ECONOMIC BULLETIN

May - June 2004

Contents

Editor's Corner

Dear readers,

The Finance Minister in his budget speech 2004-05, has spoken about transforming the National Savings Centre into a corporation to be known as Pakistan Savings. The new Corporation will diversify its business by offering mutual funds of different kinds for the individual investors.

Though details about the new scheme are not yet available, we would like to share with our readers what we feel would perhaps result from diversifying individuals' savings into mutual funds. Though mutual funds are a popular way to take some of the risk out of investing in individual stocks by investors, it will be a new learning experience for the small investors in Pakistan, many of whom are illiterate and the greater proportion of the rest have little or no knowledge of this kind of business. They have been accustomed to investing in one of the many saving schemes offered by the Government which had a fixed rate of return, was risk free, where the deposit was guaranteed by the Government of Pakistan, had an easy withdrawal mechanism, with no deductions and was conveniently accessible till the recent past at any of the branches of the commercial banks. One can still purchase them from any of the offices of the National Savings Centre, or State Bank of Pakistan.

This decision of the government must be looked at in the wider context of public debt and the welfare responsibilities of the government. The rising cost of domestic debt and the subsequent increase in the burden, resulted in growing debt servicing which was consuming a major chunk of the current expenditure, constraining the government's effort on enhancing resources for development expenditure. The later has wider benefits for the people at large, who benefit from the socioeconomic infrastructure development undertaken and by the government's spending on education and health.

It was felt that domestic debt could be slowed by bringing down the high cost of borrowing under the National Saving Schemes. The rates have been slashed quite substantially in the last few years. Defence Saving Certificates which were earning 18.04% on 10 year maturity (1996-99) have been brought down to around 8%. Despite these reductions, many pensioners, widowers and other small investors continue to invest in these schemes, largely because of confidence in the schemes, convenience of access and the fixed rate of return offered.

The Budget 2004-05 has changed all that. No longer will the individual investor be guaranteed a fixed return or continue to see a guaranteed appreciation of his savings. The returns he receives will now depend on market conditions, the economic environment, the skills of managers within the proposed assets management company, and a host of other factors.

While mutual funds have been around for a long time, it was only in the 1990s that mutual funds became mainstream instruments. In Pakistan, initially there was a mutual fund in the public sector, but later large numbers were opened in the private sector.

A mutual fund pools together money from many investors and invests it on behalf of the group. It is the portfolio manger who has to scrutinize and select the securities for investment on behalf of the investor given the general economic conditions in the economy, the regulatory framework in which he is operating etc. Because of the diversity in its investment portfolio, it minimizes the risk of capital loss and a reduction in yields, except in conditions of economic crisis. A good manager is able to avoid such circumstances by foretelling the changes in economic conditions. It is to be hoped that the proposed mutual fund, namely, Pakistan Savings, will be manned by the best in the field who would offer a rate of return similar to the one offered by the mutual fund in the public sector or at least on an average a return which is more than the rate of inflation in the economy.

The government is working towards developing specialised products which could meet the needs of individual investors. It is also working on a pension scheme and the mutual funds industry is looking into the possibility of designing products to meet the needs of retiring people by offering retirement benefit schemes. We will have to wait for the new products to be introduced in the market.

The success of the Pakistan Savings Corporation will depend largely on the convenience of access, similar to the one offered by the National Savings Directorate, i.e. through the post offices and commercial bank branches. The proposed corporation would be well advised not to dismember the existing network of easy access.

Ayesha Mahmud

Abstract of the Bulletin

Federal Budget 2004-05: A Review

- The Federal Budget 2004-05, has been presented against a backdrop of good yearly performance. In the outgoing fiscal year, the GDP growth at 6.4% surpassed the year's target, manufacturing growth was at an all time high, foreign direct investment rose, foreign exchange reserves touched $12.5 billion, budget deficit was contained at 4% of GDP, exports crossed $12 billion and external debt declined.

- The Budget has a total outlay of Rs.902.8 billion, where current expenditure constitutes 78% and development expenditure 22% of the total size.

- Total tax revenue is budgeted at Rs.654.8 billion.

- Indirect taxes constitute nearly 69% of CBR tax collection.

- Direct taxes are budgeted to grow by 12.6% in FY05.

- In FY04, bank borrowings jumped by 165% to Rs.74.0 billion over the budgeted figure of Rs.27.9 billion.

- External resources were revised downward in FY04 by 9% over the budgeted figure.

- During the year 2003-04, the pace of privatisation picked up; Rs.33 billion were realized on various transactions.

- Servicing of domestic and foreign debt and foreign loan repayment consume 45% of current expenditure.

- The size of the public sector development programme has been raised to Rs.202 billion in 2004-05, an increase of 31% over revised estimates of Rs.154.3 billion in 2003-04.

- This year, the Federal Budget has focused on the development of the agricultural sector, poverty alleviation, generation of employment opportunities, raising the level of investment, improving social indicators, rural development, infrastructure development and promotion of housing and construction.

- For the farmers an agriculture package has been announced.

- The government is working towards reforms in the pension system, and in transforming the National Savings Centre into aCorporation.

- Proposals related to tax policy and tax administration have been announced.

Public Debt Reduction & Management Strategy: An Assessment

- Rising public debt had become a major challenge confronting the government. A Debt Reduction and Management Strategy was announced in 2001, which has started to show positive results.

- Reduction in the fiscal and current account deficits, lowering the cost of borrowing, raising revenue and foreign exchange earnings have been the key features of the debt reduction strategy.

- Total public debt has been reduced from 89.2% of GDP in 2001 to 69.7% in 2004, while as a percentage of total revenue it has been brought down from 671.5% to 487.7% respectively.

- Total external debt and liabilities have been reduced by $2.072 billion in the last four years.

- In 2003-04, actual amount paid towards external debt servicing was $4.1 billion, while the rolled over amount was $1.1 billion.

Market Analysis

- The market performance was lackluster in the May-June 2004 period, falling 151 points in total over the two months. Technical factors, rising interest rates, political turmoil, and poor law and order were all factors behind the decline. The outlook ahead is positive however.

Federal Budget 2004-05

A Review

The budget 2004-05 has been presented against a backdrop of good yearly macro performance of the economy. Major economic indicators have achieved the targets set at the beginning of the year. The GDP growth was significantly higher (6.4%) over the target (5.3%), strong growth was recorded by the manufacturing sector (13.4%), exports reached $12.3 billion and imports $15.5 billion. The later mainly due to a rise in the demand for machinery and raw materials. Reserves reached $12.5 billion. Key indicators at the leading stock exchange (KSE) showed marked improvement. Banking sector saw some developments like, decline in the stock of non-performing loans, separate Prudential Regulations etc. Privatisation picked up and foreign direct investment rose. However, it has been recognized by the government that there are certain principal problems which needs to be tackled on a top priority basis, if any meaningful development is to be sustained and its benefits trickle down to the masses.

Economic indicators improve

The challenges mentioned by the Finance Minister in his Budget Speech are; the need to increase investment, especially in the private sector; the need to improve human development indicators, privatise public sector units; increase the development spending on economic and social infrastructure and improve law and order.

The Budget seeks to build upon the success of the Economic Revival programme and traverse the path towards long standing goals — higher income and employment, and sustained poverty reduction. The Budget is a part of the three year macroeconomic framework (2004-07), where the following targets form the basis:

Three year frame-work

§ GDP to grow to 8% by FY07.
§ Investment GDP ratio to reach 20%.
§ Lower fiscal deficit to 3% of GDP.
§ Inflation to average 5% during FY2004-07.
§ Foreign exchange reserves to be at a minimum equivalent to 28 weeks of imports.

In the following pages we shall review the income and expenditure of the Federal government, the areas to receive government focus, the taxation proposals, and the private sector view of the Budget.

Revenue Receipts Budgeted to Grow

As CBR revenue closed the year meeting the target and non-tax revenues showed a substantial rise of 20%, revised estimates for 2003-04 place receipts at Rs.760.9 billion, 4.5% larger than the target. This compares favourably with the previous years.

The leading tax this year is the general sales tax, whose net has been extended in the course of the last few years from manufacturing and import sectors to wholesalers, ship-breakers, importers and retailers. Sales tax is also levied on the consumption of electricity, natural gas, POL products, urea fertilizer etc. Estimates of sales tax collection show that despite a strong growth, due to rise in imports there was a slight slippage from the year's target of Rs.223.1 billion, as refund claims involving payment of Rs.44.9 billion were made during the year. For next fiscal year, collections under this head are expected to rise by 14.1% to Rs.249 billion. The buoyancy in GST could partly be explained by substantial broad basing of the tax.

GST net widens

Customs duty are estimated to exceed the year's target by nearly 11%, primarily because of higher accruals from machinery imports (10%), vehicles (23.8%) and other items (14%). Plant and machinery are subject to lower import tariff to help in industrial development. The rise in tariff is largely due to higher imports of iron & steel products, textiles and edible oil which fall in higher tariff categories. The maximum tariff has however, been reduced from 30% to 25%.

Customs duty rises

As against a 5% increase in the import target for the year, imports rose by nearly 20% to reach $15.5 billion, primarily on account of larger import of capital goods and industrial raw material. For FY05, customs duty are budgeted at Rs.103 billion, 19.2% more over revised estimates of FY04, inspite of a reduction in duties on industrial raw materials.

