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THE STATE OF PAKISTAN'S ECONOMY

First Quarterly Report for FY02

1. Overview

The uncertainty following the events of September 11, which were highlighted in the *Annual Report* for FY01, has still not been resolved. However, as more information has become available, this *Quarterly* will update its assessment of Pakistan's economy in light of these developments. The results presented do not capture the full impact of post September 11, and should be observed with this caveat in mind.

The positive developments in this quarter were the increase in home remittances, lower inflation and narrowing of the trade deficit. Also, the outlook for Kharif crops is promising. Export and tax revenue growth, on the other hand, were disappointing while private sector credit has not yet taken off. The Rupee/Dollar parity remained fairly stable but experienced a sharp appreciation at the end of the quarter.

An analysis of economic indicators, shown in **Table 1.1,** reveals the following picture:

?? Large-scale manufacturing (LSM) showed strong growth but was a shade lower than last year's performance. This was primarily due to the inability of *food, beverages & tobacco*, and fertilizer to repeat the strong buoyancy shown during Q1-FY01.

?? The trade deficit fell sharply primarily on account of lower imports, especially petroleum and food imports. Exports did not show much of an improvement compared to the first quarter last year. Looking ahead, the recent slump in international oil prices should help the trade balance.

Table 1.1: Quarterly Economic Indicators

percent

Growth rates	July-September		
	FY00	**FY01**	**FY02**
Large-scale manufacturing	5.2	8.1	5.3
Exports	5.2	14.6	1.8
Imports	15.5	12.5	-8.3
Home remittances[1]	-18.2	17.7	15.8
Tax revenues	23.4	10.0	-3.1
CPI (1Q over 1Q)	3.3	4.8	2.9
Private sector credit	-3.5	-0.8	-3.7
Money supply (M2)	-1.2	-0.2	.04
As % of GDP[2]			
Trade deficit	2.8	2.6	1.5
Current a/c balance	-0.4	0.6	0.6
Fiscal deficit	6.4	5.3	4.9

[1] Excluding compensation on a/c of Kuwait war affectees & Hajj receipts.

[2] Numbers relate to full year.

?? Home remittances presented in **Table 1.1** exclude receipts on account of the Hajj Sponsorship Scheme and compensation for war affectees (from Kuwait). On this basis, remittances actually showed an increase of 15.3 percent over Q1-FY01. These flows are likely to increase next quarter as the impact of the kerb rate collapse in October 2001, takes hold.

?? In terms of revenues, tax collection this quarter was less than what was realized during the first quarter last year. Even with the downward revision in targets following September 11, revenues were only 96.8 percent of the quarterly target. The main reasons for this fall are lower imports and higher payments by CBR in terms of rebates and refunds.

?? Inflationary pressures were not only contained this quarter, but the outlook for the remaining part of this year is that inflation is likely to edge down further. The main reasons are improved availability of essential food items and less pressure from utilities and retail petroleum prices.

?? Credit to the private sector showed higher retirement this quarter compared to the corresponding period last year. The main reason was the seasonal off-take that occurs in September simply did not materialize on account of the intensifying global recession and the uncertainty following the terrorist attacks.

?? In terms of growth in money supply, the first quarter of the year usually witnesses no increase. Although net government borrowing was lower at the end of the quarter (compared to last year), net retirement by the private sector was more than offset by the increase in domestic liquidity on account of a US$ 247 million OECF loan and the closure of foreign exchange swaps in September.

?? Looking at Pakistan's external sector, the narrowing of the trade deficit coupled with higher kerb purchases caused the current account deficit to fall from US$ 481 million during Q1-FY01 to only US$ 61 million this quarter.

Fears about a continuation of the dry spell have largely dissipated on account of better than expected rainfalls during the period April to August 2001, compared to FY01. Since ***agriculture*** growth targets were set within the context of the drought and did not incorporate the early rainfalls, areas under cultivation by cotton and sugarcane were much higher than projected, and also higher than what was sown last year. In view of this, the projected cotton crop (ex-gin[1]) is expected to be in the range of 10.2 to 10.5 million bales against an original target of 8.7 million bales (see **Table 2.1**). In effect, Pakistan could witness its third bumper crop in three consecutive years. Although a revised estimate for sugarcane is not available, it is likely to easily exceed the target that had been set.

[1] This refers to ginned cotton bales.

The cultivation of these crops has also been assisted by favorable wholesale prices during FY01, which is used by growers in determining the cultivation of their crops. A further boost is the pivotal role of these crops in manufacturing (specifically textiles and sugar), which should enhance the prospects for LSM this year. Having said this, depressed international cotton prices will not be a source of comfort to growers.

In the case of rice, however, the outlook may not be as encouraging since this crop is more dependent on canal water than rainfall. Although information is sketchy, it is likely that area under cultivation (with rice) will be 2.6 percent less than what had been targeted earlier this year, and much lower than what was realized last year. Stepping back, one should bear in mind that this is a partial analysis of the agriculture sector since it is unable to gauge the performance of *rabi* crops, specifically wheat. However, sentiments are that wheat cultivation will be higher than expected if there are no adverse developments during the year. In effect, given existing information, it is clear that the targets set for Pakistan's major crops have to be revised upwards. At the very least, agriculture should be able to achieve the 3 percent growth target for FY02 without any difficulty.

In terms of credit disbursed to agriculture, higher disbursements and lower recoveries during the quarter indicate an increase in purchasing power in rural areas compared to Q1-FY01. Although the second quarter of the fiscal year witnesses greater credit usage on account of harvesting kharif crops and the sowing of rabi crops, poor recoveries by the Federal Bank for Cooperatives (FBC) during the quarter is a source of concern (see **Table 2.4**).

In the ***manufacturing*** sector, high production during the first quarter of FY01 created a downward bias in terms of growth that could be realized this quarter. More specifically, the heavyweights in LSM (*textiles* and *food, beverages & tobacco*) managed to show positive growth this quarter but were much below rates realized during Q1-FY01. Depressed international prices of lint-cotton and the impact of global recession are being cited as the main factors for this slowdown in textiles. In terms of *food*, *et al*, negative growth in the production of vegetable ghee (due to higher international prices of palm oil and the fall in domestic production of edible oil seeds) and cigarettes, were the swing factors in the slowdown since these sub-sectors posted strong growth during Q1-FY01, which persisted throughout the entire year.[2]

[2] Looking ahead, with the month of Ramadan and the mass influx of Afghan refugees coinciding, demand for edible oil is likely to experience a significant boost.

The automobile sector continued to show strong growth that was carried over from last year. Against full year growth of 12.7 percent last year, the 19.0 percent growth posted in the first quarter of this year also reflects a sluggish first quarter last year. This demand driven growth on the back of easy lease financing, is likely to continue given the fall in interest rates and lower petroleum prices. Unlike last year, tractor production has also picked up but this is also because of the sharp contraction during Q1-FY01.

In Rupee terms, ***fiscal revenues*** collected during the quarter were lower than last year. Although revenue targets were revised downward to incorporate the likely impact of the terrorist attacks, collection for the quarter was still 96.8 percent of the quarterly target. The main reasons for this are: lower dutiable imports; reduced tariff rates on raw material imports; rebates and refunds were higher this quarter; tariff slabs were brought down in line with Pakistan's commitment to reduce and simplify trade restrictions; and finally most of the changes in the collection machinery are qualitative and results are still to be realized.[3] As part of the overall strategy to gear the taxation structure towards documentation, sales tax receipts have shown a 9.9 percent improvement this quarter.

The calm in the foreign exchange market (in terms of the Rupee/Dollar parity) during the quarter allowed SBP to ease its tight ***monetary*** stance that had to be taken to defend the Rupee last year. Two consecutive cuts in the discount rate in July and August, and reduced coupon rates on the Pakistan Investment Bond (PIB) in August, clearly signaled a changing monetary stance. In the first four primary auctions of the quarter, the 6-month weighted average T-bill rate fell from 12.9 to 10.5 percent. This easing should be viewed within the context of the gradual shift to a longer-term growth oriented program. Following the steps needed in the SBA, the level of real interest rates in Pakistan was too high. This reduction in T-bill rates should also provide much needed relief to the government in terms of its domestic debt servicing.

In terms of credit disbursements, government borrowing for budgetary support was lower this quarter compared to the corresponding period last year, mainly due to inflow of external resources. However, till the middle of September 2001, budgetary borrowing was higher than the year before primarily because tax

[3] The Government has recently approved the internal restructuring plan for CBR, and implementation is likely during FY02. Since the focus will be on governance, the induction of specialist, and better and greater scope of audits, actual results will be realized with a time lag.

revenues were below what had been realized in Q1-FY01, while debt servicing was higher this quarter.

Of greater importance is the behavior of private sector borrowers; as shown in **Figure 4.2**, the seasonal off-take of credit that begins in September did not materialize this year, with a perceptible fall in gross disbursement in the third week of September. Against net borrowing of *negative* Rs 4.5 billion during Q1-FY01, the private sector actually retired Rs 23.5 billion this quarter; excluding the impact of export financing (which fell very sharply this quarter), the numbers are negative Rs 5.7 and negative Rs 11.4 billion, respectively. Despite greater retirement by the private sector this quarter, fresh liquidity was injected on account of closing foreign exchange swaps and the Rupee counterpart provided to GOP on account of a banking sector loan from Japan. In overall terms, however, there was almost no change in the stock of money supply during the quarter.

Looking at the country's stock of foreign assets, both Q1-FY01 and Q1-FY02 posted a fall. However, while the fall last year was largely due to SBP efforts to finance the external gap, this quarter the withdrawals from foreign currency accounts (FCAs) following September 11 are largely responsible.

The more important changes in the financial system were in the realm of monetary management. With less pressure on the Rupee and the experience of last year, there was an urgent need to create a way of managing the Rupee without having to change SBP's monetary policy stance. This was done by dismantling the fixed schedule of open market operations (OMOs), and in doing so, allow SBP to call OMOs at its discretion. This has allowed SBP to manage overnight liquidity without having to worry that the rates at which SBP provides *or* absorbs short-term liquidity, will not influence the rates at which banks are willing to lend to the government via T-bills. Although there have been no episodes during the quarter when SBP had to tighten monetary management to ward off a speculative attack on the Rupee, this proactive management should ensure that SBP's monetary policy would not necessarily have to be tightened if the Rupee comes under attack.

With almost no growth in money supply during the quarter, ***inflationary pressures*** were correspondingly subdued. Averaging for the quarter, CPI growth declined from 4.8 percent (in Q1-FY01) to only 2.9 percent during the first quarter of this year. The main reasons were increased availability of essential food items (e.g. sugar, milk, edible oil, rice and vegetables) and mild increases in non-food prices, especially petroleum products. Hence, CPI and SPI growth fell on a quarterly basis, while WPI edged up from 4.0 to 5.7 percent. Looking ahead, since the month-on-month price indices are well below the 12-month moving averages (see **Figure 7.1**), barring any exogenous price shock, it is safe to say that inflation numbers will further ease during the course of this year.

Looking at the ***external sector***, although export growth was only 1.8 percent during the quarter (FBS data), the fact that imports actually fell by 8.3 percent allowed for a narrowing of the trade deficit to US$ 239.5 million. During the first quarter of last year, the trade deficit was much larger at US$ 505.7 million, despite higher export growth (14.6 percent) compared to imports (12.5 percent). The sharp fall in Pakistan's import bill this quarter was driven by petroleum and food products (edible oil, refined sugar, pulses and tea), which together account for a US$ 360.5 million decline in the import bill. This fall in demand for petroleum (crude and products) follows the commissioning of PARCO, the switching over of some IPPs to natural gas, and greater reliance on hydel generation of power following better rainfall. The suspension of the Afghan Transit Trade also contributed to the reduced import bill.

In terms of exports, receipts of US$ 2.26 billion fell short of the Trade Policy target of US$ 2.52 billion for the quarter. The impact of the global recession and falling unit prices of Pakistan's main exports, were responsible for this poor performance (see **Figure 9.3**). In terms of specific products, leather (raw and products), towels, bedware and readymade garments recorded increases, while the mainstay of Pakistan's exports (yarn, fabric and to a lesser extent, knitwear) all showed declines relative to Q1-FY01, despite quantitative increases in yarn and fabrics. Non-traditional exports did not fare too well this quarter – with the exception of surgical instruments: fish (raw & prepared), fruits, carpets and sports goods posted declines in revenues compared to Q1-FY01.

Pakistan's current account deficit also showed a significant improvement this quarter, but was not able to post a surplus as was the case for the full year FY01. In absolute terms, the external gap fell from US$ 481 million (in Q1-FY01) to only US$ 61 million this quarter. The main drivers for this narrowing gap are the trade deficit and lower service payments on account of shipping and interest payments. Despite higher kerb purchases by SBP (by US$ 170 million[4]), *current transfers* actually fell in comparison with the first quarter of last year. Official transfers into Pakistan were lower this quarter because of the smaller *imputed* value of the Saudi Oil Facility (SOF) on account of declining international oil

[4] The importance of this source of reserve accumulation, should also be gauged by the fact that the US$ 397 million purchased from the kerb market during Q1-FY02 incorporates a much lower volume of purchases during the month of September on account of the terrorist attacks, which reduced flows into the kerb market.

prices. Excluding the impact of kerb purchases and SOF, the current account deficit this quarter only narrowed by US$ 292 million.

On account of these developments, Pakistan's foreign exchange reserves increased by US$ 36 million during the quarter, which is an improvement over the US$ 51 million decline witnessed in Q1-FY01. However, if one looks into developments during October 2001, the collapse of the kerb market following September 11, has allowed SBP to purchase hard currency from both the interbank and kerb markets, pushing total reserves to record levels.

Although the Rupee **exchange rate** was remarkably stable during the quarter, developments in October 2001 must be mentioned. The stability witnessed during Q1-FY02 can be traced to the following factors: the trade deficit narrowed; market expectations were calmer after a turbulent FY01; and SBP was more proactive in managing the Rupee/Dollar parity without necessarily using its liquid reserves. This stability also allowed SBP to abolish limits on Nostro balances held by banks since August 31.

It is interesting to note that despite a fair degree of stability of the Rupee/Dollar parity between September 11 and the end of the quarter, the outstanding balance of unfrozen FCAs actually fell by US$ 75 million (see **Figure 9.7**). Anecdotal evidence suggests that hard currency withdrawals were being converted into Rupees for relief and other operations in Afghanistan. However, with the US announcement on September 21 that all cross-border financial transactions would be monitored to trace possible funding to terrorist organizations (which was endorsed by the UN on September 29), and the UAE central bank's decision to require documentation of all capital flows larger than US$ 500, the kerb market effectively collapsed on October 1, 2001.

This collapse was triggered by the sale of a large volume of Dollars (in the kerb market) in Dubai. The magnitude of this decline was unprecedented[5], with the result that the kerb rate began pushing down the Rupee/Dollar parity in the interbank market. With the kerb premium almost disappearing, the Hundi system has been seriously undermined as the network for collecting worker remittances (especially from the Gulf region) is no longer commercially viable. This explains the lower volume of transactions that have been taking place in the kerb market since early October.

[5] Between July and October 2001, the Rupee/Dollar parity in the kerb market has appreciated by 8.8 percent.

The existing uncertainty amongst moneychangers has not dissipated, and if US pressure remains, this is likely to keep moneychangers on the sidelines. In view of these developments, which have kept the kerb premium at almost negligible levels, this is an opportune time to merge these two markets. Towards this end, SBP has constituted a committee to look into converting moneychangers into foreign exchange companies. The merging of the markets is also one of the steps that needs to be taken in the forthcoming PRGF.

Prospects for FY02

Although the war in Afghanistan seems to have entered a new phase with the strategic retreat of Taliban forces from the main cities, the implications for Pakistan are still far from clear. The war-risk premium has been taking a toll on both importers and exporters, and the actual implications will only be realized in Q2-FY02. Exporters unfortunately had to bear the brunt of the uncertainty, not just in terms of the war premium and higher transportation costs, but also due to the appreciating Rupee and reduced orders from the US and EU. There is also a real fear that even if conditions return to "normal", Pakistani exporters may not be able to recapture lost market outlets in the west. Although efforts are underway to secure special access to western markets, the global recession is making G-7 countries more introverted in their short-term trade outlook. In effect, the degree of market access that Pakistani exporters are expecting may not materialize.

Although certain promises by the US and EU for special assistance to Pakistan have been made (and some actually formalized), it will take some time before this funding is actually realized. Contrary to popular belief, the debt rescheduling agreements that have been signed since September 11 are unrelated to Pakistan's enhanced stature in the global order. These agreements are mere formalities following certain decisions taken in the rescheduling talks that took place in January 2001, which was part of the stabilization program with the IMF. The approach developed by the government for discussion on Pakistan external debt is a significant departure from the conventional rescheduling and entails debt re-profiling. This will provide Pakistan an opportunity to tailor (on a permanent basis) its debt servicing payments in accordance with its capacity to pay.

In the short term, however, the most critical development in Pakistan's economy is effectively a by-product of certain international actions. Global awareness of the Hundi system and certain steps taken in UAE, have changed the behavioral pattern of large moneychangers. During the month of October, the average kerb premium was only 0.7 percent compared to 4.1 percent the month before. Although this trend may seem temporary in nature, the threat of international scrutiny is almost equivalent to a structural change in the kerb market. If international pressure remains, it is unlikely that the kerb premium will return to pre-October levels.

To ensure that the Rupee did not appreciate too much, SBP has been purchasing hard currency from both the interbank and the kerb markets. During the month of October alone, net purchases from the interbank market were US$ 317 million, while kerb purchases were only 79 million. Despite normal payments, SBP was able to increase its liquid reserves by US$ 290.5 million in October alone, pushing total reserves to US$ 3.59 billion in end-October.[6] As of this moment, purchases from both markets are continuing.

To conclude, two points should be made. First, September 11, 2001, is not the only exogenous shock to hit Pakistan in the past 4 years; it follows the nuclear tests in May 1998 and the change in government in October 1999. However, sentiments following the terrorist attacks were different from previous shocks. More specifically, although uncertainty still remains following September 11, the reforms implemented during the past year have improved Pakistan's macroeconomic fundamentals, making the economy more resilient to such shocks.

Second, until there is a credible solution to the Afghan situation, lingering doubts will remain about Pakistan's economic prospects and the speed with which things will return to normal. Following several years of poor economic growth in the country coupled with the global recession, perhaps this period should be used to take further actions to shore up confidence by taking difficult steps in terms of fiscal reforms, merging the two foreign exchange markets, dismantling subsidies and improving the financial viability of state-owned enterprises. Nevertheless, if proper steps are taken to help the agriculture sector and weather conditions remain favorable, a certain floor to Pakistan's economic growth should be assured.

2. Real Sector

2.1 Agriculture

In contrast to the first quarter last year, agriculture showed signs of improvement during Q1-FY02. Initial estimates point towards higher than targeted production

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[6] As of November 24, Pakistan's total reserves stood at US$ 4.32 billion.

of sugarcane, cotton and improved varieties of rice.[7] The impetus to this growth came from more than expected rainfall in the monsoon season (July-August), which increased area under cultivation and raised expectations of higher yields. Water availability that was anticipated to be about 48 percent less than actual need, improved in due course and the gap has narrowed to 18.6 percent at the beginning of the kharif season. Despite this improvement, water supply during kharif FY02 is 14.1 percent less than water availability during the same period last year.

Agriculture targets for FY02 were chalked out amidst drought conditions and against the backdrop of negative 2.5 percent growth last year. The fear of a lingering dry spell was the root cause for conservative targets, where area under cultivation and crop yields, were even less than what was achieved last year (see **Table 2.1**). With such bleak prospects, the livestock sub-sector was expected to be the main contributor to the targeted growth in agriculture this year.

Table 2.1: Targets and Latest Estimates on Major Kharif Crops

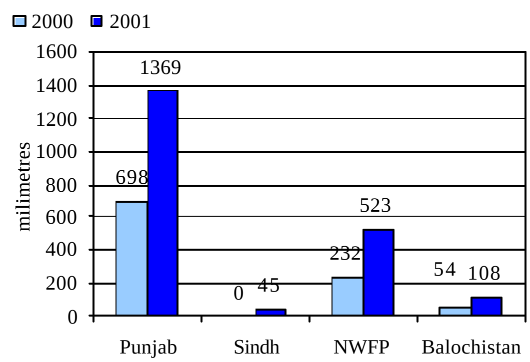
	Area			Production		
	During	During FY02		During	During FY02	
	FY01	Target	Sown	FY01	Target	Estimates
Cotton	2,928	2,560	3,162	10.7	8.7	10.5
Sugarcane	961	860	1,038	43.6	38.1	46.5
Rice	2,377	2,059	2,006	4.8	4.0	3.8

Area in thousand hectares

Production: Cotton = million bales; other crops = million tonnes

Source: Federal Committee of Agriculture

Figure 2.1: Rainfall from April to June

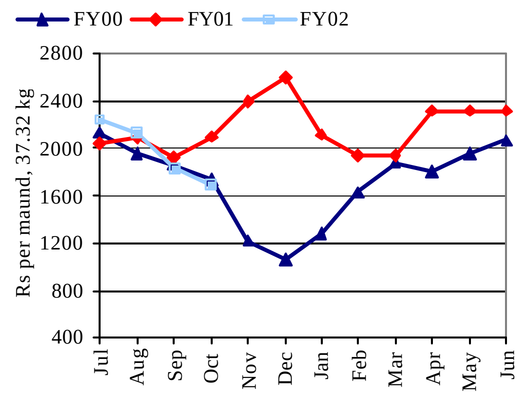


However, the present position of standing crops of cotton and sugarcane is promising. Initial estimates on acreage reveals that the past outlook may no longer be valid and is likely to be upgraded on the basis of higher than projected rainfall in the pre-monsoon season (April – June, the sowing period of these two crops). At 21 select centers of the country, rainfall

[7] As the sowing of wheat starts in November and continues till January, its progress will be analyzed in the next *Quarterly Report*.

during April to June stood at 2,046 millimeters, which was more than twice the volume recorded in the same period last year (see **Figure 2.1**). This rainfall has increased area sown for cotton and sugarcane, particularly in the provinces of Punjab and Sindh, which together account for almost 99 and 89 percent of the total produce of these two crops. In Punjab, area under cultivation of cotton and sugarcane was 24.3 and 17.9 percent higher than target, while it was 34.6 and 38.3 percent higher in the province of Sindh, respectively. In the case of rice (a water intensive crop that is highly dependent on canal water and less on rainfall), the shortage of canal water adversely impacted area under cultivation of this crop, which declined by 2.6 percent compared to the target and 15.5 percent less than last year.

Figure 2.2: Lint-Cotton Prices



In addition to favourable weather conditions, buoyant wholesale prices of cotton and sugarcane that prevailed during FY01, was another major factor that motivated farmers to bring more area under cultivation this year. During the peak harvest season last year (October-December 2000), domestic average price of lint-cotton in wholesale markets was about 76 percent higher than prices that prevailed during the same period last year (see **Figure 2.2**). The maximum gain was observed in December 2000, when prices were 143.2 percent higher than the corresponding month last year. That peak price was the combined effect of steady cotton trading in domestic markets and the highest international prices since December 1998.

In case of sugarcane, growers sold their produce to mill owners at their terms - around 40 percent higher than the government's procurement price. Other contributory factors to this improvement are farmer's ability to use water more efficiently to cope with the drought, and the role of various government research and development departments engaged in strengthening farm activities. In the present scenario, if there is no adverse development with the wheat crop, the 3.0 percent growth target for agriculture in FY02 could be achieved.

2.1.1 Market prospects of seed-cotton (phutti) for FY02

Unlike positive sentiments that prevailed in domestic markets last year (September-December 2000), following the events of September 11, buyers in the cotton market are uncertain about future prices. Lacking a futures market for cotton in Pakistan, trading is vulnerable to incomplete information and market manipulation. As a proxy, traders often take their view from international futures markets, which is not always accurate since Pakistan's crop pattern is not synchronized with large global producers. In this regard, the need for a futures market is clear: it will allow efficient risk allocation; smooth out seasonal price fluctuations; provide a benchmark for growers, ginners, textile manufacturers and exporters; reduce speculative trades; reduce credit risk for borrowers; and improve information flows.

Nevertheless, a gloomy outlook is emerging in all allied cotton businesses, since prices of phutti and lint-cotton are declining with the arrival of the new crop in early September 2001 (see **Table 2.2**). As shown in **Table 2.3**, the average price of lint-cotton in September 2001 was 14.5 and 5.3 percent less than prices during August 2001 and September 2000, respectively. Similarly, the average price of seed-cotton in September 2001 was almost 7.0 percent less than last year.

