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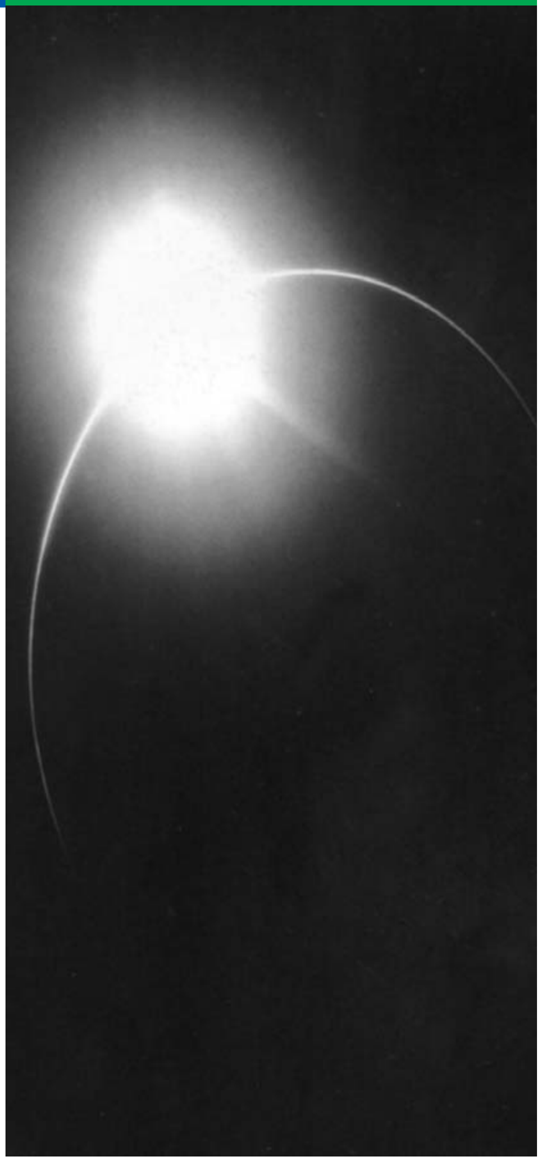
ECONOMY
PAKISTAN



Economic Growth: The Pakistan Route

An Overview of the Economy

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Introduction

Emerging economies entice investors with promises of high returns. However, the accompanying high risk exposures keep many at bay. Pakistan being an emerging economy has offered 7% CAGR of output in the last 5 years and future forecasts are positive with growth expected to continue at the same rate. In this publication we explore the factors responsible for the country's high growth, make judgments as to its sustainability, project future performance and identify risks.

The driving force behind the country's economic upturn is by and large the aggregate demand. Rising income levels and a developing middle class have spurred a consumption boom that is the engine of economic growth. Changing demographics to result in younger population lend further credence to the consumption boom. The younger population is not only more affluent but also better educated and productive.

Pro-investment policies of the government have been instrumental in attracting foreign investment. The consequent rise in business confidence is manifested in exorbitant levels of Gross Fixed Capital Formation (GFCF).

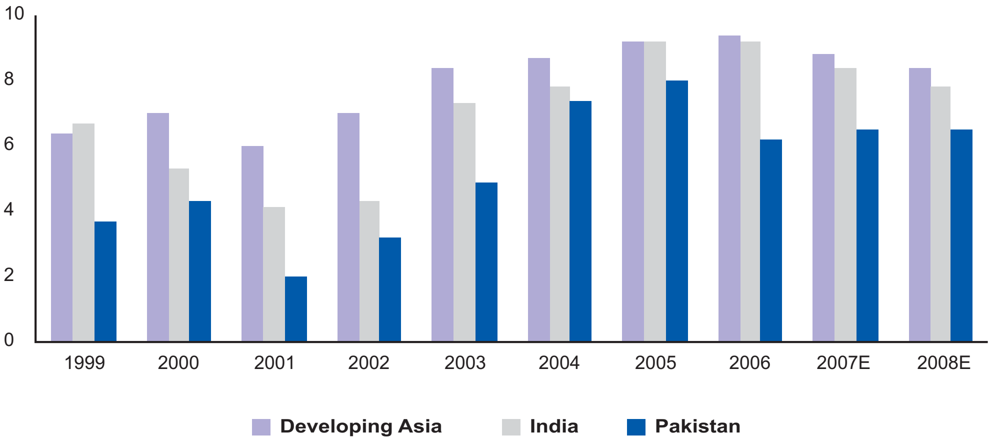
Future forecasts are positive. We break GDP growth into cyclical and trend components. Long term trend is expected to decline slightly while the expansionary phase in the business cycle is expected to continue till FY12. Continuation of economic expansion is backed by the structural changes (such as demographic transition, developing financial sector, easier availability of credit) in the economy rather than transitory factors (such as foreign aid or remittances)

The challenges faced by the economy include: High and persistent inflation that necessitate a tight monetary stance and decrease export competitiveness of the country. Twin deficit situation: a fiscal deficit of 4.2% and trade deficit of 9.0%. The trade deficit problem is compounded by inflationary concerns. Low domestic savings increase reliance on foreign sources for fueling growth and leave the country susceptible to changes in the external sector. Moreover, concentration of exports in specific commodities as well as countries also pose the same risk to the country.

GDP Profile

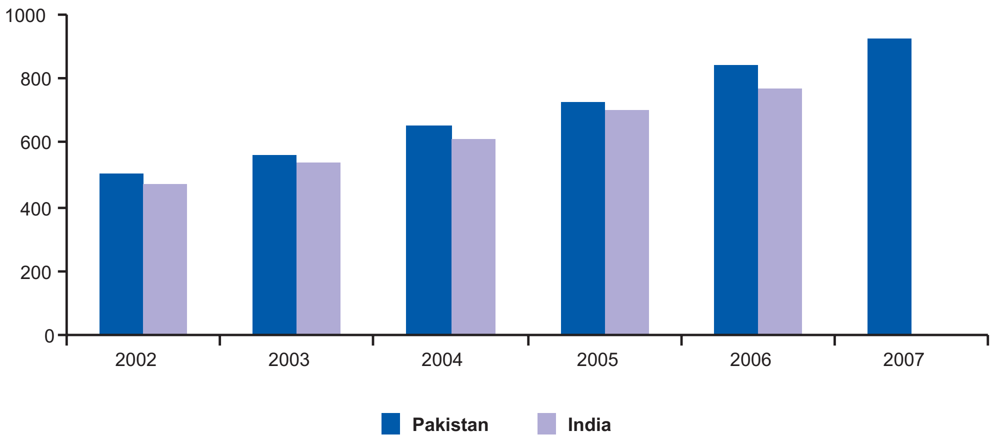
For the past 4 consecutive years Pakistan's economic growth has averaged in excess of 5%. A steep upturn in the country's real Gross Domestic Product is a reflection of its robust growth. After an unprecedented growth of 8% in FY05, real output growth slowed to 6.6% in FY06 and 7% in FY07.

Chart 1: Real GDP Growth (%)



Source: IMF World Economic Outlook & IGI Research

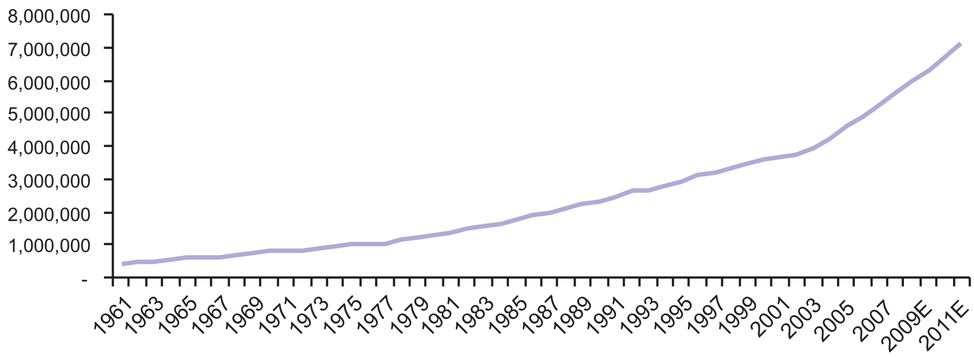
Chart 2: Per Capita Income (US$)



Source: IMF World Economic Outlook & IGI Research

Business Cycles and Long-run Trend

Chart 3: Real GDP (Base 1999 - 2000=100))

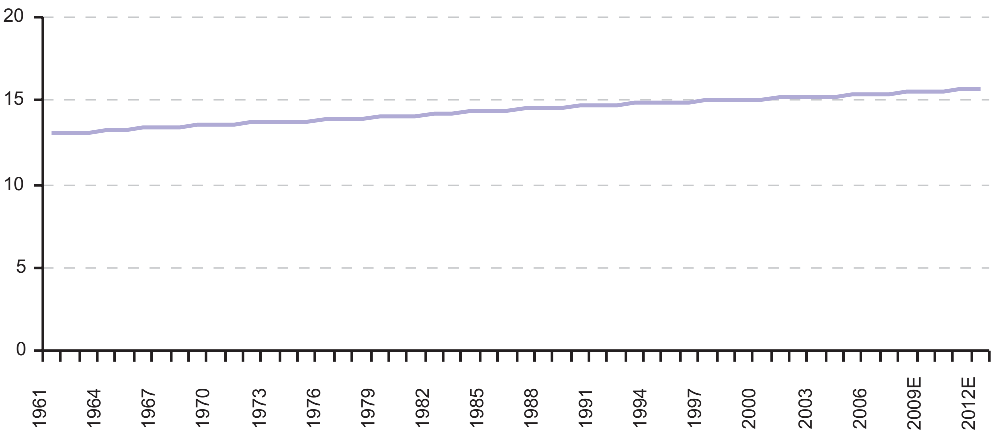


Source: Federal Bureau of Statistics & IGI Research

At first glance, the country's real output function appears to show exponential growth. In order to forecast the economy's true potential for growth we separate real GDP into three components: a long-run trend, business cycles and short-run shocks to the economy. This dissection is expected to give better insight into the changing pattern of economic growth and future prospects.

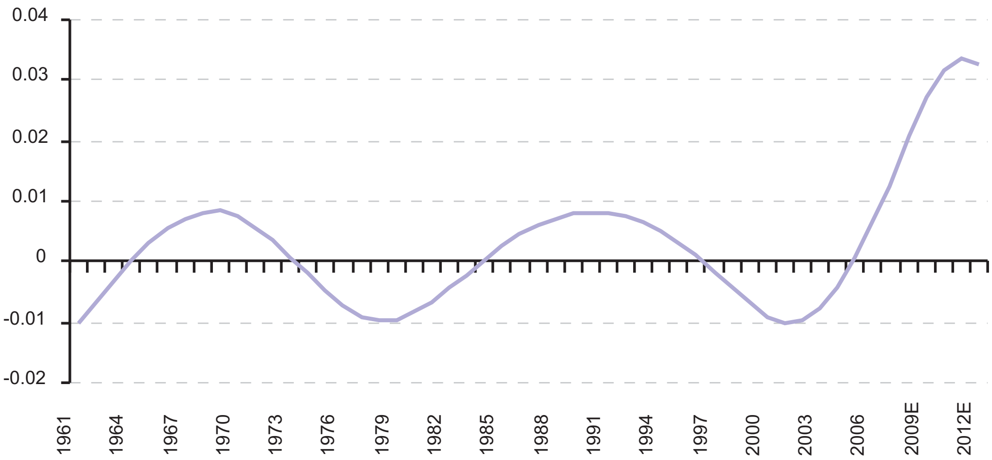
The country's real output has had a positive trend throughout the selected period (FY61-FY07). However, the increase in real GDP has depicted varying rates over the period. We attribute the change in long-run growth trend to structural changes in the economy. The highest growth in trend came in the early 60's owing to industrial and financial institutions development. The 1965 war pulled the trend growth down in the latter half of 1960s. Increasing public fixed investment in the 1970s again pushed up the trend growth and it touched a peak in FY83. Subsequently, the trend remained on a decline for an extended period (even though overall GDP growth in the 80s was high) and touched a trough in FY99. Since then the economy's long run-trend has been on a consistent rise.