Federal Government Revenue Receipts

(Rs. Bn)

	2003-04 Budgeted	2003-04 Revised	2004-05 Budgeted
Total Revenue Receipts	728.4	760.9	796.3
Tax Revenue CBR	510.4	510.0	580.0
Direct Taxes	161.1	161.5	181.9
Taxes on Income	154.2	154.6	174.4
Other Taxes	6.9	6.8	7.5
Indirect Taxes	348.9	348.5	398.1
Customs	78.1	86.6	103.2
Sales Tax	223.1	218.4	249.2
Federal Excise	47.7	43.5	45.7
Tax Revenue (Other than CBR)	67.5	70.1	74.8
Petroleum development levy	46.1	46.4	47.5
Surcharge on natural gas	15.0	14.2	15.0
Others	6.4	9.5	12.3
Total Tax Revenue	577.5	580.1	654.8
Non-Tax Revenue	150.8	180.9	141.5
Interest	67.9	67.3	54.0
Dividends	23.8	33.4	34.8
Receipts from civil administration	33.1	45.3	15.3
Others	25.8	34.9	37.3

Source: Annual Budget Statement 2004-05 Government of Pakistan

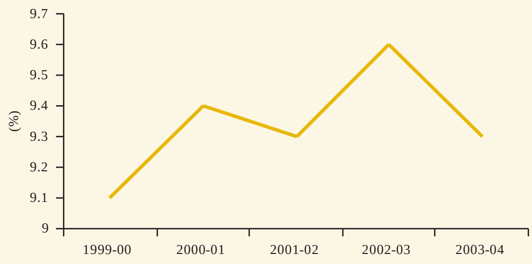
Direct taxes grow

Direct taxes are expected to increase from Rs.161.5 billion this year to Rs.182 billion in FY05, showing a growth of 12.6%. There has been a rise in voluntary payments and the reforms introduced in the income tax law have also yielded positive results. The large taxpayers unit (LTU) introduced in Karachi two years back has also helped in increasing revenues. Lahore and Islamabad will soon have such units.

Tax-GDP ratio declines

While the economy showed improved performance in FY04 with GDP growing at 6.4%, real interest rates remaining low, and exchange rate stable, it was not reflected in any improvement in the tax-GDP ratio. This ratio in fact declined marginally. The State Bank in its recent quarterly report states "the CBR tax collections should have responded to the higher nominal GDP growth proportionally."

Tax GDP Ratio



Tax revenue other than CBR

Under tax revenue (other than CBR) major portion accrues from petroleum development levy. With the deregulation of prices of petroleum products, the mechanism of development surcharge was done away with in 2001. Instead a fixed petroleum levy has been imposed at per litre price of various products notified by the government. Tax revenue other than CBR are estimated at Rs.70.1 billion in FY04, with Rs.46.4 billion accruing from petroleum levy, followed by gas development surcharge Rs.14 billion. The federal government fixes the sale price for the consumers and prescribes a price for the gas companies. The difference between the two prices is the margin available to the government as development surcharge.

Larger non-tax revenues

Non-tax revenues are estimated at Rs.180.9 billion, nearly 20% larger than the year's target of Rs.150.8 billion. The rise is attributable to higher receipts from civil administration, more specifically from defence services realized from receipts from United Nations, and from higher dividend from public sector corporations, most notably PTCL and OGDC. For fiscal 2004-05, non-tax revenues are to be lower by 21.8% over this year's revised estimates, as receipts from defence services are budgeted to fall substantially.

Net capital receipts

The net capital receipts in FY04 were Rs.3.1 billion higher over the budgeted figure of Rs.36.7 billion. For FY05, these are projected at Rs.64.4 billion. Receipts were higher under the permanent debt category, where Rs.75 billion accrued from Pakistan Investment Bonds against the budgeted figure of Rs.15 billion. Floating debt which comprise of Treasury Bills and Prize Bonds were revised higher, while investment in saving schemes declined.

Capital Receipts

(Rs. Bn)

	2003-04 Budgeted	2003-04 Revised	2004-05 Budgeted
Receipts	89.2	104.7	103.2
Recovery of Loans	29.4	31.7	28.5
Permanent Debt	(-)9.5	56.8	44.1
Floating Debt	15.6	27.6	30.1
Public Account	53.6	(-)11.4	0.5
Disbursement	52.5	64.9	38.7
Net Capital Receipts	36.7	39.8	64.5

Source: Federal Budget in Brief 2004-05 Government of Pakistan

External resources short of the year's target

External resources which were projected at Rs.159.1 billion, have been revised for the year and are placed lower by 9% at Rs.144.8 billion. This drop stems largely from a decrease in the non-food commodity aid, which are estimated 30% lower over the budgeted figure. Under the head "Other Aid", aid from Islamic Development Bank was revised downward by 64% and is estimated at Rs.6.2 billion against the year's target of Rs.17.3 billion. Credit under the oil facility dropped to Rs.17.4 billion against Rs.31.0 billion budgeted at the beginning of the year. For FY05, nil amount has been budgeted under this facility. The drop in external funding would have been larger, but for the Rs.28.8 billion realised through floatation in the Eurobond market.

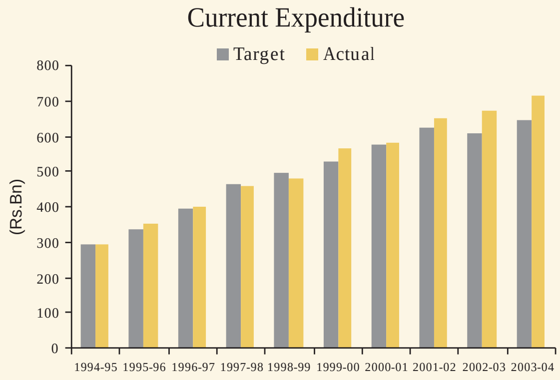
Expenditure Patterns

The Federal Budget 2004-05 has a total outlay of Rs.902.8 billion, where current expenditure accounts for 78% and development expenditure 22% of the total size. In FY04, the former exceeded the budgeted amount of Rs.645.2 billion by 10.7%, while development expenditure fell short of the target.

Debt servicing & defence consumes the bulk of current expenditure

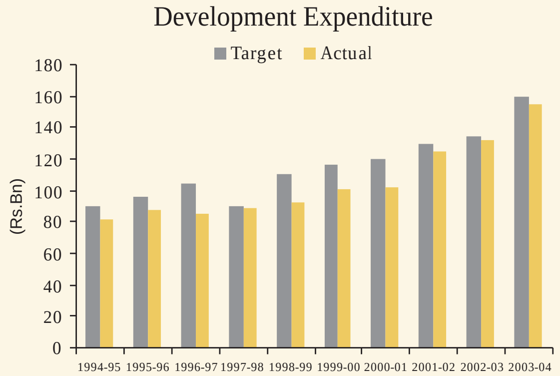
Under the new chart of accounts, bulk of expenditure is categorised under 'General Public Service', followed by 'Defence Affairs & Service'. The Rs.70.5 billion rise in the former can be attributed to foreign loan repayment, which surged to Rs.111.3 billion compared to the budgeted amount of Rs.46 billion. Servicing of foreign debt also rose by 14% to Rs.45 billion against the year's target of Rs.39.5 billion. Pakistan has prepaid some of its expensive debt. Meanwhile, servicing of domestic debt makes up slightly more than one-third of the current expenditure. As interest rates remained low, this expenditure remained Rs.9.3 billion lower over the year's target.

Defence services consume 25% of the current expenditure, and during the year saw a significant rise over the original target. This is attributable to the troop movement along the borders and the assistance provided against payment for logistic support. Next year's allocation has been raised by 7.4%.



Higher PSDP

Allocations for Public Sector Development Programme has been raised to Rs.202 billion for fiscal 2004-05 against last year's budgeted figure of Rs.160.0 billion. Revised estimates for FY04 show that PSDP fell by 3.5% to Rs.154.3 billion. This shortfall to implement development programmes has been reflected in the budgets for the last number of years.



Public sector development expenditure stimulates economic growth, as it makes available infrastructure for private sector and the basic facilities needed to improve the social well being of the people. This year the main thrust of the PSDP is on the development of infrastructure with major emphasis on water and power sectors, highways, roads and railways. Also to receive emphasis is human development, including increased allocation for education, health and population welfare. Allocations for the agricultural sector have been enhanced, alongwith an incentive package for the sector.

Privatisation Proceeds

Through various privatisation transactions, the government realized a sum of Rs.33 billion. The proceeds from privatisation (90%) are to be utilised by the Federal Government for retirement of the Federal Government debt and 10% for poverty alleviation.

Bank Borrowings

Government borrowing from the banking system at Rs.74 billion, were 164% higher than the original target of Rs.28 billion. Mobilizing resources through non-bank sources had become difficult due to low interest rates. National Saving Schemes failed to attract enough investment because of the slashing in their rates of return. Prevailing low interest rates encouraged the government to meet its expenses through bank borrowings. For FY05, such borrowings are budgeted at Rs.45.1 billion.

Implications of the Budget

The Budget has far reaching implications on the various sectors of the economy. We shall look at some of the areas.

Agriculture

Agriculture has been identified as one of the key areas of the government's revival strategy. It has always been the mainstay of the economy and despite the structural changes, the sector still contributes 25% of the total GDP. It is expected to play a lead role in achieving a higher growth with the poor benefiting the most.

The sector has strong linkages with the other sectors of the economy, but most of all it affects the livelihoods of the vast majority of the population. Rapid agricultural growth can stimulate and sustain the pace of industrial growth and make possible for the bulk of the population living in rural areas to have the purchasing power to buy goods produced by the agricultural sector.

It is the growth of the agricultural sector, which is critical in realising its beneficial impact on poverty alleviation, job creation and quality of life in rural areas.

Past experience shows that growth in the agricultural sector has not translated into sustained increase in rural income. There exists a disparity in the incidence of poverty between urban and rural areas.

There are number of constraints facing the agricultural sector like, lack of availability of sufficient irrigation water, agricultural credit, tractors and other implements etc.

