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Editor's Corner

Dear Readers,

The ongoing consolidation of financial institutions worldwide is one of the most notable contemporary features of the financial landscape. Indeed the past few years have seen an acceleration in the process, as banks responded to meet the changes in regulations and international standards.

Mergers and acquisitions in the financial sector are undertaken for a wide variety of reasons. In any given case, more than one motive may underlie the decision to merge. Though the factors vary with organizational structure, over time and across countries, but generally include among others, greater efficiency, new technology, changing laws, diversification, broader range of products, etc.

Over the past two decades or so, financial regulatory frameworks in most major countries have shifted from systems based on strict regulatory controls to systems based more on enhancing efficiency through competition. With the process of liberalization and deregulation having been undertaken in many countries, a new operating environment has been created for the banks. Mergers and acquisitions are a major component of the restructuring process. It is thought that banks that are better capitalized, are better placed to implement international best practices at governance, risk management, taxation, accounting and disclosure regulations and subsequently they can graduate to a global scale. Increased size, allows banks to better serve large customers, increase product diversification, increase the market share, thereby making it easier to attract customers. Only those banks who can venture into business expansion and risk management have the opportunity to survive in the new financial environment.

Consolidation has dramatically altered the structure of banking in countries where it is being pursued. In the US for instance, since the mid 1980s, the number of banks has plummeted, thousands of small banks have disappeared; in Argentina the period between December'95 - December 2000 was a period of heavy bank consolidation, while in Brazil the consolidation drive that began in 1994 now seems to be coming to a close.

The banking sector in countries like South Korea, Japan, Taiwan and Singapore are continuing to improve their efficiency and competitiveness through consolidation. Japanese banking sector has undergone significant domestic consolidation and some mega banks have emerged. In Taiwan, the number of banks has been reduced either through mergers among the big state owned banks or by private sector acquisition of state owned banks. In Malaysia, the first stage of consolidation reduced the number of banks from 55 to 10, while the second stage involves mergers between banks and their finance company subsidiaries. In South Korea, during the last decade some banks closed down because of large NPLs, while others with capital adequacy ratio of below 8 percent BIS guidelines were taken over by the healthy banks. With the strengthening of the financial sector in Indonesia, and government support, banks have become attractive investment opportunities for foreign players.

The governments of the less developed banking markets have played an important role in improving their respective banking system. Policies have been initiated to encourage bank reforms so that banks are better equipped to compete in the highly competitive market. As part of this process, consolidation is being encouraged to strengthen financial institutions. China for instance has raised the limit for individual ownership in a domestic bank. India is amending its banking policies to encourage mergers and acquisitions among the public sector banks and the Thai government called for consolidation to reduce the number of commercial banks.

In Pakistan, the process of consolidation begun in 2000 has gained momentum. The liberalization of the financial sector during the 1980s and 1990s had resulted in the setting up of a large number of private banks and non bank financial institutions. However, this fragmented structure of financial system, had placed the smaller banks and NBFIs with their small capital bases at a competitive disadvantage against the large public sector banks. To address these issues, a process of privatization and consolidation was adopted, with the objective to have fewer but stronger banks capable of withstanding economic downturns.

Mergers/acquisitions got underway when the State Bank of Pakistan raised the minimum capital requirements for banks to Rs1 billion in the beginning of 2002. Few years later by the end of 2005, the SBP again raised the existing minimum paid up capital requirement for locally incorporated banks/DFIs to Rs6 billion to be achieved in a phased manner by 2009. This put pressure on the medium sized and smaller banks. However, several measures were taken to help financial institutions achieve the increased capital requirement. The branch licensing policy was liberalized, thereby encouraging small and medium sized banks to increase their outreach and asset base. Tax incentives were provided and some amendments were made in the legal framework to facilitate and encourage voluntary compliance among financial institutions.

Consolidation that began in 2000 has since resulted in some 37 successful mergers involving some 85 entities (figures as of 2005). More banks have since merged. Foreign banks have shown a been interest in the domestic banking sector, and many of the mergers involve foreign participation. Given the good performance by banks, the overall growth in the economy, the large potential that exists locally, a generally conducive economic environment which encourages foreign investment are some of the factors for attracting foreign banks. One sees consolidation to continue for sometime. Strengthening of balance sheet is imperative to those who are in pursuit of expansion and gaining a market share. Banks that are unable to reinforce their financial stability through their balance sheet are likely to face difficult times in the increasingly competitive industry.

Ayesha Mahmud

Pakistan Economy
Performance, Challenges and Prospects

Good economic perfor-mance

Pakistan has shown good economic performance in the last couple of years. Reforms carried out over the last many years, through liberalization, decentralization, privatization and restructuring, in almost all sectors of the economy, are having a significant impact on the economic performance. The growth has been commended upon by both the IMF and ADB in their recent country briefs on the economy. The IMF Executive Directors have commended Pakistan's impressive macroeconomic performance since 2001. They welcomed in particular the acceleration in output growth, the steady decline in debt ratios, and the fall in poverty rates. The country has been made increasingly attractive to foreign investors as shown by the record high inflows of foreign direct investment during 2005-06. The ADB in its latest economic update commenting on the medium term outlook terms it as positive.

Agricul-ture suffers

The economy maintained a growth of 6.6 percent in FY06, driven largely by the growth in the services sector. Despite an improvement in the availability of water, agricultural credit and greater use of fertilizers, unfavourable weather conditions had an adverse impact on major crops, sugarcane, cotton and wheat, which consequently lowered agri growth. The continued price disputes between farmers and sugar mills affected sugarcane output which was lower for the second consecutive year. The agricultural growth declined to 2.5 percent against 6.7 percent a year earlier. It also affected growth of agro based industries, particularly of cotton and sugar.

Weak performance by the agricultural sector alongwith capacity constraints in key industries, high energy costs and continued monetary tightening affected the growth of large scale manufacturing. These factors pushed the GDP growth rate below, both against the 7 percent target for the year, and the growth of 8.6 percent achieved in FY05. GDP growth could have been higher, if it were not for the shortfall suffered by the agricultural sector.

The agricultural sector in Pakistan is considered as a major determinant of overall economic growth and well being of the people, because of its significant contribution to GDP, export earnings, employment and food availability. Sustained, reasonably high agricultural growth is essential to accelerate the overall growth and subsequently reduce poverty.

Institutional lending for agriculture has grown in recent years, as the large commercial banks, alongwith the domestic private banks are playing an important role in meeting the farmers' needs. Livestock is gradually showing an improved performance and grew by 8.0 percent in FY06. With the government's support to the sector, the increased activity seen ushers well for poverty reduction, as it enables the landless farmers to generate income.

Agricult-ure and poverty reduction

Performance of the agricultural sector has important implications for rural poverty, as well as for gross domestic (GDP) growth and exports. A paper, '*Agricultural Growth and Rural Poverty - A Review of the Evidence, Sohail J. Malik, Asian Development Bank 2005* examines the relationship between agricultural growth and rural poverty. In addition to the direct effect of agricultural growth on poverty reduction, through an increase in farmer's income there is a much larger indirect effect through the linkages between agriculture and non-farm growth.

Non-farm growth is closely linked with agriculture growth since peasant farmers spend a large portion of their incremental income on locally produced non-agricultural goods, thus generating employment and income in adjoining areas. The increased demand for non-farm goods leads to a much larger increase in employment, which is the main vehicle for poverty reduction.

We see in FY06 agro industries textiles and sugar were hit by poorer harvests. The rise in oil prices negatively impacted the growth in value addition by the petroleum industry. Given that these three sub groups account for 50 percent of LSM, and as their performance suffered, the overall growth of LSM also declined. Smaller industries like tea blended, cooking oil and vegetable ghee, beverages, paper and board, chemicals, leather, through accelerated growth had a positive impact on overall LSM growth.

Automobiles & electronics show good performance

While automobiles and electronics, showed some deceleration in growth, it was slight and on the whole this sub-sector showed good performance. Availability of consumer financing was a major contributory factor for the strong growth.

Production of Consumer Durables

(000 (Nos)

	FY'05	FY'06
Cars 1300cc & above	53.6	70.0
Cars less than 1300cc	72.8	91.0
Jeeps & Vans	7.5	12.9
Trucks	3.3	4.5
Motorcycles	416.2	519.4
Airconditioners	181.8	363.2
Deep Freezers	179.0	185.7
Refrigerators	784.6	861.6
TV Sets	908.8	966.5
Electric Fans	142.0	145.0

Consumer Financing for Consumer Durables

June 2004	June 2005	June 2006
1997.7	2358.4	1559.9

Source: State Bank of Pakistan

Services sector impressive

Services sector recorded an impressive growth of 8.8 percent, providing a welcome fillip to the economy. Its sub-sectors showed a mixed performance. Transport and communication sub-sector showed a significant growth during the year, because of significant private sector investment in the sector. Growth in value addition by wholesale and retail trade showed a slight dip because of the slowdown of commodity producing sectors, but its share in services inched upwards. Investment rose in the sector because of larger trade activities in the economy, rise in consumption as well as changing consumption patterns of the population. Finance and insurance continued to show a healthy growth as profitability of the sector improved, a new Islamic bank was incorporated and the proceeds received from privatization.

Domestic commerce to be strengthened

While the services sector contributes about 52 percent to the GDP and employs about 35-40 percent of the people, who are mostly poor and unskilled, it has remained a fairly underdeveloped sector. The government is now seriously considering developing this important sector. For the first time an initiative was taken by the Ministry of Commerce to organize a Conference, *Domestic Commerce - The Missing Link*.

Proceedings of the conference were published in January 2006. The report is edited by Dr. Nadeem Ul Haque and Izzah Waqaar. The objective of the Conference was how to strengthen domestic commerce; new approaches are needed which could subsequently become part of the economic growth strategy. Domestic commerce includes retail and wholesale trade, restaurants and hotels, construction, transport, storage and communication, financial and real estate and personal services.

As the sector contains a large number of small and medium sized enterprises and is the largest contributor to GDP, the aim was to understand the sector by finding out its problems, investing and developing it. It was felt that if domestic commerce could be developed it would have a favourable influence on the economy's growth rate and in poverty alleviation.

The Conference concluded with the observation that the domestic commerce sector suffers from shortage of land for commercial use, law and order problems, inadequate legal framework for property rights and speedy land transfers, inadequate transport, no warehousing, discriminatory taxation among other irritants. The Ministry of Commerce is developing new approaches to strengthening domestic commerce.