Chart 4: Long run Trend Component of Real GDP **(In of PRs mn)**



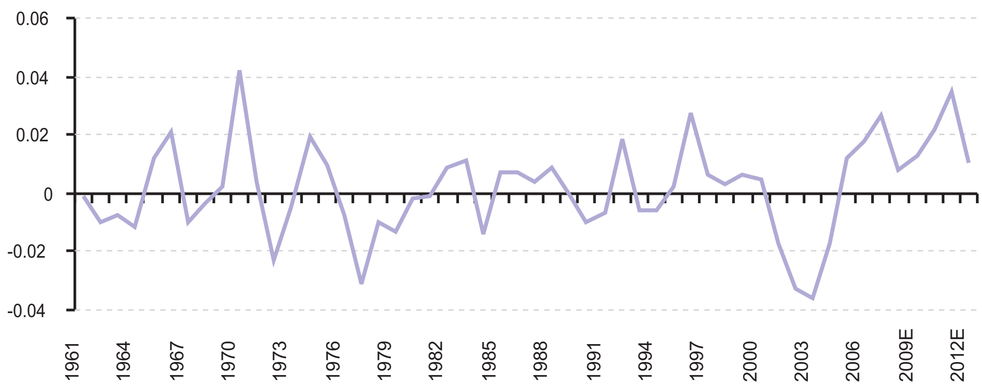
Source: IGI Research

Chart 5: Business Cycle Component of Real GDP **(In of PRs mn)**



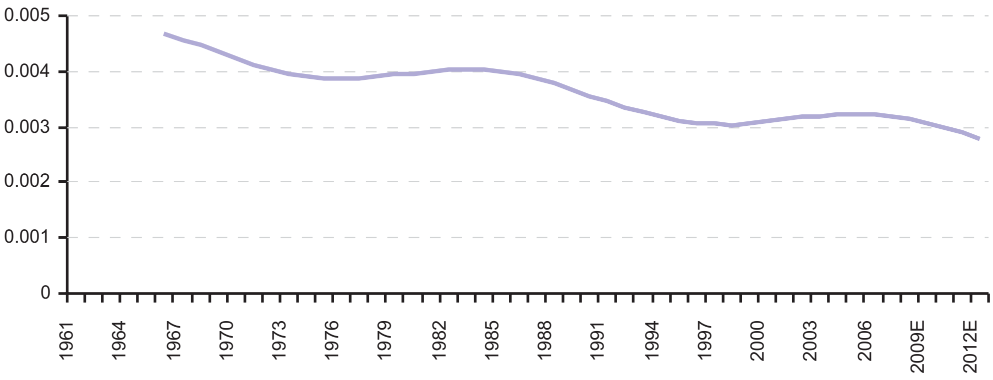
Source: IGI Research

Chart 6: Short run Shock Component of Real GDP (In of PRs mn)



Source: IGI Research

Chart 7: Long run Trend Component Growth Rate (%)



Source: IGI Research

Cyclical movements show that Pakistan has completed two business cycles since FY61; one ending with a trough in FY78 and the second one ending in FY01. Since then, the country has recovered and is currently in an expansionary phase. In FY06, the business cycle crossed the peak of the earlier business cycle and continued to expand further in FY07. Does this mark an inflection point in the cycle and is the economy about to rebound? Not according to our estimates! An important distinction between FY90 and FY07 is that the long-run trend component in FY90 was declining whereas in FY07 it was on a consistent rise. Not only does this indicate that the current expansionary phase is more a result of infrastructure building and investment rather than the expansion of the '90s which was largely due to transitory factor such as inflow of remittances and foreign aid, but also that these structural changes will support long run growth.

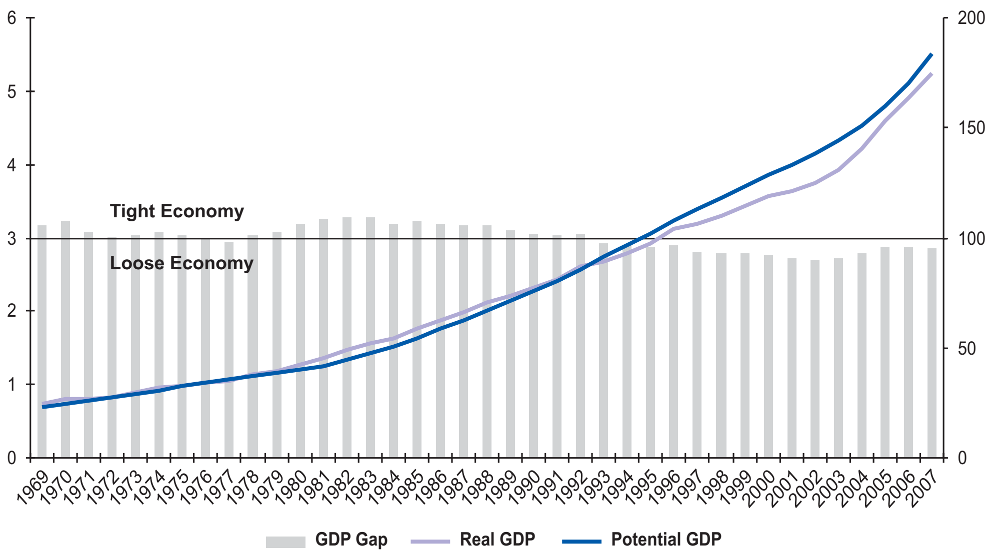
The above graphs show our projections of the real output as well as its component. It is estimated that the trend growth will gradually decline in the coming years. The cyclical component of the GDP is projected to rise further and reach its peak in FY11. Overall, the country's real GDP growth is expected to remain in excess of 6% till FY12.

This projection is based on the assumption that the economy will not suffer from any positive or negative shock during that period.

Output Gap

In order to assess the relative tightness in the economy we explore the country's potential output. The concept of potential GDP refers to the level of GDP at which the economy is running at its capacity with the capacity, in turn, being determined by labor force growth, labor participation and labor productivity. The GDP gap is an index variable that rises above 100 when the economy is "tight" – that is, when actual GDP exceeds potential GDP. Specifically, the GDP gap is defined as (GDP/Potential GDP)*100.

Chart 8: Potential Output **(PRs tn)**



Source: Federal Bureau of Statistics & IGI Research

We arrive at the potential output by using the following functional form:

log (*gdp_t*) = β_0 + β_1 * [log($smprd_t$) + log($smlfc_t$) + log($smhrs_t$)] = 1

where coefficient β_1 is constrained to unity, and where:

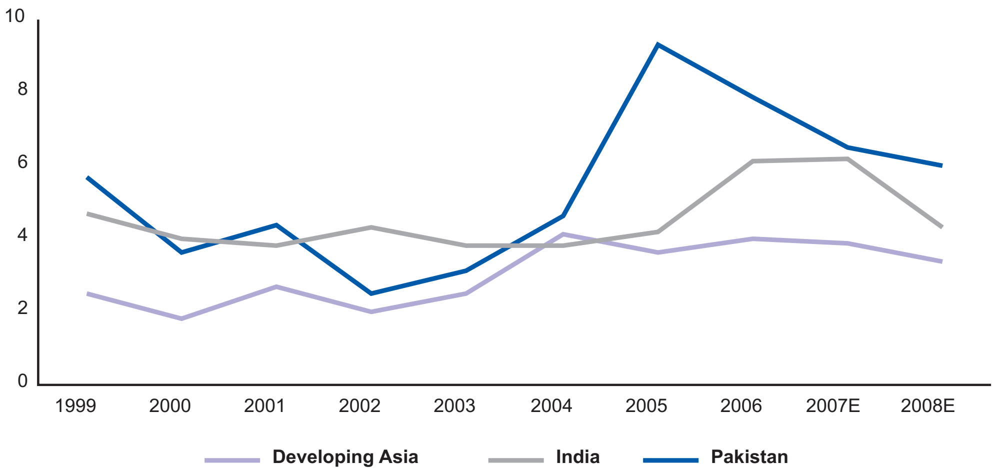
- *gdp_t* is gross domestic product;
- *$smprd_t$* is five year moving average of aggregate labour productivity;
- *$smlfc_t$* is smoothed labour force, calculated as five year moving average of the labour force participation rate multiplied by the adult population; and
- *$smhrs_t$* is five year moving average of aggregate hours worked.

Applying the above model to data for Pakistan reveals that since FY93, the country has been operating below its potential output level and the tightness in the economy is low. Low tightness in the economy reinforces our estimation of rapid economic growth in the years to come.

Inflation

Accelerated growth has come at the cost of high and persistent inflation. Consumer Price Index (CPI) in Pakistan reached a peak in FY05 when the country's economic growth also peaked. Since then it has been actively controlled by the central bank to come down to manageable levels. However, even in FY06 and FY07, inflation managed to creep up beyond the targeted number. The central bank is vigilant of inflationary pressures and has taken numerous steps to contain it. The most recent move was the increase in policy rate by 50 basis points to 10%. The objective was to curtail the escalating reserve money growth in the system. Other moves have also been taken to restrain reserve money growth. The central bank is likely to remain ever-watchful of these pressures. Further tightening of monetary policy may be implemented if inflation does not ease, which is a risk to the country's economic growth. Our estimates indicate that CPI will increase by 7.2% on average in FY08 against the target of 6.5%. Therefore, we expect the tight monetary stance to continue in FY08.