Agricul-tural package announced

The federal budget 2004-05, has announced measures to solve some of the problems of the agricultural sector. A month earlier the government had announced an agricultural package for the farmers. Agricultural growth could be stimulated by investment in irrigation, rural infrastructure, availability of water, easy access to credit etc. The Budget this year has increased allocations for water and power. Some water sector projects have been initiated by the government which is expected to have a positive effect on farm productivity. Mechanisation is being encouraged.

Relief provided to the farmers

Sales tax exemption has been provided on import of tractors, bulldozers, and other agricultural implements, duty exemptions has been proposed on raw materials for local manufacture of pesticides and duty reduction on machinery not manufactured locally. Lending is being encouraged by restructuring the Zarai Taraquiyati Bank.

Better agricultural performance would improve the living standards of the people living in rural areas and help check the migrant workers go in search of job opportunities to the urban areas. This puts tremendous pressure on available urban infrastructure, and the available resources get distributed widely.

Employment

While economic policies of the government have brought positive results, there are many challenges still lying ahead. The major challenge is taking the economy at a higher growth on a sustained basis, creating employment opportunities, reducing poverty and reducing social gap.

Economic growth heralds employment opportunities and helps in eliminating poverty. It is not growth per se that a matters but only if it emanates from sectors that create jobs and help in improving the employment situation of the market.

Invest-ment in the economy generates jobs

In the short term, the level of employment is dependent on expenditure, i.e. private investment and government spending. Public expenditure plays a positive role in building the infrastructure, easing supply bottlenecks and lending support to private investment. If both are forthcoming, opportunities are created in the economy for greater absorption of labour. Employment is a challenge for the majority of the people who are getting bypassed by the economic growth and sidelined by policies. Economic policies need to be reoriented towards a job-led growth strategy.

Focus on job creation

The Federal Budget 2004-05, has enhanced the size of the Public Sector Development Prog-ramme, emphasised housing and construction, the agricultural sector, development of the rural economy and development of SMEs which are highly labour intensive and provide employment to the bulk of Pakistan's non-agriculture workforce. Private sector investment is being facilitated so that they too contribute towards generation of employment opportunities. The government will also increase its efforts to secure jobs for a larger number of workers abroad.

Investment

Low ratio

Low levels of investment have been one of the major challenges facing the economy. The investment to GDP ratio hovering at around 15-16% for the last few years is fairly low compared with other developing countries with an above 20% ratio. It is only in the last two years that there has been some pick up in investment as both public and private sector investment have grown.

Private sector investment has been sluggish in the past, while public expenditure which stimulates economic activity has been constrained by heavy public indebtedness and requirements of strict fiscal management. This has led to low investment GDP ratio.

Private sector credit rises

In FY04, total investment picked up to 18.1% of GDP against 16.7% a year earlier. Fixed capital formation rose sharply to 16.4% of GDP driven by public sector investment which has improved significantly. Private sector investment is also picking up and would benefit from the spill over effects of public investment. Private sector credit offtake from banks and other financial institutions has risen to Rs.290 billion in FY04, not only due to the newly developed market segments (consumers and SMEs) but the corporate sector too contributed to this increase. The additional demand available in the market has given a boost to investment in the economy.

The Budget 2004-05, has provided incentives to improve investment in the economy. Economic reforms initiated will be accelerated, PSDP has been raised to Rs.202 billion, a sizeable investment will be undertaken in the public sector through the public sector corporations, tax proposals announced give a major stimulus to investment and growth in the economy.

Poverty

Poverty has been recognized as the major challenge confronting the government. The government had earlier in the year, presented the full Poverty Reduction Strategy Paper, building upon the I-PRSP. The strategy emphasizes promoting sustainable growth as the main vehicle for poverty reduction. To generate a growth of 6% as envisaged in the PRSP will require a substantial increase in private sector investment, with the public sector playing a supportive role. The investment programme for the agricultural sector would support the sector's growth and address the large problem of rural poverty. As sustained economic growth is important to counter poverty, there is a need to concentrate on how to generate growth and what should be done in addition to growth to reduce poverty.

In the Budget 2004-05, the expenditure on poverty reducing measures has been raised by 16% to Rs.277 billion. Additionally the Budget has addressed employment generation, raising investment levels, development of rural areas and the agricultural sector. The benefits of these measures are expected to reach the people and should bring about some improvement in the poverty related indicators.

Relief Measures

§ Basic threshold of income liable to tax, increased from Rs.60,000 to Rs.80,000.

§ For senior citizens who are allowed reduction in tax liability by 50% if their income does not exceed Rs.200,000 the limit has been raised to Rs.300,000.

§ Revision of pay and pension of government employees. A Committee constituted for this purpose.

§ Adhoc relief to be provided to all employees of the federal government.

§ Limit of investment in the Special Saving Scheme for widows and pensioners raised from Rs.1 million to Rs.2 million.

The requirement of depositing the entire amount in one tranche is disposed with. Investors can transfer the amount from one scheme to another.

§ Relief provided to low income borrowers from House Building Finance Corporation.

§ TV licence fee to be made in monthly instalments with the domestic electricity bill.

Budgetary Measures

The Budget has tax policy measures for the various sectors of the economy. This section highlights some of the tax changes, the initiatives announced for the development of focused areas.

Investment & Growth	*Agriculture/Rural Development*	*Poverty*	*Housing / Construction*	*Employment/Human Development*	*Industrial Sector*

• Reduce customs duties on all types of plants, machinery and equipment not locally manufactured to 5%. No sales and with-holding tax, which were currently 15% and 6% respectively on the duty paid value.
• Reduction in the rates of sales tax.
• Proposed to maintain a single rate of sales tax of 15% and do away with higher rate of sales tax of 18%, 20% and 23%.
• Abolishing further tax of 3%, to encourage growth of large number of consumer items.
• Sales tax concession on major export oriented industries.
• Sales tax regime simplified for SME Sector.
• Trade distorting measures to be abolished.
• Exemption from routine audit for steel melters and re-rollers.
• To encourage investment in the stock markets, it is proposed to extend the exemption to capital gains for another two years.
	• A number of projects would be initiated to develop water resources. Launch of Rs.66 billion crash programme for lining of 87,000 water courses across the country in the next four years.
	• Import of those agricultural implements which are not being manufactured locally, custom duty, sales tax and withholding tax would not be charged.
	• Setting up of new tractor plants has been allowed.
	• The price of DAP fertilizer has been reduced by Rs.100 per bag.
	• The mark up on Zarai Taraqiati Bank loans have been reduced from the existing 14% to 9% effective July 1, 2004.
	• Special powers given earlier to ZTBL under the Land Revenue Act to use tehsildars and police for arresting farmers in case of default has been withdrawn. No farmer will now be arrested or imprisoned by ZTBL for non payment of loans.
	• A settlement scheme has been offered to small borrowers with repayment difficulties.
	• A new gas policy to be formulated and the fertilizer policy is in the process of being finalized.
	• Allocation for water sector raised to Rs.21 billion in FY05, against Rs.15 billion a year earlier.
	• Pilot programme launched to mobilize communities for development.
	• Cottage industries to be promoted.
	• Duty exemption proposed on raw materials for local manufacture of agri-culture pesticides.
	• Reduction in with-holding tax on import of certain type of fertilizers from 6% to 1%.
	• Agricultural machinery manufactured locally exempted from sales tax.
		• Poverty related expenditure raised to Rs.277 billion in FY05, against Rs.239 billion a year earlier.
		• Microfinance to be promoted.
		• Additional resources for Pakistan Poverty Alleviation Fund.
		• Allocations for food support programme has been raised.
		• Skilled people to be supported through credit, technical advice and marketing, so that they in turn contribute towards the development of cottage industries.
		• The scope of 'Hunarmand Pakistani' scheme has been expanded.
			• Legal and administrative impediments to the development of the sector to be removed.
			• Reduction in the duties of a number of building materials, including steel and its products.
			• Reduction in the duty on imported machinery for construction sector, together with exemption from the levy of sales tax and withholding income tax.
			• Elimination of excise duty on paints.
			• Work has begun to computerise title of ownership of properties.
			• Increase in the limit of property income for the purpose of withholding tax.
				• Increase in development budget to create one million jobs
				• Allocation for education sector doubled.
				• 50% increase in the allocation for health sector.
				• Population welfare to receive enhanced amount.
				• Public sector investment to rise to 6% of GDP. This includes the investment by public sector corporations. These investments will add to job opportunities.
				• Promote technical and vocational training.
				• Job opportunities to come from the private sector. Private sector investment to be facilitated.
				• SME Bank to reduce its cost of doing business lending to increase more employment opportunities.
				• Facilitating provision of micro credit.
				• Government expending serious efforts to secure overseas jobs for its people. A target of 350,000 has been set for overseas jobs for Pakistanis.
					• Reduction in customs duties on raw materials and capital goods. Raw material covers a broad spectrum of industries and agricultural inputs.
					• Removal of administrative impediments.
					• To reduce the cost of production: -
					  • sales tax rationalised.
					  • net of excise duties curtailed.
					  • overall tax regime to be made taxpayer friendly.
					• Effluent treatment plants to be established in major industrial estates.
					• Removal of excise duty on fruit juices, squashes and syrups.
					• Minimum tax rationalised for edible oil units.

Box

Federal Budget 2004-05

Views of Federation of Pakistan Chambers of Commerce & Industry

Engr. M. A. Jabbar*

The Federal Budget for the year 2004-05 sets a target of Rs. 902.77 billion of total revenue, with the following bifurcation.

