1 An Overview and Executive Summary

1.1 Overview

A strong surge in aggregate demand, sustained external account improvement, the resilience endowed by sound macroeconomic foundations, and good fortune, contributed to a broad-based acceleration in Pakistan's economy during FY03, raising real GDP growth to 5.1 percent. This moved the country closer to achieving the target long-term growth trajectory of 6 percent (or higher) by FY06, and led to substantial improvements in most economic indictors. In fact, a distinguishing characteristic of the FY03 performance, relative to that of FY02, is the scale and depth of the improvement. Harvests of key crops improved significantly, industrial growth rose to a 7-year high; exports increased to a record US$ 11.1 billion, and the current account surplus jumped to an all-time high of US$ 4 billion (5.9 percent of GDP); remittances also accelerated to a new high of US$ 4.2 billion, underpinning a substantial improvement in national savings as well as supporting the increase in the SBP forex reserves to a record US$ 10 billion; FDI flows, too increased defying the global downtrend; inflation remained subdued, dipping to record lows. Additionally, the achievement of the tax collection target that, together with disciplined spending, pushed the fiscal deficit to a 27-year low. The confluence of low government borrowings and adroit management of external inflows by the SBP also pushed interest rates to historic lows while supporting exports through the relative stability of the exchange rate (see **Table 1.1**).

The resurgence in agricultural growth to 4.1 percent compared to a negative growth of 0.1 percent in FY02 was arguably one of the more important components of the FY03 performance, given its strong downstream impact on the rest of the economy, its impact on rural poverty and contribution to employment. The rare combination of increased productivity of major crops together with increases in prices of many agri-products was a particularly welcome development.[1] Also, the FY03 aggregate sectoral growth incorporates strong contributions by both crops and livestock, in sharp contrast to FY02, when the crop sub-sector had witnessed a decline.

The agri-sector recovery was complemented by the continuation (and acceleration) of the H2-FY02 large scale manufacturing (LSM) growth momentum into FY03. Export-led demand, in particular, continued to rise, reflecting the improved access to key foreign markets as well as the supportive stance of the SBP in holding down the appreciation of the rupee while simultaneously pushing down interest rates to historical lows. The latter development also accelerated the rise in consumer lending that, in turn, further deepened and broadened the LSM output growth. As a result LSM growth during FY03 rose to a very impressive 8.7 percent as compared to a 4.9 percent growth recorded in FY02. The services sector too witnessed a reasonably strong growth, particularly in *transport & communication*, which has the strongest linkages with the commodity producing sector.

Thus, the 5.1 percent GDP growth recorded in FY03 incorporates strong contributions from all three major sectors of the economy. This not only represents an increase in the growth *rate* compared to FY02, but also shows a visible improvement in the *quality* of the recovery.

[1] It is important to remember however, that the FY03 improvement in agriculture was essentially driven by the fortuitous availability of water due to timely rains; this continued vulnerability to the vagaries of nature strongly underlines the need for heavy investments in improving water storage and management.

