserves improved by 5.1 percent due to a relatively lower current account deficit and substantial inflows in the financial account. However, November onwards, net outflows from portfolio investment, and a steep rise in the current account deficit led to a sharp decline in the foreign exchange reserves of the country. Reserve adequacy in terms of weeks of import, eroded during July-April FY08, to 19.4 weeks of imports down from 30.6 weeks in June 2007, mainly due to the combined impact of surge in imports and drawdown of reserves.

Exchange Rate: Pak rupee, after remaining stable for more than four years, lost significant value against the US dollar, depreciating by 6.4 percent during July-April 2007-08. The movements in the rupee-dollar parity largely followed the same pattern as witnessed in the case of reserves. During the first four months of the current fiscal year, Pak rupee remained more or less stable and depreciation in the value of rupee against the US dollar was only marginal. In contrast, Nov-April FY08 period saw a steep decline in the value of the rupee, mirroring pressures in the foreign exchange market which arose after November, 2007 onwards. Beside the steep depreciation during July- April FY08, the exchange rate also remained much more volatile, particularly in mid-December 2007 onward, which prompted the SBP to intervene in the market aggressively, helping reduce the day-to-day volatility in the exchange rate. However, these interventions were not aimed at arresting the fall in the value of Rupee against the US dollar. The month of April, and especially May, witnessed an even steeper decline while the exchange rate remained under pressure, breaching the Rs.64 per dollar mark in the month of April for the first time in six years. Pak Rupee came under intense pressure in the month of May 2008 on account of speculative dollar buying in the market which prompted the SBP to take severe actions against the money changers to resist the sharp fall in the value of the rupee. The rupee had reached to an all-time low of Rs. 68 per dollar on May 9, 2008. To cool-off the foreign exchange market and curb speculation, the State Bank took several measures to stabilize the exchange market, details of which are well documented in the relevant chapter.

External Debt and Liabilities (EDL): High and rising external debt burden constitutes a serious constraint for development; a major impediment to macroeconomic stability and hence, to growth and poverty reduction; and a discouragement to foreign investment because it creates a high risk environment and exchange rate depreciation. Borrowing from within and outside the country is a normal part of economic activity. Developing countries, like Pakistan, would need to borrow to finance their development; however, they need to enhance their debt carrying capacity as well. In other words, the borrower must continue to service its external debt obligations in an orderly and stable macroeconomic framework. Furthermore, the borrowed resources must be utilized effectively and productively so that it generates economic activity. Prudent debt management is therefore, essential for preventing debt crisis.

Pakistan's total stock of external debt and foreign exchange liabilities (EDL) grew at an average rate of 1.2 percent per annum during 2001-07, rising from $37.2 billion in end-June 2001 to $40.5 billion by end-June 2007. However, in the first nine months (July-March) of FY 2007-08, the stock of EDL rose to $45.9 billion - an increase of $5.4 billion or 13.3 percent, the highest increase in almost one decade. It is important to note that Pakistan's external debt is contracted in various currencies but for accounting purpose, it is reported in equivalent of US Dollar. Therefore, any movement in exchange rates, especially against US Dollar, would translate into changes in the dollar value of the outstanding stocks of EDL. During the first nine months of this fiscal year, the total increase in EDL amounts to $5.4 billion, of which, $4.2 billion is the exchange rate translation effect while net disbursement of loan was just $1.2 billion. Pakistan has benefited immensely from the exchange rate translation effect in the past, particularly when major currencies were depreciating against the US Dollar. Unfortunately, Pakistan was on the receiving end of the translation effect in the current fiscal year because US Dollar depreciated against Japanese Yen, Euro, and SDR by 18.7 percent, 14.9 percent, and 8.2 percent, respectively. Notwithstanding, the rise in EDL in absolute terms, the burden of the debt, defined in various ways, has declined over the years. From a policy perspective, it is the incidence of the debt burden which is important and meaningful. Furthermore, the international financial institutions as well as international rating agencies look at incidence of debt burden rather than debt in absolute number. The EDL as percentage of GDP declined from 51.7 percent in end-June 2000 to 28.1 percent by end-June 2007 and further to 26.9 percent by end-March 2008. Similarly, EDL, as percentage of foreign exchange earnings, declined from 297.2 percent in end-June 2000 to 121.6 percent in end-June 2006, but exhibiting and increasing trend thereafter reaching to 127.1 percent by end-March 2008. Furthermore, EDL was 19.3 times of foreign exchange reserves in end-June 2000 but declined to 2.7 times by end-June 2005 and exhibiting an increasing trend thereafter reaching to 3.4 times by end-March 2008. The maturity profile of Pakistan's EDL also showed an improvement over the last eight years as short-term debt was 3.2 percent of EDL but declined to 1.3 percent by end-March 2008.

Performance of Sovereign Bonds: Fiscal year 2007-08 has seen increased volatility in international credit markets. The fallout from the sub-prime crisis and the ensuing credit crunch gripping the world has impacted Emerging Market debt significantly. Spreads have been increasing across the board and access to financing has decreased. Pakistan's sovereign papers were doubly affected by credit crunch in international capital market as well as unsettling domestic political and security environment. The downgrading of ratings by Standard & Poor's and Moody's also impacted the performance of Pakistan's papers in secondary market trading at the international level. As compared to the issue spread of UST + 200bps, the 2017 bond is trading currently at a spread of UST +629 bps. The 2036 bond, as compared to the issue spread of UST + 302bps, is trading currently at a spread of UST + 507 bps, about 69 percent higher. The 2036 bond was the longest ever tenor achieved by Pakistan.

Poverty and Income Distribution: The income-consumption module of the Pakistan Social and Living Standard (PSLM) Survey provides basic information for measuring the incidence of poverty and distribution of income. Until the first half of the fiscal year 2007-08, the latest estimates available to gauge poverty situation in the country was related to the fiscal year 2004-05. Based on PSLM 2004-05 survey, poverty was estimated at 23.9 percent as compared with 34.5 percent in 2000-01- an improvement of 10.6 percentage points in four years. Only recently, the Federal Bureau of Statistics (FBS) made available the income-consumption module of PSLM 2005-06 to the Center for Research on Poverty and Income Distribution (CRPRID) attached with the Planning Commission and funded by the United Nations Development Program (UNDP). *It is important to note that the estimates of poverty from PSLM 2005-06 would depict the socio-economic conditions that prevailed during the fiscal year 2005-06. These estimates have nothing to do with current ground realities which have been impacted by the surge in food and fuel prices, poor agricultural performance and slower economic growth.*

It should be clearly noted that poverty estimates are highly sensitive to a variety of factors, like how a poverty line is estimated and updated; which welfare measure is adopted, household expenditure or income; how the scale of household is controlled for, per capita or per adult equivalent; and how spatial price differences are controlled, etc. Each methodology or choice has advantages and limitations. Also, poverty estimates and the trend vary substantially depending on what methodology is selected. This very nature of poverty estimation suggests that the validation exercise needs to be designed carefully. For example, it is not constructive to simply point out the difference between the CRPRID/ Planning Commission's poverty estimates and those based on a conceptually different methodology.

The CRPRID/ Planning Commission estimated the Headcount ratio based on PSLM 2005-06 survey with a view to updating the benchmark of poverty estimates for Pakistan. The latest estimate of inflation-adjusted poverty line is Rs.944.47 per adult equivalent per month, up from Rs.878.64 in 2004-05. Headcount ratio, i.e., percentage of population below the poverty line has fallen marginally from 23.94 percent in 2004-05 to 22.32 percent in 2005-06, an improvement of 1.62 percentage points. Poverty in rural areas declined from 28.13 percent to 27.0 percent, showing an improvement of 1.13 percentage points between 2004-05 and 2005-06. Poverty in Urban areas also registered a decline from 14.94 percent to 13.1 percent during 2004-05 and 2005-06, thereby, depicting an improvement of 1.84 percentage points in the period. Poverty estimate in urban areas became less than half the rural estimates in 2005-06 for the first time since 1998-99. *It is important to note that a decline of 1.6 percentage points in poverty Headcount between 2004-05 and 2005-06 is found statistically insignificant*. In other words, statistically speaking, taking into account the margin of error in the estimates, the estimates of the two years are not different from each other. It is also important to note that a technical exercise carried out by the World Bank supports the accuracy of CPRID/Planning Commission poverty numbers for PIHS 2000-01, PSLM 2004-05, and PSLM 2005-06 using the official methodology and data cleaning protocol. The World Bank also carried out various sensitivity analyses to ensure the reliability of the estimates, and found that the poverty estimate at the national level declined slightly between 2004-05 and 2005-06, but the reduction was not statistically significant.

