1 An Overview, Prospects and Executive Summary

1.1 Overview

Contrary to earlier fears, Pakistan's economy performed reasonably well in FY02.[1] In particular, the tremendous improvement in Pakistan's external sector post-September 2001, either directly or indirectly, contributed to positive developments for many macroeconomic indicators during the year. The trade deficit turned out to be much lower than in FY01 as exports recovered in the second half of FY02 to reach the preceding year's level, while imports dropped; the current account was in surplus and underpinned the unprecedented 6.7 percent appreciation of the Rupee. An upsurge in workers' remittances, increased official transfers and savings in interest payments allowed the SBP to increase foreign exchange reserves to an all-time high; the Rupee liquidity injected through the foreign exchange purchases enabled the SBP to ease its monetary policy stance; inflation was down to 3.5 percent as the appreciating Rupee lowered the cost of imported inputs; external debt restructuring and lower interest rates on domestic debt led to a reduction in debt servicing, thereby aiding the Government 's effort to contain the fiscal deficit. Still, there were several negative repercussions of the September 11 events on the domestic economy; there was a lower collection of tax revenues as the tax base was eroded due to a reduced level of imports in Rupee terms; the export target of US$ 10 billion could not be achieved, foreign investors remained hesitant in making new commitments; and the law-and-order situation became difficult as action was taken against terrorist groups.

While acknowledging the salutary impact of the external account improvement, however, it is worth stressing that the *trend* improvement was visible well *before* the seminal September 11 events. Interest rates were already on the way down; foreign currency reserves were edging up; the exchange rate was relatively stable; the inflation downtrend was well defined, and the government's continuing fiscal discipline and commitment to reforms had already set the stage for the IMF PRGF, and the subsequent re-profiling of external debt. Nonetheless, the pre-existing positive trends did gain invaluable momentum in FY02, post-September 11. However, despite these major positives, the economy was not unscathed in FY02.

Real GDP grew by a reasonable 3.6 percent, but the increase was concentrated in fewer sub-sectors. A third successive year of water shortages took its toll, as major crops recorded another decline. The overall 1.4 percent agricultural growth thus owed almost *entirely* to yet another impressive performance by the livestock sub-sector. The manufacturing sector presented, under the circumstances, a more creditable performance. Even though the 4.4 percent FY02 growth was considerably weaker than the 7.6 percent increase recorded in FY01, it must be remembered that the economic environment was shrouded in uncertainties through much of FY02, first due to the conflict in Afghanistan and then due to border tensions with India. While some sectors targeting the local economy (electronics, car manufacturers, sugar, etc.) performed reasonably well through most of the year, it was the increased access to key Western markets and a substantial decline in interest rates that catalyzed the textile sector recovery late in H2-FY02. As a result, it was the services sector that dominated the FY02 growth profile with a 5.1 percent growth. Yet, it is important to note that, here too, the structure of growth was highly skewed, with a single component, *public administration & defense,* accounting for a major portion of the total increase in sectoral value added during the year. In other words, while the growth *rate* recorded some improvement in FY02, the *quality* of growth remained lackluster and shallow as the spread and spillovers to the rest of the economy remained highly limited. Thus the buoyancy and briskness in economic activity was not observed.

[1] Under a worst-case post-September 11 scenario, it was feared that exports would decline significantly, foreign investment flows would dry up, capital flight would intensify, output losses would be severe and GDP growth would either be stagnant or negative depending on the intensity, duration and scope of the US campaign in Afghanistan.