Table 1.1: Selected Macroeconomic Indicators

	FY99	FY00	FY01	FY02	FY03		FY04
				Actual R	Target	Actual P	Targets
				Growth rates			
Real GDP (FC) [1]	4.2	3.9	2.2	3.4	4.5	5.1	5.3
Agriculture	1.9	6.1	-2.7	-0.1	2.5	4.1	4.2
Major crops	0.0	15.4	-10.6	-1.8	0.3	5.8	5.5
Manufacturing	4.1	1.5	8.2	5.0	5.8	7.7	7.8
Large scale	3.6	0.0	9.5	4.9	6.0	8.7	8.8
Services sector	5.0	4.2	4.7	4.1	5.0	5.3	5.0
Consumer price index (FY01=100)	5.7	3.6	4.4	3.5	4.0	3.1	3.9
Sensitive price indicator (FY01=100)	6.4	1.8	4.8	3.4	-	3.5	-
Monetary assets (M2)	6.2	9.4	9.0	15.4	16.0	18.0	11.0
Domestic credit	3.5	9.0	3.7	1.9	2.9	0.6	
Exports (f.o.b.)	-9.8	10.1	7.4	-0.7	13.4	22.2	9.7
Imports (c.i..f.)	-6.8	9.3	4.1	-3.6	7.4	17.8	5.0
Official liquid FE reserves [2] (million US$)	1,729.7	1,352.3	2,075.8	4,804.9	-	9,993.0	-
				As percent of GDP			
Total investments	15.6	16.0	15.7	14.7	15.0	15.5	16.8
National savings	11.7	14.1	14.7	17.0	13.8	19.4	16.8
Tax revenue	13.3	12.9	12.9	13.2	13.6	13.7	-
Total revenue	15.9	16.3	16.2	17.2	17.2	17.7	
Budgetary expenditure	22.0	22.5	21.0	22.8	21.3	22.1	
Budgetary deficit	6.1	6.6	5.2	5.2	4.6	4.4	4.0
Current account balance (including official transfers)	-3.8	-0.3	0.6	4.8	-	5.9	
Domestic debt	47.4	50.2	50.6	47.3	-	46.1	-
External debt	54.9	53.5	60.2	55.3	-	48.0	-
Explicit liabilities [3]	2.4	2.4	2.7	1.6		1.0	
Total debt (including explicit liabilities)	104.7	106.0	113.5	104.3	-	95.1	-

P: Provisional

[1] During FY03, sectoral shares in GDP were as follows: agriculture (23.6 percent), industry (25.6 percent) and services (50.7 percent).

[2] Foreign exchange reserves for FY99 and FY00 include FE-13 deposits with SBP, whereas for FY01 to FY03, these include CRR/SLR on FE-25 deposits.

[3] Explicit liabilities include Special US Dollars Bonds, FEBCs, FCBCs and DBCs.

Another key pillar of the FY03 performance with significant positive, direct and indirect ramifications for the broader economy, were the external sector surpluses, which moved from strength to strength. Firstly, the current account surplus was substantially higher than in FY02. Moreover this improvement was *supported* by a small capital account surplus (the relatively lower FY02 current surplus had been further *undermined* by a large capital account deficit).

The structure of the improvement in the current account surplus also marks a striking difference from FY02, incorporating a reduction in the trade deficit (based on customs record), a lower services account deficit as well as a sharp rise in current transfers. The first stemmed from an exceptional export growth that comfortably outstripped the strong import growth; the second was essentially from two factors: (1) a decline in interest payments, reflecting the on-going focus on retirement of expensive debt and liabilities; and (2) the payments for logistics support to international forces. Finally, the increase in the current transfers largely emerges from a substantial increase in remittances flows.

The crucial point here is that a major part of the FY03 improvement in the current account surplus is derived from structural elements. In fact, even if the potentially non-repeating flows such as the Saudi Oil Facility, the logistics support payments and official grants are deducted, the FY03 current account remains substantially in surplus,[2] in contrast to the picture in the preceding years. This development is the first visible evidence that the improvement in the external account since FY01, may be a permanent feature of Pakistan's economy. If true, this would mark a seismic shift in the management of the domestic economy, since it was the persistent external account deficits, particularly through the 1990s, that had contributed to onerous demand management policies.

One concern that has emerged in recent months has been a modest decline in remittance flows during the initial months of FY04. While certainly unwelcome, the decline in remittances is by no means unexpected; the target for remittances announced in the budget for FY04 was US$ 3.6 billion and the flows during the first three months clearly correspond to this target. A key plank of the SBP's conservative stance, curtailing the appreciation of the rupee, has been the concern over the sustainability of these flows. Importantly, SBP projections indicate that, barring shocks, even if the rather conservative assumptions of a large fall in remittances are realized, the current account would still record a sizable surplus.