Chart 9: Consumer Prices (%)

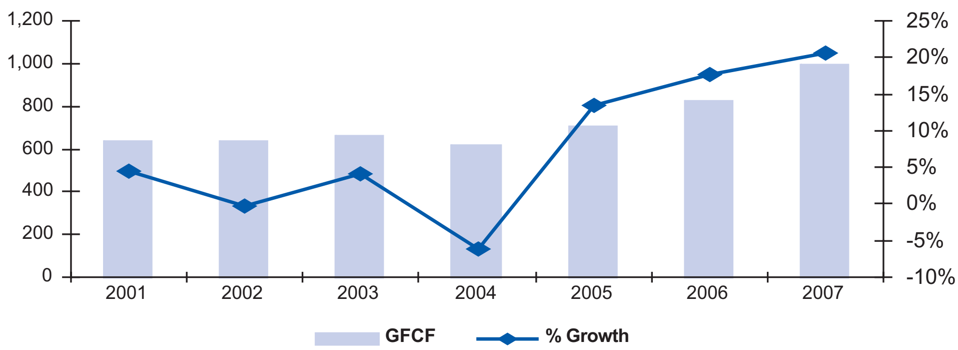


Source: IMF World Economic Outlook & IGI Research

Consumption, Savings and Investments

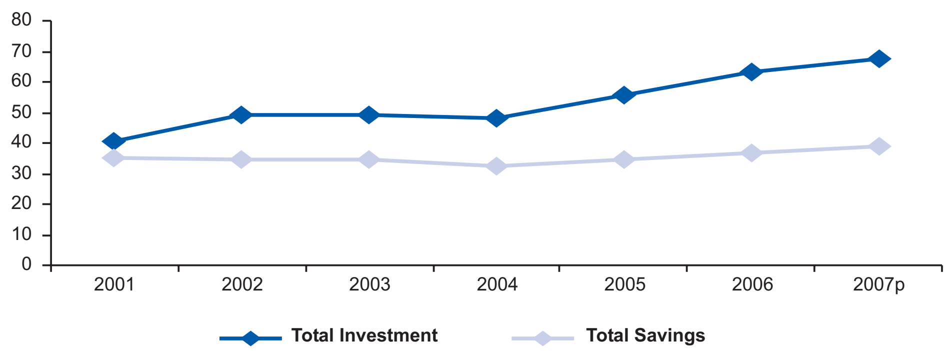
Evidence to the rising middle class is an average growth of 5.5% per annum in real per capita GDP over the last four years. In nominal terms per capita income was up by 11% to reach US$925 in FY07. Rising income levels combined with a very high propensity to consume have resulted in a structural shift in consumer spending patterns. Real private consumption has grown at an average rate of 7.4% per annum during the last four years. Changes in demographic structure in the form of a rising share of working age population have also been responsible for the increasing disposable income levels and current consumption.

Chart 10: Real Gross Fixed Capital Formation (PRs bn)



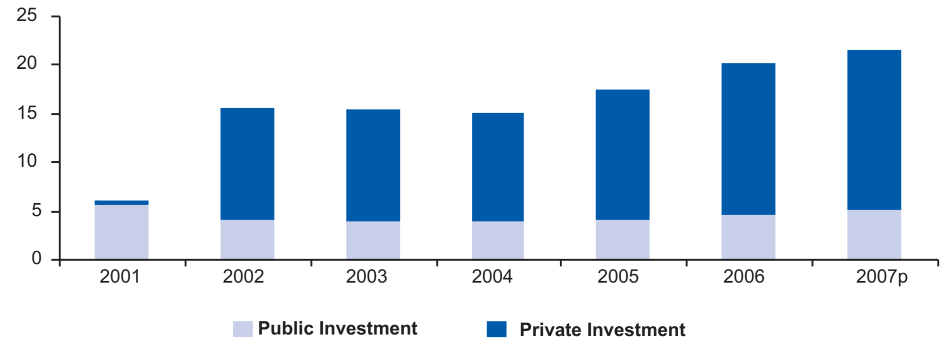
Source: State Bank of Pakistan & IGI Research

Chart 11: Savings & Investments (% of GDP)



Source: Federal Bureau of Statistics & IGI Research

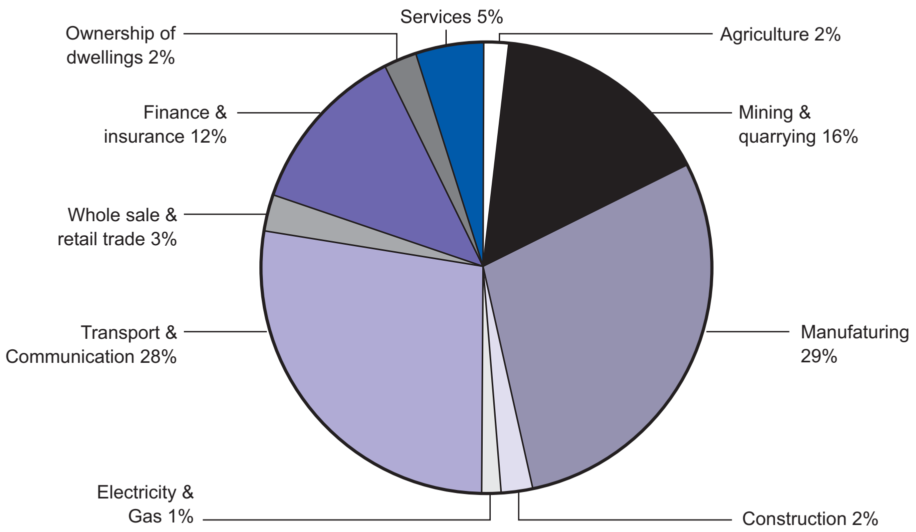
Chart 12: Gross Fixed Investment **(% of GDP)**



Source: Federal Bureau of Statistics & IGI Research

Rising business confidence has resulted in greater investments in fixed capital. Real gross fixed capital formation i.e. real investment grew by 20.6% in FY07 and has averaged 17.3% over the past 3 years. This strengthens our argument of continuing prospects for growth. All 3 avenues of investment i.e. private, public and foreign, have witnessed increase in FY07 with growth in real private investment recorded at 19.6%, public sector investment at 31.7% and foreign direct investment at 37%. It is concerning, however, that the upsurge in investments has not been accompanied by a parallel rise in national savings which currently stand at 18% of GDP whereas the balance is funded by foreign savings (this simply reflects the current account deficit in the balance of payments). Total investments form 23% of GDP and National Savings finance 84% of fixed investment.

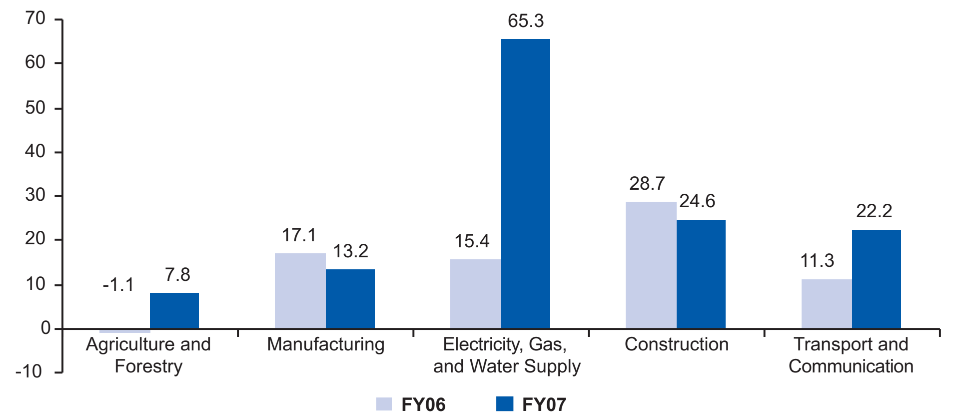
Chart 13: Sector Wise Share of Increase in GFCF



Source: Economic Survey FY07 & IGI Research

The sectors attracting the greatest private sector investment include mining & quarrying, manufacturing, construction, transport & communication, banking & finance and wholesale & retail trade. All sectors of the economy have witnessed double digit growth in investment save for agriculture (3.8%), ownership of dwellings (4.6%) and electricity & gas distribution (-49.9%). This raises questions about how far these investments can sustain the economy's growth given that such a crucial sector as electricity & gas distribution has witnessed disinvestment. Moreover, agriculture that contributes 21% to the country's GDP has received marginal investment growth. Rather than growth in investment it would be well advised to take a look at the share of each sector in total investments. However, the same perturbing situation is evident in this case too.

Chart 14: Growth in Business Sector Loans



Source: State Bank of Pakistan

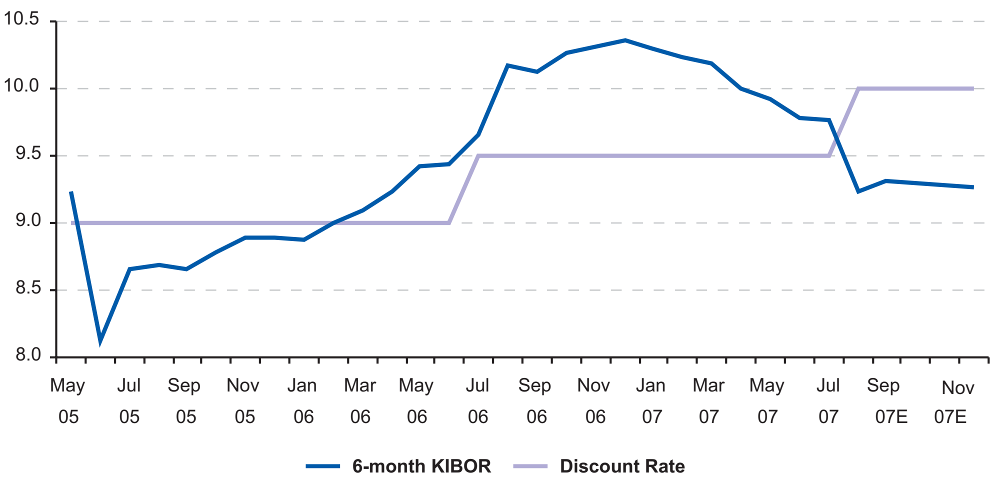
It is worth mentioning here that the investment in these sectors may not be reflected accurately through GFCF since a predominant source of funding for these sectors is bank loans. We take a look at the growth in business sector loans in the first three quarters of FY07. We find that the greatest growth in business loans has indeed come from the electricity, gas and water supply sector (65.3% or PRs12.3bn) and alleviates concern of low investment in this sector Agriculture loans on the other hand registered a somewhat low growth of 7.8% or PRs10.5bn. We expect this growth to increase as sowing season approaches.

Monetary Policy

Short Term Interest Rates

In the latter half of 2006, 6-months Karachi Interbank Offer Rate (KIBOR) averaged in excess of 10%, while the policy rate was 9.5%. The recent hike in discount rate to 10% has failed to increase the 6-month KIBOR which slid to 9.24% in August 2007. Owing to the excess liquidity in the interbank market, we estimate 6-months KIBOR to peak at 9.3% before year end 2007 and slide to 9.2% by June 2008. This estimate assumes that no change in policy rate occurs going forward. Given the dual tasks of managing inflation as well as fostering growth, SBP is not likely to implement another hike in the policy rate.

Chart 15: Short-Term Interest Rates (%)



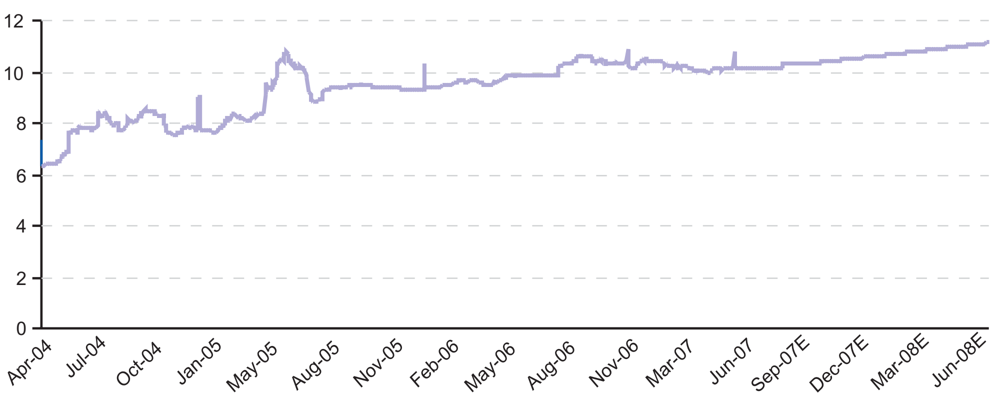
Source: IGI Research

According to SBP, the decline in KIBOR post the policy rate change is merely a rationalization of credit spreads over collateralized rates which had widened beyond historical norms after the change. This argument further reinforces our estimate of low and stable KIBOR in FY08.