Table 1.1: Selected Macroeconomic Indicators

	FY98	FY99	FY00	FY01	FY02		FY03
					Targets	Actual/ Provisional	Targets
					Growth rates		
Real GDP (fc)[1]	3.5	4.2	3.9	2.5	4.0	3.6	4.5
Agriculture	4.5	1.9	6.1	-2.6	2.0	1.4	2.4
Major crops	8.3	0.0	15.4	-9.8	-0.2	-0.5	0.3
Manufacturing	6.9	4.1	1.5	7.6	5.0	4.4	-
Large-scale	7.6	3.6	0.0	8.6	6.5	4.0	6.0
Services sector	1.6	5.0	4.2	4.8	4.4	5.1	5.0
Consumer price index (FY01=100)	7.8	5.7	3.6	4.4	5.0	3.5	4.0
Sensitive price indicator (FY01=100)	7.4	6.4	1.8	4.8	-	3.4	-
Domestic credit	15.0	3.5	9.0	3.7	6.7	2.4	5.5
Monetary assets (M2)	14.5	6.2	9.4	9.0	9.5	14.8	10.0
Exports (f.o.b.)	3.7	-9.8	10.1	7.4	7.0	-0.7	13.4
Imports (f.o.b.)	-15.0	-6.8	9.3	4.1	0.3	-3.6	7.4
Liquid foreign exchange reserves with SBP[2] (million US Dollar)	930.0	1,729.7	1,352.3	2,075.8	-	4,804.9	-
					As percent of GDP		
Total investment	17.7	15.6	16.0	15.9	15.2	13.9	14.5
National savings	14.7	11.7	14.1	13.9	15.2	15.4	12.3
Tax revenue	13.2	13.3	12.9	13.0	13.9	12.9	-
Total revenue	16.0	15.9	17.1	16.0	17.3	17.1	17.1
Budgetary expenditure	23.7	22.0	23.6	21.3	22.3	23.7	21.1
Budgetary deficit	7.7	6.1	6.6	5.3	4.9	6.6	4.0
Current account deficit (Including official transfers)	-2.7	-3.8	-0.3	0.6	-	4.5	-
Domestic debt	43.9	46.8	49.6	50.1	-	46.0	-
External debt	55.4	54.9	53.5	60.3	-	54.4	-
Explicit liabilities[3]	0.5	2.4	2.4	2.8	-	1.6	-
Total debt (Including external liabilities)	99.8	104.2	105.4	113.2	-	102.0	-

[1] During FY02, sectoral shares in GDP were as follows: agriculture (24.1 percent), industry (25.0 percent) and services (50.9 percent).
[2] Foreign exchange reserves for FY99 and FY00 include FE-13 deposits with SBP, whereas for FY01 and FY02, these includes CRR/SLR on FE-25 deposits.
[3] Explicit liabilities include Special US Dollar bonds, FEBCs, FCBCs and DBCs.

Focusing on the external account improvement, there were clearly some one-off inflows into the current account in FY02 that are unlikely to recur in future. The US$ 600 million grant from the US, the payments for logistics support provided to the US troops, and other bilateral grants, fall under this category and should be excluded in determining the trend of current account inflows.

Remittances more than doubled in FY02 to reach US$ 2.39 billion; the rise post-September 2001 has been attributed, at least in part, (1) to a reversal of capital flight, as Pakistani balances held abroad came under greater scrutiny internationally by host countries,[2] and then increasingly (2) to the waning attraction of foreign exchange holdings due to an appreciating Rupee. However, the sheer scale and persistence of the improvement suggests that a welcome and more permanent change is emerging, driven by a shift in preferences of remitters away from the informal sector due to increased

[2] It is worth noting that despite the higher remittances, the inflows into the kerb market also *accelerated*. At times, kerb market rate actually dipped *below* the interbank market rate, opening an arbitrage opportunity that closed only when local banks imposed higher cash handling charges.

international scrutiny of informal fund flows, and the collapse of the kerb market premium. These higher inflows offered the SBP a rare opportunity to substantially boost its foreign exchange reserves without an adverse impact on the exchange rate. Indeed, the purchases allowed the Rupee to stabilize around the Rs 60/US$ mark, offering some respite to exporters that had been hit by a disruption in orders due to perceptions of increased regional risk as well as by the already substantial year-to-date gains of the Rupee. Such support was deemed essential since unfettered market forces could have strengthened the Rupee abruptly, leading to a disastrous loss of export market share, even if the improvement in the current account proved temporary. In short, while FY01 SBP foreign exchange net purchases were to *support* the Rupee,[3] the FY02 buying was essentially to *prevent* it from strengthening too sharply.

A look at the external cash flows (see **Table 1.2**) depicts more insights on the external account improvement:

(1) While headline figures depict a narrowing of the trade deficit to US$ 1.2 billion in FY02 the *realized* outcome was even better, with a deficit of US$ 360 million only.