Table 1.2: External Cash Flow Position
million US Dollars

	FY01	FY02	FY03
Reserves at the beginning of the year	**2,163**	**3,244**	**6,398**
Inflows	**20,020**	**22,228**	**25,327**
of which			
Exports	8,933	9,140	10,889
Services	1,367	1,929	2,801
Remittances	1,087	2,390	4,237
Kerb purchases	2,157	1,376	0
Foreign investment	146	478	798
Official grants	844	1,500	1,014
Loan disbursements	2,740	2,910	2,392
Exceptional financing	692	138	620
Outflows	**18,939**	**19,074**	**20,058**
of which			
Imports	10,202	9,434	11,425
Services	2,332	2,214	2,733
Interest payments	1,369	1,111	974
Profit and dividends	301	457	631
Purchase of crude oil	312	394	473
Amortization	1,714	1,551	1,874
Repayment of liabilities	1,940	3,590	1,192
Reserves at the end of the year*	**3,244**	**6,398**	**11,667**

* Reserves comprise SBP forex reserves (US$ 9.5 billion), reserves with banks (US$ 1.2 billion) and sinking fund (US$ 0.9 billion) (for extinguishing central banks deposits placed with SBP or prepayments of other expensive loans).

A significant by-product of the SBP's efforts to stabilize the rupee in the face of rising current account surpluses, has been the sharp increase in the country's foreign currency reserves; in fact, the structure of the rise in Pakistan forex reserves shows that these non-debt creating flows were the principal contributors to the aggregate increase in Pakistan's forex reserves during FY03. While debt flows also helped contributed to the FY03 growth in forex reserves, these were on quite concessional terms. This increase in the forex reserves through either non-debt creating inflows is extremely positive, leaving Pakistan well placed to further lower its debt burden, especially through the early-repayment of expensive external debt and liabilities (see **Table 1.2**).

The other significant impact of the SBP purchases was on monetary policy. In contrast to the FY02 position, when the SBP essentially mopped up the rupee liquidity resulting from its forex market interventions, FY03 saw a very deliberate reduction in these sterilization operations, despite a sharper rise in the forex purchases. The resulting liquidity flooding the banking system raised competitive pressures and led directly to a massive fall in lending rates. This policy shift by the SBP in FY03 was engendered by the experience of the preceding year, when the fall in lending rates had been much lower than the reduction in discount rate by the SBP. The success of the new policy stance is clearly evident in the massive 454 basis point reduction in the weighted average lending rates in FY03, compared to the more gradual 185 basis point decline in FY02.

[2] Interestingly, this holds true even after the exclusion of an additional US$ 600 million, representing the increase in FY03 remittances that is above historic trends.

The net growth in monetary assets was a very substantial 18.0 percent in FY03, up sharply from the 15.4 percent increase in FY02. More importantly, as a result of the lower sterilization of larger purchases, reserve money growth rose from 9.6 percent in FY02 to a far more robust 14.5 percent in FY03. However, despite this exceptional rise in monetary aggregates, inflationary pressure remained subdued through FY03. While this was in fact a key comfort point for the SBP in pursuing the expansionary monetary stance, it must also be recognized that such increases are unlikely to be sustained in the months ahead, unless forced by an unwarranted jump in interest rates.

Inflationary pressures further subdued during FY03 mainly due to: (1) stable food prices, and (2) imported deflation (due to both appreciating rupee and lower international commodity prices). Interestingly, despite the apparent weakness in firm's pricing ability, corporate profitability appears to have improved in FY03, probably reflecting the rise in aggregate demand (raising sales volumes), as well as lower interest rates and stronger rupee (both positively affecting margins).