REVENUE

Heads	2004-05	Share as %	2003-04 (Revised)	Share as %
Tax Revenue	*580*	*64.25*	*510 (514†)*	*58.73*
Direct Tax	181.90	20.15	161.5	18.60
Indirect Tax	398.10	44.09	348.5	40.13
Revenue Receipt (Other than CBR)	74.81	8.29	70.11	8.07
Non-tax Revenue	141.52	15.68	180.87	20.83
(Provincial share)	(239.16)	(26.49)	(211.41)	(24.35)
Net Receipt	557.17	61.72	549.57	63.29
Capital receipts	64.44	7.14	39.79	4.58
External Resource	156.36	17.32	144.82	16.68
Self financing of PSDP	33.11	3.67	34.85	4.01
Cash balance	31.55	3.49	14.33	1.65
Privatization proceeds	15.00	1.66	11.00	1.27
Bank borrowings	45.15	5.00	74.04	8.53
Total Resource	902.77	100	868.39	100

†*collected*

Tax revenue receipts are expected to rise from Rs. 514 billion (collected) in FY04 to Rs. 580 billion in FY05. Heavy reliance on indirect taxes now constitutes 44.1% of total resources; a shift of policy for increasing revenue through regressive taxes. The share of non-tax revenue is budgeted to fall to 15.7% from 20.8% last year. The share of external resources in total resources has been budgeted higher at 17.32% (19.6% of gross revenue) compared to 16.7% in FY04. So the objective to free the economy from the debt burden seems a little difficult. The regressive structure of the tax base may cause income inequality due to its proportionately higher share.

On the other hand, incentives and relieve in Sales tax payment by the private sector was highly welcomed, specially the abolishing of all additional sales tax by providing single rate of 15%. Manufacturers and retailers, having turnover of less than Rs. 5 million, exempted from Sales Tax regime brings them into the tax net by charging 0.75% of turn-over as final liability. This will settle the agitation from 1999 by small traders and cottage industry interests.

EXPENDITURES

Heads	2004-05	Share as %	2003-04 (Revised)	Share as %
Current Expenditure	700.77	77.62	714.02	82.22
Debt Servicing	265.33	29.39	317.72	36.59
Defence	193.93	21.48	180.54	20.79
General Administration	241.51	26.75	215.76	24.85
Development Expenditure	202.00	22.38	154.37	17.78
Total	902.77	100	868.39	100

Total expenditure has been raised by 4% in FY05, while current expenditure has been lowered by Rs. 13.75 bn. Development expenditure has been raised to Rs.202 bn. Last year 17.78% of the total expenditure was allocated for development expenditure, while this year it has been allocated 22.38%. This is a good development, as its multiplier effect will increase the level of total output and national income. The goal of achieving higher income level through development expenditure can be accomplished when it is spent on mega projects. The small development projects cannot bring the desired results. In the past, development expenditure shares in the toal have fluctuated. From a high of 29.6% in the 1980s, it dropped to 19.1% in the 1990s and to 14.5% in 2001-04. Current allocation is the highest after the 1980s. This shall have a positive affect on the economy.

Next year's budget deficit has been projected at 4% of GDP, compared to current year's 3.9%. The marginal increase in deficit is due to rise in development expenditure which would encourage growth in the economy.

The government has announced reduction in power tariff for industries, cut in duty on imports of raw materials, no capital gain tax on listed shares upto 2007, withdrawal of customs & excise duty, removal of sales tax on plant and machinery. These measures are for enhancing the level of investment in the country and also for achieving the growth target of industrial development. The private sector has welcomed these measures. Although these measures are expected to have a favourable impact on investment, but it is crucially dependent upon the law and order situation. Investment is also constrained because of low factor productivity in the country and the associated reasons for higher cost of doing business. The current budget has not taken any significant measures to address these issues. The current budget in context of WTO recognizes certain area corrections which have not been put under the specific investment umbrella for addressing the issues and more so on decreasing the tariff of utilities. KESC is silent and WAPDA has made some gimmick not to the advantage of SMEs.

Trade deficit has worsened from US$ 1,251.5 million during FY03 (July to April) to US$ 2,011.4 million, i.e. 2.1% of GDP during the year due to phenomenal increase in imports (19%) against 13% increase in exports. However, current account has remained in surplus for third consecutive year by $1.6 billion due to healthy remittances from expatriate workers $3.8 million during the year. Although imports have increased, it is encouraging to note that much of the increase has come in import of machinery and raw material which indicate strong prospects of growth in future output. The share of import cost of POL products has decreased even after the significant increase in its prices in the international market, which shows that due to conversion of many power plants to the gas and increasing Hydel power generation, economy's reliance on imported POL has declined. Import bill may be lower next year if the prices of POL products decline to OPEC's target range of US$ 25-30 per barrel. The foreign exchange reserves remain very strong at US$ 12.5 billion which are enough for more than 50 weeks of imports.

In the budget speech the Finance Minister has claimed that poverty has declined by 4.2% in past few years. However this contention is not tenable as the growth in agriculture has been reduced to 2.6 percent and the unemployment rate even as per Government figures have increased during the years.

Tax burden in Pakistan is extremely high and substantial relief in the budget has not been given to reduce the cost of doing business in Pakistan. The effective income tax rate, which approaches 47.8% (35% income taxes +7% WWF + 5.8% income tax on dividends) – calculated by a firm of Chartered Accountants – acts as a strong disincentive to investment in the formal sector. The exemption limit for income at Rs. 100,000 is a good measure, as it will provide relief to low and middle income group specially. Some of the tax experts are of the view that this exemption level is still too low, this should have been increased to Rs. 150,000.

Overall it is apparently looking business friendly budget but not people friendly. The budget must be people friendly which would raise their income and consequently the level of aggregate demand, so that business may flourish. More so even the expenditure on education, health and social welfare is less than one percent of GDP which cannot raise the HDI required for lifting the productivity. The priorities have been down graded due to limitations of the basket of revenue collections and desired level of deficit financing.

* *Vice President FPCCI*

Box — Economy 2003-04 Highlights

Growth Trends

§ GDP grew by 6.4%.

§ Manufacturing sector growth rose by 13.4%.

§ Services sector showed a 5.1% rise.

§ Agricultural growth lagged at 2.6%.

§ Per capita income increased to $652.

§ Total investment as proportion of GDP rose to 18.1%.

§ Public sector investment improved to 4.6% of GDP, while private sector investment rose to 11.7% of GDP.

§ National savings as a proportion of GDP was around 20%, while domestic savings stood at 17.8% of GDP.

§ While cotton production was lower over the preceding year, the other crops; rice, sugarcane and wheat showed increase in output.

§ The government announced a package deal for the farmers.

§ Under the micro credit scheme, financing extended showed a 27.3% increase to Rs.47.9 billion.

§ The impressive 17.1% growth by large scale manufacturing was mainly because of the significant growth by automobile, electronics, and food group (vegetable ghee, cooking oil and sugar).

§ Foreign direct investment stood at $760.4 million in 2003-04 (July-April), but as a result of outflow of $131.3 million of portfolio investment, total foreign private investment stood at $629.1 million.

§ Privatisation proceeds received through various transactions during FY04 (July-March) were of a sum of Rs.33.1 billion and by end March 2004, Pakistan had received gross proceeds of Rs.134.4 billion.

Fiscal & Monetary

§ Budget deficit contained at 4% of GDP.

§ Debt servicing has been brought down.

§ Fiscal reforms continue.

§ Monetary expansion estimated at 15%.

§ Total public debt has been reduced to 69.7%.

§ Real cost of borrowing of public debt was 3.2% during 2000-04.

§ As result of the easy monetary policy pursued by the State Bank of Pakistan, interest rate environment remained investor friendly.

§ Private sector credit expansion was substantially higher over a year earlier.

§ Government borrowings for budgetary support increased during the year. It rose to Rs.273.0 billion.

§ The banking spread (average lending rate – average deposit rate) narrowed to 3.4% from 8.74% in June 2001.

§ The non-performing loans of the financial sector have declined to Rs.222.7 billion at end December 2003, against Rs.247.1 billion a year earlier.

§ Inflation has been contained at around 4%.

Trade & Balance of Payments

§ Exports are expected to reach $12.5 billion , an increase of 12% as against the growth target of 8%.

§ Imports grew by 19% against the target of 5%. It has crossed $15 billion mark.

§ Remittances from abroad have crossed $3.2 billion.

§ Current account will be in surplus at $1.6 billion.

§ Foreign exchange reserves stand at $12.5 billion.

§ The average exchange rate of the Pak rupee versus the dollar remained stable during the year.

External Debts

§ External debt and liabilities declined by $2.1 billion in the last four years to $35.8 billion.

§ As a percentage of GDP, external debt has fallen to 37.8%.

§ Pakistan has pre-paid a part of its expensive debt; the pre-payment schedule is spread over a four year period.

§ The build-up in foreign exchange reserves helped Pakistan in its debt servicing; in FY04, the actual amount paid ws $4.0 billion and the rolled over amount $1.1 billion.

§ Pakistan returned to the international capital market and issued $500 million Eurobond.

Social Sector Indicators

§ Literacy is estimated at 54% and is envisaged to rise to 60% by 2006.

§ Health indicators are low compared to some other countries; high population growth (2.2%) low life expectancy (64%), high infant mortality (82/1000) and child mortality rate under 5 (105/1000).

§ Poverty has declined by 4.2 percentage points.

§ The poverty reduction strategy is being followed by; improving economic growth rates, with emphasis on pro-poor growth, (focusing on agriculture, housing & construction, SMEs, information technology and the oil & gas sector).

Housing

§ Construction sector has grown at a rate of about 8%.

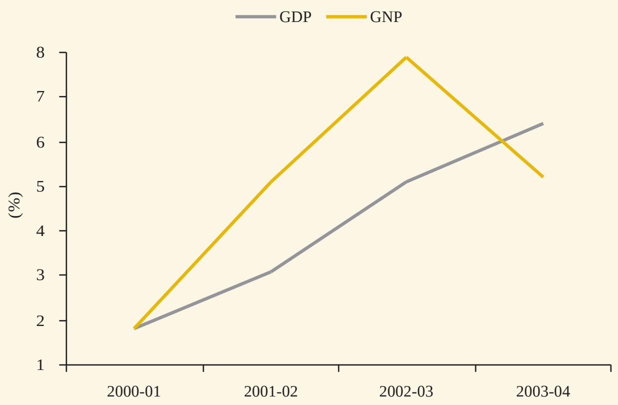
§ There are 19.3 million housing units in the country, while the demand is for 24.8 million.