Long Term Interest Rates

Long-term interest rates have been subject to much uncertainty in the past. Rationalization of interest rates and providing a spectrum of different lending maturities has been SBP's latest focus. The most encouraging steps include issuance of 30-year Pakistan Investment Bond (PIB) in December 2006 at cut-off yield of 11.59%. Lately yield on the same issue has increased to 11.68%. The recent increase in discount rate is responsible for hike in PIB yields across maturities.

Chart 16: 10 Year PIB Rate (%)



Source: IGI Research

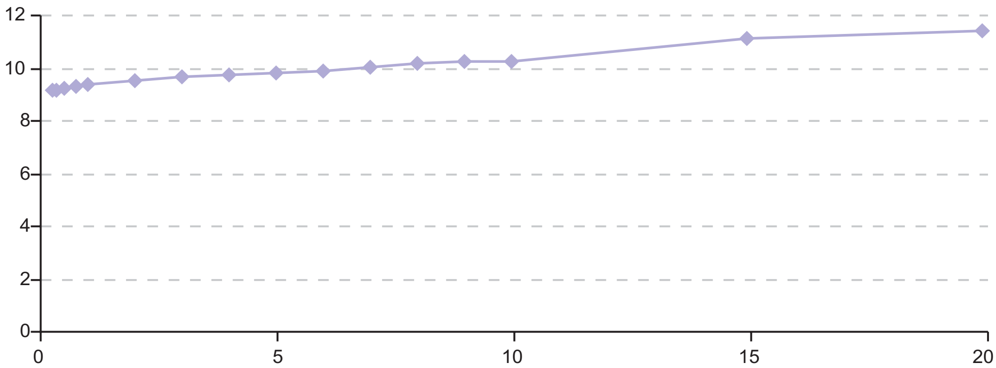
10-year PIB rates are of greater relevance as they frequently serve as benchmark rates for valuation of securities. A new issue of 10-year PIBs was made in August 2007 post the discount rate hike. Cut-off yield increased to 10.35% versus the earlier cut-off yield of 10.12% in June 2006. While it is positive to note that frequency of issue has gone down from as high as 4 issues a year in FY01 to 1 issue per year in FY08 (to date), the hike in yields creates uncertainty and may work to decrease interest in longer term issues.

Presently, secondary yields on 10-year PIBs have decreased to 10.28%. We forecast these secondary yields to reach 11.13% in FY08.

Yield curve

Given the expansionary fiscal and tight monetary policies adopted by the country the term structure of interest rates has taken a slightly upward sloping shape. This may also be interpreted as an evidence of high liquidity in the market and low maturity premiums.

Chart 17: Term Structure of Interest Rates



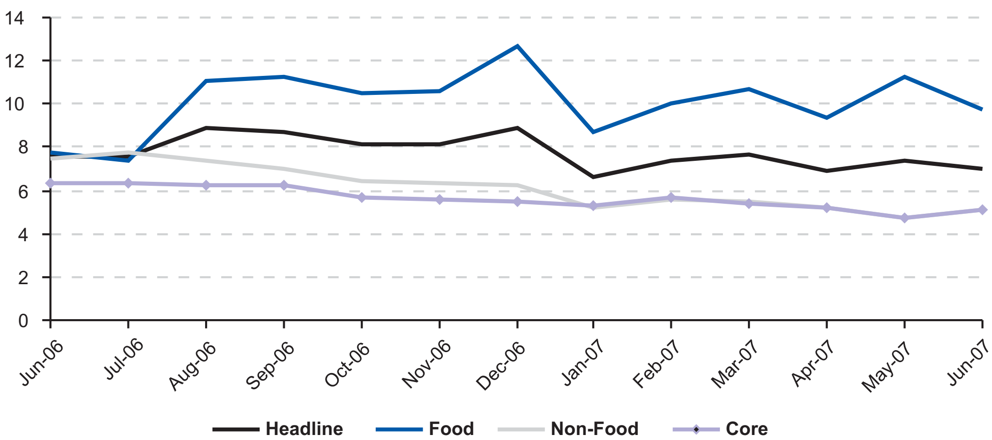
Based on secondary yields quoted in the interbank market

Source: IGI Research

Inflation

Heightened economic activity has been accompanied by rising inflation and consequently a tight monetary policy. The central bank has taken several steps to curtail inflation ranging from increased policy rate and frequent mopping up of liquidity in the inter-bank money market. Despite these efforts inflation has still managed to creep beyond the target for the year. CPI increase in FY07 was recorded at 7.8% as against a target of 6.5% for the year, and the question arises as to whether the policy is tight enough.

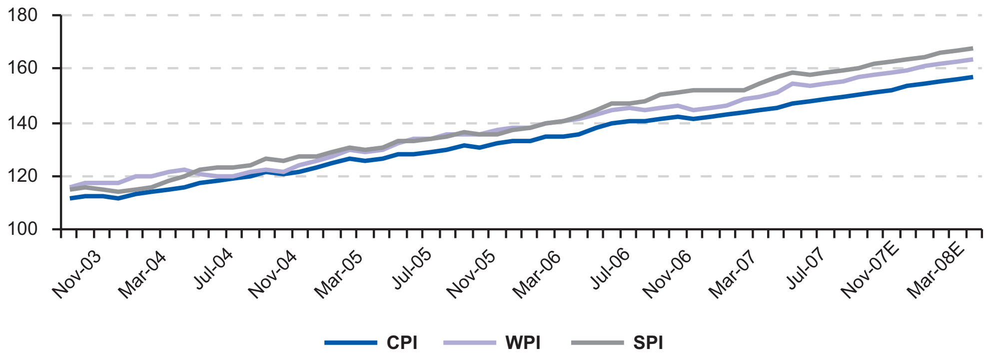
Chart 18: Inflation Trend **(%)**



Source: State Bank of Pakistan & IGI Research

Our forecasts for the three price indices for FY08 are as follows: CPI: 7.2%, WPI: 7.0%, SPI: 7.2%. These forecasts are based on the assumption that energy prices will be the main driving force behind increase in inflation going forward as against food prices in the concluding year. Food and energy prices fall beyond the jurisdiction of the central bank's control. We therefore, foresee a tough task for the central bank in controlling liquidity in the market. We expect it to continue with its policy of frequent Open Market Operations to mop up liquidity. A further hike in policy rate, however, does not seem likely nor is it advisable.

Chart 19: Inflationary Expectations (Base: FY01 = 100)



Source: State Bank of Pakistan & IGI Research

Fiscal Policy

■ Resources

The resources used to finance expenditure include revenue and capital receipts. Within capital receipts the largest component is public debt. However, this receipt is netted against repayment of previously raised debt and the total contribution to the country's resources is minimal. Every year new debt is raised to repay the earlier one while only a small portion of the fresh issue is actually utilized.

The need is to increase the second component of resources i.e. revenue receipts to reduce reliance on fresh debt for repayment of earlier debt. Encouragingly revenue receipts have risen and now form more than 85% of total resources. Revenue receipts primarily consist of taxes (both direct and indirect). Until now, indirect tax revenue has exceeded direct tax revenue. Recent tax reforms are directed towards increasing the proportion of direct taxes which will bode well for the country's internal resources. In FY07, the tax to GDP ratio for Pakistan stood at 10.5%.

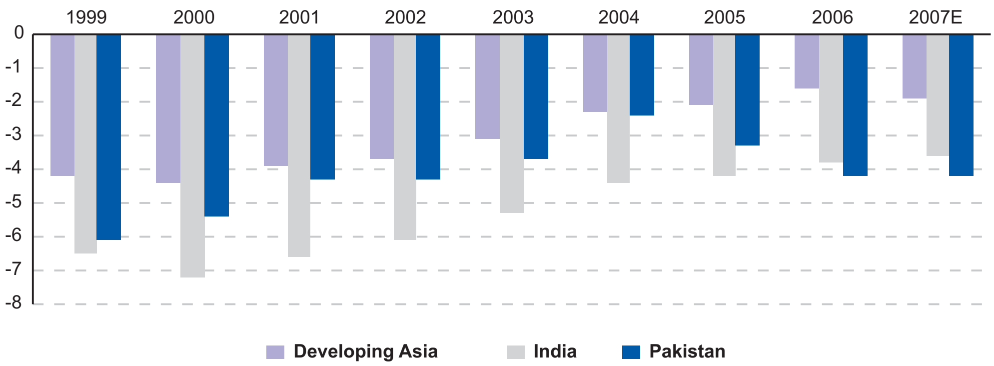
■ Expenditure

For the first time in the past 5 years development expenditure exceeded non-development expenditure for the country. This situation continued in the later years. The largest component within development expenditure is research and development of general public services. Such expenditure bodes well for infrastructure development within the country.

■ Fiscal balance

Due to fiscal expansion the budget deficit as a percentage of GDP has consistently widened since FY04. The target for next fiscal year is to reduce the deficit to 4.0% of GDP. The deficit will be financed through borrowing as well as privatization proceeds. Bank borrowing is budgeted to reach PRs130.9bn in FY08 and privatization proceeds are expected to total PRs75bn in FY08.

Chart 20: Central Government Fiscal Balance (% of GDP) **(%)**

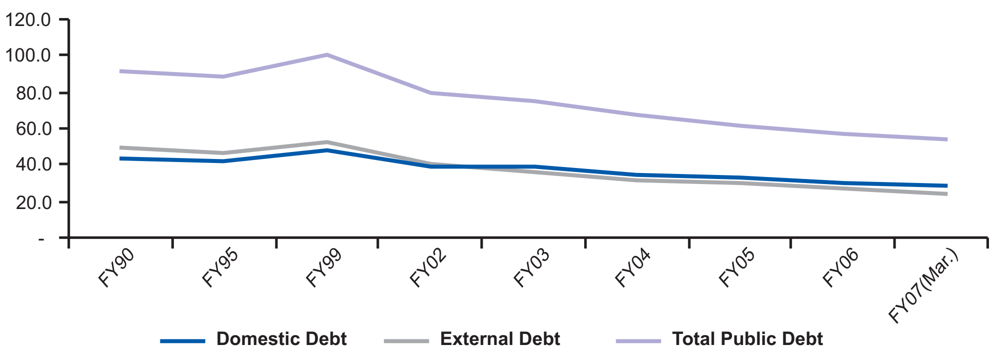


Source: IMF World Economic Outlook & IGI Research

Public Debt

Pakistan's total public debt may be divided into domestic and external debt.