Investor confidence in the economy is gradually improving and the investment to GDP ratio rose to 20.0 percent during FY'06 up from 18.1 percent in FY'05. The increase is attributable to improved confidence of local and foreign investors in the economy, rising public investment and higher credit to private sector despite increasing interest rates. While the government is taking measures to enhance investor confidence and reduce the cost of doing business in Pakistan, there are some pressing issues like provision of low cost energy and other utilities and law and order situation which negates the measures undertaken.

Investor confid-ence

World Bank figures on Doing Business provides ranking on ten topics that comprise the overall ranking. For some items, Pakistan's ranking has improved in 2006 over a year earlier and for others it has deteriorated.

Doing Business

	2006 rank	2005 rank	Change in rank
Ease of			
Doing Business	74	66	-8
Starting a Business	54	44	-10
Dealing with Licenses	89	93	+4
Employing Workers	126	120	-6
Registering Property	68	57	-11
Getting Credit	65	59	-6
Protecting Investors	19	18	-1
Paying Taxes	140	143	+3
Trading Across Borders	98	117	+19
Enforcing Contracts	163	163	0
Closing a Business	46	34	-12

Source: World Bank

Each of the above mentioned items, has a number of indicators, where Pakistan is compared to the region. For some indicators, like the time it takes on average to launch a business, the costs involved, investor protection, or getting credit information, Pakistan is better placed compared to other countries in the region. It is also better placed against indicators which show the procedures involved from starting to final agreement between two parties and ending with the delivery of goods. However, the number of procedures involved in starting a business, the costs involved in building a warehouse and obtaining necessary licences and permits is higher compared to countries in the region. It has more rigid regulations in hiring of workers, and in paying taxes, the number of payments an entrepreneur has to make is more in a given year, so is the time spent in preparing, filing and paying of these taxes.

Ranking improves for some indicators

While the government has taken measures to rationalize tariffs, improve tax refund process, remove procedural bottlenecks, improve tax laws, reform the banking system, more efforts are needed to provide low cost and uninterrupted energy, and improve law & order situation. The time it takes to enforce a contract also needs to be improved.

Studies have shown that an improvement in the investment climate affects factor productivity. For example, firm level performance analyses carried out in a study, "*Investment Climate and Firm Performance in Developing Economies" in Economic Development and Cultural Change. Volume 54 October 2005, by Dollar D., M. Hallward - Driemeier and T. Mengistae* have provided results showing that the quality of the investment environment has a significant effect on productivity. Data collected from a large number of countries, including Bangladesh, China, India and Pakistan indicate that improvements in various aspects of the investment climate (including power outages, days required to get a phone line, days required to clear imports, and exports through customs, access to financing, unofficial payments, and management time dealing with regulations) would lead to significantly high total factor productivity (ie the efficiency with which resources are used in production) growth.

Improved invest-ment climate benefits economy

More evidence on the importance of investment climate conditions in affecting Pakistan's growth outcomes comes from a cross - country data used in a report, *Pakistan Growth and Export Competitiveness, World Bank, April 2006*, to analyze the impacts of a subset of microeconomic factors and of stabilization policies on Pakistan's recent growth performance.

The results indicate that the investment environment improvements -- in public infrastructure, government burden, governance, trade openness, and financial depth - effected through the structural reforms since the late 1990s have contributed to about 80 percent of the 0.70 percentage point increase in the real per capita GDP growth rate observed during 2001-05 compared to the 1991-2000 period. The recovery growth from the stagnation of the late 1990s and the stabilization policies are the other factors explaining the growth rate increase.

Rising current account deficit and inflation

Worrying features for the economy are the rising current account deficit and inflation. As growth in the economy has picked up, there has been a sharp acceleration in imports both in FY05 and FY06. Substantial increase in international oil prices and other commodity prices, larger food imports and machinery imports raised the import bill to US $25 billion. The petroleum group contributed almost one-third of the total import growth. Import of machinery and raw materials to cater for the needs of the growing domestic economy contributed almost 46 percent to overall import growth. It was felt that larger imports were on account of enhanced economic activity and these would gradually decrease as the economy's productive capacity increase.

Imports growth started declining in the second half of 2006 and have continued to fall during July-November FY07. This decline has been across the board, with the exception of the petroleum group, machinery and other imports.

Exports rise

Meanwhile, exports rose by $2 billion in FY06 over FY05. At $16.5 billion, states the SBP Annual Report 2005-06, "the export performance is commendable given the strong competitive pressure from China, India and Bangladesh in textile and clothing items, adverse impacts of anti dumping duty and loss of preferential access under Generalized System of Preference (GSP) in the European Union (EU) market, appreciation of exchange rate in real terms against the trading partner currencies and relatively lower growth in the textile sector production".

Exports were however, not able to sustain the growth recorded in FY06 and during July-November FY07 they dropped to a mere 5.2 percent, compared to the 22.3 percent rise in the corresponding period a year earlier. A more challenging economic environment, where exports face increased competition post MFA (quota regime has ended, Pakistan has lost some of the gains under GSP, which some key competitors continue to enjoy) alongwith high domestic energy prices and infrastructural constraints have affected competitiveness.

Market diversification

Pakistan's efforts at export market diversification has been limited. However, though small in magnitude there has been some export market diversification in the countries with whom Pakistan has bilateral free trade agreements, China, India, Sri Lanka, Malaysia and SAARC. Pakistan's trade policy regime has gone through significant improvements and rationalisation in recent years. The tariff rationalisation measures introduced, the gradual reduction of the maximum tariff rate, as well as the number of tariff slabs, are aimed at lowering the overall average tariff level. Compared to the second half of the 1990s when Pakistan had one of the most highly protectionist trade regimes in South Asia, the current trade policy regime is one of the most open in South Asia. Reforms continue to further reduce the remaining anti- exports bias, so to strengthen Pakistan's export activities, and foster broader export diversification, so Pakistan's exports can compete in today's incressingly more competitive and integrated global economy.

Trade deficit rises

The trade deficit had risen to US$8.4 billion in FY06. Services account deficit widened because of increased trade activity, as well as the continued expansion in the coverage of foreign exchange transactions routed through foreign exchange companies. Outflow under travel also accelerated sharply. Investment income witnessed a deficit, due to higher direct investment outflows. Interest payments on external debt also rose.

Current account deficit widens

Meanwhile, private transfers have risen both on account of higher workers remittances and other transfers (transfers on account of exchange companies). As such current account deficit widened to nearly $5 billion from $1.5 billion a year earlier. This has deteriorated further in the current year.

Key Challenges to the Economy

Asian Development Bank Economic Update October 2006	IMF Country Report December 2006	State Bank of Pakistan Annual Report 2005-06
• Capacity constraints in large scale manufacturing. • Declining national savings. • Increased gap between gross domestic investment and savings. • Growing current account deficit. • Continuing high inflation. • Emerging power shortages.	• Containing the external current account deficit. • Containing inflation. • Obtaining foreign financing consistent with external debt sustainability. • Achieving a higher stock of international reserves.	• Persisting high inflation. • Relatively narrow growth base. • Stagnant tax base, which has kept the tax/GDP ratio in the 10-11% range for over a decade. • Over reliance on import related taxes. • Widening external current account deficit. • Reducing cost of doing business improving infrastructure, enhancing labour skills, reducing unit labour costs.

Financial account improves

The deterioration in the current account deficit was more than offset by an improvement in the financial account, which recorded a surplus of $5.9 billion compared with only $446 million in 2004-05. The improved position continued in 2007 (July-November), as financial account posted a surplus of $2.5 billion compared to $1.8 billion in the corresponding period a year earlier.

This was made possible because of a rise in foreign direct investment. In FY06, it more than doubled to $3.5 billion, including $1.5 billion in the form of privatization proceeds. The leading sources of FDI were UK, USA and UAE. The $800 million Eurobond issue was also well received.

In the past few years, FDI has flown in the telecommunications, financial business services and oil and gas exploration. Other sectors such as trade, power, textiles, have also witnessed increased foreign investment.

The improvement in the financial account last year resulted in an overall surplus of $1.3 billion in the balance of payment. Substantial overall surplus in the balance of payments raised foreign exchange reserves held by the State bank of Pakistan to $10.8 billion, at end June 2006, which are sufficient to finance 4.5 months of imports.

The current account deficit was financed through non current inflows, such as, $1.1 billion from the US for logistic support for the War in Afghanistan and inflows of foreign direct investment and foreign investment in equities. The ADB Outlook 2006 states, ‘the heavy reliance on these non recurrent and sometimes volatile inflows is a major issue for sustaining such high levels of both imports and the current account deficit, highlighting the Government’s need to strengthen the underlying fundamentals of the balance of payments’.

Inflat-ionary pressures ease

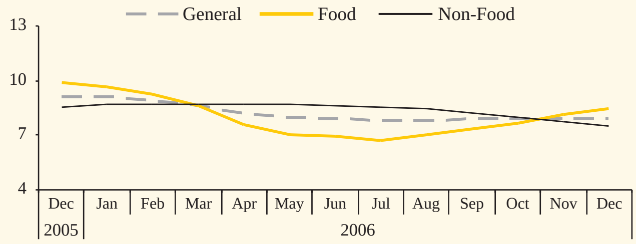
Inflationary pressures eased somewhat in FY06, as Consumer Price Index (CPI) decelerated from a peak of 9.3 percent in FY05 to 7.9 percent, mainly due to monetary tightening as well as measures taken to counter supply constraints. While food inflation halved, the non-food component of CPI rose due to rising energy costs. Domestic factors like domestic supply shortages of wheat, sugar, pulses and milk as well as strengthening of domestic demand, exerted greater pressures on inflation. The Government's policy of liberal import of essential food items, announced in last year's budget paid off by augmenting domestic food supplies.

Non food inflation falls

In the first half of the current fiscal year FY07, non food inflation shows a downward trend. This is reflected in the easing of core inflation. The non food non energy measure of core inflation dipped to 5.5 percent in December 06 compared with 7.4 percent YoY for the corresponding month of 2005.

Despite a decline in non-food inflation, CPI in the first half of FY07, is close to 8 percent and is a cause for worry. Higher than expected food inflation impacts consumers especially those in the low income groups. By pursuing a tight monetary policy, the State Bank would contain core inflation through the remaining months of FY07. It is necessary if its impact is supplemented by measures to address food inflation and high energy costs.