§ While demand for housing finance is about Rs.70 billion, currently Rs.3-4 billion is available.

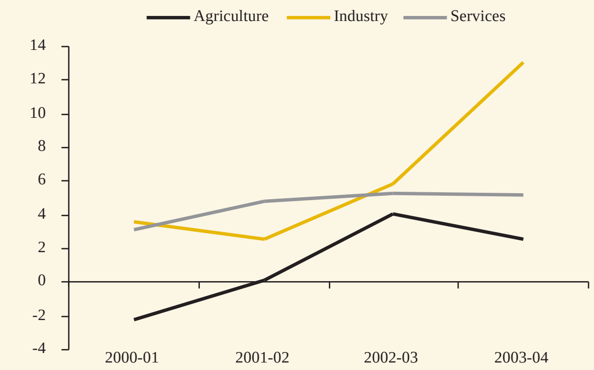
§ Government has initiated measures to develop the housing sector.

Current Trends in the Economy

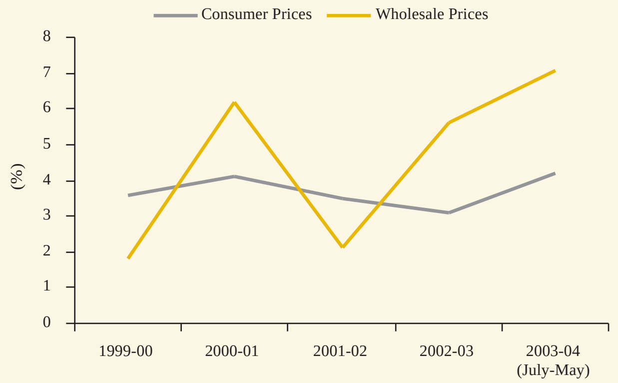
GDP/GNP Growth



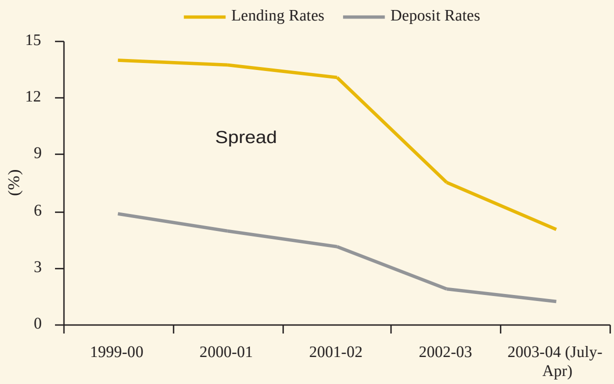
Sectoral Growth



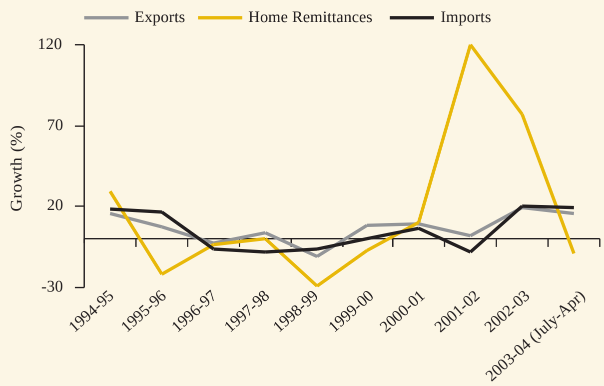
Inflation
(year-on-year change)



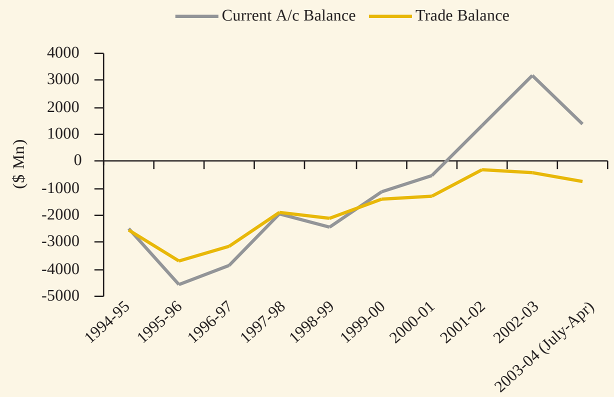
Lending & Deposit Rates

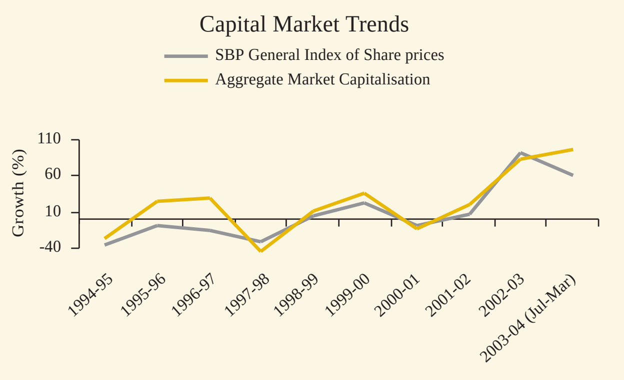


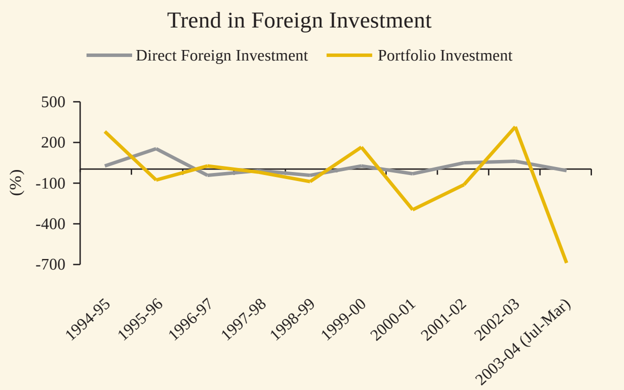
Export, Import & Remittances

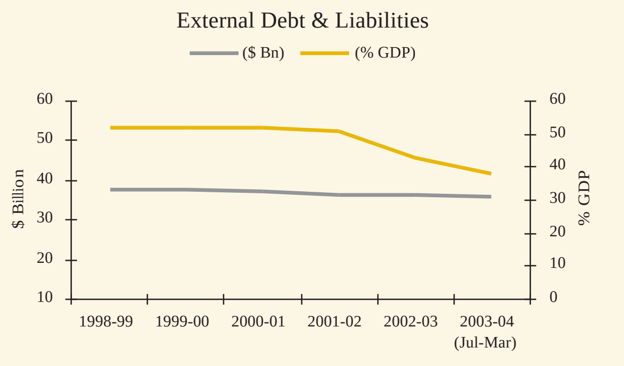


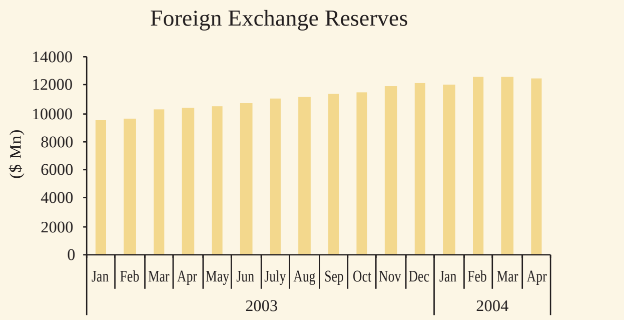
Trade & Payment Account

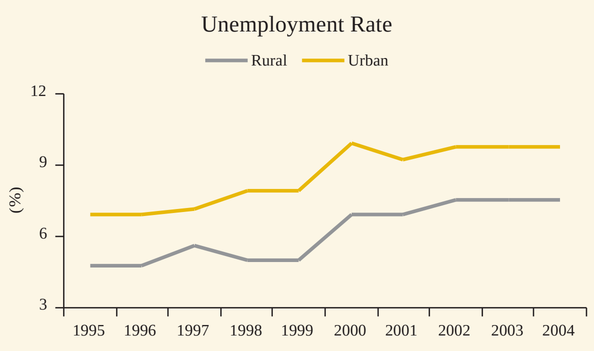


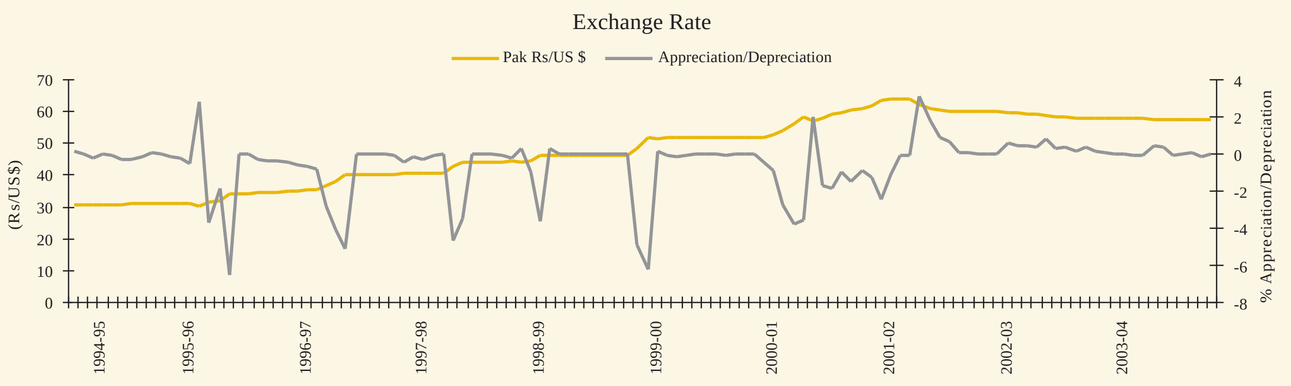

Capital Market Trends
SBP General Index of Share prices
Aggregate Market Capitalisation
Growth (%)
110
60
10
-40
1994-95
1995-96
1996-97
1997-98
1998-99
1999-00
2000-01
2001-02
2002-03
2003-04 (Jul-Mar)