Another very positive development during FY03 was the substantial increase in tax revenues, which rose by 16.2 percent, in contrast to the 8.3 percent increase in FY02. This is impressive given the fall in the tariff rate, the appreciation of the rupee (which lowers the base for ad-valorem taxes) and low inflation (resulting in loss of *seigniorage* revenues). The rise in the GST receipts, in particular, suggests a welcome increase in domestic demand as well as a broadening of the tax base. This improvement in revenues, coupled with disciplined spending, saw the fiscal deficit fall to 4.4 percent of GDP – the first time it has fallen below 5 percent of GDP in over 25 years. In fact, the only blemish in the FY03 fiscal performance is the surprising (and unfortunate) shortfall in development expenditures, despite the available fiscal space.[3]

The fiscal improvements, increased rupee market liquidity, increased non-debt creating external flows, and the Paris Club debt restructuring and a US$ 1 billion debt write-off, also catalyzed significant improvements in Pakistan's debt profile. In particular, the retirement of a substantial portion of the country's liabilities (see **Table 1.3**) and the substitution of expensive debt with soft loans from IFIs, has resulted in a significant permanent reduction in debt servicing costs, as well as reducing the vulnerability of the economy to negative external shocks, compounding the gains from the 32 percent reduction in the NPV of Paris Club debt.

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

millions US Dollars

	FY02	FY03
Commercial and short-term external debt	**2,216**	**828**
Commercial loans/credits	1,283	84
IDB	403	183
Private loans/credits	530	561
Foreign exchange liabilities	**2,025**	**1,090**
FE-45	541	235
FE-31 deposits (incremental)	200	171
Special US dollar bonds	470	284
National debt retirement program	75	69
Foreign currency bonds (NHA)	22	22
NBP/BOC, Central bank deposits	249	50
Swaps	441	235
Total	**4,214**	**1,894**
FEBCs /FCBCs /DBCs (payable in rupees)	27	24

In contrast to the reduction in external debt, domestic debt stocks increased during FY03. But here too, the average cost of the debt stock declined due to a steep reduction in interest rates.

Despite the impressive improvement in the macroeconomic fundamentals, a strong and secure external sector, increased development spending by the government, upsurge in growth rate, easy monetary policy and quantum jump in private sector credit, the popular perception about the economy amongst the media and commentators does not reflect the improvements. It is true that the

[3] Before October 2002 elections, Election Commissioner restricted the spending under development expenditures that probably led to this shortfall.

incidence of poverty in the country has risen from almost 20 percent to 33 percent, but this has happened over last 15 years and is not a result of the policies pursued in the last four years. The reversal of this trend cannot take place until economic growth is put back on the trajectory of a sustained rate of 6 percent over the next 5 years and pro-poor policy interventions are faithfully implemented; the current rate of growth can only arrest a further rise in the poverty incidence. It is therefore important for the country to have realistic expectations rather than to hang on to false pretensions or indulge in fanciful speculations. Given the carryover of the past legacy, current geopolitical and security situation, non-supportive external economic environment, and weak institutional capacity, it will simply be a pipedream to expect an accelerated fall in the incidence of poverty in Pakistan in the short term.

The biggest challenge facing the economic managers in the short term is to create as many jobs as possible. The policy focus therefore should shift to:

1) *Increased government spending on human resource developments and infrastructure.*
   A large population is Pakistan's biggest economic resource, but it will be a source of strength only if properly developed through extensive investment in education and health. An analysis of various socioeconomic dimensions of poverty suggests that Pakistan's performance has been dismal during the 1990s. Not only the income poverty but also the income inequality increased during the period. While recovery in GDP growth rate in FY03 on the back of robust performance of agricultural, manufacturing and services sectors predicts good prospect for poverty reduction, the increased fiscal space due to restructuring of external debt should be utilized for increasing the pro-poor budgetary expenditure to reverse the rising trends in poverty and inequality among the households. Poverty will not be eradicated unless the root causes of poverty, such as deprivation in human capital, are addressed adequately. Similarly, the government's ability to crowd-in private investment, which is essential to the economy's long-term growth, will depend greatly on its expenditures to improve infrastructure.