Trends in Price Inflation
12 month moving average



Revenues grow

In recent years, there has been an improvement in the government's fiscal account. Revenues have witnessed a strong growth, owing much to pickup in economic activity and growth of imports. 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. Pakistan is heavily dependent on indirect taxes, with sales tax and customs being the major contributors.

With CBR tax collection in the last few years crossing the respective target, it has enabled the government to follow an expansionary fiscal policy. However, some weaknesses persist. The fiscal deficit as a percentage of GDP has risen, so have the primary and revenue balances, measured as a percentage of GDP. The SBP states, " in this context, it is important that fiscal management be disciplined, especially when there remain structural weaknesses in the tax system, including a narrow tax base, over reliance on import related taxes, privatization proceeds, and potentially non-recurring sources of non-tax revenue."

In the first quarter of the current fiscal year FY07, there has been same deceleration in the total revenue collection, basically due to a dip in non-tax revenues. Tax revenues accelerated because of an increase in the direct tax collections by CBR. Sales tax and custom duty collection declined. Slowdown in import growth, may make achieving the CBR tax collection target a challenge.

Expend-itures rise

Meanwhile, expenditures have risen, and the rise in development expenditure is welcome. In the current expenditure category, while interest payments have risen in FY07, defence expenditure has been curtailed, creating additional fiscal space for development spending.

Expenditures have grown with an increase in the size of the public sector development expenditure. Also last year, PSDP surpassed the year's target, unlike previous years when shortfall to implement it used to occur. Large public sector spending is likely to boost demand, besides improving the physical and social infrastructure of the country.

Challenges to the Economy

The government had undertaken wide ranging structural reforms in almost all sectors of the economy to improve the country's macroeconomic environment. This has brought significant progress over the last six or seven years. The government is now faced with a new set of challenges. More reforms are needed to sustain the improvement that has taken place.

Sustain growth

While earlier the challenge was how to revive economic growth, the challenge today is to how to sustain the growth momentum of 6-8 percent per annum. The other issues facing the government include among others, poverty, income disparities, lacking social progress, water issues, law and order, achieving the Millennium Development Goals, energy, reducing the savings investment gap, illiteracy.

Saving investment gap

Historically Pakistan has had a large savings investment gap. In FY06 the gap was 3.6 percent of GDP against 1.6 percent a year earlier. At present the gap in being financed through higher foreign direct investment and remittances. But if the gap sustains it could affect macroeconomic stability. Thus, there is a need to improve domestic savings through institutional arrangements and conducive policies.

Greater efforts at poverty reduction

Over the last 2-3 years, the Government has consistently increased pro-poor public expenditure under its poverty reduction strategy spelled out in the Poverty Reduction Strategy Paper. Higher allocations are being made to sectors like, education, health, population planning, water supply and sanitation, food subsidies, food support programmes, rural development, low cost housing etc, sectors which have the greatest positive impact on poverty. In addition to pro-poor budgeting measures, the Government provides safety nets for the poor through transfers from the Zakat Fund, Employees Old Age Benefits Institution and Microcredit is being disbursed.

Poverty however, remains a serious concern in Pakistan. While GDP growth has been much more than other low income countries, but it has failed to achieve social progress commensurate with its economic growth, the rural poor continues to suffer from poor sanitation, access to water and schools and gender disparities . The National Commission for Government Reform created by the government, has been established with the objective to reform public administration to improve these basic services for the citizens.

Achieving the Millennium Development Goals by 2015 would require renewed efforts by the Government, especially for goals where the country is lagging. At the Pakistan Development Forum 2006, a paper '*MDGs and Human Development*,' showed Pakistan lagging in 13 of the 34 indicators monitored. Pakistan is however, committed to achieve MDGs. Accelerated growth within a balanced development framework would help achieve the goals.

Prospects

The government is expected to continue with the economic policies it has pursued in the last 6-7 years, infact these are promised to be strengthened. The government's reform agenda for the next five years, includes strengthening of institutions, better tax administration, improving the competitiveness of the industry, further reform of capital market, strengthening of physical and human infrastructure etc.

Over a short period of one year, the economy is expected to grow by 7 percent (in FY07) as the commodity producing sectors pick up and the services sector maintains its growth. This higher growth estimate is based on substantial increase in investment last year, stabilization in oil prices, measures undertaken in the Budget to boost agricultural output, and heavier rains are expected to increase output of water intensive rice and sugarcane crops.

Substantial public sector investment in irrigation in the last few years and an increase in imports of agricultural machinery in FY06 are seen as boosting agricultural output, as well as the duty free import of tractors, enhanced subsidies on fertilizers, and the new package of incentives for the livestock sector announced in FY07 budget. If weather conditions remain favourable, agriculture is projected to grow by 4.5 percent in FY07.

The industrial sector is expected to expand by 9 percent, with large scale manufacturing expected to grow by 11 percent, supported by new investments in textiles, cement and fertilizer industries and a number of incentives provided in the Budget 2006-07. The large public sector development programme during the year would give a boost to construction activities. Relative improvement in foreign direct investment (excluding privatization receipts) would boost the growth rate.

Inflation is expected to remain in the range of 6.7—7.5 percent during FY07. The increase in CPI that has been seen in recent months is because of higher food inflation. While the fuel component of CPI has eased in recent months, it was still higher in November 2006 over a year earlier. Any downward adjustment in domestic oil prices would be reflected in a decline of this sub-index and subsequently in the overall inflation rate. Only if inflation comes down, would it give some encouragement to savings and make exports competitive.

With the expected growth in the economy, and extension of tax net to real estate transaction and on some financial services, the tax revenues are expected to maintain a double digit growth (even though there may occur some decline in receipts from import related taxes as import growth falls. The need for further tax efforts to raise the tax GDP ratio over the next few years is clearly needed particularly by improving collections from the under taxed sectors of the economy.

Current expenditure may exceed the budget target because of:

- high defence expenditure due to ongoing operations against militants and possibly.

- greater domestic debt servicing. Pro-poor measures announced in the Budget are also likely to increase expenditures. As such the overall fiscal deficit could increase to 5 percent in 2007.

Import growth is likely to decelerate as oil prices stabilize and demand for consumer durables decline because of higher interest rates. Tight monetary policy is likely to dampen growth in domestic demand.

Exports are expected to grow as world trade is expected to expand, the lower antidumping duty on bed linen imports from Pakistan by EU will boost exports. Also the concessions given by the State Bank of Pakistan for the industrial as well as exporters to limit the cost of borrowing and R & D support to garments, home textiles and fabrics offered by the Ministry of Commerce and Ministry of Textile Industry would supplement the SBP efforts to lend support to exports. The ADB forecasts the current account deficit to increase to $8.5 billion or 5.9 percent of GDP.

The growing current account deficit, inflationary pressures and power shortages are potential risks to the economic forecasts for the economy.

The Year 2006

January

- The government announced an across-the-board 15.51 percent increase in gas prices for all consumer categories throughout the country, wef January 1, 2006.

- The federal government has decided to relax rules for existing Independent Power Producers (IPPs), encouraging them to add new power plants to meet power shortages in the country.

- In the light of the government's decision to raise gas prices by 15.5% effective January 1, the CNG Station Owners Association and CNG Dealers Association increased the CNG prices by Rs2.0 - Rs2.40 per kg.

- Over 90 knitwear and sweater units closed down owing to a host of unfavourable factors, primarily high cost of production due to hike in utilities' prices during 2005.

- The NFC Award has been amended. The provinces, which currently were receiving 42.7 percent of resources under the existing NFC award, would now be offered 45.33 percent of the total resources. The amended 6th NFC award would remain in force for five years unless provinces come up with a consensus to formulate the 7th award.

- The entire database of top five banks has been brought under direct access of the State Bank despite resistance from these commercial banks.

February

- Turkmenistan-Afghanistan-Pakistan signed a memorandum of understanding for a gas pipeline project; Turkmenistan will supply 3.2 billion cubic feet gas per day to Pakistan for a period of 30 years.

- Ferozsons Laboratories, a leading Pakistani pharmaceutical company and Bongo Group, Argentina's largest pharmaceutical group joined hands to set up Pakistan's first biotech pharmaceutical company, involving an investment of Rs600 million.

- Habib Bank to acquire upto 20 percent shares in Urmaqi City commercial bank's operations in China, having a capital of $100 million, an asset base of $2.1 billion and 1000 employees.

- In compliance with the State Bank of Pakistan's instructions, all banks introduced a Basic Bank Account facility to facilitate the low income people of the country. The Basic Balance Account allows a minimum initial deposit of Rs1000 with no limit on minimum balance and no fee for maintaining it.

March

- The Asian Development Bank agrees to provide $130 million loan from its Ordinary Capital Resources for Balochistan Devolved Social Services programme to help achieve the Millennium Development Goals. The loan is for 15 years, including a grace period of three years. The Program is to be implemented during 2006-09.

- Pakistan and China identified projects worth $12 billion, including the Islamabad international airport, oil refinery at Gwadar, Bunji hydropower project and Neelam-Jhelum hydropower project for Chinese investment.

- Habib Bank retrenches 2300 employees of non core services and outsourced non core services activity to reduce its high administrative cost and create financial cushion for hiring specialized personnel to improve its customer service.

April

- About 50 percent of local pharmaceutical industry, having a $1.6 billion market, is feared to close down in 2007, following the inflow of cheaper Chinese and Indian drugs in the market. Neighbouring countries where cost of production is much less than Pakistan, have been able to make their finished drugs cheaper than local products.

- France has pledged $94 million soft loan for the reconstruction of earthquake-hit areas of Pakistan.

- USAID is to provide more than $1.5 billion in development assistance to Pakistan over the next five years, to improve education, health, governance and economic development.

- The World Bank is to provide 'First NWFP Development Policy Credit' of $90 million towards poverty reduction, improving human development and accelerating broad-based economic growth through support of the provincial government's medium-term reform programme.

- Privatisation receipts expected to quadruple to $1.971 billion in FY06 as against $363 million in FY05. In FY'05 the government received only two payments--$102.96 million from Agha Khan Fund for Economic Development for Habib Bank Limited and $260 million from Etisalat as down payment for Pakistan Telecommunication Limited.

- Pakistan announced the realisation of debt cancellation/swap of over $650 million from donor countries, including around $392 million from Canada against the expenditures on education.

- The government issued licenses to six new bike manufacturers for setting up assembly and manufacturing of motorcycle plants in the country. With the issuance of these new licences, the number of motorcycle manufacturers and assemblers in the country has increased to 46.