Table 2.2: Volume of Cotton Related Business

in thousand bales

	During		%
	FY01	FY02	Change
Arrival of cotton in factories	2,260	1,711	-24.3
Pressing of bales	1,771	1,338	-24.5
No. of bales sold	1,542	1,182	-23.3
TCP	10	24	143.9
Exports	129	4	-96.6
Textiles	1,403	1,154	-17.8
Stock of unsold bales	230	156	-32.3
Stock of un-ginned bales	489	373	-23.6

Source: Pakistan Cotton Ginners' Association

Although seasonal price variations will also be witnessed this year, the depressed global outlook is unlikely to allow prices to exceed (or even reach) the levels enjoyed by stakeholders last year. Another factor adding to the pessimism is a surplus of 4.1 million cotton bales expected to emerge on account of a 7.6 percent increase in world production of cotton (at 95.6 million bales), compared to weak growth of 1.0 percent in worldwide consumption (at 91.5 million bales) expected during FY02. Contrary to this, 88.8 million bales were produced against consumption of 90.6 million bales last year.

With a depressed global outlook, it seems difficult for Trading Corporation of Pakistan (TCP) to stabilize the price of seed-cotton around a support price of Rs

780 per 40 kilograms, on account of downward pressure on international prices. One must realize that TCP only enters the cotton market as a second buyer, while financial constraints do not allow it to purchase more than 1 million bales. Another constraint on TCP is that it can only purchase cotton at the designated support price only if it has export orders in hand. With the global slump in cotton, even the 1 million bale ceiling is unlikely to be binding.

Table 2.3: Average Monthly Prices of Cotton

	September		August
	2000	**2001**	**2001**
Domestic (Rs per 40 kgs.)			
Seed-cotton	780	726	--
Lint-cotton	2018	1910	2233
International (Cents per lb.)			
Lint-cotton	61.7	41.4	43.5

Source: Pakistan Central Cotton Committee

-- New crop starts coming in markets by September.

As for the discrepancy in the weight of cotton bales, this can be traced to the marketing system. In fact, the production of cotton is recorded in two ways: in term of number of bales; and the weight of each bale, where the benchmark is defined at 170.1 kilogram of cotton per bale. When it comes to practice, the actual weight at the ginning factory gate can range from 160 to 165 kilogram per bale. The underlying factors for this inconsistency are specific to the requirements of textile mills[8], and ad hoc adjustments of incidental charges by ginning factories.[9] To remove this anomaly, the government has advised all concerned parties to meticulously follow the standard rules of the business. However, a more specific mechanism is needed to rectify the incentives that give rise to such practices, and also put into place a system that is simple to monitor and enforce.

Pakistan Cotton Ginners' Association (PCGA) has launched a strong campaign to convince textile mills to use the standard 170.1 kilograms per bale, or at least try to ensure this weight on average. The average bale weight was around 160 kilograms last season, but has increased to 164.4 kilograms by the end of October this season.

2.1.2 Agricultural Credit

A significant improvement of 26.0 percent in disbursement of credit during Q1-FY02 reflected various policy changes announced by SBP during FY01 (see **Table 2.4**). In short, the thrust of these changes was to ensure easy access of

[8] Higher amount of bank credit, presumably attached to number of bales, may be the one reason for textile mills to prefer larger number of bales with less than the standard weight.

[9] Ginning factories sometimes adjust their outstanding bills with textile mills by reducing the actual weight of cotton bales.

credit to farmers and to make agricultural financing more attractive for commercial and specialized banks.[10] At present, the changes have been more conducive for commercial banks, which have shown a 60.1 percent increase in disbursement and 14.3 percent in recovery.

Table 2.4: Credit to Agriculture Sector
million Rupees

	Disbursement		
	Q1-FY01	**Q1-FY02**	**% Change**
ADBP	5,986.0	6,557.8	9.6
Commercial Banks	2,404	3,847	60.1
FBC	585.5	900.0	53.7
Total	**8,975**	**11,305**	**26.0**
	Recovery		
ADBP	3,529.5	3,723.9	5.5
Commercial Banks	1,766	2,019	14.3
FBC	1,962.2	869.0	-55.7
Total	**7,258**	**6,612**	**-8.9**

Credit portfolio should improve further in the next quarter, since both the harvesting of kharif crops and sowing of rabi crops are concentrated in this part of the year. In effect, the second quarter of FY02 should witness higher net disbursements of credit to agriculture.

2.2 Large-scale Manufacturing

Growth in the production of large-scale manufacturing (LSM) was lower during the first quarter of FY02 against strong growth last year. During the quarter, LSM grew by 5.3 percent compared to 8.1 percent growth recorded last year (see **Tables 2.5** & **2.6**). This outcome is primarily on account of a higher base attained in the corresponding period last year.[11] Slow growth by two major groups i.e. *textiles* and *food, beverages & tobacco* (which have the largest say in overall performance of LSM), dragged down overall growth posted by the manufacturing sector.

Table 2.5: Summary of Growth Rates
percent

	Q1-FY01	**Q1-FY02**
Overall	8.1	5.3
Excluding sugar	8.1	4.8
Trimmed	9.9	3.9

Source: Federal Bureau of Statistics

All industries, with the exception of *metal* and *engineering*, recorded positive growth. However, only few showed improved performance over last year (see **Figure 2.3**). Groups like *petroleum products, electronics, automobiles, non-metallic minerals* and *tyre & tube* showed strong growth while others remained

[10] Detailed discussion on this issue is available in the SBP's *Annual Report* FY01.
[11] During FY01, large-scale manufacturing had already grown at higher rate of 7.8 percent, with most of the groups recording strong recovery over FY00.

weak. The fact that this slowdown is widespread can be seen in the trimmed growth, which was only 3.9 percent this quarter.[12]

Despite the fact that sugarcane crushing usually starts in late October or early

Table 2.6: Production of Selected Large-scale Manufacturing Items (July-Sep 2002)

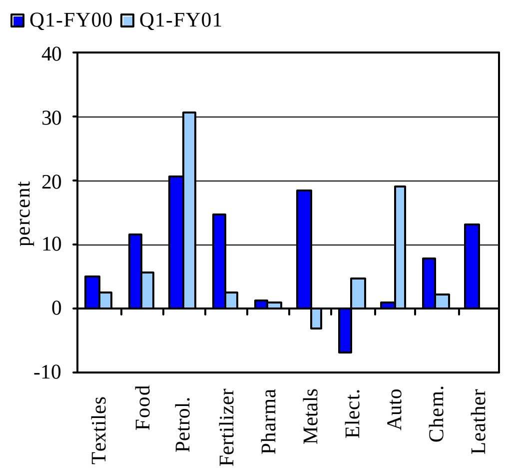
Items	Weights	Percentage Change FY01	Percentage Change FY02	Items	Weights	Percentage Change FY01	Percentage Change FY02
Textile	**19.069**	**5.07**	**2.22**	**Electronics**	**2.976**	**-7.01**	**4.60**
Cotton yarn	8.85	5.35	2.60	Electric transform	0.577	-15.78	-2.99
Cotton cloth	4.881	16.35	8.61	Storage batteries	0.451	8.36	-2.45
Cotton ginned	3.893	-4.52	0.66	T.V sets	0.363	-30.14	-11.61
Other five items	1.445	11.44	-20.80	Air conditioners	0.12	582.72	-83.71
Food, beverages, tobacco	**17.336**	**15.00**	**5.45**	Refrigerators	0.015	53.64	24.79
Sugar[1]	8.630	0.00	0.00	Other six items	1.45	-26.88	4.52
Vegetable ghee	3.004	20.81	-7.69	**Automobile**	**2.413**	**0.81**	**19.04**
Cigarettes	2.505	32.55	-9.82	Trucks	0.698	6.56	-26.67
Tea	1.785	-7.55	5.65	Tractors	0.593	-45.42	30.17
Beverages	0.964	2.01	5.34	LCVs	0.369	127.47	17.45
Cooking oil	0.448	17.83	13.64	Cars & jeeps	0.309	19.39	21.95
Petroleum products	**7.824**	**20.70**	**30.46**	Motorcycles	0.249	25.30	20.11
Fertilizer	**5.871**	**14.80**	**2.29**	Buses	0.13	-1.86	-40.62
Nitrogenous fertilizer	5.441	7.86	2.83	Diesel engines	0.065	5.56	-42.11
Phosphatic	0.430	202.19	-2.87	**Chemicals**	**2.335**	**7.85**	**1.91**
Pharmaceuticals	**5.798**	**1.27**	**0.99**	Caustic soda	0.621	3.44	2.84
Tablets	2.705	-4.23	5.08	Soda ash	0.32	-14.93	0.93
Syrup	1.602	-1.47	-1.38	Other six items	1.394	21.58	1.29
Injections	0.466	31.04	-10.55	**Non metallic mineral**	**1.915**	**-14.26**	**9.51**
Capsules	0.228	1.23	-7.89	Cement	1.846	-14.41	10.18
Other five items	0.471	11.99	2.24	Glass sheets	0.069	-9.83	-9.12
Metal industries	**3.317**	**18.38**	**-3.18**	**Paper & board**	**1.359**	**29.84**	**3.51**
Pig iron	1.477	9.70	-6.53	**Engineering items**	**0.691**	**12.46**	**-13.99**
Coke	1.319	27.93	2.17	Bicycles	0.348	25.62	-17.60
Billets	0.311	32.43	-5.71	Metal containers	0.153	9.19	-4.37
Safety razor blades	0.109	42.27	15.85	Sewing machines	0.052	-25.18	20.85
H.R/coils and plates	0.074	-26.24	14.78	Power looms	0.051	-58.94	-29.41
C.R coils/plates/	0.013	-24.50	-34.30	Other five items	0.087	-32.80	-33.27
Leather products	**2.333**	**13.31**	**0.08**	**Tyres & tubes**	**0.452**	**-16.16**	**31.23**

[1] There was no sugar production during Q1-FY01, hence calculating growth this quarter is meaningless.

[12] This refers to LS manufacturing growth excluding 5 outliers each for best and worst performing sub-sectors.

November, production of sugar took place during Q1-FY02, as processing of imported raw sugar last year continued into the first quarter of this year. Due to this unusual development, around 21 thousands tons of refined sugar was produced, which pushed up overall growth to 5.3 percent.

Figure 2.3: Growth in Seclected Industrial Groups



In sharp contrast to last year, *textiles* slowed despite depressed lint cotton prices in the beginning of the cotton season this year (see **Figure 2.2**).[13] During the quarter, textile sector grew by only 2.2 percent compared to 5.1 percent in the corresponding period last year. As most manufactured textile items are exported, the impact of the global recession on local industry cannot be ignored. Although, the quantum of textile exports has not declined, the spillover effects of recession are clearly evident from declining prices of textile products in the world market. Hence, anticipating a further deepening of the recessionary trend, manufacturers curtailed production in the first quarter of FY02.

Another factor that has caused a slowdown in textiles, is the decline in production of jute textiles.[14] As most raw jute is imported into Pakistan, and raw jute imports have fallen this year, this fall in production is not surprising.

Growth in the production of *food, beverages & tobacco*, remained lower at 5.5 percent during Q1-FY02 compared to 15.0 percent last year. This lower growth was mainly due to a sharp decline in the production of vegetable ghee and cigarettes. The fall in production of vegetable ghee, was the result of higher palm oil prices coupled with the fall in domestic production of edible oil seeds. Furthermore, an additional 1 percent surcharge was imposed on the import of raw

[13] Last year, lint cotton prices showed mixed trend; first they started rising and declined later in September, while this year, prices declined in a straight way.
[14] Major products of jute textile include jute cloth, bags used for packing and small handbags, chords etc. Production of jute textiles declined by 27.1 percent during Q1-FY02. Excluding jute goods, growth rate of textiles turn out to be 3.1 percent against 4.9 percent in the last year.

oil by ghee manufacturing units. The production of cigarettes, on the other hand, decreased as sales of cigarettes fell this quarter on account of the increase in retail prices. Furthermore, international manufacturers reduced prices of their brands, which was another factor behind the reduction in demand for local brands. During the last quarter of FY01, traders had already started building stocks in anticipation of the price hike after the Federal Budget 2001-02 was announced. As a result, local manufacturers curtailed production knowing that traders had stockpiled.

An important development that took place this quarter was the processing of locally grown tea. Previously, Pakistan was mainly engaged in blending and packaging of imported tea. Now, with the commissioning of a plant established by Lever Brothers Pakistan Limited, Pakistan has entered in the club of tea manufacturers.[15]

Production of *petroleum products* increased by 30.5 percent during the first quarter compared to 20.7 percent in the corresponding period last year. This increase was the result of Pak-Arab Refinery Limited (PARCO) that started production in September 2000. The permission to export petroleum products has provided an additional incentive to raise capacity utilization and production. Production of *fertilizer*, on the other hand, slowed mainly due to a decline in the production of phosphatic fertilizer. Imposition of non-adjustable GST on raw materials and inputs has hurt the profitability of fertilizer manufacturers especially, Fauji Jordan Fertilizer Company, which is the only phosphatic producing plant in Pakistan.

Metal industry is another sector that showed poor performance during Q1-FY02. Production of metals declined by 3.2 percent during the quarter against strong growth of 18.4 percent last year. This sharp decline was mainly because of weak sales on account of sluggish construction activities, reduction in duties on imported iron & steel products, and an increase in ship breaking activities following the Federal Budget 2001-02. As a result, the largest metal producer in the country (Pakistan Steel) restricted capacity utilization to 83 percent during Q1-FY02, down from 86 percent in the corresponding period last year.

As seen during FY01, the *automobile* sector continued its impressive performance during the first quarter of FY02, posting 19.0 percent growth against 0.8 percent

[15] This is the first ever black tea processing plant established in the country in Shinkiari near Mansehra, NWFP. It has the capacity of processing 1,000 kg of tea per day.

in the first quarter last year. This increase in production of cars, LCVs, Jeeps and motorcycles, was mainly demand driven on account of higher sales through lease financing. This year, tractors also joined this group by posting a strong recovery over last year. A fall in ADBP financing for the purchase of tractors last year, contributed to the negative growth of 45.4 percent in Q1-FY01. This clearly lowered the base, which explains the strong growth witnessed this quarter.

The production of *trucks & buses*, on the other hand, continued to fall the second year in a row, mainly due to slack demand from commercial & government institutions during the last few years. The smuggling of trucks, mostly over the Chaman border with Afghanistan, has been hurting the domestic industry. These smuggled vehicles are being sold at a price that is 30 to 40 percent lower than vehicles assembled in the country. Needless to say, domestic assemblers that have to pay duties and taxes on imported and local components, are finding it difficult to compete with smuggled trucks.

The *tyre & tube* industry also followed the automobile sector and recorded strong recovery with growth of 31.2 percent during Q1-FY02, against a decline of 16.2 percent last year. Increase in the production of tractors was an added boost to this sector.

Growth in the production of *chemicals* slowed to 1.9 percent during Q1-FY02 from 7.9 percent in the same period last year. However, production of soda ash during the quarter recorded positive growth against a sharp decline last year. This is because of two factors: production fell to the lowest level last year due to the closure of Sind Alkalis Limited, which created a low base effect; and a regulatory duty of 5 percent was imposed on the import of soda ash in the Federal Budget 2001-02.

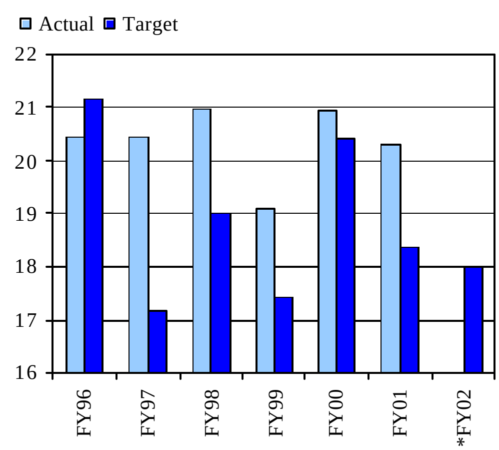
The production of *non-metallic minerals* increased by 9.5 percent during Q1-FY02 against a decline of 14.3 percent last year. This turnaround was mainly due to a strong recovery by cement manufacturers during the quarter. Despite sluggish construction activities, production of cement increased by 10.2 percent during the quarter against a decline of 14.4 percent in the corresponding period last year. Higher cost of production on account of rising furnace oil prices had dampened the cement industry over the past couple of years. In order to make production of cement viable and profitable, manufacturers are in the process of converting their kilns to coal, which is cost efficient compared to furnace oil. So far, although none of the cement plants in the country have fully converted to coal, most have been substituting away from furnace oil.[16]

3. Fiscal Developments[17]

Compared to buoyant performance in Q1-FY01, tax collections showed negative growth this year. In absolute terms, despite the projected increase, revenues were lower by Rs 2.4 billion compared to what was realized by end-September 2000 (see **Table 3.1**). The fact that revenue targets have been revised twice this quarter, itself paints a gloomy picture. Within the context of quarterly and annual targets, revenue collection was 96.8 percent of the quarterly target or 18.0 percent of the revised annual target (see **Figure 3.1**).

The two most important factors responsible for this shortfall were: a significant decline in the volume of dutiable imports, which in turn, form the base for custom duties and sales tax on imported goods; and large payment of refunds/rebates amounting Rs 21.1 billion compared to Rs 15.7 billion during Q1-FY01. Excluding this, gross revenue would have risen by 3 percent over last year.

Figure 3.1: Revenues in Q1 as Percent of



* Revised target

3.1 Direct Taxes

The compositional breakdown of tax revenue reveals that direct taxes (28 percent share in total collections), recorded a marginal increase of 2.0 percent in Q1-FY02 over the corresponding period last year (see **Figure 3.2**). This was primarily on account of the new self-assessment scheme that expired on October 1, 2001 (almost half of direct taxes were realized in September 2001 alone).

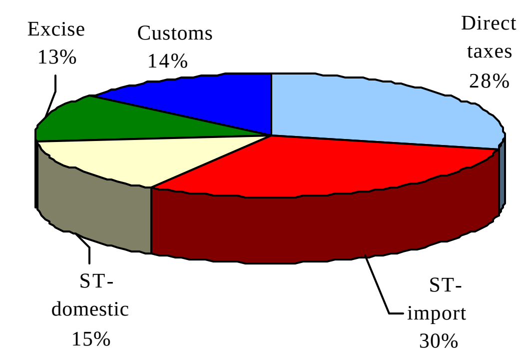
[16] It is estimated that many plants have been able to substitute 30 to 40 percent of their furnace oil needs with coal.
[17] The non-availability of data on consolidated fiscal operations limit our discussion to CBR tax collections only.

After the revision of annual and quarterly targets, direct taxes actually exceeded the quarterly target, but since the first quarter is generally slow in terms of collection, this is only 15.5 percent of the annual target. In terms of the components of direct tax, receipts from interest income on securities, profit/interest on deposits and withholding tax on imports posted much lower growth compared to Q1-FY01 (see **Table 3.1**)..

3.2 Indirect Taxes

Collection of indirect taxes not only fell short of quarterly target, but was significantly lower than the level achieved in the corresponding period last year. More specifically, indirect taxes posted negative growth of 5.0 percent in Q1-FY02 compared to a significant increase of 13.5 percent in the preceding year. This sharp reversal can be explained by looking at the compositional breakdown.

Figure 3.2: Tax Collections Q1-FY02



Sales Tax: Contrary to the negative growth in overall indirect taxes, sales tax collections registered an increase of 9.9 percent during Q1-FY02. In terms of quarterly and annual targets, this covers 95.4 and 19.6 percent, respectively (see

Table 3.1: Federal Tax Collections up to Q1-FY02

billion Rupees

	Targets		Tax collection in Q1			As % of targets		Excess/ shortfall over Q1	% change over FY01
	FY02	Q1	FY00	FY01	FY02	FY02	Q1		
Direct taxes	142.4	21.8	21.3	21.6	22.1	15.5	101.2	0.3	2.0
Indirect taxes	287.5	58.2	51.4	58.3	55.4	19.3	95.2	-2.8	-5.0
Sales tax	176.8	36.3	21.4	31.5	34.6	19.6	95.4	-1.7	9.9
Central excise	49.4	9.6	12.9	12.7	9.9	20.1	103.6	0.3	-22.0
Customs	61.3	12.3	17.1	14.1	10.8	17.7	88.1	-1.5	-23.0
Total collections	429.9	80.0	72.7	79.9	77.5	18.0	96.8	-2.5	-3.1

Source: Central Board of Revenue

Table 3.1). More importantly, an improvement was witnessed both on import related items and domestic goods and services. Despite lower imports during the quarter, higher collection of sales tax on imports was mainly on account of an increase in tax rate from 15 to 20 percent on more than a hundred select raw materials. This measure was not just designed to fetch much needed revenue for the government, but also to provide an impetus to voluntary registration of sales taxpayers in a bid to help document the economy.

The sales tax on domestic goods and services however, posted a relatively lower growth largely due to a fall in value addition by the textile sector. More specifically, the 2.2 percent increase shown by the textile sector coupled with negative import growth (in value terms) contained the potential sales tax base, while its levy on retail traders may take some time to show its contribution. As stated before, the increase in refunds/rebates also lowered net collection from sales tax on domestic goods and services.[18]

Central Excise Duties: Although revenue from excise duties exceeded the quarterly target, it witnessed a steep 22.0 percent decline compared to realized revenues in the first quarter last year. The government policy to replace CED with GST, coupled with the rationalization of excise duties on cigarettes, played a role in this significant decline. Moreover, lower collection of CED on cement and select petroleum products also contributed to this end. In the Federal Budget for FY02, excise duty slabs for cigarettes were increased from two to three effective June 18, 2001.[19] Since the new middle-slab captures high brand cigarettes (which are not the largest selling), this resulted in lower CED collection. Furthermore, lower imports and slower growth in locally produced goods (subject to excise duty) also contributed negatively.

<u>Custom Duties:</u> The revenue from custom duties also recorded negative growth of 23.0 percent in the quarter, which was 88.1 and 17.7 percent of quarterly and annual targets, respectively. The decline in imports, the reduction in tariff rates and fewer slabs, largely contributed to this shortfall.[20] More specifically, negative

[18] In Q1-FY02, refund amount related to sales tax on domestic goods and services stood at Rs 11.8 billion, which is Rs 4.4 billion higher than what was disbursed a year before.
[19] The slabs are; (i) if retail price does not exceed Rs 4.15 per ten cigarettes, the CED rate is Rs 1.77 per ten cigarettes; (ii) if retail price exceeds Rs 4.15 but does not exceed Rs 10.0 per ten cigarettes, the CED rate is Rs 1.77 plus 69 paisa on per incremental rupee; and (iii) if retail price exceeds Rs 10 per ten cigarettes, the rate is 63 percent of the retail prices.
[20] In Budget FY02, the maximum tariff rate was reduced from 35 percent to 30 percent, while the number of slabs was reduced from 5 to 4. The new slabs are at 30 percent, 20 percent, 10 percent and 5 percent.

growth of 8.2 percent in imports during Q1-FY02 and abolition of regulatory duties on various items, squeezed the base for customs and sales tax collections.

The outlook for tax collection following September 11, has been incorporated in the revised targets. The first revision was needed after CBR's revenue collection for FY01 was realized. In analyzing the second revision, the bulk of this adjustment is in indirect taxes, which accounts for Rs 14.1 billion out of the total downward revision of Rs 14.8 billion. This adjustment reflects trade impediments following the terrorist attacks and the repercussions of the global recession. More specifically, customs duties have been revised downward by Rs 7.6 billion, while sales tax receipts were lowered by Rs 6.3 billion. It is important to realize that sales tax is also imposed on dutiable imports.

4. Money and Credit

The first quarter of this year was a period of consolidation on the progress made last year (FY01). Few of the uncertainties and hard decisions, which marked Q1-FY01, existed this quarter. During this period, SBP moved towards a proactive monetary management system and in doing so, has signaled that it can defend the Rupee without necessarily resorting to a change in its monetary stance. However, as the Rupee has not come under any significant pressure during Q1-FY02, the effectiveness of this new approach is yet to be tested (see section on **Money Market**).

As said earlier, SBP had achieved a degree of market calm and prospects for the future following a 1 percent cut in the discount rate in July and August, looked promising. However, the events of September 11 have created an uncertain external environment in which monetary management has to be conducted.

As a norm, the first quarter of the fiscal year is a period of subdued economic activity, as fresh lending is low while repayments from the previous year continue. Economic activity kicks off with cotton and sugar financing that usually starts in October. Despite the seasonal slump in private sector lending, lower demand for credit this quarter (especially in September) was compounded by the following: (1) late arrival of cotton to ginners, (2) late crushing of sugarcane, (3) cotton fabric (grey & bleached) and yarn are no longer eligible for export finance, (4) cancellation or temporary suspension of export orders after September 11[21], and (5) anecdotal evidence that the private sector is resorting to

[21] There is also the view that with the narrowing spread between EFS rates and working capital loans, demand for export finance is lower than the first quarter of last year.

self finance. This has reduced demand for working capital loans by the textile sector.