2) *Greater investment by the private sector.*
   It is quite unfair to look only to the government for the investment needs of the country. Given the substantial improvement in governance, policy stability and correction of macroeconomic imbalances, the continued weak (albeit improving) private investment growth is still a matter of concern. It must be noted that even the hoped-for improvement in foreign investment is unlikely to emerge unless encouraged by a robust increase in domestic private investment. The most promising sectors for job creation by private sector are construction and housing, small and medium enterprises, and rural development (both in agriculture and non-agricultural activities). Government's policies – fiscal and monetary – should remain supportive, but institutional capacity and bureaucratic hassles forced on private entrepreneurs should be addressed.

1.2 Executive Summary

Economic Growth, Savings and Investment

During FY03, the agriculture sector posted an impressive recovery, on the back of improved water availability, which raised the sectoral growth to 4.1 percent compared to a 0.1 percent decline in FY02. The better harvest resulted mainly from productivity gain as evident in the 4.2 percent increase in the value addition by major crops even with a 1.1 percent decline in area under cultivation.

Growth in the livestock sub-sector, however, was actually subdued, rising by only 2.9 percent compared to 3.7 percent in the preceding year. However, this weakness was largely compensated by the strong growth posted by the fishery and forestry, which grew by 16.6 percent and 8.8 percent respectively during FY03 against the negative growth of 12.0 percent and 1.3 percent respectively in FY02.

In addition to improved yields, better return to the farmers on account of higher prices of most of the crops was another prominent feature for agriculture during FY03. This rise in farm income while enabling farmers to increase consumption expenditure, also encouraged them to spend more on crop related inputs thus further improving the crops outlook for FY04.

Supported by the exceptional performance of large scale manufacturing (LSM), industrial sector growth during FY03 comfortably reached 5.4 percent growth, the same as achieved in FY02. The phenomenal growth in the production of durables, construction and engineering related products and increase in textile output brought the accelerated 8.7 percent growth in the LSM during FY03 compared to 4.9 percent in FY02.

Other contributors to the industrial sector growth were; construction (up 3.4 percent) and mining & quarrying (up 9.5 percent) and the small-scale manufacturing during FY03. Electricity and gas distribution however, declined by 3.9 percent during FY03.

National savings rose sharply to reach a respectable 18.5 percent of GNP in FY03 as compared to 16.8 percent in FY02. This improvement is mainly on the back of a substantial rise in *net factor income from abroad* due to a sharp acceleration in workers' remittances. However, domestic savings decelerated falling from 16.7 percent of GDP in FY02 to 15.5 percent in FY03.

Total investment grew by 16.2 percent during FY03, showing the strongest rise during the last 6 years, this was in sharp contrast to the anemic 0.4 percent growth in FY02. Consequently, the ratio of *total investments to GNP* rose to 14.8 percent in FY03 from 14.6 percent in FY02. Encouragingly, most of the rise in the investment during the year came from private sector investment, which grew by a healthy 14.4 percent during FY03 compared to 6.2 percent in the preceding year.

Prices

Inflation, as measured by the change in the Consumer Price Index (CPI), decelerated during FY03, to 3.1 percent compared to 3.5 percent in FY02. While both *food* and *non-food* components of inflation saw a visible decline during FY03, it was the former that witnessed a sharper fall. Improved availability of majority of essential food items, imported deflation and cheap availability of credit seem to be the key factors that curtailed inflation in FY03.

However, there has been a mixed trend in the annual inflation pattern when viewed by the changes in the price indices other than the CPI. Wholesale Price Index (WPI) recorded an annual increase of 5.9 percent in FY03 as compared to 2.1 percent last year. Similarly, Sensitive Price Indicator (SPI) though recorded a subdued rate of increase of 3.5 percent during FY03 but marginally higher than the 3.4 percent increase recorded during FY02. However, in WPI, the marginal rate declined steadily through H2-FY03.

Public Finance and Fiscal Policy

Fiscal accounts showed a marked improvement during FY03 as fiscal deficit fell to 4.4 percent of GDP compared to 5.2[4] percent during FY02. This is the first time in more than 25 years that the fiscal deficit has moved below 5 percent of GDP.