- Pakistan and Canada signed a Memorandum of Understanding regarding Pakistan-Canada Debt Swap amounting to C$449 million. This is the highest ever debt conversion ever undertaken by the Canadian government.

- The Asian Development Bank will offer US$4 billion in 2006-08, to Pakistan, an all time high development assistance.

May

- The unofficial trade between Pakistan and India has increased by 37 percent to $965 million in 2005-06, following softening of trade barriers. The Associated Chamber of Commerce and Industry of India places the official bilateral trade at around $700 million during the year.

- The mid-term development plan of the Alternative Energy Development Board includes, development of wind and solar energy to meet at least 5% of the total installed capacity of 9,700 MW by 2030. AEDB will facilitate installation of 700 MW of wind energy near Gharo, Sindh by 2010.

- Pakistan and Iran decide to establish a Joint Investment Company with a capital of $25 million to promote trade and economic relations between the two countries.

- Pakistan and the United Arab Emirates have signed three Memorandums of Under-standing for co-operation in development of mega infrastructure projects. Permission has been given to the Dubai Islamic Bank to operate 50 branches in Pakistan.

June

- The Balochistan Coastal Development Authority has been assigned the task of preparing a master plan for developing the 1,100-kilometre long coastal belt in the province. Private parties would be urged to establish recreational points at various suitable sites along the coastal area.

- A Rs1.315 trillion budget for fiscal 2006-07 was announced with Public Sector Development Programme of Rs435 billion and current expenditure envisaged at Rs880 billion.

- The government plans an investment of $150 billion under the Vision 2030 to ensure additional power generation of 14,3310 Megawatt by the end of 2030.

July

- In a major landmark decision, the federal government gives complete financial autonomy to provincial and district governments from July 1, 2006.
- Pakistan announced tariff concession on imports of 4,872 items from India and Sri-Lanka in the category of Non-Least Developed Countries; and Bangladesh, Bhutan, Nepal and Maldives from the category of Least Developed Countries under SAFTA agreement.
- Manpower export from Pakistan declines to a significantly low of 91,700 in 2005 compared to 225,000 in 2003.
- UK based International Islamic Relief Fund launched its Rs1.5 billion Integrated Development Programme for AJK and Balochistan to improve the health and hygiene conditions and provide clean drinking water in the earthquake devastated areas of AJK and inaccessible areas of Balochistan.
- Trade Policy 2006-07 envisages an export target of $18.6 billion and imports of $28 billion, with a trade deficit of $9.6 billion.

August

- The government approves an alternative energy plan with main focus on import of LNG and setting up of its countrywide network to provide a cheaper source of fuel to industrial and domestic sectors. It also approved a proposal of the Petroleum Ministry to cap private sector's 350 million dollar investment for setting up of an LNG terminal at Port Qasim, Karachi.
- Toyota Indus Motor Company plans to double its production capacity from 50,000 units to 100,000 per annum by the year 2010, a plan in line with industry's target to raise its output from the current 215 thousand units to 0.5 million by 2012.
- The World Bank rates Pakistan as the 10th most attractive state for investment in the world. Britain is second largest investing country in Pakistan.
- The government offers an eight-year tariff policy to the automobile industry and also approves the establishment of a fund worth Rs6 billion for competitiveness, technology acquisition, research and development and setting up of two auto clusters in its plan to develop the sector on sustainable footings.
- World Bank's commitment to South Asian region reached $3.8 billion during 2006 ended in June. Pakistan was among the 10 major borrowers of the Bank, receiving $1.498 billion of total $23.6 billion commitments world-wide during the year.
- The federal government has shelved the privatisation plan of Karachi Shipyard and Engineering Works and instead approved a financial restructuring package.

September

- Standard Chartered Bank acquired Union Bank by purchasing 95.37 percent shares for $487 million. After the merger, the Bank has been named as Standard Chartered Bank (Pakistan) Limited. It is now the largest bank in terms of paid up capital.
- The BOC Group plc, UK, which holds the major equity in BOC Pakistan Limited, has been acquired by Linde AG, Woesh Bades. BOC Pakistan was originally a 100% subsidiary of British Oxygen Company established in 1986.
- National Bank of Pakistan has launched President’s Rozgar Scheme for the unemployed Products developed under the scheme includes setting up of community utility stores, community transport scheme and community communication centres. The

scheme will cost Rs12 billion to the national exchequer.

October

- Following the merger of Habib Bank AG Zurich with Metropolitan Bank, the name has been changed to Habib Metropolitan Bank.

- Oman Oil Company has acquired 49% stakes in Pakistan Orient Power Company Limited, the first IPP being set up under the private power policy 2002.

- The Industrial Development Bank of Pakistan accumulates a loss of Rs25.96 billion.

- MCB Bank successfully raised $150 million through the issue of 8.6 mn. Global Depository Receipts (GDRs). The GDR represented first such issue for a Pakistani company.

- The Government of Pakistan and Noor Financial Investment Company of Kuwait signed a memorandum of understanding for setting up of a $1.5 billion refinery project at Port Qasim.

- Dubai Islamic Bank arranged sale of 'Sukuks', or Islamic bonds, worth $85.3 million for two companies in Pakistan, namely, Karachi Shipyard and Engineering Works and Sui Southern Gas Company.

November

- UK's Department for International Development plans to double its assistance programme to Pakistan from Rs27.6 billion (£236 million) for the current period 2005-08 to Rs56 billion (£480 million) for the period 2008-2011. Reducing poverty is a major focus.

- The textile industry is reportedly downsizing its workforce to save costs following 10.5% decline in textile exports in the first quarter of the current fiscal year. Textile exports have fallen from $2.75 billion in the first quarter of FY06 to $2.46 billion in the comparable quarter of FY07.

- The Ministry of Finance has agreed to pay about Rs8 billion that various government departments owe to Pakistan State Oil, to pave way for the privatization of PSO by June 2007.

- The Ministry of Finance issues standing instructions to the State Bank of Pakistan to automatically retire government debt to the extent of 90% of privatization proceeds without seeking further guidance from the Ministry on individual basis.

- Under an agreement between Pakistan and Saudi Arabia, the Pak Gulf Construction Company has undertaken to build Centaurus, a project comprising state-of-the art multipurpose 7-star hotel, 316 residential apartments, a commercial complex and a large shopping mall in Islamabad at a cost of $400 million.

- The Reserve Bank of India and the State Bank of Pakistan have principally decided to issue licenses to the banks for opening branches and offices in each others countries on reciprocal basis. Three Pakistani banks, National Bank of Pakistan, Habib Bank Limited and United bank Limited have shown interest in opening their branches and offices in India. Three Indian banks, the State Bank of India, Punjab National Bank and Bank of India have sought approval to operate in Pakistan.

- Zarai Taraqiati Bank has reportedly written off Rs4.46 billion of irrecoverable loans of 11964 defaulters. Of the total, Rs4.02 billion were written off to 101 industrialists, while 11863 small farmers were written off Rs400 million only. The Bank has suffered financial losses to the tune of Rs5.164 billion between June 2004 to June 2006.

- The Cabinet Committee on Privatisation approved Oil and Gas Development Corporation's global depository receipts through 10% shares trading on London Stock Exchange. The committee also endorsed the plan for offering 5% of the company's shares for secondary public offering to retail investors in the domestic market.

December

- Standard & Poor's Rating Services assigned 'BB' long term local currency debt rating to two Pakistan Investment Bonds totaling Rs7 billion ($117 million) issued in October 2006 and due in October 2021 and October 2026. These newly rated bonds having maturities of 15 years and 20 years carry coupon rates of 10% and 10.5%.

- Unesco sees illiteracy on rise in Pakistan. The country is ranked second amongst the countries of the World with highest number of out-of-school children (6.5 million). The net enrolment ratio (NER) is less than 80% as compared to other developing countries having NER of over 85%.

- National Tariff Commission has imposed provisional anti-dumping duty ranging from 3.79% to 21.02% on 219 Chinese exporters of Ceramic tiles and unfinished tiles on the charges of dumping of tiles in Pakistan and causing injury to domestic industry.

- The Balochistan Government has fallen into a debt trap as its overdraft touched the highest ever Rs16 billion in November, while interest payments exceeded by Rs250 million per month.

- A deal has been finalized for the sale of Pakistan Industrial Credit and Investment Corporation (PICIC) alongwith its subsidiaries, the PICIC Commercial Bank, the Asset Management Company and 30% shares of PICIC Insurance Company, subject to the approval of the State Bank of Pakistan. The sale of PICIC, would bring about Rs20 billion in foreign exchange at a purchase price of Rs84/85 per share.

- Pakistan retired $830.2 million of external debt and liabilities during the first three months of the current fiscal year. Total external debt and liabilities stood at $37.72 billion at the end September.

- Agriculturists paid only Rs1.6 billion tax on their income during FY06. Agriculture sector contribute 23% to the GDP, but the tax recovery from the sector remains below 2%.

- The State Bank of Pakistan allowed the amalgamation of American Express commercial banking business in Pakistan and Jahangir Siddiqui Investment Bank's investment banking business into JS Bank Limited. JS Bank Limited, formed as a result of this amalgamation will operate as a scheduled bank.

- The Ministry of Commerce has revised the trade deficit projections for the current fiscal year from $9.4 billion to $12.2 billion in view of the rising trend in imports. The Ministry projected exports at $18.6 billion, and imports at $28 billion in FY'07. Imports were later revised upwards to $30.3 billion.

- The State Bank of Pakistan has no plans to devalue the rupee after reports appeared in the media that IMF had recommended 10% devaluation.

- The seven members of South Asian Association for Regional Cooperation (SAARC) have agreed to set up a SAARC Regional Food Bank to meet food emergencies in South Asia.

- The Central Board of Revenue decides to replace sales tax registration numbers with the wef Feb 1, 2007.

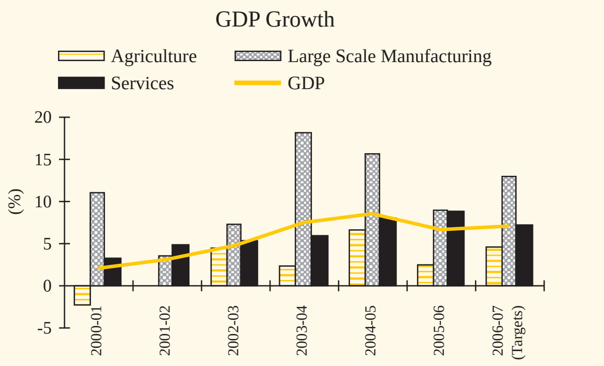
- Pakistan decides to challenge the EU's trade restriction measures adopted under the generalized system of preferences plus scheme and anti dumping duty on bed linen under the WTO.