(2) The role of exceptional financing is declining. In FY02 a notional inflow of US$ 1.7 billion on account of the Paris Club re-scheduling, was largely offset by maturities of earlier re-scheduled payments (of frozen FE-45 foreign exchange deposits, etc.). This is a positive development for Pakistan, reflecting that rescheduled loans and higher foreign currency inflows, allowed the termination of more expensive commercial liabilities (see **Table 1.3**).

Table 1.2: External Cash Flow Position

million US Dollar

	FY00	FY01	FY02
Reserves at the beginning of the year	**1,740**	**1,358**	**2,084**
Inflows	**16,845**	**19,918**	**22,107**
of which			
Exports	8,190	8,933	9,133
Services	1,501	1,466	2,027
Remittances	983	1,087	2,389
Kerb purchases	1,634	2,157	1,376
Foreign investment	546	146	478
Official grants	940	844	1,473
Loan disbursements	1,588	2,813	3,021
Exceptional financing	3,965	692	135
Outflows	**17,227**	**19,192**	**19,386**
of which			
Imports	9,598	10,202	9,493
Services	2,766	3,142	2,620
(interest payments)	*1,596*	*1,548*	*1,464*
Amortization	1,828	1,777	1,299
Repayment of liabilities	652	2,001	3,637
Reserves at the end of the year	**1,358**	**2,084**	**4,805**

The striking improvement in the current account, and the massive Rupee liquidity injections resulting from the SBP foreign exchange purchases, also had important implications for the conduct of monetary policy. It may be recalled that a major factor behind the monetary tightening in FY01 was the need to support the Rupee. Thus, as the exchange rate stabilized, the SBP immediately signaled an easing by twice lowering the discount rate in successive months.[4] The subsequent two, post-September, reductions however were aimed *more* at mitigating the impact of the prevailing uncertainties in the business environment.[5]

The increase in Rupee liquidity fueled the exceptional 14.8 percent growth in M2. This allowed a substantial expansion of banks' deposit base, but (1) net private sector credit demand did not grow correspondingly, (2) the funding requirement of the government from scheduled banks fell due to higher availability of non-bank finance in FY02, and (3) banks' demonstrated an apparent preference for less risky assets. This allowed the government to substitute its accumulated borrowings from the

[3] In FY01, the SBP foreign exchange purchases (kerb and interbank) were being injected into the interbank market to lower volatility and meet lumpy payments. The SBP was a net seller in the interbank market, in FY01.
[4] In July 2001 and August 2001.
[5] Exporters were the most immediate beneficiaries. The export re-finance (EFS) rate was benchmarked to 6-month T-bill yields, which closely tracked changes in the discount rate.

SBP with higher net borrowings from scheduled banks without putting upward pressure on interest rates. Consequently, reserve money growth was contained to just 9.6 percent, as injections through SBP foreign exchange purchases were *sterilized* by a net retirement of SBP's government security holdings, thus avoiding an excessive rise in inflationary pressures.

Pakistan's debt profile also saw significant changes in FY02 reflecting the country's adherence to the Debt Reduction and Management Strategy (DRMS), as well as a one-off Rs 193 billion stock adjustment of the domestic debt. While the absolute decline in external debt and liabilities (EDL) was a marginal US$ 607 million, the re-profiling of Paris Club debt and the substitution of expensive commercial loans by cheaper IFI credits led to a significant drop in the net present value of outstanding EDL.[6] Similarly, the domestic debt profile too saw a shift to longer tenors amidst a fall in interest rates. This said, it must be stressed that the changes, though welcome, only depict an improvement in the *dynamics* of Pakistan's debt profile; the country has still a long arduous road to travel before the debt ratios go down to international norms.

Table 1.3: Commercial, Short-term and Foreign Exchange Liabilities Paid in FY02

millions US Dollar

Commercial and short-term external debt	**2,272**
Commercial loans/credits	1,283
IDB	403
Private loans/credits	586
Foreign exchange liabilities	**2,044**
FE-45	569
FE-31 deposits (incremental)	204
Special US dollar bonds	470
National debt retirement program	62
Foreign currency bonds (NHA)	22
NBP/BOC deposits	249
Swaps	441
FEBCs/FCBCs/DBCs (payable in Rupees)	27
Total	**4,316**

1.2 Medium-term Prospects

A significant upturn in economic performance began in the final months of the FY02, and was manifested by higher exports, accelerated workers' remittances, improved water availability, and increased capacity utilization in some key industries. This upsurge has altered the prospects for FY03. In particular, the recovery by textiles on the back of increased access to key markets January 2002 onwards, seems likely to continue into FY03, aided by sharply lower cost of funds (the favorable perceptions on the sector are reflected in the continuing high imports of textile machinery). Similarly, the considerable improvement in water availability in the last few months gives rise to hopes of a substantial recovery in agriculture, with positive knock-on effects on the services sector as well.