Notwithstanding marginal and statistically insignificant improvement in poverty Headcount during 2004-05 and 2005-06, the consumption inequality during the period has increased marginally to 0.3018 as measured by the Gini coefficient. It may also be noted that consumption inequality is continuously on the rising trend since 2000-01, rising from 0.2752 to 0.3018.

The poverty estimates discussed above have nothing to do with the current ground realities which have been impacted by a high double-digit inflation, particularly food inflation, poor agricultural performance, particularly the major crops, and slower economic growth. These developments will likely be a major contributor to eroding the gains of poverty reduction. Whether these shocks will have any bearing, and to what extent, on the poverty profile of the country in 2007-08 will only be known once the income-consumption module of PSLM 2007-08 will be available sometime in the last quarter of 2008-09.

The government is fully aware of the difficulties faced by the low and fixed income groups on account of rising inflation, especially food inflation. The government is setting up an Income Support Fund with a view to providing relief to the deserving segments of the society. Such a measure will help alleviate difficulties faced by the low income group from rising food and fuel prices. In this perspective, a comprehensive survey / census will be conducted soon by the government to identify the targeted households.

EXECUTIVE SUMMARY

01. GROWTH AND INVESTMENT

Pakistan’s economy has shown great resilience against internal and external shocks of very high intensity and grew robustly at 5.8 percent in 2007-08, as against 6.8 percent last year and this year’s target of 7.2 percent. The ***Commodity Producing Sector (CPS)*** registered a growth of 3.2 percent in 2007-08 as against 6.0 percent last year owing mainly to the lackluster performance of agriculture and manufacturing. While ***agriculture*** grew by 1.5 percent, ***the manufacturing sector*** posted a modest growth of 5.4 percent in 2007-08. The ***large scale manufacturing (LSM)*** sector witnessed a modest growth of 4.8 percent, down from 8.6 percent last year. The manufacturing sector has been hard hit by political instability, frequent eruptions of incidents detrimental to law and order and the acute energy shortages. In unison with increasing prices for fuel and energy, all these factors have caused slower growth in LSM. Growth in the ***small scale manufacturing*** sub-sector moderated to 7.5 percent in 2007-08 from 8.1 percent during 2006-07.

The poor show of the agriculture sector was the result of a sharp deceleration in the growth of the ***major crops*** sub-sector which posted a negative growth of 3.0 percent in 2007-08 as against a healthy growth of 8.3 percent last year. ***Minor crops*** registered a growth of 4.9 percent as against the negative growth of 1.3 percent last year. Fishing and forestry exhibited robust growth of 3.8 percent and 11.0 percent, respectively.

The ***services sector*** has surpassed the growth target of 7.1 percent and grew by 8.2 percent in 2007-08 as against the actual achievement of 7.6 percent last year. The ***finance and insurance sector*** displayed a stellar growth performance of 17.0 percent during 2007-08 as against 15 percent last year. Value added in the ***wholesale and retail trade sector*** grew at 6.4 percent as compared to 5.4 percent last year and the target of 7.8 percent this year. The ***Transport, Storage and Communication*** sub-sector saw a deceleration in growth to 4.4 percent in 2007-08 as compared to 6.5 percent of last year.

The contribution of CPS to GDP growth has declined to 26.6 percent from 42.4 percent last year. Agriculture sector contributed only 0.3 percentage points or 5.6 percent to GDP growth in 2007-08 as against 0.8 percentage points or 12 percent contribution last year. The manufacturing sector contributed 1.0 percentage point or 17.7 percent to GDP growth as against 1.5 percentage points or 22.2 percent last year. Industry contributed 1.2 percentage points or 20.9 percent to this year's real GDP growth. The Services sector contributed 4.2 percentage points or 73.4 percent to overall growth this year. The contribution made by ***wholesale and retail trade*** has been 18.7 percent or 1.1 percentage points to GDP growth in 2007-08. ***Finance and insurance*** has also contributed 18.7 percent or 1.0 percentage point to this year's growth.

Per capita income has grown at an average rate of above 13.0 percent per annum during the last five years, rising from $ 586 in 2002-03 to $ 925 in 2006-07 and further to $ 1085 in 2007-08. Per capita income in dollar terms rose from $ 925 last year to $ 1085 in 2007-08, depicting an increase of 18.4 percent. ***Real per capita income*** in rupee terms has also increased by 4.7 percent, on average, for the last three years. The real per capita income grew by 4.2 percent as compared to 4.9 percent last year. ***Real private consumption expenditure*** grew by 8.5 percent in 2007-08 as opposed to 4.1 percent last year.

Total investment declined to 21.6 percent of GDP in 2007-08 from its peak level of 22.9 percent last year. However, total investment has increased from 16.9 percent of GDP in 2002-03 to 21.6 percent of GDP in 2007-08— showing an increase of 5.7 percent of GDP in five years. ***Fixed investment*** grew by 3.4 percent in real terms and 12.5 percent in nominal terms. ***Private investment*** grew by 16.3 percent per annum in real terms and 30.7 percent per annum in nominal terms during the period (2004-07). However, its growth declined substantially to 0.9 percent in real terms and 9.7 percent in nominal terms. Major nominal growth in private sector investment was witnessed in: mining & quarrying (15.3%), electricity & gas (11.0%), financial business (11.4%), and wholesale and retail trade (18.4%).

National Savings stood at 13.9 percent of GDP in 2007-08 down from last year's level of 17.8 percent. ***Domestic savings*** has declined to 11.7 percent of GDP from 16.0 percent of GDP in 2006-07. ***Public sector investment*** has also increased by 30.0 percent per annum during the last three years and 20.2 percent during the current fiscal year in nominal terms.

Overall foreign investment during the first ten months (July-April) of the current fiscal year has declined by 32.2 percent and stood at $ 3.6 billion as against $5.3 billion in the comparable period of last year, mainly because of the fact that the political economy suffered many headwinds at continuous intervals.

Foreign direct investment (private) has shown more resilience and stood at $3481.6 million during the first ten months (July-April) of the current fiscal year as against $4180.8 million in the same period last year thereby showing a decline of 16.7 percent. ***Private portfolio investment*** on the other hand witnessed a massive decline of 91 percent by recording an inflow of $98.9 million as against $1097.3 million in the comparable period of last year. ***Public foreign investment*** depicted a modest inflow of only $20.5 million as against an outflow of $66.6 million in the comparable period of last year.

Almost 57 percent of FDI has come from three countries, namely, the UAE, US, and UK. US investors, with 33.4 percent investment, contributed the most during the first ten months (July-April) of 2007-08. Norway (4.4% or $154.8 million), Switzerland (4.1% or $141.3 million), Hong Kong (3.5% or $121.3 million), Netherlands (2.9% or $101.0 million) and Japan (2.9% or $100.3 million) were the other contributors to FDI inflows. Three groups, namely; communication, financial business and oil & gas exploration, accounted for almost 67 percent of FDI inflows in the country.

02. AGRICULTURE

Notwithstanding its declining share in GDP, agriculture is still the single largest sector of the economy, contributing 21 percent to GDP and employing 44 percent of the workforce. More than two-third's of Pakistan's population lives in rural areas and their livelihood continues to revolve around agriculture and allied activities. Like in other developing countries, poverty in Pakistan is largely a rural phenomenon; therefore, development of agriculture will be a principal vehicle for alleviating rural poverty. The recent global food crises, while creating difficulties for net food importing countries, is equally providing opportunities for developing countries like Pakistan to get their acts together and benefit from the current situation by giving more serious attention to agriculture.

The sustained higher growth in emerging economies has impacted the consumption patterns of households, including dietary changes towards higher quality food such as meat and dairy products. As a result, the production of these items is rising globally. In Pakistan, the livestock and dairy sectors accounts for 52 percent of agriculture, 11 percent of GDP and affects the lives of 30-35 million people in rural areas. In order to achieve higher sustained growth in agricultural value added, it is absolutely necessary to give due attention to the livestock and dairy sector to achieve multiple objectives, such as, the objectives of attaining food security and poverty reduction.