[4] If one-off expenditure of Rs 52 billion incurred on KESC re-capitalization (Rs 32 billion) and CBR bonds (Rs 20 billion), is accounted for the fiscal deficit will be 6.6 percent of GDP.

Encouragingly, the larger part of the improvement stemmed from a sharp jump in revenues - consolidated tax receipts in particular depicted a 16.2 percent (Rs 77.7 billion) YoY increase during FY03, considerably higher than the 8.3 percent (Rs 36.5 billion) growth recorded in FY02. The non-tax revenues also recorded a healthy growth of 13 percent (Rs 18.9 billion). Consequently, leading to boost the *total-revenue-to-GDP* ratio to 17.7 percent in FY03 compared with 17.2 percent in FY02.

Total expenditures witnessed relatively modest growth of 8.7 percent i.e., lower than the growth in the nominal GDP and as such reduced the *total-expenditure-to-GDP* ratio to 22.1 percent in FY03 compared with 22.8 percent in FY02. The rise in the defense expenditure, subsidies and un-allocable was partially offset by the decline in the debt servicing and below target increase in development expenditure. The fall in FY03 development expenditures to GDP ratio was particularly disappointing, but the government appears to have recognized this problem, as evident in the increased FY04 developmental outlays. The rising subsidies to power utilities (both WAPDA & KESC) and contingent liabilities are also a matter of concern.

Notwithstanding the satisfactory fiscal performance witnessed in FY03, it is important to note that Pakistan still remains heavily burdened by the debt incurred in the past periods, and needs to generate sustained primary fiscal surpluses for years to come. Moreover, it is imperative that the requisite fiscal prudence be evident in current rather than developmental spending (which needs to accelerate) if the economy's ability to carry debt is to improve.

To this end, therefore, the government should hasten to send a strong signal to investors and businessmen through the passage of the draft Fiscal Responsibility Law.[5] At the same time it must ensure that the resulting fiscal space, in coming years, is used to increase investments in human development and infrastructure.

Monetary Policy

Monetary policy continued to be dominated by exceptional growth in NFA due to external account surpluses. Broadly, it can be argued that it was the exchange rate, which effectively constituted the nominal anchor for monetary policy during FY03, in contrast to FY02, when the discount rate served this role. During FY03, in response to the continuing weakness in net private sector credit, the SBP increased market liquidity by substantially reducing the sterilization of its rising forex purchases and then reduced the discount rate in November 2002. As a result, domestic interest rates plunged to all-time lows. This supported a revival in economic activity and eventually contributed to the stunning Rs 167.7 billion net private sector credit expansion.

In contrast to the NFA, growth in the NDA was subdued in FY03, since both 'government borrowings for budgetary support' and 'commodity operation loans' witnessed heavy net retirements, offsetting much of the phenomenal rise in net credit to the private sector. The former resulted from the government's improved fiscal position because of higher revenues, greater availability of cheap external financing, larger non-bank borrowings, all of which helped the government retire Rs 56.0 billion in net credit, in contrast to the net borrowing of Rs 14.3 billion in FY02. Another notable feature of the budgetary borrowings is the continuing switching from SBP to scheduled banks, which mainly represents the SBP monetary sterilization (as the SBP continued retiring its T-bills holdings to neutralize the impact of its forex purchases). The fall in commodity operation loans mirrored the rising wheat exports and increasing availability of bank credit to the

[5] The major points of this law are: (1) government is required to eliminate revenue deficit by June 30, 2007 and thereafter has to maintain a surplus beyond 2007; and (2) reduce debt to GDP ratio at 60 percent by June 30, 2012. The government can depart from these principles in case of unforeseen demand on the finances of the government due to national security or natural calamity, which are required to be determined by the National Assembly.

private sector for wheat purchases. It is encouraging to note that the aggregate stock of commodity financing loans has declined from its peak of Rs 107.4 billion in end-June 2000 to Rs 74.0 billion at the end-June 2003.