With prospects of a broad economic recovery looking bright, it becomes even more important that the FY02 improvements in the macroeconomic fundamentals not be frittered away. The key policy challenge for the government in FY03 therefore is to stay the course by remaining fully committed in implementing the on-going reform process, irrespective of gains such as the higher availability of external assistance, debt re-profiling, etc.

In particular, it is important to note the *possibility* (however modest) that the external account improvements could taper off in future; if this development emerges, it could have significant negative repercussions, not least the re-emergence of devaluation expectations and a jump in domestic interest rates. These concerns are particularly colored by the realization that domestic policy only set the enabling environment that allowed the economy to take better advantage of the positive exogenous shocks. It must be remembered that the catalyst (and, at least in part, continuing driver)

[6] This performance is even more impressive given that FY01 had also seen a large decline in EDL.

for the rise in transfer payments into Pakistan was the policies of other countries, especially the international crackdown on informal flows that drove up remittances.

In fact, it is this concern that has led the SBP to opt for a gradual adjustment of its monetary and exchange rate policies despite a substantial improvement in the current account. It must also be noted that an abrupt shift in the exchange rate is not to be desired in any case, as an inadequate adjustment period for exporters could lead to the loss of hard-to-recapture export markets, and a consequent fall in economic activity and higher unemployment. Thus, the gradual adjustment policy is likely to continue. Also, despite a hardening consensus that the increase in foreign exchange inflows is probably sustainable, the SBP intends to guard against the possible re-emergence of the kerb market, by largely subsuming it into the mainstream financial system through the newly introduced exchange companies.

The outlook for inflation does not show any signs of concern despite the growth of monetary aggregates (M2) by 14.8 percent during FY02, well above the nominal growth rate. Most of the growth in M2 originated from the continuing rise in NFA and was substantially sterilized. Consequently, the reserve money growth was contained to 9.6 percent. The large FY02 increase was not too inappropriate in light of the need to support the economy during a period of considerable uncertainty. But, going forward, it will be prudent to limit reserve money growth consistent with the nominal growth rate of the economy, since excessive growth could fuel inflationary pressures. Within this constraint, however, the loose monetary posture could be extended further.

On the fiscal side, the government should see higher net tax receipts due to the impact of the recently introduced Self Assessment Scheme, lower tax refunds, an absence of a further cut in the maximum customs duty rate, and a return to normal imports in FY03. Non-tax revenues too, should see greater stability going forward, as the re-structuring of government-controlled entities (especially WAPDA) should allow them to service their debt.

Over the last few years, revenue shortfalls (by the CBR, in particular) have traditionally resulted in a curtailment of development expenditures. In FY03, however, the government has vowed to substantially increase developmental expenditures, and to insulate this spending from below-target revenues by, (1) incremental revenue measures and (2) reductions in non-development spending. It must be noted that higher development expenditures not only increase immediate aggregate demand, but also have substantial "crowding-in" effects on private investment. For far too long, the low development spending has effectively led to a deterioration of infrastructure, reducing the economy's growth capacity (lowering future government revenues). Thus, in essence, meeting the fiscal deficit targets through low development spending was equivalent to shifting the fiscal deficit to future generations. It is therefore essential that the government's promise be kept.

It is worth noting that the positive developments in the country's economy do not appear to be fully reflected in Pakistan's current sovereign rating, possibly due to the impact of political uncertainties (general elections are scheduled for October 2002). The continuation of current economic polices (as promised by the President) would thus be expected to result in an upward re-rating, attracting greater investments.

In short, if the global economy does not see a major dip, Pakistan appears well placed to meet its economic targets in FY03. In fact, the FY02 developments provide a rare opportunity for Pakistan to accelerate the improvement in the country's economic fundamentals.