The growth performance of agriculture over the last six years has fluctuated in the range of 1.5 percent to 6.5 percent. The volatility in agricultural growth is mainly caused by the crop sector which is associated with the vagaries of Mother-Nature, pest attacks, ill effects of adulterated pesticides etc. Such volatility is detrimental to income growth of farmers and hampers government efforts to reduce poverty.

Agriculture performed poorly in 2007-08, growing at 1.5 percent against the target of 4.8 percent. This poor performance is mainly because of equally poor performance of major crops and forestry, registering negative growths of 3.0 percent and 8.5 percent, respectively. Livestock, minor crops and fishing have been the saving grace for agriculture as these sectors performed reasonably well and compensated for the performance of major crops and forestry, which allowed the growth rate in agriculture to arrive at 1.5 percent this year. Major crops, accounting for 34 percent of agriculture and 7.1 percent of GDP, suffered on account of the poor showing of wheat and cotton and less than satisfactory performance of the rice crop. Sugarcane and maize, being the other two major crops, performed impressively in 2007-08.

The cotton crop suffered for a variety of reasons, including heavy rainfall in May 2007 which caused poor germination in Punjab, high temperatures during August and September 2007, causing more shedding of fruit parts and pest attacks, especially the dangerous mealy bug infestation. Consequently, cotton production declined to 11.7 million bales as against 12.9 million bales last year — registering a negative growth of 9.3 percent. The wheat crop was adversely affected by the shortage of irrigation water to the extent of 23.3 percent over normal supplies during Rabi and the inordinate spike in prices of DAP fertilizer. Accordingly, production of wheat declined to 21.7 million tons as against 23.3 million tons last year, thereby showing a decline of 6.6 percent. In sheer contrast, the two other major crops performed well with sugarcane recording the highest ever production level of 63.9 million tons — 16.8 percent higher than last year. The production of rice witnessed a modest growth of 2.3 percent and stood at 5.6 million tons.

Minor crops, accounting for 12 percent in agriculture value added, posted a growth of 4.9 percent against the negative growth of 1.3 percent last year. The performance of ***livestock***, accounting for 52.2 percent of agricultural value added, was satisfactory at 3.8 percent. The performance of fisheries has been impressive as it grew by 11 percent in 2007-08 because inland fish catch increased by 11.1 percent while the output of marine fishing grew by 11.5 percent during 2007-08. ***Forestry*** followed the traditional negative growth pattern for the fifth year in a row. This small sector, with only one percent stake in the overall value - addition in agriculture, registered a negative growth of 8.5 percent in 2007-08 as the turnout of production of timber and firewood during the year declined by 9.3 percent.

Pakistan's agricultural output is closely linked with 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 lower in the range of 5.9 percent (2003-04) to 20.6 percent (2004-05). Relatively speaking, *Rabi* season faced more shortage of water than *Kharif* during 2007-08.

During the current fiscal year (2007-08), the availability of water for *Kharif* 2007 (for the crops such as rice, sugarcane and cotton) has been 5.5 percent more than the normal supplies and 12.2 percent more than last year's *Kharif.* The water availability during Rabi season (for major crop such as wheat), as of end-March 2008 was, however, estimated at 27.9 MAF, which was 23.4 percent less than the normal availability, and 10.5 percent less than last year's *Rabi*, adversely affecting the wheat crop, production of which has decreased by 6.6 percent over the last year.

03. MANUFACTURING & MINING

Pakistan's manufacturing sector recorded the weakest growth in a decade during the outgoing fiscal year 2007-08. Overall manufacturing posted a growth of 5.4 percent during the first nine months of the current fiscal year against the target of 10.9 percent and 8.1 percent of last year. Large-scale manufacturing, accounting for 70 percent of overall manufacturing, registered a growth of 4.8 percent in the current fiscal year 2007-08 against the target of 12.5 percent and last year's achievement of 8.6 percent. Heightened political tension, deteriorating law and order situation, growing power shortages, the cumulative impact of monetary tightening and rising cost of doing business are the reasons responsible for the poor showing of manufacturing in 2007-08.

The main contributors to this growth of 4.8 percent during July-March 2007-08 over last year, are pharmaceuticals (30.7 percent), wood products (21.9 percent), engineering products (19.5 percent), food & beverages (11.1 percent), petroleum products (6.0 percent) and chemicals (3.1 percent). The individual items that displayed positive growth include: cotton cloth (4.8 percent) and cotton yarn (3.3 percent) in the textile group; cooking oil (1.1 percent), sugar (33.9 percent) and cigarettes (5.1 percent) in the food, beverages and tobacco group; cement (17.9 percent) in the non-metallic mineral products group; and buses (32.0 percent), LCV's (16.4 percent) and motorcycles (28.1 percent) in the automobile group. A few items that showed a decline in production include: fertilizers (16.9 percent), electronics (4.6 percent), paper & paper board (5.5 percent) and iron & steel products (7.6 percent). The individual items that exhibited negative growth include; cars & jeeps (3.9 percent), phosphatic fertilizer (24.0 percent) and billets (20.6 percent).

The ***mining and quarrying sector*** registered a growth rate of 4.9 percent as against a target of 4.5 percent and 3.0 percent of last year. The higher growth was propelled by magnetite (20.5%), lime stone (17.8%) and Baryte (15.6%).

With effect from January 1991 to February 2007, GoP has privatized around 166 units at Rs. 475 billion (approx US$ 8.9 billion). The transactions carried out during the period of July 2007 to February 2008 include: UBL's divestment of 25 percent shares through a GDR fetched $650 million and was the biggest book building ever in

Pakistan's banking history. Initially 21.74 percent (175.95 million) shares were divested in June 2007 for total proceeds of $565.4 million. Another 3.2 percent (26.39 million) shares were divested in July 2007 for total proceeds of $84.81 million. The stock was priced at 5 times to book which is the highest valuation compared to similar transactions globally. The HBL-IPO was the largest offering ever in Pakistan in terms of value and the number of successful applicants. A total subscription of Rs. 18.9 billion was received against the base offer of Rs. 8.1 billion resulting in an over subscription of 2.3 times. The IPO has generated gross proceeds worth Rs. 12.2 billion against the divestment of 51.8 million shares (including a green shoe option of 17.2 million).

A new SMEs Policy 2007 was launched in fiscal year 2007-08, where an attempt has been made to define uniformly, small and medium sectors in manufacturing, trade and services sectors for all the stake-holders and give a broad frame-work for the promotion of SMEs by improving the regulatory, fiscal and business environment. The policy document gives a broad frame-work for promoting and developing small and medium sectors through institutionalization of the support structure, and outlines a strategy for SME-led private sector growth for poverty reduction and job creation.

04. FISCAL DEVELOPMENTS

Fiscal year 2007-08 proved to be a difficult year for Pakistan, with several political and economic events transpiring unexpectedly. Domestic and global headwinds have had adverse consequences for fiscal discipline. Resultantly, the fiscal deficit is likely to miss its target of 4.0 percent of GDP by a wide margin. The hard earned macroeconomic stability underpinned by fiscal discipline appears to have been evaporated.

Total revenues collected during the current year stood at Rs 1545.5 billion, higher than the targeted level of Rs 1476 billion. This increase of Rs 69.5 billion from the budgeted revenues was mainly due to higher than targeted non-tax revenues. There are expectations that the FBR may fall short of its targeted level with total tax collections of Rs 1.0 trillion—Rs. 25 billion less than the original target. It is also anticipated that the government may receive an additional Rs. 103 billion from non-tax revenues, reaching to Rs. 483 billion. Slippages in provincial tax revenues amounted to Rs. 8 billion.

Pakistan's tax revenue-to-GDP ratio stood at only 9.5 percent of GDP during 2007/08 as compared to an average of 18 percent for other developing countries, indicating that substantial tax policy reforms are still needed to broaden the tax base. The indirect tax-to-GDP ratio stood at around 6 percent, while the direct tax-to-GDP ratio was calculated to be 4 percent. The government recognizes the need to broaden the tax base and reduce marginal tax rates which would stimulate investment and production. The overall services sectors, including wholesale and retail trade, as well as agriculture, are potential candidates for broadening of the tax bases.

Gross and Net tax collection has increased by 12.3% and 16.3% respectively. In absolute terms, these collections have gone up by Rs. 89.9 billion and 107.1 billion, respectively. Among the four federal taxes, the highest growth of 28.9% was recorded in the case of federal excise receipts, followed by sales tax (19.5%), direct taxes (12.5%) and customs (11.4%). The collection of direct taxes has suffered a substantial shortfall during July-April FY 07-08.