During the first four months of FY03, the growth in net private sector credit remained below the corresponding FY02 as well as the seasonal (5-year average) figures. However, with the discount rate cut in November 2002, the net credit growth witnessed a spectacular up trend. At least a part of the unusual rise in net credit was accounted for by a sharp jump in trade-related (or foreign currency) loans, higher working capital requirements and increased consumer credit. However, a significant portion of the net credit growth in Q4-FY03 also appears to reflect the increased lending against NSS instruments. Moreover, according to sectoral distribution of credit, the manufacturing sector, chiefly textile manufacturing, was the largest source in particular.

The main source of growth in reserve money (RM) has been the escalating foreign assets of the SBP due to which, by end-FY03, over 80 percent of the high-powered rupee stock was backed by hard currency assets. Both M2 and RM growth accelerated in FY03 to 18.0 percent and 14.5 percent respectively. A striking development evident over the last three years is the gradual decline in the cash to deposit ratio (CDR), which suggests the growing intermediation of the banking system. The liquidity preference also appears to rise sharply in FY03; this jump in the ratio is essentially because of the increasing substitution of forex deposits with rupee demand deposits.

Money Market

Characterized by the continuation of SBP's policy on easing of monetary stance and substantial increase in the annual external account surplus, the money market remained highly liquid during FY03. Even a strong 28.9 percent growth in net *government borrowings from scheduled bank*, and a stunning 284.9 percent rise in *private sector credit*, could not contain downward trend in interest rates for the second successive year – the weighted average auction yield for the benchmark 6-month T-bills fell 463 basis points during FY03, taking the cumulative decline for the two years to a massive 1090 basis points.

The unusual FY03 interest movements are explainable entirely through SBP policy. Not only was the SBP injecting more liquidity into the interbank market through its forex market operations during FY03, its sterilization of these interventions were also smaller. Therefore, despite the relative stability of the discount rate, interest rates weakened considerably until (a) the net injections into the interbank market due to SBP Forex operations fell sharply in the final quarter of the fiscal year, (b) sustained negative real primary yields on all short tenor gilts, and (c) the narrowing spread between rupee and US dollar raised expectations of a rebound in domestic rates.

The exceptional liquidity injections, and the trend decline in interest rates also explain the surge in market interest for government paper as commercial banks sought to lock-in relatively high yielding assets ahead of an anticipated decline in interest rates. This was particularly evident in the rising speculative interest, particularly on longer tenor instruments (which offer greater capital gains as interest rates decline) that forced a flattening of the yield curve as PIB yields dropped to record lows.

The Banking Sector

FY03 was as an exceptionally good year for the banking sector, as the important banking indicators witnessed further improvement over FY02. Deposits of the banking sector grew by 19.5 percent (or Rs 275.1 billion) over the already strong double-digit increases in the preceding two years. This impressive deposit growth was largely driven by the unprecedented increase in workers' remittances, which reached US$ 4.2 billion during FY03 – the highest one-year accumulation in the history of Pakistan.

Strong deposit growth coupled with SBP easy monetary policy stance kept rupee-lending rates under intense pressure throughout the FY03. As a result, the weighted average lending rate slipped to single digits for the first time since 1974.
Following the decline in weighted average lending rates, banks rushed to curtail deposit rates to keep the profitability intact. While the FY03 weighted average lending rates saw a steep slide of 454 basis points to 7.6 percent, weighted average deposit rates dipped to 1.9 percent only; narrowing the banking spread by 227 basis points.

An improvement was also visible in the portfolio of non-performing loans (NPLs), as the outstanding amount of NPLs decreased to Rs 227.7 billion by end-FY03 as compared to Rs 234.7 billion in the preceding year. Both the NPLs to gross advances and net NPLs to net advances ratios have witnessed gradual decline during all four quarters of FY03, reflecting the reduction in the burden of NPLs. This is also clear from the increasing coverage ratio (provisions to NPLs).

