ECONOMIC BULLETIN

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Editor's Corner

Dear Readers,

In most developing countries, privatisation has emerged as a major policy issue, and a much debated subject. Privatisation is one of the key elements in structural adjustment programmes that encompass free trade, financial liberalisation and deregulation and a reduction of state involvement in the economy.

Initiated in Pakistan in the 1990s it has since been a part of the Government's economic reform policy, and alongwith deregulation and good governance, it seeks to enhance the growth and productivity of the economy, by harnessing the private sector. While in the earlier years it was restricted to industrial transactions, later it was expanded to also include, power, oil and gas, transport (aviation, railways, ports and shipping), telecommunications, banking and insurance. So far 160 units have been privatised fetching Rs395 billion.

Almost every country, is either divesting state enterprises to the private sector or involving the private sector in managing and financing activities previously owned and operated by the state. The reasons for privatisation are well established; state enterprises have proved wasteful and inefficient, producing low quality goods and services at high costs; are more often than not overstaffed; mismanaged owing to cronyism in appointments; are a financial burden in most instances, and in the financial sector are technically bankrupt owing to the burden of politically driven non-performing loans.

Nearly 120 countries carried out some 8000 privatisation transactions between 1990 and 2003, generating about $410 billion in proceeds.

Pakistan's experience with privatisation has generally yielded positive results. One of the success stories is the privatisation of banking sector, which, while it has improved the sector's financial indicators, services to customers, recovery of bad loans, technology upgradation and cost efficiency, induction of professional management, introduction of new products, separation of excess labour, lowering NPLs among others, has been achieved by substantial injection of public funds to offset the politically driven portfolio of non-performing loans.

Worldwide we see, success stories accompanied with growing opposition to privatisation as countries experience its impact. An IFC Study, *Privatisation: Principles and Practice*, shows that in 70 percent of the privatisation transactions in which IFC has been involved, there have been clear economic benefits for the privatizing countries. In Chile, the transfer of ownership from public to private hands has resulted in a doubling of the telephone network in four years.

On the other hand a recent World Bank report, *Privatization: Trends and Recent Developments* shows that global support for privatisation is declining. The mentioned Report lists several troubled privatisation deals around the world, including water and sewage concessions in Argentina and Bolivia and re-nationalisation initiatives, such as Rail Track in the UK and Air New Zealand (a US$300 million government rescue package).

The report also quotes public opinion polls over the past few years, For example, one poll showed Latin American popular support for privatisation fell from 75 percent in 1975 to 35 percent in 2002. A survey of Asian countries again demonstrated mixed feelings about privatization.

Literature on the subject has shown that if some necessary conditions exist, then privatization would be successful. If properly structured market friendly policy environment exist, where the industrial enterprises operate in a competitive market, in a well developed, well administered regulatory framework; where unnecessary restrictions and procedures are done away with, where the sale of enterprise is transparent by adopting competitive bidding procedures, objective criteria for selecting bids has been developed, where the private sector offers the correct price for the privatised assets; and by paying special attention to developing a social safety net to ease the social costs of privatisation, i.e. the ability of the market to absorb the labour force that is laid off as a consequence of the privatisation process. Can the whole process achieve the objective of attaining efficiency in the economy, without loss of output, employment or taxes to the national economy?

In Pakistan we see that the process of privatisation has gained momentum in recent years, as the private sector has been allowed to operate in areas considered to be the domain of the government. The inefficiencies of public enterprises had led to poor quality of services, high costs and escalating fiscal burden forced the government to look for alternates.

Billions of taxpayers money was spent in covering the losses and keeping some public enterprises afloat. With privatisation this fiscal drain has stopped and the money saved would be spent on social and infrastructure development and in retiring debt.

While it is generally agreed that competition is the key to economic development, and, ultimately to lower prices, there also exists a need for public sector control to ensure the poor and needy are not fleeced. The social aspect must also be considered, alongwith other factors, and ensuring that the units being privatised, succeed and perform better than in the pre-privatisation period.

Ayesha Mahmood

Federal Budget 2006-07 - An Overview

Relief and subsidy measures

The Federal Budget 2006-07, has taken into consideration the hardships faced by the people at large. It has provided relief and subsidy measures for the weaker section of society, for the small investors, pensioners and widows, initiated Rozgar Scheme for the unemployed youth, increased the size of the expenditure programme with emphasis on the social sector and infrastructure development, and simplified salary taxation by doing away with the cumbersome methods of computation.

Current expenditure (revised) rose last year, though this year it is budgeted to show a decline; there has been a modest improvement in the tax to GDP ratio, CBR revenue collection surpassed the target, and this year, collections are projected to be higher as some new segments of the economy have been brought in the tax net; reliance on external resources to finance expenditure remains.

Economic Scenario

Economic indicators improve

The Federal Budget has been presented against a background of good economic performance. The outgoing fiscal year has been a year of continuing economic growth despite rising oil prices, the earthquake catastrophe of October '05, and adverse weather conditions which slowed down the agricultural sector.

This review contains a brief analysis of the economic performance in FY06, the features of the new budget, the challenges the economy faces and the various policy measures announced with implications for some areas.

The GDP growth of 6.6 percent in FY06 was led by growth in the services and manufacturing sectors. The services sector showed a strong performance of 8.8 percent, while growth of large scale manufacturing was weaker at 9.0 percent, as against 15.6 percent a year earlier. Investment in the economy picked up and as a percent of GDP it rose to 20 percent . Current year's growth was largely a public-private partnership based growth where both sectors are working in tandem to augment growth in the economy. Construction activity was brisk, foreign trade surged, banking sector grew and foreign direct investment picked up substantially, partly arising from privatisation of some major public sector entities like KESC, Pak Arab Fertilizers, Mustehkam Cement, etc. Foreign investors are showing interest in the privatisation programme of the Government.

Reforms bring positive results

The reforms and policies pursued over the recent years is now paying dividends and inflow of foreign direct investment is expected at around $4 billion. Telecom, energy (oil, gas & power), financial services, trade, construction, chemicals have been the major recipients of foreign direct investment.

Exports have touched nearly $15 billion in FY06 (July-May), while imports have crossed $25 billion, resulting in a widening of trade deficit to $10 billion, against $5.5 billion in the corresponding period last year. Remittances are estimated at $4 billion, while the current account deficit will be around $5 billion.

The Karachi Stock Exchange set new records in the year, as the KSE 100 Index crossed the barrier of 12000 mark on April 13, 2006. Similarly market capitalisation increased to $57 billion (Rs3420 billion) on April 17, 2006. The tight monetary stance pursued by the State Bank of Pakistan has weakened the inflationary pressures. Inflation during July-April 2005-06 is estimated at 8.0 percent as against 9.3 percent in the same period last year.

While both, external debt and foreign exchange liabilities and domestic debt rose in absolute terms during FY06, the former on account of issuance of sovereign bonds worth $800 million, and the later due to large expenditure incurred to rehabilitate the earthquake affectees, there was an improvement in the debt carrying capacity of the economy, in the composition of debt profile and in the domestic debt to GDP ratio. The external debt to GDP ratio has declined to 28.3 percent by March '06, while as a ratio of foreign exchange earnings it has fallen to 127.6 percent. The share of expensive external debt and liabilities has too fallen.

Box

Economy 2005-06
Highlights

Growth Trends

- § GDP grew at 6.6 percent, short of the year's target of 7.0 percent.
- § Inflation is estimated at 8 percent.
- § Large scale manufacturing grew by 9 percent, mainly because of higher growth by automobiles, electricals, pharmaceuticals etc.
- § Services sector continued to perform well and grew by 8.8 percent.
- § Agriculture growth slowed to 2.5 percent, because of a negative growth of 3.6 percent by major crops. Cotton and sugarcane production declined, while wheat output increased only marginally.
- § Commodity producing sectors contributed 2.1 percentage point to this year's growth, while 4.5 percentage points contribution came from services sector.
- § Livestock sector grew by 8 percent, while the performance of fisheries has been poor.
- § Per capita income rose to $847.
- § Total investment as a proportion of GDP is estimated at 20.0 percent.
- § Domestic savings declined marginally to 14.4 percent.
- § Foreign direct investment has crossed $3 billion, with major contribution from UAE, US, UK and Saudi Arabia.
- § Telecom, energy (oil, gas and power), financial services, trade are the major recipients of FDI.
- § During the outgoing fiscal year, 11 transactions were completed for Rs217.9 billion.
- § Nearly 24 percent of the people live below the poverty line.

Fiscal & Monetary

- § Overall fiscal deficit estimated at 4.2 percent of GDP (includes the impact of earthquake spendings).
- § Wide ranging tax and tariff reforms have started paying dividends.
    - Tax collection has picked up.
    - Revenue deficit has narrowed.
    - Primary surplus has increased.
    - Public debt as a percentage of GDP has declined.
- § Tax GDP ratio is estimated at 10.4 percent.
- § Public debt to GDP ratio has declined from almost 80 percent in 2000 to 54.7 percent by end March 2006.
- § Debt servicing liability has fallen to 27.8 percent of revenue and current expenditure each.
- § Poverty and social sector related expenditure has risen from 2.2 percent of GDP in FY01 to 4.2 percent in FY06.
- § The State Bank of Pakistan continued with a tight monetary policy during the year.
- § Credit to private sector continued to exhibit strong demand and grew by Rs345 billion during July-April '06.
- § Credit to the private sector is tilted towards capital intensive sectors, and flows to priority sectors like SMEs and agriculture are still low.
- § Indicators of financial development, like M2/GDP ratio, total deposits to M2 ratio have improved.
- § Average lending rate increased to 10.14 percent during July-March '06, while the average deposit rate rose to 2.75 percent.
- § Banking spread has risen to 7.39 percent.
- § Non-performing loans of commercial banks, specialized banks and DFIs stood at Rs195.7 billion by December '05.