The ***total expenditure*** for 2007-08 was budgeted at Rs. 1875 billion — 11.9 percent higher than last year. Current expenditure on the other hand was budgeted at Rs. 1378 billion which was at previous year's level. Development expenditure was targeted at Rs 496 billion — 16.7 percent higher than last year. On the basis of revenue and expenditure projections, the overall fiscal deficit was targeted at Rs 398 billion or 4 percent of GDP as against 4.3 percent last year. However, large slippages have occurred on the expenditure side mainly on account of subsidies on oil, power, fertilizer, wheat and other foods.

Two factors had a significant impact on the budgetary outlook. Firstly, oil prices continued to rise at a greater pace, reaching as high as $ 115 per barrel in May 2008--- an increase of over 116 percent during the fiscal year. Secondly, the lack of action on the part of the government aggravated the fiscal situation as the high international price of oil was not passed on to the domestic consumers. Consequently, the oil subsidy is projected to rise to Rs 175 billion— over shooting the targeted level by Rs 160 billion. Hoarding, smuggling and mismanagement of wheat operations forced the government to import 1.7 million tonnes of wheat at all time high prices.

Interest payments surpassed their targeted level by a significant margin. A sum of Rs. 375 billion was budgeted for interest payments in 2007-08 whereas they are estimated at Rs. 503.2 billion, thereby surpassing the targeted level by staggering Rs 128.2 billion. The adverse developments on the revenue and expenditure sides resulted in massive slippages in the ***overall fiscal deficit*** for the year 2007-08. Against the target of Rs 398 billion or 4 percent of GDP the overall fiscal deficit is likely to be Rs 683.4 billion or 6.5 percent of GDP— the highest in the last ten years. In order to counter massive gaps between budgeted and estimated targets in current expenditure, the government made efforts to mobilize more resources on the one hand, and postpone development spending on the other. An adjustment of Rs 100 billion was made in development expenditure.

Domestic and external shocks not only increased the size of the fiscal deficit but they also changed the composition of financing. The borrowing requirements increased from Rs 324 billion to Rs 683.4 billion—an increase of 111 percent. External resource inflows were adversely affected by these shocks and against the budgeted level of Rs 193 billion, only Rs 119.4 billion is likely to materialize. In addition to this, Pakistan could not complete the transaction of Global Depository Receipts (GDRs) of the National Bank of Pakistan and could not launch sovereign and exchangeable bonds. Furthermore, some of the expected disbursements of multilateral banks and privatization proceeds were not materialized. These developments had adversely impacted the external resource inflows which remained below the budgeted level. Thus, the brunt of adjustments on the financing side fell on domestic sources. Against the budgeted financing of Rs 131 billion from domestic sources, it increased to Rs 564 billion. Within domestic sources, the bulk (82.2 percent) of financing came from banks while the remaining Rs 100 billion or 17.8 percent came from non-bank sources. Most importantly, the borrowings from the State Bank of Pakistan (SBP) reached an alarming level. Consequently, the money supply growth for the year 2007-08 is expected to breach the target of 13.7 percent.

Public debt as a percentage of GDP (a critical indicator of the country's debt burden), which stood at 85 percent in end-June 2000, declined to 55.2 percent by end-June 2007 – a reduction of almost 30 percentage points of GDP in seven years. The declining trend in public debt is likely to be reversed in 2007-08, mainly on account of yawning fiscal and current account deficits and a sharp depreciation of the rupee vis-à-vis the US dollar. By end-March 2008 the public debt as percentage of full year GDP stood at 53.5 percent. However, more damage has been done to public debt in the last quarter (April-June) of the current fiscal year which means a further widening of the fiscal and current account deficits, increased borrowing from domestic and external sources to finance the deficits, and a sharper adjustment to the exchange rate. The year 2007-08 is likely to end with public debt at around 56 percent of GDP – marking the first time in a decade to see a reversal in trends. Public debt in rupee terms has increased by 15.8 percent in the first nine months (July-March) of the fiscal year 2007-08.

By end-June 2007 total domestic debt stood at Rs. 2610.2 billion which was estimated at 30 percent of GDP. The outstanding stock of domestic debt rose by Rs 409.9 billion and stood at Rs. 3020.1 billion by end-March 2008 or 30.3 percent of GDP. The domestic debt had increased by 15.7 percent by end-March 2008 over end-June 2007. The increase in domestic debt mainly emanates from floating debt (27.1%) while the other two components, unfunded and permanent, witnessed a modest growth of 6.1 percent and 9.4 percent, respectively.

05. MONEY & CREDIT

Pakistan has made significant progress in improving the health and soundness of the banking and financial sector over the last two decades.

During this period of transformation, the financial sector of Pakistan has evolved into a more progressive and dynamic module of the economy, both in response to the financial sector reforms and to the growing financing needs of an expanding economy. In response to the growing demands of financial globalization, Pakistan's financial system is starting to integrate with international financial markets.

The process of the tightening of monetary policy began in FY05, from being broadly accommodative to one more aggressive. The government's December 2004 decision to lift the freeze on domestic POL prices raised inflationary expectations, forcing a more aggressive tightening of monetary policy. During FY08, the SBP continued with a tight monetary policy stance, thrice raising the discount rate while also increasing the Cash Reserve Requirement (CRR) and the Statutory Liquidity Requirement (SLR). The impact of the tight monetary stance and liquidity management began to translate into a rise in other interest rates, with varied magnitude, at different stages of the economy. For instance, the 6 months T-bills cutoff witnessed an increase of 97 basis points to 9.9 percent during Jul-Apr FY08. Similarly, the 6 months and 12-months KIBOR also increased by 77 basis points and 63 basis points to 10.38 percent and 10.71 percent respectively.

In order to improve the effectiveness of monetary policy and avoid ambiguities in sending out policy signals, the SBP has abolished the Annual Credit Plan (ACP). For 2007-08, the SBP had assumed that with real GDP growth target of 7.2 percent and inflation target of 6.5 percent, the broad money (M_2) growth should have grown by 13.7 percent. The money supply growth slowed to 9.0 percent during July 2007-May 10, 2008 compared to 14 percent during the corresponding period of FY07. The M_2 growth is entirely attributable to a rise in net domestic assets (NDA) of the banking system driven by high government borrowings for budgetary support. The NDA of the banking system registered an expansion of Rs.656 billion during July 2007-May 10, 2008 compared with an expansion of Rs.395 billion during the same period of last year. The net bank credit to the government for financing commodity operations and budgetary support amounted to Rs.423 billion against Rs.185 billion in the same period. Credit to government for commodity operations expanded by Rs.60 billion compared to a contraction of Rs.26 billion, while credit to government for budgetary support increased to Rs.362 billion. The NFA of the banking system registered a net contraction of Rs.289 billion compared to an expansion of Rs.84 billion during this period. This contraction in NFA is attributable to delays in the issuance of GDRs, sovereign bonds, lower than expected receipts on account of logistics support, decline in foreign investment, lower inflows from multilateral institutions, and SBP's decision to provide foreign exchange to support a part of oil payments even when the oil prices are at their historic high levels. Credit to private sector grew by 14.9 percent during July 2007-May 10, 2008 against 12.2 percent in the same period of last year. The key factors contributing to the recent acceleration in private sector credit growth were (i) rise in working capital requirements due to higher input costs; (ii) the need for bridge financing to settle price differential claims of OMCs and IPPs; and (iii) the higher fixed investment in the month of March 2008.

The impressive performance of Pakistan's banking sector has attracted considerable FDI inflows in recent years. The banking sector of Pakistan has undergone a visible change as about eighty percent of the banking assets are now controlled by the private sector. Assets of all banks showed a net expansion of Rs.203.1 billion in the first six months of FY 08 and stood at Rs.5155 billion as compared to Rs.4351 billion in the same period of last year.

The Islamic Financial industry in Pakistan has grown substantially in recent years. Total assets of the Islamic banks reached Rs. 200.4 billion in FY 08 from Rs. 12.9 billion in FY03 and had contributed 4.1 percent in banking assets till end-February 2008.

The importance of the SME sector cannot be overemphasized in the overall industrial development of a country. SMEs constitute nearly 90% of all the enterprises in Pakistan; they employ

80% of the non-agriculture labor force; and their share in the annual GDP is nearly 40%. During FY08, credit to the SME sector decreased to Rs.18 billion from Rs.30 billion during FY07.