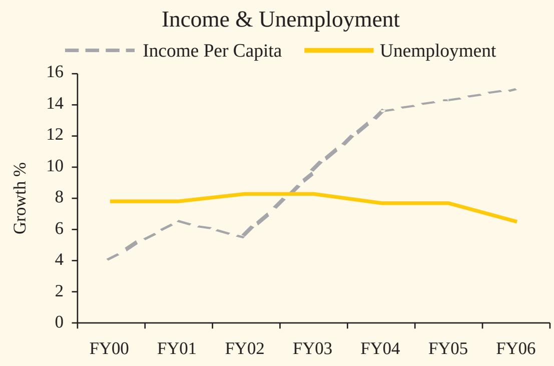
- Total foreign private investment in the first five months of FY07 rises to $2.1 billion from $1.02 billion in the comparable period last year.

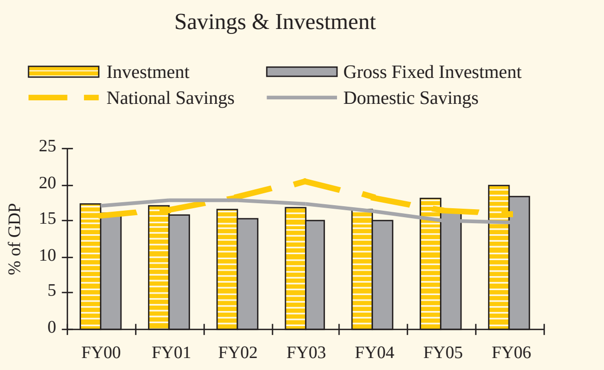
- Al Baraka a Bahrain Islamic Bank to offer 25 percent stake to the private sector.

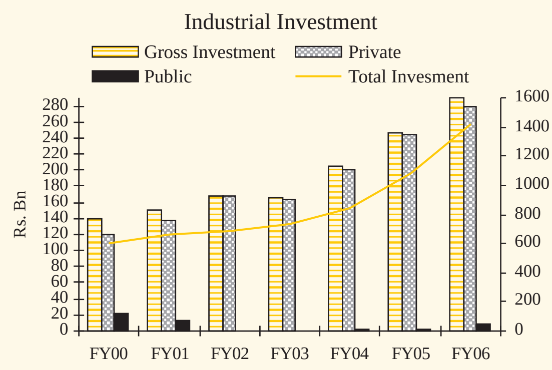
- Paktel, the country's fifth largest mobile phone operator decides to close its 16 year operation in Pakistan owing to tough market conditions.