Capital Markets

- § Strong performance was witnessed and new heights were reached. KSE-100 index crossed the 12000 mark and touched an all time high on April 13, 2006, with total market capitalization increasing to $57.0 billion.
- § Privatization of government entities through the bourses helped to broad base the equity ownership.

Balance of Payments

- § During July '05 - May '06, exports are provisionally estimated at $14.96 billion, and imports at $25.6 billion, resulting in a trade deficit of $10.64 billion.
- § Last year in the corresponding period the trade deficit was to the tune of $5.5 billion.
- § Current account deficit has widened to $4.7 billion (July-March) against $1.2 billion last year.
- § Workers remittances are to the tune of $3.6 billion (July-April) and are expected to cross $4 billion by the end of FY06.
- § Foreign exchange reserves stood at $13.0 billion at the end of April '06.
- § Exchange rate remained stable during the year.

External Debt

- § External debt and liabilities stood at $36.5 billion by end March '06, or 28.3 percent of GDP. Of this, almost 50.2 percent is owned to multilateral creditors and 39.6 percent to Paris Club official creditors.
- § Net transfers as a percentage of gross disbursements stood at 17 percent, against 44 percent a year earlier.

Social Sectors

- § Adult literacy is 53 percent.
- § Public expenditure on education as a proportion of GDP is 2.1 percent.
- § Public expenditure on health is a mere 0.51 percent of GDP.
- § Pakistan is fully committed to attaining the Millennium Development Goals, which aims to reduce child mortality, improve maternal health, among others.
- § Caloric availability per day is likely to increase from 2271 in FY05 to 2328 in FY06, and protein availability from 65.5 gms to 66.9 gms.

Rising Revenue Collection

Tax revenues exceed target

In FY06, tax revenues (revised) have exceeded the year's target of Rs700.1 billion, by 2.2 percent, primarily because of increased collections accruing from income tax and customs duty. Income tax is expected to fetch Rs9.6 billion more over the budgeted figure of Rs205.9 billion, while customs duty will net in Rs14.6 billion more revenues. Sales tax continues to be the leading tax, restricted earlier to manufacturers, but later extended to the importers, wholesalers, distributors & retailers and to specified services. For 2006-07, a tax revenue target of Rs840.9 billion has been budgeted for.

Revenue Receipts

(Rs.Bn)

	2005-06 Budget	2005-06 Revised	2006-07 Budget
Tax Revenue	**700.1**	**715.7**	**840.9**
Direct Taxes	**224.1**	**234.7**	**271.9**
Income Tax	205.9	215.5	257.8
Workers Welfare Tax	5.5	5.5	1.0
Workers Participation Fund	5.5	7.0	6.5
Foreign Travel	3.5	2.7	3.7
Capital Value Tax	4.0	4.0	2.9
Indirect Taxes	**475.7**	**480.9**	**569.0**
Customs	121.2	136.0	157.1
Sales Tax	294.0	286.5	341.6
Federal Excise Duty	59.4	56.5	68.1
Other Taxes	0	1.0	1.1
Airport Tax	1.1	0.9	1.1
Non Tax Revenue	**227.3**	**307.0**	**241.9**
Income from Property & Enterprises	**120.4**	**120.0**	**115.2**
Profit	16.3	10.9	6.0
Interest (Provinces)	22.6	21.6	22.8
Interest (PSEs & others)	28.5	23.6	31.6
Dividends	53.0	63.8	54.8
Receipts from Civil Admn & Other Functions	**33.1**	**95.8**	**53.6**
General Admn	2.0	2.1	2.4
SBP Profits	18.0	18.0	35.0
Defence	12.1	74.8	15.2
Law & Order	0.2	0.2	0.2
Community Services	0.4	0.4	0.5
Social Services	0.3	0.2	0.3
Miscellaneous Receipts	**73.8**	**91.2**	**73.1**
Economic Services	2.0	1.5	1.9
Petroleum Development Levy	16.0	20.2	0
Gas Development Surcharge	16.6	22.2	18.1
Royalty on Oil	5.5	9.0	9.3
Royalty on Gas	14.3	17.1	20.3
Passport & Copyright Fee	5.2	6.0	6.3
Others	14.2	15.2	17.2

Source: Budget in Brief 2006-07

Direct taxes grow

The collection from direct taxes has been quite impressive and its share in tax revenues have grown to nearly 33 percent. Good performance has been noted in voluntary payments, collection on demand and withholding taxes. Voluntary payments have increased, the deductions at source have grown and the collection on demand has also improved. Voluntary compliance highlights the taxpayers confidence in the system; as both payments with returns and advance tax grew during the year. The introduction of the Universal Self Assessment Scheme in income tax helped in promoting voluntary compliance.

Corporate sector performance has improved. As a policy, the rates for private and banking companies are being reduced gradually by 2 percent and 3 percent respectively each year, so that parity in corporate rate is attained at 35 percent by tax year 2007. The improved profitability of the banking sector and gradual reduction in income tax rate has also helped in revenue realization.

Customs collection increases

Revised estimates for FY06, show that indirect tax collection will be higher over the year's budgeted figure of Rs475.7 billion, primarily because of enhanced customs duty collection. Increased customs duty is attributed among others to record level of international trade transactions, incentives to investors and traders that resulted in higher demand for inputs and due to the continuous improvement in customs business processes. Major revenue earners under this category were chemicals, vehicles, POL and mechanical appliances.

With extensive revision in the duty structure within existing slabs, duty has been reduced for capital goods and smuggling prone items, the effective rate on dutiable imports has fallen. For FY07, customs duty are budgeted at Rs157.1 billion, 15 percent higher over the revised estimates for FY06. Imports are expected to grow.

General Sales tax is a major source of federal tax receipts, contributing 40 percent to the tax revenue. Collection of GST last fiscal year, fell short of the year's target of Rs294 billion or by 2.6 percent. Sales tax slippages could be partly attributable to lower sales tax collection from sugar and cigarettes. Decline in domestic production of sugar, resulted in some loss of sales tax. The reduction in collection from cigarettes has been due to the withdrawal of further tax. However, there were higher collections from cement, due to higher domestic demand and increase in sales tax collection from services (widespread usage of mobile and telecom services).

Sales tax collection declines

The CBR Quarterly Review, January-March 2006, show that sales tax refund payments have declined, mainly because five major export oriented industries who were the major claimants of sales tax refund, have now been zero rated. This has improved the liquidity problem of the exporters.

Federal excise duty coverage reduced

Federal Excise duty coverage has been reduced over the years, as it is being gradually phased out, and only one consumption tax i.e. sales tax will remain. Only those items are expected to remain in the federal excise net whose consumption is required to be regulated e.g. cigarettes, cement, beverages etc.

Revised estimates for FY06, show that the bulk of excise revenue accrued from cigarettes, cement, natural gas, POL products and beverages. These five products accounted for 86 percent of total federal excise duty collection. Receipts from this head are budgeted at Rs68.1 billion for FY07.

Non tax receipts increase

Non-tax receipts are estimated to be 35.1 percent higher in FY06, over the earlier set target of Rs227.3 billion for the year. The significant rise is attributable to higher receipts from civil administration, more specifically from defence services (Rs74.8 billion against the target of Rs12.1 billion) and from higher dividends accruing from public sector corporations, most notably OGDCL, Pakistan Petroleum Ltd and Pak Arab Refinery. For FY06-07, non-tax revenues are budgeted at Rs241.9 billion, 6.4 percent higher over previous year's target, but 21.2 percent short of the revised estimates, as dividends are expected to be lower and receipts from defence services are expected to fall sharply.

Miscellaneous receipts are estimated to have risen by 23.6 percent against the target of Rs73.8 billion set for FY06. Three fourths of the revenue under this head accrues from development surcharges and royalties. Petroleum development levy imposed as a fixed charge at per litre price of various products rose by 21.7 in the revised estimates for FY06 against the target, while the gas development surcharge rose by nearly 34 percent. In the budget 2006-07, the government has decided that petroleum development levy will not be used as a source of budgetary revenue.

External resource financing

External resources which were projected at Rs212.3 billion for the year 2005-06, have been revised upward and are placed higher by 10.2 percent at Rs233.9 billion. Under this head, foreign currency bonds are placed significantly higher at Rs47.9 billion over the target of Rs30.5 billion, while budgetary support grants have more than doubled to Rs38.1 billion against the year's target of Rs17.0 billion. In FY06, there was a substantial drop in aid received from Islamic Development Bank. As against a target of Rs30.5 billion, Rs17.9 billion were received. For FY07, external resources are budgeted at Rs239.3 billion, higher by 2.3 percent over preceding year's revised estimates of Rs233.9 billion.

External Resources

(Rs.Bn)

	2005-06		2006-07
	Budget	Revised	Budget
External Loans	190.4	189.1	213.4
Project Loans	60.9	56.6	76.4
Programme Loans	62.3	60.6	76.5
Foreign Currency Bonds	30.5	47.9	30.2
Other Aid	36.6	23.9	30.2
External Grants	22.0	44.8	25.9
Total	212.4	233.9	239.3

Source: Budget in Brief 2006-07

Expenditure Patterns

The Federal Budget 2006-07, has a total outlay of Rs1315 billion, with current expenditure accounting for 70 percent of the total size and development expenditure 30 percent. In the forthcoming fiscal year, current expenditure is budgeted at Rs880 billion, smaller by 4.2 percent over the revised estimates of FY06, while development expenditure at Rs435 billion is nearly 39 percent higher.