The non–bank financial sector has historically played an important role in the mobilization and channeling of savings in the financial system. The NBFIs have, in recent years benefited from an environment of low interest rates coupled with high economic growth but have been unable to create an impact as well-functioning, specialized financial intermediaries. The success story among NBFIs is that of mutual funds. The mutual fund sector is rapidly growing in Pakistan and accounted for the largest chunk in total assets of non-bank financial sector. Between FY00 to FY 07, net assets of mutual funds have grown by more than 12 times to reach Rs.313 billion from Rs.25 billion only in FY 00.

06. CAPITAL MARKETS

A strong economy requires a cutting-edge financial system that instills confidence and efficiently provides a wide range of financial services to households and businesses alike; and capital markets are an essential component of a strong financial system. A diversified financial system is conducive to both financial stability and to efficient resource allocation in support of medium term economic growth. Pakistan, with its large consumer base, has enormous and attractive investment opportunities, and like other developing countries, needs both local and foreign investment to support and sustain its economic growth.

Pakistan's equity market has performed comparatively better in comparison to its regional counterparts during the outgoing fiscal year 2007-08, albeit with a volatile political scenario and fragile economic outlook. A large number of mergers and acquisitions were witnessed during the outgoing fiscal year, which is a healthy sign for a corporate assessment of the country. Two major banks (HBL and Arif Habib Bank) went public on the KSE via IPOs. The premier stock exchange index (KSE-100) broke the psychological barrier of 15,500 points to close at 15,676 points on April 18, 2008. This level has never been achieved in Pakistan before, portraying an attractive valuation of the domestic equity market. The unprecendted events of November 3, December 27, February 18 and May 22 invited sharp corrections to the stock market. Nevertheless, the stock market was able to survive through these periods of tumult which increased the confidence of the equity market investors, despite the overall market return remaining notably lower than those in the past several years. LSE and ISE followed the foot prints of the leading stock exchange in the country. Moreover, the sectoral performance in the bourses remained impressive with banks and financial institutions outperforming the others.

Pakistan's debt market has seen a consistent supply of long term government securities amounting to about Rs. 69 billion and the inflation-adjusted rise in deposit rates of National Savings Schemes in 2007-08. Five new TFCs have been issued, mostly by the financial sector in the same period, and a sophisticated derivative market has taken off recently. The Pakistani investor base has observed phenomenal progress in terms of size, liquidity and growth in recent years. Over time, the Non-Banking Finance Companies sector has demonstrated better performances. In particular, the leasing and investment finance sectors have shown impressive growth. The buoyant capital market provided vigour to the growth and development of mutual funds, which nearly doubled their asset holdings during last year. However, growth in the housing finance sector has remained stagnant. It is also pertinent to note that the development of discount houses and venture capital companies remains at an initial stage. Real Estate Investment Trusts, Private Equity and Venture Capital Funds are welcome additions this year. However, the credit rating industry still lags behind with only two companies currently involved in it. This has clearly hampered the development of sub-grade investment bonds in the country though the credit quality remains high.

Capital market reforms initiated by the SECP promise far-reaching results in improving the financial markets of Pakistan although some key steps are still to be taken. However, the domestic capital markets need more aggressive reform actions and hence, a comprehensive set of recommendations has been laid out at the end of the chapter. Strong dedication and commitment by the government will lead to constant innovation and a healthy development of the local capital markets.

07. INFLATION

The inflation rate as measured by the Consumer Price Index (CPI) averaged at 10.3% during (July-April) 2007-08 as against 7.9% in the same period last year. Food price inflation is estimated at 15.0% compared to 10.2% in the same period of last year. Non-food inflation increased to 6.8% versus 6.2% in the comparable period of last year. The core inflation (non-food, non-energy sector), increased little over last year accelerating from 6.0 percent in 2006-07 to 7.5 percent in the first ten months of current fiscal year. The larger contribution towards the overall CPI inflation comes from food inflation. Based on current trends, it is expected that the average inflation rate during 2007-08 will be over 10.5%.

Major factors contributing to the rise in inflationary pressures in the economy during the current year 2007-08 include the extremely high food and energy prices, which is in fact a global problem. Food inflation was predominantly driven by unprecedented rise in the prices of few items like wheat, rice and edible oil etc. owing to supply short-fall of key consumer items as well as the impact of the significant increase in their global prices. The record high jump in oil prices lead to an increase in the cost of Pakistani imports as well as aggravating food shortages across the world through the conversion of many crops from human consumption to fuel which have also seriously spurred the world-wide price level including those in Pakistan.

Inflation is an important determinant of the macroeconomic stability and thus attracted policy measures to contain it at tolerable level. The corrective measures include: pursuing tight monetary policy by SBP to control money supply and credit expansion, easing supply by allowing imports of several essential items to augment domestic supply, gearing reforms toward additional agricultural output and effective participation of the public sector distribution network (USC & TCP).

08. TRADE AND PAYMENTS

Pakistan's exports were growing at 16 percent per annum on the back of strong macroeconomic policies pursued at home and the hospitable international trading environment the period (2002-03 to 2005-06). The impressive export performance backtracked to dismal in 2006-07 when they were hardly managed to grow at less than 4 percent. Overall exports recorded a growth of 10.2 percent during the first ten months (July-April) of the current fiscal year against 3.6 percent in the same period of last year. In absolute terms, exports have increased from $ 13847.3 million to $ 15255.5 million in the period. Although exports growth has remained far short of the average growth of 16 percent achieved during 2002-03 to 2005-06 but it was satisfactory when viewed in the backdrop of poor show last year.

Imports during the first ten months (July-April) of the current fiscal year (2007-08) grew by 28.3 percent compared with the same period of last year, reaching to $ 32.06 billion. After growing at an average rate of 29 percent per annum during 2003-04, Pakistan's import growth slowed to a moderate level of 6.9 percent in the last fiscal year (2006-07). Import's growth exhibited a sharp pick up in 2007-08 on the back of an extra-ordinary surge in the imports of petroleum products, food and raw material. Non-oil imports were up by 22.5 percent and non-oil and non food imports spiked by 18.8 percent during the first ten months (July-April) of the current fiscal year.

Imports of the petroleum group registered extraordinary growth of 47 percent and reached to $8670 million. The petroleum group accounts for 27 percent of total imports but contributed 39 percent in the overall growth of imports for the year. The rise in imports of the petroleum group has been the fallout of extraordinary hike in the crude oil prices in the international market as well as the substantial increase in its quantity imported. The imports of raw material contributed almost 21 percent to this year's rise in import bill. This is followed by imports of food group which contributed 16 percent to the overall imports growth. Imports of petroleum products and edible oil contributed 47 percent to the additional import bill in FY 08. Additional 18.7 percent contribution came from the import of wheat and fertilizer. These four items accounted for two-thirds of imports growth. Consumer durables contribution was negative (0.4%) mainly on account of decline in the import of road motor vehicles.

Pakistan's current account deficit (CAD) widened to US$ 11.6 billion during Jul-Apr FY08 against US$ 6.6 billion in the comparable period of last year, showing an increase of 75.7 percent. Even when compared to the size of the economy, CAD was substantially high at 6.8 percent of GDP during Jul-April FY08 as against 4.6 percent for the same period last year. The deterioration of the current account deficit was mainly driven by sharp rise in the trade deficit along with an increase in net outflows from services and income account. Services account deficit widened by 44.2 percent during Jul-April FY08 to reach $ 5.6 billion. This deterioration was contributed by relatively high import growth and the decline in export of services. However, the strong growth in current transfers on the back of impressive growth in remittances almost entirely offset the deficit in services and income account thereby leaving the trade deficit as the fundamental source of expansion in the current account deficit. The current transfers witnessed an impressive increase of 16.4 percent during Jul-April FY08 on the back of strong growth in both private and official transfers.

The Pak rupee, after remaining stable for more than four years, lost significant value against the US dollar and depreciated by 6.4 percent during July-April 2008. The fall in the value of the rupee is mainly attributed to rising oil prices in the international market, widening of current account deficit and the uncertain political situation in the country.