Having said this, it is still too early to evaluate how the private sector will behave in coming months. Already, import figures and gross credit disbursements to allied sectors have shown some improvement over the corresponding period last year, which suggests that the private sector is taking advantage of the Rupee's appreciation to gear up for future production. In general, however, borrowing by both government and non-government were lower in Q1-FY02 as compared to last year (see **Table 4.1**).

Table 4.1: Monetary Survey
billion Rupees

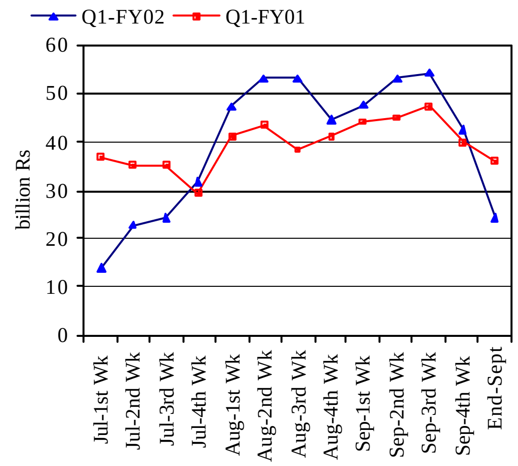
		Actual Q 1-FY02	Actual Q 1-FY01
A.	**Government sector borrowing (net)**	**23.0**	**23.9**
	1 Net budgetary borrowing	24.6	36.0
	From State Bank of Pakistan	6.8	1.5
	From scheduled banks	17.8	34.5
	2 Commodity operations	-0.9	-11.6
	3 Net effect of Zakat fund/privatization proceeds	-0.4	-0.7
	4 Others (credit to NHA & CAA)	-0.2	0.2
B.	**Non-government sector borrowing**	**-29.6**	**-8.8**
	1 Autonomous bodies[1]	-7.3	-9.8
	2 Net credit to private sector and PSCEs	-22.3	1.0
	Commercial banks	-18.9	-2.1
	PSCEs other than B(1)	4.6	2.4
	Private sector	-23.5	-4.5
	of which export refinance	*-12.1*	*1.2*
	Specialized banks	7.4	4.7
	Other financial institutions	-11.1	0.2
	PSCEs special account-debt repayment with SBP	0.3	-1.8
C.	**Other items (Net)**	**21.9**	**0.2**
D.	**Net domestic assets of the banking system**	**15.3**	**15.3**
		1.02%	1.06%
E.	**Net foreign assets of the banking system**	**-14.6**	**-18.7**
F.	**Monetary assets (M2)**	**0.7**	**-3.4**
		0.04%	-0.24%

[1] WAPDA, OGDC, PTC, SSGC, SNGPL, KESC & PR

Source: State Bank of Pakistan

4.1 Government Sector

Figure 4.1: Budgetary Borrowings



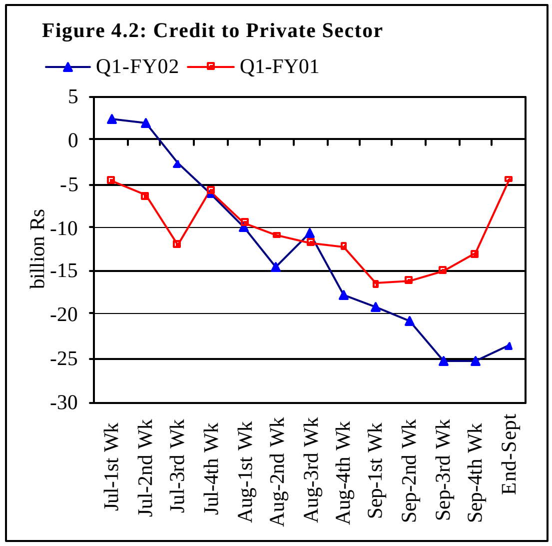
Despite the availability of Banking Sector Adjustment Loan from Japan (amounting to Rs 11 billion), and transfer of SBP profits Rs 5 billion to GOP, government borrowing for budgetary support this quarter was Rs 24.6 billion as compared to Rs 36.0 billion in the corresponding period last year (see **Figure 4.1**). It may be recalled that in Q1-FY01, GOP was unable to secure financing from non-bank and external sources and had to rely on the banking sector. This year, however, with growing awareness and popularity of the PIB, and increased mobilization by NSS instruments, GOP had better access to non-bank financing. As compared to only Rs 3.3 billion borrowed from non-banks in Q1-FY01, GOP borrowed Rs 31.1 billion this quarter.

It is interesting to note that in Q1-FY01, government borrowing peaked at Rs 47.1 billion in the third week of September, this year too, despite larger flows from non-bank sources, government borrowing peaked in the third week of September, but at a higher level of Rs 54.0 billion. The higher peak this quarter can be attributed to lower revenue collection and higher payments on account of both domestic and external debts.

Commodity operations recorded retirement of only Rs 0.9 billion this quarter against Rs 11.6 billion in Q1-FY01. This is due to the fact that FY00 ended with a record borrowing for commodity operations (Rs 40 billion in net terms) and as such, retirement during Q1-FY01 was higher than this quarter.

4.2 Non-Government Sector

Credit to the private sector recorded retirement of Rs 23.5 billion this quarter against only Rs 4.5 billion in Q1-FY01 (see **Figure 4.2**). Again (as with commodity financing last year), repayments by the non-government sector during this quarter were higher compared to Q1-FY01 due to past lending patterns. However, as shown in **Figure 4.2**, private sector credit has clearly not picked up in September 2001 compared to September 2000. The terrorist attacks and



spreading recession in the world economy has adversely affected local entrepreneurs, resulting in lower demand for credit.

The retirement of export refinance in Q1-FY02 is exceptionally high. Against an expansion of Rs 1.2 billion in the first quarter of last year, this quarter posted a net contraction of Rs 12.1 billion. This is on account of SBP's decision to make grey/blended fabrics and cotton yarn ineligible for concessional financing.[22] An analysis of previous data reveals that around Rs 12 billion is disbursed as export finance on account of these items in the first quarter of each year. If we adjust for this factor, export refinance this quarter is largely in line with past trends.[23] In view of this, it is interesting to note that the 4 percent increase in EFS rate between January and July 2001, has not had much of an impact on the demand for export finance since gross disbursements have also been hit following September 11.

Credit to autonomous bodies this quarter shows no significant change in borrowing pattern. In terms of lending by specialized banks, credit expansion is more pronounced this quarter as compared to Q1-FY01. This expansion of Rs 7.4 billion is almost entirely on account of ADBP. With effects of the drought beginning to dissipate, conditions are looking good for the agriculture sector. The increase in credit disbursed by ADBP is thus in line with expectations.

The contraction in credit disbursed by *Other Financial Institutions* (by Rs 11.1 billion) is largely on account of closing foreign currency swaps with Pak-Kuwait (US$ 87 million) and Al-Meezan Bank (US$ 120 million) in end-September.

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[22] This was made effective July 2001.

[23] An internal SBP exercise that excluded cotton fabrics (grey & bleached) and yarn from EFS, shows that gross disbursements during Q1-FY01 was Rs 51.7 billion against Rs 44.2 billion this quarter. Including fabrics and yarn, gross disbursements in the first quarter last year was Rs 64.2 billion.

With hindsight, this was unfortunate timing, since SBP could not anticipate the collapse in the kerb market rate in early October. As these swaps were closed at the rate of Rs.67.25 per US Dollar on September 28, SBP booked a Rs 1 billion exchange loss this quarter.

Other items net of the banking system shows an expansion of Rs 21.9 billion this quarter against a meager Rs 0.2 billion in Q1-FY01. This expansion is on account of the following: (1) transfer of Rs 5 billion of SBP profits to the government, (2) transfer of Rs 11 billion as part of the banking sector adjustment loan, and (3) the impact of closing foreign currency swaps.[24] All these transactions are part of SBP's *other liabilities* and any change in them if not countered by an equivalent decrease in other assets, will increase *other items net*. It was due to expansionary impact under this head that increase in domestic liquidity this quarter was almost the same as Q1-FY01.

4.3 Net Foreign Assets (NFA)

NFA of the banking system fell by Rs 14.6 billion this quarter as compared to a fall of Rs 18.7 billion in Q1-FY01. Following the events of September 11, the NFA of scheduled banks fell as foreign missions and relief agencies withdrew from their foreign currency deposit to secure Rupee liquidity. As shown in **Figure 9.7** the outstanding volume of unfrozen FCAs fell sharply after September 11, despite the fact that the Rupee only appreciated from October 1, 2001. FE-25 deposits, which had increased from their end-June level of US$ 1.54 billion to US$ 1.64 billion by September 11, fell almost to its end-June level by end-September.

The appreciation of the Rupee in the interbank market, which followed the collapse in the kerb market, prompted SBP to buy heavily from the interbank market. The aim was tw o fold: to shore up liquid reserves at relatively lower rates; and to curtail further appreciation of the Rupee. Market players are of the view that had it not been for heavy buying by SBP, the Rupee/Dollar parity would easily have slipped below Rs 60. Needless to say, this would have added to the problems facing Pakistani exporters.

4.4. Money Supply

There was no significant increase in the money supply during Q1-FY02 which only increased by Rs 678 million. In comparison money supply in Q1-FY01 had

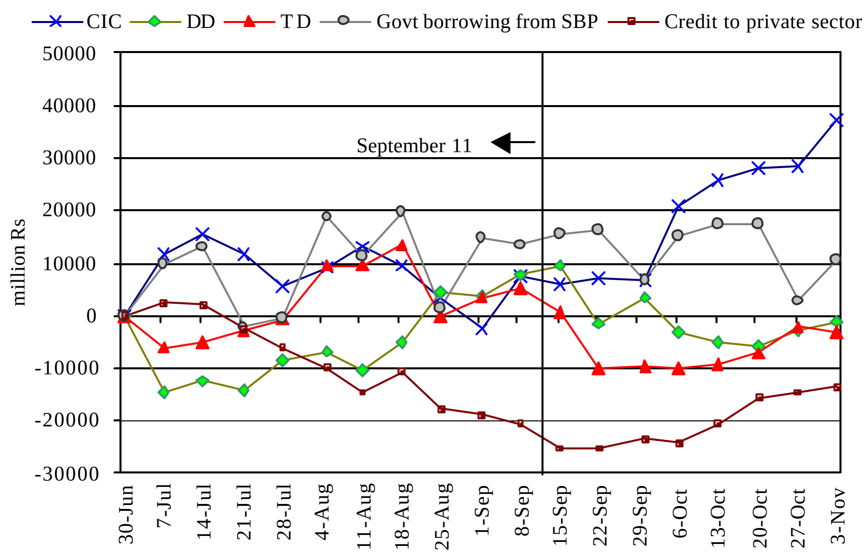
[24] In order to meet end-September bank borrowing target, the government had SBP transfer part of its profit and the banking sector adjustment loan to its account. Even then the government was only able to bring down its borrowing to 24.6 billion.

contracted by Rs 3.4 billion.

Components of money supply show no major change in the end quarter figures relative to end-June 2001. However, there was considerable variation in both the deposits and currency in circulation. In only the first week of Q1-FY02 deposits of the banking system fell by Rs 20.8 billion, while currency in circulation increased by Rs 11.8 billion (see **Figure 4.3**). This confirms our earlier assessment that the Rs 30 billion increase in deposits witnessed in June 2001 was window dressing by the banks. Thereafter, deposits started to grow and by September 8 had increased by Rs 18.1 billion over the end-June 2001 stock. However, post September 11 period witnessed panic withdrawals with the result that total deposits as of end September stood below the end-June level by Rs 5.4 billion.

It is interesting to note that during the same period in September there was no significant change in currency in circulation, which one would expect given the sharp decline in deposits following September 11. When currency in circulation is plotted against components and causative factors of money supply, it is observed that movements in currency follow government borrowing *from SBP* (see **Figure 4.3**). Since currency in circulation is demand driven, while government borrowing from the central bank creates the space to increase the

Figure 4.3: Components of Monetary Assets



stock of currency, this correlation is not a coincidence. It may be noted that between September 8 and end-September GOP brought down its borrowings from SBP from Rs.13.5 billion to Rs. 6.8 billion in an effort to meet its end September target. Thus, there were two almost equal but opposite pressures on currency in circulation with the result that they canceled out each other and there was no significant impact on currency in circulation.

This observation is further strengthened in the post September period; with attack on Afghanistan imminent, demand deposits witnessed a steep decline and government borrowings from SBP increased sharply. These two factors, which had previously worked in opposite directions, converged; hence currency in circulation increased sharply in October. As shown in **Figure 4.3**, the sharp increase in currency in the first week of November, can be traced to GOP borrowing from SBP while, demand for currency notes has also increased with the situation developing in Afghanistan.

5. Money Market

The money market witnessed a higher number of days of tight liquidity compared with Q1-FY01.[25] However, since the end-March and end-June net domestic asset (NDA) targets were met without excessive pressure on the money market, sentiments became calmer as the prospects for the first successfully completed IMF program became very strong.

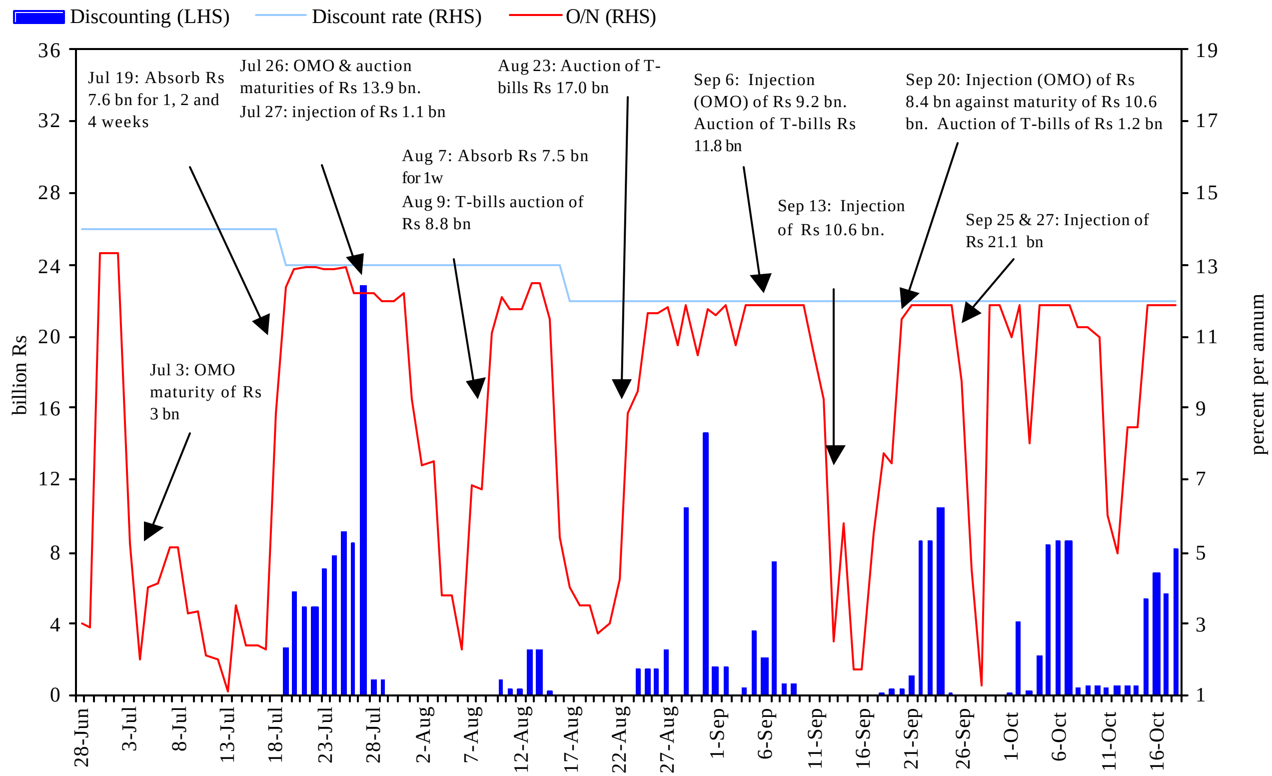
During the course of the quarter, the discount rate was reduced by 1 percent in both July and August, while SBP changed its mechanism of conducting open market operations (OMOs). The latter was motivated by the need to make SBP's monetary management more proactive, and more importantly, to manage the Rupee/Dollar parity without having to change SBP's monetary policy stance.

5.1 Discounting

During the quarter, banks discounted Rs 161.5 billion against Rs 138.7 billion in the corresponding period of last year (see **Table 5.1**). The interesting point to note here is that although the number of visits was higher this quarter, the average discounting per visit was much lower compared to Q1-FY01. This shows that although banks were short of liquidity more often, they required less support from SBP (see **Figure 5.1**). The fact that this was done with cheaper support from the

[25] During Q1-FY02, 33 working days witnessed overnight rates within 5 percent of the discount rate, against 15 days in the first quarter of last year.

Figure 5.1: Discounting and Over Night Rates



central bank (discount rate ?), suggests that cash management by the banks has improved.

In absolute terms, the higher volume of discounting could also be on account of higher transfer of funds from commercial banks to the government. Looking specifically at T-Bill and PIB auctions during the quarter, against total maturities of T-Bills (Rs 24.7 billion) and FIBs (Rs 6.1 billion), the government mobilized Rs 57.5 and Rs 15.5 billion from T-Bills and PIBs, respectively. On account of just these bonds, Rs 73.0 billion was absorbed from the market during the quarter.

Table 5.1: Activities at Discount Window
billion Rupees

	No. of visit to discount window (no. of days)			Total amount of discounting			Average per visit		
	FY00	**FY01**	**FY02**	**FY00**	**FY01**	**FY02**	**FY00**	**FY01**	**FY02**
July	15	3	11	33.6	29.8	75.2	2.2	9.9	6.8
August	8	8	12	28.2	44.0	38.9	3.5	5.5	3.2
September	3	9	16	7.8	64.9	47.4	2.6	7.2	3.0
Quarterly	**26**	**20**	**39**	**69.5**	**138.7**	**161.5**	**2.7**	**6.9**	**4.1**

Table 5.2: Open Market Operations
million Rupees

	Injection			Absorption		
	FY00	**FY01**	**FY02**	**FY00**	**FY01**	**FY02**
July	4,750	-	1,125	-	7,700	22,100
August	-	-	10,650	21,550	17,150	7,500
September	-	-	49,255	28,180	13,900	4,000
Total	**4,750**	**-**	**61,030**	**49,730**	**38,750**	**33,600**

5.2 Open Market Operations

After floating the Rupee in July 2000, SBP's monetary policy had to be used several times during FY01 to support the currency when it came under pressure. [26] Since SBP's monetary stance could not be abruptly changed depending on developments in the foreign exchange market, the overall stance last year was tight. With growing awareness of this new system of managing the Rupee/Dollar parity and the period of calm in the foreign exchange market, it was possible to change the system of conducting OMOs as a tool of short-term liquidity

[26] See section on **Money Market,** *Annual Report* FY01

also been called within the same day), monetary management has become much more proactive (see **Table 5.3**). As stated earlier, this will also help SBP manage the exchange rate without resorting to frequent changes in the discount rate and T-Bill rates.

Table 5.3: OMO Summary of Results
billion Rupees

Day	Date	Offered	Absorbed	Bid	Injected
Thu	12-Apr	1.3	0.0	0.0	0.0
Thu	26-Apr	7.2	4.9	0.0	0.0
Thu	10-May	1.8	0.0	0.0	0.0
Thu	24-May	17.5	9.1	0.0	0.0
Thu	7-Jun	3.0	0.0	0.0	0.0
Thu	21-Jun	1.0	0.0	0.0	0.0
Mon	25-Jun	6.2	0.0	0.0	0.0
Q1-FY01					
Thu	5-Jul	10.0	4.5	0.0	0.0
Thu	19-Jul	23.2	17.6	0.0	0.0
Discretionary OMOs (Effective July 25, 2001)					
Fri	27-Jul	0.0	0.0	9.1	1.1
Tue	7-Aug	10.7	7.5	0.0	0.0
Tue	28-Aug	0.0	0.0	7.7	3.3
Thu	30-Aug	0.0	0.0	12.3	7.4
Thu	6-Sep	0.0	0.0	17.9	9.2
Thu	13-Sep	0.0	0.0	13.2	10.6
Thu	20-Sep	5.6	4.0	9.3	8.4
Tue	25-Sep	0.0	0.0	29.7	15.9
Thu	27-Sep	0.0	0.0	10.1	5.2
Sat	29-Sep	0.2	0.0	0.0	0.0
Q 1-FY01		**49.7**	**33.6**	**109.1**	**61.0**

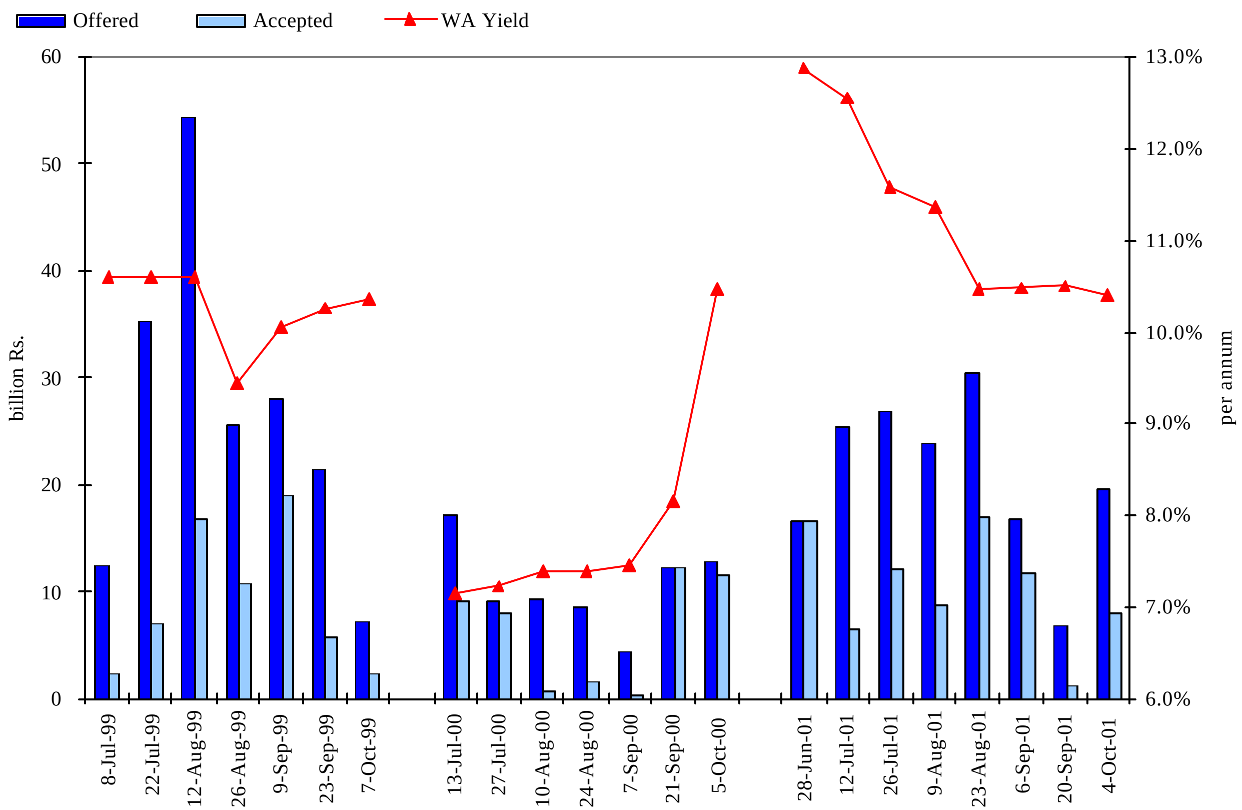
Corresponding to this effort to make a strong distinction between liquidity management and SBP's monetary policy stance, the OMO tenor structure has consciously been shortened during the quarter to further reinforce the distinction between OMOs and primary auctions. Although there is still a certain degree of benchmarking between annualized rates on OMOs and primary auctions, it will take some time for both the banks and SBP to realize that changes in OMO rates should depend on market liquidity and not SBP's monetary stance (T-Bill rates), thus enabling the market not to perceive changes in OMO rates as indicating a likely change in the central bank's monetary stance.