Important Fiscal Measures

Income Tax	*Sales Tax*	*Federal Excise Duty*	*Customs Duty*
§ Basic exemption limit proposed to be raised from Rs100,000 to Rs150,000 per year, while for women tax payers it has been raised to Rs200,000 for salaried and to Rs125,000 for non-salaried class. § The tax rate has been reduced ranging from 0.25% to 20% from 3.5-30.0%. § The age limit of senior citizen to claim reduction in tax is proposed to be reduced from 65 years to 60 years. § Tax rate reduction for inter corporate dividends (from 10% to 5%) proposed. § Depreciation allowance is proposed at 30% on machinery producing information technology products. § Tax credit for investment in IPOs - limit for investment for tax credit proposed to be enhanced from Rs150,000 to Rs200,000. § Upward adjustment in withholding tax on cash withdrawals from banks proposed. On withdrawals exceeding Rs25,000 the tax has been raised from 0.1% to 0.2%. § Fixed tax on income from property proposed. § Exemption available to Mutual Funds for carry over transactions (Badla) in stock exchanges is proposed to be withdrawn. § Withholding tax on various imports proposed to be rationalized. § Presumption Tax Regime proposed to be extended to services. § 2% higher withholding tax is proposed to be charged from those persons not having NTN or CNIC. § Withholding tax rate on government securities proposed to be taxed at reduced rate of 10%. § Upward adjustment in withholding tax rate on stock market transaction proposed. § CVT proposed to be imposed on investment in real estate.	§ Zero rating of sales tax on dairy products and stationery items. § Zero rating of sales tax on import and supply of trucks and dumpers of g.v.w. of 5 tonnes and above. § Levying upfront single stage sales tax on 30% value addition on import of pesticides. § Zero rating of sales tax on non-chemical fertilizer. § Sales tax exemption on aircrafts of all types. § Levy of single tax @3% for retailers having annual turnover or more than Rs5 million per annum. § Allowing input tax adjustment to retailers and wholesalers-cum-retailers (chain stores) who opt to pay sales tax at standard rate. § Abolishing the condition of depositing 15% of the principal amount at the time of filing appeal under the Sales Tax law. § Withdrawing exemption of sales tax on computer hardware. § Increase in retail price of cigarettes. § Broadening the scope of Third Schedule to the Sales Tax Act, 1990. § Introducing the concept of electronic filing of return and other documents through e-intermediaries. § Simplification of Refund Rules. § Identifying the scope of plant, machinery and equipment for sales tax zero-rating. § Collection of sales tax on accrual basis from WAPDA. § Imposing higher penalties for repeated offences. § Requiring cigarette manufacturers to print their name on the cigarette packets. § Powers to search without warrant withdrawn. § Amending the sales tax law to initiate proceedings in cases of deliberate short filing, without giving show cause notice.	§ Withdrawing excise duty on travel by train. § Levy of 15% excise duty on international air travel. § Levy of excise duty @5% on non-fund services provided by financial services sector. § Levy of 5% excise duty on commission and brokerage of foreign exchange dealers, exchange companies and money changers. § Levy of 5% excise duty on “franchise services”. § Cable TV operators to pay Rs25/- per connection per month as excise duty. § Enhancing the rate of excise duty from 3% to 5% on insurance services. § Excise duty on lubricating oil to be levied on retail price. § Explicitly identifying telecommunication services in the First Schedule to the Excise Act As the telecom sector has grown, there was a need to rationalize the existing Excise Schedule to remove any ambiguity regarding the scope of levy. § Power to collect excise duty on minimum fixed price.	*Sector Specific Incentives* *Agriculture* § Special incentives for development of dairy industry. § Vitamins used in poultry industry, exempted from customs duty and duty on prefabricated buildings and disinfectants have been reduced to 5%. § Inputs of horticulture and floriculture exempted from customs duty. § Duty on inputs of fish farming reduced to lessen the cost of fish farming. § Import of agricultural tractors exempted from customs duty. *Manufacturing* § Import duty rates lowered on the following sectors; leathers/footwear, marble & granite industry, pharmaceutical and rice par boiling. § Duty rates on the following raw material inputs reduced. - copper raw material - forging & foundry - zinc, lead, refractory cement - chemicals used for tanning leather - pharmaceutical chemicals - plastic sheets and - solution for rubber etc. *Specials Incentives* *Health* § Duty exempted on import of following: - all medicines for cancer - drugs used for kidney dialysis and kidney transplant - all types of vaccines for hepatitis - all vaccines/anti sera cardiac medicine etc. *Education* § Special incentive package to encourage Research & Development activities in Colleges, Research Institutes and Universities by exempting duty on import of machinery, instruments and equipment. *Automobile* § Tariff based system is being introduced wef July 1 to replace the existing deletion programme in the auto sector. § Duty on multi-axle trucks rationalized. § Duty on purpose built taxis rationalized. § The existing scheme for import of old/used vehicles under TR, Gift & Baggage schemes revised to introduce a capping on aging of the vehicles. *Baggage Rules* § Baggage rules for overseas Pakistanis simplified and improved to make them user friendly and transparent. § Payable duty/taxes on baggage items being notified. § Additional allowances introduced for foreign exchange remittance card holders.

Bulk of expenditure (61.3 percent) under the Current Expenditure head is categorised under '*General Public Service*', followed by '*Defence Affairs & Service*' (26.2 percent). The substantial rise in the former category can be attributed to a surge in transfer payments (rose from a budgeted figure of Rs79.7 billion to Rs171.2 billion) and servicing of domestic debt. Foreign loan repayments and the servicing of foreign debt declined in FY06 over the year's target. Defence services, consume 26 percent of the current expenditure, and during the year saw a rise of Rs17.6 billion to Rs241.1 billion against the budgeted figure of Rs223.5 billion. For FY07, the figure has been set at Rs250.2 billion.

Jump in transfer payments

In FY06, revised estimates of the Public Sector Development Programme place the figure at Rs313.7 billion. 15.3 percent higher over the year's budgeted figure. This is a positive development, when PSDP surpassed the year's target, unlike previous years when shortfall to implement it used to occur. For FY07, development expenditure has been raised to stimulate economic growth and provide job opportunities to large numbers. Water and Power has been focused upon, alongwith education, health, agriculture. Large public sector spending is likely to boost demand besides improving the physical and social infrastructure of the country.

PSDP higher

Financing of the Budget

(Rs.Bn)

	2005-06		2006-07
	Budget	Revised	Budget
Expenditure	1098.5	1232.5	1315.0
Current	826.5	918.8	880.0
Development	272.0	313.7	435.0
Internal Resources	768.0	841.7	860.4
External Resources	212.4	233.9	239.3
Privatisation Proceeds	20.0	90.0	75.0
Bank Borrowing	98.0	66.8	140.1

Source: Budget in Brief 2006-07

While there has been an increase in internal resources to finance the government's expenditures, they fall short of the requirements. The remaining part of the rising expenditure is met through external flows, privatisation proceeds and bank borrowings. Privatisation proceeds rose sharply to Rs90.0 billion in FY06, against the annual budget target of Rs20.0 billion, due to higher transactions during the year, PTCL, KESC, Pak American Fertilizer etc.

Relief and Subsidies

This year's Federal Budget has a number of popular measures, including relief measures for salaried, government employees, price control measures, subsidies for certain food items etc.

- Government servants to get a dearness allowance of 15 percent.
- Minimum wages increased to Rs4000.
- Pensioners to receive more.
- Reduction in tax rates for salaried employees.
- Increase in basic exemption limit.
- Grant to workers from the Workers Welfare Fund raised.
- Relief for senior citizens.
- Teachers monthly allowance raised.

(i)	Pay & Pension Relief	Rs10.0 bn.
(ii)	Safety net	Rs 5.0 bn.

- Availability of cheaper pulses for the common man - Rs2.5 bn.
- Sugar to receive subsidy. It will be available at Rs27.5 per kg from the Utility Stores. Rs7 bn.

Wheat Rs2.5 bn

(iii)	Food	Rs12.0 bn.
(iv)	Relief to the farmers by providing subsidised fertilizer	Rs12.3 bn.
(v)	Import of Cement	Rs0.72 bn.
(vi)	Power	Rs59.0 bn.
(vii)	Fuel	Rs10.0 bn.
	TOTAL	Rs109.0 bn.

Implications of the Budget

The Federal Budget has implications for various sectors of the economy. We shall look at some of these.

Mitigating Common Man's Problems

The relief measures announced will provide some respite to the common man, who is burdened with rising prices of essentials, high utility charges, poor living conditions, lacking social infrastructure, joblessness etc. The increase in minimum wages, in the pension of government servants, in conveyance allowance of lower grade employees, relief for senior citizens, providing dearness allowance at the rate of 15 percent of the basic salary, enhanced rates of return of various National Saving Schemes, simplification of salary taxation, Rozgar scheme for the unemployed, increased public sector development programme, increased subsidies on import of pulses and on sale of sugar, establishing more utility stores, are welcome decisions taken in the Budget.

While certain segments of population would benefit from these relief measures, there are still large sections in society that too need help. The ambit needs to be enlarged to bring relief to the marginalised population.

Agriculture

Of the 65 percent of Pakistan's population that lives in rural areas, 28 percent live below the poverty line. The incidence of poverty is highest amongst those who own no land. While alleviating poverty of the landless households requires major reforms, a sustained high agricultural growth would help in mitigating some of the sufferings of those associated with the sector and eking out a living directly or indirectly from this sector.

If agricultural growth suffers, the prospect of lessening poverty of those households associated with the sector is a daunting challenge. In FY06, agricultural sector performance was weak, due among others to fall in the production of major crops, cotton, sugarcane and only a marginal increase in wheat output.