1.3 Executive Summary

Economic Growth, Savings & Investment

Water shortages constrained the growth of the agriculture sector for the second year running. As a result, despite improved management and increased use of tube wells to alleviate the shortages, the major crops saw a marginal decline. However, the impact of the dismal performance of the crops was greatly moderated by the positive momentum of another encouraging performance by the livestock sub-sector. This enabled agriculture to record a positive growth of 1.4 percent for FY02.

The weak performance of the manufacturing sector, especially large-scale manufacturing (LSM) was the major factor behind slower growth in industrial value added. LSM grew by only 4 percent in FY02, much lower than the 8.6 percent growth recorded in FY01; however, this was still commendable given that the business environment through most of FY02 remained uncertain. The performance of the remaining three sub-sectors i.e. mining & quarrying, construction, and electricity & gas distribution, remained subdued.

During FY02, the services sector grew by 5.1 percent, higher than the 4.8 percent seen in FY01. The emergence of the services sector has imparted resilience to the economy, particularly at times when the commodity-producing sector is struggling.

In overall terms, while the 3.6 percent FY02 growth of the economy was reasonably good, it was narrowly based on a few sub-sectors.

With regard to investment, provisional estimates for the FY02 suggest that the pace of investment has not picked up, and the declining trend witnessed over the last decade persists. This is reflected in the 5.9 percent decline in (nominal) gross fixed investment in FY02 against an increase of 7.9 percent last year. As a ratio to GNP, it declined to 12.2 percent from 14.5 percent last year. Although, overall investment fell short of the target, the growth in foreign direct investment is encouraging – it increased to US $ 484.7 million compared to US $ 322.4 million in FY01.

While the share of both the public and the private sector declined, the deceleration in the investment by the public sector was more pronounced. This is reflective of government's budgetary constraints and the increasing emphasis on the role of the private sector. As a result, the share of the private investment in total investment reached 61.5 percent in FY02.

Prices

Annual average rates of inflation in terms of all three price indices as well as the GDP deflator went down during FY02 from their levels last year.[7] The rate of inflation in terms of the Consumer Price Index (CPI) came down to 3.5 percent in FY02 from 4.4 percent in the previous year despite the uncertainties following the September 11 events, continued border tensions and persistent drought-like situation in the country. Better availability of essential commodities due to a reasonable production of both food and non-food items, and availability of stocks from previous years had a moderating influence on inflation. The appreciation of the Rupee by 6.7 percent also helped, by reducing the cost of imports.

As the SBP was able to substantially limit the growth of reserve money, it is hoped that inflationary pressures will be contained.

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[7] Annual average rate is defined as percent change of average 12-monthly indices for FY02, over the corresponding average for FY01.

Public Finance and Fiscal Policy

In FY02, overall budget deficit swelled to 6.6 percent of GDP, significantly higher than both the budget target as well as that in the previous year. This was largely driven by increased defense spending (Rs 17.4 billion), and three one-off expenditures – a grant to CBR to clear accumulated income tax refunds (Rs 22 billion), a substantial investment in KESC to prepare it for privatization (Rs 30 billion) and a settlement of WAPDA arrears (Rs 5 billion). These FY02-specific expenditures not only pushed up the overall budget deficit, but also masked the benefits of lower interest payments realized on account of (1) rescheduling and re-profiling of external debt, and (2) low interest rates on domestic debt instruments. Adjusted for the FY02-specific spending, the "baseline" budget deficit was lower than the FY02 target.

Although total revenues posted a reasonable growth on the back of a large rise in non-tax revenues, overall tax collections were well below the FY02 target. The poor tax collections were largely attributed to a decline in imports, an appreciation of the Rupee against US Dollar, unusually high tax refunds, and a decreasing trend in domestic inflation during FY02.

Money & Credit

The easing of monetary policy in FY02 had its roots in the macroeconomic discipline achieved in FY01 and was initiated well before the post September developments took over. The monetary easing not only brought down the benchmark 6-month T-bill rates to an all-time low but also led to a 1.9 percent drop in the weighted average lending rates.