<u>Primary Auctions</u>

As shown in **Figure 5.2**, T-Bill rates posted a steady decline in the first four primary actions in Q1-FY02, as the discount rate was reduced by 2 percent during this 2-month period. This contrasts with the rise in T-Bill rates at the end of Q1-FY01, which was a precursor to the very sharp hike witnessed in October 2000. As shown in **Figure 5.2**, the first auction in July 2001 saw a mild fall in rates but the fraction of total bids accepted was very low.

The second auction of the month witnessed a much sharper fall in T-bill rates while a larger fraction of bids were accepted. This is simply because the discount

Figure 5.2: Auction Summary of T-Bills



rate was reduced from 14 to 13 percent on July 19, which forced banks to rethink their bid prices. A similar situation was seen in August where the second primary auction of the month saw a much sharper fall in rates while the fraction of total bids accepted also increased. In comparing the first quarters of FY02 and FY01, the level of T-bill rates (which sets market expectations) could explain the lower volume of bids last year – as expected, banks are less willing to offer funds when returns are low.

In overall terms, the government mobilized Rs 57.5 billion from primary auctions, which represents 44.1 percent of total bids in Q1-FY02. As expected, since interest rates fell this quarter, the fraction of accepted bids was lower than the case last year where rates were largely stagnant.[27]

PIB Auctions

As shown in **Table 5.4**, three PIB auctions were held with a combined target of Rs 21 billion. However, the amount accepted was only Rs 15.5 billion. On the face of it, this may seem disappointing, but several factors must be kept in mind. First, compared to the 10-year PIB, there is limited market appetite for the 3 and 5-year instrument. As shown in **Table 5.4**, only one of the three auctions involved the 10-year PIBs; second, the discount rate was twice reduced during the course of the quarter; and three, coupon rates on the PIB were reduced on August 17, 2001.

In the ***first auction*** that only included 3 and 5-year PIB, the Rs 3 billion target was set in consultation with the Primary Dealers (PDs). However, on July 19, the discount rate was reduced to 13 percent but coupon rates were not adjusted downwards since this would have undermined the July 20 auction. Also, coupon rates were not adjusted downward since the original coupon rates had been set when the discount rate was 13 percent, and the increase to 14 percent was not a change in monetary stance but an effort to defend the Rupee.[28] In effect, since a cut in the discount rate automatically increases the market value of the PIB, the July auction was heavily oversubscribed. However, as part of SBP's commitment not to exceed the auction target, only Rs 2.96 billion was accepted.

The ***second auction*** of the quarter involved the 10-year PIB. Given the discount rate cut in July and the over-subscription in the first auction of Q1-FY02, SBP was expecting another sell-out since coupon rates were not reduced. As the 3 and

[27] During Q1-FY01, Rs 32.0 billion was accepted representing 52.7 percent of total bids.

[28] Hence, when the discount rate was increased to 14 percent in June 2001, coupon rates were not increased; correspondingly, when the discount rate was returned to 13 percent, it would have been difficult to justify a reduction in coupon rates.

5-year rates were not adjusted down in the first auction following the cut in discount rate in July, it would have been unjustified to reduce coupon rates on the 10-year instrument. As shown in **Table 5.4**, bids totaling Rs 28.2 billion were received. Whereas a degree of over-subscription was expected, the nature of the bid patterns was not. The cheapest single bid in this auction was for Rs 10.8 billion. Although it would have been justified for SBP to exceed its target by Rs 800 million, the auction was scrapped outright. It is our firm view that since the PIB is not meant to be held by banks (whether PDs or non-PDs) but passed on to institutional investors who have been banned from investing in NSS instruments, this cornering of the PIB auction would have interrupted the flow of long-term instruments to institutional investors. Furthermore, given the nascent nature of the PIB, excessive holding by certain banks would have distorted secondary trading. This course of action was also needed to discourage lumpy bid patterns in future auctions, and to flag the central bank's concern about the accuracy of "market demand" estimates provided by the PDs.[29]

The excess demand for PIBs that was clearly shown by the bids in this auction, needed to be addressed. This market signal encouraged SBP to take two actions: the discount rate was further reduced to 12 percent on August 17, while the

Table 5.4: PIB Auctions - Summary of Results
million Rupees

Auction	Tenor	Target	Coupon rate	Amount offered	Range of price offered/Rs. 100	Amount accepted	W. A. % p.a.	% Accepted of total accpt.
7th Jul 21	3 Years		12.50%	4,829	99.50--100.10	2,385	12.4749%	80.54%
	5 Years		13.00%	1,974	100.00--100.10	576	12.9924%	19.46%
	10 Years		-	-	-	-	-	-
	Total	**3,000**	**-**	**6,803**	**-**	**2,962**	**-**	**100.00%**
8th Aug 16	3 Years		-	-	-	-	-	-
	5 Years		-	-	-	-	-	-
	10 Years		14.00%	28,183	100.00--100.24	-	-	0.00%
	Total	**10,000**	**-**	**28,183**	**-**	**-**	**-**	**-**
9th Aug 22	3 Years		-	-	-	-	-	-
	5 Years		-	-	-	-	-	-
	10 Years		13.00%	8,046	99.60--100.15	6,746	13.0002%	100.00%
	Total	**10,000**	**-**	**8,046**	**-**	**6,746**	**-**	**-**
10th Sep 21	3 Years		11.80%	3,439	99.95--100.05	3,439	11.7921%	59.46%
	5 Years		12.20%	2,844	99.63--100.05	2,344	12.2110%	40.54%
	10 Years		-	-	-	-	-	-
	Total	**8,000**	**-**	**6,283**	**-**	**5,783**	**-**	**100.00%**
Total	**-**	**31,000**	**-**	**49,316**	**-**	**15,491**	**-**	**-**

[29] It is natural for PDs to underestimate market demand to minimize their underwriting commitments.

coupon rates on all PIBs was adjusted downwards. More specifically, SBP decreased the coupon rate for 3, 5 and 10-year PIBs by 70 bps, 80 bps and 100 bps, respectively. This lowering and slight flattening of the yield curve signaled a decline in long-term rates and hinted at the possibility that SBP could invert the yield curve if needed.[30] Although the target for the new August auction remained at Rs 10 billion (with the consensus of the PDs), the coupon rate cut meant participation was restrained; SBP was only able to accept Rs 6.7 billion at a slight premium.

Given this poor result in the August auction, target for the ***third auction*** in September was kept at Rs 8 billion. Although the PDs felt market appetite for these tenors may not be as high, the fact that only Rs 9.7 billion worth of PIB had been sold in the past two auctions, suggested that there may be pent-up demand from institutional investors who require a regular flow of long-term instruments. Furthermore, it was important to signal to the market that falling short of targets did not reflect badly on the PIB itself, but was simply an error in judgment in terms of gauging market appetite. Against this target of Rs 8 billion, offers were only Rs 6.3 billion of which Rs 5.8 billion was accepted at a slight premium.

6. Banking

As mentioned in the *Annual Report*, the sharp increase in deposits witnessed in end-FY01 was reversed within the first week of the year, as demand and term deposits declined by Rs 20.9 billion. Although after this adjustment, deposits did recover somewhat, the week ending September 15 showed an increase in demand deposits with a fall in term deposits. However, the actual impact was realized in the third week of the month, as deposits (demand and term) fell by Rs 11.8 billion.

6.1 Interest Rates

As shown in **Figure 6.1**, the average lending rate has been hovering around 14 percent since the first quarter of FY01. The increase in T-bill rates witnessed last year has been reflected in lending rates (in September, March and June 2001), while the easing in SBP's monetary policy this year has seen a limited pass through. On the other hand, deposit rates have remained unchanged over the past year, with little acknowledgement of changes in T-bill rates. Although deposit rates have actually edged lower as shown in **Figure 6.1**, the fall in lending rates during August and September 2001, narrowed the intermediation spread.

[30] An inverted yield curve implies that short-term interest rates (annualized) are higher than medium or even long-term interest rates.

6.2 Non-Performing and Defaulted Loans

There was a rapid growth in both non-performing loans (NPLs) and defaulted loans (DLs) during FY01. This was due to better monitoring of delinquent loans and stricter classification requirements. As mentioned in earlier reports, the increase in NPLs is not driven by the actual incidence of bad loans at the margin.

Figure 6.1: W.A. Deposit & Lending Rates

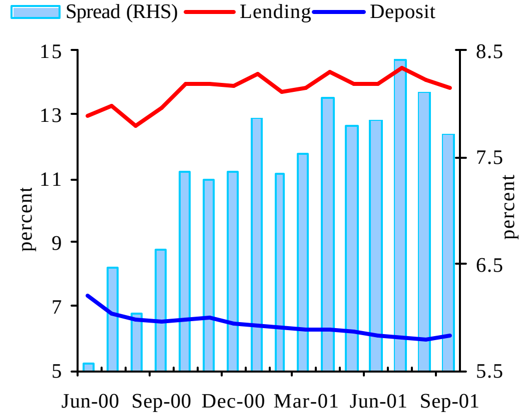
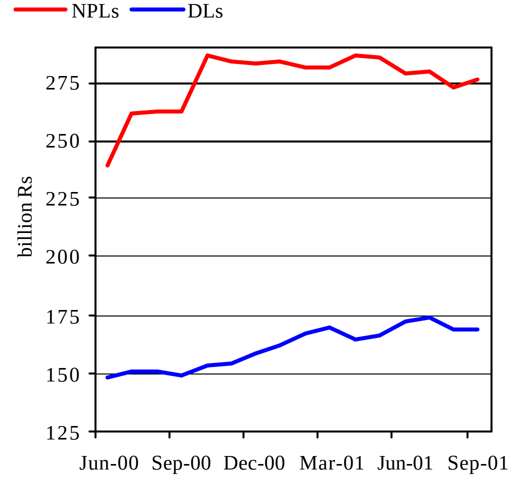


Figure 6.2: NPLs & Defaulted Loans



NPLs touched its peak of Rs 286 billion in October 2000, and have effectively tapered off since then. Despite the addition of Rs 15.6 billion in NPLs during Q1-FY02, the outstanding stock declined mainly due to cash recoveries, deletion and write off worth Rs 17.0 billion.[31] Defaulted loans, on the other hand, declined in August 2001 after increasing till July 2001 (see **Figure 6.2**). The reason for the increase can be traced to an increasing awareness that certain loans could not be salvaged, and banks' decision to act accordingly. Since the bulk of these bad assets are with large nationalized banks, such steps are needed in view of the government's commitment to privatize the NCBs. Furthermore, the implementation of mandatory credit rating by the banks has made them more cautious about the health of their balance sheets.

[31] Deletions refer to the reduction in NPLs through any factor other than recoveries or write off; this is primarily because of transfers of bad debts to CIRC.

7. Prices

Inflation remained subdued in the first quarter of FY02. A decelerating trend is visible both in terms of the Consumer Price Index (CPI) and Sensitive Price Indicator (SPI). Although, the 12-month moving average for the Wholesale Price Index (WPI) edged up in the first quarter, it is still too mild to counter the falling impetus from other indices. The inflationary trends are shown in **Figure 7.1**. Since the month-on-month inflation rates are all below the 12-month moving average, it is safe to say that looking ahead inflation rates will continue to ease well into the remaining part of this year.

The annualized rate of inflation, measured by CPI, has edged down during the first quarter this year. As can be seen from **Table 7.1**, the CPI (on an average basis) rose by 2.9 percent during Q1-FY02 compared with 4.8 percent in the corresponding period last year.

Table 7.1: Inflation Trends
percent

	Quarterly inflation		Annualized inflation					
	Cumulative July to September		Month to month basis		Quarter to quarter basis		12-Month moving average ending[1]	
	2000	2001	Sep-00	Sep-01	Sep-00	Sep-01	Sep-00	Sep-01
CPI	1.5	1.8	5.1	2.9	4.8	2.9	4.0	3.9
WPI	2.2	2.3	4.9	4.6	4.0	5.7	2.1	6.6
SPI	2.5	2.8	4.9	2.3	4.2	2.1	2.1	4.3

[1] Percent change over preceding 12-month average

Within CPI, the *food* price index grew by 0.9 percent during this quarter against 3.7 percent in Q1-FY01. This was on account of improved availability of essential food commodities, especially, sugar, milk, edible oil, rice and vegetables. The glut of sugar in the wake of higher imports in the recent past, combined with the fresh arrival of about 21 thousand tons of refined sugar during the ongoing season, further eased the *food* price index. The decline in unit value of certain imported food items (edible oil by 10.8 percent, tea by 19.3 percent and pulses by 5.4 percent) also played a critical role in an easing of inflationary pressure.

Inflation in the *non-food* group, on the other hand, remained firm at 5.0 percent against 6.0 percent in the same period last year. This trend was mainly influenced by the increase recorded in *fuel & lighting* (by 13.0 percent) and *transport &*

Figure 7.1: Twelve-monthly Changes in Price Indices

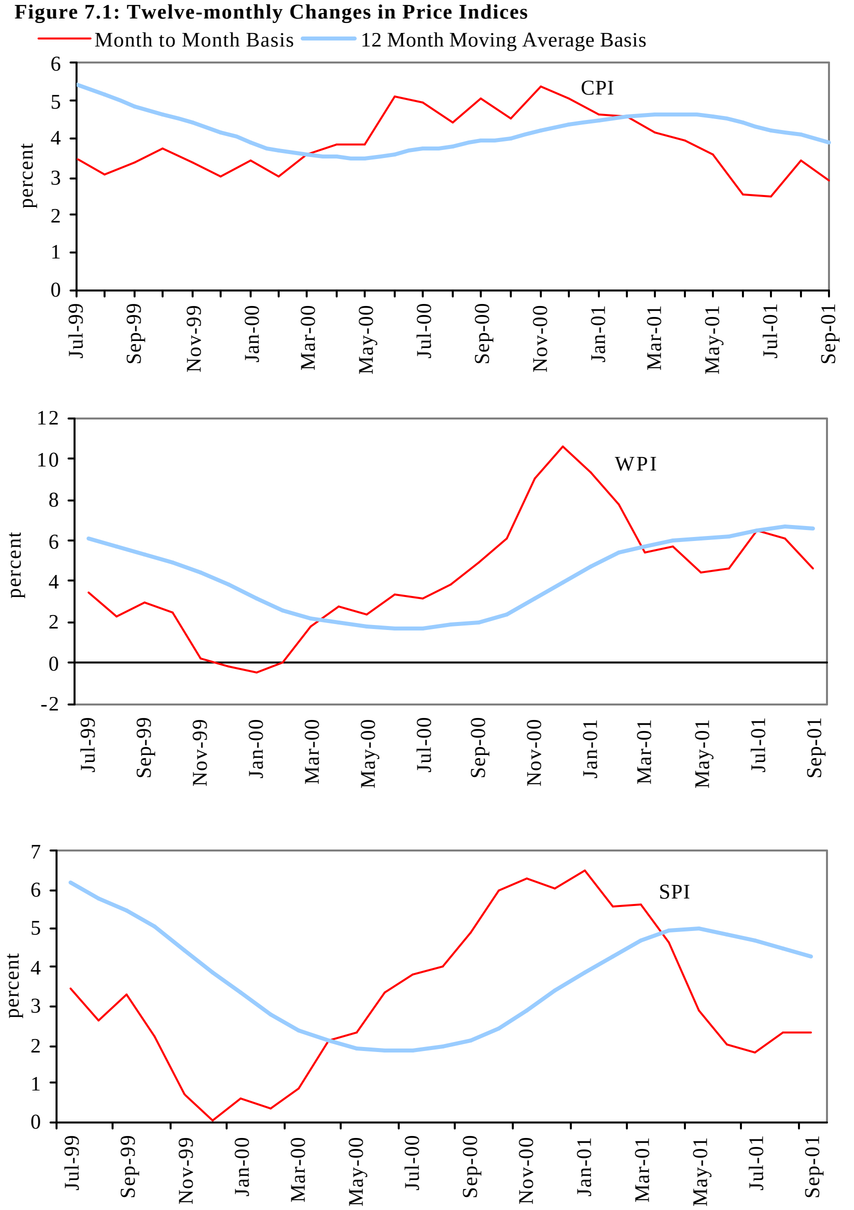
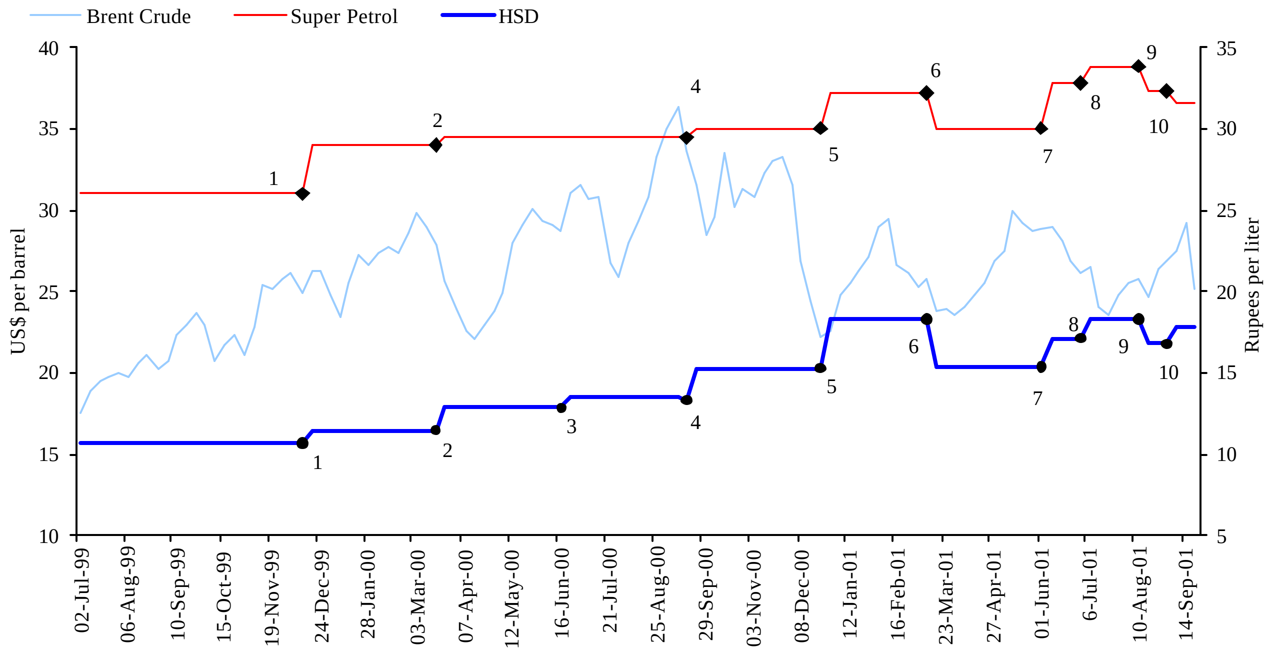


Figure 7.2: Brent Crude, Petrol & Diesel Prices



1. December 11, 99 (11.7% hike in Petrol & 7.9 % in HSD prices)
2. March 20, 00 (1.7% hike in Petrol & 1.3 % in HSD prices)
3. June 22 (5.5 % rise in HSD price)
4. September 22 (1.7% hike in Petrol & 13.1 % in HSD prices)
5. December 30 (7.5 % hike in Petrol & 19.6 % in HSD prices)
6. March 15, 01 (7.0 % decline in Petrol & 15.7 % in HSD prices
7. June 14 (9.40 % hike in Petrol & 10.97% in HSD prices)
8. July 1 (3.02% hike in Petrol & 6.8 % in HSD prices)
9. Aug 17 (4.31 % decline in Petrol & 8.37% in HSD prices)
10. Sept 1 (2.1 % decline in Petrol & 6.21% hike in HSD prices)

communication (by 11.6 percent), following the upward adjustment in diesel prices. According to current practice, the Oil Companies Advisory Committee (OCAC) reviews petroleum product prices on a fortnightly basis. During the quarter, diesel prices were revised three times, with an increase in July and September (see **Figure 7.2**).[32] However, in overall terms, these increases were smaller compared to the corresponding period last year. This was also the case for motor gasoline and high sulpher furnace oil (HSFO). Other sub-indices in the *non-food* category (e.g., *medicines*, *cleaning, laundry & personal appearance* and *house rent*) also showed a falling trend during the quarter.

The mild increase in WPI was primarily driven by *non-food* items, which increased by 9.4 percent during this quarter while *food* items posted growth of only 1.5 percent. In terms of *non-food* items, the impetus mainly came from a 16.4 percent rise in *fuel, lighting & lubricants*, 7.7 percent in *raw materials* and 5.0 percent in *manufactures*. The higher price of manufactured items was the result of low growth in chemicals, imposition of regulatory duty on polyester chips, polyester filament yarn, polyester staple fiber, disodium carbonate (Soda Ash) as well as an increase in the price of cigarettes.[33] The increase in *raw materials* prices was because of the decline observed in domestic production of pig iron and partly on account of higher exports of hide/skins and raw wool.

8. Capital Market

As discussed in SBP's *Annual Report* for FY01, continuous selling by foreign funds, uneasiness among market players regarding the implementation of the T+3 settlement system, and investigations into the activities of certain members of the stock exchanges, kept the KSE-100 index under pressure during the second half of FY01. However, this quarter proved to be even more turbulent. The KSE-100, which closed last fiscal year at 1366.4, fell by 17.1 percent to close the first quarter of FY02 at 1133.4. Similarly, the average daily trading volume fell by 29.3 percent over Q4-FY01 (see **Table 8.1**).

The KSE-100 shed 60 points in the first week of July 2001. Two factors were instrumental in this fall: the crack down by National Accountability Bureau (NAB) on certain market players in end-June 2001; and continuous selling pressure in PTCL and Hubco on rumors of foreign selling. Following NAB's

[32] The OCAC adjusts the prices of POL products keeping in view certain factors such as C&F prices, landing charges, government levies, inland freight, and dealer/distributor margins.
[33] In WPI, cigarette is classified in non-food items while in CPI it is classified in food group.

actions, investors offloaded their scrips (especially Hubco, WorldCall and Engro) into the market. Also, the average daily volume fell by 28.8 percent during July as compared to June 2001. These negative sentiments persisted throughout the month and kept the index under pressure (see **Figure 8.1**).

Table 8.1: Highlights of KSE (As on September 28, 2001)

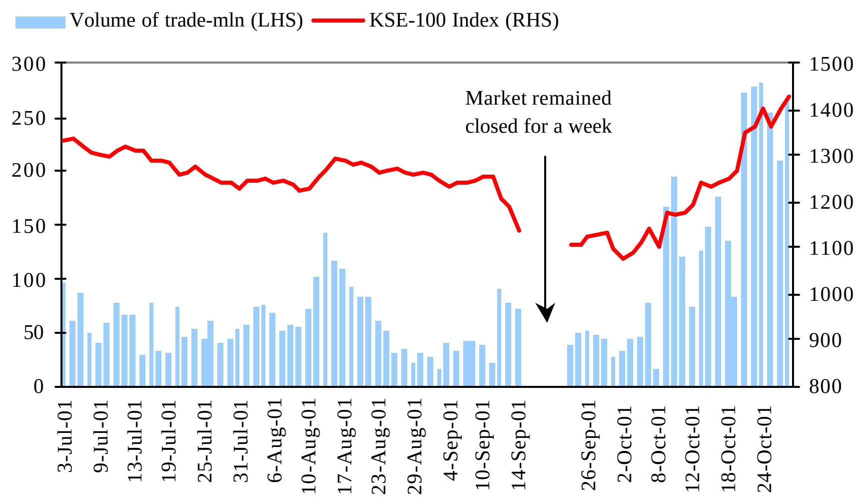
Rs and shares in billion

Listed Companies at KSE	757
KSE-100 index	1133.4
Change since June 2001 (%)	-17.1
YoY (%)	-27.6
Listed Capital at KSE	234.4
Market Capitalization	282.8
Shares traded at KSE during the quarter	3.4

By the second week of August, the KSE-100 experienced a short recovery following news of a support fund by GOP to equity markets (see **Figure 8.1**). Since this fund was expected to support certain blue chip companies (especially the privatization scrips), heavy buying was witnessed in PTCL and Hubco during this period (see **Figure 8.2 & 8.3**). However, the delay in the package, faded away this initial enthusiasm.