Worker's remittances registered commendable growth during Jul-Apr FY08 by growing by 19.5 percent on top of 22.7 percent growth in the corresponding period of last year. Worker's remittance totaled $5.3 billion in the first ten months of (Jul-April) of the fiscal year as against $4.4 billion in the same period last year. Pakistan's total foreign exchange reserves stood at $ 12,344 million as on end-April 2008, significantly lower than the end-June 2007 level of $15,646 million. Reserves peaked to $ 16,443 million at end Oct-2007 while they showed significant depletion of $ 4.1 billion during Nov-Apr FY08. During Jul-Oct 2007, reserves improved by 5.1 percent due to the relatively lower current account deficit and substantial inflows in the financial account. However, October onwards, net outflows from portfolio investment, and a steep rise in the current account deficit led to a sharp decline in the foreign exchange reserves of the country.

09. EXTERNAL DEBT AND LIABILITIES

Owing to the prudent 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 53.5 percent of GDP by end-March FY08. The external debt component of public debt (excluding private non-guaranteed debt and liabilities) has decreased from 40.8 percent of GDP end-FY02 to 24.7 percent of GDP at end-March FY08.

External debt and liabilities (EDL) at the end of March FY08 stood at US$ 45.9 billion. This represents an increase of US$ 5.4 billion, indicating a 13.3 percent increase over the stock at the end of FY07. Borrowing from multilateral and bilateral lenders accounts for 80 percent of outstanding debt, and are mostly in the form of medium and long term debt. The share of short-term debt, on the other hand, is extremely low at 1.3 percent. Pakistan took advantage of an earlier Paris Club rescheduling to re-profile its debt at a more manageable level. The external debt and liabilities (EDL) declined from 51.0 percent of GDP at the end of FY02 to 26.9 percent of GDP by end-March 2008. Similarly, the EDL were 236.8 percent of foreign exchange earnings but declined to 127.1 percent in the same period. The EDL were nearly 5.8 times foreign exchange reserves at the end of FY02 but declined to 3.4 by end March 2008. Interest payments on external debt were 7.8 percent of current account receipts but declined to 2.5 percent during the same period. The maturity profile also showed an improvement over the last five years as short-term debt was 1.4 percent of EDL but declined modestly to 1.3 percent of EDL in the same period.

International capital markets have suffered one of the most turbulent years in recent history. With the financial crisis instilling a sense of distrust amidst the market, access to financing has been restricted, with spreads widening for both developed and emerging economies alike. Given the negative sentiment surrounding capital markets, and a domestic economy with substantial macroeconomic imbalances and political uncertainty, Pakistan has not issued any new instruments in FY 08. However, the country is still pursuing a comprehensive external borrowing strategy consistent with borrowing constraints such as the saving/investment gap, amortization payments, keeping adequate reserves and most importantly the government's medium-term development priorities. The government plans to continue to tap the global capital markets, when conditions are more favorable, through regular issuance of bonds (conventional and Islamic) to ensure a steady supply of Pakistan's sovereign paper, establish a benchmark for Pakistan and to keep Pakistan on the radar screen of global investors. This will keep spreads on Pakistani paper low, give more borrowing options to Pakistani borrowers including the government and ensure that Pakistan is covered by various investment research products.

10. EDUCATION

Education is central to the socio-economic development of a country. It plays a vital role in building human capabilities and accelerates economic growth through knowledge, skills and creative strength of a society. The positive outcomes of education include reduction in poverty and inequality, improvement in health status and good governance in implementation of socio-economic policies. The multifaceted impact of education makes it an essential element for policy framework. Developing countries, where majority of the world's population resides, need to redesign educational policies for promoting productivity in different sectors of the economy by developing highly skilled manpower and addressing their development needs for rapid industrialization.

The government is making serious efforts to improve the quantity and quality of education by enhancing educational facilities within the minimum possible time. National Textbook and Learning Materials Policy (2007) has been prepared to prop up the quality of education at all levels through better quality textbooks at affordable prices and other learning materials for promoting Pakistan as a knowledge based society. National Curriculum Council (NCC) has prepared comprehensive review of school curriculum to make it relevant to student needs.

Between two Population Census 1972 and 1981 literacy rate improved by 0.5% per annum. However between 1981 and the 1998 Census revealed a growth rate of 1.07% per annum in literacy. The adult literacy rate (10 years and above) rose from 26.2% to 43.9% in this period. In the current decade, Literacy Rate has improved at a moderate pace. According to PSLM Survey data (2006-07), the overall literacy rate (10 years & above) was 55% in 2006-07 compared to 45%in PIHS (2001-02), indicating a 10 percentage points increase over a period of only six years. Males literacy rate increased from 58 percent in 2001 to 67 percent in 2006-07 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. Province wise literacy data (2006-07) show Punjab stood at 58% followed by Sindh (55%), NWFP (47%) and Balochistan at 42%.

According to PSLM Survey data (2006), the overall school attendance (age 10 years and above) is 57% (69% for male and 44% for female) in 2006-07 compared to 51% (66% for male and 36% for female) in PIHS (2001-02). Province-wise, school attendance data for 2006-07 as against 2001-02 shows Punjab to be on the top (60% Vs 54%) followed by Sindh (56% Vs 49%), NWFP (50% Vs 45%), and Balochistan (39% Vs 37%) to be at the lowest level.

According to the Ministry of Education (2006-07), there are currently 231,289 educational institutions in the country. The overall enrollment in these institutions is recorded at 34.8 million with teaching staff of 1.307 million. Out of total institutions, there are 50% primary schools, 16% middle, 10% high, 4.9% Deeni Madaris and 1.2% Vocational Institutions. About three-fourth of the institutions are in rural areas. About 67% of the educational institutions in the country are run publicly relative to only 33% in the private sector.

The government has established the National Vocational & Technical Education Commission (NAVTEC) to facilitate, regulate, and provide policy direction for technical education and vocational training to meet national and international demand for skilled manpower. In view of spreading higher education to every area of Pakistan, over the past three years, 17 new universities have been granted Charters, with the majority opened in areas where higher education opportunities were previously unavailable. To promote research and development (R&D) activities, the Higher Education Commission (HEC) has awarded 5,837 PhD scholarships (3,237 indigenous, 2,600 foreign) over the past three years.

11. HEALTH & NUTRITION

Good health, defined in terms of a state of complete physical, mental and social well being, is a prerequisite for a nation to be productive. The intrinsic importance of health in social, economic and human development of individuals implies that poor health can directly influence an individual's opportunities, his or her earning capacity, participation in community activities, and so on. The cohesive agenda of Millennium Development Goals (MDGs) also reflects the important role of health in the form of specific measurable targets. Pakistan is also a signatory to the UN Millennium Declaration and is fully committed to extend the agenda of providing basic right of health to all of its citizens. The Government's commitments regarding the 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 4,755 dispensaries, 5,349 basic health units/sub health centers (BHUs/SHCs), 562 rural health centers (RHCs), 945 hospitals, 903 maternal and child health centers (MCHs), and 290 TB centers (TBCs). Available Human resource for fiscal year 2007-08 turns out to be 127,859 doctors, 8,795 dentists and 62,651 nurses which make the ratio of population per doctor as 1,225, population per dentist as 19,121 and population per nurse as 2,501. The new health facilities added to overall health services include the construction of 56 new facilities (43 BHU and 13 RHCs), upgrading of 1,015 existing facilities (65 RHCs and 950 BHUs) and addition of 4,500 new doctors, 3,350 nurses and 400 dentists. The total outlay for the health sector is budgeted at Rs. 60 billion which shows an increase of 20% over the last year, and turns out to be 0.6 % of GDP. To reduce the incidence of disease and to alleviate people's pains and sufferings so as to improve their health status, various health programs remained operative during fiscal year 2007-08. These include the national programs for the prevention and control of tuberculosis, malaria, HIV/AIDS, hepatitis, blindness and the program on maternal, neonatal and child health etc. During the fiscal year 2007-08 the caloric availability per day is likely to increase from 2,466 to 2,529.

12. POPULATION, LABOUR FORCE AND EMPLOYMENT

Pakistan, with a population of 160.9 million in mid-2008, is the 6th most populous country in the world. In absolute numbers; almost 128 million persons have been added to the population during the last 58 years (1951-2008). Annual growth rates have risen from 1 percent in the first three decades of the country, to around 2 percent in the next three decades after peaking over 3 percent in the 1960s and 1970s and then below 3 percent in the 1990s. The country's population is estimated to double in the year 2045 if it continues to grow at 1.8 percent. The population density has increased to 203 persons per square kilometer today from 42.5 persons per square kilometer in 1951 which is almost a four time increase. Movement of population to urban areas, attributed to well known "pull" and "push" factors continues and as a result, the urban population has increased from 6 million in 1951 to today's 57 million. This has put enormous pressure on available infrastructure like housing, transportation, electricity, water, sewerage, sanitation, health and educational facilities.