The increased external inflows, improved liquidity in the market due to SBP interbank purchases, and lower net credit requirement by the private sector brought about a change in the behavior of both, banks and the government. While banks were anxious to lock-in their funds in government paper, anticipating further interest rate cuts, the government used this opportunity to retire its more inflationary debt from SBP and borrowed afresh from scheduled banks. This had two implications: (1) it helped the SBP achieve limits on its NDA targets; and (2) it effectively sterilized the effect of SBP market purchases of foreign exchange. Also, while the actual government borrowings for budgetary support stood at Rs 12.5 billion for FY02, when adjusted for the waiver given by IMF for the KESC re-capitalization and tax refunds to the banks, the borrowings are well within targets.

Higher retirements, write-offs & deletions, and availability of fund from other sources, kept the net credit to private sector figure deceptively low (gross disbursements figures in FY02, remained higher than FY01, almost throughout the year). In overall terms lower interest rates, higher refunds and better availability of internal financing, and improved access to export markets greatly mitigated the adverse impacts of the uncertain business environment during FY02.

The overall impact of monetary easing and build-up of foreign exchange reserves resulted in an exceptional growth of 14.8 percent in monetary assets, which is the highest in the last five years.

Money Market

During FY02, the money market saw a relative improvement in liquidity as reflected in a decline in the volume and frequency of banks' use of the SBP discount window. This was, in part, a result of the SBP's pro-active liquidity management.

On the other hand, as interest rates declined due to the SBP monetary easing, and deposits began rising very strongly (with a relatively lower increase in private sector demand), banks increasingly preferred to invest in government securities to lock-in assets at higher rates.

The change in the monetary stance is reflected well in the downward shifting yield curves. However, the shape of the yield curves has become steeper, depicting a relatively lower decline in returns at the longer end of the curve.

Capital Markets

During FY02, capital market exhibited better performance compared to the previous year. Although the country underwent various economic and non-economic shocks, both the equity and fixed income securities markets remained buoyant.

The benchmark KSE-100 index gained 29.5 percent, in sharp contrast to a 10.1 percent fall during the previous year. The market gained resilience from the overall betterment in economic fundamentals, a consequent improvement in corporate profitability prospects, and the financial market liquidity prevalent in the economy. Similarly the fixed income market kept the momentum generated during the previous year on the back of reforms in National Saving Schemes and the easy monetary policy of the SBP. As a result, 17 new TFC issues were launched during the FY02 as compared to 10 during the preceding year.

Banking

The main developments in the banking sector in FY02 were the remarkable growth in deposits and the substantial increase in lending of foreign currency. Both developments largely owe to the improvements in Pakistan's external account in the aftermath of 9/11. The double-digit growth of 14.0 percent in deposits would have been even higher, had FCAs not declined by 13.7 percent.[8] The phenomenal surge in the former was on the back of Rupee injections by SBP against foreign exchange purchases and higher remittance through banking channels. The fall in the latter reflects the decreasing attractiveness of foreign exchange holdings as the Rupee appreciated.

Besides the apparently subdued growth in credit, an important development in FY02 was the US$ 338.1 million (Rs 20.1 billion) surge in foreign currency loans. Although the banks were allowed to give credit in foreign currency (for trade related activities) since the introduction of FE-25 deposits in June 1998, it was only in FY02 that banks extended large volumes of foreign currency loans. Borrowing in dollars has become increasingly attractive in view of the lower rates (which range between 2 to 5 percent) and future expectations of a stable Rupee.

Unlike FY01, lending rates declined, especially in H2 FY02. This was in line with the easing of monetary policy. A lower fall in the weighted average deposit rates resulted in a narrowing of the banking spread by 111 basis point. It is important to note that foreign currency loans are not included while computing the weighted average lending rates. Incorporating these, it is evident that weighted average lending rates, and the banking spread, would have fallen further by *at least* 25 basis points.

Performance indicators (based on annual audited balance sheets) in CY01 showed a mixed picture when compared with CY00. Efforts made to improve banks' assets quality started showing progress. The pace of NPLs from fresh lending has slowed down and together with increased emphasis on recoveries, has put a break on the growth of bad loans. In addition, to account for the historically bad portfolio (most of it in lost category) of public sector banks, the need for appropriate provisioning has been emphasized.

[8] In Dollar denomination, decline in FCAs was 5.8 percent; the difference could be explained by appreciation of Pak Rupee during FY02.

Balance of Payments & Exchange Rate

Although, the current account has been steadily improving over the last three years amid higher kerb purchases, FY02 surplus of US$ 2.7 billion is the first that is *broad-based* – all the sub-categories contributed to the out-turn.