To sustain a high agricultural growth, diversification is essential. With focus on the development of the livestock and fisheries sub-sector, agricultural growth could be diversified, and any setback to the major crops would be compensated by the growth of these two sectors.

In the recent Budget:

i) A Public-Private Partnership in dairy sector development with Rs3.6 billion has been launched. This Company will set up 1200 Model Dairy Farms and will establish 2950 farms for raising livestock. This project will enhance rural incomes.

ii) The production of dairy products is now exempt from Sales Tax. The dairy and livestock equipments are exempt from custom duty and sales tax. The custom duty on the packaging material of dairy products has been reduced to 5 percent. This will help promote dairy sector in the area.

iii) Machinery for promoting fisheries will be exempt from custom duty.

iv) Custom duty is reduced from 60 percent to 30 percent on refrigerated vans.

v) Special incentive package in the shape of reduced tariff rates for poultry industry has been proposed.

Water conservation is also very essential through either equitable distribution, efficient use of stored water, lining of canals and water courses, building of small dams etc.

In the Budget:

a) Drip irrigation and sprinklers technology are being introduced in agriculture with Rs15.0 billion.

b) Rs7.0 billion is being spent in 2005-06 for lining of 15000 canals. Rs6.0 billion will be spent in 2006-07 for the same. As a result, the loss of canal water will be reduced by 25 percent.

c) Rs10 billion is allocated for the initial work on big dams in 2006-07.

All these measures will help enhance agricultural activities in the country. This will increase the incomes of the farmers.

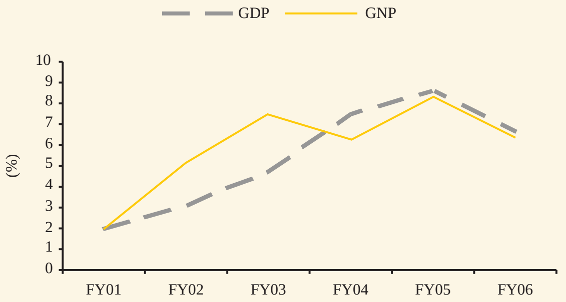
Fiscal Imbalances

In FY07, development expenditure has been budgeted at Rs435 billion, higher by 38.7 percent over last year's revised estimates of Rs313.7 billion. In the past, development expenditures had fallen short of the targets, and it had become necessary to increase it, so that the investment/GDP ratio which has been on a declining trend also rises.

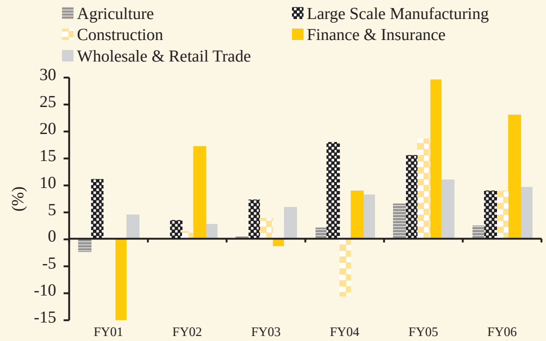
Large part of the increase in public sector development programme is earmarked for social sector, as part of the Khushal Pakistan Programme, higher allocations for education, health, and for infrastructure development. These are the growth oriented elements of the expenditure programme, plus supporting the social uplift programme. If managed with fiscal prudence, any imbalances resulting would be manageable.

Trends in the Economy

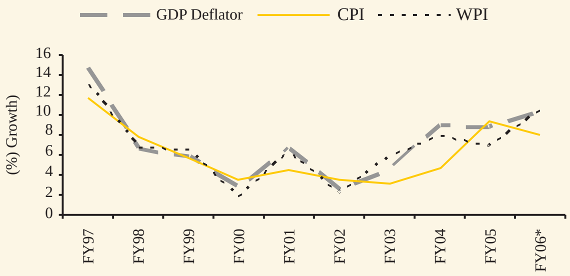
Economic Growth



Sectoral Growth



Inflation



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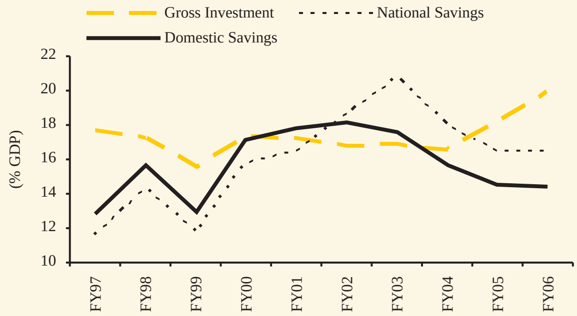
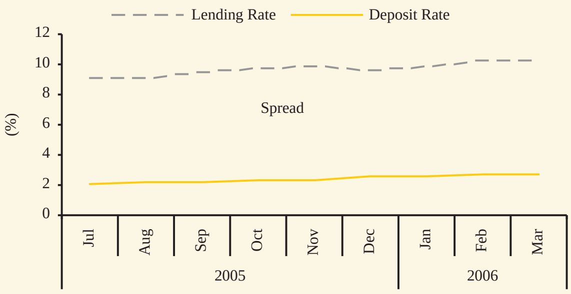
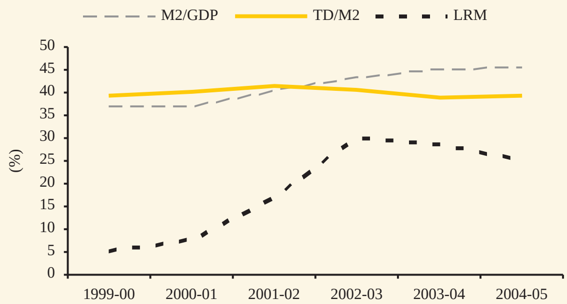
Savings & Investment



Lending and Deposit Rates

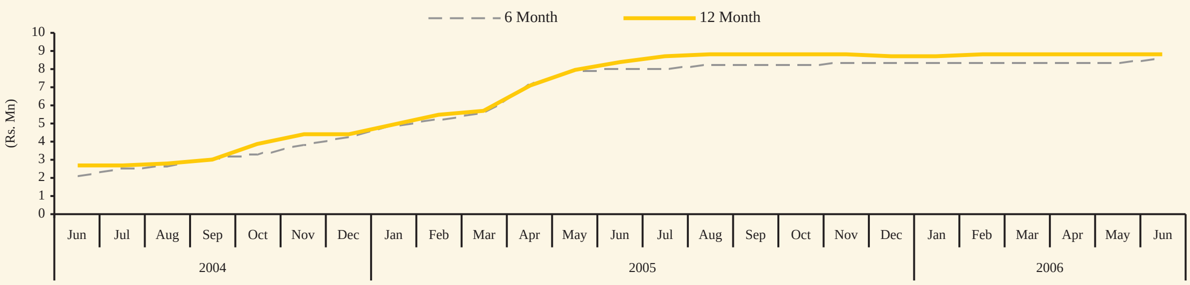


Financial Development



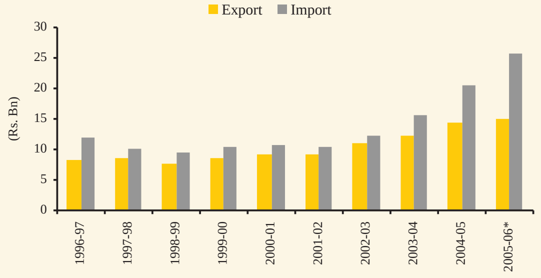
Treasury Bills

Weighted Average Yeild



M2 Currency in circulation+demand deposits+time deposits+other deposits
TD Total Deposits
LRM Liquid reserves to money supply ratio

Export & Import



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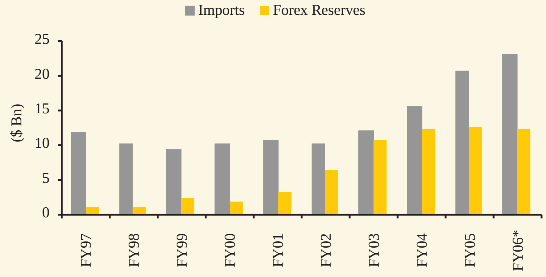
Imports and Forex Reserves



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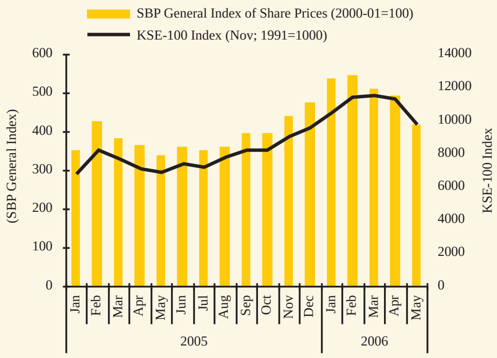
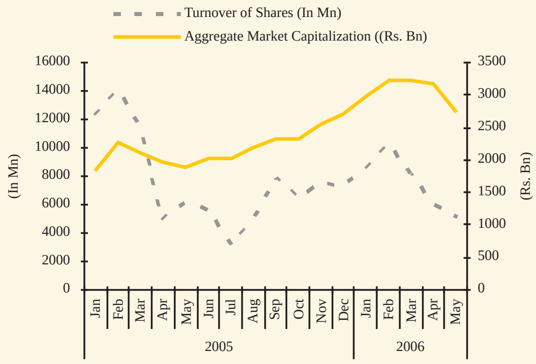
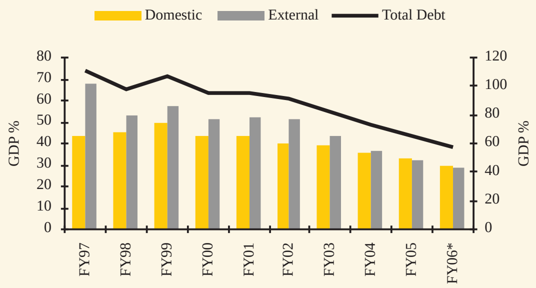
Karachi Stock Exchange