Trend in Foreign Investment
Direct Foreign Investment
Portfolio Investment
(%)
500
200
-100
-400
-700
1994-95
1995-96
1996-97
1997-98
1998-99
1999-00
2000-01
2001-02
2002-03
2003-04 (Jul-Mar)


External Debt & Liabilities
($ Bn)
(% GDP)
$ Billion
% GDP
60
50
40
30
20
10
0
1998-99
1999-00
2000-01
2001-02
2002-03
2003-04 (Jul-Mar)


Foreign Exchange Reserves
($ Mn)
14000
12000
10000
8000
6000
4000
2000
0
Jan Feb Mar Apr May Jun July Aug Sep Oct Nov Dec Jan Feb Mar Apr
2003
2004


Unemployment Rate
Rural
Urban
(%)
12
9
6
3
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004


Exchange Rate
Pak Rs/US $
Appreciation/Depreciation
(Rs/US$)
% Appreciation/Depreciation
70
60
50
40
30
20
10
0
4
2
0
-2
-4
-6
-8
1994-95
1995-96
1996-97
1997-98
1998-99
1999-00
2000-01
2001-02
2002-03
2003-04

Provincial Budgets 2004-05
Highligts

Sindh

- § Revenue expenditure budgeted at Rs.104.9 billion, and revenue receipts at Rs.100.68 billion, resulting in a deficit of Rs.4.22 billion. The deficit widens to Rs.5.43 billion due to shortfall in the current capital account.
- § Total development outlay planned at Rs.20.8 billion, including Rs.18 billion for ADP and Rs.2.80 billion foreign and federal funded development programmes.
- § Road sector development has been given the highest allocation. During the year, 173 schemes — 104 on going and 69 new would be completed.
- § Karachi to receive Rs.1.162 billion under the ADP, out of a total allocation of Rs.5.65 billion (for 16 districts of Sindh).
- § No new tax has been imposed and no increase in the rate of taxes has been made.
- § Stamp duty charged on cheques, pay orders, bank drafts, airline tickets has been withdrawn.
- § The licence fee for installation of a new cotton ginning or pressing factory which varied from Rs.500 per roller to Rs.5000, will now be charged at a flat rate of Rs.1000.
- § The existing transportation fee on seed cotton, ginned cotton, and cotton seed has been withdrawn.
- § Provincial government employees will get house building/improvement loan upto Rs.10 million and Rs.2 million at a low interest rate.
- § The amount of insurance for civil servants under the Group Insurance Scheme has been enhanced.

Punjab

- § Total outlay budgeted at Rs.185.32 billion, revenue expenditure of Rs.141.8 billion and Annual Development Programme of Rs.43.44 billion.
- § The annual development programme will be financed to the extent of Rs.34.7 billion from provincial resources and Rs.8.78 billion from foreign assistance.
- § The development outlay is more than double preceding year's allocation.
- § Social sector and infrastructure development to receive priority.
- § Of the total ADP, Rs.34.44 billion have been allocated for provincial programme and Rs.9 billion for the district programme.
- § Punjab government has finalized its Poverty Reduction Strategy Paper, aiming to reduce the incidence of poverty from 33% to 28% by 2005-06.
- § The provincial government has been able to swap its expensive cash development loan with low priced loans. This policy would help save at least Rs.10 billion within the next 3 years.
- § Property tax exemption given to one house of five marlas used for residential purposes.
- § Stamp duty abolished on Memorandum and Articles of Association of Companies.
- § Stamp duty reduced on conveyance, exchange and gift of urban property.
- § Stamp duty on agricultural land and rural property reduced.
- § The base of professional tax has been broadened to include contractors, suppliers.
- § Professional tax on lawyers and doctors has been streamlined.
- § Lifetime token tax for motorcycles/scooters has been enhanced.

NWFP

- § Total outlay budgeted at Rs.60.9 billion; 70% for current expenditure, 26.6% development expenditure and 3.4% for current capital expenditure.
- § Social services receive 39.4% of current expenditure of Rs.42.6 billion.
- § Major portion of the province's revenue receipts accrue from the federal government's divisible pool (60%), and Rs.8 billion on account of net hydel profit
- § The development programme emphasizes foreign aided projects, ongoing projects and new projects in social sectors and revenue generating sector.
- § The main focus of ADP is poverty alleviation, provision of basic facilities to a large number of people and addressing the province's backwardness.
- § A 15% raise in the pay and pension of provincial government employees announced.

Balochistan

- § Provincial budget outlay envisaged at Rs.42.73 billion — Rs.28.45 billion revenue expenditure and a development expenditure of Rs.14.28 billion.
- § Total revenue receipts are expected at Rs.26.38 billion, including Rs.24.76 billion as federal receipts and Rs.1.62 billion as provincial revenue.
- § The revenue receipts show a shortfall of Rs.2.06 billion as against the revenue expenditure of Rs.28.45 billion.
- § The budget shows an overall deficit of Rs.8 billion, which goes up to Rs.9.5 billion because of a 15% increase in the salaries of government employees.
- § The development programme focuses upon road development, investing in education, water sector, Gwadar port, mega projects like Mirani dam, Kachhi canal, extension of Pat Feeder Canal, Balochistan effluent disposal project etc.

Public Debt Reduction & Management Strategy:

An Assessment

Public debt management had become a priority for the government in the late 1990s, when both domestic and external debt acquired alarming proportions and had become unsustainable. Rising stock of debt had resulted in resources being utilised for servicing the debt, rather than being employed for more productive purposes: for development works, for social sector spending, for poverty alleviation etc. Deepening of the debt problem had adversely affected the economic stabilisation mechanism.

Rising Debt

While the ratio of public debt to GDP had increased to over 100% by mid 1999, the ratio of debt to revenues increased to 625%. At the same time, the proportion of interest payments to revenues rose to 61%. According to the IMF's statistics for 1990-98, Pakistan's total debt servicing and interest payments on foreign loans were the highest among all income groups. In 1998, Pakistan paid 12.5% of its GNP on debt servicing alone. This average for low income countries was 3.1%, for all developing countries it averaged 4.5%, and for South Asia it was 2.5%.

Cognisant of the problem, the Government formulated a Debt Reduction & Management Strategy in 2001. For the benefit of our readers, we shall recap the major elements which formed the basis of the Strategy. This will be followed by reviewing the progress towards debt reduction goals.

Following eight elements formed the basis of the Debt Reduction Strategy: -

Elements of the Strategy

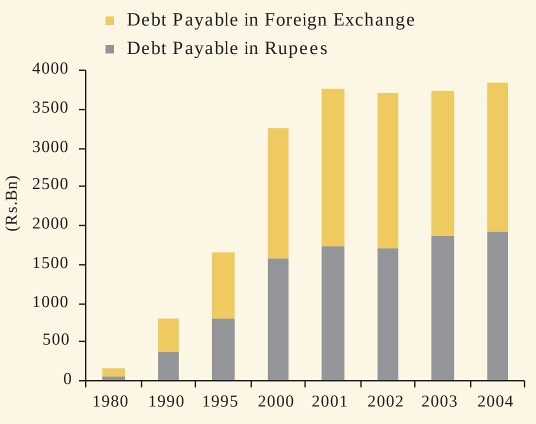
§ Reviving economic growth.
§ Improving debt paying capacity through growth in exports, remittances and government revenues.
§ Bringing down the real cost of government borrowing, especially domestic borrowing.
§ Working towards an agreement with the IMF for Poverty Reduction and Growth Facility for 2001-04.
§ Accelerating the process of privatisation.
§ Improving the effectiveness of government expenditure, especially the use of borrowed resources.
§ Reducing the rate of future borrowing.
§ Adopting a medium and long term debt strategy with clearly defined goals of debt burden reduction.

These areas of focus were given some targets and ways were identified to achieve them in the context of other economic goals. Let us look at some of the major targets set to reduce the debt burden and achievements so far. (next page).

The strategy shows positive results

The Government's Debt Reduction Strategy has started to show positive results. While in absolute terms public debt has grown, the rate of increase has however, subsided substantially, and as a proportion of both GDP and total revenue it has fallen. In the five year period 1995-2000, the quantum of total public debt grew from Rs.1662 billion to Rs.3246.4 billion or by 95%, but in the next four years it rose by 18.5% to Rs.3848.5 billion (2004). The public debt to GDP ratio meanwhile fell from 89% to 84.7% and further to nearly 70% in the same period. Seen in the relation to total revenue, the ratio rose from 514.7% to a high of 671.5% but then fell to 487%.