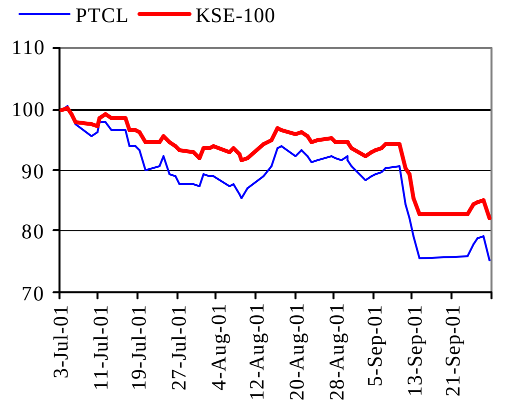
The September 11 terrorist attacks in New York and Washington clearly set the trend for rest of the quarter. The KSE-100 index shed 116.3 points in just three trading days following September 11 (see **Figure 8.1**). This sharp fall also led to

Figure 8.1: Movement in KSE-100 index and volume traded



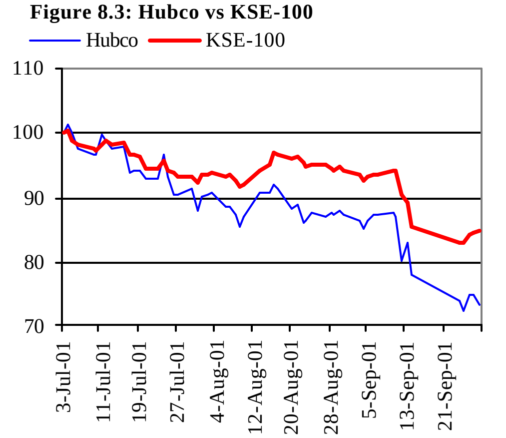
settlement problems in the *badla* market. Due to the decline in market value of investments financed by *badla*, many market players were caught in rising price of badla finance. Also, a decision by KSE management not to recognize any deal involving badla charges exceeding 24 percent per annum, discouraged badla financers who remained on the sidelines. Hence, to avoid a further decline in the market due to panic selling and non-availability of badla financing, the bourses were closed down for a week from September 17 to 21.

Figure 8.2: PTCL vs KSE-100



One of the main players impacted by this crisis was Crescent Investment Bank. In a prompt and coordinated response, the State Bank of Pakistan, SECP and Ministry of Finance stepped in and five major commercial banks were asked to buy the portfolio of Crescent Investment Bank at a discount. As a result, by the beginning of October, this step helped stabilize the market by overcoming the liquidity shortage that had manifested following the September 11 events.

Figure 8.3: Hubco vs KSE-100



While equity markets remained turbulent, corporate debt market were buoyant. Seven new issues were floated in the market since the start of this fiscal year (see **Table 8.2**). The main factors for the bullish sentiments were the reforms in

National Saving Schemes (rationalizing rates and banning incremental institutional investment), and the launch of the Pakistan Investment Bonds (PIBs). Similarly, the outlook is also encouraging as a few more TFCs are in the pipeline and will be floated very soon.

Table 8.2: TFCs issued since July 2001

Security	Issue Date	Maturity	Issuance Size million Rs	Coupon Rate
ICI/PTA	Aug-02	Aug-06	1600	PIB 5 Yr + 300bps = 16.00%
ATLAS LEASE	Aug-16	Aug-06	100	15.0%
PACKAGES	Aug-27	Jan-05	700	13.50%-17% Discount rate +1.25% pa
GULISTAN	Sep-05	Sep-06	320.7	2% + DR. floor 14%, ceiling 17.5%
DAWOOD LEASING	Sep-12	Sep-06	253.8	Perpetual with put and call option, yield 1.75 + DR, floor 13.5%, cap 17.5%
INTERBANK	Sep-15	Sep-06	500	13.75-16% 3 yrs = 13.75% pa monthly 3 yrs 6 mnts = 16%
NISHAT	Sep-19	Sep-05	600	14.5% 1st year, 2-4 year 1.5% over DR, floor 13% ceiling 17%

9. External Sector[34]

As discussed in the last *Annual Report*, the external sector of Pakistan has experienced a significant structural change following September 11. More specifically, the lifting of economic sanctions by the US and other G-7 countries, resumption of economic assistance by these governments, debt relief and better market access, should provide much-needed room to Pakistan's balance of payments. At the same time, in the immediate and short-term, these gains will be offset by trade disruption in the form of the war-risk premium and loss of export markets. Nevertheless, the collapse of the kerb market premium and a sharp appreciation of the Rupee in both the interbank and kerb markets has brought about a new set of dynamics in the foreign exchange markets. This development alone, if it persists over time, has strong implications not only for trade and foreign exchange reserves, but also for the conduct of monetary policy.

Since the analysis is limited to Q1-FY02, it will not discuss in detail the structural change in Pakistan's balance of payments. Furthermore, it is still too early to gauge the magnitude of the structural change. In particular, while recent data shows the impact of September 11 on workers remittances, kerb purchases and

[34] This section will rely on exchange records from SBP, which will not tally with more detailed customs data used in the Trade subsection.

resident FCAs, there is still a time lag before the implications are felt in other heads like trade, services, official transfers and capital flows.

Despite the global recession and September 11, the current account deficit during the first quarter was only US$ 61 million, registering a sharp improvement of US$ 420 million over last year (see **Table 9.1**).[35] Compared with developments in FY01, when the current account posted a surplus mainly due to unrequited transfers, the improvement during Q1-FY02 was spearheaded by a steep reduction in the import bill (mainly POL and food), lower shipment and interest payments, and higher outright purchases by SBP. Excluding the impact of SOF and kerb purchases, the external gap during the first quarters of FY01 and FY02 were US$ 923 and US$ 631 million, respectively, which still shows an impressive improvement.

In terms of the capital account, lower project aid from IFIs and bilateral countries, higher outflows from the stock markets, repayments of commercial loans/credit, and the closing out of swaps with various commercial banks in July, increased net outflows during Q1-FY02 relative to the corresponding period last year. At the same time, *inflows* in exceptional financing during the quarter were lower due to hard currency payments of previously rescheduled loans (PTMA) and the fact that central bank deposits with SBP did not have to be rolled-over in the quarter (see **Table 9.1**).[36]

9.1 Current Account

The trade deficit during Q1-FY02 was US$ 194 million compared with US$ 568 million during the same period last year. This narrowing of the deficit came primarily on account of import contraction in edible oil and POL products due to subdued prices in the world market. Furthermore, import of raw sugar was not needed owing to sufficient domestic stocks. In terms of exchange record, export revenues registered growth of 4.2 percent, mainly driven by larger quantitative exports (see section on **Trade**). Textile exports, with 65 percent share in total exports, once again dominated despite recording a substantial negative price effect.

As shown in **Table 9.1**, net outflows in services declined by 6.6 percent during Q1-FY02 over last year, despite higher travel expenditure and payments of

[35] The Saudi Oil Facility (SOF) in Pakistan's BOP was recently changed from aid to grant, retrospectively. Hence, BOP data for FY99 onward has been revised accordingly.
[36] This is Pakistan Trade Maintenance Agreement, which refers to commercial credit from banks for the financing of oil imports. After the crisis in May 1998, this commercial debt was rescheduled.

Table 9.1: Balance of Payments
million US$)

				Q 1-FY02/Q1-FY01	
	Q 1-FY00	Q 1-FY01	Q 1-FY02	Absolute	Percent
1. Trade balance	**-466**	**-568**	**-194**	**374**	**-65.8**
Exports (fob)	1798	2135	2225	90	4.2
Imports (fob)	2264	2703	2419	-284	-10.5
2. Services (net)	**-658**	**-884**	**-826**	**58**	**-6.6**
Shipment	-190	-213	-197	16	-7.5
Other transportation	20	18	-15	-33	-183.3
Travel	-9	-28	-35	-7	25.0
Investment income	-508	-653	-570	83	-12.7
Interest payments on external debt	-425	-483	-373	110	-22.8
Profit and dividend	-83	-170	-197	-27	15.9
Other goods, services & Income	29	-8	-9	-1	12.5
3. Current transfers (net)	**942**	**971**	**959**	**-12**	**-1.2**
a) Private transfers -net	766	707	775	68	9.6
Workers' remittances	215	366	340	-26	-7.1
FCA (residents)	141	76	23	-53	-69.7
Outright purchases	240	227	397	170	74.9
b) Official transfers	176	264	184	-80	-30.3
Of which: Saudi Oil Facility	145	215	173	-42	-19.5
4. Current account balance (1+2+3)	**-182**	**-481**	**-61**	**420**	**-87.3**
5. Financing	**182**	**481**	**61**	**-420**	**-87.3**
Capital account (net)	**-1240**	**-441**	**-596**	**-155**	**35.1**
a) Foreign investment	137	27	16	-11	-40.7
Direct investment abroad (net)	0	0	0	0	
Direct investment in Pakistan (net)	149	36	69	33	91.7
Portfolio investment in Pakistan (net)	-12	-9	-53	-44	488.9
of which: stock markets	-30	-16	-47	-31	193.8
b) Foreign long-term loans/credit (net)	-423	-425	-358	67	-15.8
Disbursements	315	233	179	-54	-23.2
Project aid	306	199	166	-33	-16.6
Food aid	0	0	0	0	
Non food	0	0	0	0	
Others	9	34	13	-21	-61.8
Amortization	738	658	537	-121	-18.4
Official	549	513	396	-117	-22.8
Others	189	145	141	-4	-2.8
c) Official assistance (net)	-385	168	5	-163	-97.0
d) FCA (non-residents)	-564	-60	-25	35	-58.3
e) Others	-5	-151	-234	-83	55.0
Changes in reserves (-inc/+dec)	**123**	**303**	**84**	**-219**	**-72.3**
Assets	173	366	-136	-502	-137.2
SDRs	0	0	2	2	
Forex (State Bank of Pakistan)	173	320	-42	-362	-113.1
Forex (commercial banks)	0	46	-96	-142	-308.7
Liabilities	-50	-63	220	283	-449.2
Use of Fund credit	-50	-63	220	283	-449.2
Purchases/drawings	0	0	267	267	
Repurchases	-50	-63	-47	16	-25.4
Errors & omissions	**320**	**43**	**346**	**303**	**704.7**
Exceptional financing	**1121**	**584**	**231**	**-353**	**-60.4**
SBP reserves	1354	1034	2134	1100	106.4
SBP reserves (excluding FE 13/CRR)	564	595	1724	1129	189.7

dividend and profit. This was possible due to the fall in freight and insurance payments (a reflection of lower trade volume) and lower interest payments on external debt/liabilities. This was helped along by the declining stock of private loans and FE 45 deposits relative to the corresponding period last year. The outflow in services is expected to increase next quarter due to the war-risk premium on Pakistan's trade flows.

As shown in **Table 9.2**, the full quarter figure for worker's remittances, which posted a decline of 7.3 percent to US$ 325.4 million relative to last year, presents a misleading picture in the sense that Q1-FY01 also includes receipts on the account of Kuwait war affectees. Excluding this compensation and receipts from the Hajj Sponsorship Scheme (HSS), cash remittances recorded an increase of 15.8 percent during Q1-FY02. The events following September 11, had a favorable impact on cash remittances, as these registered healthy growth of 41.4 percent during the month of September over August, mainly driven by inflows from UAE, US and other countries. The inflow of remittances from UAE registered a growth of 79.9 percent in September following the collapse of the kerb premium (see section on **Exchange rate**). The increased scrutiny of the Hundi system by the US and its allies, as a possible conduit for financing terrorist organizations, led to this collapse. The narrowing of the Rupee/Dollar gap between the official and kerb rate was enough to encourage overseas Pakistanis to send foreign exchange through banking

Table 9.2 Region-Wise Worker's Remittances

million US$

	July-September			? Q 1-FY02/Q1-FY01?	
	FY00	**FY01**	**FY02**	**Absolute**	**Percent**
Gulf region:	**144.9**	**275.4**	**216.3**	**-59.0**	**-21.4**
Bahrain	7.3	7.3	6.7	-0.6	-7.7
Kuwait	17.1	70.4	12.5	-57.9	-82.2
Qatar	3.2	4.4	3.7	-0.7	-15.5
Saudi Arabia	77.8	102.2	85.4	-16.9	-16.5
Sultanat-e-Oman	11.8	10.7	10.9	0.2	2.0
U.A.E.	27.6	80.3	97.1	16.8	20.9
Other than Gulf	**56.7**	**75.7**	**109.1**	**33.5**	**44.2**
Canada	1.2	1.0	2.3	1.3	124.3
Germany	2.9	2.8	2.4	-0.4	-14.4
Japan	0.3	0.6	1.0	0.4	67.7
Norway	1.3	1.8	1.6	-0.2	-10.6
U.K.	17.9	20.7	22.7	1.9	9.4
U.S.A.	18.8	29.0	50.1	21.1	73.0
Others	14.3	19.7	29.0	9.3	47.1
TOTAL	**201.0**	**351.0**	**325.4**	**-25.6**	**-7.3**
Encashment FEBCs & FCBCs	14.1	14.8	14.6	-0.1	-0.9
Total (incl. FEBC & FCBCs)	**215.1**	**365.8**	**340.1**	**-25.7**	**-7.0**
Growth cash remittances	**-10.2**	**74.6**	**-7.3**		
Growth excluding Kuwait war affectees & Hajj receipts	**-18.2**	**17.7**	**15.8**		

channels. This was also because, the low kerb premium made the collection of worker remittances financially unviable for the Hundi system.

As far as resident FCAs are concerned, withdrawals from FE-25 deposits were witnessed as a result of the uncertainty following September 11. More specifically, sharp withdrawals were noticed in Peshawar even before the kerb rate collapsed. Anecdotal evidence suggests that with increasing pressure on Afghanistan and the likelihood of a war, demand for Rupees rose sharply against Dollar balance that were drawn down. These concerns were reinforced due to the appreciation of the Rupee/Dollar parity in early October. The resulting outflows almost wiped out FCAs mobilized during July-August.[37] In net terms, resident FCAs registered an inflow of only US$ 23 million during Q1-FY02. This reversal of capital flight is resulting in many individuals liquidating their FCAs held abroad (but not in FCA schemes originating in Pakistan) and bring them into Pakistan in Rupees (see **Figure 9.7**).

Outright purchases, which are used to build up foreign exchange reserves, amounted to US$ 397 million during Q1-FY02 as compared to US$ 227 million during Q1-FY01. Although, kerb purchases were low at the start of the fiscal year (US$ 93 million in July), SBP geared up its purchase during August (US$ 183 million). However, the fall in kerb market inflows following September 11, clearly impacted SBP purchases during September.

9.2 Trade Account[38]

Within the backdrop of September 11, Pakistan's trade performance during the first quarter of FY02 was not so disappointing. However, it is too early to assess the likely impact in coming quarters. Based on custom's data, Pakistan's trade deficit was US$ 239.5 million during Q1-FY02, showing an improvement of 52.6 percent over the same period last year (see **Figure 9.1**). Though there was no significant increase in export earnings (a mere 1.8 percent rise), the lower trade deficit was mainly due to a 8.3 percent decline in imports this quarter, which is in sharp contrast with positive growth of 12.5 percent in Q1-FY00. As a result, the ratio of exports to imports also went up from 81.5 percent in Q1-FY01 to 90.4 percent this quarter.

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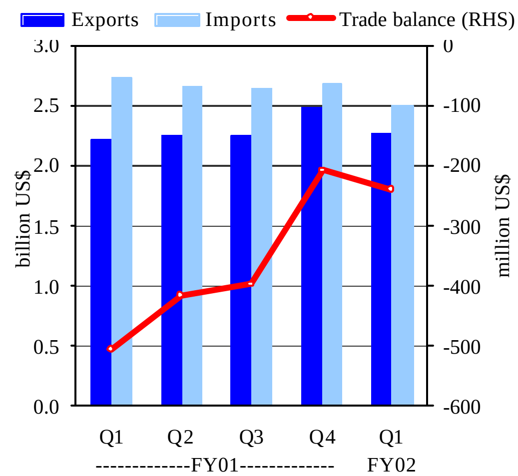
[37] Out of US$ 83 million resident FE-25 deposits mobilized during Jul-August, US$ 50 million were withdrawn in September alone.

[38] The sub-section is based on customs data, which is more detailed. The numbers will not tally with those in the balance of payments as they are based on exchange records. For a comprehensive look into trade data, please see ***Special Section 3*** in SBP's first *Quarterly Report* for FY01.

9.2.1 Exports

Exports during the first quarter of FY02 stood at US$2.26 billion (see **Table 9.3** & **Figure 9.2**). This fell short of the trade policy target of US$ 2.52 billion for Q1-FY02. Even before the terrorist attacks, the looming recession in our biggest export markets like the US and EU, was viewed as a serious threat to Pakistan's export performance.[39] Under these circumstances, showing positive export growth during Q1-FY02 is itself a significant achievement.[40] Pakistan's major exports, including cotton fabrics, yarn, readymade garments, bed-ware, towels, POL, leather, surgical instruments, footwear, and cutlery, were able to show moderate to impressive quantitative increases over Q1-FY01. The total quantity effect for the quarter amounted to positive US$ 152.2 million.[41] However, unit prices continued to deteriorate over the period resulting in an overall loss of US$ 130.2 million in export earnings. The ramifications of September 11 on Pakistan's exports will be reflected in the data for coming months. Keeping in view the present world economic scenario, Pakistan may have to revise downwards its exports target, as it seems unlikely to achieve the US$ 10.1 billion target set in the Trade Policy. Some of the adverse factors facing Pakistan's exports are:

Figure 9.1: Trade Account



[39] The economic outlook in the US is becoming increasingly pessimistic, with consumer sentiments continuing to fall. Widespread layoffs and rising unemployment do not signal a rebound in confidence anytime soon. Composite Index of Leading Economic Indicators declined 0.5 percent in September, following a revised 0.1 percent drop in August. The latest 50 bps cut in the US interest rates by the Fed, the 10th such cut since the beginning of the year, is yet another indication of the flagging US economy. European Central Bank and Bank of England have recently cut their interest rates to 3.25 percent and 4.0 percent, respectively, to bolster their sagging economies.

[40] More specifically, our exports to the US and EU registered a 1.0 and 5.7 percent growth, respectively.

[41] The quantity and price effect (on exports) is calculated on the basis of detailed data available on 27 items, covering 79.1 percent of total exports.

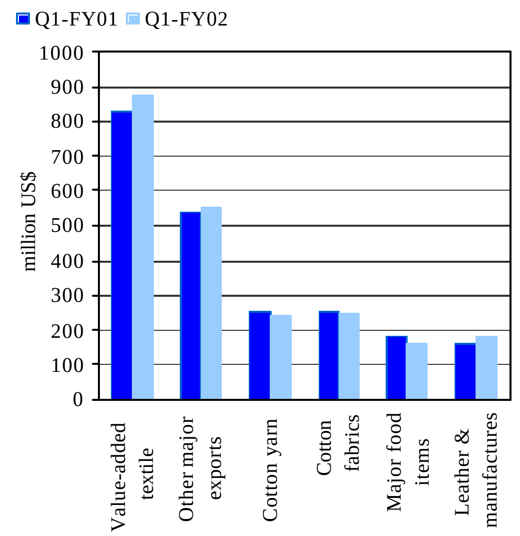
Table 9.3: Major Exports

value: US$ million; unit value: US$

	Unit	Q 1-FY02		Q 1-FY01		Abs ?	% ? in Q1-FY02/ Q 1-FY01		
		Value	Unit value	Value	Unit value	in value	Qty.	Value	Unit val.
A. Primary Commodities		**241.0**		**270.1**		**-29.1**		**-10.8**	
Rice	MT	103.7	282.8	110.3	281.9	-6.6	-6.3	-6.0	0.3
Raw cotton	MT	3.2	982.2	26.0		-22.7	-87.6	-87.5	0.7
Raw wool (excl. Wool tops)	MT	0.4	940.9	0.4	1,249.9	0.0	44.3	8.6	-24.7
Fish and fish preparations	MT	35.4	1,984.2	42.7	2,100.2	-7.3	-12.2	-17.0	-5.5
Leather	SQM	61.3	13.8	50.4	12.9	11.0	13.3	21.8	7.5
Guar and guar products	MT	4.2	750.9	4.2	1,229.4	0.0	62.0	-1.0	-38.9
Fruits	MT	18.4	408.8	24.8	420.6	-6.4	-23.5	-25.7	-2.8
Vegetables incl. roots and tubers	MT	6.2	202.2	6.8	196.7	-0.6	-10.7	-8.2	2.8
Crude animal material	MT	3.5	418.2	4.2	546.7	-0.7	10.0	-15.9	-23.5
Oil seeds & nuts etc.	MT	4.6	457.5	0.4	434.5	4.1	911.2	964.7	5.3
B. Textile Manufactures		**1,466.7**		**1,436.9**		**29.8**		**2.1**	
Cotton yarn	MT	239.6	1,874.3	254.2	2,021.9	-14.6	1.7	-5.7	-7.3
Cotton fabrics (woven)	SQM	246.0	0.6	255.2	0.6	-9.2	5.3	-3.6	-8.4
Hosiery (knitwear)	DOZ.	247.6	24.2	251.1	24.5	-3.5	-0.1	-1.4	-1.3
Bed ware	MT	217.7	5,073.4	177.9	5,047.7	39.8	21.7	22.4	0.5
Towels	MT	66.9	3,464.5	51.9	3,585.3	15.0	33.4	28.9	-3.4
Cotton bags and sacks	MT	4.0	4,086.9	4.5	4,239.1	-0.4	-6.4	-9.7	-3.6
Readymade garments	DOZ	228.8	21.1	214.7	26.7	14.1	34.5	6.6	-20.8
Tarpaulin & other canvas goods	MT	6.5	2,186.9	8.5	2,336.2	-2.0	-17.8	-23.0	-6.4
Tule, lace embroidery etc.	—	2.5	---	1.8	---	0.6		35.1	—
Synthetic textiles	SQM	114.7	0.6	134.0	0.7	-19.3	-9.9	-14.4	-5.0
Other textile made up	—	90.6	---	82.1	---	8.5		10.4	—
Waste material textile fibres/fabrics	MT	1.8	577.9	1.1	501.5	0.7	45.4	67.5	15.2
C. Other Manufactures		**401.5**		**365.8**		**35.7**		**9.8**	
Carpets, carpeting rugs & mats	SQM	47.7	44.1	60.6	46.3	-12.9	-17.2	-21.2	-4.9
Petroleum and petroleum products	MT	66.0	201.1	40.3	244.0	25.7	98.8	63.9	-17.6
Sports goods	—	61.1	---	61.5	---	-0.4		-0.6	—
Leather manufactures	—	123.0	---	112.6	---	10.4		9.3	—
Foot wear	PAIR	9.6	5.9	8.4	6.5	1.2	24.0	14.3	-7.9
Surgical and medical instruments	No.	32.6	1.2	28.5	1.4	4.1	30.4	14.3	-12.3
Cutlery	Gr.	6.4	29.5	6.7	32.6	-0.3	5.8	-4.0	-9.3
Onyx manufactured	MT	2.9	1,589.6	3.7	1,880.2	-0.7	-5.8	-20.3	-15.5
Chemicals and pharmaceuticals	—	31.8		37.7		-6.0		-15.8	---
Molasses	MT	20.3	42.4	5.8	30.0	14.5	148.5	251.7	41.6
D. Others		**155.3**		**151.8**		3.5		2.3	
Total Exports		**2,264.6**		**2,224.7**		**39.9**		**1.8**	
excl. Major food items and Raw cotton		2,093.0		*2,013.7*		*79.3*		*3.9*	
excl. Major food, raw cotton and yarn		*1,853.3*		*1,759.5*		*93.9*		5.3	

?? September 11 and the anthrax scare have reportedly led to the cancellation of export orders from the US and other western countries. Even if the war stops in near future, its impact will continue to be felt due to lost market outlets.

Figure 9.2: Composition of Exports



?? Delay in clearance by US Customs of containers originating from Pakistan, has also resulted in the cancellation or suspension of many export orders. In addition to the extra delay, US importers have to pay more on account of special examinations and demurrage. Moreover, authorities in the US and other European countries are taking more time in processing the paperwork sent from Pakistan.

?? Foreign buyers are being asked by their respective governments to avoid visiting Pakistan, which is clearly hampering our export business. The suspension of foreign airline operations, issuance of visas by Singapore, Hong Kong, Dubai, Korea etc., is further aggravating the situation.

?? Not only have foreign buyers stopped shipments from Pakistan, they are also holding back payments against confirmed L/Cs creating liquidity problems for exporters.

?? The bulk of Pakistan's international trade is shipped through foreign shipping lines that are reluctant to use Pakistani ports, while many cargo airlines have ceased to operate. Consequently, exporters are facing space constraints for their cargo.