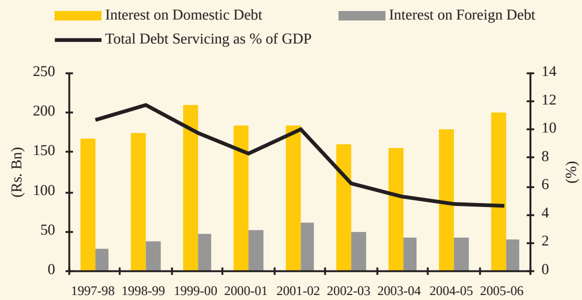


Domestic/External Debt

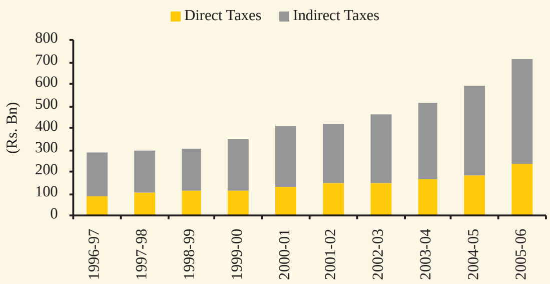


*Jul-Mar

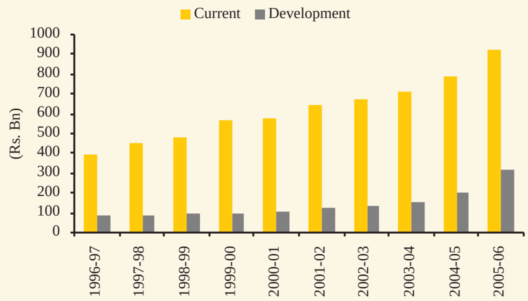
Debt Servicing



Tax Collection



Expenditure Pattern



Provincial Budgets 2006-07

Highlights

Punjab

§ A Rs274 billion tax free budget for the province. The proposed budgetary outlay is 22.13 percent higher than current year's estimates of Rs224.4 billion.

§ Revenue expenditure proposed at Rs191.4 billion. This is 21.5 percent higher than current year's estimate of Rs157.5 billion.

§ Of the total provincial revenue receipts, Rs201.4 billion would be federal transfer, and Rs72.7 billion would be the province's own resources.

§ The province would generate, Rs30.34 billion from tax revenue and Rs42.3 billion from non-tax sources.

§ A sum of Rs12.5 billion has been allocated for education, Rs4.3 billion for health.

§ The government has recommended abolition of sales tax on promotional advertisements, for population and education, released to radio and television and being sponsored through the USAID programme.

§ Landholders having upto 12.5 acres of land have been exempted from agriculture tax; exempted 5 marla houses from property tax, distributed 0.1 million acres of agri land among landless farmers, provided Rs1.5 billion on low mark up for SMEs.

§ Of the development programme of Rs100 billion, 70 percent would be spent on ongoing schemes and 30 percent on new schemes.

§ 55 percent of the total ADP allocations are earmarked for the social sectors, while infrastructure development would receive 35 percent.

§ The social sector programme would help achieve the Millennium Development Goals.

Sindh

§ A Rs193.1 billion budget proposed for the year.

§ Total estimated receipts stand at Rs193.4 billion.

§ The budget shows a small surplus of Rs300 million.

§ Annual development programme is proposed at Rs32 billion, and Rs18 billion is proposed for federally assisted projects, foreign assisted programme, drought emergency relief etc.

§ Current expenditure has been budgeted at Rs139.2 billion.

§ The new development outlay includes Rs20.83 billion for key sectors of the province, with a special package of Rs5.5 billion for urban and rural areas.

§ The provincial government will contribute Rs24 billion towards the ADP from its own resources, whereas district government's share of Rs8 billion, will come through single line transfers from July '06 onwards based on the NFC award.

§ Rs4.5 billion has been allocated for communications, Rs1.5 billion for water and power sector.

§ Under the special package programme, Rs2 billion has been allocated for Karachi, Rs1.5 billion for Hyderabad and Rs2 billion will be spent on rural uplift.

§ Education budget has been enhanced from Rs4.1 billion to Rs12.7 billion.

§ Remote area allowance will be given to the primary school teachers posted in rural areas.

§ Incentives given to doctors posted in rural areas.

NWFP

§ The provincial government has presented a Rs95.9 billion budget.

§ Revenue receipts for the year have been estimated at Rs67.54 billion, which includes federal tax assignments of Rs37 billion.

§ Rs26.6 billion has been allocated for the Annual Development Programme.

§ New job opportunities have been created.

§ Allocations for education and health has been raised.

§ Industrial zones proposed in Mardan, and Karak districts.

§ Special measures to be initiated to rehabilitate earthquake affected people, provision of social security scheme for senior citizens, educated youth and families of deceased provincial government employees.

§ While no new taxes have been levied in the recent Budget, upward revision of certain provincial taxes will help the government to improve provincial receipts.

§ Current expenditure has been earmarked at Rs54.5 billion.

Balochistan

§ Total outlay budgeted at Rs59.7 billion.

§ The PSDP shows a development plan of Rs10.81 billion.

§ The development outlay for 2006-07, comprises of the ongoing schemes and unimplemented schemes of the outgoing fiscal year.

§ For the PSDP for FY07, the provincial government has allocated Rs6.35 billion, and Rs3.76 billion is from the foreign programme assistance.

§ The Public Sector Development Programme makes the highest allocation of Rs4.18 billion for roads, Rs1.95 billion for education, Rs728.64 million for the water sector, Rs700 million for poverty alleviation in the province, Rs417 million for the health sector.

§ Total resources budgeted at Rs48.73 billion, leaving a deficit of Rs10.96 billion.

§ In the new fiscal year, 1300 villages would receive electricity.

§ Livestock sector badly affected by the long spell of drought will receive Rs29.71 million, while Rs22 million will be provided to the Balochistan Coastal Development Authority.

Trade Policy 2006-07

Highlights

§ Exports are targeted at $18.6 billion for 2006-07 against preceding year's $16.5 billion, showing an increase of 14.4 percent.

Last year the Rapid Export Growth Strategy (REGS) had been formulated to facilitate growth in exports, through regional diversification of export markets, strengthening of trade promotion infrastructure, skill development, provision of modern infrastructure and by resorting to trade diplomacy to increase market access.

§ Within the framework of REGS, the government plans to focus on the export promotion of a few selected product groups. The product groups selected for this purpose include leather products, engineering goods, chemicals and pharmaceuticals, towels, denim and services.

§ Trade Development Authority will be established, replacing the Export Promotion Bureau, which has been responsible for trade promotion for the last 43 years.

§ Carpet cities are planned for Lahore and Karachi, which would help enhance exports of carpets by making them competitive in terms of price as well as quality and other standards.

§ To promote exports of gems and jewellery "*Dazzle Park*", is being established on 16 acres of land near Karachi airport. Providing one window facility, it will have all the required state of the art processing facilities for the sector. It will also provide training to the workers. As it has been declared as an export processing zone, it can enjoy the standard tax and procedural relaxations associated with such zones.

§ Expo Centres will be set up in Islamabad, Quetta and Peshawar.

§ Any company (earlier it was export oriented companies only) setting up cool chains and cold storages, will be eligible for a reduced mark up for any credit obtained. The first 6 percent of the mark up would be picked up by the Export Development Fund. This should help exporters of perishable horticulture products.

§ Since FY03, the government is giving a 25 percent freight subsidy on exports of new products and new markets, with the objective of achieving geographic and product diversification in our exports. The following modifications are being made in the scheme:

§ Export of all items except those which will be notified separately will now be able to avail a 25 percent freight subsidy, provided they are being exported to Africa, Pacific Islands, Eastern European countries that are not in the EU and Central Asian Republics.

§ Export of products falling in the developmental category will be entitled to 25 percent freight subsidy even if they are going to one of the top 20 export destinations.

§ Any individual exporter, firm or company will not be entitled to a freight subsidy in excess of five million rupees in a single year.

§ The scope of the Skill Development Board established last year and assisting in training of garment workers in partnership with selected garment units has been widened to also include training of workers producing terry towels and bed linen.

§ The 6 percent compensatory rebate for readymade garments and knitwear as research and development support, given till end of June this year, will now be provided till end June 2007; thereafter till end June 2008 at the rate of 3 percent.

§ To facilitate exporters, the Government would be providing 50 percent subsidy for the cost of obtaining certain specified certifications, i.e. ISO-22000, Eco-labeling Conformity Europea and Organic Food products certificate.

§ A specialized SME Export House will be established with public private partnership to act as a catalyst to promote SME export.

§ It is planned to set up a specialized coal, clinker and cement terminal at Port Qasim, Karachi.

§ A 6 percent Research and Development support has been provided to the footwear sector on the same lines as is presently available to the textile garments sector.

§ Meat exports to the Islamic world will be promoted. Halal meat export zones will be established in Karachi, Lahore, Peshawar and Quetta, where state of the art infrastructure including for health safety would be provided.

§ The government plans to establish a modern warehouse facility in Karachi, with public-private partnership.

§ The Long Term Financing facility for export oriented projects on concessionary terms has been modified for its full potential to be realized.

§ Imports are projected at around $28.0 billion for 2006-07.