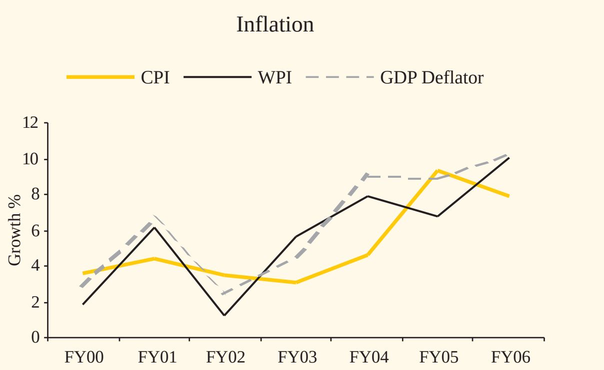
Economic Performance

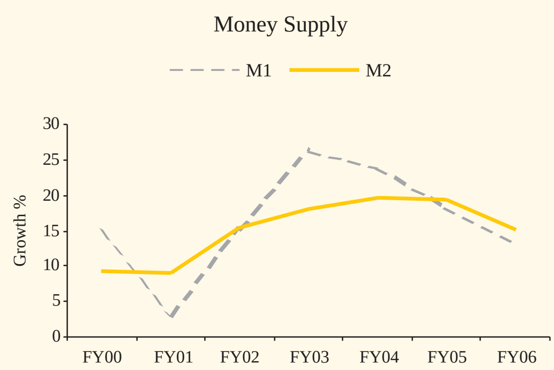


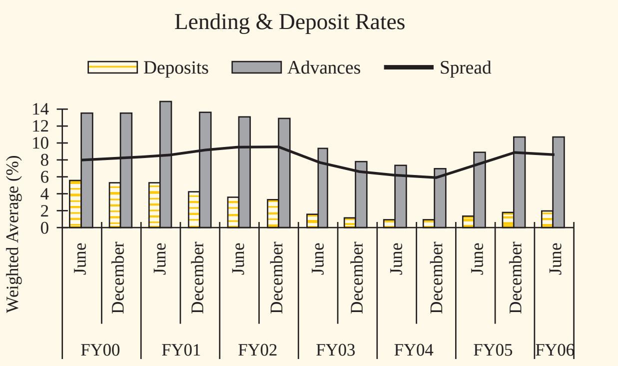


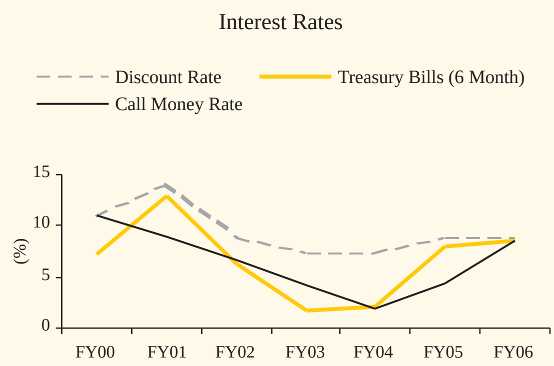




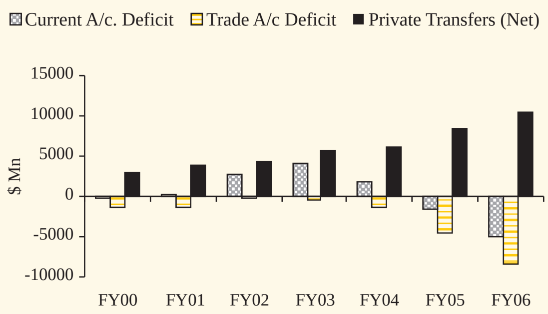




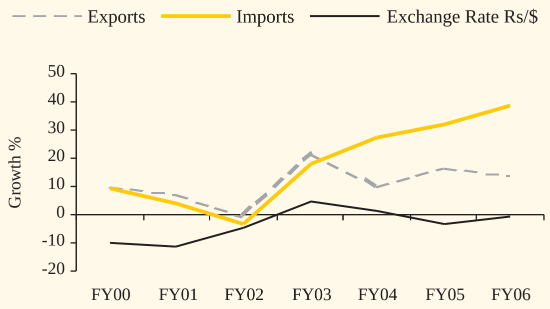




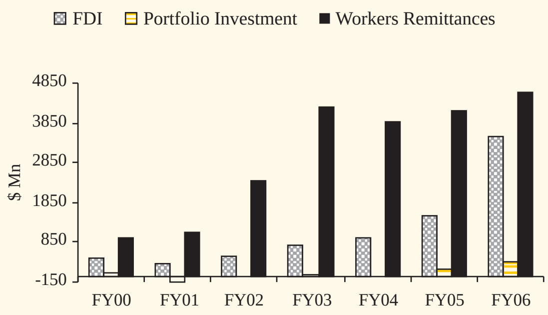
Balance of Payments



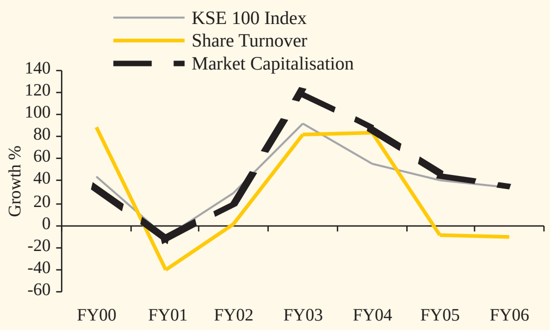
Export/Import Trend



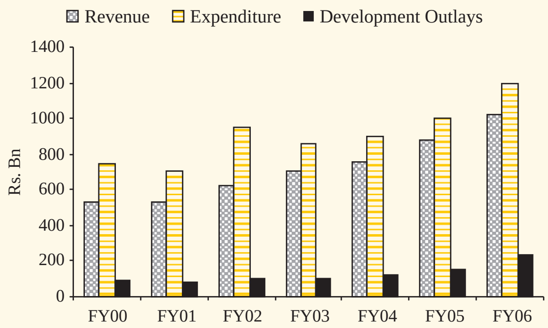
Foreign Investment & Remittances



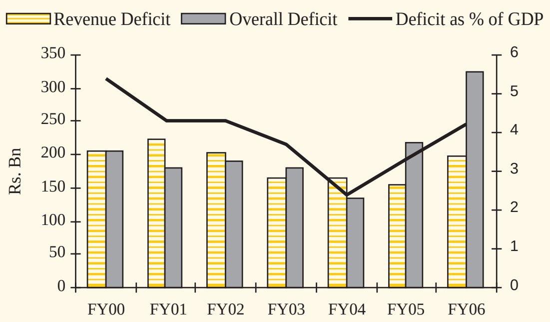
Capital Market



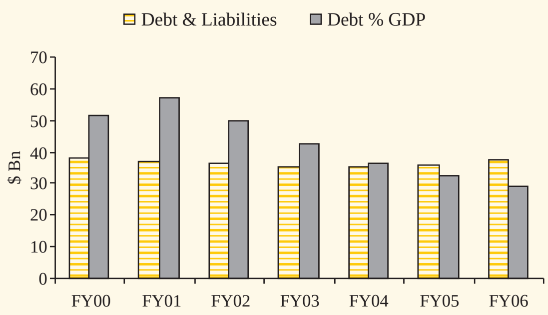
Federal Budget



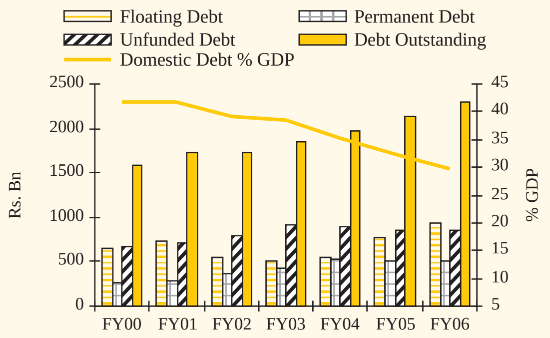
Budgetary Deficit



External Debt



Domestic Debt



Quarterly Performance of the Banking Sector 2006 - Selected Banks

Rs. Billion

	Major Banks					Provincial Banks		Domestic Private Banks													Foreign Banks					
	National Bank of Pakistan	Habib Bank	United Bank	MCB Bank*	Allied Bank	Bank of Punjab	Bank of Khyber	Askari Commercial Bank	Soneri Bank	Bank Al-Habib	Bank Al-Falah	Union Bank	mybank**	Metro-politan Bank	Faysal Bank	Prime Commercial Bank	KASB Bank	Picic Commercial Bank	Saudi Pak Commercial Bank	Meezan Bank	Standard Chartered Bank	CitiBank	ABN Amro Bank	American Express	Habib Bank AG. Zurich	Kong-Kong & Shanghai Banking Corp.
Assets																										
2005	577.7	528.9	347.0	298.8	192.6	111.2	25.1	145.1	63.3	91.5	248.3	117.1	17.2	79.7	110.3	53.8	19.1	65.1	47.7	30.7	111.7	76.5	59.6	8.2	44.9	13.3
2006																										
Q1 March	572.7	527.2	359.0	301.4	208.5	114.8	23.8	137.1	63.5	99.4	251.6	122.0	17.5	87.5	112.0	51.9	21.2	66.7	40.5	31.4	119.5	79.5	66.7	7.9	45.4	16.0
Q2 June	659.3	552.6	392.3	316.5	234.1	135.1	26.7	150.8	66.6	104.8	260.1	121.8	21.5	92.8	113.9	54.1	23.5	70.5	52.0	34.9	128.1	85.8	69.4	7.7	46.6	15.2
Q3 Sept.	625.6	534.9	388.2	317.6	232.2	139.2	26.5	152.5	67.0	107.9	261.5	113.6	22.2	94.3	116.8	54.5	23.5	65.4	49.5	38.8	136.9	89.1	69.0	6.7	45.2	15.5
Deposits																										
2005	463.4	432.5	289.2	229.3	161.9	88.5	17.5	118.8	47.6	75.8	222.3	91.2	12.9	56.7	74.7	38.9	14.8	53.5	37.1	22.8	83.6	53.1	47.0	5.7	33.4	8.6
2006																										
Q1 March	457.2	441.9	288.7	242.3	171.8	90.1	16.1	107.4	47.7	80.5	209.2	92.6	13.3	58.2	71.1	40.6	16.2	55.4	30.4	22.9	92.0	50.6	51.8	5.4	32.0	10.5
Q2 June	523.7	442.6	325.5	256.0	198.5	114.5	19.8	122.5	52.1	84.9	206.8	90.3	15.7	60.0	78.2	40.2	18.7	58.9	43.5	26.2	98.0	55.4	51.5	5.4	33.6	10.6
Q3 Sept.	483.2	427.2	308.1	251.1	198.0	114.9	19.4	122.7	50.9	88.0	214.8	73.4	16.2	60.4	78.2	42.7	19.1	53.1	40.7	29.4	100.1	61.9	53.1	5.6	33.2	10.8
Advances																										
2005	268.8	316.9	204.8	180.3	111.2	63.6	10.6	86.0	32.0	55.3	118.9	69.0	9.3	43.5	62.3	25.5	10.7	33.2	19.5	19.7	50.2	39.2	32.9	0.7	27.7	5.7
2006																										
Q1 March	271.0	312.1	208.3	174.9	116.6	71.4	10.9	85.6	33.2	59.9	124.3	71.6	10.0	47.0	65.2	27.5	11.2	34.2	17.9	21.5	51.6	41.4	36.7	0.6	29.7	6.9
Q2 June	294.7	315.1	236.1	185.4	133.9	83.7	10.5	89.9	33.0	60.9	128.4	72.6	10.5	47.6	64.2	30.7	12.2	33.6	18.9	22.7	54.0	44.1	38.0	0.5	30.3	6.5
Q3 Sept.	300.6	319.8	235.3	183.6	135.0	88.0	10.1	89.8	32.8	60.7	133.8	68.8	11.5	47.0	66.1	31.3	11.9	32.8	22.6	22.5	59.6	47.9	39.5	0.4	29.2	7.6
Investment																										
2005	157.0	107.4	63.0	69.5	44.9	18.0	7.6	25.7	16.4	19.8	57.4	19.2	3.3	22.8	24.4	13.4	3.8	13.7	12.5	1.6	25.4	19.8	13.0	1.9	6.1	0.6
2006																										
Q1 March	155.9	105.5	68.8	73.9	40.2	23.5	7.7	25.8	16.3	24.7	80.4	27.5	3.3	25.9	32.4	14.2	4.4	15.6	12.3	2.9	32.5	20.2	16.8	1.9	6.1	0.6
Q2 June	166.3	105.4	67.0	64.0	46.3	24.8	7.5	28.2	15.8	26.3	81.6	25.8	3.0	27.2	30.1	12.3	3.5	13.9	18.9	2.7	22.4	16.6	13.1	0.9	5.6	0.8
Q3 Sept.	168.7	94.1	56.9	65.3	49.3	27.4	7.8	28.5	15.8	25.7	68.2	23.7	3.8	28.7	31.1	14.1	4.9	13.2	15.1	3.0	22.5	18.1	15.4	1.8	5.1	0.5
Equity																										
2005	36.2	32.7	18.8	18.3	11.4	6.8	2.1	7.4	3.6	4.7	6.7	5.1	2.5	5.0	8.1	3.5	1.7	4.2	3.2	3.0	8.8	5.8	4.1	1.4	2.8	2.2
2006																										
Q1 March	39.8	34.1	19.8	19.9	12.5	7.4	2.8	7.8	3.9	4.8	7.1	5.0	2.5	5.4	7.8	3.1	2.1	3.9	3.3	3.2	10.0	6.2	4.5	1.4	2.9	2.2
Q2 June	43.8	37.0	22.3	22.6	14.1	9.2	2.9	8.5	4.2	5.4	7.6	5.5	2.6	5.9	9.3	3.7	2.1	4.2	3.3	3.3	7.2	5.4	5.0	1.4	3.1	2.3
Q3 Sept.	49.8	41.4	24.5	24.5	15.2	9.8	3.0	9.1	4.4	5.7	10.1	5.2	2.8	6.3	8.6	3.6	2.1	4.4	3.2	3.4	8.5	6.0	5.4	0.7	3.3	2.4
Interest Income																										
2005	33.6	32.3	20.2	17.8	9.8	6.1	1.5	8.8	3.7	4.9	12.2	8.1	1.0	4.4	6.3	1.6	1.1	4.2	2.6	1.5	7.0	5.6	4.4	0.3	1.5	0.7
2006																										
Q1 March	9.8	10.1	7.1	5.8	3.7	2.3	0.4	2.8	1.3	1.7	4.9	2.8	0.4	1.5	2.3	1.0	0.4	1.4	0.8	0.6	2.4	1.9	1.4	0.1	0.9	0.2
Q2 June	10.8	10.3	8.0	6.2	4.4	2.8	0.5	3.0	1.3	2.0	5.2	3.2	0.4	1.6	2.5	1.1	0.4	1.5	0.9	0.6	2.5	2.2	1.6	0.1	0.9	0.3
Q3 Sept.	11.0	11.8	8.7	6.6	4.5	3.1	0.5	3.3	1.4	2.0	5.5	3.1	0.4	1.7	2.3	1.1	0.4	1.4	1.0	0.7	2.8	2.4	1.8	0.1	0.9	0.3
Interest Expense																										
2005	10.3	7.3	6.0	2.8	2.0	2.7	0.9	4.2	2.0	2.1	7.2	3.7	0.3	2.2	3.3	0.7	0.7	2.1	1.8	0.7	1.7	2.0	1.6	0.2	0.7	0.4
2006																										
Q1 March	3.1	3.3	2.6	0.9	1.3	1.4	0.3	1.6	0.9	0.8	3.6	1.6	0.2	0.9	1.4	0.6	0.3	0.8	0.6	0.3	0.5	0.9	0.5	0.06	0.6	0.1
Q2 June	3.2	3.0	2.8	1.0	1.6	1.7	0.3	1.6	0.9	1.0	3.7	1.8	0.2	0.9	1.5	0.7	0.3	0.9	0.7	0.3	0.6	1.0	0.6	0.06	0.6	0.1
Q3 Sept.	3.6	3.3	3.1	1.2	1.8	2.0	0.3	1.8	0.9	1.0	3.7	1.7	0.2	1.1	1.6	0.7	0.3	0.9	0.9	0.4	0.7	1.1	0.7	0.05	0.6	0.1
Net Interest Income																										
2005	23.3	25.0	14.1	15.0	7.8	3.5	0.5	4.5	1.7	2.8	5.0	4.5	0.7	2.1	3.0	1.0	0.4	2.1	0.8	0.8	5.3	3.6	2.8	0.1	0.8	0.3
2006																										
Q1 March	6.8	6.8	4.5	5.0	2.4	0.9	0.1	1.2	0.4	0.9	1.2	1.2	0.2	0.5	0.8	0.5	0.1	0.5	0.2	0.3	1.9	1.0	1.0	0.05	0.3	0.09
Q2 June	7.6	7.3	5.2	5.1	2.8	1.1	0.2	1.4	0.4	1.0	1.5	1.3	0.2	0.7	1.0	0.4	0.1	0.6	0.2	0.3	1.8	1.2	1.0	0.04	0.3	0.1
Q3 Sept.	7.3	8.5	5.6	5.4	2.7	1.1	0.2	1.5	0.5	0.9	1.7	1.4	0.2	0.6	0.8	0.4	0.08	0.6	0.06	0.3	2.1	1.3	1.1	0.05	0.3	0.1
Non Interest Income																										
2005	9.4	7.9	5.0	5.4	1.9	1.3	0.4	1.6	0.6	1.0	2.2	2.6	0.2	0.9	2.1	0.6	0.2	1.0	0.6	0.6	2.4	2.6	1.5	0.3	0.3	0.2
2006																										
Q1 March	2.0	1.5	1.7	1.3	0.6	0.4	0.07	0.5	0.2	0.3	0.8	0.7	0.1	0.3	0.3	0.2	0.06	0.3	0.1	0.2	0.7	0.6	0.4	0.02	0.1	0.04
Q2 June	2.9	1.6	1.6	1.1	0.6	1.6	0.06	0.5	0.2	0.3	0.7	0.8	0.1	0.3	1.5	0.2	0.1	0.2	0.2	0.07	0.7	0.7	0.4	0.01	0.1	0.05
Q3 Sept.	4.1	2.0	1.5	1.3	0.6	0.3	0.1	0.6	0.2	0.3	0.8	0.7	0.2	0.4	0.3	0.2	0.2	0.2	0.2	0.2	0.7	0.8	0.3	0.06	0.1	0.05
Admn.Expenses																										
2005	11.2	14.1	7.9	6.5	4.3	1.3	0.4	2.6	0.8	1.7	4.3	3.2	0.5	1.0	1.4	0.9	0.6	1.1	0.7	0.7	2.3	3.0	1.7	0.5	0.5	0.3
2006																										
Q1 March	3.0	3.5	2.2	1.8	1.2	0.4	0.1	0.8	0.2	0.5	1.3	0.9	0.1	0.3	0.3	0.4	0.2	0.3	0.2	0.2	0.8	0.8	0.5	0.07	0.2	0.09
Q2 June	3.2	3.6	2.7	1.8	1.3	0.4	0.1	0.8	0.3	0.6	1.4	1.1	0.1	0.3	0.5	0.4	0.2	0.3	0.3	0.2	0.8	1.1	0.5	0.06	0.2	0.1
Q3 Sept.	3.2	4.0	2.7	2.1	1.3	0.4	0.09	0.9	0.3	0.6	1.6	1.5	0.1	0.3	0.5	0.4	0.2	0.4	0.3	0.3	0.7	1.0	0.6	0.8	0.2	0.1
Profit/(Loss)B.T																										
2005	19.1	13.8	9.5	13.0	4.8	3.2	0.3	2.9	1.4	2.0	2.6	2.8	0.2	2.0	4.0	0.5	-0.5	1.9	0.1	0.6	5.4	2.6	2.1	-0.02	0.5	0.2
2006																										
Q1 March	5.6	2.1	3.5	4.2	1.6	0.8	0.09	0.6	0.4	0.6	0.5	0.8	0.2	0.5	0.7	0.2	0.08	0.5	0.08	0.3	1.7	0.7	0.7	0.006	0.2	0.06
Q2 June	6.6	3.9	3.6	4.5	1.8	2.2	0.1	0.9	0.4	0.8	0.6	0.7	0.1	0.7	1.9	0.1	0.06	0.4	0.05	0.2	1.7	0.6	0.7	-0.09	0.3	0.06
Q3 Sept.	8.0	6.5	3.4	4.3	1.7	0.8	0.05	1.0	0.3	0.6	0.8	-0.3	0.2	0.7	0.5	0.01	0.07	0.4	-0.09	0.2	1.8	0.8	0.7	-0.7	0.2	0.07
Profit/(Loss)A.T																										
2005	12.7	9.6	5.9	8.9	3.0	2.4	0.3	2.0	0.9	1.4	1.7	1.7	0.3	1.5	3.0	0.3	0.3	1.5	0.06	0.4	4.0	1.5	1.3	0.06	0.4	0.2
2006																										
Q1 March	3.6	1.3	2.3	3.0	1.1	0.6	0.09	0.4	0.2	0.4	0.4	0.5	0.1	0.4	0.5	0.1	0.06	0.4	0.008	0.2	1.3	0.3	0.4	0.006	0.2	0.02
Q2 June	4.4	1.2	2.4	2.7	1.2	1.8	0.05	0.7	0.3	0.5	0.4	0.5	0.08	0.5	1.5	0.1	-0.02	0.3	0.02	0.1	1.2	0.6	0.5	-0.09	0.2	0.07
Q3 Sept.	6.0	4.2	2.2	2.9	1.1	0.6	0.06	0.6	0.2	0.4	0.5	-0.3	0.2	0.5	0.3	0.004	0.07	0.3	-0.01	0.1	1.3	0.5	0.4	-0.7	0.2	0.04