The Crude Birth Rate (CBR) and Crude Death Rate (CDR) are statistical values that can be utilized to measure the growth or decline of a population. The CBR and CDR are both measured by the rate of births or deaths respectively among a population of 1,000. The Crude Birth Rate is called "crude" because it does not take into account age or sex differences among the population. CBR of more than 30 and less than 18 per 1000 population are respectively considered high and low. The CBR in Pakistan is estimated at 26.1. It is worth mentioning that health statistics in Pakistan are gradually improving; mortality rate is declining and was 7.1 (per thousand) in 2005-06; the decline is attributed to the elimination of epidemic diseases and the improvement in medical services. Despite a considerable decline in the total mortality in Pakistan, infant mortality remains high at 76.7 per thousand live births in 2005-06. The major reasons for the high mortality rate include diarrhea and pneumonia. While maternal mortality ratio ranges from 350-400 per hundred thousand births per year, the contraceptive prevalence rate (CPR) is estimated at 26 percent and total fertility rate (TFR) has exhibited a decline from 4.5 percent in 2001-02 to 3.8 percent in 2005-06.

The labour force participation rate is an important variable which indicates the supply of labour in the economy and the composition of the country's human resource. Labour force analyses also helps in policy formulation for employment, human resource development, determination of training needs, etc. In addition this indicator of labour force is helpful in assessing the labour market behavior for different segments of population, especially for youth. The working age (10 years & above) population is estimated to be 111.39 million. The labour force participation rate, though demonstrating an increasing trend in recent years, is nevertheless lower than the global or regional rates. The increasing trend in labour force participation witnessed in the recent years can be attributed to rising employment opportunities owing to robust growth and lowering of socio-cultural barriers for females to enter the job market. Total provincial LFPR (both sex) has however, witnessed a decline in all the four provinces in the year 2006-07. The most pronounced reduction has been noted for NWFP (from 39.7% to 36.3%). A province-wise break up of refined participation rates suggest that against the national average of 45.2 percent, the participation rate in Punjab is 48.5 percent followed by Sindh (42.7%), Balochistan (43.6%) and NWFP (36.3%).

Agriculture employs 43.61 percent work force in Pakistan followed by trade (14.43%), services sector (14.41%) and manufacturing (13.54%). In other words, over 86 percent of work force is employed in these four sectors. As against 2005-06 the shares of agriculture and services in employed workforce marginally increased in 2006-07 while those in manufacturing and trade registered a marginal decline.

There has occurred a shift in employment in major sectors of the economy; however, agriculture still remains the dominant source of employment in Pakistan. In 1999-00, the share of agriculture in employment was 48.4 percent, while in 2006-07 this has reduced to 43.6 percent. Targeting of labor intensive livestock and dairy sectors can 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 14.4 percent, 14.4 percent and 13.5 percent workforce, respectively. An increase in the share of manufacturing sector (2.1%), over the last seven years, is an indication that employment opportunities are being created in both rural and urban regions of the country. Trade (0.9%), construction (0.8%) and transport (0.4%) are supplementing employment generation as well. The policy of deregulation, privatization and liberalization helped in increasing the participation of private sector in the economy. As a result, a significant number of employment opportunities are being generated in urban areas. The capital intensity of the industrial sector, however, limits its employment generating capacity.

13. POVERTY AND INCOME DISTRIBUTION

The income-consumption module of the Pakistan Social and Living Standard (PSLM)

Survey provides basic information for measuring the incidence of poverty and distribution of income. Until the first half of the fiscal year 2007-08, the latest estimates available to gauge poverty situation in the country was related to the fiscal year 2004-05. Based on PSLM 2004-05 survey, poverty was estimated at 23.9 percent as compared with 34.5 percent in 2000-01- an improvement of 10.6 percentage points in four years. Only recently, the Federal Bureau of Statistics (FBS) made available the income-consumption module of PSLM 2005-06 to the Center for Research on Poverty and Income Distribution (CRPRID) attached with the Planning Commission and funded by the United Nations Development Program (UNDP). *It is important to note that the estimates of poverty from PSLM 2005-06 would depict the socio-economic conditions that prevailed during the fiscal year 2005-06. These estimates have nothing to do with current ground realities which have been impacted by the surge in food and fuel prices, poor agricultural performance and slower economic growth.*

The CRPRID/ Planning Commission estimated the Headcount ratio based on PSLM 2005-06 survey with a view to updating the benchmark of poverty estimates for Pakistan. The latest estimate of inflation-adjusted poverty line is Rs.944.47 per adult equivalent per month, up from Rs.878.64 in 2004-05. Headcount ratio, i.e., percentage of population below the poverty line has fallen marginally from 23.94 percent in 2004-05 to 22.32 percent in 2005-06, an improvement of 1.62 percentage points. Poverty in rural areas declined from 28.13 percent to 27.0 percent, showing an improvement of 1.13 percentage points between 2004-05 and 2005-06. Poverty in Urban areas also registered a decline from 14.94 percent to 13.1 percent during 2004-05 and 2005-06, thereby, depicting an improvement of 1.84 percentage points in the period. Poverty estimate in urban areas became less than half the rural estimates in 2005-06 for the first time since 1998-99. *It is important to note that a decline of 1.6 percentage points in poverty Headcount between 2004-05 and 2005-06 is found statistically insignificant*. In other words, statistically speaking, taking into account the margin of error in the estimates, the estimates of the two years are not different from each other. It is also important to note that a technical exercise carried out by the World Bank supports the accuracy of CPRID/Planning Commission poverty numbers for PIHS 2000-01, PSLM 2004-05, and PSLM 2005-06 using the official methodology and data cleaning protocol. The World Bank also carried out various sensitivity analyses to ensure the reliability of the estimates, and found that the poverty estimate at the national level declined slightly between 2004-05 and 2005-06, but the reduction was not statistically significant.

Notwithstanding marginal and statistically insignificant improvement in poverty Headcount during 2004-05 and 2005-06, the consumption inequality during the period has increased marginally to 0.3018 as measured by the Gini coefficient. It may also be noted that consumption inequality is continuously on the rising trend since 2000-01, rising from 0.2752 to 0.3018.

14. TRANSPORT AND COMMUNICATION

A well performing Transport and communication structure is vital for a country's development. Investment in a country's infrastructure directly affects economic growth as producers find the best markets for their goods, reducing transportation time and cost, and generating employment opportunities. The transport and communications sector accounts for about 10.0 percent of the country's GDP, and 20.9 percent of Gross Fixed Capital Formation in FY07/08. It provides over 2.3 million jobs in the country (6% of all employment) and receives 12 to 15 percent of funds from the annual Federal Public Sector Development

Program (PSDP). Apart from being a significantly large source of budgetary expenditure, the transportation sector imposes huge demand on Pakistan's energy supply, absorbing approximately 35% of total energy annually.

Pakistan, with 161 million people, has a reasonably developed transport infrastructure. The country generates a total domestic transport load of around 239 billion passenger kilometers and 153 billion tonne kilometers annually. Road transport is the backbone of Pakistan's transport system. The 9,574 km long National Highway and Motorway network - which is 3.65 percent of the total road network - carries 80 percent of Pakistan's total traffic. Recent initiatives and developments in sectors such as shipping, railways, and aviation are a welcomed step towards a more comprehensive, efficient, ad multi-modal transportation system. The total road network is about 260,000 km of which around 60% is paved. Road density is 0.32 km/km^2 which is low and compares unfavorably with other South Asian countries (Bangladesh-1.7 km/km^2, Sri Lanka-1.5 km/km^2 and India-1.0 km/km^2). The Government intends to generate/ mobilize all possible resources to double road density to 0.64 km/km^2. Total roads, which were 229,595 KM in 1996-97, increased to 264,853 KM by 2007-08 — an increase of 15.4 percent. During the out-going fiscal year, the length of the high typed road network increased by 3.2 percent but the length of the low type road network declined by 2.8 percent

Port traffic in Pakistan has been growing at 8 percent annually in recent years. Two major ports, Karachi Port and Port Qasim, handle 95 percent of all international trade. Gwadar Port, which was inaugurated in March 2007 and is being operated by Singapore Port Authority, is aiming to develop into a central energy port in the region. In addition, 14 dry ports cater to high value external trade. During the first six months of FY 2007-08, Karachi Port had handled a total of 20.5 million tonnes of cargo. From July to March of the current financial year, 2007-08, Port Qasim handled 19.76 million tonnes of cargo depicting a growth rate of 10% over the same period last year.