§ Time to time import policy is liberalized to permit import of specified used machinery subject to certain conditions. This year, some changes in the import of certain kinds of used machinery have been made.

§ The Federal Budget has announced reduction in customs duty for certain sectors which have export potential.

§ Some amendments have also been announced in the import policy in view of the public interest involved.

Trade Performance

($ Mn)

Exports	2005-06 (July-May)	2004-05 (July-May)
Rice	1028.2	850.6
Raw cotton	63.1	106.6
Fish & fish preparations	179.7	124.8
Fruits & vegetables	130.7	103.8
Cotton yarn	1285.4	954.3
Cotton cloth	1943.7	1681.3
Bedwear & knitwear	3391.7	2726.8
Towels	533.2	471.1
Readymade garments	1188.6	955.2
Carpets & rugs	231.6	250.7
Petroleum products	668.7	412.9
Sports goods	314.5	275.3
Leather & leather products	885.0	732.6
Footwear	115.5	109.8
Surgical goods & medical instruments	144.5	165.0
Chemicals & pharmaceuticals	400.0	376.6
Engineering goods	181.2	162.0
Total	14,961.8	12,858.8

Imports	2005-06 (July-May)	2004-05 (July-May)
Tea	201.9	204.3
Soyabean & palm oil	667.3	684.7
Sugar	435.2	61.5
Pulses	147.5	105.6
Machinery	7026.8	5203.4
of which		
Road motor vehicles	1435.1	940.0
Textile machinery	711.7	866.6
Petroleum products & crude	5957.9	3626.2
Synthetic fibre & yarn	446.3	242.0
Fertilizer	584.2	312.0
Plastic materials	913.0	707.0
Medicinal products	296.1	262.7
Iron & steel	1229.0	784.3
Paper & paper board	225.4	165.4
Total	25,598.3	18,368.5

Basel II - An Introduction

Basel II

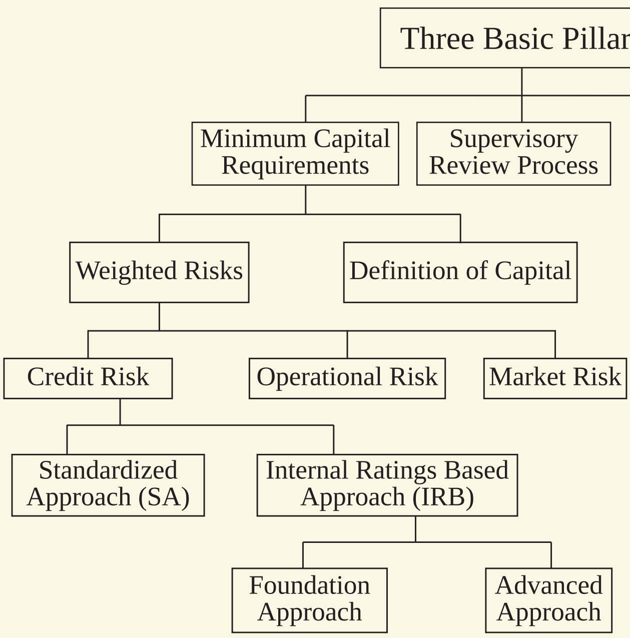
In 1988, the Bank for International Settlements (BIS) in Basel, Switzerland first introduced regulatory capital standards for the financial services industry. It was basically an agreement among the G-10 central banks to apply common minimum capital standards to their financial institutions.

There were however, certain weakness in this accord. It did not differentiate between assets having less risk and assets having higher risk. There was no capital allocation against operational risk as well as no consideration was given to other risks such as concentration risk, liquidity risk etc.

In June 2004, the BIS finalized the new capital adequacy framework, widely known as Basel II. The accord represents a major revision of the international standards for bank capital adequacy that were first established in 1988. The Basel II Accord, lays out a framework for financial institutions to incorporate risk management into their daily business practices.

It was a regulatory response to the lack of operational risk sensitivity in the earlier Accord and also because of significant developments in technology, telecommunications, and markets have changed the way that banks collect, measure and manage their risks. By adopting a “more risk sensitive capital framework”, Basel II permits a better alignment of regulatory and economic capital and promotes improvements in risk management, thereby underpinning banking solvency. Basel II will initially come into effect on January 1, 2007.

Overall, the Basel II Accord seeks to strengthen existing capital adequacy standards by introducing more sensitive metrics for credit and market risks, and new capital requirements for operational risk. The Accord also details requirements for the supervisory review process, and outlines external disclosure standards. These requirements place greater responsibility on company management and their adherence to market-based discipline. Basel II framework comprises of three parts referred to as the three pillars of the Accord.



SA - relies on external credit assessments.

Foundation IRB Approach - For corporations, sovereigns, and banks exposures, financial institutions must provide internal estimates of probability of default.

Advances IRB Approach - For advanced IRB approach, all factors must be calibrated using internal data for corporations, sovereigns and banks exposure.

Pillar I
Minimum Capital Requirements
It prescribes the capital allocation methodology against credit and operational risks. To ensure that risks within the entire banking group are considered, improvements in the measurement of credit risks have been made in Basel II. For the measurement of credit risk, Basel II proposes two principle options as seen in the above graphical representation.

Pillar II
Supervisory Review Process
It requires banks to establish a risk management framework to identify, assess and manage major risks inherent in the institution and allocate adequate capital against those risks. Major risks including those that are not covered under Pillar I, i.e. liquidity risk, concentration risk, interest rate risk etc.

Pillar III
Market Discipline
It sets out disclosure requirements and facilitates market discipline. Effective disclosure is essential to ensure that market participants can better understand banks' risk profiles and the adequacy of their capital.

Pillar II has two key elements:

a) A firm specific internal assessment and management of capital adequacy.
b) Supervisory review of this internal capital assessment and the robustness of risk management processes, systems and controls.

SBP's Roadmap for the Implementation of Basel II in Pakistan has discussed the four key concepts of supervisory review through which supervisors can ensure that each bank has sound internal processes in place to assess the adequacy of its capital and set targets for capital that are commensurate with the bank's specific risk profile and control environment:

Principle 1: Banks should have a process of assessing their overall capital in relation to their risk profile and strategy for maintaining their capital levels.

Principle 2: Supervisors should review and evaluate banks' internal capital assessments and strategies as well as their ability to monitor and ensure their compliance with regulatory capital ratios. Supervisors should take appropriate supervisory action if they are not satisfied with the results of this process.

Principle 3: Supervisors should expect banks to operate above the minimum regulatory capital ratios and should have the ability to require banks to hold capital in excess of the minimum.

Principle 4: Supervisors should seek to intervene at an early stage to prevent capital from falling below the minimum levels required to support the risk characteristics of a particular bank and should require rapid remedial action if capital is not maintained.

Each of these pillars addresses the Basel II Accord's stated objective of moving financial institutions to incorporate risk management into their daily business practices.

In Pakistan, the State Bank of Pakistan has decided to adopt Basel II. For its implementation it has provided a roadmap. According to State Bank, BSD Circular No.8 of 2006, dated June 27, 2006, the timeframe for adoption of Basel II will be as under:

i) Standardized Approach for credit risk from 1st January, 2008.

ii) Internal Ratings Based (IRB) approaches from 1st January, 2010. Banks/DFIs interested in adopting any IRB Approach before 1st January, 2010 may approach SBP for the purpose. Their requests will be considered on case-to-case basis.

iii) For Operational Risk, Banks/DFIs can adopt either Basic Indicator Approach or Standardized Approach from 1st January, 2008. However, the Advance Measurement Approach (AMA) is not being offered at present. The decision on the timeline to adopt AMA will be taken in due course keeping in view the preparedness of banks/DFIs and after consulting with Pakistan Banks Association. However, the banks/DFIs are encouraged to follow the international best practices in this regard and prepare themselves for an early adoption.

iv) For market risk, Internal Models Approach has also been allowed alongwith the standardized approach. However, Internal Models Approach will only be available to the banks/DFIs adopting Foundation or Advanced IRB Approaches.

v) Banks/DFIs are advised to adopt a parallel run of one and a half year for Standardized Approach and two years for IRB Approach starting from 1st July, 2006 and 1st January, 2008 respectively.

Adoption of Foundation or Advanced IRB for Credit Risk and Internal Models Approach for Market Risk will be subject to the prior written approval of the State Bank. Therefore, banks/DFIs interested in adopting any of these approaches are advised to approach the State Bank for getting necessary approval.

In an earlier BSD Circular No 3 of 2005 dated March 31, 2005, each bank/DFI is required to formulate their internal plans specifying the approach they are willing to adopt and the plans for moving to the particular approach. The plans should envisage the risk management setup, various risk assessment methodologies being used for assessment of various risk categories and the policy and procedures for the capital allocation. It must highlight what are the gaps for moving the Basel II implementation and what steps are required to overcome those gaps.

Banks and DFIs are also required to raise their minimum capital requirements vide BSD Circular No.6 of 2005. The SBP has raised the minimum paid up capital of banks/DFIs to Rs6 billion to be achieved by the end of 2009.

The required minimum CAR, on consolidated as well as on stand alone basis, would continue to be 8 percent. However, the existing uniform requirement for CAR has been replaced with the variable CAR which will be based on the Institutional Risk Assessment Framework (IRAF) Rating assigned by the State Bank to each bank and DFI. For this purpose, SBP will intimate IRAF rating to each bank/DFI separately. Under IRAF, each bank and DFI is rated on a scale of 1 to 5 based on its (a) compliance with standards, codes and guidelines; (b) supervisory and regulatory information; (c) financial performance and condition; and (d) market information and intelligence.