* *Formerly Muslim Commercial Bank*   ** *Formerly Bolan Bank*   *Note: Total may not tally due to rounding of*

Market Analysis

Time to adopt a more defensive-bias

The last four years have seen corporate earnings growth surge by a CAGR of 44% (2001-2005), in line with overall economic recovery, while the KSE-100 has jumped by a CAGR of 66% during the same period. As most of the economic growth has been driven by consumer spending, this has been reflected in both the topline and bottomline of the corporate sector during this period. However, corporate earnings are now beginning to appear increasingly vulnerable, as profit margins have little room to expand (but more to shrink) while volumetric growth opportunities appear limited in the near term due to cooling of demand and expansions in capacity/increasing competition.

An analysis of the major sectors indicates that corporate earnings and therefore equity returns will be increasingly vulnerable in 2007. Cooling of global economic growth and increasing domestic competition is driving prices down in sectors such as E&P, OMCs, Telecoms, and Cement, threatening revenue growth going forward. Moreover, demand is decelerating in sectors such as Banks, capacity/supply constraints are limiting growth in the Fertilizer and Gas Marketing sectors while the OMC sector continues to suffer on account of shrinking volumes.

Persistent inflation and a growing external deficit have increased the likelihood of a weaker Pak Rupee going forward, which will directly impact the margins of sector such as Auto Assemblers while making the market less attractive for foreign portfolio investors. On the brighter side, major sectors including E&P, OMCs, IPPs and Telcoms (to a lesser extent) provide a fairly strong currency hedge. Another key risk to corporate profitability going forward is the upward pressure on interest rates. While most major sectors are relatively unleveraged, the Cement, Fertilizer and Gas Marketing sectors are significantly exposed due to their higher leverage ratios. On the flip side, the Auto Assembling and the E&P sector actually benefits from higher interest rates due to very high cash balances.

Invest-ment strategy

We recommend investors to adopt a defensive bias while seeking value in growth sectors during 2007. In this regard, we recommend overweight exposures to defensive sectors while waiting for value opportunities in growth sectors.

- Defensive: Our top defensive sectors are IPPs and Fertilizers.
- Growth: Our favorite growth sectors include E&Ps, Banks and Auto Assemblers.

Perhaps as importantly, we believe that size will matter increasingly and recommend companies that have the economic scale to succeed going forward, are industry leaders and enjoy strong local franchises. Our top picks for the year are HUBCO, FFBL, PPL, NBP, MCB, Lucky Cement and Pak Suzuki although we recommend waiting for value opportunities, especially in banking stocks which appear expensive at current levels.

Market Review 2006: A lackluster year

A stellar beginning

Following a 3-year (2002-2005) stint as one of the best performing markets in the world, 2006 ended with the benchmark KSE-100 posting a lackluster return after touching an all time high of 12,273 in April 2006. The market continued to depict high volatility during 2006 but unlike the previous four years, the KSE-100 posted a lackluster return of 5.1 (up 484 points to 10,040 on an average daily volume of 257m shares). The market rally that began near the end of 2005 continued for the next three-and-a-half months into 2006. During this period from January 1 to April 17, 2006, the KSE-100 surged 28 or 2,717 points to a record high of 12,273 on an average daily turnover of about 450m shares. The rise in the index during this period can be attributed to the following factors:

- Bellwether sectors such as banking and oil and gas exploration and production posted strong annual/quarterly earnings growth.
- Rising international crude oil prices and news of discoveries led to surging stock prices of E&P scrips such as OGDC, PPL and POL.

- Settlement of PTCL privatization transaction led to speculative activity in other state-owned units such as PSO and the two gas utilities (SNGPL and SSGC).

- A sharp increase in foreign portfolio investment.

The crash of April 2006

After the KSE-100 reached its all-time closing peak in mid-April, the market took a sudden correction in the run-up to the FY07 Federal Budget which led to a shattering of investor confidence. From April 17 to June 14, the index plummeted 3,500 points or 29% to reach the 2006 low of 8,768 on average daily turnover of 222m shares. The major reasons for the bear market during this period were:

- 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 FY07 because of the doubling of CVT and withholding tax on shares to 0.02% and 0.01%, respectively.

- Global monetary tightening and interest rate increases by the Federal Reserve in the U.S. and the Bank of England.

Lack-luster closing

The market during the second-half of CY2006 was mixed and lackluster. The KSE-100 staged a strong recovery from mid-June to mid-October and the index jumped by about 2,800 points or 32% to 11,566 by October 19, 2006. The main factors behind this recovery were excellent FY06 and 3Q06 results reported by major sectors such as banking, oil & gas E&P, and, oil marketing; resumption of Indo-Pak peace talks; M&A rumours and developments in the banking sector; placement of MCB Bank's GDR and sizeable inflow of foreign portfolio investment.

However, this recovery could not be sustained for the rest of the year as the market experienced correction alongwith thin trading because of apprehensions regarding the new risk management regime; negative reaction to the forensic report on the March 2005 market crash; and, placement of OGDC's GDRs at a 10% discount to the local market price.

Market outlook 2007: Bumpy ride ahead

Key factors that in our opinion are likely to guide the market's mood in 2007, include the direction of international oil prices; persistence of inflationary pressures, which are driving expectations of continued monetary tightening; growing fiscal and external imbalances; slowdown in corporate earnings growth; and, the much needed yet widely disliked equity market reforms. On the political front, we feel that the upcoming elections are likely to cause a degree of increased uncertainty in the market.

However, we also feel that the reforms initiative of the current government is likely to continue irrespective of the constitution of any new government following the elections. On the brighter side of things, we feel the widening of the investor base through expansion in the mutual fund sector and the increased foreign portfolio interest in Pakistan is a major positive for the market.

Declining international oil prices: Good for the economy, not so for the market

Although Pakistan is an oil importing country (high oil prices have been a major factor behind the widening of the current account deficit), E&P companies represent nearly 30% of total market capitalization while the sector contributes only 2.5% to the country's GDP. With local pricing of E&P, refining and oil and gas marketing companies linked to international product prices, local equity market stand to gain from rising oil prices. In fact, steadily rising oil prices were the main driver of strong equity market performance during 2005.