?? The unprecedented 'War Risk Premium' imposed by Underwriters Association and Lloyds of London, on all cargoes to and from Pakistan, in addition to a surcharge (at $180 per container) on the pretext of our proximity to the war zone, has increased transportation costs. Not only will this affect the competitiveness of our exports in the international market, but local goods manufactured using imported raw materials, will also become more costly. Pakistan may continue to lose export markets in the near future.[42]

- ?? Negative propaganda about delays in export consignments, uncertainty of shipments, disruption in industrial activity and the safety of persons and property, simply compounds the existing predicament.
- ?? The appreciation of Rupee vis-à-vis US Dollar is bound to erode export competitiveness, especially in the textile sector.

The following positive developments may mitigate these adverse effects to some extent:

- ?? The European Union has withdrawn duties on all types of products exported from Pakistan except five items (yarn, fabric, leather goods, leather products and carpets) besides granting a 15 percent increase in quotas with effect from January 2002.
- ?? Turkey has also agreed to increase textile quotas by 3,000 tons for Pakistani exports in categories to be indicated later.
- ?? Japan has also lifted sanctions on Pakistan imposed after the nuclear tests in 1998.
- ?? Pakistan and the US are also negotiating a free trade agreement to increase the volume of trade between the two countries. It is expected that the US will also increase quotas for textile import from Pakistan and reduce duties on Pakistani goods.
- ?? The rate reduction for repayment of customs duties (that is paid on inputs used for manufacturing of export goods under the Duty Drawback Scheme to exporters) has been postponed for two quarters. The existing rates applicable from October 1, 2001, will continue to be effective till June 2002.

The following highlight Pakistan's trade performance during the first quarter of FY02:

- ?? Exports of ***textile manufactures*** during the first quarter of this year amounted to US$ 1,466.7 million, recording a 2.1 percent improvement over Q1-FY01. The exports of bed-ware, towels, readymade garments, tule, lace embroidery, other textile made-ups, and waste material of textile fabrics, showed increases; while cotton yarn, cotton fabrics, knitwear,

[42] Pakistan may invoke the sovereign guarantee against the War Risk Premium, whereby GOP will safeguard the interests of importers and exporters, against possible incident in Pakistan's territorial waters.

cotton bags, tarpaulin & canvas goods, and synthetic textiles recorded negative growth. Though higher textile quantitative exports contributed additional earnings of US$ 133.0 million, the negative price effect of US$ 112.4 million reduced this gain to a meager US$ 20.6 million (see **Figure 9.3**).

?? ***Cotton yarn*** exports stood at US$ 239. 6 million in Q1-FY02, showing a 5.7 percent decline over the same period last year.[43] In a bid to enhance export volumes, the All Pakistan Textile Mills Association (APTMA) revised downwards the minimum export price (MEP) of various counts of cotton yarn and polyester cotton yarn, effective August 9, 2001. However, lower per unit export prices reduced total receipt by US$ 18.9 million, which completely nullified the gain of US$ 4.3 million from the 1.7 percent increase in export quantities.

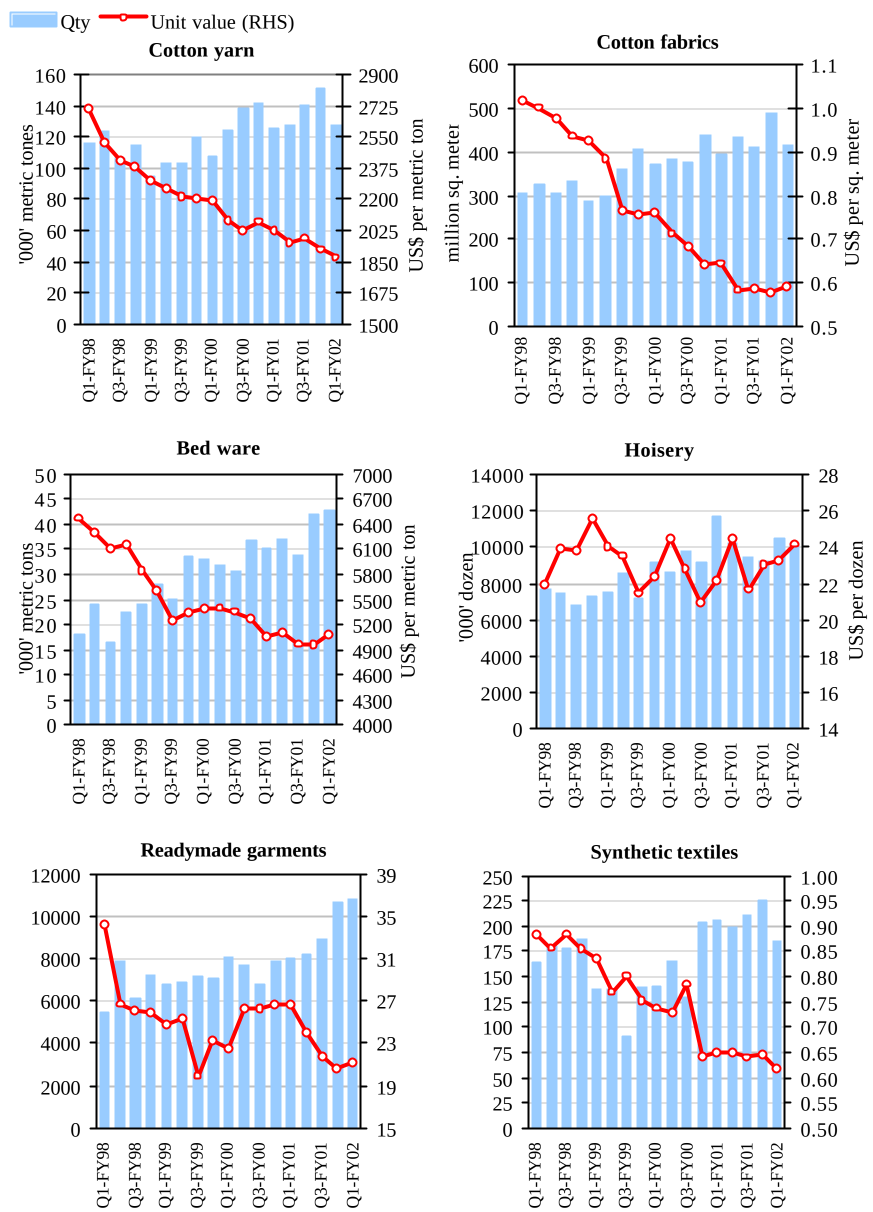
?? There is tremendous potential in the towel industry with a special focus on upgrading existing factories for the production of high value-added towels. During Q1-FY02, ***towel*** exports earned US$ 66.9 million by exporting 19,310 metric tons of towels, registering an increase of 28.9 per cent compared to the corresponding quarter last year. The US$ 15.0 million increase in export revenues can be decomposed into a positive quantum effect of US$ 17.3 million and a negative price effect of US$ 2.3 million. Main buyers of Pakistani towels are the US, UK, Germany, the Netherlands, Italy, France, Canada, Australia, Spain and the UAE.

?? The export of ***rice*** fetched US$ 103.7 million in the first quarter of the current fiscal year as compared to US$ 110.3 million in the same period last year, showing negative growth of 6.0 percent. Despite the improvement in per unit export price by 0.3 percent, the fall in export earnings resulted from a quantitative decline of 6.3 percent leading to a net loss of US$ 6.9 million.[44]

[43] An appellate body of the World Trade Organization (WTO) has ruled in favor of Pakistan in the combed cotton yarn quota case (under safeguard clause), and has asked the US government to remove the quota restrictions on such imports from Pakistan. The US government had imposed quota restrictions on combed cotton yarn (known as Category 301), in March 1999, after failed consultations between the two sides in February 1999.

[44] There are vast opportunities for export of rice to Iraq, as it is importing up to 600,000 metric tons of rice annually. Many rice producing countries managed to sell huge quantities of Irri-6 to Iraq, but despite Pakistan's advantages over other exporting countries (such as proximity and early arrival of crop), it was unable to tap into this market. The traditional suppliers of rice to Iraq include Thailand, Vietnam and China.

Figure 9.3 : Textile Manufactures-Quantitative Exports and Unit Prices



?? ***Carpet*** exports in the first quarter of FY02 fell by 21.2 percent due to both lower quantum and falling unit prices. During the period, a total of 1,083.8 thousand square meters of carpets (worth US$ 47.7 million) were exported, showing a decline of 17.2 percent over Q1-FY01. Since the US is a major market for Pakistani carpets, continuing weakness in the US economy, had an adverse impact on the performance of this sector. American and European importers of hand-knotted carpets have reportedly held back payments to Pakistani exporters for consignments that have already been received, thus creating liquidity problems.[45] Moreover, continuing cancellation of orders from the US and Europe will further aggravate the situation.

?? Despite falling international prices, ***POL*** exports during the quarter under review earned US$ 66.0 million, registering a hefty growth of 63.9 percent over Q1-FY01. During the quarter, Pakistan exported 142,176 metric tons of crude petroleum valued US$ 28.6 million, which is 40.0 percent higher when compared with the corresponding quarter of FY01.[46] Export of petroleum products also showed remarkable growth of 192.6 percent in terms of quantity and 129.8 percent in terms of value. The reason for this increase was the commissioning of the Pak Arab Refinery Co Ltd (PARCO) that is currently exporting 70,000 to 90,000 tons of motor gasoline.[47] PARCO is in the process of producing 300,000 tons surplus motor gasoline (petrol), which it intends to export. However, in order to increase national oil res erves in the tense global environment, the government is reviewing its earlier decision to export surplus motor spirit.

9.2.2 Imports

Imports during the first quarter of FY02 amounted to US$ 2,504.1 million, depicting an 8.3 percent decline over the corresponding period last year (see **Table 9.4**). Lower imports of food items and a reduction in the POL import bill (resulting from lower international oil prices and reduced quantum of petroleum products), were mainly responsible for this decline in Pakistan's total import bill.

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[45] Since carpets and rugs, specially "hand knotted" and "man made", are time intensive, they require a longer duration for their export financing. Moreover, such exporters were facing serious difficulties in the realization of export proceeds. Keeping in view the above factors, SBP has increased the export finance facility period to 270 days (pre-shipment and post-shipment) for carpets and rugs.

[46] Exports of crude oil is necessary since Pakistan lacks refining capacity for low-grade crude oil produced in the country.

[47] PARCO has a capacity to process 100,000 barrels per day (bpd) of crude and is currently producing a full range of petroleum products since September 2000. After meeting local demand, PARCO has been exporting surplus motor gasoline since April 2001.

Table 9.4: Major Imports
value: US$ million; unit value US$)

	Unit	Q1-FY02		Q1-FY01		Abs ?	% ? in Q1-FY02/ Q1-FY01		
		Value	Unit value	value	Unit value	in value	Qty	Value	Unit val.
A. Food Group		**175.4**		**296.0**		**-120.7**		**-40.8**	
Milk & cream incl infant milk food	MT	3.2	2,421.3	6.6	1,663.7	-3.4	-66.8	-51.6	45.5
Wheat unmilled	MT	10.7	193.6	9.4	203.2	1.2	18.8	13.2	-4.7
Dry fruits	MT	7.2	380.6	8.6	549.8	-1.4	20.6	-16.5	-30.8
Tea	MT	36.6	1,576.4	50.1	1,953.8	-13.5	-9.4	-26.9	-19.3
Spices	MT	3.5	844.4	3.5	842.3	0.0	-0.7	-0.5	0.2
Edible oil	MT	71.7	292.9	94.8	328.4	-23.1	-15.2	-24.4	-10.8
Soya bean	*MT*	*5.6*	*348.4*	*13.6*	*349.6*	*-8.0*	*-58.5*	*-58.7*	*-0.3*
Palm oil	*MT*	*66.0*	*289.0*	*81.1*	*325.1*	*-15.1*	*-8.5*	*-18.6*	*-11.1*
Sugar	MT	15.4	268.1	89.7	252.6	-74.3	-83.8	-82.8	6.1
Pulses	MT	27.1	313.7	33.3	331.6	-6.2	-14.0	-18.6	-5.4
B. Machinery Group		**479.7**		**459.3**		**20.4**		**4.4**	
Power generating machinery	---	37.2	---	39.3	---	-2.1	---	-5.3	—
Office machinery	---	57.4	---	62.1	---	-4.8	---	-7.7	—
Textile machinery	---	118.6	---	85.5	---	33.0	---	38.6	—
Construction & mining machinery	---	35.7	---	15.9	---	19.8	---	124.7	—
Electrical machinery & apparatus	---	24.6	---	35.5	---	-10.9	---	-30.7	—
Railway vehicles	---	8.6	---	1.9	---	6.8	---	363.0	—
Road motor vehicles	---	74.1	---	80.7	---	-6.5	---	-8.1	—
Aircraft, ships and boats	---	11.3	---	20.4	---	-9.1	---	-44.5	—
Agricultural machinery	---	2.6	---	5.1	---	-2.5	---	-48.7	—
Other machinery	---	109.6	---	113.0	---	-3.4	---	-3.0	—
C. Petroleum Group	**MT**	**755.5**	**185.5**	**998.9**	**218.4**	**-243.4**	**-10.9**	**-24.4**	**-15.1**
Petroleum products	MT	389.1	183.4	617.6	221.7	-228.5	-23.9	-37.0	-17.2
Petroleum crude	MT	366.5	187.7	381.3	213.4	-14.9	9.2	-3.9	-12.0
D. Textile Group		**40.2**		**33.5**		**6.7**		**19.9**	
Synthetic fibre	MT	14.7	1,302.3	17.0	1,285.3	-2.3	-14.5	-13.4	1.3
Synthetic & artificial silk yarn	MT	18.2	1,503.9	10.5	1,942.9	7.7	123.1	72.7	-22.6
Worn clothing	MT	7.2	318.3	5.9	303.8	1.3	16.1	21.7	4.8
E. Agricultural and Other Chemicals		**482.3**		**460.4**		**21.9**		**4.8**	
Fertilizer	MT	50.8	120.0	27.0	161.0	23.8	152.2	88.0	-25.5
Insecticides	MT	33.2	2,788.3	30.2	2,893.2	3.1	14.4	10.2	-3.6
Plastic materials	MT	78.2	821.0	92.0	839.7	-13.8	-13.1	-15.0	-2.2
Medicinal products	MT	50.1	20,671.2	60.6	23,193.7	-10.4	-7.1	-17.2	-10.9
Others	---	269.9	---	250.6	---	19.3	---	7.7	—
F. Metal Group		**116.9**		**79.4**		**37.5**		**47.2**	
Iron and steel scrap	MT	10.5	116.9	6.5	118.1	4.0	62.9	61.2	-1.0
Iron and steel	MT	96.6	288.8	64.3	323.6	32.3	68.3	50.2	-10.8
Aluminum wrought & worked	---	9.8	---	8.6	---	1.2	---	14.1	—
G. Miscellaneous Group		**63.2**		**62.3**		**0.9**		**1.5**	
Rubber crude	MT	9.5	653.2	9.8	679.6	-0.3	1.3	-2.7	-3.9
Rubber tyres & tubes	No.	15.1	21.2	16.8	24.4	-1.7	3.3	-10.1	-12.9
Wood & cork	---	3.3	---	3.6	---	-0.3	---	-9.3	—
Jute	MT	3.6	280.5	6.6	269.1	-3.0	-48.1	-45.9	4.2
Paper and paper board &	MT	31.7	742.3	25.5	755.8	6.3	26.8	24.5	-1.8
H. Others		**390.8**		**340.5**		**50.3**		**14.8**	
Total Imports		**2,504.1**		**2,730.4**		**-226.3**		**-8.3**	
excl. Food group		*2,328.7*		*2,434.3*		*-105.6*		*-4.3*	
excl. POL group		*1,748.5*		*1,731.5*		*17.1*		*1.0*	
excl. Food and POL groups		*1,573.2*		*1,435.4*		*137.7*		9.6	

Excluding POL, imports actually increased by 1.0 percent, while non-food non-oil imports, showed a much higher growth of 9.6 percent (see **Figure 9.4 & 9.5**).

The following points highlight the major developments in Pakistan's import performance during the first quarter of the current fiscal year.

Figure 9.4: Imports excl. Food and POL

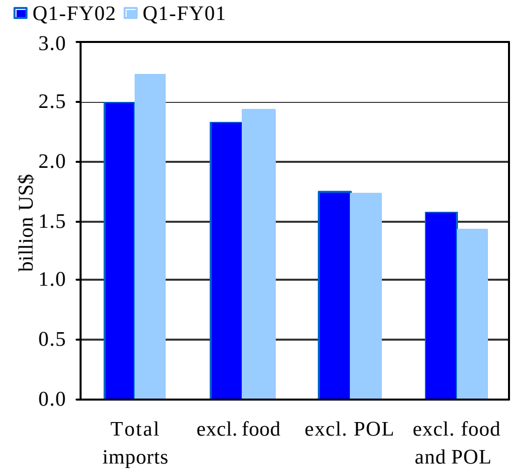
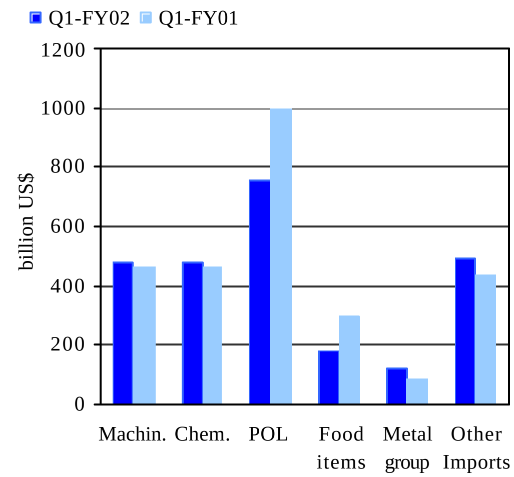


Figure 9.5: Composition of Imports



?? Pakistan's ***POL*** import bill during the quarter amounted to US$ 755.5 million, a 24.4 percent decline over Q1-FY01. The average POL import price during the period fell by 15.1 percent owing to a decline in world oil prices, resulting in a net saving of US$ 134.1 million. Notwithstanding the increase of 9.2 percent in the volume of crude imports due to the commissioning of PARCO (which will refine 4.5 million tons of crude oil a year), there was an appreciable 23.9 percent decline in the import of petroleum products, which led to a further saving of US$ 109.3 million.

In addition to the commissioning of PARCO, the use of natural gas instead of oil to generate electricity; and higher hydel power generation due to greater availability of water contributed towards lower import of petroleum products. Furthermore, suspended operations by certain foreign airlines coupled with reduced flights by PIA after September 11, decreased the demand and use of jet fuel.

?? Import of ***machinery*** (except textile machinery) has been declining over the years, indicating poor investor confidence and sluggish industrial activity in the country. The depreciating Rupee over the past three years has also discouraged import of machinery, which has been compounded by cost over-runs that rendered many projects commercially unviable. Pakistan's machinery imports increased by 4.4 percent (from US$ 459.3 million to US$ 479.7 million) during the first quarter of FY02. Continuing the BMR drive, the textile sector imported machinery worth US$ 118.6 million as compared to US$ 85.3 million in Q1-FY01, showing an increase of 38.6 percent.

?? ***Fertilizer*** accounted for US$ 50.8 million in the import bill for Q1-FY02, which is 88.0 percent higher than Q1-FY01. This is on account of an increase of 152.2 percent in imported quantity, which may be a direct consequence of the decision by FFC-Jordan Fertilizer Company to stop Di-Ammonium Phosphate (DAP) production due to heavy losses and dismal prospects. The US$ 41.2 million positive quantum effect was partially neutralized by the negative price effect of US$ 17.4 million resulting from lower import unit prices.

?? During Q1-FY02, import of ***tea*** cost US$ 36.6 million, registering a 26.9 percent decline over the corresponding quarter of last year. A 19.3 percent fall in unit price accounted for a net saving of US$ 8.8 million, while lower import quantity saved US$ 4.7 million. Anecdotal evidence suggests that tea smuggling by Afghan traders via the Afghan Transit Trade is on the rise due to an upward revision in import tariffs on black tea.

?? ***Edible oil*** imports during the first quarter of FY02 amounted to US$ 71.7 million, indicating a US$ 23.1 million fall over last year. Lower imported quantities due to falling demand were mainly responsible for this decline (to the tune of US$ 14.4 million), while weak international prices resulted in a gain of US$ 8.7 million.

?? During Q1-FY02, ***refined sugar*** imports declined by 82.8 percent owing to adequate availability from better prospects of domestic production, and carryover stocks from the last season. It is expected that domestic availability will be more than sufficient for the overall requirements of 3.0 million tons and no import of sugar will be required this fiscal year.[48]

?? The import bill for ***pulses*** registered a decline of 18.6 percent during the first quarter of FY02. A total of 86,435 metric tons of pluses (at a cost of US$ 27.1 million) was imported to meet domestic needs, as compared to 100,461 metric tons imported during Q1-FY01.

9.3 Capital Account

The capital account deficit posted an increase of US$ 155 million to US$ 596 million during Q1-FY02, from US$ 441 million last year. As shown in **Table 9.5**, lower inflows (credit entries) were the main reason as outflows (debit entries) registered a marginal decline. Despite higher foreign direct investment (FDI) and larger inflows of commercial loans/credit and IDB trade related support, inflows declined during the quarter mainly because: (1) lower project aid was realized from IFIs and bilateral countries; (2) lower private loans/credit and; (3) no special deposit were needed by SBP to shore up Pakistan's liquid foreign exchange reserves.

Net foreign investment

The realized inflows of foreign investment in Pakistan were US$ 16 million during Q1-FY02 as against US$ 27 million in the corresponding period last year (see **Table 9.5**). The fall is attributed to higher outflows of foreign investment from the stock markets, as bearish trends induced foreign investor to liquidate their holdings. On the other hand, direct foreign investment increased by US$ 33 million during Q1-FY02, mainly in the Oil & Gas sector. This is in contrast to last year when direct foreign investment fell due to the disinvestments and exit of Bank of America from Pakistan. FDI, which stood at US$ 323 million in FY01, is projected to increase by US$ 600 million during this year. However, the events following September 11 have made this target unrealistic.

In terms of portfolio investment in securities, the impact of maturing 3-year Special US Dollar Bond from August 2001, has not been realized in the first quarter of BOP data. Based on partial information received only from Lahore and Karachi offices of SBP, people enchased only US$ 10,000 into US Dollar in

[48] On September 21, 2001, the Central Board of Revenue (CBR) abolished the concessionary rate of custom duty on the import of refined sugar and withdrew the exemption of custom duty on the bulk import of raw sugar. The 10 percent ad valorem duty on imports of refined sugar was raised to 20 percent.

Table 9.5: Capital Account
million US$

	Q 1-FY00			Q 1-FY01			Q 1-FY02		
	Cr.	**Dr.**	**Net Credit**	**Cr.**	**Dr.**	**Net Credit**	**Cr.**	**Dr.**	**Net Credit**
1. Direct investment abroad	0	0	0	0	0	0	0	0	0
2. Direct investment in Pakistan	149	0	149	36	0	36	69	0	69
3. Portfolio investment	0	12	-12	0	9	-9	0	53	-53
(of which stock market)	-	30	-30	-	16	-16	-	47	-47
Long-term capital									
4. Official sector	307	566	-259	199	785	-586	166	418	-252
4.1. Assets	0	0	0	0	0	0	0	0	0
4.2. Loans drawn	307	549	-242	199	513	-314	166	396	-230
4.3. Other liabilities	0	17	-17	0	272	-272	0	22	-22
5. Deposit money banks	0	0	0	0	1	-1	0	0	0
5.1. Assets	-	-	0	-	-	0	-	-	0
5.2. Loans	-	-	0	-	-	0	-	-	0
5.3. Other liabilities	-	0	0	-	1	-1	-	-	0
6. Other sectors	44	189	-145	167	145	22	13	350	-337
6.1. Assets	-	-	0	-	-	0	-	-	0
6.2. Loans	9	189	-180	34	145	-111	13	141	-128
6.3. Other liabilities	35	0	35	133	0	133	0	209	-209
Short-term capital									
7. -Official sector	72	457	-385	246	78	168	226	221	5
7.1. Assets	0	5	-5	0	0	0	22	0	22
7.2. Loans	72	152	-80	130	78	52	204	221	-17
7.3. Other liabilities	0	300	-300	116	0	116	0	0	0
8. Deposit money banks	31	317	-286	77	39	38	63	12	51
8.1. Assets	0	25	-25	77	0	77	62	0	62
8.2. Bilateral balances-assets	-	-	0	-	-	0	-	-	0
8.3. Bilateral balances-liabilities	-	-	0	-	-	0	-	-	0
8.4. Liabilities under NR A/cs	31	0	31	0	1	-1	1	0	1
8.5. Other liabilities	0	292	-292	0	38	-38	0	12	-12
9. Other sectors	0	303	-303	0	109	-109	15	94	-79
9.1. Assets	0	38	-38	0	90	-90	0	81	-81
9.2. Loans	-	-	0	-	-	0	-	13	-13
9.3. Other liabilities	0	265	-265	0	19	-19	15	0	15
Capital account	603	1,844	-1,241	725	1,166	-441	552	1,148	-596

September (see **Table 9.6**). As for encashments in October, the collapse of the kerb premium and appreciation of the Rupee/Dollar parity, prompted many individuals to avail the option of redemption in Rupee (which comes with 5 percent redemption bonus) as compared to hard currency payment or reinvestment.