Tightening of Monetary Policy

CRR and SLR raised

Just ahead of the first half FY07 monetary policy statement, the State Bank of Pakistan tightened the monetary policy by raising the Cash Reserve Requirement (CRR) and the Statutory Liquidity Requirement (SLR). Now the CRR required weekly average of 7 percent (subject to daily minimum of 4 percent) of total demand liabilities (including time deposits with tenor of less than 6 months) and weekly average of 3 percent (subject to daily minimum of 1 percent) of total time liabilities (including time deposits with tenor of 6 months and above). The SLR has been raised from 15 to 18 percent of total time and demand liabilities.

Private sector credit slowed down

In recent months, monetary tightening was achieved through frequent OMOs and not through raising of the discount rate or the auction yields on treasury bills. The resulting rise in interest rates had an impact on credit growth. The major monetary aggregates have been showing significant weakening compared with FY05. Because of higher interest rates, demand for credit slowed down. On the supply side, tighter liquidity conditions in the inter bank market as a result of the SBP tightening measures probably contributed to the slowdown in private sector credit.

Growth in private sector credit during July-June 10 FY06 was lower than in the corresponding period of FY05. Credit to private sector was Rs333.7 billion in FY06 against Rs378.0 billion in FY05. The current increase in CRR and SLR of banks will further dampen the banks' ability to lend, as they now have to set aside higher cash reserves with the State Bank and increase their holdings of T-bills.

Faced with the new liquidity requirements, the banks ability to lend would be affected. They may attempt to increase their deposit base by offering better return to the depositors, thus putting pressure on banking spreads.

Inflation-ary pressure exist on economy

The Third Quarterly Report for the year 2005-06 of the State Bank of Pakistan, has stated, "oil prices are at historical highs, with attendant risks to price stability and growth. Moreover, the broadest inflation measure, the GDP deflator, is estimated at 10.3 percent for FY06, up sharply from 8.8 percent in the preceding year, suggesting that inflationary pressures still persist in the economy. The path of future monetary policy becomes further complicated by both, the proposed expansionary fiscal policy as well as the uncertainty on the degree of monetization of the fiscal deficit.

It further adds, "the expansionary fiscal stance will add to aggregate demand, and therefore to inflationary pressures. The impact could be worsened if the government depends heavily on central bank borrowings to finance the deficit. The budget for FY07 envisages a receipt of Rs35 billion from SBP profits, which suggests that this may be the case, and therefore the burden of containing inflationary pressures will fall disproportionately on monetary policy.

Thus, from SBP's perspective, a discontinuation of tightening remained far from consideration. Moreover, continuity of monetary tightening is also vital to achieve the moderate inflation target of 6.5 percent in FY07, especially given the need to reduce aggregate demand in the economy in the face of an expansionary stance of the FY07 budget, and the projected widening of the current account deficit."

Market Analysis

Market Review

The market during the second quarter of 2006 was generally bearish in contrast to bullish sentiments and trend during first quarter of 2006. Overall, the KSE-100 index during second quarter dropped 1583 points or almost 14% on average daily turnover of 240mn shares. For HY06, the Index gained 317 points or 3.3% on average daily turnover of 345mn shares.

The quarter began on a positive note as the recovery that started on March 13 continued into the first two weeks of April 2006. From March 13 to April 17, the KSE-100 Index gained 2,180 points or around 22% to reach an all-time record high closing of 12,273 on an average daily turnover of 384mn shares. The main driver behind this recovery was the speculative buying by punters in large cap scrips in the banking, cement and E&P sectors. However, this momentum could not be sustained and a major correction occurred from this point.

Correction - crisis of confidence

The market rising by over 2,700 points or 28% in 15 weeks was shocking and unexpected for many investors and analysts. From April 17 to June 14, 2006, the Index plummeted by over 3,500 points or about 29% to reach a seven month low closing of 8,768 on average daily turnover of 222mn shares.

The correction that took place from mid-April to June 2006 can be attributed to the following factors:

- Profit taking by both local and foreign investors.
- March-end quarterly earnings announcements of major companies such as PTCL, MCB, PSO and Nishat Mills were below market expectations.
- Negative reaction by the brokers to the Federal Budget 2006-07 because of the doubling of CVT and withholding tax on shares to 0.02% and 0.01%, respectively.
- With many open-end equity mutual funds being 80-90% invested at the end of May, they had little liquidity to support the market.
- Lack of participation by retail investors as reflected in the thin daily turnover during this period.
- Global monetary tightening and interest rate increases by the Federal Reserve in the U.S. and the Bank of England.
- Alleged abnormal and/or illegal trading practices such as blank selling which led to the SECP to start investigating from June 9.

Roller coaster recovery

In light of the continuous downward trend observed in the market, the board of directors of the KSE in their meeting on 14th June took some important decisions including implementation of previous mechanism for application of lower circuit breakers, prohibition on short selling for June futures contract, amendments in margin requirements and extension of the CFS facility from 14 to 30 scrips. The decisions were viewed favorably by the market and the index during the last 12 days has recovered 14% or 1,220 points.

Looking forward

It will not be incorrect to say that the month of June '06 was one of the darkest periods in the short history of the bourses. As mentioned earlier, many factors were responsible for the devastation caused during the month. The corporate result season is round the corner which alongside attractive values in major index stocks (and others) may trigger a bull run towards the latter half of July '06.

Risk management at the bourses - short term pain for long term gain

On the risk management front, the Securities and Exchange Commission of Pakistan (SECP) has proposed several measures to strengthen the existing risk management framework deployed at the local bourses.

Inspite of the associated long-term benefits for the market including less speculation, price stability and an improved risk-return matrix at local bourses, the proposed measures especially with regards to the netting requirement may have a short-term adverse effect on the market. Nevertheless, longer-term benefits appear to significantly outweigh the short-term costs and we feel that any pressure with regard to this issue should be viewed as an opportunity for investors to accumulate scrips.

Federal Budget 2006-07: Impact on various sectors

Budgetary Measures

	Expected	Actual	Last Year
Banking Sector	Reduction in the Corporate Tax rate from 38% to 35% Imposition of CED on Consumer Loans, car and house financing Imposition of 7.5% as Excise duty on fee income, commission and brokerage income	Reduction in the Corporate Tax rate from 38% to 35% Levy of 5% as CED on services such as L/C opening, brokerage credit card processing & renewal, on sale/purchase of foreign currency and bank gurarantees Imposition of 0.2% WHT on cash withdrawals in excess of Rs 25,000	Corporate tax rate reduced from 41% to 38%. Imposition of 0.1% WHT on cash withdrawals in excess of Rs 25,000
Textile Sector	Removal of 5% duty on import of machinery Reduction of duty on furnace oil for captive power house in the sector	No Measure No Measure	Duties reduced to 5% on machinery and spare parts as per BMR measures. Removal of sales tax on imports and local supply of major raw materials and on local plants & machinery. Withholding tax on selected fabric imports reduced to 1% and reduction of duty on various materials.
Cement Sector	Reduction of CED from Rs750/ton Increase in PSDP particularly aimed at infrastructure	No Measure PSDP budget increased to Rs415bn, by 38.7% YoY. Rs7bn allocated to cement 15,000 water courses. Rs5.5bn allocated for Kachhi Canal construction. Rs10bn to initiate the construction of three major dams. Subsidy of Rs720m to maintain lower prices for cement imports.	Approx, 10000 water courses were cemented during FY05-06.
Power & IPPs Sector	Income Tax Exemption for new entrants	Rs25b to be provided as subsidy to WAPDA & KESC	Exemption for Hubco in respect of profit and debts on accounts with financial institutions, proposed to be restored Exemption proposed to be allowed to KAPCO on assets purchased in 1996 prior to privatization. Exemption from income tax for corporatized entities of WAPDA.
E&P/ OMC Sector	None	No measures in budget aimed specifically at oil sector (OMCs and E&Ps). The Petroleum Development Levy (PDL) for 2006-07 has been set at zero as against the revised 2005-06 estimate of Rs20.8bn. The original 2005-06 budget target for PDL collection was Rs 15.9bn.	The PDL for 2005-06 was set at Rs15.9bn as against the revised 2004-05 estimate of Rs 10.8bn.
Auto Sector	Reduction of CKD duty from 35% to 32.5% Reduction of Custom duty on import of CBUs Increase of Custom duty on import of High-end cars (CBUs) Imposition of 6% Withholding Tax on new cars Strict policy for import of used cars (regarding depreciation limit of 50%) Implementation of TBS	No Measure No Measure No Measure No Measure Import restricted upto 5 year old cars Implementation of TBS replacing the deletion program. 20% to 10% and CBU duty from 60% to 30% for trucks and dumpers.	Allowed import of second hand cars under the baggage scheme. Duty was reduced on CBUs with capacity of upto 1500cc and over 1800cc to 50%, 65% and 75% respectively.
Telecommunications Sector	Waiver of activation charges of Rs500 on new cellular connections	Imposition of 15% CED on various telecommunication services. Imposition of Excise duty at the rate of Rs25 per connection per month on cable TV operators	15% Excise Duty imposed on the sale of pay phone and pre-paid calling cards instead of on billed amount of PTCL. 15% Ecxise Duty imposed on Wireless Local Loop. Activation charges for mobile connection reduced from Rs1,000 to Rs500.

Budgetary Impact

Banking Sector

The imposition of the above mentioned duties will transform into higher cost of financing for the borrowers, which in turn may dampen demand for such services to some extent. In the Federal Budget '05 - '06, it was proposed to levy 7.5% as CED on services such as L/C guarantees, on sale/purchase of foreign currency and fee on commission which was subsequently withdrawn.