Pakistan Railways (PR) suffered heavy losses and damage to property owing to violence and rioting around the country this year. The network carried 59.74 million passengers and 5.2 million tons of freight during July-March of the outgoing fiscal year. Pakistan Railway's earnings stood at Rs. 13,954 million during the first nine months of FY 2007-08.

PIA carried 5.415 million passengers in 2007 as against 5.732 million in 2006 showing a decrease of 5.5 percent. While having to deal with challenges of rising fuel costs and imposition of a ban placed by the European Union, the Airline suffered losses of Rs. 13.4 billion in the outgoing fiscal year. Along with PIA, there are three private sector airlines operating in Pakistan.

Telecom sector continued to show a stellar growth in last few years. Tele-density in the country has jumped from a mere 6% to 57% (Mar- 08) in just a few years. On average, more than 2 million subscribers are being added on cellular mobile networks per month which is an exemplary growth in the region. Pakistan has become one of the fastest growing mobile markets among the emerging telecom markets. This year the sector grew by 80% whereas average growth rate in last 4 years is more than 100%. Today total subscriber base stands at 82.5 million (Mar 2008) whereas it was 34.5 million in 2006. Pakistan's broadband market has been slow despite the fact that services have been available since almost five years. Currently there are a total of almost 12,689 Broadband subscribers. According to estimates by the Internet Service Providers Association of Pakistan (ISPAK), currently there are about 3.5 million internet subscribers all across in Pakistan where total users crossed 17 million marks. Currently around 3,008 cities are connected to internet cities.

15. ENERGY

Energy is essential for the maintenance and development of the quality of human life as well as for economic activities. The world is facing a daunting task to meet the growing energy demand that is likely to double in the next twenty years. Pakistan is among those developing countries where the need to tackle the challenge is greatest. Ensuring availability of usable and affordable energy is therefore, the bedrock of Pakistan's current and future developments. In recent years, the energy demand has increased sharply in Pakistan owing mainly to strong economic growth and the attendant rise in per capita income. The supply of energy, on the other hand, has remained far too short to match growing demand because the existing energy resources could not be sufficiently explored and exploited. To address the issue of demand-supply gap, the government is working on many fronts, including the import of electricity and gas from Iran, utilization of 185 billion reserves of coal, development of small hydro projects, promotion of efficient use of energy, and acceleration of current programmes of alternative energy development.

The consumption of petroleum products, gas, electricity and coal during the first nine months (July-March 2007-08) of the current fiscal year increased by 10.1 percent, 2.8 percent, 5.7 percent and 11.9 percent, respectively over the corresponding period of last year. On the other hand, supply of crude oil, gas, petroleum products, coal, and electricity during the first nine months of the outgoing fiscal year 2007-08 increased by 6.5 percent, 2.7 percent, 7.4 percent, 13 percent and 4.4 percent, respectively over the corresponding period of last year

Production of crude oil per day has increased to 70,166 barrels per day during July-March 2007-08 from 66,485 barrels per day during the same period last year, showing an increase of 5.54 percent. The overall production of crude oil has increased to 19.3 million barrels during July-March 2007-08 from 18.2 million barrels during the corresponding period last year, showing an increase of 5.9 percent. On average, the transport sector consumes 50.9 percent of the petroleum products, followed by power sector (32.8 percent), industry (11.0 percent), household (1.9 percent), other government (2.2 percent), and agriculture (1.2 percent) during last 10 years i.e. 1997-98 to 2006-07.

The average production of natural gas per day stood at 3,965.9 million cubic feet during July-March, 2007-08, as compared to 3,876.4 million cubic feet over the same period last year, showing an increase of 2.3 percent. The overall production of gas has increased to 1,090,620 million cubic feet during July-March 2007-08 as compared to 1,062,124 million cubic feet in the same period last year, showing an increase of 2.7 percent. On average, the power sector consumes 36.8 percent of gas, followed by fertilizer (20.7 percent), industrial sector (19.8 percent), household (17.4 percent), commercial sector (2.7 percent) and cement (1.1 percent) during last 10 years i.e. 1997-98 to 2006-07.

The total installed generation capacity has increased to 19,566 MW during July-March 2007-08 from 19,440 MW during the same period last year, showing a marginal increase (0.65 percent). Total installed capacity of WAPDA stood at 11,654 MW during July-March 2007-08 of which, hydel accounts for 55.6 percent or 6,474 MW, thermal accounts for 44.4 percent or 5,180 MW. During first three quarters of current fiscal year 74,032 GWh electricity has been generated as against 71,033 GWh were produced in the same period last year, showing an increase of 4.2 percent. The number of villages electrified increased to 126,296 by March 2008 from 113,605 upto 2006-07, showing an increase of 11.2 percent.

Presently, some 2,068 CNG stations are operating in the country. By March 2008 about 1.70 million vehicles were converted to CNG as compared to 1.35 million vehicles during the same period last year, showing an increase of 26 percent. With these developments Pakistan has become the leading country in Asia and the third largest user of CNG in the world.

16. ENVIRONMENT

Environmental degradation is fundamentally linked to poverty in Pakistan. Approximately less than one-fourth of the country's population, like in most developing countries, is poor and directly dependent on natural resources for their livelihoods. The current cost of environmental degradation in Pakistan is considerably high. According to a recent assessment made by the World Bank (WB)[1], the cost of environmental neglect and degradation to the economy has

[1] Pakistan: Strategic Country Environment Assessment by WB (Sep, 2007)

amounted to Rs. 365 billion during the current year. The latest red-list of endangered species in Pakistan, released by the World Conservation Union (IUCN), includes the *Blue Whale, Fin Whale, Hotson's Mouse-like Hamster, Indus River Dolphin Markhor, Urial, Snow Leopard, Woolly Flying Squirrel, Brown Grizzly Bear, Western tragopan, Hobara Bustard, Siberian White Crane, Olive ridly turtle, Green turtle, Marmot, Blackbuck and Sand Cat.*

In order to address environmental concerns at the national level a multifaceted programme namely National Environment Action Plan (NEAP) was launched by the government in 2001. It mainly aimed to achieve environmental sustainability and poverty reduction in the context of economic growth. 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* etc.

Pakistan is likely to achieve many of the MDG 2009-10 and MTDF 2015 targets, in advance. The Forest Cover including state and private forests/farmlands (%age of total land area) stood at 5.2% during the current fiscal year. The targeted area was 5.2% for MTDF 2009-10 and 6% for MDGs 2015 confirming that the country is doing well in terms of achieving the signified target. However, according to international organizations such as IUCN and the World Wide Fund for Nature (WWF) it is feared that Pakistan is experiencing the world’s second highest rate of deforestation. The protected area for conservation of wildlife (%age of total area) was estimated at 11.3% while the targeted levels were 11.6% and 12.0% according to MTFD and MDG targets, respectively.

Air pollution levels in Pakistan's most populated cities are among the highest in the world and are likely to climb further, causing serious health issues. The levels of ambient particulates - smoke particles and dust, which cause respiratory diseases - are generally twice the world average and more than five times as high as in industrial countries and Latin America (Energy Information Administration, 2004).

In 1951, per capita water availability in Pakistan was calculated at 5300 cubic meters, which has now decreased to 1090 cubic meter just touching water scarcity level of 1000 cubic meter. Currently, only 44 percent of the population of Pakistan has access to safe sanitation and 65 percent to safe drinking water, whereas the MDG targets for 2015 are 90 percent and 93 percent, respectively. The **National Sanitation Policy** resolves to meet the MDG targets whereby the proportion of people without sustainable access to improved sanitation will be reduced by half, by the year 2015 and 100 percent population will be served with improved sanitation by 2025. Persistent Water logging, Salinization and Sodicity is continuously reducing the productivity of fertile soil in the country. It is estimated that about 38 percent of Pakistan's irrigated land is water logged, 14 percent is saline and the application of agricultural chemicals has increased by a factor of almost 10 since 1980.

The Government in collaboration with various concerned organizations has recently initiated the Technical Advisory Panel (TAP) on Climate Change. The official launch of the TAP was held on **February 15, 2008**, Funded by the Royal Norwegian Embassy and the Department for International Development, U.K., and TAP is a joint initiative of the Ministry of Environment, Government of Pakistan, and The World Conservation Union (IUCN).