Capital Markets

The capital market in Pakistan maintained its upward momentum during the most of FY03 and emerged as one of the best performing equity markets in the world. The strength was visible in the substantial increase of both, the average daily traded volume and the turnover ratio. KSE-100 Index broke its previous all-time high[6] to reach as high as 3402.5 points by the close of FY03, up a stunning 92.2 percent increase for the year. The broader SBP general index of share prices, also mirrored this record performance, rising 91.9 percent through FY03.

The fuel and energy Sector clearly outperformed all other sectors both in terms of market activity as depicted by its traded value as well as in terms of the market size as reflected by the market capitalization. It accounted for almost two-third of the total value traded during FY03.

Balance of Payments & Exchange Rate

Current and the capital account surpluses together contributed to an overall FY03 BOP surplus of US$ 4.6 billion - 6.7 percent of GDP. The dominant contribution to this spectacular performance was from current account components, including workers' remittances, a sharp fall in interest payments, robust non-structural inflows and substantial growth in exports earning. As a result, the current account balance to GDP ratio improved from 4.8 percent in FY02 to 5.9 percent in FY03. Even excluding the *non-structural* flows, the ratio is a healthy 3.7 percent.

This improvement in the external sector had strong policy implications for both SBP and the government. The continued inflows throughout the year kept the Rs/US$ parity rate under upward pressure and helped the SBP in strengthening the foreign exchange reserves further. The higher availability of external financing and improved fiscal discipline also reduced the government borrowings from the banking system.

The trade deficit narrowed for the third successive year in FY03, falling to a 10-year low of US$ 1.1 billion. Unlike FY02, the 12 percent reduction in the trade deficit was largely due to the strong export growth.

While the expansion in exports is a positive development, the structure of imports shows that the rising level of imports is also not unwelcome in view of rising non-food, non-oil imports, indicating improved production capacity and hence increased manufacturing activity in the economy in FY03.

[6] The previous high of the KSE-100 Index was 2661.3 on March 22, 1994.

The rupee appreciated gradually by a net 3.9 percent against the US dollar during FY03 substantially *lower* than the 6.7 percent witnessed in FY02. Much of this rise was underpinned by a substantial year-on-year improvement in Pakistan's current account through workers' remittances and a relatively lower trade deficit. T he SBP, actually, moderated the ascent of the rupee during FY03 through its interventions in the foreign exchange market to support exports.
The accumulation of foreign exchange reserves accelerated sharply in FY03, due to rising net external inflows, pushing up the aggregate reserves to the US$ 11.7 billion mark by end-June 2003, significantly improving the country's reserve adequacy indicators. More encouragingly, a dominant portion of the increase in the country's forex reserves emanated from non-debt creating inflows.

Domestic and External Debt
Pakistan's debt profile witnessed a significant improvement for the second successive year in FY03. The most important developments were the sharp reduction in the cost of debt and the lengthening of the maturity profile, which ultimately reduced the dependence on external debt and resulted into a sharp fall in the debt to GDP ratio.

In fact, the growth in Pakistan's overall debt stock has slowed significantly in recent years, driven primarily by the government's improved fiscal position, pre-payments of expensive debt and the strengthening domestic currency. This was also evident in FY03, which saw the stock of public debt rise by only 1.0 percent (Rs 38.7 billion) by end-June 2003, pushing down the debt to GDP ratio from 104.3 percent in FY02 to 95.1 percent in FY03.

Moreover, the rise in the debt stock emanates entirely from a sharp 7.8 percent increase in domestic debt, as the rupee value of the country's external debt and explicit liabilities declined for the second successive year. In turn, all of the increase in domestic debt during FY03 stemmed entirely from long-term debt. The latter, in particular, is certainly very commendable, given that domestic interest rates were at historical lows, but the large share of relatively expensive borrowings through the NSS is a little disappointing.