Chart 21: Pakistan's Debt Burden (as % of GDP) (%)



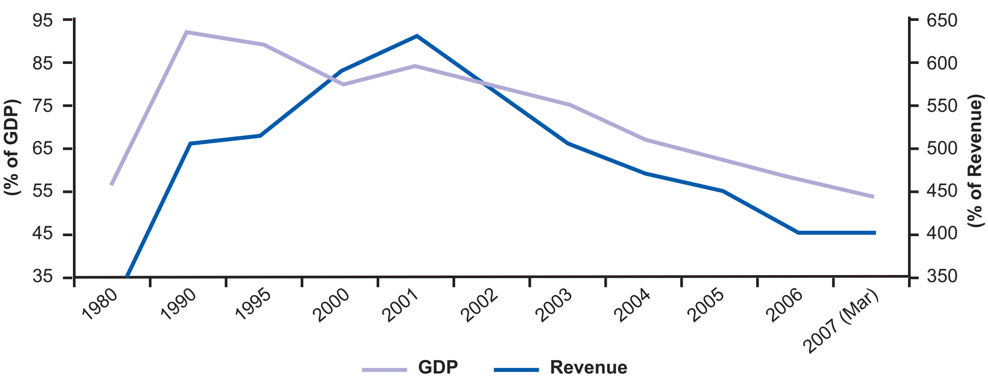
Source: Federal Bureau of Statistics & IGI Research

Domestic debt mainly comprises of three components: permanent, floating and unfunded debt. Permanent and unfunded debt is normally medium to long term in nature whereas floating debt is short term. The government's strategy is to keep a balance between long and short term debt so as to minimize debt servicing costs. It is encouraging to note that over the past years Pakistan's debt to GDP ratio has consistenty declined from about 40% in FY02 to less than 30% in FY07. Several steps have been responsible for effective debt profiling:

- Lowering of interest rates in FY05
- Ban on institutional investment in National Saving Schemes (NSS) (unfunded debt) which was later removed
- Rationalization of issuance of PIBs to discourage speculation in the long term interest rate

Similarly external debt as a percentage of GDP has also declined consistently from over 40% in FY02 to 25% in FY07. This low reliance on foreign financing has increased the country's resilience and has made it less susceptible to external shocks.

Chart 22: Trends in Public Debt (%)



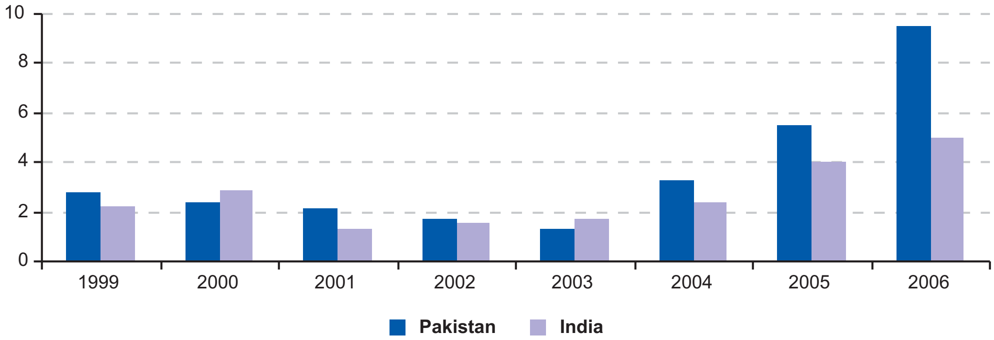
Source: Federal Bureau of Statistics & IGI Research

External Linkages

■ Trade balance and partners

Rising aggregate demand accompanied by an increasing appetite for imports has caused the country's trade deficit to widen. Trade deficit reached 9.5% of GDP in FY06-the highest in 10 years. Tight monetary policy to shave off excess demand, decline in petroleum prices and decline in fertilizer imports did well to curtail the spiraling import demand in FY07 and import growth slowed to 9% in FY07 versus 40% in FY06. However, efforts to promote exports of the country did not bear fruit and exports of the country actually declined by 3% in FY07 as against average growth of 16% per annum in recent years. Resultantly, trade deficit of the country reach 9.0% of GDP in FY07 which is better than the past year but by no means laudable.

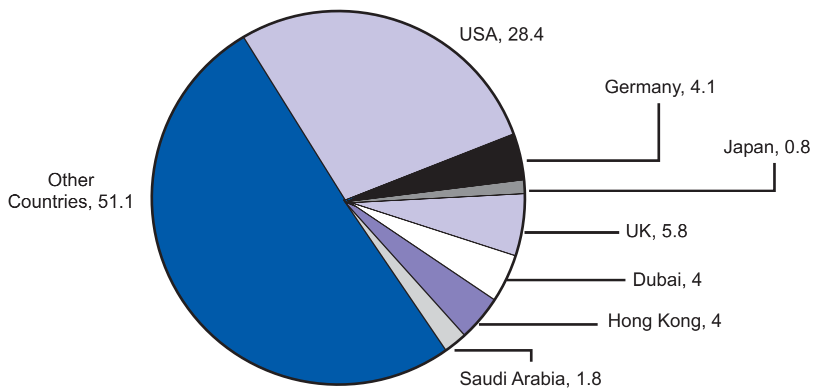
Chart 23: Trade Deficit (as % of GDP)



Source: IMF World Economic Outlook & IGI Research

Pakistan's international trade suffers from concentration in specific countries as well as specific items. The same perplexing situation exists in both imports and exports. Only 5 countries account for more than 45% of the country's total exports. USA alone is the single largest export market and accounts for 28% of the country's exports. This situation makes Pakistan's export performance extremely susceptible to changes in a few economies.

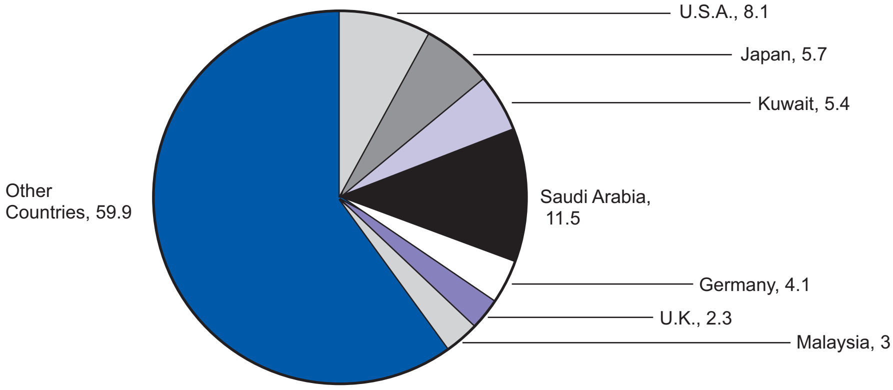
Chart 24: Major Exports Market FY07



Source: Federal Bureau of Statistics & IGI Research

Altough imports markets are more widely distributed with only Saudi Arabia accounting for 11% of total imports, even then only 5 countries account for 35% of the country's total imports.

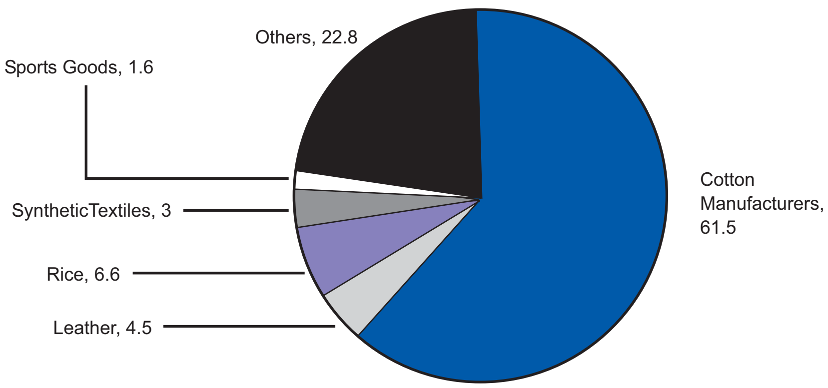
Chart 25: Major Sources of Imports FY07 **(%)**



Source: Federal Bureau of Statistics & IGI Research

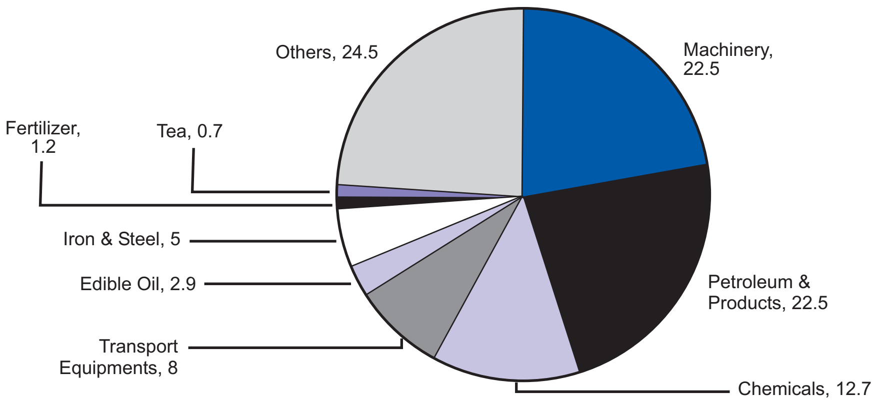
As for composition, 61.5% of Pakistan's exports comprise of cotton which is a heavy domination. No other single item accounts for even half as much. In recent times Pakistan's textile and cotton exports have suffered in the international market. These products are uncompetitive, poor quality and low value added. Lack of investment in research and technology has rendered these exports uncompetitive. Although the government is supportive in terms of assistance and subsidy, the industry's internal inefficiencies are responsible for its dire state. There is an urgent need to invest in state of the art technology in order to compete internationally.

Chart 26: Pakistan's Major Exports FY07



Source: Federal Bureau of Statistics & IGI Research

Chart 27: Pakistan's Major Imports FY07

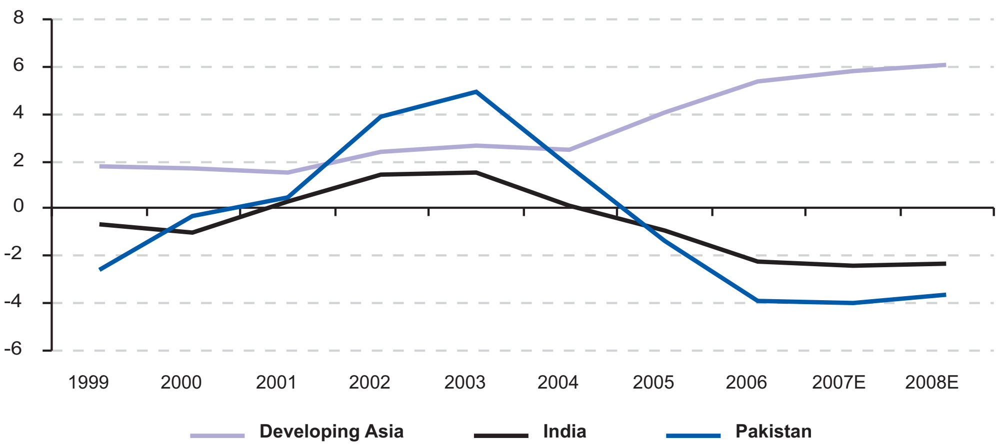


Source: Federal Bureau of Statistics & IGI Research

Current Account

Pakistan's current account has been in deficit for the past 3 years. The overall trade deficit has been the principal driver of the current account deficit. Although current transfers especially remittances from abroad remain burgeoning they are not enough to bridge the gap between imports and exports. We expect the current account to remain in deficit of 4.2% of GDP in FY08. Growing aggregate demand is expected to continue driving imports higher while export performance does not show signs of improvement.