Public Debt



Goals of Debt Reduction

Targets	*Achievements*
Reviving Growth Deserves High Priority	
§ GDP to grow at 5.5% by 2003-04 and further to over 6% in the second half of the decade.	§ In 2003-04, the economy achieved a growth of 6.4%, supported by higher growth of manufacturing & services sector.
§ Investment to GDP ratio to increase from 15% to 16.8% by 2003-04 and to 22.6% by 2009-10.	§ The ratio rose to 18.1% in 2003-04, led by the public sector where the improvement was significant.
§ Of this, public sector investment is projected to rise to 5.3% of GDP by 2003-04 and private sector to 9.5%.	§ Public sector investment rose to 4.6% of GDP in FY04, while private investment was much higher at 11.7% of GDP.
§ Inflation to be limited to 6% in the period.	§ Inflation has been brought down to 3.9% in FY04.
§ Current account balance of payments deficit will continue to decline till 2004, but will gradually increase to 3% of GDP by the end of the decade.	§ The current account is in surplus. During 2003-04 (July-March) the surplus was $1369 million. As a proportion of GDP it was +3.8% in FY03.
§ Investment to average 19.7% of GDP between 2004-10.	§ Investment to GDP ratio rose to 18.1% in FY04.
§ Population growth rate expected to drop from the present 2.2% to 1.8% by 2009-10.	§ Population growth has declined to 1.9% in FY04.
Fiscal & External Adjustment (Implement fiscal & external adjustment with the hope to eliminate the need for further IMF programmes). Fiscal adjustment needed to achieve this, includes;	
§ Reduction of the fiscal deficit from 6.5% of GDP in 1999-00 to 3.0% by 2003-04. This requires: -	§ Fiscal deficit has been reduced to 3.3% in FY04.
§ 75% increase in government tax revenues from Rs.407 billion to Rs.704 billion over a three year period, and raising the tax revenue to GDP ratio from 12.8% in 1999-00 to 14.7% in 2003-04.	§ Tax revenues estimated at Rs.510 billion for FY04 and the tax to GDP ratio at 10% are both short of the target.
§ Raising exports from $8.2 billion in 1999-00 to $12.0 billion in 2003-04.	§ Exports are expected at slightly over $12 billion in FY04.
§ Raising the share of merchandise exports from 13.3% of GDP to 17% over the period.	§ Exports were 13.2% of GDP in 2002-03.
§ Reduction in the share of defence spending from 4.7% of GDP in 1999-00 to 3.9% in 2003-04.	§ Defence expenditure reduced to 3.3% of GDP; is now below the target set.
§ Elimination of borrowings for non-development expenditure.	§ Borrowings are resorted to as internal resources fall short of expenditure needs.
Contingent liabilities, both explicit and implicit which arise from losses incurred by public sector enterprises exert major claims on the budget. In the past, the Government has had to provide financial relief to WAPDA, KESC, Pakistan Steel Mill, and the Pakistan Railways. Unfunded losses of public sector banks are another source of implicit contingent liability.	While the government continues to meet the explicit/ implicit contingent liabilities, the quantum has been brought down. In conformity with the Macroeconomic & Medium Term Budgetary Framework adopted by the government, a policy of limiting guarantees and the risk analysis of contingent liabilities has been institutionalised. During FY04, the government issued guarantee equivalent to Rs.75.93 billion or 1.39% of GDP against Rs.144.56 billion or 3.28% of GDP issued in FY02.

Targets	*Achievements*
Real fiscal adjustment can only come through comprehensive restructuring, introduction of corporate management structure and ultimate privatisation.	Government's implicit contingent liabilities have more than halved from Rs.123.7 billion in FY02 to Rs.57.2 billion in FY04 primarily because of no fresh equity injected into KESC. Financial improvement plans of the two power utilities, WAPDA and KESC are currently being implemented. Operational performance continues to be weak. They are being prepared for privatisation.
Privatisation	
§ Mobilize at least $3 billion over the next 3 years and use the privatisation proceeds partly to retire high interest short term external debt and partly to build up foreign exchange reserves.	§ While privatisation picked up significantly last year, as in one year alone, the Government of Pakitan realized Rs.33 billion through various transactions, the target will hopefully be met in the near future.
§ In the next three years focus on sale of PTCL, PPL, OGDC, PSO, KESC, HBL & UBL.	§ HBL, UBL & OGDC have been privatised, the Government plans to privatize the other entities in the near future.
Cost of Borrowing	
§ Reducing the real cost of government domestic debt which averaged nearly 9% during 1998-00. The norm should be 3 to 4% per annum.	§ Real cost of borrowings of domestic debt has been brought down to 5.8% in FY04.
§ Interest payments on NSS be reduced and so restructured that the returns correspond to a market based yield curve based on FIBs.	§ Interest on the various instruments of NSS are increasingly becoming market based as these are being aligned to yield on Pakistan Investment Bonds of relevant maturities. The returns have been brought down significantly.
§ Reduce reliance on high cost NSS.	§ Reliance has been reduced, as interest rates have fallen on NSS. Unfunded debt is now 37.2% of GDP as against 43.3% in 1999-00.
§ Reduce the burden of multilateral debt service.	§ While servicing of foreign debt rose in 2003-04 by 14%, repayments of foreign loans more than doubled during the year.
§ No need for further assistance from the IMF beyond the proposed PRGF. § No need for any additional debt relief after 2004.	§ The Finance Minister in his Budget Speech 2004-05, has reiterated that we are saying goodbye to IMF.
§ Reduction in external debt burden to 200% of foreign exchange earnings by mid 2005.	§ External debt & liabilities as a percentage of foreign exchange earnings reduced to 168.7% by 2003-04.
§ Raise foreign exchange reserves to $5 billion by mid 2004.	§ Foreign exchange reserves have crossed $12.5 billion.

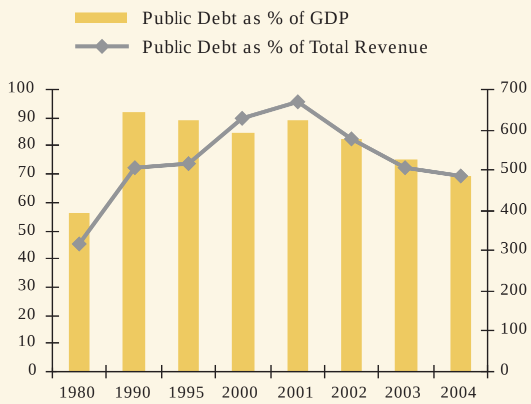
Note: - Explicit contingent liabilities legally oblige the government to make a payment if a specific event occurs. They represent a hidden subsidy.

Implicit contingent liabilities are not officially recognized until a failure occurs. In most countries the financial system is the most serious contingent implicit government liability.

Shorter term debt falls

One of the features of the Debt Reduction Strategy was to change the profile of domestic debt. As interest rates offered by various instruments of the national saving schemes were rationalised, the unfunded debt has fallen and so has the share of floating debt to total debt. The later has fallen to 27% of total domestic debt against 41% in FY01. While the share of domestic debt of longer term maturity has risen to nearly 30% against 20% at the end of FY00, the proportion of unfunded debt has fallen to 44.1%. This has been an achievement of the Strategy which sought to reduce the profile of debt from shorter term to longer term maturity.

Public Debt



Cost of borrowing declines

Interest payments on domestic debt have come down to Rs.161.5 billion or 20.4% of total revenue in the outgoing fiscal year against Rs.210 billion or 41% of revenue in FY00. The real cost of borrowing on public debt has come down from 5.6% in the late 1990s to 3.2% in the period 2000-04. This improvement alongwith fiscal consolidation has resulted in a sharp decline in the debt burden during 2000-04.

Large current account deficits, imprudent use of borrowed resources, rising cost of borrowing, stagnant exports and a declining flow of foreign exchange had resulted in rising debt and foreign exchange liabilities. This had risen in FY00 to $37.9 billion or 297.3% of foreign exchange earnings, but fell to 169% in FY04, and as a proportion of GDP it fell to 37.8% from 51.7% in the same period. The 1990s had accumulated a debt of almost $16 billion.

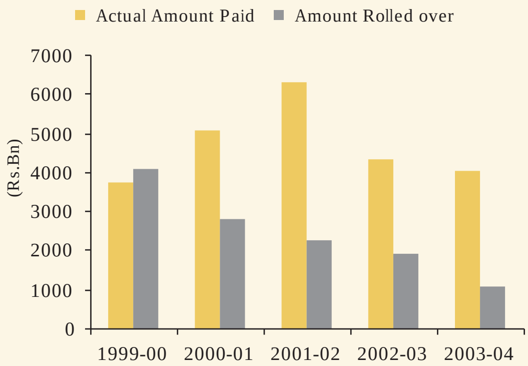
External debt position improves

The debt reduction strategy has succeeded in reducing the stock of external debt and foreign exchange liabilities by $2.027 billion in the last four years from $37.6 billion in 1999 to $35.8 billion by March 04. Surplus current account, rising foreign exchange reserves, higher foreign exchange earnings, pre-payment of expensive debt and write offs are the principal factors which have contributed to the improved position.

With improved foreign exchange reserves, and foreign exchange earnings, Pakistan has been able to retire its expensive debt and improve its debt profile. Some $4.5 billion of high cost debt to the multilateral institutions were identified for early payment. These loans carry interest ranging from 6.3 – 11%. It pre-paid $1.17 billion and the balance amount will be paid in the next few years.

With an improved foreign exchange reserves position, the actual amount paid as debt servicing has risen, while the rolled over amount has shown a declining trend. This trend has persisted and during the outgoing fiscal year both have shown a further fall. The total servicing was $5.2 billion ($4.1 billion actual paid and $1.1 billon amount rolled over) against $7.8 billion in 1999-00 ($3.7 billion amount paid and $4.1 billion amount rolled over).

External Debt Servicing



Real growth of external debt burden declined by 13.1% in the period 2000-04, after growing by 4.9% in the second half of the 1990s, while in the corresponding period the real growth in foreign exchange earnings improved substantially from 1.1% to 13.9%. The real cost of borrowing has dropped from 5.5% to 0.7%, due to low interest and inflation rate environment.