Table 9.6: Encashment and Reinvestment of Maturing 3-Years Special US$ Bonds

thousand US$

	Maturity	Payments		Reinvestment
		US$	Rs. With 5% Bonus	
Aug-01	-	-	-	-
Sep-01	10.0	10.0	-	-
Oct-01	104.6	-	84.6	20.0
Cumulative Total	114.6	10.0	84.6	20.0

Source: Karachi and Lahore offices of SBP.

Long-term capital (official)

This posted a lower outflow in Q1-FY02 relative to last year due to lower repayment to IFIs and bilateral donors, and the absence of rolling-over central bank deposits. Foreign assistance from IFIs and bilateral donors also decreased as shown by lower disbursements under project aid (see item 4.2 in **Table 9.5**).

Long-term capital (others)

Long-term capital (others), which is mainly suppliers credit, PAYE loans and swaps, posted the sharpest reversal from inflows of US$ 22.0 million in Q1-FY02 to outflows of US$ 337 million this year (see item 6 **Table 9.5**). In terms of suppliers credit and PAYE loans (item 6.2), lower disbursements and repayment of past debts, increased net outflows. In case of item 6.3, the closing out of foreign exchange swaps with various commercial banks, created a net outflow during Q1- FY02, against inflows of US$ 133 million in the corresponding period last year.[49]

Short-term capital (official)

Short-term capital inflows declined sharply by US$ 163 million to only US$ 5 million in Q1-FY02. This was due to repayment of commercial swaps (of one-month maturity) contracted in June 2001, and BOP support realized from IDB during the course of last year. Furthermore, since SBP did not require a NBP placement of foreign exchange this quarter, against US$ 116 million placed during the same period last year, there was a sharp reversal in item 7.3 (see **Table 9.5**).

[49] The Rupee payment of these swaps is matched by new inflows under errors and omissions to neutralize those hard currency repayments that never have to be made (see **Table 9.1**).

Short-term capital (deposit money banks & others)
This includes outstanding export bills (OEBs) held by commercial banks and exporters, and non-resident FCAs mobilized by commercial banks and NBFIs. In net terms, outflows declined from US$ 71 million in Q1-FY01 to US$ 28 million during this quarter, primarily due to a decline in OEBs held by exporters and lower conversion of FE-45 deposits into Rupees.

9.4 Exchange Rate Policy
The most noteworthy event on the exchange rate front was the collapse of the kerb market premium after the US government began investigating possible cash flows to terrorist organizations involved in the September 11 attacks. This resulted in a complete reversal of devaluation expectations in Pakistan. In doing so, this also reversed the causal relationship between the interbank and kerb rates. At this point, given the uncertainty that prevails in both markets, the kerb rate is once again setting the tempo for the interbank rate.[50]

But this development outshines the exchange rate stability that prevailed during the quarter, which is in sharp contrast to the 10.9 percent depreciation witnessed during the same period last year (see **Figure 9.6**). This stability reflects many factors: (1) trade deficit during the quarter fell, (2) since the Rupee had already depreciated by 18.6 percent during FY01, this created expectations of a more stable exchange rate, and (3) proactive management by SBP. In terms of the last point, SBP focussed more on ensuring that even lumpy payments are met directly by banks, without recourse to support from the central bank.[51]

This calm in the forex market allowed SBP to abolish limits on *Nostro* balances held by banks. These are foreign currency balances in banks' own accounts with correspondent banks outside Pakistan for *clearance* purposes only.[52] With a view to discourage speculative holdings, banks were only allowed to maintain *Nostro* balances up to 20 percent of their paid up capital. However, as a part of SBP's commitment to relax restrictions in the forex market, and the fact that these limits

[50] See special section in SBP's third *Quarterly Report* for FY01.
[51] In the case of lumpy payments, SBP sometimes provides support in the forward market with the expectations that this forward transaction would be setteled in due course from the market itself at a time when market liquidity improves.
[52] For example, a Pakistani bank will have Dollar account in the US, a Yen account in Japan and a DM account in Germany etc. to carry out bank-to-bank transactions and manage customer driven payment & settlement in multiple currencies.

Figure 9.6: Interbank rate and Kerb Market Premium

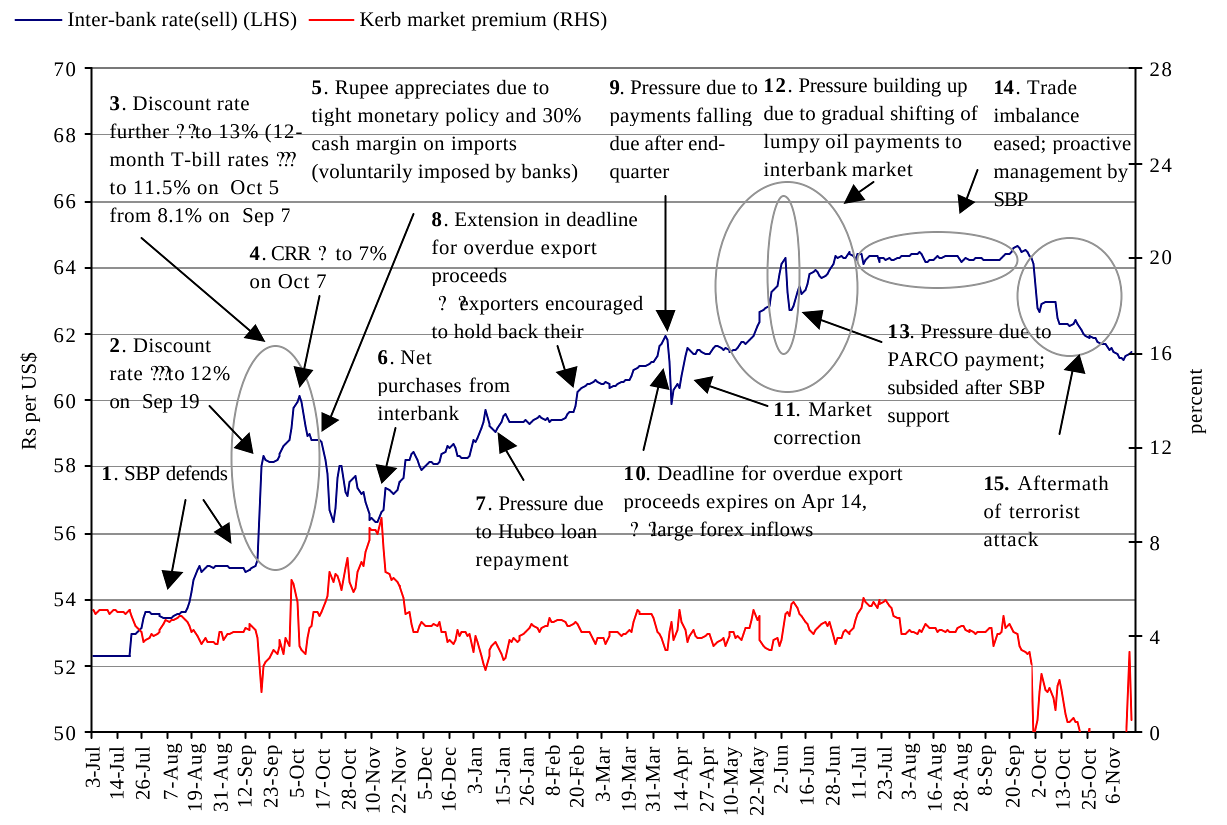
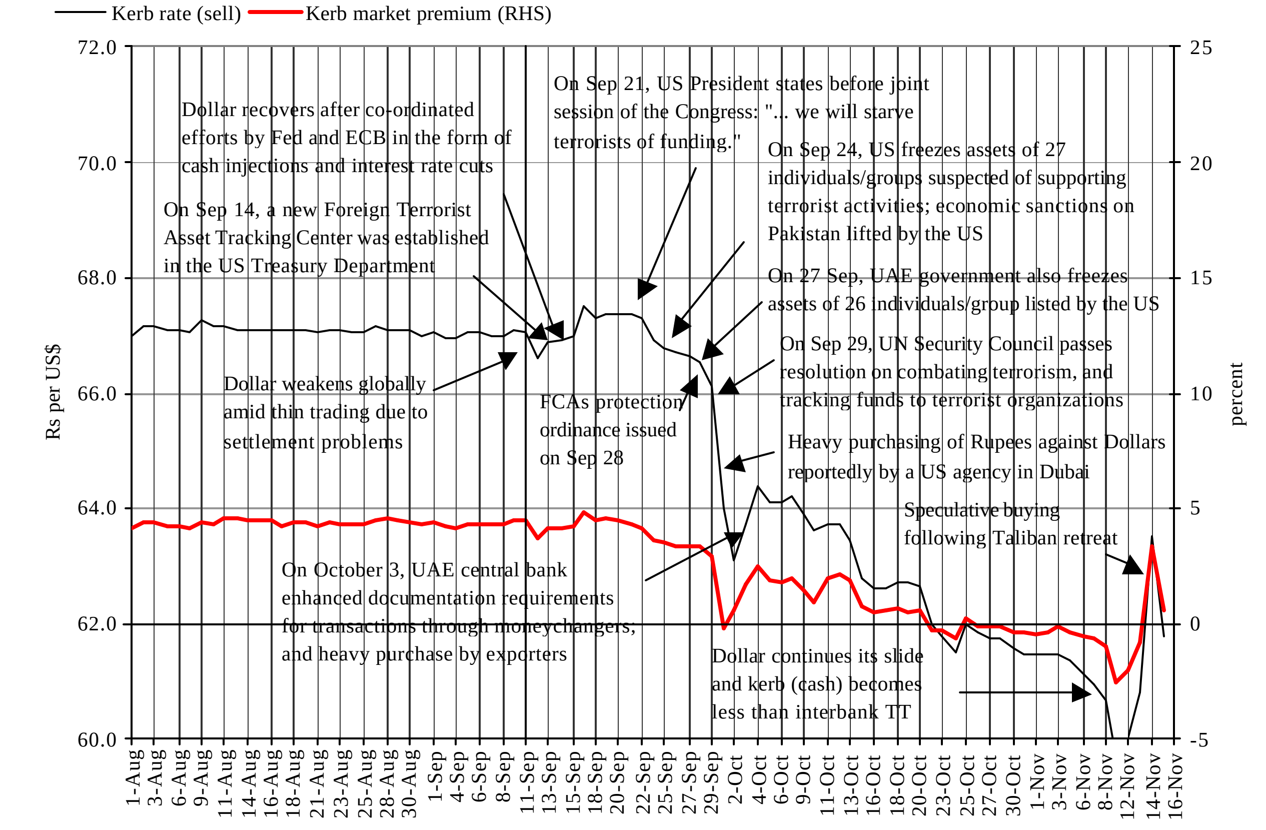


Figure 9.7: Interbank Rate and Kerb Market Premium- Impact of September 11



were limiting the interplay of market forces (particularly in the forward market), *Nostro* limits were removed with effect from August 31. Since most of banks were already operating well below their limits, its removal did not create any difference in the interbank market.

Looking again at September 11, the initial response of the interbank market was cautious, as trading volumes were very thin due to near suspension of clearing activities in New York. With the resumption of normal activity, the Rupee initially depreciated, reflecting higher demand for Dollars as a precautionary hedge. However, concerns in the kerb market gathered strength following the US government announcement that it would track financial transactions that could be funding the terrorist network (see **Figure 9.7**). Fearing international scrutiny, panic inflows of hard currency flooded the kerb market, while buyers of Dollar were sidelined in anticipation of further appreciation of the Rupee. As mentioned before, this exogenous shock effectively reversed the direction of causality from interbank to kerb market that had prevailed after the free float of the Rupee.

In response to this sharp appreciation of the Rupee, certain endogenous forces also came into play:

1) Exporters started releasing their hard currency earnings (held in special accounts) into the interbank market to avoid exchange losses.[53]

2) With the collapse of kerb market premium, exporters were encouraged to pay their outstanding export bills by purchasing hard currency from the kerb market. Anecdotal evidence also suggests that exporters are prematurely paying expected proceeds from goods that would otherwise result in inflows in December and January 2002.

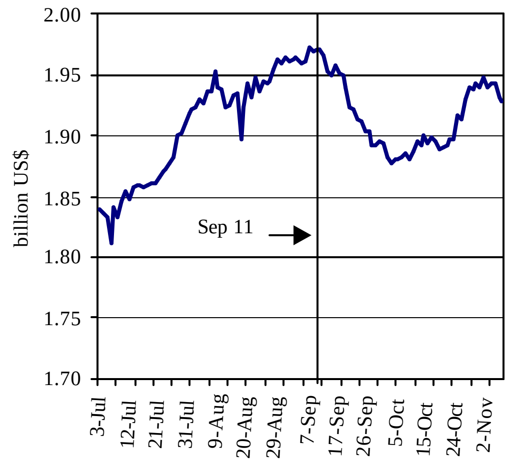
3) Importers, on the other hand, prefer to remain at bay in anticipation of a further decline in the Rupee/Dollar parity.

4) Individual savers started liquidating their foreign currency accounts and Special US Dollar Bonds fearing that the Rupee value of their holdings could be further undermined if the Rupee continues to appreciate (see **Figure 9.8**).

[53] Exporters are allowed to keep their realized foreign exchange proceeds in a special account for a maximum three working days. During this period, they are free to shop around in search of a better rate for their proceeds.

5) Also, with the international scrutiny of suspect capital flows, people who have used the Hundi system for capital flight (in foreign currency accounts held abroad), are finding it safer to transfer such balances into Pakistan. The issuance of a Presidential Ordinance guaranteeing full protection for foreign currency accounts against seizure by any government, has also encouraged people to transfer their funds into Pakistan.

Figure 9.8: FCAs Outstanding (FE-25 & FE-31)



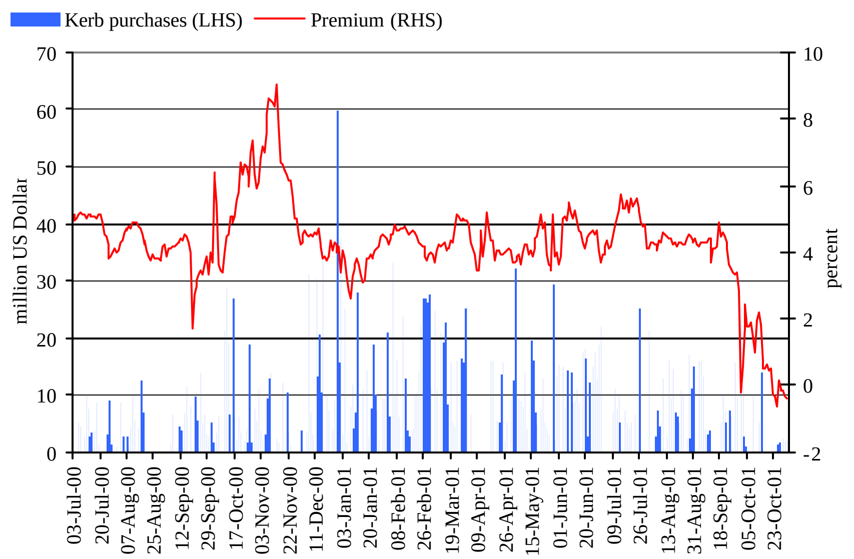
6) Since the kerb premium is a proxy for the cost of whitening undocumented funds (Dollar balances converted to Rupees at the official rate carry a blanket immunity), inward remittances through official channels have sharply increased as the kerb premium disappeared.

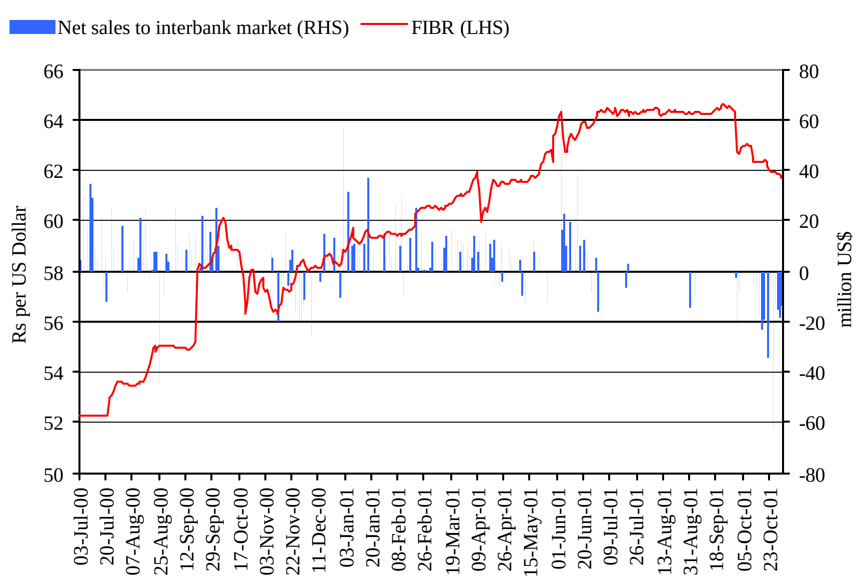
Besides resulting in lower debt servicing in Rupee terms, the Rupee appreciation offset much of the losses incurred by importers on account of the war risk levy. But this fall in the Rupee/Dollar parity is a cause of grave concern for exporters, who are trying to cope with the loss of traditional markets following the Afghan war and the perceived inability of Pakistani exporters to meet their commitments. In view of this, SBP started purchasing Dollars from the interbank market to provide a floor to the parity. During July-October, SBP purchased a total of US$350 million from the interbank market, of which, 90 percent was bought in October alone (see **Figure 9.9**). Despite such large purchases, which also made up for the shortfall in kerb purchases on account of lower volume of transactions, the interbank rate still appreciated by 4.3 percent during this period. Had SBP not purchased from the interbank market, the Rupee/Dollar parity would have fallen well below Rs 60.

9.4.1 Kerb Market

The downstream implications of September 11 dominated development in the kerb market (see **Figure 9.6**). In terms of initial response, since the Dollar

Figure 9.9: Kerb Purchases, Premium and Market Support





suffered globally, it resulted in a mild appreciation of the Rupee in the kerb market. However, higher demand for Dollars by individuals in Pakistan (which is considered a safe haven in times of uncertainty) led to a quick reversal in this trend. Consequently, the kerb rate depreciated from Rs 66.60 on September 12, to 67.50 on September 17.

The suspicion that the Hundi system is a possible conduit for cash flows to terrorist organizations, led to nervousness in the kerb market that is dependent on the Hundi network. However, the steps announced by the US government on September 24, to track financial transactions that may have funded terrorist operations, started the fear. In addition, the following inter-related factors have also contributed to the Rupee's strength in the kerb market:

1) As an initial response to the uncertainty following September 11, huge withdrawals from FE-25 deposits were witnessed (see **Figure 9.8**). These concerns were reinforced by the appreciation of the Rupee/Dollar parity. Later on, the fear that international agencies might investigate accounts abroad and freeze them in case of doubt, forced many individuals to liquidate their deposit abroad and bring them into Pakistan. In some cases, these accounts were even converted into Rupees in the kerb market.

2) Foreign missions and relief agencies have been selling hard currency in the kerb market for use in *relief* operations in Afghanistan.

3) The fall in smuggling, particularly through Afghanistan, has led to a drop in demand for hard currency in the kerb market.

4) With the mass movement of Afghans towards the Pakistan border, there was an induced demand for Rupees against Dollars

5) With the collapse of kerb market premium, the network for collecting remittances from individual workers in the Gulf, has become commercially unviable. This has reduced the inflow of hard currency in the kerb market.

6) The decision of the central bank of UAE to enforce proper documentation of outgoing transfers (more than AED 2,000 or US$ 500), has dampened moneychanger activities in Dubai.[54] Furthermore, the authorities have closed

[54] Dubai has served as the hub for the Hundi system for two reasons: (1) it is the focal point of the Gulf region, which is a major source of remittances, and (2) it carries reasonable free financial structure.

down several moneychangers in Dubai. In effect, this is forcing some remitters to delay sending funds into Pakistan, or Hundi agents themselves are hesitant about accepting funds from workers in the Gulf. This is to be expected given the verbal nature of Hundi transactions, which clearly will not help justify outflows to the UAE central bank. Demand for hard currency in the Gulf has also been hit, since if this money were purchased for onward transfer to other countries, the restriction imposed would also impact such transactions.

The first four points have reduced net demand for hard currency in the kerb market, the fifth point has reduced supply, and it is hard to gauge the impact of the last point. The pressure on the kerb market may also be gauged by the fact that on several occasions, the kerb rate for *cash* transactions even dipped below the interbank TT rate.[55] In overall terms, the Rupee/Dollar parity in the kerb market has appreciated by 8.8 percent during July-October.

Looking forward, there are still concerns about the sustainability of these developments. In particular, it is difficult to gauge whether this episode is a result of a temporary change in market sentiments or a permanent shift in the kerb market structure. Although, it is hard to conjecture at this moment, it is clear that the US government and its allies are firm about curbing flows to terrorist organizations. Any country that does not put in place necessary restrictions could face financial isolation. This means the Hundi system will continue to be monitored closely, which will keep in play the forces that have allowed the Rupee to appreciate.[56] The resulting uncertainty amongst moneychangers and low premium, therefore provides the ideal time to merge the two foreign exchange markets.[57] This will require a strong monitoring framework on the part of SBP, which is also working to formulate rules for establishing foreign exchange companies. It should also be mentioned that merging the two markets is part of the structural changes required in the forthcoming PRGF from the IMF.

9.4.2 Foreign Exchange Reserves

Liquid foreign exchange reserves during the quarter have increased by US$ 36 million to reach US$ 3.30 billion. Of that, SBP has US$ 1.72 billion whereas

[55] Since the kerb market transfer funds through the interbank, the TT rate in the kerb cannot be less than that prevailing in the interbank market.

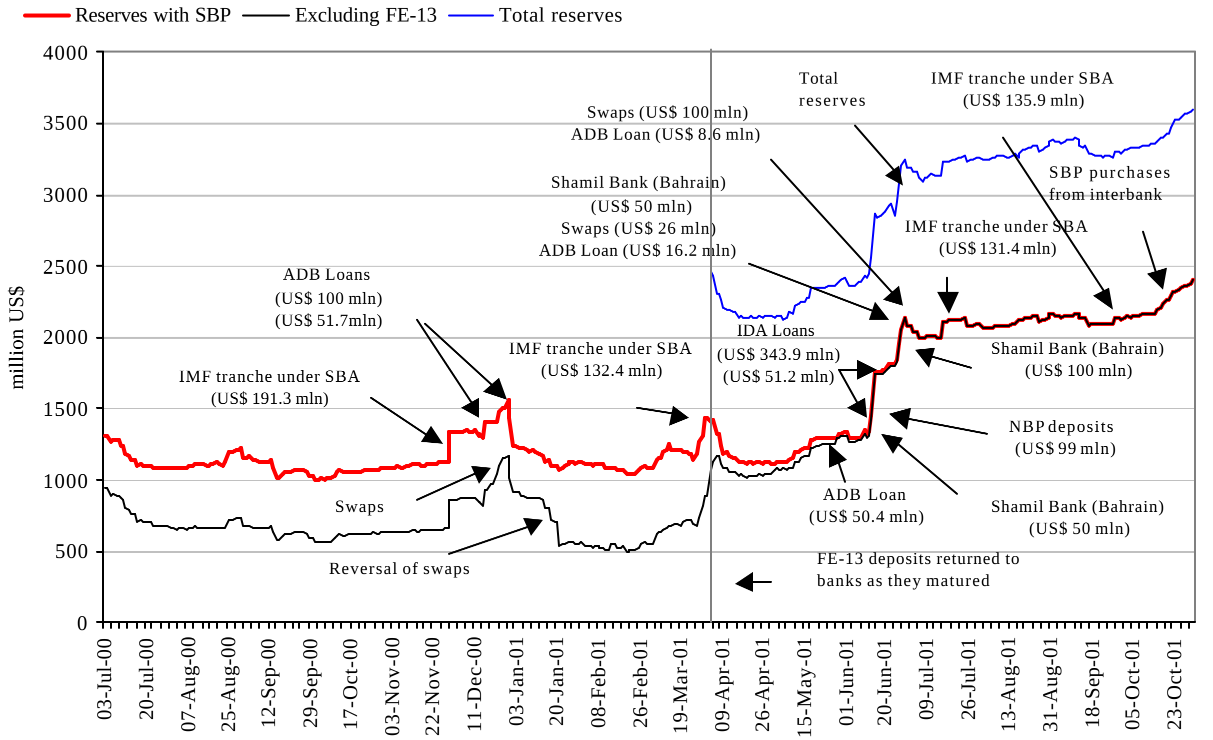
[56] The overall size of the Hundi system based in Dubai may not be very large compared to global money laundering activities. However, since the network was allegedly used as a conduit to fund 'Al Qaeda', brought it under global scrutiny.