Chart 28: Current Account Balance of Payment **(% of GDP)**



Source: IMF World Economic Outlook & IGI Research

However, the encouraging factor is the growth in remittances which reached a record high US$537.98mn in May 2007 and are expected to cross US$550mn per month in FY08.

Table 1: Balance of Payments **(US$ mn)**

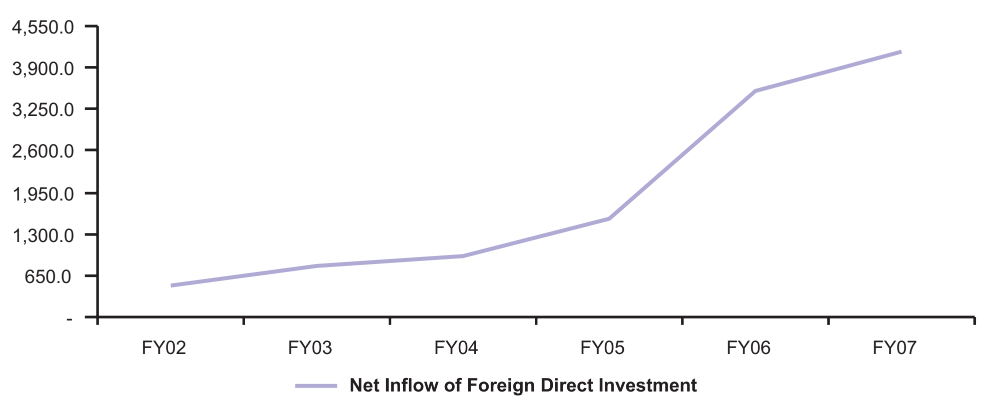
	FY01	FY02	FY03	FY04	FY05	FY06	FY07P
Current account balance	(1,112)	1,589	4,203	1,893	(1,344)	(4,774)	(4,363)
Trade balance	(1,269)	(294)	(444)	(1,208)	(4,352)	(8,259)	(5,148)
Exports f.o.b	8,933	9,140	10,889	12,396	14,401	16,388	8,390
Imports f.o.b	10,202	9,434	11,333	13,604	18,753	24,647	13,538
Services (net)	(3,142)	(2,617)	(2,128)	(3,594)	(5,841)	(7,304)	(4,377)
Private transfers(net)	2,460	3,005	5,737	6,116	8,440	9,914	4,833
Workers remittances	1,087	2,390	4,237	3,871	4,168	4,600	2,568
Official transfers(net)	839	1,495	1,038	579	409	875	329
Capital account	(624)	(2,321)	(1,710)	(2,903)	(1,248)	1,379	2,688

Source: State Bank of Pakistan & IGI Research

Capital and Financial Account

This account has been in surplus for the past three years on account of higher foreign investment in direct and portfolio form. Estimated Foreign Direct Investment (FDI) of US$4.2bn was made

Chart 29: Net Inflow of Foreign Direct Investment **(US$ mn)**

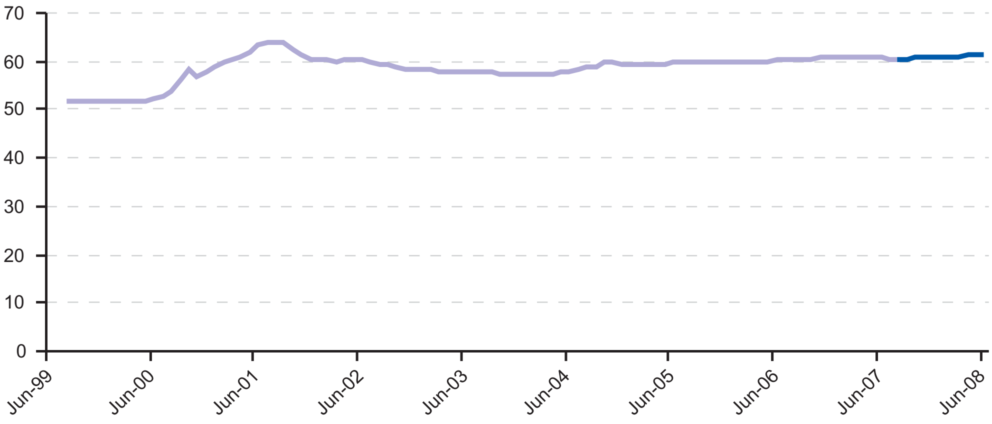


Source: Company Reports & IGI Research in FY07 while Foreign Portfolio Investment (FPI) of US$1.7bn was made in FY07. The most remarkable factor is the continued rise in foreign investments despite the political turmoil in the country. This reinforces our view that the current wave of growth in the economy is a result of structural upheaval rather than political prowess and a change in government cannot dampen the momentum of the economy.

Exchange Rate Movement

The nominal exchange rate has been experiencing depreciation since the beginning of FY06 but at a muted pace. SBP has been vigilant in controlling the amount of foreign inflows in the banking system as these are one of the biggest contributors to domestic inflation. We expect the Pak Rupee to continue to depreciate in a controlled environment and reach PRs61.34/US$ by the end of FY08.

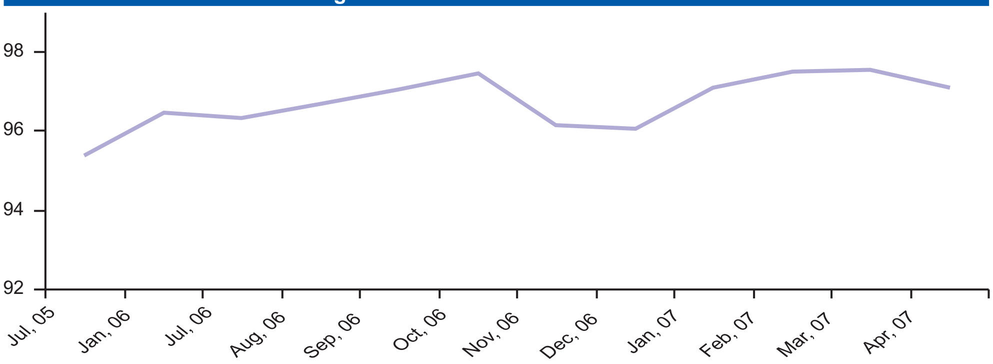
Chart 30: Foreign Exchange Rate **(PRs / US$)**



Source: Company Reports & IGI Research

Nominal exchange rates mask the impact of relatively higher domestic inflation as compared to trade partners. For this purpose we look at the Real Effective Exchange Rate (REER) which has actually appreciated in FY07. This appreciation adversely affects exports of the company because as a result of domestic currency appreciation they earn less in domestic currency terms. It is encouraging to note that SBP's efforts in curbing inflation have started to bear fruit and the REER has begun to decline.

Chart 31: Real Effective Exchange Rate



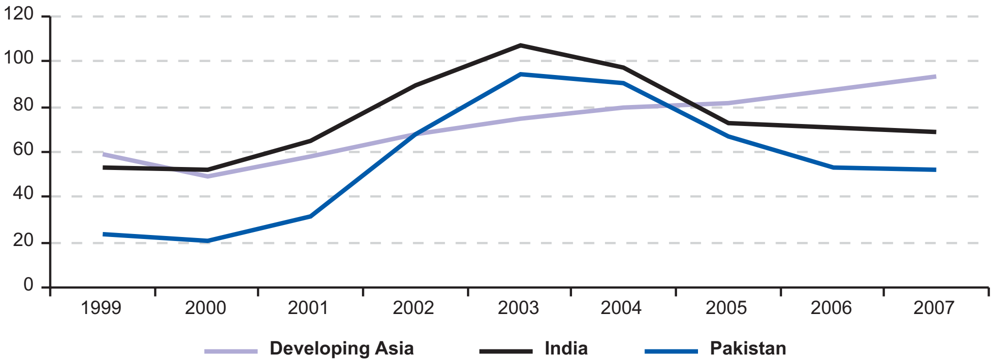
Source: IMF World Economic Outlook & IGI Research

Despite speedy growth in Foreign Exchange Reserves of the country, its ratio of Reserves to imports has actually declined. One of the largest outflows of reserves is caused by oil support payments. With the recent upturn in international oil prices we expect outflows from reserves to increase in the future. However, SBP may conduct direct purchases from the interbank market to increase inflows in the reserves.

Chart 32: Foreign Exchange Reserves **(US$ bn)**

Source: IMF World Economic Outlook & IGI Research

Chart 33: Ratio of Reserves to Imports



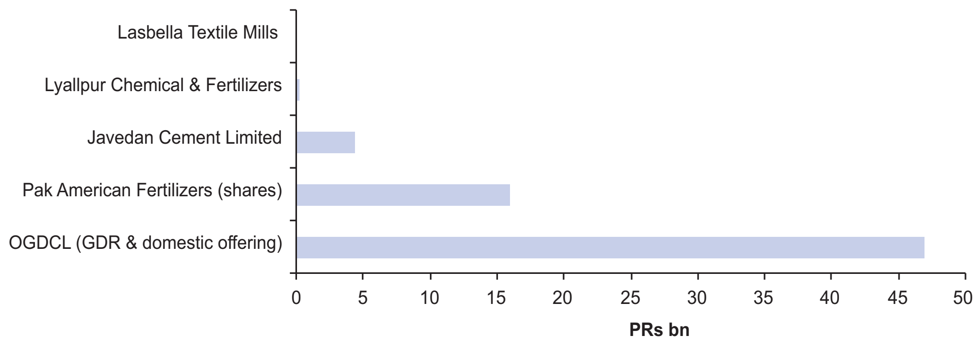
Source: IMF World Economic Outlook & IGI Research

Structural Reforms

Privatization

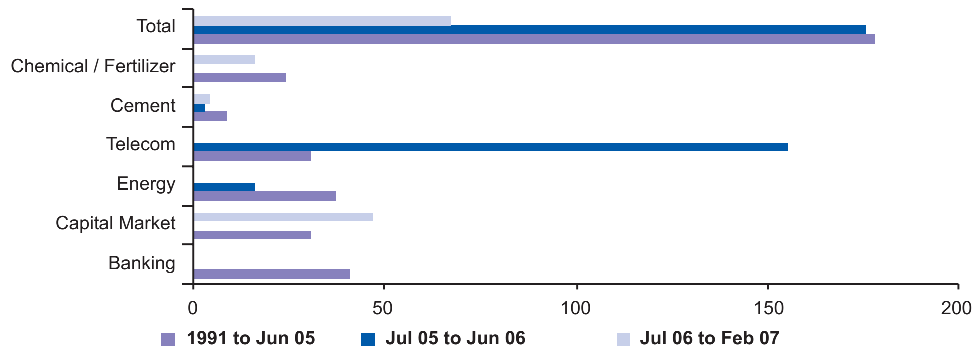
Privatization of major public sector entities like KAPCO and PTCL in FY06 attracted huge investor interest. In FY07, no major privatization occurred, however, Global Depository Receipt (GDR) offering and local offering of OGDCL was successfully completed amounting to a total of PRs46.963bn. Moreover, the GDR offering of MCB Bank* was also well received by foreign investors. Recently, GDR issue of UBL raised US$650.3mn whereas privatization of PSO, NIT and PPL are in the pipeline.