Successful penetration in the consumer business by numerous banks, alongside increased economic activity has increased the share of non mark-up based income to the bottom-line of banks and we feel that robust growth witnessed in these areas will negate the impact of duties in this segment. Scheduled reduction in the corporate tax rate charged on banking companies from 38% - 35% or 300bps should bode favorably for the sector and improve the bottom-line of the sector. It should also be noted that the effective tax rate for most of the institutions is already below 38% (due to the presence of deferred tax assets).

In order to provide impetus to the agricultural sector, the Government has allocated Rs68bn towards improving the country's water supply system. This alongside, abolishment of customs duty on import of tractors and an additional Rs7.8bn investment to increase the income of the farmers is expected to bode favorably for institutions involved in the agri-business.

In light of the recent guidelines issued by the SBP regarding participation by commercial banks in infrastructure financing, we feel that the allocation of Rs415bn for PSDP purposes should strengthen demand for credit and hence translate into a higher top-line for banks. Profit for all saving schemes and prize bonds have been increased from 0.5 percent to 1.5 percent which was expected (for saving schemes) in light of the recent PIB auction. We don't expect the upward revision to have any detrimental impact on the banking sector due to relatively better rates presently being offered on time deposits.

Withholding tax on cash withdrawals in excess of Rs25,000 has been raised from 0.1% to 0.2%, which is not expected to have any major impact on the sector.

Insurance Sector

The Government has announced an increase in Excise Duty from 3% - 5% on insurance services, which will be levied on gross premium of services provided by insurance companies excluding the life insurance business. Increased infrastructural projects, reconstruction of earthquake stricken areas and the ongoing boom in the auto industry translates into a healthy top-line for insurance companies and the above mentioned increase in duty is not expected to have any significant impact on demand. Furthermore, in our view, the extension of exemption from capital gains tax (which was introduced in the Federal Budget '05-'06) should continue to provide support to the bottom-line.

Textile Sector

Against all expectations, the FY07 budget announced no measures targeting the textile sector. The sector is struggling to not only maintain its margins, but also to remain profitable. High cost of inputs, inadequate infrastructure and shortages of basic utilities, increasing fuel and energy costs, increased export competition, especially from China, India and Bangladesh, anti dumping duties from the EU and a host of negative factors have arrested growth in the sector. The unresponsive budget has thwarted high expectations for positive developments regarding cost-benefits in import of machinery, raw materials and reduced duty on furnace oil as many textile companies have captive power plants.

Now the major sectoral players are looking towards the upcoming trade policy hopeful of some positive supportive measures. More than 60% of total exports comprise textile products and the increasing trade deficit can only be controled and reduced through increased exports, with textiles as the main driver.

Cement Sector

Cement sector is positively impacted by the increase in the PSDP. In the budget FY06-07, the PSDP allocation has been increased by 50.9% to Rs415bn, with the government allocating Rs7bn for the cementation of 15,000 water courses. The allocation of Rs5.5bn for building the Kachhi Canal and Rs10bn to initiate work on three strategic dams will increase the demand for cement.

Consequently, the demand-supply gap is widening, spurring a surge in domestic prices increasing the price of 50Kg bag to Rs400/bag and so, leading to a government policy of allowing subsidized cement imports at the retail level. The current budget announced a subsidy of Rs720m to maintain lower cement prices. Despite the expected negative impact in the sector, the government had no choice but to facilitate imports in an attempt to curb the surge in cement prices, which are key determinants of the cost of construction.

Power & IPPS

In an attempt to overcome the looming energy crises, the Government in the Federal Budget for FY06-07 has allocated Rs10bn for the construction of five dams including the controversial Kalabagh Dam.

According to press reports, total cost of new hydel projects, which are given in the power sector in the PSDP, has been estimated at Rs180.18bn. Furthermore, the water and power division of WAPDA has been allocated Rs47.7bn, exclusively for power projects including the allocation for village electrification.

The Government has allocated Rs25bn as subsidy to WAPDA and KESC to cover their rising cost of power generation and to ensure that they are not fully passed on to the end-users in the form of increased tariff. It has also been proposed that mechanism for sales tax be streamlined since under the present scenario, sales tax is levied on cash collection basis in the case of WAPDA, whereas KESC pays sales tax on billing basis. KESC has been pleading to be allowed to pay sales tax on cash basis (due to lower collection versus the billed amount), which if allowed, should provide some cushion to the bottom-line.

E&P/ OMC Sector

With PDL target set at zero, this means that the retail prices of POL product are expected to remain fairly constant throughout 2006-07 and thus, the OMC margin will not change in absolute terms. With OMC margins remaining relatively unchanged in absolute terms than earnings growth should be modest during FY07. The revenues and earnings growth of the E&P sectors will continue to be tied to the price levels of international crude oil and production growth. There is a possibility that the Petroleum Policy 2001 may be amended or replaced by a new policy that may increase the ceiling on wellhead gas prices from US$36 a barrel to around US$40 a barrel. However, such a change would not be applied on existing fields but on new concessions and also, we do not expect the amended or new policy to be introduced before the end of CY2006.

Auto Sector

As per expectations, Tariff Based System for cars will be implemented from July 1, 2006 (FY07) replacing the deletion program which existed for almost two decades. Under this new system, parts produced locally, if imported, will be subject to 50% duty whereas a 35% (CKD) duty will be applicable on parts which are not locally available. This differential duty of 15% is the protection for the vendor industry but will have a negative impact on vendors as auto assemblers now have the choice to either import parts paying higher duty or save cost by using locally produced parts.

Government has also maintained the duty structure on new imported CBU cars whereas policy to import second hand cars has been restricted to only five year old cars. CKD duty of 35% has also been maintained against the proposed duty of 32.5%. This measure has negative to neutral impact on the sector as status quo has been maintained for CKD as well as CBU duties.

CKD and CBU duty on trucks and dumpers is reduced from 20% to 10% and 60% to 30% respectively as per the requirement due to increased development in the country. Overall impact of these measures is neutral on the sector and on the four major car assemblers namely Pak Suzuki, Indus Motor, Honda Atlas Cars and Dewan Farooque Motors, while reduction in the duty of trucks/dumpers will have negative impact on Ghandhara Nissan.

Tele-communications Sector

Excise duty at the rate of 15% of charges has been levied on various telecommunication services. However, given the robust demand for telecommunication services, the affect of passing on these charges to the consumers of PTCL and other telecom operators is expected to be negligible.

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

Pakistan Economy - Key Economic Indicators

Economy Size & Growth			FY '03	FY '04	FY '05	FY '06
GNP - Market Prices		Rs. bn	4974.6	5657.1	6715.6	7864.5
GDP - Market Prices		Rs. bn	4822.8	5640.6	5681.1	7713.1
Per Capita Income	Market Prices	Rs.	33899	38524	44028	50618
	Market Prices	US$	579	669	742	847
Growth*						
GNP		%	6.3	7.3	8.3	6.4
GDP		%	4.7	7.5	8.6	6.6
Agriculture		%	4.3	9.2	9.2	4.3
Large-scale manufacturing		%	7.2	18.1	15.6	9.0
Services Sector		%	5.2	5.9	8.0	8.8
Rate of Inflation		%				
Consumer Price Index[x]		%	3.1	4.6	9.3	7.9
Wholesale Price Index[x]		%	5.9	7.9	6.8	10.1
Balance of Payments		$mn				
Exports (f.o.b)			10889	12396	14401	11854[a]
Imports (f.o.b)			11333	13604	18753	17958[a]
Trade Balance			(-)444	(-)1208	(-)4352	(-)6104[a]
Services Account (Net)			(-)2128	(-)3594	(-)5841	(-)5393[a]
Current Transfers (Net)			5737	6116	8440	6801[a]
Current Account Balance			3164	1314	(-)1753	(-)4695[a]
Fiscal Balance		% of GDP				
Total Revenue (Net)			14.9	14.3	13.7	14.2
Total Expenditure			18.6	16.7	18.2	17.6
Overall Deficit			(-)3.7	(-)2.4	(-)3.3	(-)4.2**
Domestic & Foreign Debt						
Domestic Debt		Rs. bn	1894.5	2012.2	2158.4	2267.0[a]
As % GDP			39.3	35.7	32.8	29.4[a]
Total External Debt & Liabilities		$bn	35.47	35.26	35.83	36.56[a]
As % of GDP			43.1	36.7	32.6	28.3[a]
As % of Foreign Exchange Earnings			181.2	164.7	134.3	127.6[a]
Investment & Savings		% of GDP				
Gross Investment			16.9	16.6	18.1	20.0
Gross Fixed Investment			15.3	15.0	16.5	18.4
National Savings			20.8	17.9	16.5	16.4
Domestic Savings			17.6	15.7	14.5	14.4
Foreign Investment		$mn	816.3	921.7	1676.6	3525.4[b]
Portfolio			22.1	(-)27.7	152.6	313.4[b]
Direct			798.0	949.4	1524.0	3212.0[b]
Monetary Aggregates		%				
M_1			26.2	24.0	18.4	8.9[c]
M_2			18.0	19.6	19.3	10.8[c]
Literacy Rate		%	51.6	53.0	53.0	53.0
Foreign Exchange Reserves		$mn	10719	12328	12623	13021
Exchange Rate		Rs./$	58.4995	57.5745	59.3576	59.8050[a]
Stock Market Growth Rate		%				
SBP General Index of Share Prices[x]			91.9	57.8	12.2	17.7
Aggregate Market Capitalisation			83.1	88.0	45.2	35.8

* Constant Factor Cost of 1999-2000 [x] 2000-01 base [a] Jul-Mar [b] Jul-May [c] Jul-Apr
** Excluding earthquake spending the deficit is 3.4%.

Source: Economic Survey FY'06
State Bank of Pakistan