[57] The segmented foreign exchange market is without doubt one of the most damaging structural problem in Pakistan's economy.

commercial banks have US$ 1.58 billion. This marginal increase in reserves includes two IMF tranches worth US$ 267 million, which were clearly offset by payment pressures during the quarter (see **Figure 9.10**).

As mentioned earlier, commitments for grants and foreign economic assistance made by different countries following September 11, are still to be realized. However, SBP still managed to shore up its reserves to US$ 3.60 billion as on November 14, because of heavy purchases from the interbank market (see **Figure 9.9**).

Figure 9.10: Foreign Exchange Reserves



Appendix

1. Policy Measures for Agriculture Sector During July-September 2001

Deep-sea Fishing Policy

To protect the interest of local small fishermen and maintain the source of earning foreign exchange, the government announced changes in the deep-sea fishing policy on 2nd July 2001. The main feature of the policy entails that:

- The deep-sea fishing trawlers will operate between 35-200 nautical miles subject to monitoring of their performance and conduct on a quarterly basis by the Marine Security Agency, the National Fisheries Development Board and the Fishermen's Co-operative Society.
- To upgrade the existing local fishing fleet with an aim to reduce/prevent the post-harvest losses, Agriculture Development Bank of Pakistan (ADBP) and the Small Business Finance Corporation (SBFC) will provide credit facility on priority basis.
- The Food and Agriculture Ministry will ensure the installation of secured satellite tracking system through the Maritime Security Agency on all deep-sea fishing vessels and every vessel will have a Global Positioning System (GPS) onboard with its satellite control at strategic points on the fish harbour, which is mandatory for obtaining a licence.
- Minimum Export Pricing (MEP) will be introduced to avoid under-invoicing. The MEP will be based on the recommendations of a committee, which will be set up by the National Fisheries Development Board and the provincial fisheries minister will be the chairman of the Board of Directors of the Fishermen's Co-operative Society.
- The deep-sea fishing vessels, whose licences were cancelled by the government last year, will have to apply again to the Agriculture Ministry to resume their operations. The government last year cancelled the licences of deep-sea fishing vessels after finding that those were violating mileage limits, engaged in poaching fish stocks from the area reserved for small fishermen and under-invoicing fish catch.
- The majority of small-scale fishermen cannot operate their boats beyond 12 or 15 nautical miles, consequently the zone between 12-35 nautical miles largely remains under exploited due to small ill-equipped boats/vessels coupled with insufficient capabilities of the local fishermen. To address the problem, the government has decided that medium-sized vessels ranging from 100 to 250 GRT (Gross Registered Tonnage) may be allowed to operate in the above-mentioned zone.

Incentive for Contamination free Cotton

To reduce price loss in international market on account of contaminated cotton, the Federal Textile Board (FTB) on 13th July 2001 announced a premium of Rs 200 per maund (37.32 kgs.) for contamination free cotton and Rs 75 for cotton with low contamination contents. Initially, district of Rahim Yar Khan has been declared as the project area. The premium will be paid by the buyers to the ginners and they in turn, will share it with the cotton growers.

2. Policy Measures for Industrial Sector

The following measures were taken for the industrial sector:

Trade Related Measures

- In order to rationalize the prices of steel products to promote economic activities in engineering and construction industries, custom duty on the import of a number of steel products was reduced by 10 percent on September 7, 2001. The major items on import of which custom duty was reduced include flat rolled products of iron or non-alloy steel of width of 6000 mm, cold rolled, non-clad, plated or coated, cold rolled tubes, pipes of hollow profiles and seamless of iron or steel.
- To enhance the export of cement and tobacco leaf, their export to Central Asian Republics (CARs) and Afghanistan was allowed to avail duty drawback facility w.e.f. September 6, 2001.
- In the wake of insufficient domestic production, custom duty on the import of synthetic staple fibre-not carded, combed or otherwise, was reduced from 20 percent to 5 percent on September 7, 2001.
- On August 2, 2001, repayment of customs duty was allowed on the import of raw materials used in 100 percent cotton grey made-ups filled with polyester stable fiber and polypropylene; woven or knitted made-ups whether or nor dyed or printed; 100 percent cotton bleached made-ups filled with polyester stable fibre and polypropylene; dyed and printed made-ups; partially-dyed or printed; grey blended made-ups (all blends of polyester stable fibre from 15 percent and cotton fibre) filled with polyester stable fibre and other textile products meant for export.
- To provide relief to pharmaceutical industry from increasing costs of production, the import of over 400 raw and packing materials for the industry were exempted from custom duty in excess of 10 percent ad valorem at the import stage on July 13, 2001.
- To promote the production and export of pharmaceuticals, duty drawback facility on the import of raw materials used in the manufacturing of medicinal products for exports was allowed on August 30, 2001.

?? To promote nuclear research and power generation in the country, the rate of custom duty on the import of nuclear reactors, machinery and apparatus for isotopic separation and parts thereof, fuel elements non-irradiated and parts of nuclear reactors was reduced by 5 percent on July 1, 2001.

?? In order to rationalize custom duties on various imports, the rate of import duty on refrigerators, freezers and other refrigerating equipments was reduced from 35 percent to 30 percent with effect (w.e.f.) from July 1, 2001.

?? For the vehicles manufactured to be supplied to diplomats, diplomatic mission, privileged person and organization etc., eligible to import duty free vehicle, import of CKD kits was allowed free of duty on September 7, 2001.

?? Duty drawback facility to manufacturers-cum-exporters of leather shoes was withdrawn with effect from August 1, 2001.

?? To boost the tyre & tube industry, repayment of customs duty on the export of tyres & tubes of trucks, buses, cars, jeeps and motorcycle, was allowed on July 26, 200

Tax Incentives (Sales Tax and Excise Duty)

?? In order to boost the production of petroleum products, Central Excise Duty (CED) on 'base lube oil' used in the manufacturing of lubricating oil in refineries was withdrawn since July 5, 2001.

?? On September 7 2001, sales tax on the import and supply of raw materials like oleostearin, oleo-oil, tallow oil used in the production of oil and soap, was increased from 15 percent to 20 percent.

?? General sales tax on the import and local supplies of over 50-fertilizer and fertilizer raw materials was imposed on September 2, 2001.

?? Under the 6^{th} schedule issued by the CBR, raw materials for basic manufacture of pharmaceutical active gradients and raw materials for manufacture of pharmaceutical products were exempted from sales tax in the federal budget 2001-2002.

Protection

?? To provide relief to the domestic sugar industry, custom duty on the import of refined sugar was increased from 10 percent to 20 percent on September 21, 2001. At the same time, 20 percent import duty was also imposed on the import of raw sugar with immediate effect.

?? To protect the local industries, regulatory duty on the import of soda ash (Di-sodium carbonate) Polyester Staple Fibre (PSF), Pure Terephthalic

Acid (PTA), polyester filament yarn and polyvinyl chloride was imposed at the rate of 5 percent ad valorem with effect from July 1, 2001.

- In order to promote production and export of value added leather products, a regulatory duty of 20 percent ad valorem was imposed on the export of raw hides and skins, wet blue tanned hides and skins w.e.f July 1, 2001.
- In order to protect and encourage the domestic farmers, with effect from July 1 2001, a regulatory duty on the import of edible oil and oil seeds was imposed at the rate of 5 paisa per Kg of the edible oil imported and 10 percent of the custom duty collected on the import of oil seeds imported for crushing.
- The custom duty on the import of flat rolled products of iron or non-alloy steel of a width of less than 600 mm, not clad, plated or coated, was increased from 10 percent to 20 percent on September 7, 2001. The government also levied custom duty of 10 percent on the import of special round steel bars and rods of non-alloyed steel exceeding diameter 75 mm.
- To promote the domestic production of air conditioners for the motor vehicles, the rate of custom duty on their import was increased from 25 percent to 30 percent with effect from July 1, 2001.
- On September 7, 2001, the duty exemption on the import of compressors and filter dryers for air conditioners, refrigerators and deep freezers, trichlorofluoromethane, dichlorodifluoromethane, trichlorofluoroethane, dichlorotetrafluoroethanes, and chloropentafluoroethane was withdrawn (and the previously leviable rate of 10 percent was enhanced to 20 percent).
- In order to promote indigenous production of steel chord used in the manufacturing of tyres, 5 percent duty was notified on its import on September 7, 2001.

Credit Facilities

To boost the construction activities in the country, the State Bank of Pakistan (SBP) advised the commercial banks to float ten-years bonds to mobilize funds for housing loans. This was stated in BSD circular letter issued on July 13, 2001.

3. Fertilizer Policy 2001

After a long period of twelve years and a year of anticipation, new 10-year fertilizer policy was announced on 30th August 2001. The new policy is aimed at encouraging new and existing investors to come and invest and expand the production capacity to ensure prompt availability of fertilizer to farmers at reasonable prices. The policy has been adopted with effect from 1st July 2001.

The new fertilizer policy is divided into two parts; one for existing plants while the second for expansion, BMR and new investment. The salient features of each one are given in the following:

For Existing Plants

- Under the gradual subsidy reduction program, the price of feed gas will be increased in the next six years as follows:
- There will be no increase in FY01 followed by an increase of 5 percent in July 2002, and then onward, the price will be increased by 2.5 percent annually to eliminate the remaining 10 percent subsidy in the next four years.
- Thereafter, the price for those existing investors who bring in new plant, will be $ 1.1 / MMBTU or prevailing Middle East (ME) prices, whichever is higher.[58]
- Concessional feed gas, allowed under the 1989 Fertilizer Policy to companies that undertook expansion, will be continued until their ten years period is exhausted. Thereafter, the price will be same as described above.

New Investments

- For expansion and BMR purposes, the price of feed gas supplies will be 10 percent less than the ME price prevailing on the date of signing the Gas Sale Agreement (GSA) or $ 0.77 / mmbtu whichever is higher and shall remain fixed at such price till the expiry of 10 years from the date of commissioning. The Gas Regulatory Authority of Pakistan will determine this price in dollar terms, on the principle of general parity with the price prevailing in ME.
- In the case an investor undertake an expansion and major BMR of an existing plant that results in increase in capacity, the additional feed gas supply will be treated at par with a new plant for 5 years.

General

- The price of fuel gas supply to the existing or exiting plants where BMR is undertaken or new fertilizer plants will remain same as those for all industrial consumers.
- The fertilizer industry would remain deregulated where the manufacturers will allow free market forces to play their role and pass on the benefits to the farmers in the case of lower price. To ensure this, a committee will

[58] MMBTU stands for Million British Thermal Units.

be set up that will review the situation on quarterly basis and will take appropriate steps as necessary.

- All raw materials required for the production of NPK fertilizer i.e. Di-Ammonia Phosphate (DAP), Mon-Ammonia Phosphate (MAP), Triple Super Phosphate (TSP) etc. and micro nutrients are allowed to import free of duties and taxes.
- Investors will be allowed to relocate second hand plant, equipment and machinery, with the same concessions/exemptions as applicable to new plants.

4. Fiscal Measures Taken During July-September 2001

Taxation measures taken during the Q1-FY02 are summarized below.

Sales Tax

- On July 5, 2001, the Central Board of Revenue (CBR) announced that the jewelers are not allowed to claim input tax adjustment under special procedure for jewelers notified in budget FY02. The invoices issued by the registered jewelers in the prescribed format are not and cannot be treated as invoices for refund. As the special procedure for jewelers, rules, 2001 is a concessional package and jewelers have to pay sales tax only on the value addition with a minimum threshold of 10 percent value-added.
- With effect from July 14, 2001, the CBR has imposed 15 percent general sales tax (GST) on the supplies of "Murabajat". Previously, the customs authorities were charging 30-percent duty ad valorem on the import of 'Murabajat' prepared and preserved from various fruits and vegetables.
- The CBR has announced that jewelers engaged in the making of their products by using machinery and equipment need no registration with the sales tax department. Previously, the persons utilizing machinery for the manufacturing of jewellery were not exempted from GST. The CBR has made an amendment in Special Procedure for Jewelers Rules, 2001 through an SRO 675(I)/2001 issued on September 28, 2001.

Central Excise Duty

- Central Excise Duty (CED) has been imposed on the local production of 'methyl tertiary butyl ether' (MTBE). The rate of CED would be 88 paisa per litre on the locally manufactured MTBE. Moreover, CBR has also levied CED on the locally manufactured polyester chips at the rate of five percent ad valorem on the local production of polyester chips excluding polyester chips of bottle grade and yarn grade. The imposition of CED on both these items would be applicable with effect from July 1, 2001.

?? The CBR has imposed fixed CED on 20 cosmetic items manufactured in the non-tariff area of Swat/Mingora. The decision was taken on August 24, 2001 by withdrawing excise duty charged as 10 percent of retail price imposed in the budget. Under fixed tax arrangement the cosmetic manufacturers of Swat/Mingora are expected to pay Rs 142.5 million CED to the CBR. The agreement will be valid for one financial year i.e 2001-2000.

?? The CBR has announced that the CED would not be charged as 'ten percent of the retail price' on the import of lubricating oil in bulk. Now, the CED would only be calculated at the rate of Rs 7.15 per litre on the import of lubricating oil. The conditionalities pertaining to excise duty were not applicable on oil containers imported in bulk. Previously, the importers of lubricating oil were bound by a notification issued in the budget to calculate CED on the retail price.

?? The CBR has imposed 10 percent CED on the import of telephone cables. The department has also enhanced the rate of excise duty on the import of petroleum lubricants used as greases from 30 to 50 percent ad valorem.

Customs

?? With effect from July 1, 2001, the rate of custom duty has been slashed from 35 percent to 30 percent on refrigerator-freezers, fitted with separate external doors; refrigerators, household type; compression type; absorption type, freezers of the chest type and freezers of the upright type.

?? On August 29, 2001 the CBR has amended an SRO issued on June 18, 2001 to revise the duty drawback rates for the exporters of silk and woolen carpets of all blends. According to the revised formula, the extent of repayment of custom duty would be 6.7 percent of the f.o.b. value on the goods exported between August 27, 2001 and September 30, 2001; 4.93 percent during October 1-December 31, 2001; 2.16 percent in January 1, 2001-March 31, 2002; and the extent of repayment of custom duty would be 1.39 percent of the f.o.b. value on the goods exported from April 1, 2002, and onwards.

5. Money and Credit Measures

Export Finance Scheme

?? Effective from July 1, 2001 the maximum rate of finance to be charged by banks from their borrowers under Export Finance Scheme for all eligible commodities and export sale under LMM was raised from 10.5 percent to 13 percent per annum and SBP refinance rate from 9 percent to

11.5 percent. These rates were reduced by 1 percentage point with effect from October 1, 2001.

- Effective from October 1, 2001, the State Bank of Pakistan introduced new instructions under Part-I of Export Finance Scheme. Modifications in the old scheme that had been in practice since January 1, 1999 were aimed at simplification of procedures to eliminate excessive documentations, cut in the rate of mark up, extended coverage and set up of pre-shipment Export Guarantee agency as substitute for the collateral requirements.
- On September 27, 2001 it was clarified to banks that all IT enabled software remote services would be eligible for export financing under the Export Finance Scheme in the same manner as software exports. SBP would provide refinance in all such cases as per usual terms and conditions.

Discount Rate

- Effective from July 19, 2001 the minimum rate of return to be paid by recipients of financing facilities from State Bank for meeting temporary liquidity shortages and SBP 3-Day Repo facility against MTBs and FIBs/ Pakistan Investment Bonds was reduced from 14 percent to 13 percent on an annual basis and to 12 percent August 16, 2001 the minimum rate was further reduced to 10 percent from October 22, 2001.

Money Market Measures

- Effective from July 25, 2001 OMOs will be conducted as and when required by market conditions. The State Bank of Pakistan will, however, give prior intimation. Other terms and conditions on the subject will remain unchanged.
- Effective June 18, 2000 banks reappointed as Primary Dealers for FY02 are Habib Bank Limited, National Bank of Pakistan, Union Bank Limited, Citibank, ABN Amro Bank, American Express Bank and Standard Chartered Bank

Inception of Housing Refinance Window

- Refinance Window at the State Bank of Pakistan, which will be operative through Housing Finance Companies (HFCs) registered and functional in the private and public sector. Following guidelines are issued with immediate effect: -
  a) Banks are free to extend mortgage loans for construction of houses, up to a maximum period of fifteen years. The commercial banks would ensure matching of asset liability. For the purpose the

commercial banks are encouraged to float long-term housing bonds of not less than 10 years maturity.

b) While extending financing facilities to their customer, the banks would ensure that the installment of the loan extended by them is commensurate with the cash flow and payment capacity of the borrower. This measure would be in addition to banks' usual evaluations of each proposal concerning credit worthiness of the borrowers as also the fact that the banks' portfolio under housing finance fulfills the prudential norms and instructions issued by the State Bank and do not impair the soundness and safety of the bank itself.

c) Banks are encouraged to develop floating rate products for extending housing loans, thereby managing interest rate risk to avoid its adverse effects. State Bank would also encourage banks to develop in-house system to stress test their housing portfolio against adverse movements in interest rates as also maturity mismatches.

d) Commercial banks shall ensure that at no time their total exposure under house financing exceeds 5 % of their net advances.

e) The housing finance facility would attract a minimum debt equity ratio of 70:30

f) The existing limit of Rs 500,000/- fixed in respect of housing finance by the banks has been enhanced immediately to Rs 5 million.

?? In order the allow banks to have an active role in lending for mortgage purposes as envisaged in the National Housing Policy recently approved by the Federal Government, and with a view to bring in healthy competition among the commercial banks in respect of their lending activities for Housing Finance, It has been decided to activate a Housing

Other Measures

?? NBFIs' financing facilities against shares of listed companies, which was subject to minimum margin of 30 percent its average market value of the preceding 12 months, was reduced to 25 percent effective September 15, 2001.

?? On October 10, 2001 banks SBP amended the existing forms of Accounts and Balance Sheet of banks. The revised forms of Balance Sheet, Profit & Loss Account, Statement of changes in Equity and Cash Flow Statement together with notes forming part thereof will substitute the existing forms effective December 31, 2001.

- ?? In order to create a database of NPLs at the State Bank, the SBP advised banks on October 10, 2001 to submit to the Credit Information Bureau, data of their non-performing loans of Rs.10 million and above as per prescribed formats on monthly basis, starting from the month of October 2001, within 15 days of the end of each month.
- ?? Keeping in view the capital-intensive nature of the Telecommunication Sector, it was decided to lower the debt-equity ratio to 75:25 for the aforesaid sector with immediate effect.
- ?? The margin requirement of 75% fixed for advances to traders against finished goods in 1987 has now been reduced to 40%. The financing facilities extended by banks in respect of finished goods manufactured in Pakistan is available only to those traders only who are registered with GST/Income Tax Department

6. Policy Measures for External Sector:

Foreign Trade

- ?? The government fully deregulated the export of wheat and allowed the private sector to export wheat and its flour without any restrictions on quantity, value and purchase from any source. The government also allowed the wheat imports by the private sector and increased the import duty to 30 percent from 5 percent on July 4, 2001.
- ?? Trade Policy for FY02 was announced on July 9, 2001 setting the US$ 10.1 billion exports and US$ 11 billion imports targets, indicating a US$ 900 million trade deficit.
- ?? All Pakistan Textile Mills Association (APTMA) revised downwards the minimum export prices (MEP) for various counts of cotton yarn as well as polyester cotton yarn effective from August 9. Standing Committee on Export Price Check of APTMA reduced MEP for all counts of cotton yarn by $10 per bale. Whereas, MEP for polyester cotton yarn, all counts, have been slashed by $5 a bale.
- ?? The Central Board of Revenue (CBR) on July 2, 2001 imposed the regulatory duty on the import of edible oils, oil seeds, di-sodium carbonate (Soda Ash), polyester staple fibre, polyester filament yarn, polyvinyl chloride and pure terephthalic acid (PTA) effective from July 1, 2001. Regulatory duty on the export of raw hides and skins, wet blue tanned hides & skins and various types of bones including crushed bones was also levied by the CBR.

- On August 1, 2001 the Central Board of Revenue (CBR) withdrew the duty drawback facility from the manufacturers-cum-exporters of leather shoes allowed on April 30, 2001 with immediate effect.
- The CBR on August 29, 2001 exempted the export of 20 items to Afghanistan and Central Asian Republics (CAR) through land route from sales tax. These items include: safety matches, furniture (wood, plastic, metal and fibre-glass), water storage tanks (fibre-glass, plastic and metal), tobacco leaf (in crates and cartons), gur, agricultural machinery, electric motors, pumps, fans and transformers, leather manufactures and footwear, confectionery items, jams, juices and pickles.
- On September 15, 2001 SBP announced the new mark up rates to be charged on the Foreign Currency Export Finance (FCEF) Facility. Effective from September 15 2001, 5.84 and 5.34 percent mark up rates were fixed for pre-shipment & post shipment financing to the exporters and post shipment financing where post shipment insurance cover has been obtained by the exporter, respectively. Rate of mark up for refinance to be charged by SBP from the banks was fixed at 3.84 percent.
- The CBR on September 21, 2001 notified the abolition of concessionary rate of custom duty on the import of refined sugar and withdrawal of exemption of custom duty on the import of raw sugar in bulk. Import duty on refined sugar was increased from 10 percent to 20 percent ad valorem while 20 percent import duty was imposed on raw sugar.
- SBP on September 27, 2001 decided to extend the facility (to retain export proceeds upto 35 percent in a Foreign Currency Account for use for the purposes mentioned therein) available to the exporters of software to all Service Sectors such as Financial Services, Wholesale, Distribution and Retail Trade, Transportation, Storage and Communications, Tele-communication Services, Medical Services, Educational Services, Engineering Services, Real Estate Development, Hotel and Tourism/Tourism Related Services, Technical Testing Facilities and Consultancy Services etc.
- SBP on September 28 2001 revised its earlier instructions regarding repatriation of export proceeds. The exporters are now required to repatriate the export proceeds on the due date for payment or within six months from the date of shipment, whichever is earlier.
- According to instructions contained in FE circular 12 dated July 29, 2000, in case where an exporter does not repatriate export proceeds within three days of the due date or within 4 months of the shipment date, whichever is earlier, he was entitled to export proceeds at the rate of exchange prevailing on the due date or at the rate prevailing on the date of realization of export proceeds whichever is lower. In respect of export

bills already overdue, the exporters were entitled to have rupee proceeds at the exchange rate prevailing on the date of realization. The above instructions were withdrawn with effect from September 28, 2001.

- Presently, if the exporter is not required to pay commission or where he is required to pay to the foreign agent an amount less than the maximum permissible limits, such amounts of commission/differential not exceeding 5 percent FOB value of goods realized can be retained in Foreign Currency Accounts with Authorized Dealers in Pakistan. SBP on September 28, 2001 enhanced the above ceiling of 5 percent to 6 percent.
- With a view to simplify the procedure and eliminate excessive documentations, SBP has revised the instructions in respect of Part-I of the Export Finance Scheme on September 28 2001. It was also decided to allow export finance to commodities which fall within the ambit of specified industries viz; fisheries and sea food, information technology, processing, canning and preserving of fruits, vegetables and flowers etc. and down stream vendor industries of automobile, house hold appliances, light engineering goods, gems and jewelry, marbles and onyx effective from October 1 2001.
- On September 28 2001, SBP also decided to fix the maximum rate of finance to be charged by the banks from their borrowers under the Export Finance Scheme for all eligible commodities as also under (Part-B) Export Sales of the Scheme for financing Locally Manufactured Machinery at 12.0 percent and a maximum of 10.5 percent for refinance obtained by the financial institution from the State Bank effective from October 1, 2001.

Foreign Exchange Market

- On August 27, ADs were delegated powers to allow remittance of surplus passage/freight collection of foreign airlines or their general sales agents in respect of those passage/freight, which have already been undertaken.
- With effect from August 31, limits on Nostro balances held abroad by ADs were abolished.
- On September 1, resident Pakistani (including firms and companies) were allowed to make equity based investment (other than portfolio investment) in companies (whether incorporated or not)/ joint ventures abroad on repatriable basis with prior permission of SBP subject to certain conditions.