Chart 34: Assets Privatized During FY07



Source: Economic Survey FY07 & IGI Research

Chart 35: Amount of Privatization Transactions (PRs bn)



Source: Economic Survey FY07 & IGI Research

Among M&A activities foreign interest has been predominant. The major M&A activities in recent years include the following:

Table 2: Foreign Acquisitions in Pakistan (US$ mn)

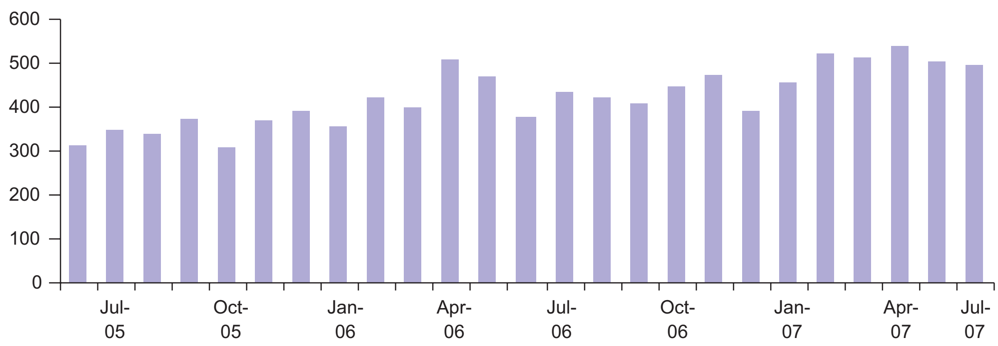
Acquirer	Target	Size of Transaction
Etisalat	Pakistan Telecommunications Co. Ltd.	2600
Standard Chartered Bank	Union Bank	487
SAMBA	Crescent Commercial Bank	100
ABN AMRO Bank	Prime Commercial Bank	230
Tamasek Holdings Singapore	PICIC	300
China Mobile	Paktel	284
Philip Morris	Lakson Tobacco	340
Oman Telecom	Worldcall Telecom	113

Source: Economic Survey FY07 & IGI Research

Favorable policies encouraging repatriation of funds to Pakistan have been instrumental in channeling greater funds in the form of home remittances. These have reached all time highs and crossed the US$537.98mn mark in May 2007.

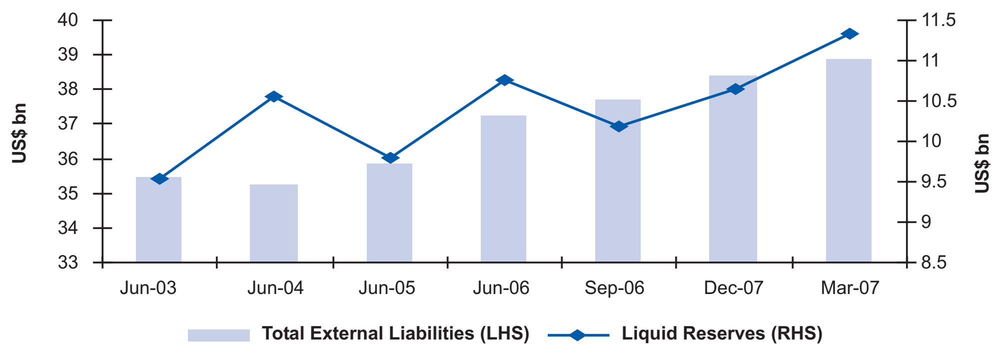
* *GDR of MCB Bank was not a privatization event as the bank is already privately owned. However, it does mark an important event of foreign interest in Pakistan.*

Chart 36: Home Remittances **(US$ mn)**



Source: SBP & IGI Research

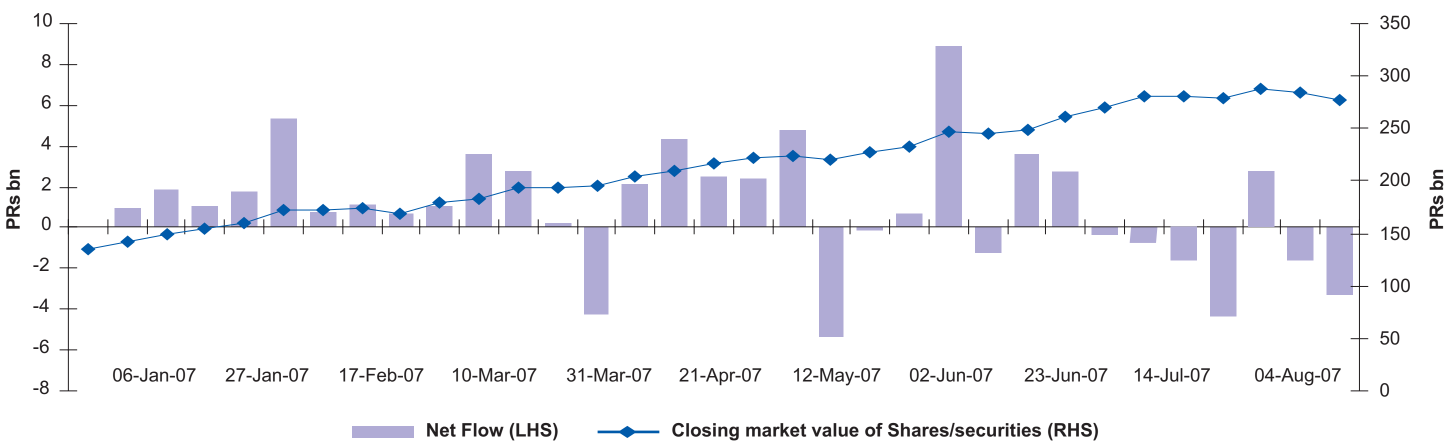
Chart 37: External Liabilties and Reserves



Source: SBP & IGI Research

Foreign investment in the country's capital markets is gauged through balances in the Special Convertible Rupee Accounts (SCRAs). The market value of securities held by foreigners in Pakistan reached PRs276bn in August, 2007. The market value of securities has been on a consistent rise during the year owing to positive inflows as well as rise in the security prices themselves. It is interesting to note that lately the interest seems to be shifting from equities to debt investments.

Chart 38: Foregin Investment Through SCRAs



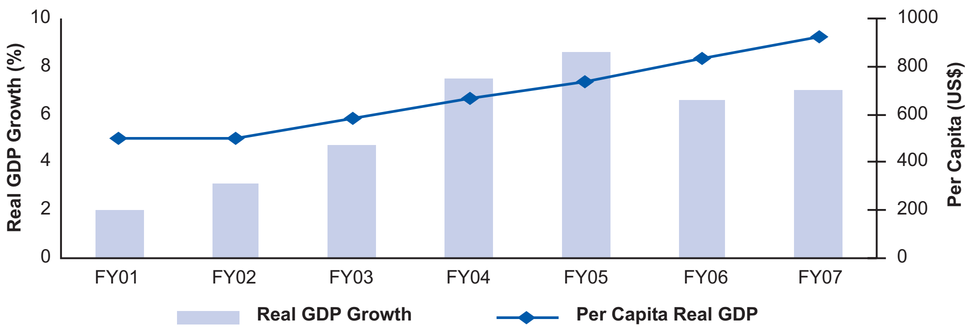
Source: SBP & IGI Research

Country Profile

Income Profile

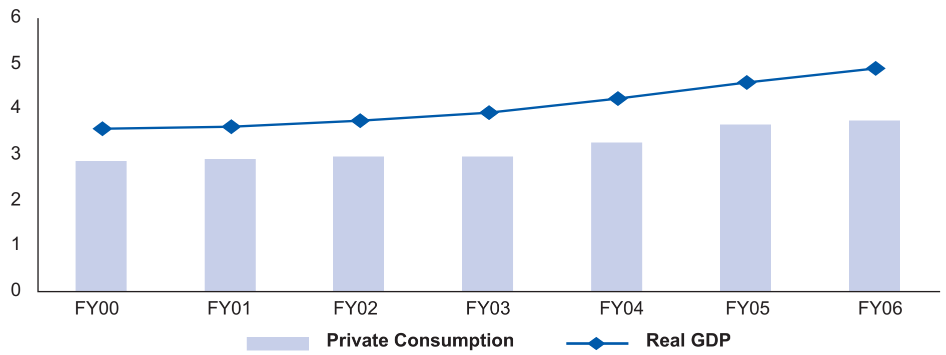
A demographic transition is in process that has enabled Pakistan to host a predominantly young population that is more affluent. Income levels have shown robust growth in the past 5 years as evidenced by the steep upturn of the country' real Gross Domestic Product (GDP). After an unprecedented growth of 8% in FY05, real output growth slowed to 6.6% in FY06. Evidence to the rising middle class is an average growth of 5.5% per annum in real per capita GDP over the last four years. In nominal terms per capita income was up by 11% to reach US$925 in FY07.

Chart 39: Real GDP Profile



Source: Economic Survey FY07 & IGI Research

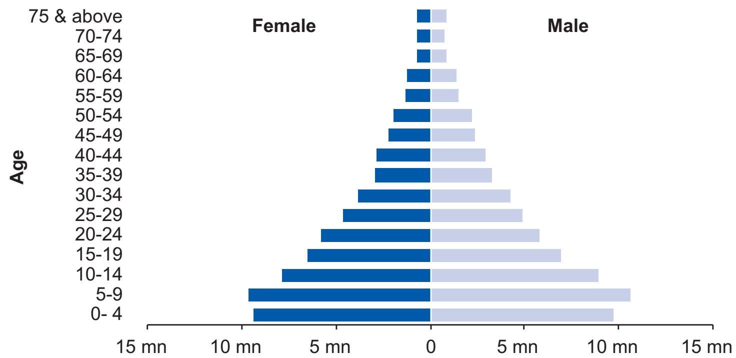
Chart 40: Private Consumption Expenditure **(PRs tn)**



Source: Economic Survey FY07 & IGI Research

Higher income levels have instigated an upsurge in consumption expenditure. Growth in private consumption has been the engine behind the economic growth. Moreover, rising consumption is reassuring as it ensures that the country's economic growth is fuelled internally and the country is less susceptible to external turmoil.

Chart 41: Demographic Profile



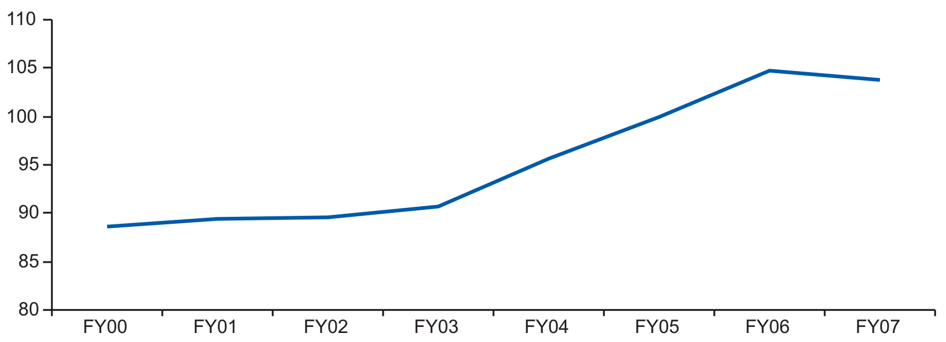
Source: Economic Survey FY07 & IGI Research

Education Trend

Productivity of the average labor force of the country is on a rise. Consistent rise in the future will depend upon investments in skill development and education of the population. Growing literacy levels and greater participation of skilled workforce warrant continued rise in productivity in the future.