Subsequently, the reversal in the direction of international oil prices, which peaked at about US$ 78/pbl in July 2006 only to tumble to the range of around US$ 60/pbl by September, has been one of the reasons for the poor performance of oil stocks during 2006.

With promising exploration and production activity expected in the coming years, local equity markets offer an attractive energy play. OGDC, the largest E&P company in the country is expected to spend around US$ 1.9 bn on exploration and development programs and is targeting to increase oil and gas production by

13% per annum for the next three years. Since January 2003, the KSE-100 has been moving largely in tandem with international crude oil prices. From January 2003 to present, the KSE-100 has jumped by about 290% while Arab Light crude oil prices have doubled during this period. Nonetheless, earnings are highly vulnerable to any major fall in international oil prices and we have assumed that international crude oil prices will decline gradually at an annual rate of US$ 5/pbl to settle around US$ 45/pbl by FY11.

Economic concerns: Rising inflationary pressures and macroeconomic imbalances

While the long-term growth outlook of the economy remains positive, the immediate challenges facing the economy are likely to dominate market concerns in 2007. These include deceleration of growth in real sectors, persistent inflation, a burgeoning current account deficit, and a growing budget deficit.

Economic growth

The country has experienced a robust economic recovery from FY01 when the real GDP growth rate was only 1.8 percent. The growth rate has been averaging around 6 percent per annum during the last 5 years while the last 3 year average has been around 7.5 percent as compared to an average annual GDP growth rate of 4.6 percent during the 1990s. The government is forecasting real GDP growth for the current fiscal year (FY07) to be around 7 percent, which we believe will likely be achieved if the agriculture sector performs according to expectations.

Monetary policy & inflation

The State Bank pursued a highly accommodative monetary policy back in FY03 when it decided to reduce its sterilization activity in the forex market to bring down lending rates further. The resultant increase in market liquidity and the SBP policy stance helped bring interest rates down to all-time lows. This triggered an economic revival and ultimately contributed to the stunning net private sector credit growth from Rs.48.6bn in FY01 to Rs.337.4bn in FY06. However, a policy reversal took place in FY05 by the SBP to a tight money policy as the economy showed signs of overheating. The impact on the equity market was felt this year as the KSE-100 has shed 12% from its all-time high closing of 12,273 on April 17, 2006.

Double digit food inflation has so far kept headline inflation above the central bank's target. However, the trend in core inflation, which has gradually crept to around 6%, has been more positive. Going forward, we feel that headline inflation is likely to remain high especially if fuel prices are not reduced in line with the decline in international oil prices.

Balance of payment troubles

Rapid deterioration in the trade account has led to a sharp jump in Pakistan's current account deficit, thereby increasing concerns of future weakness in the exchange rate. While cooling aggregate demand has helped slow the pace of growth in imports, performance of exports has been even poorer. Accordingly, the SBP expects the current account deficit to deteriorate to 4.2% of GDP in FY07 (FY06: 3.9%).

We believe that under the circumstances, the current year's deficit will likely be financed fairly comfortably given the privatization and GDR pipeline, FDI and Portfolio investment trend and strong growth in remittances. However, a current account deficit over 3% of GDP will be difficult to sustain in the medium term.

Corporate earnings growth: A reversal of fortunes

Following several years of robust profitability, earnings growth in some major sector has decelerated sharply and in some cases, earnings have actually fallen. Foremost among these are the Cement and OMC sectors. Cements, which had been enjoying strong profitability on the back of robust demand and firm prices, have seen profitability evaporate as massive capacity expansions have led to a price war amongst major players.

OMCs have also been posting record earnings growth on the back of steadily rising international oil prices, which have resulted in windfall gains in the shape of inventory gains despite flat sales volumes. More recently, international oil prices have reversed in direction, causing major inventory losses for the large OMCs.

With little room for improvement in margins of major sectors (and lots on the downside), we feel that vulnerability of corporate earnings will remain a key theme in the market and will add to volatility in share prices during 2007.

Capital market reforms

The markets have embarked on a number of reforms since the late 1990s in order to manage and reduce systemic risk, improve the functioning of capital markets and enhance investor protection. The Asian Development Bank's Capital Market Development Program (approved by the ADB in 1997 for US$ 250m) was the first major intervention to reform the non-bank financial sector implemented over 1997-2001. The main achievement under the CMDP has been the establishment of an effective regulator in SECP in addition to improvements in the technological infrastructure of capital markets. The next generation of reforms consists of introducing margin financing, strengthening broker margin requirements and demutualization and corporatization of the exchanges.

The SECP has proposed several risk management measures to strengthen the existing framework deployed at the exchanges within the country. The new rules addresses VaR based margining system, netting of exposures, the mechanism for marking to market of exposures and valuation of securities eligible as collateral.

Margining system

A new margin system based on 'Value at Risk'(VaR) has been introduced at the bourses compared to the previous system which was based upon different slabs, discounts (Haircuts) lower of the 52-week average price and the current price. VaR is defined as the maximum amount of money that can be lost on a portfolio over a given period of time, with a given level of statistical confidence.

Netting for exposure purposes

It is proposed that the netting of exposures not be allowed unless (1) netting is in the same scrip on the same day and for the same client (within Ready Market), (2) netting is between buy and sell positions in the same scrip, for the same client and in the same contract period (within Futures Market - Deliverable Contracts) and (3) netting is between buy and sell positions in the same scrip for the same client during the same contract period and in the same market (within Futures Market - Cash Settled Single Stock Futures Contracts). The only exception is in the CFS Market and Ready Market, where a CFS broker finance may have an open ready market sale position and an open CFS purchase position in the same scrip with settlement of both open positions being on the same date.

Mark-to-Market (M2M) loss collection and profit distribution

For the purpose of M2M, profit/ loss is to be calculated at the end of each trading day at the 'Daily Settlement Price.' Netting will only be allowed in profit and losses of the same client or proprietary position in different scrips but not in contract of different periods.

Valuation of securities eligible to be held as security (collateral)

Contrary to the earlier practice which only considered turnover and EPS of the scrip against deposit, it is proposed that all securities should be categorized on measures of liquidity and volatility. Furthermore, software deployed by the NCEL will categorize stocks into 3 broad groups based upon percentage of days traded during the last 6 months and impact costs. Securities eligible for collateral will be categorized using VaR calculations with different hair-cut rates being applicable to different categories (i.e. the more risky a security, as measured by VaR, the higher the applicable hair-cut). While the aforementioned market reforms are expected to be positive for the market as they will help reduce systemic risks, the short-term impact will likely be negative in the shape of reduced trading volumes.

Widening investor base

The last 5 years has seen increased participation in the capital markets by both domestic retail investors and foreign institutions which have helped boost the liquidity situation in the markets. The rise in the number of mutual funds over the past 5 years in Pakistan has been dramatic. In FY01 (July-June), the number of funds were 17 and net assets under management was only Rs.25.1bn (US$ 418m) and by the end of FY05, the number of funds has doubled to 33 with Rs.124bn (US$ 2bn) of net assets under management (NAUM).

Likewise, foreign institutional investment in the equity market has surged over the last 5 years. From a foreign portfolio investment outflow of $140.4 mn in FY01, it has risen to an inflow of $351.5mn in FY06. The net inflow for 6mFY07 comes to US$ 278m. With the recent placement of MCB Bank and OGDC GDRs, the country's profile among international investors is expected to be enhanced going forward.

Books Review

Income Tax Law Plus Practical Problems with Solutions 2006-07
Prof Dr. Khawaja Amjad Saeed

Pakistan is in search of a fiscal policy which can ensure an accelerated tempo of domestic resource mobilization to not only meet the current expenditure at federal level but also contribute substantially towards financing annual development plans. The financing of the federal budget depends substantially on external assistance. This has had to large external debts, posing difficulties for the balance of payments.

The Federal Government generates its revenues through direct and indirect taxes and through the non-tax revenue sources. The book under review relates to income tax. Based on available statistics, there are around 1.4 million income tax payers in Pakistan of a population of 160 million. This calls for immediate attention, for evidence available suggests the untapped number of income tax payers to be around five million.

The book consists of two parts; the first deals with the income tax law in detail, and the second part with some of the problems covering assessment of individuals, companies etc. Easy to comprehend notes on the Finance Act, 2006 issued by the CBR have also been included in the book. Amendments to the Income Tax Ordinance 2001 have also been included.

Human Development Report 2006

This year's Human Development Report looks at an issue that has a profound influence on the human potential and progress towards the Millennium Development Goals.

Access to water is a basic human need, but more than one billion people are denied the right to clean water and 2.6 billion people lack access to adequate sanitation. Every year some 1.8 million children die as a result of diarrhoea and other diseases caused by un-clean water and poor sanitation. In many countries young girls go out to collect water for their families, which denies them the opportunity to education and gainful employment. Lack of water and sanitation results in ill-health and undermines productivity and economic growth.

This year's Report shows that though the problems vary by country, but several issues emerge. These have been discussed in detail. There is limited budget allocations for water and sanitation. Second, some of the world's poorest people are paying some of the world's highest prices for water, reflecting the limited coverage of water utilities in the slums and informal settlements where poor people live. Third, the international community has failed to prioritize water and sanitation in the partnerships for development, that could integrate around the Millennium Development Goals. Underlying each of these problems is the fact that it is the poor people and women who suffer the most and they often lack the political voice needed to assert their claims to water.

The Report has examined these challenges and has shown that many countries have made good progress in providing clean water and sanitation. Many of those living in the developing world have mobilized resources and initiated some innovative schemes to tackle their problem. The developing world today has the finance, technology and capacity to consign the water and sanitation crisis to history. What is needed is concerted efforts to extend access to water and sanitation to all through well designed and properly financed national plans.

The State of Pakistan's Children 2005 SPARC (Society for the Protection of the Rights of the Child)

SPARC, a non-profit organization is trying to improve the lot of children in Pakistan by highlighting their plight, writing and disseminating publications on various subjects relating to them and pressing relevant governmental quarters to do something for the children of this country.

The Report 2005 presents a range of issues which affect our children, with a chapter on the consequences of the October 2005 earthquake on children. The other chapters are on education, child labour, health and survival, violence against children, the plight of children in prison. A large number of Pakistan's children suffer from lack of even reasonably equitable access to healthcare and education. Millions work in hazardous occupations in the country and miss out on education and with it, the major means through which they could have been set free from the clutches of poverty.

They are subject to violence and all kinds of exploitation, trafficking. These traumatic experiences leave life long scars affecting the child's daily life.