The trade deficit narrowed mainly due to falling imports on the back of lower fuel and food imports. Also, while exports did decline in FY02, a portion of the fall is attributable to lower unit prices for Pakistani exports. The improvement in the services account reflects the receipts against logistics support for international forces in Afghanistan as well as the savings following the re-profiling of external debt. However, the most valuable improvement seems to be the sharp increase in workers remittances; FY02 receipts were more than twice the FY01 collections.

Despite lower SBP purchases from the kerb market and lesser inflows realized in resident FCAs, the current transfers registered a phenomenal growth during the current fiscal year. In this regard, the major contribution came from the workers' remittances, which registered an extraordinary growth of 129 percent (on a cash basis) during FY02. In fact, an international crackdown on *hundi* networks changed the dynamics of current transfers, as incentives to use the informal channels largely disappeared.

In terms of the capital account, the completion of the IMF Stand-By Arrangement not only paved the way for successful negotiations for a medium-term PRGF but also led to a higher non-food aid from the World Bank and ADB, as well as a generous re-profiling of Paris Club debt.

FY02 was also an unusual year for the foreign exchange market. The global crackdown on hundi networks led to: (1) the collapse of the kerb premium, (2) an end to market expectations for devaluation; and (3) a U-turn in the *direction* of exchange rate management of SBP. All of these developments provided grounds for liberalizing the foreign exchange market, particularly the removal of segmentation between the interbank and the kerb markets, which has been one of the key structural problems in Pakistan's external sector.

The pressures on the kerb market not only outweighed the traditional downward stickiness of the kerb rate, but also reversed the traditional market expectations for devaluation of the Rupee. In terms of exchange rate management, SBP *net* purchases from the interbank market showed a dramatic shift from *negative* US$ 1,126 million to *positive* US$ 2,483 million.

The higher purchases in FY02 were aimed at providing support to exporters who had already suffered on account of an appreciating Rupee, loss of export orders and imposition of a risk premium. In overall terms, the Rupee strengthened by 6.7 percent against the US Dollar in the interbank market during FY02.

Although at the start of the fiscal year reserves already stood at US$ 3 billion, post-September 11 developments accelerated reserve accumulation, taking Pakistan's foreign exchange reserves to US$ 6.4 billion by the end of FY02. This surge in reserves was mainly shaped by lumpy inflows from International Financial Institutions (IFIs) and SBP purchases. The build-up of reserves allowed SBP to settle expensive and short-term liabilities, which will improve the creditworthiness of the country.

Domestic and External Debt

There is a distinct improvement in Pakistan's total debt profile during FY02. Specifically, the total debt burden declined from Rs 3,866 billion to Rs 3,761 billion and debt to GDP ratio improved to 102 percent. This note worthy achievement mainly shows Pakistan's adherence to the Debt Management and Reduction Strategy (DMRS) formulated in March 2001.

On the external front, the successful completion of IMF Stand-By Arrangement (SBA) restored Pakistan's credibility with International Financial Institutions (IFIs) and reaffirmed the government's commitment to reforms. This in turn paved the way for successful negotiations for a medium-term IMF assistance program (PRGF) as well as increased aid from other IFIs. Moreover, Pakistan also obtained a *stock* re-profiling of bilateral debt from Paris Club creditors on very generous terms, which will result in an implied reduction in the net present value of EDL of between 28 to 44 percent, depending on the interest rate negotiations with individual creditors.

Pakistan also retired commercial debt by US$ 0.9 billion and at the same time contracted soft loans from IFIs, which improved the term structure of external debt. Furthermore, the stock of external liabilities declined significantly by US$ 1.9 billion during the course of the current fiscal year. This decline is mainly driven by the hard currency payments of FCAs (FE-45 and FE-31) and retirement of Special US Dollar bonds, NBP deposits placed with SBP and swaps.

As far as domestic debt is concerned, it also reflects similar improvement. A one-time adjustment in floating debt substantially reduced the stock of short-term debt (reducing the stream of future interest payments). Additionally, the increased long-term borrowings through PIBs and NSS instruments also facilitated the lengthening of the maturity profile. The appreciation of the Rupee also eliminated the upward pressure on interest rates considerably, which led to a sharp reduction in the cost of domestic debt.