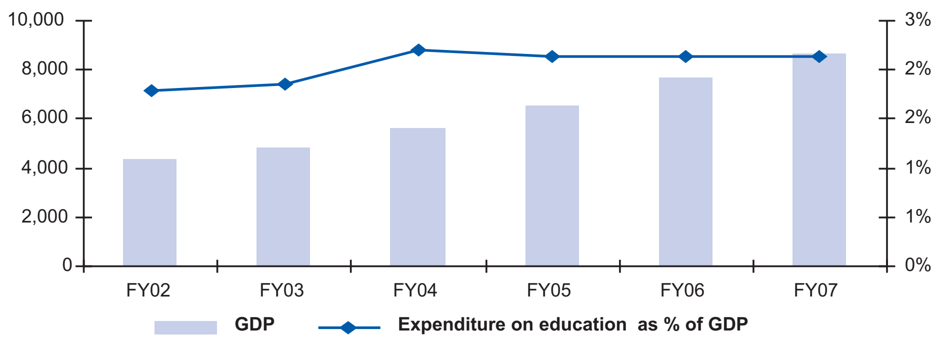
A number of initiatives that mark a transition in education levels in the country include: National Education Policy (NEP) review approved in 2005 which includes reform of the education system through free education up to Matriculation. Not only primary education, higher education spending has also been on a rise since the establishment of the Higher Education Commission (HEC) in 2002. Pakistan's higher education budget has increased sevenfold to about US$449mn which amounts to 0.5% of the GDP.

Chart 42: Labour Force Productivity **(PRs per capita)**



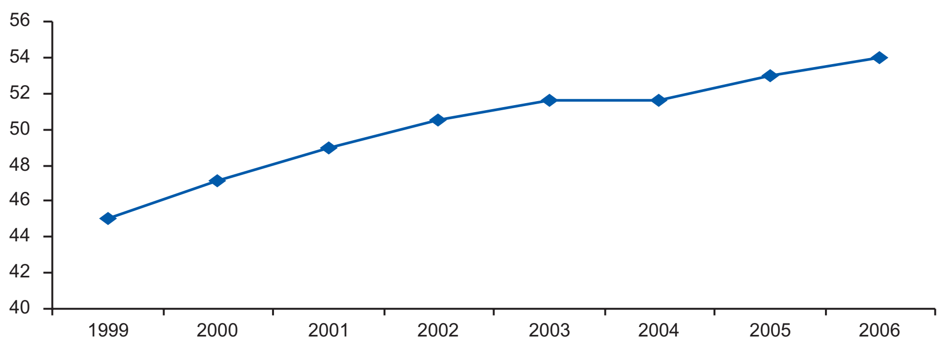
Source: Economic Survey FY07 & IGI Research

Chart 43: Actual GDP and Expenditure on Education **(PRs bn)**



Source: Economic Survey FY07 & IGI Research

Chart 44: Literacy Rate **(%)**



Source: Economic Survey FY07, SBP & IGI Research

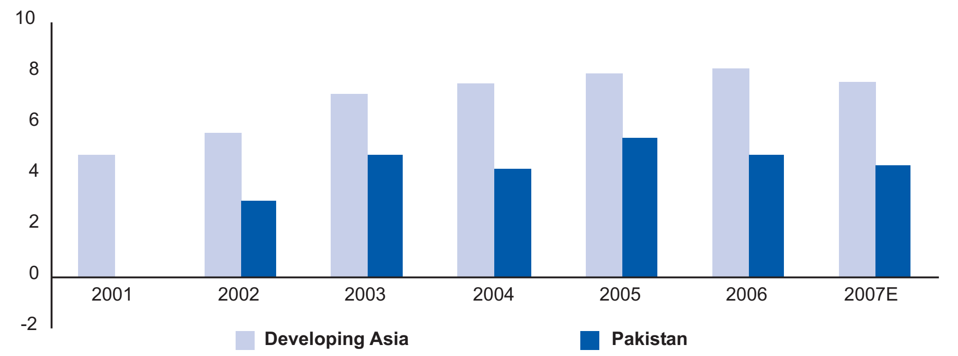
Comparison with Other Countries - Developing Story

On a regional basis, we compare Pakistan's economic growth with that of Developing Asia* Growth in real per capita income is lower than the region due to less growth in overall real GDP.

However, such comparison is distorted by the phenomenal growth in overheated economies such as India and China. When we exclude China and India, the numbers are much more favorable and show that Pakistan's growth in real terms has been greater than the average in recent years although it was a laggard in years 2000-03.

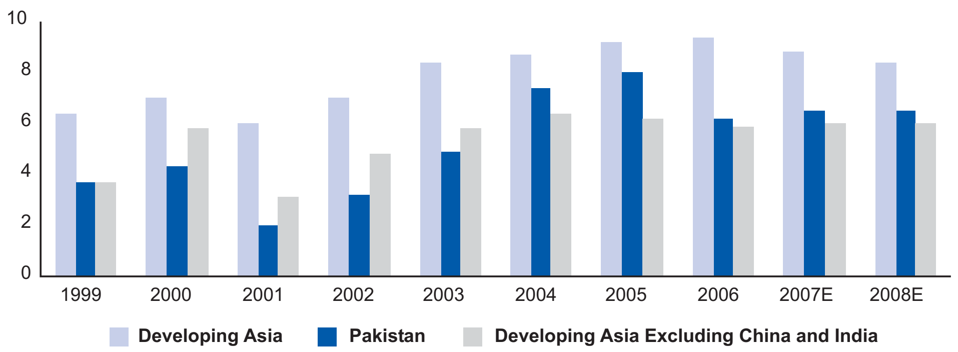
Inflation has been of mounting concern to policy makers in the rapidly growing economy. Pakistan has averaged higher inflation than Developing Asia but has fared better when we exclude China and India. A constrained monetary policy however, has left money supply in the country reduced as compared to the region.

Chart 45: Real Per Capita GDP Growth (%)



Source: World Economic Outlook April '07, IMF

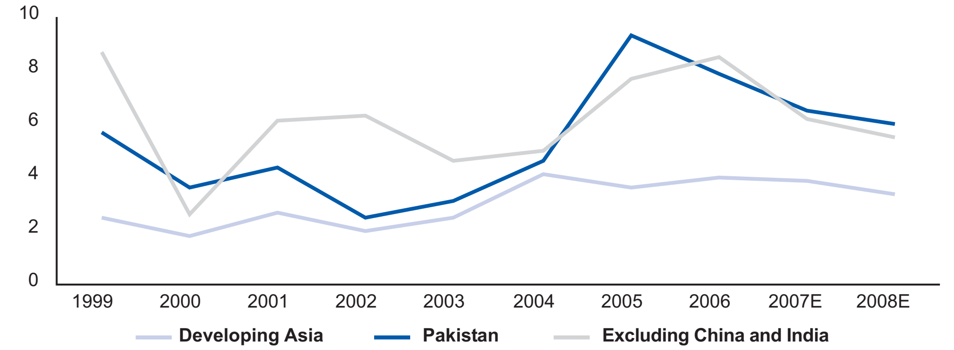
Chart 46: Real GDP Growth (%)



Source: World Economic Outlook April '07, IMF

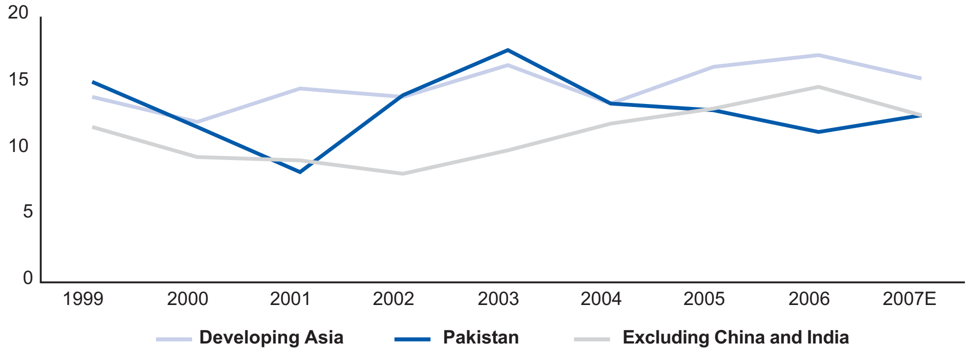
**Developing Asia includes: Bhutan, Cambodia, China, Fiji, Indonesia, Kiribati, Lao PDR, Malaysia, Myanmar, Papua New Guinea, Philippines, Samoa, Solomon Islands, Thailand, Tonga, Vanuatu, Vietnam, Bangladesh, India, Maldives, Nepal, Pakistan, Sri Lanka*

Chart 47: Consumer Prices (%)



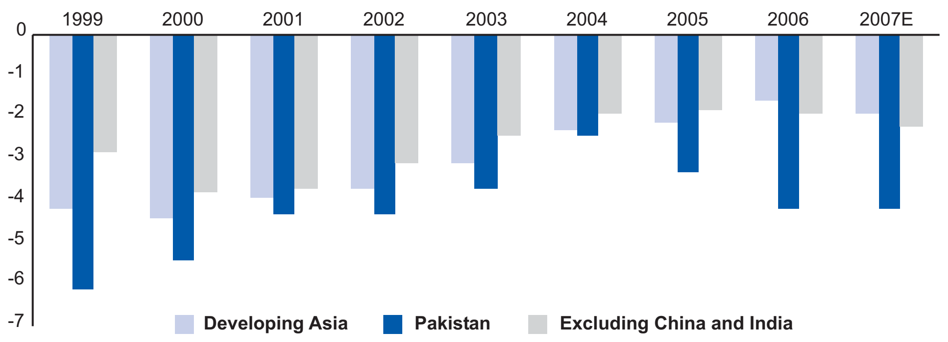
Source: World Economic Outlook April '07, IMF

Chart 48: Board Money Aggregates (% change)



Source: World Economic Outlook April '07, IMF

Chart 49: Central Government Fiscal Balance (% of GDP) (%)



Source: World Economic Outlook April '07, IMF

Table 3: Economic Indicators

Growth Rates (%)	FY05	FY06	FY07	FY08E
GDP	9.0	6.6	7.0	7.0
Agriculture	6.5	1.6	5.0	
Manufacturing	15.5	10.0	8.4	
Commodity Producing Sector	9.5	3.4	6.0	
Services Sector	8.5	9.6	8.0	
Monetary Assets (M2)	19.3	15.2	11.0	
Consumer Price Index	9.3	7.9	7.9	7.2
% of GDP				
Total Investmnet	18.1	21.7	23.0	
National Savings	1.6	4.5	5.0	
Tax Revenue	10.1	10.6	10.5	
Fiscal Deficit	3.3	4.3	4.3	4.2
Exports (f.o.b)	13.0	13.0	9.7	
Imports (f.o.b)	18.5	22.5	17.4	
Trade Deficit	3.3	5.5	9.5	9.0
Current Account Deficit	1.6	4.5	4.3	4.2

Source: Economic Survey FY07 & IGI Research

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Analyst Certification

I, Sobia Muhammad Din, hereby certify that the views expressed in this research report accurately reflect my personal views about the subject, securities and issuers. I also certify that no part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed in this research report.

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