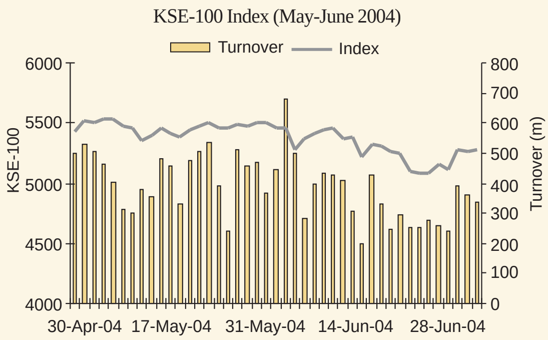
Conclusion

The Government's Debt Reduction Strategy has ensured positive results. Public debt appears to be on a downward trend, as reflected in the fall of public debt to GDP ratio. This has been an effect of substantial primary surpluses, high real growth, falling interest costs and a modest appreciation of the Pakistani rupee against the US dollar. Modest increase in tax revenue, savings on interest expenditure and some pruning of budget support to state owned enterprises would contribute to further debt reduction. What has government done with the fiscal space it has bought? Have development expenditures risen? Has govern-ment been able to utilise, if not all, at least these additional resources more effectively? We will analyse these in a forthcoming issue.

Market Analysis

Market Review

The market performance was lackluster in the May-June 2004 period. While the KSE-100 Index managed to rise 67 points in the month of May'04 to close at 5498 points, June was bearish and saw a 219 point drop to close at 5279 points. Technical factors, rising interest rates, political turmoil, and poor law and order were all factors behind the decline.



The top performing stocks (out of the 30 volume leaders) during the two months were Telecard, ICI and Pak Oilfields.

§ Telecard rose ahead of the award for local loop and LDI licenses. It was one of 19 companies awarded an LDI license on July 5, 2004, and as a result, can be expected to show strong revenue growth from its new line of business.

§ ICI Pakistan's share price did well after it announced its board had agreed to sell its shareholding in PPTA (though it is still premature to expect any sale).

§ Pakistan Oilfields did well for technical reasons, its share price had fallen earlier and it was merely rebounding again from support levels.

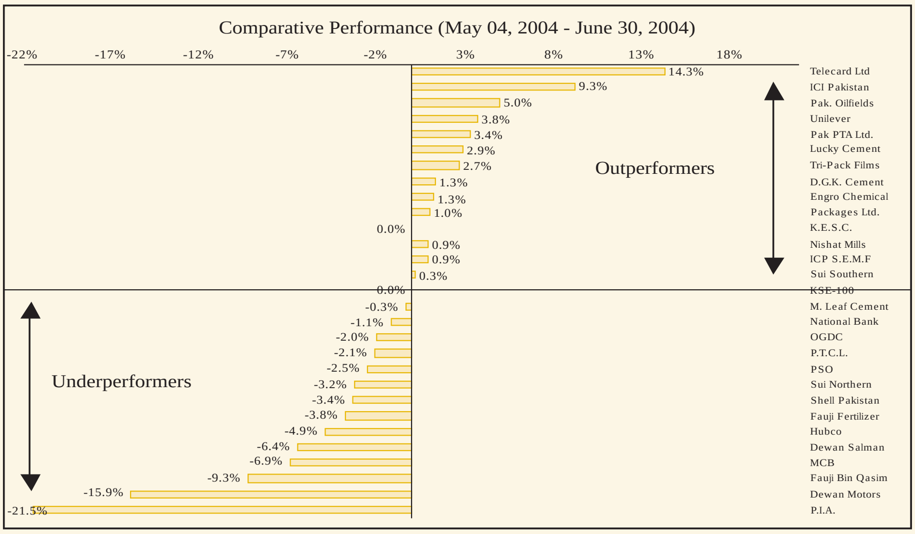
The worst performers included PIA, Dewan Motors and Fauji Bin Qasim. PIA and Fauji Bin Qasim were both over priced, and so fell more steeply when the market was in decline. Dewan Motors fell in reaction to expected lower import duties and the possibility that the import of reconditioned cars would be allowed.

The sugar and cement sectors were the best performing sectors overall.

§ The sugar sector did well on an improved earnings outlook following high sugar production this year.

§ The cement sector has shown 20% sale growth in 2003-04 versus 2002-03, and capacity utilization in 4Q04 (Mar-Jun'04) was over 90% for the industry. Cement prices remain high and the industry outlook is very positive. Cement is expected to continue performing well.

Not surprisingly, the auto sector performed poorly in anticipation of lower import tariffs in the 2004-05 budget. Paradoxically, while the budget did announce a large drop in import tariffs for CBUs



(completely built up units), the level of protection is still high enough to keep the threat of imports at bay, particularly in the smaller sized car segments. As a result, auto sector stocks, after their steep fall, are now attractively priced. The power sector performed poorly because of Hubco. As a yield stock, Hubco's share prices fell in response to the rising interest rates.

Budget Impact - CVT

The Federal Budget 2003-04 was a good, pro-growth, pro-investment budget but it had very few sector specific initiatives. The most noticeable effects were for the stock market itself with the imposition of capital value tax, and for the auto sector (as mentioned, tariff protection was lowered for the auto sector and this is seen as a negative for the industry).

CVT reduced

The 2004-05 budget initially proposed a Capital Value Tax at 0.1% of transaction value. This level would have been too high as it would in some cases double the transaction cost associated with shares trading and reduce the level of market activity. The CVT was thus was later reduced to a far more manageable 0.01% of share purchase value.

The aim of the CVT is to capture tax revenues from the fairly high level of activity seen in the capital markets. However, CVT is a form of turnover tax and assumes that all turnover leads to profit, which is not necessarily true- stock market investors will be required to pay tax even when they incur a capital loss. On the whole, because the revised CVT rate is fairly low, it should not hamper market activity. It will have the effect of encouraging longer holding periods however, as frequent turnover will mean greater payment of tax.

Market Outlook

Though the market performance was poor in May and June 2004, the long-term outlook is still positive. The market has already factored in that interest rates are now on the rise, so further increases are not likely to have more than a very short-term effect on market valuations- to the extent that the rise in interest rates are within expectations.

The market also reacted positively to the nomination of Shaukat Aziz as the future Prime Minister though this could be a source of volatility for equity markets, at least until he has been sworn in as PM.

Market will rise due to high liquidity

Liquidity is the primary driving force behind the market currently, supported by continuing strong corporate earnings growth and a positive economic outlook.

To drive home the point on liquidity, five new closed-end mutual funds were launched during the quarter with a total paid up capital of Rs6.5b. More are in the pipeline. The growing number of mutual funds is a reflection of the liquid market environment that will drive the market upward in the quarter to come.

(Contributed by Taurus Securities Ltd, a subsidiary of National Bank of Pakistan)

Key Economic Indicators

Economy Size & Growth		2000-01	2001-02	2002-03	2003-04
GNP - Market Prices	Rs. bn	4108.2	4425.4	4973.1	5576.3
GDP - Market Prices	Rs. bn	4162.6	4401.7	4821.3	5458.1
Per Capita Income	Market Prices Rs.	29269	30910	34074	37495
	Market Prices US$	501	503	582	652
Growth					
GDP	%	1.8	3.1	5.1	6.4
Agriculture	%	(-)2.2	0.1	4.1	2.6
Manufacturing	%	9.3	4.5	6.9	13.4
Wholesale & Retail trade	%	4.5	2.8	5.9	8.0
Rate of Inflation	%				
Consumer Price Index**		3.6	3.5	3.1	4.6
Wholesale Price Index		6.2	2.1	5.6	7.9
Balance of Payment	$mn				
Exports (f.o.b.)		8933	9140	10889	11293‡
Imports (f.o.b.)		10202	9434	11333	12415‡
Trade Balance		(-)1269	(-)294	(-)444	(-)1122‡
Services Account (Net)		(-)3142	(-)2617	(-)2128	(-)2969‡
Private Transfers (Net)		3898	4249	5737	5443‡
Current Account Balance		(-)513	1338	3165	1352‡
Fiscal Balance	% of GDP				
Total Revenue (Net)		13.3	14.2	15.0	14.3
Total Expenditure		17.2	18.8	18.6	17.5
Overall Defict		4.3	4.3	3.7	3.3
Domestic & Foreign Debt					
Domestic Debt	Rs. bn	1799.2	1757.6	1879.2	2028.4
As % GDP		43.2	39.9	39.0	37.2
Total External Debt & Liabilities	$bn	37.139	36.532	35.474	35.846†
as % GDP		52.1	51.0	43.0	37.8†
as% of Foreign Exchange Earnings		259.8	237.0	181.1	168.7
Investment & Savings	% of GDP				
Gross Investment		17.2	16.8	16.7	18.1
Gross Fixed Investment		15.8	15.5	14.8	16.4
National Savings		16.5	18.6	20.6	19.8
Domestic Savings		17.8	18.1	17.4	17.6
Foreign Investment	$mn	182	475.0	820.1	867.3‡
Portfolio		(-)140	(-)10	22.1	(-)35.5‡
Direct		322	485	798.0	902.8‡
Monetary Aggregates	%				
M_1		3.0	15.2	26.2	21.4
M_2		9.0	15.4	18.0	17.2
Literacy Rate	%	49.0	50.5	51.6	54.0
Foreign Exchange Reserves^	$mn	3220	6432	10719	12450†
Exchange Rate++	Rs./$	58.4378	61.4258	58.4995	57.5378
Stock Market Growth Rate	%				
SBP General Index of Share Prices**		(-)7.9	10.1	91.9	61.9†
Aggregate Market Capitalisation		(-)13.4	20.0	83.1	96.7†

* Constant Factor Cost of 1999-2000 ** Base 2000-01

† July-May ‡ July-March

^ Excludes FE 13/CRR and includes Indian pending transfers, new FCA and Trade Nostro.

++ Average during the year.

M_1 Outstanding stock of currency in circulation+demand deposits of schedule banks+other deposits with SBP.

M_2 M_1 +outstanding stock of time deposits+outstanding stock of FRCDs.

Source: Economic Survey 2003-04